

Counting the cost of purchasing

Jean-Michel Peny and Michel Jacob examine the potential for making savings in purchasing costs and describe how one pharmaceutical company succeeded in reducing its external expenditure by 10%.

How can pharmaceutical company profit margins be optimised? In today's difficult environment, increasing pressure on healthcare expenditure from payers, falling R&D productivity, and more intense competition all combine to erode pharmaceutical company profits. To maintain their margins or at least postpone any deterioration, pharmaceutical companies can pursue two lines of action – they can strengthen their sales or reduce their operating costs.

Multiple cost-containment measures introduced by governments in all major countries, such as reference pricing, incentives to market generics, price cutting and growth ceilings, mean that opportunities to speed up revenue increase are very limited. At the same time, programmes to reduce operating costs have generally been synonymous with large-scale lay-offs.

Making savings in the area of purchasing costs is an attractive and relatively painless alternative. Such costs account on average for 50% of a pharmaceutical company's total sales. A target improvement of 10% in purchasing costs would directly improve the average pharmaceutical company's operating margin by 20%.

The enormous potential for making savings in purchasing costs in the pharmaceutical sector is due partly to the decentralisation of many businesses and the fragmented nature of expenditure in many of these companies. In addition, purchasing, until now, has not been a priority area for reducing costs.

Recently, however, several leading international pharmaceutical companies have woken up to the possible cost savings and have launched global purchasing projects throughout their organisations.

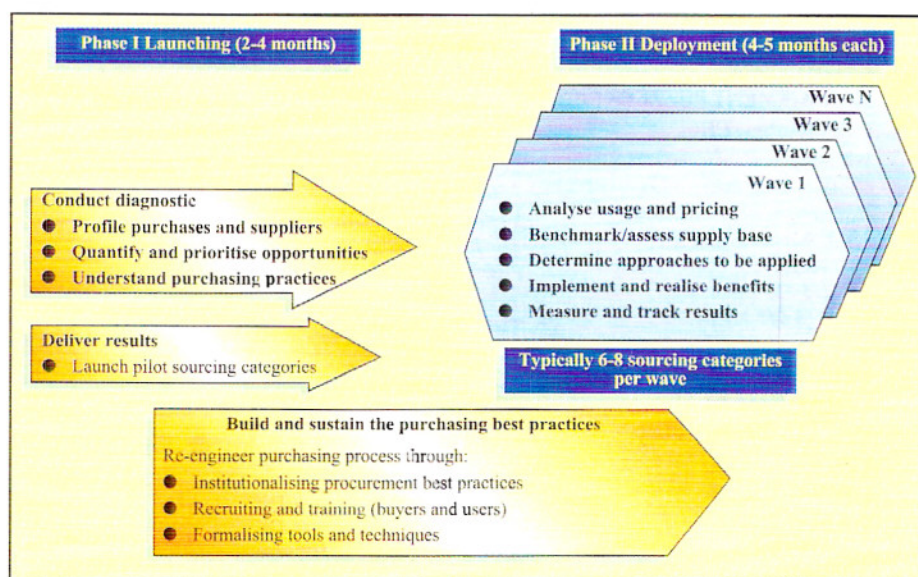


Figure 1: One way of making savings in purchasing costs involves the division of total company expenditure into sourcing waves, from which point purchasing costs are then systematically renegotiated. Source: AT Kearney.

One approach designed to generate and sustain maximum savings, with limited disruption to internal resources, is illustrated in Figure 1.

The approach starts with a diagnostic period lasting typically one to two months during which purchasing costs are assessed, these costs are segmented into homogeneous sourcing categories (for example, travel expenses, packaging costs) and profiles are drawn up on corresponding suppliers and purchasing practices. Cost savings opportunities are quantified by performing a gap analysis between current company performance and benchmark performance in two areas, purchasing practices and prices. The sourcing categories are then prioritised according to the level of expected savings, the case of renegotiating with suppliers and the extent of internal resources required. In the final stages of the diagnos-

tic period, the total savings target is assessed and sourcing categories are grouped into manageable 'waves' of implementation. The waves cover typically six to eight categories at the same time and last four to five months, depending on size and complexity. In this way, total company expenditure is divided into sourcing waves, from which point purchasing costs are then systematically renegotiated.

