



Preparing for Productivity Transformation in Pharma

2005 Pharma, Biotech, and Device Colloquium

June 7, 2005

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TODAY'S DISCUSSION

- **Industry context for the growing need to focus on productivity**
- Practical challenges and constraints pharmacos will likely need to overcome
- Some of our perspectives on what it will take to be successful

PHARMACOS FACE GROWING INTERNAL PERFORMANCE PRESSURES . . .

Patent expiries

- Over \$65 billion in branded drugs* losing patent protection in 2004-2008
- 21 blockbusters** going off patent/exclusivity 2005-2007

R&D productivity

- 13% CAGR for R&D spending 1970-2002, while total IND and NDA output remained relatively flat
- Survival rate in Phase II trials decreased from near 50% to less than 30% by some estimates
- Top 10 pharmacos' share of industry development pipeline decreased by ~40% from 1997-2002

Slowing US performance

- Pharma profit pool shrank by \$10 billion in 2003, compared with 18% increase in overall US corporate profitability

Legal challenges

- Expensive product and business-practice related litigation
- High-profile product withdrawals

Blockbuster infrastructure

- Organization size and spending levels remain high in many situations despite slowing pace of blockbuster launch/discovery

* 2003 sales levels

** Over US \$1 billion in WW peak sales

... COMPOUNDED BY AN EVER MORE CHALLENGING EXTERNAL ENVIRONMENT

Pricing pressures

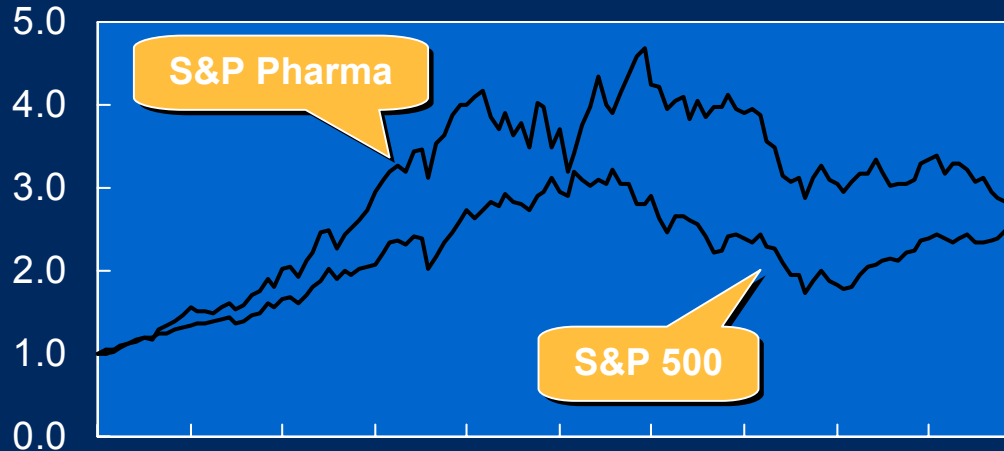
- Uncertain U.S. pricing environment
 - Re-importation
 - Medicare Modernization
 - Up tick in generic substitution
- EU reimbursement challenges
 - Directive price and reimbursement cuts (e.g. Germany, Italy)
 - Reference pricing within class or to generics (all EU5 markets except UK)
- Reimbursement of off-label use being challenged
- Rising copays making consumers increasingly aware of prices

Negative perception of industry

- Growing number of “follow-on’s” and “me-too’s”
- Pharmaceuticals represented 11% of US healthcare spending and 58% of healthcare profits in 2002
- Lobby from uninsured populations
- Government drug spend roughly doubled every 5 years since 1990, resulting in increased pressure to manage costs
- High-profile product recalls
- Business practice inquiries

