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Optimism Is Alive and Well

P. Reed Maurer

This summer it was my privilege to visit and talk in depth with 23 Japan-based presidents of foreign health care companies. Then during the last week of August I met with analysts and investors in Boston, New York and Chicago to respond to their questions on the Japanese pharma market. This article summarizes the "take home" messages from these meetings.

Surprise

Given all the posturing in the media about the difficulties of doing business in Japan, the presidents I talked with were uniformly optimistic concerning their company's future in Japan. They expressed confidence in their future growth based on rich pipelines and the large number of qualified people applying for positions in their companies. Their revenue growth targets are much higher than market growth. In short, they are on a roll. This surprised me because similar conversations a few years ago were mostly doom and gloom.

A second surprise was the level of enthusiasm I sensed for investments in Japan by the analysts I met in the US. I thought everyone was flying over Japan to invest in China.

I was wrong. The Ministry of Finance recently reported on direct foreign investments in Japan during the January to July period. Capital inflows surged to ¥4.64 trillion. Meanwhile, direct foreign investments in Japan during August alone totaled 25 and were valued at ¥105.2 billion.

Capital outflows in the same January to July period reached ¥2.28 trillion, or a net inflow of 2.32 trillion yean. This amount easily surpassed the annual net inflow record of 1.45 trillion set in 1999.

Why? The large net inflow was due to a growing number of US and European companies acquiring Japanese firms who have an established domestic position. They see acquisitions as a quick way to expand their global shares. Another reason is that financially troubled Japanese companies are looking for white knights in a bid to insure their future competitiveness.

Present Status in the Domestic Pharma Industry

The pharmaceutical industry has lagged behind the above mentioned trend of increased direct foreign investments. I do not know of any out/in deals since Roche acquired a majority interest in Chugai in 2002. In the same year Abbott acquired Hokuriku Seiyaku, and Ranbaxy acquired 10% interest in Nihon Pharmaceutical Industry, a subsidiary of Nippon Chemiphar, which was raised to 50% in 2005.

The pharma industry appears to be immune from what is going on elsewhere in Japan. One reason is there are no financially troubled companies in this industry. They are making money and have excessive levels of cash and marketable securities. Furthermore, they do not face shareholder pressure to make changes.

They are, as I characterized them in an article a few years ago, boiled frogs. The water they sit in is getting warmer, but it is comfortable and not hot enough to make them consider jumping out. But the water will continue to get warmer and then it will be too late to jump, and they will be boiled frogs.

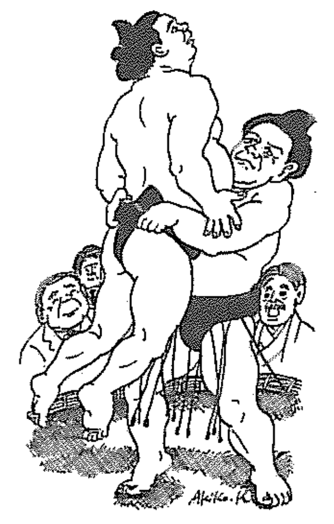
In fact, most of their moves are defensive, not offensive. Increased cross-shareholding is one example. Another is to go into generics or contract manufacturing to generate revenue while cutting costs to boost their net income. These measures are fine but will not insure long-term survival in an industry where new, innovative products drive growth.

A sense of urgency will emerge if the government gets serious about cutting costs and lowers the reimbursement prices of long-listed drugs to their generic equivalents. Or if they delist reimbursable products that are available OTC. Savings derived from promoting generics is peanuts compared to the savings from these actions.

Of course this government rarely takes drastic actions, but the writing is on the wall. Companies highly dependent on long-listed drugs will feel the heat sooner than later. Without a pipeline of new drugs they will (must) enter into strategic business or capital tie-ups with foreign or Japanese firms who have a future.

Future Implications

Another message from my talks this summer was the desire to grow faster than the current level of double-digit growth achieved organically. Many companies would be satisfied with this rate of growth. In other words, they want to do deals. That is, acquire assets to accelerate development of their products and achieve greater critical mass in the market.



The implication is that if the government lowers the prices of long listed drugs and increases the premiums for innovative drugs it will help foreign firms to conclude strategic alliances with firms who cannot survive on defensive strategies.

Looked at positively this can be a win/win game, but do not expect change overnight. Not to worry, because foreign companies have enough to do with managing their internal growth at the present time.

Two express trains are leaving the station. One train is made up of large Japanese companies focused on global growth. Their revenue and profit is growing very nicely outside Japan. Stopping to pick up smaller, troubled companies will only slow them down. Another train is made up of foreign companies growing rapidly in Japan.

Slow-growing Japanese companies are outside the station trying to decide whether or not to buy a ticket on one of the trains. If they wait too long they will be left behind, or forced to take a local train.

My conclusion from these discussions is that foreign pharma executives and analysts are not wearing rose-colored glasses. They have very good reasons for an optimistic outlook. This should make Japan a fun place to be for the foreseeable future. No one I talked with wanted to leave, and my audiences in the US are eager to get in.

P. Reed Maurer is much happier in the field than sitting in his own office.