Radical remix

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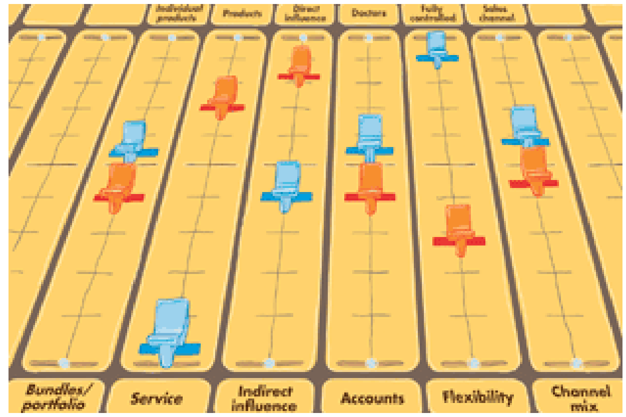

Doom and gloom prevail in the press. Fears abound of an abiding depression hitting the world economy, resulting in a shrinking global GDP for several years to come. There are reports that unemployment could double or triple compared to 2008 and that governments could continue to take over large banks to fight the systemic crisis. Many companies will go bankrupt, they say, releasing a vicious circle of mass unemployment, loss of purchasing power and further insolvencies. They predict that economic programmes will have little effect and governments will run out of money to support the economy. Protectionism will restrict global trade and many companies will be nationalised.

I expect a less drastic scenario, but it will still be heavy going. A recession of one or two years seems probable. Global GDP will shrink by one to two per cent, affecting virtually all countries and industries. The financial crisis will be accompanied by a real economic crisis that will heavily impact the US. Europe will suffer less and developing economies should keep on growing in aggregate.

Politicians will step-up support of their national economies and continue to work on reforming the international financial system. Their efforts will have limited effect because of a lack of confidence among savers, consumers, investors, and companies. Unemployment will rise and bring protectionist tendencies and increasing regulation. Many companies will struggle with falling turnover and begin cost cutting and restructuring. Consolidation will be prevalent and for well-managed, cash-rich companies, the crisis will present huge opportunities.

The three aspects of the economic downturn influencing pharma are:
• The influence of the crisis on public and private healthcare spending
• The implications of the crisis from an investor's point of view
• The potential reactions of pharmaceutical companies.

Pressure on spending
The major drivers of healthcare spending are governments and private out-of-pocket payments. The share of out-of-pocket spending depends on the national healthcare system. Traditionally, the US – with a significant share of its population being uninsured or underinsured – has a high share of private healthcare funding. In Western Europe healthcare spending is largely publicly funded but Central and Eastern European countries can have over 70 per cent private funding. In Russia, for instance, an increasing per-capita income and the growing willingness to pay led to recent strong growth rates in the commercial pharma market.

As unemployment rates and credit payment burdens now increase, out-of-pocket payments for healthcare are decreasing. At the end of last year, about one-third of US consumers were reported to have postponed medical care or skipped recommended tests and treatments. Dispensed pharmaceuticals have dropped for the first time in 10 years. Consumers in many European countries have also reduced their healthcare spending, particularly on dental care, a healthcare segment with a large out-of-pocket contribution. Dental implant companies saw sales decrease by at least 5 per cent in the fourth quarter of 2008.

Public spending through government and social securities is not expected to slide as quickly. Nevertheless, the economic crisis is expected to accelerate the negative trends identified in Roland Berger's pre-credit crunch report Pharma at the Crossroads.

Rise of generics
In the past, many companies concentrated on individual products, particularly blockbusters. Now these patents are set to expire, opening up the market to generic products. Many product portfolios, and thus a large proportion of pharma industry's revenues, are at risk. In the light of the current crisis, demand for lower-priced generics is likely to increase even faster.

Cost effectiveness, the fourth hurdle beyond safety, efficacy and quality, will rise even faster than anticipated. Cost containment mechanics have already increased the pressure on prices. Most European countries evaluate the cost-effectiveness of drugs according to their own methodologies and processes, and could be inclined to implement more rigorous measures for rationing purposes. The US market is expected to be under even stronger pricing pressure, particularly with the new administration's focus on reforming healthcare.

Dwindling stock prices
These recent trends have left deep marks on company valuations. Traditionally, the life sciences industry is renowned for being less cyclical and therefore less crisis-prone than others. Investors often regarded pharma stocks as a safe haven during a harsh investment climate. Most large pharma companies are still cash rich and therefore relatively immune to the credit crunch as they don't rely on debt financing.

