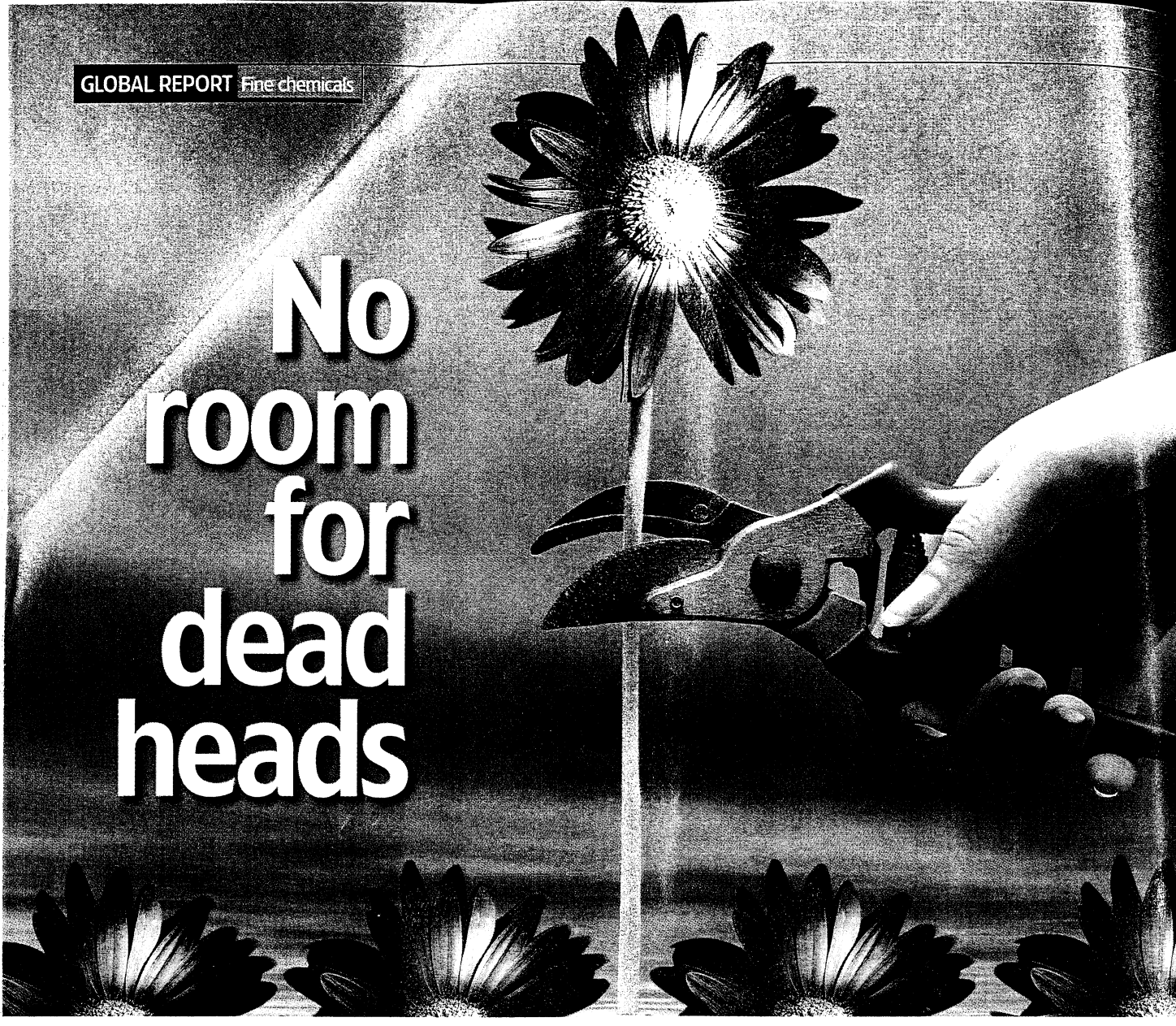


No room for dead heads

Five years after its buying spree, the fine chemicals sector continues to put its affairs in order and is looking forward to long-term sustainable growth. **Clay Boswell** reports

DEGUSSA'S OCTOBER write-off of its Laporte acquisition, following Rhodia's of ChiRex and, more distantly, Clariant's of BTP, may signal that the fine chemicals sector has put the past behind it. Overcapacity remains a problem, particularly in the less-differentiated segments most affected by the influx of competitors from India and China, but custom manufacturers believe the argument for outsourcing the manufacture of active pharmaceutical ingredients (API) is more compelling than ever, and for companies offering special technologies, attentive service and stability, the future looks bright.

