

Cash on prescription

Pharmaceutical companies and
working capital management 2013



Building a better
working world



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Summary

Cash on prescription is the latest in a series of working capital (WC) management reports based on EY research.

The results from our analysis of big pharma's WC performance in 2012 shows a further, albeit more modest, deterioration from the prior year. Cash-to-cash (C2C) increased by 1%, after rising by 3% the year before. This brings the industry's overall increase in C2C since 2005 to 9%.

Japanese pharmaceutical companies once again scored especially poorly in 2012 compared with 2011, seeing their C2C rise by 8%. This means that their C2C has increased by 19% since 2005.

However, these generally poor WC results mask a much stronger management focus on cash and WC in recent years, as companies have sought to optimize capital and grow shareholder value. Significant progress has already been achieved in some areas of WC, but its impact has not been enough to offset the adverse effect on the industry's overall performance of changes in distribution arrangements and transformation of its business model.

Overall, our research suggests that big pharma companies have up to US\$40b of cash tied up unnecessarily in WC. This figure is equivalent to 7.1% of these businesses' combined sales. For Japanese pharmaceutical companies, the corresponding figure is US\$2.2b, or 4.4% of sales. Pharmaceutical companies may

be able to identify additional opportunities for WC improvement by examining the practices of leading WC performers in other industries, such as consumer products.

As the pace and scale of change in the industry escalate, pharmaceutical companies seeking further progress in WC will need to respond to emerging operational and market issues with more substantial changes than they have to date. Firms should consider collaborating more closely with wholesalers and other distributors; building greater responsiveness into systems and processes; achieving supply chain resilience; managing outsourcing more effectively; taking a balanced approach between cash, cost, service levels and risk; tailoring WC strategies to conditions in rapid-growth markets; and changing internal behaviors.

Further WC deterioration in 2012 for big pharma

Big pharma's WC performance in 2012 declined from 2011, albeit at a slower rate: C2C increased by 1%, after rising by 3% the year before.

Table 1: Change in WC metrics across the industry, 2012 vs. 2011

Big pharma	2012	Change 12/11
DSO	67.5	-3%
DIO	48.5	10%
DPO	28.1	5%
C2C	87.9	1%

Note: DSO (days sales outstanding), DIO (days inventory outstanding), DPO (days payable outstanding) and C2C (cash-to-cash), with metrics calculated on a sales-weighted basis. Source: EY analysis, based on publicly available annual financial statements.

Table 2: Number of companies and % change in WC metrics, 2012 vs. 2011

		DSO	DIO	DPO	C2C
Reduction	> 5%	4	1	3	2
	0%-5%	4	1	2	4
Increase	> 5%	1	9	7	5
	0%-5%	5	3	2	3

Source: EY analysis, based on publicly available annual financial statements.

The weaker WC performance in 2012 resulted from a 10% rise in days inventory outstanding (DIO), partly offset by a combination of lower days sales outstanding (DSO), down 3%, and increased days payable outstanding (DPO), up 5%. Eight companies out of 14 reported a higher C2C year-on-year, with five of them showing an increase of more than 5%.

A number of factors may explain these variations in WC performance, each with varying impacts on different companies:

- ▶ **A challenging environment for big pharma, marked by a drop in sales and WC levels:** Compared with 2011, big pharma's sales declined by as much as 3% in 2012, due to increased competition from generics, pressures on pricing and the negative impact of exchange rates for companies reporting in US dollars (which accounted for two-thirds of total industry sales). These forces more than offset the ongoing development of rapid-growth markets. Demand for consumer health care products also weakened significantly in the second half of the year, notably in the US and Europe. Merger and acquisition activity was limited. Against this backdrop, WC levels also dropped, but at a pace (-2%) that was a little slower than for the decline in sales.
- ▶ **Persistent volatility in exchange rates:** Changes in exchange rates also affected pharmaceutical companies' WC performance in 2012. For those reporting in US dollars, the dollar's weakness against the euro at the end of 2012 compared with its average during the year negatively impacted WC performance. In contrast, for those reporting in euros, the currency's strength benefited WC performance.
- ▶ **Continued attention to WC management:** While the above external factors played a part in last year's changes in overall WC performance, so did the variety of new initiatives that many pharmaceutical companies pursued in the WC area. These included actions focused on lean manufacturing, billing and cash collection, spend consolidation, sourcing, renegotiation of payment terms, and supply chain efficiency.
- ▶ **Broad inventory performance deterioration:** 2012 saw a significant deterioration in inventory performance among big pharma compared with 2011: 12 companies out of 14 reported higher DIO, including nine with an increase of more than 5%. Using cost to sales (COS) rather than sales would have shown a similar result. This decline in performance was due to the

