April 2014

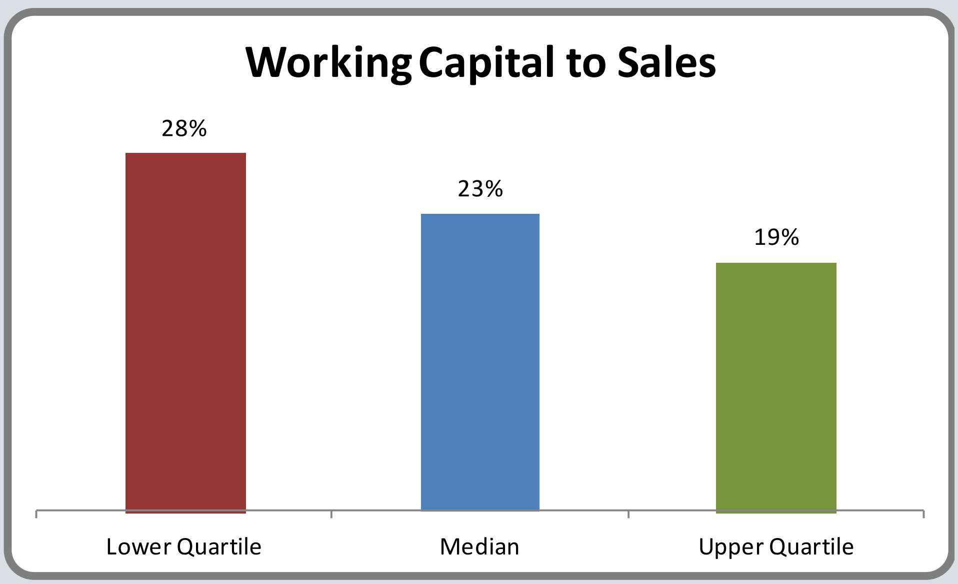
Pharma working capital performance highly variable

€41 Billion in Excess Working Capital

We last completed this survey in 2012. We expected that there would be a broad improvement across the board. Interestingly, while this has not turned out to be true the level of working capital has only very slightly decreased and results have varied from one company to the next. Our 2012 survey suggested that there was as much as €50.7 billion in excess working capital. Our latest survey suggests that the total industry opportunity has reduced by 19%. But many of the gains in receivables and payables have been offset by increases in inventory,

The pressures to release cash have continued to increase partially due to the expected competitive pressures in South America and Asia but also the high cost of acquiring biotech companies. But two new factors are increasing the pressure - margin erosion and dividends. Margins in North America and Europe have been under severe pressure due to various government austerity measures. This has proved to be a boom for the generic producers. And investors are increasing their demands for dividend growth from pharmaceutical companies as a means of generating cash in a low interest rate environment.

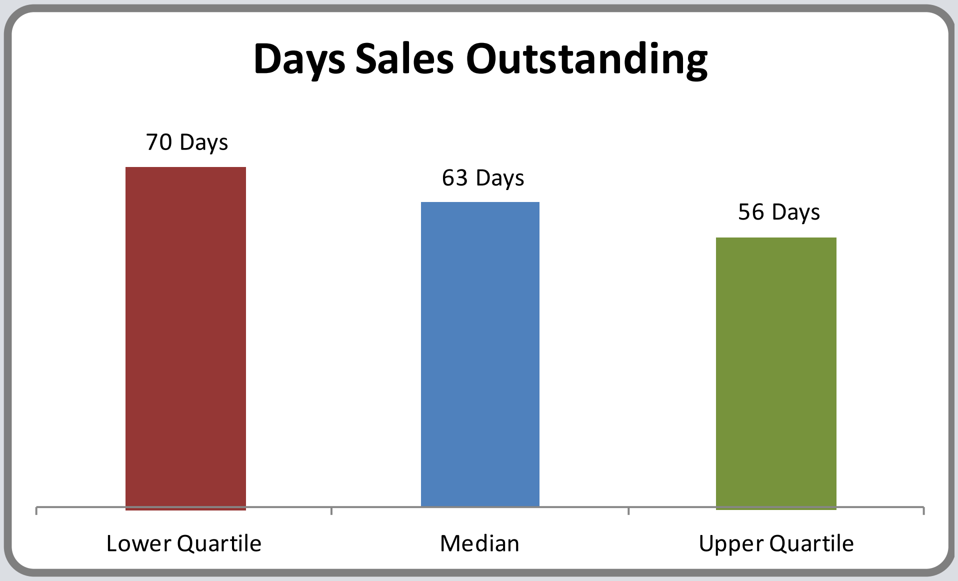
In our survey of pharmaceutical companies based in North America and Europe, we found that if all companies had performed in the first quartile, there would have been an opportunity to reduce working capital by €41.0 billion. That would have the effect of reducing the industry average working capital to sales ratio from 23% to just 14%. While the median performance is the same as our last survey, the opportunity in percentage terms has dropped by 2% due to increased revenues.



