GSK - A MERGER TOO FAR?

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This case summarises events leading to the creation of a global pharmaceutical giant and the early years of its performance while inviting readers to consider the process of growth through mergers and acquisitions as a general strategy. The case also looks at the expectations, deliberations and motivation of managers and stakeholders in doing so. The case invites readers to reflect on whether more mergers are to be the future of GlaxoSmithKline.

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After a first round of merger talks collapsed acrimoniously in 1998, renewed interest in a merger between Glaxo Wellcome and SmithKline Beecham emerged when Jan Leschly announced his retirement from SmithKline Beecham in mid-1999. The announcement effectively removed a major barrier to the merger. Sir Richard Sykes, head of Glaxo Wellcome and destined to become chairman of the new colossus, said about his company's determination to do a deal:

> "This is where two big successful organisations come together, not to protect future earnings growth but actually to increase critical mass to really outperform the industry…. The more effort, the more money, and the more power you can put to research, the stronger the company is going to be."[1]

Syke's statement summarised how Europe's pharmaceutical companies have been locked in a high stakes multibillion dollar struggle with their US rivals to stay in business in the 21st century. This struggle associated with increased take-over activity and pharmaceutical companies seeking economies of scale to finance escalating research and development budgets. For instance, at the time of the creation of GlaxoSmithKline in 2000, the Association of the British Pharmaceutical Industry (ABPI) estimated the cost of bringing a new drug to market to be in the region of £350 million. Three years later that estimate had ballooned to £500 million. Not surprisingly the slowdown in new drugs coming to market was a major concern. In 2001 only 24 genuinely new drugs were launched in the US, considered a poor outcome of so costly an investment by so many companies. The year 2002 was even worse with only 17 genuinely new drugs introduced. Poor returns to R&D investment came despite sharp increases in spending on research and development by the main companies, which according to Goldman Sachs, the US investment bank, reached $35 billion in 2001. This was double the figure for 1997 and nearly triple the 1992 investment.

Pharmaceutical companies in both sides of the Atlantic had been trying to finance spiralling research and development budgets through amalgamation. In the endless race to keep up with transatlantic rivals, Pfizer announced a $60 billion take-over of US-based Pharmacia. This created a new world

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[1] *Pharmaceutical Executive,* May 1999, p. 37

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pharmaceutical giant, as the deal rocketed Pfizer's share of world market sales from 6.7 per cent to just over 10 per cent, compared with GlaxoSmithKline's 6.9 per cent. Green light for the amalgamation was given in 2003. As a result Pfizer's share of the lucrative US market increased from 10 per cent to almost 15 per cent. With this move Pfizer effectively became the market leader in the US as well as in Europe (where it was previously number 4), Japan (previously number 3) and Latin America.

Merger activity took place while pharmaceutical companies were seeking economies of scale in research and development at the same time that associated marketing costs of new products were growing quickly. However, little evidence had emerged to suggest bigger research programs were better (least of all after a merger) to replenish the pipeline. Indeed, the Pharmacia deal put Pfizer way ahead of GlaxoSmithKline at a time when many questioned the ability of the latter to generate and sustain revenue growth. GlaxoSmithKline was struggling with patent expiries and a lack of new drugs. There were some 125 promising compounds in the pipeline but in the short term the company was being forced to increase the number of licensing agreements.

In fact, between 1998 and 2003, GlaxoSmithKline had bought licences to market 40 drugs from other companies (effectively doubling the number of licences acquired between 1988 and 1997). This compared with the average for the industry's top 20 companies which was 31. Not surprisingly in the second quarter of 2003 GlaxoSmithKline's share price slumped to its lowest level in five years (when considering pre-merger stock market valuations or its lowest ever as a stand alone company). See Exhibit 1.

[Insert Exhibit 1 around here]

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THE BIRTH OF GLAXOSMITHKLINE (GSK)

In 1998, the merger between the two top British drug companies seemed virtually complete with Glaxo Wellcome shareholders having 59.5 per cent of the new group, leaving 40.5 per cent to SmithKline Beecham (SB) shareholders. With a market capitalisation of $110 billion US dollars, the deal would create the biggest pharmaceutical company and the world's third biggest corporation. The chief executive for the new group was going to be Jan Leschly, a former international pro-tennis star turned pharmaceutical executive and SB's CEO. The new chairperson would be Sir Richard Sykes, CEO of Glaxo Wellcome. But after a weekend meeting of intense negotiations and to everyone's surprise, the deal was called off. The following trading day $6.6 billion or 10 per cent of SB's market capitalisation was knocked off while the stock price of Glaxo Wellcome lost 13 per cent.

Formally, Glaxo Wellcome's directors indicated that they were not prepared to proceed on the agreed basis. Informally, SmithKline Beecham directors claimed that Glaxo Wellcome reneged on the original agreement that Leschly would be leader of the new colossus. Glaxo Wellcome executives never challenged this version of the events. Sykes also rejected Leschly’s suggestion of spinning off the

entire research effort into a separate capital raising company. Sykes and his team considered the plan too radical as it would sacrifice innovation in the pursuit of short-term cost reductions.

