Big pharma:
Business model choices for the new market

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The pharmaceutical industry faces a critical need for change. The unsustainable trajectory of health care spending and a wave of regulatory reforms have triggered forces that are transforming the pharmaceutical landscape and introducing new complexities into the marketplace. Business models that were once highly effective now yield diminishing returns and may not be a good fit for a future market increasingly driven by data, health economics, and comparative effectiveness. To make matters worse, many leading companies continue to wrestle with revenue gaps left by patent expiries—and a shortage of high-impact breakthroughs to replace them—making it hard to set a clear path for sustained growth and value creation.

Some pharma companies are trying to address these challenges with traditional strategies such as reloading product pipelines through mergers and acquisitions (M&A). Others are looking for growth "beyond the pill." And many larger companies are taking a broader approach, pursuing a wide range of growth initiatives in the hope of hitting on something of significant value.[1] However, our experience suggests these strategies are generally not delivering the kind of value shareholders expect. Companies that deviate from their core business in search of growth often add complexity without clear benefits. What's more, many organizations have not yet done enough to address their operational inefficiencies.

[1] Initiatives include, but are not limited to, significantly increasing a company's presence in emerging markets; broadening the health care products footprint to include consumer products, animal health products, generics, etc.; and attempting innovative new models (e.g., entry into the cash-pay pharma market.)

Two paths to growth and value

To thrive in this challenging environment, management should consider that in the near term pharma companies should decide exactly how they will compete in the value chain. Although the fundamental goal of every pharma company is to generate a return on investment by improving patient health, that mission is generally achieved in two different ways:

(1) by driving new product innovation through *scientific excellence*, or

(2) by increasing market access through *customer excellence*.

Scientific excellence is similar to the traditional business model for pharmaceuticals. A company that chooses this path leads with science and innovation by investing heavily in R&D for a specific therapeutic area (or areas) with high unmet needs. It seeks to cultivate networks of scientific influencers by becoming the go-to company for related innovations through organic investment and external partnerships (e.g., joint ventures and royalty deals). The potential rewards from this strategy are high, but so are the risks because the investment returns are uncertain.

Customer excellence is fundamentally different. A company that chooses this path looks to build stronger customer and stakeholder engagement models to generate value, rather than play the high-stakes game of breakthrough R&D. In addition, an urgent need for growth may require more timely returns than a focus on scientific excellence can realistically provide. Instead of investing in scientific innovations, a company pursuing customer excellence seeks to innovate how it brings products to market and how it connects with customers in a specific therapeutic area. It finds ways to accurately serve payers and providers in a more timely manner in order to foster durable revenue streams, and adopts new commercial technologies such as digital engagement. This approach is designed to extract the greatest possible value from the company's existing product portfolio—making the most of scarce resources and generating economic profits where others see none. In addition, this approach can be used to build a war chest for effectively capitalizing on scientific breakthroughs that other companies develop in the future. A customer excellence strategy tends to produce business results that are steadier, more predictable, and less risky—attributes many investors find appealing.

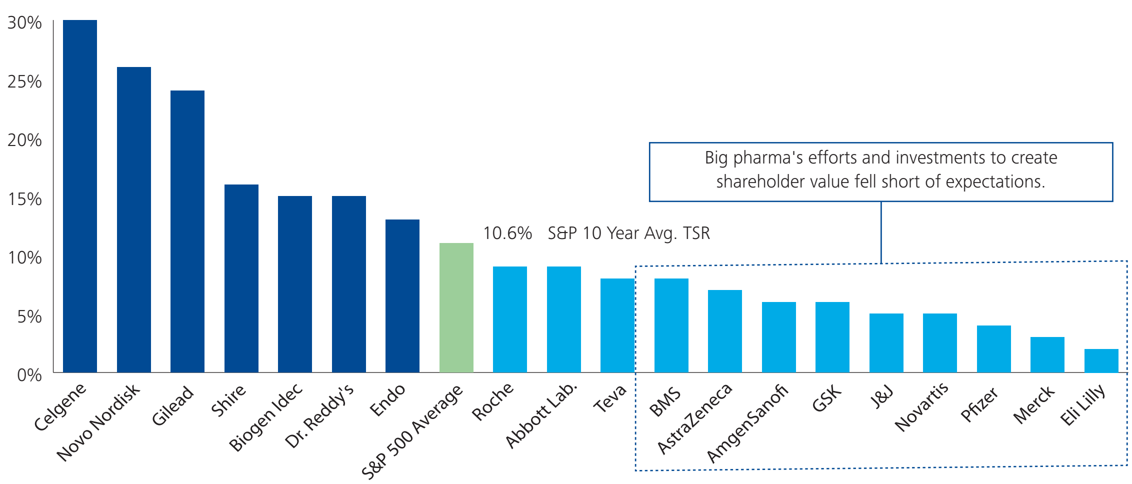
Although business strategies are rarely black and white, we believe that focusing your efforts on one of these two distinct poles can help you develop a clear long-term vision of where your business should be going—and how to get there. On the other hand, the hybrid approach most big pharma companies have taken, one that tries to pursue both strategies at the same time, is likely to blur your organization's vision at a time when strategic clarity is essential. This could lead to missed opportunities and conflicting efforts.

