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Fortune Favors the Bold
Shifting to Private Health

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 can we participate in and anticipate the evolution of the private health care market?

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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Shifting to Private Health

China has committed to making private health care a larger part of its overall ecosystem, aiming for 20% of beds and 20% of spending to be conducted through private institutions by 2020. To achieve this ambitious goal, the government has laid out multiple policy initiatives aiming to relax historical constraints that have previously limited growth.

These changes unleashed a wave of growth in private health care that is only just beginning. State-owned Enterprises (SOEs), MNCs and private companies are looking to capitalize on the rapid growth in private health care. The speed at which this market will develop presents challenges to today's pharmaceutical business model — offering new channels and customers — but also creates new opportunities to partner with patient programs, outcomes data collection or other possibilities down the road.

Building the foundation for private care

China's private health care market expanded rapidly over the past several years, moving from a relatively insignificant part of the overall market to representing 8% of total care. Recently stated ambitions and continued pushes from the government should see continued expansion of private health care, both delivery and insurance, in the coming years.

A number of trends are shaping the future of the private care market including:

- An improving policy environment
- Greater patient demand
- Expanding private insurance offerings

An improving policy environment

In 2007, the NHFPC placed approximately 500 public hospitals on the market to encourage privatization and modernization of health care services. However, this initiative was not seen as a success due to very little interest from the private market (Figure 31).

In 2009, the government re-emphasized its commitment to private health and laid out several ambitious objectives — the most significant being increasing private delivery services from 11-20% by 2015[47]. The government supported these actions with further policy changes that address existing systematic issues and underscore its commitment to private health care (Figure 32).

Figure 31: Challenges in Privatizing Public Hospitals

Inflexible Legacy Hospital Policies	• Changes in human resource issues such as compensation, pensions and termination of under-performing physicians / staff were not allowed • Majority of the hospitals offered for privatization were unprofitable
Physician Immobility	• Experienced physicians preferred to stay with public hospitals for job security, cumulated pension and established career track and relationships • Physicians were legally tied to personnel systems of one particular public hospital
FDI Restrictions	• Mandated joint-ventures for the establishment of a foreign private health provider • Foreign ownership limited to 70%
Lack of BMI Transferability	• Eigibility of private providers for BMI coverage decided on a case-by-case basis • Administrative burden resulted in limited number of private applications for BMI coverage

[47] Zhao Y., China Daily, 20% of Hospital Beds to be Privately Funded by 2015, 2012.

Figure 32: Policy Changes to Support Private Care Investment

	Policy Change	Intended Impact
1	Offered profitable public hospitals for privatization	Increase incentives for investments in privatization
2	Removed 8% business tax on for-profit hospitals	Support profitability in establishing private health institutions
3	Abandoned 70% FDI limit	Attract foreign investors with experience to improve private health service quality
4	Allowed physicians to practice at multiple work places	Encourage senior physicians at public hospitals to practice at private institutions
5	Announced efforts to define standards for private hospitals' eligibility to accept public health insurance	Improve affordability of services at private institutions and simplify administrative burden for public insurance application

