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Leaner Isn't Meaner for 9 Big Pharma Firms That Tried to Cut Their Way to Greatness

By Jim Edwards | Jun 15, 2010

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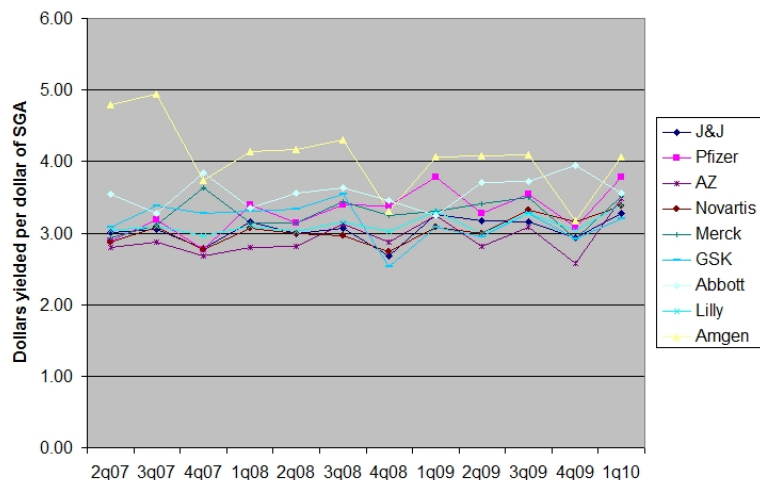
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The idea that cuts and consolidation lead to increased efficiency is a cliché in corporate capitalism, but is it true? Not in the pharmaceutical sector, if revenue results from the last three years are compared with the expenses the companies paid to earn them.

Despite some improvement — Pfizer (PFE) and Merck (MRK) are both more efficient following their mergers with **Wyeth** and **Schering-Plough**, respectively — the best a large company can hope for is an average level of efficiency, even when the entire sector it's competing in has gone through a massive efficiency drive.

This chart, which tracks how many dollars in sales nine companies get for every dollar invested in marketing and administrative expenses, tells the tale:

Comparison of Revenues Earned per \$1 Spent on SG&A



(Click to enlarge.)

The graph measures operating efficiency or operating leverage. Basically, it asks, How good is a company at using the resources it has right now to sell the products it has right now? (It therefore ignores more speculative stuff about potential future cash flows, long-term investments and management's strategic vision.)

If there was an efficiency drive under way, we should have seen an obvious upward drift in those lines. Instead, they're all bunching at around \$3.50. Cost-cutting seems to have had little more than a tiny,

incremental effect on the sector's ability to earn its own revenues.

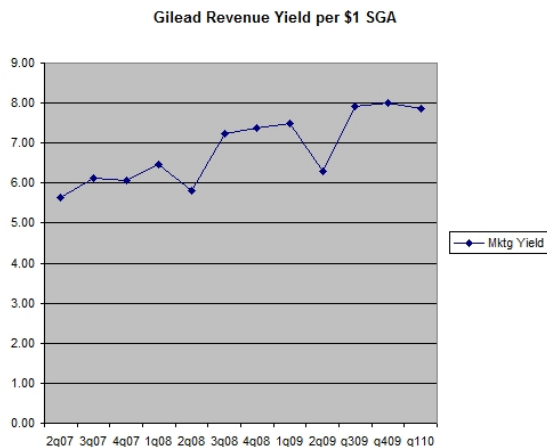
As the recession loomed in 2007 — and [the patent cliff behind that](#) — all the major drug companies announced cost-cutting moves, restructuring plans, or “transformation” efforts, most of which involved laying off staff. **GlaxoSmithKline** (GSK) and Abbott Labs (ABT) are doing just that, right now. Tens of thousands of employees in both sales and R&D have been let go from the industry. [Those jobs will most likely never come back.](#)

Companies hoped to emerge from the recession leaner and meaner. Instead, they've emerged looking basically the same as each other: Everyone has reverted toward the industry average.

Why? It's not that sales have gone down. At most of these companies — **Eli Lilly** (LLY) is a good example — sales have stayed flat or crept up. Because revenues have not, overall, gone down, we can't say that companies merely cut their costs in line with declining results — which would be a sign of good management.

Some, like Pfizer and Merck, bought other companies, instantly adding hundreds of millions of dollars in revenues. That should have given them an “easy out” for efficiency: With all that extra revenue sloshing around all they had to do was not hire anyone, let attrition takes its toll, and ax the duplicated functions in the companies. That's the way consolidation efficiency is supposed to work. If everyone had done that, those lines would be going upward. It's true that Pfizer and Merck saw improvements from their consolidations, but when you compare them to everyone else it turns out that all they did was improve their efficiency from “below average” to “average.”

In the absence of further evidence, I'm tempted to conclude that it's something to do with size: All these companies are big or got bigger during the period. It may just be that to run a drug company of a certain scale, there are built-in structural costs that can't be taken out of the system, even if you're trying to. Is there any advantage to being more modestly sized? Possibly. I've mentioned before that **Gilead Sciences** (GILD), which has about \$8 billion in annual revenues, enjoys [a level of operating productivity far higher](#) than any of these other companies. Here's how it performed over the same period:



Bear in mind, there was consolidation at Gilead too — it bought **CV Therapeutics**. Gilead also specializes in expensive HIV drugs. Once again, the management lesson is clear: If you want to increase productivity, be smaller and be a specialist, because bigger simply isn't better.