

Belgium - Life Sciences
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Life Sciences Insights



Welcome to the fourth Belgian newsletter for the Life Sciences industry, published by Deloitte! We publish this newsletter every 2 months and we hope this will be an enjoyable and productive reading – please [contact us](#) if you have any questions or wish to discuss any of the topics further.

Topics

[“Big pharma” mergers in crisis times: business as usual...](#)

What are the lessons learnt from the recent wave of merger & acquisition activity in the pharmaceutical industry? Most importantly, what is going to turn those into a success?

[More](#)

[Where did the margin go?](#)

Some observations on how pharmaceutical companies could be better controlling their margin leakage when dealing with Wholesalers and Pharmacies...

[More](#)

[People share their wisdom for free on the internet.](#)

Social customer relationship management: what is this about? People share their wisdom for free on the internet. It's up to you to learn from it...

[More](#)

[Human Resources perspective: Managing talent in a turbulent economy? \(Part 2 of the series\)](#)

What is the right balance between reducing headcount and workforce costs on one hand, and focusing on strategic talent issues on the other hand? What has changed since our first study in January 2009...

[More](#)

[Financing of the healthcare system: open debate](#)

The increase in healthcare expenditures leads to the question of the future financing of healthcare. What are the possibilities to make our system evolve?

[More](#)

[Did you know? Some insights, surprises ...](#)

[More](#)

“Big pharma” mergers in crisis times

Roll back to the end of 2008 and the beginning of 2009. Economic and business analysts were afraid of a recession worse than the Great one. Warren Buffett said that the economy had fallen off a cliff. Merger & Acquisition activity throughout the economy, excluding government takeover of financial institutions, seemed to have all but frozen.

Then, in quick succession, Pfizer bought Wyeth (for \$67 billion), Merck bought Schering-Plough (in a reverse takeover worth \$38bn), and Roche launched an offer to buy out the 44% it did not own in Genentech (in a deal worth \$47bn, valuing Genentech at \$100bn). Smaller deals, such as Gilead Sciences' acquisition of CV Therapeutics (\$1.3bn), or GlaxoSmithKline's purchase of Stiefel Laboratories (\$3bn), almost flew under the radar.

Many equity analysts and observers expect that this will set off another wave of consolidation in the industry. One New York Times article¹ called this “Fantasy M&A”. But what are the reasons for the sudden wave of mergers, and why aren't they affected, or rather why are they spurred, by the economic crisis?

The glass today: half-empty or half-full?

Let's start by looking at a picture of the big pharma sector. Conventional wisdom is that many megaplayers are facing difficult times – pipelines are thinner, patent expiration on many blockbuster drugs is looming, research costs are higher and development / approval times longer, governments and large buyers are putting pressure on pricing, and blockbuster potential is growing rare as drugs are targeted to narrower patient groups to improve their clinical efficiency.

Of course, conventional wisdom may be wrong. According to a study, 2008 represented the biggest ever increase in the total pipeline, to 9,217 drugs in development (though this is tempered by a low number of new active substances reaching the market – only 25)².

Even if other large players' pipelines are faring less well, not all is bad. The population in the Western world is still ageing, and is still expected to require an increasing amount and variety of medication, while public health budgets keep increasing. Emerging markets, with health sectors that are embryonic by the standards of the developing world, are still seen as potentially huge markets. And there are areas where, although R&D is difficult, any approved drug could be a blockbuster: Alzheimer's, obesity, stroke.

So what are the main drivers for the latest big pharma mergers, and for potential new ones?

Recession-proof sector

“People will always get sick”, goes a common refrain. While the financial and automotive sectors are suffering in the economic downturn, together with other technology and manufacturing, a defensive sector remains attractive. If a wider shift towards more government intervention in the economy materialises, as some predict, this may also have positive structural effects on the health sector, since the government is a prime sponsor of large-scale medical insurance / health care programmes.

Prices are cheap if you're cash rich

“Some of the most successful transactions in history have occurred during times of economic distress”, says Philip E. Pfrang, Deloitte's US Healthcare and Life Sciences leader. According to a study³, the average EBIT multiple for pharma transactions in 2009 has been 9.7x, well below the average over the period 1995-2009, which is 15.9x. This would suggest that those companies which have cash, and due to high credit ratings can raise additional debt relatively cheaply even during the credit crisis, are well placed to negotiate acquisitions at lower prices than would be possible in a growing economy.

Shareholders of target companies may also be more inclined to accept a cash-rich offer in turbulent times. This is borne out by the cash-equity mix of the three main acquisitions in 2009: Pfizer paid more than two thirds of the price for Wyeth in cash; Merck paid almost half of the price in cash for Schering-Plough, and Roche's offer for Genentech shareholders was all-cash.

