Marketing Research is Power in Negotiations to Sell a Small Business

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ABSTRACT

Small firms are at a disadvantage in negotiations with larger firms and need to have something on their side of the table to give them power in the process. Primary marketing research can provide proprietary information for the smaller firm that may be used to support a forecasting model to be used in evaluating offers during negotiations. This paper describes such a negotiation supported by a proprietary forecasting simulator that created an advantage for the smaller firm over the larger firm. As a result, the smaller firm had a go-it-alone baseline revenue forecast to determine the incremental value of a specific co-promotion or royalty arrangement, was able to adjust negotiation positions quickly ensuring that full value was obtained for the smaller firm in the sale.

BACKGROUND

Marketing research can play a key role in selling a firm, making an acquisition, or seeking a merger in the pharmaceutical industry. This use of marketing research to support forecasting and negotiations is important in these situations because, in the current pharmaceutical environment, many large companies are experiencing patent loss on block-buster drugs and have few candidates to replace them. Faced with a new product short-fall and declining revenues, many big pharmaceutical companies are turning to partnerships, joint ventures, mergers, and acquisitions involving smaller, more entrepreneurial firms to improve their product portfolios. Small companies can be at a disadvantage in negotiations with larger firms. There is no shortage of advice about how to sell a business (Handelsman, 2012a; Handelsman, 2012b; Nigh & Boschetti, 2006; Rosenbloom, 2001; Warrillow, 2010). It is demonstrated here that one way to level the playing field is to develop a forecasting simulator based on a market model informed by proprietary marketing research to use in real-time negotiations with a large company.

WHEN A SMALL FIRM WANTS TO BE ACQUIRED

When a small firm desires to be acquired by a larger firm, negotiations are many times even more difficult and protracted than usual. A danger to the small firm is leaving money on the table and not getting the full value for the risk assumed in starting the company, developing a successful product, and building a business desired by the buyer firm One way to avoid such situations is for the small seller firm to develop a detailed forecasting simulator that incorporates all the relevant assumptions and variables that can be easily modified on the spot to show the financial impact of various changes in the terms of the deal proposed by either the larger buyer firm or counterproposals from the seller firm.

Typically, the negotiations come in three phases. These phases and the activities involved appear below.

Phase	Activities
Preliminary Negotiations	Secondary Data Analysis Public Information Analysis Internal Data Analysis
Full Negotiations	Proposals of Partnership, Joint Venture, Merger, or Acquisition
Deal Structuring	Converting a Proposal into a Deal

BENEFITS OF A MARKETING RESEARCH BASED FORECASTING SIMULATOR

Developing a forecasting simulator has several benefits to the seller firm when converting a proposal into a deal. Such a simulator allows:

- A way to represent the structure, terms, and conditions of any buyer firm proposal
- Representation of the seller firm's own best proposal
- On-the-spot changes in relevant variables to see what the bottom-line financial impact of a structured deal will be for both the seller and the buyer firms, as well as the financial impact in terms of net present value, internal rate of return, and revenues
- A baseline revenue forecast if the deal is not formalized and the seller firm goes forward as a single entity
- Leverage in the negotiation process

AN EXAMPLE

An illustration of the value of a marketing research supported forecasting simulator to a small firm comes from two companies who sell a highly specialized product to Nephrologists for use in patients with kidney disease. In this example, both products are indicated for treatment of the side effects of dialysis. The dialysis market has two relatively small patient populations, one in hemodialysis (HD) and one in peritoneal dialysis (PD). The small firm has developed an oral product for use with a much larger market of pre-dialysis patients who have chronic kidney disease (CKD). In the pharmaceutical industry, owning a New Drug Application (NDA) that will gain FDA approval is money in the bank. The potential profits in the CKD market are huge relative to the HD and PD markets making the small firm an attractive acquisition for the large firm, especially since its new product pipeline was without near term candidates.

Negotiations began with two proposals, one from each side. The structure of the proposals appears below. In this example Product X is the seller's product and Product Y is the buyer's product. The main difference in the proposals is that co-promotion is involved in the seller's proposal and royalties are the main stay of the buyer's proposal.

