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The Fate of Small Pharma Companies

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I recently met a man who returned to Japan after a 10 year absence. We had hardly got started on a nice lunch in a Ginza restaurant when he told me, "Nothing has changed in Japan since I left." If you know me or read my articles in this paper you can appreciate why his statement set off a vigorous debate on what has changed and what has not changed.

Every long term resident of Japan and returnee has a list of what has not changed. It typically includes the following:

* Japanese politeness and patience with foreigners.
* Corporate values that stress the importance of employees versus shareholders.
* A consensus style of decision making that gets everyone behind the execution of decision.
* Deference and respect toward those senior to oneself, either by title or age.
* Everything begins and runs on time, e.g. meetings, parties, trains, buses, and mail delivery.
* A preference for avoiding confrontation in actions or words.
* Waiting for the light to turn green before crossing the street even though there is not a car in sight.
* The never ending talk but no action about increasing foreign direct investment.
* Taxi drivers who stop by the side of the road to take a pee.

But let's get back to what has changed, not to make another list but to get to the point of this article, the fate of small to mid-sized pharma companies in a rapidly changing pharma market.

Three changes this decade have brought many strategic issues to small/mid-sized companies. The first is consolidation of large companies, second is the aggressive moves outside Japan by the newly merged companies plus Takeda and Eisai, and third is the market penetration by foreign companies. In 1996 the domestic market share of foreign companies was 17.8%. By 2006 it had climbed to 35.0%. In 1996 only five foreign companies were ranked in the top 25 by sales. By 2006 there were 11 companies on the list.

Moves outside Japan by the four large companies have been dramatic. External growth was fueled by a combination of innovative drugs and acquisitions, particularly during the past 12 months. Should we label Takeda a Japanese company when 51% of its sales are outside Japan?

These changes put the small/mid-sized companies in unfamiliar territory, i.e. marginalized from the mainstream. The three charts herein present this polarization in stark terms.

Compare Charts I and II and note the following:

* There is a tremendous difference between the average net sales, op. profit, and net profit in nine small/mid-sized companies versus the four large companies.
* Revenue growth for small/mid-sized firms was negative over the time frame analyzed. Large companies grew their revenue by a significant amount, primarily from sales outside Japan.

The most striking comparisons between the two sets of companies are the growth rates. Large companies focused on strategic moves to increase revenue, while small/mid-sized companies focused on cost cutting measures to increase their op. profit and net profit.

Cost cutting was warranted, but it is a tactical measure run by the bean counters who have no idea how to grow a business. Furthermore, once you cut out the fat you get down to muscle, and cutting muscle harms the firm. People running these companies are managing the gradual decline of corporate value.

And yet, as strange as it may seem to outsiders, there is very little shareholder pressure on management to initiate a major business transformation or to take risks.

A quick look at Chart III makes you wonder why anyone would buy shares in the nine small/mid-sized companies versus the big four. Earnings per share are low, ditto for dividends, and the dividend yield is not much better than investing in Japanese government bonds which are risk free.

If the guy I met for lunch is right and nothing changes, the small/mid-sized companies are locked into their present business models that do not achieve and have not achieved sustainable growth. Here are some characteristics of the present model:

* A focus on the Japanese market with its limited value growth potential, and serious attacks on the reimbursement prices of long listed products.

Alliance with Non-pharma Companies
Examples include Hisamitsu/SS Pharma, Kowa/Nikken, Kirin/Kyowa Hakko, FUJIFILM/Toyama, Japan Tobacco/Torii.

Become a Japanese Subsidiary of a Foreign Company
A Japanese small/mid-sized company has a present infrastructure but no pipeline to support a future. A foreign company needs infrastructure to support its robust pipeline. It seems like a win/win combination, BUT there is a deep-seated allergy to this form of alliance, and it is seen as a measure of last resort.

There may be other innovative strategic moves for small/mid-sized companies but these companies are not noted for an innovative culture. There is no outside or inside pressure to change. There is no sense of urgency. There is no entrepreneurial spirit in their organizations. Taking risks is considered to be too risky.

Any reasonably intelligent observer will agree change is inevitable, but no one can predict when it will occur.

P. Reed Maurer is thankful to Japan for teaching him the virtues of patience.