

# Thriving under disruption: How to succeed in the years ahead

*The healthcare industry is on the brink of sweeping change. The experience of other industries that have faced disruption suggests that a new set of winners and losers will emerge. Our research into these other industries reveals three approaches incumbents can use to thrive during and after a disruption.*

Disruptive change is now a fact of life for many industries. Healthcare is no exception. Although healthcare has been changing for decades—think about the introduction of diagnosis-related groups (DRGs) or the initial push toward managed care in the 1980s—the Affordable Care Act (ACA) promises to accelerate both the rate of change and the level of uncertainty confronting the industry. Payors face navigating a difficult transition: from an industry in which the customer is often a corporation or small company and the business is paying claims to one in which consumers make healthcare purchasing decisions, the direct provision of care may be necessary for success, and consumer and retail capabilities really matter. Furthermore, payors must make this transition amid regulatory and consumer uncertainty and in a fairly short time frame. This industry and business-model shift is on a scale that few companies and few sectors in the economy have been through.

Over time, however, the transition should create new opportunities with significant upside. The entrance into the market of more than 30 million new consumers, many of whom have never bought healthcare products before, may ultimately trigger changes that drive real productivity improvements in an industry that has lagged

in this regard. It may also allow new industry leaders with broader and more compelling business models to emerge.

The promise of opportunity creation and upside is far from certain. In fact, the historical record is unambiguous: incumbent companies are often unseated by industry disruption. Thus, we expect that many payors could be unseated in the years ahead. However, our research reveals two key insights for payors that want to thrive despite disruption:

- There are three strategic paths that companies in other industries have used successfully to thrive during and after disruptive change.
- Regardless of which path they took, these companies built the organizational capacity and agility required to lead during the disruption. They made big shifts in leadership focus and major changes to resource allocation, and they developed a faster organizational clock speed and leaner cost structure.

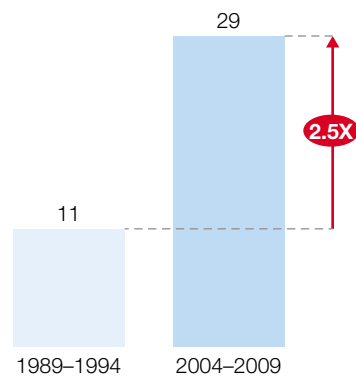
## Understanding disruptive change

Industries change for different reasons. Sometimes, the cause is a crisis. The

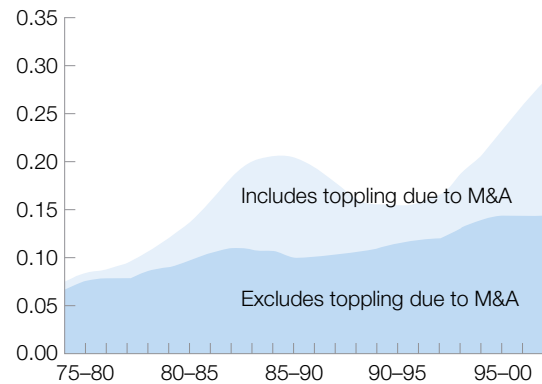
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## EXHIBIT 1 Industry leadership volatility has risen steeply

Percentage of companies that fell out of the S&amp;P 500 during the years shown

Five-year topple rate<sup>1</sup>

35 industries, 1,320 companies



<sup>1</sup>The “topple rate” is the likelihood that an industry leader will lose its dominant position during the next five years. The graph includes data through 2002. S&P 500, Standard and Poor 500 Index.

Source: McKinsey Global Forces and Corporate Strategy Service Lines

subprime mortgage meltdown, for example, rocked the financial services industry. Institutions that had existed in some form for a century or more, such as Lehman Brothers, disappeared rapidly. More commonly, competitive dynamics (anchored in a variety of drivers, including product quality, performance, and cost) produce big changes in the competitive landscape over time—think about how Japanese competitors gained share in the US automobile industry over several decades. In some cases, a distinct catalyst triggers a discontinuous change. The iPod, for example, transformed the music industry, just as the iPhone and its applications changed the game in mobile handsets, demonstrating the power of creative destruction. Healthcare is facing such a discontinuous change.

