Now What?
Markets are crazy, the outlook is dicey, but there are plenty of ways to profit, if you keep your cool.

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From Scandal to Stardom: How Merck Healed Itself

Poor lab results. A slumping stock. Lawsuits against one of its most profitable drugs. General malaise. Everything was going wrong for Merck a few years ago. So how did it get its mojo back? BY JOHN SIMONS
JUST ANOTHER PIPE DREAM IN POWERPOINT: That’s what Merck’s recovery plan looked like in 2004. At the company’s annual meeting with Wall Street analysts that December, then-CEO Ray Gilmartin unveiled Merck’s lineup of future medicines. The audience was skeptical. The company had missed three quarterly earnings targets and had been forced to cancel two late-stage research programs for promising drugs. Analysts were in a “show me” mood.

Gilmartin’s slide show included three vaccines, all based on groundbreaking science—one for rotavirus, one for shingles, and one for cervical cancer. Yawn: Vaccines had a reputation for not making big money. Then there was a new diabetes medicine. More yawns. Where, the analysts wondered, were the $1-billion-a-year blockbusters? Was Gilmartin, CEO since 1994, still up to the challenge? Five months later he was gone.

Today Ray Gilmartin is having the last laugh. Even his critics now concede that the seeds of Merck’s resurgence were planted on his watch. The FDA has approved all of the drugs he touted in December 2004. Combined, they could add up to $7 billion a year in revenues. “Their pipeline was grossly undervalued,” says Barbara Ryan, an analyst with Deutsche Bank who led the chorus of Wall Street skeptics calling for Gilmartin’s ouster back in 2004. “They’ve executed handsomely and have been much more successful than we thought they would be.”

Over the past two years Merck has exceeded expectations on all fronts—scientific, financial, and legal. Since the beginning of 2006 it has gained FDA approval for seven new drugs, more than any of its peers. At the same time, the company has won the majority of the jury trials in its defense of Vioxx, the painkiller it was forced to withdraw from the market in October 2005 after studies linked it to heart attacks and strokes. These victories enabled the company to settle the bulk of its lawsuits last November for $4.85 billion—considerably lower than the initial estimates of $20 billion. Investors have noticed, sending Merck’s stock price up 75% since the beginning of 2006, far outpacing its peers.
The lion’s share of credit for Merck’s recovery goes to three men: CEO Richard Clark, chief scientist Peter Kim, and former legal counsel Ken Frazier. Clark, who started at Merck in 1972 as a quality-control inspector, became CEO in mid-2005. Aware that the Vioxx recall had shaken the company, Clark immediately began to hold small meetings with Merck employees. “Over time Merck had developed into several fiefdoms, each doing their own thing,” says one insider. Clark, 61, insisted on “One Merck,” a catch phrase he repeated often. Beyond the words, he sought to unite Merck operationally. “We needed a more integrated approach,” says Clark. “From the moment we begin talking about a particular drug franchise, I want researchers, marketers, and manufacturing people sitting in the same room.”

As Clark kept his eye on the big picture, Kim focused on the labs. Merck’s scientific excellence had long inspired admiration and envy; corporate leaders voted it America’s Most Admired Company in FORTUNE from 1987 to 1993. By the early part of this decade, however, Merck was finding it difficult to turn its science into new, profitable medicines. In Merck’s case, there was a unique element added to what was an industrywide drought. Merck was so pleased and proud to be Merck that its research culture had become haughty and insular. The company refused to consider medicines discovered outside its own labs and spurned the mergers and research alliances that were reshaping the industry.

Enter Peter Kim. Until landing at Merck in 2001, Kim had no business experience, having spent most of his career as a biologist at MIT. He took over day-to-day management of Merck’s labs in 2003. As an outsider in a place with a clubby, insider culture, Kim had a perspective longtime employees lacked. He made it his mission to convince researchers that good-quality science could actually be done outside Merck—and that the company should compete to acquire the fruits of others’ research.

By late 2004, Kim had overseen a new system that allows scientists to mine scientific literature to identify promising chemical compounds. He also encouraged Merck scientists to use their connections to open doors for Merck’s acquisitions department. The results have been striking. In 1999, Merck entered into just ten collaborative licensing deals; by 2006, there were 53 joint-development transactions and small acquisitions.

Kim, now 49, faced a second challenge: restoring morale after the Vioxx recall. Accusations that Merck scientists had pushed a dangerous drug on an unsuspecting public were more than embarrassing: Merck was losing top research talent, and new recruits were no longer lining up to join. “It had to be hard,” says longtime Merck board member Samuel Thier, professor emeritus of medicine and health policy at Harvard Medical School. “He could easily have been consumed by that in several ways, but somehow he focused.”

