

Value-creating purchasing

Lorenzo Formiconi, Martin Lösch, Jean-Philippe Talmon,
Marco Ziegler

Pharma companies have not traditionally made purchasing a priority. But new pressure on profits, and structural changes in the industry, are driving many to reassess its importance. New research reveals what purchasing leaders can achieve, and how they do it.

A RENEWED INTEREST IN AN OLD BUSINESS

Stable growth, healthy margins, and virtually no control on important spend buckets like marketing, research, and development have relegated the role of purchasing in pharma to little more than a back-office transactional function. But a new focus on cost has sparked interest in the “art of buying,” with several pharma companies embarking on purchasing initiatives to capture value from what many consider no more than low-hanging fruit.

Unfortunately, it’s not easy to achieve purchasing excellence, and even companies with the highest aspirations need to overcome cultural and organizational hurdles.



“Project Forward, [which includes] all divisions in procurement and IT, [will save] \$1.6 billion over two years.”

– Daniel Vasella, Chairman and CEO



“[We expect significant] savings from procurement and streamlining various operations as we become a biopharma business. This initiative should be complete in 2012.”

– Jean-Marc Huet, SVP & CFO



“[We] set an ambitious five-year savings target of more than \$1.2 billion through changes in the way we procure goods and services. We achieved that goal 18 months early—and set a new target to deliver an additional \$1 billion over the next three years.”

– Richard Spoor, SVP Global Procurement



“In February we announced a major program to improve asset utilization in our supply chain. We are tackling procurement. And...we are doing everything we can to drive out complexity in different parts of the organization.”

– David Brennan

Pharmacos typically face several barriers to better purchasing. Many have a highly fragmented organization and a silo mentality, both the result of geographical dispersion. Country, regional and global organizations may manage overlapping spend without a common understanding about how to collaborate.

Second, managers have low transparency on spend, costs per unit, prices for alternative materials and services at different suppliers within the same category, and so on, thanks to fragmented reporting systems.

Third, a corporate culture driven by risk awareness will pay high premiums to keep overall risk profiles low. This attitude—originating from the need to ensure supply and sustain growth, but also extended to sourcing of indirect cost categories—has in some cases prevented the adoption of more modern risk and volatility management approaches.

Fourth, purchasing staff may lack incentives in terms of remuneration, and more important, in terms of reputation and career opportunities. Purchasing positions can therefore look unappealing, and talent moves towards other functions.

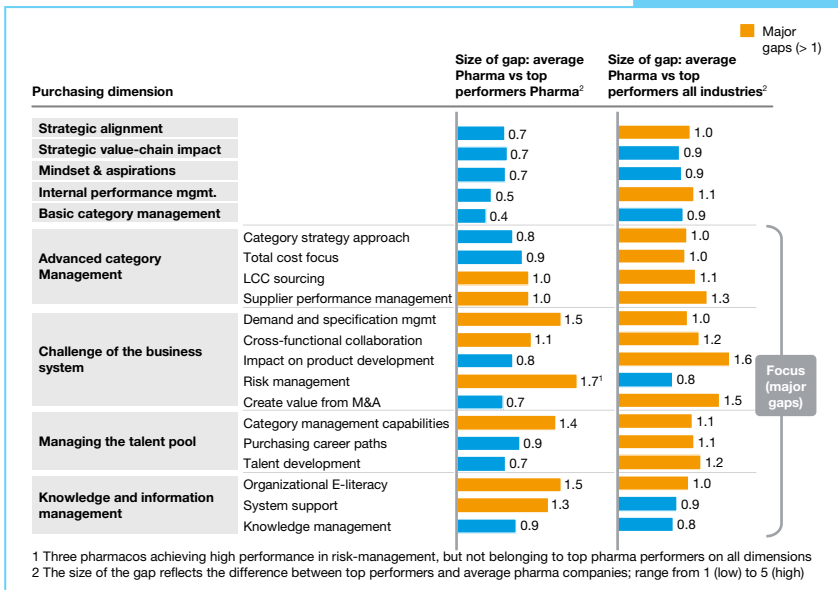
In this context, how can pharmacos create value in purchasing? Can examples within or outside the industry help them navigate there? What are the mantras for the purchasing of the future in pharma?

