



Case 11: HealthCareCo

- Type: Basic Support Functions
- Difficulty: Hard
- Industry: Healthcare
- Firm Format: McKinsey

HealthCareCo

RCC Original – McKinsey Style Case

Difficulty: Hard

Industry: HealthCare

Type: Basic Support Functions

Problem Statement

Your client is the CEO of a leading diversified healthcare products and pharmaceuticals company - HealthCareCo.

The company's principal business is the discovery, development, manufacture and sale of a broad and diversified line of healthcare products.

Thinking ahead for the next 5 years, the CEO of HealthCareCo wants to consider cost optimization as one of the important elements of his strategy.

He has engaged McKinsey to help him with this effort.

NOTE: This is upfront information and not the end of the prompt. Because this is a McKinsey Case, there are specific questions that follow.

Information Provided Upon Request

HealthCareCo has about 50,000 employees in approximately 100 countries around the world.

Currently, HealthCareCo has 4 different revenue generating business units namely - pharmaceuticals, medical devices, health foods, and specialized surgery products.

The CEO wants to distinguish the firm through innovation in the healthcare and pharma industry in the next 4-5 years

There are 3-4 main competitors, client firm can be said to be #2, #3 in the market

Question 0

What would be the key factors that you would consider in preparation of your first meeting with the CEO and his team?

Financial Reports

Understand the company's business, Analyze the Income Statement / Balance Sheet, Important financial ratios, Historical performance, Compare ratios with competitors, similar players in other industries

Value Chain / Company Business / Org Structure:

Because we are taking an overall company view, a good candidate will bring up the concept of a Value Chain. A value chain helps to identify different business drivers and logically separates the individual elements of a firm. This should also account for the different business units

Primary Functions: Inbound Operations, Company Operations, Outbound Operations, Marketing, Sales, Service.

Support Functions: Finance, HR, IT, Legal, Procurement, Facilities etc

Competitors

Who are the competitors in the market

How is HCC different from the other competitors, value proposition, target consumer

Strategy

Understand the overall strategy of the firm and also how it relates to the 4 different Business Units, different geographies
A good candidate will bring up the discussion of cost-based differentiation or value based discussion and will also offer an initial hypothesis that because this is a pharmaceutical / healthcare company, the company will have to invest in R&D and innovation

Market Trends:

Any trends in the healthcare market across the world

Industry Factors / Regulatory / Patents / Other Factors

Considering the global nature of the company's operations, we would also have to factor in regulatory changes
Foreign relations, Taxes, Foreign Exchange implications etc.

Question 1

Give the candidate Exhibit 1 and ask him to offer initial thoughts / hypotheses

Typical Response:

1. The COGS number is at par with the industry. But this could be an area to explore if the company is to create a cost –advantage.
2. R&D costs as compared to the industry benchmarks are lower (as a % of sales). This could imply that the firm does not invest as much in R&D as compared to some of the other competitors. So this could mean either that the firm is a “follower” in this industry and therefore probably competes on costs OR that the firm competes in a different segment of the healthcare, nutritional segment that does not require as much R&D.
3. Business support costs as significantly higher than the industry averages. Given that the CEO wants to focus on cost optimization, this line item offers significant potential to cut costs.
4. Earnings per share are lower as compared to the industry. Assuming everything to be the same for the comparable companies, this should be a cause of concern for the CEO.

Synthesis: It is important to focus on overall cost reduction for the firm, as this will not only boost the competitiveness of the firm, but also free up capital to invest in R&D, if the company wants to differentiate itself in the industry based on innovation. Business Support Functions could play a significant role in helping to reduce costs.

Exhibit 1

Income Statement - HealthCareCo

(\$ in Millions, except per share data)

			<u>HCC</u>	<u>Industry</u>
Net Sales	\$ 40,000	COGS (% of sales)	39%	40%
Expenses		R&D (% of sales)	10%	12%
COGS	\$ 15,500	Business Support	30%	25%
R&D	\$ 3,500			
Business Support	\$ 12,000	EPS**	\$ 2.00	\$ 2.50
Total Expenses	\$ 31,000			
Other Adjustments*	\$ 3,000			
Gross Profit	\$ 6,000			
Taxes	\$ 2,400			
Net Earnings	\$ 3,600			
Total Shares	1,800			

* Includes interest adjustments, Forex loss, loss on extinguishment of debt

** Ignore Preferred Dividends

Question 2

(See Note Below). BRAINSTORMING.

