How balanced is your Emerging Markets business portfolio?

Applying portfolio management principles to make better investment decisions globally

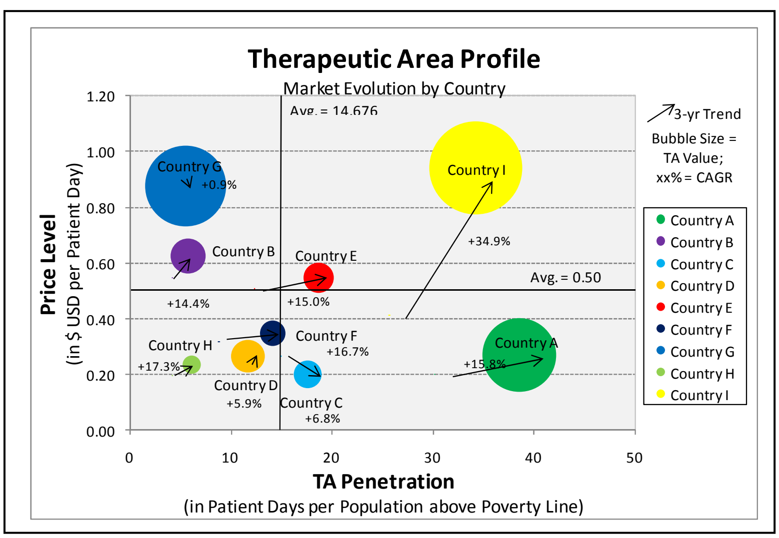
Emerging markets have become the darling of C-suites in nearly every pharmaceutical company. Given very limited growth in the global top seven markets, a continued dearth of breakthroughs in traditional Pharma R&D labs, ever increasing price pressures and generics competition at home, it is no surprise that emerging markets have become a primary focal point for pharmaceutical executives. However, just like the "new commercial model" – another elusive concept giving rise to optimism among pharma executives and shareholders alike – generating real and sustainable bottom line growth from emerging markets can be tricky and success is far from guaranteed.

While there are good reasons to extend one's focus to emerging markets, executives need to evaluate their strategies and investments in this area judiciously and objectively. The risk of misallocating resources, overestimating potential, and never realizing expected returns is too high to jump into unknown territory just because everyone else is doing it.

Emerging markets have different rules than the home market

Doing business in emerging markets requires us to let go of some of our experience-based "truths and beliefs" about requirements for success. The dynamics across emerging markets differ too much and the variables are too many to evaluate foreign business opportunities based on benchmarks or investment rules of thumb proven to work in more familiar markets. Executives know intuitively that certain products / therapeutic areas (TAs) have higher table stakes than others; that some TAs are less promotionally sensitive than others; some require more patient involvement; some are driven by clinical data, while success in others depends on branding and share of voice.

However, intuition can be misleading. Because these rules of thumb do not apply in the same way across all emerging markets, analytic models – based on country and therapeutic area specific data – are needed to sort through the multiple variables and provide the right information to enable sound investment decisions.



Many factors at play:
The most attractive markets are not always obvious – the biggest market may not grow, the fastest growing market may not be profitable, etc.

Factors such as market size, historic growth trends, price levels and price controls, reimbursement policies, distribution channels, local competition, promotional noise level, and treatment penetration (% of sufferer population receiving treatment) are all factors in and valuable indicators of a market's attractiveness and long-term potential.

Besides the traditional evaluations of country risk (i.e., currency fluctuations, economic stability, government attitudes towards free enterprise, protection of intellectual property, barriers to foreign competition, etc.), pharmaceutical executives must look into the unique factors affecting their own therapeutic area(s) – only a customized analysis taking into account the impact of health care systems, reimbursement policies, disease burden, socio-economic levels, willingness to pay out-of-pocket (if not reimbursed), gov't budgets, and geographic differences within a country will enable an objective prioritization of markets to explore and invest in. There is no one-size-fits-all answer and for each therapeutic area, the best opportunities may be in very different markets.