Both Leschly and Sykes had worked together in the past and some sort of rivalry seemed to have emerged since then. Leschly's patriarchal management style and SB's financial rigour and performance-related culture seemed to have clashed with Sykes' passionate (sometimes even messianic) belief in science. But it appears that if Leschly and his colleagues had retreated on the CEO issue, the merger would have gone through, and Leschly would have been $100 million dollars richer - the value of his shares and stock options in SB, according to an estimate published in The Economist.

Another explanation offered for Leschly's bitter reaction against the possibility that he might not be the chief executive of the new group was based on matters of principle and dignity. As CEO of SmithKline Beecham and before that as the CEO who delivered Squibb to Bristol-Myers, Leschly had done well financially. With or without the merger with Glaxo Wellcome he had already amassed enough for him and his family to fulfil any conceivable material wants. At the same time, Sykes and his management board disliked Lechly's management style and feared the merger would turn into a takeover by SB people. Glaxo Wellcome's management board also wanted to break with tradition (as Skyes had not led the initial move to merge) and claim the top post, because Glaxo Wellcome was the biggest of the proposed partners in terms of market capitalisation, products, and R&D expenditure.

The fact remained that after the failure to merge SmithKline Beecham still lacked the R&D funds to pursue its many leads for new drugs. Other major drug companies continued with their plans and merged. Later that year Glaxo Wellcome still remained without partner as managers also failed in their talks to amalgamate with Bristol-Myers Squibb while SB's had two other unsuccessful merger attempts (including one with American Home Products).

After a first round of merger talks collapsed acrimoniously in 1998, renewed interest in a merger between Glaxo Wellcome and SmithKline Beecham emerged after Jan Leschly announced his retirement as SB's CEO in mid-1999. The announcement effectively removed a major barrier to the merger. As part of the deal in the year 2000, Sir Richard Sykes agreed to become non-executive Chairman, a post of influence but with little management responsibilities.

Jean Paul Garnier was appointed the Chief Executive of GSK (as the company was commonly referred to in the industry). Known simply as '*JP*', he had been raised in Normandy, where he grew steadily on a diet of British and US movies and music (he still claims Jimi Hendrix as a patron saint). Garnier gained a master's degree and a doctorate from France's Université Louis Pasteur before accepting a Fulbright scholarship to pursue an MBA at Stanford University. Except for a few years in various parts of Europe, Garnier's career had kept him in the US ever since. He joined SB in 1990 as president of the pharmaceutical division. Although his early training in France was in pharmacology, he made his name in marketing, and was credited with much of the success of SB's leading products, specifically Paxil, taken for depression, and Augmentin, an antibiotic.

JP Garnier had been Leschly's right hand man for three years as Chief Operating officer and was clearly seen as a *'bad cop´* or hatchet man with Leschly playing the *'good cop'*. Garner's style could not have been more different than that of Jan Leschly. Although externally Leschly was perceived as *'patriarchal'*, he managed to keep good relations with the City. Leschly was also good at communication internally but he was more than that: he was truly charismatic and managed to engage people. He was popular with staff and endeavoured to '*make the job fun*'. His oft repeated mantra was '*if you're not keeping score, you're not practising*', echoing the performance driven culture. In contrast Garnier was known to be tough with people, highly attentive to detail and was perceived as cold and sometimes even arrogant. Garnier moved to number one after Leschly announced his retirement and was an acceptable candidate for the management team at Glaxo Wellcome.

British and European regulators were swift to give clearance to the emergence of GSK. However the Federal Trade Commission (FTC), the US competition regulator, forced the divestiture of medicines for chemotherapy-induced nausea and herpes with annual sales of almost $400 million dollars. At that point managers felt the most substantive issues had been dealt with. However, the FTC continued to have concerns on the merged company's perceived domination of the US smoking-cessation market and this caused a second delay in taking the merger forward. The concerns of the FTC were based on the fact that, at the time, SB had the leading over-the-counter brand and Glaxo Wellcome the only approved prescription drug to help smokers quit. Two key products which the FTC felt would give the combined company control over 90 per cent of that market.

For some observers, managers at GlaxoSmithKline failed to envision that creating the world's biggest pharmaceutical firm could involve a complex regulatory submission process. Others argued that the arrogant approach by the new company management team to the FTC was to blame. Yet others felt that regulators were burdened with the increased number of mega-mergers (in pharmaceuticals and elsewhere) taking place at the end of the 1990s. The influenced of the run-up to the US presidential election in 2000 was also felt as candidates put the spotlight on healthcare spending.