Pilot studies are carried out in parallel to the diagnostic period in two or three representative sourcing categories. These pilots are used to demonstrate the feasibility of both the cost improvement opportunities and the approach, and to mobilise the organisation around the project. Pilot selection is critical, since the categories to be addressed at this stage should present an opportunity for large savings, a contract which can be easily renegotiated in a short period of time, and

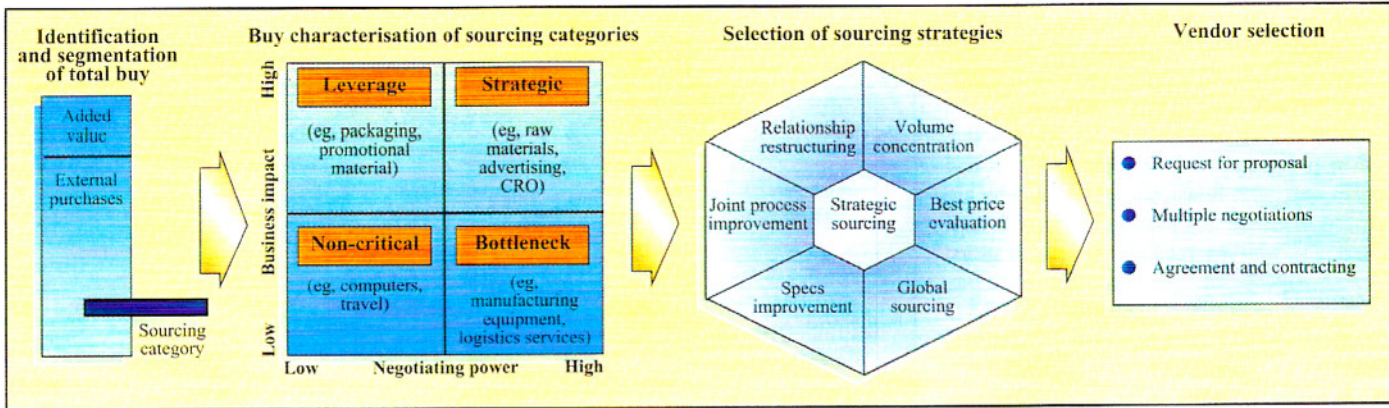


Figure 2: Both pilot studies and waves are implemented in a typical four-step sourcing process. Source: AT Kearney.

should be representative of the company's business. Typical candidates for the pharmaceutical sectors are packaging, printed promotional material and transportation.

The implementation of both pilots and waves is a typical four-step sourcing process (see Figure 2). This encompasses the identification and segmentation of the total buy, the characterisation of the buy, the selection of sourcing strategies, and the selection of vendors. The process should be implemented by cross-functional teams to ensure that users' needs as well as costs are considered. It should also be cross-divisional and global to take into account the total purchasing power of the company and so derive the greatest benefit from the exercise.

The most critical step is the selection and development of the best sourcing strategy from the six potential strategies (ranging from volume concentration to relationship restructuring) and the elaboration of the request for proposal, negotiations and the final selection of preferred providers.

One company's experience

One of the top ten pharmaceutical companies by sales followed this approach and, over the course of two years, managed to renegotiate more than 50% of its total external expenditure. It achieved worldwide purchasing savings of 10%, the equivalent of several hundred million dollars, while maintaining the same level of quality and service and improving relationships with selected preferred providers.

All areas of expenditure were addressed and generated typically a reduction in purchasing costs of 4-30%. Apart from the traditional areas of cost reduction, such as chemicals, packaging, distribution and information technology, some cost categories specific to the pharmaceutical industry were targeted, such as promotional material and advertising, conferences and seminars, and contract research and clinical studies (see Figure 3).

In the area of printed promotional mater-

ial, for example, average savings of more than 17% were achieved by cutting down the supplier base, negotiating mid-term contracts and removing pre-press services from the creative agencies. Further significant savings were identified through standardising specifications and developing demand management with the preferred suppliers.

In contract research and clinical trials, savings in the range of 15% were generated by negotiating service unit prices. Further opportunities in the field of joint process improvement were identified, which should allow drug testing cycles to be shortened and hence the time-to-market. Make-versus-buy issues were highlighted as further areas for study, once contractors' costs have been optimised through the sourcing exercise.