The healthcare industry’s disruption is taking place at a time when the overall pace of change in the economy continues to increase. Two measures highlight this long-

term trend of increasing “industry leadership volatility”: the churn rate in the S&P 500 has more than doubled during the past 25 years (Exhibit 1). And the odds that an industry leader loses its position during the subsequent five years—what we call the “topple rate”—tripled during the 25 years from 1977 through 2002.<sup>1</sup>

When an industry faces disruption, companies often fail to appreciate quickly enough the nature, extent, and velocity of the changes taking place. A number of reasons explain this failure. Often, disruptions start at an industry’s periphery, among companies that provide specialized value propositions to different customer segments. In these cases, market penetration begins slowly, with barely perceptible impact. However, change can occur much more quickly when the “rules of the game” are altered. McKinsey research has identified eight characteristics that are commonly found during industry dis-

<sup>1</sup>Patrick Viguier and Caroline Thompson, “The faster they fall,” *Harvard Business Review*, May 2005.

ruptions, particularly those triggered by significant regulatory shifts.<sup>2</sup> Healthcare executives can expect to see most or all of these in the next few years:

**Competitors churn.** Lots of new players enter the market, but most fail. (For example, at one point after the US telecommunications industry was deregulated, there were more than 50 different long-distance fiber networks in the country. Almost all of them are gone.) However, churn is not limited to new entrants. Although a few incumbents are able to gain stronger positions, many shrink, are acquired, or disappear.

**Battles occur on two fronts.** During industry disruptions, companies often face regulatory as well as competitive challenges. (In the first few years after telephone deregulation, more battles were fought in the courts than in the marketplace.) This is apt to be true in healthcare. Not only are the political battles over the ACA likely to continue for a while, but numerous negotiations may be required to settle finer points of implementation.

**Structural advantage prevails.** When market forces become more important than regulatory rules, real competitive advantage determines the winners. Understanding and exploiting the future points of advantage can enable companies to thrive despite disruption.

**Performance differences widen.** As the level of competition increases and the basis of competition shifts to true sources of advantage, the difference in the financial performance of top and bottom players increases—and the gap often persists for years.

**Productivity and innovation increase.** Strong financial performance depends not

only on competitive advantage but also on operational efficiency. Many of the airlines that survived deregulation did so in large part because of continuous productivity improvements and organizational restructuring. As a result, they fly considerably more passengers now than they did a couple of decades ago and at a significantly lower cost per seat mile, even though fuel prices have more than doubled.

**New value propositions reveal new customer segments.** Few people knew they wanted smartphones until smartphones were invented. In healthcare, new customer segments will emerge as innovative products are introduced into the market and consumers become more aware of the diversity of their choices.

**Profit pools often shift.** During disruptions, the most attractive industry segments often become the least attractive, and vice versa, as new entrants flock to the more attractive segments and compete away profits.

**The volume of mergers and acquisitions rises.** Deal activity tends to increase during industry disruptions, but it often comes in waves as competitors attempt to keep up with each other. A few decades ago, the introduction of DRGs led to a large wave of provider consolidations. ACA enactment has already resulted in a high volume of both payor and provider deals.<sup>3</sup>

The net result of disruption is usually a massive reshaping of the affected industry and its key segments—where the profit pools lie, who gets them, and through which business models. Entire parts of the value chain may be unseated or change in importance.

<sup>2</sup>These observations are based on both direct industry experience and McKinsey research—in particular, analysis of a wave of deregulating industries in the United States. (Joel A. Bleeke, “Strategic choices for newly opened markets,” *Harvard Business Review*, September–October 1990).

<sup>3</sup>More information about recent payor M&A activity can be found in the article by Ankur Agrawal, Celia Huber, and Bryony Winn, “Riding the next wave of payor M&A,” on p. 136.

## Disruptive change in the healthcare industry

Even before the ACA was enacted, healthcare had the hallmarks of an industry vulnerable to disruption. For more than half a century, healthcare expenditures have risen considerably faster than GDP growth. Furthermore, healthcare has not achieved the types of productivity increases that most other industries have experienced. In fact, healthcare ranks near the bottom in terms of productivity improvements since 1990 (Exhibit 2).

