ECKUITY
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SIZE DOES MATTER!

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Size Does Matter

Measuring Markets Methodically.

This is a real quote from a real SEC prospectus for an IPO: "The global transportation fuels market represents one of the world's largest markets at over $2 trillion…Over time, we expect to compete in the broader market for…". The company that wrote this in their prospectus went bankrupt less than 5 years after IPO and these trillions of dollars never materialized. This probably wasn't the first time or the last time that the management of a company made incorrect assumptions about the actual market size, but we highlight it simply because we saw this debacle from extremely close quarters and knew the management team very well. And oh, by the way, we drafted that prospectus as their investment bankers.

In another example, a next-generation supply chain product company informed us that their global market is some trillions of dollars (again!) and when we started asking probing questions about where actually their product would fit in, it turned out to be a $500 million total addressable market, at best.

Very often only **SOME of SOM** is the true market size

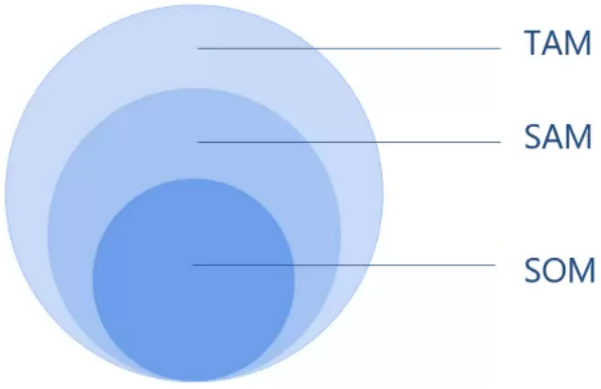

Figure 1. The above figure is the classic market analysis graph that depicts the Total Addressable Market, Serviceable Addressable Market, and the Serviceable Obtainable Market.

When we look at healthcare, similar pitfalls are evident, but we believe that sizing these markets are trickier due to a myriad of unforeseen forces that need to be taken into consideration. Unlike the technology sector, where me-too products are a little cheaper than the branded ones, in healthcare, particularly in the pharmaceutical vertical, the me-too products i.e., generics, can be 1/20th or 1/50th the price of the branded version. Additionally, the unique cycle of drug development where the first pill costs a billion dollars, and second one a few cents, requires a thorough understanding of the *actual* market. We highlight below some key elements that we at Eckuity focus on when assessing investable ideas. We also guide and help our portfolio companies to ensure they have a better understanding of their markets.

The total dollar value of annual sales generated for that indication.

A common mistake made by many inexperienced entrepreneurs is in their market size assumptions when their therapy/product/service is applicable to a larger portion of the market. For example, if a women's health drug is useful for both pre-menopause and post-menopause subsets of the population, some may assume that their TAM or Target Addressable Market is say, 160 million women (50% of the population) in the US. While they may imply that they have factored in age and excluded women under 18 and say, over 80 years, to arrive at a more conservative number; those numbers are generally still extremely large. As an example, if their product sells for $50 per unit, in this example, the TAM is around $50 x 160 million = $8 billion and SOM is around $5-6 billion.

But if we look at the total dollar value of sales generated for that indication annually by existing players, it may be around $300-400 million *globally*. So, one can argue that the market is actually less than 10% of their assumption regardless of the math. While one can argue that the market is underpenetrated and there is ample white space for newer entrants, there is generally a reason for the annual sales to be in a certain range.

The share of the branded versus generic in that market.

What is the price gap between the branded and generic products? If this gap is too high, additional analysis is warranted to ensure the new breakthrough product will be able to justify the pharmaco-economic benefits and convince the payers and insurance companies. This assumes that the new breakthrough product will generally be priced at the higher end of the market.

Many customers or patients will simply not switch their medications and others may be restricted due to payer constraints or other reimbursement issues. In some markets, the stickiness with the brand may be too high while in others, the price war among undifferentiated generics may significantly drive down profitability for the next entrant. These practical limitations can adversely impact the calculated SOM.

