



## Future-Proofing the PBM and Pharmacy Business

### Executive Summary

Pharmacies and pharmacy benefit management firms (PBMs), large and small, are being forced to fundamentally remake their business models. This is due to several factors, including a reduction in the number of blockbuster drugs, shorter product lifecycles and design cycles and quick-and-easy replication of efficient distribution models by the competition. Many of these companies are losing their hard-earned competitive advantage and are seeking the next big thing to revitalize their revenue streams.

The competitive landscape is changing rapidly, with competition coming from unexpected quarters. For example, Argus Health is pioneering a new approach for selling services to PBMs via a utility model. Walmart-Caterpillar's direct-to-payer contract model is also causing a stir by disintermediating PBMs. This is not too dissimilar to what is going on in other industries. For instance, who in the previous decade would have thought that e-tailing behemoth Amazon would be among today's cloud computing leaders? Or that music distribution or mobile communication would be revolutionized by a PC maker, Apple?

Moreover, the unrelenting forces of regulation, demographic changes, consumerism and technological advancements are challenging pharmacies and PBMs. Additionally, shrinking margins in core revenue streams, commoditization of services, and transparency regulations that undercut

black-box earnings are a bigger threat. Getting there requires PBMs and pharmacies to rapidly build distinctive capabilities and optimize existing operations – two challenges that, if not done efficiently and in a timely fashion, could further jeopardize their long-term existence.

This white paper examines how companies in the pharmacy and PBM space can optimize key business processes and improve their overall operational health by embracing new and distinctive organizational designs that make pharmacies and the PBM more agile.

### Industry Trends Forcing Business Cycle Change

- Healthcare reform transparency regulations
- Simplification of pharmacy benefits
- Generics replacing blockbuster drugs
- Reduced emphasis on pharmacy benefits management
- Increased emphasis on patient-centric approach
- PBM disintermediation from retail giants
- Rapidly emerging nontraditional PBM models: PBA, transparent PBMs
- Questionable viability of standalone PBMs
- Conflicts of interest for retail-owned PBMs
- Concerns over increased payer costs in self-dealing PBMs

Figure 1

## Business Model Transformation

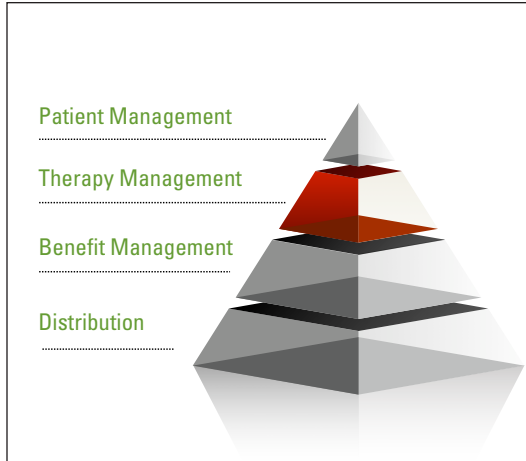


Figure 2

### Business Model Transformation

The pharmacy industry has traditionally generated earnings by driving efficient delivery of drugs from manufacturers to patients. A majority of the industry's earnings have historically been driven by the sale of blockbuster drugs. Several bio-pharma challenges – including patent expiration deadlines for many brand drugs, a dearth of blockbuster drugs in the pipeline, a highly competitive landscape and a low barrier for new entrants to replicate the current low-cost drug delivery-based operating model – are rippling across the industry value chain, indirectly impacting pharmacies and PBMs. These forces influence rebate yields, average prescription price and simplification of pharmacy benefits design. As a result, pharmacy companies are looking to revitalize their revenue streams by adding new and innovative value-added services to their current distribution channels (see Figure 2).

Among the supporting trends is ongoing health-care reform. As reform slowly churns, the pharmacy segment is rightly positioned within the industry value chain to drive high-quality, lower-cost healthcare for all. As evidence, pharmacies are already experimenting with in-store clinics, in-store inoculation, disease management and health services to foster reductions in patients' out-of-pocket healthcare costs. Another force

At issue is whether pharmacy companies can leverage existing knowledge and capabilities to successfully transform.

demanding change is the Health Resources and Services Administration's launch of the Patient Safety and Clinical Pharmacy Services Collaborative for evidence-based pharmacy services.

As the pharmacy space undergoes major business transformation, many players will need to re-invent themselves. At issue is whether pharmacy companies can leverage existing knowledge and capabilities to successfully transform.