CAPITAL MARKETS SEEM TO BE RECOGNIZING AND RESPONDING TO THESE CHALLENGES

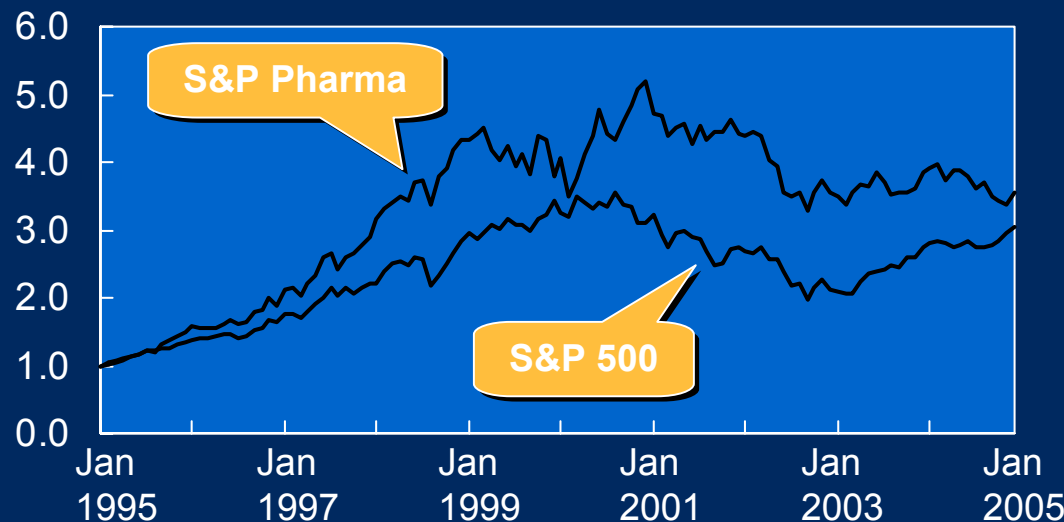
Price index, Jan 1995-Dec 2004



CAGR*
Percent

	<u>S&P</u>	<u>S&P Pharma</u>
1995-2000	21.0	27.6
2001-2004	-1.5	-8.1

TRS index, Jan 1995-Dec 2004

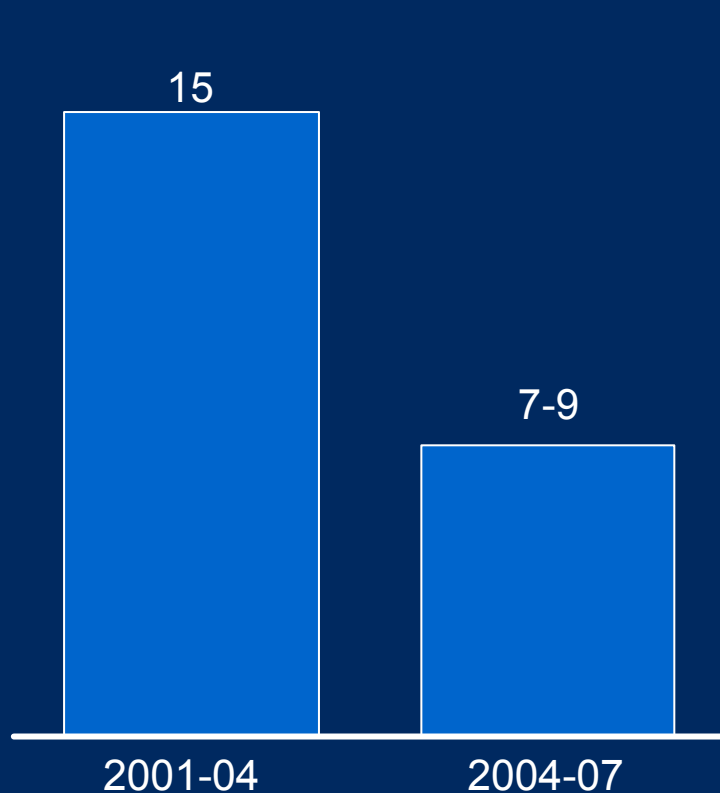


	<u>S&P</u>	<u>S&P Pharma</u>
1995-2000	23.1	29.7
2001-2004	0.2	-6.3

* Based on average indices for each year

HOWEVER, EARNINGS EXPECTATIONS FOR TOP PHARMACOS REMAIN OPTIMISTIC

Average EBITDA CAGR*
Percent



Implications

- Driving productivity in the full P&L
 - Topline
 - Cost
- Creating opportunities to fund growth, not only earnings

