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FEATURE

Life sciences companies more bullish on US investment post tax reform

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Deloitte's survey of life sciences CFOs reveals that many biopharma and medtech companies are planning to strategically invest in R&D, business operations, and capital projects in response to US tax reform.

One goal of the new law commonly referred to as the Tax Cuts and Jobs Act (TCJA), which was signed into law on December 22, 2017, is to increase domestic business investment and thereby create more jobs in the United States. One anticipated expectation of the bill was that companies would reinvest money into areas that will help the US economy grow. The Congressional Budget Office (CBO) predicted that "the act's effects on the US economy over the 2018–2028 period will include high levels of investment, employment, and gross domestic product."[1]

Deloitte's survey of biopharma and medtech chief financial officers (CFOs) reveals that the majority of companies surveyed are interested in investing in research and development (R&D), business operations, and capital projects, some of them in the United States. This finding may surprise market speculators who predicted that biopharma companies would primarily invest financial gains in share buybacks or mergers and acquisitions (M&A).[2] That said, most CFOs surveyed do not expect the law to have a major impact on their hiring or compensation plans.

The TCJA is just one issue that CFOs are dealing with as policymakers change international tax laws and trade agreements and ramp up rhetoric on curtailing drug price increases. In the meantime, many companies are working to understand financial reporting requirements and investing in enterprise resource planning (ERP) systems and analytics to meet the tax reform law's requirements.

SIGNIFICANT CHANGES THAT THE TCJA INTRODUCED TO THE TAX CODE

- Adds a one-time "transition tax" to unremitted foreign earnings: 15.5 percent for liquid assets (cash and cash equivalents) and 8 percent for noncash assets (intellectual property), which can be paid in installments over eight years.
- Reduces the corporate tax rate from 35 to 21 percent.
- Allows companies to expense the cost of new or used fixed assets acquired after September 27, 2017 and before January 1, 2023.
- Limits the deduction for net business interest to 30 percent of EBITDA for tax years 2018 through 2022, scaled back to 30 percent of EBIT after that.
- Starting in 2022, capitalizes and amortizes research expenses incurred in the United States over five years. The cost of research done overseas will be amortized over 15 years.[3]

SURVEY METHODOLOGY

The Deloitte Center for Health Solutions, along with Forbes Insights, surveyed CFOs of biopharma and medtech companies in summer 2018. The objective was to understand how biopharma and medtech companies were strategically preparing for and responding to tax reform.

- Sixty executives responded to the survey, 30 from biopharma and 30 from medtech companies.
- Half of respondents work for companies with annual revenues over US$10 billion and half work for companies with annual revenues between US$1 and US$10 billion.
- Of the 60 respondents, 80 percent were from US-headquartered companies.
- The survey was single-blinded; the identities of the respondents were anonymous to Deloitte.

Life sciences companies see a mostly positive financial impact

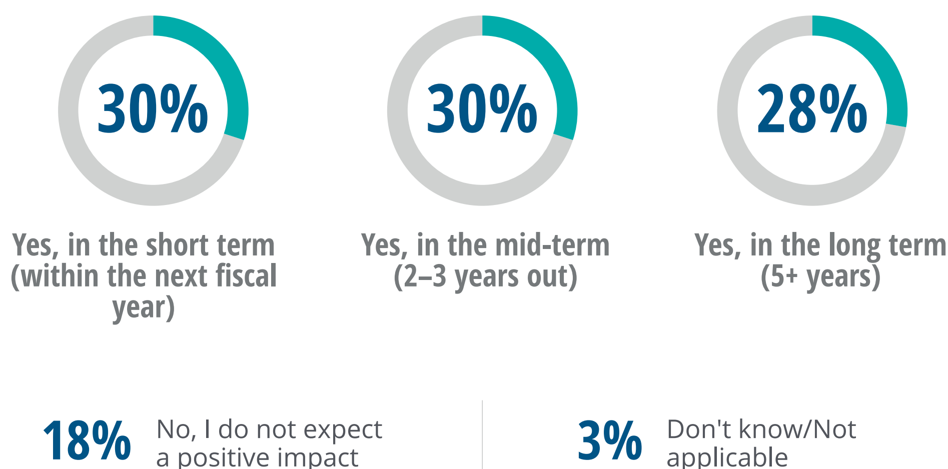
Six months after the president signed the TCJA, many life sciences CFOs are still assessing its impact on their organizations. Seventy-eight percent expect to benefit from the law, though they differ on when the benefits will take effect; they are about equally split between the coming fiscal year, the mid-term, and five or more years later (see figure 1). Some expect multiyear benefits.

