

## *The Art of Partnership*

### **REAL Software Systems: Enabling the Financial Benefits of Life Sciences Partnerships**

Large pharmaceutical companies have long relied on innovations developed by other Life Sciences companies to fill the gaps in their product pipelines and improve time to market. In 2001, in-licensed innovations accounted for 30% of Big Pharma revenues. With the looming expiration of key patents, lagging R&D productivity, and a need to sustainably bring new products to market, that reliance is likely to grow.

Maximizing the mutual value of innovation partnerships is imperative as in-licensed innovation plays an increasingly critical role in product development. Whether a partnership yields talent, technology, compounds, or information, the objective is to improve the time to market and cost structure of the product development lifecycle. By effectively defining and managing the financial terms of your partnerships, you will increase the likelihood of sustainable partnership benefits.

Royalty agreements and other forms of contingent compensation are often central to the supply chain of intellectual property. Business realities typically yield complex arrangements to appropriately allocate the risks and rewards among partners who work together to develop and bring to market intellectual property-based products. These very arrangements, however, often confound a company's infrastructure to service them requiring information that may be spread across multiple systems and organizations or, oftentimes, is never even captured and tracked in any system.

Traditionally, this has resulted in a mixture of custom legacy systems, spreadsheets and manual intervention to keep up with the constant change and increasing complexity that characterize the financial terms of licensing agreements. It is not unusual for this situation to result in delays, inaccuracies and financial surprises that can lead to the erosion of trust among partners. Not to mention the resulting lack of detailed, accurate, enterprise-wide management information that inhibits the organization's ability to evaluate and manage its business.

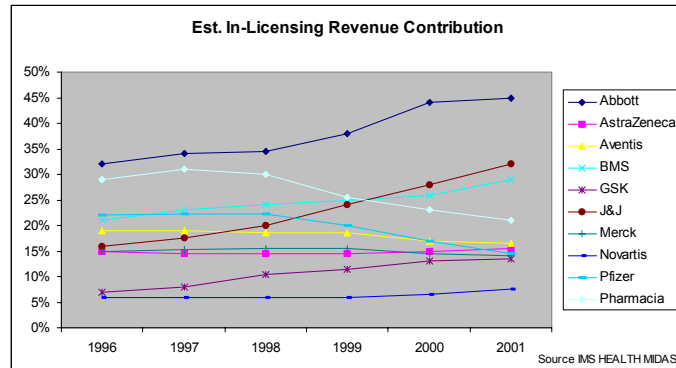
### ***Life Sciences Products & Innovations: Pure Intellectual Property***

In its most pure form, intellectual property, such as medical devices, biotechnologies and pharmaceuticals, are protected by copyright law and patents. As a result, patent laws provide a powerful incentive for innovation and discovery. Patents are especially important to the discovery of new innovations in Life Sciences, where it can take 12 to 15 years and more than \$500 million to bring a new medicine to consumers. Patents give the research-based pharmaceutical and biotechnology companies the opportunity to recover the high costs of research and clinical trials in the development of new and innovative medicines. Additionally, these research-based companies often use in-

licensing partnerships to mitigate the high costs and risks associated with research and clinical trials.

*Examples include:*

**Major Pharmaceuticals** develop and distribute products that combine licensed products and technologies with in-house innovations to build their product portfolios. These companies have complex and ever changing bills of materials and must reconcile the flow of manufacturing, shipments, duplication, and documentation to determine and report on their royalties. Royalties can become



due based upon a variety of events including acceptance into inventory, sale, and/or shipment of product. For larger organizations, these obligations make up hundreds of millions of in-licensed revenues, and, at times, in excess of a billion dollars in product costs.

As shown in the graphic above, some major pharmaceuticals attribute a large percentage of revenue to in-licensed partnerships. The complexity and diversity of the terms of these arrangements require sophisticated methods of processing these contractual obligations. In addition, the auditability of these transactions is crucial to support the growing scrutiny of accounting and financial reporting.

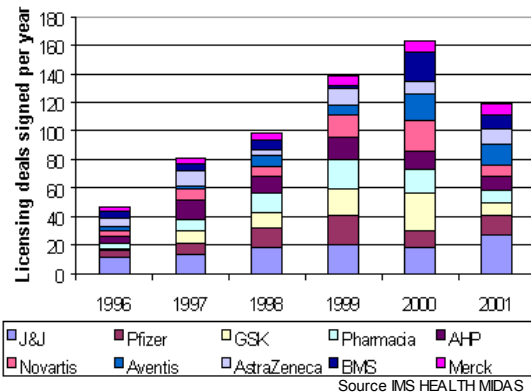
**Medical Kit Manufacturers** bundle internally developed products with licensed products and technologies that create solution kits for sale to end-users. These companies often license and integrate other applications or components into their products that they ultimately market to end-users. The significance of these licensed components varies greatly, and in some cases may be substantial. These organizations must be equipped to capture the utilization of licensed components and accurately calculate and report on royalties to their licensors.

**Medical Device Manufacturers**, like the examples above, must manage licensed technologies used in the creation of a finished product. If not managed carefully, licensees can unintentionally violate licensing agreements and perhaps lose the right to utilize a component that has been tightly integrated into their products, at considerable expense. These parameters must be tracked closely to fulfill these obligations and maintain strong partnerships.