NOTE: First ask if the candidate understands what BSF means. Let them explain what they think about it. Then give this information:

BSF: Functions which are necessary for running the main operations of any firm. Typical BSFs include Finance, HR, IT, Legal, Procurement, Facilities etc. These functions are typically non-revenue generating functions.

Then ask them what would they do now?

Typical answer. Look at the breakdown of BSF. See which ones of those is a problem. Compare numbers with industry benchmarks. **THEN HAND OUT EXHIBIT 2.**

The candidate should quickly comment on two things:

- 1. All key BSF functions are worse for the client as compared to industry benchmarks.**
- 2. Industry benchmarks costs for BSF functions are 30-40% lower than those for the client.**

IDEALLY, a candidate should proactively answer why he thinks this could be the reason. IF not ask this question:

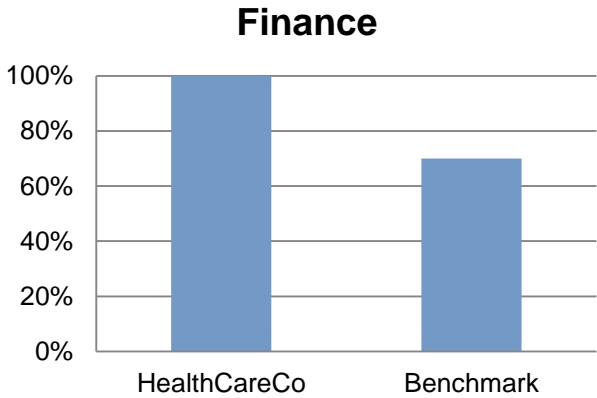
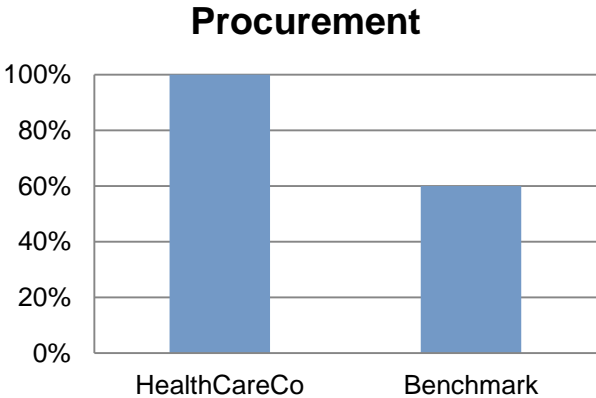
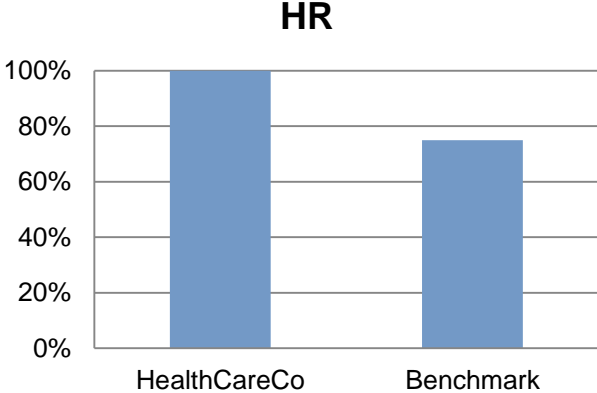
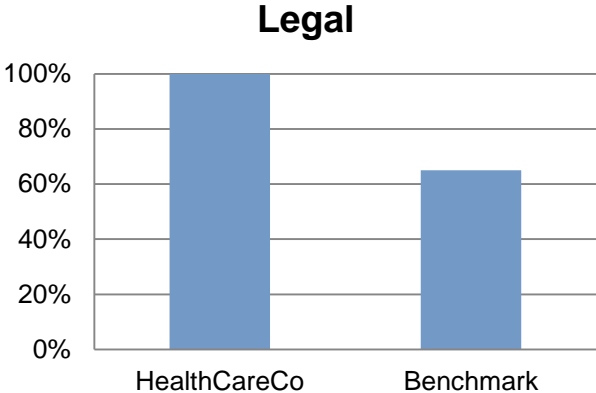
Question 2: Why do you think these costs are high for the client?

