Collateral Damage: Industry Focus

Implications of the Financial Crisis for the Biopharmaceutical Sector

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Implications of the Financial Crisis for the Biopharmaceutical Sector

The financial crisis is no longer just a financial crisis—it has spread to the wider economy. As a result, there will be what BCG has elsewhere described as significant “collateral damage.” All companies will have to get used to operating in a tougher—and, in many cases, a recessionary—environment.

But companies in the biopharma sector are likely to be less directly affected than most others because the demand for health care is relatively independent of the trends troubling the wider economy. While the overall impact may be challenging, the disruption also creates real opportunities for biopharma companies to change industry dynamics, build new sources of competitive advantage, and even tackle some of the root causes of the sector’s underperformance over the last five years.

This is not to say that biopharma companies will be completely unaffected by these turbulent times. The industry can expect significant pressure from major purchasers—such as governments and insurers—to contain the costs of drug spending. Where “self pay” is a significant component of drug expenditure, declining personal income is already translating into lower revenues for biopharma companies. And some companies will be hit harder than others.

The companies that not only survive but even thrive in the downturn and strengthen their competitive position will be those that pay close attention to cash management, trade credit, and working capital; that tackle operational inefficiency; that understand how the crisis is affecting different markets and parts of the value chain; and that leverage their relative financial strength to make value-creating deals with companies in a weaker financial position.

1. Introduction: The Causes and Consequences of the Financial Crisis

The modern financial system rests on three pillars: capital, liquidity, and confidence. Unprecedented losses have depleted the capital of financial institutions faster than they can raise new capital. Illiquid capital markets have made it hard for them to finance their own debt, and falling confidence has damaged interbank lending and made depositors jittery. Not since the crash of 1929 has the global financial system been subjected to such a severe shock.

The credit crisis is the consequence of aggressive risk taking by highly leveraged financial institutions that funded unsustainable economic growth, particularly in the United States. Underlying this dynamic were three widely held misconceptions: that the creditworthiness of borrowers was strong, that investors were sophisticated, and that credit risk was widely distributed.

Unfortunately, not only was homeowner credit suspect, but the market misread the risk. In the ensuing panic and consequent liquidity crisis, the safety net of risk analytics and ratings was found to be an illusion. When investors realized that the risk was largely concentrated on bank balance sheets, their confidence in the financial system eroded rapidly.

Although the financial system stands at the center of this turmoil, the wider economy is starting to suffer the consequences. The combination of less available (and more expensive) credit and stagnant or even declining demand will hurt even healthy companies. Corporate financing decisions are typically driven by demand-side factors (for example, economic growth and the capital-equipment replacement cycle) and

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1. To obtain copies of “Collateral Damage Part 1: What the Crisis in the Credit Markets Means for Everyone Else,” and “Collateral Damage Part 2: Taking Robust Action in the Face of the Growing Crisis,” please send an e-mail to bcg-info@bcg.com.
supply-side factors (for example, the cost of money). In the current situation, both are likely to limit new investment by companies.

The bottom line is this: companies are facing a very tough environment and certainly a recession in many countries. The only question is, how severe will it be? Some have argued that it will be relatively short and shallow. However, the International Monetary Fund (IMF) has studied more than 100 past recessions around the world, and it has arrived at a clear conclusion: recessions induced by financial crisis are deeper and worse. According to the IMF, these recessions tend to be “two to three times as deep and two to four times as long.” Realistically, companies need to be prepared for a serious recession.

2. Issues and Implications for the Biopharma Industry

Over the past few years, the biopharma industry has been in a state of flux. Multiples have been declining, R&D productivity has become a critical issue, cost level and operating models in general have been fundamentally questioned, and society’s trust in the industry has fallen dramatically. The industry also has a set of underlying characteristics that set it apart from many others (for example, the nature and drivers of demand, patent protection, and regulation). What, then, are the specific implications of the current financial crisis for the industry?

A. Drivers of Growth, Macroeconomic Pressures, and Public Policy

The fundamental drivers of demand for drugs are relatively independent of the wider economy. These drivers—the prevalence of disease, unmet medical needs, population growth, and an aging population—mean that demand continues to grow over time and is relatively inelastic compared with the demand for cars, holidays, or restaurant meals. This makes the sector more attractive than others in tougher economic conditions, which is reflected in the health care sector’s relative stock market performance through 2008. (See Exhibit 1.)

Tougher economic conditions will, however, have an impact on society’s ability and willingness to pay for drugs. This factor will be evident in the publicly funded health-care systems and in the private-pay market.

