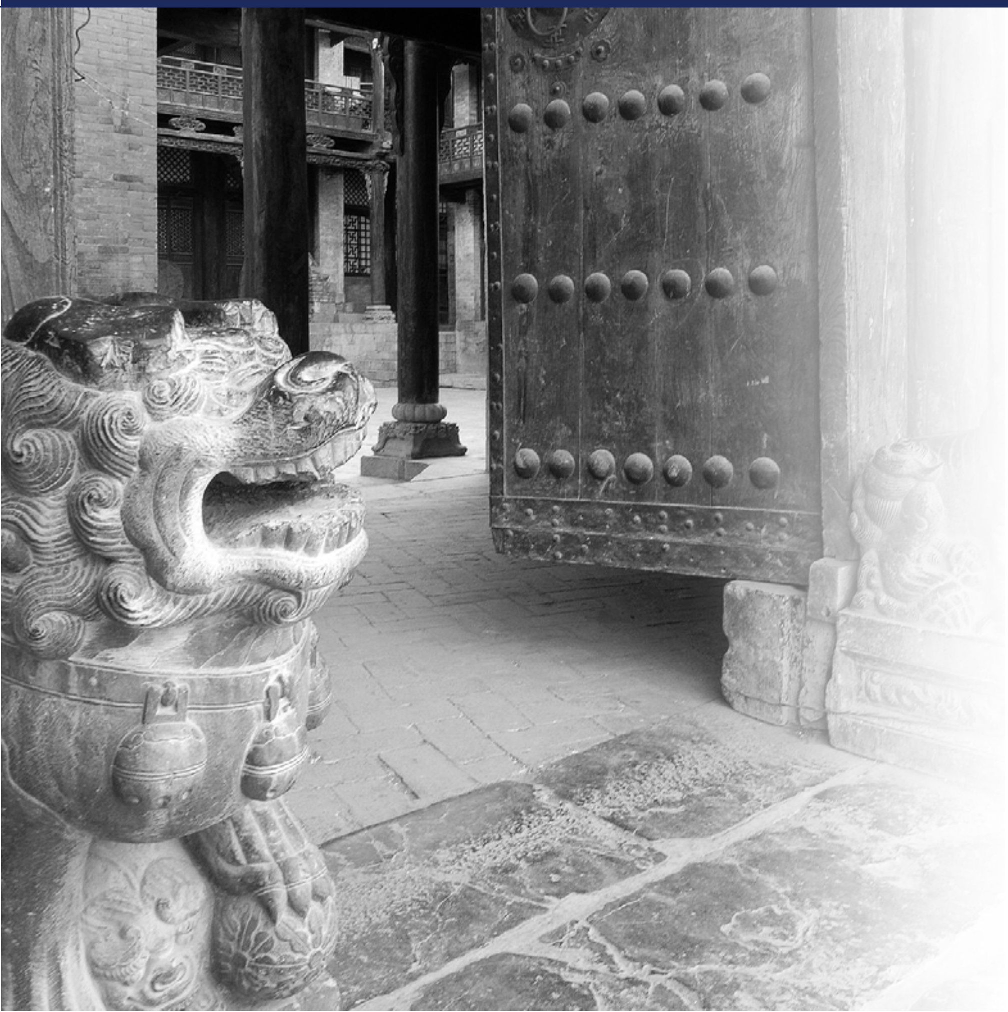
InterChina Insight

InterChina
英特华

Diagnosis for growth

MNC pharma companies in China will face layoffs

By **Yu Jingyi** | October 27 , 2011



InterChina Consulting
英特华投资咨询有限公司

Beijing

Shanghai

Madrid

Washington DC

Management Consultants
www.InterChinaConsulting.com

China's pharmaceuticals market is expected to grow at a rate of over 20 percent annually in the next few years, after 22 percent growth in 2010. In 2010, the pharmaceutical market was the world's fourth largest, at US$62 billion and it is forecast to become the world's third largest, after the U.S. and Japan by 2013. Naturally, many multinational pharmaceutical companies have devoted billions of dollars into China sales and manufacturing, while maneuvering to find an optimum strategy for growth.