In preparation for negotiations, the small firm built a market model and forecasting simulator in Excel following extensive primary marketing research which provided input for both products and various market segments. The marketing research projects included individual depth interviews, focus groups, and quantitative surveys. These projects were done domestically and internationally and were conducted over two years to provide input to the market models in preparation for negotiations. The method of market modeling in pharmaceuticals has been well documented over the years (Latta, 1998a, Latta, 1998a, Latta, 2002).

By way of summary, the market models incorporate

- Marketing research data to reflect patient eligibility, product use, and days of therapy currently and the future growth rate of these variables
- Historical data to set growth rates and patient population size
- Internal data to reflect inventories, costs, resources, and prices
- Any management assumptions about the future of the business including opportunities, threats, strengths, weaknesses, and organizational changes

THE SELLER'S PROPOSAL

The seller's proposal structure appears below:

Type of Agreement
    Co-promotion rights to CKD and oral Product X 0.5 mg capsules
Cash Payments
    $10mm Upfront Payment at signing
    $25mm Approval Payment of CKD indication
    $10mm Commercial Success payments at attainment of each $100mm in sales
    Phase IV commitment for US is Buyer responsibility
    Buyer and Seller share profits 60/40
    Buyer books sales for CKD for 0.5 mcg capsules
Marketing
    60/40 split in marketing costs
    Final marketing approval stays with NDA owner
Other Provisions
    Sub License rights - Rest of the world (ROW)
    Product registration and other regulatory undertakings - Buyer would be responsible for all

Manufacturing - Buyer would be a secondary manufacturer for capsules and injection
Next generation products - joint development of Product Z and Product W
Exploration of other compounds already patented

Conversion of the seller's proposal into a five-year forecasting simulator supported by marketing research data following the market model approach appears below.

TABLE 1

SELLER'S CO-PROMOTION PROPOSAL REPRESENTED IN A MARKET MODEL FORECASTING SIMULATOR

Year		***1***	***2***	***3***	***4***	***5***
Revenue Stage III/IV CKD		**$4,000,000**	**$23,000,000**	**$44,000,000**	**$69,000,000**	**$92,000,000**
WARF Royalty	**3%**	**$120,000**	**$690,000**	**$1,320,000**	**$2,070,000**	**$2,760,000**
Manufacturing Cost ($0.10 per cap)	**0.10**	**$615,385**	**$3,402,367**	**$6,258,534**	**$9,437,038**	**$12,098,767**
Gross Margin		**$3,264,615**	**$18,907,633**	**$36,421,466**	**$57,492,962**	**$77,141,233**
Gross Profit Split						
	60%	**$1,958,769**	**$11,344,580**	**$21,852,879**	**$34,495,777**	**$46,284,740**
	40%	**$1,305,846**	**$7,563,053**	**$14,568,586**	**$22,997,185**	**$30,856,493**
Selling expense		**$8,000,000**	**$8,000,000**	**$8,800,000**	**$13,800,000**	**$18,400,000**
Number of seller reps @ $150,000/rep		**53**	**53**	**53**	**53**	**53**
Marketing expense		**$25,000,000**	**$25,000,000**	**$10,000,000**	**$6,900,000**	**$9,200,000**
Variable Contribution		**$(29,735,385)**	**$(14,092,367)**	**$17,621,466**	**$36,792,962**	**$49,541,233**
Up Front payments		**$15,000,000**	**-**	**-**	**-**	**-**
Royalties	**0%**	**-**	**-**	**-**	**-**	**-**
Net contribution		**$(12,776,615)**	**$(2,747,787)**	**$39,474,345**	**$71,288,739**	**$95,825,973**
Net present Value to Buyer	**12%**	**$362,740,130.47**				
IRR		**160%**				
		159%				
Total payments to Seller		**$16,305,846**	**$7,563,053**	**$14,568,586**	**$22,997,185**	**$30,856,493**
Net present Value to Seller		**$142,805,663.80**				
0.5mcg Capsule Price (WAC)		**$0.65**	**$0.68**	**$0.70**	**$0.73**	**$0.76**
Revenue - Go Alone Forecast		**$ -**	**$690,505**	**$3,449,040**	**$5,852,898**	**$7,621,300**

THE BUYER'S PROPOSAL

The buyer's proposal structure appears below:

