Where To Compete In A Post-Reform World

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Editor’s note: In addition to Shubham Singhal (photo and linked bio above) this post, the first in a periodic series of posts by McKinsey analysts on the landscape facing payors in the post-reform world, is authored by Rohit Kumar, Susan Nolen Foushee, and Jeris Stueland. Rohit Kumar is a consultant in McKinsey’s Chicago office. Susan Nolen Foushee is an expert in the Corporate Finance Practice in its New York office. Jeris Stueland, an expert in McKinsey’s Healthcare Systems and Services Practice, is also in the Chicago office.

The power of “where-to-compete” decisions, particularly in an industry in as much flux as US health insurance, is enormous. Our analyses suggest that the bottom-line performance differential between a payor who selects a market-average portfolio across businesses and geographies and an identical payor who instead selects a top-quartile portfolio is likely to be almost twofold (Exhibit 1). Across industries, McKinsey research (summarized in The Granularity of Growth by Patrick Viguerie et al) shows that the majority of the performance differential among corporations results from their alignment with “rising tide” markets rather than from share gain within less attractive markets.

Furthermore, we have found that there are three “macro” approaches that can enable companies to thrive during major industry disruptions: refocus their portfolio on more attractive businesses, build one or two large new businesses, or radically transform their business model. The first two rely squarely on where-to-compete decisions. The last approach is not for the faint of heart.

Thus, today’s payors must carefully choose which markets they want to concentrate their resources on to win. The choices made will be critical not only within the payors’ core health-plan business but also in adjacent areas within the healthcare value chain.

Choices Within Health-Plan Business

Predictive models we have developed suggest that, over the next several years, there is likely to be tremendous variability in growth potential across markets in the US health insurance landscape. Exhibit 2 illustrates our estimates for the extent of this variability across states and business lines. For example, growth in the individual market could be as low as 32 percent in some states and as high as 141 percent in others.

Current margins are similarly variable. Our research shows that, in 2012, small-group margins averaged 6 percent across the country but ranged from an average of −5 percent to +13 percent in different states.

Admittedly, our models cannot predict the future with certainty, and thus actual growth (in specific states or across the country as a whole) may be higher or lower than our estimates suggest. Nevertheless, we believe that growth and margin variability will be a characteristic feature of the US health insurance landscape for at least several years to come. Indeed, we have found that the extent of such variability rises when we look at the rating areas or micro-markets within each state an individual payor operates in.

A second important dimension to consider is the return on capital each business delivers, most commonly assessed as the return on equity (ROE). Healthcare reform is having a meaningful effect on the capital intensity of each business. For example, both the risk profile and capital consumption of the individual health insurance business rise significantly in a guaranteed-issue, modified-community-rating, risk-adjusted market. Exhibit 3 shows the likely
change in the ROE growth characteristics of various payor business lines over the next 10 years. It is important to note, however, that the actual trajectories are unlikely to be as linear as shown. A number of factors, including competitive conduct and further changes in regulations, will alter the trajectories over time. Payors will need to continually assess and adjust their decisions as new information becomes available on market evolution.

**Choices In Adjacent Businesses**

Payors looking for growth today do not have to confine themselves to their core books of business. Opportunities abound in a number of adjacent areas, including supplemental products, data analytics/healthcare IT, distribution to consumers, and retail healthcare (Exhibit 4). For example, the current revenue pool for supplemental coverage is roughly 20 percent of the total revenues for group health coverage today. We expect that revenue pools in most of these adjacent areas will continue to rise—the growing role of consumer choice in health coverage purchasing (through public exchanges, defined-contribution employer coverage, and private exchanges) will likely prompt more consumers to buy supplemental coverage and create a greater role for B2C and B2B2C distribution services. (More information about this topic can be found in the McKinsey white paper by Celia Huber et al. “Supplemental products: No longer just a side dish.” July 2011. For a copy of this paper, contact Karen_Harden@mckinsey.com.) In our private exchange simulations, for example, up to 40 percent of consumers—and up to 60 percent of families—opted to spend out of pocket (above the employer-provided defined contribution) to purchase supplemental products.

Beyond the sizeable revenue and profit potential, payors have strategic reasons to consider opportunities in adjacent areas. As the capabilities they need to compete in different business lines diversify, payors may find that they are acquiring the capabilities required in adjacent areas. For example, as care management becomes increasingly important for their Medicare and Medicaid business, some payors may find that vertical integration with providers is becoming increasingly attractive. (Whether it makes sense to integrate vertically in every instance is another issue that must be analyzed on a granular level. More information about how to think about vertical integration will be given in an upcoming blog post, “When does vertical integration make sense?”) Similarly, as the individual market grows and marketing and selling directly to consumers becomes more important, expansion into distribution services or retailing could become synergistic.

As payors make the above choices in their core business and adjacent areas, a nuanced understanding of their competitive advantage will be critical. Different payors have different abilities to compete effectively and win in different markets. For example, network cost advantages in different geographies will dictate the relative attractiveness of those geographies for an individual payor. Existing assets in adjacent areas would make market entry easier for some payors than for others.

**Acting On Where-To-Compete Decisions**

Committing resources—capital, talent, and management attention—is what makes where-to-compete decisions real. However, most organizations fail to make these resource-allocation decisions. Indeed, at most companies, the biggest predictor of budget allocations in any given year is last year’s budget. We have found that more than 90 percent of resources are allocated by momentum—that is, to the same areas as the year before. Yet, companies that are more aggressive in reallocating capital to back up their where-to-compete decisions significantly outperform their peers.

Our research into more than 1,600 US companies across a range of industries shows that those that reallocated a large proportion of their resources in response to changing market conditions achieved a much higher total return to shareholders over a 16-year period than did companies that reallocated a smaller proportion of their resources (Exhibit 5). This result was surprisingly consistent across all industries. The companies that reallocated a high proportion of their resources were also markedly less likely to be acquired or go bankrupt. (More information on the impact of resource reallocation can be found in an article by Stephen Hall et al. How to put your money where your strategy is. *McKinsey Quarterly*. March 2012.)
Given the disruptive changes in the healthcare industry, payors that want to thrive over the next few years will need to develop the discipline to make and act on where-to-compete decisions. They will need insights into where growth and margin will be earned, the foresight to determine when inflection points in the market might happen, a clear view of their own competitive advantages and capabilities (which would give them the ability to win and earn a superior return), the fortitude to make tough resource-allocation decisions, and the agility to alter their course as the market shifts. Acquiring the needed discipline is challenging but necessary. The upside from getting where-to-compete decisions right is substantial enough to demand top management’s attention—and the downside is potentially fatal.

EXHIBITS

(Click to enlarge.)

Exhibit 1

Where-to-compete decisions can significantly alter future valuations

Exhibit 2

Growth and margins vary across industry segments and states

Exhibit 3

Growth-return characteristics of business lines will shift over time
Exhibit 4

Where to compete: Choices extend beyond core health

Multiple directions in which payors might diversify

SOURCE: Press reports, McKinsey analysis, Gartner, CPNC, HIRC industry report, IBISWorld

Exhibit 5

Companies that can reallocate resources nimbly win

1,616 US companies, 1990-2005

| TRS CAGR, median (%) | 7.8 | 8.9 | 10.2 |

A company with TRS at 10.2% CAGR rather than 7.8% CAGR would be
FOLLOWING THE ACA

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