Drive the Right Supply Chain Behaviors

BY ADAM J. FEIN

FOR SUPPLY CHAINS TO OPERATE at their best, partners need incentives to perform their roles as efficiently as possible. This has not always been the case in the pharmaceutical industry, where drug distributors were long motivated to engage in behaviors that, at best, added no value to the supply chain and, at worst, ran counter to it. Today this is changing, to the benefit of an entire industry.

Until recently, drug makers compensated their wholesalers by allowing them to purchase more products than near-term sales demand required. The wholesalers would sit on the extra inventory, selling it when prices increased. They earned as much as 40% of their margin this way. Drug makers pulled future demand forward in time and avoided accounting for distribution expenses because unrealized profits do not get reported on a financial statement.

Unfortunately, drug manufacturers found themselves unable to control the behavior of their distributors, which made money as speculators rather than as product distributors. Thousands of small wholesalers sprang up to buy and sell the excess channel inventory in a virtually unregulated secondary market, creating opportunities for criminals to introduce counterfeit or mishandled products into the U.S. drug distribution system. Neither manufacturers nor wholesalers had clear incentives to lower total supply chain costs for hospitals, pharmacies, nursing homes, or patients.

This situation was untenable. And so with drug producers leading the way, a new relationship between manufacturers and distributors is taking shape, one in which manufacturers directly pay distributors for their services. To avoid stockpiling, manufacturers can now penalize wholesalers holding more than one month of inventory, and most of these arrangements offer some form of performance benefit to help distributors offset revenues they've lost by discontinuing inventory investment and to reward them for their continued participation. For example, wholesalers may receive higher payments for making more-accurate forecasts of prescription demand.

Today, manufacturers are successfully paying wholesalers not to speculate with inventory. According to Pembroke Consulting's analyses of 10-K and 10-Q SEC filing by the wholesalers, inventories at the Big Three drug distributors grew only one-fifth as fast as sales from 2002 through 2004, allowing distributors to avoid an incremental $4.6 billion of inventory on their balance sheets. And although manufacturers removed investment-buying profits, distributors' operating cash flows have increased substantially as they reduce inventory investments.

There are other benefits as well—transparency, for one. Fees are stated as an expense on a manufacturer's income statement, whereas forgone profits from a price increase do not have to be disclosed. By tying compensation to performance, they introduce accountability to channel relationships—the manufacturer is now explicitly a customer and can hold the wholesaler accountable for its performance. In some cases, fee-for-service payments are directly linked to metrics that ensure a wholesaler is shipping to customer orders, not merely building stock. Manufacturers are also requiring order and transaction flow data to monitor wholesalers more closely.

Fee-for-service compensation is a powerful tool for aligning distributor compensation with measurable business outcomes. With it, manufacturers can reward superior performance and penalize performance below requirements, such as late deliveries or inaccurate forecasts. Controlling excess channel inventories limits gray market activities and maintains price integrity across customer segments. Finally, manufacturers can lower the internal supply chain costs associated with unanticipated fluctuations in order patterns. ◆

Adam J. Fein is the founder and president of Pembroke Consulting, a strategy consulting firm with offices in Philadelphia and Chicago that serves both manufacturers and distributors. He can be reached at SupplyChain@hbsp.harvard.edu.

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