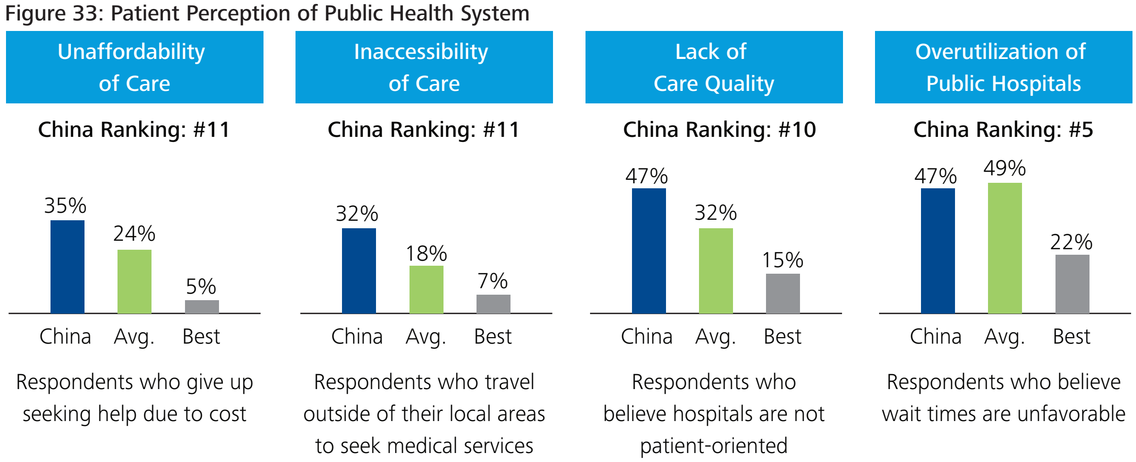
Greater patient demand

According to Deloitte's 2011 Survey of Health Care Consumers Global Report, only 21% of Chinese patients are satisfied with China's health care system's performance. Further, only 26% of patients rated their overall health as excellent, the lowest rating among the 12 countries surveyed. The survey found the primary issues contributing to the lack of enthusiasm for China's health care system are summarized in figure 33.

Some 31% of survey respondents believe privatization would improve the system's performance (2nd highest percentage among countries surveyed).

Frustration with public hospitals will likely persist as patient volume increases and infrastructure and delivery personnel struggle to keep up with rapidly rising demand. According to the NHFPC, China is already seeing a rapid rise in outpatient flow at private hospitals, which has increased

Figure 33: Patient Perception of Public Health System



Source: Deloitte Center for Health Solutions, 2011 Survey of Health Care Consumers Global Report, 2011 at a CAGR of more than 21% since 2010, compared to only 11% at public hospitals[48]. Patient frustration with the quality and availability of care in the public system will likely continue to drive growth in the private health care market.

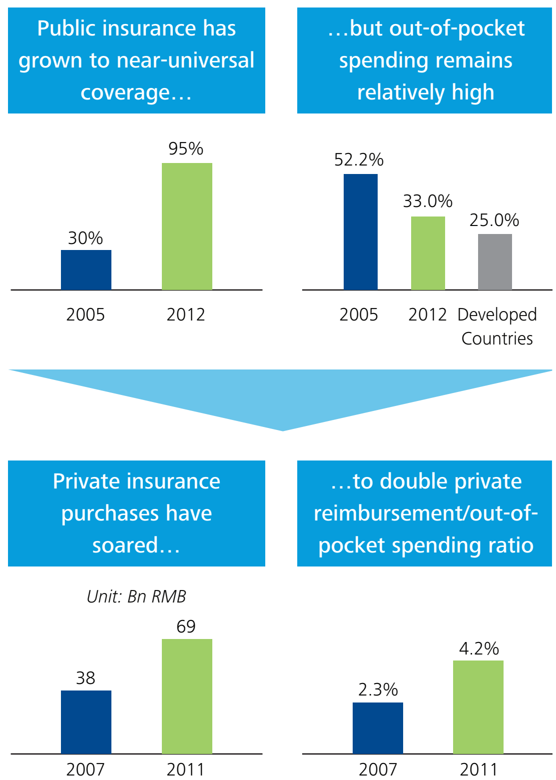
To understand where private health care can offer help, it is useful to know that a key focus of China's public hospital reform is to create a multi-tiered provision system in which basic health care needs are addressed mostly by public hospitals and Community Health Centers (CHC), while public hospital VIP sections and some mid-end private hospitals target specific needs from a mix of the general population and high-end private hospitals support affluent individuals. For each tier, private investment can play a role, either by collaborating with public hospitals or offering its own operations to serve patients' demand.

Expanding private insurance offerings

Public insurance coverage increased to 95% of the population between 2006 and 2012[49], the equivalent of 700 million new enrollments. This is impressive by any measure, but the actual level of insurance, and thus reimbursement, remains low (Figure 34). More than 27% of Chinese respondents in Deloitte's Global Health care Survey consider themselves under-insured, the highest percentage among surveyed countries. Previously, citizens filled this gap with a relatively high savings rate that helped provide coverage should medical expenses be incurred.

