PHARMACEUTICALS

CURRENT TRENDS

- The COVID-19 pandemic has had a significant effect on health care spending and trends. Spending for non-essential medications fell, but investment in potential COVID-19 vaccines and treatment regimens soared. Analysts expect overall branded pharmaceutical spending to increase by 4.9% in 2021.
- Demographic fallout from the COVID-19 pandemic will negatively affect pharmaceutical spending. There was a 33% increase in overall mortality in 2020 compared to pre-pandemic per capita pharmaceutical spending forecasts.
- Forecasters expect branded and generic pharmaceutical industry revenues to increase at annualized rates of 1.9% and 2.6%, respectively, through 2026, which is a reduction from pre-pandemic forecasts of 3% and 2.6%, respectively.
- U.S. pharmaceutical pricing increased by an average of 6.2% over the past 10 years but by just 1.2% year to date through May 2021.

PROJECTED VALUES
(12-MONTH OUTLOOK)

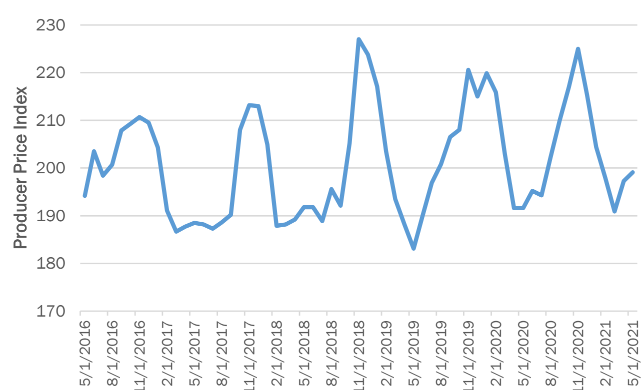
DECREASING **STABLE** **INCREASING**

GORDON BROTHERS BY THE NUMBERS

$20B+
healthcare assets appraised & disposed

869+
healthcare engagements

PRODUCER PRICE INDEX: PRESCRIPTION DRUG RETAILING



REFERENCE SOURCES: MCKINSEY, IBISWORLD, UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO, THE WALL STREET JOURNAL, CHEMICAL AND ENGINEERING NEWS, NATIONAL PUBLIC RADIO, U.S. BUREAU OF LABOR STATISTICS, U.S. CENTER FOR DISEASE CONTROL AND PREVENTION, U.S. CENSUS BUREAU.

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PANDEMIC FALLOUT: There was a 33% increase in overall mortality in 2020, according to the U.S. Census Bureau, which will negatively affect pharmaceutical spending compared to pre-pandemic spending forecasts. Total U.S. health care spending decreased by $400 billion in 2020 because of the pandemic and the resultant reduction in elective procedures.

Initially during the pandemic a drop off in demand for non-essential medicines resulted in an overall drop in health care spending, in 2021 as hospitals and healthcare facilities have resumed elective procedures and vaccination levels have skyrocketed, overall healthcare expenditures have recovered to pre-pandemic levels. Broad campaigns to vaccinate at least 70% of the U.S. population have been a boon for pharmacies and pharmaceutical manufacturers.

While industry research firm IBISWorld projects $500 billion in spending growth for 2021, it expects overall growth will be just 2.9% annually from 2019 through 2021, which is below the 10-year average.

BRANDED PHARMACEUTICAL INDUSTRY DRIVERS: Before the pandemic, IBISWorld projected the branded pharmaceutical segment in the U.S. would grow by 4.6% in 2020. However, actual sales of branded pharmaceutical products increased by 11% in 2020 over 2019, because of the high demand for COVID-19 vaccines and therapies.

IBISWorld expects branded sales to increase an additional 4.9% in 2021 but then taper off from 2022 to 2026 with an estimated annualized growth of 1.9% Sales are also expected to increase because of positive health care spending projections, higher biologics sales of biologics, oncology drug and therapy developments and higher prices on widely used specialty drugs.

GENERIC PHARMACEUTICAL INDUSTRY DRIVERS: An aging population, an increased prevalence of chronic disease and a continuing focus by insurance companies and the federal government on trimming healthcare spending are all positive factors affecting the generic business. While the pandemic hit the industry hard with generic pharmaceutical sales dropping by 0.6% in 2020, sales are expected to bounce back by 5.3% in 2021 based on IBISWorld research in the generic space.

Absent pandemic influences, the industry is growing, with the expiration of patent protection for multiple high-revenue drugs including Abilify, Copaxone and Crestor in 2015 and 2016 and Viagra and Lyrica in 2019.