For decades, rising healthcare expenditures have triggered industry changes (e.g., managed care, ongoing cost shifting to employees). Nevertheless, cost and productivity pressures have continued to mount and have created enormous impetus for innovations that drive better outcomes at lower costs. Many such innovations are now possible. For example, technological developments (universal mobile “endpoints” or handsets, cloud computing, big data, etc.) make it feasible to manage chronic diseases more efficiently.

On their own, the cost and productivity pressures would probably have been sufficient to produce major structural shifts within the healthcare industry. However, the added pressure from ACA implementation provides the catalyst for even more changes to occur, and to occur more quickly.

Consumers may well benefit from the innovations that healthcare disruption is apt to unleash—consumers typically do when disruptive changes arise. Incumbents, on the other hand, often falter during disrup-

tions, for many reasons. Many incumbents focus on the status quo; have incentives that encourage P&L leaders to concentrate on near-term, “Horizon 1” performance across existing businesses; and are hobbled by significant organizational complexity that makes major adaptations difficult. For most companies, it is also quite hard to create an effective strategic response to disruption. A robust strategic response requires an incumbent to navigate a change in business models—to strike the right balance between the new and the old at the right time—something an attacker does not need to worry about. For an incumbent, the scope of change typically requires transformation, and historically only 30 percent of organizational transformations succeed.<sup>4</sup> Classic cases of disruption (when a company faces a competitor with a superior business model that results in markedly lower costs) ultimately call for a significant boost in the incumbent’s competitiveness, which can be difficult to impossible to achieve, depending on the circumstances.

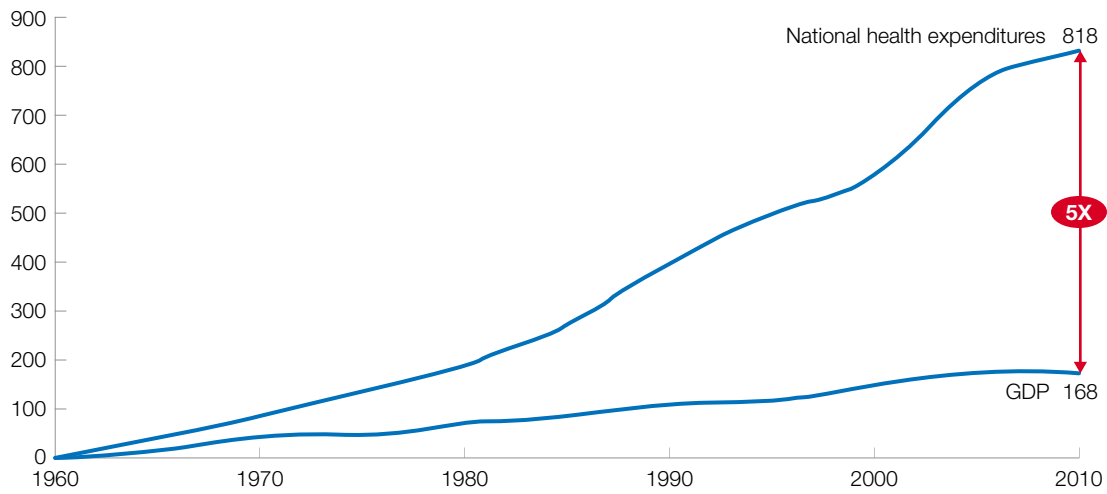
The existing payor business model is now being disrupted in several ways. Because the traditional model of employer-sponsored insurance is shifting toward individual offerings in an exchange setting, payors need to build a new set of consumer- and retail-focused capabilities.<sup>5</sup> They are also facing new competitors for their chosen segments and geographies. Integrated offerings that bundle care and payment are threatening classic payment-focused approaches. In addition, a raft of innovations that promise to do a better job helping companies and consumers manage their healthcare spending is likely to put pressure on existing payor value pools.

<sup>4</sup>More detailed information about the dynamics of successful corporate transformation can be found in the book by Scott Keller and Colin Price, *Beyond Performance: How Great Organizations Build Ultimate Competitive Advantage* (John Wiley & Sons, 2011).

<sup>5</sup>For more details about the capabilities payors will need, see the article by Jenny Cordina, Ali Keshavarz, Rohit Kumar, and Shubham Singhal, “Winning with consumers: What payors can learn from ‘consumer’ companies,” on p. 51.