Although many respondents expect their effective tax rates to either go up or stay the same in 2018 and 2025, the benefits from the law come from other

FIGURE 1

Most respondents expect to realize benefits from US tax reform

Do you expect your company to realize benefits from US tax reform?
If so, when do you expect your company to realize these benefits?



Note: Base size = 60.
Source: Deloitte 2018 Life Sciences CFO Survey.

provisions, such as the ability to repatriate overseas cash after a one-time "transition tax."

CFOs reported that they are most concerned about the global intangible low taxed income (GILTI) and base erosion anti-abuse tax (BEAT) provisions:

- The *GILTI tax* is a new worldwide minimum tax on the income of US corporations earned by their foreign subsidiaries. It may result in many US multinationals having their global income subject to current US taxation, less a potential partial foreign tax credit and with certain exceptions.
- The *BEAT* is a provision that may limit the deductions from taxable income for certain intercompany payments made by US entities to foreign affiliates. Although titled as a mechanism to reduce the ability of large multinational companies to use cross-border payments to shift income to their affiliates in lower-taxed countries, it actually operates as a new minimum tax regime.

CFOs surveyed are split when it comes to being prepared to benefit from tax reform: 45 percent are confident they are doing everything they can to capitalize on the new law; 45 percent are still working to understand the implications; 10 percent say they will need to make significant investments to be able to capitalize on tax reform.

"It is likely we will still see positive impacts from the law."

—Surveyed CFO

"We will utilize the wait-and-see approach to see how things evolve and then we can make any further decisions."

—Surveyed CFO

R&D and business operations are top investment priorities

Survey results show that a greater percentage of CFOs are likely to invest in activities intended to grow their business rather than in share buybacks or M&A. Most companies plan to invest in R&D (65 percent), followed by general business operations (55 percent) and capital projects (50 percent). Share buybacks and M&A ranked fifth and sixth (see figure 2).

Even fewer companies selected increasing compensation and hiring new talent—areas that tax reform supporters hoped to impact—as likely investments. That said, investment in R&D, business operations, and capital projects may result in more or different jobs. For example, of the respondents likely to invest in business operations, 88 percent indicated that analytics and automation are likely targets. While some companies may be planning to automate tasks and increase efficiencies by using data, they may also need to hire new talent to help leverage new technology to achieve these goals.

Surveyed CFOs expect most of their spending to occur within the next year. In the short term, CFOs plan to focus on business operations and charity. They reported that they are most likely to make debt repayment, capital project, and M&A decisions in the longer term (three years or more). This aligns with the Congressional Budget Office's projections that the economic impact of the law will be greatest between 2018 and 2023 and soften after 2025.[4]

When asked whether the ability to expense fixed assets in the United States would affect companies' approach to capital investments, 62 percent of CFOs responded that they expect to accelerate their capital investments in response. This is another indicator that the law may increase domestic investment.

FIGURE 2

Life sciences companies expect to invest in R&D, general business operations, and capital projects

How likely is your company to invest its incremental financial resources in the following activities?

