

Opportunities for Action in Health Care

China's Growing Drug Market: Will You Be a Contender?

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China's Growing Drug Market: Will You Be a Contender?

Even though China's 1.25 billion people represent significant untapped opportunity, most global drug companies don't consider the nation a priority. That's because few of the multinational firms that have operated there since the 1980s have yet realized the country's immense potential as a drug market. Frustrated by China's complex regulations and distribution networks, its seemingly unenforceable intellectual-property laws, and its comparatively low expenditures on health care, foreign players foresee minimal near-term success in China. They have responded by investing cautiously in the market—many overly so. Most important, these players have withheld their most innovative drugs from the market, fearing that China's traditionally weak patent protection would expose breakthrough drugs to copycat versions and price erosion.

Despite the challenges, however, analysis by The Boston Consulting Group indicates that China is fast becoming a major opportunity that can't be ignored. Indeed, by 2010 we expect the country to emerge as the fifth-largest pharmaceutical market in the world, with revenues of over \$24 billion—more than triple its current size.¹ (See the exhibit “China Will Become the Fifth-Largest Pharmaceutical Market.”) Such growth would catapult China's market, which currently ranks seventh behind the markets of Italy and the United Kingdom, to a position right behind the drug markets of France and Germany. Driving this growth are China's ongoing economic development

1. All market sizes are calculated in nominal local currency at 2001 exchange rates.

China Will Become the Fifth-Largest Pharmaceutical Market

Estimated Market Size for Ethical and OTC Drugs (U.S.\$billions)

1996 Top 11		2000 Top 10		2005 Top 10		2010 Top 10	
United States	91	United States	150	United States	262	United States	466
Japan	52	Japan	58	Japan	65	Japan	81
Germany	20	Germany	17	Germany	24	Germany	37
France	18	France	17	France	21	France	28
Italy	10	United Kingdom	11	United Kingdom	16	China	24
Brazil	8.4	Italy	11	Italy	15	United Kingdom	24
United Kingdom	8.2	China	6.8	China	14	Italy	23
Spain	6.0	Brazil	6.7	Brazil	10	Canada	17
South Korea	4.5	Canada	6.3	Canada	10	Spain	16
Canada	4.3	Spain	6.2	Spain	9.8	Brazil	15
China	4.3						

SOURCE: BCG analysis.

and its recent entry into the World Trade Organization (WTO).

The most promising opportunities will emerge in the areas of greatest unmet need: innovative ethical, or prescription, drugs and differentiated over-the-counter (OTC) products. The market for ethical drugs in China, valued at \$5.8 billion in 2000, will climb to approximately \$19 billion by 2010. Innovative drugs will fare particularly well, commanding 30 percent of revenues and, more important, about 70 percent of the profit generated in the ethical category. The OTC market, practically nonexistent today as defined by Western standards, will grow at a compound annual rate of 19 percent, from about \$1 billion in 2000 to about \$5.7 billion in 2010.

Best positioned to fill these needs are multinational companies (MNCs), which possess superior R&D capabilities as well as scale and experience in marketing, distribution, and sales. But if they are to become major players in China, MNCs must move forward more aggressively as changing regulations and economics open the window of opportunity. That means better anticipating the needs of the market as it evolves in order to build true local capabilities as well as relationships with regulators and distributors.

The Transformation in China

Several powerful forces will converge over the next decade to transform China's competitive landscape. First, China is a rapidly developing nation with a rising gross domestic product. As the country and its economy modernize, demand for advanced health care will increase, and with it health-care expenditures. The population will move beyond the basic anti-infective treatments common in China today to embrace drugs that will improve the quality of their lives. This latter category includes medicines that address chronic conditions that are widely treated in already developed nations.

Second, although China's rural areas will remain less developed, pockets of wealth are already emerging in urban areas such as the Shanghai Delta and the Beijing–Tianjin and Guangdong–Pearl River Delta regions. Increased affluence in these areas will usher in increased demand for—and ability to pay for—world-class ethical and OTC drugs. In fact, this trend is already taking shape, as evidenced by the success of Heptodin, a treatment for hepatitis B. Although not currently covered by the state, Heptodin has become a top-selling drug in China, largely because patients demand it and are willing to pay for it.

