

Grow through Strategic Collaborations



As the escalating cost of both M&A and R&D continues to challenge the global pharmaceutical industry, CEOs know that it's incumbent on them to explore innovative ways to grow their businesses.

As the escalating cost of both M&A and R&D continues to challenge the global pharmaceutical industry, CEOs know that it's incumbent on them to explore innovative ways to grow their businesses. The most entrepreneurial have recognised the significant opportunity to create business value through strategic collaborations. Initiating collaborations is complex and difficult. However, the most successful examples show that it helps organisations to fuel transformative growth by establishing a deeper strategic focus and a more effective deployment of high-value assets and capabilities. In this paper we examine the need for strategic collaborations, examples from pioneers, and the lessons learned from our experiences with making them happen.

New paradigms for pharma growth required

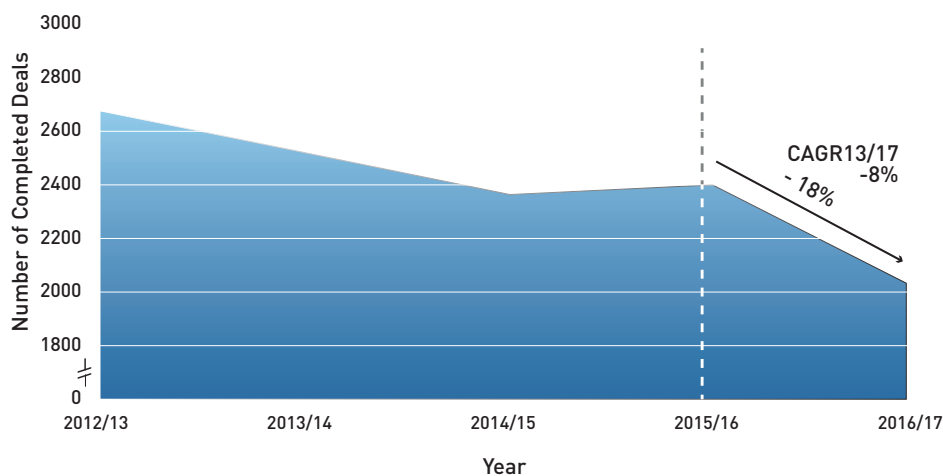
The decline in R&D efficiency since the 'glory days' of small molecule blockbuster medicines has been well documented: it just isn't getting any easier to discover and develop your own great new medicines when there are so many great ones already out there. So pharma CEOs are still looking for alternative business models to fuel their quest for growth. The value to be had from me-too and incremental innovation has dissipated in many markets, while the cost of developing breakthrough medicines has rocketed.

Grow Through Strategic Collaborations

As organic top-line and bottom-line growth has therefore become ever more difficult to achieve, pharmaceutical companies of all sizes have increasingly looked for external sources of on-market or late-stage products to bolster portfolios and accelerate short-term revenues. Traditionally, company acquisition has been considered a good way of adding immediate top-line, in contrast with individual country/region deals for specific products. However, scaling a business through company or product acquisition alone presents significant challenges; there are many more in-licensors of products than out-licensors, while the prices of both companies and products have been inexorably rising. Alternative approaches to growth are required.

In recent years, the difficulty of securing inorganic growth has fuelled a revealing trend across the sector: a marked fall in the number of deals that are executed. The global volume of mergers, acquisitions, asset transactions and strategic collaborations has been in steady decline over the last five years. In the past twelve months it has collapsed, dropping by 18% in the last year:

