FOCUS

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Pharmaceutical Industry's Use of M&A and Pricing Power for Growth

(Sources: Two articles: One prepared by Hassan Mazhar and published by The Market Mogul and the other by Joseph Walker and published by the Wall Street Journal)

This year, 2015, has been a record breaking year for pharmaceutical mergers and acquisitions (M&A), with deal value in the first half of the year reaching a record high of US$221 billion, more than tripling the value of M&A deals in the first half of 2014. Three key factors have explained this boom in pharmaceutical M&A: (1) firms looking to further specialize their operations; (2) the ability to acquire approved blockbuster drugs; and (3) the requirement of cost cutting.

A key driver of this increase in deal volume has been the need for firms to replenish their pharmaceutical pipelines. Developing drugs is becoming an increasingly risky business, and large firms can obtain a known blockbuster drug through acquiring a firm that has already developed one. Many of the world's biggest drug makers, such as Pfizer and GlaxoSmithKline, have been built around such mergers. This year AbbVie, which outbid rival competitors in acquiring the Californian pharmaceutical start-up Pharmacyclics, offered US$21 billion in cash and shares to acquire the company. This represented a premium of 50% on the market valuation of Pharmacyclics, yet what drove the deal was the opportunity to acquire the start up's blockbuster cancer drug, *Imbruvica*. The acquisition is likely to bring synergies, as AbbVie does have oncology drugs in the pipeline, but sales of Imbruvica are likely to compensate for the ending of AbbVie's patent on its most profitable drug, Humira. The author, Hassan Mazhar, suggests this deal represents a trend in the industry; companies rely heavily on the sales of blockbuster drugs, and are willing to pay hefty premiums for companies in order to acquire them.

Smaller companies have been driving growth in the development of drugs, while large pharmaceutical labs have been disappointing in this field. The consulting firm Bain & Co. estimates that the best performing drug companies receive 70% of their revenues from drugs that are not developed in-house. Smaller, young companies have shown themselves to be more resilient in creating new drugs, yet they lack both the expertise and finance to organize drug tests, deal with regulators and get drugs to markets. Estimates show that it can cost up to US$2.5 billion [compared to US$500 - US$800 million only 15 years ago] to get a single novel drug to market, and smaller firms don't have the funds to deal with such costs.

Nevertheless, the role of cutting tax bills has played an important role in pharmaceutical M&A, with American companies seeking to engage in 'tax inversions'. Tax inversions have been seen by American companies seeking to acquire non-American companies, with the aim of re-domiciling the company's tax base. The U.S. Treasury has begun to clamp down on such activity, AbbVie criticized the current administration for the rule change that blocked their potential acquisition of UK based Shire.

In Brief . . .

◆ **PHOENIX Group** reported its total operating performance (revenue as well as handled volume for service charge), increased by 6.7% to €14.3 billion (US$16.1 billion) and earnings before interest, taxes, depreciation, and amortization (EBITDA) rose to €218.5 million (US$245.6) for its first half ended July 31st. Results were driven by an increase in revenue in Germany, where the pharmaceutical wholesale market experienced strong growth and the group also recorded higher revenues in the majority of its foreign markets.

◆ **AmerisourceBergen** will acquire **PharMEDium Healthcare Holdings** (US), a privately-held provider of outsourced compounded sterile preparations to hospitals and physicians for US$2.6 billion in cash. PharMEDium maintains 4 compounding facilities, provides a broad range of 2,000 SKUs and serves over 3,000 hospital customers across all 50 states. "The acquisition of PharMEDium strengthens our core business and meaningfully expands our innovative service offerings for health systems," stated Steven Collis, AmerisourceBergen president and CEO *(and an IFPW Director)*.

◆ **Celesio** has launched a donation matching scheme to address the current refugee situation in Europe: every euro that employees donate to the **Red Cross** refugee campaign before 30 October 2015 will be doubled by Celesio up to a total of €50,000. In addition and as a sign of solidarity with its US parent company, **McKesson Foundation** is providing a US$100,000 special grant to the International Rescue Committee. *Marc Owen*, Chairman of the Management Board of Celesio, said: "As one of the leading healthcare providers in Europe, Celesio is assuming a share of the responsibility for the refugees. For 180 years, Celesio and its employees have been committed to helping people in healthcare matters and emergencies. It is not only a long-term commitment, but also an important part of our Corporate Responsibility activities."

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Conversely, M&A is not the only strategy being used by the industry to foster growth. In an article published in the Wall Street Journal, the strategy of "pricing power" was illustrated. For example, the multiple sclerosis drug's maker, Biogen Inc., raised its price an average of 16% a year throughout the decade-21 times in all. It is an example of drug companies' unusual ability to boost prices beyond the inflation rate to drive their revenue, even when demand for the drugs doesn't cooperate.

A result of this pricing power is that across 30 top-selling drugs sold by pharmacies, U.S. revenue growth has far outpaced demand in the past five years, according to a *Wall Street Journal* analysis of corporate filings and industry data. Revenue growth averaged 61%, three times the increase in prescriptions.

Attention has focused lately on new drugs with startling prices and on a few whose price a new owner – a private equity

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Pharmaceutical Industry (cont.) . . .

firm - abruptly raised several-fold. But what many drug companies rely on for sales growth is a pattern of steady increases, year in and year out, on older medicines. Wholesale-price increases for the 30 drugs analyzed by the Journal averaged 76% over the five-year stretch from 2010 through 2014. That was more than eight times general inflation.