We know that many pharmaceutical companies have implemented very large working capital programmes but few have achieved working capital improvement in all areas and it has been difficult to maintain these improved levels of performance. Others have struggled to get their programmes off the ground in a meaningful way and results have been disappointing, sometimes going backwards. Fundamentally pharmaceutical organisations have not changed to a degree where working capital improvements have happened throughout the organisation. Congratulations to those who have achieved success, but there are still many who need to make meaningful changes that will affect working capital performance.

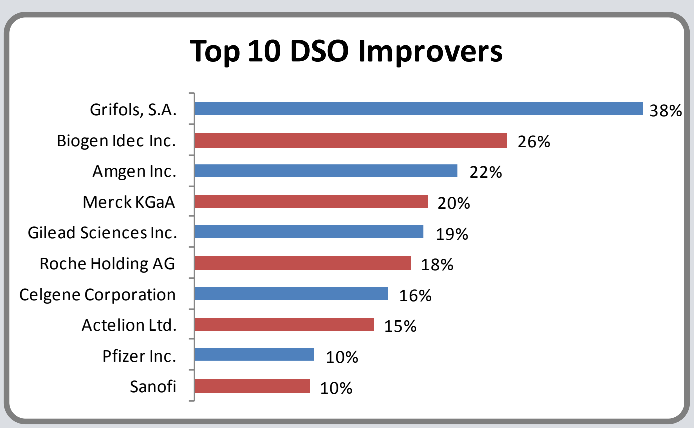
Receivables: A mixed bag of improvers and decliners

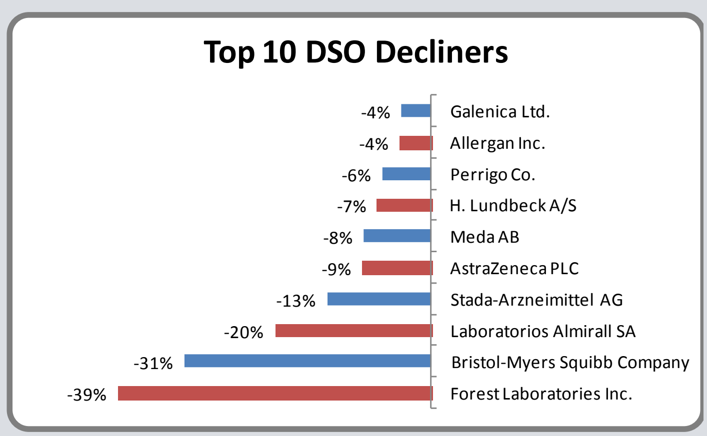
Compared to our 2012 survey the lower quartile, median and upper quartile points have all improved. This improvement should be of little surprise since companies usually start working capital programmes with receivables, Southern Europe has dramatically improved for pharmaceutical companies and factoring is becoming much more common. More surprising is that the total peer group only improved by 3%. Those companies that are in the lowest quartile have fallen further back from the pack and this is evidenced by those who were significant decliners. Of the peer group of 37 companies 19 improved their DSO but 18 declined. This emphasises that it is important to improve DSO performance and can be difficult to sustain that performance without the right structures and processes.



