Drug Industry Most Profitable Again

New Fortune 500 Report Confirms "Druggernaut" Tops Other Industries In Profitability Last Year

In a topsy-turvy year that saw stocks plunge and investors lose $4.6 *trillion* in wealth, one sector was all but immune to market convulsions: the drug industry.

Once again, the drug industry "was more profitable than any other" according to the new Fortune 500 analysis of America's largest companies in the year 2000.

And the drug industry did not win by a tissue-thin margin. No, the druggernaut walloped competitors. The 11 companies that make up the Fortune 500 drug industry category enjoyed an 18.6 percent return on revenues and a 17.7 percent return on assets. By comparison, the median for all Fortune 500 industries was 4.9 percent and 3.9 percent, respectively[1] (see Graph 1).

The only Fortune 500 measure that the drug industry did not dominate was return on equity (profit as a percent of equity). In that category, the drug industry finished second, less than one-half of a percent behind the oil industry, which had a booming year, thanks to enormous price increases, rising demand and energy deregulation.[2] Still, the drug industry return on equity was twice the median for all Fortune 500 industries – 29.4 percent to 15.8 percent.

Given the industry's robust profits, it's almost laughable that drug companies have fiercely opposed prescription drug coverage through the Medicare program. The industry's intransigence is based on the fear that a Medicare drug plan will lead to price discounts as the federal government becomes a bulk buyer for millions of Americans. That position appears all the more greedy when you consider that drug industry profits are largely the result of coddling by the government. The industry benefits from research on new drugs by the federal government. It enjoys generous tax breaks that leave it paying tax rates that are lower than those of almost every major industry. Finally, federal patent laws give new drugs generous market monopolies that allow companies to charge whatever price the traffic will bear for new medicines.

In all, Fortune 500 drug companies saw their return on revenue increase 15 percent from 1999 (see Table 1). That success came at a time when the American economy saw overall profit growth drop from 29 percent in 1999 to 8 percent last year.[3]

No wonder Fortune 500 accolades for the drug industry included: "exceptional growth," "incredibly healthy" and "well positioned to excel in a slower economic environment."[4]

As consistent profit-generators, drug companies tend to outperform other industries during economic downturns, and investors know it. Not surprisingly, they boosted the stocks of Fortune

500 drug companies 38 percent while selling off other industries during last year's stock market turbulence.[5]

The drug industry's success in the Fortune 500 profitability rankings has become a rite of spring. In the 1970s and 1980s, profitability of Fortune 500 medicine merchants (measured by return on revenues) was two times greater than the median for all industries in the Fortune 500. In the 1990s, when the benefits of the landmark Hatch-Waxman Act kicked in, the drug industry's profitability was almost four times greater than the median for all industries in the Fortune 500[6] (see Graph 2).

Leading the way for the drug industry was Merck, with $40.4 billion in sales, which put it between Sears and Roebuck and Procter and Gamble in the list of biggest American companies. Merck's profits of $6.8 billion in 2000 were more than the profits of all the Fortune 500 companies in the airline, entertainment, food production, metals and hotel/casino/resorts industries *combined*.[7]

Merck's profitability (17 percent of revenues) was the envy of companies such as Nike (6 percent), Boeing (4 percent), Walt Disney (4 percent) and Wal-Mart (3 percent).

Merck's drug operation was even more profitable than it appears at first glance. That's because approximately half of the company's revenues come from its massive pharmaceutical benefit management company, Merck-Medco, which has much lower profit margins than the parent company's drug business.[8] Counting just the drug-making side of Merck, profits were a whopping 44.2 percent of revenues in 2000.

Standing second among drug companies was Pfizer, which saw its sales jump 82 percent – in part because of its merger with Warner-Lambert, but also because of strong performance by its painkiller Celebrex, its cholesterol-reducer Lipitor and its Bob Dole-hyped Viagra.

Described as a "marketing machine" by *Fortune* magazine, Pfizer employs twice as many (20,000) sales representatives as Merck. Pfizer's sales force is also notoriously aggressive and combative – perhaps because 15 percent of them hail from a military background, according to a company spokesman.[9]

As a result, nine of the company's products hold the top sales spot in their therapeutic category and Pfizer now claims eight blockbuster drugs with sales of at least $1 billion each. As *Fortune* says, "With celebrity drugs like these, it's no surprise that the company's stock is up a stunning *1,454 percent* over the past decade. This also helps explain how Pfizer was able to make the gravity-defying drug revenue leap from No. 14 in the industry in 1990 to No. 1 today."[10] (Remember, not all of Merck's revenue comes from drug sales.)

