

The Winner's Curse

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One of the most widely watched stories in recent weeks has been Merck's dramatic recall of its arthritis drug Vioxx. The announcement sent Merck's stock spiraling downward because the drug generated more than 10% of the company's annual revenues.

Overlooked in all the hoopla is the fact that Merck's misfortune is the result of a change within the pharmaceutical business that has far-reaching implications for industry giants as well as their investors: the ongoing demand to create huge new growth has left industry leaders unable to place anything but giant bets.

Vioxx is what is known as a "blockbuster" drug, a remedy that can be sold to the broadest possible base of customers afflicted with a common ailment. Before the recall, Vioxx had annual sales of more than \$2.5 billion. Investors and analysts correctly realized that it's devastating news when a company loses such a large chunk of its sales.

But how—and why—did Merck allow itself to get into this situation? And what lessons can we learn that might help us understand how the pharmaceutical industry is likely to change in the future?

Merck essentially is a victim of its past success. As the company's revenues have grown, so has its need to satisfy investor and analyst expectations for ongoing, steady growth. Because new blockbuster drugs can quickly generate large revenue sums, Merck naturally focused its efforts on the biggest possible drug categories that promised the largest, fastest returns.

Almost all successful companies, whatever the industry, eventually face this problem. It comes down to simple math: to maintain a constant rate of growth, a company has to create a greater dollar amount of new growth each year.

Consider a business that has \$500 million in sales and aims to grow 20% per year. In year one, the company has to create \$100 million in new growth. After five years, it has become a \$1.2 billion company that needs to create \$200 million in new growth. After 10 years of hitting its target, it has become a \$3 billion company that must create more than \$500 million in new growth.

This is a true winner's curse. The very things that made a company great—in Merck's case the ability to discover and develop new drugs—then hinder the company's ability to continue to prioritize the sorts of opportunities that established its reputation in the first place. When Merck was a smaller company, it could happily go after a \$250 million drug. At Merck's current size, however, a \$250 million drug just doesn't cut the revenue-generation mustard.

The need to prioritize only large opportunities is one of the critical drivers of The Innovator's Dilemma. After all, from the disruptor's perspective, it's the small, immeasurable markets that

tend to serve as springboards for disruptive growth. Yet from a large company's vantage point, those emerging growth markets appear today to be insignificant blips.

Established companies get into trouble when they need to create big growth businesses fast. This causes them to feel they have to take only big bets. Ironically, placing a big bet makes it difficult for the company to adapt to market realities, actually decreasing its chances of success. Even worse, companies feel as though the only market that justifies a big bet is a large, obvious one—markets that are exactly the wrong home for disruptive innovations.

What are the implications of this line of thinking for Merck and other massive pharmaceutical companies? It seems that the blockbuster era is beginning to end, that markets of the future will be significantly smaller than those considered desirable today.

The companies that are driving this change are emerging biotech leaders such as Massachusetts-based Millennium Pharmaceuticals, New Jersey-based Medarex, and a multitude of other players that are eschewing broadly targeted blockbuster drugs in favor of narrowly focused treatments.

The Boston Consulting Group reported that biotech companies have almost two-thirds of the drugs currently in clinical trials (the development stage that precedes a market launch). Some second-tier players, such as Bristol-Myers Squibb and Abbott Laboratories, have already retrenched, cutting staff and shifting their focus. Both of those signals are leading indicators of a long-term shift whose impact will intensify over the next few years.

Why couldn't large pharmaceutical companies drive this change? Narrowly targeted markets, by definition, generate small revenues compared to the billion-dollar blockbuster markets. The large companies just couldn't prioritize going after markets that wouldn't help them meet their growth needs.

This shift poses a fundamental challenge to large pharmaceutical companies. Their processes are currently optimized around discovering and commercializing blockbuster drugs; their income statements demand that they continue to play the blockbuster game.

Some of these companies believe that the market is overreacting to scant evidence. Our belief is that large pharmaceutical companies that wait until there is decisive evidence that the game has shifted consign themselves to playing catch-up when it is already too late.

Not every company is in the "don't worry, be happy" camp. Consider Pfizer, which has formed an alliance with Medarex. The small company focuses on drug discovery while its giant partner focuses on large-scale commercialization, using its top-shelf sales forces to maximize the marketplace performance of the smaller drugs.

If Pfizer and other drug companies develop a real competency related to the identification of the right partner companies, they could create alliances that would allow them to thrive in a changing world. If today's marketplace leaders don't adjust now however, it is quite likely that in five years they will have fallen by the wayside, mere shadows of their former selves.

For more information, see:

"The Waning of the Blockbuster Drug," by Catherine Arnst with Amy Barrett, Michael Arndt, and John Carey. *BusinessWeek*, 18 October 2004.

"Do You Know What You Do Best?" by Clayton M. Christensen and Scott D. Anthony. *Strategy & Innovation* September-October 2003, Volume 1, Number 3.

"Managing the Strategy Development Process," Chapter 8 of *The Innovator's Solution: Creating and Sustaining Successful Growth*, by Clayton M. Christensen and Michael E. Raynor. Harvard Business School Press, 2003.

"There Is Good Money and There Is Bad Money," Chapter 9 of *The Innovator's Solution: Creating and Sustaining Successful Growth*, by Clayton M. Christensen and Michael E. Raynor. Harvard Business School Press, 2003.