

# Cash on prescription

Pharmaceutical companies and working capital management 2015

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow triangle is positioned above the 'Y', pointing downwards towards the letters.

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# Summary

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

The pharmaceutical industry has continued to evolve rapidly – with pharmaceutical companies striving to bring new products to market, reshaping their portfolios of businesses and optimizing their cost base, while growing earnings per share and improving cash returns to shareholders.

Against this challenging background, most pharmaceutical companies have intensified their efforts on working capital (WC). The results from our analysis of big pharma companies in 2014 show an acceleration in the pace of improvement in WC performance from 2013. Their cash-to-cash (C2C) fell by 5%, after dropping by 2% the year before. The impact of the initiatives implemented in the past two years helped more than reverse the deterioration in WC performance seen during the previous five years (2007-12).

Yet, at the same time, progress in WC remained far from uniform, with some businesses continuing to improve their performance and others failing to do so.

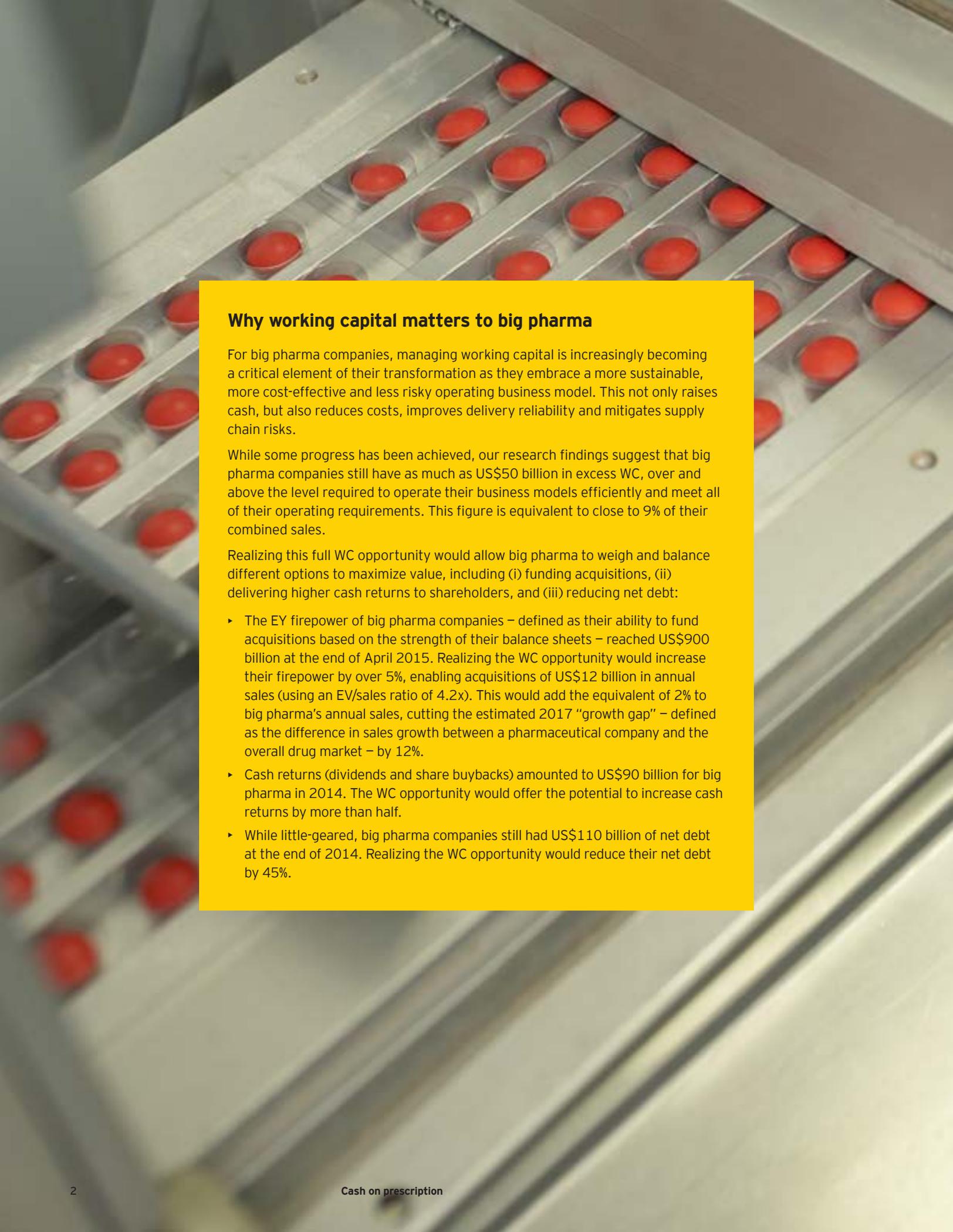
The wide variations in WC performance between pharmaceutical companies point to significant potential for improvement. While these performance gaps may partly result from varying business models, they also highlight fundamental differences in the intensity of management focus on cash and the effectiveness of WC management processes.

