The Pharmaceutical Market Analysis

Porter Approach based on FT article (and other sources)

Wojciech St. Mościbrodzki, Poznan WSB Executive MBA
wojmos@interia.pl http://ecomm.no-ip.com/wojmos

1. Introduction

The pharmaceutical business is currently in a somehow transition state. A few years ago it was claimed to be a very promising area without real, significant dangers. The powerhouses' strengths seemed to be unquestioned. However recent years have shown that this image changed. We will try to analyze the situation using wide known Porter's model.

2. New entrants

A few years ago, when pharmaceutical industry was at the dawn and heavy protection from patents was protecting the market from fresh entrants, the situation was far better for existing companies. Introduction of a new medicine was dependent on costly investments on facilities, research and clinical tests. Right now, expiring protection (flagship products like Zantac, Prosom or Vibramycin are 30 years old in their patent life) invites new players to join the market and undermine powerhouses' position with a wide spectrum of relatively cheap products. In emerging markets of fresh EU countries, some government incentives for new players are available, as the state wants to lower the cost of health care products.

3. Substitute product

This area has significant influence on overall image. Even a few years ago pharmaceutical market was dominated by a blockbusters from a major powerhouses. Right now, the substitutes are a very real threat, as patent rights are expiring and smaller companies are more than eager to copy flagship products. For instance, Pfitzer's Lipitor (anti-cholersterol drug) is to be free for public production in 2010, but a number of other products can be copied even earlier. Moreover, there are some dangers from countries that pay less attention to protect intellectual rights. Companies makes efforts to extend patent protection time, but their tries are not so successful (even though US and Brussels have slightly extended the patent period).

Generic drugs are far more cheaper than patented medicines. Polish medical controlling committee announced, that a patented to generic price ratio in a selected group of 10 drugs was around 3:1. However, cases with this ratio around 20:1 are not uncommon. This factor is particularly important in para-pharmaceuticals and not life-supporting drugs sector, as people are more concerned on price in that segment. However, even generic suppliers are not fully safe from substitute products. During last years Poland has witness a public discussion on quality of generics. The National Health Fund, state's central drug body is considering a slight change in refund lists. Even some of the generics are claimed to be too expensive and company (and physicians) lobby has to take all measures to defend the status quo (if they fail, the biggest players will suffer significant financial losses which will be reflected in doctors' benefits).

On the other hand, in some states (even in a few US regions) drugstores are prohibited to sell substitutes. Physicians usually prescribe only the one drug name so patients are forced to buy particular (usually expensive) medicine, even when cheaper substitutes are common. This policy is, however, declining recently.

4. Buyers power

Global customers have now wider possibilities to compare and choose products and their knowledge of market is significantly raised. Even though the need for medicine and para-pharmaceutical products is increased, the market pulls the prices down, as many customers look for bargains. Therefore, the common opinion is, that blockbuster era seems to reach its end. The necessity to lower the cost emerged and

big companies feel that the sales costs are weighting them down (rep average salary estimated $150.000).

On the other hand, suppliers still look for quality and do not accept eagerly policy to shift research and testing to low-cost countries in Asia. That places companies in uncomfortable situation where they have to maintain costly R&D while still competing on price.

Sometimes the suppliers can even force drug producers to be more flexible – both in pricing and intellectual property protection. The good example comes from Brasil, where government issued an official ultimatum for pharmaceutical concern Abbot. The company is to lower the prices for anti-AIDS drug Kaletra or the government will allow to break patent procedures. The officials point to WHO statutes which allow the temporary patent break in case of large scale epidemics and other critical situations (natural cataclysms etc.). WHO allow the governments to produce critical products if the patent owner will be paid licensing fees. However license fees can be set by government side (annual Kaletra treatment is $2600, while Brasil officials say that $500 will be enough to cover producers costs and profits). The same problems is with Africa and public opinion is become angry with the situation where millions of people die while companies warehouses are full of medicines. This brings more and more ethical issues (which could influence further business). Bristol-Myers Squibb Co. recently announced that they will pay $30.000.000 for anti AIDS campaign in Africa and lower prices for its AIDS treatment drugs – Zerit by 50% and Videx by 90% (!!!).