Overall, the number of suppliers was divided by a factor of between three and 20, depending on the sourcing categories addressed, making these areas easier to manage and enabling potential partnerships to be formed between the company and

selected suppliers. An additional advantage of this exercise is improved service from the supplier, who is encouraged to be proactive in offering the latest products and services, and is more willing to participate in their joint development. This is already the case in those industries with more advanced purchasing programmes, such as the automobile industry.

A result of the organisational re-engineering in the company was that a new purchasing procedure was put in place to support the five key operational elements of strategic procurement – strategic sourcing, supplier management, transaction execution, measurement and tracking, and continuous improvement.

The aim was to derive the greatest benefit from the purchasing operation by using the company's negotiating power to the full while ensuring maximum local user satisfaction. Given the company's decentralised structure and the fragmented nature of its expenditure, this could only be achieved

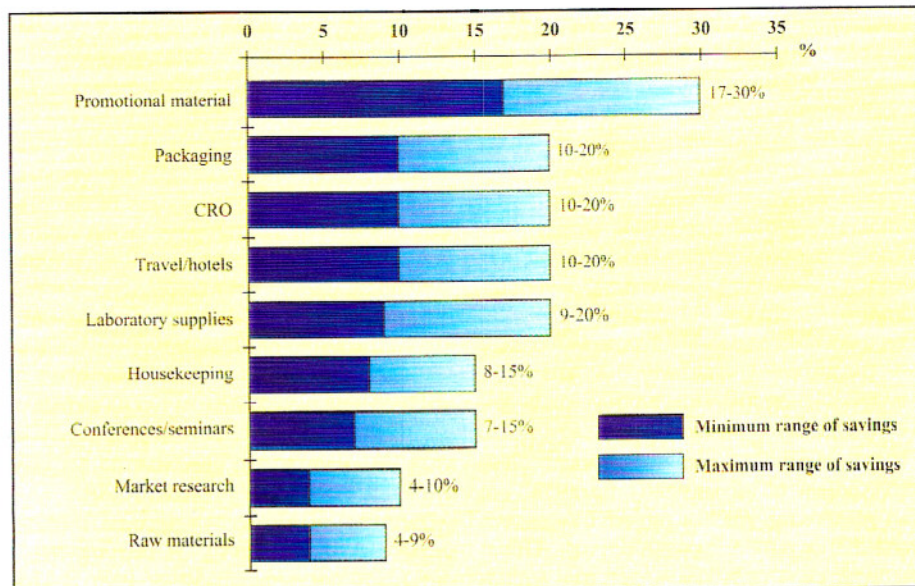


Figure 3: One leading pharmaceutical company reassessed all its individual areas of expenditure and generated a typical reduction in purchasing costs of 4-30%. Source: AT Kearney.

through a centre-led model (see Figure 4). The model helped to change the company culture by building a cross-functional, cross-divisional and truly global organisation.

Within such an organisation, an attractive career path needs to be created to attract and retain staff with functional expertise, who are able to negotiate at a strategic level with suppliers and who are credible in front of users. The company in question, for example, reacted by recruiting marketing and R&D people with purchasing expertise. It also made a significant investment in staff training.

Procedures and information systems were redesigned according to the new purchasing principles, based on the selection of suppliers and long-term contracts. Once all contractual conditions have been agreed, preference should always be given to those procedures and systems which allow the user to interact easily with suppliers, without generating excessive paperwork. Buyers can thus move away from the traditional administrative tasks and focus on the management of sourcing and suppliers, while users have streamlined access to suppliers for the fulfilment of their day-to-day needs.

Key success factors

The success of such a project relies more on the proper management of its launch and deployment than on the pure sourcing methodology. To achieve this, eight key requirements need to be fulfilled. There should be:

- Fast delivery of improved purchasing value either through a 'quick hit' approach or a pilot exercise. This gives credibility to the project, demonstrates its value and justifies the internal resource requirements for future waves.
- Global coordination with appropriate synchronisation of the sourcing efforts between different regional teams (for example, in Europe, the US and Asia). This coordination can vary from experience sharing (eg, in the areas of tools/techniques, practices, know-how) to collaboration over supplier selection in order to enhance the company's global purchasing power. The more global the suppliers' markets and purchasing needs, the stronger the global coordination should be. For example, chemical raw materials and information technology are global categories, whereas packaging and advertising materials are regionally driven categories.
- The right level of resources through close involvement of all company functions, not just purchasing. Such a project cannot succeed if it is only a 'buyer's project'. Users' demands need to be challenged, and technical and other qualitative criteria must be integrated when selecting preferred providers.

