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Pharmaceutical
Companies in the
Economic Storm
*Navigating from a
Position of Strength*



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EXECUTIVE SUMMARY

Financial and economic turmoil now span much of the globe. Many sectors have been hard hit. Historically, the pharmaceutical sector has been less and later exposed to economic fluctuations, but is that true in the current crisis? We believe not and foresee increasing pressure on the healthcare sector in the medium to long term that will affect all players, including the large pharmaceutical companies. This Perspective examines the impact of the crisis on the sector and discusses strategic moves that pharmaceutical companies in particular can make now to manage their way through the crisis and emerge in a stronger position.

PHARMACEUTICAL SECTOR STAYS STRONG AMID TURMOIL

The world is experiencing the most severe recession since the Great Depression. Economies globally are slowing down dramatically—even contracting in some places—and the current economic outlook remains grim. Cyclic sectors like automotive, construction, and chemicals have been especially hard hit.

Traditionally, the healthcare industry—specifically, life science sectors including pharmaceutical, biotech, and medical devices—has been less exposed to fluctuations in the economy for a couple of reasons. Healthcare demand is less sensitive to economic trends, and there is no price elasticity in times of crisis, at least in European social welfare economies, which account for 35 percent of the global market. People continue to become ill and still need treatment, irrespective of global economic forces. Moreover, in times of crisis, people may be even more susceptible to stress- and depression-related illnesses or diseases.

The resilience of the pharmaceutical sector makes it an attractive haven for investors; pharmaceutical stocks outperform broader market indexes

during economic downturns. While the Dow Jones Industrial Average fell by 38 percent from June 2008 through the end of March 2009, the Dow Jones U.S. Pharmaceuticals Index fell by only 15 percent.

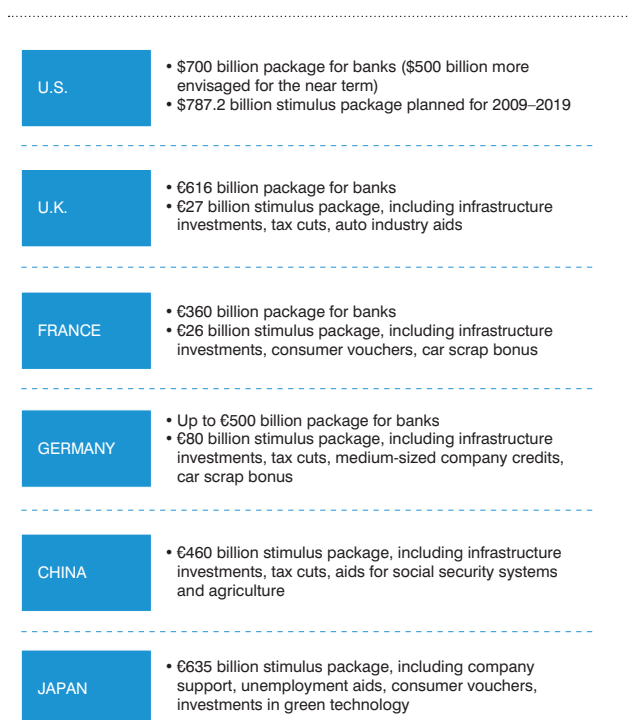
Meanwhile, pharmaceutical companies are reporting solid financial results in their latest annual and quarterly reports. For example, revenue increases at Novartis produced record earnings last year; they are expected to be even stronger in the upcoming year. On average, revenues of the top 20 pharmaceutical companies rose by 9 percent from 2007 to 2008 and are expected to increase by 3.5 percent more over the next year. Although growth projections by IMS have been cut to less than 1 percent for the coming year, many pharmaceutical executives are quite bullish; one boldly stated that the impact on the sector “is not even tangible.” Consumer-oriented markets such as consumer health and animal health have likewise shown remarkable resilience and are showing strong results.

RISING PRESSURE IN THE HEALTH-CARE INDUSTRY

While the overall outlook for the pharmaceutical industry remains fairly strong, some dark clouds loom on the horizon. Specifically, biotech companies and smaller pharmaceutical niche players that do not yet have stable cash flows from products are experiencing difficulties as the credit crunch dries up their traditional funding sources. On average, public U.S. biotech companies that are not yet showing a profit have 1.7 years (mean) and 0.8 years (median) in cash; 55 percent of those companies have a year or less in cash.¹ These companies are already tackling their funding problems by reducing high cash-burn rates through radical cost cutting and aggressive working capital management, and by looking to external resources such as strategic investors for quick access to cash. A large share of these companies, unless well funded, will not survive this crisis; many will be bought by large pharmaceutical companies seeking to fill their pipelines with promising products.