The deadly middle

Big pharma companies have spent the past decade simultaneously pursuing both scientific excellence and customer excellence, but the results of trying to cover all the bases have been marginal. These companies rose to great heights in the era of blockbuster drugs, and collectively invested more than $450 billion in R&D over the past 10 years. Yet an analysis of their total shareholder returns shows they generally underperformed the market, delivering returns that were low or even negative (Figure 1).

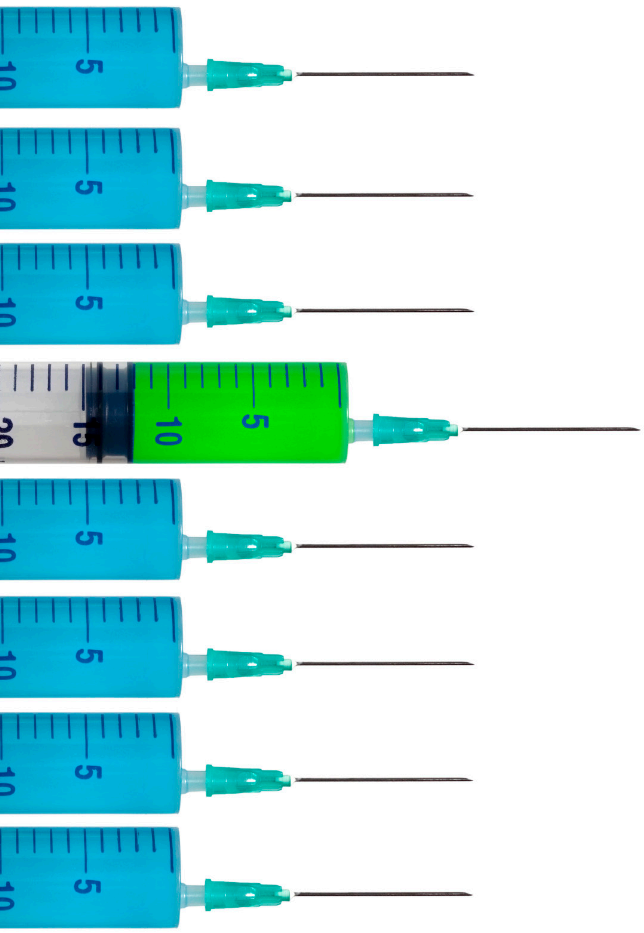
Skyrocketing revenues and profits may have given big pharma companies the luxury of trying to do too much. But whatever the root cause, a lack of direction and focus clearly produced sub-par financial results.

Figure 1: 10 year annualized Total Shareholder Return (TSR)
(period ending 12/31/12)



Source: Deloitte Consulting LLP

Learning from the top performers



In contrast to big pharma, a number of smaller pharmaceutical companies with focused business strategies were able to deliver total shareholder returns well above the norm over the same period (left side of Figure 1).

Some of these top-performing companies focused on scientific excellence. For example, Gilead's significant, high-risk investments in complex treatment areas (e.g., HIV) have made it a dominant player in its market. However, other top performers progressed by focusing on customer excellence. For example, Teva has historically competed as a low-cost provider that can deliver post-patent expiry treatments to the marketplace efficiently and profitably. (It will be interesting to see if Teva's acquisition of Cephalon's specialty portfolio will undermine the company's long-term performance by causing it to lose focus).

The lesson is that scientific excellence is not the only path to success; pharmaceutical companies can also create extraordinary value from the long tail of yesterday's innovations by focusing on customer excellence. It is important to pick a strategic focus and then fully commit to it—at least in the near term.

The long-term paradox

Ironically, committing to one strategic direction in the near term can actually improve your company's ability to pursue the other direction in the long term.