Managers thought that some regulatory delays were anticipated but not that regulatory concerns in the US over monopoly power of the new group in certain therapy classes would consume more than 10 months of negotiations and backtrack the merger process twice. Furthermore, lengthy negotiations with US regulators prevented the early implementation of the new organisational structure. Executives were prevented from specifying how economies of scale in labs would be achieved, how performance would improve or how co-operation across business units would be implemented. Delays in getting regulatory clearance also prevented managers from stopping speculation that the company could eventually split up into separate business or announce how they would reckon with incompatible information technology platforms. All this, in turn, threatened staff's morale and increased the potential of a '*brain drain*' of middle managers. These developments were worrying for a corporation which had yet to be born and which was already involved in a process full of mishaps.

A NEW STRUCTURE FOR R&D

Cost Reductions

In January 2000, when Glaxo Wellcome amalgamated with SmithKline Beecham at the height of the merger boom, the move was explained in visionary terms. As one of the key points of the merger, managers considered building operational headquarters in the US while corporate headquarters would remain in the UK. The new company's increasing tendencies to a US management style and reliance on US markets puzzled many, as Britain was home for both originating companies and the UK one of the world's leading centres for the research, development, and manufacture of prescription medicines. However, Garnier argued that GSK had 99 manufacturing sites in 44 countries (including the UK). Moreover, ever since the merger was announced, Garnier maintained that whilst the new company was proud of its UK roots:

> "… a world-class competitor cannot operate all its functions from a market that represents only 6 to 8 per cent of its existence. The US, by contrast, accounts for 45 per cent of the global pharmaceutical market."[2]

As with any other merger of companies in related areas there was potential for cost reductions. Top executives anticipated the combined company would save an annualised £1 billion after three years. These savings would come on top of previously announced restructuring at both companies, expected to cut a combined £570 million a year. Initially analysts of pharmaceutical companies at investment banks were disappointed by the planned savings. Most estimated the figure to be between £1.1 billion and £1.5 billion, and expected some sort of immediate disposal of factories, reduction of intermediate capacity or outsourcing plan. After two and half years cost savings had in fact amounted to £1.8 billion and measures taken two years earlier were beginning to bear fruit. By 2003, cost reductions had taken GSK's trading profit margin to 35 per cent, although it remained close to the 2002 level when excluding £87 million from disposals. Continued enthusiasm for cost savings as the main fuel for increasing pre-tax profits in 2002 and 2003 resulted in Jean-Pierre Garnier hinting that he was considering a second stage of cost cutting.

Breaking Up the 'Pipeline'

Combining Glaxo Wellcome with SB also promised to deliver the most cost efficient research organisation in the pharmaceutical industry. Expected savings of £250 million from combined R&D operations were destined to be plough back into R&D efforts. The company would kick off into life with an annual research budget of £2.4 billion, the largest in the world after that of Pfizer. Analysts were

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[2] *Chemical Market Reporter*, January 2000, p. 24

encouraged by potential pay-offs that could come from the complementary research skills of the two companies. In other words, Glaxo Wellcome's investment in technology to automate the chemistry of developing drugs combined well with SB's leadership in genomics[3] (which promised a wealth of drug development opportunities). In fact, SmithKline Beecham had an existing pipeline of four promising drugs in the final stages of development. This was indeed very attractive to Glaxo Wellcome, who relied heavily on the generic sales of its blockbuster drug Zantac.

The new company then revealed plans to re-engineer its R&D and marketing operations. At the time, Jean Pierre Garnier considered that organising 15,000 scientists across several time zones, with an annual budget in the billions of pounds, would require a radical new structure. However rivals such as Pfizer, Novartis or Aventis, which had already restructured their core operations, questioned how radical Garnier's plan really was. Garnier was philosophical about such struggles, he considered that the ultimate success in the pharmaceutical industry lay in innovating for the future, not fighting over the past. He also frankly admitted that his company's approach was not guaranteed to deliver, but he was absolutely certain that the old way would no longer do.

The plan considered breaking up discovery efforts through a combination of centralisation and decentralisation. Investments to generate new chemical entities (NCE) would concentrate on traditional activities and genetics while aiming to develop economies of scale. Discovery efforts would then be broken into six autonomous sub-units, aiming to maintain the excitement of a small discovery outfit. They were to remain small enough to be creative and innovative, without the dead-weight associated with the bureaucracy of a large global player. Drug development (including clinical trials) and marketing would again be co-ordinated by the central organisation.

Maintaining a single effort to discover NCEs sought to apply scarce skills and expensive equipment across a range of diseases, two administrative divisions were created, one in Genetics Research and the other to look at the traditional Drug Discovery Research. The emphasis on genetic research followed the new company inheriting substantial investments in the use of genomics in drug discovery: at its formation, GlaxoSmithKline had over 500 patent filings for genomics-based drugs. Actually, just as merger proceedings evolved, SmithKline Beecham brought to clinical testing a genomic-based drug to treat obesity and one to treat hypertension.

