



# INTERCHINA INSIGHT

## Responding To Challenges In The Chinese Healthcare Market

### Part I: Volume Based Procurement

[This is the first in a three-part series]

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The Chinese healthcare sector was once extremely attractive to multinationals who were able to sell their patented drugs and medical devices to a captive Chinese market. But those days have gone as China sets out on a long-term plan to tackle spiralling healthcare costs and make the sector more efficient.

Not only has the unit cost of drugs and medical devices risen sharply – with the result that every patient in the country is costing the government more and more - but at the same time demand for these products is soaring as consumers reap the benefits of having access to innovative new drugs and medical devices.

These challenges have also been brought into sharper focus by the impact of zero Covid too, which has put huge budgetary pressures on regional health authorities and hospitals, and has made the efficiency drive even more essential.

In this series of three articles, we will look at the specific ways in which the government has tackled this huge issue and what multinationals now need to be doing in response. We begin our series with a look at the huge impact of the Volume Based Procurement (VBP) policy.

## VBP Success

The government's efficiency drive in healthcare centers on a number of specific policy measures around procurement which have, taken together, profoundly impacted the margins of multinationals operating in China.

The dramatic reduction in medical costs that has since been witnessed across a broad swathe of treatment areas has impacted the whole industry, from manufacturers (both home-grown and multinationals) through to distributors, retail pharmacies and hospitals themselves.

At the heart of this affordability drive is the VBP scheme which was first rolled out by the Chinese government a few years ago in order to specifically reduce its reliance on expensive, off-patented drugs. Specifically, the government has been targeting those drug categories with strong local players and, crucially, has been benchmarking the price of these drugs in China compared with prices abroad.

### *Expensive*

The government found that the Chinese market remains very expensive, and has therefore been using this data to help inform its pricing decisions around new contracts with local suppliers. The result has been a significant fall in prices.

Importantly, to ensure that quality and patient safety is always maintained, the government also conducts a test (known as the Generic Confirmation Evaluation) to ensure that the chemistry behind the local product and the off-patent multinational drug is exactly the same before proceeding with VBP for that drug.

Looking ahead, given that regional health authorities now have considerable experience in terms of the planning and implementation of VBP, these authorities are now keen to roll out the policy further. As such a number of other drugs are now being targeted for VBP, especially those which consume a lot of healthcare budgets and where the most savings can be made.

### *Rising retail channel*

Most drugs are currently consumed in public hospitals, but one of the wider impacts of the success of VBP is that the retail channel is likely to become much more important in the future.

Due to recent changes to the reimbursement system for pharmacies, the price of VBP drugs is now broadly the same in pharmacies as it is in hospitals because the government is essentially reimbursing the price of VBP drugs. So, patients have a choice in terms of how they want to access drugs.

In the past multinationals focused heavily on the hospital sector but now they can engage with pharmacy chains too. Although at the moment the share of VBP drugs purchased through retail pharmacies remains small, we expect it to grow quickly as both more drugs are considered for VBP and more provinces include VBP drugs in retail pharmacies.

**VBP in medical devices**

Significantly the VBP model is now being implemented – albeit more slowly - into the medical devices sector.

