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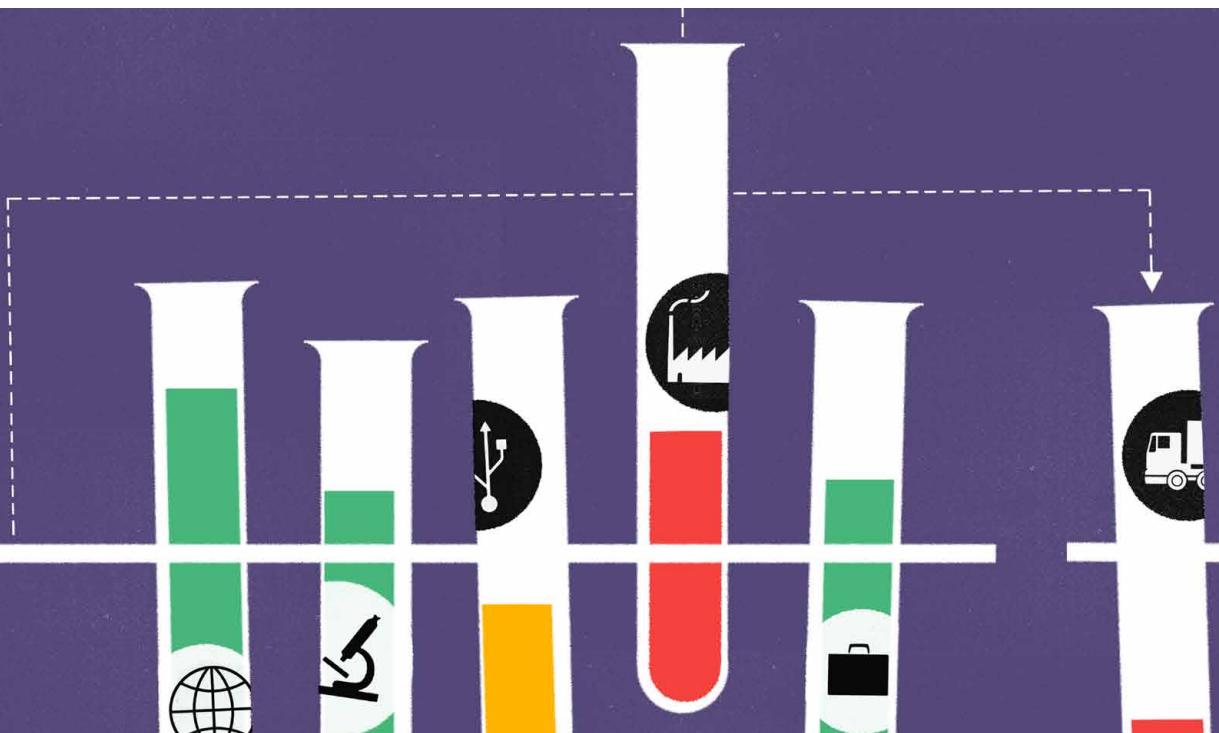
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PHARMACEUTICALS & MEDICAL PRODUCTS PRACTICE

A wake-up call for Big Pharma

Lower profit margins suggest a need for new business models.

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The good old days of the pharmaceutical industry are gone forever. Even an improved global economic climate is unlikely to halt efforts by the developed world's governments to contain spending on drugs. Emerging markets will follow their lead and pursue further spending control measures. Regulatory requirements—particularly the linkage among the benefits, risks, and cost of products—will increase, while the industry pipeline shows little sign of delivering sufficient innovation to compensate for such pressures.

These factors suggest that the industry is heading toward a world where its profit margins will be substantially lower than they are today. This dramatic situation requires Big Pharma executives to envision responses that go well beyond simply tinkering with the cost base or falling back on mergers and acquisitions.¹ A bolder, more radical approach to Big Pharma's operating model must become a realistic planning scenario. While an immediate corrective response in the coming weeks and months may not be the answer, a purposeful strategy that provides for this change in the medium and longer term is necessary.

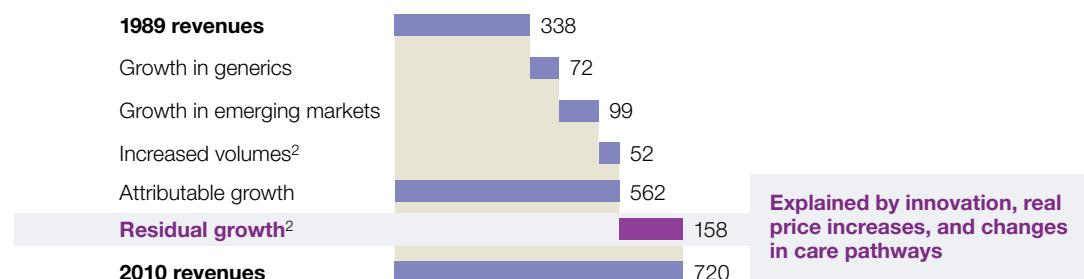
The case for difficult times ahead is straightforward. McKinsey analysis shows that over the years, real price increases, rewarding past innovation and changes in pathways for treating patients, have been the most significant driver of the pharma industry's growth (Exhibit 1). Less attention has been paid to managing the cost base. The industry may have recently begun to focus on that, but its heart doesn't seem to be in the effort, and it has little to show for these efforts.

