STRATEGIC CASE STUDY NOVEMBER 2018 EXAM ANSWERS

Variant 1

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SECTION 1

Requirement 1 – strategic benefits

Combining the revenues from Novak and Poutire would give the merged entity roughly 11% of the pharmaceutical market by revenue. Being largest could create economies of scale in areas such as marketing and distribution and could give the merged company an advantage over larger competitors such as Horter and Groenne. The merger may enable Poutire to start selling Novak's patented drugs to new markets in which it has stronger distribution channels. Novak could also permit Poutire to start using its trademarks for the sale of off-patent products that were developed and trade-marked by Novak.

The merged entity will be able to spend more on research and so be able to develop new drugs more quickly than at present and more quickly than competitors. Many new drugs are likely to displace products that are already on the market for indicated conditions and so the new drugs could further increase market share. The fact that Poutire does not currently have a significant research and development programme could be advantageous in avoiding conflict and disagreement over the focus for research. Poutire's experience of selling off-patent drugs which will generally be older formulations, may give it insights into concerns expressed by the medical profession about existing drugs and the areas where new products would be welcomed by physicians.

Novak and Poutire have different, but potentially complementary, business models. Novak has considerable expertise in developing successful new products and in bringing those to market, while Poutire has built itself on the basis of manufacturing and distributing off-patent pharmaceuticals. Making best use of this potential will require some care, though. Poutire may be selling off-patent products that were originally developed by Novak in competition with Novak, which may require some rationalisation. It may also prove difficult for Novak to make a commercial success of the launch of new products if Poutire is undercutting it on price in the sale of effective off-patent alternatives.

Poutire is also involved in non-pharmaceutical markets that could be expanded after a merger. Poutire derives approximately 20% of its revenue from "other healthcare"

products and also manufactures over-the-counter remedies. The merged entity will have the financial strength to expand in those areas, possibly exploiting contacts with hospitals and health service customers to develop sales. Novak may also be able to apply its research expertise to the development of medicines for the over-the-counter market, using its reputation as a leading pharmaceutical brand to promote these new products.

Requirement 2 – trends in share prices

In theory, the price of a quoted company is set by the stock market and, in an efficient market, the price reflects all available information. If that is the case then there would be little need for negotiation concerning prices. At its most basic level, weak form efficiency suggests that the market price reflects all past information from trends and historical movements in share prices. It could, therefore, be argued that past trends should be ignored because market prices already reflect the information in those trends and so it would be double counting to include those in any discussions. It is unlikely that either board will take such a passive approach to negotiating their shareholders' share of the merged entity. At the very least, they will wish to convince their shareholders that they are receiving the best possible deal.

Both boards are likely to argue that the past trends do not reflect the potential synergies and speculative forces that might arise because of the proposed merger. These could only be incorporated into past trends if the market could have anticipated the merger. The boards of both Novak and Poutire will wish to argue for a larger share of the merged entity and one way to do that would be to argue that their share price is temporarily undervalued while the other company's is temporarily overvalued. For example, it might be argued that the merger will create synergies and that one company's shareholders deserves a larger share of those expected benefits. Similarly, it might be argued that speculators are investing heavily in one of the companies in order to benefit from the other company's need to buy those shares, artificially overstating the share price on a temporary basis in the process.

There are some obvious arguments about the past directions that share prices have taken. Poutire's board might, for example, argue that past trends suggest that they have the more robust business model, which would suggest that Poutire's share of the merged entity should be increased. The share price itself has been volatile, but it has varied around a slight upward trend over time. This suggests that Poutire has created wealth and stability for its shareholders and will hopefully continue to do so into the future of the merged entity. Such an argument will have to be reviewed for consistency, though, and take account of any other factors such as dividend policies. If Poutire's upward trend in share prices can be attributed to the retention of retained earnings rather than a fundamental commercial strength then its board's credibility will be undermined.

Novak's board may use its knowledge of the pharmaceutical industry to argue that long-term trends in share prices tell us very little about the underlying strength of the company. Novak's share price has fluctuated around a slow but steady decline over the past five years, but that may simply reflect the nature of doing business as an innovator in this industry. Typically, even large and successful companies have very long product lifecycles that are linked to the long process of developing new patented drugs and bringing them to market. Most major pharmaceutical companies have only a few successful products at any given time and even those will have diminishing patent

protection. It may be that a declining share price means very little even viewed over the medium term.

