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Generic Pesticide Producers Must 'Add Value' To Their Products To Survive And Prosper, Consultant Advises

Jim Budzynski, a principal in BrightPath Capital, offers analysis and recommendations at a recent CPDA workshop on a wide range of topics, including the strategies generic pesticide companies should adopt to successfully compete in a rapidly changing environment.

Generic pesticide producers must "add value" to their products if they are to survive and prosper in an increasingly competitive marketplace, an agri-food consultant and private equity professional advised at the summer meeting of the Chemical Producers and Distributors Association.

During his July 25th presentation in Newport, R.I., Jim Budzynski – a principal in Zionsville, Ind.-based BrightPath Capital – touched on a wide range of issues affecting pesticide producers in general, and generic pesticide companies in particular.

Among other conclusions he reached from his industry analysis, Budzynski said that "focusing on low [product] price as your only differentiator is a fool's errand unless you are Wal-Mart." Budzynski believes generic pesticide producers must base their business models primarily on customer needs – while ensuring that their profit drivers are sustainable and logical.

Before providing guidance on the pesticide industry, Budzynski provided the members with a big picture view of several global and domestic economic trends that will dramatically impact the environment in which all agri-food companies will compete. He observed that, "At the very time that global business competition is ratcheting up, U.S. consumers are in the midst of a debt- and real-estate-bubble-driven spending spree which will end badly."

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Insider asked Budzynski to elaborate on some of his conclusions and recommendations.

TECHNOLOGICAL INNOVATION

Budzynski believes there are three ways to create value for customers: product leadership, which involves delivering value to customers via state-of-the-art technology; customer intimacy, which involves tailoring and shaping offers for individual customers; and operational excellence, which means being a leader in price and convenience. Of these three options, Budzynski said, "product leadership" is the most misunderstood, because, for the generics, "'state-of-the-art technology' doesn't necessarily mean investing in new molecules.

"One of the fallacies of product leadership," Budzynski continued, "is the assumption that it means a new molecule. Certainly, for the basic manufacturers, that's what it typically means because that's how their business models work. But, if you've selected mature molecules over new molecules for your business model, there are many ways to be a product leader without inventing new molecules.

"Let's say," Budzynski added, "that a customer has a particular challenge in easily using your product because of its handling characteristics, and you devise a new, delivery system that greatly simplifies the way the customer uses your product. In that case, even though the molecule in the container may be mature and off-patent, what you're doing is delivering a technological innovation that adds value for the customer by providing a product that's more usable for them. So, that's an example of product leadership through 'non-molecule' innovation."

INNOVATIVE FORMULATIONS

Budzynski notes that innovative product formulations are another important example of product leadership. "Formulation expertise is a critical area in which to differentiate mature products," he said, "and there are lots of examples of older molecules which, frankly, were never in great formulations even in their heyday – and, by applying up-to-date formulation techniques, there are opportunities to improve those products."

Another way to assert product leadership for mature molecules, Budzynski said, is creating formulations with new ingredient combinations. "If there are two unique molecules that are often used together, and have some unique synergy," he said, "you could put those together in a unique way and add value for the customer.

"There are many products with multiple active ingredients," he continued, "although I think the industry is further along in core row crops, where there is more product volume to justify product development – and more intense competition to fuel the need for product differentiation. In a lot of areas of specialty pesticide use, like golf courses, the industry often still uses [active ingredients] one at a time or tank-mixes them. So companies have the ability to add value by coming up with synergistic ingredient combinations. There are lots of ways to add value without developing a new molecule."

A *PESTICIDE.NET* PROFILE

JIM BUDZYNSKI

Jim Budzynski, a principal in BrightPath Capital, is a PhD soil scientist who – after a series of career transitions – is now "looking to find opportunities to back management teams or companies who need growth capital for their businesses or seek to take products or divisions private."

An Indiana native, Budzynski had his first taste of soil science when, as a youngster, he helped his father – a soil scientist with an agricultural consultancy – gather soil samples. The experience, and an interest in science, led to a Bachelors Degree in Agronomy (Purdue University) and a Masters and Doctorate in Soil Science (University of Arizona).

Budzynski would also follow his father's consultancy example, but not until he had spent 12 years at Monsanto in a variety of product management, marketing, and strategic planning assignments – and having reached the position of Global Product Director at the time (1994) he departed to try a solo career.