As mentioned, out of the middle section of the pipeline six sub-units were created in 2000 (one in Italy, two in the UK and three in the US). A seventh Centre of Excellence for Drug Discovery (CEDD) was created in 2003 to concentrate on biopharmaceuticals, a field where GSK was progressing a growing number of chemical compounds in the early stages of the pipeline. The CEDD's effectively organised the efforts of the 24 R&D sites across the world in existence prior to the merger. They work semi-autonomously and compete to attract financial resources from head office (and eventually from venture capitalists and even the stock market).

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[3] Genomics, the study of genes and their function, promised to increase treatment effectiveness while limiting side effects by identifying people who would definitely respond to a specific medicine.

The seven sub-units were empowered to use compounds discovered within internal early research divisions, brought in from academia or from external biotechnology groups. It was hoped that as a result of the plan, the CEDD's would avoid the hassle of bureaucracy, associated with a large global player, while maintaining agility, creativity, entrepreneurial spirit and individual accountability in a key part of the drug discovery process. There was an expectation that talent would be attracted by emulating the culture at biotechnology firms, including the introduction of big share option packages through which scientists receive royalties on the sale of medicines they helped to invent.

GSK's structure also considered clinical trials and marketing had to be undertaken on a massive scale, often across continents, and simultaneously complying with strict regulatory conditions. Scale at this last stage of the pipeline aimed to achieve corporate control and uniformity as well as capitalise on global reach. For instance, shortly after the merger was announced, two licensing agreements were signed by SmithKline Beecham while looking to strengthen links with the Japanese pharmaceutical sector. Since marketing partnerships were seen as the only way to enter some markets (particularly for non-Americans to enter the US or for non-Japanese to enter Japan) the deals could become very important to make the best of the new organisation. Alliances expanded in markets outside the US and Europe. For instance in India, where a deal was signed in 2003 to collaborate with a local company, called Ranbaxy, in the development of NCEs. Interestingly, Ranbaxy and GSK often came head to head in the sales of generics in the US market.

[Insert Box 2 around here]

FROM PLAN TO ACTION

Effectiveness of R&D

For all its efforts and fanfare the jury was still out on the relative success of the new R&D and marketing structure. There had been little time between 2000 and 2003 for *'the dust to settle*'. Nevertheless, from the start observers were sceptical as to actual degree of autonomy that would be granted to the seven '*internal biotech units*'. There was also scepticism that the CEDD's plus the global platforms for drug discovery, clinical trials and marketing would actually deliver increased productivity.

At the time of the creation of GSK there was significant overlap in the product portfolio of the amalgamating companies (both being weak in cancer and cardiovascular diseases but strong in gastrointestinal, antibiotics and nausea prevention drugs). Only 7 per cent of Glaxo Wellcome's sales depended on drugs whose US patents expired before 2006 as compared to SB's 33 per cent. GlaxoSmithKline was therefore born with assured income streams given patent protection and the fact that no single drug accounted for more than 12 per cent of sales. Thanks to this, GSK was protected from the sudden-death syndrome that afflicts some companies when their blockbuster looses protection. Assured income streams also gave GSK managers some slack time to test the efficacy of the '*radical*' new organisational structure. In 2002, however, GSK only had 42 new chemical compounds in

early-stage clinical trials. Few of these would actually make it to the market and questions were being raised as to whether the company might or might not maintain its growth rate while (eventually successful) drugs slowly made their way to market.

Between 2000 and 2003, the company did launch a few interesting medicines but an increasing number of them were licensed from other firms, and none were considered blockbusters. Internally, during the first two to three years R&D people had felt as if in limbo. The number of re-organisations in the way of implementing the new structure effectively meant absence of direction: for instance, the forming and reforming of teams, changes in location, alterations and delays in plans associated with the new global organisational structure only lengthen the time to take products to market.

In 2003 the company held a *research day* to discuss promising drug candidates with analysts and investors - the first time it has done so since the merger in 2000 that created the company. The meeting was crucial for GSK's management team as it needed to reassure investors, anxious about its long-term growth prospects, that GSK had potential blockbuster drugs in the pipeline. While it has been adept at cutting costs since the merger, questions remain about its ability to convert exciting research into marketable drugs after a history of disappointments.

During the *research day* GSK informed it had 147 projects in clinical development, spanning a variety of therapeutic areas and encompassing a number of pioneering approaches to treating patients in need. The 147 projects include 82 new chemical entities (NCEs), 45 product line extensions (PLEs), and 20 vaccines. The company had 30 more NCEs in the pipeline than at October 2001, and had increased the number of NCEs in Phase II and III/registration from 23 in 2001 to 44 in 2003. GSK‘s goal was to bring more than 20 NCEs to Phase III development between 2004 and 2007, leading to an anticipated record number of filings between 2004 and 2009 many of which, the company said, with the potential to reach blockbuster status.

