Fortune Favors the Bold
Rethinking the Customer Model

Foreword

As Deloitte reported in The Next Phase: Opportunities in China's Pharmaceuticals Market (November 2011), China will soon be the Asia Pacific region's leading market for health care — a widely anticipated result given the country's unrelenting socioeconomic growth trends. However, the past 24 months have seen a rapid acceleration in the development of the life sciences and health care market in China. With this acceleration comes rising uncertainty about where the market is headed and how it will impact the companies that operate within the health care system. This uncertainty comes from the unprecedented demographic changes and continued experimentation from the government as it seeks to expand the quality of care while also controlling expenditures.

Many pharmaceutical companies are now looking at China's health care market and asking themselves, where next? The opportunities that drive growth are less clear now than in the previous decade and the risks in the market are substantially higher than ever before. Finding a path forward that delivers the returns and performance companies want will not be easy in this environment.

This report highlights major events of the past 24 months in the health care market and explores one of the key questions facing pharmaceutical companies as they think about their future in China: How do we evolve our customer model in our core markets?

The answers to this question will impact the success of pharmaceutical companies moving forward and help determine who wins and who loses in China's health care market. The opportunity is large but so is the challenge.

We believe that fortune favors the bold in China and those companies who take decisive action today will be the ultimate winners, while companies who seek gradual change will be left behind as the market passes them by.

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Rethinking the Customer Model

Success in top-tier cities like Beijing and Shanghai has been the primary revenue driver for most multinational pharmaceutical companies operating in China. However, over the past 18-24 months, continued efforts to implement cost control measures, combined with a shifting focus to evidence-based medicine, have slowed the growth of branded generics in these markets.

As the market shifts, companies must rethink their existing high-cost, high-touch, sales rep-supported model and move toward an approach that is balanced across functions. Moving forward, the market will demand balanced, scientifically-driven dialogue that is supported by practical, real-world evidence in China. Companies will have to adapt their customer model to reflect new realities. To succeed, they will need to invest in the capabilities and performance of non-sales functions moving forward.

Growth dynamics in top-tier cities are shifting

Growth drivers in upper-tier markets are rapidly shifting, challenging companies' ability to maintain historical growth rates. Factors that are acting as a drag on growth include:

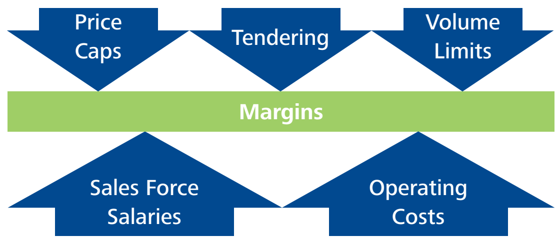
1. Reduction in gross margins through pricing pressure and cost increases
2. Changing physician and patient dynamics
3. Broadening of key stakeholders in the market

These changing dynamics threaten MNCs' reliance on the originator premium (pricing premium allowed by the government for branded generics with expired patents) and a rep-driven model to drive growth and profitability, leaving many companies to ask, "How do we maintain growth in the top-tier markets?"

Reduction in gross margins through pricing pressure and cost increases

Companies are facing significant challenges at both the top and bottom line of their businesses. From a topline perspective, companies are dealing with pricing restrictions, volume limits and more challenging tendering processes, all of which limit their ability to grow revenues (Figure 11). On the cost side, companies' rising sales force compensation and overall operating cost increases are pressuring gross margins.