In a McKinsey purchasing survey based on executive interviews and quantitative data from more than 400 corporations¹ including 20 pharmacos, we found that pharmacos lag top performers from industries such as high-tech, automotive, and consumer goods. We identified four areas where the gap is especially wide: a robust category management approach, the opportunity to challenge the business system, focused purchasing talent management, and effective knowledge creation and distribution (see Exhibit 1).

Does matching top-performing industries represent an unrealistic aspiration for pharma because of its unique industry requirements? Maybe not. In fact, a few pharmacos in the survey were able to achieve top scores in selected purchasing excellence dimensions, closing much of the gap with the top-performing industries: their example could represent a starting point for other pharmacos.

1 Based on McKinsey's Global Purchasing Excellence study—a large-scale, empirical study correlating procurement practices with corporate performance. Results are based on in-depth interviews with Chief Purchasing Officers and extensive written surveys of large corporations from all major industries and across all geographies. More than 400 survey responses have been analyzed so far, and results correlated and validated with confidence level of over 95%.

exhibit 1



SOURCES OF VALUE IN PHARMA PURCHASING

1. Implement advanced category management

Sharpen your category strategy approach

Purchasing leaders have a culture of exploiting every opportunity to reduce their total cost of supply using a well-established category management process, where purchasing is recognized as a value-driver by all business functions. Top performers integrate basic instruments, such as better spend transparency, clear-cut category definitions and responsibilities, a deep understanding of the company's day-to-day business, and overall spend size and drivers. They also use more advanced approaches, such as a purchasing strategy tailored to take advantage of the specificities of the supplier market in each category; a total cost focus that helps them capture and compare costs and benefits of different purchasing options throughout the life cycle of the purchased good; active LCC sourcing; and a well-structured approach to supplier management based on objective performance measures.

Pharmacos can benefit from advancing beyond the basics in category management. One pharmaco that recently focused on improving its category management for packaging materials saved over 10% by more carefully screening the supplier market, expanding the scope of its RFPs to more

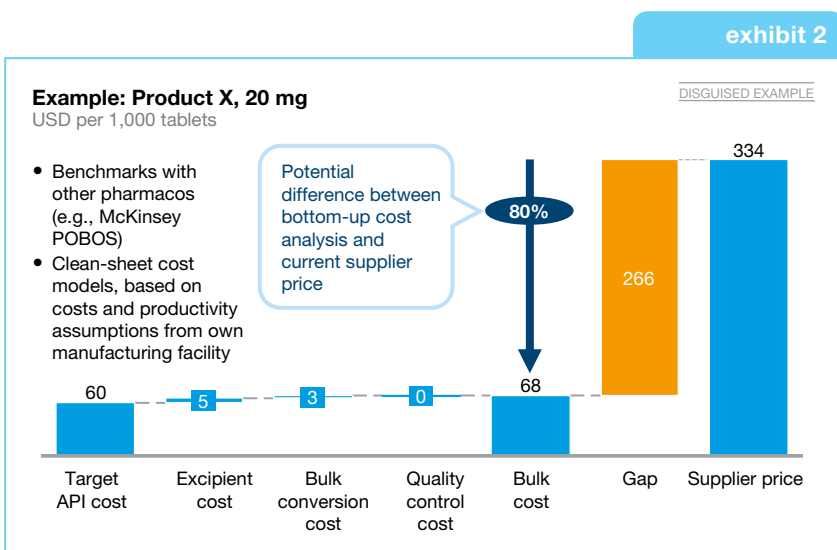
candidates, and more aggressively negotiating conditions with the selected partner on the basis of insights gathered during the RFP process.

Create transparency on total cost with a benchmarking mindset

An important element of an advanced category management is full transparency on the total costs—direct and indirect—of a good or service before starting negotiations. Transparency allows the company to set realistic targets in advance to get the best possible price during negotiations.

Two approaches can improve cost transparency: benchmarking and clean sheets, sometimes used together. The former is easier—it requires only that companies broaden the scope of an RFP and compare quotations—but has its limitations in concentrated markets with few players that know each other's price ranges.

The second requires more effort to understand and model the relevant factor cost for a good or service, but allows companies to gauge the supplier's underlying cost base and gain leverage for negotiation. Pharmacos are focusing more on cost transparency, having noticed that most suppliers enjoy high margins. Supplier markups of up to 80%—as in a recent case with a contract manufacturer (see Exhibit 2)—are not uncommon and represent golden opportunities for additional savings². Transparency can and should then extend to capacity and utilization, providing powerful arguments for cost reduction through in-sourcing or outsourcing, or even for negotiating rebates from suppliers with the threat of in-sourcing.