**EXHIBIT 2 Healthcare is vulnerable to disruption (independent of reform)**

**Cumulative real per-capita growth in national health expenditures vs GDP, % growth since 1960**



	Productivity improvement rates, 1990-2007, %	Avg. growth in employment, %
Computers and semiconductors	7.6	-2.3
Internet and data processing	7.2	1.4
Telecom services and broadcasting	6.0	0.8
Retail trade	4.0	1.0
Information, other	3.8	0.9
Wholesale trade	3.5	0.5
Utilities	3.5	-1.6
Finance	3.0	1.0
Manufacturing (excluding computers)	2.5	-1.3
Transportation	2.3	1.7
Real estate and leasing	1.2	1.4
Professional and business services	0.6	2.7
Recreation, hotels, and restaurants	0.2	2.4
Mining	-0.3	0.2
Other services	-0.6	1.2
Education	-0.7	3.0
<b>Healthcare</b>	<b>-0.8</b>	<b>3.0</b>
Construction	-2.3	2.1

Source: Centers for Medicare and Medicaid Services; Bureau of Economic Analysis; Haver Analytics; McKinsey analysis



If the experience of other industries that have undergone disruption is a guide, the health-care industry will see many new entrants. Few are likely to survive, but some of those that do may become new industry leaders if they can couple innovative business models with strong operational efficiency (as Southwest managed to do in the airline industry). Who these winners will be in healthcare remains to be seen, but potential candidates include companies that are using information and insights to help patients make more value-conscious care decisions and companies that are making more closely coordinated care delivery possible.

### Three strategies that can help incumbents thrive

Our research into previous industry disruptions suggests three broad approaches for navigating disruptive change.

#### **Refocus your portfolio**

The most straightforward way to avoid the negative consequences of industry disruption is to shift the company's emphasis to the customers or products that will benefit from the disruption (or at least be insulated from it) and to de-emphasize the areas of business that are most vulnerable. This approach can work well for a multibusiness/multisegment payor if the core of the company is still competitive, even though pieces of it are under challenge. For example, a payor could scale back its exposure to the small-group markets that will face increased pressure and further build its capabilities in the individual markets. Although this strategy is not without risk, it could enable the payor to refocus its portfolio in line with broad market trends.

A refocused portfolio can produce rapid results. About 15 years ago, disruption in the consumer products industry—a result of the rise of big-box retailers, online shopping, and private-label products, among other factors—led P&G to conclude that it needed a new strategy. The company shifted away from commodity categories (e.g., food) and toward higher-margin areas that were more insulated from private-label products, such as health and beauty (Exhibit 3). The company knew that it had greater pricing power in the latter categories, could use its innovation expertise to develop new products for those categories, and could leverage its size to bring products to market faster. P&G then made several major organizational and operational improvements to support its new strategy. The result, over the next five years, was a 20-percent year-on-year increase in its return to shareholders.

Two challenges are inherent in this approach, however.

First, when deciding where to concentrate, you must be able to gauge the likely future attractiveness of various industry segments, not their current attractiveness. This is a challenge many companies have gotten wrong. For example, when the airlines were deregulated, many incumbents focused on long-haul flights (their most profitable routes) and scaled back service to second-tier cities (service that had been subsidized under regulation). However, profit margins on long-haul routes shrank after new entrants introduced significant price competition (e.g., \$99 coast-to-coast flights). In contrast, the entrants that focused on commuter service to second-tier cities found themselves as sole providers on these routes and flourished economically.

Second, you must be realistic about your company’s capabilities, because the likelihood of succeeding with a refocused portfolio is far higher when an organization can build on existing strengths. This fact alone makes it clear that there is no one-size-fits-all answer to how a payor should reshape its portfolio.

For payors, greater emphasis on growth segments in Medicare Advantage and Managed Medicaid are clear examples of refocused portfolios. Indeed, the national carriers appear to have placed bets on this approach by making major acquisitions to capture portfolio momentum and acquire new capabilities. However, many questions remain, including how the nationals will develop these new potential profit pools and where these acquisitions leave the Blues plans.