* Average includes Merck & Company, Eli Lilly, AstraZeneca, Novartis, Johnson & Johnson, GlaxoSmithKline, Bristol-Meyers Squibb, Abbott Labs, Pfizer, and Roche

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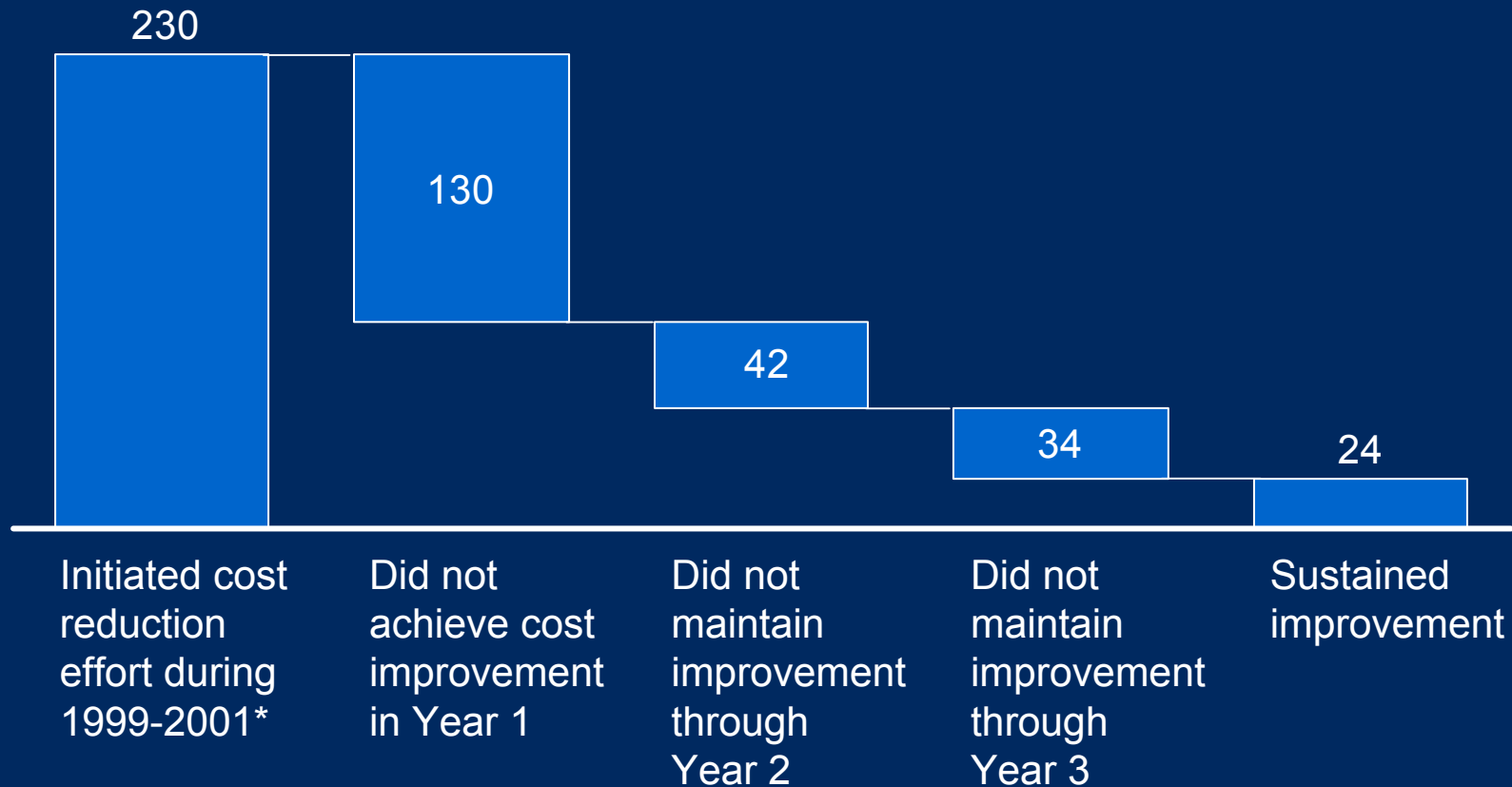
- **Practical challenges and constraints pharmacos will likely need to overcome**

