Distribution Outsourcing Case Study

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Novartis, the global pharmaceutical giant, was at a crossroads, and the Executive Director of the company’s North American pharmaceutical supply chain, knew that Novartis would eventually have to make a major decision. One that could radically affect internal operations that had been in place for decades.
The ultimate issue before Novartis would be monumental. The company had to decide whether to outsource the nerve center of its U.S. supply chain - the New Jersey-based warehouse and distribution operation responsible for receiving, packing and preparing for shipment the full range of Novartis pharmaceuticals to its U.S. customers.

For Novartis, and for many life science companies, outsourcing on that scale had rarely been attempted. Pharmaceutical supply chains are highly complex, and navigating them can be literally a matter of life and death for patients, who need medicine delivered on time and in pristine condition. Shippers must comply with a host of government regulations, employ special handling and storage procedures - including temperature control for some drugs - and respond quickly to sudden shifts in demand for products.
High Stakes

Novartis, which typically ranks in the top five in sales in the global pharmaceutical industry, manufactures drugs for some of the world’s most devastating diseases and illnesses. Those include Gleevec, a cancer treatment drug; and Diovan, a drug used by many patients with high blood pressure; and Ritalin, for attention deficit disorder.

The company had been honing that ability for literally centuries. Novartis AG, based in Basel, Switzerland, has roots in three venerable Swiss companies, and traces its history back to 1758, when, according to the company’s official history, Johann Rudolf Geigy began trading in “materials, chemicals, dyes, and drugs of all kinds.” In 1970, the Geigy Co. merged with Ciba. And in 1996, Ciba-Geigy joined with Sandoz to form Novartis.
The New Jersey Connection

In the U.S., Novartis manufactured about 80 percent of its branded prescription drugs in a Suffern, N.Y., plant, and then trucked the product 40 miles south to the northern New Jersey community of East Hanover, home of Novartis’ U.S. corporate headquarters, and its warehouse and distribution center. The center was the consolidation point for all Novartis’ U.S. pharmaceutical products. The products would get stored in the warehouse until packed and shipped in precise quantities to the wholesalers, which have distribution sites set up throughout the United States.

By the early 2000s, however, the warehouse was starting to deteriorate and needed a multi-million dollar investment to restore it to top condition. At the same time, the East Hanover campus had become more of an administrative headquarters, nearly tripling in size due to mergers and acquisitions.
Wholesalers Feeling the Pressure

Consolidations and mergers in recent years had left just three large national wholesalers - AmerisourceBergen, Cardinal Health and McKesson - handling most product shipments for the entire U.S. pharmaceutical industry and 90 percent of Novartis’ U.S. shipments, and a few smaller regional wholesalers handling the balance.

The relationship between the wholesalers and manufacturers was changing, and to a certain extent, fraying.

The predominant business model had long been the so-called ‘buy-and-hold approach,’ in which the wholesaler purchased the product from the manufacturers and sold it to retail and institutional customers at a markup. The wholesalers were also able to bolster profits through speculative buying - purchasing large quantities of product, holding it in stock until the manufacturer raised the price, and then selling it at the higher price.
The wholesalers’ response to the changing marketplace was to impose a monetary fee on the manufacturer for distribution services. Some drugmakers balked at the fee-for-service approach, and at least one flatly refused to pay the fee.

Novartis, on the other hand, analyzed its costs and determined it was still less expensive to continue to distribute through the wholesalers. But, the volatile changes were forcing Novartis to look for new models of distribution, and be ready to make a switch - fast.

“As the wholesalers continue to want a bigger piece of the pie, at some point we are going to have a tough decision to make,” Novartis’ Head of US Supply Chain said. “We want to be in the best position possible to support the customers if that ever happened. So my charge is not only to look at today or tomorrow but five and 10 years down the road.”
Fresh Approach With 3PLS

As Novartis continued looking at the picture, it became clear that even though Novartis would continue working with wholesalers, the company had to consider outsourcing its warehouse and distribution center - if only to provide flexibility for the future. Novartis began evaluating third-party logistics providers, or 3PLs, that specialize in warehousing and transportation services that can be scaled and tailored to a customer’s needs. One advantage of most major 3PLs, is that they have warehouse operations in place nationwide that can generally accommodate most changes in business models in a relatively short period of time.

“When we first said we were considering doing this, the marketing group immediately came out and said, ‘We’ve got some concerns,’ “What if the third party fails? What if they had a strike? What if they decide they don’t want to do this?”

The marketing group wasn’t the only internal stakeholder that was taken aback. The customer service and finance departments were also concerned. And, outsourcing would also mean job losses for longtime Novartis warehouse workers, an extremely stable group of employees with an average of 20 years experience and a high caliber of customer service.
Novartis evaluated three in-sourcing options:

- Maintaining the East Hanover operation at an annual cost of about $15 million plus an additional investment of $3.5 million to upgrade failing infrastructure.

- Building a new facility on the site of the Suffern, NY production plant at a cost of about $50 million and with a three-year construction time.

- Leasing an alternative site at another location, which we estimated would cost $26 million to retrofit.

Novartis also evaluated 16 3PL providers, narrowed them down to six semifinalists, and then three finalists. The team also made site visits to the semifinalists to see their operations first-hand and then invited the three finalists to come to Novartis to present their proposals.
The Decision

More than a year after starting the review, Novartis arrived at the decision: Outsource the warehousing operation to Exel, a leading logistics company with sites throughout the U.S., Canada, and Latin America. In 2005, Exel had been acquired by Deutsche Post DHL and was now part of a global network operating in 220 countries with about 300,000 employees. The company posted revenue of more than $76 billion in 2010.

Under the plan, the East Hanover warehouse and distribution center would be phased out, and an Exel facility would take its place to become the consolidation point for all of Novartis’ U.S. products. Novartis would continue to use the wholesalers to distribute the product to the retail and institutional customers. Within this new supply chain, the product would travel straight from the Novartis’ production plant to the Exel warehouse. It would be Exel employees who would receive, store, pack and prepare the pharmaceuticals for shipment to the wholesalers.
The Novartis SCM team still had a daunting task before them:

Persuade senior managers and, eventually, the CEO of Novartis’ U.S. operations and the board of directors, that this plan was the best option for the company’s future.
1) You are a member of the Novartis team and must persuade senior management to adopt the outsourcing plan. What would be your top three arguments, and why?

2) In selecting a 3PL provider for pharmaceuticals, what special skills should they have, what would you look for in their work history?

3) If the outsourcing was approved, how would you handle the transition? What conditions would you set up in order to ease the transition? Set up a plan.

4) Theft of pharmaceuticals has been a big problem for the major drug companies, like Novartis, with even entire trucks stolen. Do you think outsourcing would help or hurt Novartis in terms of reducing theft? Why or why not?
Questions?