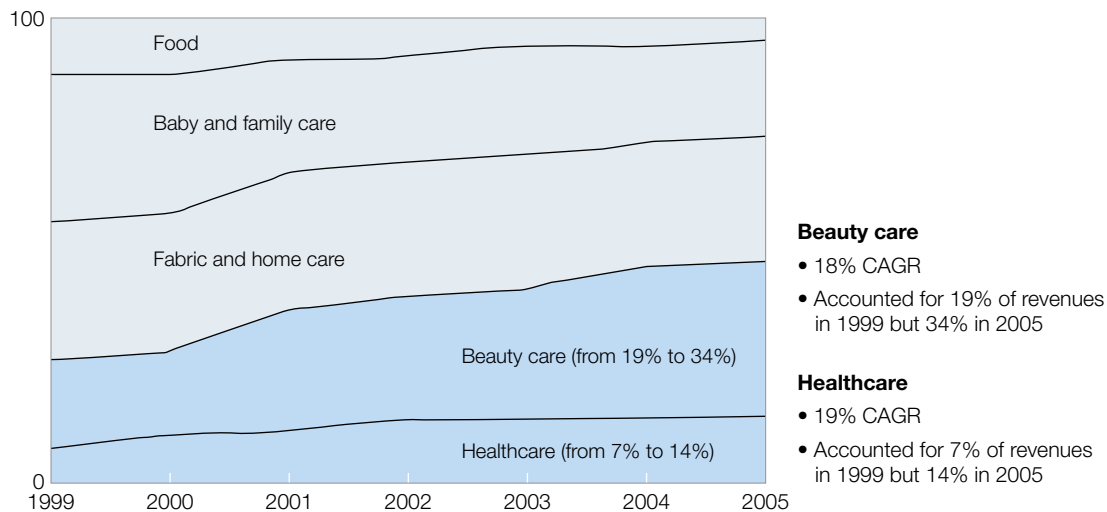
**Transform your business model**

A second option is to make fundamental—and potentially radical—changes in the company’s core activities to meet the disruptive challenge head-on. Charles Schwab used this approach after a wave of lower-priced, Internet-only stock brokerages gained significant market share in the late 1990s. Schwab, the first major discount brokerage, had initially succeeded by undercutting the prices of traditional brick-and-mortar brokers, but the arrival of E\*Trade and other online brokers put its value proposition in jeopardy. In deciding how to respond, Schwab knew it had some advantages that online brokers would find difficult to match. If it could rapidly develop online trading capabilities for customers, it could offer consumers both online and branch-network services, as well as its reputation for superior customer service.



EXHIBIT 3 Refocusing its portfolio helped P&G grow despite industry disruption

**Revenue mix, 1998-2005, %**



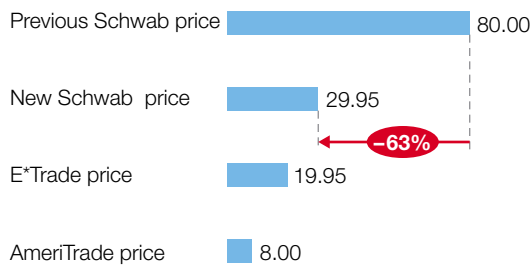
Source: AG Edwards; Bloomberg; company reports; Factiva; Hoovers

This exhibit originally appeared in *The Granularity of Growth* by Patrick Viguerie, Sven Smit, and Mehrdad Baghai (John Wiley & Sons, 2008).

#### EXHIBIT 4 Volume growth allowed Charles Schwab to maintain economics despite the advent of online trading

##### Schwab significantly cut prices but still charged a premium compared with online-only brokers

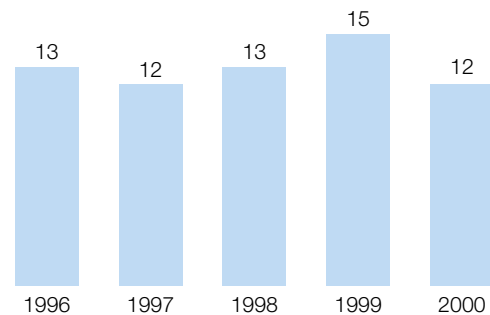
Commissions, December 1997, \$/trade



- Schwab cut its price by ~60%
- Nevertheless, it was able to maintain a large premium compared with E\*Trade and AmeriTrade because it could offer multichannel access (branch and online) and superior customer service

