

Public CROs Craft New Strategies to Achieve Financial and Strategic Objectives

Tough economic times have prompted CROs to reflect on their past performance and to create potential solutions for the future



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The lackluster performance of publicly traded contract research organizations (CROs) has disappointed shareholders during the past four years. From 1997 to 2001, the share prices of most major CROs lagged well behind those of major market indices such as the S&P 500. By the end of 2000, share prices for most CROs had sunk 50% from what they were at the end of 1996, whereas the S&P 500 had risen 75% above its 1996 close. In the meantime, the market value of the CROs' Big Pharma clients in many cases had risen 200% to 300%.

Difficult Times

The difficult times that CROs faced during 1999 and 2000 resulted from major study

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cancellations and slowdowns in research programs following a wave of Big Pharma mergers. Such tough times prompted the major CROs to do some important soul-searching about the reasons for their poor performance. Three factors seemed to account for their performance problems: bloated costs, a bad business model, and an unfavorable client mix.

Bloated costs. Rapid growth in the mid-1990s fueled an expansion binge at most major CROs, which spent heavily on global infrastructure, acquisitions, and business development activities. When activity slowed in 1999, the big CROs found themselves with uncompetitive cost structures and, in some cases, substantial debt. They lost contracts to smaller, privately held CROs that enjoyed lower costs and were perceived as providing better service.

A bad business model. High costs and acquisition activity often resulted from pursuing a "one-stop shop" business strategy. That strategy was built on the notion that CROs could leverage client relationships, brand recognition, and business development expenditures by offering a complete package of preclinical; chemistry, manufacturing, and controls; and clinical research services. The February 2000 bankruptcy of Oread, Inc., a major proponent of the one-stop shop, exposed the strategy's weaknesses. The costs of maintaining a full range of operations are extensive, and few sponsors are interested in or structured for buying a broad continuum of services from a single provider.

Client mix. Major CROs depended on the largest pharmaceutical companies for the

bulk of their business, which is not surprising considering that Big Pharma accounts for 65% or more of research and development dollars. However, this client base made the CROs vulnerable to sudden project terminations because of the large pharmaceutical companies' view that CROs are providers of supplemental capacity rather than high-performance strategic alternatives. Furthermore, the Big Pharma companies, with their considerable buying power, often forced the CROs to accept narrow profit margins.

Launching Strategic Initiatives

After identifying the preceding factors, most public CROs undertook some basic operational restructuring to cut costs and launched major strategic initiatives to improve their long-term performance. These performance initiatives comprised three primary objectives: decrease the volatility and enhance the predictability of revenues and profits; increase operating leverage (by accelerating growth in revenues per employee, for example); and improve the returns from capital investments and scientific and industry knowledge.

Performance-enhancing strategies that have emerged from the CROs' analysis are wide-ranging. These strategies reflect various perspectives about how best to use CRO skill sets and about the nature of and prospects for the contract research business. Most companies are pursuing multiple strategies to achieve their objectives, including concentrating on businesses with high profitability, broadening their client base, building strategic relationships,

Outlook: Innovative Outsourcing

Innovative outsourcing deals are still rare in the pharmaceutical industry, so when a new idea comes along, it merits some attention. What is particularly striking about these novel outsourcing arrangements is the client's considerable confidence in a contractor's ability to perform and the clear win-win nature of the relationship.

A recently announced deal between MDS Pharma Services (www.mdsp.com) and Sankyo Pharma (www.sankyo-pharma.com) seems to be a prime example of a mutually beneficial contract. MDS Pharma Services has built, and will operate on behalf of Sankyo Pharma, a 24-bed clinical pharmacology unit in Neptune, NJ. MDS Pharma personnel will staff the unit under direction of an advisory board composed of Sankyo and MDS Pharma officials. The agreement, which has an initial term of five years, stipulates that Sankyo's payments to MDS will be partly fixed and partly activity based.

The arrangement gives Sankyo Pharma the best of both worlds: the consistent quality, priority access, and proximity of a company-owned facility along with the cost savings and expertise of a focused service provider. MDS Pharma Services runs seven phase 1 facilities with more than 600 beds in Europe and North America, and it has large bioanalytical and central laboratory operations to support studies at those facilities.

"They have lots of expertise that we didn't want to recreate ourselves," said John Alexander, MD, president of Sankyo Pharma Development, Sankyo Pharma's R&D arm. "It's a way for us to get additional key staff, too." Sankyo Pharma also will realize cost savings because MDS Pharma can offer the beds to other clients if Sankyo is not using all of them.