It's also worth noting that Fortune 500 drug industry performance would have been even more remarkable had it not been dragged down last year by the crash of American Home Products, which suffered a staggering $2.3 billion loss. American Home's loss was mainly attributed to litigation costs related to the safety problems of its infamous obesity medicine fenfluramine (known as "fen-phen"). The company also recalled its infant vaccine RotaShield and painkiller

Duract. ("No company in the history of the industry has had so many recalls in such a short period of time," said independent industry analyst Hemant Shah in *Fortune*.)[11]

In addition to aggressive sales, several other factors contributed to drug industry profitability last year:

- **Aggressive advertising:** Since the federal Food and Drug Administration (FDA) relaxed the rules governing TV ads in 1997, the drug industry has increased its direct-to-consumer spending by roughly 40 percent a year. (Last year, ad spending was up 41 percent, according to *Fortune*.) As a result, two companies – Merck and Pharmacia – spent $460 million on ads in 2000, which was 20 percent more than Burger King.[12]

- **Lower tax rate:** A 1999 study by the Congressional Research Service found that thanks to a variety of tax credits, the effective tax rate for drug companies was 16 percent compared to the overall industry average of 27 percent.[13]

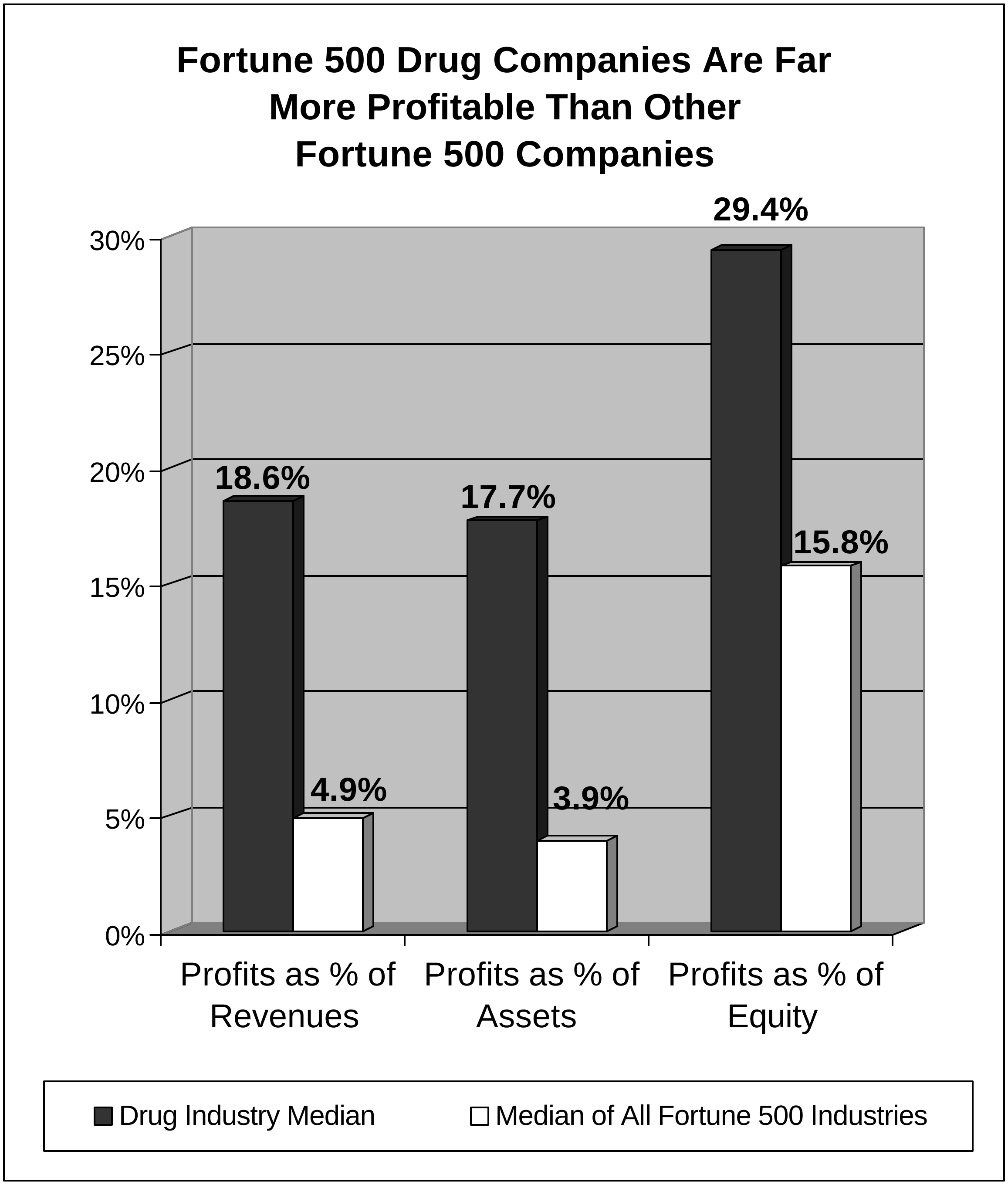
- **Corporate welfare:** According to a study released by the FDA in January 2000, one relatively new government incentive alone accounts for $600 million in additional annual profits.[14] The so-called Pediatric Exclusivity Provision gives companies an extra six-months of monopoly patent protection in exchange for conducting tests on children. But rather than use the incentive to primarily study drugs most important to children – as Congress had hoped – drug companies used it for blockbuster products, such as Claritin, that stood to gain the most from a six-month patent extension. The pediatric provision sunsets at the end of this year and its congressional sponsors, Sens. Mike DeWine (R-Ohio) and Chris Dodd (D-Conn.), are pushing for permanent authorization. The FDA estimates this would cost consumers $14 billion over 20 years, by delaying the market entry of lower-priced generic drugs.[15]

