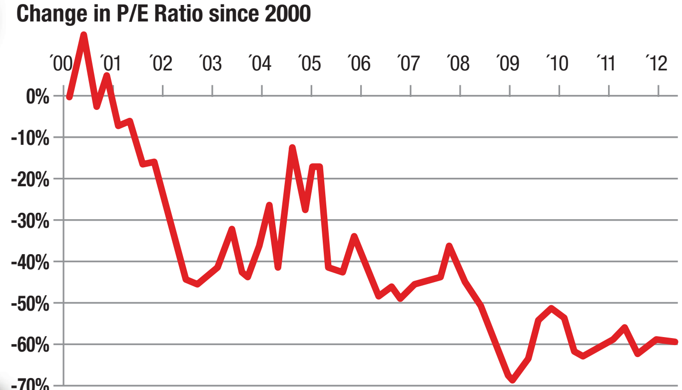
INSIGHTS

Aligning your Supply Chain to the Changing Drug Marketplace

Industry Challenges

Over the past decade, the Pharmaceutical industry has experienced a myriad of market forces leading to a continual decline in shareholder value. In a financial analysis of leading Pharmaceutical companies conducted by Clarkston Consulting, data reveals a continual decline in price-to-earnings (P/E) ratio for those companies over the last 10 years. Since 2000, the ratio, a forward looking indicator of value reflecting investor demand for a company's shares, has steadily declined by 60%.

Change in P/E Ratio since 2000



This decrease is being driven by a variety of game-changing forces.

- **Shrinking drug pipelines and R&D spend**; Pharmaceutical spending on R&D has been on a steady decline. Winning regulatory approval for a drug takes, on average, 15 years and $1 billion, so drug companies are being more cautious as to where to place their bets.
- **Shifting of growth overseas**; There has been significant expansion into new and emerging markets, as well as an increase in outsourcing core business functions, such as manufacturing, R&D, and clinical trials, overseas to countries such as China and India.
- **Competitive pressure from generics**; Since the "patent cliff" began to hit the Pharmaceutical industry, generics are claiming more market share and driving brand name drug prices up. According to Thomson Reuters, for the 15 bestselling drugs, prices rose faster in 2010 than in each of the last 5 years. Two-thirds of the drugs saw double-digit price hikes.

- **Evolving regulatory environment**; The Prescription Drug User Fee Act, the implementation of new biosimilars guidelines, and the changing landscape of new drug development are also keeping companies on their toes.

Strategic Responses

Pharmaceutical companies are not sitting idly by as these industry challenges become more evident and exert increased pressure on their profitability. Business strategies are changing rapidly and no two paths seem to be the same. Some companies are expanding globally to tap into new and emerging markets. To supplement shrinking pipelines, many companies are pursuing and executing mergers and acquisitions to add new products to their portfolios and expand into new markets. At the same time, companies are shifting the strategic focus of their core business functions.

In The Discipline of Market Leaders (sidebar), authors Michael Treacy and Fred Wiersema provide a useful, straightforward framework for coming to terms with your company's strategic changes. They assert that a company should center its strategy on what makes it unique within three alternative disciplines: product leadership, customer intimacy or operating excellence. You cannot succeed by being all things to all people; rather, companies win by providing an unsurpassed offering in a specific dimension of value. Ask yourself the following questions about your strategy:

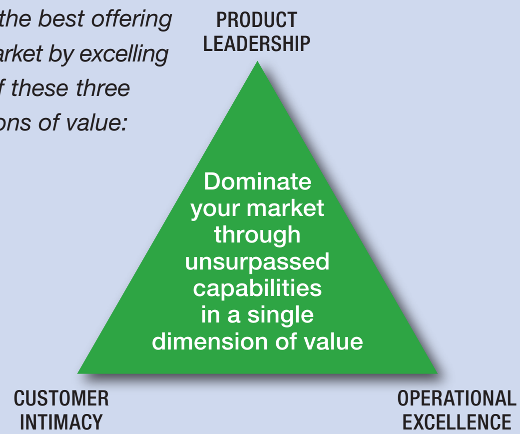
- Will we offer the lowest price within our markets?
- Will we offer the best product and continually innovate?
- Will we tailor our products and services to fit customer needs?

In the following section, we describe how pharmaceutical companies pursuing each of these primary disciplines are reversing the trend of declining shareholder value and how they can leverage aligned operations to improve their chances of success. Three examples are cited: Pfizer, Mylan, and Shire, who collectively have been able to grow their P/E ratio at a rate double that of their peer group since 2009.

The Discipline of Market Leaders

After reviewing eighty corporations in thirty six markets, authors of The Discipline of Market Leaders conclude companies must focus on the differentiated value which they can deliver to a selected market.

