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# ESG in Pharma: Has the ‘S’ Reached a Turning Point?

INSIGHTS

Increased regulation and heightened competition are transforming the pharma industry’s behavior when it comes to the pricing and availability of medicine.



**Alexandra Hillier**

Head of Global Health Care  
Research—Equities

Like all industries, the pharmaceutical industry faces both challenges and opportunities across the full spectrum of environmental, social and governance (ESG) considerations. On the environmental side, challenges typically relate to the supply chain, transport logistics and the disposal of pharmaceutical products and propellants. While many companies are making strides, challenges remain, even if the industry scores well when it comes to water and energy usage. Governance challenges also exist, connected with factors ranging from the heavy regulation of disease-treating therapeutics, to product quality and safety. But again, progress is being made.

Social issues continue to be an area rife with controversy. Most recently, this has stemmed from the pricing and availability of Covid vaccines, with pharma being painted as both a savior and a villain. However, what some investors may not realize is that following years of societal pressures and government regulations, the 'S' may also be the area where pharma companies have the greatest potential for progress and meaningful change. There will certainly be winners and losers as part of this transition, with ESG-forward companies focused on R&D and innovation likely to come out on top.

## Regulation, Competition Driving Global Change

The access to a medicine, and the affordability of it, are two key factors likely to impact a pharma company's financial performance. The attention paid to companies' practices in these areas not only reflects the increasing pressure on pricing across the industry, but also the continued importance of access to innovation and new technologies when it comes to the health and well-being of our global population. Around the world, this pressure has come predominantly from targeted regulation and heightened competition.

### U.S. HEALTH CARE REFORM

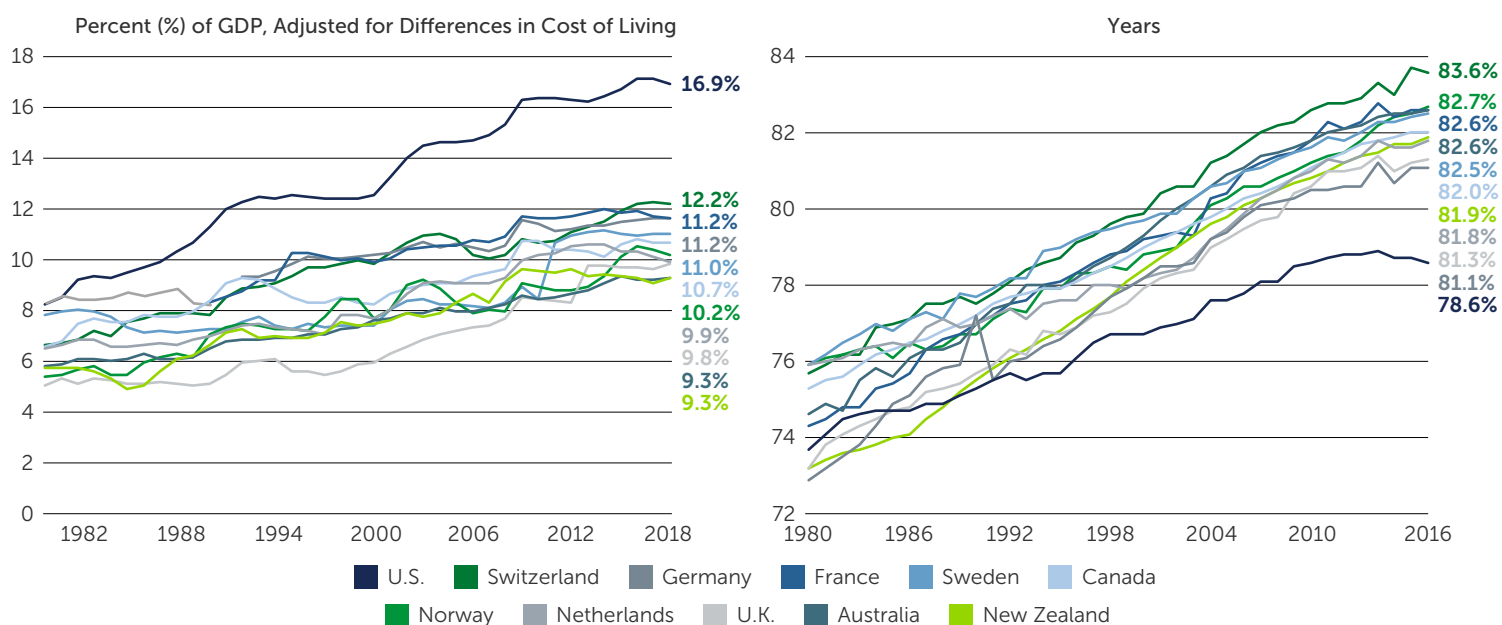
The U.S. pharmaceutical market is by far the largest, accounting for 46% of global sales in 2020.<sup>1</sup> One of the key reasons for this is drug pricing. According to a 2021 report from RAND Corporation, prescription drug prices in the U.S. are more than 250% higher than those in the 32 Organization for Economic Cooperation and Development (OECD) countries. The gap is even more pronounced for brand name drugs (as opposed to generic drugs), with U.S. prices nearly 3.5x higher than in other countries.<sup>2</sup>

1. Source: Statista. As of December 2020.

2. Source: Rand Corporation. As of January 2021.

High U.S. drug prices have dominated headlines off and on for years, a subject of near-constant political and media focus. In fact, the U.S. government spent more on health care in 2020 than any other country—nearly 17% of GDP. However, circling back to one of the social components of pharma, the country’s life expectancy is below that of the OECD average (Figure 1).