Typical Response:

1. The client has grown through acquisitions, each acquiree adds its own BSF FTEs and complexity
2. Geographical complexity / differences
3. Organizational complexity
4. No overlap of tasks between different Business Units / silo's in the business units

NOTE: Keep asking what else, till the candidate has given 4-5 good answers.

Exhibit 2: Basic Support Function Costs Comparison



Question 3

Assume your team does a further analysis on the type of activities within each of these BSF functions and they find this. (Hand out Exhibit 3).

NOTE:

Transactional activities: Defined as day-to-day activities, low-skill, repetitive

Specialized activities: High skill, specific to each business unit / geography, requires involvement of multiple people etc.

An ideal candidate will try to answer why different departments show difference in Transactional / specialized:

- Procurement / Legal are inherently localized and specialized functions – every location / Business unit has different requirements / laws / regulations.
- Finance and HR have a fairly large number of day-to-day activities: book keeping, payroll, time and expense etc.

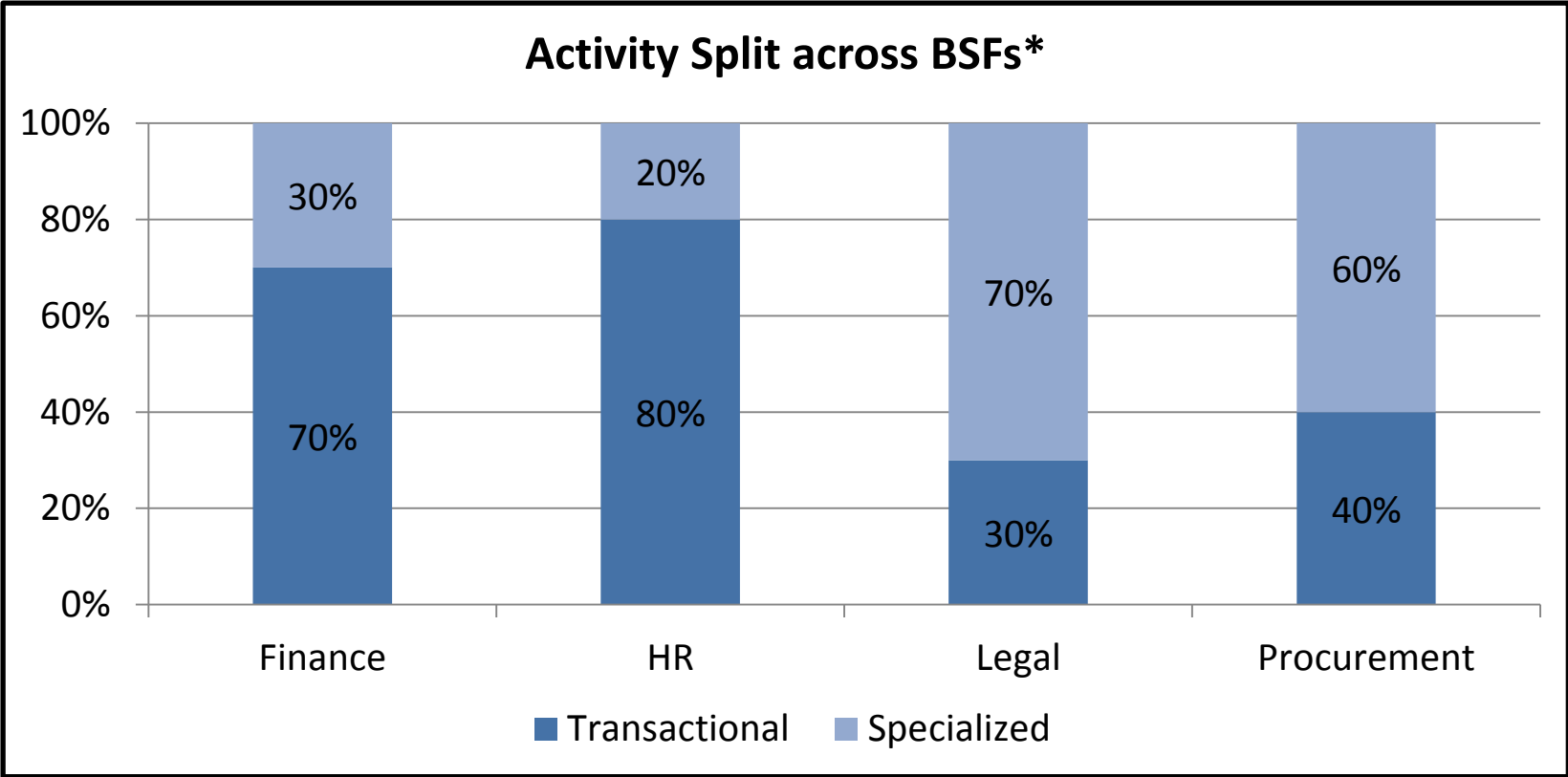
Question 3: Can you think of ways to reduce these costs?