change in the mix of product sales and inventory following the launch of new products, the loss of exclusivity for a number of blockbusters, and the higher safety stocks required to serve rapid-growth markets. For products facing generic competition, inventory management has also become more difficult. This is because companies are losing the ability to estimate the levels of returns from distribution channels with the same degree of precision as for patented products, due to uncertainties around the launch timing, pricing and level of take-up of generics. Several pharmaceutical companies also mentioned the negative impact of acquisitions (due to the accounting revaluation of the acquired inventory) together with higher levels of vaccines at year-end. The poorer performance in inventory was partly offset by additional improvements in manufacturing and supply chain operations.

- ▶ **Better receivables performance:** In sharp contrast to the continuous deterioration seen since 2005, the pharmaceutical industry reported a meaningful improvement in receivables performance in 2012, with eight companies showing lower DSO. This was primarily due to a significant improvement in the recoverability of trade receivables in a number of southern European countries following settlement plans with governments and local authorities. Pressures on payments from US wholesalers also appear to have eased during 2012. An analysis

of the payables performance of the three largest wholesalers in the US shows a slight drop in DPO (based on COS) in 2012 compared with 2011, suggesting that they may have chosen to pay early or negotiate shorter terms. In Europe, five major wholesalers out of seven also reported a lower DPO year-on-year. Bad debt provisions were increased in some cases, bringing the industry's levels of provisions for bad debt in balance sheet reserves from 0.53% of sales in 2011 to 0.59% in 2012. The number of pharmaceutical companies using factoring – and the total volume of factoring – also increased last year, but this has had no impact on our measure of DSO, as our calculations always include the factored amount.

- ▶ **Stronger payables performance:** The pharmaceutical industry exhibited a further improvement in payables performance in 2012, underpinned by progress made in leveraging and consolidating spend, extending payment terms and increasing collaboration with suppliers. Nine companies posted a stronger performance, including seven of them that showed an increase of more than 5%. The reported changes in payables overall also reflected companies' differing strategies and tactics. For example, some companies have been stretching terms with their main suppliers, or reducing their supplier bases to achieve greater leverage in negotiations. Others have been choosing to pay faster in return for bigger cash discounts.



Significant deterioration in WC performance since 2005

The results for 2012 bring the total increase in C2C since 2005 to as much as 9%. This deterioration in performance arose from much higher DSO and DIO (up 10% and 12%, respectively), partly offset by increased DPO (up 17%). The high degree of change in each metric reflects the ongoing transformation of the industry's business model during the period under review.

Nine companies out of 14 reported weaker WC results in 2012 than in 2005, with eight of these showing an increase in C2C of more than 5%.

Table 3: Change in WC metrics across the industry, 2012 vs. 2005

Big pharma	2012	Change 12/05
DSO	67.5	10%
DIO	48.5	12%
DPO	28.1	17%
C2C	87.9	9%

Source: EY analysis, based on publicly available annual financial statements.

Table 4: Number of companies and % change in WC metrics, 2012 vs. 2005

		DSO	DIO	DPO	C2C
Reduction	> 5%	2	6	3	4
	0%-5%	3	0	3	1
Increase	> 5%	8	8	8	8
	0%-5%	1	0	0	1

Source: EY analysis, based on publicly available annual financial statements.

Several factors may explain these variations in reported WC performance:

- ▶ The weakness in receivables performance was primarily caused by changes in distribution arrangements in many countries. These included a move toward fee-for-service and direct-to-pharmacy schemes and the tendency for wholesalers to pay late or negotiate longer terms, with consolidation providing them with the opportunity to leverage scale. Another contributory factor was the rising proportion of sales coming from rapid-growth markets, where customer payment terms are generally much longer than in the US and overdue payments relatively higher. Measures to contain health costs in many developed countries, compounded by financial difficulties in some European markets, have also contributed to this deterioration. Nine companies reported weaker receivables performance in 2012 than in 2005.
- ▶ The deterioration in inventory performance was the net result of several conflicting factors. Collaboration between manufacturers and wholesalers has increased, but many of the benefits from this appear to have already been captured in the early part of the period under review, when most manufacturers implemented inventory management arrangements (IMAs) with wholesalers. Significant reductions in lead times and inventory levels have also been delivered through lean transformations of sites. Meanwhile, many customers have adopted a similar approach to inventory management to that taken by manufacturers, dealing with fewer suppliers and expanding the use of just-in-time methods and vendor-managed inventory initiatives. Changes in the mix of product sales and inventory following the launch of new