**Figure 1: Health Care Spending as a % of GDP vs. Life Expectancy**



Sources: The Commonwealth Fund. Health care spending data as of December 2018. Life expectancy data as of December 2017.

The reforms proposed as part of President Biden’s tax and spending bill target the country’s high prices specifically, and would arguably represent the biggest change to U.S. drug pricing policy since the Medicare Modernization Act in 2003. Specifically, the measures would allow Medicare to negotiate certain drug prices directly with pharma companies, which is currently prohibited and could ultimately make medications more affordable. While this is a very significant step, it is a far scaled-back version of the more sweeping measures that have been proposed in recent years. And, importantly, free pricing for genuine innovation would still be available.

**BIOSIMILAR DRUGS: UPPING THE COMPETITION, LOWERING THE COSTS**

Outside of legislation, the U.S. pharma industry is also facing significant pricing pressure as generic competition to biologic drugs—which have significantly higher R&D costs and can be more complex to manufacture—escalates. In recent years, one of the ways the FDA has tried to lower drug costs is by facilitating the development of a well-functioning generic market for so-called biosimilar drugs, which are similar, but not identical, to the original biologic drugs. In theory, this should help lower the price consumers have to pay for medications that have lost patent protection.

Up until now, the U.S. biosimilar market has been dwarfed by the European market, slowed down by legal, regulatory and commercial hurdles—but that may be about to change. In the U.S., an estimated \$72 billion of biologic sales will come under pressure from biosimilar drugs between now and 2030, with pricing pressure likely remain high going forward.<sup>3</sup> We are also seeing this in real-time with medications like Humira, which treats inflammatory diseases like arthritis and is one of the world’s best-selling drugs, with roughly \$16 billion in sales in 2020. Humira is currently facing competition from biosimilar versions expected to hit the market as soon as 2023, which could pose potential challenges for manufacturing company AbbVie.

### CHINESE REGULATIONS PUSHING FURTHER COST-CUTTING

Elsewhere, the Chinese market has become increasingly important in recent years. It is now the second-largest pharma market behind the U.S., with a projected value of \$300 billion by 2025.<sup>4</sup> With this growth, the country has developed into a lucrative market for medications developed by well-established foreign companies. For example, 21% of AstraZeneca’s sales in the first half of 2021 came from China, with the company’s Chinese sales base growing 11% during the period. While patented drugs are seeing the fastest growth, they make up less than 30% of the market, which remains dominated by generics.<sup>5</sup>

Similar to the U.S., there is increasing pressure on the Chinese government to both widen access and keep health care costs under control, while at the same time encouraging innovation. Given the extent of regulatory power in China, significant progress has been made already. For example, the monthly cost of a typical PD-1 antibody treatment such as Keytruda or Optivo is above \$10,000 in the U.S.<sup>6</sup> China’s domestic PD-1 drugs now

cost below RMB5,000 (less than \$800), which is roughly 80% less than they cost two years ago.<sup>7</sup> The overhaul to China’s health care system has been largely driven by the country’s National Healthcare Security Administration (NHSA). The government agency is utilizing two principal tools to lower drug pricing, which have significant implications not only for Chinese companies, but also for international companies looking to tap into the country’s enormous market:

- **National Drug Reimbursement List (NDRL):** The NDRL accepts innovative medications designed to treat diseases ranging from cancer, to cardiovascular disease, to diabetes. In exchange for manufacturers agreeing to steeply cut their prices—typically by 50% to 60%—the list offers faster hospital penetration and a significant volume uplift as more consumers are able to afford the medication. It’s a tradeoff that companies have largely been willing to accept, with many innovative drugs competing to be included in the list. Since 2017, the NHSA has included 272 new drugs.<sup>8</sup>
- **Volume-Based Procurement (VBP):** VBP is the program under which the Chinese government buys drugs and medical equipment in bulk with the aim of reducing generic drug prices and consolidating the fragmented market for procuring generic drugs. Since its launch in 2018, there have been five rounds of drug-buying in total, with 67 billion yuan (roughly \$10 billion) taken out of 218 drugs in the first five rounds.<sup>9</sup> As 70% of the country’s drug market by value is still in generics, virtually all companies will be impacted by this program to some extent. As an example, with insulin treatments for diabetes expected to be included in VBP this year, Danish company Novo Nordisk, which has about one-third of the market share for diabetes products in China, said it anticipates a negative impact of roughly 3% on its annual global sales growth.

