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Perspective

China: "Capturing the Opportunity" During an Inevitable Slowdown

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Although China continues to offer great revenue growth opportunities for medical device companies, recent economic and healthcare-related issues may start stifling that growth. Situation will require more than just being "in China"; instead, senior executives will need to have a laser-sharp focus on executing tailored strategies to ensure continued success.

The Opportunities

Although still underdeveloped given its population size, the $13 billion Chinese device market (2011) has become the fourth largest globally after the US, Japan and Germany. L.E.K. Consulting expects China's medical device market to almost double to $25 billion by 2016 given its projected 11-13% per annum growth. L.E.K. estimates growth in the orthopedic sector at 18% annually. However, growth estimates for the medical device market and orthopedic sector have been reduced from earlier projections by L.E.K..

L.E.K. breaks down China's medical device market as follows:

- Diagnostic Imaging — $5.3 billion
- Consumables — $2.2 billion
- Patient Aids (pacemakers, hearing aids, therapeutic appliances) — $2.0 billion
- Orthopedic and Implantable Products — $0.7 billion
- Dental Products — $0.4 billion
- Other — $2.5 billion

According to L.E.K., China's rapidly aging population, its continuing urbanization and its increasing affordability are the underlying drivers of the country's healthcare and device markets. In addition, the Chinese government has significantly improved medical insurance coverage — in 2009, almost 40% of China's healthcare expenditure was patient out-of-pocket-payment, making cost a greater factor in China than in other markets. Finally, China recently completed a three-year overhaul of its healthcare system. The $125 billion effort included expanded health insurance coverage to 95% of Chinese, the opening of new hospitals around the country and expanded primary-care facilities.

L.E.K. noted (2009) that “awareness and usage of the orthopedics international brands are strong in top tier city markets”. However, “domestic Chinese brands now dominate for more established products in mid-to lower tier markets” (2011). Average selling prices for Chinese brands are typically less than half that of imported (international) brands in mid-to lower tier markets.

The Challenges

Although China’s economic fundamentals remain healthy, the world’s second largest economy faces the risk of even slower growth because of the euro-zone crisis. In addition, lingering longer-term problems such as the unbalanced nature of China’s economic growth, listless external demand, a difficult operating environment for businesses and industrial overcapacity have stifled growth. Major stimulus efforts are currently being discussed in China to help revive the economy. However, these measures may be postponed until China embarks on a once-a-decade leadership reshuffling later in 2012.

Aside from slowing economic growth, several “speed-bumps” have also surfaced in the healthcare market in China including: mounting costs, problems at public hospitals, a surge in patients with chronic diseases, low physician pay and more intense local competition.

Results of Latest Overhaul

In July of 2012, Chinese health officials called for an additional overhaul of the country’s healthcare system. The announcement highlighted the challenges facing the Chinese government — even after overhauling its healthcare system over the past several years. The Deputy Director General of the Beijing Health Bureau said “there is no correlation between the heightened spending and the health of the country’s citizens”. China’s healthcare system “does not have sufficient measures in place to prevent diseases such as heart disease and cancer, which are costly to treat”.

The Chinese Ministry Of Health also suggested that more than 260MM Chinese suffer from a chronic disease — including diabetes, obesity and hypertension. Peking

University has offered that China is now home to one of the largest populations of diabetics. A recent study published in the British journal Lancet reported “about 138 million adult diabetics live in China and Russia”.

China’s Ministry Of Health said that 85 of every 100 deaths in China are now caused by chronic diseases. As comparisons, the World Health Organization (WHO) says chronic diseases account for 63% of deaths worldwide, and the US Centers For Disease Control and Prevention claims that the rate is 70 of every 100 deaths in the US. Chinese health officials are blaming the country’s high rate on smoking, diets that increasingly include fat and fast food and the prevalence of salt in local cuisine.

Officials in China have proposed “a need to create new reforms to deal with the problems” and recommended that “further measures by central authorities should include efforts to improve education, doctor training and access to routine screening”. The WHO has added that one of the biggest opportunities for China is preventative care — “about 80% of the (Chinese) government spending on health care goes to cover the cost of chronic diseases, yet only about 2% is allocated toward primary prevention”.

