Glaxo Smith Kline may be Britain's biggest drug company and may spend £280,000 an hour on research, but its share price reveals a company that is losing its touch at making innovations profitable. The company was formed by the merger of Glaxo and SmithKline Beecham. In their hey day in the 1980s and 1990s such pharmaceutical companies regularly turned in operating margins of 40%. In part, such margins were the norm because the companies were able to extend patents almost at will. A compound could be reformulated with only modest improvements in efficacy but the regulators and courts seemed happy to grant and protect new patents. But things started changing in the 1990s. Glaxo first came up against the change when it failed to protect its ulcer drug Zantac - which had achieved annual sales of over $1 billion. The result was swift and predictable. Generic imitations rapidly appeared on the market and Zantec’s sales price and sales volume both tumbled. Pharmaceutical firms started investing heavily in lawyers - Glaxo spends hundreds of thousands of pounds - but at the same time firms producing generic drugs continued challenging patents, realising that there were high returns to be made if they were successful. And by the turn of 2000 over 85% of such patents were being overturned. In 2002 Glaxo revealed that sales of Augmentin, an antibiotic, fell by 40% in the USA as Geneva Pharmaceuticals launched a cut price generic version of the drug, having successfully challenged the Glaxo patent. And the politics of drug pricing continues to move against the big pharmaceutical firms with the US government closing a loophole in the law that had allowed companies to extend patents artificially for up to 5 years.

The other side of the problem is that the pharmaceutical firms are finding it increasingly difficult to discover pioneering new drugs at anything like the old rate of invention. The rule of thumb in the industry is that if you spend $1 billion a year on research, you need one new drug approved (by the likes of the US Food and Drug Administration) a year to make an economic return. Glaxo Smith Kline currently spends $4 billion a year but between 1996 and 1999 it averaged just two and in 2000 and 2001 just one. In 2002 there were three, although none were major.

So what is Glaxo Smith Kline doing to address the problem? It has separated its research departments into six semi-autonomous units each with its own budget. The idea is that each unit must manage research using commercial criteria and judge its investment decisions by the commercial return they make.
But perhaps more interestingly Glaxo has observed from its recent history that its profitability can be sustained by its skill in buying drugs from smaller competitors and then using its marketing power and global distribution network to bring the drugs to a global market place quickly. Glaxo employs 42,000 sales and marketing people compared to 15,000 in research and development - a huge investment and a significant competitive advantage. For the time being the company is happy to pursue this twin-track strategy.

Up-to-date information on Glaxo can be found on their web site: www.gsk.com

Question

What do you think about Glaxo’s policy towards innovation?