Finally, it's important to note that the drug company's annual reports reveal where their revenues go – and what their priorities really are. The drug industry has long maintained that it needs extraordinary profits to fuel risky and expensive research into new medicines. But the reports show that the companies plow far more into profits and marketing than into research and development (R&D). Consider:

- Fortune 500 drug companies channeled 17 percent of revenue into profits last year and 30 percent into marketing and administration – yet they spent just 12 percent of revenues on R&D.[16] (see Graph 3)

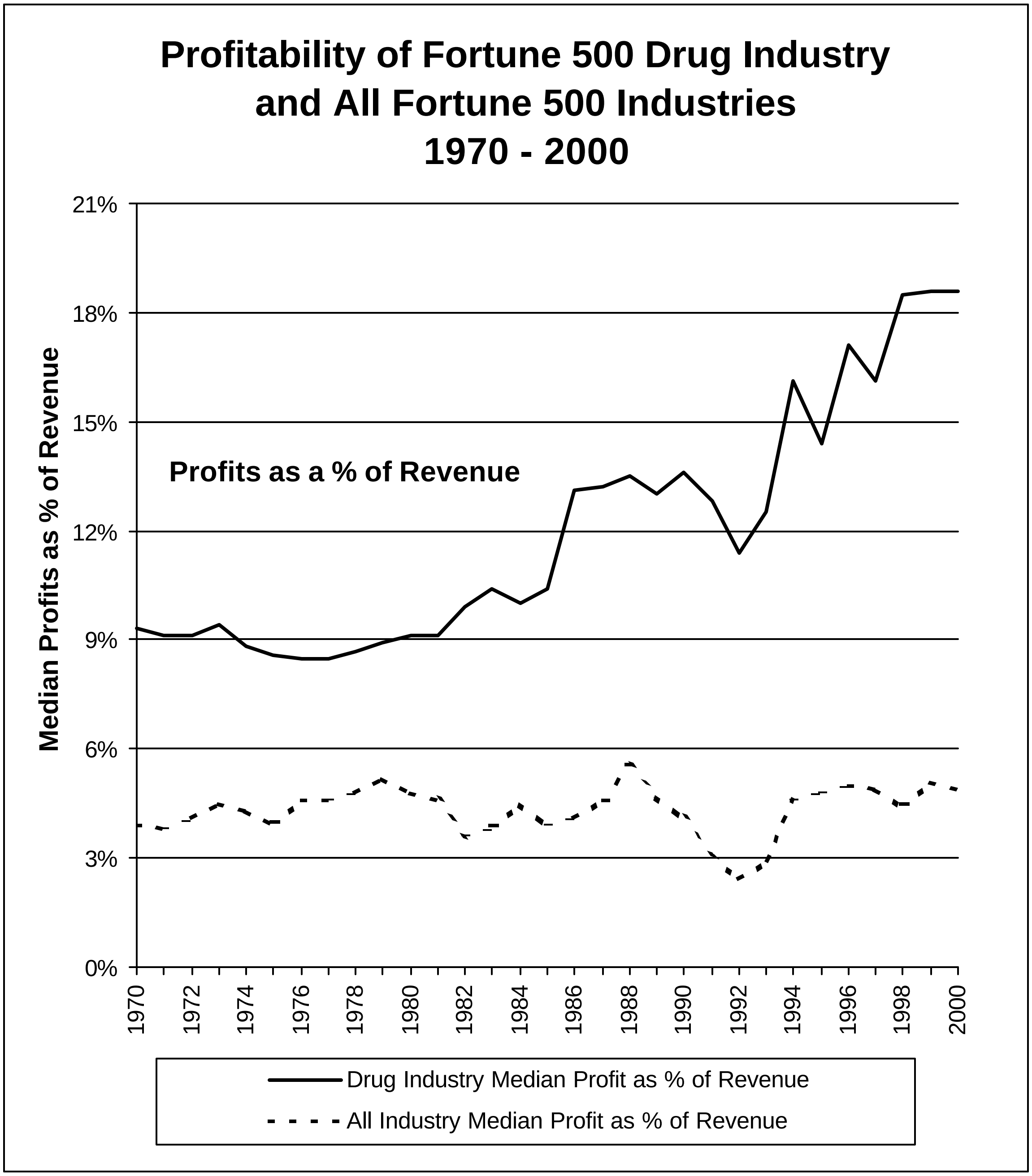
- Eight of the 10 most profitable Fortune 500 drug companies devoted more of their revenue to profits than to R&D.[17] (see Graph 4)

