Negotiating and Structuring Strategic Alliances

The past decade witnessed a growing strategic shift toward pharma/biotech alliances, a move driven by key challenges facing both parties. On one hand, economic pressures are making traditional double-digit profit growth increasingly difficult for big pharma to maintain. On the other lies a growing determination of biotechs to increase the value they can realize from their intellectual property.

Despite the rising importance of alliances, historic trends are less than encouraging when predicting the likely outcome of any given partnership. Recent surveys suggest a failure rate of 40–50%. In addition to those that fail, many alliances fall short of achieving maximum value for the partners involved. That frequently results from suboptimal structuring rather than shortcomings in either partner — and a failure to appreciate and extract the entire potential benefit that could be attained.

Environment for pharma/biotech alliances. The nature of biotech value has undergone a noticeable change in recent years. Instead of the gradual increase witnessed during the 1990s, a steep increase has occurred in the value of late-stage developments, skewing value away from early-stage projects. Two main factors have driven this change: the heightened focus of big pharma on late-stage opportunities, coupled with intense competition for biotech partners who can fill late-stage pipelines, and a vertical expansion of biotechs into late-stage development and commercialization to capture more value.

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Barriers to implementation. The key barriers to implementing change and building alliances that are truly beneficial to both parties are threefold. First, over-optimistic biotech management may continue to create an unrealistic perception of value, thereby sustaining the cycle of funding unavailability for early-stage projects and higher risk of failure.

Second, analysts may maintain their skepticism about biotech’s ability to quickly generate cash flow and repeat successes from technologies and products. Further education of the investment community is
needed on the opportunities (and risks) offered by biotech–pharma partnerships. Reducing the high volatility of biotech stocks and increasing the value of biotech–pharma deals in the eyes of investors would provide the incentive to form such partnerships.

Third, big pharma may continue to focus its short-term growth strategy on seeking and competing for the few late-stage projects with high sales potential. The stakes are already growing dangerously high in that game. A proposed reduced-risk strategy, in which big pharma lays the foundation for future sales revenue by investing in early-stage alliance projects, will not succeed unless pharma management commits staffing and resources to implement the change.

The future competitive environment may see escalating R&D costs that force big pharma to compete with biotechs for equity market funding. Alliances involving closer cooperation and cross-reliance across all development stages would be crucial to the well-being of both.

Too few partnerships successfully achieve the objectives of both parties involved. A primary cause of underperformance is the failure to regard alliance management as a core business or corporate capability. The “Increasing the Odds of Success” box lists some other factors.

**A 10-Step Negotiation**

Our experience with copromotions and collaborations between big pharma and biotech in North America and Europe reveals that certain negotiation strategies and tactics are essential to maximizing the value of a deal. There is no “one size fits all” approach, but the 10-step process described below can provide a basic framework for successful collaborations. Figure 2 illustrates this framework for negotiating strategic alliances. This 10-step approach is not the answer to a successful collaboration. However, it can provide a helpful framework to guide questions that potential partners will want to consider when negotiating effective deal structures for mutual benefit to both companies.

**Maximize alternatives at the outset.** Whenever feasible, biotech companies in the process of selecting licensing partners are keen to assemble multiple bidders for auctioning opportunities. Maintaining credible alternatives for as long as possible is a key strategy to maximize negotiating leverage. If multiple bidders cannot be fielded, the outlicensing party should convey the message that a go-it-alone strategy is being considered. Such an approach should also be adopted when the desired licensing partner has a particularly sought-after therapeutic or marketing strength or if it does not otherwise make sense to seek multiple bidders.

Companies adopting a go-it-alone strategy must ensure that bidders do believe they can (and will, if necessary) finance and manage their drug projects at least into the next stage of development. Generally speaking, if a potential partner believes the company has an acceptable fallback alternative, it will bid higher and work harder to meet its needs.

**Term sheets: lofty “heads of terms” visions or precise deal terms?** The particular circumstances of a deal will dictate whether to remain conceptual or focus on specifics during early negotiations. In general, term sheets should be based on precise terms (implying that conflict should be faced sooner rather than later) if either your leverage or alternatives are expected to diminish substantially over time of the negotiations.

