Towards an uncertain future – Hungary's drug industry

The pharmaceutical industry in Hungary, once the jewel in the country's crown, has an uncertain future. Theresa Agovino looks at the problems and reports on the government's attempts at privatisation.

The Hungarian government was kind to the country's once mighty pharmaceutical industry this year, instituting several new policies that benefitted the sector. But while these new additions have helped improve company results, they have not eased long-term concerns about the industry's future, which are tempering interest in local firms as the government attempts to privatise them.

The government is marketing stakes in pharmaceutical companies at a time when the industry – which accounts for 10% of Hungary's exports and 6% of its gross domestic product – is at a crossroads. The major companies are still thriving, but much of their growth is a result of cost-cutting, unexpected cash windfalls, restructuring and recently instituted government policies. If the industry is to continue to prosper it must develop new strategies that will allow it to adjust to new patent laws, and fierce, better-funded foreign competition both within its borders and in its traditional export markets.

Foreign interest in Hungarian pharmaceutical companies has been slow to materialise. After more than two years on the market, Biogal Pharmaceutical Factory has a buyer. An agreement was finally reached in November to sell 78% of the company to Teva Pharmaceuticals, for US$26 million. Stakes in Alkaloida Chemical Factory, Egis Pharmaceuticals, and Gedeon Richter are also up for sale.

All Hungarian pharmaceutical companies are grappling with the same changing landscape. The collapse of communism five years ago opened up the Hungarian market and those of the former Soviet Union and eastern block countries to foreign competition. Hungarian companies had a stranglehold on these markets before the political changes.

Russia remains the largest buyer of Hungarian pharmaceuticals. But the Secretary-General of the Hungarian Pharmaceutical Manufacturers & Wholesalers Association, Laszlo Buzas, says sales to Russia have dropped dramatically since the changes five years ago allowed for more foreign competition and caused economic upheavals that impeded the country's ability to pay for drugs. According to Buzas, in 1990, Hungarian pharmaceuticals accounted for 74% of sales in Russia, but last year that number dropped to 47%. It fell to 45% in the first half of this year.

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The difficulties the Hungarian pharmaceutical industry is experiencing within its own borders should subside, at least temporarily, thanks to the country's weak economy. In an attempt to save money the National Health Insurance Fund lowered its reimbursement rates on drugs, a move which has helped Hungarian companies since their products are an average of 20% to 30% cheaper than their foreign counterparts. The government further strengthened the position of Hungarian pharmaceutical companies when it took steps to cut the country's trade imbalance last March. By devaluing the forint, the government made Hungarian pharmaceuticals less expensive overseas. The addition of an 8% import tax made foreign products even more expensive in Hungary.

But these moves haven't hastened the sale of the Hungarian pharmaceutical companies. Indeed, there is some concern that the government will clamp down further on healthcare spending, which will eventually hurt local pharmaceutical producers. Hungarians have high rates of alcoholism, cancer and heart disease and have traditionally spent more on drugs than many of their European counterparts. Last year, the size of the Hungarian drug market grew by 29% to US$496 million.

"The time to sell [the drug companies] was really five years ago," says Miklos Gyorgy, Chief Executive of Chinoin Pharmaceutical, which is 51% owned by Sanofi. "But it is such an emotional issue."

The Hungarian pharmaceutical industry was always one of the country's crown jewels because of its strong hold on the former Soviet Union. When communism collapsed the industry's major export markets were thrown into turmoil, making the companies far less attractive as investment opportunities. Gyorgy believes that the Hungarian companies' claim that they understand the CIS better than western firms was more appropriate five years ago and that the government should have capitalised on that strength when it had the opportunity. Now foreign firms have had time to do research and set up their own operations in those countries. Nevertheless, knowledge of the Commonwealth of Independent States (CIS) is often cited as the chief reason a western firm should invest in a Magyar pharmaceutical concern. It is also always noted that doctors and patients in the CIS are familiar with the Hungarian drug companies.

While Hungarian pharmaceutical companies were adapting to the new world



Illustration by Rob Wilcockson.

The Hungarian government is selling off its pharmaceutical industry but foreign interest has been slow to materialise.

order, the country was also under intense pressure to change its patent laws. One reason the pharmaceutical industry in Hungary blossomed was because patent laws only protected the process by which a drug was created, not the product itself. This allowed Hungarian companies to produce drugs still under patent protection in the West by simply making the product through a different process. The law was changed last year to recognise product patents although drugs already on the market as well as those in the development pipeline before 1987 were exempt. Today, the biggest selling drug in Hungary is Tensiomin (captopril), an ACE-inhibitor which is sold by Egis but was discovered by Bristol-Myers Squibb.