Exhibit 1. The Health Care Sector Outperformed the Market in 2008

![Exhibit 1](image-url)
The pressure on public-health-care budgets and drug spending will arise from a combination of likely developments:

- First, as GDP growth slows, consumer spending will fall and unemployment will rise, leading to decreased tax revenues, increased demand on social-service budgets, and significantly increased pressure on public finances
- Second, the cost of various governments bailing out the financial services sector will exacerbate these regulatory pressures
- Third, as the gap between the growth in health care spending and the growth in GDP widens, the specific pressure for cuts in health care spending will grow
- Fourth, while inflationary pressures remain strong, the room for maneuver within the overall health-care budget will be constrained by the need to meet public-health-care workers’ wage expectations

Health care systems supported by insurance may feel the effects more quickly than those supported by taxes because of the close relationship between income and payments. In Germany, for example, health insurance premiums are a direct percentage of people’s income. Expenditure calculations for 2009 were based on expected income growth of 2 to 3 percent; now, zero percent growth is more likely. By contrast, the impact on tax-funded systems may be felt somewhat more slowly. But this is not guaranteed: governments that have pledged to divert money to support the financial sector will need to find it elsewhere, so the pressure on health care budgets may be almost immediate.

The pressure on biopharma companies will take different forms in different countries, depending on the nature and extent of the cost containment measures used by governments.

- In countries where the use of generic medicines is relatively low, governments may seek to replicate tried and tested measures to increase generic usage—such as prescribing guidelines, electronic prescribing systems, and incentives for physicians
- Where tendering is already established, it is likely to be used to increase rebates from biopharma companies
- Proof of value—medical and economic—will be increasingly demanded by governments and other major purchasers; and there will almost certainly be greater use of bodies such as the National Institute for Health and Clinical Excellence (NICE) in the United Kingdom to make more rigorous assessments of the cost and clinical effectiveness of new drugs, which will lead to more restrictive reimbursement policies for new products
- The willingness of governments and other purchasers to work with big biopharma in new ways (such as treatment programs instead of plain drug reimbursement) is likely to be much more focused on projects that have a clear and proven short-term impact, rather than on those promising medium- to long-term results

In the United States, a key question is whether the financial crisis is likely to make significant health-care reform more or less likely following the presidential election. Early in the campaign, health care was a top priority, but the financial crisis pushed it further down the agenda. The budgetary constraints created by the financial crisis will certainly add to the pressure for cost containment—possibly accelerating, for example, the removal of the Medicare nonnegotiation clause for Medicare Part D. BCG estimates that this legislation alone could negatively impact revenues to pharma companies by somewhere between $10 billion and $30 billion annually, not counting the potential spillover for non-Medicare purchases. At the same time, budget constraints may make far-reaching health-care reform more difficult to achieve while attention is focused on more “urgent” issues.
Several governments in emerging markets, while currently playing a less significant role in the provision of health care, have plans to increase funding coverage. But if they, too, suffer budgetary constraints, those plans may be scaled back or shelved.

If governments can be expected to review the way they fund health care, so too can individual consumers. As the current situation exacerbates the “normal” recessionary pressures on health care, there is already evidence, based on data from IMS Health, of patients in the United States skipping doses, cutting pills in half, and failing to fill prescriptions. The effects are even more apparent where spending is most discretionary—in cosmetic-related medicines and surgery, for example.

This is a particularly important issue in developing and emerging markets, which are key markets for future biopharma growth given the pressures in Europe and North America. In markets such as India, Brazil, Mexico, and Egypt, 70 to 80 percent of the value of drug spending comes from out-of-pocket expenses. In some markets, those who pay privately are heavily concentrated in the highest income brackets (the rich and “super-rich”)—segments that may be relatively immune from the effects of the financial crisis.

B. Asymmetrical Impacts and Access to Capital

As in all financial downturns, the pressures and impacts will be asymmetrical.

Happily, compared with some other sectors, the biopharma industry is relatively underleveraged and many companies have significant cash reserves. Average net debt as a proportion of capital employed for the top 20 pharmaceutical companies is just 6 percent, compared with 95 percent for financial institutions. At the end of June 2008, nine of the largest U.S. biopharma companies (Amgen, Bristol-Myers Squibb, Eli Lilly, Genentech, Johnson & Johnson, Merck, Pfizer, Schering-Plough, and Wyeth) between them had more than $105 billion in cash and short-term investments—although spending that money in the United States would have incurred a 30 percent tax liability.

However, the picture varies by company: lack of cash, stock value, or leverage potential makes some biopharma companies more vulnerable than others. The decline in biopharma company share prices in the current crisis ranges from 10–15 percent to around 30 percent. This represents an opportunity for those companies that have declined the least, since they have effectively raised the relative value of their currencies—at the same time that potential targets have become cheaper. Thus, the situation could add impetus to a new wave of M&A within the sector.

Smaller specialty pharmaceutical companies look more exposed. Unlike the large biopharma companies, many of these niche companies conduct little in-house research and a number of them have lower credit ratings that limit access to capital markets. As a result of the financial crisis, they are likely to face difficulties raising the funds they need to fuel the flow of the new products that they rely on.

As sources of future funding become much more constrained, the credit crunch is also making things significantly harder for smaller biotech companies. The impact has been twofold: first, valuations of existing biotech companies are depressed; second, biotech companies without a listing are finding that their other funding sources and paths to commercialization have been further restricted.

