

Storm Warnings

Robert Langreth and Matthew Herper, 03.13.06

This isn't any passing slump in the pharma sector. The revenue drain at big drug companies could be with us for a long time.

Massive layoffs are usually associated with decaying sectors like Detroit or perennially troubled industries like airlines. But some of the bigger job cuts these days are coming from the high-tech world of pharmaceuticals. Drug companies have announced 70,000 job cuts in the last three years--17% of the workforce and more than in the entire previous decade, according to consulting firm Challenger, Gray & Christmas. Six out of the top ten bestselling drugs have stagnant or declining sales. That has hit behemoths like Johnson & Johnson, **Pfizer** (nyse: [PFE](#) - news - people) and **Bristol-Myers Squibb** (nyse: [BMJ](#) - news - people), which all reported declining sales at the end of last year. Yes, the drug business remains very profitable, but it's not what it used to be. In the last five years Pfizer, **Merck** (nyse: [MRK](#) - news - people), Bristol-Myers Squibb and **Schering-Plough** (nyse: [SGP](#) - news - people) have lost a combined \$394 billion in market value, a decline of 54%.

The really bad news: This slump is not likely to end anytime soon. The industry is struggling with an onslaught of generics and an inability of its research labs to replace aging drugs like Lipitor and Prevacid with equivalent blockbusters. But a big shift is taking place as well. While the industry has traditionally emphasized mass-market drugs, the hot growth area is expensive treatments for cancer and rare diseases--and that plays into the historic strength of biotech companies. Niko Canner, cofounder of consultant Katzenbach Partners in New York, sees the "very beginnings of a change in the balance of power"--away from the large East Coast companies toward innovative biotech. "The existing dominant business model in large pharma is being called into question," he says.

The changes could fuel upheaval in the next decade, perhaps provoking another round of pharma consolidation and new industry leaders as biotech companies like **Amgen** (nasdaq: [AMGN](#) - news - people) and **Genentech** (nyse: [DNA](#) - news - people) stand to gain ground (see chart). European drug companies that invested in smart research could move to the fore. Look for drugmakers to move to get into the booming medical device business.

An unprecedented flood of generics is the immediate problem. This year household names like Zocor, Pravachol, Zoloft and Ambien face generic competition for the first time. Next year it is the turn of **Pfizer's** blood pressure drug, Norvasc, and allergy pill Zyrtec, also from **Pfizer**. The patent-loss frenzy culminates in 2011, when world bestseller Lipitor goes kaput. By that year "everything [drug companies] sell today will be gone," says **Deutsche Bank** (nyse: [DB](#) - news - people) analyst Barbara Ryan. Benefits manager Express Scripts predicts that 75% of all prescriptions could be generic by that time, up from 56% today. "We are at the beginning of a golden era of generics," says Steven Miller, vice president for research at Express Scripts.

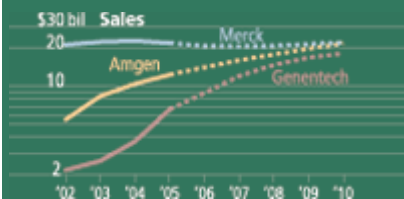
Pharmaceutical firms have always had to deal with patent expirations. What's new is that generic-drug firms are moving more quickly to challenge patents in court, and insurers and employers are striving to switch over patients immediately. For three big drugs that lost patent protection in the last year, 87% of prescriptions were switched over to generics within one month, says Medco Health Solutions.

All this wouldn't matter if the industry were coming up with oodles of new drugs. But only 20 new drugs reached the market last year, down from a peak of 53 in 1996. Many recently approved medicines have been disappointments: **Eli Lilly** (nyse: [LLY](#) - news - people)'s attention-deficit drug Strattera, introduced in 2003, is already on the downswing and has been linked to liver toxicity. The woeful output comes even as big pharma spends \$50 billion annually on R&D, more than twice as much as all of biotech, says Ernst & Young.

type="text/javascript"> "You have success rates that haven't improved in 30 years," says **Amgen** research head Roger Perlmutter, who was recruited from **Merck** in 2001.

Gaining Ground

Merck used to be America's biggest drug company by sales. But analysts' projections have Amgen and Genentech catching up.



Sources: Reuters Fundamentals via FactSet Research Systems; Prudential Equity Group; Sanford C. Bernstein.

Heart disease, for example, has traditionally been big pharma's biggest market. But there are few compounds to replace the vast array of hypertension and cholesterol pills soon to be available in generic form. The American Heart Association annual meeting is normally a showcase for new drug trials. Last year only one out of ten major drug trials presented was clearly successful. "There is no more low-hanging fruit," says Cleveland Clinic cardiologist Steven Nissen.

In the 1990s big pharmaceutical firms spent large sums on newfangled genomic databases and other exotic technologies that didn't produce much. GlaxoSmithKline's predecessor, for example, coughed up \$125 million in 1993 to gain privileged access to the **Human Genome Sciences (nasdaq: HGS) - news - people** gene database; no approved drugs have yet come out of the deal. Japanese drug firms, by contrast, stuck with old-school chemistry, tweaking and experimentation, and have done better.

Big pharma's infatuation with mass-market drugs meant some companies were slow to pick up on the market for high-price medicines narrowly targeted to particular cancers and some uncommon ailments. "There may have been a bit of overemphasis on mass-market blockbusters," acknowledges **Schering-Plough** Chief Executive Fred Hassan. "Some companies used to turn [up] their noses at half-billion-dollar drugs."

Realizing their mistake, drug companies have rushed into cancer and other specialty markets over the past few years. But now they have to play catch-up with biotech firms such as **Genentech**, which has four targeted cancer drugs already on the market. **Genentech's** colon cancer drug Avastin is predicted to reach nearly \$6.2 billion in 2009 sales, as it is used in some breast and lung cancers, according to Credit Suisse. **Pfizer's** similar Sutent drug, approved in January for less-common kidney and stomach-lining tumors, is forecast to hit only \$570 million in 2009 sales.

Many drug companies say that things will turn around as new compounds like Sutent deliver pleasant surprises. "People are irresponsibly bad-mouthing big pharma," says John LaMattina, head of R&D at **Pfizer**. "There are definitely opportunities that offer blockbuster potential."

New drugs to boost good cholesterol (high density lipoprotein), in testing at **Pfizer** and elsewhere, look promising. **Merck** vows better earnings in 2007, and **Schering-Plough** says its turnaround is well under way. **Bristol-Myers Squibb** has focused increasingly on the kind of specialty drugs that are the hallmark of biotech. It has brought in managers from abroad accustomed to dealing with stringent cost controls and promises renewed growth next year. "We're not throwing in the towel on the industry just yet," says Anthony Hooper, Bristol's president of U.S. pharmaceuticals.