To capitalize on this opportunity, pharmaceutical companies will need to embrace more substantial and sustainable changes in

the way they do business and manage their WC. Businesses must become even more responsive and resilient, while delivering continuous process improvements and cost reductions. To achieve this, companies will need:

- ▶ A strategic focus on WC throughout the year, with the whole business engaged and incentivized to drive improvement
- ▶ Increased responsiveness to change, through lean and agile manufacturing and supply chain solutions deployed for different products or market segments as well as cross-functional cooperation and effective collaboration with wholesalers and other pharmaceutical buyers
- ▶ Supply chains that are resilient, through robust risk management policies, alternative sourcing and enhanced visibility across the end-to-end supply chain
- ▶ Strong discipline in terms and transactions, internal controls over cash and WC, and appropriate performance measures in place
- ▶ Clear understanding and effective management of the complex and evolving trade-offs between cash, costs, delivery levels and the risks that each company must take

In the short term, our expectation is that WC results are likely to show even wider divergence between individual companies, reflecting each one's ability to plan and execute responses to a rapidly evolving marketplace.



## Why working capital matters to big pharma

For big pharma companies, managing working capital is increasingly becoming a critical element of their transformation as they embrace a more sustainable, more cost-effective and less risky operating business model. This not only raises cash, but also reduces costs, improves delivery reliability and mitigates supply chain risks.

While some progress has been achieved, our research findings suggest that big pharma companies still have as much as US\$50 billion in excess WC, over and above the level required to operate their business models efficiently and meet all of their operating requirements. This figure is equivalent to close to 9% of their combined sales.

Realizing this full WC opportunity would allow big pharma to weigh and balance different options to maximize value, including (i) funding acquisitions, (ii) delivering higher cash returns to shareholders, and (iii) reducing net debt:

- ▶ The EY firepower of big pharma companies – defined as their ability to fund acquisitions based on the strength of their balance sheets – reached US\$900 billion at the end of April 2015. Realizing the WC opportunity would increase their firepower by over 5%, enabling acquisitions of US\$12 billion in annual sales (using an EV/sales ratio of 4.2x). This would add the equivalent of 2% to big pharma's annual sales, cutting the estimated 2017 "growth gap" – defined as the difference in sales growth between a pharmaceutical company and the overall drug market – by 12%.
- ▶ Cash returns (dividends and share buybacks) amounted to US\$90 billion for big pharma in 2014. The WC opportunity would offer the potential to increase cash returns by more than half.
- ▶ While little-gearred, big pharma companies still had US\$110 billion of net debt at the end of 2014. Realizing the WC opportunity would reduce their net debt by 45%.

# Background

Compared with 2013, the global pharmaceutical market experienced solid growth of close to 7% in 2014, its highest rate since 2004.