During the current crisis however, life science stock valuations came down significantly. In particular biotech companies have suffered severely. Biotech indices are down and many companies sell at below cash valuations. The worldwide financing environment in 2009 is extremely challenging and several publicly-traded biotechnology companies are desperately in need of cash. Cash-rich pharma and big biotech companies are anticipating the expiration of patents and look to advanced product pipelines. They will try to benefit from the shaky economy to buy at discount prices. Mergers and Acquisitions activity is expected to go up again over the next few quarters, indicated by Pfizer buying Wyeth and Roche attempting to take over the remaining publicly traded shares of Genentech.

Cost reductions
With profit margins under pressure, pharma companies are reacting with different measures to reduce their costs accordingly. In 2008, several large players such as Novartis, Wyeth and Pfizer announced significant personnel reduction initiatives in marketing and sales as well as manufacturing and even R&D.

Early this year AstraZeneca announced that an additional 6,000 jobs would be lost worldwide before 2013, making a total of 13,600 layoffs since 2007 in European sales and marketing operations and in worldwide R&D. This initiative is expected to deliver savings of $2.5bn a year when fully implemented. The company is reacting to the increasing price pressure in healthcare markets as well as stronger competition from generics.

GlaxoSmithKline is reported to be planning to eliminate up to 6,000 jobs in addition to the 7,500 announced in 2007 and 2008. The London-based company said last year it would cut more than 2,000 positions in sales, manufacturing and research as part of a plan to save £700m a year by 2010. In 2007, Bayer announced it would reduce R&D costs by $210m per year by laying off 1,400 R&D staff. Half of these job loses would be in Europe. In addition, they laid off about 2,800 employees in administration and 1,800 people in production.

Further cost reductions in marketing and sales are achieved by reducing marketing spend, for example by outsourcing activities. Furthermore, pharma corporations plan to bundle their sales and marketing activities in European regions, particularly in the Baltics, Scandinavia and the former Yugoslavian states. Pfizer has already gone a step further and announced a restructure of its European pharma operations into five business units. One of the five, the Established Products Business Unit, will be located in Zurich with essential functions being centralised in order to exploit regional synergies.

Business models
Operational excellence initiatives tackle the costs in order to counteract the decreasing top-line business. However, the acclerating dynamics of healthcare systems – driven by reforms particularly related to market access and

reimbursement – challenges existing commercial business models. Over the course of the next five years, new models will be needed to deal with these new realities. Future growth will depend upon innovation and clear clinical differentiation triggering significant alterations to sales and marketing.

Back in 2007, Roland Berger developed its 'Business Model Mixer' – a tool designed to support pharmaceutical executives. Based on broad industry experience, we identified six key dimensions which make up the characteristics of a pharmaceutical company's commercial business model. When reviewing their current model, companies follow a two-step process: First, each company must determine its current position, depending on its products, customers and competitive situation. Then it must decide how to position itself within each of these six dimensions:
• Individual pharmaceutical products through to bundles/portfolios – for example those related to therapeutic areas such as cardiovascular, oncology and diabetes
• Products through to healthcare services such as patient screening, patient education support and also 'paid-for' services such as AstraZeneca's out-patient cancer centres and Pfizer Health Solutions telephone-based care supervision schemes
• From direct influence to indirect influence on prescribers, including payers and patients
• From doctors to 'accounts' such as hospital (groups), doctor networks, regional authorities, pharmacy chains
• From full in-house control to flexibility/outsourcing
• From a focus on the sales channel to emphasis on other channels, such as the internet (as explored in Tailor Made PME May/June 2008).

By favouring one dimension over another, pharma executives define the characteristic attributes of their new business model, focusing on specific objectives such as assuring market access or increasing profitability.

New realities

Pharma is currently facing several challenges, some caused by the ongoing recession, othes merely accelerated by recent economic developments. Marketers are confronted with new realities to which they need to adapt quickly to maintain the success of the past decades. I expect an accelerated transformation of commercial business models driven by profitability and market access objectives. The increasing expiration of patents, resulting in almost immediate sales reductions, needs to be tackled. Companies determined to replenish their product pipelines by mergers and acquisitions might actually profit from current low valuations, particularly in the biotech sector.

The Author

Aleksandar Ruzicic is principal at the Zurich office of Roland Berger Strategy Consultants
He can be contacted on: aleksandar_ruzicic@ch.rolandberger.com