The risk for GSK, however, was that investors remained unconvinced. According to Max Hermann, analyst at ING Barings, during the presentation GSK's management had " …four or five interesting products to talk about … and in the past, they had a bad record at taking drugs from phase III trials to market."[4]

The Spirit of GSK

In spite of promises that synergy in R&D would *'turn the corner'* of decreased productivity plaguing the industry, three years on there was little evidence of success. Indeed, because of a thin late stage pipeline GSK had become dependent on licensed products such as Levitra - Bayer's impotence treatment - and cost savings to lift short-term growth. Not surprisingly Garnier was increasingly being asked by the media as to whether his company might consider another merger. He would shrug off these questions alleging his company already had everything needed to succeed:

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[4] *Financial Times*, December 03, 2003.

> "Miracles don't exist, but you will see that R&D has changed at GlaxoSmithKline. It has taken hard work and painful choices."[5]

Garnier and senior management team had made an effort to come close to employees: emails could be sent directly to him while responses were placed for all to read in the company's intranet. They felt efforts to combine both cultures under the *Spirit of GKS* banner had been successful. Other initiatives included an improved benefits package (internally called *Total Reward*) which brought all forms of remuneration under one programme - including a favourable share purchase scheme and links between performance to pay and bonus.

Some managers and particularly those outside the US and the UK, however, felt there was evidence that, after three years, the company was still in desperate need of a distinctive identity: the different management philosophies of the two merged companies was still much alive. So much so that specific advice was often at hand in how to deal with the former Glaxo or former SB employee. Getting people to work to common processes was also a '*problem*': managers, for instance, would agree on a way forward during a meeting but when returning to their sites, they would carry on as before and allow people to stick to their Glaxo or SB way of doing things.

Some felt that the added time needed to dissipate differences in management style plus other teething problems was allowing bureaucracy to run rampant and all this was getting on the way of long term change. Gossiping about potential further cost cuts, possibilities of more business units were turned into autonomous companies and indeed the phantom of a new merger was very distracting for some employees. In spite of internal differences and unease, people got on with the job. GSK did portray a coherent image to the outside world thanks to consistency at the business unit level. Moreover, to the eternal question of whether each new merger deal intensified pressure on rivals to either respond with matching amalgamations or risk falling behind in the race for market share; GSK people retorted:

> "Where would we be if we hadn't merged? Would we be able to do all the things we do today?"[6]

Commentators wondered if the shareholders of GlaxoSmithKline would continue to endure disappointing results? Should GSK look for a new amalgamation? And if so, who? Accounting anomalies followed by a government investigation ruled out a number of potential partners in the US (including Bristol-Myers Squibb, Elan Corporation, Merk & Co and Eli Lilly's). Another possibility was looking in Europe: for instance considering amalgamating with AstraZeneca, the Anglo-Swedish pharmaceutical. But AstraZeneca's share price was at least 30 per cent overvalued (trading at 23 times earnings, compared with an industry average of 15 and GlaxoSmithKline's 13 times earnings). Moreover, it was rumoured that Swiss-based Novartis could merge with Roche, the other Swiss giant, into a powerful cancer franchise, the worlds' leading diagnostics business and one of the best biotech

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[5] *Financial Times*, May 01, 2003.

[6] *Personal interview*, October 30, 2003.

research facilities around. Together their sales would be $45 billion per annum, nearly 7 per cent share of the global market. The likelihood of this deal happening, however, was dampened by Roche's in-built defence mechanism that had repeatedly spurned merger attempts.

Jean-Pierre Garnier, the chief executive of GlaxoSmithKline, pointed out that his company made profits of £3.7 billion in the first six months of 2003, up 9 per cent on 2002, or 18 per cent if the effects of the depreciating dollar versus sterling were stripped out. Turnover was up 6 per cent in constant currency terms, with disappointment only in the consumer goods business. Moreover, GSK was strengthening its presence in the global market for over-the-counter (OTC) drugs and was due to present its portfolio of new drugs to investors at the end of 2003. Garnier hoped to announce a drug development pipeline positively alive with exciting new products. However, somehow that message had proved hard to sell.

BOX 1: GROWTH THROUGH AMALGAMATION

The companies giving birth to GlaxoSmithKline themselves resulted from amalgamation. On the one hand, SmithKline Beecham was created in 1989 through the merger of Beecham and SmithKline Beckman. Officially the *'correct*' abbreviation for the latter was *'SB*' and reference to just *'SmithKline*' was avoided as this gave the impression that Beecham had been taken over. Preventing the alienation of Beecham people was also why the abbreviation was a new *'SB'* rather than the old *'SKB'* used by SmithKline Beckman.

SmithKline Beecham

The creation of SB resulted in a transcontinental pharmaceutical and healthcare firm, which sparked a wave of mergers of pharmaceutical companies that spanned the following decade. Beecham and SmithKline Beckman (SKB) were two '*also rans*', both running out of internal options: SKB had failed in its efforts to replace the income stream of its main blockbuster drug (Tagamet) but had an aggressive sales force in the US. Beecham was essentially a consumer goods company that had been successful in early research on antibiotics. Beecham was very *'old school British*': for example, some buildings had separate dining rooms for different grades of staff and managers and there was even a *'members only*' bar at Beecham House (i.e. head office). Beecham had neither the mass nor the competencies to become a serious pharmaceutical player but it and SKB felt threatened as potential takeover targets.