Third, China's entry into the WTO in December 2001 promises to bring the country's regulations and distribution networks in line with world-class standards over the next five years. Among its most important changes in the pharmaceutical arena, the WTO agreement specifies that China will do the following:

Enhance its protection of intellectual property rights (IPRs). China is now obligated to enforce foreign and international patents in accordance with the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) of 1995, the most comprehensive multilateral agreement on IPRs. TRIPS mandates that drugs receive at least 20 years of patent protection.

Reduce import tariffs on pharmaceuticals. Within three years of joining the WTO, China will reduce tariffs on imported pharmaceuticals from, on average, today's 9.6 percent to 4.2 percent.

Increase foreign participation in the drug distribution industry. China has already opened pharmaceutical retail in Beijing and Shanghai to foreign companies. Within three years, the nation's retail and wholesale markets will open entirely.

Comply fully with global regulatory standards. As a WTO member, China must guarantee efficiency and quality when licensing drug companies and approving or denying drugs. In addition, the WTO requires transparency from regulatory agencies; this will ensure that companies have information about regulatory decisions that affect drug pricing and availability.

Significant changes will sweep China in the wake of its entry into the WTO, thereby providing foreign players with new opportunities in health care. We focus here on the largest of the opportunities: branded ethical drugs and OTC products.

Delivering Innovative Ethical Drugs: From Me-Too to Breakthrough

In China today, the pharmaceutical market is awash in me-too drugs, with almost all of the approximately 6,000 local manufacturers producing primarily generics and competing almost entirely on price. Three factors drive this glut of undifferentiated drugs:

- The Chinese government has concentrated initially on basic medical needs, such as anti-infective products.
- In doing so, it has focused the state-owned local industry on generics and hasn't been particularly effective in preventing local manufacturers from infringing on foreign drug patents.
- At least historically, new drugs in China have been quickly copied and their price points eroded by the resulting generics. Thus, MNCs in China have found it difficult to justify the investments required to bring new, innovative drugs to market.

In this environment, where as many as 40 knockoffs may compete illegally with a patent-protected drug, enforcing the provisions of TRIPS will naturally take time. Nonetheless, we expect that within five years, significantly enhanced intellectual-property protection and reduced import tariffs will give MNCs a greater incentive to introduce breakthrough drugs that address illnesses that otherwise go untreated—or are treated inadequately by existing or generic drugs. In fact, we have found that executives at MNCs are increasingly foreseeing a future for innovative drugs in China. More than two-thirds of the 35 senior executives BCG surveyed at multinational pharmaceutical companies said that they expect the WTO agreement to strengthen IPR protection.

The shift to breakthrough drugs will be further fueled by the enormity of the opportunity: the unmet need for sophisticated drugs is vast in China, and the potential payoff is significant. China is, after all, a nation where 100 million to 150 million people carry the hepatitis-B virus and where neck and head cancers are more prevalent than anywhere else in the world. China also has its share of patients with chronic conditions routinely treated in the West, such as high blood pressure, high cholesterol, diabetes, depression, osteoporosis, and arthritis. In addition, AIDS is just beginning to be acknowledged in China, and demand is emerging for the pharmaceuticals used to treat the disease and its related complications.

Differentiating OTC Products for Consumers

Like branded ethical drugs, OTC medications are significantly underrepresented and often misunderstood among the Chinese today. That's because OTC drugs tend to be dispensed and reimbursed as prescription medications, are not widely available for purchase, and are not marketed. Many Chinese also have a strong attachment to traditional home remedies.

As the country phases out government reimbursement for OTC drugs, however, consumers across the nation are likely to behave as we have already seen in China's more affluent areas—where a willingness to self-medicate with home remedies translates quickly into demand for Western OTC drugs. In addition, as Chinese authorities encourage growth in the retail pharmacy arena and open it to foreign players, consumers will gain an outlet (which they currently lack) for selecting and purchasing OTC drugs on their own—further accelerating the development of the OTC market. In this transformed environment, the

key to succeeding in the OTC sector will be a company's ability to market directly to the consumer.

To date, the prohibitive cost of establishing a strong OTC brand with consumers—exacerbated by the lack of clarity in OTC regulations as well as a general lack of marketing expertise in China—has deterred most drug companies from aggressively pursuing the OTC sector. There are, of course, some notable exceptions, such as Harbin Pharmaceutical Group, Xian-Janssen, and Tianjin Smith Kline & French. Eventually, however, we expect that on the heels of China's entry into the WTO, a handful of large, international players will emerge to lead this segment. Today that space remains open and up for grabs.