### The Challenge for Business Model Transformation

Business reinvention requires new distinctive capabilities and enhancements to existing operating models, which takes time and resources to build and let mature. According to Amazon's CEO Jeff Bezos,<sup>1</sup> it takes five to seven years before the seeds of innovation planted at his company have a meaningful impact on the economics of the business. When it comes to transforming the business model, the commitment of resources – combined with a high level of risk and uncertainty surrounding the ability to deliver effectively and on time – is among the biggest decision barriers business leaders face. Sometimes, by the time decisions are made and the capabilities are developed, a new business cycle begins

### A Congruent Relationship

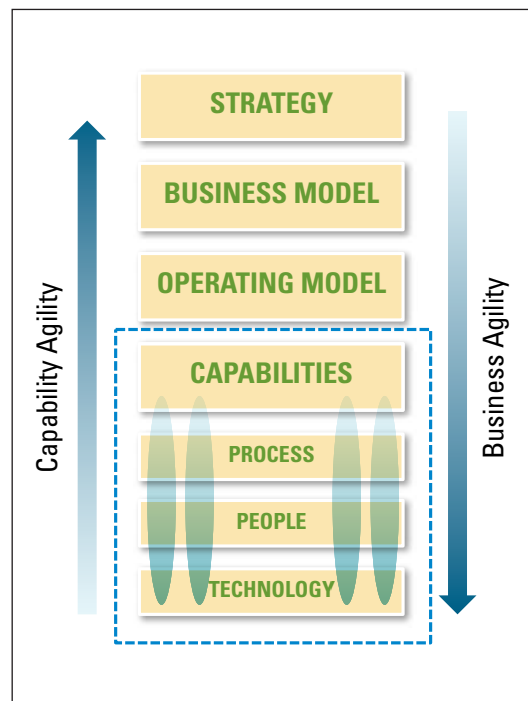


Figure 3

to emerge and the company ends up behind the curve, needing to contend with the challenges of the next business cycle.

The pharmacy space is currently at this juncture. Major pharmacies have to make the decision of whether to embark on adding clinical management, therapy and disease management and benefits management services to their current product portfolio to improve the economics of the business. To build these new product and services offerings, senior leadership must assess how quickly and efficiently their teams can build new and distinctive capabilities.

To achieve material increases in net margins, our experience reveals that business leaders must assemble the right combination of processes, skills, knowledge, structure and tools. Moreover, they need a business operating model that is agile enough to quickly integrate the new and distinctive capabilities required to support new products and services. Those companies that can more swiftly revise their business operating models to accommodate new capabilities and decouple current capabilities that no longer align with business strategy will be better positioned to rapidly adapt to changing business cycles. Those companies willing to embrace these new concepts will be positioned to leave their rivals behind (see Figure 3).

## Embracing the Future of Work

It takes a great amount of resources to build distinctive capabilities within the organization, not to mention the time required to mature and scale them. As business cycles compress, pharmacy and PBM companies have to continually revitalize by frequently creating new and distinctive capabilities. The reason: shorter planning cycles means they have little latitude to wait for returns on expensive Cap-Ex investments. In the past, pharmacies and PBM companies could depreciate capital investments over five- to 10-year horizons. However, given accelerating industry changes, today they must plan and invest for returns achieved three to four quarters down the road.

To rapidly add or remove the capabilities to match tighter business cycles, PBMs must move from an integrated to a virtual operating model. This virtual operating model, where contextual business functions and capabilities are provided by more efficient partner

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## Shifting Operating Models

