# Hedge Your Bets

## Inflation and foreign-currency considerations in pharma vendor contracts

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THE MODERN PHARMACEUTICAL SPONSOR can readily pay its global suppliers in a broad range of currencies. The majority of Contract Research Organizations (CROs)[1] also pay their staff worldwide in a range of local currencies, but typically prefer to bill the sponsor in a major currency: most often US dollars (USD) but also Euros (EUR), British Pounds (GBP), etc.

Inflation and foreign-exchange (FX) variability across these major currencies is often fairly easily characterized and managed. However, broad global FX fluctuations and headline consumer-inflation rates must still be balanced against an intelligent analysis of industry-specific inflation — i.e., CRO wage and cost inflation — even in these more straightforward major currencies and the more stable countries in which the major currencies are used. In emerging, secondary, or soft-currency markets, the need for careful analysis only becomes far more acute.

Pharma sponsors frequently allow their CROs to charge additional inflation fees on top of agreed rate cards. These additional fees are often indexed to broad headline inflation in the regions where services are rendered. While this need not be troublesome to the sponsor necessarily, I will illustrate how some pernicious dangers lurk behind this ostensibly innocent and fair practice. Chief among these dangers is applying nominal headline inflation from a given non-major-currency country to a contract budget denominated in a major currency. The effect of such practice is to overpay the vendor in real terms, relative to its genuine outlay and the genuine inflation (if any) over time of that outlay in the countries where it delivers services. At worst, CROs are exploiting such discrepancies to improve their own revenues, margins, cash management, and foreign-currency risk — and by definition, such improvement is at the cost of the sponsor.

### A Thought Experiment

An easy way to illustrate the nature of the problem — of overpayment of inflation — is to imagine the following scenario during the famous Zimbabwean hyperinflation episode circa 2008[2]. Headline inflation in Zimbabwean dollars (ZWD) reached millions of percentage points before ascending into peaks of absurdity in the sextillions of percent. However, local inflation in USD terms was, and is, moderate. Imagine, nonetheless, a pharma sponsor hiring a global CRO to perform services only in Zimbabwe. Following common practice, the contract is set in USD but the CRO argues for some compensation for inflation; perhaps indexing to local headline inflation. If this mechanism were actually applied in practice, the contract value would be corrected on the next effective date to an amount of USD greater than the value of all combined trade in human history.

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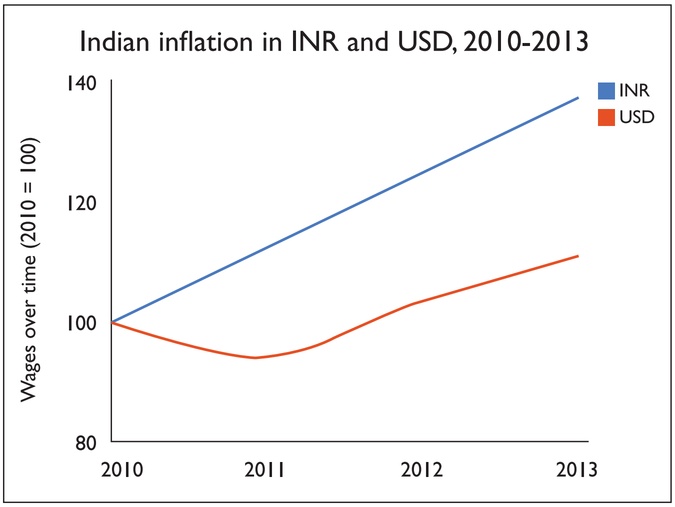
Absurd, you protest? Certainly, but on a much smaller scale, this is precisely the mechanism sponsors are frequently agreeing to. One might well argue that there is still inflation inherent in the USD, and that the above contract should instead have allowed for U.S. Federal Reserve headline inflation, or similar. But this would be to neglect the opportunity to take some moments to analyze whether that would be reasonable in Zimbabwe. Were wages of CRO professionals, and rents of office space, *when expressed in USD,* rising in Zimbabwe at the time at a rate approximated by U.S. consumer inflation? They may well have been rising, but may have been doing so faster or slower.