It's high time to control costs

If profit generation from pure R&D is slowing down, and the regulatory environment increases pressure on pricing, another way to maintain profitability is through cost reductions. Mergers incur significant one-off costs but can then deliver significant recurrent cost synergies in support and administration, as well as marketing and operating costs. The risk here is that cost cutting, especially in the R&D area, affects long-term profit generation capacity.

Widening / replenishing the pipeline

One of the most quoted reasons for consolidation in the pharma sector is the weakness of pipelines for many major players. One has to be careful with this argument. It may make sense for specific business combinations – for instance, Merck is considered to have acquired a strong pipeline with Schering-Plough. However, at the entire sector level, if pipelines are weak, then consolidating them will not make them any stronger automatically (just like in the financial sector, where dispersing risk in the entire financial system through complex instruments did not reduce the overall, systemic risk).

The argument gains some strength if we assume that the companies merging have complementary skills in R&D and respectively marketing, and hence that they can exploit their existing pipelines more successfully. Integration of R&D teams may also generate gains (in terms of better R&D rather than just cost savings), but this is more likely when there is already a degree of collaboration on specific projects between the R&D departments of the merging firms. The key here is that realising gains depends on specific circumstances, and on excellent execution, rather than arising automatically as a result of a merger.

Not everyone is convinced by a “large M&A” strategy. Andrew Witty, the CEO of GSK, is skeptical: “I don’t particularly believe that big M&A is going to be a solution to anything in the next few years,” he said in January. “I’m much more in the business of bolt-on acquisitions than big acquisitions.”⁴ David Brenan, CEO of AstraZeneca, is also circumspect on mega-mergers. “I just don’t see it,” he says. “Once you’ve reached a certain size, there is no benefit for R&D productivity, and if it’s about taking out scale, you should be doing that anyway.”⁵ William Hasseltine (former founder, CEO and Chairman of Human Genome Sciences), goes several steps further and argues that “big pharma mergers magnify [R&D] failures”⁶.

So can one draw a general conclusion about further M&A in the pharma sector?

One thing that’s likely is that M&A activity in this sector, now sparked by the mega-mergers in early 2009 and the (paradoxically) positive market conditions, will continue this year and probably the next one. But will these mergers turn out successful or will they fail to deliver shareholder value?

In our view, such a broad conclusion, be it positive or negative, would be wrong. Several past pharma mergers haven’t delivered as expected and future ones may also stumble. On the other hand, there are compelling reasons for certain players to seek an improvement in value through a large acquisition. Mergers that score highly on more than one or two of the strategic criteria above are more likely to be successful (paying little for a strong pipeline with high cost savings potential is always a good idea) but, as the CEO of Sanofi says, “you’re out of the picture for three or four years trying to get ‘big massive deals’ bedded down”⁷, so if a merger is to deliver the medium-term benefits it aims for, good execution is just as essential as good strategy.

¹ Source: http://www.nytimes.com/2009/02/25/business/25place.html?_r=1

² Source: http://www.pharmaprojects.com/therapy_analysis/annual-review-0508.htm

³ Source: <http://www.reuters.com/article/pressRelease/idUS124032+19-Mar-2009+BW20090319>

⁴ Source: http://www.natap.org/2009/newsUpdates/010909_05.htm

⁵ Source: http://www.natap.org/2009/newsUpdates/010909_05.htm

⁶ Source: http://business.theatlantic.com/2009/03/why_big_pharma_mergers_magnify_failures.php

⁷ Source: http://www.nytimes.com/2009/02/25/business/25place.html?_r=1&ref=business

[back to top](#)

Where did the margin go?

Although negotiations between Pharmaceutical companies and their buyers is really nothing new, in the last years wholesalers, pharmacies and others have significantly improved their negotiation skills. Pharmacies play a big role in these changes, due to the fact that they are now paying more attention to

stock rotation, cost control, end-user prices in order to maximize their own margin and to avoid the kind of products that simply are not consumed that often.

While wholesalers have always been fairly organized, - with their size and importance in the market allowing the establishment of a standard pricing structure that was generally accepted by both parties - Pharmacies were somewhat the underdog in this relationship, due to low management skills and no real interest in taking a too active part in this kind of negotiations. Actually, most pharmacies were happy to be kept out of the whole thing, especially because in most cases pharmacists only played an intermediary role between the physician and the patient.

So, what has changed? Well, in many ways the business has changed substantially. The first signs came from the Consumer Health side of the business. Although accounting only for an average 20% of the shop turnover, it led to a business that required the pharmacist to actually pro-actively push and promote products that were not being backed-up by a prescription or by a severe headache, just to give an example. These products also introduced the new paradigm of competition. In most cases these products have copycat or equivalent competitors, eager to have their shelf space and kick the competition out. More recently, Generic companies and even "out-patented" traditional pharmaceutical companies also stepped into this discussion, in order to move stocks faster.