Private health insurance offerings have emerged to fill this gap, supplementing treatment coverage and providing targeted coverage for specific conditions. This has interested a variety of stakeholders, as illustrated by the partnership between pharmaceutical manufacturer Roche, state-owned insurance company PICC and private reinsurer Swiss Re to offer an oncology-specific insurance.

Figure 34: Inadequate BMI Reimbursement Has Led to Increasing Demand for Private Insurance



48 Ministry of Health, 2012 China Health Care Development Report, 2012.
49 Ministry of Health, China Health Care Industry Whitepaper, 2012.

Figure 35: Relationship Between Public and Private Health Insurance

Private insurance offerings have focused on providing supplemental coverage and services to patients

Supplemental	**More treatment options**	**Complex diseases**	**Flexible reimbursement rules**	**Convenient filing process**	**Reduced financial burden**
Private Health Insurance	Import & rehabilitation drugs; outpatient costs; examinations	Serious, chronic and rare diseases e.g., cancer, diabetes	Ranges depending on patients' needs	Single receipt or physician diagnosis to insurer	Prepaid or postpaid, depending on types
Fundamental	**Basic treatment options**	**Common diseases**	**Strict reimbursement rules**	**Complicated filing process**	**High financial burden**
Public Health Insurance	Basic Medical Care Insurance Medicine; inpatient costs	Common diseases e.g., influenza	A type reimbursed in total, B type 80%	Multiple receipts to company and health care center	Only postpaid available

Source: Company websites

Structure of the private health care system

Like the multi-tier provision system to be implemented in China, a multi-tiered system in health insurance is emerging.

The private insurance industry has grown at an 18% CAGR since 2007[50], and the number of provinces boasting insurance premium enrollment of over 1 billion RMB increased from 15 in 2007 to 26 by 2012[51]. Another trend within these numbers is the significant growth of high-end insurance products, providing patients with access to high-end private facilities or public VIPs. This, in turn, drives the growth of private health care provider investment.

Going forward, the majority of growth will likely come from a mix of government and corporate driven purchases, along with individuals seeking their own coverage. Going back to the multi-tiered framework, private health insurance is expected to grow in all three levels:

Fundamental: In recent months the NHFPC has encouraged local governments to improve coverage and operational efficiency of public insurance schemes by collaborating with commercial insurers, such as Taicang County in Jiangsu Province, which has done so with PICC. In addition to the collaboration model on critical illness insurance plans being implemented in most provinces, more collaboration on UEBMI, URBMI and NRCMS is being explored by multiple city governments and commercial insurers.

Supplemental: Supplemental commercial insurance has enjoyed strong growth in recent years and now represents 95% of the total private health insurance market. In the next 3-5 years, this segment is expected to grow steadily and become more integrated with BMI, with main buyers coming from employers looking to increase benefits for their employees.

High-end: Although insurers selling high-end products and MNC insurers looking to enter the market have struggled recently to grow their businesses, needs from the mass affluent population for better health care service at affordable cost have driven demand for high-end health insurance products. In the market place, insurers are diversifying their products to meet these needs (for example, newly emerged products offer coverage for patients visiting public hospital VIPs at an annual premium in the 50,000–70,000 RMB range). Coupled with improving consumer income levels, awareness and increasing trends of employer purchases, private insurance will continue to expand for the foreseeable future.

Growing a variety of provider types to deliver private care

Most of the growth in private hospitals has come from privatizing large public hospitals, but changing government regulations means increased growth in other segments including:

- Growth in private hospitals driven by private investors
- Specialty hospital chains emerging as a viable business model
- Domestic and foreign players driving expansion of high-end clinics
- Emergence of elderly care facilities
- Increased focus on health management

[50] China Insurance Regulatory Commission.
[51] China Insurance Regulatory Commission.