¹ For this article, we define Big Pharma as companies with more than \$5 billion of annual revenue in 2009 dollars.

Exhibit 1

Historically, the biggest contributors to industry revenue growth have been innovation, real price increases, and changes in care pathways.

Contributions to revenue growth for pharma, biotech, and generics players, 1989–2010, \$ billion¹



¹In real 2009 dollars; figures do not sum to totals, because of rounding.

²For originator products (ie, nongeneric) in developed markets.

Source: S&P Capital IQ Unit; McKinsey analysis

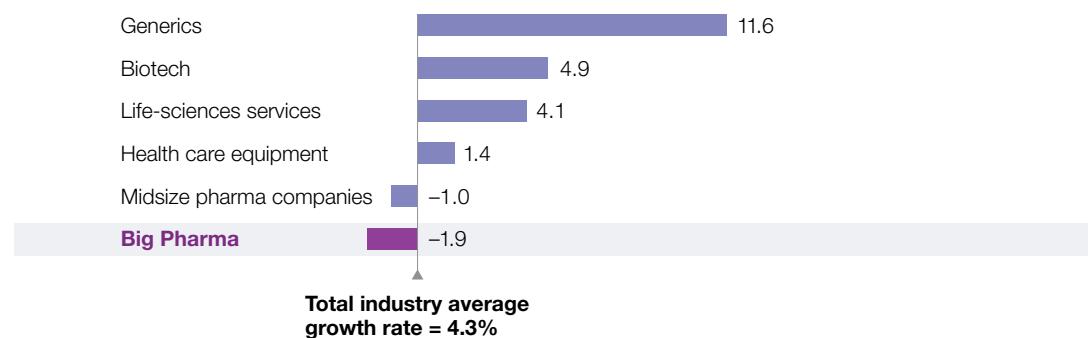
Years of expansion and profitability were in part enabled by regulatory regimes permitting new products to be introduced, benefiting patients and pharma companies alike. More recently, and to varying degrees, regulators are introducing new measures raising the bar for entry, particularly in parts of the developed world. They show little inclination to permit market access, price increases, and follow-on products without proof of substantial incremental clinical benefits. As health care spending relative to GDP continues to rise in many countries, pharma costs will come under increasing scrutiny from governments under pressure to balance their budgets.

The era now drawing to a close may have brought outstanding innovations to patients and profitability to Big Pharma, but the industry's composition evolved considerably during this period, and not necessarily in favor of large companies (Exhibit 2). Conventional wisdom, perhaps fed by high-profile mergers, holds that the industry has consolidated. But on the contrary, our analysis shows that it has become more fragmented: the number of companies competing for the profit pool has more than doubled (Exhibit 3). As a result of that fragmentation, Big Pharma must compete for parts of the value chain with focused players—for example, generics companies that excel at manufacturing; life-science service providers that offer flexible, specialized services (such as managing clinical trials) at scale; and biotechnology companies that generate innovative ideas and products.

Exhibit 2

The pharma industry's composition has evolved considerably.

Growth relative to industry,¹ 1989–2010, %



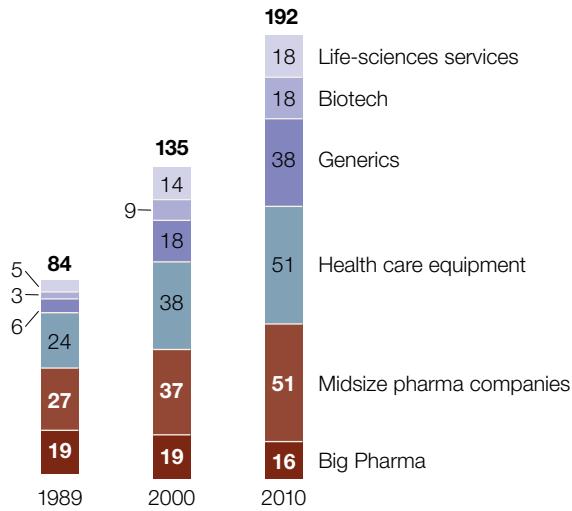
¹Includes only companies with >\$500 million in revenues in real 2009 dollars. Midsize pharma companies defined as those with \$500 million to \$5 billion in revenues; Big Pharma as those with >\$5 billion.