Issues Unique to China

Select healthcare issues are unique to China. Physicians are severely underpaid and must rely on “gifts” from patients to supplement their state salaries of a few hundred dollars annually. In addition, hospitals sell pharmaceutical products for revenue in order to remain profitable — and boost the pay of physicians.

Lessons from Big Pharma

Slowing economic growth, intense local competition and government’s efforts to control healthcare costs and support local firms have slowed the prospects for the top drug makers in emerging markets, including China. The extremely high sales goals baked into many pharmaceutical stocks may potentially be threatened.

At Eli Lilly, slower growth in China and pricing pressures in certain other countries have affected sales and could have an impact on the Company’s goal of doubling 2010 emerging-market sales in 2015.

Novo Nordisk A/S, a leading maker of diabetes treatments, expects about 25% of its revenue to come from China and other fast-growing countries in five years, up from 20% today, as its share of revenue from Europe and some other countries falls.

However, Nordisk's CFO recently admitted that sales growth in China has slowed down — from about 20% a year ago to the mid-teens in 2012.

The CEO of Pfizer recently scaled back projections for growth in emerging markets to high single-digits from low double digits. Although Pfizer grew sales in China about 30% during Q212, a company official admitted "the challenge is keeping such sales growing".

Pfizer's CEO also mentioned that "the majority of the growth is going to local companies that sell low-price generics. It is difficult to keep up with that growth because we don't have the products there". Another Pfizer official added "branching out from top tier cities to keep sales growing means taking on entrenched local firms. Big drug makers are still sorting out how to sell to doctors and hospitals in these smaller cities without breaking the bank, and how to provide the mix of affordable medicines that those potential customers seek. Hiring away staff who know these markets and then retraining them is tough".

Interestingly, Ernst & Young estimates that a $47 billion gap between the sales that leading drug makers expect in emerging markets (including China) over the next four years and the revenue that they can ultimately reach.

Conservatism in BRIC Proposed by One Investment Bank

In late 2011, a Goldman Sachs report proposed that "growth in BRIC markets was forecasted to be flat [note: same as 2011] at approximately 8% through 2012 for Brazil, Russia, India and China. This may come as a big surprise to many large med-tech players who have committed big-bucks to these emerging markets to offset US growth".

How Ortho Companies Can "Capture the Opportunity" in China

Zimmer, JNJ/DePuy Synthes, Stryker, Biomet, Smith & Nephew and Medtronic have experienced rapid growth in China over the past several years. These companies are placing an even more significant emphasis in China over the next 3 to 5 years with the goal of further accelerating company sales.

Given some of the latest identified “speed-bumps” in China, orthopedic companies will need to sharpen their focus and execute their tailored strategies to ensure success. McKinsey & Co. proposes the following to “best capture the opportunity” in China:

- Segment the market, and be thoughtful on investments — given the diverse account base of ~ 20,000 hospitals and ~ 600 geographically dispersed cities, targeting and winning in chosen segments is critical
- Be an insider — make China your second home
- Broaden your portfolio to serve your current customers, as well as the low-end market — adopt a mix of both premium and affordable products, as well as global/local brands AND get your cost structure right to compete successfully with local players
- Develop China-specific products through product innovation to reflect local tastes and needs
- Win the war for talent

Conclusion

Some analysts have scaled back projected growth rates for the medical device market — and the orthopedic sector — in China. Select senior executives in the pharmaceutical industry have done the same. Hopefully, the leaders of orthopedic companies will not expect “too much revenue, too soon” in China — the effort may take a lot more strategic planning, execution, investment and out-of-the-box thinking than originally anticipated.

L.E.K. continues to stress that it’s no longer enough just to be “in China” — the complexity of this market requires differentiated strategies by portfolio to drive continued revenue growth. Given the economic and healthcare-related issues that are surfacing in China, the advice offered by McKinsey and L.E.K. should not be taken half-heartedly by orthopedic executives.

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