The deal with MDS Pharma Services comes as Sankyo Pharma's parent company, Sankyo Co. Ltd. (www.sankyo.co.jp), Japan's second-largest

pharmaceutical company, is taking steps to establish infrastructure in Europe and North America. The company is developing and marketing its own products outside its home market rather than depending on licensing partners to commercialize its discoveries globally.

Diosynth Is Expanding

Nine months after acquiring the Research Triangle Park (RTP), NC, biomanufacturing operations of Covance Biotechnology Services (www.covance.com/biotech), Diosynth (www.diosynth.com) is planning to expand the RTP site. According to Roger Lias, vice president of business development for Diosynth Biotechnology, the company will exercise its option on land adjoining the current 30-acre site and is looking at additional property nearby. Diosynth RTP also is expanding its current 600-person work force despite intense competition for staff with GMP experience in the RTP area.

The expansion plans come on the heels of a robust year for the Diosynth RTP operation, which earned \$110 million in 2001. The facility has sold out its capacity for commercial-scale fermentation and downstream processing for 2002, but it can meet requests for process development and clinical materials manufacturing.

In the meantime, Diosynth is completing an upstream facility at its site in Oss, The Netherlands, which will begin operation in late 2003. That facility will have two microbial trains (5000 L and 10,000 L) and one 18,000-L cell culture train; a large-scale purification facility was completed last year. Lias said the company is taking a "watching brief" on further expansion of cell culture capacity, with a particular eye on the expansion plans of competitors and the development of alternative technologies.

offering proprietary processes and technologies, making investments in clients, and developing proprietary products.

Concentrating on businesses with favorable economics. Many public CROs are concentrating their service offerings in

businesses that have higher barriers to entry but offer increased profitability as use increases (operating leverage). Laboratory services, including central lab, bioanalytical, and pharmaceutical chemistry services, are high on this list, as are preclinical and

Galen Is Divesting

The news that Galen Holdings plc (www.galenplc.com) has agreed to sell its Chemical Synthesis Services (CSS, www.css-galen.com) operations confirms speculation that Galen soon will exit the contract services arena. Galen CEO Roger Boissonneault said the deal "continues the process of focusing Galen on its fast-growing pharmaceuticals business" and notes the transaction will "free up additional resources to focus on our pharmaceutical growth plans." Galen's profile changed dramatically when it acquired U.S. pharmaceutical company Warner Chilcott (www.wclabs.com) in 2000.

Galen's other contract services businesses include Clinical Trials Services (CTS), a clinical packager with operations near Philadelphia, PA, and in Craigavon, Ireland; Interactive Clinical Technologies Inc. (ICTI), a provider of interactive voice response systems; and Pharmaceutical Development and Manufacturing Services (PDMS), a provider of dose manufacturing and development services in Craigavon. CTS and ICTI are free-standing operations that would be simple to divest, but PDMS uses facilities that also manufacture Galen proprietary products.

A management team led by Dr. Allen McClay, the founder and former president of Galen, purchased CSS. CSS has two constituent operations, SynGal and QuChem, which employ a 110-person staff at two sites in Northern Ireland and posted \$7.5 million in sales in fiscal 2001. CSS services include basic R&D, small-scale chemical synthesis, and kilogram-scale GMP production. The sale price of \$36 million in cash represents a multiple of almost five times revenues.

phase 1 clinical services. All are somewhat capital intensive, but not so much so that they will burden a CRO with heavy debt. All increasingly lend themselves to automation, maximize opportunities to employ

technicians rather than scientists with master's and doctoral degrees, and become more profitable as instrument use is maximized. Several of those service areas have enjoyed growth rates in the range of 20% to 30% during the past few years.

Covance Inc. (www.covance.com) is a prime example of a CRO pursuing this strategy. Burdened with disappointing results and heavy debt, the company sold off its very capital-intensive biomanufacturing and clinical packaging businesses in 2001, leaving it with industry-leading operations in central lab and preclinical services. In 2001, 75% of its revenues came from preclinical and clinical laboratory businesses, with traditional, low-margin clinical research services accounting for less than 20% of its volume.

Another example is MDS Pharma Services (www.mdsp.com), which has strong positions in bioanalytical and phase 1 testing. Yet another example is PPD, Inc. (www.ppd.com), which is expanding its bioanalytical and pharmaceutical chemistry operations.

Broadening the client base. CROs are making a concerted effort to broaden their client base to include a greater representation of biopharmaceutical and specialty pharmaceutical companies. This strategy dovetails the record-breaking success such companies achieved in raising equity in both 2000 and 2001. Companies with therapeutic products raised \$11 billion in 2000 and more than \$3 billion in 2001 from initial public and secondary offerings. With biotech companies consolidating and their pipelines maturing, the opportunities for CROs beyond Big Pharma never have been better. Nearly all the public CROs credit increased revenues from the biotech sector as a principal reason for their improved performance in 2001.