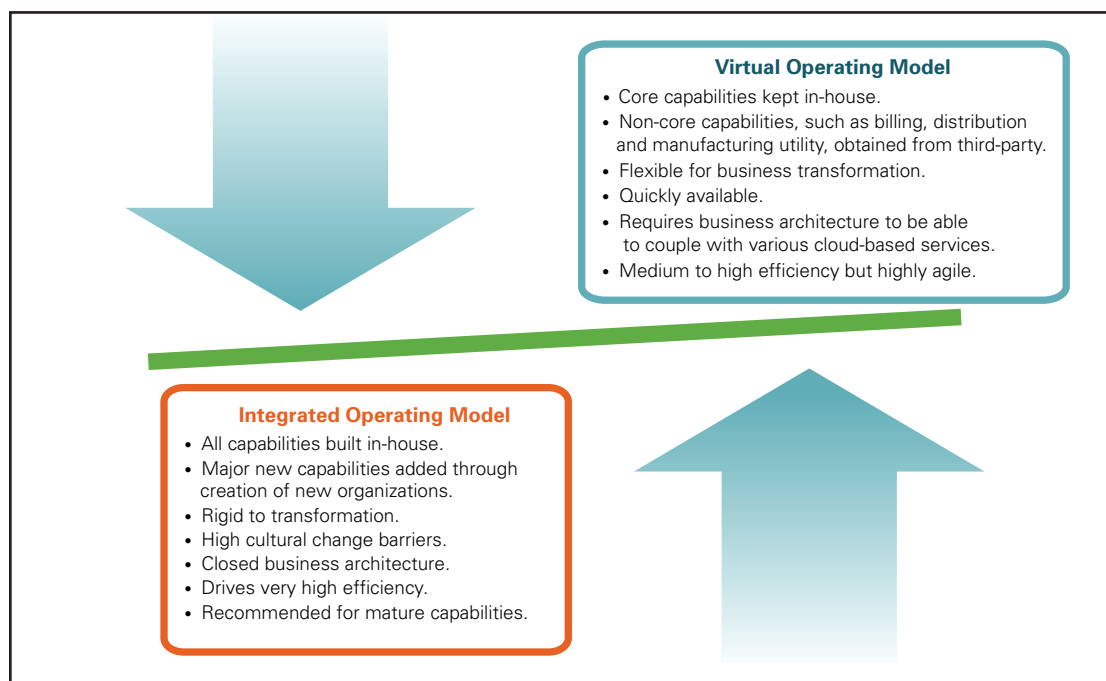


Figure 4

companies, has already been adopted by some of the more successful companies in the high-technology market, a sector where winning requires not only innovative products but also dynamic business models and go-to-market strategies.<sup>2</sup> The virtual integration operating model requires tight but flexible integration between companies with transparent processes and information freely flowing between the partners.

**But with increasing volatility, pharmacy companies and PBMs will have to shift from a completely integrated operating model to a hybrid approach before fully embracing a virtual operating model – but only if warranted by business conditions.**

This virtual model is evident at companies such as Dell, where almost all business functions and capabilities of product manufacturing, delivery and support (other than brand management) are handled by third parties.<sup>3</sup>

For pharmacies and PBM organizations to migrate from an integrated to a virtual operating model, they must completely understand current business processes and fundamental performance levels. They also need to instrument its demand forecasting process so output can be shared by all the partners within the virtual model.

A key challenge to overcome is the decision of which business processes to turn over to a partner. To answer this, the organization must acquire a strong understanding of the current process, its performance and its impact on the business. The decision to partner can be a challenging one given that these decisions may require the organization to partner for business processes in which it already has significant investments.

Another impact of this model will be on the organizational structure. The organizational structure of the company adopting the virtual operating model will undergo a major change and will have to add the capabilities to manage processes that can span multiple partner companies. In addition, the organization will have to apply more mature decision-making processes to harness the benefits of the virtual operating model.

Increased competition in the pharmacy and PBM segment<sup>4</sup> will force existing players to embrace a virtual operating model, where many non-core

business functions and capabilities are delivered as utility-based cloud services (see Figure 4).

Pharmacies have been slow to embrace virtual collaboration models and externally delivered services for one primary reason: Their business environment did not compel them to do so. But with increasing volatility, pharmacy companies and PBMs will have to shift from a completely integrated operating model to a hybrid approach before fully embracing a virtual operating model – but only if warranted by business conditions.

For starters, pharmacies will have to open up their business architectures and identify loose couplings for seamless adoption of the emerging cloud-delivered services within their current operating models. The current spectrum of “as a service” utility-based offerings such as business process as a service (BPaaS), infrastructure as a service (IaaS), platform as a service (PaaS) and software as a service (SaaS) are examples of point solution-based capabilities that reliably and consistently deliver a specified outcome.

Sanovia’s PA-Logic is a good example of a prior authorization capability delivered as BPaaS. ADP’s Payroll Services is another example of a utility-based BPaaS to manage the employee payroll process, a function that is often not the core competency of the pharmacy or PBM.

To swiftly derive distinctive business capability relevant for the pharmacy business space, businesses must optimally combine the dynamic potential of these point solutions-based capabilities from various vendors. The combined benefit of a traditional operating model with the dynamic potential of cloud-based services will reduce the learning curve the organization must ascend when building new and distinctive capabilities, and it will also reduce the capital investment usually required.

Pharmacies and PBMs that learn how to adopt “cloud services” will be better equipped to transform themselves by embracing a more virtual business operating model. Taking this tack will enable them to more efficiently and rapidly respond to changing market dynamics and business cycle volatility. In fact, this approach will form the foundation for thoroughly transforming the business core across the enterprise for the future. Cloud-based services will be the key attribute for next-generation operating models that leave key rivals in the rear-view mirror.

## Footnotes

- <sup>1</sup> Paul Nunes and Tim Breene, "Reinvent Your Business Before It's Too Late," *Harvard Business Review*, January 2011.
- <sup>2</sup> This is evidenced by the fierce competition in the smartphone market, where Apple came from behind and captured market share through the introduction of innovative products such as the iPhone.
- <sup>3</sup> Joan Magretta, "The Power of Virtual Integration: An Interview with Dell Computer's Michael Dell," *Harvard Business Review*, March 1998.
- <sup>4</sup> Several events – including the recent entrance of Walmart in this market segment, the merger of ESI, Medco and Catalyst Rx, as well as the acquisition of Walgreens' PBM business – are all indications of an increase in competition.

## About the Author

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