Global deal volume declined sharply over the last year



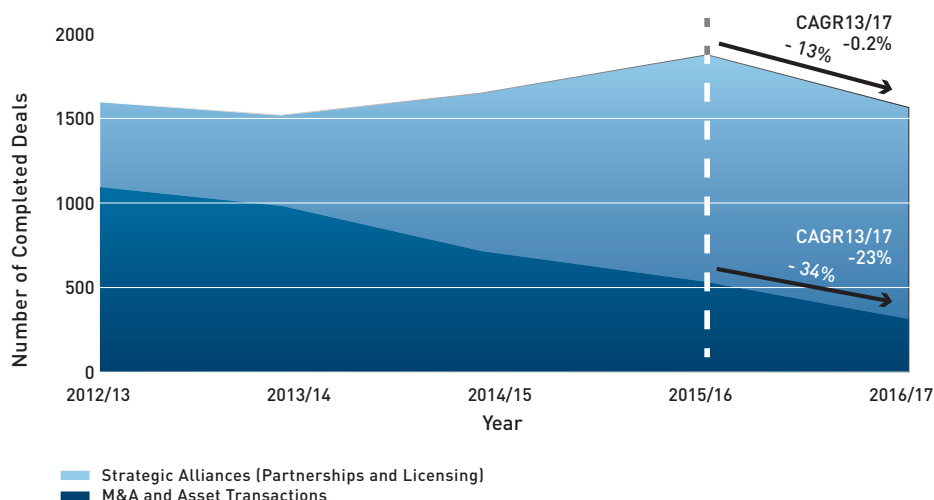
Notes – Novasecta analysis from GlobalData database of disclosed and completed pharma/biotech deals, for the year periods from July to June

The decline in deal volume has not been limited to one particular type of deal, with the volume of M&A, asset transactions and strategic collaborations each reducing in the last year. Although the fall in M&A and asset transactions (-34%) is more pronounced, strategic collaborations have also seen a double-digit decline (-13%) in the last year:

“Global volume of M&A and asset transactions has trended down by more than strategic alliances”

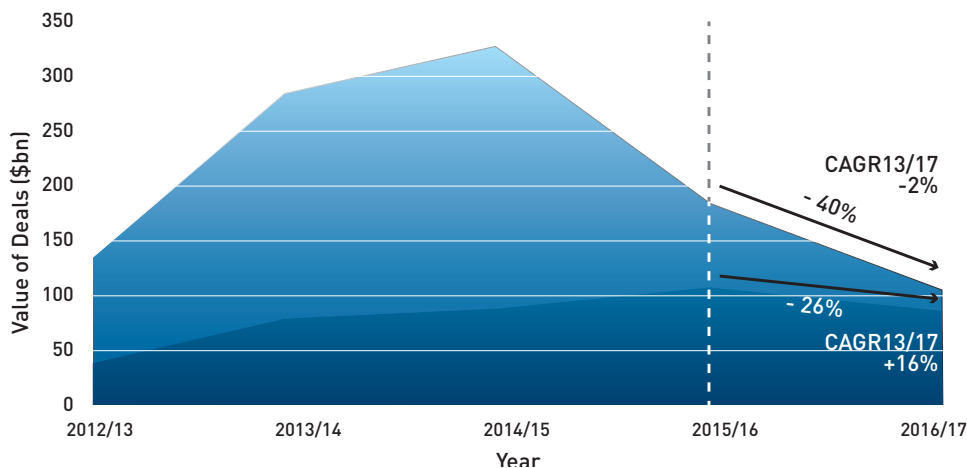
Grow Through Strategic Collaborations

Global volume of M&A and asset transactions has trended down by more than strategic alliances



The value of deals is down too. M&A and asset transactions value has fallen in the last two years and is now similar to the level 5 years ago. The value of strategic collaborations has been more resilient, though again the last year has shown a significant drop:

Global value of M&A, asset transactions and strategic alliances is down



The drivers for the fall in M&A activity are varied. Fundamentally, M&A is risky, costly and time-consuming. Studies routinely indicate that a high percentage of acquisitions fail to deliver on their estimated value targets.

Grow Through Strategic Collaborations

The challenges of M&A have been compounded in the last years by the escalating cost of doing deals. Our own deep-dive research – published in the Financial Times at the start of 2017 – showed that the price of acquiring businesses has almost doubled, making it prohibitively expensive for all but the largest and most well capitalised companies.

In addition, the challenges of post-deal implementation – known to be complex, sluggish and protracted – undermine the promise of immediate top-line growth. Common incompatibilities between business models, processes and cultures means it can take more than 5 years – and significant operational disruption – to integrate a company. Moreover, the diversity, scale and complexity of the new entity can itself become too costly or too difficult to manage.