About 10% of the drugs sold in Hungary were copied from other companies while they were still under patent. That is equivalent to the percentage of drugs sold that are products of original research. "I think we lost a lot of brain power by concentrating on making drugs discovered by other people," said Gyorgy.

Perhaps. But the experience derived from finding new ways to make existing drugs means that Hungarian pharmaceutical companies are experts at producing generics. That talent is frequently touted when trying to entice western firms to invest in Hungarian pharmaceutical companies.

Despite Hungarian drug companies' ties to the CIS and their drug development expertise there is little tradition of direct foreign investment in the firms. Nonetheless, as the Hungarian government seeks to privatise the drug companies it is looking to sell stakes to larger, foreign pharmaceutical companies.

Earlier this year, the government sold its 28% stake in Egis to NatWest Markets, which is in turn looking for a strategic investor for Hungary's third largest drug company. NatWest is also authorised to sell at least part of the 30% of Egis held by the European Bank for Reconstruction and Development. The government is employing investment banks to sell 75% of its stake in Alkaloida. Human Serum Production and Medicine Co was successfully privatised earlier this year when Novopharm, Canada's biggest generic drug company spent US$17 million to increase its share in the company to 51% from 15%. Another 25% of Human was sold on the Budapest Stock Exchange. The government is retaining a 25% plus one vote share in Human.

However, the government is not planning to sell its 68% stake in Richter, Hungary's largest pharmaceutical company, to a larger drug concern. Financial investors are being sought instead. At the time of writing, 16% of Richter was scheduled to be sold through an international private placement and domestic stock offering. The shares were to be sold for US$14.75 each, the low end of the US$14.50 to US$16 per share range set by the government. However, the weak Budapest stock market is blamed for the low price, not the company's performance.

Sources say Richter isn't being sold to a strategic partner because its general manager Erik Bogsch would like the company to be kept independent. In the past, Bogsch has stated that Richter's 100 plus sales force in Russia and the former eastern block countries will lure in development and licensing partners.

Yet most of the large international drug concerns have chosen to set up their own operations in Hungary instead of selling through local companies. An example is Ciba, which was active in the Hungarian market for 70 years via licensing agreements and sales agents. After the political changes, in 1990 Ciba set up a joint venture with Biogal. By 1993, Ciba opted to open its own company in Hungary. "In the end it wasn't that hard to learn the market ourselves," said Gary Phillips, Managing Director of Ciba Hungaria.

Phillips echoes the feelings of several other large, multinational drug company executives when he says the best way to have control over your firm's products is to have a local subsidiary. Like the other large, foreign drug companies operating in Hungary, Ciba's sales are suffering because of recent government actions. Phillips estimates Ciba's sales will be 10% below the US$35 million registered last year. He expected that in the short-term the government's import tax and reimbursement policy may lead to more licensing deals for Hungarian drug companies as foreign firms that aren't in the market opt for a less expensive way to enter. But in the long run Phillips believes companies serious about the eastern European market will want to have their own operations in place.

Richter's Bogsch is hoping Phillips is wrong. His strategy has been to stay ahead of the pack by adding sales representatives in eastern Europe and setting up joint venture companies in Russia and the Ukraine. "Richter has moved fast into that region," said Nomura analyst Frances Cloud. "It means a lot to them to be successful there."

Indeed, 67% of Richter's 1994 sales were derived from export and the majority of the exports went to the CIS. Overall, last year sales rose 4% to US$202 million and profits jumped 89% to US$38.8 million thanks to the recovery of bad debt from the former Soviet Union. Operating profit increased 20% to US$35.2 million.

For the first six months of 1995, Richter's sales jumped 25% to US$100 million. But analysts said part of the jump was caused by Hungarians stockpiling medicines in advance of the change in reimbursement. Richter's pre-tax profits skyrocketed 93% in the first half of 1995 but the meteoric rise was due to the sale of its stake in a non-pharmaceutical company and recovering some bad debt from the former Soviet Union. Without such extraordinary items, operating profit grew 17% to US$23 million.

Richter has made a stunning turnaround since 1992 when it felt the sting of the Soviet Union's collapse. That year it lost US$10 million on sales of US$130 million. Since then, it has shed over 1,500 jobs and narrowed research activity from seven to two areas – cardiovascular and central nervous system diseases.

It is critical for Richter to raise money from investors especially since it isn't seeking a strategic partner that could supply it with a wider stable of products. Drug development costs are expensive for any company, especially one with meagre assets.