"I ran the strategic division of a company much smaller than Monsanto for a while," he recalls, "but, for most of the last 12 years, I was a consultant to senior management in chemical, agri-food, retailing, distribution, fertilizer and seed companies. I started BrightPath Capital this year by teaming with a partner who has many years of experience in investment banking and private equity, and by combining our strengths we've formed a private equity firm focused on the agri-food space. There are so many great ideas and managers in this industry who can do so many things with access to strategic capital."

Asked if he misses science, Budzynski said, "Yes, but I've found that, when you're looking to help a company with its products, the science skills come right back and you can apply what you've learned to understanding their product positions and helping them to either better promote the current technology or buy complementary technology to take the business to a higher level."

Budzynski, who currently resides with his wife and daughter in Zionsville, Ind., notes that he "learned a lot working for a giant company like Monsanto," but adds, "You can't deny your entrepreneurial instincts forever."

CUSTOMER INTIMACY

Customer intimacy means, among other things, providing products tailored to customer needs – but not necessarily the needs of such retail customers as growers or applicators. “For most post-patent players,” Budzynski says, “the predominant customer is the channel customer [including dealers and distributors]. The channel customers represent a huge percentage of the revenue [for both generics and basics].”

Channel customers, Budzynski pointed out – especially the big distributors with retail outlets of their own – “typically have built their business models on customer support. In my view, the survivors will be those with the closest customer relationships. They understand the ultimate end users’ needs the best, which is precisely why post-patent companies need to focus on adding value for their channel customers – and that involves doing something more than rolling in the door and saying, ‘Well, here’s the program, this week, and if you buy this, we’ll give you this discount.’

“[Generics] selling to channel customers,” Budzynski added, “should talk less and listen more. What are [channel customers] trying to accomplish for their customers and growers, and how can [generic companies] help them? A lot of them have a product focus, ironically, not unlike the big chemical companies. The ‘Big Six’ manufacturers have always had a disproportionate focus on their molecules instead of their customers’ businesses, and what’s ironic is that many of the post-patent companies have followed into those same markets with precisely the same strategy. Of course, this is not totally surprising since many of the people selling post-patent products got their training working for one of the Big Six, which makes this mindset difficult to ‘unlearn.’”

NICHE PRODUCTS

Does listening to the needs of channel customers include a potential investment in niche product development?

“Yes,” Budzynski said. “You can tell when an industry is over-focused on operational efficiency when you see them resisting niche products. Niche products, if they’re well thought through and meet a particular customer’s needs or offer unique product benefits, are exactly the kind of products generic suppliers should be offering. Niche products can offer a healthy profit margin, and companies with a focus solely on ‘big’ molecules could find themselves in a very difficult position [as competition for ‘big’ molecule market share intensifies] unless they have the absolute best cost position.”

Niche products would include aquatic herbicides, which, because of increasing restrictions (particularly at the state level) are becoming “more and more an applicator’s market,” Budzynski said. “SePRO, for example, has done an outstanding job with their business model for that niche and meeting the diverse needs of applicators.

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"Termiticides," he added, "have undergone a similar transition. There was a time, 30 years ago, when homeowners could buy these products and treat their homes themselves. Now, they wouldn't think of doing those treatments themselves. They virtually always hire a professional applicator. In many cases it's becoming an applicator-driven market for these niche products."

FIELD SUPPORT

Should generics consider investing in the level of field support that Monsanto provides for its glyphosate products?

"It depends," Budzynski said, "on how you define field support. If your definition is, 'I'm going to hire 50 sales people to call on growers one-on-one,' it would be very difficult to make that model work. In fact, it isn't even working for Monsanto anymore; they have methodically downsized their sales force and shifted people from chemicals to seed over the last several years, and that's not unusual when you look at what's going on with the big players. Virtually none of them are increasing their sales force. And, where there has been any growth, most of those people are calling on channel customers, not end users."

PRICING DECISIONS

Meanwhile, many companies – both the basics and the generics – are said to be decreasing their prices in response to a variety of pressures. "Pricing leadership," Budzynski said, "is a component of operational excellence, and it means the company uses their high level of efficiency and their cost leadership position to add value for customers."