Figure 36: Evolution of Hospital Privatization

	1997-2001: Development Phase	2001-2006: Continued Growth	2006-2009: Dormant Period	2009-Today: Reactivated Growth
Market Environment	• Encouragement of private funding and development of private hospitals	• China's WTO entry permitted foreign investment and direct competition with public hospitals	• Introduction of strict policies in attempt to standardize and control quality of health care	• Loosened restrictions on investments and a move towards equal treatment of public and private hospitals
Privatization Activities	• Boying Pharma and Phoenix Healthcare Group engaged in management of Class II hospitals	• A number of Class II and III hospital acquisitions led by Phoenix and Central America	• No significant activities	• Variety of investors including equity funds, insurance companies and foreign health care groups

Source: Monitor Deloitte analysis

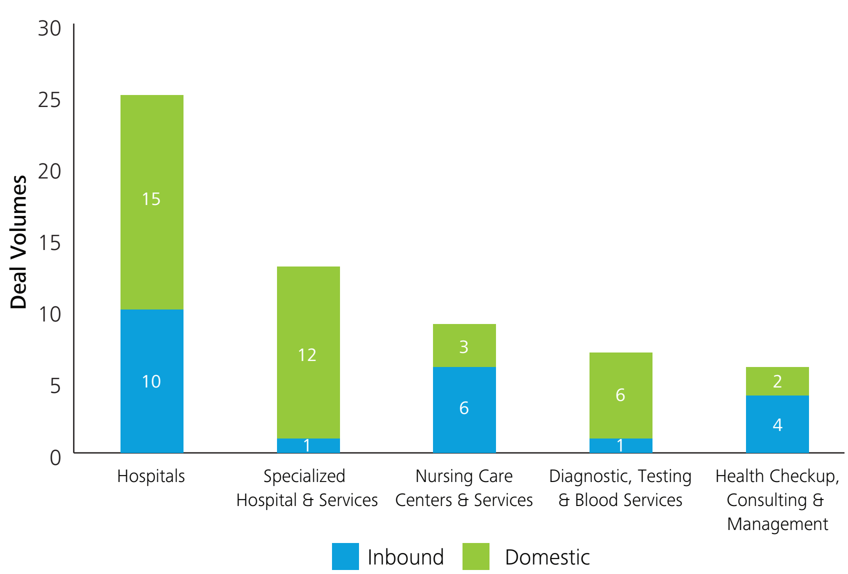
Growth in private hospitals driven by private investors

Hospital privatization activities have seen a resurgence post-2010, emerging from a dormant period between 2006 and 2009, driven primarily by changes in the policy environment. Significant private capital has been invested from both domestic and foreign investors following retraction of the 70% maximum ownership constraint for foreign companies investing in private health care institutions. As an example, Asia Pacific Medical Group recently acquired two public hospitals — Hengshanhong Obstetrics & Gynecology Hospital in Shanghai, and another public hospital in Beijing[52]. China Resources also recently purchased five hospitals in Henan Province. Most private capital is seeking opportunities to invest in specialty clinics because profitability dynamics with China's general hospitals are currently challenging.

Most investors are not seeking majority stakes in hospitals (Figure 37), but rather smaller proportions of assets. Partial acquisitions have been common because they provide an ability to influence hospital operations while limiting financial and political risk. Future growth in privatization will likely continue in this vein, despite an increasing prevalence of whole asset purchases.

With large private investors acquiring multiple hospitals, a hub-spoke model among private facilities will likely appear. This innovative model helps reduce cost and maintain high quality, while mitigating the risk of lacking sufficient medical resources.

Figure 37: Private M&A Investment Volumes into Chinese Hospitals & Health Institutions (Q1 2003 – Q1 2012)



[52] Zhong KF, People.com.cn, "US Capital Taking Two Public Hospitals under Reform.

Another model being explored by investors is a "hospital management approach." Under this model a private company would operate the hospital, but would not own the underlying assets (e.g., land, facilities, equipment), all of which would, in essence, be rented from the government or another private party. While not yet a common model, it could generate substantial future growth, particularly for companies looking to operate general hospitals. Shanghai International Medical Center (SIMC), with selected resources from 12 SIMC affiliated hospitals, operated by Pathway Health, is one such example.