On the positive side, long-term expectations are sketching the increasing demand level. Life expectancy of many countries in Europe and in Asia is significantly increasing. Even in Africa and Latin America, where health care is at much lower level the life and health indexes are raising: reports point that the same life expectancy growth took 40 years in Latin America, while in Europe it took 3 times more. Newly joined countries of UE are also promising markets. During last 10 years the market volume in those countries tripled, yet still there is a place to grow (e.g. annual medical spending in 14 UE members is around 400 euro, while Poland is slightly above 100 euro).

The public (and customer) opinion is also paying increasing interest in legal aspects, especially in US and Western markets. People are more aware of possibilities of taking companies to the court (e.g. Merck faces more than 500 lawsuits). Drug producers therefore must change their policies and make additional effort to inform about possible undesired treatment effects (which means prolonged, budget-ruining medical tests). Some companies was even forced to withdraw promising products after investigation of some health problems related to drug usage (Merck's Vioxx or Pfitzer's Bextra).

The buyers position is often supported by government activities. Politicians seem to be very eager to join such campaigns as the image of an activist protecting poor people from big corporations is very appealing. The argument "new drugs need researching and researching is money-consuming" is therefore politically weak, even if logical and true. The state's efforts to control drug market were especially common in European and Japanese regions (where governments are far more closely interacting with economics), but recently even US is moving towards more controlled drug prescription. That is supported by both state officials and private firms concerned about costs and cutting health service budgets.

On the other hand, some governments accepted powerhouses argumentation and issued some procedures to prolong patent protection (GATT and WHO resolutions, TRIPS agreements, SPCs - supplementary protection certificates etc.).

5. Suppliers power

During recent years the market witnessed some merges and acquisitions. Many companies seek to gain access to other parties knowledge bases (especially smaller firms, usually those of biotechnological profile – with Arakis and Ventura, overtaken by Novartis as a perfect working example) and to boost their research potential. Research for new medicines is becoming more and more challenging, as innovations

raise in costs but patent protection does not extend (so potential profitability decreases). A good example is Schering Group which R&D budget raised by 150 mEuro in 2000-2002. Specialists claim that even though research on humane genome is in constant progress, companies will need about 20 years before the results will meet practical implementation. That means that only those companies who sustain incoming years would benefit from potential gains.

A big part of expenses can be get rid of by moving clinical tests and some labs to India or China, but customers does not feel that approach is reliable. Moreover, the pace of rat race to fill the initial research pipeline is increasing, as those who stand in place, are easily overrun.

6. Summary

The mid-term expectations were constantly falling down during last years. That will probably still continue for some time. Investors opinions follow that forecast and the value of powerhouses' shares decreased (e.g. Pfitzer, whose shares drop 30% - but other major players suffer similar losses, due to McKinnell's report). Players had to tune their strategies in changing market. Roche moved to specialty medicines and diagnostic an plan to take benefit from personalized therapy based on high-tech genome researches. Johnson&Johnson belives rather in diversification, while Pfitzer merged with Pharmacis and introduced a significant cut-cost program. Every company is still before some rationalization as manufacturing and marketing model needs to adapt to the new situation (e.g. new entrants and substitution challenges force optimization in facilities, which usually operate at 30-40% of capacity, boosting variable cost of production). Moreover, the sales network will have to be redefined (salaries will be lower and even more dependent on effectiveness and profitability) and free samples policy will have to be limited.

On the other hand, long-term perspectives are rather bright. Fast aging societies will be in need of more and more drugs. Stress level and bad health policies will generate new customers even in younger groups while body-caring and image management style will boost para-pharmaceutical segments. The implementation of high-tech, genome-based personalized treatment will also create a trend for expensive drugs.

We can expect that new general strategies have to be implemented before 2010 and the shareholers will carefully observe the results. Companies not changing quickly enough will face loss of value while winners can expect additional premiums for risk taking.