



Pharmaceutical Shareowners Group

SUMMARY REPORT

The Public Health Crisis in Emerging Markets

*An Institutional Investor Perspective on the
Implications for the Pharmaceutical Industry*

September 2004

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What is the Pharmaceutical Shareowners Group (PSG)?

The Pharmaceutical Shareowners Group (PSG) is an international grouping of fourteen institutional investors that have significant exposure to the pharmaceutical sector (see www.pharmashareownersgroup.org).¹ PSG is concerned that the sector has faced extensive public criticism over the last five years, with potential negative impacts on its reputation and licence to operate. While this criticism has spanned many issues, including drugs pricing in the USA and allegations of misconduct in areas such as clinical trials and marketing, a key issue has been the sector's response to the HIV/AIDS pandemic and wider public health crisis in emerging markets.

PSG has a particular interest in the impact of this issue on long-term shareholder value. In March 2003, the group launched the *Investor statement and framework on pharmaceutical companies and the public health crisis in emerging markets* (see Appendix 1), which outlined our understanding of best practice based on extensive interviews with specialists from both within and outside the pharmaceutical sector. The aim of the statement and framework was to encourage companies to ensure that they were fully briefed about the risks stemming from the public health crisis in emerging markets and also to assess how well companies were managing these challenges. PSG has since met with seven global pharmaceutical companies to assess their responses and performance against the framework.² We are grateful to these companies for the valuable insights that these meetings provided.

What does PSG want to achieve?

PSG members want to protect the long-term value of their investments. To this end PSG thinks it is important for investors to understand the business impact of the crisis and encourage companies to adopt best practice where this can protect long-term shareholder value. PSG does not presume to micro-manage companies and does not offer 'one size fits all' prescriptions: we fully endorse the importance of management deciding how to implement company-specific solutions that are consistent with good practice standards. Where companies are faced with demands that are not in the interests of shareholders, PSG also thinks it important that this is made clear both to company management and also to other stakeholders.³

Why is the public health crisis in emerging markets an issue for institutional investors?

There have been marked shifts in societal perceptions of pharmaceutical companies following the lawsuit involving 39 pharmaceutical companies and the South African government in March 2001 and the negative publicity surrounding the WTO TRIPs negotiations in 2003. A view has emerged that pharmaceutical companies have not been playing their part in tackling the public health crisis. PSG was concerned that this negative perception could have a significant impact on the sector's reputation and licence to operate with potential effects on its ability to defend the case for strong patent protection globally and to sustain 'premium' pricing in industrialised markets.

This view has been echoed by companies, many of which argue that a proactive response to the crisis is justified for several bona fide commercial reasons. These include:

- Defending the 'social contract' between governments, society as a whole and pharmaceutical companies, upon which intellectual property law and future innovation depends;
- Limiting the potential for emerging market countries to opt out of or otherwise weaken international patent treaties;
- Protecting company reputation and licence to operate with potential impacts on pricing power in the USA and other lucrative markets;
- Building political goodwill to help secure future markets;
- Improving stakeholder relations;
- Enhancing employee morale and recruitment prospects.

How have pharmaceutical companies responded so far?

Recognising that licence to operate and reputation with regulators and consumers might be affected, most companies have responded positively. PSG believes that the primary responsibility for tackling the crisis rests with governments but welcomes the considerable progress that has been made by many companies. We appreciate that this is a very

¹Central Finance Board of the Methodist Church; Co-operative Insurance Society; Credit Agricole Asset Management; Ethos Investment Foundation; Henderson Global Investors; Insight Investment; ISIS Asset Management; Jupiter Asset Management; Legal & General Investment Management; Morley Fund Management; PGGM Investments; SAM Sustainable Asset Management; Schroder Investment Management (UK); and Universities Superannuation Scheme (USS).

²AstraZeneca plc, Bristol Myers Squibb Company, GlaxoSmithKline (GSK) plc, Merck & Co., Inc., Novartis AG, Pfizer Inc. and Roche Group. We also attempted to meet with Aventis but, despite the company's willingness to meet with us, we were unable to schedule a meeting due to merger activities with Sanofi-Synthelabo.