Most significant WC initiatives taken by the industry

products and the loss of exclusivity for a number of blockbusters, together with higher safety stocks to serve rapid-growth markets, have also contributed to a rise in inventory levels. Industry consolidation was a further factor, with the accounting revaluation of the acquired companies' inventory temporarily cancelling out, to some extent, the benefits derived from supply chain rationalizations. Moves to fee-for-service and direct-to-pharmacy schemes (especially since 2007) were also a further negative factor. Eight companies reported weaker inventory results in 2012 than in 2005.

- ▶ In contrast, payables performance continued to be supported by better management of the procurement and payables process, including managing terms more effectively (notably via extended payment terms). Ongoing consolidation in the pharmaceutical industry was a further positive factor, as it created larger companies with greater buying power, capable of extracting better cash terms from suppliers. Conversely, some companies may have pursued a deliberate policy of trading off improvements in payables against reductions in purchasing costs. Changes in sourcing strategies may have also played a role. Eight companies managed to improve their payables performance.

In recent years, pharmaceutical companies have been focusing on a number of initiatives to improve WC management, including:

- ▶ Optimization of global manufacturing footprint and increased adoption of lean principles
- ▶ Reconfiguration of supply chains by deploying different strategies and solutions for different products or countries
- ▶ Improvements in billing and cash collections
- ▶ Monitoring of chargebacks, rebates, returns and cash discounts, especially in the US
- ▶ More effective management of payment terms for customers and suppliers, including renegotiation of terms
- ▶ More effective management of 'alliance' contract agreements, including terms and conditions, alliance and responsibilities
- ▶ Consolidation of spend, intensification of global procurement and standardization of products portfolios, packaging and business processes
- ▶ Increased collaboration with channels of distribution and suppliers
- ▶ More effective management of outsourcing arrangements
- ▶ Improved coordination between sales, manufacturing, procurement and supply chain processes
- ▶ Adoption of common technologies up and down the value chain to enable sharing of real-time and accurate supply and demand information
- ▶ Deployment of global ERP systems to help drive greater operational efficiencies and improve visibility across the supply chain
- ▶ Implementation of more robust risk management policies
- ▶ Tracking and monitoring of WC metrics and linking compensation to these metrics



**Case studies:
improving WC
management**

One of the world's largest pharmaceutical companies, which had pursued a number of initiatives to improve working capital performance during the past few years, felt that its performance could still be improved much further. An EY project team was engaged to support management in reviewing the existing processes and designing an action plan to implement leading practices in this area. The program involved an end-to-end review of the receivables processes that examined terms in the markets managed through the shared service centers (SSCs) as well as in the major emerging markets outside the scope of the SSCs.

For another pharmaceutical company, EY evaluated current and future inventory needs, as supply chains had been reconfigured and the vertically integrated nature of the business had not been managed as one, but rather as independent silos. Our implementation support covered raw materials through API and drug product and packaging through to the end markets. In addition, a program was designed and implemented jointly with the client's global procurement function aimed at increasing the level of global days payable outstanding.

Wide variations in current WC performance among big pharma

Current WC performance among big pharma continues to vary widely overall and for each metric, but with 2012 showing a significant tightening of the spread in C2C.

In 2012, the average level of C2C for big pharma was 88 days, with a spread of 16 days using standard deviation as a measure. More specifically, the averages for DSO, DIO and DPO were 68 days, 49 days and 28 days, respectively, with spreads of 9 days, 11 days and 12 days.

For big pharma, the spread in C2C in 2012 was much lower than in 2011 and 2005 (when it was 21 days and 20 days, respectively).

However, excluding 2012, this spread has remained relatively constant in recent years, suggesting persistent differences in the degree of focus and in the success of some initiatives aimed at improving C2C performance.

It is worth noting that a degree of caution should be exercised when reviewing individual C2C performances, due to differences in accounting and disclosure methods for trade accruals.

Table 5: WC performance distribution among big pharma, 2012

C2C	Average*	Top quartile	Bottom quartile	Standard deviation
DSO	67.5	61	73	9
DIO	48.5	43	57	11
DPO	28.1	38	19	12
C2C	87.9	72	97	16

*weighted
Source: EY analysis, based on publicly available annual financial statements.