Typical responses:

1. Eliminate redundant activities
2. Automate certain activities
3. Improve efficiency – by reducing number of steps in a process
4. Reduce frequency of unnecessary activities
5. **Outsource certain activities (Do not give this away. This is critical for the next part of the case).**

ASK THE CANDIDATE, would he think of outsourcing differently for transactional v/s specialized. Give the candidate a minute to think. If he comes up with an answer, continue with next slide. OR Just move to the next slide if the candidate cannot think why. (Obviously, he doesn't get the brownie points!)

Exhibit 3



**Typical Geographical sub-unit of a Business Unit*

Question 4

(Hand out Exhibit 4). Some one on your team suggests that this is a way that the client can think about it's outsourcing / consolidation. What do you think about it?

Typical Answer:

This makes complete sense. Here's why:

- Transactional activities can be consolidated at a global level. India / Chile make good options because of:
 - Cheap labor
 - Cheaper costs
 - Availability of labor
 - Expertise in services outsourcing
- Specialized activities can be consolidated at a regional level because:
 - Region specific requirements
 - Similarity of business
 - Laws / Contracts / Regulation
 - Language

Exhibit 4



LEGEND

- Outsourced Center – Transactional Activities
- Center of Excellence – Specialized Activities

Question 5

Let's say the company goes this route. Ships transactional work to Outsourced centers, and specialized activities to Centers of Excellence. The company also does some IT rationalization efforts How much cost savings will these changes help the company realize: (Hand out Exhibit 5)

NOTE: IT rationalization: Centralizing databases, establishing common platforms etc, renegotiating with vendors etc)

