Pricing Tug of War Heats Up Between Drug Makers and Payers

Pricing power in the United States has been a reliable driver of growth for biotechnology and pharmaceutical companies, especially with the above-average increases seen over the last several years. Diminution of this pricing power is a key risk to the multi-year biopharmaceutical bull market. Recent news around pricing of hepatitis C drugs has caused volatility in the shares of participating drug companies and highlights the market sensitivity to this issue. Although the market has been surprised, we argue that these pricing pressures are not new and are merely a continuation of efforts over the past several years to manage drug costs. Pricing power may be past its peak for biopharmaceutical companies, but we believe the overall industry will remain relatively resilient with treatments for some markets more protected from pricing pressures than others.

Pricing Pressure Is Not New

Health care costs in the U.S. have been growing in excess of the rate of inflation and the growth of the overall economy – a trend that is clearly unsustainable. For many years, expenditures on medications contributed to that faster than average expansion. The pace of drug spending moderated from 2008 through 2013, however, as many popular medications lost patent protection and were replaced by generic drugs at a fraction of the cost. Over the same period, the rate of spending on high-priced medications for less common conditions, termed “specialty” drugs, accelerated. As the conversion to generics slowed, the rise in drug spending re-accelerated, largely due to specialty drugs. Drug formularies, using copayments to encourage use of less expensive drugs, have been around for many years. Anticipating the inflection point in drug spending, pharmacy benefit managers (PBMs), who process prescriptions and negotiate drug prices and distribution with biopharmaceutical companies, have more aggressively used formularies to control costs. In 2013, CVS Caremark was the first to explicitly exclude certain drugs from its formulary. The following year, Express Scripts established exclusive formularies in a number of large drug categories, including diabetes and respiratory, and demonstrated they could move meaningful market share in exchange for more favorable prices from drug manufacturers. Pricing pressure mounted the following year with Sanofi disclosing in October a significant increase in rebates to secure formulary position for its diabetes drug Lantus. The announcement drove a 9% single-day decline in Sanofi shares.

In the months before approvals of the hepatitis C drugs from Gilead and AbbVie, Express Scripts talked openly about targeting this class of drugs. Upon approval of AbbVie’s drug in December,
Express Scripts announced its National Preferred Formulary would only cover AbbVie’s drug and not Gilead’s, which drove a 14% single-day decline in Gilead’s stock price, but was entirely consistent with previous comments from Express Scripts. Subsequent deals between Gilead and other PBMs for exclusive positions provided Gilead’s drug with formulary access but at a greater-than-expected pricing discount. In January, Gilead disclosed that the average U.S. discount on its hepatitis C drugs in 2015 is expected to be 46%, which contributed to another 8% decline in its shares the next day.

**Hepatitis C Is a Unique Situation**

The hepatitis C market has unique characteristics that make it more susceptible to price pressures and exclusive formularies. For example, hepatitis C drug treatment is curative with two to three months of therapy (vs. chronic conditions), so it is easy to move market share very quickly. In addition, there is limited medical rationale for preferring one product over another, as the competitors provide similar cure rates and the primary differentiation is convenience.

**What Other Drug Categories Are at Risk?**

PBMs have already made their mark on the diabetes, respiratory, and hepatitis C market, and we expect them to continue to exert their power and expand their reach to other therapeutic areas. In hepatitis C, the expected entry of a product from Merck in 2016 is likely to renew pricing concerns.

There are a number of factors that contribute to pricing pressure susceptibility including:

- The number of competitors
- Degree of clinical differentiation
- Coverage under drug or medical benefit
- Complexity of the treatment paradigm
- Chronic or episodic treatment
- New or established market

The expected launches of biosimilars – drugs that are copies of large molecule compounds produced by biological organisms as opposed to copies of small molecule compounds produced through chemical processes and commonly marketed as generics – over the next several years will provide payers with another mechanism for managing drug costs. Based on these factors, markets that may be targeted include rheumatoid arthritis, psoriasis, multiple sclerosis, cholesterol, blood thinners, and macular degeneration. Express Scripts and CVS Caremark have talked about targeting new cholesterol drugs ahead of expected approvals and launches by Amgen and Regeneron/Sanofi in mid-2015. Each of these classes, however, has unique characteristics that we believe will make them more resilient than markets like respiratory and diabetes.

Finally, we believe that the orphan disease and oncology markets will remain most insulated from pricing pressure due to limited or no direct competitors in most markets, coverage under medical benefit for many products, and complex cancer treatment algorithms.

**Implications for Investing in Health Care**

Overall, the biopharmaceutical industry is likely to be past the peak of its ability to raise prices in the U.S. That said, significant power remains, and we expect some pharmaceutical companies to continue to benefit from price increases. We evaluate the specific drug markets in which companies compete, and our portfolios emphasize those companies with above-average pricing power. More importantly, we target investment in innovative companies that bring new products to market and create shareholder value independent of price pressures.

While companies that sell drugs face challenges to sales and profits, those who purchase pharmaceuticals should benefit from price reductions. The health insurers benefit directly from paying less for drugs used by their insured populations. PBMs also stand to benefit by controlling drug prices, although it remains to be seen how much of the benefit they will capture rather than pass on to their clients. We recommend exposure to both insurers and PBMs.
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