Among other benefits, more precise term sheets serve to identify and address each party’s key issues — those they are not prepared to complete a deal without. They provide a gating function that enables both parties to condition exclusivity based on roughly resolving a certain number of issues. Determining when to push for precise terms is driven by the knowledge of when to fight and when to flee (and fight another day).

**Identify conflicting objectives.** Whether a big pharma or start-up biotech, each company will have diverse internal views on and interests in the benefits and burdens of a potential collaboration. These views may differ to varying degrees with those of the potential licensing partner. Be opportunistic about such conflicts, and realize that they can be used to your benefit. For example, some opposing team members may prefer high initial milestone payments at the expense of lucrative but less certain back-end payments. When negotiating differences, it helps to remember that compromises come in many forms. Each party may be prepared to make value concessions.

**Trust, but verify.** Reconfirm how basic collaboration objectives will be achieved. A

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**Figure 1. The biotech value curve**

**Figure 2. Ten-step framework for successfully negotiating strategic alliances**
Increasing the Odds of Success

The failure of so many biotech–pharma alliances can be attributed to a number of factors.

Assumption of success. This is unrealistic in an industry where failure must be anticipated. If failure is defined and planned for, corrective action is more effective and the chances of success are higher; or, if the alliance must be dissolved, the damage to each partner can be minimized.

Unclear objectives. Alliances must be structured to meet clear goals. Defining both partners’ objectives and communicating them throughout each organization is essential.

Inadequate skills base. Alliance management is characterized by negotiation with equals rather than delegation of duties. A specific management skills set is prerequisite.

Cultural issues. Understanding the partner, its work methodologies, and its business philosophy is critical to the success of any alliance.

Company and its advisors should confirm the basic deal points that they believe were agreed upon — and the way in which they will become operative. Collaboration deals generally commit the partners to certain actions, including sharing development and promotion costs, paying event or performance milestones and royalties, and indemnifying one another for various liabilities such as patent infringement.

Those financial commitments often can run into hundreds of millions of dollars. To better ensure payment and verify the creditworthiness of a licensing partner, it is wise to obtain a financial guarantee from bona fide operating companies and investment-grade parents, if possible. That may be particularly necessary with privately owned businesses and independently operating subsidiaries of publicly traded companies.

Sometimes, companies select a particular partner for collaboration because of its primary focus on a specific therapeutic area or technological capability. The issue then must be addressed as to what happens if that partner is subsequently consolidated into a larger group that does not share the therapeutic focus. Such a situation illustrates the need to verify change-in-control provisions and termination scenarios.

Compromise on noncore issues. Successful collaboration requires the ability of both parties to work together postsigning to develop, approve, and market a drug. Prospective collaboration partners will want to ask themselves constantly whether they can really work together on the project. As with merger-and-acquisition (M&A) deals, collaborations have a high incidence of failure — a fact that should prompt prospective partners to assess seriously whether they can form a successful joint venture. Quite often, larger collaborations involve the creation of representative committees that address key task areas such as regulatory, product approval, and marketing issues. Such committee structures often develop their own dispute resolution procedures. The relative willingness of each partner to accept an erosion of “sovereignty” frequently determines how compromise and creative problem solving will be perceived during and after the negotiation stage.

Joint ventures generally involve at least two partners contributing significant resources (whether cash, intellectual property, manufacturing and marketing capabilities, or people), but only a fraction of each partner’s overall resources will be represented. Usually collaborations do not put in place a single corporate/partnership entity that holds those resources. If partners cease to cooperate, the division of means can result in a diversion of capabilities and support. This scenario illustrates why postsigning compromise is integral to creating a platform for continued cooperation and success. Ultimately, the final goal always should be considered: that is, trying to establish a collaborative, problem-solving relationship rather than attempting to win at all points.

Adapting to cross-border circumstances. Invariably, the cross-border nature of many collaborations requires both partners to understand the opportunities and restrictions imposed by their respective countries. For instance, when planning copromotion or comarketing, consider that local competition laws in several European Union countries may bar partners from engaging in copromotion of the same drug under one brand name. In that case, comarketing alternatives need to be reviewed.

Various laws in the United States may restrict the parties from indemnifying one another for aspects of product liability exposure to the extent that negligence may be involved. For issues like that, companies may need to examine remedies designed to alter or undo what the local law may otherwise impose by default.

