# A Strategy FOR PHARMA DIVERSIFICATION

Confronted with an increasingly competitive landscape, **global pharmaceutical companies are experiencing threatening pressures that defy their inner core capabilities**.

In response to myriad challenges and with the hope of renewing double-digit growth, the question becomes whether pharmaceutical firms should hold on to a pure pharmaceutical business model or embrace a more aggressive diversification strategy, says Roger Fournier, a senior executive working at a global pharmaceutical company.

Some companies are reducing the breadth of their portfolios via a series of strategic divestments, according to Mr. Fournier. He cites Pfizer, for instance, which seems to be refocusing its core business around novel drugs primarily centered on large disease areas and targeting aging populations; the company has made the discovery of products aimed at the specialist market, such as oncology, a priority.

Mr. Fournier says other companies are going in the opposite direction, expanding their portfolios through diversification. Pharmaceutical giants such as Novartis, Johnson & Johnson, and Abbott are fueling their business growth and profitability through the pursuit of more aggressive diversification strategies.

When assessing if strategic diversification is a desirable strategy, Mr. Fournier says leaders must answer three fundamental questions.

First, can the company achieve higher profit margins over time with moderate diversification? Second, can the company create value and sustain competitive advantage within the traditional and new markets being targeted? Third, what are the potential barriers and costs of entry and exit into the targeted markets?

"In several cases, diversification attempts have destroyed rather than created shareholder value," he says. "Consequently, pharmaceutical companies must carefully examine their particular situation while appraising strategic diversification options. Keeping an eye on the present, they must successfully anticipate the disease areas and winning healthcare market conditions that will prevail in the next decade. Armed with this insight, they must make strategic choices now that will favorably position their companies to reach the desired end-state tomorrow. Within that strategic vision, diversification may or may not play a critical role in formulating their line of attack."

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Roger Fournier

## DECIDING ON THE RIGHT STRATEGY

Several studies performed in various industries over the past 30 years indicate that firms that have successfully attained moderate, related diversification have surpassed both focused and highly diversified companies. And they have achieved consistently higher shareholder returns over the years. Therefore, pharmaceutical companies might want to conceive a corporate strategy that supports related diversification methods.

"Value creation and competitive differentiation resulting from a moderate diversification strategy might be achieved through leveraging a range of opportunities," Mr. Fournier says. "One opportunity consists of optimizing and sharing resources and core competencies across a set of related businesses and functional areas, such as R&D, sales, marketing, supply chain, manufacturing, or distribution. Another tactic is to leverage economies of scope, such as eradicating duplication between businesses through the creation of global shared facilities. Related economies of scope can occur by consolidating basic research activities into more focused R&D labs, taking advantage of breakthrough research platform technologies."

Additionally, he says firms can leverage intangible assets such as corporate image and brand equity. These can be leveraged advantageously across businesses in a cost-efficient manner. Another possibility is to leverage state-of-the-art health science technologies enabled by highly differentiated know-how practices.

Related diversification might equally be pursued to acquire new core capabilities that the company does not have yet, but that might be essential to exploit longer-term opportunities.

"Diversification, in such a case, is used as an accelerated organizational learning stratagem," he explains. "Diversification is then primarily focused on honing new resources and core capabilities with the purpose of achieving competitive differentiation as well as sustainable, profitable growth in the future. For instance, the growing convergence between drugs, diagnostics, and medical devices will lead to the creation of innovative combined products that drastically improve the prevention, diagnosis, and treatment of various diseases. But to reap the full benefits of this upward convergence trend, companies must hone new core capabilities."

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Mr. Fournier says to capitalize on these core capabilities it will be essential for companies to create, from the bottom up, groundbreaking combined product pipelines that have a tight integration between these three core technologies.

"Companies with existing capabilities in

more than one of these life-sciences sectors might have a competitive advantage," he says. "For companies that do not have this expertise, it will be essential for them to build up new core capabilities to appraise and leverage emerging opportunities and technology platforms that will lead to the development of revolutionary combined products or new services."

## CONSIDERATIONS TO KEEP IN MIND

Besides increased market share potential, total industry revenue, and predicted overall profitability analysis, other considerations must be carefully weighed while contemplating related diversification.

