Capital injections could help pharmaceutical industry

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India has made significant progress in terms of self-reliance in pharmaceutical products. Prices for indigenously manufactured drugs are the lowest in the world.

The success story of the pharmaceutical sector stems from its reliance on reverse engineering – a process that has allowed quick replication of new drugs at a low cost – to make and sell generic drugs.

This was possible thanks to the overall policy environment created by the Patents Act, 1970, which allowed only process patents.

However, with the integration of the Indian patent regime with the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) and the consequent introduction of products patents, Indian pharma companies can no longer produce a patented product by adopting a different process from the one registered.

In a strong intellectual property regime, the pharma companies are left with no option but to build the in-house capabilities necessary for original research in order to survive and compete with the international standards.

However, research and development (R&D) of new drugs is a costly affair. In addition to R&D, expenses incurred on clinical trials, regulatory approvals and international patent filings also demand high investments.

Why PE/VC funding?

The capital-intensive nature of the healthcare sector coupled with its typical characteristics of high risks, long gestation periods, but high and long-term rewards, makes it an ideal target for funding by venture capital (VC) at the start-up stage, and by private equity (PE) investors at the expansion stage.

Indian healthcare companies have the research and production skills as well as the cost advantage necessary to compete, but they require the necessary financial support.

The PE/VC investors can assist by financing technology-intensive projects and innovative research, projects that would otherwise remain only on paper.

In addition to the necessary funding, PE partners, who have the experience of working with companies in a wide range of industries, can support Indian companies with managerial inputs as well as the right strategies that could help them dominate key export markets.

Technical input

Foreign PE players may also provide technical advice on a number of specialized areas, for example, on how the company could best organize itself to meet the standards set out by the US Food and Drug Administration, which regulates the industry in that country.

With the increased interest of investors, a new trend of de-merging R&D operations into separate entities is developing quickly.

A wide cross-section of companies such as Dr Reddy Laboratories, Ranbaxy, Nicolas Piramal and Sun Pharmaceutical have de-merged their R&D operations into stand-alone companies to limit the risk to their pharmaceutical businesses while seeking out PE investors to support their research initiatives.

Hived-off research units that are highly focused attract more investments as the business is judged on its potential to create new products and the anticipated value of those products.

Limited tax benefits

So far, SEBI-registered venture capital funds (VCF) and venture capital companies (VCC) have benefited from what is known as "pass through" tax treatment.

This means that income earned by the VCC or VCF by way of dividend, interest or capital gains would continue to retain the same character in the hands of investors, who are deemed to receive such income directly from the venture capital undertaking.

However, the Finance Act, 2007, limited this tax benefit to investments in certain sectors only.

As far as the healthcare sector is concerned, the tax benefit is available only for R&D of new chemicals, and not for other segments, such as contract manufacturing, import and marketing of drugs, setting up of hospitals and diagnostic centres.

Government input

Global pharmaceutical companies are increasingly outsourcing manufacture of drugs to low-cost destinations like India. In turn, contract manufacturing is one of the biggest growth areas in the industry.

What's more, people need health care while increased medical tourism to India has generated an urgent need to improve and expand the country's medical infrastructure, a goal that may be more easily achieved through VC/PE investments.

However, it is necessary that the government provide an environment that enables PE/VC investment in the sector by extending more tax benefits to the healthcare industry as a whole.

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