How bright is the future for generics?

The generics market is expanding thanks to US and European laws that favour cheap drugs. But reference prices are now cutting into their profits too, says Jean-Michel Peny

Over the past few decades, governments worldwide have had problems financing healthcare and there is no reason to think the situation will improve. The price of healthcare will continue to escalate because of the aging population, and the costs associated with treating it, as well as increasingly sophisticated therapeutic protocols.

So far, governments have mainly concentrated on containing pharmaceutical spending but they haven't achieved any spectacular results, largely because, on average, it only accounts for 16% of total healthcare costs. However, cost-containment measures on the pricing of pharmaceuticals will be maintained because, from a technical and political standpoint, they are easy to implement.

The focus of governments on pharmaceutical costs has favoured the development of the generics market, which showed an annual growth rate worldwide of 15% between 1996 and 2001, while the original brand market grew by only 6% during the same period. In 2001, the worldwide generics market was estimated at US$42 billion – 11% of the total prescription market. It appears that prospects for the worldwide generics market are good and that current players, as well as potential entrants, have reason to feel enthusiastic.

However, careful, country-by-country analysis of the impact of changes in the regulatory and competitive environment reveals a future of contrasts for the worldwide generics market. The results of such an in-depth assessment may lead certain generics companies to revise their development strategies, and encourage potential players to reconsider whether they should enter the market or the way they intend to do it.

If each country's generics market has a set of particular characteristics, they share a pattern of development conditioned largely by the regulatory measures introduced by local health authorities. In fact, the regulatory environment has had a strong impact on the attractiveness of the generics markets, especially in terms of market size, potential growth and level of profitability (see Figure 1). This is illustrated by a review of two mature markets, the US and Germany, and of two developing markets, France and Spain.

US market

With sales of US$16.2 billion in 2001 and a 21% annual growth rate between 1999 and 2001, the US is the largest and most dynamic generics market. Generics account for 52% of the volume of all prescriptions and 9% of the value. The difference between value and volume reflects the importance of the price gap – 82% on average – between originators and generics.

The introduction in 1984 of the Hatch-Waxman Act, which facilitates the registration of generics by introducing the abbreviated new drug application (ANDA) process, has strongly contributed to the market's development. Thus, the generics companies no longer had to conduct their own safety and efficacy studies, they could rely on data supplied to the FDA by the innovators. Generics companies have only to demonstrate that their generic products are bioequivalent to the corresponding innovator drug. This simplified procedure also operates throughout the EU. The Roche/Bolar Provision (1984), which completes the Hatch-Waxman Act, stipulates that generics companies may have access to active ingredients, and may undertake all preparatory work to meet the registration requirements and file registration applications. This hasn't yet happened in the EU. Since 2000, the first generics company to file an application will benefit from 180 days of marketing exclusivity, provided there is no patent infringement. This measure represents a considerable source of profit for the first entrant. The American generics company Barr, which obtained marketing exclusivity for its 20mg capsules of fluoxetine (Prozac) in August 2001, has generated sales of US$365 million over nine months. However, legal procedures to challenge originators' patents can take two or three years and cost generics companies between US$10 to 12 million.

The US is adjusting existing measures to make it easier for generics to penetrate the market. These adjustments include stopping patent extensions obtained for minor product modifications such as those

	Mature markets					Developing markets				
Generics penetration in % of total prescriptions	54	54	52	42	40	12	11	7	2	2
Regulatory measures likely to favour the generics market development	US	Germany	UK	Netherlands	Canada	France	Japan	Spain	Italy	Brazil
Reference pricing system		✔	✓	✔	✓	✔		✔	✔	
Substitute right	✔	✔	✓	✔	✔	✔		✓	✔	✔
INN prescription		✔	✓		✓	✔		✔	✔	✔
Fast track approval	✔	✔				✔				✔
Roche/Bolar Provision	✔				✔					
Incentives/constraints for pharmacists				✔	✔	✔	✔	✔		
Incentives/constraints for physicians		✔	✓			✔		✔		
Constraints imposed on patients	✔									✓
Public campaign by health authorities						✔		✔	✔	✔
Market attractiveness (2001-2006)	●	●	●	●	●	●	●	●	●	●
Market size (2006 estimates in US$ billion)	31.0	5.3	2.4	0.6	1.2	1.8	6.0	0.6	0.3	1.1
Sales growth potential (2001-2006 CAGR)	14%	10%	8%	7%	6%	10%	4%	20%	41%	52%
Profitability level (2001-2006 average PBIT)	$$$$	$$$	$$	$$	$$$	$	$$	$$	$$	$$

✔ = implemented ✓ = partly implemented ● High ● Moderate ● Low $$$$: >15% $$$: 10-15% $$: 5-10% $: <5%

Figure 1: Regulatory measures and attractiveness of selected generics markets.
Source: Smart Pharma Consulting analyses

to colour, flavour or packaging. The six-month patent extensions granted for the development of paediatric formulations could also be reconsidered. Only real innovations such as new indications should be retained for patent protection.

