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How Healthy Is Your Growth Strategy? Five Principles To Fight Complexity In Today's Medtech And Biopharma Enterprise

by

Top performers in today's health care market are transforming their growth strategies. They excel at category leadership, cost reduction and customer-focused innovation. Complexity – in strategy, portfolios, operations, organizations and people – is a little-noticed impediment to achieving margin-busting growth, on target and on time.

- Tackling what Bain research tags as the “five Ps” of complexity enables companies to focus attention on their most important priorities and create streamlined organizations that are fit for a fast-changing market.
- Companies that reduce unnecessary complexity build competitive advantage and position themselves to outperform for years to come, typically adding three to five percentage points to the business bottom line.
- So what? Understanding what the customer perceives as value is the starting point for the harder task that unfortunately few medtech and pharma companies tackle: weeding out products, processes and customers that no longer create value and distract attention from growing the business

Medtech and pharma companies have long viewed revenue growth as their highest priority. To increase the top line, many launched new products without addressing implications for legacy products, entered new therapeutic categories without a path to leadership, and expanded to all corners of the world without sufficient local scale.

Over time, unchecked growth created two problems. Leadership teams lost sight of the businesses that generated real value; and complexity spreads like sand in the gears of their businesses. Execution at the operations level became less efficient, less effective and less

focused.

As long as gross margins remained high, the profit generated from these growth strategies appeared to outweigh the complexity they created. Now, harsher market conditions are exposing the risk of pursuing growth at all costs. Companies need to increase revenue and margins just as the hurdle for innovation is rising and as intense therapeutic competition adds to pricing pressures. Under those conditions, complexity can pose a serious drag to performance. It slows down decision making, adds hidden costs, impedes innovation and damages customer relationships. Simply put, the very strategies that health care companies pursued to deliver growth may now be undermining it.

Tackling complexity in a systematic way allows companies to accelerate growth while reducing costs, even in the face of continued market pressures. In Bain's experience, companies that remove unnecessary complexity can achieve above-market growth while also delivering significant margin expansion, typically adding three to five percentage points to the bottom line. Here's how: A streamlined organization and portfolio unlock growth potential by focusing a company on the products and services that customers value most, breaking down barriers to collaboration across silos and freeing up funds for innovation. On the cost side, simpler structures and product offerings create efficiencies in manufacturing, research and development (R&D), quality, regulatory and marketing – functions vital to top-line and bottom-line growth.

Reducing complexity, and the structural cost exposures it creates, can also help the general manager build a healthier profit and loss statement (P&L) – one able to withstand market volatility without depending on discretionary cost-cutting and headcount reductions.

This is not to say, that all complexity destroys value. Companies with diverse businesses and capabilities can offer customers a more comprehensive value proposition, which may include more extensive product offerings, value-added services and logistics support. However, leadership teams must determine whether customers truly value the breadth of offerings or if, in fact, they find them confusing or marginally relevant. In that case, complexity is likely to be undercutting performance and should be eliminated.

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Five Types Of Complexity

Leading companies understand that there are different kinds of complexity, and they seek to reduce each type. We see five important types of complexity: portfolio, product, place, process and people. The “five Ps” of complexity are interrelated, and addressing one will often help confront others

Portfolio complexity is a measure of how related a company’s businesses are to one another. Companies with high portfolio complexity have fragmented businesses across different segments or therapeutic areas. A key symptom: Operating units have little in common across areas such as customers, competitors and capabilities.

Why it matters: Fragmented businesses often lack critical scale and consume disproportionate resources from shared functions and capital that could be deployed more productively elsewhere. Bain research shows that category leadership in both pharma and medtech delivers higher total shareholder returns (*see Exhibit 1*)

Many manufacturers in pharma and medtech have assembled large portfolios of businesses. In some cases, they built leadership positions in categories that helped deliver superior economics through customer loyalty, improved commercial advantage, value-added services and accelerated innovation. But often, they have also saddled their portfolios with less competitive businesses in unrelated categories, few of which received the appropriate level of investment or management attention.

Exhibit 1 The Five Ps Of Complexity



SOURCE: Bain & Company

Companies with complex portfolios that have accumulated businesses that lag the competition typically are burdened with higher general and administrative (G&A) costs as a percentage of sales. The reason is clear: Key functions, such as regulatory oversight, quality control, marketing, human resources, information technology and finance, must serve disparate needs. With a fragmented and less competitive set of businesses, it's also more difficult to create supply chain efficiencies in manufacturing or supplier relationships. When companies scatter capital and management attention across a multitude of businesses, they starve their core business of resources. The result of subscale positions is often higher costs and lower growth. (Also see "[Category Focus Rewards Biopharma Shareholders](#)" - In Vivo, 1 Feb, 2017.)