The amalgamation of Beecham and SKB was lengthy and relied on a combination of benchmarking (i.e. continuous improvement efforts) and process re-engineering. Initially the integration process resulted in a great deal of uncertainty for the workforce as stringent demands were made on individual managers, who were not given their new responsibilities until after the integration plans and new organisation structures were approved.

With hindsight, however, the lengthy integration process was actually a success. Top management invested substantial time and effort to create a new culture (under the *'SB Way*' banner, also called the '*simply better way'*.) This initiative introduced new methods to measure and reward individual performance. At the same time, managers worked together saving the best of each group: for instance, the more street-wise and marketing orientated Consumer Healthcare people (largely from Beecham) were encouraged to cross-fertilise with their pharma colleagues. The *'Leadership and Development Review*' was set up to facilitate that this sort of cross-fertilisation sat nicely alongside the career development plans of staff.

The company thus tried to live its values of innovation, performance, integrity, people, customer: something quite new then. Continuous improvement was a big thing - *'plan, do, check, act*' for doing anything and *'situation, target, proposal'* for all reports. The more laid-back British approach of the Beecham group was replaced by a process orientated way of working. Even the old dining habits were caught in the process of change: Beecham House now had a single canteen for all employees and another set up down the road at New Horizons Court, where the corporate headquarters was. In short,

there was a *'reward and celebrate'* culture and SB people in general were genuinely proud to work for their company.

By 1994 there was a real feeling of success about SB. Processes, procedures and corporate culture had come together in harmony. The company had grown and developed critical mass in new geographical markets, especially Central and Eastern Europe. The amalgamation really felt like a merger of equals and the company went at great lengths to show this to the outside world. The share price just rocketed. This also benefited employees that had taken advantage of the very generous *'buy one get one free*' share plan. Indeed, the canteen at headquarters even had a screen with the share price and people talked about it obsessively.

Through amalgamation both Beecham and SmithKline Beckman tried to keep up with critical mass in R&D, as the combined research budget doubled, but total R&D expenditure still lagged behind the likes of top firms such as Glaxo, which was outspending them two to one. At the same time, some managers felt the SB Way initiative was running out of steam.

Glaxo Wellcome

Glaxo Wellcome resulted from the merger of two leading UK pharmaceuticals in 1995. In the mid-1970s, Glaxo was a small British firm with its origins in the dried milk business and had most of its sales in antibiotics, respiratory drugs and nutritional supplements. During the 1980s Glaxo grew organically and rapidly thanks to the commercial success of its R&D efforts. By 1994 sales totalled £5,656 million or 3.6 per cent of the world market with earnings emerging from a strong presence in Europe and the US. The top industry position was secured in 1995 when the industry as a whole faced increased drug discovery costs yet again. Glaxo managers effectively engineered a takeover of Wellcome, as the Wellcome Foundation (the largest non-profit medical institution in the UK) owned a 40 per cent stake in Glaxo's Zantac and 39 per cent of Wellcome's share capital. Zantac was an anti-ulcer blockbuster product and the world's best selling drug, commanding 35 per cent of the antiulceran market and achieving record sales of £2.4 billion in 1994. Zantac had been launched at the beginning of the 1980s and became the top product even though it was second to market and 60% more expensive than SmithKline's Tagamet. Zantac contributed 43 per cent of Glaxo's revenues, resulting in a large part of Glaxo's growth being based on its success. The problem was that Zantac's patent expired in 1997. At the same time, the Wellcome Foundation was amenable to the merger as it offered possibilities to dissipate risk and to ensure that resources would be available for basic research.

Wellcome was known for its *'academic'* approach to pharmaceuticals, with strong science but weak marketing. In 1996 and six months after the merger of Glaxo with Wellcome, managers claimed that the newly created Glaxo Wellcome was fully integrated. Its sales volume rankling was the first in the world, it was the third largest company by market capitalisation in London and the world's largest pharmaceutical research firm with 54,000 employees.

But the reality was that a severe clash had occurred: On the one hand, Wellcome had rather *laisse-faire* or laid back management style, that is, it oblivious to budget control but focused on science and

medical applications. A style that Wellcome people saw as positive in fostering innovation. On the other hand was Glaxo's hard-nose, commercial and control-driven culture. Whereas the styles of Beecham and SmithKline Beckman co-existed in the formation of SB since both were a corporate/team approach, Glaxo's culture predominated and obliterated Welcome's benevolent style. Things worsened by the fact that few former Wellcome executives survived the takeover to serve the new Glaxo Wellcome. Top managers endeavoured to rationalise the overall organisation and introduce economies of scale in R&D activities. But the truth was, however sad, that in spite of complements in the product portfolio top executives had great difficulty holding the new company together.