Figure 11: Overview of Pressures to Drug Gross Margin

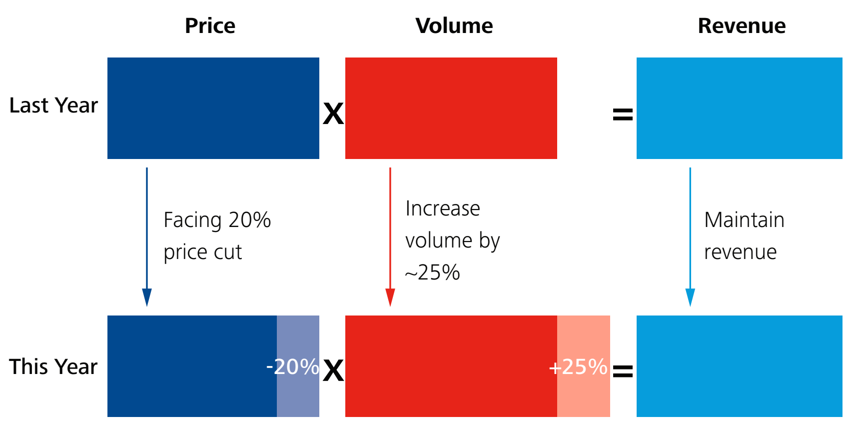


Increasing pressure on topline growth

As we have seen, the Chinese government is exploring multiple policy initiatives to control both the cost and the volume of prescribed products. Among the primary constraints have been the expansion of the EDL and NDRC price cuts, changes in the tendering process and increased use of volume-based capping to control overall costs.[25]

A company facing a 20% price cut across the board would have to increase volume by approximately 25% to simply maintain its performance from the prior year (Figure 12). To realize 20% growth, or growth in line with the overall market, a company would have to sell 50% more prescriptions.

Figure 12: Illustration of Price and Volume Adjustment Under Price-cut Scenario



The pricing challenge has been exacerbated by limits to the number of brands that can be listed within a given province

[25] National Development and Reform Commission press releases.

or hospital. As a result, losing a single tender for a large hospital can materially impact the growth of a brand.

In many top-tier markets, companies are beginning to face strict caps on the volume of products that can be prescribed in a given hospital as prescription caps are being used to control overall expenditures. Therefore, even if a company succeeds in winning a tender, it may face significant volume restrictions at the hospital level.

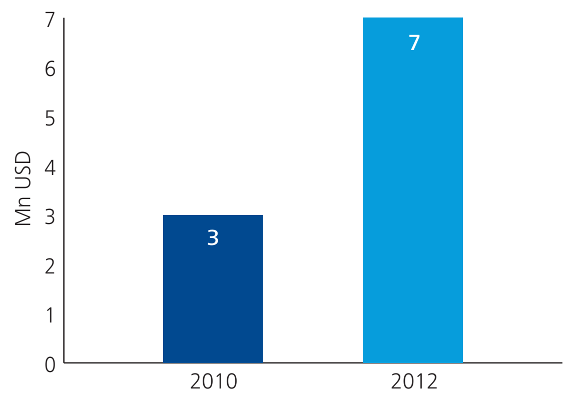
These limits combined have constrained the growth of the pharmaceutical market in the top tier, with estimated sales growth slowing to below 15%.

Rising costs are compounding pressure on price and volumes

> "It looks like we're having a good start to the year, but then in the third and fourth quarter our sales drop-off dramatically as the volume caps kick-in."
>
> — Executive from a multinational pharmaceutical company in China

Companies are seeing operating costs rise across the board, most noticeably in compensation for sales representatives. The fully-loaded average cost (including salary and overhead costs) per sales rep in Tier 1 cities is between 350,000 to 500,000 RMB[26]. For a typical high-investment brand, the cost can exceed $7 million for a 100-person sales force (Figure 13), up from just $3 to 4 million as recently as 2010[27].

Figure 13: Total Cost of a 100-Person Sales Force



Source: Monitor Deloitte interviews and analysis

Other operating costs are rapidly escalating as the regulatory and compliance requirements for operating in China increase. The addition of a stronger medical field force, the challenges of complying with increased requirements on pharmacovigilence and increased regulatory and administrative burdens are mandatory cost components that materially increase the cost of doing business in China.

Changing physician and patient dynamics

As the Chinese health care system in upper-tier markets matures, the needs and interests of its physicians have evolved correspondingly. Physicians are under substantial pressure to maximize their patient-facing time, provide better service to patients and play a larger role in controlling health care costs. As a result, demands on physicians' time have escalated, making doctors less willing to meet with sales reps, let alone grant reps the time to fully explain a product to them. Evidence of this is provided from a survey of physicians conducted jointly by Monitor Deloitte and Hao Yi Sheng (a leading online physician community) in 2012, which revealed a number of important trends in physician behavior in China's major cities. One of the most striking facts from this report is that 74% of physicians preferred not to interact with sales reps face to face (Figure 14).