"Important criteria such as proper timing for market entry, the rate and speed of diversification, the awareness of existing or unanticipated competitors, the ability to rapidly scale up differentiating capabilities in relation to the competition, and the use of complementary assets and core capabilities that can be leveraged synergistically between companies on a global basis, all must be carefully analyzed by the company," Mr. Fournier says. "Additional considerations include conducting in-depth industry life-cycle analysis and competitive war game simulations."

While considering diversification, it is of the utmost importance to err on the side of caution because the cost of strategic miscalculation is significant, Mr. Fournier warns.

"The company should not underestimate or overestimate its core capabilities and its potential for developing new ones," he says. "Nor should it disregard the competitive landscape and the likelihood of potential retaliation from rivals, especially if the targeted markets are consolidated as opposed to fragmented."

A simple technique to minimize the risks of unconsciously developing internally focused biases is identifying reference classes. A reference class is defined as a set of comparable decisions that other firms have made in the past in more or less comparable markets.

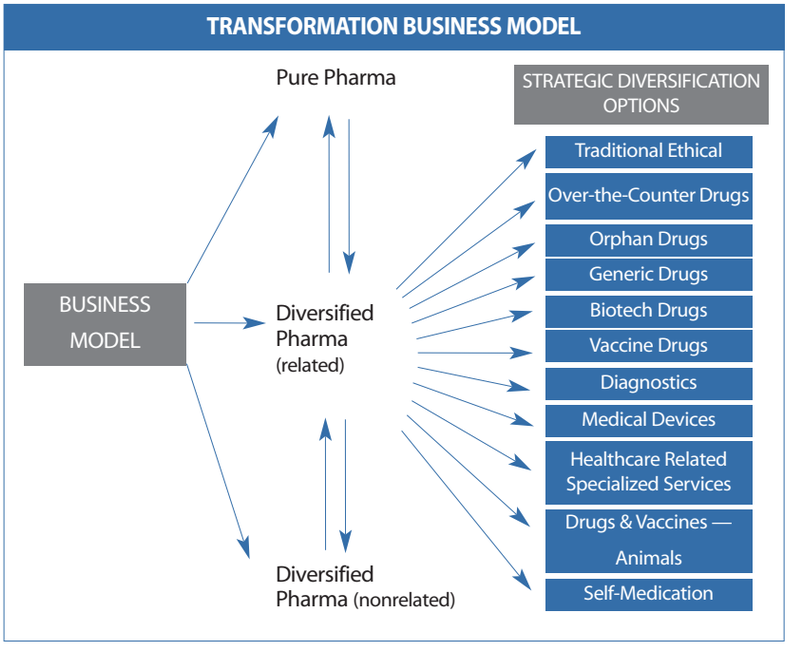
"By analyzing these data carefully, the company derives valuable insights and learning from the successes and failures of similar firms," Mr. Fournier says. "While performing these unbiased reviews, companies can often hedge a certain number of qualms. They might even discover unforeseen opportunities and change their trajectory to exploit untapped value propositions."

## POSSIBLE SCENARIOS

Mr. Fournier suggests one diversification scenario that companies might consider is entering into the generic drug market.

"Over the next decade, a combination of product patent expirations and payer cost-containment strategies will drive respectable growth in the global generic drug market, including in the United States," he explains. "Increasing competition will lead to further consolidation, characterized by intense merger and acquisition activities. This will lead to the emergence of powerful generic key players with strengthened global reach and extended core capabilities."

In such a context, firms might consider entering the generic drug market and leveraging their sales, marketing, manufacturing, supply chain, distribution, and R&D core capabilities. But if they want to remain competitive, large pharmaceutical companies must be able to operate their business with a significantly lower cost structure. This core capability is mandato-




ry to compete head-to-head with established generic firms, which benefit from very low cost structures.

"Another essential core capability is the ability to attain a subtle balance between protecting branded product patents while challenging other firms' patents," he says. "Generic drugs are sold at much lower prices than branded drugs in the United States. Despite the fact that they can be sold in higher volumes, they are characterized by lower operating profit margins. But intense competition and pricing pressures will likely force the major generic players to develop higher value products, such as super generics and even branded products."

Mr. Fournier contends that the creation of super generic drugs requires more R&D investment than for common generic drugs.