Agreements under which first generics entrants can be paid by originators for not launching their product during the exclusivity period could also be banned. If a product were not launched within ten days, the second entrant would be allowed to market its product. And the rule by which the marketing authorisation of a generic drug may be blocked by the FDA for 30 months to give the courts time to deliberate when an originator sues for patent infringement could be reconsidered on a case by case basis. Given these regulatory measures and opportunities offered by the flow of patent expiries, the generics market should grow from US$16.2 billion in 2001 to US$31.0 billion in 2006, showing an annual growth rate of 14.1%.

It is not rare to see generics players in the US market achieving profits before interest and taxes (PBIT) of more than 25%. Mylan and Barr Laboratories achieved such profits in 2001. However, generic companies' profitability may vary considerably from one year to another. Litigation settlements with originators may cut their profits, while their performance may be boosted if they win a 180-day marketing exclusivity. From an estimated range of between 20% and 25% during the 1996-2001 period, the profitability of the US generics market should be reduced to between 15% and 20%. This depreciation will largely be the result of intense price competition induced by the arrival of new entrants – Indian companies, for example – the consolidation of wholesalers and stronger pressure on prices imposed by Pharmacy Benefit Management (PBM) and US authorities for their Medicaid and Medicare programmes.

German market

Germany is the largest generics market in Europe with estimated sales of US$3.6 billion in 2001. The market penetration of generics is high in terms of volume, accounting for an average of 54% of prescribed products, and 72% of genericised molecules.

After 1993, the German generics market was strongly driven by budgets imposed on physicians who could be fined if they overspent on drugs. But this system was abandoned in 2001, with the result that physicians became less vigilant over the cost of their prescriptions.

In 1991, the government introduced a reference price system called the Festbetrag, under which a flat level of reimbursement was set for all genericised molecules. But this measure has not favoured the development of the generics market, as initially expected, because the great majority of original brands aligned their prices at reimbursement level. In fact, Festbetrag has been detrimental to the generics market because the government negotiated a 27% decrease in reference price levels in 2001.

Since March 2002, pharmacists are officially obliged to substitute in favour of the equivalent generic from the bottom third of the price range, provided the physician does not specifically oppose this. Such a measure will not increase generics' penetration, which is already high, and may even have a negative impact on this market by generating a price war between generics companies. Leading generics companies like Ratiopharm, Hexal or Stada should be less affected than smaller players because they are strong enough to offer attractive discounts to retail pharmacists.

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Generics companies that used to call on physicians to prescribe their brands will have to revise their marketing strategy now the decision-making is shifting from physicians to pharmacists.

All in all, the effect of patent expiry of major molecules should be outweighed by government measures likely to affect the average price of generics, such as decreases in the reference pricing level. The net results should have little impact on current annual sales growth of 10% and, in 2006, the generics market should be worth US$5.3 billion. However, the substitution right granted to pharmacists would reduce generics companies' operating margins from an estimated average of 18% in 2001 to 14% in 2006.

French market

The French generics market was dormant until the substitution right was granted to pharmacists on September 1999. At that time, physicians were not familiar with generics, and prescribed drugs mainly by their brand name, while patients had no reason to buy low-cost generics because 92% of patients were fully reimbursed for their prescribed drugs.

To encourage pharmacists to substitute generics for originators, the government modified their margin system, which was originally proportional to the selling price. Under the new system, they receive the same margin, in absolute terms, for both the original brand and the corresponding generics. In addition, generics companies are allowed to give pharmacists discounts of up to 10.74% of the wholesalers' price, while 2.5% is the most original brands can offer. In fact, pharmacists receive much greater discounts from generics companies – 40% on average. The substitution right has had an impact. The generics market saw overall annual growth of 16% between 1999 and 2001, while the substitutable segment rose by 45%.

To be substitutable, generics need to be bioequivalent to their originators and their active ingredients must have the same quantitative and qualitative composition, and the same formulation. However, patients were reluctant to accept generic substitution until the government introduced two measures to remove this barrier. First, since 2001, physicians have been allowed to prescribe drugs by their international non-proprietary name (INN) alone. Second, in July 2002, GPs signed an agreement with the government under which they committed to ensuring that 25% of their prescriptions would be written using their INN and 12.5% from the government list of substitutable molecules. Surprisingly, in just a few months, the number of drugs prescribed by their INN alone has increased rapidly and patients are increasingly accepting generics substitution. When a physician prescribes a drug by its INN alone, pharmacists are obliged to dispense the cheapest product, which is almost always a generic.

