

HEALTH CARE

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Seizing China's pharma opportunity

China's pharmaceutical market is growing by upward of 20 percent a year, but global drug companies still must capture its full potential.

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**Article
at a
glance**

Demand for pharmaceuticals is rising throughout China, but multinational companies face a daunting task if they are to capture this new potential. The market's magnitude and complexity are the main challenges.

Multinationals will be able to extend their footprint in China only if they broaden their product range, reach deeper into the big cities while exploring new territory, and build larger sales forces in the face of intense competition for talent.

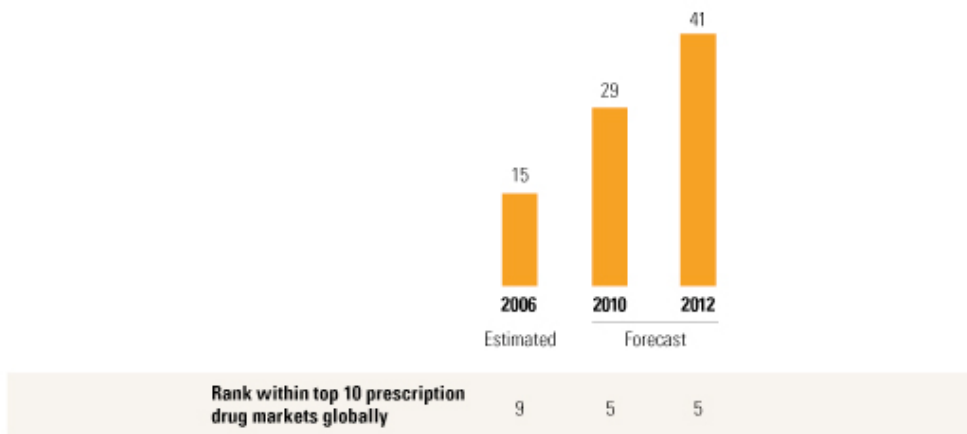


Few people would dare call China the sick man of Asia. But a surge of "diseases of affluence"—including diabetes, breast cancer, and cardiovascular disease—is among the unfortunate side effects of a booming economy. Demand for drugs treating these and other health problems, combined with a rising level of income, is enlarging China's pharmaceutical market by more than 20 percent a year and creating attractive opportunities for global pharma companies at a time when rates of growth in key European and US markets are decelerating (Exhibit 1).

EXHIBIT 1

A growing demand

Size of China's pharmaceutical market,¹ \$ billion



¹Excludes over-the-counter (OTC) and traditional-Chinese-medicine segments; data reflect ex-factory price, ie, price of drug as sold by pharmaceutical company to distributor; includes hospital and retail channels.

While some multinational pharma companies are projecting near-term revenue growth of more than 30 percent a year in China, none have captured the market's full potential. In a recent survey of almost 1,600 Chinese hospital doctors in 38 cities, we found evidence that companies are having trouble dealing with the magnitude of the country and the fragmentation of the industry and the market. While almost all major global companies have a presence in China's largest and wealthiest cities, for instance, few have completely penetrated them. The impact of the multinationals is especially patchy in rural areas and smaller cities. What's more, few products have achieved critical scale. Among the portfolios of the leading pharma companies, we estimate that only 12 drugs achieved more than \$50 million in sales in China in 2007; about 80 percent of the multinationals' products generated less than \$10 million in revenues apiece.

To serve China effectively, multinational pharma companies must start thinking big. They should put more resources into tailoring (and probably expanding) their product portfolios to meet China’s growing needs and develop a distribution strategy that deepens and broadens their reach. And to create the bigger sales forces needed to support this effort, they will have to find and nurture new sources of talent.