SECTION 2

Requirement 1 – ethical arguments

The CIMA Code of Ethics provides us with a useful starting point.

Failing to report puts us in breach of the concept of integrity, which requires Novak to be straightforward and honest in its dealings. We cannot use the fact there could have been other explanations for the dizziness to justify ignoring the possibility that patients who take Vartizin at the same time as Frondat may suffer adverse reactions. The small number of cases may not reflect the severity of the problem because not all patients who suffered dizziness would have informed their doctors and some of the doctors who were notified may not have reported the cases to Novak's drug safety hotline. We have had eight cases in which qualified medical practitioners have reported that they may have observed a reaction between Vartizin and Frondat and nothing can alter the fact that we have received those notifications.

We also appear to be in breach of the concept of objectivity, which requires us to set aside conflict of interest in the application of professional judgement. We have been notified of a specific concern that our new drug may react to a particular antibiotic and we cannot simply disregard those reports because it may inconvenience Novak. The nature of the two drugs means that a patient may take Vartizin for many years and could find it necessary to take a short course of Frondat at some point during that period. The potential interaction between the two drugs must be investigated, even if Novak's board wishes to argue that the risks are tolerable.

The concept of professional competence and due care requires that there be an ongoing commitment to professional knowledge and skills. These results could offer Novak an opportunity to develop additional understanding of interactions between different products, which may not be confined to Vartizin and Frondat. There may be wider implications for understanding interactions between different families of drugs that will be missed if Novak suppresses these notifications. Apart from risking patient welfare, this decision to ignore the reports could also cost Novak the opportunity to develop knowledge that could have valuable commercial benefits.

This also appears to be a breach of professional behaviour, which requires compliance with laws and regulation. There is a protocol for dealing with reported side effects and it appears that Novak is potentially in breach of that regulation. Apart from the direct risk of causing side effects, this behaviour could undermine confidence in prescription drugs. Patients may suffer harm if they become tempted to refuse treatment because of fears that their medication may harm them and that could lead to their underlying health problems worsening.

Candidates would have been credited for valid arguments against the need to disclose. For example, the concept of integrity would also suggest that Novak should not act recklessly by reporting a possible problem on the basis of very slim evidence. Doing so may disrupt the ongoing treatment of many patients if they are presently taking Vartizin and the drug is withdrawn. Novak's management should not report its concerns unless there are valid and material reasons for doing so. Simply making a defensive report in order to enhance the company's reputation would reflect a lack of integrity.

Requirement 2 – relationship with regulator

As a matter of routine, Novak should maintain strong informal links with the regulator, with designated managers maintaining contact with their counterparts at the regulator. Such links can then be used to ensure that informal advice is obtained concerning marginal cases such as this, so that Novak can point out that it took the regulator's advice in the event that there are ever problems with Vartizin. The advantage of this approach is that the regulator will give definitive advice as to whether a formal report is necessary. In the event that it is then Novak will be prevented from making a potentially expensive mistake. If the advice is not to file a report then Novak will be protected by the fact that it sought informal advice and so there has been no real lack of transparency.

Novak could further protect itself by conducting its own investigation into those reports. Novak could then contact each of the doctors who submitted reports and gather additional information, such as seeking opinions as to whether the symptoms could have been attributable to, say, allergy to Frondat rather than a reaction to Vartizin. The results of such an investigation would then enable Novak to demonstrate that it had taken the doctors' reports seriously. The evidence gathered might also force the company into taking action, such as making a formal report, in the event that the problem is more severe than it had imagined.

Novak could also conduct a more low-key study into the interaction between the two drugs implicated in these concerns. It could contact the 18,000 doctors who have prescribed Vartizin in order to establish whether any of those patients had taken Frondat in conjunction with it. Those doctors who had experience of both drugs being taken together could then be asked to indicate whether there had been any reports of problems. The fact that Novak has taken this initiative will enable it to demonstrate that it has taken the possibility of a problem seriously. Ideally, there will have been a large number of cases in which there were no reported problems.