Try to reduce gamesmanship. Each partner will understandably remain focused on how to maximize its individual economic returns while minimizing its investment and efforts. Spending time structuring away opportunities for gamesmanship in initial negotiations can pay off in the long term. One example is developing opt-out and opt-in provisions. In several recent, publicly announced collaborations, the inlicensing partners received the choice of opting out of further development for specific drugs or therapeutic applications. However, they retained the option to opt back in at a later clinical development stage (with reimbursement to the outlicensing party for back development costs plus a “risk of capital” factor). The benefit is a reduced opportunity or incentive for either party to force a one-time “in or out” decision.

It is also important to determine each partner’s detail obligations. Collaborations in which both parties possess marketing functions ensure that both will spend time designing rational detailing obligations and, importantly, appropriate financial penalties to avoid “freeriding” problems on successful drug rollouts.

Work to a realistic schedule. A realistic “all hands” timeline for contract execution will best focus the efforts of all parties and advisors. Often during periods of lower volatility in the capital markets, mid-cap and smaller-cap companies want to accelerate the dissemination of “good news” collaborations. That goal must be balanced against proceeding too quickly, which may lead to the sacrifice of strategic goals and implementations.

Rethink the need for complexity. Keeping a deal structure simple is often beneficial; all the “bells and whistles” are not always necessary for an agreement to be successful. Overelaborate deal structures may involve the inlicensor granting the outlicensor an opportunity to copromote one or more possible drugs that the inlicensor is developing. That type of quid pro quo is logical from a certain point of view, but it is
not suited to every deal. Those on fast-track timing, for example, or collaborations on very specific therapeutic opportunities may be cluttered by such inclusions.

A minority of collaboration agreements between big pharma and biotech are accompanied by a financial obligation of the big company to purchase the equity of the smaller over time. Such equity-support programs can introduce an added layer of complexity. Apart from the specific financial issues, both partners would need to consider corporate governance matters and, if the biotech is traded on U.S. capital markets, possible federal securities “controlling person” liability issues.

Weigh everything against the postcollaboration world. Always consider who wins and who loses — and how they win and lose — when a strategic alliance comes to an end or terminates abruptly. In any collaboration agreement, each partner should ask, “How do we compete against one another when this ends?” It is also important to consider each party’s right to use resulting intellectual property advances. Many collaborations generate significant new scientific discoveries, and how each partner is entitled to use those should be considered early on.

Structuring Alliances

More unlike M&A activities, alliances are a process and not an event that concludes when the deal is finalized. A structured approach to their management is crucial.

Clearly, the objectives, responsibilities, and governance framework of an alliance must be agreed from the outset. However, attempting to overstructure the detailed progression of an alliance during the negotiation phase is counter-productive because that aspect of the alliance demands flexibility. Only by jointly reviewing and adapting to circumstances and market conditions will each party best achieve its objectives. The ability of management to respond rapidly and effectively therefore adds value to both parties, and developing that ability as a corporate capability will strengthen any company’s value proposition.

The key requirements for alliance management teams include full-time commitment, relevant expertise, empowerment to resolve issues, close communication with partner organizations, and incentives to achieve alliance objectives.

Several other key areas must be considered. Alliance objectives must be clarified up-front. The alliance structure should not be fixed until late in the negotiation process, once the best way to meet each party’s objectives has been determined. Metrics to evaluate success are crucial: “What you measure is what you get.”

Realizable benefits must be assessed accurately. Ensuring that both partners have a clear understanding of the benefits arising from their alliance allows resources to be focused on the joint investment.

We also recommend a regular formal review process to assess the health and progress of the alliance relative to preagreed milestones and objectives.

Determinants of deal value. Figure 3 illustrates three key variables in the deal structure that determine the total value realized from an alliance. Certain “hard factors” are built into the alliance contract following negotiations (up-front payments, milestones, royalties, equity investment, and so on). “Soft factors” will come into play related to management of the alliance and the quality of the relationship.

Financial modeling carried out by investment banks and financial analysis is an attempt to rationalize value by predicting future market drivers, estimating sales potential, and quantifying the risks involved. This results in a calculated net present value (NPV) for the deal. Although it provides a useful anchor for assessing the value of a deal and determines a range for its upper and lower limits, the NPV has limited influence on the actual value achieved by either party.