One more thought experiment that is of use is to imagine what a sponsor is actually paying a CRO over time in terms of barrels of oil, gold-ounces, or other alternative benchmark. A sponsor can easily end up overpaying in real terms in a major currency such that a local CRO office in a weak-currency/high-inflation zone could buy, with its share of the parent company's revenue, a much greater quantity of commodities (leaving aside for a moment the confounding variable of commodity prices — a phenomenon even more vexing than FX fluctuation).

### Inflation and FX are Inextricably Linked

Sponsor and CRO employees alike will often argue that FX and inflation are entirely separate topics. But a moment's consideration of Zimbabwe, the Weimar Republic, Argentina, or modern India shows that, on the contrary, high inflation is very often a function of a local currency weakening versus a basket of harder currencies. De-linking inflation from FX is to risk ignoring the fact that nominal high inflation in a given country does not automatically mean the CRO should be paid more to compensate; in the contract currency, once FX is considered, real inflation may be zero or even negative (more on deflation below).

An instructive example is the Indian Rupee (INR), and nominal inflation in India, versus that same wage inflation progression when expressed in USD. The progress of a salary in INR starting in 2010 (see Chart 1[3]) appears to evince strong wage inflation, but in USD terms the inflation was far more muted, and even negative from 2010 to 2011.




A USD contract for Indian services during this time period need only have allowed for a modest annual inflationary increase (approximately 3.6%[4]; only moderately higher than U.S. consumer price inflation over the period of about 2.1% annually[5]) in the USD service fees in order to adequately compensate the vendor and their employees for Indian wage inflation; whereas Indian wage inflation in INR ranged from 10% to 12% over this period.

### Secular/Standard-of-Living Inflation Vs. Nominal Inflation

To be fair to CROs, on occasion wages of clinical research professionals may rise faster than headline inflation in a given country. This will occur when there is a fundamental structural rise in real wages even when expressed in hard currency or, say, gold-ounces. This can also be referred to as a secular increase in the standard of living of local clinical research professionals. In this case, the CRO may argue that they should be paid more in such territories, year-over-year, even in USD terms.

However, entertaining that argument will require the sponsor to calculate what the real level of secular, standard-of-living inflation is in the territory in question, *as expressed in a hard currency.* It will inevitably be less than the nominal, headline inflation in local currency. Furthermore, the sponsor will want to consider whether it ought to pay for such secular inflation, or whether the CRO should (a) absorb some of the increase itself, in a natural abating of higher margins as the local market matures; (b) employ technological and other innovations to preserve margins by lowering input costs other than wages; and/or (c) compensate with greater efficiencies in working practices. If that seems unfair, consider that by definition in such a scenario, the standard of living of the CRO's employees is increasing; it is reasonable to expect that in turn the overall quality of life, safety, and infrastructure in the territory is improving, and that this will lead to manifold improvements in efficiency — e.g., employees commuting to work faster, internet connection speed improvements, truancy/accident/illness leave reductions, etc. If the sponsor instead absorbs all secular inflation costs, the effect is to subsidize the CRO through failure to enjoy these benefits being passed through.

### Confusion Between Wages and Total Costs

In the above discussion, we are still mainly considering only wage inflation. To properly evaluate whether a CRO is deserving of inflation in their fees, we must consider the proportion of wages to other input costs, such as building rents/leases/mortgages; laptops, printers, and smartphones; telecoms; travel; and servers and software licenses, etc.

It is overly simplistic to imagine that all such costs increase for CROs at the rate of headline inflation — in many cases, while wages push ever upwards, the costs of IT equipment and services relentlessly go down. Similarly, real estate costs can often be advantageously kept down during the current global recession.

A sponsor does well to ask its CRO what proportion of its costs are wages and what trends it sees in both its wages and other costs (a starting rule of thumb could be 75% to 80% of CRO revenue (i.e., service fees) representing labor costs[6]). The CRO may still prevaricate, but the conversation has begun and transparency can only improve if the sponsor persists in this line.

## What's Sauce for the Goose is not Sauce for the Gander

Consider the real-life (anonymized) case of a prominent Indian services vendor of business-process-outsourcing and support. The vendor's services and business model are predicated almost entirely on services provided by Indian staff in India; though some corporate HQ functions are in the U.S.