Southern Europe has been a pleasant surprise for many in the past two years. A stiplulation of the various bailouts and central bank assistance programmes has been the extraction of promises to pay outstanding public sector bills to private corporations. The most dramtic change has been in Italy where there are still many problem accounts but the chronic funding problems have largely gone. So if you have not seen recivables balances fall in these countries you should be asking your affiliates tough questions.

The other area that seems to have blossomed in factoring. Almost all the major pharmaceutical companies are doing it somewhere with Japan, the Unites States, Italy, Spain and Portugal the most popular markets where this kind of facility is being offered. We have heard numerous stories of companies being offered factoring agreements in Japan, through Japanese banks, for as little as 50 basis points above base and in the United States for as little as 65 basis points above base. Given the WACC rates for most pharmaceutical are very high, these factoring deals provide an excellent opportunity to both reduce receivables and create a fantastic investment return. Our only caution about these deals is around sustainability. Most of these arrangements contain clauses allowing the factoring bank to withdraw from the scheme very quickly. So if interest rates were to rise or if the banks' source of liquidity were to become more restricted the effect of these fantastic deals might evaporate. It follows that our recommendation is that factoring can be part of a total receivables strategy, but cannot be a replacement for solid credit and collection processes with your customer.

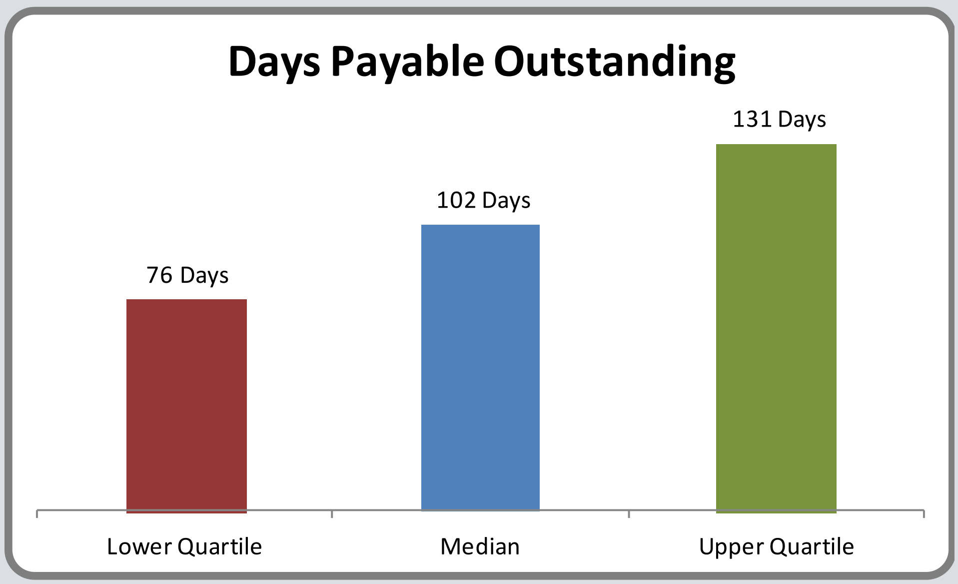


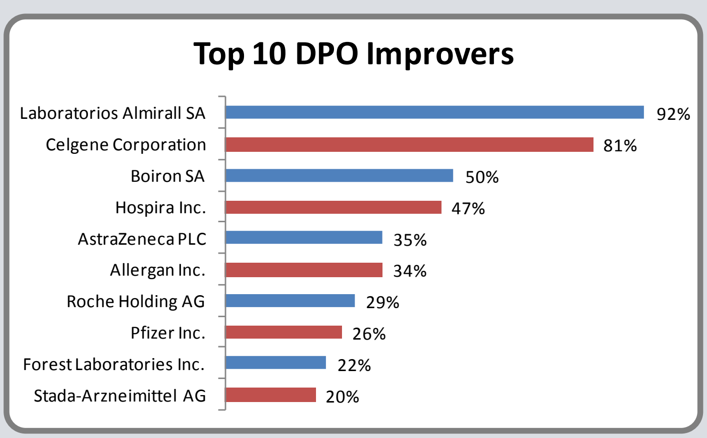


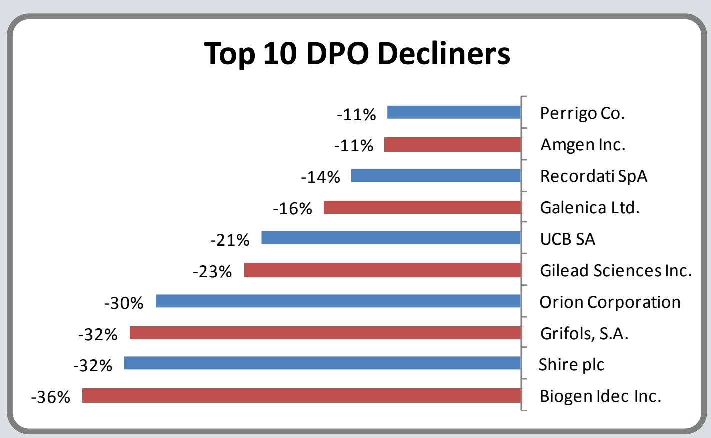
Payables: Some big improvements but can it be sustained?