For 20 leading global drug companies last year, 80% of growth in net profits stemmed from price increases in the U.S., according to a May report by Credit Suisse. Pricing power helps some in the pharmaceutical industry to compensate for sluggish demand, new competition or weak product pipelines. "Pricing has covered up a multitude of other disappointments over the past 15 years" in the sector, said a biotech analyst at AllianceBernstein.

Pharmaceutical companies defend their pricing as helping to finance development of innovative medicines, an expensive and risky enterprise they say wouldn't attract investment without the potential for large returns when a new drug succeeds. Many in the industry also say a focus on drug prices is shortsighted because it overlooks drugs' role in helping to contain overall health-care costs by preventing disease complications.

A spokesman for Pharmaceutical Research and Manufacturers of America said that eventually, prices for all drugs will decline sharply when they lose patent protection and go generic. Avonex maker, Biogen, has noted the central role of price boosts in the drug's success. "For 2014 compared to 2013, the increase in U.S. Avonex revenues was primarily due to price increases, partially offset by a decrease in unit sales volume of 10%," Biogen said in its 2014 financial report. A similar note has appeared in its annual reports since 2005. But Biogen points to the way this revenue funds its quest for new medicines. The company spent an average of US$1.19 billion annually on R&D from 2005 through 2014, or 24% of total revenue. Besides Avonex, the company has brought out two other multiple sclerosis drugs and is studying a treatment to repair nerve damage from the disease. "Over the past two decades, which is the life of Avonex, we've done more than any other company to improve the treatment of multiple sclerosis," said a Biogen senior vice president. "The reality is that revenues from therapies available today make this possible."

US Pharmaceutical Distribution Trends

(Source: Edited excerpts from the Introduction and Guide to the report: "2015- 16 Economic Report on Pharmaceutical Wholesalers and Specialty Distributors" by Drug Channel Institute. A full report is available at: http://drugchannelsinstitute.com/products/industry report/wholesale/)

For the first time, U.S. drug distribution revenues at the Big Three public wholesalers - AmerisourceBergen, Cardinal Health, and McKesson - exceeded US$300 billion. Other notable developments have occurred subsequent to the publishing of the 2014-15 report, including:

• Large pharmacy retailers continue to restructure their wholesale relationships, shifting from self-warehousing to establishing direct-store deliveries from a wholesaler. Some of the largest retail and mail pharmacies are also transitioning generic purchasing to wholesalers. So far, Cardinal Health has been most successful at winning these new relationships, due to its Red Oak generic purchasing joint venture with CVS Health.

• Consolidation and acquisitions among pharmacies and payers are pressuring wholesaler margins, especially as the acquiring companies consolidate buying power. These deals are also creating significant volume shifts among the Big Three.

• New hepatitis C therapies and other specialty drugs are boosting wholesalers' revenues but challenging their profits. Payers are shifting specialty dispensing into the largest, payer-owned specialty pharmacies, which offer the smallest margins for wholesalers.

• Manufacturers' channel strategies for specialty drugs are reshaping the distribution industry. For pharmacy-dispensed medications, the expansion of limited specialty networks is challenging the value of the wholesale channel. Genentech's channel strategy change for three of its provider-administered drugs is boosting wholesalers' profits and increasing revenues at specialty distribution subsidiaries.

• Generic inflation, which had boosted wholesalers' profits, has begun to slow. The pharmaceutical industry is approaching peak generic substitution rates for traditional drugs. Meanwhile, the first U.S. biosimilar drug launched in September 2015.

• The Big Three wholesalers continue to alter their businesses with acquisitions. In 2015, Cardinal Health has been an active acquirer, buying two smaller distribution companies and further expanding its medical business. McKesson recently expanded its operation in Europe and AmerisourceBergen has expanded into veterinarian medicines and pet supplies.

In Brief (cont.) . . .

- **TOHO Holdings** is constructing a new highly-automated 31,000+-square-meter distribution center in Hiroshima prefecture to prepare for an expected increase in handling volume as well as an expansion of customers' direct delivery systems, while taking into account further enhancement of traceability as well as countermeasures against disasters based on the lessons learned from the Great East Japan Earthquake.
- **Cardinal Health** has completed its acquisition of **Johnson & Johnson's Cordis** business, a global leader in cardiology and endovascular devices, for US$1.94 billion. The acquisition of Cordis will strengthen Cardinal Health's portfolio of physician preference items, including offerings in the cardiovascular, wound management, and orthopedics areas. The company is helping customers standardize around medical devices, while offering innovative solutions in supply chain management, inventory optimization, and work flow tools and data to support the most effective management of the patient.
- The **US Healthcare Distribution Management Association** (HDMA) announced the reelection of *Ted M. Scherr* (President/CEO, Dakota Drug, Inc.) and *Jon Giacomin* (Chief Executive Officer,Pharmaceutical Segment, Cardinal Health, Inc.) as Chairman and Vice Chairman, respectively, of the HDMA Board of Directors.
- The French pharmaceutical industry has reacted angrily to a set of government cost-saving measures, including price cuts and sales rebates, that it says will cost it almost €1.7bn (US$1.9bn) next year.

(Sources: Cardinal Health, Celesio, Drug Store News, HDMA, PHOENIX, Scrip and TOHO Holdings)