The US market – representing more than one-third of the total – was the primary driver, with an increase of 13% (equivalent to an extra US\$70 billion in spending). This accelerated growth was due in part to the reduced impact of generic-drug incursion and the launch of new products. The number of new drugs approved by the Food and Drug Administration surged to 41 last year, its highest number since 1996 and well above the annual average of 26 seen in the past decade. In addition, prices for branded products rose as much as 13% on an invoice basis last year, reduced to a 5%-7% increase when taking into account off-invoice discounts and rebates.

In contrast, the major markets in Europe continued to see limited growth, affected by the impact of patent expiry and competition from generic drugs, as well as increasing pressure to contain health care spending, especially on medicines.

Rapid-growth markets and Asia-Pacific continued to perform strongly.

Against this background, big pharma's sales in 2014 remained almost unchanged from 2013, adversely affected by the continued sales erosion of products coming off patent and pressures on pricing, as well as by movements in exchange rates.

A number of trends also continue to affect pharmaceutical businesses. These include:

- ▶ industry cost pressures;
- ▶ increasing product development specialization, driving manufacturing into smaller and more frequent batch production;
- ▶ ongoing consolidation of suppliers, manufacturers and buyers;
- ▶ rising outsourcing;
- ▶ new alliances and collaborations;
- ▶ expansion into new markets and distribution channels;
- ▶ changing regulatory requirements; more complex demands on logistics; and
- ▶ the need to maintain product integrity and security.

# Accelerated improvement in WC performance in 2014 for big pharma

The results from our analysis of big pharma in 2014 show an acceleration in the pace of improvement in WC performance from 2013. Big pharma's C2C fell by 5%, after dropping by 2% the year before.

## Change in WC metrics across the industry, 2013-14

Big pharma	2014	Change 2014/2013
DSO	64.3	-2%
DIO	51.3	3%
DPO	34.1	14%
<b>C2C</b>	<b>81.5</b>	<b>-5%</b>

## Number of companies and % change in WC metrics, 2014 vs. 2013

		DSO	DIO	DPO	C2C
Reduction	> 5%	7	4	1	<b>8</b>
	0%-5%	1	3	0	<b>3</b>
Increase	> 5%	4	4	14	<b>4</b>
	0%-5%	4	5	1	<b>1</b>

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.

This stronger WC performance overall in 2014 was driven primarily by further progress in the management of payables, with DPO rising 14%. Performance in receivables was also better (DSO down 2%). In contrast, there was a further deterioration in inventory performance, with DIO up 3%. Eleven out of 16 companies reported a lower C2C in 2014 than in 2013, with eight of them showing a decrease of more than 5%.

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

- ▶ **Intensification of WC efforts:** Big pharma companies have intensified their efforts on WC in the past two years, with the impact of the initiatives implemented having helped more than reverse the deterioration in WC performance seen during the previous five years (2007-12). These initiatives focused on reconfiguring manufacturing and supply chains to make them leaner, collaborating more closely with wholesalers, improving demand forecasting accuracy, managing payment terms for customers and suppliers more effectively, improving billing and cash collections, consolidating procurement and developing e-sourcing, managing outsourcing arrangements more effectively, creating a more unified shared-services organization, standardizing packaging and simplifying structures.
- ▶ **Transformation of business portfolios:** The pharmaceutical industry saw a flurry of deal-making activity in 2014, as large companies sought to reshape their portfolios of businesses, with a common goal to strengthen future growth prospects while delivering greater value to shareholders. This transformation has had an impact on last year's overall C2C – and for some individual companies especially – as involved businesses display different WC requirements (for example, generics, vaccines and animal health care typically carry much higher levels of WC than consumer health care).
- ▶ **Exchange rate movements:** Movements in US dollar exchange rates also played some part in driving the industry's WC performance in 2014. For companies reporting in US dollars, the reported reduction in their C2C (down 13% year-on-year) was exacerbated by the impact of the strength of the US dollar against all major currencies at the end of the year compared with its average levels during the year. In contrast, for those reporting

in euros and in Swiss francs, the strength of those currencies against the US dollar was a negative contributory factor (their C2C was up 7%).