Kim got the labs to concentrate on a simple goal: getting late-stage drugs to market. In the past two years, Merck’s labs have reduced the average time it takes to put a drug through the final stages of testing by 11 months.

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**A Short History of Merck**

A glance at the chart shows that Merck has climbed out of serious trouble. The keys: management, product innovation—and a bit of luck.

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**Month of October**

Merck is forced to end late-stage research on a potentially lucrative antidepressant known as “Substance P.” The drug turned out to be no more effective than a placebo.

**Sept. 30**

Merck pulls arthritis painkiller Vioxx from the market after studies link the drug to heart attacks and stroke. Estimated liability claims go as high as $30 billion.

**May 5**

CEO since 1994, Ray Gilmartin is pushed into early retirement. He is replaced by Richard T. Clark.

**July 5**

The 1st Vioxx product liability jury trial begins in Angleton, Texas. Plaintiffs allege Merck failed to disclose the risks of taking the pain reliever.

**Aug. 1**

Merck general counsel Ken Frazier, architect of the company’s Vioxx defense, is promoted to the company’s No. 2 position, overseeing the global drug business.

**Nov. 9**

After winning over the jury in most of the 20 Vioxx cases that go to trial, Merck agrees to settle the bulk of the lawsuits for $4.85 billion.

*SOURCES: BLOOMBERG, MERCK*
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<tr>
<th>Zostavax</th>
<th>FDA approval: May 25, 2006</th>
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<td>A vaccine for varicella zoster, the virus that causes shingles and chickenpox. Annual sales potential: $500 million</td>
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<th>Janumet</th>
<th>FDA approval: March 30, 2007</th>
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<tr>
<td>A combination treatment of Januvia and metformin for type 2 diabetes. Combined annual sales potential: $2.5 billion</td>
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Restoring Merck’s reputation as a scientific partner grew easier as the company began to win Vioxx verdicts. And for that, the credit goes to Ken Frazier, 53. It was Frazier’s call to contest, not settle, the Vioxx cases. Merck, according to insiders, wanted to compensate patients whose heart attacks and strokes were caused by Vioxx. But the company also wanted to show that it could defend itself in court against what it saw as frivolous claims, such as events that were the result of existing health problems. Frazier, an African-American graduate of Harvard Law who once helped reverse an Alabama man’s death sentence, was legal counsel at the time. He believed that Merck could win enough cases to create conditions for a much less expensive settlement. “An early settlement was the obvious question on the table,” says Merck board member Shelly Lazarus, chairman and CEO of Ogilvy & Mather Worldwide, “but from the first discussion, Ken was so sure and so persuasive that his was the [right] strategy, the board believed in him.”

Frazier’s defense was risky because it hinged on the company’s ability to explain complex science to juries. And at first it looked like a bad call. The initial verdict came in August 2005, when a Texas jury found the company liable for 59-year-old Robert Ernst’s death from an irregular heartbeat; Merck had to pay $27 million. In subsequent cases, though, Merck began to score some wins. By late 2007, 20 Vioxx cases had gone to trial. Merck won 12 (though two of those verdicts have been set aside) and lost five. Three ended with deadlocked or hung juries. The record was good enough to give the company leverage to carve out a favorable settlement with opposing lawyers. Clark rewarded Frazier last August for his strategic thinking and aggressive advocacy, promoting him to the company’s No. 2 position, executive vice president and president of global human health.

Merck’s resurgence is still a work in progress. Its seven newest drugs are just beginning to make an impact on revenues. Most notably, cervical cancer vaccine Gardasil garnered sales of $1.5 billion in 2007, its first full year on the market. Overall, Merck’s revenues grew 7% last year, to $24.2 billion. The bad news is the company may have another legal melee on its hands. The Justice Department and 32 state attorneys general continue to investigate Merck’s marketing practices, including whether the company promoted Vioxx for “off-label,” or unapproved, uses. Regulators are also questioning whether Vytorin, a cholesterol-lowering medicine that Merck co-markets with Schering-Plough, works as well as claimed. The companies released a rather damning study of the drug on Jan. 14. Since then, the share prices of both companies have dropped sharply. Compared with what Merck has been through, those are problems that the company is confident it can handle. And this time Wall Street isn’t so skeptical. “At a time when Big Pharma is struggling to discover new drugs, seven new products in 24 months is real leadership,” says Seamus Fernandez, an analyst with Leerink Swann & Co. “They’re at the very beginning of a long, virtuous cycle.”

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