In order to respond to the increase in complexity, wholesalers and pharmacies have evolved, either by doing it independently, or by joining forces creating acquisition chains. The negotiations have become tougher, sales reps are given almost unlimited negotiation power to go through the typical price waterfall: price negotiation, discounts and rebates. As a result, the rumor is out that last year some reps ended up giving away 300% free product. Do you think it's too much? It could be, but even if it is a bit lower, what are the processes in place to control this? Experience from other industries shows that while most companies control the large deals, they just don't pay as much attention to small deals. There are some clear messages that should be put in the field, the most important one being that price is a mean to an end, and not an end in itself. Sales reps should be made aware of margin erosion, not necessarily by sharing all the cost structure with them, but by setting up a scoring system for their deals and compensate their sales efforts accordingly.

Overall, what every company is looking for is a sense of control:

- how are reps really behaving?
- how flexible should they be in terms of deals?
- how often, and with which clients?

Of course, the objective is not to punish the reps who achieve less profitable deals but to reward those who consistently raise the bar. This type of control/reward system is a must-have to develop stronger negotiation skills for the reps and changing current box-pushing mindset into a true Account Management mindset.

Fostering an organization with such a level of control on the price is a relatively hard and complex project, but highly rewarding. In fact, such projects typically pay themselves off within the first two years due to an average profit increase from 1 to 3%.

The fact that Pharmacies and Wholesalers have started fighting more and more for their margin might be a relatively new thing in the pharmaceutical industry, but other industries have been facing this issue for quite some time, and have been successful in putting in place some game rules in an otherwise all-out price war. There is no reason why Pharma could not benefit from these tested rules...

[back to top](#)

People share their wisdom for free on the internet

Thanks to the evolution of the internet, people are currently using collaborative technologies such as Facebook, Blogger, MySpace and YouTube (among others) to share their life stories, to solve problems

and to give comments on all kind of issues.

During the past decade, internet websites were mainly used as a read-only application to inform the customers about the firm and the products and services that the firm had to offer. This situation of traditional customer relationship management has changed during the years into a read-and-write web, in which the focus is more on collaborative relationships and more elaborated networks.

This evolution enables customers to start a conversation with like-minded peers, which can result in new ideas for the company itself.

Contradictory to this fact, companies still focus very much on a one-on-one relationship and try to capture the customer wisdom through subject-specific surveys. The fact that people freely share their ideas about new functionalities and possible improvements on the internet is thereby neglected.

Social customer relationship management is thus about joining ongoing conversations between customers and business partners and furthermore about implementing this valuable information in the life-cycle of the firm to leverage bottom-line results. Remark that not only the company itself can benefit from this approach, but all parties involved in the network will benefit from the information exchange.

For companies active in life sciences and healthcare where innovation is very important, companies could better track what they need from their target audience and by consequence focus their R&D efforts in the right direction.

For instance, a forum could also be used by physicians internally. The effectiveness of a new drug on patients is very likely an area where it would be crucial to exchange this information with colleagues very simply.

From the life sciences and healthcare stakeholders, there is hardly any market research that could replace the value of this information. There are many initiatives to put in place to take advantage of this phenomenon: nobody in the Life Sciences world has really realized or even dreamed to realize the potential of these trends. However, they are not reserved for the sole use of consumer goods marketers, or innovative trend setters. Rather, they could benefit R&D, clinical and commercial entities, care providers, patients and physicians.

Now is the time to take the advantage!

[back to top](#)



Human Resources perspective on global recession: retain your top people

As the global recession deepens, Corporate Executives in every major market and across every major industry clearly recognize the mounting economic challenges they face today and the need to reorder their strategic priorities to survive. One in three executives sees even tougher times ahead demanding “defensive actions”. This means that they will focus sharply on three main priorities:

1. Cut costs and take severe measures to align company costs with today's economic realities
2. Keep and expand the customer base to ensure increase in sales and quality of services
3. Manage the human capital within the organization

Investing in R&D and developing new products and services do not rank as one of the top three priorities anymore for life sciences executives, although they considered this was being very important in the beginning of the year (first wave of the Deloitte/Forbes study). In addition to this they see improving top- and bottom-line performance as a lower priority than other companies. This is consistent with the finding that they have a moderately more optimistic view about the economic conditions.