Interestingly, Egis has made an abrupt about turn on the issue of a strategic investor and now welcomes the idea. "For the next five years we would do fine with our own resources," says Eva Barta, head of Egis' corporate office. "But we realise there is keen competition out there and we want to continue to have our slice of the cake. Our



Photograph by Grant Smith/Telegraph Colour Library.

Hungary, with its high rates of alcoholism, cancer and heart disease, has traditionally spent more on drugs than many other European countries.

shareholders will feel more assured if we are partnered with a Western company and we want to keep our shareholders' confidence."

Egis stresses its expertise in producing generic drugs. It plans to stay competitive by continuing to be a producer of branded generic drugs that offer some benefit such as a new formulation. Egis' profits have also been steadily rising but there have been boosts from one-time gains. In 1994, net profits increased by 200% because of cost cutting and debt repayment from the former Soviet Union. Operating profits jumped 28% to US$23 million. Some analysts worried that profits were out-pacing sales, which grew 20% last year to US$115 million.

In the first six months of 1995, Egis' sales rose 38% to US$76 million. Again, the large increase is tied to Hungarians hoarding medicine in advance of the reimbursement changes. Profits once again benefitted from debt repayment from the former Soviet Union as well as the sale of a stake in an unrelated company. Net profit ballooned 162% to US$21 million.

While Egis aims to differentiate its generic products by giving them added benefit, such as improved dosage, drug delivery, etc, Pharmavit simply aims to be the lowest cost producer. It spends no money on original research. This is not surprising since Pharmavit started out producing vitamins and nutritional supplements. Last year was the first time that pharmaceutical sales surpassed the revenues of its original mainstay products. Pharmavit is also expanding into other eastern European companies but is steering clear of Russia because of the money needed to enter the market.

Analysts say Pharmavit has a strong pipeline and that the government's push towards low-cost drugs should benefit the company. Last year, Pharmavit's revenue jumped 74% to US$30 million while profits slipped 4% to US$3.8 million. The decrease in earnings was attributed to start-up costs for marketing in Slovakia, Poland and the Czech Republic.

The Hungarian government does not have, and never has had, a stake in Pharmavit – a fact which makes it an anomaly in the Hungarian pharmaceutical industry. Alkaloida also stands out among Hungarian drug companies in that it produces 10% of the world's morphine. However, that has not been enough to secure a sale. India-based Torrent Pharmaceutical was close to buying the firm but pulled out at the last minute. Tibor Eszeny, a spokesman for Alkaloida, said the government was seeking US$20 million for a 75% stake in Alkaloida, but that Torrent was concerned about environmental problems at the company's plant. Others suggested that Alkaloida's debts – which at US$30 million amounts to 50% of the company's total capitalisation – was also a deterrent.

Ironically, while all of Hungary's pharmaceutical companies say they are looking for more licensing deals, Biogal's large number of such arrangements held up the company's sale. Experts say major drug companies didn't want to buy Biogal because they feared competitors would opt out of licensing arrangements due to conflict of interest concerns and thus deprive the firm of its major revenue source. In addition, Biogal's 1,700 person workforce was also seen as an impediment to the sale.

Indeed, Teva only agreed to buy Biogal after it was allowed to discuss a company restructuring with the firm's unions. Associate Director of Bank Austria-Giro Credit Investment, Greg Timar, who is handling the sale for the government, said some employees would be laid off because of the sale but he would not speculate on the number. Timar also said he believes Teva and Biogal are devising a plan to keep as many of Biogal's licensing deals as possible. Teva plans to use Biogal as a base to expand into eastern and central Europe.

Novopharm Chairman Leslie Dan said he looked into buying Biogal but the cost of purchasing and upgrading the company would amount to between US$30 million and US$40 million. He decided against the purchase since he had just expanded his ownership in Human.

Dan said he bought a majority stake in Human because it has the capacity to produce injectable drugs, an ability Novopharm lacks. Dan intends to use Human to produce Novopharm products for both the local and export markets.

The only other company which is controlled by a foreign firm is Chinoin. Sanofi purchased a 51% stake in Chinoin in two stages for US$100 million in 1991. After the purchase, Sanofi cut staff, curtailed product offerings and downsized research activities. Nonetheless, Gyorgy said he welcomed Sanofi because it offered financial stability and a steady stream of new products. He maintains Sanofi has used Chinoin to expand into eastern Europe. Certainly, Sanofi's influence has helped Chinoin's finances. Sales gained 15% last year while operating profit surged 32% to US$352 million.

Gyorgy concedes that Sanofi's ownership means Chinoin has lost some of its local identity and that might irritate those who relish Hungary's pharmaceutical tradition. But as Gyorgy comments, "Some companies have too much of a nationalistic feel. The reality is that we live in a market that is global."

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