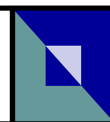

JKS READING ROOM

New dawn for

pharma in Japan

New dawn for pharma in Japan

Despite their long history and dominance of the pharma market from manufacturing through to distribution, Japan's pharma giants have no guarantees of long-term survival. Although mergers and acquisitions, especially with foreign partners, are viewed with suspicion in Japan, Dr Valentin Dimov and Masahiro Hosoda predict the era of mega-mergers may not be that far off

It has become almost a given that publications covering Japanese pharma like to remind their readers that Japan is the second largest single-country pharma market in the world – at least in volume terms. However, in many other aspects, it is not the second at all: the number of domestic innovative drugs is negligible, the management structure of Japanese pharma companies is outdated and, most worryingly, the frequency of mergers and acquisitions is lagging far behind the developed markets in North America and Europe.

Numerous pundits lament the sorry state of Japanese pharma and naggingly urge it to follow, copy, and imitate global market trends, posing the question of how this relates to the country that has one of the most sophisticated manufacturing sectors in the world? How come it's only the pharma industry (and reportedly the aerospace sector, too) that is running a negative trade deficit? Are the managers of the ultra-successful Japanese automobile industry so very different from their pharma counterparts? Are M&As really avoided by Japan's pharma sector or is the number of M&As small simply because potential targets among Japanese pharma companies are not attractive enough?

The Chugai incident

The tracking of pharma M&A activity in Japan started in late 1980s, according to surveys by the Japan External Trade Organization. Until 2005, only one truly large-scale deal had been successfully concluded – that of Chugai Seiyaku KK joining the Roche Group in December 2001. (See Figure 1).

By the mid-1990s Chugai Seiyaku KK was a medium-sized, moderately successful, listed but family-run business, and known mainly to the general public for its non-drug products – a health drink and an anti-cockroach fumigant. Yet, back then the company had one of the few Japanese blockbusters: the anticancer product Picibanil, reportedly given during the 1980s to every oncology patient in the country. Chugai also tried to innovate and consistently invested nearly 20% of its sales in R&D – by far one of the highest levels among Japanese pharma companies – and for a short period it subsidised the Tokyo Institute for Immunopharmacology (based on Roche's Basel Institute of Immunology). The company's focus on recombinant technologies resulted in the of launch of two breakthrough biotechnology drugs in the early 1990s: Epogin (recombinant human erythropoietin) and Neutrogin (recombinant human granulocyte-colony stimulating factor).

Based on these successes, therefore, why was the news of the proposed merger with Nippon Roche such a surprise? Traditionally, Japanese pharma promote from within – people with experience in the industry. In this instance, the deal was between a very traditional Japanese company and the Europe-based multinational, with two US banks as advisors. It was conducted in an exemplary culture-sensitive way: Nippon Roche was merged with the surviving entity,

Major M&As in the Japanese pharmaceutical industry (1996-2005)

Year	M&A Deal	At present
April 1996	BASF Japan - Hokuriku Seiyaku	Abbott Japan[1]
April 1999	Japan Tobacco – Torii Seiyaku	Torii Seiyaku[2]
October 1999	Mitsubishi Chemical - Tokyo Tanabe	Mitsubishi Seiyaku
January 2000	Nippon Boehringer Ingelheim - SS Seiyaku	SS Seiyaku[3]
June 2000	UCB Japan - Fujirebio (pharma business)	UCB Japan
January 2001	Nippon Schering - Mitsui Seiyaku	Nippon Schering
October 2001	Mitsubishi - Tokyo Seiyaku - Welfide[4]	Mitsubishi Seiyaku
December 2001	Nippon Roche - Chugai Seiyaku	Chugai Seiyaku[5]
April 2002	Dainabot (Abbott Japan) - Hokuriku Seiyaku	Abbott Japan
July 2002	Suntory - Daiichi Seiyaku	Dai-ichi Sankyo Holdings
August 2002	Taisho Seiyaku - Toyama Chemical	Taisho Toyama Seiyaku
October 2002	Ajinomoto - Shimizu Seiyaku	Ajinomoto
January 2003	Merck Japan - Banyu Seiyaku	Banyu Seiyaku[6]
September 2003	Rotho Seiyaku - Morishita Seiyaku	Rotho Seiyaku
October 2004	Yamanouchi Seiyaku - Fujisawa Seiyaku[7]	Zepharma Seiyaku
April 2005	Yamanouchi Seiyaku - Fujisawa Seiyaku[8]	Astellas Seiyaka
September 2005	Daiichi Seiyaku - Sankyo	Daiichi Sankyo Holdings
October 2005	Teikoku Hormone Mfg.- Grelan Seiyaku	Asuka Seiyaku
October 2005	Dainippon Seiyaku - Sumitomo Seiyaku	Dainippon Sumitomo Seiyaku

Notes: 1. Re-sold to Abbot Japan in 2002; 2. JT consolidated subsidiary; 3. NBI is the majority stockholder; 4. Formed from Yoshitomi Seiyaku and Green Cross Corporation; 5. Member of the Roche Group; 6. 100% owned by Merck; 7. Merger of OTC business; 8. Merger of Rx business.