At the time of the merger with Wellcome, the chief executive at Glaxo was Sir Richard Sykes. Sykes held the job since 1994, a former (very successful) British academic and R&D director, as well as a firm believer in investing in R&D for company growth. One of the biggest setbacks of his career at the top position in the new Glaxo Wellcome, was the UK government's decision in 1999 not to name Relenza, the company's flu drug and the first real success of combinatorial chemistry research, on the National Health Service list of prescription drugs. However, he had been responsible for the diversification into emerging markets, joint ventures in India and Japan. He also introduced a new organisational structure (called '*global products responding to regional needs*'), that aimed at offering the same products under different brands and marketing schemes or the same adverts adapted for local conditions.

By the end of the 1990s, some analysts were sceptical on whether the merger of Glaxo with Wellcome had produced any synergies at all. It was true that sales of revitalised Wellcome products through Glaxo's marketing muscle had helped to avoid slipping in the rankings, but it was also true that the drugs pipeline was unimpressive and many new products had failed to live up to expectations. The merger had, indeed, brought Glaxo presence in therapeutic areas that it had not exploited before (eg. antivirals), while Wellcome benefited from greater financial discipline and focus. This resulted in analysts wondering whether costs had really been brought under control, whether Glaxo Wellcome had relied too much on disposals to flatter its earnings performance and, on balance, many were disappointed that augmented R&D facilities had done little to replenish the pipeline by producing new potential blockbusters.

The Merger

The planned marriage of Glaxo Wellcome and SmithKline Beecham at the turn of the century was expected to reverberate on both sides of the Atlantic. The merger came at a time when Europe's pharmaceutical companies were locked in a high stakes multibillion dollar struggle with their US rivals to stay in business beyond the first decade of the twenty-first century. The overwhelming industry response to the need for critical mass in R&D and global marketing presence was a wave of mergers and previously unheard-of hostile acquisitions leading to amalgamation. The frenzy of take-over activity included the amalgamation of Hoechst (Germany) and Rhône-Polenc (France) into Aventis, a merger which reported a meagre 13% annual increase in profits between 1999 and 2000. Aventis' financial performance was amongst the lowest in the industry but typical for a drug company that had merged

and had realised as much cost-saving as possible. Other products of amalgamation in the late 1990s included Novartis (1996), AstraZeneca (1999) and Sanofi-Synthelabo (1999) in Europe. Amalgamation in the US included the creation of Pharmacia & Upjohn (1995), the acquisition of Monsanto by Pharmacia & Upjohn to create Pharmacia (2000) and the acquisition of Warner-Lambert by Pfizer (2000).

BOX 2: GOVERNANCE AND SOCIAL RESPONSIBILITY

Between 2000 and 2003, the corporate governance and corporate social responsibilities were a mixed bag of good and bad news for the top team at GlaxoSmithKline (GSK). On the bright side the company had developed and met very specific goals for global corporate environmental standards. Another positive development came in 2003 when, for the second consecutive year, GSK was recorded as giving the largest amount to global good causes of any FTSE 100 company. This as GSK's program of involvement in the community was worth at least 2.4% of pre-tax profit in 2002.

On the less brighter side, ineffective public relations left GSK open to accusations of profiteering. The company held the patent for a key drug in the treatment of HIV/Aids. The issue of how best to provide treatment in Africa resulted in a very public and very long clash between GSK managers and the South African Government, Aids-Africa relieve activist (including Nelson Mandela) and even some of GSK's institutional investors. Even more damming, however, was the whole issue of the ultimate pay awarded to JP Garnier in 2003.

In large public corporations, such as GSK, the salaries of senior executives are set by a remuneration committee. Usually the committee's chair and most of its membership is made out of non-executive directors plus a couple of senior executives. In 2003, after a long and highly publicised row with both small and institutional investors, GSK had to withdrew plans to award JP Garnier what the press considered an outlandish share package worth at least £11 million. Sir Christopher Hogg, by then GSK's chairman, was called in to override the recommendation of the remuneration committee and negotiate a pay package that had the potential to reverberate throughout the biggest companies in the UK.

Sir Christopher Hogg was a former non-executive director of GSK (and of SB), who stepped in to take the helm in 2002. At the time, Sir Richard Sykes made an unexpected early exit from GSK and decided to go full-time as the head of Imperial College - a prestigious UK university with strong research profile in the sciences and superb medical school. Hogg expected that the new post, one at the pinnacle of British industry, would bring a brilliant end to his distinguished career. Shortly after and much to his surprise, he was in the middle of a convoluted process for setting the pay of his senior executives, a surprisingly heavy responsibility because in 2003 GSK- through a combination of bad luck and insensitive management - became the British symbol of corporate excess.

A pay deal worth £2.45 million in 2002 already made Garnier one of the best-paid executives in the UK. Shareholders were told that the 2003 package was needed to keep his incentives in line with those of top executives at leading US-based pharmaceutical companies. Garnier's proposed package for 2003 was

made up of £935,000 per annum as basic salary plus a complex mix of share options, free shares, pension benefits and other bonuses.

