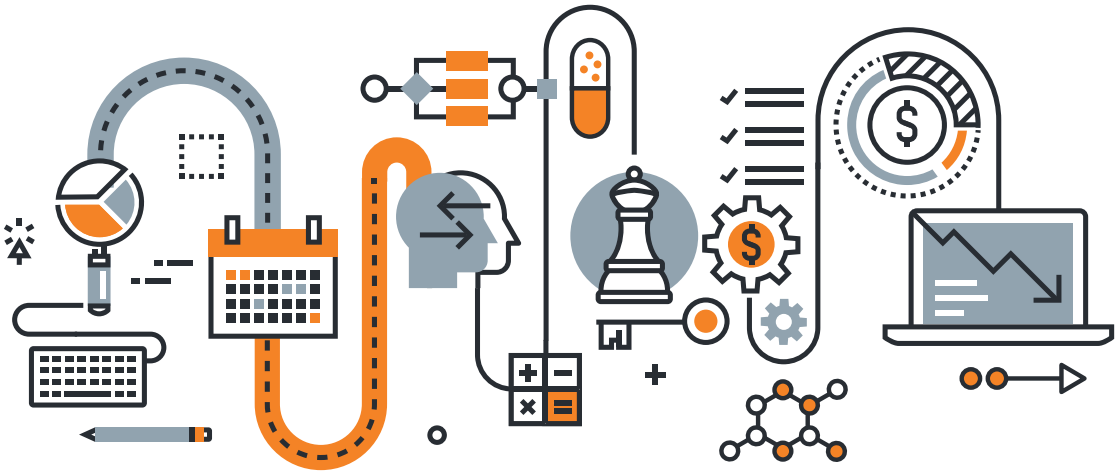
PERSPECTIVES ON PRODUCT PRICING STRATEGY AND PRACTICE



Drug pricing remains pharma's most contentious issue. Under tremendous pressure, the industry continues to evolve pricing strategy to satisfy intensive regulation, social/political scrutiny and competitive market forces – how other industries face the challenge of pricing may offer fresh insight to fuel an effective strategy. Getting pricing "right" is a tricky balancing act, but one that offers tremendous value for all.

→ BY **HAIG ARMAGHANIAN** AND **JOSH DUNN**, NICE CONSULTING

IN 2016, two drug-price-related "scandals" ignited near-universal criticism of the pharmaceutical industry, generating angry international headlines sustained by the intense scrutiny of social media. Regardless of the harsh rhetoric and political posturing, drug owners and developers are compelled to understand and consider an amazingly complex set of factors and influences to craft an effective, profitable pricing strategy in response – especially when attempting to introduce a new standard-of-care therapy that has no peer to help with its valuation.

To many consumers, advocacy groups and politicians, the pricing of drugs is seen as an arbitrary, exploitative process – the product of unbridled corporate greed and pursuit of profit above all else. Fortunately, for ethical companies the reality of pricing strategy is much, much different. The complexities associated with product pricing in the pharmaceutical sector continue to trouble the industry's leadership, who are increasingly being driven to justify and defend the valuation process to a broad range of special-interest stakeholders.

Effective pricing comes from discipline and process

It's nearly a given that the more sophisticated the product, the more sophisticated the organization behind it. This maxim applies to pricing strategy equally well, especially in the pharma sector. But no matter the industry, pricing strategy is a distinct discipline. Best practice for most sophisticated commercial and industrial players is to train professionals and staff internally and institutionalize a solid, viable pricing process that serves the commercial interests of the company best. Organizations like the Professional Pricing Society support the discipline, providing continuing education, information sharing and networking to help its members and member companies continuously improve their pricing models.

Pricing models vary, but there's no one-size-fits-all process. One fundamental tenet is that efficient pricing systems tend to be associated with low-margin industries. Retail gasoline pricing, for example, is highly efficient because it fluctuates constantly to balance micro and macro supply-and-demand signals. A prime advantage for gas stations is convenience – so a station located on the higher-traffic side of a street may often price higher; this sort of tactic does nothing to demystify gas pricing to the public. Regardless, if the price of gasoline is perceived to go above historic norms, the industry is subjected to public scrutiny and scorn similar to that experienced by the pharmaceutical industry.

Pricing at the intersection of supply and demand

Effective pricing policy strikes a balance between supply and demand; priced too high, demand falls and vice versa. The classic Disneyland example comes to mind: "When you have customers lining up to come in, your price is probably too low." Studies by the Institutes of Medicine show that if the point-of-purchase price is too high, people tend not to fill their prescriptions and never take the medicines they've been prescribed.

