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DEPARTMENT OF GRADUATE BUSINESS STUDIES

REGULAR/ODEL PROGRAMME

CMM 619: CASES IN STRATEGIC MANAGEMENT

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| Date: AUGUST 2021 | Duration: 3 Hours |
| INSTRUCTIONS: Answer ALL Questions | |

Read the cases provided and answer the questions that follow.

Case 1

Historically, the pharmaceutical industry has been a profitable one. Between 2002 and 2006 the average rate of return on invested capital (ROIC) for firms in the industry was 16.45%. Put differently, for every dollar of capital invested in the industry, the average pharmaceutical firm generated 16.45 cents of profit. This compares with an average return on invested capital of 12.76% for firms in the computer hardware industry, 8.54% for grocers, and 3.88% for firms in the electronics industry. However, the average level of profitability in the pharmaceutical industry has been declining of late. In 2002, the average ROIC in the industry was 21.6%; by 2006, it had fallen to 14.5%. The profitability of the pharmaceutical industry can be best understood by looking at several aspects of its underlying economic structure. First, demand for pharmaceuticals has been strong and has grown for decades. Between 1990 and 2003, there was a 12.5% annual increase in spending on prescription drugs in the United States. This growth was driven by favourable demographics. As people grow older, they tend to need and

consume more prescription medicines, and the population in most advanced nations has been growing older as the post–World War II baby boom generation ages. Looking forward, projections suggest that spending on prescription drugs will increase at between 10 and 11% annually through till 2013. Second, successful new prescription drugs can be extraordinarily profitable. Lipitor, the cholesterol- lowering drug sold by Pfizer, was introduced in 1997, and by 2006, this drug had generated a staggering \$12.5 billion in annual sales for Pfizer. The costs of manufacturing, packing, and distributing Lipitor amounted to only about 10% of revenues. Pfizer spent close to \$500 million on promoting Lipitor and perhaps as much again on maintaining a sales force to sell the product. That still left Pfizer with a gross profit of perhaps \$10 billion. Since the drug is protected from direct competition by a 20- year patent, Pfizer has a temporary monopoly and can charge a high price. Once the patent expires, which is scheduled to occur in 2010, other firms will be able to produce “generic” versions of Lipitor and the price will fall—typically by 80% within a year. Competing firms can produce drugs that are similar (but not identical) to a patent- protected drug. Drug firms patent a specific molecule, and competing firms can patent similar, but not identical, molecules that have a similar pharmacological effect. Thus, Lipitor does have competitors in the market for cholesterol lowering drugs, such as Zocor sold by Merck and Crestor sold by AstraZeneca. But these competing drugs are also patent protected. Moreover, the high costs and risks associated with developing a new drug and bringing it to market limit new competition. Out of every 5,000 compounds tested in the laboratory by a drug company, only five enter clinical trials, and only one of these will ultimately make it to the market. On average, estimates suggest that it costs some \$800 million and takes anywhere from 10 to 15 years to bring a new drug to market. Once on the market, only three out of 10 drugs ever recoup their R&D and marketing costs and turn a profit. Thus, the high profitability of the pharmaceutical industry rests on a handful of blockbuster drugs. At Pfizer, the world’s largest pharmaceutical company, 55% of revenues were generated from just eight drugs To produce a blockbuster, a drug company must spend large amounts of money on research, most of which fails to produce a product. Only very large companies can shoulder the costs and risks of doing this, making it difficult

for new companies to enter the industry. Pfizer, for example, spent some \$7.44 billion on R&D in 2005 alone, equivalent to 14.5% of its total revenues. In a testament to just how difficult it is to get into the industry, although a large number of companies have been started in the last 20 years in the hope that they might develop new pharmaceuticals, only two of these companies, Amgen and Genentech, were ranked among the top 20 in the industry in terms of sales in 2005. Most have failed to bring a product to market. In addition to R&D spending, the incumbent firms in the pharmaceutical industry spend large amounts of money on advertising and sales promotion. While the \$500 million a year that Pfizer spends promoting Lipitor is small relative to the drug's revenues, it is a large amount for a new competitor to match, making market entry difficult unless the competitor has a significantly better product. There are also some big opportunities on the horizon for firms in the industry. New scientific breakthroughs in genomics are holding out the promise that within the next decade pharmaceutical firms might be able to bring new drugs to market that treat some of the most intractable medical conditions, including Alzheimer's, Parkinson's disease, cancer, heart disease, stroke, and AIDS. However, there are some threats to the long-term dominance and profitability of industry giants like Pfizer. First, as spending on health care rises, politicians are looking for ways to limit health care costs, and one possibility is some form of price control on prescription drugs. Price controls are already in effect in most developed nations, and although they have not yet been introduced in the United States, they could be. Second, between 2006 and 2009, 12 of the top 35 selling drugs in the industry will lose their patent protection. By one estimate some 28% of the global drug industry's sales of \$307 billion will be exposed to generic challenge in America alone, due to drugs going off patent between 2006 and 2012. It is not clear to many industry observers whether the established drug companies have enough new drug prospects in their pipelines to replace revenues from drugs going off patent. Moreover, generic drug companies have been aggressive in challenging the patents of proprietary drug companies, and in pricing their generic offerings. As a result, their share of industry sales has been growing. In 2005, they accounted for more than half of all drugs prescribed by volume in the United States, up from one third in 1990. Third,

the industry has come under renewed scrutiny following studies which showed that some FDA approved prescription drugs, known as COX- 2 inhibitors, were associated with a greater risk of heart attacks. Two of these drugs, Vioxx and Bextra, were pulled from the market in 2004.