■ 1/2 - Very unlikely/Unlikely ■ 3 - Neutral ■ 4/5 - Likely/Very likely ■ Don't know/Not applicable

1 Research and development

15% Very unlikely/Unlikely 20% Neutral 65% Likely/Very likely

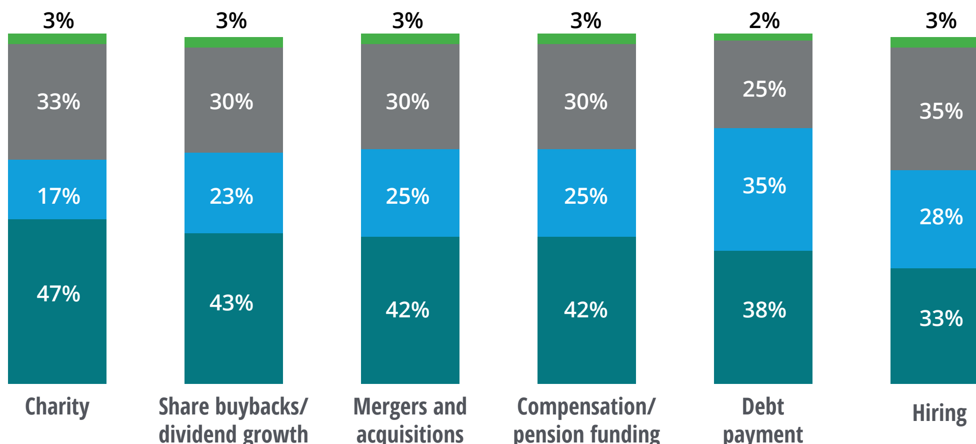
2 Business operations (administrative, HR, IT, etc.)

13% Very unlikely/Unlikely 32% Neutral 55% Likely/Very likely

3 Capital projects (build new manufacturing infrastructure, etc.)

22% Very unlikely/Unlikely 28% Neutral 50% Likely/Very likely

Other planned investment activities



Note: Percentages may not total 100% due to rounding. Base size = 60.

Source: Deloitte 2018 Life Sciences CFO Survey.

BIOPHARMA AND MEDTECH HAVE DIFFERENT SECONDARY PRIORITIES

While both biopharma and medtech companies are most likely to invest in R&D, they differ in the ranking of their next likely areas of investment: Biopharma is likely to focus on capital projects and medtech on business operations (see table 1).

TABLE 1

Secondary priorities for biopharma and medtech

Secondary priorities	Biopharma (Percentage)	Medtech (Percentage)
Research and development	67	63
Capital projects	57	44
Business operations	50	60
Share buybacks/dividend growth	50	36
M&A	47	37
Charity	40	53
Compensation/pension funding	40	43
Debt payment	40	37
Hiring	40	27

Note: Base size = 30 for each activity (biopharma and medtech).
Source: Deloitte 2018 Life Sciences CFO Survey.

Increased M&A activity expected

While only 42 percent of surveyed CFOs stated they would likely invest financial gains from tax reform in M&A, 66 percent nevertheless expect increased M&A activity because of tax reform. This may be because of a combination of financial gains, reduced uncertainty around tax policy, and targets becoming more attractive. Biopharma companies are more likely than medtech companies to invest in M&A.

During the 2016 election and tax reform discussions in 2017, many life sciences companies postponed M&A decisions. With the passage of the reform, M&A activity picked up in the first half of 2018 compared to the same period in 2017. The deals are also larger. In the first half of 2018, M&A deals worth approximately US$141 billion were announced; during the same period in 2017, they amounted to approximately US$105.[5] Notable US deals announced during the first half of 2018 include Sanofi's acquisition of Bioverativ for US$11.6 billion,[6] Celgene acquiring Impact Biosciences and Juno Therapeutics for up to US$7 billion and US$9 billion, respectively,[7] and Novartis acquiring AveXis for US$8.7 billion.[8]

Of the CFOs expecting an increase in M&A investment, 38 percent believe that tax reform will change how they calculate target valuations, whereas 28 percent feel valuations will remain the same. Valuations may be impacted as a result of changes in the corporate tax rate, as well as how tax attributes of the buyer and target may fit together. For instance,