Source: Companies, original research

Figure 1: Although 2005 saw an increase in the number of mergers, because these were between domestic companies they are of limited importance in terms of the market dynamics.

Chugai Seiyaku, and only after Roche acquired a controlling stake. Any mention of an M&A had been carefully considered and the transaction was represented almost as a partnership, a new business model – dissimilar to any in the history of the Japanese pharma industry up to that point.

By the time of the acquisition, Chugai ranked fifth in Japan with sales of about US$2 billion; it had climbed to the third position by 2004. Even without the contribution from the skyrocketing sales of Tamiflu, the 'new' Chugai appears to be successful. Yet, it is seen as atypical and remains an isolated case.

The vertically-integrated towers fall

Surprisingly, the Japanese pharma industry is not young – Takeda can trace its origins back to 1781 in the traditional pharmacists' district of Doshomachi in Osaka. However, real scientific progress and a distancing from Chinese herbal medicine were only made in the 20th century, especially after 1960 with the enforcement of the Pharmaceutical Affairs Law (PAL). The long history of Japan's oldest pharma companies has given them immense influence over the domestic market. Until very recently, Takeda, Sankyo, Shionogi, Fujisawa and Tanabe were powerful, fully vertically integrated conglomerates, each having prescription and OTC drugs, animal drugs, agro-chemicals, reagents and massive wholesale and distribution networks. Moreover, the majority of them began as wholesalers and for decades their control over distribution channels, shelf space in drugstores and pharmacies has continued to provide them with a considerable advantage over any foreign or local competitors, thus giving these vertically-integrated conglomerates the status of towers in the landscape of Japanese pharma. From the mid-1950s, all overseas manufacturers had no other choice but to enter into partnerships and co-marketing agreements with the vertical Japanese conglomerates – relationships that are maintained even today, long after the capital requirements for participation in local JVs were abolished and despite many foreign companies having built up impressive sales forces of their own.

But the vertical towers are very unlikely to survive in the longer term. In spite of heavy restructuring in the past few years, including divesting of non-core operations (a restaurant business in one case), some

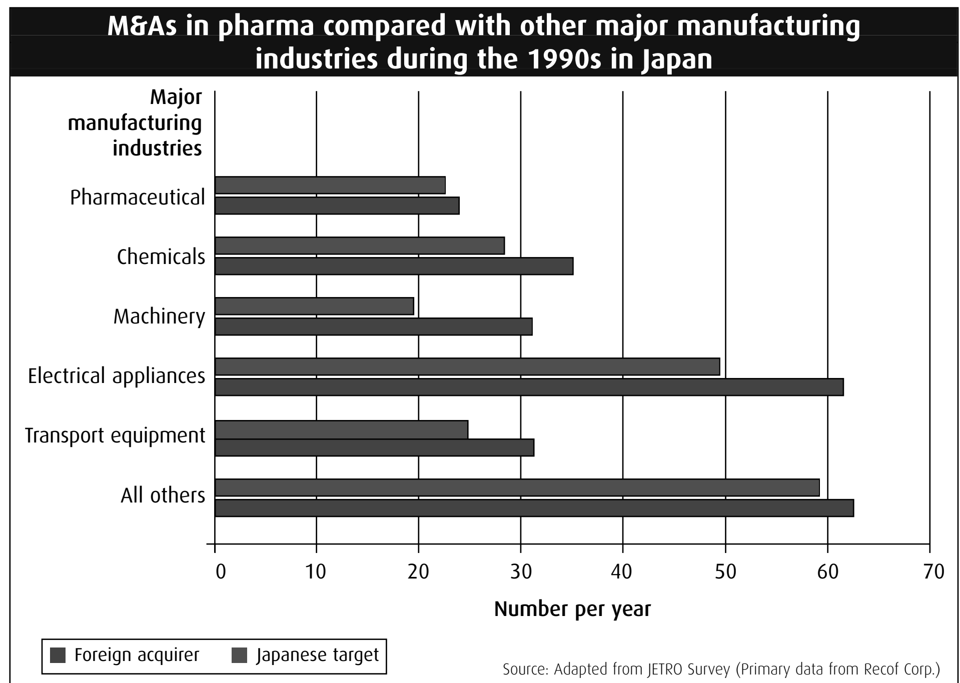

Figure 2: The pace of pharma transactions was slower in the 1990s compared with other industry sectors.

companies were ultimately forced to merge. For example, Fujisawa was swallowed up by Astellas, Sankyo merged Daiichi and Tanabe attempted to form a new company with Taisho. What will the fate of Takeda and Shionogi be? Even the fate of the two remaining domestic vertical giants Takeda and Shionogi is not beyond conjecture now.