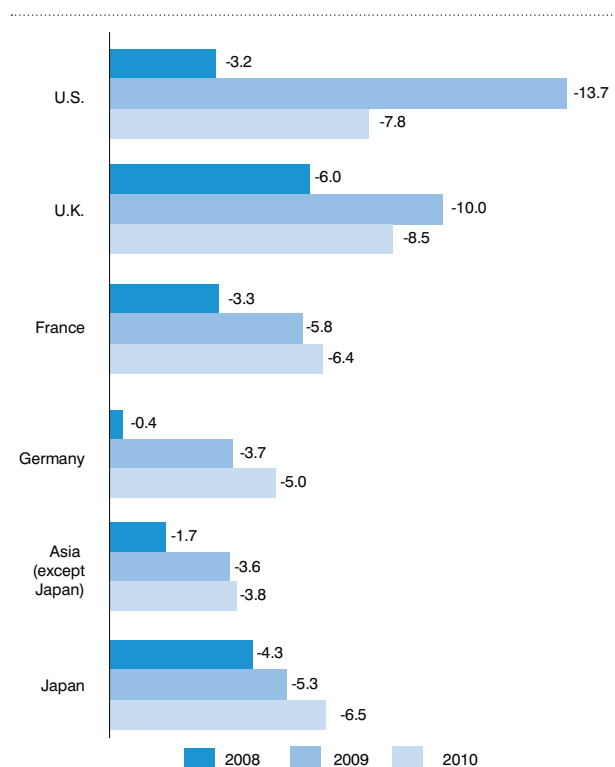
We foresee difficulties down the road even for larger players in the industry. The economic downturn has had an impact on the budgets available for healthcare, on both the public and private sides, reducing their ability and willingness to pay for healthcare. This is particularly true in the U.S., where employers, already under financial pressure from spiraling healthcare costs, lead the charge to contain healthcare-related expenditures. Market growth for pharmaceuticals in the U.S. is projected to fall to the low single digits next year. Public finance is likewise under significant pressure in the U.S., as well as in most European and Asian countries. Governments have infused their ailing financial sectors with huge amounts of cash, while at the same time slower economic growth cuts into tax revenues and higher unemployment rates cause the cost of social services to rise (*see Exhibits 1 and 2*).

Exhibit 1
Government Economic Stimulus Package



Source: Booz & Company Analysis

Exhibit 2
Actual and Projected Budget Balances, 2008–2010 (percentage of GDP)



Source: Bloomberg, Deutsche Bank, Booz & Company Analysis

Accordingly, governments and other payors will intensify scrutiny of healthcare budgets, leading to further cost containment measures to drive down drug prices, increase generic substitution, and increase demands for proof of value. In turn, pharmaceutical companies will face pressure first and foremost on their patented prescription drugs/ethical businesses but also on their generic businesses. Additionally, consumers hurt by the economic crisis will struggle to pay for over-the-counter (OTC) drugs, which account for about 15 percent of pharmaceutical sales. A similar trend appears to be emerging for the pet and companion animal health businesses.

Furthermore, emerging markets are in large part self-pay markets for all pharmaceuticals; in countries like Brazil and India, out-of-pocket expenses make up 70 to 80 percent of drug spending. Patients in these markets have been hard hit economically by the crisis and will look for ways to reduce healthcare and pharmaceutical spending by avoiding therapy or by switching to generics or alternative therapies (e.g., Chinese medicines). Medical device and diagnostic companies each face investment postponements by hospitals and private practices and more aggressive sourcing and purchasing negotiations, especially for less differentiated technologies and products.

In this environment, pharmaceutical executives must make proactive decisions to ensure that their companies are well prepared for the tougher times that still lie ahead.

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LOWER THE COST BASE AND IMPROVE VARIABILITY

Pharmaceutical companies should first be exhaustive in evaluating costs. While that clearly entails reducing the overall cost base, an even higher priority is to install cost management measures that allow for greater variability and flexibility in order to better align the cost base with the business cycle and potential revenue fluctuations in the future.