These developments create an opportunity for strong biopharma companies to strengthen their pipelines through some relatively cost-effective licensing deals and acquisitions. In the last two years, there has been a continued fall in the volume of biopharma-biotech licensing deals (down by 18 percent per year

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2. Datamonitor, ”Opportunity knocks for big pharmaceutical companies in the credit crunch,” October 9, 2008.
since the start of 2006)—but the credit crunch makes the conditions for both licensing and acquisitions more favorable to well-resourced biopharma companies.

C. Taking Advantage

The challenge for companies in the biopharma sector is to understand these asymmetries and the opportunities they create—and to act decisively to take advantage of them.

While the relative stock-market performance of biopharma companies has improved in the last year, the sector has underperformed in terms of total shareholder return over the past three to five years. (See Exhibit 2.) The reasons for this are well known: the failure of R&D to replace drugs going off patent, together with the tougher market environments in which biopharma companies are now operating. As a result, the price-to-earnings ratios of biopharma companies have decreased by half since 2000 and, at least until the financial crisis, lagged behind those of many other mature branded industries, such as consumer and retail companies.

Despite the relative attractiveness of the biopharma sector in the current environment, the fundamental, systemic issues facing the industry have not gone away; if anything, the crisis has further illuminated them. The disruption caused by the financial crisis does, however, offer biopharma companies an opportunity to change industry dynamics, build competitive advantage, and tackle these fundamental issues.

What, then, should biopharma companies be doing? In “Collateral Damage Part 2: Taking Robust Action in the Face of the Growing Crisis,” BCG suggests an action plan of practical steps. Four of these should be at the top of the agenda of biopharma companies:

◊ First, focus closely on cash management, trade credit, and working capital—especially given the increased cost of capital and the heightened credit risks everywhere in the economy. Many biopharma companies have paid less attention to this area than companies in other sectors; as a result, there could be significant benefits to be realized. For example, a recent report from Ernst & Young suggests that improving payment terms, credit billing, and collections would be worth 3 to 7 percent of sales (or $17 bil-
lion to $35 billion for the 16 largest U.S. and European companies) within 12 to 24 months. Of course, realizing these benefits becomes more difficult in an environment where everyone is much more cash constrained, but the potential is clear. In particular, biopharma companies should proactively assess the risks faced by other companies in the supply chain. For example: What would be the cash implications of wholesalers trying to reduce stock levels? What would be the impact of a trade partner such as a wholesaler or distributor going out of business?

- Second, seize the opportunity to make significant improvements to operational efficiency, including major structural moves (such as consolidating manufacturing operations, accelerating changes to business models, and decreasing fixed infrastructure) that have been put off for too long. While many companies have started doing this, there is a long way to go. Now is the time to cut back on less differentiated capabilities and assets in order to build up those needed to create new sources of competitive advantage. But be warned: the wider economic climate may make these sorts of moves more costly, particularly in Europe, if governments begin to take policy steps to protect employment levels.

- Third, look closely at the specific ways in which the financial crisis has affected the dynamics within the industry and decide on smart actions to capitalize on them. New dynamics are evident not just in the evolving relationships between biopharma companies and biotechs or wholesalers—they apply in a multitude of areas. For example, as business becomes tougher for providers of marketing services (events, PR, market research, and so on), the dynamics of contracting for these services change. In a similar way, the dynamic between companies and employees or potential employees is shifting as uncertainty increases and unemployment rises. In some countries, for instance, the labor market for managers has changed dramatically. Whereas before it was very difficult to find experienced candidates for jobs, now multiple candidates are available and willing to work at more competitive salary levels.

- Fourth, actively search for attractive deal opportunities, whether licensing arrangements or acquisitions. Falling valuations—not only of small biotech companies but also of some pharma companies—have made potential deals more attractive. So reexamine deals that might not have made sense three to nine months ago. In addition, there is an increased opportunity for cash-rich biopharma companies to effectively fund the liquidity-starved biotech sector—for example, through internal venture-capital-type funds. However, each company needs to understand its own unique situation and determine its strategy accordingly. Is it in a position to become a predator? Is it potential prey? Or is it somewhere in between?

The opportunity for large, cash-rich biopharma companies is very real: the right investments in the right companies at sensible prices will give these companies a good chance to breathe fresh air into their product pipelines, and the crisis both heightens the need and provides an opportunity to address necessary restructuring aggressively.

3. Conclusion

While this is clearly a challenging time for everyone, it is also—for some large biopharma companies—a time of genuine opportunity. A tough economic environment provides a strong platform for taking action to improve operational efficiency, and the impact of the credit crunch on the biotech sector offers the prospect of attractive, value-creating deals for companies that are prepared to be fast, bold, and disciplined.

Only some companies will succeed and come out of the economic difficulties in a stronger position than before. They will be the ones that act fast to identify what opportunities the current situation presents and act decisively to take advantage of them.

5. Ernst & Young, “Big pharma has potential to free up US$35 billion in working capital,” October 1, 2008.
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