

DRUG COST MANAGEMENT REPORT

The Evolving PBM Marketplace: Emerging Threats and Future Opportunities

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During the past 10 years, pharmacy benefit managers (PBMs) have evolved from small, niche-focused companies that provided very basic administrative services to today's model of highly evolved health care institutions. Throughout this growth, PBMs have been able to achieve remarkable financial results. For example, one PBM, MIM, was the second best performing stock on the Nasdaq stock market during 2001, with a share price increase of over 1,800%.

The underlying trends in the industry seem to bode well for continued growth. Those trends include:

- ◆ Employers and other payers will continue to seek relief from rising prescription drug costs, forecast to continue to increase by double digits over the next five years.
- ◆ The aging of the population will drive an increase in overall drug utilization, including that managed by PBMs.
- ◆ The R&D investments by the pharmaceutical industry will result in a steady stream of new product introductions. Some of these new products will be managed by PBMs' profitable injectable distribution channels.
- ◆ The potential for a Medicare outpatient drug benefit.

Despite these favorable trends, the picture is not entirely rosy for PBMs. Consider the following potential threats to the future of the current PBM business model:

- ◆ **Erosion of pricing power.** Pricing power is eroding in the client revenue portion of the business. Employers and other payers are demanding more accountability from their PBMs for controlling health care costs, yet are less willing to pay for services.
- ◆ **Inability to differentiate product offerings.** In the current environment, purchasers of care are able to draw few distinctions among PBMs. Even when innovations are developed by one PBM, they are quickly followed by others, thus minimizing the ability to sustain long-term competitive advantage.
- ◆ **Diminishing returns of significant scale.** Scale has become an important key to maintaining viability in the current environment. By spreading operating costs over a large membership base, PBMs are able to derive acceptable margins from their client base. In addition, increased scale enables a PBM to negotiate better agreements with pharmacy network providers and with pharmaceutical manufacturers. The "urge to merge" has been irresistible to the

top PBMs over the last few years, but future mergers and acquisitions may not create a dramatic change in the industry's overall competitive landscape.

◆ **Shrinking membership due to market saturation.** The insured health care market is almost entirely saturated by today's PBMs. To create organic membership growth, PBMs will be forced to win business from the competition. If pricing discipline is not maintained, this could put pressure on margins.

◆ **Potential legal threats.** Another issue the industry will face in the coming years is the potential impact of legislative initiatives aimed at different facets of the health care marketplace. Patient privacy issues could limit PBMs' ability to perform UM on behalf of clients, and could limit the marketability of data assets to the pharmaceutical industry. A number of legal issues affecting pharmaceutical manufacturers (drug pricing, anti-remuneration, fraud, etc.) could limit the ability of PBMs to secure additional revenue from this segment.

Growth Engines of the Future

The successful PBM of the future will learn to better leverage two very important assets: sales channels and data. Some of the efforts PBMs are undertaking in an effort to reinvent themselves are described below:

- ◆ **Create new customer segments for existing products and services.** Many top-tier PBMs were active in the Medicare prescription drug coverage debate during 2001. Though somewhat less of a political goal in 2002, many believe that some form of prescription drug coverage for Medicare eligibles will be developed and implemented over the coming years. PBMs must take an active role in capturing a large share of this target audience. This will require PBMs to develop a more consumer-oriented marketing approach, and develop a strategy for low-cost administration, enrollment and customer service for these members.
- ◆ **Sell new products and services to existing customers.** This strategy has been a major push among PBMs for years. The hottest growth market over the past 12 months has been in the provision of injectable drug coverage. Each of the top four PBMs now provide a specialty drug service. Second- and third-tier players are expanding into this market rapidly. The injectable drug arena is one that should provide better than average margins for the foreseeable future.
- ◆ **Create meaningful UM and population-based disease management programs.** The first generation of "disease management" programs developed by PBMs achieved

limited success in the marketplace. In many cases, these programs were an extension of patient education programs, with limited ability to influence and ultimately change patient or prescriber behavior. The marketplace is now looking for a second-generation approach that will deliver meaningful results. The most recent example is in Florida where a pharmaceutical manufacturer was able to avoid discounting its products by offering to provide disease and utilization management services for Medicaid beneficiaries. The key to the program will be the ability to deliver on promises, and make meaningful improvements in patient care.

◆ **Create new markets for “non-traditional” services.**

The data assets controlled by PBMs are underutilized in the health care arena. PBMs should develop strategies for creating new avenues to market these assets to additional audiences (e.g., consulting firms, government agencies, universities, etc.). Several large PBMs have already developed strong and profitable research relationships with major research universities.

◆ **Aggressively lower cost structure.** Efforts to increase top-line growth may not be enough to help PBMs achieve the profitability targets they have set. PBMs should exam-

ine ways to further simplify their business models and reduce costs associated with providing services to clients. This will be crucial if and when a Medicare prescription drug program is implemented as the entire marketing, implementation and customer service model may change from a business-to-business model to a business-to-consumer model.

It seems that the PBM industry is at a crossroads. Inherent market trends will likely sustain PBMs for the short term, though profitability is likely to continue eroding if PBMs do not change their business model. Successful PBMs of the future will find a way to revolutionize their product portfolio in a way that will maximize the value of the most important assets: sales channels and data.

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