However, despite the challenges, it's evident that securing inorganic growth remains a strategic priority for many across the industry. This comes as no surprise. Pharma is a highly fragmented industry – its top five global players account for just 25% total market share (compared to 60-80% in sectors like Financial Services and Oil & Gas). Such fragmentation means that even the largest pharma companies almost always lack 'critical mass' in one area or another – whether that's being 'sub-scale' in any of the various stages of R&D in diverse therapeutic areas, or having limitations in manufacturing, commercial or regional capabilities. These limitations are a natural barrier to growth. But they can also be a catalyst for opportunity.

Pharma's inherent fragmentation suggests that there is enough capacity within the industry for an increase in collaborative deals. The challenge is to be brave and to think differently. In a marketplace where the risks and costs of M&A have led to widespread caution, strategic collaborations – in which companies trade complementary assets and capabilities – could offer an alternative path to growth.

In the past 12 months, Novasecta's high-level dialogue with CEOs across its diverse network indicates an increasing appetite – particularly among mid-sized pharma companies – to take a bolder, more collaborative approach to growth. Entrepreneurial pharma companies are recognising that risk-sharing between companies can both mitigate the effect of limited capabilities in certain areas and fuel transformative value growth.

Strategic pharmaceutical collaborations: trade, swap, or share

Strategic collaborations are distinct from conventional BD activities such as M&A and licensing in that the emphasis is 'strategic' rather than 'transactional'.

Grow Through Strategic Collaborations

Strategic collaborations are distinct from conventional BD activities such as M&A and licensing in that the emphasis is ‘strategic’ rather than ‘transactional’.

The industry has an established BD system of functions in organisations, conferences and deal brokers that enables the buying, selling or licensing of assets because they’re tangible, quantifiable and liquidly transactable. The final deal, whether purchasing a company or in-licensing a product, is ultimately a relatively simple transaction. However, conventional deals can often be reactive, opportunistic or serendipitous, with targets sometimes pursued due to their availability rather than as part of a more considered strategy.

A more effective method is to approach growth through the lens of trading, swapping or sharing carefully selected capabilities and assets. Strategic collaborations, which are founded upon transacting with something other than cash, provide an opportunity for organisations to reinforce their strategic focus by trading capabilities and assets with like-minded partners for mutual benefit. Cash may also change hands depending on the value of what is traded, but the foundation is the securing and giving of more than cash.

The rationale is simple. Every organisation has a unique and diverse set of strengths – capabilities and assets – across multiple dimensions and countries. Similarly, almost every organisation has legacy assets and capabilities that may be misaligned with core strategy or surplus to requirements. Each of these areas has its own transactable value. Moreover, each presents an opportunity to build greater strategic focus and to collaborate to create scale. These assets and capabilities are the DNA of effective strategic collaborations.

An organisation’s ability to leverage its assets and capabilities is therefore the key to strategic collaboration. This might be through a strategic ‘swap’, where companies trade complementary assets and capabilities, or a Joint Venture (JV), where partnering companies combine to create a new entity, or other types of creative structured deals.

The strategic collaboration pioneers

Examples of major strategic collaborations between Big Pharmas have been rare, but notable. Probably the most high-profile example was the 2014 deal between GSK and Novartis which saw the Swiss company swap its vaccines business for GSK’s oncology unit, with the two companies