Finally, Novak could take a preventative measure, such as warning doctors that they should exercise caution in prescribing Frondat to patients who are already taking Vartizin. Frondat is not a particularly common drug and so it should not create any great difficulty for doctors in prescribing an alternative. All of the concerns that have been expressed involved the combination of those two drugs and so Novak will also be able to demonstrate that it acted swiftly and responsibly. It will also cost Novak little or nothing in terms of revenues because patients tend to be prescribed Vartizin in the long term for chronic illness and so this warning is more likely to displace sales of Frondat.

SECTION 3

Requirement 1 – Non-executive directorships

Most of the merged entity's non-executive directors will have come from Poutire. That could mean that the non-executives will have insufficient understanding of the governance issues arising from developing and testing new drugs. That lack of understanding could be further complicated by the fact that the executive directors will also come from Poutire and so there could be a lack of understanding across the whole board with regard to oversight of the former Novak. The lack of understanding from the non-executives could undermine important responsibilities of the board committees, particularly the audit committee. It will be more difficult to discharge key responsibilities associated with finalising the financial statements if the committee members do not have a suitable background.

The previous roles held by both Dirk and Dorothy probably mean that neither would be a suitable person to serve as a non-executive director. Both are heavily identified with Novak as a company, particularly Dorothy as a descendent of the founder. Their presence on the board may prove divisive and could disrupt the governance process. The two may seek to form an alliance as former leaders of Novak to protect the interests of their former employer. Also, a non-executive post is a significant demotion for both the chairman and the CEO. They may be demotivated if asked to serve in a relatively humble capacity.

Poutire should provide the non-executive directors with an induction programme to ensure that they understand the strategic management of an entity like Novak. It would be worth investing in having external consultants study Novak's strategy and corporate history and deliver this as a workshop. The members of board committees should receive further specific training on issues that might equip them to discharge their responsibilities more effectively, such as the financial reporting issues associated with accounting for research. There should also be a programme designed to introduce the non-executives to senior management from the business units acquired from Novak so that a mutual trust and understanding can be developed.

It would be preferable to give Dirk and Dorothy roles that were a better reflection of their previous status as CEO and Chairman. Dirk could, for example, be asked to join the board in a special capacity such as executive director in charge of research. That would help ensure continuity of the strategic management of a Novak function that Poutire should be keen to maintain. It would also make sense to give Dorothy a more prominent role, given her family connections. It would even make sense to have her serve as Chairman. Poutire could retain its former chairman as deputy chair to ensure that Dorothy was not given excessive power.

Requirement 2 – risks to achieving commercial benefits

Acquiring Novak appears to be motivated largely by a desire to acquire an active and expert research team. The most obvious risk to that ambition is that Novak's researchers may not wish to remain with the merged company. Poutire could lose both the expertise and a great deal of the intellectual property that the research staff could take to any competitors who hire those scientists. The fact that Novak is the junior partner in this merger may lead the research staff to fear for their futures, with worries that their jobs will either be insecure or that their research activities will no longer be funded to the same degree as before. That risk is compounded by the fact that Novak Research will be managed by Poutire's former head of product development.

The other major commercial benefit is the creation of a large and potentially dominant pharmaceutical manufacturer. The hope is that Poutire will acquire a significant increase in its manufacturing capacity and will then use its existing distribution network to sell that increased output. The danger is that the rationalisation process could disrupt production at a cost in terms of market confidence. Poutire's factories may not be able to match the quality and efficiency of Novak's in manufacturing the latter's products, which could further undermine confidence.

The most immediate priority is to mitigate the loss of the research staff by ensuring that there are no doubts about their job security or future prospects. Ideally, department heads should be called together to discuss future research activities and be reassured that research activities will continue as before. Staff might be encouraged to stay with financial incentives, such as stock options that will only vest if they remain with Poutire and Novak. The importance of the subsidiary could also be underpinned by giving the CEO of Novak Research a seat on the Poutire and Novak main board.

The risks of disrupted production would be best avoided by avoiding making hasty decisions about significant changes. It might be possible to justify maintaining production as before, with no closures or loss of capacity. After all, neither company would have had significant redundant capacity before the merger. In the first instance, it should be sufficient to avoid the duplication of effort associated with making off-patent drugs at two locations. Certainly, communication is key. Production staff should be informed of Poutire's plans, particularly at the former Novak factories.