Out of the major pharmaceutical giants AstraZeneca, Roche and Pfizer all made significant gains. This has been a result of clear global programmes to extend supplier payment terms and to implement supply chain finance initiatives. Compared to our 2012 survey the lower quartile and median points have improved while the upper quartile has come down slightly. The total peer group has improved DPO by 7% between 2011 and 2013. This would suggest that lots of companies procurement departments have been busy renegotiating payment terms. Anecdotal evidence would suggest that this has been the case for some big players, but many others have not even attempted this route on any broad scale. Others have gone for supply chain financing solutions and yet others have done some traditional year-end window dressing by stopping payments in the final weeks before year end. Where many North American and European companies have had success is adjusting payment terms in Latin America and Asia to local norms that are often much longer than in more developed economies. There also have been a number of large supply chain finance programmes that have been driven by the availability of cheap liquidity and the need to get quick results to the balance sheet. But there have been other factors in the opposite direction. The latest EU Directive on Late Payment (2011/7/EU) came in to full force in 2013 and as yet there are no reports of any significant impact on payment patterns across Europe. Part of this is the fact that the Directive's provisions only apply to new contracts but there has also been much confusion about what the new rules are and how they should be applied. In basic terms it means that any payment term in a new contract in excess of 60 days will be illegal. This is a significant threat to the supply chain finance market since the notion that you might need to pay a fee in order to be paid in excess of 60 days is specifically deemed illegal.

Many supply chain finance schemes have payment terms that extend to 90 or 120 days. One of the major American players in this market has been so alarmed that they have stopped marketing their offering in Europe. But just as with factoring, success is dependent on the availability of cheap credit and plentiful liquidity from financial institutions. If those circumstances change we could see some big reversals in DPO performance in the coming years. As always there is no substitution for a sustainable and robust process.

