

# Case analysis – "merck-medco" essay



**ASSIGN  
BUSTER**

Merck & Company (Merck) was a pharmaceutical researcher and manufacturer while Medco Cost Containment Services, Inc.

(Medco) was a pharmacy benefit manager (PBM). On November 18, 1993, Merck purchased Medco for \$6.6 billion. Immediately after the merger, Medco operated as a subsidiary of Merck.

In 1994, Merck-Medco was formed. Grant states that corporate strategy involves decisions that define the scope of the firm. In addition, he states the importance of vertical integration as it has caused companies to redesign their value chains within their organizational boundaries. The acquisition of Medco by Merck is an example of Merck expanding its organizational boundaries while at the same time adding value.

Merck added value to its operations by purchasing Medco. Pharmaceutical companies operated in a relatively stable environment that was characterized by solid profits and minimal pressure to alter pricing policies and large barriers to entry. Much of the competition was hindered by several important factors. Drug manufacturers engaged in product differentiation. The market was divided by the therapeutic class of drug and there was little product overlap across the manufacturers. Second, there was little price pressure from buyers.

Physicians, who purchased pharmaceuticals, were generally unaware of the prices of the drugs that they prescribed. In addition, since insurers and employers began offering benefit packages that covered prescription drugs, individuals generally did not shop for the lowest priced drug. Analysis of Current Situation. Prior to the acquisition, Merck's strengths are strong

research and development capabilities, which is imperative in the pharmaceuticals industry. In addition, Exhibit 1 of the case study reflects that Merck dominates the market for number of blockbuster drugs. 2 The threat of substitutes in the pharmaceutical industry is low.

Substitutes include herbal supplements and surgery. Also, expiration of drug patents has a great impact on Merck as well as its competitors. Opportunities for the pharmaceutical industry are an aging population, which will increase the need for products. Read aboutIn the early 1990s, many mergers occurred that changed the shape and competition with the pharmaceutical industry.

The purchase of Medco by Merck offered advantages. At the time of the acquisition, Medco managed about \$3. 0 billion in drug spending for its clients. 2 Typically, PBMs supplied products to wholesalers, chain and pharmacy, and mail-service retailers, who then supplied to consumers. By the 1990s, PBMs were mainly involved in1) developing and maintaining a network of providers, 2) claims processing, and3) benefit program design.

2 The acquisition of Medco by Merck seems like a good strategy for adding value to Merck's corporate strategy. According to Bleeke and Ernst, this type of acquisition is considered an alliance of complementary equals. 4 Merck's business is drug manufacturing while Medco's is the management and selling of pharmacy related benefits. The Merck-Medco merger can provide the full scope of products and services. Around the time of the merger, Merck needed to address its long-term strategy. Although it acquired Medco, other alternatives were available to the company.

According to Christensen, managers who determine that an organization's capabilities aren't suited for a new task have three options through which to create the new capabilities. They are: \* Acquire a different organization whose processes and values are a close match with the new task. \* Try to change the processes and values of the current organization. \* Separate out an independent organization and develop within it the new processes and values that are required to solve the new problem. 6 These alternatives and their ramifications are discussed below.

Alternative #1. Acquiring an organization with the competency of pharmacy management to add to Merck's value chain is an option. This option is attractive due to short-circuiting the process of developing new, but time-consuming processes. Over the past few years, there has been increasing pressure to expedite the drug approval process and for manufacturers to increase the yield from their research and development activities.

Taking into account these pressures and Merck's primary business being drug manufacturing, the acquisition of a PBM will be the quickest and most effective manner in which to acquire pharmacy management competencies. Yet, acquiring companies face difficulties in acquisitions, such as the integration of the acquiree's capabilities with its own. Alternative #2. Rather than acquiring or buying the pharmaceutical benefit management competencies of Medco, developing individual competencies, expansion of research and development, and establishment of closer relationships to customers is an option for Merck to consider.