##### The move did not compromise its economics

Net income margin, %



- Despite the price drop, trading volume increased rapidly (high price elasticity at \$29.95)
- Bottom line was affected at the beginning, but net-income margin stayed flat over time

Source: Harvard Business School Case: Charles Schwab Corporation; company 10-Ks 1992-2006

Through massive effort, the company was able to launch its online trading site within about a month; it also cut its prices, although it charged a significant premium over online-only brokers. Schwab was able to maintain its profitability and margins because of the added volume it obtained through its new business model, the premium it charged relative to other online brokers, and the overall growth in the Internet brokerage market (Exhibit 4).

The biggest challenge a company that wants to transform its business model faces is that new entrants often offer a “better mouse-trap”—some combination of superior benefits and lower cost. It is usually hard for an established organization to transform itself to the extent and with the speed necessary to thrive

(think about print magazines in an age of digital media). The odds of success are higher if the company can identify and exploit competitive advantages that others cannot replicate (Schwab’s offline presence was particularly powerful in this regard). Finally, the pricing model and approach selected are critical, because few decisions flow more quickly to the bottom line than pricing changes. Understanding the relationships among pricing, overall demand, and market share changes is therefore crucial. In Schwab’s case, lower prices worked because volume was growing rapidly, and the incremental cost of servicing the increased volume was lower online than through the company’s traditional model.

For payors, it is not yet clear what the winning business model(s) will be in the future



or how the transition can best be made. Some payors are taking (or, at least, experimenting with) a “do-it-yourself” model by teaming with physicians and building new capabilities to manage care. Others are developing more exclusive partnerships with health systems or pursuing vertical integration. Still others are implementing and refining new payment models that support and reward providers for reducing the total cost of care. However, past experience makes one thing very clear: indecision is not an acceptable path when industries are undergoing disruption. A good decision about a new path is required if a company wants to thrive.

### **Build a major new business**

The third option is to acquire or build a new business that can leverage the company’s core capabilities and grow large enough to replace earnings lost from its existing business. This may be the most challenging of the three options.

One company that was able to succeed with this approach faced a situation analogous to the one confronting payors today. The advent of the personal computer undermined IBM’s primary business model (one that integrated hardware, software, and intensive sales and support capabilities). In the new world, customers were using technologies from many different vendors, which disrupted Big Blue’s vaunted end-to-end approach. At the same time, these customers found themselves having to cope with much greater complexity as the number of computers and computing platforms within their organizations proliferated. New CEO Lou Gerstner ignored pundits’ suggestions to break IBM into pieces and instead decided that the company’s best move would be to build a large computer

services business to help customers better deal with the increased complexity. Within a decade or so, half of IBM’s revenues were coming from that new business (Exhibit 5).

Over the past two decades, IBM has transformed itself in other ways. For example, it refocused its hardware business on high-end PCs rather than mainframes; it then sold off its PC business to concentrate on corporate software solutions. IBM’s ability to keep transforming itself has enabled it to keep pace with several waves of change in the rapidly evolving IT market.

What is the lesson for payors that want to build a major new business? Probably the most important one is to follow Wayne Gretzky’s advice to “skate where the puck is going, not where it has been.” That is, you should develop a worldview—by understanding and developing insight around the key trends and uncertainties—and move toward that future state, with real clarity around the business(es) you choose to be in. As part of this process, you must decide the primary role your company will play in areas such as claims processing, risk selection, underwriting and management, and data analytics.

### **What is needed to succeed**

Responding rapidly to industry disruptions is hard. At most companies, the economic constraints of operating a business at scale hamper the ability to make changes “in flight.” Many organizations are also prisoners of their past—and the more successful that past, the harder it usually is to make changes. Furthermore, rapid responses may be especially challenging for healthcare companies. Many parts of the industry are heavily





regulated. Interactions among stakeholders (payors, providers, patients, employers, etc.) are often complex. Proud professionals everywhere have deeply grooved operating models and successful track records.