WC performance per big pharma, 2012

Table 6: C2C (based on sales)

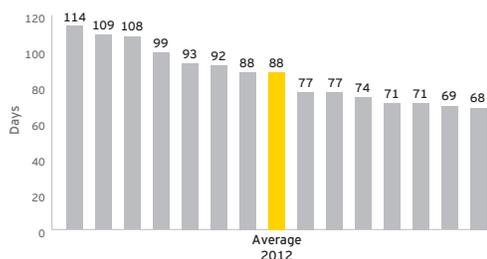


Table 7: DSO (based on sales)

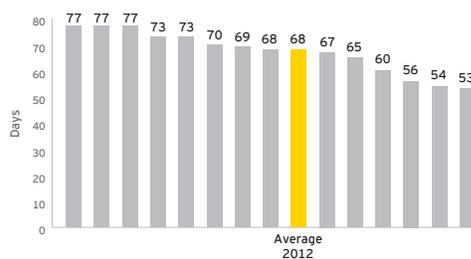


Table 8: DIO (based on sales)

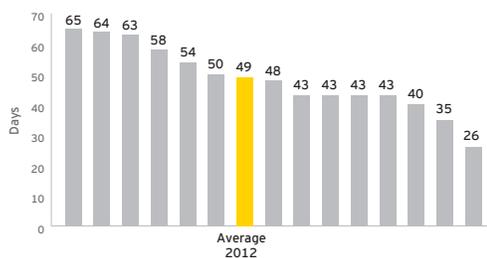
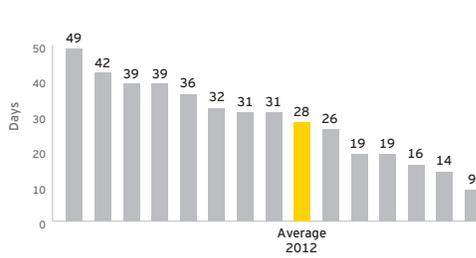


Table 9: DPO (based on sales)



* Average is sales-weighted.

Source: EY analysis, based on publicly available annual financial statements.

Drivers affecting current WC performance

While we see fundamental differences in management focus and process efficiency among pharmaceutical companies, there are additional drivers that need to be considered when comparing current WC performance. A comprehensive analysis should also consider the trade-offs between cash, cost and service levels that pharmaceutical companies agreed to with their customers and suppliers.

Wide range of payment practices

Differences in payment practices by activity across and within regions can partly explain the differences in receivables performance among pharmaceutical companies (for big pharma as a whole, the DSO range stands at 53-77 days).

For the companies analyzed in our survey, North America accounts for 43% of total sales, Europe 24%, rapid-growth and other established countries 22% and Japan 11%. Non-pharmaceutical and vaccine activities now represent close to 30% of total sales, as some pharmaceutical companies are opting for more diversified and less risky growth strategies by entering vaccines, medical devices, and consumer and animal health care.

Wholesalers are generally the quickest payers for pharmaceutical products, while hospitals and government agencies tend to pay later. For US wholesalers, the average payment period (DSO) is 35-45 days. Europe shows wide variations in payment terms across wholesalers, with a small number of them dictating the overall level for each country. Germany and Scandinavia exhibit the lowest

DSO (25-35 days), reflecting the prevalence and high take-up of early-payment discounts. In the UK, the range of payments has widened to 60-90 days. In Japan, DSO remains high, at 90-120 days, while in the rest of the world, there is a wide distribution of DSO performance, reflecting varying levels of market maturity, local payment practices and commercial strategies.

Besides wholesalers, pharmaceutical companies in Europe deal with a mix of doctors, pharmacies, hospitals and government buying agencies, which results in extended payment terms, high levels of overdue payments, and high logistics and distribution costs. For this segment, DSO can be estimated at 70-80 days, with wide variations across categories and within each country.

Among non-pharmaceutical activities, consumer health care continues to carry the lowest level of receivables (35-40 days), while animal health care and medical devices have the highest (70-80 days and 60-70 days, respectively). For chemicals, the DSO range is 45-55 days.

Varying levels of outsourcing

The pharmaceutical industry increasingly relies on third-party providers to manufacture, supply, incorporate and package intermediates and active ingredients, with outsourcing now accounting for 30%-35% of primary and secondary manufacturing and 35%-40% of packaging. A substantial proportion of clinical and preclinical research, sales force and logistics operations are also conducted by external service providers. More recently, outsourcing has been extended to include business management processes, such as finance and accounting, sourcing and procurement, and R&D.