Provide the best offering in the market by excelling at one of these three dimensions of value:



Source: *Treacy & Wiersema*

Aligning the Supply Chain

Clarkston's perspective is that the highest and greatest purpose of supply is to enable the company's growth and advantage. As your company's strategy shifts, it is critical to assess whether current operating capabilities will support the primary value discipline moving forward. If your business strategy is no longer centered on blockbuster drugs, then shouldn't your supply chain evolve as well?

It's evident that Pharma's traditional business model, built on blockbuster drugs, is no longer working. As companies in this industry transform their strategy, it is critical to remember your operations must also evolve to support the new model.

Every supply chain design makes implicit trade-offs between customer service, inventory, and cost. The key is to figure out what capabilities will be important to your company moving forward. Companies need to implement a supply chain design that is aligned to their business strategy, products, and distribution channels.

Primary Discipline	Business Strategy	Supply Chain Emphasis
Product Leadership	Innovation	Customer Service
Operational Excellence	Generics	Cost, Inventory, Speed
Customer Intimacy	Globalization	Customer Service, Solutions

Product Leadership: A research and development machine continually innovating products that expand the existing performance boundaries.

The traditional model of developing blockbuster drugs to address the medical problems of millions is no longer working. But this does not negate the opportunities in specialty or niche markets. Shire Pharmaceuticals, for example, has achieved admirable financial returns in specialty pharmaceuticals as a virtual company. Rather than heavily investing in research and development, Shire keeps its pipeline flowing by acquiring very promising drugs nearing regulatory approval. Operating functions are often sourced externally when trading partners can deliver deep expertise and internal competencies are not considered to be critical.

The supply chains supporting specialty pharmaceutical companies like Shire have appropriately focused on ensuring that these innovative products are always available. The costs associated with delivering a high level of customer service is usually more than covered by high profit margins. Responsiveness to swings in demand can be achieved through inventory buffers as well as tactical investments in speed, depending on the cost and character of the drug. As these products mature and achieve market share, consistently high volumes provide the opportunity to be more inventory efficient.

Operational Excellence: Standardized and centrally governed operations affording customers quality drugs at the best price with the least inconvenience.

Through a period of geographic expansion, generics leader Mylan has decided to centralize its global supply chain planning function.[1] Global planners are standardizing systems and practices to drive efficiency through Mylan's vertically integrated active ingredient, bulk and finished dosage plants.[2] This new structure also helps the company to more quickly react to market tender opportunities.

The lower margin products of generics companies call for a supply chain design that emphasizes cost efficiency while concurrently maintaining customer service. Skilled planners utilizing leading practices and advanced planning systems are needed to enable a profitable set of trade-offs between cost and customer service. It is appropriate to engage in periodic network and inventory optimization studies, employing quantitative methods to define smart supply network alternatives. Monthly Sales and Operations Planning (S&OP) is a worthwhile investment to maintain a strong connection between commercial groups, operations, and a profitable plan. When competing with several similar drugs on price, it's imperative to have a cost-efficient operation with end to end visibility allowing a rapid response to market shifts.

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Customer Intimacy: Strong customer relationships and unique solutions enable companies to increase their share of the client's business.

Biopharmaceutical giant Pfizer is shifting to a business model that emphasizes customer innovation. Internally, the company is structured around autonomous business units that develop, market, and sell. Nonetheless, Pfizer actively tailors its operations to the unique requirements of each market. An active "outside-in" dialog with key customers drives customized solutions for sales, manufacturing, and distribution.

Companies seeking growth through globalization may face the greatest supply chain challenges. On one hand, these businesses seek cost efficiency through standardized practices and global business systems. On the other hand, the formula for winning in each market is unique—the payers, providers and distribution environment vary widely. Accordingly, global companies should assess the supply chain in each market independently and strive to create a supply chain which balances economies of scale with customer responsiveness in far flung global networks.

There is one caveat to supply chain alignment: As many companies' business strategies are hybrids, Clarkston believes that you should consider segmenting supply chain capabilities. The simplicity of a one size fits all supply chain may well be the lowest cost alternative, but at the same time a less than optimal approach. Consider creating differentiated supply networks that are suited to the particular needs of each segment of your business.

What Path Will You Take?

The industry is clearly at a crossroads. What path will your company choose? As your company's strategy evolves, think about how you intend to win in the marketplace and work to align your supply chain in support of that focus. The game is changing. Your supply chain needs to change too.

About the Author

Bruce Twery is a senior manager with Clarkston Consulting and a leading contributor to the firm's supply chain efforts. His experiences span over 25 years applying process and technology to drive performance in marketing, supply chain, and business systems.

References

1 Mylan Press Release, Mylan Provides Blueprint for 2012 and Beyond Accessed at http://investor.mylan.com/releasedetail.cfm?releaseid=650358

2 Mylan 2011 10-K Annual Report

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