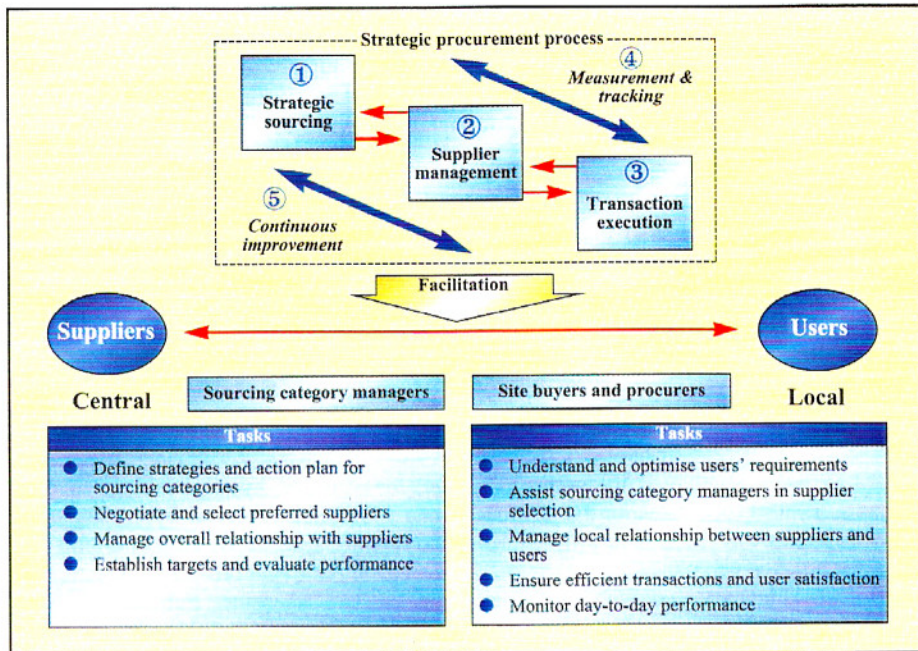


Figure 4: The pharmaceutical company's structure and the fragmented nature of its expenditure meant that only a centre-led model could help to change the culture within the organisation. Source: AT Kearney.

This requires the existence of multifunctional and multinational teams, which are usually coordinated by buyers.

- A pragmatic and systematic approach to achieve tangible results in order to avoid the 'study syndrome'. Sourcing teams should thus draw up clear objectives in terms of productivity and quality improvements, and project deadlines. An appropriate incentives and reward system for the best performing teams should be put in place.
- Permanent support from top management. This ensures that the necessary resources from business units are available for project implementation. It is also necessary for quick decision-making, since many established practices (such as make-versus-buy issues and human resources policies) will need to be challenged, often requiring top level arbitration.
- The 'buy-in' of users in sourcing decisions. Firstly, there should be constant communication and promotion of the project throughout the company, using various means such as internal newsletters, presentations or forums with major stakeholders. Secondly, formalised and systematic validation by users of all sourcing recommendations and decisions should take place at each critical milestone (sourcing strategies, shortlisting of suppliers, negotiations) to take into account site specifics, eg delivery time, differing quality standards, etc.
- The right purchasing organisation in place, requiring re-engineering of existing structures and the recruitment of high calibre staff. Without it, improvements generated at team level will not be correctly imple-

mented, the impact on profits will remain very limited, no change will be perceived by selected suppliers and their willingness to cooperate could be jeopardised for years, putting the business at risk.

- The implementation of a performance measurement and tracking system based on both productivity and internal customer satisfaction. Purchasing savings are usually difficult to measure and therefore finance staff need to be closely involved. Users' satisfaction surveys should be performed regularly to ensure careful monitoring of all aspects of purchasing performance.

Significant opportunities undoubtedly exist for pharmaceutical companies to make substantial savings in purchasing costs within a relatively short space of time. Experience shows that to secure long-lasting benefits, global purchasing projects need to be performed jointly with a change management programme. Focusing only on the re-engineering of the purchasing function will not provide the company with quick tangible savings. Likewise, a stand-alone, one-time sourcing exercise will fail to overcome the natural tendency to continue business as usual, causing all achievements to be forgotten once the project is over. SM

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