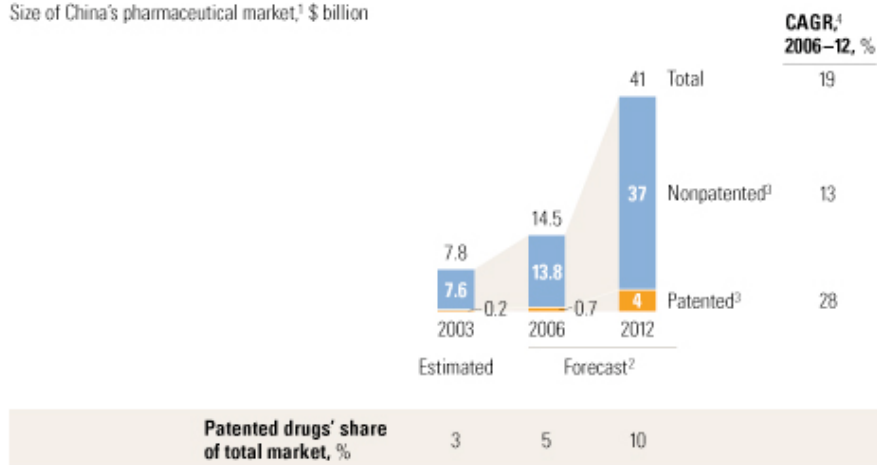
A dose of change

To some extent, the failure of multinationals to penetrate China’s pharma market is hardly surprising. Until recently, they considered the country a secondary market because of its relatively low commercial prospects and concerns over the protection of intellectual property. In the past, many multinational pharma companies brought prescription products to China only several years after their launch in other markets. These treatments often competed against local generics that had already won regulatory approval. Competition from local players remains fierce in the generic and over-the-counter (OTC) segments alike.¹ But with China expected to rank among the top five global markets for pharmaceuticals by 2012—and with demand for innovative patented drugs growing fast—new opportunities beckon (Exhibit 2).

EXHIBIT 2

Patented growth

Size of China’s pharmaceutical market,¹ \$ billion



¹Excludes over-the-counter (OTC) and traditional-Chinese-medicine segments.

²Market forecast is based on ex-factory price, ie, price of drug as sold by pharmaceutical company to distributor.

³Nonpatented defined as prescription drugs with no patent protection, including generics; patented defined as prescription drugs with patent protection in China.

⁴Compound annual growth rate.

Source: IMS Market Prognosis, IMS Health; McKinsey analysis

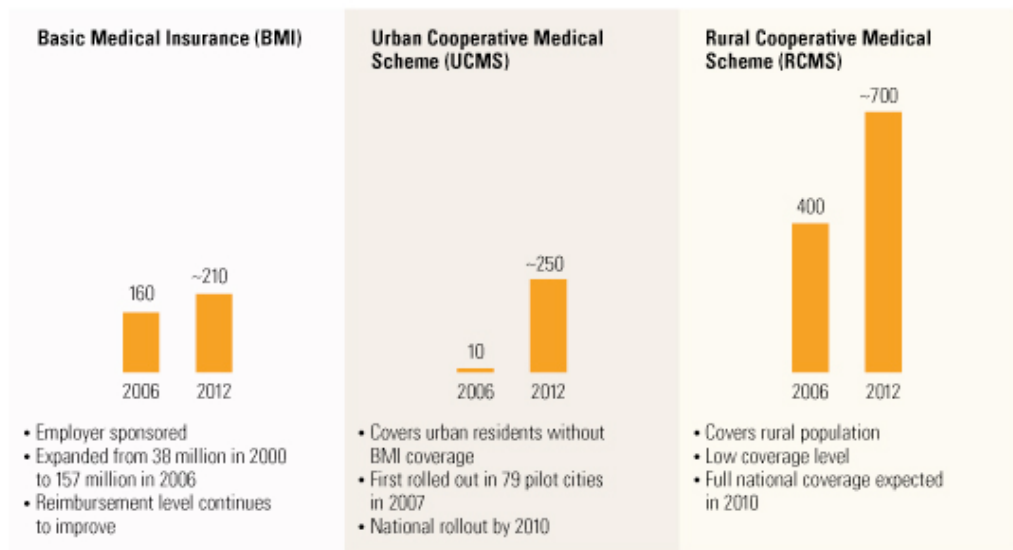
Intellectual property protection is improving as both the Ministry of Public Security and the State Food Drug Administration (SFDA) clamp down on phony drugmakers and even some reputable companies that don't respect patent rights strictly. In 2006, the SFDA shut down over 1,200 drug and medical-equipment makers for producing fake or low-quality goods. The government, meanwhile, increasingly supports patent protection and has refused, for example, to approve generic products if patented molecules are on the market.