Consequently, the same investment will yield very different results in different markets. As such, senior executives have choices to make to maximize the value of their global business portfolio. In reference to an earlier *point-of-view* by Cogent Consulting ("Is your 401k better balanced than your business"), portfolio management principles and tools can be applied to evaluate how much investment each country should receive for a particular product or product class.

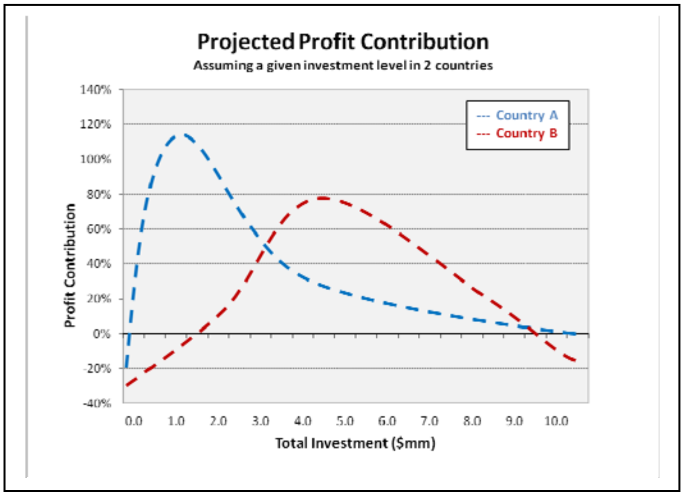
Market models generate valuable insights for informed portfolio investment decisions

Studying performance levels of key benchmark products across markets, correcting for known factors such as competition, pricing, promotional spend, time on market, etc., one can model differences in market dynamics across countries and use this to project and compare expected returns for the product(s) in question under different investment scenarios. Thus, the executive is able to allocate resources across markets in order to create a balanced investment portfolio for the region as a whole.

Critical inputs for portfolio decisions:
Comparing expected returns from different markets enables pharmaceutical executives to make informed investment decisions based on their risk/return profile.

A good model should provide measures of

- ***NPV**: Expected discounted net cash flow over a selected time period for a particular investment strategy*
- ***Risk:** The probability of achieving a given NPV or the confidence interval around that NPV*
- ***Upside potential:** The total potential that could be obtained with the optimal investment strategy vs. the status quo*



To make a more informed investment decision, the executive overseeing multiple countries or regions (for one or more therapeutic areas) should use such a model to develop longer-term investment strategies that balance (i) risk vs. return, (ii) revenue vs. profit, (iii) short-term vs. long-term cash flow, (iv) focus vs. diversification, etc. to build the optimal business portfolio across countries.

Optimizing the global portfolio will enable the executive to achieve a broader set of business objectives typically associated with sophisticated portfolio management. These objectives include not only profitability, but also predictability, risk management, sustainable growth and strategic fit. (See also *point-of-view* "Is your 401k better balanced than your business".).

Country Portfolio Management supports critical business objectives

- ☑ **Strategically align products with emerging market opportunities**
  - Invest in products, including mature, new, and even R&D projects, based on market dynamics, patient needs, and the long-term growth potential for a given therapeutic area.
- ☑ **Optimize investment levels to maximize returns**
  - Take into account different profit contribution expectations across markets to balance cash flows across the 'country portfolio' and over time
- ☑ **Manage overall risk**
  - Minimize risk for a given level of return, or ensure an appropriate return for a higher level of risk
- ☑ **Achieve sustainable growth**
  - Balance long-term sustainability with short-term profitability, leveraging today's cash cows to fund tomorrow's emerging opportunities