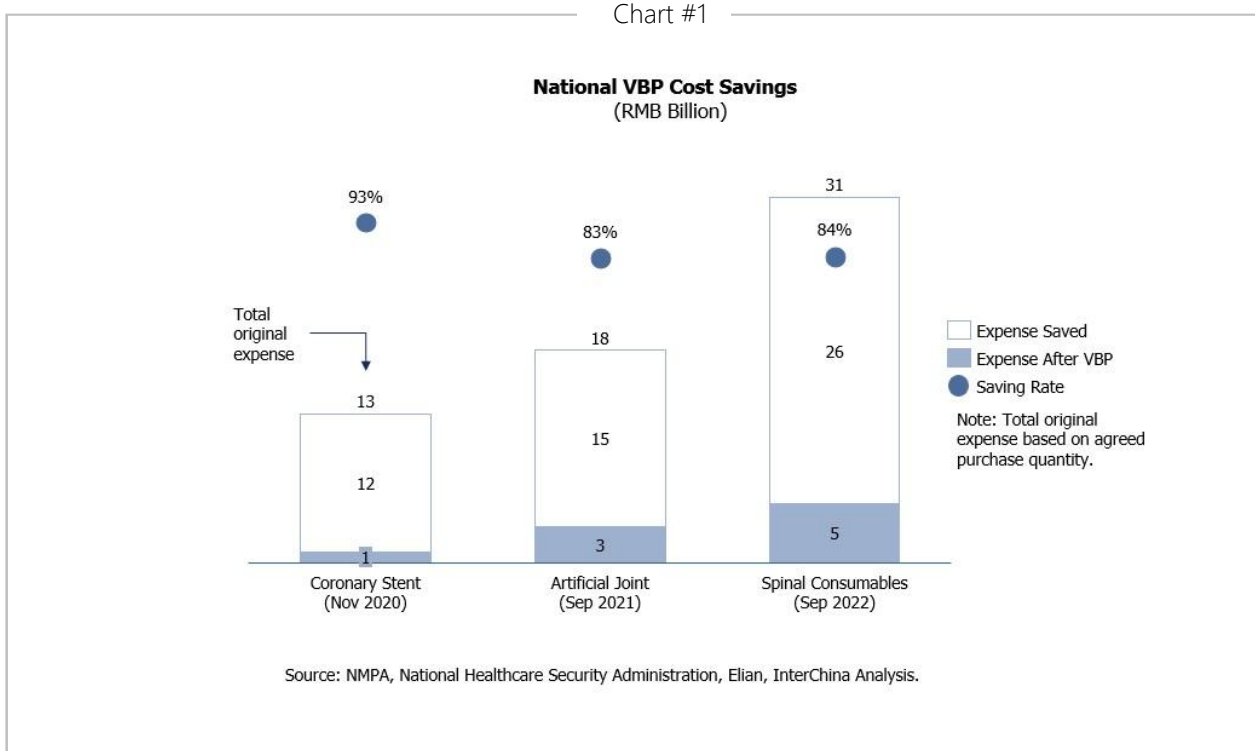
VBP in medical devices has started with three specific devices – coronary stents, artificial joints, and spinal implants. These have been specifically chosen because

they are markets where there is already a high degree of local competition and the Chinese market is already mature and fairly commoditised. As the chart below shows, the government is now sourcing these devices from local companies at far lower prices.

However, rolling out VBP further across other medical devices is challenging. As mentioned above, drugs can be subjected to a ‘consistency evaluation’ which is much harder to apply to medical devices because each type of medical device has different components, materials and techniques, so they are hard to compare. Each regional VBP for specific medical devices may also have different classification criteria so it’s hard for the national VBP to group devices together.

This actually creates an opportunity for both local players and multinationals to influence the future criteria for VBP in medical devices as the government is seeking advice on these issues from medical devices companies. This is exactly what happened with spinal implants, where the original rules about classification and material selection changed following advice from companies.

Chart #1



## How multinationals should respond

### Constant focus on innovation

In the face of fierce product competition and the compression of profit margins under VBP, multinationals must continue to focus on the development of innovative drugs and medical devices. To compensate for loss in sales due to VBP, or lower margins with VBP products, companies will need to bolster their investment in new product development and commercialisation. Given that the most innovative medical devices are currently not included in VBP gives even more urgency to this strategy.

As our chart below illustrates, traditional supply chain models are also being upended by VBP. Sourcing is moving from imported products to local products, while the reduction in imports also greatly reduces the power of distributors whose role is now more confined to logistics. The increasing role of pharmacies as a DTP (Direct to Patient) supplier is also having a major impact on supply chains.