Therefore, it's perilous for companies to focus on pricing as the only way to differentiate themselves, Budzynski warns. "If you make that decision, you are making two assumptions: first, that you have today, and can maintain in the future, the lowest cost structure in the industry; and second, that you have enough resources to survive the shake-out process. Remember the old joke that you are only as smart as your dumbest competitor? It's funny only because of an element of truth. For all but a handful of companies, focusing on price as the only differentiator is a death sentence – although you may get to spend a few agonizing years on 'death row.'"

THE PERILS OF THE 'MIDDLE'

A company that's in the "middle" is "a company like Sears," Budzynski observed, pointing out that, "They never said, 'Here's where we're going to differentiate ourselves.' What they said was, 'We're going to try to be everything to everybody.' In other words, they said, 'We want to be in the middle.' As a result, they are 'OK' at everything, but not better than anybody at anything. They do not have the best products, the best cost, or the best relationships.

"So," Budzynski continued, "never decide that how you're going to differentiate is solely by price, because the vast majority of companies, obviously, are not going to occupy that space. By definition, for any given molecule, there's only one company with the lowest cost position. There may be a few others kind of close, but everybody else, if their strategy is pricing – they're kidding themselves. The way to differentiate yourself is by products and customer focus, and avoiding pricing as your sole strategy for differentiation."

INTERNET TRANSPARENCY

The Internet, however, has increased pricing pressure simply by providing opportunities to buy products at lower prices than those offered by dealers. Budzynski says this "Internet transparency" has infrequently resulted in "people switching their supplier from Company A to Company B. Instead, it's resulted in people going online and finding a quote on the chemical they want at a cheaper price, and then going to their retailer and saying, 'Listen, I can get it for this price online; will you match it?' So, this pricing transparency has effectively lowered margins and product profitability for retailers who match the online prices. And, while he is maintaining the volume of product moving through his shed, he is making less money on that volume. The key to managing this is being able to candidly ask the customer to pay you for all the services you provide. The Internet has done more to help retailers learn to sell services than all the training programs ever put together have."

THE PITFALLS OF REBATES

At the same time, Budzynski maintains, distributors and retailers are far too dependent upon rebates. "Home Depot," he said, "couldn't imagine running their business that way. They couldn't imagine losing money on everything they sold and counting on a rebate from the manufacturer to be profitable for the year. Yet in our industry we do this all the time.

"Home Depot," Budzynski continued, "makes money at the time of sale. They'd never consider a business model in which they linked their profitability to the uncertain payment of a rebate from a manufacturer months into the future. But this practice is huge in the pesticide industry. There are retail organizations which, if you took away their rebate checks, would be unprofitable. There are a lot of huge organizations that lose money at the time of sale and depend on those rebate checks to stay in business.

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"As an industry," Budzynski added, "we've been horrible at selling products profitably and also keeping rebates. Basic manufacturers that offered 5% discounts have discovered their channel customers giving away four of those points in the marketplace, which drags down the pricing for everybody. When many of those manufacturers discovered that the market price of their products had dropped 4%, they said, 'These guys

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can't be counted on to keep anything we try to give them and put it in their pockets. So, since they seem to be obsessed with giving away our discounts immediately – in fact, sometimes before they get them – we're switching over to year-end 'black box' rebates [meaning rebates based on various performance formulas].'

"Those 'black box' rebates," Budzynski pointed out, "range from 0%-to-15% – and sometimes even more – and they have the effect of telling the channel customers, 'You can't easily give away our discounts anymore. So, if you give away 12% during the year, and our rebate check is only 5%, you're broke!' What does it say about our industry that the only way we can make money is to withhold information?"

Yet, despite the efforts of many basic manufacturers to rein in pricing competition, "Overall, the rebates are increasing," Budzynski says. "In this post-patent, 'Wild West' environment, all the generics want to get in the game – many by giving rebates that are comparable with those of the basics. The basic says, 'I want to stay in the game, too, so I'll bump up my rebate.' This sort of competition is common today among the automakers, and it hurts them, too. Car companies offering rebates are stealing from future demand to fuel short term volume at a lower margin, which doesn't make any sense in a long-term view of the auto industry. It is no different with pesticides. Just because a generic glyphosate is cheaper, are you going to buy twice as much? You only have so many acres and crops out there. Pricing doesn't change core demand for these chemicals. Using pricing to drive volume basically just steals from future demand."