² McKinsey's proprietary operations benchmarking (POBOS) compares unit costs and plant performance on a normalized basis.

Push low-cost country (LCC) sourcing beyond the obvious

Most pharmacos already source part of their chemicals and API needs from LCCs like India and China. Leaders have managed to get to the next level by developing comprehensive LCC sourcing strategies across their entire spend portfolio; for the leaders, LCC sourcing is a key part of global category management, with a growing focus on indirect materials and services.

For example, one pharmaco reduces costs for stability testing by 40% after a new product introduction by outsourcing the service to a provider in Eastern Europe. Another pharmaco requires managers of most spend categories to screen and assess LCC sourcing opportunities regularly, and to evaluate suitable LCC alternatives before every negotiation round.

More generally, we have seen pharmacos including more non-traditional spend categories, such as contract manufacturing, packaging equipment, and tooling for machinery, in their LCC sourcing portfolio, often realizing double-digit percentage savings.

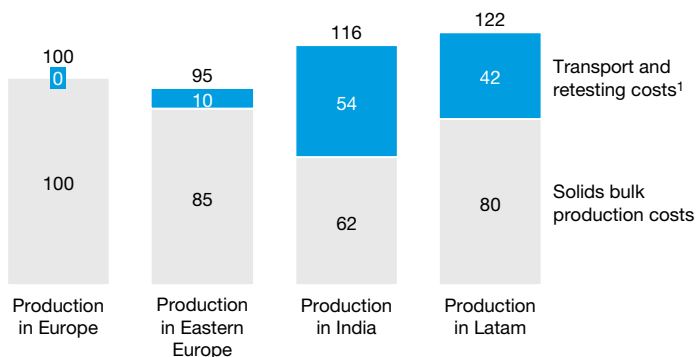
Sourcing leaders who consider total cost of supply in every decision sometimes reach with counterintuitive conclusions. One compared LCC sourcing alternatives for bulk manufacturing, for example, and found that total cost of supply from some remote low-cost countries was higher than their current supply in Western Europe (see Exhibit 3), and limited its sourcing to regions with clear cost advantages.

exhibit 3

Normalized total landed bulk production costs to supply European market, 2011

DISGUISED EXAMPLE

USD per 000 tablets, indexed to 100



¹ Inter region transport and retesting costs set to zero; Road transport within Europe and USA and air-freight transport between continents

Implement “automotive-like” supplier performance management

McKinsey research shows that automotive companies are top performers in supplier performance management. They actively manage their supplier base, include deliverables and performance metrics in contracts, and standardize supplier scorecards to track and remunerate performance.

Toyota, Honda and others have established regular quantitative assessments to drive continuous improvements in supplier performance and ensure productivity increases balance cost increases in the face of technological progress and rising commodity prices.

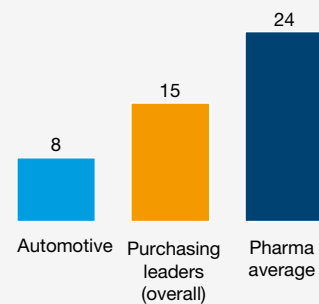
To implement “automotive-like” supplier management, however, pharma has to rationalize their supplier base first. In fact, our survey indicates that a purchasing associate in pharma is responsible for nearly twice as many suppliers as other sectors, on average, and only half of the spend (see Exhibit 4). Without reducing the number of suppliers and concentrating on the few that matter, any aspirations towards effective performance management are doomed.

exhibit 4

Supplier performance management

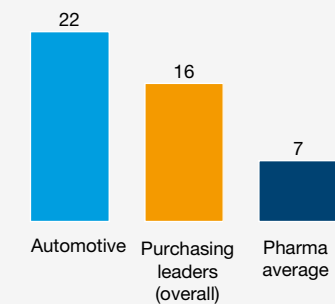
Pharma purchasers manage many suppliers . . .

Number of supplier per strategic FTE¹



. . . with a low average spend

Spend per supplier¹
USD million



¹ Accounting for 80% of controlled spend
SOURCE: McKinsey Global Purchasing Excellence Survey

2. Challenge your business system

Dare to challenge demand, not just price

A robust category management process pushes purchasing organizations to go beyond classical annual price rebates in direct spend and start addressing demand-related levers. Top sourcing organizations excel in extending their activities into demand areas, and tend to start by addressing spend categories that have gone unnoticed in the past.