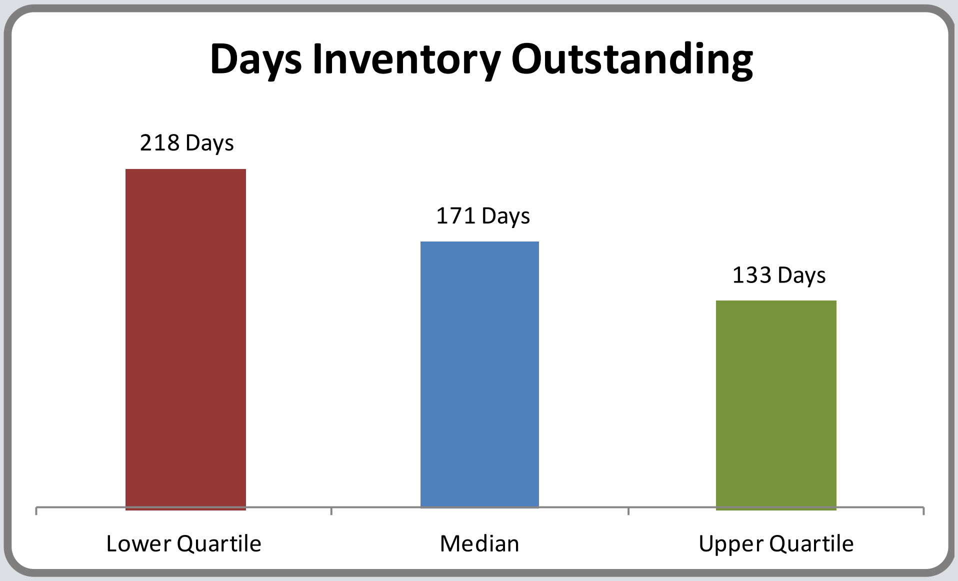




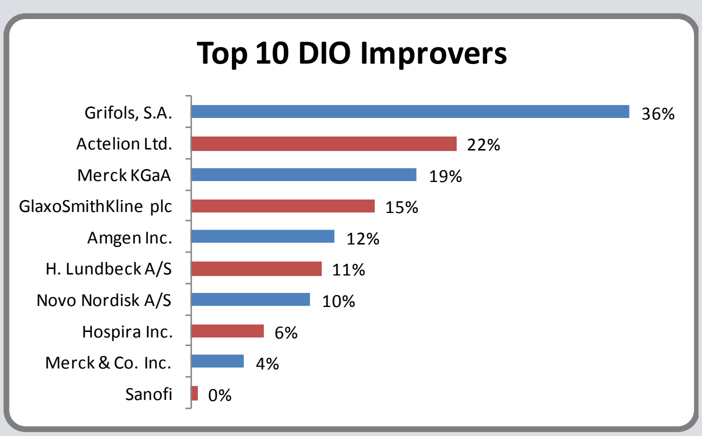


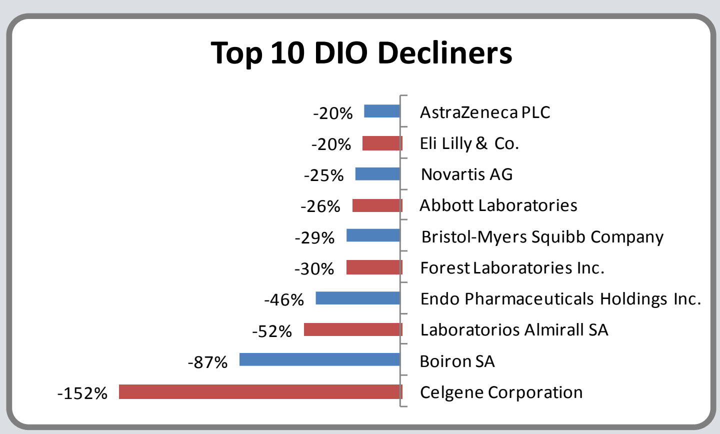
Inventories: Modest improvement, but a long way to go

Since our 2012 survey the lower quartile, median and upper quartile points have all declined. The total peer group DIO has declined by by 14% since 2011. The numbers show that some pharmaceutical companies are trying to get smart in how they design their production environments and manage their supply chains not just to ensure product reaches the patient but also to ensure that inventories are optimised across the supply chain. But it is not quite time to be celebrating. Of the 37 companies in the peer group only 11 companies improved their DIO and 26 companies saw their DIO decline. Most improvements have been modest and start from a very low base. In other industries the idea of having a top quartile performance while having a DIO of 133 Days of COGS would be laughable. But all progress is positive.