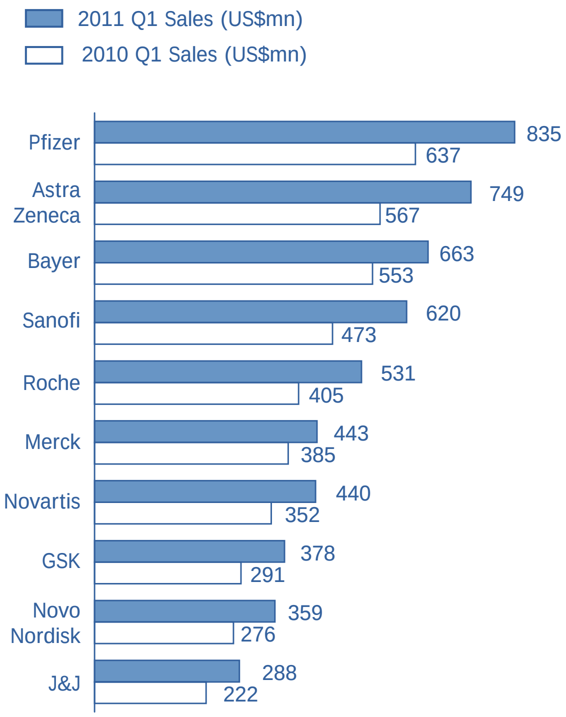
Since 2006, the pharmaceutical MNCs have restructured, setting up business units to guide the expansion of sales for each product. For example, a business unit specializing antibiotics will have its own sales, marketing and sales support departments. Each sales department of each BU has several specialized teams, say one for oral antibiotics, one for injections and three for new products. The rationale behind this elaborate structure was that the MNCs believed they could expand sales and profit simply by increasing their sales forces.

Within just five years, the game has changed again. Now the MNCs are preparing to abolish those business units as too costly and not conducive to maximizing profit. "Many U.S. and European MNCs are now considering layoffs in China. It is most likely to happen in the second half of 2012, depending on how fast they could implement the plan," a pharmaceutical industry source said.

InterChina expects that at least 10 percent of MNC pharma staff in China might be cut during this upcoming round of restructuring. More than half of the layoffs will be of medical representatives (MR), the de facto sales forces, in the sales departments. The MNCs have an average of 2,000 MRs scattered across China; some even have more than 4,000. Not only the sales departments but also sales training departments and marketing departments under the Business Units will be the targets of major layoffs. We expect top management people such as Business Unit general managers to be replaced or removed before the major layoffs take place.

Sales keep growing...

Pharmaceutical MNC sales in China, Q1 2011/10



Source: BMI Pharmaceutical China Report, 2011 Q1

InterChina
英特华

Before 2006, most pharmaceutical MNCs had only one sales department and one marketing department, with department directors directly reporting to Country Managers. After restructuring began in 2006, Business Units (BU) were set up under country managers according to each product line. A BU head (Sometimes called a BU general manager) was appointed to each BU, with marketing and sales teams reporting to him. Within each BU, the sales force was further split into smaller sales teams with each team covering fewer products than before _ sometimes only one or two. Almost all the major MNC pharmaceutical companies in China undertook this type of restructuring in the past 5 years.

But adding staff does not automatically translate into growing sales and the dogged focus on short-term performance, along with high turnover, tended to damage corporate culture and raise training and recruiting costs. In the sales teams, new people lack loyalty to their employers and veterans become more desperate day by day. All of the MNCs have a more than 50 year history and strong corporate cultures with emotional attachments between employees and their companies. The employees are proud of working for those companies and they would like to do their best to contribute to the company. But the fast expansion and the high turnover rates are detrimental to this New employees cannot build up an emotional connection that quickly and veterans feel they have been fooled by the companies' culture; they have done everything to develop the business, but the companies don't take care of them when they cannot achieve unreasonably high targets. As productivity dropped, the output of each medical representative (See the box "The Role of MRs") declined but overhead costs could not be lowered. Many MNCs now believe the most effective way to salvage operational efficiency is through layoffs.