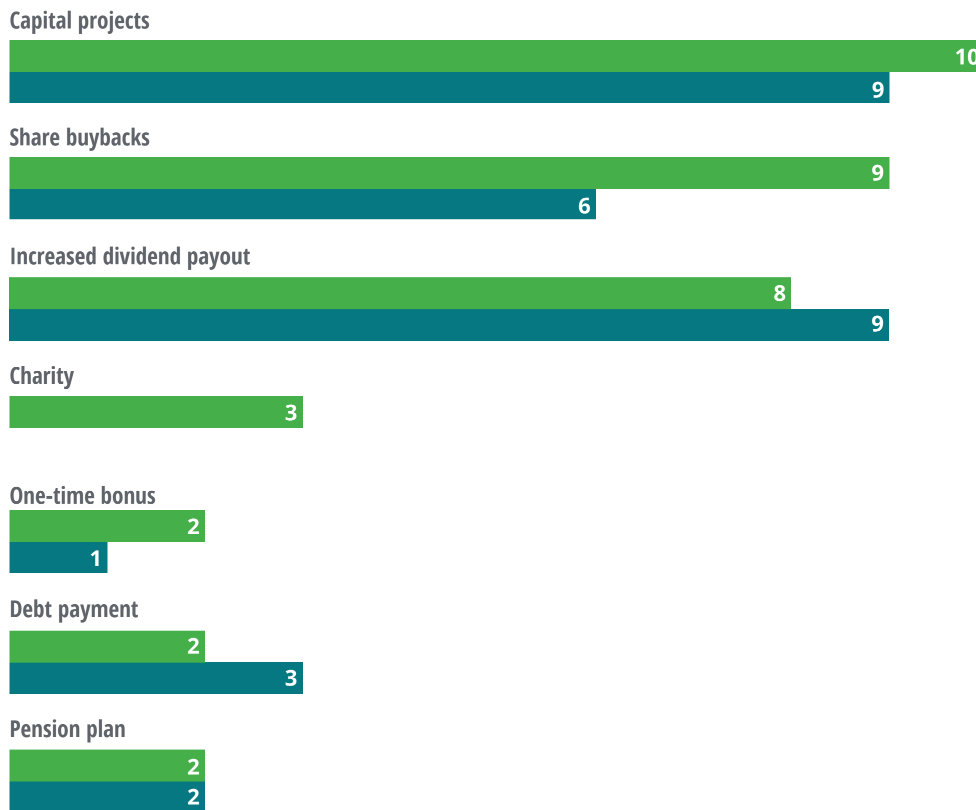
tax reform caps the net operating losses (NOLs) at 80 percent of taxable income and such losses cannot be carried back to earlier years. Although NOLs can be carried forward indefinitely, the value of future and previous NOLs will be reduced as a result of the lower corporate tax rate. All these factors will have an impact on target valuation.[9]

WHAT DO PUBLIC RECORDS SAY ABOUT COMPANIES' PLANS?

The 10K filings and earnings transcripts of the 10 largest biopharma and 10 largest medtech companies based in the United States give some indication as to how they plan to invest their financial gains from the tax law (see figure 3). Capital projects, share buybacks, and dividends are high on the list. Business operations and R&D were not publicly reported, however, and therefore, are not included in the figure below.

FIGURE 3

What activities have companies publicly reported?



Note: The figure represents count of the 10 largest US biopharma and 10 largest US medtech companies investing in each of the mentioned areas.

Source: Deloitte analysis of company 10K filings and earnings transcripts.

Tax reform prompts many CFOs to consider moving investments to the United States

One of the stated goals of the tax reform was to encourage US domestic investment. Surveyed CFOs stated that they were significantly or somewhat more likely to develop new research facilities (68 percent), locate new intellectual property (57 percent), and build new manufacturing facilities (48 percent) in the United States because of tax reform (see figures 4, 5, and 6). Whether these considerations will be acted upon and result in material investments remains to be seen, but many CFOs are weighing their options.