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SUSTAINING IMPACT FROM PRODUCTIVITY EFFORTS IS NOT EASY

Cost reduction sustainability among the S&P 500*

Number of companies

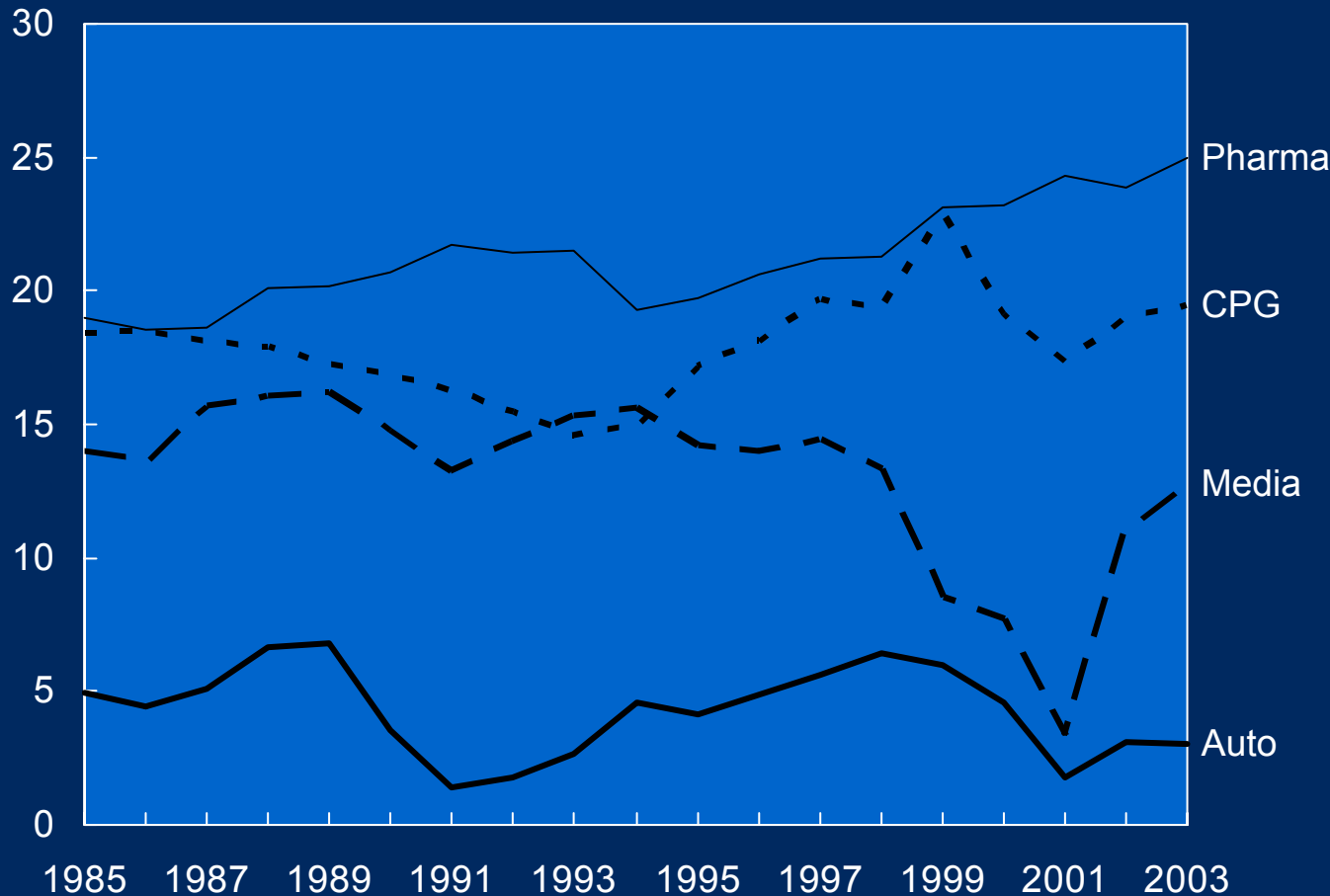


* Excludes 4 companies for which relevant comparison data was not available; based on costs as a percent of sales

Source: Bloomberg; Factiva; Transformation Compendium; Beer and Nohria (2000); Conference Board report (Fortune 500 interviews); Press analysis; McKinsey analysis

IN PHARMA, A LIMITED HISTORIC NEED TO OVER-EMPHASIZE MARGINS . . .