Consider the case of a pharmaco where purchasing helped to reduce occupancy costs by over 10% by switching headquarters locations to newer buildings with more efficient layouts. The change was sparked by realizing that existing locations had poor utilization rates due to an old layout and furniture: the company's sourcing group assessed relocation alternatives and selected the best fit together with the local business leadership.

In another situation, purchasing managed to reduce facilities and site service costs—a varied category including cleaning, security, building and equipment maintenance, gardening—by around 15%. It did this by realigning service-level requirements in non-critical dimensions and aggressively renegotiating agreements with service providers.

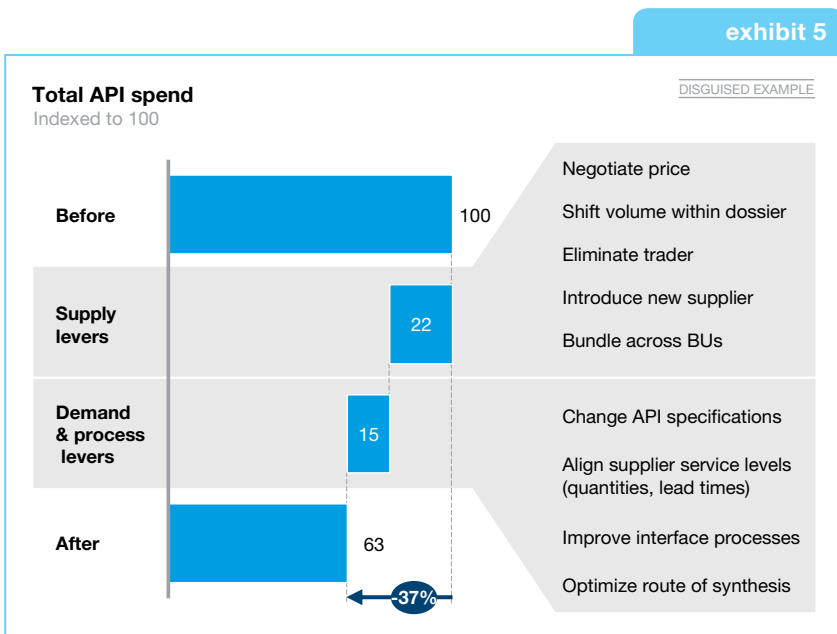
Connect purchasers to the business

In most industries, commercial negotiation tactics account for as little as 20 to 30% of the potential impact of purchasing improvements. The rest comes from managing product specifications and demand—practices that purchasers can learn from close cooperation with the business functions.

In addition to classical price negotiations, top sourcing leaders therefore challenge the business system itself. By stimulating the dialogue between purchasing and the business functions, these leaders take a more entrepreneurial view of purchasing, which helps them overcome organizational fragmentation. Especially in direct spend categories, the opportunities can be huge: one pharmaco reduced its API spend by as much as 37% by challenging product specifications and current processes (see Exhibit 5).

Deep cross-functional relationships from collaboration also help purchasers address sacred cows—spend categories that have historically been beyond the influence of purchasing. Pharmaco fragmentation offers ideal habitats for sacred cows, including marketing, research and development, and critical outsourced business. But cross-functional links can help overcome these hurdles.

At one pharmaco, sourcing and marketing collaborated to reduce the number of speaker training events for congresses and other marketing events, saving



more than 20%. In another case, the sourcing group and the businesses reduced over 15% of IT helpdesk costs by replacing the support in the local language with standard English support, thereby increasing the possibility of cross-country back-ups, and by fully offshoring the service to India.

Collaboration does not need to stop at the company's gates, as there are plenty of opportunities for cooperating and bundling spend with external organizations. Some pharma companies are recognizing the value of collaborating with competitors on categories distant from the sources of competitive advantage, such as distribution, where sharing of logistics assets—warehouses, fleet, suppliers—significantly contribute to cost reduction.

And opportunities can multiply when searching for collaboration beyond the pool of competitors. In operations, for example, it is a common practice in several industries to share processes and assets for power generation, security or cleaning services to raise scale and lower costs.