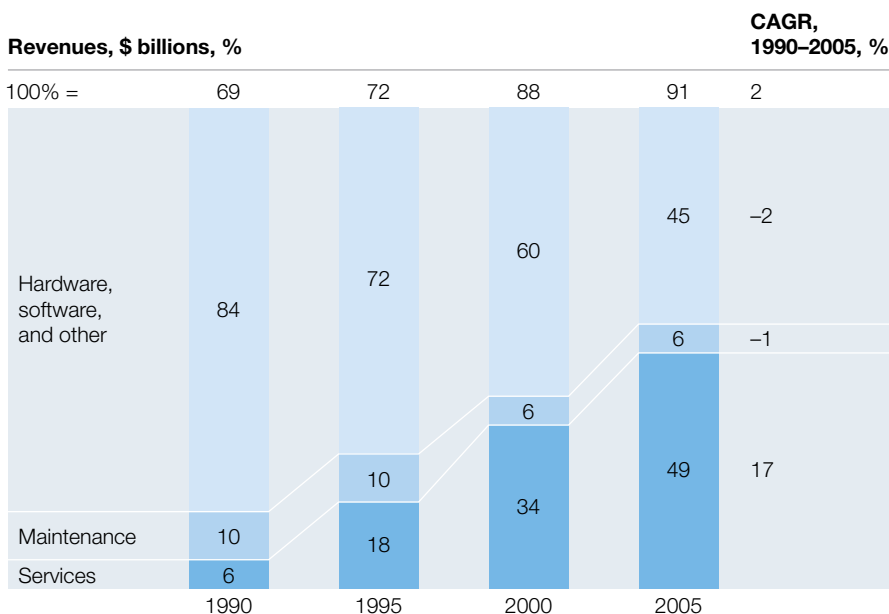
However, the market does not care about the past or about any of these constraints. Thus, payors that want to navigate disruption successfully must get in front of it quickly. Navigating disruption effectively requires a healthy organization,<sup>6</sup> a solid governance model, and—especially—leadership. In each of the three corporate transformations described above, the CEO was at the center: A.G. Lafley drove the strategic and organizational changes at P&G, Charles Schwab personally led the charge at his company, and Lou Gerstner came in from the outside (RJR Nabisco) to save IBM.

We believe that senior payor executives should undertake four sets of actions if they want to get in front of the coming disruption. The first three will enable them to select and implement a strategy. The fourth will give them the economic breathing room they need to implement that strategy and compete effectively.

**Shift focus**

First, senior executives should shift their own focus. In essence, they need to take on two jobs: they must run today’s business while creating the business of tomorrow. To do this, they should have a clear vision, based on solid insights, of the future. This vision should include the key present and potential market segments. Which of these segments do the executives believe will grow rapidly or become more profitable? Which ones will shrink?

EXHIBIT 5 IBM leveraged its strength to diversify successfully into IT services

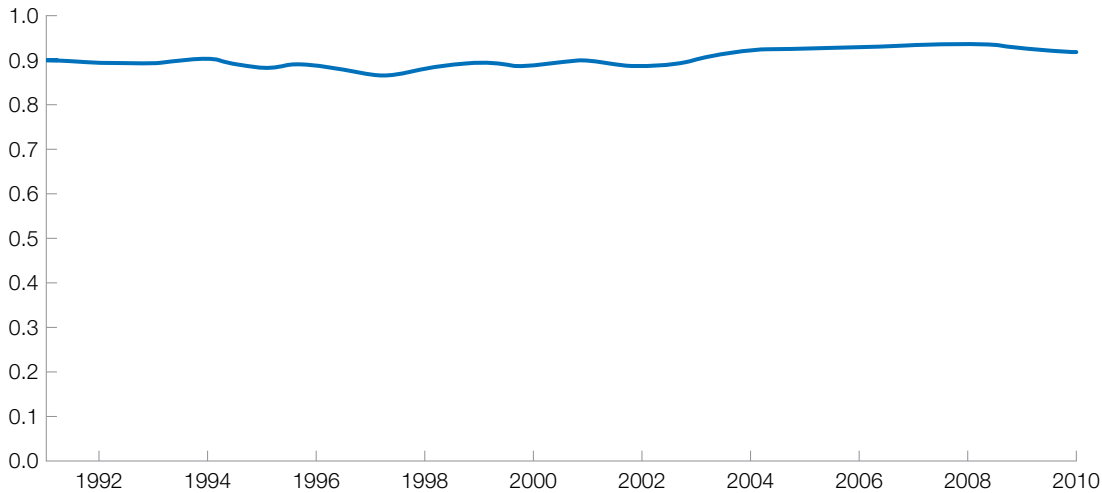


<sup>6</sup>For more information about how to ensure organizational health, see the article by Gretchen Berlin, Aaron De Smet, Shubham Singhal, and Bryony Winn, “Health-focused redesign: Creating a payor organization for the future,” on p. 123.