³For example, PSG members were approached but unable to support a shareholder resolution that focused on a particular company and the pricing of specific drugs.

challenging area and the success of company activities is highly dependent on external factors, not least the development of adequate health care infrastructures in the poorest countries. Many companies have displayed real commitment to tackling these obstacles as well as a willingness to engage in constructive dialogue with stakeholders and we have been encouraged to learn, even in contexts that are far from ideal, how action by pharmaceutical companies can stimulate action by other important parties.

Although some companies have been actively involved in these issues for some time, PSG's judgement is that it is really only in the last year or two that this has become a matter for senior management attention and integration into core business processes. Even in the period that PSG has been working, we have noted a marked change in confidence and openness. We see these as highly positive developments and encourage companies to continue in this manner.

PSG particularly welcomes the progress made by companies such as GSK and Merck & Co., Inc. On balance, we feel these companies demonstrate many of the elements of what we consider to be an effective strategy. It is only fair to recognise, however, that all of the companies that we saw had particular strengths and, even amongst the leading companies, there were some gaps between current company practice and good practice standards.

Has the sector gone far enough?

Since reporting is not systematic or linked to discussions of investment value, this makes it difficult for investors to assess whether companies are effectively optimising opportunities and minimising risks. That said, it is our judgement that the industry believes it is doing enough to contain risks associated with the emerging markets health crisis and is no longer on the back foot. We welcome the fact that the focus has now returned, rightly in our opinion, to governments. We are concerned, however, that the sector's approach has tended to be reactive, with companies often developing their approaches to meet specific, high-profile external events and demands. The fundamental dynamics of this crisis – namely the growing trade power of the BRIC countries⁴, the growing burden of First World diseases in Third World countries as well as the enormous impact of AIDS – are such that the public health crisis in emerging markets is going to become a bigger challenge year on year. We did not hear a convincing story that the sector is ready for this – i.e. that it has a proactive, coherent and forward-looking approach for adapting to these new realities which is linked to overall business strategy. This may leave the sector exposed in the future.

What would a good practice strategy look like?

Based on our engagement with companies and wider discussions, we think there are eight key elements that make up a good practice strategy for addressing the public health crisis in emerging markets. These are as follows:

- **Articulate the business case:** While recognising that companies may have philanthropic reasons for their activities, a clear articulation of the business case for action and its potential impact on long-term value/risk is the essential underpinning of a good practice strategy.
- **Promote leadership at board level:** A board member or committee with specific responsibility for this area of corporate activity is critical because various aspects of corporate strategy will need to adapt to allow progress in this area.
- **Take a forward-looking approach:** A good practice strategy needs to be forward-looking and take account of evolving disease burdens and patterns of consumer demand over the next 10–20 years.
- **Objectively assess alternative options:** This should take into account factors such as such commercial sustainability, proportionality, effectiveness and risks of diversion.
- **Show flexibility and breadth:** Companies that have expertise in a range of approaches (e.g. voluntary licensing, differential pricing, donations) will be better prepared to respond to changing expectations and regulatory environments.
- **Collaborate and share best practice:** Collaborating with peers in order to deliver innovative solutions, contain the problem of 'free-riders' within the sector and generally rebuild public trust is another important criterion.
- **Demonstrate responsible use of influence in public policy:** It will become increasingly important to provide evidence that a company's public policy positions and lobbying efforts are aligned with its access targets and strategy.
- **Track performance and be transparent:** Systematic reporting of goals, objectives and activities, ideally with relevant KPIs and performance targets, and discussion of how these activities relate to core business strategy and value creation will allow for continuous improvement.

PSG recognises that responding to the public health crisis in emerging markets is a dynamic issue. Through addressing the above elements as part of an overall strategy, this will help companies better articulate their approach to investors and other stakeholders, which in turn will help investors understand and support sound management decisions. PSG welcome dialogue and feedback with companies and other stakeholders on the usefulness of the observations and suggestions set out in this report.

⁴'Dreaming with BRICS: The Path to 2050', Goldman Sachs, October 2003

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