Product complexity is the proliferation of products and stock-keeping units (SKUs) that are no longer part of the growth trajectory of the business; and overlapping formulations, products and generations that do not benefit customers.

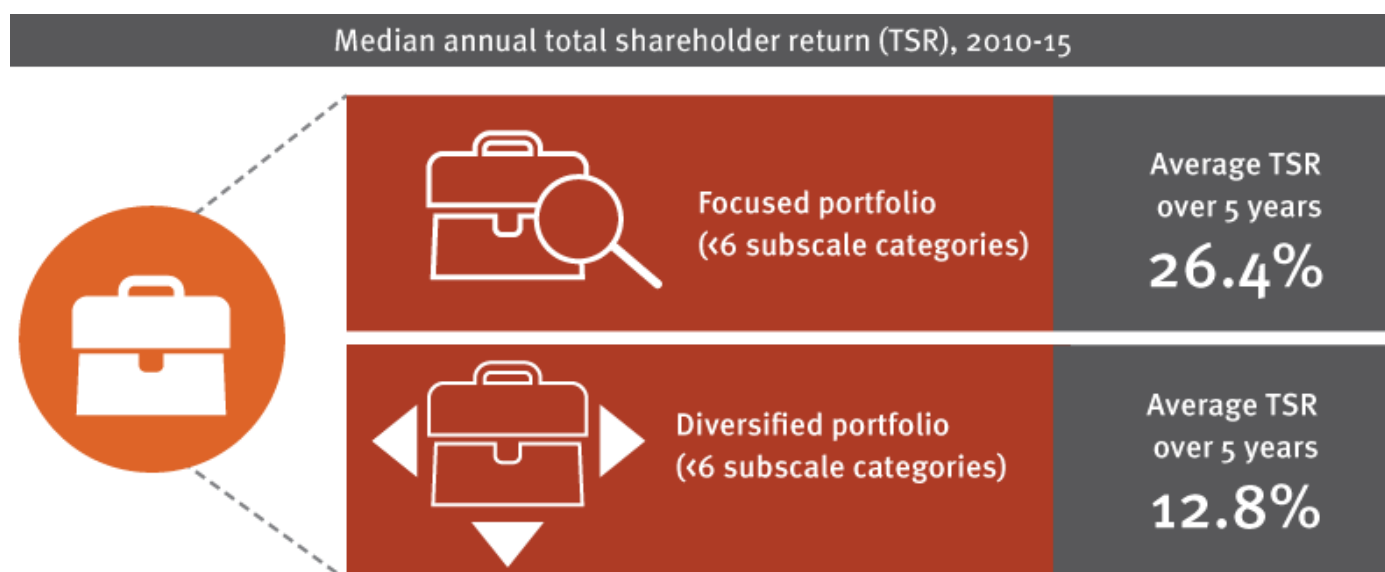
Why it matters: Rampant product complexity drives up cost, and to the surprise of many, may in fact significantly inhibit revenue growth(see *Exhibit 2*)

For years, health care companies developed new product lines, new formulations and new generations of existing products in the race to innovate, respond to customer demands and polish their brand image. New versions were designed to improve functionality and outcomes.

But they rarely triggered the retirement of prior-generation products, as they commonly do in other industries (try buying an *iPhone 5* at your local retailer). Rather, pharma and medtech companies sold older products alongside new ones, believing older versions still addressed some customers' needs.

Exhibit 2

Portfolio Focus Improves Total Shareholder Return In Pharma



SOURCE: Company financials, Bain analysis

That approach led to a lack of discipline in managing the legacy product portfolio and often limited the ability to build share for newer product lines. In many cases, companies used legacy products or formulations to serve lower-cost tiers or to enter emerging markets, based on the assumption that they are cheaper to manufacture and sell, which is rarely true when total production volumes decline. In addition, as the industry pursued mergers and acquisitions, few companies integrated their portfolios, instead keeping competing products from both companies in the marketplace.

Product complexity confuses customers and sales representatives with a fragmented portfolio of similar and undifferentiated products. It also siphons resources away from the company's most important products, since a legacy portfolio requires continued attention and investment. The highly complex portfolio at one health care company consumed nearly half of the R&D budget to support the legacy portfolio at the expense of innovation. At many health care companies fragmented product portfolios divert funding from marketing and commercial budgets that is vital to promoting new products.