For the industry as a whole, outsourcing has played a significant role in optimizing costs and increasing speed to market. It has also led to significant reductions in inventory levels, especially when applied to short production runs (a common industry requirement). The use of outsourcing still varies widely between companies. This affects inventory as well as payables performance. But the extent of this remains difficult to assess given the varying nature of supply contracts and the associated cost, cash and service level trade-offs chosen between manufacturers and third parties.

Importance of alliances and collaborations

There is a wide spread of inventory distribution by category across the industry, with different companies pursuing differing inventory acquisition strategies. Some companies push products to finished goods, while some hold more work in progress (WIP) to provide them with greater flexibility to finalize the product in the right packaging or ship in bulk to markets around the world. Some companies favor a continued replenishment policy, while others prefer to emphasize service levels, inflating the proportion of finished products.

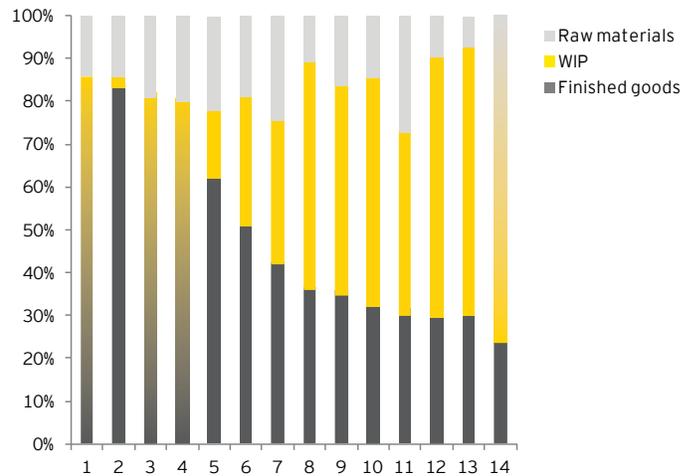
At the end of 2012, finished goods accounted for 51% of the industry's total inventories (with a range of 24% to 83%), WIP for 34% (with a range of 3% to 76%) and raw materials for 15% (with a range of 7% to 27%). Compared with 2011, the proportion of WIP increased in 2012 (by two percentage points), while that of finished goods declined (by one percentage point). It is worth noting that individual and industry changes in recent years also reflect variations in the mix of product sales and in the proportion of manufacturing and packaging processes that are outsourced.

Varying exposure to generics

Varying degrees of exposure to generics also played a role in the WC variations between pharmaceutical companies in 2012, with some having pursued an active policy of acquisitions and partnerships in this market.

Compared with branded pharmaceutical activities, generics typically carry much higher levels of WC in relation to sales, with an average C2C of 135 days in 2012 (based on a selection of four "pure" generics pharmaceutical companies: Dr. Reddy's Laboratories, Mylan, Stada and Teva Pharmaceutical Industries). This is as a result of much higher DSO (96 days) and DIO (93 days), partly offset by a stronger DPO (55 days).

Table 10: Inventory breakdown by category for big pharma, 2012



Source: EY analysis, based on publicly available annual financial statements, with x-axis showing inventory breakdown by category for each big pharma.

Part of the performance gap for DSO reflects differences in the customer base. US wholesalers, for example – offering generally shorter payment periods – represent a much lower proportion of total sales. Variations in accounting methods for sales reserves and allowances may have been a further contributory factor.

For DIO and DPO, performance gaps would have been much reduced – to a 16% and 18% premium, respectively – had the calculations been made using COS rather than sales, as generics boast a much higher COS to sales ratio than big pharma (50% vs. 30%). A degree of caution should be exercised when comparing individual DPO performances owing to differences in trade accruals accounting and disclosure.

Japanese pharmaceuticals posted further weakness in WC performance in 2012 vs. 2011

The Japanese pharmaceutical companies we reviewed reported a further significant deterioration in WC performance in 2012 compared with 2011. Overall C2C increased by 8%, with every company but one posting weaker results.



This occurred in the context of falling sales for Japanese pharmaceutical companies (down 2% year-on-year), brought on by patent expirations, drug price revision, efforts worldwide to restrain health care spending and intensifying global competition.

Table 11: Change in WC metrics across the industry, 2012 vs. 2011 and 2005

Japan pharma	2012	Change 12/11	Change 12/05
DSO	93	3%	5%
DIO	56	14%	46%
DPO	26	4%	12%
C2C	123	8%	19%

Source: EY analysis, based on publicly available fiscal year ending March 2013.