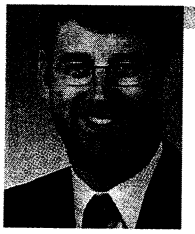
"The large companies, the new entrants, are cleaning up," says Enrico Polastro, vice president and industry manager with the Brussels office of Arthur D. Little. "Some are likely to exit totally. Established players, the ones with a tradition in the field, appear to enjoy a pick up of demand, as customers return to outsourcing. So after a pruning, if you like, there is a recovery. Whether things will return to the levels we enjoyed in the late '90s, this is something else."

Of the four massive fine chemical acquisitions made around the turn of the millenium, only DSM's $800 million purchase of Catalytica Pharmaceuticals has not been put down as a loss. Clariant was the first acquiror to write off its purchase, in 2003 writing off CHF790 million ($611 million) in goodwill remaining from its £1.1 billion ($1.9 billion) purchase of BTP in 2000. Rhodia, which acquired ChiRex for $580 million in 2000, wrote off €135 million ($161 million) in goodwill in January, followed in August by a €101 million charge for the remaining value of the business. Degussa, which acquired Laporte for about £1.36 billion in 2001, last month announced that it was taking an impairment charge of €710 million relating to goodwill and €120 million relating to other assets.

"These companies bought the fine-chemicals activities at the peak of the cycle," Polastro points out. Growth expectations of 15 percent per year made the sector seem the most attractive in the chemical industry. "Most chemical companies wanted to set a base in this field, and eventually they com-

peted to acquire these businesses, paying multiples that at the end of the day were not justified, particularly when growth did not materialize," he says.

"At the end of the day, the value that was vested in organic synthesis was overstated, in the sense that people thought that if they had a brilliant [synthesis] or innovative technologies—it was the time of the chiral dreams, if you want—that this would translate into enormous profit, given that there was chance to get proprietary a position."



Subsequent product failures, delayed launches, pharma mega-mergers and inroads by suppliers in India and China yielded overcapacity and severe pricing pressure, decisively tempering the optimism of the late 1990s. And whereas critical mass was once a hot topic, the notion seems to have fallen out of vogue. "This is still a relatively niche business where economies of scale do not seem to be boundless," Polastro observes. Small to medium-size companies, particularly if they are privately owned and free of the constraints of quarterly earnings reports, do better in a market characterized by long lead times and unpredictability, he says. Ultimately, customers are less interested in the size of their suppliers than in their stability.

RESTRUCTURING

Clariant, Rhodia and Degussa have each restructured to salvage their position. Degussa sold its Radebeul, Germany, facility to generics producer Hexal in March 2004, and the same year began a cost-cutting program. "This program will bring some reductions in headcount at various sites, but we do not expect to shut any down," says Patrik Wohlhauser, head of Degussa Exclusive Synthesis & Catalysts. "The overall environment has indeed forced companies to restructure. But in our view, the market as a whole is improving." Noting that business trends and market prospects "fell short of expectations," in part owing to overcapacity, Wohlhauser says the impairment charge "frees us to focus our energies on our operations. Exclusive Synthesis & Catalysts continues to be a core business. In fact, our Exclusive Synthesis business expects to meet budget for the year. And Degussa overall expects a slight improvement in sales and EBIT for the year."

"It is one of those classic things: if you can't be differentiated, don't do it"

Nick Hyde, global business director, Dowpharma

For its part, Rhodia has mothballed a facility in Holmes Chapel, UK, and closed another in Staveley. Eighty-five jobs, 24 percent of the workforce, were cut last year from the facility at Dudley.