Product complexity also drives up costs in G&A and manufacturing. Functions including quality assurance and control, regulatory, customer service, legal compliance and sales and operations planning must support complex and fragmented portfolios, even if those products generate little return. Product proliferation raises manufacturing costs and inventory levels. Plants must maintain dedicated lines or invest in expensive changeovers and equipment for low-volume SKUs and maintain safety stock across many more product lines. Older products suffer more often from quality problems, adding to higher customer service support costs. Finally, product proliferation results in a multitude of suppliers, making it harder for management to focus on a core group of strategic partners that can offer better cost and service.

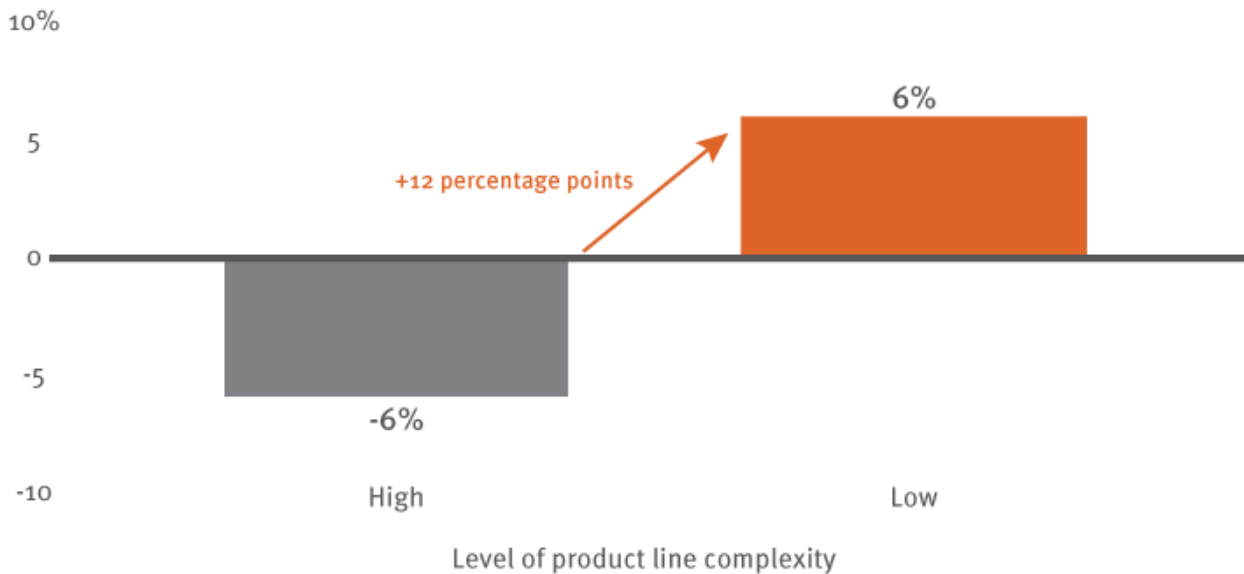
Place complexity is geographic fragmentation. Key symptoms: highly dispersed revenue streams and multiple markets with subscale revenues.

Why it matters: Pharma and medtech companies enter many markets that do not have a path to profitability, and where selling costs are prohibitive. But losses go unnoticed because financial systems rarely capture the full burden of geographic complexity.

Many leadership teams assume that all revenue from new geographic markets is accretive, but the full cost of operations including regulatory, customer service, quality, manufacturing, labeling, shipping, R&D, monitoring and compliance often makes these markets unprofitable (see *Exhibit 3*). The costs of geographic complexity are rarely captured because financial systems typically are built to capture marginal costs rather than total costs. Management and marketing teams end up investing too much time and energy in markets with marginal returns, instead of growing share in markets that have the greatest potential for scale and leadership economics.

Across Industries, Less Complex Product Lines Win The Day

Predicted revenue growth (indexed to average product line complexity)



Note: High complexity includes companies one standard deviation above their industry average; low complexity includes those one standard deviation below; complexity metrics selected independently for each industry; n=63 in 10 industries.

SOURCE: Bain analysis

Process complexity refers to duplicative and inefficient business processes throughout the organization. Key symptoms: functional, system and IT redundancy and manual workarounds.

"Why it matters: Complex processes slow decision making and execution and blur accountability.

When health care companies grow rapidly across product lines and geographies, basic business processes become more complex. Management teams increase oversight, regional and local stakeholders multiply, and process localization grows. Many processes are tied to legacy IT systems, so complexity soars when companies merge without doing the necessary system integration. Pharma and medtech companies often have overlooked these process challenges, assuming complexity is a given. Successful companies tackle process complexity to reduce run rates, increase the speed of decision making, lower costs and make the business more productive.

Process complexity often leads to multiple decision nodes throughout the system, diluting decision ownership. As a result, key processes such as new product design, supplier and manufacturing transfers, and product redesign become slow and labor intensive. Slower decisions and processes impede customer responsiveness, undermine growth and increase costs.