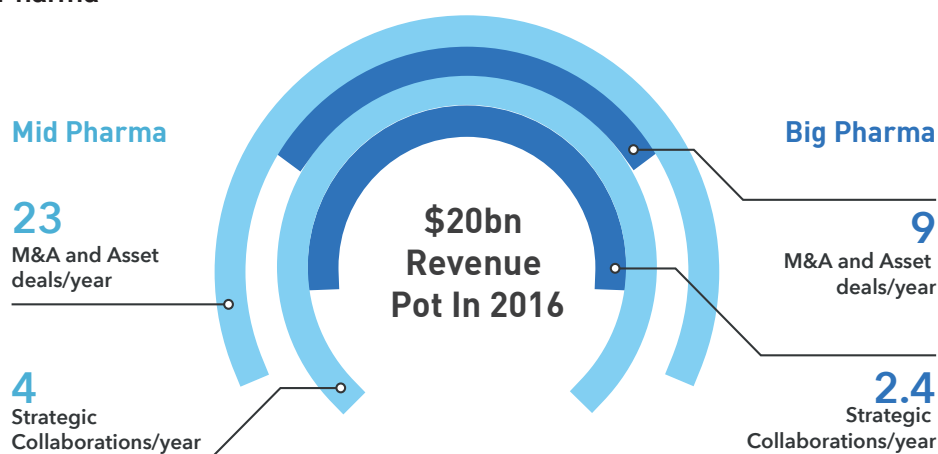
Grow Through Strategic Collaborations

forming a JV in Consumer Healthcare. More recently, Merck has entered collaborative agreements with both AZ and Eli Lilly, through which companies will share R&D capabilities to accelerate new cancer treatments. Coverage of the latter formed part of a wider discussion of how ‘fierce’ pharma rivals are increasingly becoming ‘frenemies’ that are cooperating with each other to help bring medicines to patients. It’s a direction of travel that’s likely to continue.

However, although the most memorable examples appear to involve large multinationals, opportunities for strategic collaborations have been more likely to be seized by mid-sized companies – ‘MidPharmas’. Of late Big Pharmas have reduced its reliance on partnering as their deep pockets and strong balance sheets allow them to pursue the more apparently simple route of acquiring companies and maintaining long-term control over their smaller targets. Conversely, mid-sized organisations have been more open to collaboration, not least because their business models are more suited to ‘equitable partnering’ where financial resources, skills, capabilities and risks are more easily shared to create synergistic value.

The notion that MidPharmas are more dynamic in executing M&A and strategic collaborations is borne out by the numbers. Our analysis of deal-making in 2016 shows that mid-sized companies are punching well above their weight when the volume of deals is considered as a proportion of the companies’ annual revenues:

\$20bn of revenue gets you many more deals in MidPharmas than in Big Pharma



Notes – Novasecta analysis from GlobalData database of disclosed and completed pharma/biotech deals, combined with public domain revenue data from Novasecta’s analysis of European MidPharmas and Big Pharmas: strategic collaborations comprise both partnerships and licensing deals as categorised by GlobalData

Grow Through Strategic Collaborations

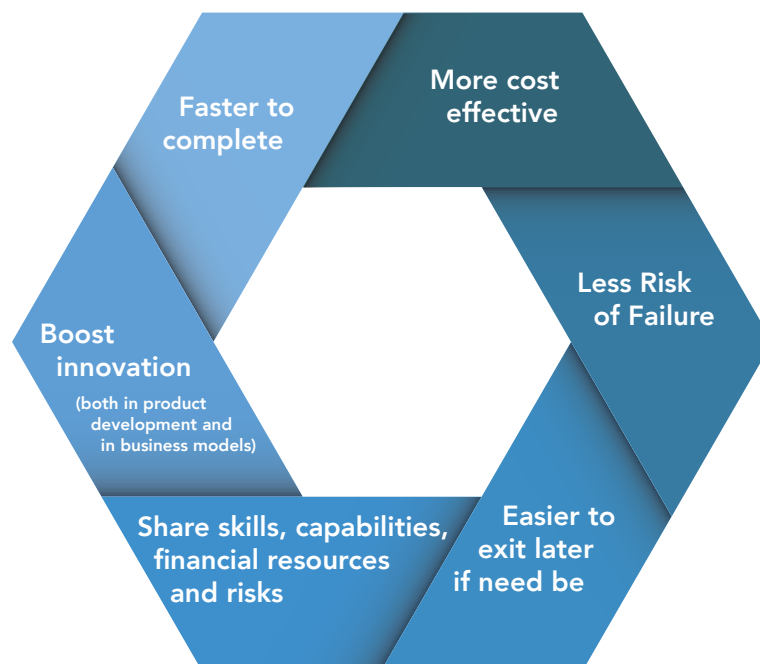
Reasons to strategically collaborate

The emergent trends make interesting reading for CEOs considering new approaches to growth: collaboration is becoming more frequent than M&A in companies of all sizes. There are many potential reasons for this. Primarily, transaction values for strategic collaborations are much lower than for M&A. The average partnering deal is between five and ten times cheaper than the average M&A. This, in turn, translates into lower risk. Better still, collaborations are often easier to exit should the need arise.

