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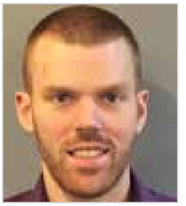
Opportunities for medical device companies in China's reforming healthcare industry



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Starting in 2015, Chinese authorities began a series of major reforms to its healthcare system. The goal of the reforms is to increase the efficiency and sustainability of the system in preparation for three macro trends that will lead to a significant increase in healthcare costs for the national government.

1) Slowing economic growth – As the Chinese economy enters the 'New Normal,' year-on-year economic growth will continue to slow. Slower economic growth leads to slower growth of tax income, impacting the government's ability to fund future healthcare costs that are projected to grow at a rate nearly double that of the economy.

2) Rapidly Aging population – China's population will age at an unprecedented rate, a result of the one child policy. An older population will increase the growth of healthcare expenditure, increasing government expenditure on healthcare.

3) Greater incidence of costly non-communicable diseases – Chinese citizens are also becoming more and more at risk of developing chronic diseases such as diabetes, hypertension and COPD.

The combination of the impacts of these three trends will inevitably lead to a significant increase in healthcare costs. We have forecasted out four future scenarios for the percentage of China's governments budget that will be spent on healthcare based on projected demographic changes and economic development.

All four of these scenarios would result in the Chinese government spending the highest or amongst the highest proportions of its government expenditure on healthcare in the world. The system, thus, must be reformed to become more sustainable, efficient and affordable.

Impact on medical device firms

The reforms affecting the medical device sector have two main goals: 1) downward price pressure and 2) support of the technological development of local companies.

To put downward price pressure on device companies, new regulations aim to cut out extraneous middle men and change the hospital reimbursement system to one based on disease groups (i.e. ACL treatment) vs services provided (i.e. MRI). The government will also likely increase direct pricing pressure on device companies in the bidding and approval process.

Regulatory authorities will support the technological development of local companies through favorable device approval policies and locally produced purchase requirements for hospitals.

Taken together, the reforms rightly have worried most multinational device companies in China and have caused a rethink of many companies' China strategy. However, even with these reforms, there remains profitable strategies to take advantage of the fast-growing China healthcare market.

Local Acquisitions and multiple product lines - Purchasing a local, low cost player is a way for a multinational company to

Investing in early diagnosis

preserve brand value whilst still competing and profiting from the growing market. It also helps MNCs meet requirements for local purchases and provides them with enhanced market understanding and local relationships – an important key to success in China and other emerging markets.

Profitable strategies

One good example of this is Stryker's acquisition of Trauson, a local Chinese device manufacturer that specialises in spine and trauma devices.

At the time of the acquisition, Trauson was a direct and lower cost competitor of Stryker for several product lines. The acquisition allowed Stryker to maintain its own brand value whilst still profiting from the fast-growing orthopedic segment through Trauson, its local subsidiary.

Overlooked market and Innovative products: Boosted by government support, local companies will enter and quickly dominate larger, well-publicised device markets as well as markets that don't require as much technical knowhow.

This clustering of local companies in certain segments will cause downward price pressure in those device markets, decreasing the profit margin for foreign players. However, many opportunities will still exist in smaller and overlooked markets such as those devices that treat relatively rarer diseases.

These overlooked device markets will still offer highly attractive profit margins for MNC firms. Similarly, it is also important for MNCs to continue to invest in R&D and bring to market innovative products that maintain their technical advantage over local competitors. Innovative and unique devices will continue to demand a price premium in post reform China.