Graph 1



Source: *Fortune* magazine, April 2001, Fortune 500 (www.fortune.com).

Graph 2



Source: Public Citizen update of Stephen W. Schondelmeyer calculation, *Competition and Pricing Issues in the Pharmaceutical Market*, PRIME Institute, University of Minnesota based on data found in *Fortune* magazine, 1958 to 1999; *Fortune* magazine, April 2001, Fortune 500 (www.fortune.com).

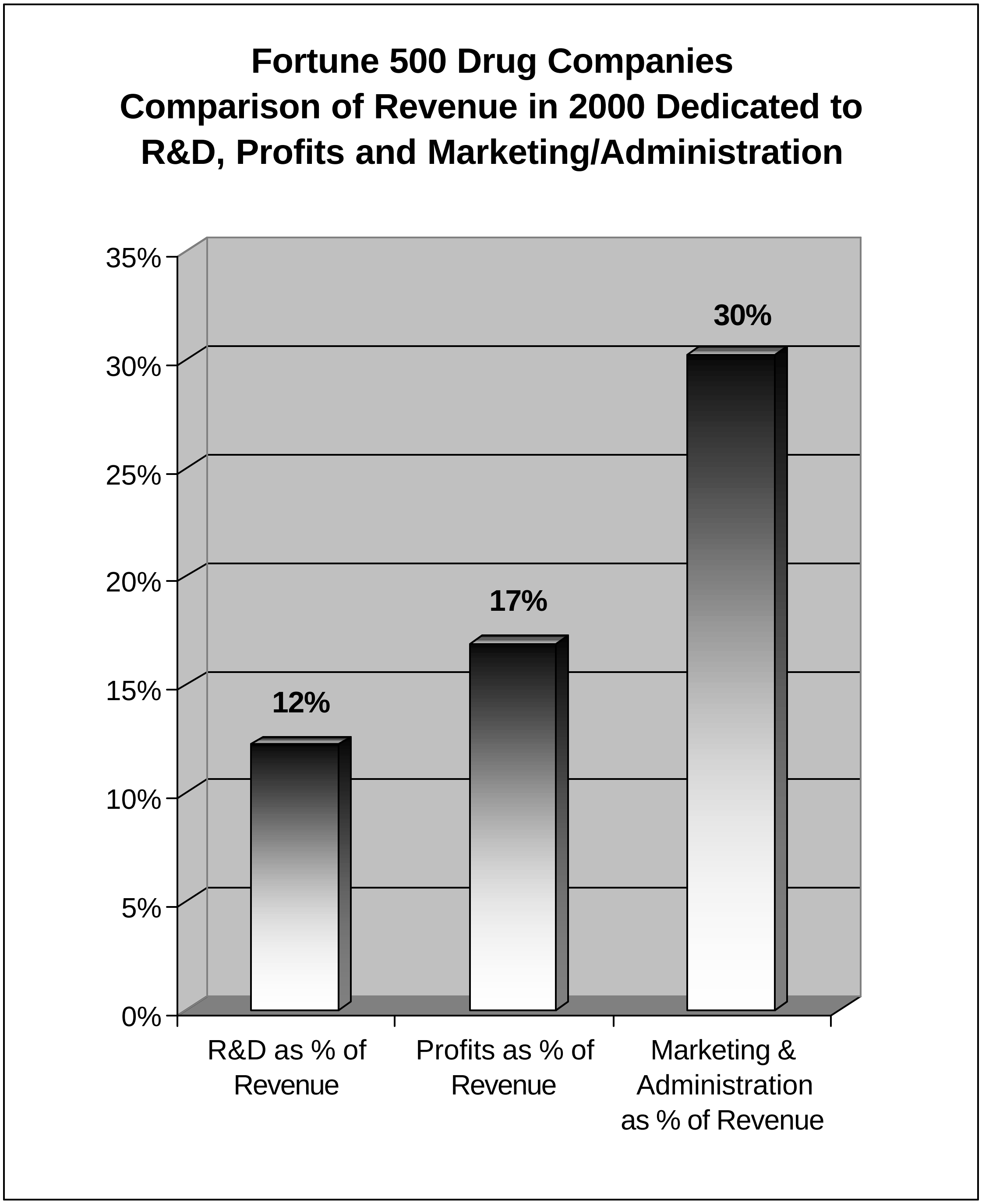
Table 1

Fortune 500 Drug Companies Profit and Revenue Increases in 2000

Rank	Company	Revenues		Profits		Profits as % of		
		$ millions	% Change From 1999	$ millions	% Change From 1999	Revenues	Assets	Stockholders' Equity
1	Merck	$40,363	23%	$6,822	16%	17%	17%	46%
2	Pfizer	$29,574	82%	$3,726	17%	13%	11%	23%
3	Johnson & Johnson	$29,139	6%	$4,800	15%	16%	15%	26%
4	Bristol-Myers Squibb	$21,331	6%	$4,711	13%	22%	27%	51%
5	Pharmacia	$18,150	79%	$717	25%	4%	3%	6%
6	American Home Products	$13,810	2%	-$2,371	NA	-17%	-11%	-84%
7	Abbott Laboratories	$13,746	4%	$2,786	14%	20%	18%	32%
8	Eli Lilly	$10,862	9%	$3,058	12%	28%	21%	51%
9	Schering-Plough	$9,815	7%	$2,423	15%	25%	22%	40%
10	Amgen	$3,629	9%	$1,138	4%	31%	21%	26%
11	Allergan	$1,563	11%	$215	14%	14%	11%	25%
Total	**--**	**$191,982**	**--**	**$28,025**	**--**	**--**	**--**	**--**
Median		**$15,948**	**9%**	**$2,922**	**15%**	**19%**	**18%**	**29%**