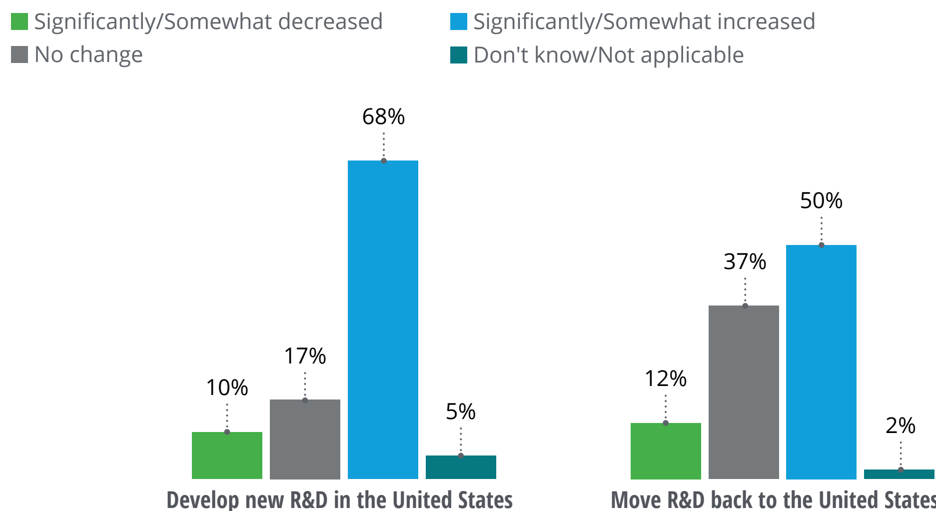
With regard to impact on R&D, despite a decreased net tax credit for research on rare diseases (the new bill reduces the tax rate for research on rare diseases, known as the Orphan Drug Credit, from 50 percent to 25 percent), 50 percent of surveyed biopharma CFOs plan to increase investments in rare disease/orphan drug R&D, and another 40 percent expect no change. Possibly, other market and regulatory incentives and the intrinsic clinical importance of these research areas are keeping companies focused on these areas despite the modified tax implications.

CFOs surveyed report that the new tax law has a greater impact on supply chain processes than on manufacturing operations, particularly on logistics and distribution (67 percent), followed by sourcing and procurement (50 percent), supply chain planning (47 percent), and manufacturing (37 percent). In building their supply chain models, many life sciences companies have taken tax considerations into account, and any changes to tax law, as in the current case, necessitate a review of these models. A company's supply chain, including the location of intellectual property, facilities, sourcing, production, and inventory management, are typically significant contributing factors to a company's effec-

FIGURE 4

Two-thirds of surveyed CFOs reported increased likelihood of developing new R&D in the United States

Has US tax reform increased or decreased the likelihood that your company would move existing or develop new R&D to/in the United States?

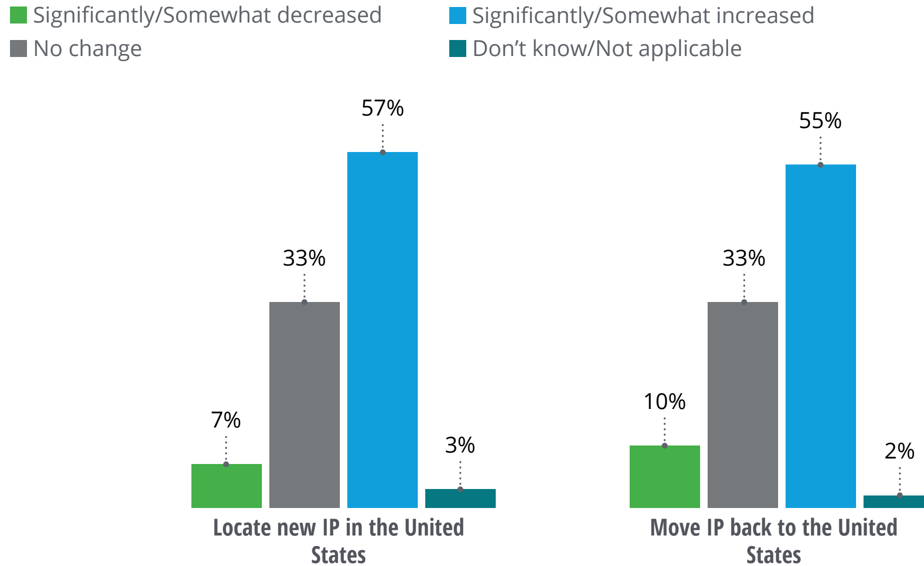


Note: Percentages may not equal 100% due to rounding. Base size = 60.
Source: Deloitte 2018 Life Sciences CFO Survey.

