The Big Pharma BUST

The collapse of western pharmaceutical companies is inevitable

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Ranbaxy, Dr. Reddy's Laboratories, Nicholas Piramal, Cipla, and Biocon – are these Indian pharmaceutical companies familiar to you? They may not be today, but in the coming decades these are the brands that will likely be lining the shelves of pharmacies across the western world. Between 2010 and 2013, Eli Lilly will see four of its five patents on top-selling drugs expire. Other leading members of "Big Pharma", such as Pfizer, Novartis, Merck and Sanofi-Aventis will each be facing a similar predicament by 2016. These inevitable patent expirations will provide generic drug producers with a tremendous opportunity to capture a large part of the pharmaceutical industry worldwide.

The Death of the Blockbuster Drug

Big Pharma has long known that its blockbuster drug business model would come to an end. For years the major industry players have struggled to develop new drugs that would be able to replace giants such as Lipitor, which generated close to $13 billion during 2008 alone. Furthermore, Big Pharma has very few opportunities to accelerate new drug development due to the laborious and time consuming processes involved in developing a drug, undergoing trials, and obtaining regulatory approval.

Industry Value Chain

Explosive growth in the sales of pharmaceutical industry giants in the 1990s and 2000s was a direct, but not shocking result of the heavy investments Big Pharma made throughout the 1980s. During this time, the major industry players also began to make a series of vertical acquisitions designed to bring more operations in-house in order to protect their intellectual property and bring their promising drugs to market faster. The success (and expense) of Big Pharma's activities during this period prompted the industry's biggest companies to shift their financial resources from R&D to marketing in an attempt to fully capitalize on their high-potential portfolio and swelling asset base. However, the result of this strategy was a weakening of these companies' most essential capability: drug development.

Due to the long-lead times associated with bringing a new drug to market and the favourable patent terms available to Western pharmaceutical companies, the effects of this industry shift are only being felt today. Since recognizing their lack of prospective drugs in the late stages of R&D and exhausting their efforts at acquiring patent extensions, Big Pharma has commenced a series of acquisitions to build their patent portfolio, such as Pfizer's US$60 billion acquisition of Wyeth in early 2009, or have teamed up with generic drug makers to take advantage of their low-cost manufacturing and widespread distribution capabilities. The problem, however, is that there are only so many competitors that can be acquired, and eventually these companies will not be able to sustain themselves without developing their own new products.

In contrast, the lesser-known Indian pharmaceutical companies have spent the past 20 years building strong capabilities in the early stages of the value chain: R&D, production, and distribution. Improvements were facilitated by India's ability to conduct clinical trials faster and an abundance of inexpensive local talent. These advantages, matched with the Indian companies' focus on R&D, rather than marketing, allowed them to reap the benefits of their patent protection.

Western pharmaceutical companies, under the traditional blockbuster drug strategy, simply cannot compete on cost and do not have the R&D pipeline to be sustainable on their own. In fact, the only real advantages that these companies have over their Indian counterparts is their brand equity and existing relationships with consumers. Though this is a crucial selling point, it is one that cannot be sustained without having new, unique and life-altering drugs for an extended period of time. To mitigate this, Big Pharma has begun to aggressively pursue both joint ventures and acquisitions with a number of different Indian pharmaceutical companies. GlaxoSmithKline recently purchased a stake in Aspen (a South African generics manufacturer) and entered into an agreement with India-based Dr. Reddy's laboratory to sell generic products in Asian emerging markets under the GlaxoSmithKline brand. Similarly, Pfizer created Greenstone, a spin-off company selling generics, and has entered an agreement with multiple Indian companies to sell their products in the US and other markets. Though these strategies will help the Western pharmaceutical giants to sustain their profits in the short term, how much longer will it be until their Indian competitors no longer need them to succeed and grow?

The Black Clouds

Joint ventures between Western and Indian pharmaceutical companies allow Indian generic drug makers to leverage the brand equity of their Western counterparts to sell "branded generics". The two-tiered selling scheme allows Big Pharma to continue selling its higher-priced branded drugs in Western markets while accessing developing markets by selling branded generics at substantially discounted prices.

However, the long term implications of this strategy have yet to be seen. Will consumers from developed countries sit back quietly as the exact same drugs they purchase, made by the same companies, are sold for a fifth of the price abroad? Or will consumers speak up and demand lower prices or seek alternatives, as we have seen in other industries? The "medical tourism" industry, which is quickly growing internationally, is a prime example of the lengths consumers may be willing to go to reduce their healthcare costs. North Americans are now frequently traveling to developing countries such as Argentina, Cuba, Columbia, India, Malaysia and Thailand in order to obtain faster and cheaper medical treatment.

In addition, there is reason for consumers to be concerned that this strategy ignores the real problem: Western pharmaceutical companies are not rebuilding their capabilities at the early stages of the value chain. A recent study conducted by two professors at York University indicates that drug companies in North America continue to spend three times more on advertising and promotions than on R&D. In an industry that places so much emphasis on the size of its R&D investments, consumers should question the extent to which they trust the big branded companies over their smaller counterparts and other generics producers.