Biotech and specialty pharmaceutical companies are attractive for other reasons also. Such clients are more dependent because they lack the extensive in-house capabilities that the major pharmaceutical companies have. In addition, they offer opportunities to incorporate into the contract a royalty fee or other compensation on the basis of product performance.

Building strategic relationships. CROs are eager to develop long-term relationships for predictability in revenues, improved resource



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use, and lower business development costs. Traditional preferred-provider relationships promised some of these benefits, but they seldom delivered the expected work volumes despite greatly discounted price schedules. CROs and sponsors are now trying to build relationships that reflect increased integration of sponsor and CRO operations and focus more on value and performance than on price.

Quintiles Transnational Corporation (www.quintiles.com) and Kendle International (www.kendle.com) both recently announced strategic alliances with Pharmacia Corporation (www.pharmacia.com) for clinical research services that promise tighter integration, greater transparency, and volume guarantees in exchange for favorable pricing. In one of the more innovative deals yet to be announced, MDS Pharma Services will operate a clinical pharmacology-phase 1 testing site on behalf of Sankyo Pharma (www.sankyo-pharma.com). Long-term strategic relationships also have been established in situations in which CROs have acquired operations from Big Pharma; for example, the Quest Diagnostics (www.questdiagnostics.com) acquisition of SmithKline Beecham's (www.sb.com) central laboratory business and Quintiles' acquisition of the Hoechst Marion Roussel (HMR, www.hoechst.com) development operations in Kansas City, MO.

Offering proprietary processes and technologies. Contractors can improve profit margins and raise the costs associated with switching vendors by offering proprietary technologies

that enhance each client's products or processes. Common examples are proprietary compound libraries for drug discovery, drug delivery technologies, and electronic data capture systems.

A prime example of a CRO using this strategy is Albany Molecular Research, Inc. (www.albmolecular.com), a provider of chemistry-based discovery and development services that has benefited greatly from the royalties from a process technology it developed. Albany used the proceeds to acquire two companies, one with proprietary biocatalysis technologies and one with a proprietary library of natural products. Many formulation and manufacturing contractors are acquiring (or forming alliances with) companies that offer unique drug delivery technologies. For example, the pharmaceutical technologies and services group of Cardinal Health, Inc. (www.cardinal.com) has built a network of manufacturing operations with capabilities in specialized dosage forms and delivery technologies, including softgels, specialty coatings, and fast-dissolving formulations.

Making direct investments in clients. Making direct investments in clients is an emerging CRO strategy. Such equity investments, which sometimes combine equity and debt components, secure the client's business while providing a higher return on the CRO's knowledge of drug development and commercialization.

To play the direct-investment game, a CRO must have cash reserves over and above its operating and capital investment requirements. Consequently, although several CROs have considered the strategy, only two are now pursuing it actively and publicly. Quintiles, with \$600 million in cash accumulated from selling its medical claims processing business, has set up an investment unit. The unit, known as PharmaBio Development, has made nearly 10 investments. More recently, PPD formed an investment unit with J.P. Morgan Partners (www.jpmorgan.com), called Apothogen, Inc. (www.apothogen.com), which has announced two investments.

Developing proprietary products. The most extreme strategy is for a CRO to decide that it can get a better return for its shareholders by using its resources to develop proprietary drugs. The underlying assumption is that

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profits from products are greater and more reliable than profits from services and represent a better return on accumulated scientific and market expertise.

The principal adherent of this strategy today is aaiPharma (www.aaipharma.com), which was a pioneer of the CRO business but has publicly announced its intention to transform itself into a specialty pharmaceutical company. The company has developed proprietary drug delivery technologies that it has exploited in licensing agreements and for its own products. In 2001, it also acquired a marketed product line from AstraZeneca (www.astrazeneca.com). Revenues from proprietary products and licenses have grown to nearly half of aaiPharma's total sales, and those revenues are accelerating rapidly while contract revenues are nearly flat.

Balancing Objectives

The wide array of strategies that CROs currently are pursuing underscores the relative youth of the contract research sector and the evolutionary state of outsourcing practices in the pharmaceutical industry. Although CRO shareholders expect immediate returns, CROs and their clients are still trying to determine what value and benefit each expects from the contractor-client relationship and how best to achieve those objectives. Some of these strategies represent significant steps toward resolving those issues, whereas others suggest that some CROs have lost faith in the service business model. **BP**