FIGURE 5

A majority of respondents are more likely to develop IP in the United States

Has US tax reform increased or decreased the likelihood your company will move intellectual property (IP) back to the United States or locate new IP in the United States?

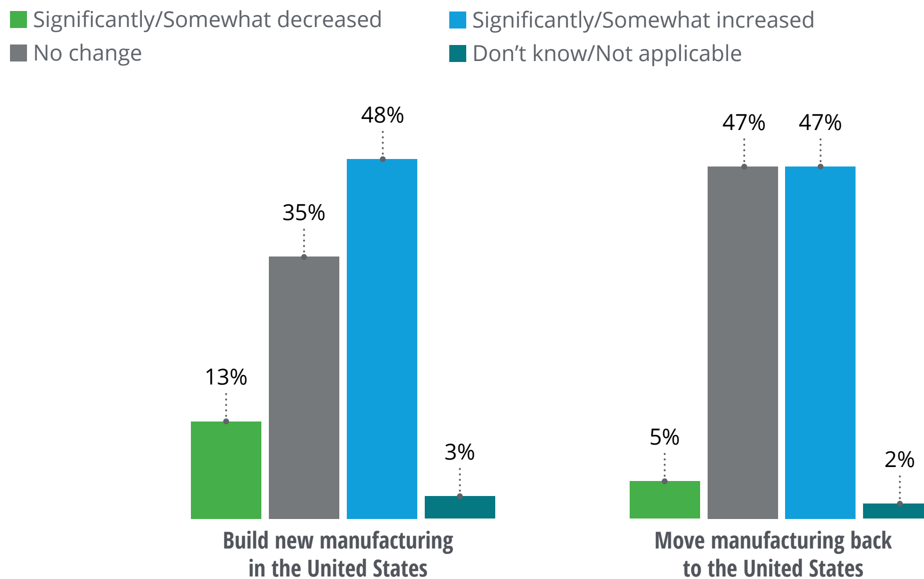


Note: Base size = 60.
Source: Deloitte 2018 Life Sciences CFO Survey.

FIGURE 6

Nearly half of respondents say tax reform has increased the chances of companies locating manufacturing in the United States

Has US tax reform increased or decreased the likelihood that your company would move existing manufacturing facilities to or locate new manufacturing facilities in the United States?



Note: Percentages may not add up to 100% due to rounding. Base size = 60.
Source: Deloitte 2018 Life Sciences CFO Survey.

tive tax rate. Supply chain structures designed years ago for competitive advantage and operational and tax efficiency may need to be reevaluated in light of domestic tax reform as well as continued tax reform initiatives around the globe.

Preparing for the road ahead

Many CFOs are closely monitoring US tax reform along with other global tax and policy changes. Forty-five percent of surveyed CFOs are adopting a "wait and see" approach, as they believe the law is still evolving (27 percent) or they are questioning the permanence of tax reform (18 percent). The remaining 55 percent see the tax law as one of many new global requirements that they will need to prepare for and allocate resources to in the interest of long-term strategy.

The OECD's Base Erosion and Profit Shifting (BEPS) initiative, which is currently under review by over a hundred countries,[10] and other non-US fiscal legislation and policy are the main issues influencing surveyed CFOs' business strategies. The US administration's proposed trade measures and health and tax reforms are the next most important issues.

Many CFOs are also taking stock of their organization's current capabilities to prepare for tax reform. US tax reform presents opportunities to newly establish or improve internal processes and capabilities. 57 percent of respondents want to improve their understanding of financial reporting requirements, 45 percent want to better understand the larger impacts of tax, and 42 percent want to better meet tax reporting requirements.

