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Should pharma firms sell out?

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Big Indian pharma firms selling their stake does raise the fear of drug prices rising, but the question is whether they can ever hope to create a value equal to what MNCs are willing to pay them today.



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Big pharma firms can't grow much faster than the market, so to sell at high valuations makes sense — for smaller firms, there is room to grow, so they shouldn't sell out

The Indian pharmaceutical sector has witnessed significant growth in the recent past, and is expected to continue to grow at an attractive 12-13 per cent per annum from \$7 billion in 2007 to around \$13-14 billion in 2012. This growth is driven by numerous factors apart from just GDP growth, such as increased penetration in rural markets, growing incidence of lifestyle diseases and greater coverage of medical insurance.

In the context of such an attractive market, why should an Indian pharma firm ever consider selling out? There are three reasons for this.

One, the company may be able to secure extremely attractive prices, which could be well above its future cash flows from the business even after factoring in expected growth. Global pharma firms have been under significant pressure to reduce prices due to limited growth opportunities in their home markets, dwindling product pipelines, and regulatory constraints. These factors are pushing foreign firms to look for growth outside their home markets. Indeed, the question being asked by the boards of many of these companies is not whether they should play in India but how they should play in this attractive market. As a result, pharma MNCs are willing to pay a significant premium for high-quality pharma assets in India. The most recent example is that of Abbott that paid the equivalent of nine times the sales revenue of Piramal's health service division.

Two, for big pharma firms, given the patent laws that came into effect in 2005, and given that they have already expanded both geographically and across therapeutic areas, it is harder to look at growth rates far in excess of market growth rates. With product portfolios already comprising upwards of 400 drugs and sales forces frequently in excess of 1,500, in most cases, there is limited room for a step change in growth. A quantum leap could come from developing new molecules and launching these globally, but given the \$1.5-2 billion development cost per successful molecule, few firms are betting their future growth prospects on

discovering the next blockbuster drug.

Finally, from an overall portfolio perspective, there are several alternative investment opportunities available to large pharma promoters in India with a significantly higher return potential as compared to the pharma industry. With an industry price-earnings ratio of 23, existing share prices of larger firms already factor in most of the future growth, leaving little capital appreciation opportunities. Given potential attractive valuations from MNCs, Indian promoters need to consider whether they can create more value than what is being offered by staying in the business or whether they would be better off selling and investing the proceeds in other sectors. Indeed, this is pretty much what the Singh brothers of Ranbaxy are doing — they are aggressively pursuing opportunities in health-care services and financial services sectors. On the other hand, the situation is quite different for promoters of mid-size Indian pharma firms. Many of these firms can and are growing well above market levels, and are creating quite a substantial value through this growth. Indeed, analyses show that in the last five years, mid-size firms have grown substantially faster, on an average, than larger firms by leveraging growth levers such as geographic expansion, growing into new therapeutic areas, and through operational effectiveness initiatives such as reducing sourcing costs, improving pricing, and sales force effectiveness. Further, mid-size companies do not make attractive acquisition targets for large MNCs as their sales are not significant enough for these multinationals. Also, mid-size pharma companies have the opportunity to grow through acquisition of smaller companies/brands, as the companies at the bottom of the industry pyramid come under pressure due to lack of scale. The combination of these three factors argues for promoters of mid-size pharma companies to focus on aggressively growing their businesses as opposed to selling out.

Alvarez & Marsal is a global professional services firm with a deep operational and turnaround heritage (Views expressed are personal)



D G Shah

Secretary General, Indian Pharmaceutical Alliance

The Abbott valuation is quite rare and several promoters love the challenge the generic space provides — so not all will sell. If major firms sell out, drug prices will skyrocket

The sale of the formulations business by India's Piramal Healthcare to US-based Abbott has revived the debate surrounding acquisition of Indian generic companies by global innovative firms. The question whether Indian pharmaceutical companies should sell out or not arises because, in the minds of people, Indian generic companies are associated with low-cost, safe, effective and quality medicines, whereas global companies are associated with “new” (e.g. Otrivin Nasal Drops which once sold at Rs 5 is now offered in a new dosage form as a spray for Rs 45), high-priced medicines. It is, therefore, understandable that people concerned about affordable, quality medicines not only resent such a selling out but also worry over whether other companies will stay in business or let Big Pharma gobble them up as well.

The concerns about the survival of the Indian generic industry are real. One could argue that the entire Indian generic industry, with an estimated revenue of about \$20 billion, applying the Piramal valuation as benchmark, can be acquired for about \$180 billion! And some recent global acquisitions of \$50-billion-plus would suggest that it is not something impossible. The global majors would have a field day in the marketplace once the Indian generic industry, a major competitor, or more appropriately, a disruptor, is eliminated.

There is already speculation about who will be the next to sell out. Those concerned about access to medicines in developing countries like India, where drugs constitute 79 per cent of the cost of treatment (NSO Survey), would fear that once alternative sources of supply are eliminated, prices of even off-patent

medicines will skyrocket.

However, the pharmaceutical business is far too complex and not amenable to such simplistic scenario depictions. Once technology barrier is overcome, any change in the risk-return equation will throw up new players, if the established ones will have sold out.

Thus, howsoever the global innovative industry wishes and a few Indian companies oblige, it is not feasible to eliminate generic competition. The valuation such as that of Piramal Healthcare is very rare for generic businesses. It is, therefore, unrealistic to assume that global majors will be willing to pay similar valuations for all major Indian generic companies. Nevertheless, Abbott's valuation is a reason to celebrate not only for the Piramals but for the whole generic industry. Besides recognising their value, the deal will result in one competitor less for the remaining generic companies, as Abbott will create a headroom for them by aggressively pricing its newly acquired products.

If one were to address the question whether Indian pharmaceutical firms should sell out or not, the most likely answer would be that it would depend on the valuation. However, the answer to whether Indian entrepreneurs will sell or not lies in: One, it is very rare to get the scale of valuation offered by Abbott. This was obvious in the Piramal deal itself. Other suitors had quoted much lower prices. Two, all promoters are not enamoured by wealth alone. Beyond a point, they seek name and fame. The generic space provides this opportunity. Three, many entrepreneurs still see the untapped potential in their business. Instead of luring them to sell, the abnormal valuations will spur them to strive for more to further improve valuation. Four, many first-generation promoters have their roots in the soil of the land. They see in their business an unconscious mission to reach out to the poor and the downtrodden. They do not want to fail them. And five, some entrepreneurs thrive on challenges. Pharmaceutical is one such business where there is never a dull moment. They do not wish to run away from these challenges. Events such as Abbott's acquisition will only make them proud of their possession!

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(Views expressed are personal)*