Additionally, there are a significant number of branded biologic products including Lantus, NovoLog, Rituxan and Remicade that have lost patent protection and can be converted to "biosimilar" products, which will have a positive effect on the industry. For these reasons, IBISWorld projects generic pharmaceutical industry sales in the U.S. will grow 2.9% annually from 2022 through 2026.

INCREASED PRICING PRESSURES: Pharmaceutical price controls remain a major focus for regulators and the public. Over the past 10 years, pharmaceutical pricing in the U.S. has risen by an average of 6.2%. However, the rate of price increases has eased since 2019. The Producer Price Index for pharmaceutical manufacturing rose 3.1% in 2019, a drop from 3.7% in 2018 and well below the five-year average of 5.2%, according to the U.S. Bureau of Labor Statistics (BLS). Pricing continued to fall in 2020, increasing by only 1.5%.

The Expert: Alex Sutton

Alex Sutton is Managing Director, Head of Research, for Gordon Brothers' Valuation division where he coordinates industry guidance and market research to support cross-asset appraisals. With over two decades of experience, Alex has directed inventory appraisals across a range of industries, including aerospace, agriculture, metals, pharmaceuticals and plastics. Read his full bio here.

The BLS reports only a 1.2% increase on producer prices through May 2021. As most pharmaceutical companies adjust their prices early in the calendar year, this indicates 2021 price increases will likely be below the trailing five-year average for the fourth consecutive year. Pharmaceutical pricing at pharmacies and drug stores has likewise been limited, with producer prices in 2019, 2020 and year-to-date 2021 registering increases of 2.7%, 1.7% and negative 2.8%, respectively.

SUPPLY CHAIN CONCERNS: The pandemic has increased the focus on risk management as companies reassess their supply chain strategies and footprints to become more agile and resilient to disruption. They continue to evaluate their suppliers and weigh solvency risks, the amount of control they desire, the need to choose partners based on diversifying locations and other considerations that balance cost versus risk.

There has long been an underlying sense of unease in the industry, as core supply centers are located far from their demand. The COVID-19 crisis reinforced this unease and forced companies to consider moving a portion of last-mile production-supply capacity closer to end markets.
There are also concerns regarding the supply chain reliance on China and India. An article in the American Chemical Society's Chemical & Engineering News notes the number of facilities in China supplying active pharmaceutical ingredients (API) has more than doubled since 2010, to 13% of all those serving the U.S. market as of 2020.

The U.S. remains home to the most API manufacturing plants worldwide, and the European Union is a close second, with both accounting for just over 25% of the total, according to Janet Woodcock, U.S. Food and Drug Administration's (FDA) Center for Drug Evaluation and Research Director. China and India combined account for 31%.

ONGOING OPIOID LEGAL ACTION: A federal class action lawsuit referred to as the National Prescription Opiate Legislation was filed on December 17, 2017, concerning the alleged improper marketing and distribution of various prescription opiate medications nationwide. Lawsuits have been brought by thousands of local governments across the United States.

However, because of the extent of the litigation over the addiction epidemic, it could take years to resolve and make up for some of the economic losses caused by the crisis.

PHARMACEUTICAL CHARGEBACKS DISCOUNTED IN LIQUIDATION: Large hospital buying groups and retail pharmacies typically negotiate purchase prices for pharmaceutical drugs directly with manufacturers based on volume. Pharmaceutical chargebacks help remedy differences in purchase prices. They occur when a wholesaler sells a product to customers at a price lower than its purchase price from the manufacturer. The wholesaler can contractually charge back the manufacturer for the difference and thereby receive normal margin. Drug manufacturers do not often reimburse this chargeback in cash; rather, wholesalers typically receive a credit they can apply to future purchases. Accordingly, there are always payables due to the wholesaler for chargebacks and payables due to the manufacturer for the original inventory purchase.

Gordon Brothers typically assumes a wholesaler and, in turn, the secured party, will not receive the chargebacks in a liquidation, as the company would offset them against other account payables owed. This means the company would not realize the full contracted margins in a liquidation scenario.

While chargebacks were in the range of 5% to 6% of total sales 20 years ago, today they can be as high as 30% to 40% of total sales, especially on generic products. Additionally, companies did not track chargebacks at the lot level, and competitors would buy pharmaceuticals below cost in a liquidation and recover the chargeback when they sold the product, minimizing the chargebacks' effect. Now, companies track at the specific lot level because of gray market pharmaceutical concerns and cross-border sales issues, and only the parties involved in the original purchase can recover them. Competitors who buy pharmaceuticals in a liquidation will not consider the benefit of a chargeback into what they pay for the product.

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