Many CFOs are also looking at investing in internal IT infrastructure and hiring professionals in order to comply with US tax reform. The majority of companies (58 percent) want to invest in ERP systems to meet the data requirements of the new tax law and 55 percent are planning to increase the use of data analytics to tackle tax reform.

> "We need real-time, data-driven insights to make tax-related decisions and to move forward."
>
> —Surveyed CFO

Recommendations

This survey provides insights into current biopharma and medtech CFO reactions to US tax reform. Yet the majority of companies are still evaluating their strategic decisions and financial investments. US tax reform represents a significant policy change, and along with other major global tax, trade, and health care reforms, could drive a shift in industry dynamics. For example, a lower corporate tax rate could make the United States a more attractive investment destination, but changes to trade policy could impact the relative attractiveness of other geographic markets. An increase in M&A activity, expected by 66 percent of surveyed CFOs, could change the industry's competitive balance and structure. CFOs should consider multifaceted variables and uncertainties when deciding on where to invest in the future.

While US tax reform will not impact all companies in the same manner, all organizations will likely face some level of strategic uncertainty. Deloitte be-

LONG-TERM UNCERTAINTY ON GLOBAL POLICIES MAY REQUIRE A STRATEGIC RISK APPROACH

Operating under so much uncertainty can elevate the importance of strategic risk management. Company executives should identify all the strategic risks, model potential scenarios, and estimate the relative impact of each one. Executives should engage strategic decision-makers to prepare for potential scenarios. Global uncertainty is unlikely to go away, and companies should systematically plan for and track organizational risks to analyze and interpret how they relate to their strategy.

BIOPHARMA VS. MEDTECH INVESTMENT IN CAPABILITIES

Many biopharma CFOs are focused on modeling new tax provisions for tax planning; many medtech companies are focused on increasing the use of data analytics for reporting.

When it comes to development of technology, many biopharma companies are looking to build internal IT infrastructure to comply with tax reform while medtech companies are more likely to seek help from third-party vendors and depend on external IT infrastructure.

TABLE 2

Comparing investments in capabilities

Capabilities	Biopharma (Percentage)	Medtech (Percentage)
Data analytics for reporting	43	67
Use of AI & cognitive learning	47	37
Leveraging ERP systems	57	60
Scenario modeling	60	37
Others	33	20

Note: Base size = 30 for both biopharma and medical device.
Source: Deloitte 2018 Life Sciences CFO Survey.

lieves that tax policies enacted in TCJA are not "one and done." The tax law will continue to evolve in an ever-changing process that companies will need to prepare for in advance. Thus, CFOs may want to consider the following actions as they execute strategic plans in light of US tax reform and future changes:

- **Standardize global business processes**, including increased visibility into areas such as intercompany payments.
- **Create a tax-efficient operating model**. Companies should reassess the manufacturing footprint and supply chain operations and consider if business, supply chain, and tax objectives are aligned.
- **Look to technology**. Analytics, automation, data management, and ERP system enhancements can bring greater efficiencies and insight to help optimize operational and financial models.[11] Our survey suggests that many life sciences companies are already planning to invest in these areas.
- **Bring all the necessary stakeholders to the table**. Our survey found that although R&D was one of the biggest areas of investment with the greatest likelihood of moving to the United States, just 35 percent of the companies surveyed involve R&D heads in strategic tax decisions. Involving relevant stakeholders can result in more effective decision-making.[12]
- **Plan for uncertainty**. As global tax policies continue to take shape, companies should continue to adapt and strategically pivot. Companies should build scenario-planning capabilities leveraging advanced cognitive tools to proactively prepare for and address business risk and uncertainty.

Endnotes

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Project team

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The impact of 2017's tax code rewrite reaches far beyond your organization's FY2018 tax filing. It's a call to revisit business models and practices across your organization: global talent programs, mergers and acquisitions plans, IP oversight, use of repatriated funds, customer and third-party management strategies, supply chain, and more. The planning you do now may influence your business strategy for years to come. We combine our tax reform services with our deep life sciences and health care industry experience, policy insights, and knowledge of your business to help you make informed decisions for your organization and face the new tax reality with confidence.

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