One further aspect to be considered is the actual sustainability of this plan when it comes to emerging markets. Economic growth will eventually bring these countries the levels of government and insurance provided healthcare that we've come to expect in the developed world. However, who is to say that the drug policies of these emerging market countries will cover the purchase of identical, higher-priced drugs instead of cheaper generic drugs that are produced domestically. Instead, it is more likely that consumers will be encouraged, if not forced, to purchase the cheapest generic drugs (that still meet the necessary quality standards), in order to obtain coverage by insurance companies. This trend will further diminish the market power of today's big pharmaceutical companies, and help give rise to India's budding giants.

Winds of Change To The West

Many pharmaceutical companies, such as GlaxoSmithKline, Pfizer, and Novartis, have realized their long term survival depends on their success in emerging markets. Western pharmaceutical companies employing a vertically integrated strategy simply cannot sell their products at a lower price in emerging markets. To be successful in emerging markets, the Western pharma companies need to outsource non-core processes.

For example, Western pharmaceutical companies could decide to outsource distribution and on developing their R&D pipelines. Another strategy that Big Pharma could employ would be to target a population in a lower economic strata and develop a new market rather than focus on more mature markets. Novartis has taken the initiative to develop a pilot program targeting the bottom of the social pyramid in rural areas of India that plans to reach 50 million consumers that, before now, were not able to afford or access almost all major drugs. Hence, the company's strategy lies in distribution not marketing. An alternative sustainable strategy for Big Pharma lies in innovation. Instead of drug discovery, pharmaceutical companies can focus on new technologies like gene therapy, or "personalized medicine".

The key to being a sustainable global pharma company is to disaggregate the value chain and focus on core competencies based on available resources. A company with a great R&D pipeline, and weak distribution should partner with a company that has strong marketing capabilities and a widespread distribution infrastructure. It is these weaknesses in the value chain of the Big Pharma companes that will force them to outsource non-core processes.

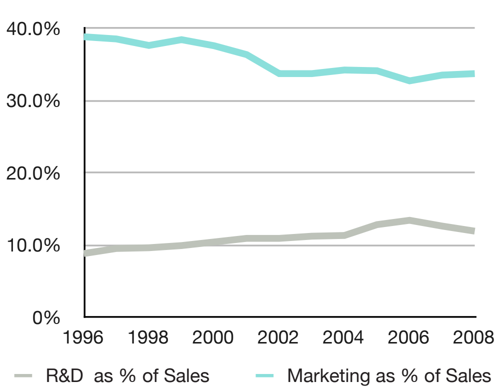
On the other hand, the Indian pharmaceutical companies have engaged in numerous joint ventures with their Western counterparts, and with any joint venture comes the transfer of knowledge. Joint ventures and the establishment of reputable brands by the Indian companies will allow them to be able to gain the support of insurance companies in both developed and developing markets. With high regard from insurance companies, Indian pharmaceuticals will finally be able to secure brand trust and ensure consumer confidence.

Finally, these Indian companies are ideally located in areas of large populations. Many of these companies have distribution already set-up in India, and are very close to other large Asian countries such as China. This will provide them with a huge, and increasingly important population to target before moving to North America and the rest of the developed world.

Indian pharma companies are already ahead of the race. Further acquisitions in this industry have allowed the Indian drug giants to build their R&D pipeline. With strong capabilities in manufacturing at a low cost and widespread distribution infrastructure, the Indian pharma companies are outsourcing their only weak component of their value chain: marketing.

While the Western pharmaceutical companies build their strategy on a disaggregated model, the Indian pharmaceutical companies will gain marketing knowledge, build their brand equity and eventually become vertically integrated. At this point, these companies will have strong capabilities in every component of their value chain. Though it is impossible to know who will come out on top, these changing industry dynamics suggest that "Indian Pharma" is poised to lead the industry in the coming decades.

Marketing as a Percent of Sales



Selection of Most Valuable Drugs in the World

Company	Drug	Probable Expiracy	Annual US revenue at risk
Pfizer	Lipitor	1-Jun-11	$5.8 billion
AstraZeneca	Nexium	1-Nov-14	$4.8 billion
Bristol-Myers Squibb	Plavix	1-Nov-11	$3.8 billion
AstraZeneca	Seroquel	1-Nov-12	$2.9 billion
Merck	Singulair	1-Aug-10	$2.9 billion
Purdue Pharma	Oxycontin	1-Apr-13	$2.5 billion
Zydus CND	Actos	1-Jan-11	$2.4 billion
Forest Laboratories	Lexapro	1-Mar-12	$2.4 billion
Bristol-Myers Squibb	Abilify	1-Apr-15	$2.4 billion
Eli Lilly	Cymbalta	1-Jun-13	$2.2 billion