Even China's currently insufficient insurance coverage, another hindrance to commercial success in the prescription drug market, may be improving. Sales of many prescription drugs depend on whether they are covered by the government's Basic Medical Insurance (BMI) program, an urban insurance scheme funded by contributions from employers and employees. To date, the program covers roughly 25 percent of the urban population, or 160 million people by 2006 estimates.² The government plans to have universal coverage by 2020, however, and by 2012, 85 percent of the population should have some kind of health insurance (Exhibit 3).³

EXHIBIT 3

Toward universal coverage

Millions of Chinese people insured



Encouraged by the prospects of the local market, many international pharma companies are including China in their global launches. Bayer Schering Pharma and Bristol-Myers Squibb (BMS), for example, went that route in their recent global launches of Nexavar (for renal cell carcinoma) and Baraclude (for hepatitis B), respectively. Yet most global pharma companies have yet to address the principal challenge—understanding and mastering China’s large and highly fragmented market—at all seriously. Pharma sales vary widely among regions, and even within them, depending not just on the income levels and reimbursement status of their consumers but also on the treatment practices of physicians and the level of local competition. Companies struggle to understand these differences in the dynamics of markets, in part because data on them is lacking. Some companies, we find, may define market segments inconsistently and therefore have product portfolios that often fail to meet local needs.

A suitable portfolio

While some companies have captured demand in the niche prescription or mass-market OTC segments, few manage to grab both, and few pharma products have achieved significant scale. The characteristics of drugs that succeed commercially range a good deal; for example, both Johnson & Johnson’s low-cost, mass-market OTC product Motilium, for gastrointestinal disorders, and BMS’s expensive breakthrough drug Baraclude, for hepatitis B, earn healthy revenues.

Although most companies are not naturally equipped to produce and sell all kinds of treatments, any company that wants to take full advantage of the opportunity in China should aim to cover three key categories: innovative and patented products, branded generics, and OTC drugs. Most multinationals will stress newer innovative products already in their global portfolios, for there is growing demand in China for drugs in this highly profitable segment. Nonetheless, they make up only a narrow portion of the overall market, which is dominated by branded generics addressing major diseases, such as diabetes or liver cancer. (China accounts for 50 percent of all liver cancer cases in the world.) Chinese consumers prefer strong brands even if the products behind them are generics.

Given the plethora of local generics producers, only companies with critical scale and capabilities should compete in this category. We have seen some niche patented specialists attempt to enter the branded-generics segment only to fail because they could not devote sufficient resources to their products. The OTC segment, though equally competitive, is less exposed to the pricing constraints that the government puts on prescription drugs.

One way to fill gaps in a portfolio is to in-license products for China and other Asian emerging markets that tend to have similar needs. A company might, for example,

approach either local pharma companies or multinationals that have little or no presence in China—perhaps Indian or Japanese companies, which often boast strong formulation capabilities. Bayer HealthCare’s recent purchase of the exclusive marketing and trademark rights for Insugen, an insulin product made by the Indian company Biocon, exemplifies that strategy.

Another alternative for multinationals would be arranging to sell products of small US companies that lack an Asian presence; AstraZeneca, for instance, holds a license to sell Cubist Pharmaceuticals’ bacterial antibiotic treatment Cubicin. This and other recent deals suggest that players looking for opportunities to fill product gaps will have a higher chance of success if they pair up with smaller pharma companies and biotech companies.

Acquiring a local company with complementary capabilities may be attractive, too, especially as Chinese companies strengthen their marketing and sales operations. Acquisitions of companies that have enjoyed commercial success in niche OTC segments could be particularly appealing, since Chinese consumers tend to self-medicate for minor ailments. The operations of China’s OTC makers also tend to be more transparent than those of some producers of generics and patented drugs, and product promotions depend more on brand building than on relations with doctors. Another option is to partner with one of the increasing number of local companies that have achieved commercial success in niche disease areas. In addition, multinationals should pursue opportunities to create entirely new OTC categories.