THE 'RULE OF THREE'

Under the "rule of three," Budzynski points out, three entities ultimately emerge to dominate most competitive marketplaces. Price wars among the generics, whose profit margins are thinner than those enjoyed by companies selling products with patent protection, will make it even more difficult for generic companies "in the middle" to survive, he points out. But the pressure of price wars will increase the susceptibility of the basics to the "rule of three," as well.

"We have six basics vying for the three slots in the 'rule of three,'" Budzynski says, "and they are also competing with each other to see if they can out-rebate the other guy to be the survivor."

The 'Big Six,' in order of global sales revenue, are Syngenta, Bayer, BASF, Monsanto, Dow and DuPont. Asked if some of those companies could disappear in combinations, Budzynski said, "Absolutely. They all have to be looking at who's going to survive long term. I recently read that Hertz had been number one in global rental car sales until Avis bought Number Four, so now they're number one and they had to drop those 'We try harder ad's' because they're not number two anymore. That's precisely the kind of dynamic that's pressuring the Big Six. It would be challenging, for

The "Rule of Three"

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antitrust reasons, for Syngenta to easily acquire anybody else because their portfolio is so broad and they play in virtually every segment of the market, they would most likely be forced to divest several of their product lines. It would probably be difficult for Bayer, too, but not impossible. But, if you look at the other players, there are any number of combinations among them that are possibilities."

GENERIC COMPETITION

Budzynski believes that the basics, while striving to maintain molecule share, should not become "arrogant" about their market shares for post-patent molecules. "If you're a basic, you know you'll lose some market share post-patent," he notes, "but, the question is, at what rate will that 100% share erode? In a successful scenario, the original basic keeps 50% of the sales volume under its name while maintaining 35% of the volume under channel private labels. So, that would be an 85% molecule share – not a brand share.

"A failure scenario for the original registrant," Budzynski continued, "is when 30% of the volume falls into the hands of true generics or some other entities with no relationship to the original registrant. Failure arises from doing dumb things to maintain a 100% share of the volume. The basics can make a lot of money in the post-patent game, but, if they're arrogant about how they manage their business in a molecule post-patent, they'll actually encourage greater generic share. A lot of companies that weren't smart about playing the post-patent game have been burned."

THE NEW POST-PATENT GAME

Years ago, when generics were low-volume and variable-quality, Budzynski said, "channel players got into the post-patent game and would tell the basics that they would start buying from generics unless they were offered a good, post-patent deal – and they virtually always got a good deal.

"Now," Budzynski continued, "the game is more about balancing because some of these international suppliers have become big enough to where they're fairly reliable, high-quality suppliers. So, now the channel players have to say, 'Maybe I shouldn't just bluff. Maybe I really should go with someone else.'"

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A joker in the deck, however, is the recent copyright decision against a generic producer accused of copying an FMC Corporation bifenthrin-product label (see *Insider*, Vol. 2, No. 11, "Me-Too Registrants Reeling From Court Decision," June 7, 2005) to obtain a me-too registration.

If that decision withstands appeal, and the value of a copyrighted label becomes a routine component of data-compensation awards, then the cost of generic products could increase dramatically, and the channel customers will have less flexibility to go elsewhere. Generics have been placed in a no-win situation where they either violate copyright law by following FIFRA [language requiring identical or substantially similar wording on generic product labels] or they violate FIFRA with substantially different labels. Something must give – either this ruling will be lost on appeal or FIFRA – and EPA policy – will need to be amended to allow differentiated, non-copyright-infringing label language. Think of the regulatory, legal, and economic consequences of having six or seven completely different labels for the same active ingredient in one market."

CAPITAL STRUCTURE

"The post-patent playing field," Budzynski observes, "is in a state of flux, and it's going to require a lot more financial sophistication on the part of agrichemical companies, which, except for a few bigger companies, have capitalized their businesses almost exclusively with insider or family equity. Although there is a great deal of capital available today on relatively attractive terms, the lack of connections between these capital markets and ag companies has resulted in the majority of these funds going into traditional manufacturing and high tech industries. There are many ways for companies to enhance their returns by being more sophisticated about how they finance growth. If you have a company that's capitalized primarily with insider equity, and without much debt, you're not returning much on your capital if you're operating on extremely thin margins. These companies will have to take advantage of the wide range of opportunities in the debt and equity markets to fund the growth of their business.

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"I believe," Budzynski added, "that this strategy applies even more to generics because they have the same financial challenges as the basics – but on a much smaller business volume."

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