3. Source: Alliance Bernstein. As of May 6, 2021.

4. Source: GlobalData. As of December 2021.

5. Source: Clarivate. As of November 2020.

6. Source: KEYTRUDA. As of March 2022.

7. Source: Eversana. As of March 3, 2021.

8. Source: PharmExec.com. As of January 4, 2022.

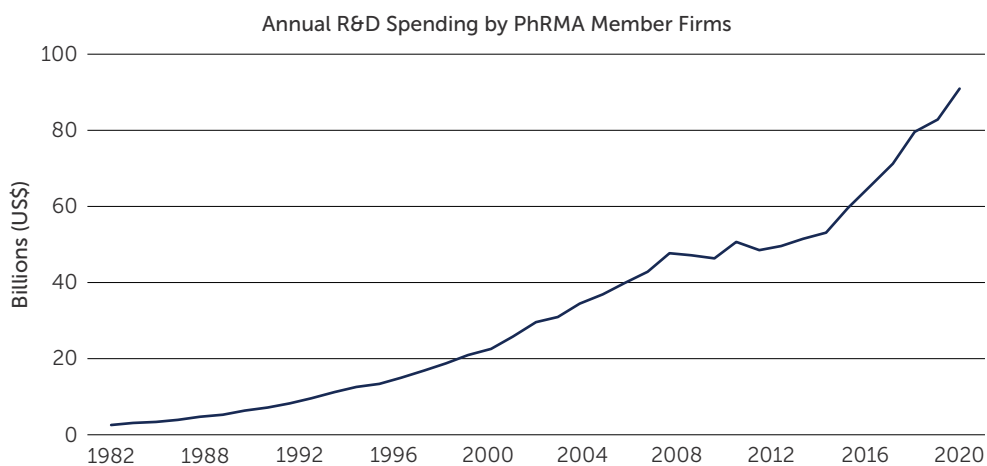
9. Source: EVERIANA. As of June 23, 2021.

## The Opportunity

These broad initiatives around cutting drug pricing and improving access to medicine—inherent in the social aspect of ESG—are informing and transforming the pharma industry’s behavior. While this transition is likely to create challenges for some pharma businesses, there are a number of companies that are proactively making changes to adapt, and often improving their ESG profiles in the process. Innovation, in particular, has become increasingly important as a result of these trends. As a result, companies that are making genuine scientific and commercial breakthroughs in disease areas where there is a high unmet medical need, such as Alzheimer’s, obesity and oncology, look well-positioned to benefit from the changes across the industry. Novo Nordisk, Roche, Eli Lilly and AstraZeneca are examples of companies developing drugs in these areas, and we believe their front-footed approach in the shift toward fairer pricing and access to medicine will set the stage for strong performance going forward.

There is also an accelerating trend for larger pharmaceutical companies to buy smaller biotechnology companies, particularly those operating in more niche or specialist areas, to help bolster their portfolios of medications and support innovation efforts. Tied to this, R&D spending in pharma has increased notably relative to other industries, exceeding \$91 billion at the end of 2020 (Figure 2).<sup>10</sup> In pursuit of more cost-effective production, many companies have begun to outsource drug manufacturing, which has in turn also benefitted sub sectors like life sciences and tools & contract manufacturing. Companies like Lonza Group and Merck KGaA, which partner with pharmaceutical companies to manufacture drugs or provide components for the R&D process, look well-positioned to benefit as a result.

**Figure 2: Pharma R&D Spending is on the Rise**



Sources: 2021 PhRMA Annual Membership survey. As of July 22, 2021.

10. R&D spending includes expenditures within the U.S. by all PhRMA member companies, expenditures outside of the U.S. by U.S.-owned PhRMA member companies, and expenditures by U.S. divisions of foreign-owned PhRMA member companies.



## Key Takeaway

At Barings, **ESG analysis plays an integral role** in our understanding of the potential risks and opportunities that a company faces. When it comes to the pharmaceutical industry, analyzing health care companies from a social perspective offers visibility into how their business model and financial performance may fare in the face of increased price-cutting measures and heightened competition from generic and biosimilar drugs.

Of course, environmental and governance factors are equally as important, and we also look for companies with good management and sustainable business practices. In particular, companies with detailed policies on business ethics and corruption—such as whistle-blower protection— and those that have strong diversity and inclusion policies and a focus on employee recruitment and retention look particularly attractive. We also look for companies that are taking steps to reduce their environmental footprint, such as by lowering their own carbon emissions. Ultimately, we believe the companies that are addressing and adapting to the growing regulation and competition across the industry, while making progress on the environmental and governance front, look best-positioned to deliver strong, long-term growth.

*“Analyzing health care companies from a social perspective offers visibility into how their business model and financial performance may fare in the face of increased price-cutting measures and heightened competition from generic and biosimilar drugs.”*

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