Focusing on defense: Talent priorities reflect the rough economy

The generally pessimistic economic outlook of Executives and the strong emphasis on reducing costs may also be cutting into plans aimed at repositioning companies for better times ahead. Overall managers are struggling with how best to align their workforce with the reality of the prolonged downturn. Traditional answer to the current economic crisis are layoffs as 47% of the executives reported cutbacks over the last three months and 42% expects more layoffs to come over the next quarter in order to "right size" the workforce for a weaker economy. Nearly 39% of the corporate leaders consider headcount reduction as their top talent priority.

However, for Life Sciences/Health Care executives, this is not their main talent priority today: rather, they are more focusing on recruitment compared to other companies.

Retaining and training key talents stays crucial

Despite widespread cost-cutting, talent managers and corporate executives remain committed to developing their top talent and future leaders. In order to retain employees, executives surveyed are increasingly focused on three areas:

- Redeploying workers to divisions and jobs in higher demand (31%)
- Redirecting outsourced work to in-house employees (27%)
- Increasing the use of flexible work through telecommuting and reduced work weeks (23%)

Life sciences/Health care executives are more likely to have a high level of concern over losing key employees. **On top of this, life sciences executives often raise their concern about competitors recruiting their high-potential employees.**

If you are interested in reading the full report from Deloitte, please click [here](#).

[back to top](#)

Financing of the healthcare system: open debate

The main characteristics of the health care structure in Belgium are the compulsory health insurance system and the strong governmental interference. From the patient's perspective, the system is working relatively well today through:

- The universal provision based on solidarity across social classes
- The freedom of choice when seeing a healthcare provider. Indeed, patients can still freely choose to visit a generalist or a specialist
- The virtual non existence of waiting lists to provide care

However, taking a look at the evolution of healthcare expenditures from the RIZIV/INAMI simply illustrates the profound impact that the evolution of the population has on the management of the healthcare budget. With the changing demographics and lifestyles, the evolving consumption habits, the increase in chronic diseases and life expectancy, the technological progress, etc., there will only be more

pressure on healthcare expenditures in the short and long-term. Indeed, healthcare expenditures in Belgium have increased by 35% between 2000 and 2005, and by 47% between 2000 and 2007.

Year	RIZIV/INAMI Healthcare expenditures* (million EUR)	Index
2000	12.820	100
2005	17.250	135
2007	18.873	147

*source: RIZIV/INAMI

The constant increase in expenditure creates a major political challenge to manage the healthcare budget. The big question is how to create a sustainable system in the long run. Any solution in this matter will require thorough political debates and clear societal choices.

In any case, the debates should at least tackle the following topics: increased collaboration across the value chain of care and increased simplification across governments and regions.

Increased collaboration?

- A better collaboration across the value chain of care is needed. Nowadays for example the budget allocation of each health care provider (whether we are talking about hospitals, specialists, GPs, etc.) is done separately and each institution manages its own fixed budget, human capital, technical resources and independent strategies. Although this leaves flexibility, it doesn't favor collaboration between the different levels of care.

Collaboration will be critical to move faster, to avoid duplication of work and spend and to ultimately create more benefits for patients.

- A better collaboration of citizens and patients will increase sense of personal responsibility? Research indicates that citizens/patients are looking forward to being empowered in the care that they receive. There are ways to capitalize on this trend to actually generate more awareness around diseases and associated costs, but also and ultimately around prevention.

Increased simplification?

- Looking for simplification across government and regions: The structure of the decision-making (power residing at different levels, federal and regional) can lead to some inefficiency. An approach similar to a recent project undertaken by Deloitte for the European Commission on the reduction of administrative burden could be beneficial.
- Focusing on latest technological evolutions: Additionally, the focus on the concretization of the e-Health platform project is a move in the right direction. Taking advantage of the latest technological advances will mean faster, more convenient and more customized care. Some countries are ahead of Belgium in that respect, it would be good to get some inspiration.

All of the efforts mentioned above will require investment to develop the healthcare system of the future. However, the investment required today could be minimal compared to the future situation if we stick to status quo.

[back to top](#)

Did you know?

- That physicians are getting worried about the jargon used by the NHS (National Health Service) in the UK? For instance, physicians are puzzled when some official documents use the words of “client or service user” when actually talking about a... patient. Another example is when talking about “efficiency savings and divestments” simply means talking about... cuts. Consequently, physicians either spend too much time reading the document or just ignore it. The Plain English Campaign is taking the issue to heart and has started developing guidelines to avoid such issues...
- That the pharmaceutical industry is still largely experimenting with various marketing and sales models? Large pharma marketing can learn from the consumer business approach to customer segmentation, targeting, relationship management and product promotion. Consumer business strategy also provides insight into highly effective promotional spending, the targeting of investment at customer segment and the balancing of product portfolio. Sales forces can benefit from various approaches including outsourcing, relationship-building with various stakeholders and a consultative technique.

[back to top](#)

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