Historic trends show that the fundamental principle underlying a deal’s worth is that of supply and demand. As seen with the biotech value curve, the price paid is determined predominantly by the ability of each party to bargain for the best deal. Even so, supply and demand only determines value derived from hard factors.

Significant benefits frequently overlooked and underexploited are realized through the process and associated soft factors. This is where companies could do much to capture extra value: by optimizing the negotiation process to allow deals to be structured flexibly and imaginatively, and by striving to meet their partners’ objectives as well as their own, thereby enhancing the alliance relationship. That way, each party’s objectives are achieved through an optimal strategy, ensuring that both extract maximum value from the partnership.

A Fact of Life (Sciences)

BioPharm alliances are an essential element of corporate strategy. A number of factors, largely relating to the ability to structure partnerships optimally, determine...
The now infamous story of the largest product deal in biotech — Bristol-Myers Squibb’s $2 billion bid for a 20% stake in ImClone’s lead cancer drug candidate, Erbitux — opened a Pandora’s box of suspicion and distrust that delivered a mighty jolt to the equity markets in general. The ImClone debacle, following closely on the heels of the unrelated Enron scandal, proved to be far more than just a product’s failure to pass muster with FDA. It challenged the very surrogates for value that Wall Street has treasured since the biotech industry came into being. ImClone had everything: a good management team (the Waksals have been at the helm throughout the company’s 18-year history); an all-star board of directors (including John Mendelsohn, MD, president of the M.D. Anderson Cancer Center and developer of Erbitux); important and potentially lucrative area of therapeutic focus (cancer); late-stage compound (Phase III); large and good partners (Bristol-Myers Squibb); the “best deal” with Bristol ever done by a biotech company; and lots of money. Notwithstanding all those surrogates, investors lost 70% of their investment in ImClone in less than a month.

By the end of January 2002, the biotech industry saw its value plunge by 15%, with continuing reverberations. ImClone enjoyed a brief resuscitation in late February when it looked as though FDA might accept data from the European clinical trials for Erbitux (called Cetuximab outside the United States); those were being conducted by ImClone’s European partner, Merck KGaA. But in April, ImClone’s stock gave back nearly all that it had gained when Merck KGaA decided to delay filing for Cetuximab just days after a CNBC report suggested that doctors were casting doubt about Erbitux’s ability to shrink tumors of the head and neck. By the end of April, shares of ImClone were back down in the mid teens.

Other biotech companies have fallen into Wall Street’s penalty box. In December 2001, Pharmacyclics’ Xytrin for brain metastases and Protein Design Labs’ Remitogen for non-Hodgkin’s lymphoma both received setbacks. January brought bad news for Abgenix’s ABX-IL8 for rheumatoid arthritis, Cubist Pharmaceuticals’ Cidecin for pneumonia, Dendreon’s Provenge therapeutic cancer vaccine, and Miravant’s SnET2 for macular degeneration. In March, Corixa’s “smart bomb” cancer drug, Bexxar, received a setback when FDA demanded further proof of efficacy, and in April, Genentech’s investors lost nearly $3 billion when an abstract for its experimental cancer drug, Avastin, suggested safety concerns.

Genomics under Scrutiny
Genomics companies, in particular, are under scrutiny — even those that are trying to become fully integrated drug discovery operations such as Celera, Incyte, and Curagen. Millennium Pharmaceuticals and Human Genome Sciences, biotech’s classic RIPcos turned FIPcos, have slipped dramatically from their 52-week range highs. Millennium, which saw its stock rise to $45 per share in June 2001, is now trading in the mid teens, and shares of Human Genome Sciences, which were selling for $77 last June, are also trading in the mid-teens (Table 1).

What’s up? These are savvy companies with good management and strong track records. Nonetheless, the strategies adopted by them, however forward-thinking and promising, are about products in the making, not about approved, marketed blockbusters. Right now, Wall Street is chomping on reality and reticent to buy into dreams. But when the concept of personalized medicine is no longer nebulous and we see these novel therapies entering the marketplace, the lowly status that Wall Street now doles out for which companies are most likely to excel. Companies that build on a broad base of collaborations will enjoy greater opportunities for funding and more effective risk diversification. Pursuing such a strategy in addition to understanding and implementing optimal alliance management should both improve the likelihood of success and enhance the eventual value of each partnership.

Reference