A useful principle is that no cost should really be fixed—or at least that all cost items have to become more flexible. The levers for creating flexibility are many:

- Making corporate functions lean by capitalizing on measures such as shared services, outsourcing, and offshoring
- Restructuring the supply base to increase overall asset effectiveness—e.g., consolidating production networks, moving facilities to low-cost countries, increasing manufacturing outsourcing, and working with contract manufacturers
- Moving beyond current sales and marketing effectiveness initiatives that have focused on substituting new channels (e.g., the Internet) for traditional physician detailing
- Engaging with payors and providers in fundamentally new ways to improve patient outcomes and create more overall value

- Optimizing R&D efforts, installing more centers of excellence, “out-tasking” standard or non-differentiating steps, and using enhanced clinical trial design
- Reducing, or adding more variability to, labor costs by increasing both workforce and compensation flexibility
- Applying emerging innovative concepts such as joint utility operations between pharmaceutical companies in noncompetitive areas such as manufacturing; chemistry, manufacturing, and control (CMC) development; and certain R&D functions.

While many companies have applied these measures sporadically through ad hoc projects or targeted campaigns, few have committed to wholesale structural change aimed at reducing their cost bases and improving flexibility. Those that preemptively act will be much better positioned to absorb reimbursement reductions—resulting from government and private cost containment efforts—while maintaining margins.

LEVERAGE STRONG FINANCIAL POSITION

Cost reduction and variability will support the ability of pharmaceutical companies to take advantage of this time of crisis and uncertainty to make strategic moves in order to come out of the crisis in a stronger position.

Large pharmaceutical companies have managed to avoid the “leverage game” that has plagued companies in many other industries. As a result, they generally have strong balance sheets with little debt. According to Datamonitor, the average net debt of the top 20 pharmaceutical companies is just 6 percent of capital employed, with an average access to US\$7.5 billion in cash, cash equivalents, and short-term investments.

Now is the time for pharmaceutical companies to leverage their strong positions to address the fundamental issues that have led to their underperformance in recent years, threatening their ability to maintain historically high growth rates. Specifically, they must turn

the tide on their failures to discover and develop new high-value and innovative products to replace drugs going off patent.

In the recent study referenced earlier, Datamonitor forecasts that the top 50 pharmaceutical companies will face patent expirations on \$84 billion in potential drug sales between now and 2012. To expand their pipelines for new drugs, companies should consider using the cash they have generated through aggressive cost management to pursue attractive deal opportunities, especially in the biotech sector. These include licensing agreements—under more attractive terms, now that biotech companies have considerably less bargaining power—or full acquisitions of biotech or small niche pharmaceutical companies. The credit crunch has dried up typical sources of financing, leaving large, cash-rich pharmaceutical companies as the only investors still in the game.

Valuations for both biotech and smaller pharmaceutical companies have already dropped, resulting in bargain prices for acquisitions. Even the three recent mega-acquisitions—Pfizer/Wyeth, Merck/Schering-Plough, and Roche/Genentech—have likely been triggered by the combination of a need to supplement pipelines and an attractive acquisition environment for companies with cash on hand.

A third option for large pharmaceutical companies, beyond licensing and acquisitions, is to develop partnerships. As David Brennan, CEO of AstraZeneca, put it during an industry gathering in October 2008, "The crisis makes it even more important for cash-rich pharma companies like AstraZeneca to do more partnership deals. Strong companies don't sit around passively waiting for the storm to pass. For AstraZeneca, strategic partnering is priority."

Companies must carefully assess their respective positions, potential opportunities, and the implications of various strategic moves as part of developing an overall game plan. Pharmaceutical companies now have more opportunities to improve and complement internal R&D productivity and to enhance external sourcing of technology and capability.

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CONCLUSION

The pharmaceutical sector is much less exposed to the economic crisis than others due to its relatively inelastic demand. As a result, many expect pharmaceutical companies to weather the storm much better than those in other industries. Nevertheless, the sector will come under pressure as governments and private payors look to contain their healthcare budgets by curtailing expenditures, and consumers cut back on out-of-pocket or self-pay spending for OTC drugs, pet products, and the like.

Accordingly, companies should be taking measures now to increase the variability and flexibility in their entire cost base to limit the expected financial impact from reduced revenues.

Furthermore, companies should evaluate their positions and develop comprehensive plans to take advantage of upcoming opportunities. Large pharmaceutical companies can use this period to exploit their strong cash positions to pursue attractive deals that will help fill their pipelines through licensing agreements, full acquisitions, or strategic partnerships.

Endnotes

¹ Datamonitor, "Biotech Financing in the Credit Crisis," December 2008.

About the Authors

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