- ▶ **Accelerated progress in payables performance:** The pharmaceutical industry exhibited a further substantial improvement in payables performance in 2014, with DPO increasing by 14%, following a rise of 7% the year before. Every big pharma company but one posted a stronger performance, including 13 that showed an increase of more than 5%. This improvement was driven primarily by a further extension in payment terms, as well as by greater efficiency in procurement and payables processes.
- ▶ **Better receivables performance:** For the third year in a row, the pharmaceutical industry reported better receivables performance in 2014, with DSO falling by 2%. This was due primarily to further strong progress in the collection of receivables, notably in southern European countries. However, only half of the companies analyzed showed lower DSO. The overall progress in receivables performance was achieved against a background of contrasting trends in payment terms with wholesalers. In the US, each one of the three main wholesalers reported a higher DPO (based on cost of sales, or COS) in 2014 compared with 2013, which appears to reflect the impact of acquisitions and increased purchases of generic pharmaceuticals – which have longer payment terms than brand-name pharmaceuticals – rather than the benefit of paying late or negotiating longer terms. In contrast, our analysis shows diverging trends in DPO among European wholesalers, suggesting that they chose either to ease or to increase payment pressure during 2014.
- ▶ **Further deterioration in inventory performance:** In contrast with payables and receivables, 2014 saw a further deterioration in inventory performance compared with 2013, with DIO up 3%. Nine big pharma companies out of 16 reported a higher DIO (including four of them that saw an increase of more than 5%). Using COS rather than sales would have shown a similar result. Again this deterioration in performance was primarily caused by changes in the product sales and inventory mix following the loss of exclusivity for a number of blockbusters, as well as by the need for higher safety stocks to serve rapid-growth markets. The overall poorer performance in inventory was partly offset by additional improvements in manufacturing and supply chain operations.



# Current WC performance of big pharma stronger than in 2007

Thanks to the progress made in both 2013 and 2014 years, big pharma managed to regain more than the ground lost in WC performance during the previous five years (2007-12). Big pharma C2C was 3% lower in 2014 than in 2007.

## Change in WC metrics across big pharma, 2007-14

Big pharma	Change 2014/2007	Change 2014/2012	Change 2012/2007
DSO	1%	-4%	5%
DIO	13%	6%	7%
DPO	38%	23%	13%
<b>C2C</b>	<b>-3%</b>	<b>-7%</b>	<b>4%</b>

## Number of companies and % change in WC metrics, 2014 vs. 2007

		DSO	DIO	DPO	C2C
Reduction	> 5%	6	3	1	<b>6</b>
	0%-5%	2	1	0	<b>3</b>
Increase	> 5%	5	8	13	<b>1</b>
	0%-5%	1	2	0	<b>4</b>

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

Big pharma reported an increase of 4% in C2C between 2007 and 2012 (from 84.4 days to 87.7 days), and then a drop of 7% between 2012 and 2014 (to 81.9 days). It should be noted that the start date of 2007 for the period under analysis has been selected to allow more meaningful comparisons of long-term performance, given the subsequent impact of the global financial crisis of 2008-09 on the industry's volume growth, pricing, reimbursement and payment schemes.

Overall this improvement in WC performance since 2007 resulted from much higher DPO (up 38%), partly offset by a combination of higher DIO and DSO (up 13% and 1%, respectively). Nine out of 14 companies reported a lower C2C in 2014 than in 2007, with six of them showing a decrease of more than 5%.