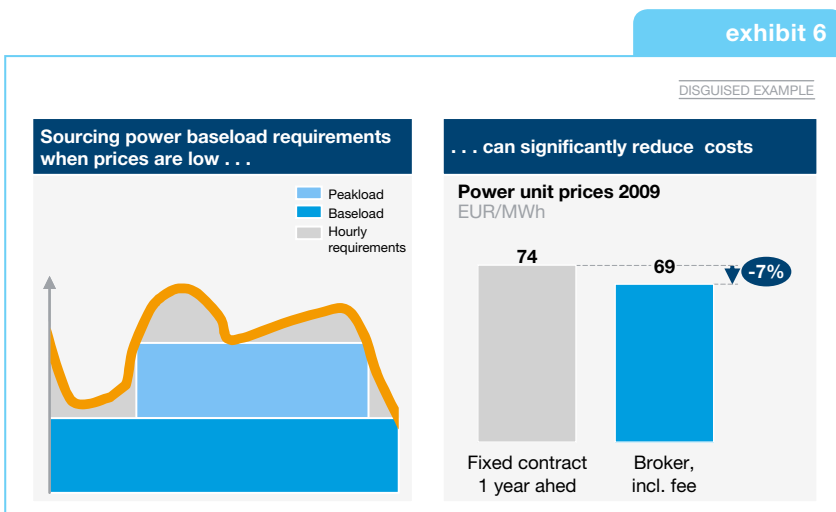
Leverage purchasing as a source of innovation

Top performers realize that purchasing can catalyze innovation once it relies on professional category management and has established its role within the organization. In fact, purchasing associates will see a number of innovations while screening supplier markets in search of less-expensive items, from new packaging solutions up to best-of-breed dosage devices or test kits.

The main challenge in leveraging suppliers as a source of innovation is setting the right incentives and context for purchasing associates. They need deep knowledge about marketed drugs and their effects—and how to push an innovation through all approval stages.

Don't just avoid risk—manage it

Purchasing leaders manage supply and supplier risks and dedicate resources and expertise to this task. In its best expression, purchasing integrates risk modeling and scenario planning with the corporate risk management. In pharma, some players are also timidly taking steps toward managing risk and volatility in a more active way. One pharmaco has reduced its electricity costs in Europe by 7% by replacing yearly fixed-price contracts with a brokerage approach that included risk-based purchasing on the forward electricity market (see Exhibit 6).



Another company increased self-insurance on its company vehicle fleet and accepted the risks of being exposed to the volatility of cash outflows for reimbursements, convinced by a 10% forecast savings on insurance fees, net of expected cash outflows for reimbursements.

Create value from mergers & acquisitions

M&A in pharma is typically driven by top-line growth. This often obscures the operational synergies and the value purchasing could realize, with the result that purchasing representatives are only marginally involved in the due diligence process, with low or no saving targets during post-merger

integration. Purchasing leaders, on the contrary, are involved early in the process and have high pre-merger targets. Based on our experience, purchasing savings from a pharma merger can easily exceed 5% of total spend.

3. Strategically manage the talent pool

Pharma purchasers have above-average educational qualifications. Still, education alone does not pay off in terms of the overall purchasing performance of the industry, which lags significantly behind top performers. Sourcing organizations at most pharmacos seem to have difficulties attracting and retaining talented associates with the same pace they achieve in, say, sales or research. The problem is typically related to limited career opportunities beyond purchasing.

Sourcing leaders have a strategic priority in filling in their key purchasing positions with talent and rewarding them with good career opportunities in their “life after purchasing”: by hiring strong people, these companies improve procurement’s credibility, set the stage for successful purchasing initiatives, and create a base for attracting new talent.

Talent-development programs that help purchasers beef up their commercial acumen and establish relationships with internal customers are a common tool at top sourcing performers: for promising university recruits, this training might take the form of a rotation program offering a variety of experiences; for long-term staff some companies create tailored programs. Some pharmacos, for example, establish “procurement academies” providing training and workshops in selected product categories, individualized development plans, and advanced negotiation skills.

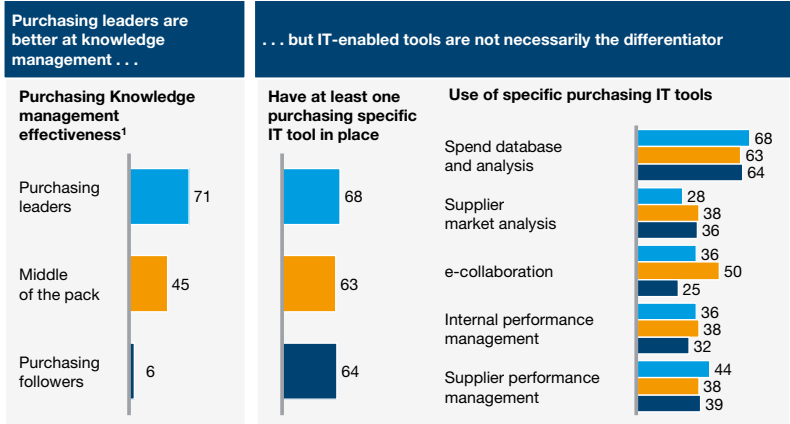
4. Foster knowledge and knowledge creation