Positioning for Competitive Advantage in China

In an increasingly competitive and global business environment, multinational pharmaceutical companies cannot afford to ignore the real opportunities imminent in China. To stake out a position in this frontier market, MNCs must pursue two goals simultaneously:

Assemble and prioritize a portfolio of patented and OTC products tailored uniquely to the Chinese market. The first step is to review your existing global portfolio of drugs. Your company may be able to meet the needs of the Chinese market simply by tweaking its current product offering. You may, however, need to make a more significant investment in overhauling the portfolio, either by accelerating well-suited products still in the late stages of development or by *inlicensing* promising drugs from other players.

The best drugs for China will be those in therapeutic areas likely to experience the highest growth, includ-

ing medicines for chronic diseases already treated in the developed world. Following this logic, your company might want to focus resources in the cardiovascular, central-nervous-system, and endocrine areas, addressing conditions such as heart disease, depression, and diabetes.

Once the right mix of products has been identified, corporate and local resources should coordinate closely to begin securing Chinese regulatory approval for these offerings—a process that could take as long as 48 months. Because we believe that the window for enhanced IPR protection in China will begin to open in about 18 to 24 months, it is critical that MNCs initiate this step immediately so they can best exploit the impending opportunities.

Focus the head of Chinese operations on assessing and sharpening local capabilities in the sales, marketing, and distribution of ethical and OTC products.

Your marketing capabilities in particular will become more critical as self-pay patients and commercial insurers become more common. Of course, you should keep in mind that when it comes to consumer marketing, the superpowers in consumer products—Procter & Gamble, for example—may currently exceed pharmaceutical companies in scale and skill. But MNCs in the drug industry needn't cede this space automatically. Certain drug players, for example, may determine that they themselves possess superior skills that they can enhance for greater advantage. For instance, companies such as GlaxoSmithKline and Johnson & Johnson could further exploit their current strengths in marketing to consumers in China.

Other companies, concluding that they lack the capabilities required to succeed in China, can buy or borrow them. Some may gain the needed skills through acquisition, a strategy that is already being used fre-

quently as consolidation ripples through the industry. Still other players may borrow the capabilities of others by opting to license their most promising products to companies that already demonstrate marketing prowess in China. Note, however, that another alternative—building the required capabilities from scratch—will likely prove to be prohibitively expensive and take too long.

Ultimately, to accomplish *both* goals—improving the portfolio of drugs and developing marketing and other capabilities—MNCs must build critical mass in human resources, supporting their Chinese operations with world-class regulatory specialists and marketers. Future contenders will need to staff up now to gain scientific and marketing expertise in all the therapeutic areas critical to China, including those that may not even be recognized there yet. Consider, for example, that although cholesterol and obesity are not yet prevalent among the Chinese, as the economy changes, diet and health trends will also change—and so, too, will treatment needs. Companies seeking to stake a claim in China will also need to hire more systematically and train more intensively the human resources they deploy “on the ground.” Relying solely on a handful of Western expatriates or less-expensive and less-experienced locals will expose a foreign company to the high risk that its few key experts could be lured away.

Because none of these tasks will be easy, MNCs will also need to engage their corporate and local leadership in an ongoing dialogue about which expectations can be realistically achieved—and when. Previously, without such alignment, many corporate leaders entered China overly enthusiastic about the near-term potential. Once disappointed, many have since become too conservative about investing in the mar-

ket. In contrast, by understanding local realities, MNCs will view China more accurately: as a burgeoning opportunity that will take a few years—and some investment—before it blossoms fully.

Over the next decade, as the pharmaceutical market in China continues to evolve, drug regulations will become clearer, enforcement of IPRs more stringent, distribution systems more efficient, and the country's medical needs more advanced. In concert, these factors will no doubt sweeten the attraction of China for drug companies and heighten the competition there. But most important, they will also level the very playing field on which the competition plays out—making victory more likely for foreign drug companies.

John Wong
Xudong Yin

John Wong is a senior vice president and director in the Hong Kong office of The Boston Consulting Group. Xudong Yin is a manager in the firm's Shanghai office.

You may contact the authors by e-mail at:

wong.john@bcg.com

yin.xudong@bcg.com

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