The government recently announced its intention to introduce a reference price system in 2003 that is likely to have a negative impact on the development of generics in France. To avoid a drop in sales, the majority of originators would prefer to align their prices to reimbursement levels set to the current level of generics pricing. Therefore, to maintain a competitive advantage, generics companies will have no choice but to further reduce the price of their products. But the overall impact of this measure should be limited, because the government is likely to implement it only for molecules it considers not sufficiently genericised. The cut-off point should be in the range of 40% to 50% in 2003 and 2004.

In this regulatory environment, the French generics market is expected to grow

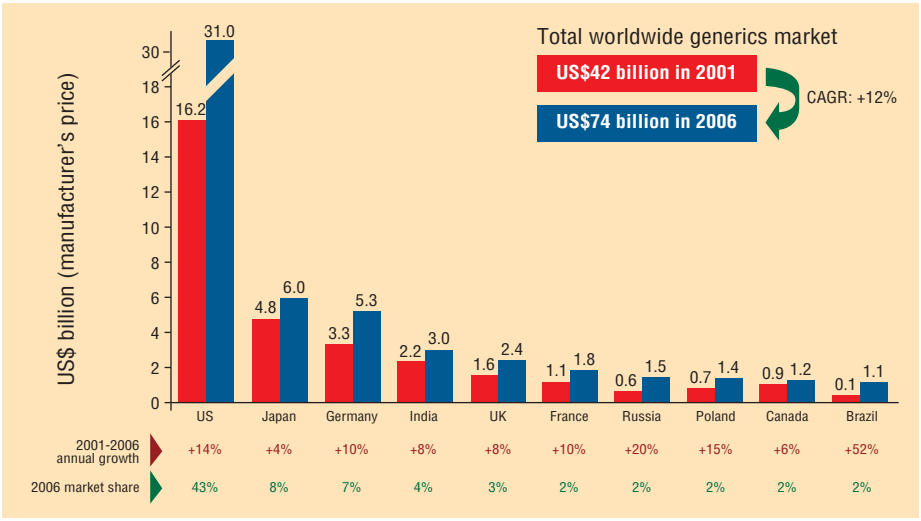

Figure 2: Structure and evolution of the worldwide leading generics market between 2001 and 2006. Source: Smart Pharma Consulting analyses

from US$1.1 billion in 2001 to 1.8 billion in 2006. Market profitability should become slightly more positive, moving from an average of -4% in 2001 to between 2% and 3% in 2006.

Spanish market

Generics products have benefited from the EFG label (Especialidades Farmecéuticas Genéricas) since April 1997, although they were officially launched in December 1996. The EFG label guarantees the products' efficacy, safety and bioequivalence to the original product. In 2001, the Spanish generics market reached sales of US$0.25 billion, a market penetration of 3% in value and 7% in volume. In 2002, growth in the generics market did not exceed 8%. The reasons for this include the late introduction of patent protection in 1992, which allowed many 'copies' of drugs that competed on price against generics products. The introduction of a reference price system in December 2000 was detrimental to the generics market's dynamics and profitability. As in Germany, originators have aligned their prices at reference levels. As well as reference prices being set at the average of the cheapest products, and the low-priced 'copies' tend to reduce reimbursement levels.

The substitution right, which has been shown to stimulate the growth in the French generics market, does not really work in Spain. Introduced in December 2000, this measure can only be applied when the prescribed brand is not available or when its price is above the reference price. In the absence of adequate margin compensation, pharmacists generate less profit in absolute terms when they dispense a generics product. To encourage them to dispense their products, generics companies offered pharmacists discounts averaging 30% until this practice was prohibited by Royal Order in July 2002.

In the absence of any drastic changes in the legal and competitive environment, the Spanish generics market should not exceed US$0.63 billion in 2006 and 6% of the market's value. The average operating margins of generics companies is likely to remain below 10% between now and 2006, making generics a not very attractive option.

The global picture

The worldwide generics market should see an annual average growth rate of 12%, to US$74 billion in 2006 (see Figure 2). The market growth should be mainly driven by the US, Eastern Europe and developing markets in Latin America, such as Brazil. At the same time, the operating profitability of the worldwide generics market is likely to decrease from an average of 13% in 2001 to 9% in 2006, as a result of more intense pressure on prices from governments and price competition among generics players, as well as increasing discounts offered to pharmacists.

With the help of prescription software and government encouragement, physicians will prescribe more drugs by their INNs. At the same time, pharmacists' substitution rights, along with financial incentives to dispense generics, will be applied in most markets. Thus, the decision-making process should progressively move from the physicians to pharmacists, or at least be shared.