Required:

- a) Drawing on the five forces model, explain why the pharmaceutical industry has historically been a very profitable one **(8 Marks)**
- b) After 2002, the profitability of the industry, measured by ROIC, started to decline. Why do you think this happened? **(8 Marks)**
- c) What are the prospects for the industry going forward? What are the opportunities, what are the threats? **(10 marks)**
- d) What must the firm do to exploit the opportunities and counter the threats? **(8 Marks)**

Case 2

Oracle Corp., based in Redwood City California, is the world's largest maker of database software and the third largest global software company in terms of sales after Microsoft and IBM. This commanding position is not enough for Oracle, however, which has set its sights on becoming the global leader in the corporate applications software market. Here, Germany's SAP which has 45% of the market is the acknowledged leader and Oracle, with only 19%, is a distant second.³⁸ Corporate applications is a fast growing and highly profitable market, however, and Oracle has been snapping up leading companies in this segment at a fast pace. Its goal is to quickly build the distinctive competencies it needs to expand the range of products that it can offer to its existing customers and to attract new customers to compete with SAP. Beginning in 2005, Oracle's CEO Larry Ellison spent \$19 billion to acquire 14 leading suppliers of corporate software including two of the top five companies: PeopleSoft, a leading Human Resource Management (HRM) software supplier it bought for \$10 billion, and Siebel Systems, a leader in customer relationship management (CRM) software which cost Oracle \$5.8 billion. Oracle expects several competitive advantages to result from

its use of acquisitions to pursue the corporate strategy of horizontal integration. First, it is now able to meld or bundle the best software applications of these acquired companies-with Oracle's own first- class set of corporate and database software programs-to create a new integrated suite of software that will allow corporations to manage all their functional activities such as accounting, marketing, sales, HRM, CRM, and supply- chain management. Second, through these acquisitions Oracle obtained access to thousands of new customers-all the companies that currently use the software of the companies it acquired. All these companies now become potential new customers for all of Oracle's other database and corporate software offerings. Third, beyond increasing the range of its products and number of its customers, Oracle's acquisitions have consolidated the corporate software industry. By taking over some of its largest rivals, Oracle has become the second largest supplier of corporate software and so it is better positioned to compete with leader SAP. Achieving the advantages of its new strategy may not be easy, however. The person in charge of assembling Oracle's new unified software package and selling it to customers is John Wookey, Oracle's senior vice-president in charge of applications, who jokingly says that his "head is the one on the chopping block if this doesn't work." CEO Ellison has been quick to fire executives who don't perform well in the past, however, who expects a lot from his top executives. To grow Oracle's market share and profits Wookey must draw on the best of the technology Oracle obtain from each of the companies it acquired to build its new suite of state-of-the-art corporate software applications. He also has to persuade customers not to switch software vendors, for example, jump ship to SAP, while Oracle builds its package and then to gradually adopt more and more of Oracle's software offerings to run their functional activities. Wookey is well-placed to implement Oracle's new strategy. However, he is known as a consensus builder and product champion, both inside the company and outside, when interacting with Oracle's customers. He spends his working day sharing information with the top managers of Oracle's various businesses, and meeting with his team of 14 senior staff members, to work out how the whole package should be put together and what it should include. He also regularly visits major customers, especially those that came with its acquisitions, to gain their

input into how and what kind of software package Oracle should build. Wookey even formed an advisory council of leading customers to help make sure the final package meets their needs. One of Wookey's notable achievements was retaining the top-rate software engineers who Oracle obtained from its acquired rivals. These people could have easily found high-paying jobs elsewhere, but most of the top engineers Oracle wanted stayed to help it achieve its new goals. Nevertheless, by the end of 2006 there were signs that all was not going well with Oracle's new strategy. SAP is a powerful competitor, its popular software is fast becoming the industry standard, so unseating SAP in the \$23.4 billion corporate software market will not be easy. Moreover, SAP is still the leader in more advanced functional applications incorporating the latest technologies and its proprietary technology is all homegrown, so it doesn't face the huge implementation issue of bringing together the applications from many different acquisitions. Preventing customers from switching to SAP may not be easy now that their loyalty to their old software supplier has been broken because of its acquisition by Oracle. Analysts also say that Oracle runs the risk of stretching itself too thin if it continues to purchase too many companies too quickly because high-tech acquisitions are the most difficult to pull off in terms of management and execution. Larry Ellison is under pressure to accelerate sales growth and surpass investors' expectations and only if Oracle can put out corporate application software sales numbers that beat expectations will analysts regard its strategy as a success. Still, Oracle's stock gained 47% in 2006 compared to SAP's 15% and in 2007 Oracle announced record revenues and profits. Its stock price jumped as investors now believe he and Wookey have the ability to make its acquisitions pay. In 2008 Oracle announced yet another major acquisition of software supplier BEA Systems; will they be able to continue their track record of success?

Required:

- a) In what ways is Oracle seeking to create value from its acquisitions? **(8 Marks)**
- b) Critically, analyze Oracle corporate-level strategy that will aid it in achieving competitive advantage **(8 Marks)**

- c) What influences from the external environment do you think might affect the way Oracle competes? **(6 Marks)**
- d) Will Oracle be able to continue their track record of success? Give your comments **(4 Marks)**

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