THE REAL B2B:

CONTRACTS, JOINT VENTURES AND ACQUISITIONS

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• As Merck looks to expand its portfolio of marketed products, access complementary R&D and drive additional avenues of growth to complement Merck’s core business, we often evaluate different models in structuring the transaction

  – Contracts (Licenses and Collaborations)

  – Joint Ventures

  – Acquisitions
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• A 1998 survey\(^{(1)}\) of the Fortune 300 Companies showed that approximately 50% of corporate transactions were mergers and acquisitions; only 10% were joint ventures and only 9% were licenses or collaborations

• While Merck has made one large and several smaller acquisitions over recent years, we have also concentrated on licenses and joint ventures

\(^{(1)}\) Hypotenuse Enterprises Inc., Corporate Development Practices Survey
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• **Acquisitions**
  – Medco
  – Systemed
  – Gentili
  – SIBIA Neurosciences
  – ProVantage

• **Contracts - Licenses and Collaborations**
  – Zeneca (AstraZeneca) - INVANZ injectable antibiotic
  – Biogen VLA-4 inhibitors - respiratory
  – Celltech - PDE IV - collaboration

• **Joint Ventures**
  – Johnson &Johnson•Merck Consumer Pharmaceuticals
  – Astra Merck Inc.
  – DuPont Merck Pharmaceuticals
  – Merial
  – Schering-Plough Partnerships
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ACQUISITIONS

Benefits:
  • Unilateral management control over the business
  • Business is consolidated into the Company’s “Business Processes” - planning, reporting, resource allocations, etc.

Hurdles:
  • Premium paid for control
  • Management time to effectively integrate acquisition into the business
  • Ability to retain key employees
  • Short term earnings issues may be more pronounced versus alternatives
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LICENSES

Benefits:

• Access specific technology or compounds with no additional baggage
• Usually straight forward - limited management time required
• Relatively high level of control over asset

Hurdles:

• Competitive marketplace has driven the price of these transactions up
• Level of retained rights desired by licensor
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JOINT VENTURES

Benefits:

• Access to assets/expertise that are “not for sale”
• Expand into market segments which complement core business - without the distraction of an acquisition
• Leverage internal and partner’s expertise

Hurdles:

• Increased management time required vs. outright ownership
• Divergent operational/financial goals need to be reconciled between partners
• Historically, life span of a joint venture is generally less than 10 years
JOINT VENTURES

Key Considerations in Structuring Joint Ventures

– **JV Competes** - Any direct competition between the JV and one or both of the parent companies will need to be carefully managed to avoid conflicts of interest

– **Asymmetrical Value and Profits** - Equal value going in and equal value coming out of the JV -- 50/50 JV vs. asymmetrical profit splits

– **True-ups** - Avoid “true-ups” or retroactive adjustments of initial contributions

– **Insurance** - With large deductibles, insurance can provide protection and alignment of objectives, up to a point

– **Window Period** - Avoid finite horizons
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Managing the Joint Venture

When the JV structure includes:

- JV competes
- Profit splits asymmetrical
- True-ups
- Insurance
- Window period

the partner management costs (c) increase substantially

- The value (V) of (a,b) must now consider (c) the increased cost of “partner management”
- Over the longer term, this may lead to re-evaluation of “strategic value” of the JV structure
- The overheads to follow will review some real-world examples which Merck has encountered
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Carefully manage any direct competition between the JV and one or both parents to avoid conflicts of interest.

Company ‘A’ has three assets: A*, a*, a
  – A* is A’s core business -- will not share (Rx business)
  – a*and a - may be contributed to a joint venture
  – a is an OTC product (Rx to OTC switch)

Company ‘B’ has three “assets” B*, b*, b
  – B* is core OTC business
  – b is an expertise in marketing OTC products

Joint Venture formed with assets a and b
Joint Venture may compete with ‘B’ core business
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A

ASSETS
A* - Core Business (Rx)
a* - Core Products (Rx)
a - Rx to OTC Switch Product

B

ASSETS
B* - Core Business (OTC)
b* - Core Products (OTC)
b - Expertise in Marketing OTC Products

JV

a - Rx to OTC Switch Product
b - Expertise in Marketing OTC Products
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A

ASSETS
A* - Core Business (Rx)
a* - Core Products (Rx)
a - Rx to OTC Switch Product

B

ASSETS
B* - Core Business (OTC)
b* - Core Products (OTC)
b - Expertise in Marketing OTC Products

JV

a - Rx to OTC Switch Product
b - Expertise in Marketing OTC Products

JV may compete with B Core Business
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Equal Value Going In, Equal Value Coming Out of the JV

1st Transaction  Value
- A contributes product a = $50
- B contributes product b = $50
- Profit splits 50/50

Follow-on Transaction
- A contributes product a* = $70
- B contributes product b* = $30
- Profit splits 70% to A; 30% to B

- When resource allocation issues arise, which product (a or a*) will A want to protect?
- Resource allocation and level of funding issues consume significant parent company management time, even in a 50/50 JV. Asymmetrical profit splits increase that time geometrically.
Avoid “True-Ups” or Retroactive Adjustments

Forecasts

- ‘A’ contributes product a = $50
- ‘B’ contributes product b = $50

Initial profit split is 50/50, but contract provides for a look back true-up of initial contributions.

Actual

- Product a contributed $ 50
- Product b contributed $ 54

Value $104

‘A’ receives $52; ‘B’ Receives $52 (50/50)
True-up ‘A’ pays ‘B’ $2 to reflect contributions

- When resource allocation issues arise, which product (a or b) will ‘A’ want to protect?
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Avoid Finite Horizons

Even in a 50/50 JV, when assets will be returned to both or one partner in accordance with a finite horizon, resource allocation conflicts arise as the JV winds down.

Misaligned objectives to “Game the System”
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Avoid Finite Horizons

– As the window period approaches, the relationship and incentives for one or both partners to maximize the business may begin to deteriorate

– Willingness to explore and fund new projects may become diminished

– “New dynamics” impact not only the partners, but JV employees
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Avoid Finite Horizons

– On the flip side, without appropriate dissolution provisions, a change in one or both partners’ strategic direction increases the management time required to redirect the JV or negotiate a larger restructuring

– Restructure of Astra Merck Incorporated
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Joint Ventures - Lives Within a Deal

Astra Merck Relationship

- In 1982 Astra and Merck executed an agreement to provide Merck with rights to develop and market most of Astra’s product in the U.S.
- 1982-1994 -- Merck had rights under a contract (license) to develop and market Astra’s products with a royalty paid to Astra
- 1993 -- Separate Astra Merck Group formed within Merck
- 1994 -- Stand alone 50/50 joint venture formed
- July 1998 -- Restructured joint venture with Astra
- December 1998 -- Astra announced merger with Zeneca
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Astra Merck Relationship

• The relationship with Astra is approaching 20 years.
• Unique business relationship which has grown and changed over the years
• Early stage - 1982-1994 - licensee/licensor relationship governed by a contract
  – Astra received monetary value, but gained limited U.S. business experience
• 1994 - Joint venture is formed
  – Relationship is governed less by contract and more by relations, through joint management of JV
  – Astra received monetary and business experience
• 1998 - Joint venture is restructured
  – Relationship is governed by contract
  – Merck receives monetary value
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Conclusions/Observations

– If an asset can be acquired and economically justified -- Buy It

– Choose your partners carefully
  • Impact on parent bottom line
  • Ability to change relationship over time
  • Ability to make decisions quickly

– The structure of a Joint Venture has just as much of an impact on its long term success as the external business conditions