Lack of understanding of the pricing complexities.

Many biotech entrepreneurs (rightly) focus heavily on their clinical trial design, efficacy and side-effect profile, PK/PD and scale-up issues, and partnerships with big pharma. But many do not have an understanding of the complex drug pricing, especially in the US. For example, health insurance companies in the U.S. including those that administer the federal government's Medicare plans can control spending on branded medicines by establishing "formularies" of approved treatments, requiring prior authorization of prescriptions, and giving incentives to doctors to prescribe generic medicines. Many hospitals and the Pharmacy Benefit Management (PBM) companies that purchase medicines have a significant market share and therefore significant leverage over the prices paid for medicines[1]. As in almost every other industry, the list prices (the prices that sometimes make disapproving headlines) seldom reflect the prices obtained by large buyers. When entrepreneurs use these "so-called" list prices in their market growth assumptions, that can meaningfully alter the size of the actual SOM.

[1] Forbes.

The current competitive landscape.

This includes not just an understanding of the total number of competitors, but also the profile of the market leaders. For example, the multi-trillion-dollar mobile phone market has numerous manufacturers, but one also needs to understand the profile of Apple, Samsung, and Google before venturing into a supposedly “extremely large” market. Similarly, in life sciences, for example, obesity and diabetes represent extremely large markets. Does that mean that a newer entrant with an effective treatment will be able to capture a sizeable portion of that market? One needs to understand the impact of existing GLP-1 drugs including Novo's Ozempic and Wegovy, and Lilly's Mounjaro and Zepbound before assessing the truly obtainable market. The potential expense in developing a sales force that can effectively compete against industry giants may render any calculated SOM simply impractical.

Purchasing Power.

In many cases, the size of the market is defined by external factors that are not directly related to the product or indication at hand. For example, many medical device purchase decisions are handled by the Group Purchasing Organizations (or GPOs) on behalf of their hospital groups. The sales cycle of new product introductions to GPOs and eventually to physicians can materially impact the actual market share. For one of our potential portfolio companies, their global TAM in the Global Image Guided Surgery Device Market is $11 billion, while the SAM in Oncology, Cardiac, Orthopedic is $5.7 billion, and finally the expected SOM in applications performed with ultrasound + CT + fluoroscopy is $876 million. But once we factor in the fact that over half of US hospitals are expected to lose money every year, we quickly realize that many of these “so-called” SOM hospitals simply do not have the risk appetite and capital to entertain any purchase decisions, regardless of the merits of the technology.

If we extend this to the overall medical device market, the problem becomes a little more apparent. GPOs in U.S. healthcare grew slowly since their inception, rapidly accelerating in the 1970s with the advent of Medicare and Medicaid. Depending on the analyst, an estimated $300 billion+ in provider spending flows through GPOs. Nearly

two-thirds goes to the top three, and 90% is concentrated in the top six. Approximately 70% of GPO revenue is collected as administration fees from suppliers.

They're so named because GPOs take on suppliers' administrative burden by pooling members' purchasing under a single general contract. However, additional pressure on medtech suppliers is created when large provider integrated delivery networks (IDN) seek additional discounts with individual purchasing contracts (IPC) using the general GPO agreement as a starting point for negotiations. An estimated one-third to one-half of medtech sales through GPOs flow through IPCs, with the GPO continuing to collect admin fees. For many medtech suppliers, a significant portion of sales run through GPO contracts [2]. At the GPO level, the general contracts are typically negotiated first, followed by IPCs with larger IDNs. Once the complexity, negotiation delays, procedural agreements, etc. are taken into account, most revenue projections by early-stage companies look too aggressive and unattainable.

At Eckuity, we encourage our portfolio companies to focus on commercialization as it is never too early to start thinking of ways to create a profitable enterprise. Regardless of the underlying technology or therapeutic indication, it is essential for all stakeholders to closely assess market dynamics to ensure a successful investment.

[2] Source: ZS Associates

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