**Biotech Companies** develop and license innovations such as compounds and genome libraries that are consolidated into the early-stage agreements sold to Pharmaceutical and other finished product vendors. To manage the risk of drug licensing, drug firms

typically offer Biotech firms upfront advances against future royalties for preclinical products that result in larger financial obligations as products reach clinical trials.

Analysts such as McKinsey & Co. have assessed the advantages of early-stage vs. late-stage deals and their result on the overall profitability of these partnerships. Nonetheless, the royalties due to licensors can be a very significant percentage of the resulting revenue to the Biotech firm. Thus, providing an efficient, reliable mechanism to execute these financial transactions is crucial in building a successful partnership.



In all these examples, the negotiating position of licensees can be substantially eroded if they cannot demonstrate the ability to service their obligations on an accurate and timely basis. And, indeed, many licensees cannot provide these assurances.

### ***Complexity at Every Turn***

The root causes of difficulties in servicing the financial terms of licenses are manifold. The process is often complex and constantly changing as business models evolve. Many licensees treat the issue as a low priority, back-office function not worthy of serious attention from IT. The enormous amounts of money that needs to be controlled and the strategic issues of building trust and negotiating strength with partners often take a back seat to more obvious and pressing issues. The financial terms of licensing arrangements vary from license to license, company to company, and industry segment to industry segment. Common terms include:

- Advances to be paid at various times, events or milestones in a project and that may be recouped in various ways.
- Reserve allowances for product returns and bad debts that are taken and liquidated according to various criteria.
- Guarantees of royalties to be generated within given time periods or over the life of the license and the methods by which guarantee shortfalls are distributed and possibly recouped.
- Tiering of royalty rates over various factors: time and units, a combination thereof, and varying within tiers based on numerous factors.
- Royalty rates that vary over a plethora of factors including territory, intended use, channel of distribution and many others as well as combinations of these factors.
- Complex allocations of revenue and royalty rates must be addressed when multiple products containing licensed content are packaged together and sold as a unit.

The combinations and permutations of these terms actually in use lead to a vast array of financial arrangements. When there are multiple contributors to a given product the number of licenses and financial terms can mushroom. In order to produce meaningful

management information royalties must be calculated and tracked by a variety of characteristics, such as product, territory and sales channel, to name a few. Add to this an environment of industry consolidation and evolving distribution methods and licensees face a formidable challenge living up to their obligations.

As the head of financial reporting for Allergan, a technology-driven, global health care company, states:

*" We've saved a lot of manual work and secured control over a complex process by depending on the unique capabilities of a royalty management system. The software is flexible, easily integrated with our ERP system, and easy to use."*

Allergan implemented the system to process its complex agreements with providers of pharmaceutical compounds and surgical devices. Negotiations with partners result in many unique combinations and variations of terms and standards are difficult to develop. High levels of complexity and change provide a constant challenge in this environment and we must get it right to support critical relationships with key partners.

Reacting to this complex environment, many companies have either attempted to build custom systems or have relied on spreadsheets. The problems with structured custom systems include requirements that are continuously in flux, a dearth of IT talent experienced in the domain, projects that are uniformly under-scoped, and resulting systems that lack flexibility. Spreadsheets are wonderfully flexible, but lack inherent controls, do not scale well as contract volumes increase, are difficult to mine for enterprise-wide management information, and typically require extensive manual intervention. Seeking to solve the problem, these strategies at best delay the ultimate solution and may even make things worse.

Clearly, while the subject of royalties may not be perceived as the highest profile issue for many organizations, it remains a subject with profound strategic implications for innovation licensees. The situation will only get more vexing as new revenue and distribution models evolve and move into the business mainstream.

### ***Framework for a Solution***

Considering the scope of the problem, organizations require a robust, enterprise-wide solution that can easily interface with multiple, diverse systems; normalize the required data in a common repository; can handle unpredictable complexities; and can adapt easily as the business evolves.

REAL Software Systems (RSS) offers just such an approach, based on years of experience in the licensing realm. *Alliant*, RSS' flagship product for the management of royalties, relies on a unique environment driven by business rules that can be developed efficiently and adapted quickly as business needs evolve. The use of such business rules provides great flexibility in the manipulation and processing of royalties data. The application also provides a highly flexible interface engine that can be quickly configured

to accept and normalize data originating in virtually any type and number of systems. Information generated from royalty processes is used for many different purposes: to support operations, management reporting, licensor reporting, accounting, and cash disbursements. *Alliant* provides a number of methods to access data for these purposes, from ad-hoc query facilities to embedded reporting tools. An ease-of-use philosophy is pervasive throughout the application to simplify the inherent complexities of royalties from the end user.

This approach is unique in the market, and has led to the rapid acceptance of *Alliant* as the de facto standard for large licensees of innovation with numerous, complex licensing arrangements. With this unique and powerful environment, RSS is helping industry leading Pharmaceutical, Biotechnology, and Medical Equipment companies as well as some of the largest intellectual property driven companies to manage the significant challenges of innovation partnerships reliant on effective royalty management.

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