- ▶ **Shifting business models:** The ongoing transformation of the industry's business models has been a significant factor influencing C2C over time. Some companies chose to pursue mergers as a means of enhancing revenue, while generating significant cost reductions, lowering tax rates and reducing R&D risk. Others opted for a more diversified and less-risky sales growth strategy through bolt-on acquisitions, coupled with aggressive expansion in rapid-growth markets. A third strategy has been to focus on fewer therapeutic areas, through asset swaps and small-scale acquisitions, partnerships and licensing deals. Pharmaceutical companies have also moved from managing for revenues to managing for return on a more sustainable and less-risky basis.
- ▶ **Changing trade-offs between cash, costs, delivery levels and risks:** Changes in WC performance across the industry over time also reflect the complex and evolving trade-offs among cash, costs, delivery levels and risks that each company must make and manage to drive business growth, improve the bottom line and strengthen the balance sheet. Other associated features include the need for quality assurance at several points of the supply chain and timely delivery of products to avoid the risk of disrupting patients' lives. For example, some companies may choose to trade off customer payment terms for sales price rebates, supplier payment terms for early payment, or inventory levels for consignment stock arrangements or customer service levels. In addition, as carrying WC became much less costly

## Case studies

**Global WC reduction program:** EY was chosen by a large pharmaceutical company to develop a global WC reduction program. This program involved: defining roles and responsibilities for WC across all relevant functions; validating reporting processes with relevant stakeholders and supporting WC decision-making; reviewing the existing WC process and identifying areas for improvement; developing detailed action plans to implement leading practices and measure progress through the design of appropriate KPIs; and putting in place the right incentives to motivate and change internal behaviors.

**“Purchase-to-pay” process improvement:** EY was also engaged to improve the management of this pharmaceutical client’s “purchase-to-pay” processes. The program involved: segmenting the supplier base according to payment terms, trigger and frequency; renegotiating and harmonizing the payment practices for each segment, while ensuring compliance; eradicating the root causes of invoice processing delays; and introducing reports and metrics to monitor and assess progress.

**Inventory management improvement:** A pharmaceutical company had pursued a number of initiatives to improve its inventory management over a three-year period, but felt its performance could still be improved. An EY project team was engaged to review the existing processes and design an action plan to reduce inventory levels. Inventory levels were calculated to reflect the characteristics of each stock-keeping unit (SKU), including supply lead times, forecast accuracy, order-fill rate goals and minimum ordering quantities. Forecast accuracy was improved via the planning process, while lead times were reduced for key products. This program led to an overall reduction in inventory levels and write-offs, although some SKUs reported higher inventory levels to support improving service levels.

during the year following the decrease in the cost of capital, others may have chosen to trade off WC improvements against sales growth, margin expansion or increased provision of financing solutions to their suppliers and customers.

- ▶ **Much stronger payables performance:** Payables performance has improved significantly since 2007, owing to better management of the procurement and payables process, including managing terms more effectively (notably via extended payment terms). 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 also played a role. Every company but one managed to improve its payables performance since 2007.
- ▶ **Weak receivables performance:** The last two years saw an improvement in receivables performance among big pharma companies (their DSO was down 4% between 2012 and 2014), partly reflecting further progress in recovering trade receivables in a number of southern European countries. But these results were still not sufficient to reverse the deterioration seen in the previous five years (DSO up 5% between 2007 and 2012). Performance continues to be adversely affected by changes in distribution and payment policies 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 longer and overdue payments higher than in the US. Measures to contain health costs in many developed countries have also contributed to this deterioration. However, the number of companies reporting better receivables performance between 2007 and 2014 now exceeds those showing a deterioration.

- ▶ **Continuing deterioration in inventory performance:** For many pharmaceutical companies, the benefits of becoming much leaner and more agile have been more than mitigated by a number of negative factors. These include changes in the mix of product sales and inventory (following the loss of exclusivity for a number of blockbusters), higher safety stocks to serve rapid-growth markets, and moves to fee-for-service and direct-to-pharmacy schemes. Most of the gains from increased collaboration between manufacturers and wholesalers also appear to have been captured in the early part of the period under review. And many customers have adopted an approach to inventory management similar to that taken by manufacturers, dealing with fewer suppliers and expanding the use of just-in-time methods and vendor-managed inventory initiatives. Overall, 10 companies reported a higher DIO in 2014 than in 2009.

# Wide variations in current WC performance among big pharma

Current WC performance among big pharma continues to vary widely overall and for each metric, with 2014 showing a large increase in the spread in C2C (and for each WC metric) compared with 2013.