Pricing in the Natural Resource Industry

Oil and similar commodities have specific pricing challenges, and may offer insight into how to respond to fluctuating markets. Oil and gas retailers tend to operate in cyclic markets, commanding higher margins when demand outpaces supply and lower margins (often negative) when market conditions change and supply exceeds demand. As mentioned, gasoline retailers respond to the same inputs on oil-per-barrel price, but rely more on refinery-capacity surplus and shortages (supply) to set gasoline prices. The premise is simple: companies must maximize pricing (margins) during good times so they can cover the downturns in demand and sales during the bad times. In the petroleum industry, the cash and profit generated from high-margin sales and upcycle demand is often invested in exploration, acquisition and production expansion – which eventually leads to increased supply and lower prices/margins.

Cost-plus vs. Value-based pricing

It is generally accepted that value-based pricing is the more effective pricing method. According to Invento's Balaji Viswanathan (VP Products), "Cost-plus pricing calculations are often used by default by many organizations and it creates many problems."[1] Critics of the methodology point out that cost-plus pricing has the dubious ability to simultaneously leave money on the table and leave customers wholly unsatisfied.

One solution to control the industry's ability to set prices is to mandate a cost-plus pricing model. Under such regulation, the government only permits the company to charge just enough to cover production costs

THE TREND TO REGULATE DRUG PRICES VIA COST-PLUS POLICY IS WANING.

and make a "fair return" on the product's sale. This is possibly to allow the drug to be accessible to the general population and prevent the company from gaining too much profit.

However, the trend to regulate drug prices via cost-plus policy is waning. Both Germany and the U.K. have regulated toward value-based pricing regimes. The Affordable Care Act also introduced the value-based healthcare ethic to U.S. consumers as well. The reasons are legion, but setting price on a common understanding of cost and performance between buyer and seller has the potential to serve each party's interests.

Pharma Industry forward

It's clear that, contrary to the traditional approach of product pricing via a cost-plus margin rubric, these practices must now acknowledge the needs and perspectives of the customers as the starting point for any pricing/strategy development discussion. This applies as much to the pharmaceutical industry as it does to any other. The traditional pricing question of "What do I need to charge to cover my costs and make a decent return?" is quickly being supplanted by "Given the market's perception of my product portfolio's value, which of those products can we profitably produce?"

Pricing pharmaceuticals is a challenge. The complexities of establishing value can be both daunting and costly, starting with data from the earliest development phases, clinical trial results and eventually post-approval studies. The value-based pricing model is challenging to implement, especially when the product is first-in-class or aims to become a new standard of care. Ethical dilemmas must also be addressed; pricing to what the market will bear, for example, can result in disproportionately served populations.

Driving Efficiencies

The industry is seeking new ways to introduce efficiencies into all aspects of drug manufacture in order to help offset the external pressures that raise the cost of creating and manufacturing drugs, especially by developing longer-term product strategies that involve moving into the generic space. The rise of generics has also had a significant influence on drug pricing and product strategy, and is a great example of efficient drug pricing in close-competition environments. When margins drop, drug suppliers must refocus their business models on efficient pricing. This includes the need to manage production and supply chain cost more diligently. It's at this point that CDMO/CMOs can play a key role: As pricing pressure mounts, drug manufacturers can drive economies of scale via a flexible supply chain.

PRICE OPTIMIZATION IS CRUCIAL FOR A BUSINESS SEEKING TO BOOST ITS BOTTOM LINE.

Value of Price Optimization

Price optimization is crucial for a business seeking to boost its bottom line. Experience across multiple industry sectors points to an opportunity on the order of 1% to 2% of gross revenue. In other words, optimizing prices can raise a company's annual revenue by as much as 2%. Overall, a business will gain value in terms of higher cash flow. For example, a $300M corporation can achieve as much as $6M a year in revenue as a result of minimal (<$1M) training and internal process development. Unlike many cost and productivity investments, price optimization can be done quickly (a matter of a few months) without the disruption of restructuring or the need for heavy CapEx investment. In almost all cases, pricing optimization has the better ROI.

Price optimization across the entire pharma value chain has the potential to yield benefits for all – pharmaceutical suppliers, pharma companies and consumers. Ultimately, pharma's drug-pricing policies must focus on discovering, demonstrating and communicating the value of their therapies and the performance of their products to all stakeholders. The world is demanding much more than symptomatic relief from high drug prices, and this has prompted an entirely new valuation calculus for the industry. P

ABOUT THE AUTHORS

Haig Armaghanian President & CEO, Haig Barrett Management Consultants and Managing Consultant, Nice Consulting

With over 25 years of experience, **Haig** has accumulated a wealth of knowledge and experience in global business leadership and strategic facilitation and planning. Over the last 15 years, Haig has built Haig Barrett into a leading consulting firm with clients from the chemical, automotive, energy, pharmaceutical and biotech sectors. Prior to founding Haig Barrett, Haig led divisions for leading global Fortune 50 corporations, including Rio Tinto. Haig graduated with a BSc (Hons) in chemical engineering from Surrey University, England.