Getting a grip on distribution and sales

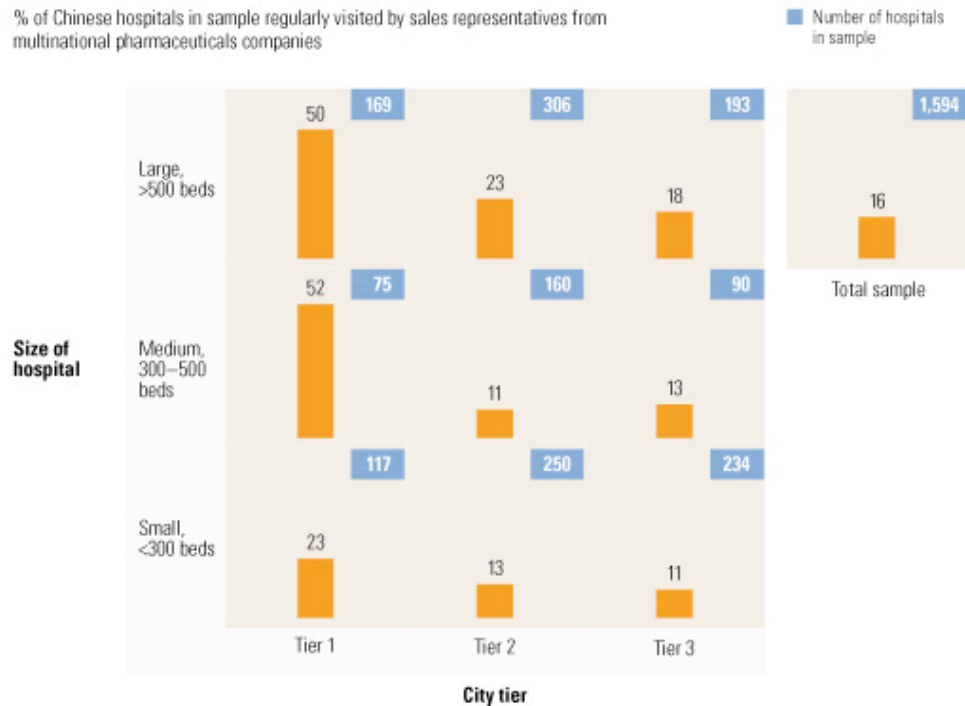
Of course, as companies enter new treatment categories, they will have to develop more sophisticated marketing and sales capabilities. Creating a proper segmentation is particularly tough in a country where almost 160 cities have more than one million people each and several (such as Shanghai, Shenzhen, and Chengdu) have populations above ten million. Although some leading multinationals already cover upward of 150 cities, they have yet to gain a significant foothold outside the three wealthiest (tier-one) metropolitan areas: Beijing, Shanghai, and Guangzhou, which together account for 21 percent of the pharma market by disposable income.⁴ Perhaps more important, these giant cities are home to some of China’s leading physicians, whose opinions influence health care throughout the country.

The roughly 36 tier-two cities, representing 37 percent of the market, are arguably as important. Although global companies have stepped up coverage here, their penetration can be patchy. In tiers one and two alike, multinationals have relied on sales representatives to build relations with key physicians in large hospitals but

neglect to target their colleagues in midsize and smaller ones (Exhibit 4), many of which rank among the most commercially attractive opportunities. To reach them, a company should expand the sales force and use it in a more targeted way.

EXHIBIT 4

Targeting the sales force



Source: 2006 McKinsey survey of ~1,600 Chinese physicians associated with hospitals in 38 cities

Such expansion efforts will also help multinationals broaden their reach into the 600-plus tier-three cities (like Lanzhou and Ürümqi), which are mostly in the interior⁵ and largely represent virgin territory for them. These cities too offer long-term growth prospects that could improve a global company’s competitive advantage.

Going deeper . . .

To go deeper into the primary markets (tiers one and two), multinationals should aim to reach more departments in the hospitals they target and to increase the frequency and quality of their sales reps’ visits to those departments. Our survey found that in 2006, sales representatives on average visited half of the physicians in large cities once a month and the other half not at all. Such practices hurt sales—we

found, for example, that physicians were more likely to try a new product if they received at least two visits from pharmaceutical sales reps. More frequent visits help the companies to inform physicians more fully about new and existing products and to build better relationships.