The increase in C2C from 2011 to 2012 was due to a combination of higher DIO (up 14%) and, to a lesser extent, DSO (up 3%), partly offset by increased DPO (up 4%). Weakness in the Japanese yen against the US dollar at year-end compared with the average for the year exaggerated the variations in WC metrics.

These latest results mean that Japanese pharmaceutical companies' C2C has increased by as much as 19% since 2005, with four companies out of five reporting weaker results. This deterioration in performance has risen primarily from much higher DIO (up 46%). DSO was also higher (up 5%), while, in contrast, DPO rose by 12%.

The weakness in inventory performance may have been caused by changes in distribution arrangements, the rising proportion of sales coming from generics that carry much higher levels of inventory, and increased investment in inventory to support growth outside Japan.

The receivables performance was the result of the interplay of several factors. In Japan, some wholesalers appear to have paid early or negotiated shorter terms since 2005, but ongoing consolidation may also have played a role by providing the

opportunities for others to extract better terms from their suppliers. In the US (representing one-quarter of total sales), wholesalers extended terms or paid late in recent years except in 2012. Another influencing factor was the rising proportion of non-Japanese sales, as payment terms with non-Japanese customers are generally much shorter than they are with Japanese customers.

For payables performance, the improvement arose from the impact of rising inventories and increased levels of purchasing made outside Japan, where payment terms are generally longer.

In comparison with big pharma, Japanese pharmaceutical companies display much higher levels of WC in relation to sales, with C2C averaging 123 days in 2012.

This figure is primarily due to poor receivables performance (with a 38% DSO premium), reflecting much longer payment terms with domestic pharmaceutical wholesalers (90-120 days). Inventory performance is also weaker (DIO is 15% higher). Interestingly, inventory distribution by category shows that Japanese pharmaceutical companies hold a larger proportion of finished goods in their total inventories (61%) than big pharma (51%). With regard to payables, performance appears to be similar to big pharma's, notwithstanding possible differences in trade accruals accounting and disclosure.

It is also worth noting that Japanese pharmaceutical companies' spread in C2C remains much higher than for big pharma, at 23 days in 2012, while narrowing from 2005 when it was 31 days.

WC performance per Japanese pharmaceutical company, 2012

Table 12: C2C (based on sales)

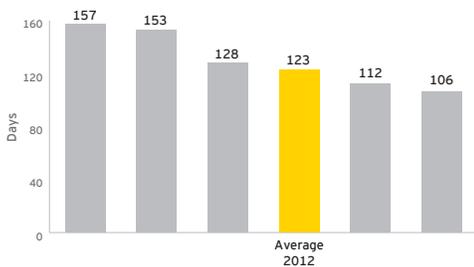


Table 13: DSO (based on sales)

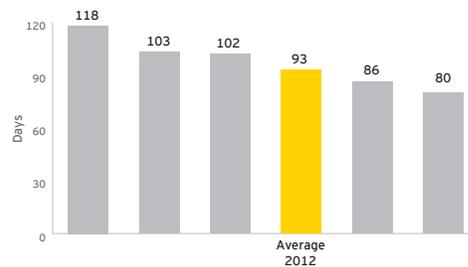


Table 14: DIO (based on sales)

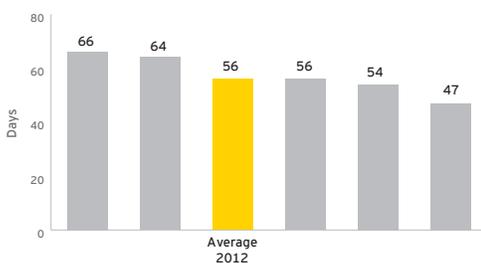
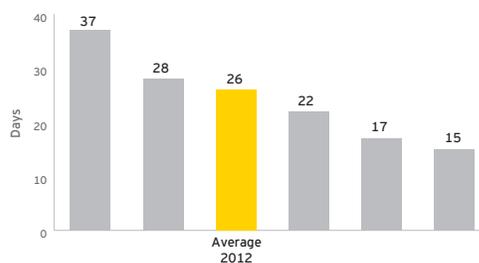


Table 15: DPO (based on sales)



* Average is sales-weighted.

Source: EY analysis, based on publicly available annual financial statements.

Opportunities going forward

The wide variations in WC performance between different pharmaceutical companies that our research reveals point to significant potential for improvement.

We have calculated this range of cash opportunity by comparing the performance of the WC components of each company with that of the average (low estimate) and the upper quartile (high estimate) of its sub-peer group (big pharma and Japanese pharmaceutical companies). Even at the top end of each range, our experience across many projects, industries and geographies shows that often a dedicated focus on WC management can realize results at or above this level.