Figure 14: Physician Attitude Towards Company Sales Reps

[26] Monitor Deloitte interviews and analysis.
[27] Monitor Deloitte interviews and analysis.

68%	Rank sales reps as least preferred information source
55%	Consider sales rep visits to be ineffective
74%	Prefer non face-to-face interaction with reps

Source: Joint Survey by Monitor Deloitte and HaoYiSheng.com, 2012

In fact, the survey indicated physicians felt that reps were the least trusted source of information about a pharmaceutical product. While details varied, the survey showed physicians are rapidly adopting emerging technologies such as mobile applications, discussion communities, real-time connections to their peer network and other channels as their most trusted and frequented sources of medical information. These changing dynamics limit a sales rep’s ability to increase overall brand performance and suggest the effectiveness of a more cross-functional approach to physician interactions.

Increasingly in China, patients are important stakeholders in the health care system, taking ownership and responsibility for much of their own care. As one leading executive noted, “We don’t actually understand the patients, what they want and how they flow through the system. This data is incredibly hard to come by with any accuracy, given the size and regional differences that exist in China.” Patients’ increasing role in treatment will require companies to adopt a more patient-focused approach, one that helps physicians understand and address a wide variety of patient needs (Figure 15).

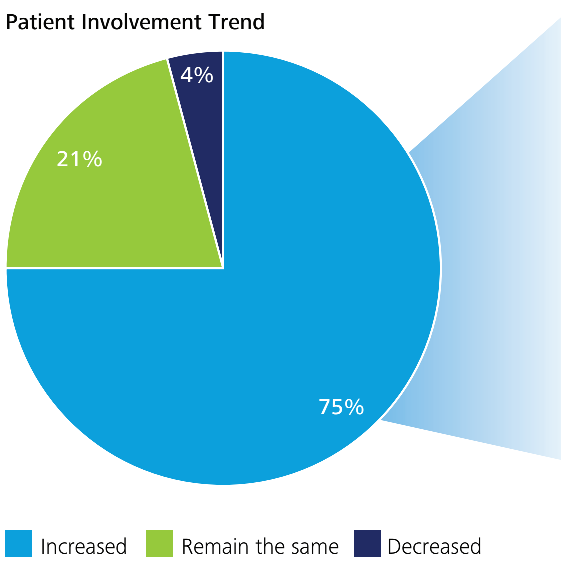
Changing dynamics in physician-sales rep interactions, as well as physician-patient interactions, limit the attractiveness of a customer model that relies on sales rep promotions targeted to physicians. The market demands a more balanced customer model, one providing on-demand information from a variety of sources.

Broadening of key stakeholders in the market

While most companies continue to focus primarily on

Figure 15: Trends and Reasons for Patient Involvement

Patient Involvement Trend



Why are Patients more Involved?

- **Better access to information**
  “Patients are becoming more knowledgeable through Internet use.” — Physician In Charge, Class III general hospital
- **Demand for better care**
  “Patients increasingly seek better care, as recognition of the importance of disease prevention rises.” — Physician In Charge, Class II general hospital
- **Rising medical disputes**
  “Physicians need to communicate more in the current environment, which is filled with physician-patient conflicts.” — Resident Physician, Class III general hospital

N = 1003

Source: Joint Survey by Monitor Deloitte and HaoYiSheng.com, 2012 physicians, the most successful companies recognize the growing importance of understanding the needs of, and engaging with, other stakeholders. Let's consider some of the key stakeholder dynamics that are emerging today:

- Key opinion leaders and medical societies are publishing guidelines that increasingly form the basis for new treatment protocols and drive adoption of best practices across providers
- Hospital administrators and hospital management committees will increasingly move final treatment authority away from physicians and towards management
- Private insurance companies are becoming more prevalent, representing yet another source of potential coverage for pharmaceutical companies
- Health officials have always been important, but the increasing focus on compliance and province-specific policy adjustments requires greater transparency and customized approach

The changing emphasis and power of different stakeholders in the treatment system drives the need for a more cross-functional, collaborative customer model that effectively targets all critical decision makers.

