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Pharmaceutical Issues in Perspective

The downside of upsizing in the fine chemical industry

Dr Rob Bryant looks at the consolidation of the fine chemicals industry and asks whether larger companies really deliver an improved service to their customers

Illustration by Rob Wilcockson

The consolidation and restructuring of the global innovative pharmaceutical industry continues to create challenges for its suppliers. As major pharmaceutical companies concentrate their resources on the discovery, sales and marketing of their products, opportunities to secure new chemical supply contracts arise. However, the loss of existing contract business is also proving to be a problem. The net result for many pharmaceutical fine chemicals companies has been negative.

Such bad news is becoming harder to absorb as the pharmaceutical fine chemical (PFC) industry passes through a period of consolidation of its own, with the growing number of publicly quoted companies demanding higher sales growth and profits.

So has the restructuring of the fine chemical industry been worthwhile and who has benefited most? Are the larger, publicly quoted groups really more efficient and offering an improved service to their customers?

Over the past 40 years, a variety of sub-sectors within the PFC industry have developed, reflecting the differing needs of its pharmaceutical customers. The types of operation and staffing of companies suitable for producing bulk pharmaceuticals (APIs), for example, are quite distinct from those required for custom synthesis of novel intermediates. Each form of activity requires a different level of capital investment, a different type of marketing and a different set of chemistry and technical skills for success.

While the recent trend to put together 'one-stop-shops' offering a 'cradle-to-grave' service seems logical, in reality it has not served the best interests of the companies and their customers. The truth of this assertion will become apparent as the long-term performance and financial results of many recent mergers and acquisitions (M&As) are revealed (Figure 1).

But what are the criteria for success in these sub-sectors of the PFC industry? Figure 2 provides some clues, with typical pure-play examples provided. Many leading companies, such as Lonza, DSM Fine Chemicals and Laporte, are omitted because they operate in more than one sub-sector. The management of these companies would claim, with some justification, that their size confers benefits of scale that outweigh the natural disadvantages of larger companies.

Acquirer	Company acquired	Date/value of deal (US$m)
Arch Chemicals, US	Hickson International, UK	July 2000/195
Ascot Holdings, UK	ChiroTech, UK	1999/163
Clariant, Switzerland	BTP (Archimica), UK	Jan 2000/1,815
DSM, Netherlands	Gist-brocades, Netherlands	1999/1,770
DSM, Netherlands	Catalytica, US	July 2000/810
Evotec, Germany	Oxford Asymmetry, UK	July 2000/285
Great Lakes Chemicals, US	NSC, US	1999/190
Honeywell, US	Allied Signal, US	2000/ –
PPG-SIPSY, US	SmithKline plant, France	2000/ –
Rhodia, France	Chirex, US-UK	July 2000/545

Figure 1: Recent mergers and acquisitions activity in the pharmaceutical fine chemicals industry. Sources: Company press releases and analysts' reports

However, customers seem to prefer suppliers that offer a strong technology focus – the opposite of a 'one-stop-shop' – with a strong independent management that is oriented towards customer needs rather than investor priorities. They also like medium-sized companies where an ethos of chemical and technical development is nurtured, rather than those which focus on continual growth. The succession of acquisitions and mergers that has characterised the fine chemical industry over the past two to three years has flown in the face of these customer preferences. As merged groups struggle to work as an effective unit, they must wonder whether their investments will really pay off. Moreover, the pharmaceutical industry itself has become used to dealing with a fragmented supply base and it is not clear that it is keen to deal with companies of similar scale.

The purported benefits of larger companies include:

•Economies of scale, which are rarely of

critical importance in PFC manufacture.
•Greater global reach, which does not, however, increase simply as a result of greater numbers of sales and marketing executives.
•Lower costs, which are often achieved at the expense of increased inefficiency as the wrong surplus resources are pared away.
•Synergies, which are much harder to achieve in practice than the opposite effect, inefficiencies, created by clashes of culture and techno-commercial conflicts.
•Access to capital, which can often lead to unwise levels of capital investment being made, and later turn out to be difficult to recover.

Driving forces for mergers

Given the fact that most M&As have been deemed failures[1–3], one has to ask why merger mania has taken hold in an otherwise financially conservative industry. The answer probably lies in the following driving forces:

•Quick fixes for balance sheets and easy money – The real driving forces for M&As are usually less laudable than those actually espoused. Senior directors end up much richer after the merger, as do the investors, consultants, financial advisers and banks involved in the deal. There is little that can be done about this unpalatable fact. As long as large chemical corporations feel that poor sales growth can be cured by bolting on high-profit PFC businesses, such ill-advised activity will continue. Of course, another reason for the popularity of these types of M&A in the PFC industry is the overflow arising from similar activities within the pharmaceutical industry. Too many investors labour under the misapprehension that the two industries enjoy similar levels of profitability. They are in for a big disappointment.