On this basis, big pharma firms have between US\$20b and US\$40b of cash unnecessarily tied up in WC processes, equivalent to between 3.6% and 7.1% of their aggregate sales. Note that the top range of cash opportunity identified in 2012 is slightly lower than a year before.

Japanese pharmaceutical companies have between US\$1.1b and US\$2.2b of cash unnecessarily tied up in WC processes, equivalent to between 2.2% and 4.4% of their aggregate sales. Note that the bottom range of cash opportunity identified in 2012 is lower than a year before.

Pharmaceutical companies may be able to identify additional opportunities for WC improvements by examining the practices of leading WC performers in other industries, such as consumer products.

Table 16: WC cash opportunity for big pharma, 2012

	Cash opportunity					
	Value (US\$b)		% WC scope*		% Sales	
	Average	Upper quartile	Average	Upper quartile	Average	Upper quartile
Receivables	5	11	5%	11%	0.9%	2.0%
Inventories	7	12	10%	16%	1.3%	2.1%
Payables	8	17	17%	39%	1.3%	3.0%
Total	20	40	9%	18%	3.6%	7.1%

Table 17: WC cash opportunity for Japanese pharmaceutical companies, 2012

	Cash opportunity					
	Value (US\$b)		% WC scope*		% Sales	
	Average	Upper quartile	Average	Upper quartile	Average	Upper quartile
Receivables	0.5	1.2	4%	10%	1.1%	2.5%
Inventories	0.3	0.5	4%	6%	0.6%	0.9%
Payables	0.3	0.5	8%	14%	0.5%	1.0%
Total	1.1	2.2	5%	9%	2.2%	4.4%

*WC scope = sum of trade receivables, inventories and accounts payable

Source: EY analysis, based on publicly available annual financial statements.



Adapting WC strategies to a changing environment

Over the past few years, the pharmaceutical industry has been paying much more attention to cash and WC management as it seeks to optimize capital and grow shareholder value. But as the pace and scale of change in the industry escalate, companies seeking further gains will need to adapt their WC strategies to a broad range of emerging operational and market issues. To do this, companies need to consider the following actions.

- ▶ **Collaborating more closely with wholesalers and other distributors:** Achieving true collaboration between manufacturers and distributors would represent a further major step forward in streamlining supply chains and improving service levels. For many companies in the sector, the greatest barriers to collaboration remain issues such as poor data quality, complicated production and distribution compliance rules, non-standardized infrastructures and lack of trust. To address some of these challenges, companies must first decide on the specific type of collaboration they want to pursue with each partner. Partnerships must also be allowed to grow and evolve over time to align the partners' infrastructures more effectively and build trust by sharing information on demand (for example, via access to sales channels data).
- ▶ **Building greater responsiveness into systems and processes:** In a business environment that is becoming far more complex to navigate, responding more quickly and effectively to demand fluctuations has become increasingly important for the pharmaceutical industry. These trends have resulted in most supply chains being reconfigured to make them leaner and more agile, but their complexity has also made them harder to manage. This is why it is imperative that organizations become more responsive. To this end, they need to work more closely with suppliers to standardize processes and share information on demand. They also need to combine different manufacturing and supply chain solutions. In addition, companies need to implement better integration and coordination between sales, manufacturing, procurement and supply chain processes.
- ▶ **Achieving supply chain resilience:** Supply chains have become more vulnerable to business disruptions as a result of lean practices, rising use of outsourcing and reduced supplier bases. The impact of such disruptive events on supply chains can be severe across the whole network. To manage and mitigate these risks, it is important for pharmaceutical companies to embed higher resilience into their supply chains while taking into account the potential efficiency cost associated with it. To achieve this, a number of actions are necessary, such as: re-engineering parts of supply chains, including putting processes in place to ensure alternative sourcing and to provide additional capacity and inventory at critical points for the organization; building agility by enhancing the visibility of products across the network and reducing lead times; developing more collaborative supply chain relationships; and creating a risk management culture in the organization.
- ▶ **Managing outsourcing more effectively:** Outsourcing has become more important to pharmaceutical companies as they seek to optimize costs and increase speed to market. Yet this shift has also introduced an array of additional risks and challenges, including greater complexity in logistics, potentially longer and more variable lead times, excess safety stocks, and the loss of visibility and control over the manufacturing and delivery processes. To be effective, outsourcing requires dedicated structures with clearly defined roles and responsibilities, trusted providers with contracts that are carefully configured and managed with improved communication and planning, and the preparation of adequate contingency plans.