To date, little activity has been seen in constructing private care facilities from scratch. Nearly all activity has involved privatizing existing hospital facilities. Moving forward, the available stock of high-quality hospitals suitable for privatization should rapidly dwindle, forcing companies interested in driving private care delivery to construct new facilities. In the next 2 to 3 years most companies looking to expand their private care footprint likely will design and build facilities from scratch.

Specialty hospital chains are emerging as a viable business model

Specialized hospital chains have seen significant growth in recent years, growing at a CAGR of 18% since 2006[53]. This growth is especially apparent in popular therapeutic areas such as obstetrics & gynecology (42% CAGR), cosmetic surgery (25%), dermatology (17%) and ophthalmology (15%). This space is dominated by domestic players, due to early entrance, the hospitals' smaller size / investment requirement, ease of scalability and higher reliance on medical equipment versus physicians. These factors should further the segment's growth in the future. The first Chinese medical services institution listed on the Shenzhen Exchange, Aeir Eye Hospital, is one example illustrating the potential of creating branded, chain-based operations to serve a highly specialized segment of the market.

Case Study:
Aier Eye Hospital Group

Aier Eye Hospital (Aier) holds the leading position in China's ophthalmology market, having grown its chain of eye hospitals from 10 locations in 2005 to as many as 36 across 21 provinces. The company operates with a "Three Tier Linkage" business model[54] — in which its higher-tiered hospitals provide relatively more comprehensive patient services and technical support for lower-tiered hospitals, which are generally located within regional urban centers. Aier replicates this model across cities in its nationwide expansion. The group's resource sharing scheme supports overall cost reduction while improving management efficiency.

The rise of such chains is expected to continue as diseases like cancer, diabetes and cardiovascular conditions become more common and the public demands a higher standard of care than the public system may be able to provide.

Research & technology center, and consult patients with rare and difficult condition

Located in provincial-capital cities, positioned to carry out comprehensive ophthalmic services and provides technical support to Tier 3 operations

Located in prefecture-level cities, focus on common eye disease treatment, and refers patients with special conditions to Tier 2 operations

[53] Bank of China, Prospects of Health Care Services of an Urbanized Society, 2012.
[54] Company website.

Domestic and foreign players driving expansion of high-end clinics

While most care is delivered in over-crowded facilities, such as large Class III hospitals or smaller clinics with less-experienced physicians, high-end clinics are expanding to serve wealthy Chinese and expatriates. High-end clinics offer an attractive opportunity given their premium price point, low capital investment and relative ease of operations. Due to their target client base, many clinics can charge service fees as high as 40 to 80 times that of public hospitals[55].

Growth in these clinics has primarily been generated by foreign companies, which make up 90% of the 29 high-end brands in China[56]. Expansion has been driven both through growth of existing clinics and the appearance of new market players. For instance, ParkwayHealth has expanded operations by increasing its capacity through staff additions and acquiring Shanghai Ruixin Hospital Group (previously known as WorldLink). Raffles Medical Group, from Singapore, opened its first clinic in Shanghai in 2010, providing a comprehensive range of services ranging from general medical and dental services to health screening[57].

Signs hint that the dominance of foreign companies will end as domestic operators begin to focus on this space and foreign and domestic players begin to partner with each other to expand services. One example of this changing dynamic is Fosun Group's partnership with TPG Capital to purchase Chindex, owner of United Family Healthcare which operates high-end hospitals in China's top-tier cities[58].

The high-end clinic market will likely remain highly fragmented as investors look to build their own brands and take advantage of the segment's high margins. Continued innovation in pricing, service offerings and operational models can be expected as competition in this space accelerates.

Emergence of elderly care facilities

Elder care institutions represent one of the single largest opportunities in China's private health care market. International and domestic companies are beginning to enter the market to offer high-end home care and assisted living services.