Strategic collaborations are undoubtedly difficult to initiate. However, once opportunities have been crystallised and discussions have advanced, deals are proportionately faster to create and often function without the need for full integration of processes and cultures. This gives companies an operational speed and agility that is rarely experienced with M&A. Similarly, since collaborations do not have the same impact on organisational culture as acquisitions, the risk of losing talent is significantly reduced. In fact, collaborations often create opportunities for skills transfer and learning, helping organisations retain and motivate talented employees.

Fundamentally, strategic collaborations provide a powerful opportunity to create transformational value – helping companies stimulate innovation, deepen strategic focus and, ultimately, grow faster.

Illustrative examples of the benefits of strategic collaborations compared to M&A



Grow Through Strategic Collaborations

Making strategic pharma collaborations happen

So how can businesses determine whether strategic collaborations are an appropriate consideration for them? And once they have, how can they catalyse the opportunity to make collaborations happen? It's a complex process that requires methodology, objectivity and trusted relationships.

To start the process of considering strategic collaborations pharmaceutical companies need to view their complex businesses across four distinct units:

- **R&D assets**
- **R&D capabilities**
- **On-market assets**
- **On-market capabilities**

Each of these units drives value and is eminently tradable. We define them as 'Units of Transactable Value'. They're at the root of transformative strategic collaborations, and to trade them effectively requires companies to know themselves, know their market, and make their moves.

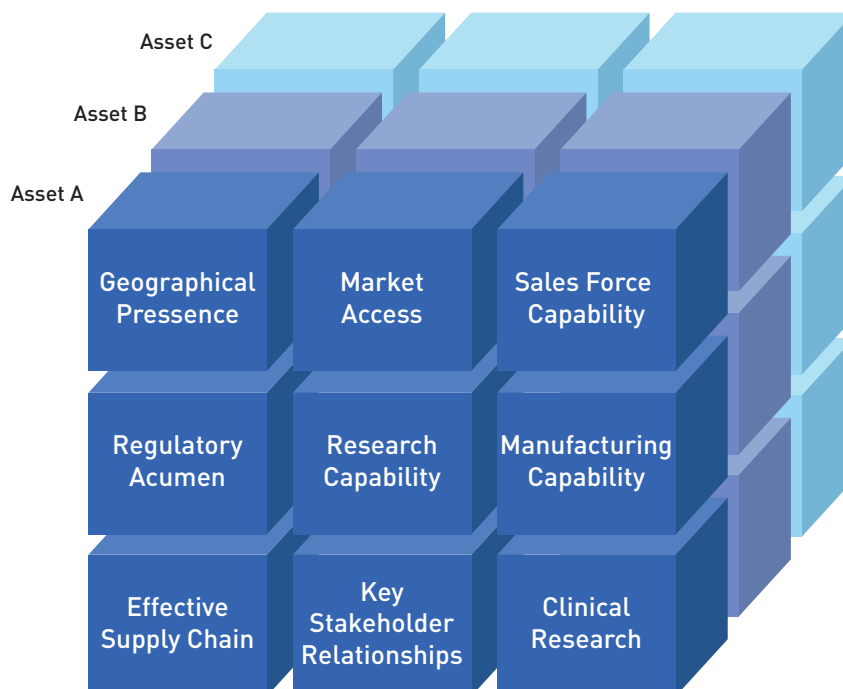
Step One: know thyself

To identify opportunities for strategically focusing their business, organisations must have a profound and critical understanding of their own Units of Transactable Value. It is only by securing a "partners-eye" understanding of the strengths, weaknesses and value of its internal assets and capabilities – right across the value chain from R&D through to manufacturing and commercialisation – that a company can determine how attractive it is to potential partners and what it really needs to trade. Critical assessment can help identify areas where a business may be 'sub-scale'. More importantly, opportunities can emerge to create greater value with the assets and capabilities the company has already got.