- Type of Agreement
    - Royalty Payments
- Distribution stays with New Drug Application (NDA) owner
- Contracting stays with the NDA owner
    - National Accounts are responsibility of NDA owner
    - Other products could be added to contracts
- Seller promotes other products in CKD
    - Primary detail – Product X (HD/PD)
    - Secondary detail – Product Y (CKD)
- Buyer promotes Product X in CKD
    - Primary detail – Product Y (CKD)
    - Secondary detail – Product X (CKD)
- International Rights
    - Buyer submits for approval in each country or region
    - Buyer markets in each country
    - Seller receives royalties based on sales of Product X in each country or region
- Booking of Sales
    - Seller – Injection and 2.5 mcg capsules (HD/PD)
    - Buyer – 0.5 mcg capsules (CKD)

Conversion of the buyer's proposal into a forecasting simulator following the market model approach appears below.

TABLE 2
BUYER’S CO-PROMOTION PROPOSAL REPRESENTED IN A MARKET MODEL FORECASTING SIMULATOR

Year		***1***	***2***	***3***	***4***	***5***
Revenue Stage III/IV CKD		**$4,000,000**	**$23,000,000**	**$44,000,000**	**$69,000,000**	**$92,000,000**
WARF Royalty	**3%**	**$120,000**	**$690,000**	**$1,320,000**	**$2,070,000**	**$2,760,000**
Manufacturing Cost ($0.10 per cap)	**0.10**	**$615,385**	**$3,402,367**	**$6,258,534**	**$9,437,038**	**$12,098,767**
Gross Margin		**$3,264,615**	**$18,907,633**	**$36,421,466**	**$57,492,962**	**$77,141,233**
Selling expense		**$8,000,000**	**$8,000,000**	**$8,800,000**	**$13,800,000**	**$18,400,000**
Number of seller reps @ $150,000/rep		**53**				
Marketing expense		**$25,000,000**	**$25,000,000**	**$10,000,000**	**$6,900,000**	**$9,200,000**
Variable Contribution		**$(29,735,385)**	**$(14,092,367)**	**$17,621,466**	**$36,792,962**	**$49,541,233**
Up Front payments		**$15,000,000**	**-**	**-**	**-**	**-**
Royalties	**25%**	**$1,000,000**	**$5,750,000**	**$11,000,000**	**$17,250,000**	**$23,000,000**
Net contribution		**$(45,735,385)**	**$(19,842,367)**	**$6,621,466**	**$19,542,962**	**$26,541,233**
Net present Value to Buyer	**12%**	**$45,903,234.05**				
IRR		**26%**				
		24%				
Total payments to Seller		**$16,000,000**	**$5,750,000**	**$11,000,000**	**$17,250,000**	**$23,000,000**
Net present Value to Seller		**$109,324,829.29**				
0.5mcg Capsule Price (WAC)		**$0.65**	**$0.68**	**$0.70**	**$0.73**	**$0.76**
4% price increase each year						
Revenue - Go Alone Forecast		**$ -**	**$690,505**	**$3,449,040**	**$5,852,898**	**$7,621,300**

IMPACT ON NEGOTIATIONS

Because of the marketing research supported market model forecasting simulator, the smaller seller had the advantage in the negotiations. At the first meeting, the marketing research professional brought the simulators to the negotiations. The larger buyer company had no such tool available. As the negotiations unfolded, the larger buyer tried to construct market models for use in the discussions. However, their market models were incomplete since they lacked the two years of background marketing research the seller had available. At the end of the negotiations, the smaller seller company realized their asking price and got terms and conditions of sale much to their advantage.

CONCLUSIONS AND IMPLICATIONS

Benefits of this approach to being acquired are valuable even if no final deal is struck. The very process of self-examination of the business model, market position, financial matters, and operational issues adds significant value to the seller firm in the form of intellectual capital. Thorough understanding of assumptions, business operations, and the market environment makes a firm get stronger, more able to compete, and capable of developing a sustainable strategy.

Benefits in the negotiation process include:

- Having a go-it-alone baseline revenue forecast to determine the incremental value of a specific co-promotion or royalty arrangement.
- Being able to adjust negotiation positions quickly and assessing the impact of the changes on both the buyer and seller firm.
- Ensuring that full value is obtained for the seller firm.

Smaller firms that are under consideration for acquisition by larger firms are urged to do comprehensive background proprietary marketing research, develop a market model, and create a forecasting simulator to use in negotiations.

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