"But as super generic drugs have the potential to be patentable, higher demands might be generated and therefore improved profit margins might be realized through lesser competition," he adds. "Hence, over the long term, global generic companies might pose a serious threat to traditional pharmaceutical companies. They might augment their R&D capabilities and invade the branded drug market, while maintaining their low-cost operating advantages."

Another promising prospect for global generic firms is the gradual emergence of groundbreaking technologies that will facilitate the production of follow-on biologics.

Industry experts contend that by 2015, about 80% of the lucrative biopharmaceutical products currently available will suffer the loss of patent protection. Hence generic firms that can develop follow-on biologic core capabilities might be able to benefit from achieving significantly higher profit margins than those associated with commodity-based generics.

"Moreover, the regulatory landscape for approving bio-generic products is gradually improving around the world," Mr. Fournier says. "The European Medicine Agency is expected to approve more bio-generic products in the future. In America, there is no comprehensible regulatory pathway for the approval of bio-generics yet. But it is highly probable that the approval of a roadmap for a comparable Biologic License Application pathway will soon become a reality."

Mr. Fournier contends that if the previously mentioned assumptions materialize, then a pharmaceutical company like Novartis with its Sandoz generic business unit might be well positioned to recoup its investments in the generic drug market and achieve healthier profit margins.

Two other lucrative areas that could be targeted for moderate diversification are the medical device and diagnostic sectors. These two sectors enjoy noteworthy profit margins. Furthermore, sustained growth and higher profit margin prognostics are favoring these two sectors, because of unmet medical needs and new scientific discoveries.

"On the risk side, the core capabilities associated with large pharmaceutical companies, such as organic chemistry and biotechnology know-how, are quite different from those in the medical-devices business," Mr. Fournier says. "Leaders in the medical-device industry have developed advanced engineering and high-technology research and development capabilities."

The medical-device market is characterized by a high concentration of products from a few major players, such as Johnson & Johnson, Medtronic, and Abbott. The potential for competition from those important players might be high, Mr. Fournier suggests. Nonetheless, a global pharmaceutical company with large capital funding could come up with a strategy whereby it would gradually acquire the core capabilities and assets necessary to enter this market by targeting some sweet spots.

"Then the company could progressively strengthen and expand its new core capabilities over the years to eventually emerge as a major player," he says.

The importance of the diagnostic sector, especially in novel areas such as molecular testing, will increase over the next decades.

"This will be especially true when personalized medicines finally take off as a result of major genetic breakthroughs stemming from the mapping of the human genome," Mr. Fournier says.

He cites Roche as a good example of a pharma company that has, over the years, successfully built up a critical set of capabilities to compete in the biotech sector, including diagnostics.

"This success was accomplished through the strategic acquisition of biotech firms, such as Genentech," he explains. "Roche gradually became more conscious of the increasing convergence between the diagnostic and pharmaceutical health-science disciplines. This convergence was substantiated by a series of scientific breakthroughs in molecular biology and genetic testing in particular."

Capitalizing on this important trend, in 1997 Roche started a diagnostic business through the acquisition of Boehringer Mannheim. Over the next decade, Roche gradually evolved into a global powerhouse in diagnostic products and related systems.

Another opportunity for diversification is in the professional healthcare service industry, which is largely overlooked by companies during their analysis process.

"Firms could transform themselves into true customer-centric organizations, as opposed to product-driven organizations with a focus on customers," Mr. Fournier says. "They could then institutionalize superior knowledge management capabilities, for example knowledge acquisition, interpretation and exploitation, and create deep and thorough understandings of their valued customers' needs, both explicit and implicit, across the entire healthcare delivery value chain.

"Then innovative and differentiated services could be created by pharmaceutical companies to help the global healthcare industry to improve productivity and efficiently close major healthcare gaps," he adds. "Some of these novel services could be engineered, for instance, to measure and improve a variety of professional healthcare delivery structures and methods across specialized healthcare institutions, such as emerging integrated practice units, especially in the United States. Such pioneering services could potentially evolve over time into important sources of competitive advantage and command higher profit margins. With progressive experimentation and superior insight, an entrepreneurial pharmaceutical company could even explore the possibility of creating an independent, product-agnostic global healthcare consulting unit."✦

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