There is still no evidence that pharmaceutical companies have begun to tackle to the structural issues that create high inventories across the industry. We said in our 2012 survey that this was never going to be a quick fix. What is surprising is that the supply chain philosophy has hardly changed, i.e. manufacture in the largest quantities possible to minimise unit costs. Even with new drugs coming on the market there has been very little effort to understand the trade-off between minimised unit costs available from globally centralised production and the inventory optimisation benefits that might be available from a more distributed model. There is a real danger that reaching a tipping point will be required before more intense action is seen on the design of the pharmaceutical supply chain. As margins continue to fall globally and the main growth markets continue to be emerging markets such as China, India and Brazil this tipping point gets that much closer. In the meantime it is pleasing that at least some pharmaceutical companies have got the inventory reduction bug. More and more realise that managing inventories effectively will enhance patient care and not endanger it. But the structural barriers will mean that many inventory improvements have been restricted to reduced raw materials stocks and reduced packaging. Often these improvements have been achieved by the implementation of consignment arrangements. That represents a solid start but compared to the vast majority of manufacturing industries there is a very long journey to be completed.





Conclusion: Variable progress but broadly in the right direction

We are starting to see the results of the working capital programmes that many pharmaceutical companies embarked on over the last few years. In some areas there have been big improvements but in many cases the corporate cultures that do not understand why such hugely profitable companies would worry about working capital have not been overcome. This has meant that a lot of these improvements have been delivered through financial instruments rather than actual improvements in business process. There is nothing wrong with factoring or supply chain finance. In their various guises they have both been around for a very long time, but they have never been proven to be a complete and sustainable solution. That will only be achieved by structural improvements to the supply chain, better customer processes and more effective supplier relationships. There are no new medicines but the willingness of the patient to take the medicine has improved.

Survey Methodology

Informita has compiled information from the following companies published accounts for the year ended 2013:

Abbott Laboratories, Actelion Ltd., Allergan Inc., Amgen Inc., AstraZeneca PLC, Bayer AG, Biogen Idec Inc., Boiron SA, Bristol-Myers Squibb Company, Celgene Corporation, Eli Lilly & Co., Endo Pharmaceuticals Holdings Inc., Forest Laboratories Inc., Galenica Ltd., Gilead Sciences Inc., GlaxoSmithKline plc, Grifols, S.A., H. Lundbeck A/S, Hospira Inc., Ipsen S.A., Johnson & Johnson, Laboratorios Almirall SA, Meda AB, Merck & Co. Inc., Merck KGaA, Novartis AG, Novo Nordisk A/S, Orion Corporation, Perrigo Co., Pfizer Inc., Recordati SpA, Roche Holding AG, Sanofi, Shire plc, Stada-Arzneimittel AG, UCB SA, Actavis Inc.

The measurements utilised have been calculated according the following methods:

Net Working Capital to Sales Ratio - Revenue / Working Capital * 100;

Days Sales Outstanding – Trade Accounts Receivables / Revenue * 365;

Days Payable Outstanding – Trade Accounts Payable / Cost of Goods Sold * 365; and,

Days Inventory Outstanding – Total Inventory / Cost of Goods Sold * 365.

About Informita

Informita was formed to act as an advisor to companies in the areas of working capital and procurement, focusing on Analytics, Implementation and Advisory. Informita is there to support your working capital and procurement programmes from cradle to grave in a cost efficient and effective manner. Our people have a mixture of deep industry and consulting experience across many sectors and geographies. This gives us the ability to bring insights across many industries and cultures.

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