As for timing, some pharmaceutical MNCs that have replaced their BU heads recently, or within the past year, are taking a wait-and-see attitude toward the BU model. That is why we think that some of the layoffs will not happen until 2013, with the peak coming in 2014. Some BUs will be abolished, while others will be combined. Before the big official layoffs come, some senior management level executives will be transferred - a sign changes are coming.

The Role of MR

China's main sales forces are MR just like elsewhere in the world.

Before the MNCs set up BUs, each MR was responsible for 3-4 products in a certain territory. The products would either be in the same product line or share the same prescription doctor groups. An MR could budget for marketing and promotion for four products together, and would usually visit 10 doctors a day.

After the set up of BUs, the MRs handled one or two products and their territories were expanded. They had less money to spend per hospital and needed to cultivate relationships with new doctors. Meanwhile, onerous administrative requirements under the CRM system cut into their work time, forcing most to cut back on doctor visits.

MRs compete by seeking to persuade doctors about the therapeutic advantages of their products through frequent calls and academic conferences. They often give out small gifts, such as pencils, but such promotions are of little use when everyone is offering the same things. At the same time, MRs that cannot make enough calls will see sales suffer.

Unfit structures and systems

The frequent replacement of many BU general managers in recent years has left us very pessimistic about the BU structure. Although each company grew steadily after the BU structure was fully rolled out, actual growth did not match their headquarters' expectations. It also failed to cover the additional expenses related to the huge numbers of staff working for the new BUs.

The MNCs set up BUs hoping that much bigger profits from China would help make up for low sales and profit growth elsewhere. The companies invested heavily in recruiting new sales teams and new directors, and many employees were promoted. Top managers believed that sales would jump dramatically when one team was split into two or three, with each team focusing on fewer products.

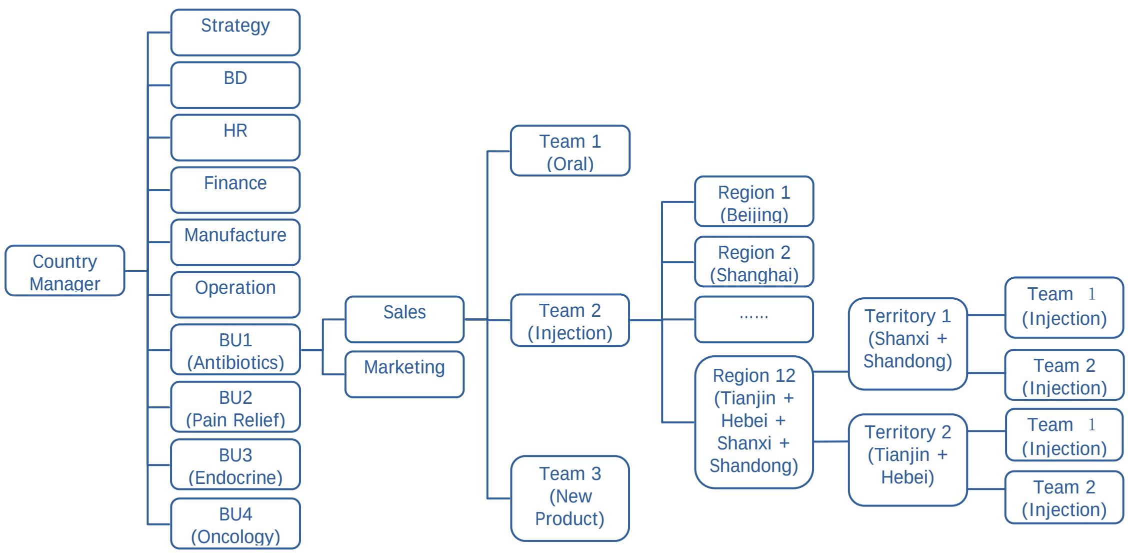
Why did the BU structure fail to live up to those expectations? The China pharmaceutical market is huge, but it takes time for companies to penetrate to the grassroots market level. When setting up the BUs, the MNCs recruited too many people in a short time, all competing for a not-big-enough cake. Sales growth was also dinted by excessively high targets and inefficient management and operations.