People complexity is the proliferation of employees and managers with unclear roles and

accountability. A key symptom: many organizational layers between customers and senior management.

Why it matters: Whenever portfolios, products, places and processes become complex, people complexity grows, too. Unclear decision rights, misaligned incentives and duplicative functions slow decision making and execution, inhibit innovation and add costs to the system.

The clearest signs of people complexity are too many spans and layers of management, and organizational structures with far too many nodes. When the customer interface is too far removed from the C-suite, the result is reduced market sensitivity and agility. Senior managers have more limited spans of control, increasing costs without creating incremental value. Organizations with too many spans and layers risk leaving R&D cut off from the front line, investing primarily in safe projects rather than innovations that might command more value.

When an organization becomes so complex that no senior leader is able to navigate all its functions and silos, general managers become less accountable.

Over time, their skills diminish as the company develops into a collection of cost centers where each defends its own budget. In that setting, few general managers focus on the combined mission of growing revenues and margins.

People complexity also undermines the efficiency of corporate or shared services. Organizations that lack clear roles for shared functions to support multiple internal stakeholders are unable to leverage administrative costs.

Why Tackling Complexity Is Hard

If complexity is such a drain on growth and margins, why do companies struggle in their efforts to tame it? There are three key reasons, in our experience:

First, the costs of complexity often are hidden – they don't appear in financial systems or P&Ls. Standard cost accounting spreads costs across product lines and geographies instead of clustering costs by activity. So even when leadership teams believe that complexity adds costs, it's hard to prove with readily available data.

Second, companies often do not approach complexity reduction from the perspective of what's best for their customers. Complexity reduction, when done correctly, improves the customer experience and makes a company's value propositions more powerful. Unfortunately, many companies think they have to make a trade-off between complexity and growth, when in fact reducing complexity will most often help accelerate growth. Companies that frame complexity reduction as primarily a cost-cutting initiative, separate from what's best for their customers and employees, inevitably fail to achieve their full potential.

Finally, many companies fail to capture the full cost savings from complexity reduction. Streamlining a product or service portfolio does not automatically eliminate costs or improve business performance. Line owners must adopt new cost targets. Managers need to reset budgets. Dedicated teams have to redesign processes and procedures to capitalize on the newly simplified portfolio. Over time, companies can take many other actions to enhance cost savings, such as reallocating R&D funds to reflect the new product strategy, consolidating vendors, reducing spare-part inventories and simplifying manufacturing schedules.

These three factors make addressing complexity different from other strategic initiatives – and point to the need for a new approach

A Path Forward

While tackling complexity is hard, it is critically important to performance. Successful companies follow five basic principles to deliver stronger revenue and profit growth in today's challenging health care landscape:

Establish a cross-functional team and governance structure: Complexity flows across functions, so rooting it out requires a cross-functional team of commercial divisions, R&D and operations. In our experience, complexity reduction efforts are most successful when commercial and marketing executives lead them. They help focus decisions around a winning portfolio and ensure new disciplines become embedded in management processes.

Build a cost-of-complexity model that captures all embedded costs: The costs of an individual business unit, geography, product or process can be difficult to identify, so it is critical to develop objective data that highlight the total cost of complexity. Often this requires a more nuanced, activity-based methodology to allocate costs, and an understanding of what sets in motion new activities and resource allocation.

Develop a clear business case for removing complexity based on what customers value: Armed with data on the total cost of complexity and proprietary customer insights, leadership teams can decide which products and services add value to the business and which do not. In some instances, companies may decide the high cost of portfolio complexity is justified because customers value those products.

The key is understanding exactly what customers in each segment want from the product in question, and designing it to those specifications. Leadership teams may also decide adding complexity is warranted when establishing a beachhead in a new market, for instance. The most effective approach is to build a business case based on an enterprise-wide view of the return on investment, since the benefits and costs of eliminating complexity often do not sit within the same P&L or operating unit.

Strengthen organizational alignment: In our experience, companies that reduce complexity to unleash growth – instead of indiscriminately cutting costs – empower employees to find incremental opportunities to simplify their activities and focus on high-priority brands and priority markets.

Take steps to reduce complexity and keep it out: Complexity programs are a multiyear effort that require a well-coordinated, cross-functional team with appropriate governance. Participants should remain in sync on both the activity milestones and actions to remove costs. Managers can use trigger events such as a merger or the launch of a new product line to signal the opportunity to decrease complexity by eliminating roles, projects and other resource-draining activities.

Leading companies redesign internal processes to ensure complexity does not creep back in. They build in clear guidelines to define the criteria for adding new geographies, for example, and establish rules for eliminating prior generations of products a few years after a new launch.

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