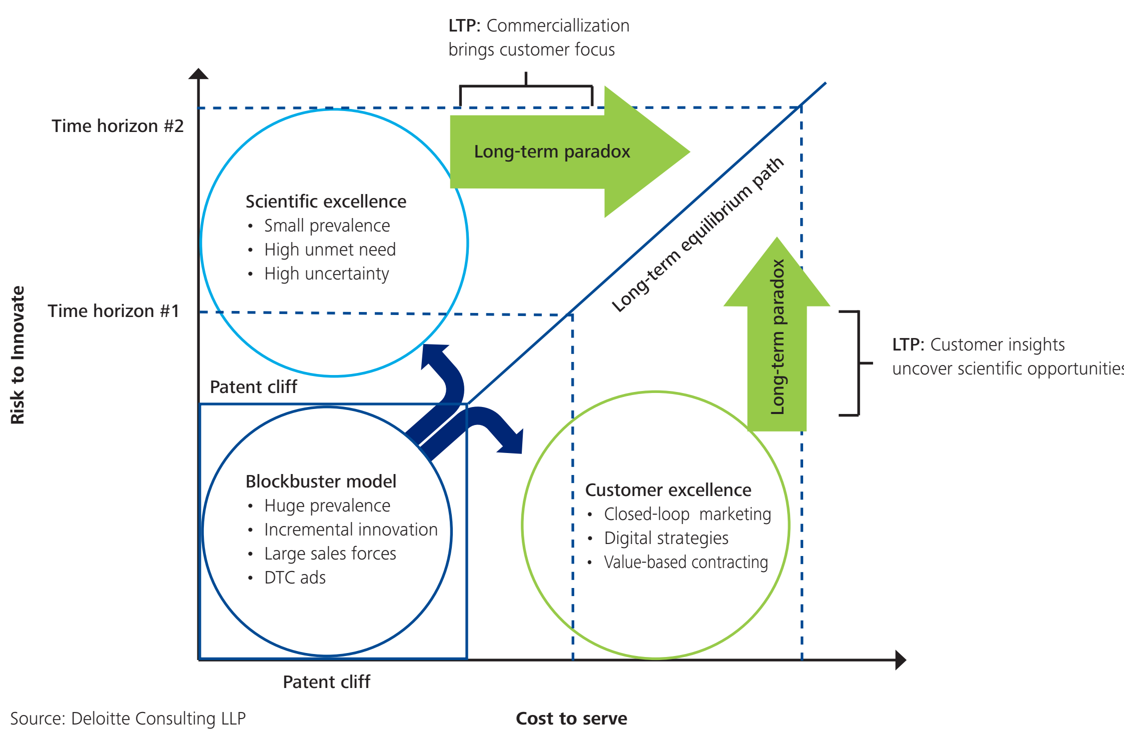
Top-performers Gilead and Celgene developed compounds that helped fulfill unmet needs by leading with science and specializing in a specific therapeutic area. But in both cases, delivering on the promise of their scientific breakthroughs eventually led to a complementary focus on customer excellence which enabled them to develop differentiated customer engagement programs to the patients in their narrow disease areas.

Gilead's HIV treatments (Viread in 2001 and Emtriva in 2003) were scientific breakthroughs. But in developing those products, the company gained a strong understanding of the complexity of managing HIV, which led to customer-oriented innovations (the first combination HIV therapies—Truvada and Atripla in 2004 and 2006) that secured Gilead's dominance as a market leader.

Celgene brought new hope to patients with hematologic malignancies (e.g., multiple myeloma) through its game-changing immunomodulatory franchise. Although it led with scientific excellence, Celgene was able to increase market potential by enhancing its customer excellence capabilities to satisfy one of the industry's most intensive Risk Evaluation and Mitigation Strategies (REMS) programs.

Another top performer, Novo Nordisk, was able to establish itself as a therapeutic leader by first executing on a customer excellence strategy. Eli Lilly was a pioneer and established market leader in diabetes care, but Novo Nordisk was able to take the lead in the U.S. thanks to a customer excellence strategy that featured a broad portfolio of insulin products, aggressive channel tactics, and superior insulin delivery devices (first, the NovoPen in 1985 and later the FlexPen). Novo Nordisk then reinforced its lead by making the scientific decision to shutter its once promising oral anti-diabetic developments in order to invest more heavily in injectable technologies.