The pharma M&A stage

The entire pharma M&A environment in Japan consists of three parallel, although not necessarily mutually-dependent processes, involving both foreign and domestic players. Foreign companies are considered to be those headquartered abroad and funded predominantly by non-Japanese capital (regardless of whether or not they have a wholly-owned subsidiary in Japan), while those domestic companies are understood as being founded and incorporated in Japan, with Japanese stockholders in the majority.

- **Domestic-domestic M&As (between Japanese pharma companies)**. There are few mergers that stand out, including Astellas and the recently launched financially and structurally complicated Daiichi-Sankyo Holding KK. Yet, the majority of the domestic deals are of limited importance in terms of the market dynamics – the acquisition of Torii Seiyaku by Japan Tobacco went almost unnoticed, as did the recent merger of Grelan Seiyaku and Teikoku Hormone.
- **Foreign-domestic M&As**. This type of transaction generates most hype among foreign and Japanese market watchers, and the trend is expected to increase from this year when a number of financial restrictions, including the use of stock in takeover bids, will be lifted. No other M&A deals come near Chugai in terms of size or impact on the industry. During the 1990s, the pace of the transactions taking place in pharma (including manufacturing and distribution), was slow compared with the other major manufacturing sectors (see Figure 2). The trend of foreign pharmas obtaining full control or a majority stake in Japanese companies peaked around 2000-1, with a cluster of acquisitions by Europe-based multinationals.
- **Foreign-foreign M&As (between the subsidiaries of the overseas manufacturers).** Ironically, this is the commonest type of M&A and, as far as the foreign pharma companies in Japan are concerned, the last ten years saw a series of changes – many of them are permanently preoccupied with joining forces with the local subsidiaries of the merged entities. The undisputed record-bearer appears to be Sanofi – originally a small company with only a 30-year history and maintaining a handful staff in Tokyo that has become the successor of the vast remnants of Fisons, Hoechst, Marion Merrell Dow, May & Baker, Rhone-Poulenc, Rorer, Roussel Uclaf, Synthelabo, Sterling Winthrop, Pasteur, and Aventis. However, the aggregation of foreign subsidiaries does not always

translate into expanded market share – in spite of its impressive pedigree, the new Sanofi-Aventis KK, scheduled to be launched formally on January 1, 2006 will rank only 13th among all pharmas in Japan.

M&A as a dirty word

A lot of what is already said about the sluggish pace of pharma M&A in Japan is at least correct in some respects: the cumbersome regulations, slow deregulation, bureaucracy, cross-holding of shares, lack of M&A specialists, and too many distracting non-core businesses. However, all those reasons are of secondary importance – cultural factors should not be overlooked. Following the wave of very high-profile hostile takeover attempts in early and mid-2005 in the IT industry that were financed by foreign investment banks in Tokyo, M&As entered the lexicon of the general public as a dirty word – something aggressive, alien and, hence, requiring a counter-offensive. Companies of various persuasions have been feverishly adopting 'poison pill' provisions and, more recently, some elders of industry sternly lectured on the incompatibility of the more aggressive forms of M&A with the Japanese style of management, which is famed for providing the economic successes of Japan in the post-war period. However, in contrast to the mobile communications, IT, finance and other leading sectors, a hostile takeover bid placed for a Japanese pharma company is not expected in the near future. Even the remaining vertical towers seem unattractive.

Doshomachi Seiyaku?

Has the era of Japanese pharma mega-mergers already arrived? Since 2001 the only significant foreign-domestic deal is the formation of Banyu Seiyaku, a Merck subsidiary, which took a decade to complete. By contrast, 2005 saw truly large-scale mergers taking place within the top five pharma companies in Japan and, for the first time, resulting in realignment of the industry.

Evidently, as in the preceding period of the 1990s, the pharma M&A processes in Japan are moving at their own sluggish pace, which, while appearing sluggish, reflects the natural evolution of the domestic manufacturers. The alternative scenarios are very limited as the private investment bank Morgen, Evan & Co, recently commented: "Either they must merge to achieve critical mass or be swallowed up in due course." So far, the tendency for domestic-domestic M&A prevails.

What would happen if all the pharma companies based in the historic Osaka district merged and formed a new entity – say Doshomachi Seiyaku? Would the new giant be capable of competing globally with its arsenal of brands, its pipeline and distribution prowess? While this is a far-reaching assumption, it cannot be denied that over the next few years Japanese pharma shall undergo profound changes.

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