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Life Sciences & Health Care M&A Transaction Services Issues Brief #5

Understanding and Evaluating Deal Considerations in the Contract Research Organization Sector

An update for private equity investors

This issue explores certain financial and tax issues that private equity investors should consider when making investments in contract research organizations (CROs).

Financial Considerations

Revenue recognition – A CRO's services can include multiple elements and extend over several quarterly or annual reporting periods, requiring involving significant estimation and judgment in recognizing revenues over the earnings cycle. The scope of CROs' services span from planning, administering, and reporting of clinical trials, and revenue is recognized as services are performed generally under a proportional-performance method. Under a proportional-performance method, units of measures (e.g., sites initiated, investigators enrolled, or labor hours) are identified at the onset of a contract, and revenue is recognized based on the proportion of units completed to date to the total units identified. Revenue true-ups can occur throughout the contract term due to scope changes and changes in unit of measure estimates resulting in out-of-period recognition of revenue that should be evaluated as part of the quality of earnings. CRO services typically include multi-element arrangements that should be evaluated in the context of the CRO's revenue recognition policies.

Unbilled and deferred revenue - Buyers should consider the working capital implications of a CRO when evaluating a transaction. Payment terms tend to be prescribed on predetermined payment schedules, and as result, a CRO's financial statements may contain a significant amount of unbilled and deferred revenue. Unbilled revenues should be analyzed to assess whether they supported and do not include any unapproved scope changes or indications of disputed amounts. Deferred revenue represents cash received in advance of services being performed. Buyers should consider whether deferred revenue balances will continue at historical levels (i.e., deferred revenue balances are replenished by future cash advances). If not, buyers will be left with the performance obligation but without the corresponding cash flow associated with future advances. Upon purchase accounting, the buyer only recognizes a deferred revenue liability measured at its fair value to the extent that deferred revenue represents a performance obligation assumed by the buyer. It is unlikely that the fair value of the deferred revenue is to equal the carrying amount on the deferred revenue on the buyer's books, possibly resulting in less amount of revenue being recognized in the post-transaction period.

Revenue backlog – Revenue backlog represents the future revenues from work not yet completed under executed contracts, letters of intent, or in some cases pre-contract commitments when supported by pervasive evidence that an arrangement exists. Revenue backlog should be considered in evaluating a potential acquisition target; however, buyers should be cautioned on relying on revenue backlog as the sole indicator of future revenues. The realization of a CRO's revenue backlog into revenue can be affected by a number of factors – a number of which are outside the control of the CRO, including cancellations, changes in scope, or delays by customers or regulatory authorities. Buyers can evaluate the quality of a CRO's backlog by analyzing:

- **Net new business** – Measures the amount of new contract awards and change orders less contract cancellations that occurred during the period.
- **Book to bill ratio** – Evaluates the ability of the CRO to replenish their backlog with new business by comparing net new business generated in the period to revenue recognized in the period. A ratio of greater than 1.0 signifies backlog growth and a ratio below 1.0 signifies contraction.
- **Conversion ratio –** The ability of the target to convert backlog to billed revenue.

- **Backlog concentration** – Concentration with one customer may indicate a risk to the CRO if one significant customer decreases or terminates its relationship with the CRO. Or, concentration within one therapeutic area may indicate a risk to the CRO if clinical trials are cancelled because of new scientific information, approval of competing product candidates, or as a result of regulatory directives.
- **Aging of backlog** – The aging of the revenue backlog may be an indication of whether the backlog will ultimately be recognized into revenues. Projects can be delayed due to the completion of requisite clinical trial phases or can be an indication of a customer's ability to obtain project funding.
- **Pass through expenses** – An analysis of a CRO's revenue backlog should include an analysis of the amount of pass through expenses included in the revenue backlog. A significant portion of a contract award could be a reimbursement of expenses by the customer – the margin of which may be significantly lower than the margin on services provided directly by the CRO.

Development stage customers – A CRO's customer base may include a number of development stage companies that may not have the requisite funding to complete clinical trials. This can cause delays in project starts and completions, and also may result in the CRO taking on additional collection risk or structuring contingent or equity based fee arrangements. The composition of a CRO's customer base should be analyzed in an effort to identify potential risks of converting revenues to cash.

Industry trends – A number of industry wide trends have impacted CROs, which should be considered in a buyer's evaluation of a CRO.

- **Global reach of clinical trials** – Pharmaceutical companies are increasing the number of clinical trials at sites in the developing world, which requires that successful CROs have a global presence. The proliferation of global clinical trials subjects CROs to multiple regulators and to foreign currency fluctuations, which should be evaluated by a potential buyer in an effort to identify potential compliance and foreign currency exposures.
- **CRO concentration** – A number of large pharmaceutical companies have consolidated their use of CRO service providers, resulting in lost backlog and increased competition among CROs.
- **CRO consolidation** – Many CROs, in an effort to achieve scale to compete in later stage clinical trials and increase their global presence, have executed a number of recent acquisitions. As a result, a CRO's historical performance may not fully reflect recent acquisitions, the impact of which should be considered in diligence.

Tax Considerations

Deferred revenue – A CRO that is an accrual method taxpayer may account for advance payments using the deferral method, whereby such taxpayer may defer the recognition of advance payments to an immediately succeeding tax year if the revenue is also deferred for financial reporting purposes. During due diligence, it is important to evaluate whether the target may be deferring too much income for tax purposes, as this could create historical income tax risk to a buyer. Subsequently, when a CRO is acquired, the terms of its contracts and the structure of the deal will likely dictate the seller's and the buyer's tax consequences. In a stock acquisition, for example, accounting methods generally carryover and a buyer could be forced to recognize taxable income in a post-closing tax period without the corresponding cash if the target uses the deferral method. As such, it is important to know whether a target uses the deferral method in order to analyze "debt-like" items and project future cash taxes. In deemed and actual asset acquisitions, for example, the Treasury Regulations and other authoritative sources may prevent a buyer from recognizing taxable income in a post-closing tax period; however, such Treasury Regulations and other authoritative sources may accelerate the recognition of deferred revenue to the sellers. As such, it is important to analyze deferred revenue early in the deal process in an effort to manage sellers' expectations.

Trapped cash – Multinational CROs with U.S. parents may conduct their operations outside of the U.S. via controlled foreign corporations (CFCs), which are subsidiaries that are formed in the respective foreign jurisdictions. Often, the undistributed earnings of the CFCs are indefinitely reinvested in the respective foreign jurisdictions, which enables the CROs to shield such earnings from taxation in the U.S. and potential withholding taxes. In a cash-free/debt-free deal, parties often agree to increase the purchase price for any excess cash that is recorded on the consolidated balance sheet. Some of the excess cash may be "trapped" outside of the U.S. in CFCs, meaning that there will be a tax cost to repatriating the excess cash to the U.S. As such, it is important to consider the tax cost of repatriating the excess cash when determining purchase price.

Foreign tax compliance – Many multinational CROs have operations in numerous foreign jurisdictions. Such operations may create permanent establishments, which are fixed places of business that trigger income tax and/or value added tax (VAT) filing requirements. Complying with the various requirements can be challenging, given that each jurisdiction has its own rules and regulations. As such, it is important to analyze whether a CRO has policies and procedures in place to comply with the various requirements, given that historic tax exposure could be inherited and future cash flow could be adversely impacted.

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