Several foreign companies recently entered the market to provide high-end health care services for seniors, including:

- Singapore-controlled Pinetree Senior Care Services, founded in 2009 and currently offering home care service to over 20,000 seniors
- Sweden-based home care provider Econ-SCA Health Management Co Ltd entered in 2011 to provide high-end senior services across China
- U.S. company, Emeritus Senior Living, entered in 2011 to build high-end facilities for seniors in Shanghai

Growth in private senior care services will continue given recent policy focus and high demand. In 2011, the NHFPC issued new rules to encourage establishment, and improve the quality, of private nursing homes and assisted living. These policy changes have come in the form of mandatory facility upgrades, tax-break incentives, government subsidies and loosened FDI constraints, and have cascaded down to the provincial levels. The Beijing municipal government and Shanghai authorities both announced plans and specific targets for adding nursing homes and adult day-care centers[59].

Although the senior care sector today is relatively small and focused on the high-income segment, we expect it to grow rapidly and gradually expand to provide care for middle-income patients.

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55 Company website.
56 Monitor Deloitte analysis.
57 Company website.
58 Bloomberg, Fosun-TPG Agrees to Buy Chindex With Sweentened Bid, 2014.
59 Wang Hongyi, China Daily, China seeks measures to aid elderly population, 2012.

Increased focus on health management

Health management, broadly defined as providing proactive care services to both healthy population and patients not under acute care, has gained tremendous attention over the last two years both from the government and private investors. Companies have invested heavily in expanding facilities and establishing networks, mostly in the form of health check-up centers. iKang Healthcare Group, backed by Goldman Sachs and GIC, listed on the NASDAQ in April, aiming to expand beyond its 45 preventative healthcare centers throughout China. IKang's rival, Ciming Health Checkup Management Group, has been eyeing an IPO on the Shenzhen Stock Exchange.

With increased consumer awareness and employers' need to retain talent by offering better benefits, this market will grow. However, aside from offering health check-ups, an innovative operational model has yet to emerge to really integrate health data with clinical information, enabling transformation in the health care ecosystem.

Despite positive momentum, challenges remain

Given all the developments in government policy, patients, private health insurance and private providers, private health care will remain a growing and attractive market. Nevertheless, to sustain growth over the long-term, several key challenges must be addressed (Figure 38).

Figure 38: Ongoing Challenges in the Private Health Care Market

Policy Effectiveness	Effective policy changes and execution will need to continue to encourage and balance the growth in both private and public care quality without one overshadowing the other
Patient Flow and Access	Private care affordability and accessibility as well as continued dissatisfaction in public hospitals will determine the level of increase in private patient flow and spending
Data Availability	Current lack of epidemiology and cost data remain the biggest obstacle for private insurers to build effective pricing models and insurance packages to increase affordability
Physician Mobility	Public and private policies will need to appropriately address physician needs and concerns in order to improve physician and overall treatment quality at private institutions
Overall Profitability	Overall profitability needs to be attractive to domestic and international private funds, providers and insurers to encourage additional investment

These issues remain the largest barriers to continued expansion of the private care market. Without effective solutions, stakeholders for any one of these challenges could effectively derail growth of the private care market.

Some negative market signs have emerged, including expanded social insurance coverage levels that are shrinking the supplemental insurance market, low patient flow at some premium clinics and generally low return on investment and long payback period. The market is still immature, lacking protocol or processes to follow; hence, investors are taking careful steps in assessing and entering the market.

Potential considerations for pharmaceutical firms

Explore unique partnerships

Partnering effectively with private health care providers can provide unique opportunities to pilot physician or patient care programs, or to gather outcomes data about products or services.

Assess sales channels

While private health care service remains a small part of the overall health care market, it is growing quickly. Many patients are affluent and can afford western medicine and care. Ensure your sales force and distribution channels are set up to serve the new private clinics, hospitals and elder care facilities.

Think beyond product sales

Private providers offer unique opportunities to gather real-life outcomes data, gain practical experience in treating Chinese patients and create new revenue and service opportunities.

Consider organic entry

China does not prevent pharmaceutical firms entering health care provision. Opening diabetes clinics, oncology centers or health check-ups could be a lucrative revenue source.

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