This vendor, when pressed by a sponsor to change its contract currency to INR (since it was the preference of the sponsor to set contract budgets in the currency of the country where the majority of services are to be performed), declined, noting that it did not set contracts in INR for any of its global customers, and did not intend to start. The subtext was that this vendor did not consider the INR a worthwhile or desirable currency. Sponsors faced with this attitude should consider whether it seems fair to pay the majority of one's employees in a given currency, but shun that currency as an inferior store of value in their company business.

A related concept is how the vendor passes down its inflation rates, as awarded by the sponsor, to investigators and subcontractors. If vendors are responsible for investigator contract negotiation, it is of interest whether their contracts allow for award of inflationary increases to investigators. One should ask the same question about subcontractors: if there are less generous inflation factors in the vendor's subcontractor agreements (those that are not straight passthroughs, that is, but rather woven into service fees), then on that portion of services, the sponsor is effectively padding the vendor's margin.

## A Simple Principle

Now, a word on the Swiss Franc (CHF), since it is, and has long been, a special case. Inflation in Switzerland has not, in recent years, existed, at least in many sectors. Rather, in areas of the economy such as housing rents, the federal index governing such rents has dictated decreases for several years running. Wage inflation, however, does exist inasmuch as the richest and most profitable companies, such as Swiss pharma giants, still pay modest base annual increases in CHF salaries of perhaps 1.2%.

Despite this, at least one pharma sponsor has agreed inflation factors with global CROs that allow for fully 4% inflation year-over-year of CRO service fees, for services rendered only in Switzerland. Again, sponsors must ask themselves whether it is fundamentally fair or reasonable to award an external company's employees with greater pay rises than their own.

Of course, CROs may indeed not award their employees annual pay rises that match or beat headline inflation. As seen above in the standard-of-living-inflation section, if CROs manage to suppress wage inflation, this can either flatter their own margins, or be passed through to the customer. It is the canny customer who insists on extracting this value through exerting firm control over inflation terms.

## The Dogma of Permanent Inflation Vs. the Reality of Deflation

The CHF discussion above highlights an important point: the previous couple of decades have led people to adopt a dogmatic tendency to expect continual inflation as the natural order of things. But deflation exists in many guises and forms, not just in across-the-board deflation in Japan and Switzerland, but also in the continually decreasing cost of computing power and storage (as noted, sponsors should beware paying inflationary increases on that portion of fees representing IT overhead).

Again, country-by-country and service-type-by-service-type considerations must be made to ascertain whether a given vendor's fee-inflation requests are justified.

It risks becoming routine practice for pharma sponsors to accept CRO service fees in multi-year contracts being automatically increased year-over-year, by factors based on headline inflation in local currencies. A more careful analysis of this practice shows that the primary risk of such practice is to overpay in the contract currency, if the underlying inflation rates are based on softer currencies, yet those rates are applied to a hard contract currency.

Other areas demanding more cautious analysis abound: the improvements over time in CRO efficiency, technology and productivity that should at least in part accrue to the sponsor; the crucial distinction between wages and other CRO costs; and the existence of genuine deflation in many jurisdictions.

Most fundamentally, sponsors must also ensure that basic principles of fairness and reciprocity are adhered to in what are, after all, fashionably referred to as "partnerships" with their CROs. Vendors who reject being paid in the currency they pay their staff, or who ask to be effectively paid higher salary increases than their sponsor counterparts enjoy, are asking for special treatment which the pharma industry increasingly cannot afford.

Indeed, such partnerships (read: "deep strongly-preferred-vendor relationships"), if they are true, mature collaborations, will allow for this and other topics to be negotiated by applying the greater level of sophistication required to do them justice. As in all things outsourcing, however, all parties would do well to heed Ronald Reagan's favored axiom: "Trust, but verify." ■

### References

1 This article applies just as well to all pharma vendors, but for simplicity the analogy of a CRO is employed throughout.
2 http://en.wikipedia.org/wiki/Hyperinflation_in_Zimbabwe
3 Data sources for Chart 1: http://www.aon.com/apac/human-resources/thought-leadership/asia-connect/2013-may/salary-increases-in-india.jsp and http://www.oanda.com/currency/historical-rates/ (USDINR rate taken for each year from the average midpoint rate for the final week of that year)
4 http://www.ultimatecalculators.com/compound_interest_calculator.html
5 http://www.usinflationcalculator.com/inflation/historical-inflation-rates/
6 Source: personal conversation with the CEO of a regional CRO