NOVARTIS

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The dismantling of a general goods store (Translation)

NZZ, Sergio Aiolfi, 20 Dec 2021

In the 25 years since it was founded, Novartis has become a lean pharmaceutical company

Just how far back in time the historic event was is illustrated by the fact that it was announced by fax. It was through this medium of choice that the surprise announcement was sent out to newspapers on 7 March 1996 informing them that Ciba and Sandoz had agreed a merger. More than 10 months later, on 20 December 1996, the new entity was then entered in the commercial register under the name Novartis.

A lot has happened since then. The conglomerate that it was has been transformed over the 25 years into a lean organization that is focusing its activities increasingly on specialized, innovative medicines. If Novartis, were also to separate its generics subsidiary Sandoz from the group structure, as seems possible at present, this would leave a "pure play", a purely pharmaceutical company. This would be the ideal arrangement for investors, who more than ever have a preference for companies with sharply focused operations. It makes their job easier; these companies are simpler to analyze and compare with each other.

How did the company's management bring about this transformation? According to Daniel Vasella, the defining figure of the first 17 years of Novartis, the management decisions were always logical and consistent. "An analyst who thinks logically," he once said in an interview with NZZ, "should be capable of anticipating all the steps taken by Novartis." This implied on the one hand that analysts can guess the thought processes of the chief strategist and, on the other, that they had to be familiar with the constraints under which the management took its decisions. And of these there were quite a few.

Motley legacy

The first constraint came in the form of the portfolio inherited from Ciba and Sandoz: a smorgasbord of products that ranged from medications through nutrition (Ovomaltine, Caotina, Isostar) and veterinary medicines to crop protection agents and seeds. Through extensive diversification Ciba and Sandoz made sure that the risks of the pharma business were well-balanced.

At Novartis, this wide range of products was initially seen as a blessing. Alex Krauer, the first chairman of the group, who died in early December, believed "the potential for innovation and synergy that was created overall with Novartis was unique". But it did not take long before they realized that the link between pharma and agriculture was tenuous at best. And "thinking logically" they decided to spin off the agribusiness into the newly established company Syngenta in 2000. But Novartis remained a general goods store even after this; in 2004, the group still comprised seven divisions.

A further constraint was the push for size. They wanted "to determine the rules of action themselves so as not to have the rules dictated to them by others later on," Krauer said. To do this, they saw themselves compelled – in light of the generally expected consolidation of the pharma sector at the time – to acquire so as not to be acquired. They also needed to establish a "critical mass" to ensure they remained competitive, so that the constantly growing expenditure in pharma on research and development and also marketing remained sustainable. It was this striving for size that led in 2001 to the (futile) attempt at a tie-up with Roche and in 2004 to the (equally unsuccessful) effort to acquire the German-French competitor Aventis.

Since expansion by means of a mega-merger in the pharma sector was evidently not possible, they decided instead to move into territory that was close to pharma. In 2005, Novartis made acquisitions to beef up both its generics business and its segment of over-the-counter medicines, and in the same year also decided to enter the vaccines business. In 2008, to round off the portfolio, they also acquired a stake in the eye-care company Alcon. While this allowed Novartis to achieve the size it was looking for, it was only at the price of further diversification.

The model of Ciba and Sandoz was thus continued, although doubts were soon being voiced in investor circles about the general goods store character of the company. The widening of its operations came at the cost of the profit margin and earned the stock a "conglomerate markdown". But for the company's management the model had the advantage that it was able to stabilize the business. And above all it left the portfolio mix to the creative drive of the management (and not

to that of investors). The management wanted to "determine its own future, and not have it determined by others".
Mishaps and setbacks

From 2008 onwards, they spoke at Novartis of "focused diversification". However, this model was only convincing for as long as the management promised to create more value with the mixed portfolio than with a pure play portfolio. Or in the terminology of the legal business world: as long as the "agent" could convince the "principal" that he was worth his princely salary.
But this was increasingly proving to be no longer the case. The year 2008 saw the start of a seemingly endless series of mishaps and setbacks, which can be attributed partly to bad luck and partly to excessive demands and mistakes on the part of management: A series of "warning letters" to the US regulatory agency FDA, which had found "a pattern of problems" in Novartis factories in the US; problems and production slumps in vaccines and generics; and difficulties in the manufacture of over-the-counter medicines. In 2012, the difficulties of the mixed model became clear for all to see when the pharma business also began to slow down. The head of the division was compelled to hold out the prospect of "seven challenging quarters ahead".

At the balance sheet press conference in 2013, Vasella nevertheless spoke of a "solid course" that would allow Novartis "to cope with the volatility and uncertainty of the business environment". For a "logically thinking analyst", however, it was clear that the problem was the strategy and that the model of "focused diversification" had had its day. Vasella stepped down amid a considerable uproar. And the possibility cannot be ruled out that it was the frustrated "principal" who advised the "agent" to leave the stage.

Clearance sale

A glance at Novartis before and after the Vasella era reveals a clear break in the strategy. Under the new chairman, Jörg Reinhardt, decisions were still made "logically and consistently", only now it was no longer the logic of management that was paramount, but that of the investor.

The "principal" took the failure of the old model as an opportunity to cement its position with regard to the "agent". The consequence was that Novartis began to move in the direction of pure play; the company no longer diversified, but focused and sold. And investors rewarded the move. From 2013 to mid-2015 the Novartis share price, which had barely budged for years, rose more than 50%.

In 2014, Novartis sold its animal health and the (constantly loss-making) vaccines business and also found an elegant joint venture solution with UK company GlaxoSmithKline as a way of shedding its business with over-the-counter products. The separation of the ophthalmic medicine specialist Alcon presented bigger problems, which were once again the company's own fault.

Novartis completed its acquisition of Alcon, which was hailed as the "most profitable ophthalmology company in the world", in 2010 at a cost of $51bn, but then gave too little attention to managing the operation. The consequence was that the growth and earnings of Alcon fell below average and the investment proved to be a flop. It eventually needed a comprehensive reorganization before the company was spun off in 2019.

Without smoke and mirrors

Novartis took the gradual transformation to a pure pharmaceutical company as an opportunity to reposition itself on the pharma market. In place of products that are used in more widespread indications (hypertension, multiple sclerosis, respiratory diseases), therapies for personalized medicine have begun to emerge: Niche products for small patient groups, expensive in development, high in price and not yet established as therapies.

Now it appears that the model of the purely pharmaceutical producer favored by the "principal" has its pitfalls. The risk profile of Novartis has considerably worsened. This means that any failures with its innovative pharma products can no longer be offset against the results of other divisions (that are doing well). Failures or poor acquisitions are now appearing in the glare of the spotlight and – without any cushioning – can be reflected directly in the consolidated results. In the pure play model, the risks associated with the pharma business are no longer offset in the pharma company itself, but among investors; they can diversify their portfolios with stocks of different companies depending on their appetite for risk.

At present, investors seem to be harboring doubts as to whether the new Novartis model is sustainable. The share price at least suggests there are some reservations: After the surge in 2013, the price has not shown much upward movement since 2015. If the Sandoz generics business is also sold off in the near future, the former general goods store that was Novartis will have been pared down to its foundation walls. It is uncertain, however, whether the company will prove itself as a pure play company that produces purely pharmaceuticals.

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On 7 March 1996, Alex Krauer (second from left) and Daniel Vasella (third from left) announced the merger of Ciba and Sandoz to form Novartis.

Michel Kupferschmidt / Keystone