Our research also highlighted the untapped potential of smaller hospitals in large cities such as Guangzhou and Shanghai: we found that 71 percent of the physicians working at such hospitals see more than 20 patients a day, whereas less than half of their colleagues at large hospitals see as many. We noted that in general, the more frequently physicians interacted with patients, the more prescriptions for primary-care drugs they wrote.

The development of China's new community health centers in large tier-one and -two cities presents another opportunity to reach deeper into the market.⁶ These centers—in effect, small hospitals—are part of a government-led initiative to provide more alternatives for primary care, thereby alleviating the crush of patients in large hospitals. There are signs that the centers will play an increasingly important role in the health care system. In Beijing, for instance, they now provide treatment and insurance coverage for a variety of chronic diseases, such as hypertension, diabetes, and stroke.

To take advantage of these opportunities, global pharma companies need more on-the-ground representation. Besides improving the segmentation of physicians and increasing the frequency of visits to them, companies should upgrade the training of sales reps in primary markets, where more innovative treatments require greater knowledge of products.

. . . and going broader

To date, many multinationals have avoided China's smaller cities because it is hard to identify the most commercially attractive ones and to coordinate complex distributor networks. They also worry that short-term profits in these areas will lag. But while significant sales of innovative, more expensive medicines will probably remain limited to the wealthiest 50 or 60 cities (and to even fewer for high-priced therapies), smaller cities offer strong markets for high-quality OTC treatments and older prescription medicines, as well as long-term growth for prescription drugs generally.

Tier-three cities have 43 percent of China's total urban wealth and 42 percent of its total sales of drugs in hospitals. Some of these cities (such as Suzhou, near Shanghai) are wealthier on a per-capita basis, though smaller in population, than most tier-two cities. What's more, the largest 100 hospitals in tier-three cities use as many innovative drugs as hospitals of comparable size in bigger cities do, and their

physicians on average prescribe as many drugs.

A handful of multinationals have tapped this market with representatives who specialize in tier-three cities, though most companies rely on intermediaries, such as distributors, to reach the physicians who work in them. This model cuts costs but prevents companies from controlling their sales channels. It makes more sense to create a specialized sales force to target large hospitals, where most pharmaceutical sales in these cities are made.

Whether companies target this opportunity as they expand in the tier-one and -two markets will depend on their resources. But reaching tier-three cities may be easier than it seems, for they have only about 450 large hospitals, accounting for 16 percent of the country's total pharmaceutical market. To manage the increasingly complex logistics of expansion, companies should consider a pilot approach, including a two-year roadmap for expanding into new territories and regular assessments of progress toward initial objectives.

To determine which areas to prioritize as part of a "go-broad" strategy, executives should assess each city's macroeconomic data and relevant health care infrastructure. Regional differences in the practices of physicians are also a critical factor in geographic expansion: for example, our survey found that physicians in the north were less likely to use innovative drugs than those in the south.

Investigating the percentage of the population with Basic Medical Insurance (BMI) is critical too, since our research indicates a strong correlation between that kind of coverage and a physician's willingness to prescribe innovative drugs. Since the government's health care policies are still in flux, using the available market information to estimate the potential growth of the population with BMI will be a challenge (see sidebar, "How to get the information you need").

Tier-three cities close to primary markets could well have more allure. For them, a company could employ a "hub and satellite" strategy that would leverage its existing sales force, distributor relationships, and (where relevant) investments in OTC advertising. That strategy would also help raise the productivity of the sales force: prescription patterns influenced by leading physicians in hub cities might cascade into the hinterland.

The difficulty in harder-to-reach places will be getting sales reps to serve in them and finding skilled distributors or training new ones. A few companies have begun experimenting with the use of distributors rather than sales reps to execute key promotional activities. It should soon be clear whether this strategy works.

One risk of expansion is managing the productivity of the field force in remote areas. Sales reps must carry enough pharmaceuticals in their bags to be productive, but

some companies don't have portfolios with enough offerings suitable for markets outside the major cities. The dilemma reinforces the argument for adjusting product portfolios.