New players are also arriving on the scene, suggesting there is still opportunity in the market. For example, Groupe NovaSep was formed by the merger of NovaSep and Dynamic Synthesis, the fine-chemicals business of Dynamit Nobel, late last year. About the same time, Kemira's fine-chemicals unit in Kokkola, Finland, was acquired by UK-based venture capital firm 3i. The new business, named KemFine, acquired Avecia Fine Chemicals in Scotland, in September.

BASF dramatically improved its standing in the sector with the acquisition of Orgamol, a move that might seem to parallel earlier big-chemical leaps, except for Orgamol's quality and BASF's timing, notes Polastro. "They have built patiently," he says, noting that BASF did not participate in the millenial buying frenzy.

Antonio Germani, director, contract manufacturing at BASF, is "somewhat optimistic" for both 2005 and 2006, though challenges remain. "In the past years, competitive pressure from Asian suppliers has grown," he acknowledges. Additionally, the exchange rate between euro and U.S. dollar is quite adverse for Western companies." BASF's R&D and manufacturing integration (Verbund) is one means for coping with these challenges, he says. The acquisition of Orgamol is another. "It is a strategic step towards expanding our business and achieving sales and profitability targets that will help us sustain continued growth."

MORE THAN KETTLES

The last five years show that success takes more than reactor capacity.

"The CMO market is far from being homogeneous, there is a large difference in financial performance between those that are doing well and those who are not." says Mark Cassidy, business director for small molecules, Dowpharma. "My feeling is that this divide will increase further. Companies that have differentiation will be successful, those that haven't will suffer and the emergence of Asia will impact them much more."

Dowpharma made a strategic decision not to compete in any area where it was not differentiated, adds Nick Hyde, global business director, Dowpharma. The company's decision to close its Smithfield, R.I., facility and exit mammalian cell culture was one consequence. "That is one of those classic things: if you can't be differentiated, don't do it," he says. "What we've been doing subsequently is developing microbial expression technology—Pfenex—in San Diego, and another part of Dowpharma has been developing the plant transgenics and vaccines activities." Hyde says the strategy is paying off in growth of two to three times the small-molecule market average of 5 percent, and even higher in some biotech areas.

Clariant seems to have heeded the lesson in its restructuring, which it carried out in 2003. "When we decided three or four years ago that we wanted to be excellent in the areas we knew well and we are known well for—organic chemistry solutions—we began to differentiate our offerings and investing in our position of having supply capabilities in both the EU and the USA," says Ralf Pfirmann, global business director of Clariant's pharmaceutical fine chemicals business. "Pharmaceutical innovators are acknowledging the robustness of our offering."

The company has also diversified its offering, in late 2004 entering the market for producing controlled substances at its Spring-

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SOLD

There have been other shifts in the market. In the last year alone, GenCorp sold Aerojet to American Pacific; Lonza sold its Pasadena facility to Gulf Bayport; Nufarm sold SEAC to Minakem; and Rütgers Chemicals AG sold its fine chemicals business in Mannheim, Germany and Augusta, Georgia, to International Chemical Investors, which renamed it WeylChem. Borregaard sold Borregaard Synthesis in Newburyport, Mass. to Polycarbon Industries and closed its facility in Maddone, Italy. Diosynth put its Buckhaven, UK, facility up for sale; EMS-Chemie spun off Dottikon; and the investors behind Avecia have begun to parcel the business out.

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field, Mo., facility, developing a line of problem-solving reagents—SynSelect Functional Products—and revitalizing its generics portfolio, with plans to expand it by two to four launches per year.

Pfirmann sees "steady, sustainable growth" in the market, but with a caveat. "Pharma companies are becoming more selective in the suppliers with whom they will work."

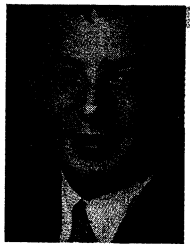
Beyond a distinct offering, though, success also requires a commitment to service, a commitment Hovione chief executive Guy Villax believes was neglected by the chemical giants. "I think they never considered it relevant and did not organize themselves to address that critical aspect," he says. "The execution of the service element is extremely challenging, as it relies almost entirely on the project team to do good service, that is, it is they that interface with the customer—not the sales person."