Naturally, identifying and valuing assets is familiar territory for pharma. It's eminently straightforward. However, the same cannot be said of capabilities, which are often harder to define and equally difficult to value. The relationships between assets and capabilities are multi-dimensional and complex; a company's capabilities are aligned within and between assets, making it essential to understand the individual parts and the relationship between the two. Structured thought is key, at Novasecta we have found that clarity can be supported by reducing down the complexity to manageable elements:

Grow Through Strategic Collaborations

Illustrative asset and capability matrix



Despite the undeniable importance of robust self-awareness in defining strategic focus, many companies lack a clear and objective view of their capabilities and their associated value to potential partners. This makes collaborations harder to ignite. In reality, such evaluation is therefore best carried out through an honest, critical and informed dialogue between executives and their most trusted and experienced external advisers.

Step Two: look at the relevant partnership space with fresh eyes

The second phase of unlocking strategic collaboration is to identify potential partners. This is a complex process that requires a deep knowledge of the marketplace and a broad understanding of the assets and capabilities that competitors may be prepared to put 'on the table' for collaboration. Naturally, this is difficult. There is no open market for companies to disclose where their organisations are sub-scale or indeed to indicate willingness to divest parts of their business. Moreover, although communications between CEOs are generally warm and supportive, it's highly unusual for leaders to share sensitive strategic information or discuss areas of corporate vulnerability with peers.

Again, a structured and experience-based approach is key, allowing a bespoke and sophisticated segmenting of potential targets based on both analytical evidence and subtle understanding of the motivators and drivers of other companies. Proxy measures can be used to improve decision-making in this area. These could include pipeline data, R&D intensity,

Grow Through Strategic Collaborations

on-market product/portfolio sales, geographical footprint and divisional headcount. Likewise, in companies that have made a significant strategic shift – for example, a move from one therapy area to another – it's a reasonable assumption that they may have legacy products or capabilities that they're willing to trade or divest.

With the right partner, proven methodology and clear decision criteria to support partner identification, it's possible to build a shortlist of potential targets for collaboration. Once established it's then a case of mapping capabilities and assets to develop deal hypotheses and rationales that may resonate with specific prospective partners.

Step Three: make your move

The sensitivities of brokering strategic collaborations mean that the final step is wholly dependent upon courage and trust. This is an exploratory and open dialogue, a long way away from pitch decks and mandates. Ideally, initial discussions with target companies will preserve the anonymity of the enquiring business, leading to a more open and honest view of deal feasibility and requirements.

Novasecta's experience in catalysing collaborations for clients is that a trusted and anonymous dialogue with a CEO or BD Head based on an initial well-reasoned deal hypothesis yields concrete interest and disclosure of additional deal hypotheses. This allows our clients to leverage the insights from such dialogues to inform – and, if necessary, change – their strategic approach. By opening the door to collaboration – irrespective of whether they choose to walk through it – organisations can benefit from real-world insights that might encourage them to rethink strategic goals. This, once again, underlines the emphasis on strategy that is inherent in collaborations – an emphasis that distinguishes it from more transactional deals.

Naturally, in the event of discussions with a potential partner becoming more advanced, dialogue is 'best unblinded' – freeing the two companies to engage, negotiate and agree directly based on an excellent starting hypothesis.

Catalysing strategic collaborations

The need for strategic collaborations across the pharmaceutical industry has never been greater. However, they are incredibly difficult to do well. Successful collaborations rely on trust, clear deal hypotheses and – crucially – courage. One of the parties has to be brave enough to propose something that is not publically available that could be of interest to another party – and this alone dictates the need for strong trust between CEOs to enable open and honest discussion of future possibilities.

In fact, the CEO is integral to the success of any potential collaboration.

Grow Through Strategic Collaborations

CEOs know that it is their responsibility to shape the strategic focus of their business to drive value creation and growth. The most entrepreneurial recognise that they must seriously consider spin-outs, divestments and out-licensing as well as acquisitions, asset transactions and joint ventures. However, forging successful strategic collaborations requires much more than a willingness to consider innovative growth models – it requires commitment, engagement and leadership.

The good news is that strategic collaborations can be done. Our experience is that through the addition of our experience, analysis, strategic creativity and trusted CEO network our clients are catalysing strategic collaborations that would not otherwise have been considered. And in pharmaceuticals a collaborative industry will always beat an overly consolidated one.