Source: S&P Capital IQ Unit; McKinsey analysis

Exhibit 3

The number of companies competing for the profit pool has more than doubled.

Number of companies in pharma industry,¹ 1989–2010



¹Includes only companies with >\$500 million in revenues in real 2009 dollars. Midsize pharma companies defined as those with \$500 million to \$5 billion in revenues; Big Pharma as those with >\$5 billion.

Source: S&P Capital IQ Unit; McKinsey analysis

Fragmentation is especially troubling for Big Pharma because it would be natural to expect that economic rents will accrue to an industry's most innovative companies. Since some Big Pharma players can't deliver innovations as quickly as biotech players can, only brand strength and a global commercial footprint would allow it to go on charging premium prices. A parallel might be drawn with the consumer goods industry, where companies operate on margins about half of those that big drugmakers enjoy. Continuing with this scenario, we would expect Big Pharma's current level of R&D spending to become a luxury that investors no longer tolerate. We already see these signs today, as some investors and analysts believe that many of Big Pharma's R&D investments destroy value.

A look at the evolution of the automotive industry may offer some lessons. For many years, it was vertically integrated and dominated by large, primarily Western corporations. But the value chain has been disaggregated into companies specializing in narrow parts of the process. Today, component manufacturers, design houses, and basic-materials companies share much of the industry's revenues: the automakers are responsible primarily for the design of major components (such as engines), assembly, sales, and marketing.

Similar trends are already apparent in the pharmaceutical industry: Big Pharma increasingly focuses on sales and marketing, relies on in-licensing for innovative products, and outsources portions of activities such as research and manufacturing. This approach has helped pharma and medical-product service providers to grow at a disproportionate pace. Of course, the analogy can be taken only so far—the functions that big companies retain in the two industries will differ. The key message, though, is that the value chain has been disaggregated and that the role of incumbent, soup-to-nuts players is much diminished.

Big pharma's situation can also be viewed through the lens of game theory. It potentially faces a “prisoners' dilemma” in which refusing to rock the boat helps preserve the existing, profitable model. Alternatively, a single big player, perhaps prodded by a crisis, could decide to act in its own interest and secure a first-mover advantage by radically restructuring and slimming its commercial and R&D infrastructure. But with markets and stakeholders focused on the shorter term, the pressure to sustain the current model is significant. In a hybrid scenario, pharma companies might aim to hedge their bets by sustaining the current model while preparing for the future. Under this option, companies could source a substantial part of their innovative compounds from outside firms, externalize activities such as clinical trials and manufacturing, and try to sustain an internal discovery capability at previous levels. But high costs are associated with the hybrid approach.

From the outside, it seems that companies are adopting the hybrid option anyway. While there is much discussion of cost control and investment discipline, the actions taken so far seem modest compared with the challenges the industry faces. But the bold first-mover approach isn't necessarily the right one for all companies. What we advocate is a much greater recognition of the coming changes, so that the strategic response to them is explicit rather than accidental.

Unless players choose to make preemptive moves, change in the industry will be led by companies that are less encumbered (for example, privately held ones with a longer-term perspective) or more desperate (such as those facing decline as a result of weak pipelines or other structural defects). In this scenario, players would strive to remove fixed costs in response to more volatile and compressed revenues. “Owned” commercial, manufacturing, and R&D infrastructure would be shed, and companies would rely much more on contracting for all but the core, most value-creating activities. The residual organization would be much lighter—perhaps less than half of the starting point.

Executives should test their own level of readiness for such a fundamental shift in the industry's model. To what extent do their strategic plans accommodate this scenario? How would they reconfigure the pipeline, manufacturing, and commercial infrastructure to

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adapt to the change? More fundamentally, how should companies adjust their portfolios of business units and therapy units?

At a more tactical level, Big Pharma companies will require new and improved capabilities in financial planning, capital allocation, communication, the management of external resources, and market access, to name but a few things. Executives must tighten their companies' financial discipline, ruthlessly reallocating capital across businesses and, in particular, away from underperforming R&D assets and mature markets that can no longer sustain big sales forces. Informing a more competitive R&D strategy with commercial understanding, rather than simply targeting regulatory approval, could help companies emerge as winners in the industry.

Our analysis and the conclusions we draw imply that executives must approach this environment in a new manner. They should develop responses that focus on how quickly the change will take place rather than debate what seems inevitable. Strategy is firmly back on the agenda for Big Pharma. Companies that don't have one or stumble into something by accident will be picked apart, broken up, or taken out. ◉

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