In 2014, the median level of C2C for big pharma was 80 days, with a spread of 19 days using standard deviation as a measure. More specifically, the median levels for DSO, DIO and DPO were 64 days, 48 days and 31 days, respectively, with spreads of 11 days, 14 days and 14 days, respectively.

For big pharma, the spread in C2C in 2014 was much larger than the level reported in 2013, or in 2007 (when it was 16 days and 18 days, respectively), suggesting that some companies have continued to do well, but others are failing to do so.

However, a degree of caution should be exercised when reviewing individual WC performances, due to continuing differences in financial reporting and disclosures.

There are also a number of drivers that need to be considered when comparing current WC performance, including payment practices, levels of outsourcing, alliances and collaboration arrangements, inventory acquisition strategies and exposure to generics.

## WC performance distribution among big pharma, 2014

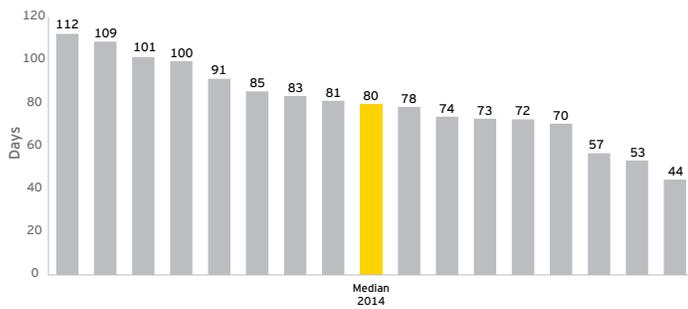
C2C	Median	Top quartile	Bottom quartile	Standard deviation
DSO	63.6	57	69	11
DIO	48.2	41	59	14
DPO	31.4	46	22	14
<b>C2C</b>	<b>79.6</b>	<b>72</b>	<b>93</b>	<b>19</b>

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

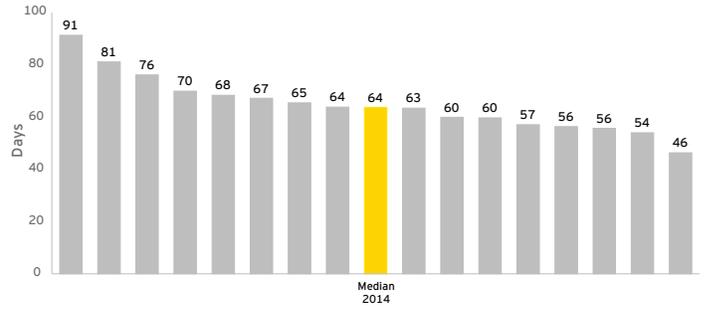


## WC performance per big pharma company, 2014

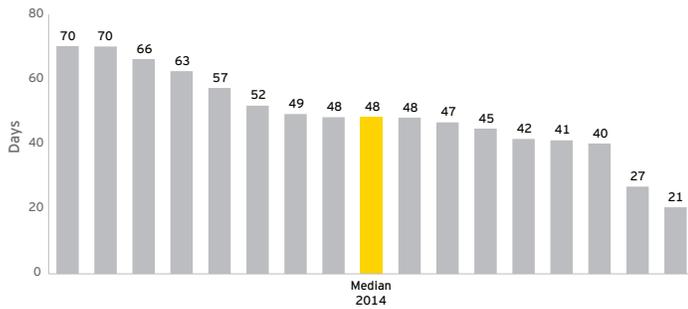
C2C (based on sales)



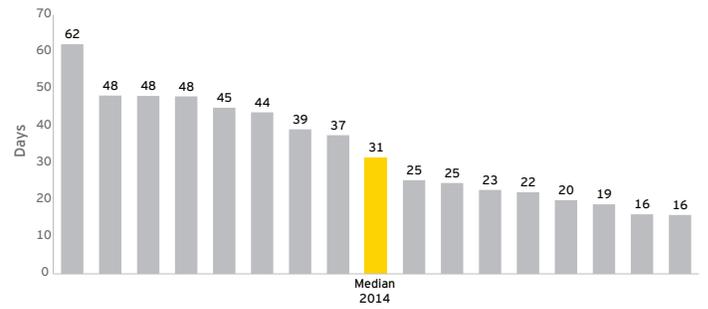
DSO (based on sales)



DIO (based on sales)



DPO (based on sales)



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



# Opportunities going forward

The wide variations in WC performance between pharmaceutical companies revealed by our research point to significant potential for improvement, amounting to an aggregate of US\$50 billion for big pharma.