Weighted-average EBIT margins for selected industries, 1985-2003
Percent



- Pharma profitability is 5-15% higher than most industries and has seen sustained increases
- Other industries (auto, consumer packaged goods) already forced to re-invent operating models to sustain margins (late 80s, early 90s)

... HAS CREATED SOME UNIQUE CHALLENGES (AND OPPORTUNITIES) TO OVERCOME TO SUCCESSFULLY DRIVE PRODUCTIVITY

- **Senior management** attention and focus on productivity
- Institutional **skills and capabilities** (e.g., versus financial institutions)
- Focus on “across the board” **process excellence** (e.g., versus auto companies)
- Legacy of **decentralized operations** compounded with uncaptured M&A synergies
- Frontline **mindsets and behaviors** (especially when the “sky is not falling”)
- Effectiveness and efficiency of **support functions** (pharma rarely in the top quartile)

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WE OBSERVE 7 FACTORS COMMON TO SUCCESSFUL, SUSTAINED PRODUCTIVITY PROGRAMS

 *Illustrated
in more detail*

1. Carefully thought out **architecture to the program** including focus on approaches and tools to use, aimed at getting cost out and keeping it out
2. **Absolute commitment (in word and practice)** from CEO, CFO and every member of the executive team
3. Meaningfully **changing the way the business works**, fundamentally redesigning the organization, and reducing/changing work
4. A “modus-operandi” of delivering on **stretch targets**, with zero tolerance and major consequences for under delivery
5. **Building capabilities** to transfer “one-time” experiences into on-going “ways of working”
6. Driving the felt urgency and the need down to the **frontline employees with focus on mindsets and behaviors**
7. Having **rock-solid performance metrics** that measure the right things, providing transparency around them, living up to consequences of not delivering against metrics

MAJOR DIMENSIONS OF A WELL-ARCHITECTED PROGRAM

B. Establishing the right governance and leadership

- Role of senior management/program leadership
- Decision-making processes
- Resource deployment
- Tracking and monitoring progress

A. Determining what to focus on and how to do it

- Aspiration and target setting
- Areas of the business to focus on
- Approaches and tools to use