Designing a model for upper-tier markets

To continue growing in upper-tier markets, companies must reexamine their current customer model and make several fundamental changes. The most important of these are to:

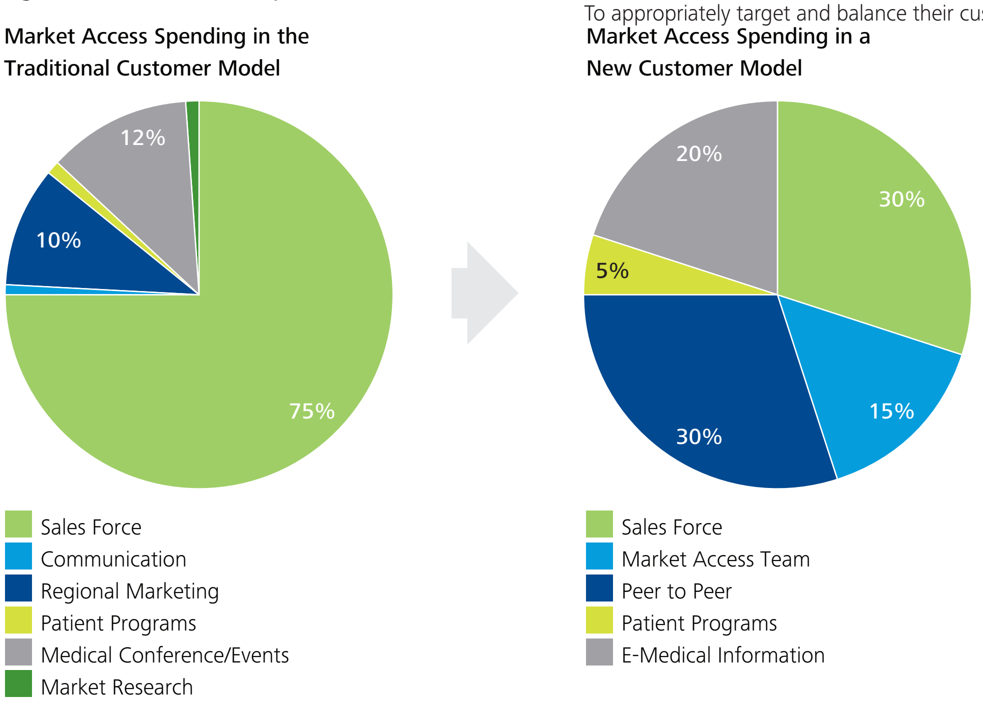
- Understand the system of care
- Provide unique value to individual stakeholders
- Use channels more effectively and consider partnerships to drive targeted, relevant dialogues
- Conduct rapid cycle pilots--and be prepared to fail quickly and often

The new customer model will move spending and activity away from the sales force toward a more cost effective approach reflecting the needs of different stakeholders. This approach reflects the relative importance of each stakeholder group within China's health care system (Figure 16).

Understand the system of care

To appropriately target and balance their customer models,

Figure 16: Illustration of Representative Scenarios of Traditional Customer Model and New Customer Model



companies must first have a comprehensive understanding of the system of care. While everyone acknowledges the importance of hospital administrators, patient societies and other market actors, few companies have made the effort to truly understand these stakeholders. Building a clear understanding of the different stakeholders, their interactions, decisions, needs and criteria will help companies be more effective in their resource allocation and message targeting.

For example, companies need a more thorough understanding of the economic choices facing individual hospitals as they make trade-off and volume-capping decisions. Most companies approach this issue by extolling the benefits of their product relative to its closest competitors. However, this approach does not reflect how trade-off decisions are made in an environment where hospitals are increasingly making trade-off decisions across multiple therapeutic areas and products. Developing a clear understanding of the hospital economics, trade-offs under consideration and the decision criteria can help companies be more targeted in their efforts to limit the impact of value caps.