Raising sales target too quickly was counterproductive. It takes at least two to three years for sales performance to visibly improve after a major restructuring. The new teams and team leaders need time to gradually develop an understanding of the market and their company's culture. When the MNCs raised their sales targets by 100 percent compare with the target in 2006, sales teams took short-term actions, such as overstocking at hospitals. Hospitals buy prescription and OTC drugs for affiliated pharmacies, usually keeping one month's stock. MRs would ask hospitals to buy six months' stock or even a year's supply to meet sales targets and win bonuses. But when targets were increased to 200 percent or more, the sales people felt the goal was impossible to achieve and instead just did nothing. In some cases, entire teams and later whole BUs and entire companies could not achieve their sales targets.

Another problem with the BU model is the Client Relationship Management, or CRM, system. The system was designed to increase managerial efficiency and gather information about prescriptions and approve sales expenses quickly. Instead, onerous paperwork requirements frustrated medical representatives and other sales people who were obliged to spend about a third of their working

... but the structure is not right

Example of a typical pharmaceutical MNC structure



Source: InterChina Analysis

hours filling in forms, applying for expenses and checking expense transfers. With corporate compliance becoming stricter, approval of big marketing expenditures by legal departments could take a few months. Overwhelmed, sales staff would make up information about calls to doctors, distorting the information in the system. With only two-thirds of their working hours left for visiting doctors, the drop in productivity is not surprising.

Another factor hurting efficiency was the low productivity of sales managers. While the teams focused on fewer products, sometimes just one or two, companies put regional sales managers in charge of wider territories. Regional sales managers have to travel often to cities and hospitals they have never visited before. Travel expenses were rising but sales managers were weary of traveling and frustrated not to be able to take advantage of long-existing customer relationships cultivated over many years. Instead of client relationships and resources concentrated in one city or two, now they are covering five cities and putting much effort into developing new customer relations.

With the expansion of sales teams, sales support teams and marketing teams also expanded rapidly, significantly increasing administrative overhead. Managers in sales support teams and marketing teams generally are former district sales managers or regional sales managers who were transferred internally to the positions. They are experienced sales people who have been working with the companies for many years, thus their salary and traveling expenses are much higher than the sales teams. This structure failed to help the companies maintain ROI (return on investment).

After the BU model was implemented, sales training teams were removed from sales teams in most cases. The sales training departments therefore don't share the credit of sales targets with the sales teams. Training fails to address actual problems in the field. And when sales support departments are not supervised by the sales departments, they lack the motivation to boost sales and control expenses. These points also to the lack of adequate capacity in HR departments that could not keep up with demand when companies needed to hire 500 new sales reps and 50 managers. Meanwhile, the sales targets continued to rise regardless of whether openings were filled or not.

As it became clear that sales targets were reaching fantasy levels and profit margins were failing to cover huge overheads, the industry began to question the BU model. Companies started to replace sales reps, and then sales managers, and later BU heads. In many cases, BU heads have been replaced 3 times since 2006.

Conclusions

Is the BU structure unfit for the Chinese market? The BU structure clearly is not as advantageous as expected. Is it an absolute mistake? Should the companies abandon the BU structure and restore their previous organization? When applied to the proper product line, the BU structure can help companies boost sales. However, it is crucial that sales teams do not have a too narrow focus and sales managers' territories are not too wide. Teams should have both cash cows (products which ensure a stable cash flow) and also new products to guarantee their long- and short-term profitability. Teams with only new products will require (unrealistically) high sales targets to cover their overhead. A good balance of sales of staple products and new product launches can help boost confidence in future growth - a crucial factor for enhancing profitability.