Key success factors

As a result of these changes, generics companies will have to reconsider their performance on some of the key success factors. Manufacturing costs which, on average, will need to be kept as low as possible, account for 50% of sales. Generics players will need to delocalise or sub-contract the production of their APIs and their finished formulations to countries like India, China or South Korea, where qualified manpower and equipment costs are low. They would also be advised to shop around and sign agreements with suppliers, rather than depend on their own facilities, which may not always be the cheapest. This approach has been followed by companies like Stada and Ratiopharm, while Mylan, Hexal and Teva have so far preferred to manufacture at least some of their own APIs.

To maintain revenue growth in the generics market where prices keep falling, it is necessary to secure a continuous flow of new products. Therefore, it is strategically important for generics companies to have access to high process-development skills. Process development must be cost effective and not infringe originators' patents.

To avoid, or at least to limit, the impact of price erosion on their profitability, certain major players have developed value-added generic operations in parallel with their commodity generics portfolio. A case in point is Mylan, which drew 12% of its 2002 revenues from branded products marketed through its wholly-owned subsidiaries, Berteck and Mylan Tech. Similarly, 43% of Ivax revenues are generated by branded drugs. Through its UK subsidiary Baker Norton, Ivax markets a generic beclometazone in a proprietary metered dose inhaler for asthmatic patients. More interesting still, Ivax is developing an oral version of the injectable anti-cancer paclitaxel (Taxol) from Bristol-Myers Squibb. The European generics company Hexal has followed the same route, commercialising proprietary technology in delivery systems like patches and implants. Other leading players like Ratiopharm, Merck KGaA, Novartis or Teva do not seem to believe in this strategy. But unless such companies develop real, value-added generics with tangible therapeutic benefits over plain generics, payers will not continue to pay a premium price. It is interesting to note that in France, the Drug Pricing Committee (CEPS) has recently been asked by the Ministry of Health to price new drug formulations that do not offer therapeutic advantage or significantly improve convenience at the same level as generics – a 40% price decrease compared with the formulations already marketed by the originator.

If the two largest generics companies in the world, Teva and Novartis, have a global presence, local players like the US Mylan or the German Ratiopharm and

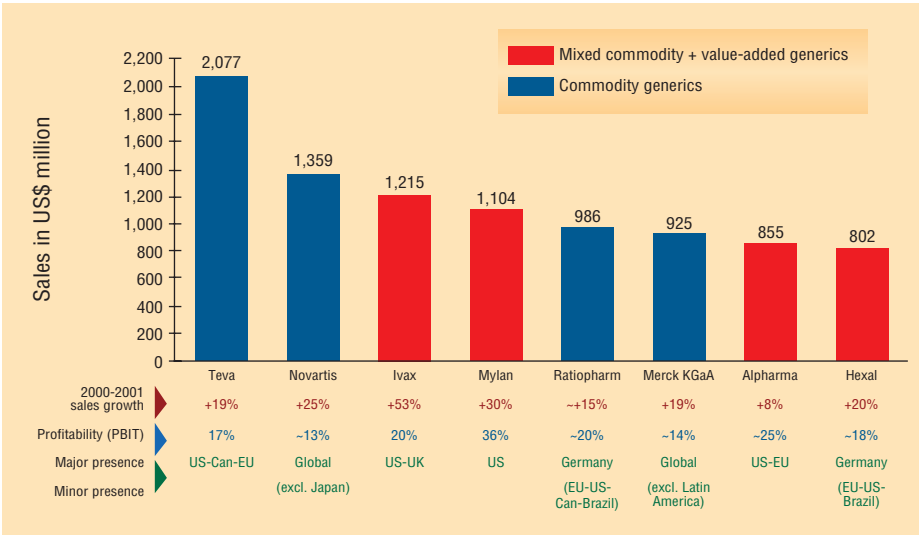

Figure 3: Worldwide leading generics companies in 2001.
Source: Smart Pharma Consulting estimates based on annual reports

Hexal may also occupy a leading position and perform well (see Figure 3). However, these companies have a strong position in their domestic markets. Generics companies like Novartis, Merck KGaA and, to a lesser extent, Teva, which have developed a global presence, appear to be comparatively less profitable and less dynamic. These companies are more complex to manage, but can spread their business risks across several markets. Thus, the recent introduction of the substitution right granted to pharmacists in Germany may change the competitive environment and severely hit Ratiopharm and Hexal.

The best strategy for generics companies may lie in developing a strong presence in attractive markets that are already mature (US, Germany and Canada, for example) and to restrict their geographic presence to a selected number of attractive developing markets such as Brazil. The development should be opportunistic and heavily dependent on the attractiveness of the companies likely to be acquired.

There is no doubt generics can still offer good business opportunities over the coming years, provided companies do not forget they operate in a difficult market, where it is important to calculate the risks carefully. Price wars between commodity generics will increase, value-added generics must bring real benefit to patients and the changeover in local regulations may also weaken their performance. To succeed in worldwide generics markets, players will have to be faster, smarter, cheaper and wiser than ever. SM

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