Building capabilities

Expansion will take more than just reconfiguring product portfolios and targeting new markets. Companies will find it almost impossible to meet their growth ambitions without building up their sales forces at the same time. We estimate that global pharma companies, to meet their growth aspirations in China, must add at least 11,500 representatives in all by 2011, from the 2006 base—on average, an increase of over 18 percent a year. Sources of talent are limited, however: the leading medical schools graduated 6,200 students in 2005, for instance, and specialized pharmaceutical colleges only 3,900. Not all graduates wish to become sales representatives, and competition is fierce for the ones who do. Hiring from local companies can be problematic, since their commercial practices and compliance standards may not meet international standards.

Salary inflation and the race for perks are driving churn rates of up to 25 percent a year, so most sales reps have less than two years' experience at any one company. Even the best-performing multinationals have turnover rates of around 15 percent and must constantly train new representatives. Companies must therefore invest more in their human resources in order to mine the talent pool and manage the candidate flow effectively. Instead of relying on the limited number of graduates from medical and pharmaceutical schools, for example, companies should consider broadening the type and number of universities they tap for talent. For some products that don't require extensive medical expertise, recruiting and training high-potential undergraduates may be an option.

As global pharma companies compete against their local rivals for sales reps, they should emphasize attractive employee value propositions. Since frontline sales managers serve as models for the rest of the sales force, an effective operating approach would strongly emphasize their training—with onboard instruction, rotating positions (including stints outside of China), and perhaps the financing of executive education. Novartis, for example, sends high performers to the United States and promotes them when they return home. Multinationals must also create new roles and incentives to retain these managers and keep them in each position long enough for them to perform effectively; in other words, companies shouldn't fall into the trap of promoting managers as often as every 18 months. Such efforts will help to lure new sales reps and retain existing ones.

In less than a decade, China will be transformed from a secondary pharmaceutical market into the world's fifth largest. Companies aiming to capture a large chunk of it

must build stronger capabilities to better identify and meet China's changing health care needs—adjusting product portfolios, expanding wider and deeper into key cities, and devoting more attention to the competition for talent. 

How to get the information you need

Quality of data is always a concern in China, but a wealth of information is available to companies that know how to find and use it. Market information for any city can be acquired by tapping into a number of available public sources, including the Ministry of Health's annually updated database of all hospitals in the country. The database includes key data points, such as hospital beds and consumption of Western drugs. To map future growth, companies might also use sales reps and distributors to collect data at the hospital level. Many companies have yet to use these information sources fully, and most don't use them consistently: for example, different business units of a single company may not have the same criteria for categorizing tier-two and -three cities. Investing in analytical capabilities and building systematic definitions are critical to achieving competitive advantage in China in view of its fragmented market and rapid pace of change.

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Notes

¹Traditional Chinese medicine is a highly fragmented market dominated by local companies, including many state-owned enterprises. Traditional medicine accounts for roughly 8 percent of hospital doctors' prescriptions by value.

²According to official statistics, roughly 50 percent of the rural population in 22 provinces receives health care through rural cooperative medical schemes, though coverage is thin.

³A product's coverage under Basic Medical Insurance is further complicated by a requirement that the drug be registered under China's list of reimbursable drugs. Companies must exert considerable time and effort to make their products candidates for the list. Although the government aims to revise it every two years, in practice four to five years elapse before a new one is issued; the next update is expected to begin in 2009. Even after a product makes the national list, several years usually pass before that product sells in significant quantities, because once the national list is issued, local governments may need two years to implement it. (Provincial governments can change the drugs on the list by up to 15 percent.) Another two years may pass before a significant number of physicians begin prescribing the drug. Although multinationals are powerless to speed up the process, they can ensure that they have sufficient means to support products along the way.

⁴China's cities are generally classified into tiers based on factors such as population and per capita income. We define tier-one cities as those whose populations had a total disposable income above 100 billion renminbi in 2006. Tier-two cities have a total disposable income greater than 18 billion but less than 100 billion renminbi. Tier-three cities have a total disposable income of less than 18 billion renminbi.

⁵China's wealthiest regions lie along the coast. Some cities in the interior, such as Chengdu and Xi'an, are relatively wealthy, but most of those in the central and western areas fall in the tier-three category.

⁶The central government began experimenting with community health centers in the mid-1990s, partly by converting small hospitals. The private sector has also financed the establishment of centers. They tend to employ about six general practitioners and nine nurses and to have 5 to 50 beds.

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