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

On this basis, big pharma companies have between US\$25 billion and US\$50 billion of cash unnecessarily tied up in WC processes,

equivalent to between 4.5% and 8.9% of their aggregate sales. Note that the top range of cash opportunity identified in 2014 is much higher than a year before, when it was between 3.6% and 6.7%.

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.

## WC cash opportunity for big pharma, 2014

	Cash opportunity					
	Value (US\$b)		% WC scope*		% sales	
	Average	Upper quartile	Average	Upper quartile	Average	Upper quartile
Receivables	5	11	6%	12%	1.0%	2.0%
Inventories	11	18	14%	23%	1.9%	3.2%
Payables	9	20	17%	39%	1.6%	3.7%
<b>Total</b>	<b>25</b>	<b>50</b>	<b>11%</b>	<b>22%</b>	<b>4.5%</b>	<b>8.9%</b>

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

\*WC scope is defined as sum of trade receivables, inventories and accounts payable.

Numbers may appear inconsistent due to rounding.



# Driving working capital excellence

Pharmaceutical companies have made some strides in increasing WC efficiencies, albeit with large differences in the degree and speed with which each of them has delivered these efficiencies. Their most significant initiatives have been:

- ▶ Further streamlining of manufacturing and supply chains to drive greater efficiencies and build higher responsiveness into systems and processes
- ▶ Collaborating more closely with wholesalers and other pharmaceutical buyers
- ▶ Improving demand forecasting accuracy through better modeling, collaborative forecasting and scenario planning
- ▶ Optimizing supply chain planning through improved data management and more integrated planning processes
- ▶ Accelerating billing cycles and improving cash collections, including ensuring adherence to contractual terms and billing trigger points
- ▶ Monitoring rebates and discounts, notably in the US
- ▶ Managing payment terms for customers and suppliers more effectively, through renegotiating terms and other steps
- ▶ Managing outsourcing arrangements more effectively, with contracts more carefully configured and managed
- ▶ Intensifying spend consolidation and standardization by increasing global sourcing, while rationalizing the supplier base
- ▶ Implementing a larger, more unified shared-services organization
- ▶ Reducing the “excessive” number of different packages, which require frequent and costly manufacturing changes
- ▶ Driving WC synergies to deliver higher value from acquisitions, through improved processes and more widely sharing WC leading practices across the extended organization
- ▶ Implementing more robust supply chain risk management policies
- ▶ Tracking and monitoring WC metrics and linking compensation to these metrics



# How EY can help

EY's global network of dedicated working capital professionals helps clients to identify, evaluate and prioritize actionable improvements to liberate significant cash from WC, through sustainable changes to commercial and operational policies, processes, 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 create the frameworks to sustain those improvements.

WC improvement initiatives are also typically earnings-accretive. In addition to increased levels of cash, significant economic benefits may arise from productivity improvements, reduced transactional and operational costs, and lower levels of bad and doubtful debts and inventory obsolescence. Wherever you do business, our WC professionals are there to help.

## Methodology

This report is based on a review of the WC performance of big pharma, which is composed of the 16 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 as follows: Abbott Laboratories, AbbVie, Allergan (new name for Actavis), 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 performances of individual pharmaceutical companies are not disclosed.

## Glossary

- ▶ **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 accrued expenses for goods and services received but not invoiced, 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)
- ▶ **Pro forma sales:** reported sales net of VAT and adjusted for acquisitions and disposals when this information is available

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