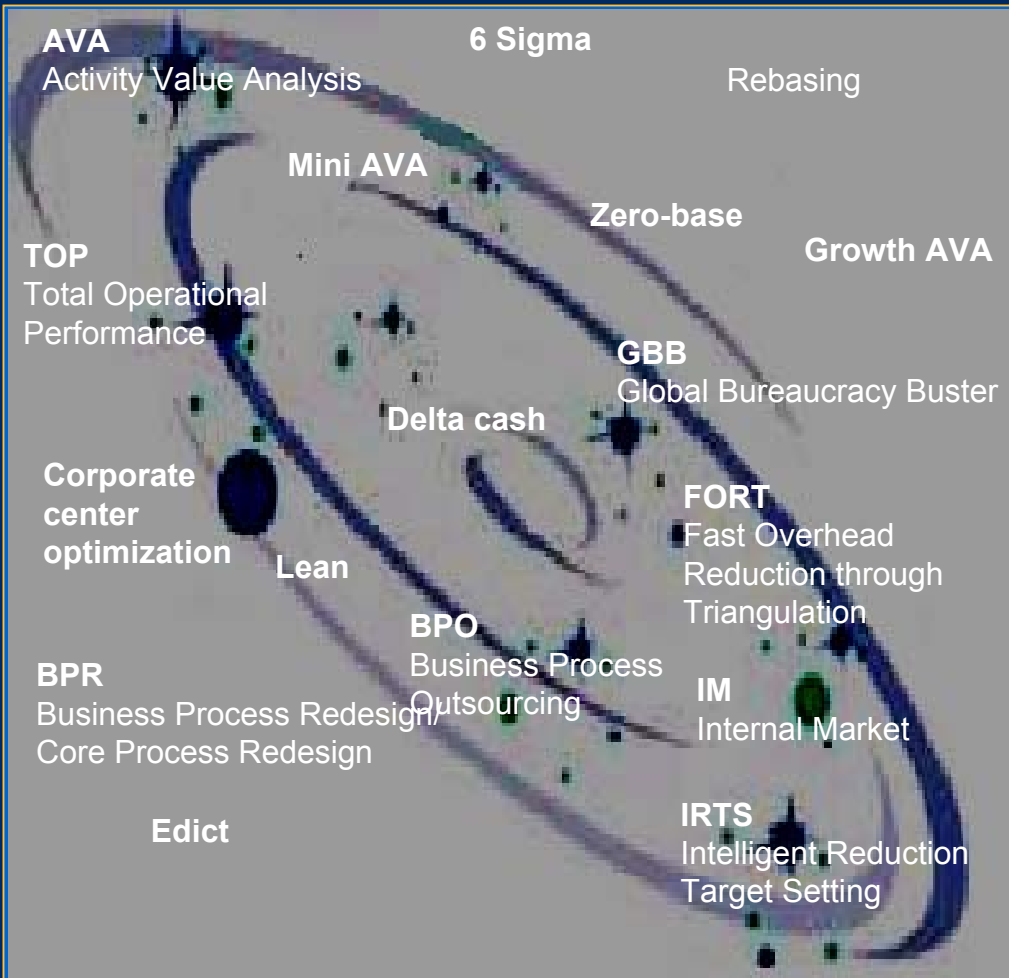
Well-architected productivity program

C. Communicating and gaining alignment around the program

- Engaging the organization, e.g., communication
- Skills/capabilities

THERE IS NO PERFECT APPROACH TO FIT ALL INITIATIVES WITHIN A PROGRAM

There is no shortage of productivity approaches to choose from . . .



. . . in our experience, simplicity works best

- **No one right approach**
 - Fundamental differences between initiatives drive the need to **tailor** approach
 - **Breadth of analysis will vary**
- Specific work should be **easy** to design and **timely** to implement
- Approach should be **simple** to communicate and **institutionalize** in the organization to ensure sustainability
- Should help **identify inefficiencies** in the system (e.g., redundant activities, low value products) to enable tangible action

EXAMPLES OF CHANGING THE WAY THE BUSINESS WORKS

	Examples of potential initiatives	Time to diagnose/launch	Time to full impact of savings*
Changing the operating model	<ul style="list-style-type: none"> • European regional models • Aggressively managing non-strategic products • Global vs. regional vs. local marketing models 	<ul style="list-style-type: none"> • Differs by specific initiative but generally 3-4 months 	<ul style="list-style-type: none"> • Could start in 6-12 months with full impact likely in 12-18 months
Redesigning processes and practices	<ul style="list-style-type: none"> • Functional process excellence (e.g., portfolio prioritization in R&D and S&M) • Support function optimization (standardization, off-shoring, demand management) 	<ul style="list-style-type: none"> • ~2-3 months 	<ul style="list-style-type: none"> • Savings begin in 6-12 months with full impact in 12-18 months
Managing demand and supply levers on external spend	<ul style="list-style-type: none"> • Category by category business-driven procurement initiatives focused on unit price and demand (often >65% of savings) 	<ul style="list-style-type: none"> • ~2-3 month waves 	<ul style="list-style-type: none"> • Typically in ~6 month waves but may differ by spend category
Issuing top-down mandates	<ul style="list-style-type: none"> • Travel • Hiring • Compensation • Meetings 	<ul style="list-style-type: none"> • Less than 1 month 	<ul style="list-style-type: none"> • Immediate – within ~3-4 months

* Timing post launch of initiative

SUCCESSFUL COMPANIES HAVE SYSTEMATICALLY CHANGED MINDSETS AND CULTURE FOR LASTING IMPACT

“I will change my mindsets and behaviors, if . . . ”



IN CLOSING . . .

- The need for productivity focus in the industry is real and will likely continue
- There is meaningful upside for those who can sustain productivity – particularly as a lever to fund medium to long-term growth (not only near-term earnings)
- Players who want to achieve sustained productivity will need to put in place a careful up-front architecture coupled with a real execution/implementation focus over time