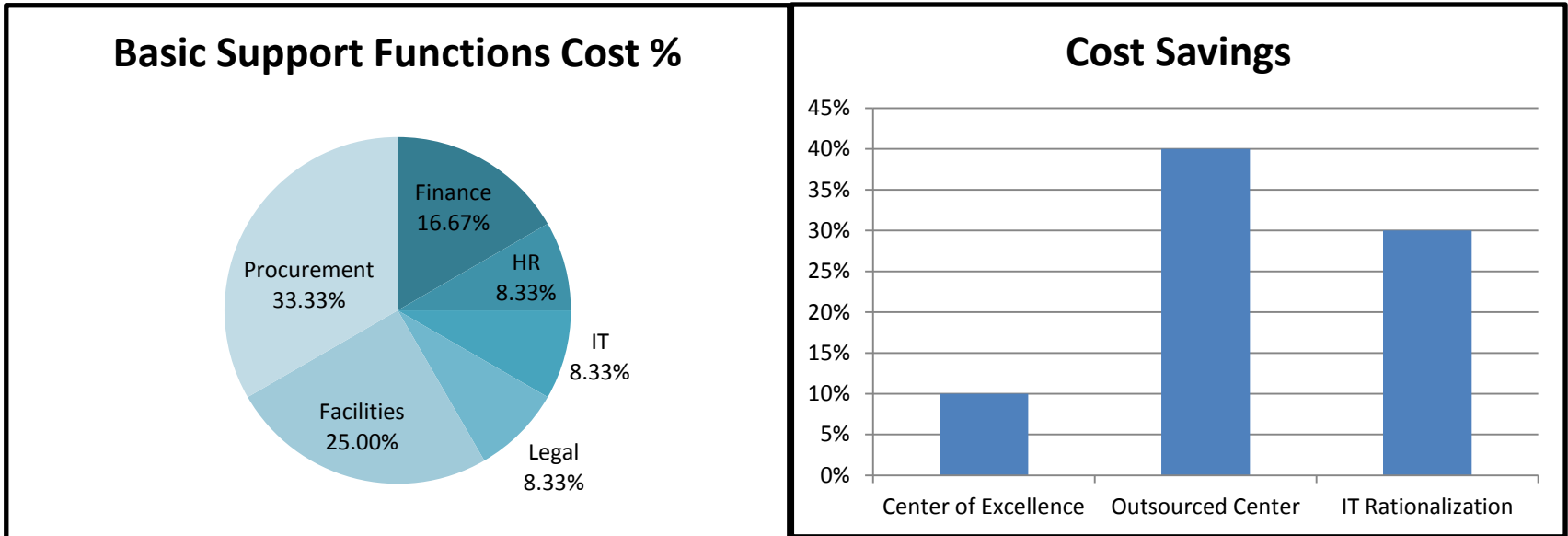
Typical Response:

Total BSF	\$ 12 Bn	\$ Bn	% Tran.	% Spc	CoE Savings	Out-sourced	IT Ratz	Cost Savings (\$ Bn)
Finance	16.66%	2	70%	30%	10%	40%	-	0.62
HR	8.33%	1	80%	20%	10%	40%	-	0.34
Legal	8.33%	1	30%	70%	10%	40%	-	0.19
Procurement	33.33%	4	40%	60%	10%	40%	-	0.88
IT	8.33%	1	-	-			30%	0.3
Facilities	25%	3	-	-			-	-
Total Cost Savings								\$ 2.33 Bn

- A quantitatively strong candidate will be quickly able to calculate that $16.33\% = 1/6$, $8.33\% = 1/12$, $33.33\% = 1/3$, $25\% = 1/4$
- Calculation: Finance Cost Savings = Total Finance Costs*Transactional%*OutSourcedSavings + TotalFinanceCosts*Spec%*CoESavings
- Similarly for HR, Legal, Procurements
- IT cost savings = IT Costs*ITRationalization%
- Cost Savings for Facilities is out of scope for this case
- **An Excellent Candidate will go back to Exhibit 1, and reflect on what effect will this have on the financials. Currently, BSF costs are higher by 5% as compared to the industry (5% of \$40 Bn = \$2Bn). The savings that we see above are higher than \$2Bn. These additional savings can be put into R&D, given out as dividends, and also boost the EPS. All great results from the CEOs standpoint.**

Exhibit 5

- Total BSF Costs: \$12 Billion



* Facilities are local, Ignore cost savings coming out of facilities

Typical Response:**Recommendation:**

The CEO should engage into a large-scale organizational transformation. Specifically to optimize the BSF costs. There are three reasons for this.

1. BSF Costs are higher as compared to industry benchmarks
2. They are hurting the client's position in the market
3. And are critical for the future strategy of the firm – to differentiate itself through innovation

One of the important highlights of this transformation should be the creation of outsourced centers and Centers of Excellence to manage the transactional and specialized BSF tasks. This could give a net run-rate savings of \$2.3 Bn in today's terms.

Biggest Risk:

1. Downsizing repercussions
2. Foreign limitations, time for implementation

Next Steps:

1. Do a cost-benefit analysis. How long will this transformation take. How much will it cost
2. Opportunity Costs
3. Find out ways to manage the implications of down-sizing