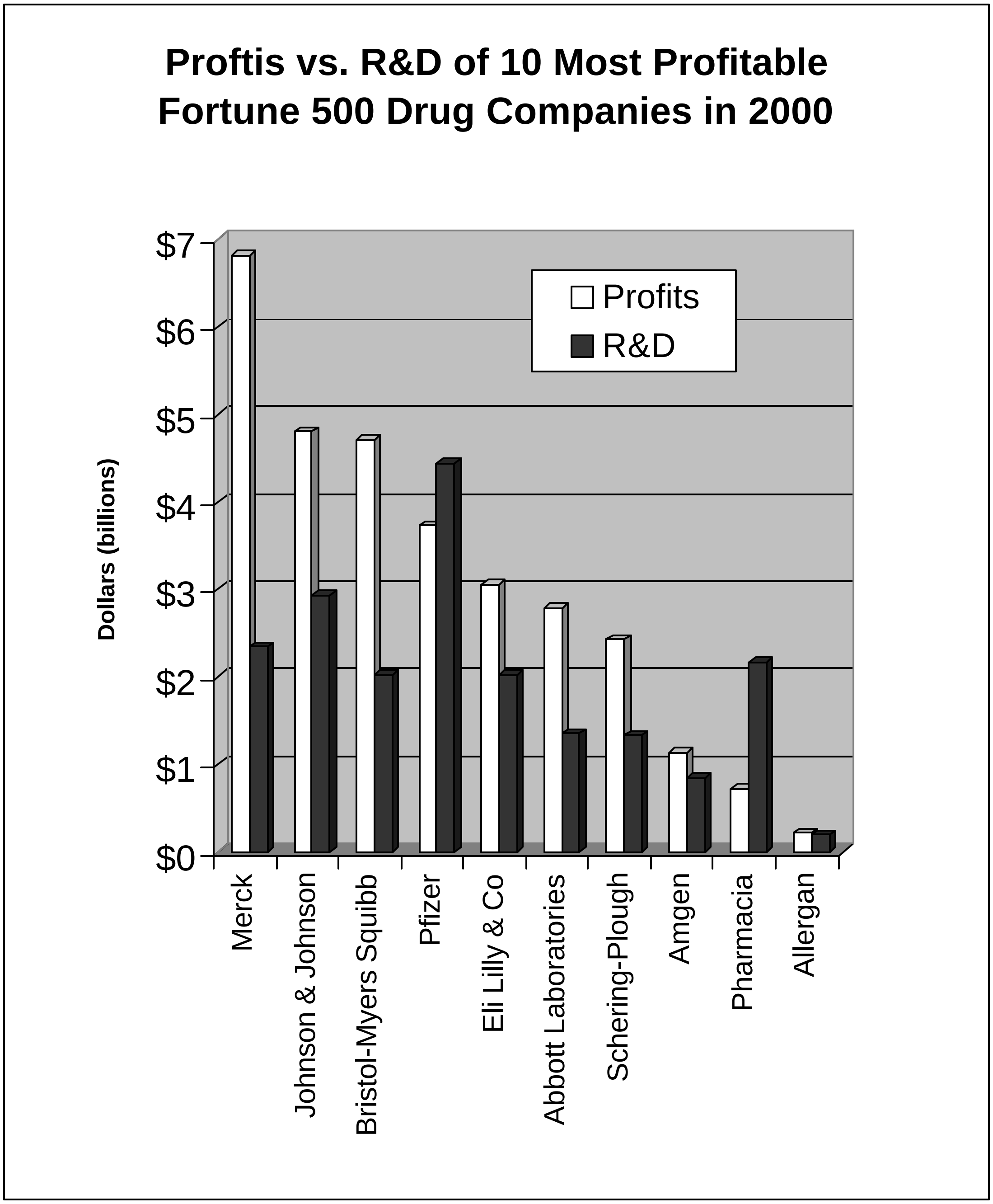
Source: *Fortune* magazine, April 2001, Fortune 500 (www.fortune.com).
Note: Median values do not include American Home Products.

Graph 3



Source: Public Citizen analysis of company annual reports; *Fortune* magazine, April 2001, Fortune 500 (www.fortune.com).

Graph 4



Source: *Fortune* magazine, April 2001, Fortune 500 (www.fortune.com).

Endnotes

1. *Fortune* magazine, April 2001, Fortune 500. (www.fortune.com)

2. See n. 2

3. Lee Clifford, "The Story of American Business," *Fortune*, April 16, 2001. (www.fortune.com)

4. David Rynecki, "All Star Analysts: Drugs," *Fortune*, December 18, 2000.

5. Public Citizen analysis of stock prices for calendar year 2000 obtained from Commodity Systems Inc., accessed at www.finance.yahoo.com

6. Public Citizen update of Steven w. Schondelmeyer calculations, "Competition and Pricing Issues in the Pharmaceutical Market, PRIME Institute, University of Minnesota, based on data found in *Fortune* magazine, 1958 to 1999; *Fortune* magazine, April 2001, Fortune 500. (www.fortune.com)

7. Public Citizen analysis of Fortune 500, "Most Profitable Industries." (www.fortune.com)

8. Lee Clifford, "Tyrannosaurus Rx," *Fortune*, October 30, 2000.

9. See n. 8

10. See n. 8

11. David Whitford, "AHP's Awful Losing Streak," *Fortune*, November 22, 1999.

12. David Schwab, "Drug Makers Draw Mixed Reactions with Decision to Spend More on Marketing," *The Star-Ledger* (Newark, N.J.) March 26, 2001.

13. Congressional Research Service, "Federal Taxation of the Drug Industry from 1990 to 1996," December 13, 1999.

14. Department of Health and Human Services, U.S. Food and Drug Administration, "The Pediatric Exclusivity Provision," Status Report to Congress, January 2001.

15. See n. 14

16. *Fortune* magazine, April 2001, Fortune 500 (www.fortune.com) and Public Citizen analysis of company annual reports.

17. See n. 16