



Outsourcing Outlook

Jim Miller

What does 2002 hold for the contract services industry? 2001 was a robust year for most publicly traded CROs and contract manufacturers, with many companies able to turn losses into profits and show revenue increases of 20% or more compared with revenues in 2000. The 2001 POMA Sourcing Survey (see "Outsourcing Outlook," *Pharmaceutical Technology* 25 (11), 88–90 [2001]) indicated that contractors can anticipate another good year in 2002, although growth rates are not expected to be as strong. As we move into 2002, some trends that accelerated in 2001 are likely to reshape the outsourcing industry during 2002.

Growing importance of small pharma and biotech. Contractors are increasing the representation of small pharmaceutical and biopharmaceutical companies in their client mix. Although the 40 largest pharmaceutical companies account for two-thirds of industry R&D spending and produce most of the commercially approved products, most view outsourcing as only a tactic to overcome near-term capacity shortages. Big Pharma relationships can be volatile, low-margin, and subject to cancellation at a moment's notice.

In contrast, smaller companies offer opportunities for strategic relationships that are more stable because of their limited in-house capabilities. Their dependence creates opportunities for contractors to secure equity or royalty positions that can boost financial returns. Moreover, the maturing biotech pipeline and accelerating licensing activity are generating more opportunities in this segment. Successful contractors still need a core of Big Pharma business, but

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look for them to pursue smaller company business ever more aggressively.

Search for appropriate business models. Contractors also are tinkering with their business models to gain greater operating leverage and more-predictable revenues. Technology-intensive services experiencing strong demand (e.g., preclinical and bioanalytical testing, pharmaceutical chemistry, and informatics) are getting a lot of attention from the larger CROs. The substantial capital investment requirements for those services represent barriers to entry to smaller competitors. In contrast, traditional labor-intensive services such as clinical trials monitoring and data management are easily entered by low-cost competitors. Some of the big CROs also are using their financial strength to make direct investments in clients. The implication: Look for the major CROs to drop some service offerings while making significant investments in targeted strategic capabilities.

Consolidation of contract manufacturing. We've entered a second generation of contract manufacturing. Deep-pocketed and financially sophisticated global corporations have acquired many of the independent players, especially in biologics manufacturing and dose manufacturing.

This capital-intensive industry now offers sponsors a much greater level of financial stability than when it comprised small, independently owned companies. Also, sponsors now have the opportunity to partner with companies with which they are likely to have long-standing business relationships. Furthermore, more contract manufacturers now have the wherewithal to make capacity expansions and add new technologies to respond to the changing needs of the market.

As a contract manufacturer's business grows, its scope also expands. Many contractors are backward integrating into formulation and process development in hopes of capturing clients at an earlier de-

velopment stage. Some are looking to add value and differentiate themselves by offering unique or proprietary drug delivery technologies.

The bottom line: With greater financial strength and broader capabilities, contract manufacturers have become more attractive strategic partners for large and small sponsors. We expect to see Big Pharma giving contract manufacturers more serious consideration in the coming year.

DPT acquisition

DPT Laboratories Ltd.'s (San Antonio, TX) acquisition of the Lakewood, New Jersey, contract manufacturing and packaging operations of **West Pharmaceutical Services, Inc.** (Lionville, PA) is a win-win deal for both parties. The deal, which closed at the end of November, doubles DPT's semisolid and liquid dose manufacturing capacity, gives it a mid-Atlantic location near the headquarters of major sponsors, and makes it a player in the contract packaging business. The deal also seems to vindicate DPT's strategy of focusing on semisolid and liquid dose manufacturing, where it has been very successful despite considerable competition and surplus manufacturing capacity in the market.

The deal also provided West a graceful exit from the contract manufacturing business. The company seemed serious about pursuing a contract services strategy when it purchased the Lakewood facility in 1995 (when it was known as Paco Laboratories) and then bought a clinical research services business in 1998. In recent years, however, West's contract services businesses suffered operating losses resulting from revenue declines, and West management seemed more focused on building its drug delivery business. Despite a decent performance turnaround in 2001, the price of \$30 million in cash, notes, and assumed debt was less than half of revenues. **PT**