Shareholders and particularly UK-based institutional investors were not happy. Most US pharmaceuticals linked their CEO's pay to share-price movements. British investors considered that short-term stock price performance was a poor reflection of management quality. Shareholders were particularly infuriated with Garnier's two year notice period and a one year's share entitlement he would receive after leaving. Shareholders also complained that the proposed targets for Garnier were too lenient and wanted them explicitly linked to GSK's performance compared with that of other pharmaceuticals, rather than to the economy as a whole. Shareholders ultimately voted to reject the proposed remuneration package for Garnier at the annual general meeting - a vote unprecedented in UK corporate history.

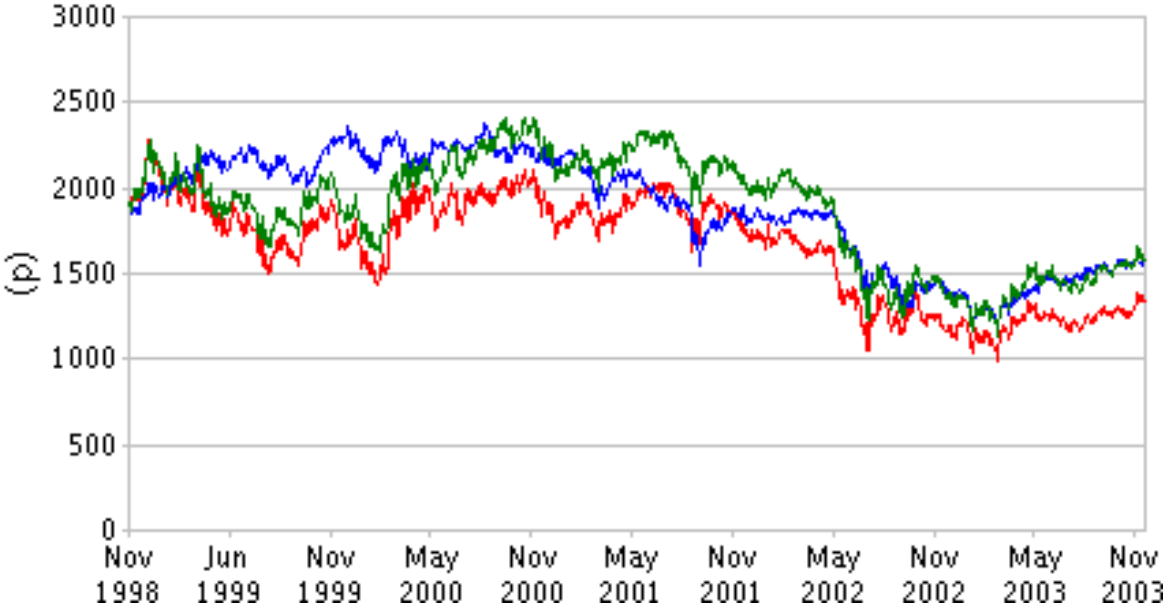
The feeling of shareholders found echo with some of the staff at GSK. Many felt detached and were taking no risks as their share options (traditionally a large perk) had little or no value. During the bull market of the 1990s, long standing employees (and particularly those coming from SmithKline Beecham) had seen the share price rise from around £2 per share in 1994 to almost £10 per share in the first half of 1999. That price was equivalent to roughly £23 in new GSK shares. During the bear market that followed, the very public power struggle around the remuneration issue was instrumental in the share price reaching its lowest level in five years when trading at £10 per share in mid-2003.

Hogg was called in to head the pay policy review panel and he employed Deloitte & Touche as advisers. Garnier (and his lawyers) argued that the bulk of the severance package was part of the contract signed when joining SmithKline Beecham from Schering-Plough in 1990. They also argued he was the lowest paid among chief executives of the largest pharmaceutical companies. Moreover, that the move was for the benefit of the whole executive team and not only for himself. Indeed, few key figures had deserted the top echelons of GSK management after the merger. Garnier emphasised the generosity of US remuneration packages as well as the fact that the US provided 54% of GSK's revenues in 2002 and was home to two-thirds of top executives. Hogg was warned that the application of '*UK cultural attitudes*' on pay could leave the company vulnerable to rivals.

Ultimately, the proposed solution by Deloitte & Touche found middle ground between the demands of Garnier and the particular demands of UK investors while keeping pay at competitive levels. However, identifying how much he would ultimately reap was tricky, given that the formulae that determined his pay turned out to be quite complex and largely impenetrable. It was also unclear whether Hogg's goal would be achieved and the same formulae could be applied to hundreds (and possibly thousands) of senior employees at GSK.

At the end of 2003, the share price was trading just above £13 per share while, at the same time, many employees were demoralised as they had found the remuneration debacle very embarrassing.

Exhibit 1: GSK stock market performance, 1998-2003



Source: Hemscott Long, 2003.

Key: Red - GSK share price; Blue - FTSE All Share index; Green - Average stock price pharma sector.