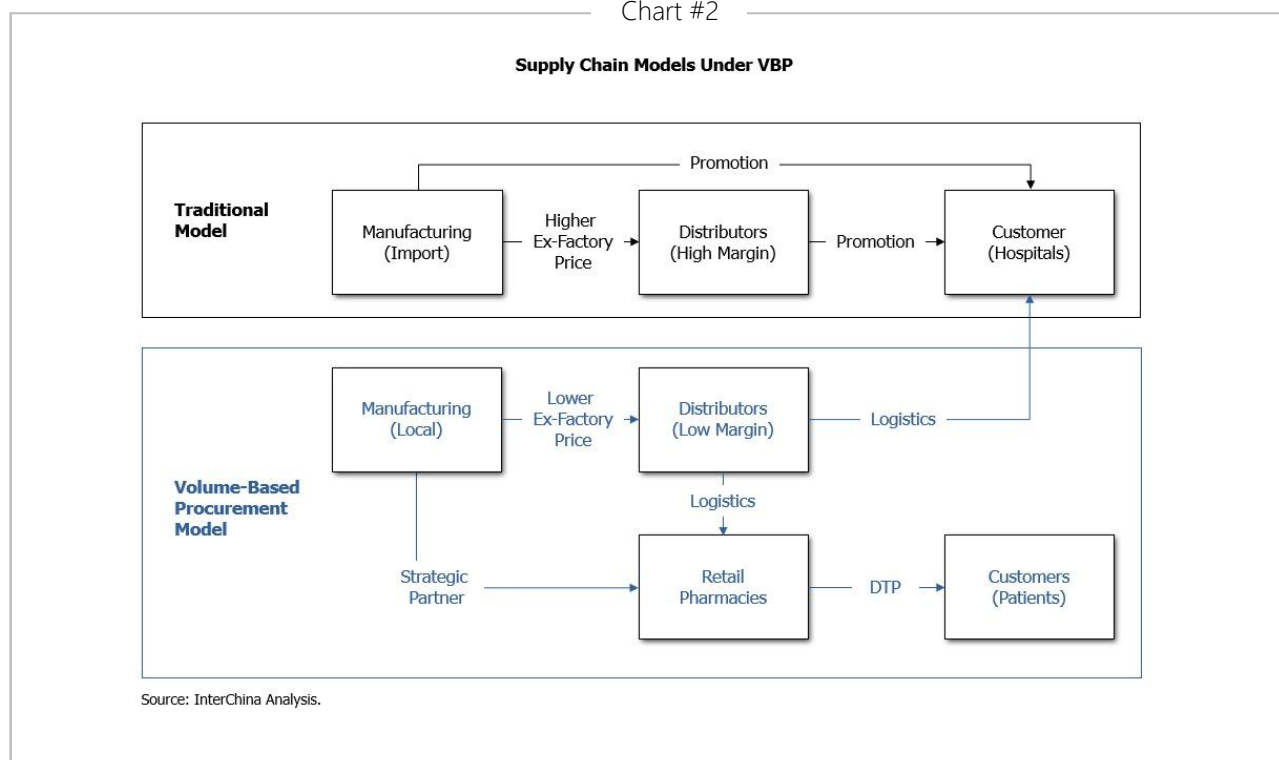
### Options

In this framework multinationals have two broad options. Firstly, they can go down the route of local manufacturing which can either be achieved through own production, or through acquiring local production facilities in order to speed up the process.

Alternatively, they can start supplying direct to retail pharmacies, becoming the strategic partner that sits between local manufacturing and retail pharmacies. In this scenario multinationals need to adopt a proactive stance, negotiating with large retail chain pharmacies to put VBP products in all stores, while also supporting DTP activities.

With VBP drugs it is worth noting that there will be more patient flow and engagement with retail pharmacies, so also increasing the scope for more cross selling of other products.

Chart #2



## Next time

The direction of travel regards local sourcing is now very clear in China. Next time we take a closer look at local product preference procurement policies, and specifically at the choices that multinationals now face in terms of how they source and manufacture drugs and medical devices, and the extent to which they need to consider M&A activity to achieve their goals.

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Rick Woo is a Principal in InterChina's Strategy Practice. He has over 20 years experience in pharmaceutical and medical devices sales in China and APAC, as well as rich strategic project management experience in Pharmaceuticals & Medical Devices sector.

## About InterChina

InterChina is a leading strategy and corporate finance boutique specialized in China. Healthcare is one of our core sectors of expertise with consultants and advisors dedicated to the space. Our multinational and Chinese clients choose to work with us because we provide real understanding, deliver practical results, and know how to get things done. We are a partner led firm and distinguish ourselves by the deep level of engagement partners have in client engagements.



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