Despite the hardships of the last five years, the small and mid-size generic API manufacturers that pursued outsourcing have managed to grow, he says, because they not only had capacity, they also had a track record, proven competencies and management that focused on serving customers well. Further, they had the vision to see that the center of innovation was shifting to the biotech sector. "Till the end of the '90s, who you had buying outsourcing services was Big Pharma. In this decade, the buyers became the biotechs. They need to buy a very different product. They are not driven by tax strategies. They are not in the rent-a-vessel business. They need a complete solution that involves many disciplines, and they prefer people with a track record in APIs, not in intermediates."

"The model offers flexibility for the separate development of fine chemicals"

Wilhem Stahl, head of R&D/head of marketing pharmaceuticals, Lanxess

Lanxess' fine chemicals business has been under serious strain, burdened by underutilization, obsolete assets, and annual losses in the hundreds of millions of euros. The company is responding by carving the fine chemicals business out as an independent company under the umbrella of the Lanxess Group. "I believe this is a necessary step, if we are to successfully implement the new business model," says Stahl. "The new model offers maximum flexibility for the separate development of the fine chemicals business," he explains. "It enables us to drastically reduce costs by closing facilities where capacity utilization is low or the plants are unsuitable. We will deliberately forgo unprofitable business. And finally, all key services will be rendered directly by the new legal entity—in an efficient manner and carefully tailored to support our fine-chemicals business."



"There remains an excess of supply to demand but... we see this being more balanced in the future"

Nick Green, president, Rhodia Pharma Solutions

Nick Green, president of Rhodia Pharma Solutions, believes industry dynamics are favorable. "There remains an excess of supply to demand, but if the present trends continue, we see this being much more balanced in the future," he says. "We have restructured our business in order to improve our costs. At the same time, Rhodia Pharma Solutions is getting closer to customers in order to better understand their needs and offer mutually beneficial solutions. We are also focusing on technologies, like hydrolytic kinetic resolution (HKR) and aromatic bond formation (ABF), that differentiate us in the market. All of these actions are yielding positive results as we seek to improve our operations."

Matt Hanson, market manager at SAFC, expects continued consolidation and fallout as a result of overcapacity. SAFC's business has been "solid," however. "Emerging pharma and biotech companies continue to have moderate success raising capital for developmental projects, and that has created continued buoyancy in the contract manufacturing industry."

Roger Laforce, general manager, marketing/sales, R&D and logistics at FIS, is optimistic. Business is improving, he says, not only at FIS, but apparently more generally, even though the number of NDAs has not increased. "The better situation may be attributed to more outsourcing (also of mature products) but also to more intense marketing and sales activities of the providers," he suggests. "Outsourcing practices have become more challenging—this gives us a chance to show our skills." Pipeline management has become more complex and demanding, he says, with more and smaller projects in earlier clinical phases. "Turnaround times of offers have become incredibly short," he notes. "Full project management is the response."

OVERCAPACITY

Excess capacity remains a serious problem. "We have seen a number of restructuring activities at various custom manufacturing companies over the last few years," says Wilhelm Stahl, head of R&D and head of marketing pharmaceuticals in the business unit fine chemicals at Lanxess. "This has, however, not yet led to any substantial consolidation of overcapacities." He observes a "slight improvement" in business conditions, and notes that moves by a number of large pharmaceutical companies to consolidate their production sites are generating outsourcing opportunities, but there is a way to go yet. "The market continues to be a buyer's market with considerable competitive pressure."

PIPELINE QUALITY

Clariant's Pfirmann says that virtual or biopharma companies are serving their role as a source of innovation on the way to commercialization very well. "In the last three years, we've had more than 30 active projects with these types of companies."

Pfirmann also makes an observation: While pharmaceutical pipelines are increasing in size and value, FDA approvals are not rising but falling, a dynamic that would tend to limit the growth of the contract manufacturing industry. But he sees a bright side. "This may not be such a bad situation for the custom manufacturer and fine chemical company, however," he surmises. "If pharma companies have smaller pipelines that are healthier, you see a situation in which sustainable, manageable growth can occur. The risk is smaller.

"If you look in the past, major projects with expectations that have not come through have triggered investment that resulted in overcapacity."