Knowledge has always been intertwined with talent, and, like talent, it must be carefully managed. The purchasing survey shows that top performers achieved far higher scores in managing knowledge than low performers. But, interestingly enough, we found no correlation between superior knowledge management and IT spend and use (see Exhibit 7). The results hint at the fact that information is important, but people are the key.

For this reason, line management and knowledge managers should pay particular attention to the degree of formalization they aim at while codifying knowledge, and carefully evaluate benefits and costs in terms of effort and motivation.

Purchasing knowledge management effectiveness

Percent



¹ Scoring 3, 4, or 5
SOURCE: McKinsey Global Purchasing Excellence Survey

Getting there: Shoot for the stars but start at the ground

Below the top performers in our survey, many companies started on their path to excellence by challenging their transparency of spending. The fragmentation of reporting systems is the major hurdle to transparency. Nonetheless, in the absence of an integrated reporting system, entrepreneurial purchasing organizations temporarily run spend allocation and basic analyses manually, reallocating bookings into financial accounts into a spend category structure. Leaders often adopt this procedure in the aftermath of a merger, when reporting systems are not integrated yet.

Second, top performers set high aspirations and challenging but achievable goals. The clearer the goals—typically a quantified objective or set of metrics—the higher the probability that the company will achieve them. While this may seem obvious, we have seen many companies among the low and average performers that don't set any targets or make them vague in terms of quantification and timing. Conversely, among the top performers, purchasing associates have a clear-cut understanding of target cost reductions and timeline.

Third, leaders ensure that the boardroom backs their aspirations, regularly reviews their attainment of goals, and coordinates activities across businesses and functions. Typically, the transition begins when purchasing becomes a more frequent C-level discussion and the CPO and the CEO commit—together with other senior executives—to aggressive organization-wide savings targets.

Finally, leaders bet on talent, coupled with the right incentives, and quick results rather than on changes to the formal organization structure, to achieve the change. The basic philosophy is simple: talent is able to deliver impact, which in turn motivates behavioral change in the people around it. The alignment of the formal organization is a mere consequence, a recognition of what has already happened.

Pharma's typical geographical fragmentation is a barrier to this virtuous circle, since it reduces the transparency of performance across country organizations. For this reason, leaders ensure that the whole organization—not only the boardroom or few selected functions or countries—is aligned towards common targets and well aware of the results of purchasing's successes by improving transparency and communicating results. This pushes centralization of roles at regional or global levels, especially for purchasing categories presenting similar requirements on the demand side and overlaps on the supply side.

Leaders generally recognize the importance of being “close to the business” and rarely go too far in centralizing purchasing responsibilities. In fact, a common feature in successful purchasing initiatives is the early involvement of “local champions,” who are made accountable for target-setting together with central purchasing as well as for the realization of results. While selecting, training, and coaching local champions absorbs resources from central purchasing, the multiplier effect they yield cannot be overemphasized. And they may demonstrate the acumen and motivation to take over more senior leadership roles in purchasing.

* * *

Purchasing is becoming an increasingly hot topic for pharmacos aiming to increase their profitability. Successful purchasing for pharma is characterized by robust category management, a strategic focus on talent management, and a willingness to challenge the business system. Pharmacos embarking on the path to excellence should focus on creating the necessary transparency, setting bold aspirations, getting backing from the boardroom, and communicating results throughout the organization.

Lorenzo Formiconi (Lorenzo_Formiconi@mckinsey.com) is an engagement manager in the Frankfurt office, **Martin Lösch** (Martin_Loesch@mckinsey.com) is a principal in the Stuttgart office, **Jean-Philippe Talmon** (Jean-Philippe_Talmon@mckinsey.com) is an associate principal in the Geneva office and **Marco Ziegler** (Marco_Ziegler@mckinsey.com) is a principal in the Zurich office. Copyright © 2010 McKinsey & Company. All rights reserved.