Source: STAC – Corporate Performance Analysis Tool

**EXHIBIT 6 Companies are slow to reallocate resources**

**Correlation between new capex allocations and previous year's allocations, 1990–2010**



Source: McKinsey Corporate Strategy Research Program

Questions like these are crucial, because healthy institutions need growth—growth drives value, creates opportunity, and enables distinctiveness. Our research across sectors shows that without growth, large companies find it hard to create value after 10 years and are six times more likely to exit their industries than other large companies are.<sup>7</sup>

However, the vision of the future must also be grounded in an accurate understanding of which market factors the company can control and which ones are inevitable. The executives can then attempt to shape to their advantage the factors within their control and avoid wasting time and money on inevitabilities.

**Reallocate resources**

Senior executives should also be willing to make significant changes in how and where resources are allocated. After all, a strategy is only a theory until resources are allocated

to it! In making the allocation, the executives should take care to ensure that they are not under-resourcing the new strategy.


There is also a second danger the executives should guard against: at many companies, budget processes favor existing businesses over new ventures. Our research into more than 1,600 US companies shows, for example, that about 90 percent of all capex allocations can be explained by the previous year's capex allocations (Exhibit 6).<sup>8</sup> Although all of the companies had detailed planning and capex allocation processes, those processes were inadvertently reinforcing the status quo.

**Increase speed and capacity for change**

If a company is to survive industry disruption, senior executives must increase its speed and capacity for transformation and innovation. Their ability to accomplish this will be much

<sup>7</sup>More information about the importance of growth can be found in *The Granularity of Growth* by Patrick Viguerie, Sven Smit, and Mehrdad Baghai (John Wiley & Sons, 2008).

<sup>8</sup>More details about this research can be found in the article by Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012 (available on mckinsey.com).



greater if they have a clear picture of what the organization is good at and what assets can be leveraged in other areas. Thus, before they finalize their decision about which strategy (or strategies) to follow, the executives should make sure that they have a realistic understanding of their organization's capabilities. Otherwise, they risk over-valuing business building at the expense of other options.

The executives should also think long and hard about where their existing assets can make a difference in the new world. For example, scale may be beneficial for payors that need to manage volatility or make large investments in an IT systems migration.<sup>9</sup>

### Get lean

In the post-reform world, administrative efficiency will be a must-have, not a nice-to-have—and not merely because of regulations governing medical loss ratios. If history is a guide, many new entrants will be much more efficient than incumbents are and will have much more favorable cost structures. Incumbents are likely to find it difficult to compete with them unless they have “leaned out” their operations.

Furthermore, performance differences typically become much more exposed during industry disruptions. Until now, the fact that there is no correlation between a payor's size (in terms of the number of lives covered)

and its administrative costs has not received much scrutiny, but this situation is not likely to persist.

Remember: cost reduction is not a recipe for success. But in the post-reform world, it will most likely be a prerequisite for success.



The coming disruption is likely to significantly reshape the healthcare industry. Payors have occupied a large and critical—but relatively focused—role in the industry's value chain. As the full effects of the ACA take hold, disruptive forces will begin to attack payor business models. Winning payors will get in front of these forces by aggressively moving to refocus their portfolios around the most attractive segments, successfully transforming their business models, and/or building significant new businesses. The opportunities are many, but to take advantage of them, senior payor executives must make clear strategy choices and exercise the leadership required to ensure that the necessary organizational changes are made. ○

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<sup>9</sup>For more information about the benefits that scale may (or may not) offer payors, see the article by Rohit Kumar, Shubham Singhal, and Jeris Stueland, “Bigger may not be better: Does scale matter for payors?,” on p. 30.