LinkedIn www.linkedin.com/in/haigbarrett
Email haig@thatsnice.com

Josh Dunn Division Lead, Strategy & Execution, Haig Barrett Management Consultants, Nice Consulting

As a Senior Consultant, Strategy & Execution Lead for Haig Barrett, **Josh** brings more than 25 years of corporate Fortune 500 experience and over 5 years of consulting experience. Josh has spent most of his working career rising through two companies from the ground up: Avery Dennison and Rio Tinto. Josh has the experience to bring a strategic long-term view on how our clients can expand their market. Josh holds a BA in chemistry and an MBA.

LinkedIn www.linkedin.com/in/josh-m-dunn-6110573
Emai josh.dunn@haigbarrett.com

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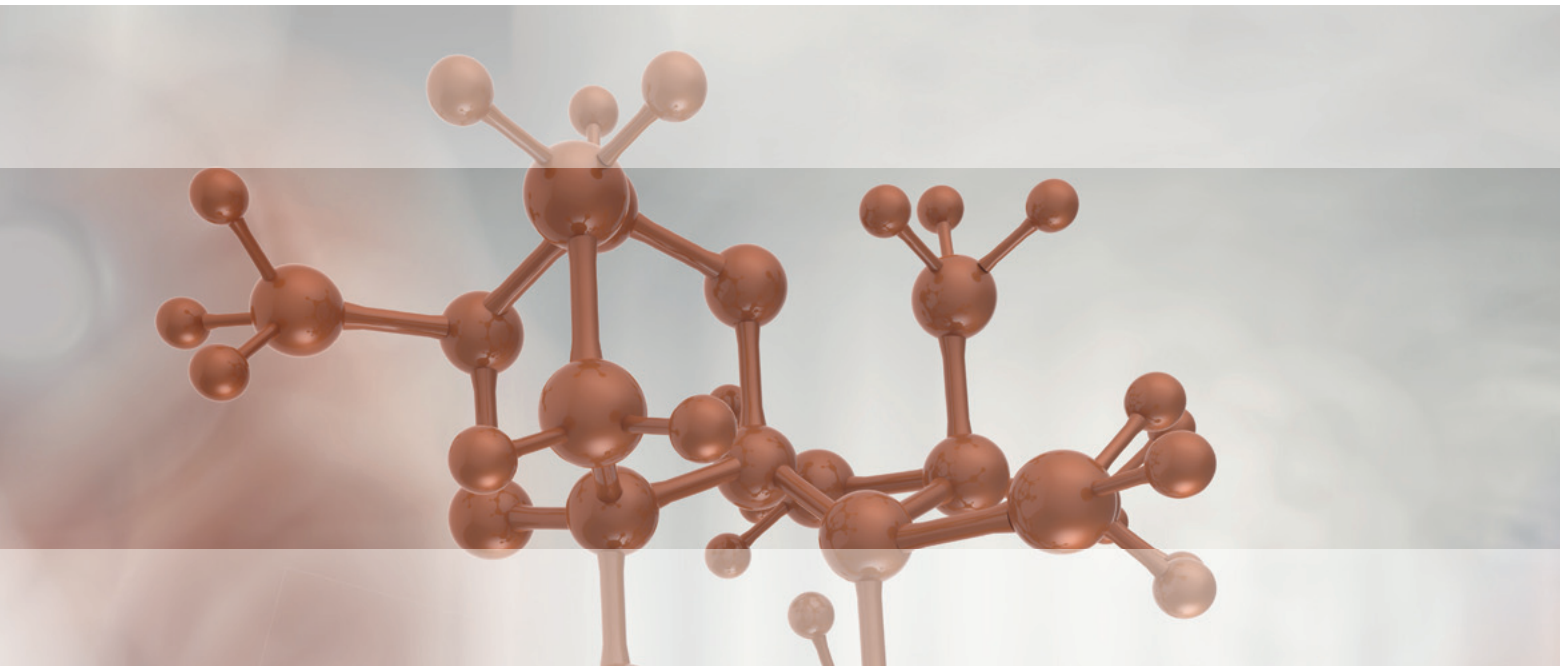

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