Figure 2: Moving on from blockbusters . . . choose a path



Source: Deloitte Consulting LLP

Choosing the right path

The choice between a science-driven and customer-driven strategy (as illustrated in Figure 2, preceding page) depends in large measure on your company's current capabilities and future opportunities to create value. Selecting the right path also requires an objective assessment of your company's tolerance for risk and uncertainty. Should you cut R&D investments now in order to retain the ability to grow later when the science is more certain? Or, should you make big bets now on focused innovations that could potentially change the rules of the game? The ability to confidently answer these kinds of questions is critical to effectiveness in this uncertain business environment.

Scientific excellence

Scientific excellence requires large and risky investments to achieve R&D breakthroughs that can transform the market and change the basis of competition. Recent lulls illustrate the inherent risks of this strategy; major uncertainties include the size of the discovery, timing, regulatory response, and competition. Will your company be the first to discover a new compound, and will the discovery matter?

A science-driven portfolio focuses on therapeutics that elevates the standard of care through overwhelming clinical superiority. Discoveries are leveraged across multiple platforms to create a deep product portfolio in a particular treatment area. Acquisitions are used to add advanced scientific capabilities, products, and relationships.

Scientific excellence has become a high-price, low-volume strategy. Many compounds deliver tremendous value, but only for a narrow segment of the population.

An effective approach requires close relationships with the scientific community so the company can become the partner of choice for breakthrough developments. These collaborations build discovery networks with specific influencers that shape the future standards of care. The rewards from these R&D and science-led alliances can be very high, but so are the risks.

Achieving scientific excellence requires specialized support functions that can enable highly developed innovation models. These functions require advanced technology platforms, highly skilled talent, sophisticated analytic capabilities, and the ability to manage a portfolio of alliances.

For many scientific breakthroughs, the target market is anxiously waiting for the molecule to be commercialized, so a primary sales challenge is to responsibly articulate its indications and limits. As a result, companies choosing this path will likely need to execute on a business model that requires bringing leading solutions to market, which will likely require an increasing focus on larger, more complex clinical trials in targeted therapeutic areas and markets.

Figure 3: Here are some critical differences to consider when deciding which path to follow

	Scientific excellence	Customer excellence
Investment strategy	Bold R&D plays	Excellent customer engagement
Portfolio breadth	Focused on finding cures	Focused on disease and population management
Margins	Premium	Variable
Growth and acquisition strategy	Driven by high-risk, high-reward molecules and technologies	Driven by channels, stakeholders, and influencers
Commercial/sales	The molecule is its own value proposition	Innovative engagement with customers and stakeholders across the health care spectrum
R&D collaboration and relationships	Viewed as partner of choice by the scientific community	Viewed as partner of choice by the pharma-economic community
Enabling functions	Highly specialized support functions that help foster scientific breakthroughs	Support functions that help foster customer-related innovations by encouraging smart risk-taking

Source: Deloitte Consulting LLP

Customer excellence

Customer excellence requires commercially driven investments to improve customer interactions, acquisition, and retention. Development activity focuses on incremental advances to existing products and services—rather than big scientific breakthroughs—and there is a strong emphasis on price management.

A customer-centric portfolio is designed to help the targeted customer base manage a particular condition more effectively—for example, by improving the delivery method or formulation to achieve improved compliance and outcomes. Products in the portfolio tend to feature a wide range of margins, with the highest margins for products that more closely align with customer needs and offer the greatest utility. Acquisitions tend to focus on improving the company's channel position and value proposition.

Customer excellence makes up for its lack of scientific innovation by using sophisticated commercial tactics for consumer marketing and physician engagement. This may require retooling the sales force to more effectively communicate the specific value of a customer-driven approach.

A customer-focused company becomes the partner of choice in a specific therapeutic area through differentiated commercial capabilities and intimate knowledge of the targeted customer and partner landscape. Partnerships with customers and other key stakeholders—including payers, providers, state governments and integrated delivery networks—can help create shared value. Similarly, partnerships with suppliers, wholesalers, and distributors across the value chain can lead to a network of interlocking incentives that create a sustainable competitive advantage.

Achieving customer excellence requires leading support functions that *empower* innovation in customer engagement, rather than *limiting* innovation due to habitual risk aversion. Such functions help build in-house commercial capabilities that can differentiate the company from its competitors—including capabilities such as CRM, closed-looped marketing, and advanced analytics. Support activities that do not help the company differentiate itself are likely to be outsourced to reduce costs and improve efficiency.

By choosing this path, companies recognize the importance of developing a business model that is focused on customer and key influencer engagement. In order to generate near-term value, these companies can leverage tactics used by generic companies to gain leading practices in commercial excellence to become formidable players in the emerging area of population management and to increase access across the integrated delivery network.