More significant progress on customer models will require companies to establish a clear sense of how patients move through the health care system, and which stakeholders are capable of influencing specific decisions.

Use channels and consider partnerships to drive targeted, relevant dialogues

Most companies tap their sales force as the most dominant channel for communication, and interactions tend to be one-way, focused on broadcasting messages to the market. These interactions are not based on the needs of the physician or other stakeholders, but rather on where and when the company wants to interact with an individual.

As companies design a more effective customer model, creating more impactful two-way dialogues that engage customers where and when they want will be necessary to achieve long-term success. Companies should explore innovative new channels such as mobile applications, video sales calls, on-demand sales information and other approaches to deliver the most effective message to build these dialogues. Ensuring the channel used reflects the needs and desires of the individual stakeholder will ensure messages are appropriately delivered, while at the same time providing valuable information about the market and a company's competitive status through a more open dialogue. While these channels may act as supplementary

Figure 17: Providing unique value to individual stakeholders

Stakeholders have an increasingly broad set of decision-making criteria, needs and responsibilities. For each group, individual needs must be reflected in the materials and interactions that companies design. Examples of actions companies should consider taking include:

Physicians: Drive greater scientific dialogue in promotional materials, moving away from a dialogue that is primarily about the efficacy and safety of an individual therapy to the relative comparative benefits of the therapy.

Patients: While standard patient education programs will always be a necessary component of patient services, greater use of two-way digital technology, such as mobile applications, online tools and social media should be considered to boost engagement with patients.

Payers: Drive relevant dialogues for payers by proving clear, relevant, value-based information. In this instance, decisions will not be based on traditional measures like Quality Adjusted Life Year (QALY), Disability Adjusted Life Year (DALY) and Incremental Cost Effectiveness Ratio (ICER) but rather a more targeted dialogue about how an individual therapy creates benefits in the health care system.

approaches to companies' sales force for the foreseeable future, successful implementation may shortly replace the conventional customer model. Many pharmaceutical companies are therefore experimenting with partnerships to expand their presence in social networks and other digital platforms.

Conduct rapid cycle pilots and be prepared to fail quickly and often

Designing a new customer model will be a process of experimentation and continued change. It is highly improbable that companies will 'get it right' the first time. As such, it is crucial to build an internal program and the supporting momentum to rapidly pilot, test and evolve multiple models before a successful model can be implemented. The ability to rapidly prototype and test new models will be crucial to establishing a new customer model for the upper-tier markets.

Without risk there can be no reward

Changing the customer model will require bold and brave leadership from pharmaceutical companies. Senior leadership must become comfortable with redesigning a model that, although currently working, is rapidly losing its effectiveness. One key restraint on change is the widespread anticipation of EDL mandates — where the government is expected to further enforce price cuts and limit drug usage to certain levels among hospitals for selected major products. Driving this change will therefore require a higher degree of risk tolerance, greater comfort with failure and internal alignment on the importance of these initiatives. Taking these steps will allow companies to make substantial progress in successfully designing and implementing a new customer model that reflects the changing dynamics in upper-tier markets.

Companies that successfully navigate this transition can realize disproportionate rewards from the market as other companies, still using the old model, stagnate. Companies that design a new customer model can accrue an array of benefits:

- Return to profitability and growth as more targeted interactions drive greater uptake and reduced focus on sales force lowers overall cost base
- Greater engagement from the critical stakeholders in the market
- Strong insight about the market and faster response time to changes as dialogues shift from a one-way broadcast to a more balanced, two-way dialogue with key stakeholders
- Better decision making as internal decision processes are balanced across functions and account for the needs of all stakeholders in the market

Creating an effective customer model that reflects upper-tier cities' changing dynamics is one of the most pressing challenges facing pharmaceutical companies today. Getting the model right will allow some competitors to separate from the pack — as others continue to invest in a model that is rapidly losing relevance.

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