Pharmaceutical MNCs will need to consider their key competitive advantages and adapt their strategies as they restructure the BU system. In the future, the structure of sales teams is bound to be more diverse, reshaping the industry as a whole. Many MNC are likely to return to what they were doing before, that is, selling three to four products in a smaller territory.

Recommendations for MNC Pharma Companies

1. **Enlarge the product range per MR.** The combination of sales teams with same target doctors can increase the call frequency on doctors. Doctors' prescription behavior will not be affected by receiving more MR visits from the same company in a day for different products. However, too frequent visits are inefficient. With each MR responsible for a broader product line, the calls will be more efficient and doctors would like to spend more time with one MR.

2. **Reduce territories.** To improve sales managers' efficiency, the managers can be assigned with smaller regions or territories, but more products targeting the same hospital department. Sales managers will be allowed to leverage the resources and maximum relationship with KOLs and important hospitals. Simultaneously, traveling expenses will decrease, reducing operating expenses.

3. **Structure business units around regions.** The set up of regional business units, e.g. Northern China Business Unit, Southern China Business Unit, etc. could manage the sales of the complete product portfolio within a defined region. The economical development, local government policy, and hospital purchasing power remain to be different from region to region, and require a BU head to be familiar with local / regional circumstance to efficiently develop the strategy and allocate budget. This is likely to lead to increased productivity of the BU.

4. **Outsourcing sales teams.** The outsourcing of tail-end products or also entire sales teams to 3rd party organizations, such as contract sales organization or marketing organization has been neglected by most MNCs in China. However, the need for such services (i.e. temporary sales forces) may strongly increase in the next few years, as the provision of such services are on the uptake as well. This would reduce overhead costs and create a higher degree of flexibility for the MNC, and typically the MNC would deploy its own sales force on the blockbusters and newly introduced drugs in the key sales territories.

5. **Co-marketing.** When the own sales force cannot deliver, partnering up with either other pharma companies will be a trend that is likely to happen more in China in the future. MNC could make more efficient use of existing sales forces with the right department access and regional coverage for specific brands and drugs, either by out-licensing to another MNC sales team, a Chinese pharma company, or even a local distributor.

Contributed by
Yu Jingyi,
Manager,
InterChina Consulting

Yu,Jingyi@InterChinaConsulting.com

Yu Jingyi, a Chinese national, is a Manager at InterChina's Beijing Office. She has 8 years of pharma sales management and governmental affairs experience in China with Precede Medical (Oncology, antibiotics, medical devices), Takeda Pharmaceutical (all products), and Pfizer Pharmaceutical (Zithromax).

Edited by Kazuhiko Shimizu, Shanghai-based writer and editor.

InterChina Consulting

Specialist in China

InterChina is one of the leading advisory firms in China, and the number one alternative to the global consultancies and investment banks.

We were founded in 1994, and through our unique combination of capabilities, have delivered the highest quality of services to clients for 17 years.

Our team of 50 professionals has conducted over 500 strategy projects and closed more than 150 transactions, with an aggregate value of USD 3 billion.

Multinational and Chinese clients choose to work with us because we provide real understanding, deliver practical results, and know how to get things done.

Strategy Consulting

We work with clients to capitalize on top line growth opportunities while also addressing long-term profit protection.

Our practice of 25 consultants is organized around sector specializations with substantial project experience.

We pride ourselves on being practical, developing real understanding through fieldwork, and delivering workable results to an actionable level.

M&A Advisory

We provide full cross border M&A advisory services to multinationals expanding in China, Chinese companies investing overseas, and on strategic divestments.

Our practice of 25 advisors is comprised of senior Chinese negotiators with strong corporate development, investment banking, private equity and Big Four backgrounds.

We conduct ~40 mandates each year, providing clients with transparency and control from start to finish, with an annual closure rate of 4-6 transactions.

InterChina is also the exclusive China partner of IMAP, the oldest and largest global organization of independent mid-market M&A advisors.

Contact Us

We have two operations offices in China (Beijing and Shanghai) supported by two liaison offices in the West (Madrid and Washington D.C.).

For further information, please visit our website at www.InterChinaConsulting.com