As long as large chemical firms feel poor sales growth can be cured by bolting on high-profit PFC firms, ill-advised M&As will continue

•Disposals of chemical manufacturing plants by the pharmaceutical industry – In slimming down its global chemical production capacity, multinational pharmaceutical companies have enticed many of their suppliers to buy these surplus operations, usually by offering extended manufacturing contracts. In many cases, these deals, which look superficially attractive, turn out to be poor investments, since the plant design is often ill-suited for general purpose operation. It has to be said that closer links between the customer and the supplier do appear to be beneficial, although they may eventually create problems. A partial list of such deals is shown in Figure 3. These companies may well find replacing the existing contracts harder than they expect.
•Downstream acquisitions for speciality chemical companies – This class of acquisition is probably the most distressing for anyone who cares about the industry. Such acquisitions continue to increase as the chemical industry refocuses its operations. There is something perverse about chemical company executives who are driven to make PFC acquisitions that are doomed to failure. They usually focus on the non-cyclical profitability of fine chemical companies, as a panacea for the boom/bust cycle that plagues their own industry. The problem is that many fine chemical operations have to be purchased in order for this medicine to work – as DSM's 'shopping list' has demonstrated. This, in fact, is the real reason why size matters.

What many of these executives do not seem to understand – and, what is worse, many simply will not be told – is that managers of speciality and chemical companies generally find it very hard to run fine chemical, let alone pharmaceutical fine chemical, operations successfully, because the key factors for success in PFCs and chemicals are quite different. A background and experience in running one is usually a disqualification for running the other. Therefore, many large fine chemical operations offer poorer returns than small to medium sized companies.
•Government bureaucracy – As in any industry, the impact of overly stringent regulations drives companies to relocate to regions or areas where life is freer. The

Sub-sector (typical sales range in US$m)	Key strengths for success	Companies*
Basic intermediates (100-500)	Scale of manufacture Access to feedstocks	PPG – phosgene derivatives Wacker – diketene derivatives
Custom synthesis (1-20)	Talented chemists Speed of response Laboratories Good access to customers Chemical R&D	Oxford Asymmetry Pharm-Eco
Process R&D (5-20)	Talented chemists Speed of response Laboratories Access to scale-up plant	Synprotec
Contract manufacture of intermediates (2-100)	Flexible manufacturing capacity Development skills	ChemDesign Laporte
Contract manufacture of advanced intermediates and bulk APIs (20-150)	cGMP manufacturing units QA operation Thoroughness of response	Chirex Syngal Catalytica
Independent manufacture of bulk APIs (20-500)	cGMP manufacturing units QA operation Access to key intermediates	Albemarle Uquifa
*These are typical examples of companies in 'pure-play' PFC sectors		

Figure 2: Sub-sectors of pharmaceutical fine chemicals industry. Source: Brychem

Killing the goose that lays the golden egg? The headlong rush for mergers and acquisitions in the pharmaceutical fine chemicals industry will ultimately have a damaging effect on profitability.

sacred cows of GMP and other regulatory standards have led to a massive increase in the time it takes to get things done, the capital investments needed and the levels of manning required. While the problems that prompted government intervention were real enough, the use of a sledgehammer to crack a walnut is a bureaucrat's SOP.

Ironically, the multinational pharmaceutical industry has encouraged the bureaucratisation of the industry in order to extend its product lifecycles and to create barriers to unlicensed producers. The net result has been to stave off the effects of patent expiry at the expense of the PFC industry's ability to make good profits. The US- and European-based PFC companies find it increasingly hard to offer a service at a price that their customers consider reasonable. As a result they are facing increasing competition from Asian companies.

Outlook for the future

There are some positive signs for the future, however. New business for the US and European PFC industry is emerging from both extremes of the pharmaceutical product lifecycle.

At the discovery end, the growth of the biotech sector has resulted in hundreds of small start-up companies that usually do not get involved in chemical manufacture. New business is emerging from such companies, much of it for relatively sophisticated fine chemicals, in which the many companies in the US and Europe still maintain a healthy lead over Asian competitors.

Meanwhile, the growth in off-patent medicines has also meant that the production of bulk pharmaceuticals for the generic sector continues to create demand from generics companies without chemical manufacturing operations. The trend towards greater outsourcing of bulk actives remains patchy, so the supply of PFCs for older products helps to provide sustainable higher-value-added business to the industry.

What is less certain is how well any companies in the US and Europe will compete if they continue to consolidate on such a scale. One can only hope that the customers will begin to complain about the increasingly slow response times and higher prices, and so choose to source from more nimble and technically capable PFC companies. This, in turn, should bring pressure to bear on the current supporters of large publicly quoted PFC companies to rethink their strategy. SM

References

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Pharma plant and location	Acquiring PFC company
Boehringer Ingelheim, Ireland	Irotec (now part of Cambrex), Ireland-US
Bristol-Myers Squibb, Germany	DSM, Netherlands
GlaxoWellcome, Greenville, US	Catalytica, US
GlaxoWellcome, Annan, UK	Chirex, UK-US
Monsanto, US	Quality Chemicals, US
Sanofi (Francis), Italy	Laporte, UK
Roche, Springfield, US	BTP, UK
SmithKline Beecham, France	PPG-SIPSY, US
SmithKline Beecham, Mexico	Uquifa (a division of Revertex), UK
SmithKline Beecham, Spain	Farmhispania, Spain
SmithKline, Conshohocken, US	Lonza, Switzerland

Figure 3: Selected fine chemical plants acquired from pharmaceutical companies. Source: Brychem