Grant says, "...one approach to capability development is to develop the human resources required for a particular capability." Yet, he states that developing human resource competencies can be effective in maintaining and developing existing competencies, but is limited in forming new capabilities. <sup>1</sup>Due to the highly competitive and time-to-market issues of new drugs, this option is not advisable for Merck.

Development of new drugs and getting them to market is critical for remaining competitive in the pharmaceutical industry. Alternative #3. Creating new capabilities may also be obtained through a spinout organization. Merck realizes that its resources and capabilities are insufficient to rapidly move into the pharmacy management area. Most of its resources are devoted to drug research and development.

Christensen states that spinout organizations are appropriate when a separate organization is required when the mainstream organization's values are incapable of devoting resources on the new processes or innovation. <sup>6</sup> Furthermore, he states that spinouts should only be used when a threatening disruptive technology requires a different cost structure or when the current size of the opportunity is insignificant relative to the growth needs of the main organizations. Neither of these criteria is relevant to Merck. Services provided by PBM organizations are not disruptive to drug manufacturers.

They may be considered as value-added to drug manufacturers. In addition, the size of the opportunity by acquiring a PBM can be significant to a drug manufacturer. Recommendation. It is recommended that Merck select Alternative #1, which is to acquire Medco.

Acquiring Medco and its competencies makes the most sense for Merck.

According to Merck's 1993 annual reports, its vision is to create the world's first coordinated pharmaceutical care company that will optimize discovery, development, selection, delivery, utilization, and value of prescription drugs.

2 The quickest and most effective manner in which to achieve this vision is through a PBM acquisition. The internal development of pharmacy benefit competencies would be very difficult and time-consuming for Merck. When making its decision, Merck should not view moving into the pharmacy benefit management area as enhancing existing competencies, but rather expanding into a different business within the pharmaceutical industry in which new competencies will be needed.

Based on the aforementioned quote by Grant that internally developing new human resource competencies for new capabilities is limiting, it is not advisable to use Alternative #2. Based on the criteria presented by Christensen on when to use spinouts, Merck should not use Alternative #3. Conclusion. The case study states that despite the initial plans to integrate Merck and Medco upon the acquisition, the companies remained independent. Specifically, it states that management decided to preserve both cultures.

Merck's strengths were in the medical, clinical, and sciences areas while Medco had strong relationships with employers, plan sponsor, and managed care organizations. The new CEO says, " Therefore, at Merck and Medco we had critical and complementary skills to build our strategy looking forward. 2 In August 2003, Merck-Medco announced the spinout of Medco, which is now named Medco Health Solutions. Medco Health Solutions is considered one

the top pharmacy benefit management companies in the US. It currently serves about 65 million members. The company assists health plans in managing drug costs by negotiating rebates with pharmaceutical companies and processing claims.

Patients may fill their prescriptions through a network of 60, 000 pharmacies, a mail-order program, or the company's Internet pharmacy. Medco Health Solutions processes nearly 550 million prescriptions per year for clients that include unions, corporations, HMOs, insurance companies, and federal employees. 5 In retrospect, the Medco acquisition was beneficial for both companies. Its website reports the following: Together, Merck and Medco Health have enjoyed 10 years of growth and success. As a subsidiary of Merck, Medco Health grew to become the nation's leading pharmacy benefits management (PBM) company, providing integrated prescription health care to 62 million Americans.

Medco Health increased revenues from \$2. 2 billion in 1992 to \$33 billion in 2002, and last year, filled or processed approximately 548 million prescriptions. By all measures, the acquisition of Medco Health by Merck has been highly successful," said Merck Chairman, President and Chief Executive Officer Raymond V. Gilmartin. " With the spin-off, the market now has the ability to value each entity as ' pure plays' in their respective industries.

We believe that by establishing Merck and Medco Health as two separate companies, we will enhance the potential for success of both businesses and, as a result, increase shareholder value."