In pursuit of the customer excellence path, companies should invest in and build differentiating capabilities across the commercial model, including foundational areas such as customer information management, local market influencing mapping, and delivering innovative customer engagement tactics that effectively communicate value propositions (e.g., comparative effectiveness data). Additionally, insight creation and dissemination will likely be critical to predicting and responding to customer and stakeholder demands. Companies able to create more meaningful customer interactions, through digital and other innovative means, will likely be well positioned to obtain customer insights and to understand and meet customer needs in order to inform and improve future customer and stakeholder strategies. The effectiveness of a customer excellence strategy may be determined by how a company can differentiate itself through multichannel customer engagement and "closing the loop" on customer insights.

Sharpening your focus

Companies caught in the "deadly middle" are recognizing their predicament and have begun to shift their strategies accordingly. For example, in February 2011, Merck CEO Ken Frazier withdrew the company's guidance for earnings-per-share growth, noting that "we are mindful of the need to drive greater productivity in our R&D program . . . [but] we are committed to innovation as a strategy, and we believe that over the long term it will pay off."[2] Novartis is moving in a similar direction, going lean across the organization in order to focus its resources on innovation. According to CEO Joseph Jimenez, "Novartis wants to keep R&D spending high . . . using our cost reduction to continue to keep our R&D spending at the top of the industry."[3]

Although these examples suggest a major shift is under way, many companies continue to pursue an ambiguous strategy—with a bias toward the science-driven approach. In our view, pharmaceutical companies should sharpen their competitive edge. Instead of investing in a wide range of improvement initiatives, they should choose a clear strategy and then align their investments and cost structure to support it.

A company pursuing scientific excellence can ratchet up its R&D investments and aggressively acquire promising start-ups in order to establish a commanding market position, while divesting businesses that no longer fit its strategy, and to reduce Selling, General and Administrative (SG&A) costs in order to narrow its focus and generate capital for strategic investments and acquisitions.

For example, over the last few years Pfizer has steadily declared and pursued a strategic course to re-focus its business model on the 'innovative core'. In March 2011, Pfizer announced it was considering divesting 40 percent of the company in order to focus on its core business. CEO Ian Read explained, "trimming away of the non-pharmaceutical divisions as well as its business that sells off-patent drugs would enable it to focus on the firm's 'innovative core' of high-value treatments."[4] Subsequently, in January 2013 Ian Read reiterated, "I believe that at some point the industry will globally separate into business models with an innovative core and a value core and you would see our management moving to manage the business that way over time. If there is a value to shareholders of a split, I have acknowledged we are open to any construct that produces value for Pfizer."[5] Only months later, following a successful February IPO of its Zoetis animal health business, Pfizer announced in May 2013 its intention to fully divest its majority stake in Zoetis to focus on drugs and vaccines for the human market.[6]

A company pursuing customer excellence can focus its investments on the development of commercial capabilities and specific partnerships across the commercial value chain. Its business model will likely be driven by the ability to align incentives and develop leading delivery of products and services for highly targeted customers.

[2] http://www.forbes.com/sites/matthewherper/2011/02/03/mercks-ceo-on-not-cutting-research/

[3] http://www.marketwatch.com/story/novartis-prunes-costs-for-stronger-growth-2011-04-03

[4] http://www.fiercepharma.com/story/forbes-analyst-says-pfizer-could-divest-units-bring-32b-revenue/2011-03-14

[5] http://www.ft.com/cms/s/0/39b608e6-6a14-11e2-a7d2-00144feab49a.html#ixzz2RORRhvSn

[6] http://online.wsj.com/article/SB10001424127887323975004578498994013821124.html

The road ahead

The golden era of blockbuster drugs is in decline. Product pipelines are no longer filled with guaranteed winners, and products that manage to survive today's increased regulatory scrutiny face a commercial market beset by intense, macro-driven downward pressure. In this challenging environment, scattered investments and small tweaks to traditional strategies and business models are unlikely to deliver the kind of transformation required to compete effectively in the future. A business that tries to be a jack-of-all-trades is likely to be the master of none.

To thrive in the years ahead, a pharmaceutical company should define and articulate a clear strategy, and then fully commit to it. It should assess where it can win in the marketplace, and then decide whether scientific excellence or customer excellence is the better way for the company to create and sustain value. Business leaders will need objectivity and insight to choose the right strategy—as well as discipline to make the tough operating choices required to execute it effectively.

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