- ▶ **Taking a balanced approach between cash, cost, service levels and risk:** In a fast-moving environment, it is critical for companies to actively and consciously manage the trade-offs between cash, cost, service levels and risk that various WC strategies require. For pharmaceutical companies, this means regularly reassessing the decisions that have been made concerning sourcing; lean practices and agile response; cost-to-serve and customer service; and the balance between maintaining strategic inventory levels and the risk of disrupting patients' lives or missing a profitable sale.
- ▶ **Tailoring WC strategies to conditions in rapid-growth markets:** Ensuring continuing and profitable growth in rapid-growth markets is one of the most pressing WC challenges for the pharmaceutical industry. As each new market has its own characteristics and dynamics, no single WC approach is likely to fit them all. Successful WC strategies are tailored to each market, with specific, measurable and balanced goals around cash, cost, quality, delivery and risk. Strategies should also be reviewed regularly to ensure they continue to reflect evolving local market conditions.
- ▶ **Changing internal behaviors:** To realize all these opportunities in WC, an organization must not only continually implement leading practices in this key area. It must also change its internal behaviors. This requires people, process and technology to work more closely together. It also compels organizations to set adequate targets for improvements in sales, cost and cash; accurately assess the progress being made at both a corporate and unit level; and align the compensation of different groups (with multiple and sometimes conflicting interests) to the relevant performance measures.



How EY can help

EY's global network of professionals helps clients to identify, evaluate and prioritize realizable improvements to liberate cash from WC through sustainable changes to policy, process, metrics and procedure adherence.

We can assist organizations in their transition to a cash-focused culture and help implement the relevant metrics. We can also identify areas for improvement in cash flow forecasting practices and then assist in implementing processes to improve forecasting and frameworks to sustain those improvements.

Companies that undertake WC improvement initiatives often realize a high return on investment. In addition to increased levels of cash, significant cost benefits may also arise from process optimization, through reduced transactional and operational costs and from lower levels of bad and doubtful debts and inventory obsolescence. Our WC professionals are there to help wherever you do business.

Methodology

This report is based on a review of the WC performance of big pharma, which is composed of the 14 largest pharmaceutical companies (by sales) headquartered in the US and Europe, representing almost half of the world pharmaceutical market.

The companies included in our report are Abbott Laboratories, Amgen, AstraZeneca, Bayer, Bristol-Myers Squibb, Eli Lilly, GlaxoSmithKline, Johnson & Johnson, Merck, Merck KGaA, Novartis, Pfizer, Roche and Sanofi.

The review of WC performance is both industry- and company-specific and uses metrics based on publicly available annual financial statements.

The analysis involved a review of the WC performance of five major Japanese pharmaceutical companies: Astellas Pharma, Daiichi Sankyo, Dainippon Sumitomo Pharma, Eisai and Takeda Pharmaceutical.

The performances of individual pharmaceutical companies are not disclosed.

Glossary

- ▶ **Pro forma sales:** reported sales net of VAT and adjusted for acquisitions and disposals when this information is available
- ▶ **DSO (days sales outstanding):** year-end trade receivables net of provisions, including VAT and adding back securitized and factored receivables, divided by full-year pro forma sales and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise)
- ▶ **DIO (days inventory outstanding):** year-end inventories net of provisions, divided by full-year pro forma sales and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise)
- ▶ **DPO (days payable outstanding):** year-end trade payables, including VAT and adding back trade-accrued expenses, divided by full-year pro forma sales and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise)
- ▶ **C2C (cash-to-cash):** equals DSO, plus DIO, minus DPO (expressed as a number of days of sales, unless stated otherwise)

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About EY

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How EY's Global Life Sciences Center can help your business

Life sciences companies – from emerging to multinational – are facing challenging times as access to health care takes on new importance. Stakeholder expectations are shifting, the costs and risks of product development are increasing, alternative business models are manifesting, and collaborations are becoming more complex. At the same time, players from other sectors are entering the field, contributing to a new ecosystem for delivering health care. New measures of success are also emerging as the sector begins to focus on improving a patient's "health outcome," and not just on units of a product sold. Our Global Life Sciences Center brings together a worldwide network of more than 7,000 sector-focused assurance, tax, transaction and advisory professionals to anticipate trends, identify implications and develop points of view on how to respond to the critical sector issues. We can help you navigate your way forward and achieve success in the new health ecosystem. For more information, please visit: www.ey.com/lifesciences or email: global.lifesciences@ey.com.

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