Putting Portfolio Management to Work

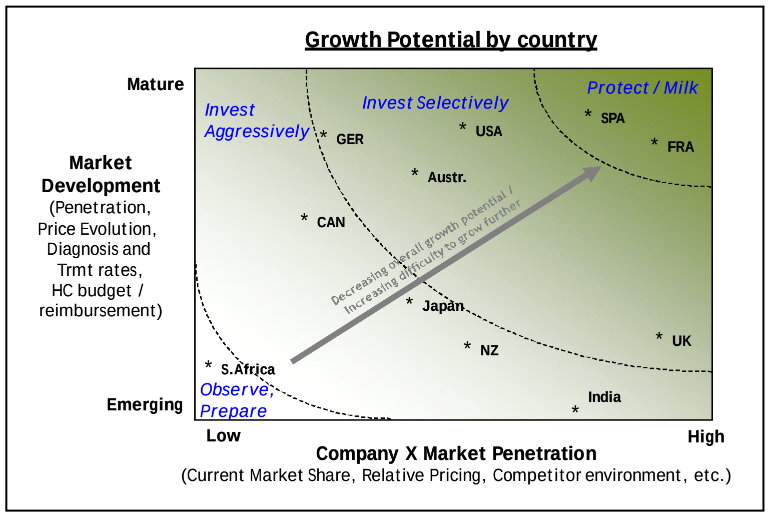
Looking at geographic markets as the assets in the business portfolio provides a new perspective to evaluate strategic investment decisions. Similar to a stock portfolio, the portfolio manager needs to decide where to over-invest and where to generate positive cash flows to fund these investments. S/he needs to determine which markets require higher expected returns to justify higher risk. And last but not least, s/he needs to identify markets to stay out of (for now) in order to achieve a sustainable growth rate, acceptable profitability, and a desired risk/return profile for the business as a whole.

Once the analytics have been developed, the management of the emerging markets portfolio requires coordination at two levels:

1. Strategic Portfolio Decisions: At this level decisions are made with a long-term, global perspective. Investment strategies are determined for each market in order to achieve global portfolio objectives. This requires deciding where to invest and what kind of returns are desired (i.e., invest aggressively for future payback, participate conservatively in a wait and see manner, milk the market, etc.). The objective is not to maximize immediate returns in every single market, but to maximize the long-term value of the business portfolio overall – taking into consideration financial and strategic benefits (i.e., cash flow, NPV, risk management, diversification, etc.). Global managers should use the market model to run different scenarios and provide concrete guidelines and targets for each local management team.

2. Local Optimization: The individual country manager is then responsible for allocating resources locally that achieve the stated objectives for his/her country. As stated above, the goal may not be absolute short-term revenue or profit maximization in this local market – instead, the goal is to use the resources allocated to this market to achieve the financial and strategic objectives in the context of the global portfolio. This may mean running a deficit for future returns, refraining from certain investments to balance risk across markets, maximizing profit contribution to balance other countries' negative cash flows, or placing a risky bet on new customers or indications that may pave the way for other markets. How exactly the local market team decides to allocate its resources is up to them – as long as they can achieve the *unique* objectives set for their particular market, not simply the same global financial targets (e.g, profit margins or similar) applied to every country.

Detailed country analyses will provide a portfolio view similar to the depiction on the right. Based on numerous variables, markets can be plotted on a market map (in this case focusing on the market development and Company X penetration as critical dimensions). Differential investment strategies emerge and specific guidelines can be developed, not only for the level of investment but also the focus (e.g., market development vs. market share)



Emerging markets: No panacea but part of a long term solution

As the pharmaceutical industry is looking for solutions that pave the way for the next 20 years, emerging markets are no panacea. However, they can play an important role – just not in the same way for every pharma company. Driving business in emerging markets needs a customized approach for each organization, each therapeutic area, and each country. Each market represents a different opportunity with different risks and potential returns. Many variables come into play that might not exist, or factor in differently in familiar home markets. Senior management is responsible to assess these risks and opportunities specific to their business – not to follow blindly the herd that is running towards the same handful of emerging markets. Market models can help management understand how these numerous factors interplay with each other and affect investment returns. With a solid portfolio management framework, investment strategies can be developed, communicated, and executed in a well-coordinated manner. If done correctly, the right emerging markets strategies result in a well balanced portfolio generating steady growth and profitability instead of becoming a black hole for investments with returns eluding year after year.

To learn more about our approach to portfolio management for the pharmaceutical business, please contact Cogent Consulting.