

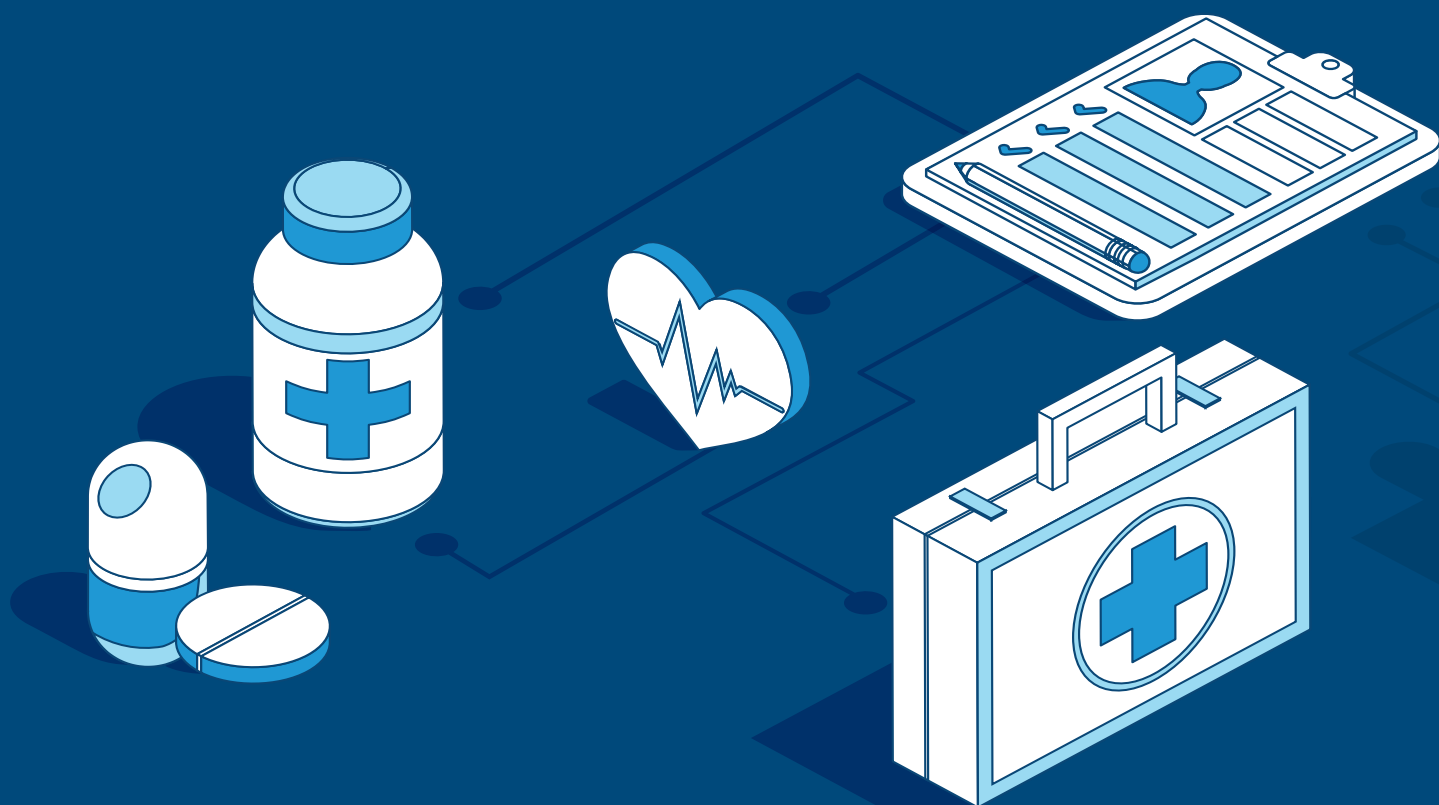


How pharma companies can
address the retail market
transformations in China



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I. Overview	3
II. Status and challenges	4
III. Four transformations	7
IV. Conclusion	12
Endnotes	13
About the authors	14
Contacts	14

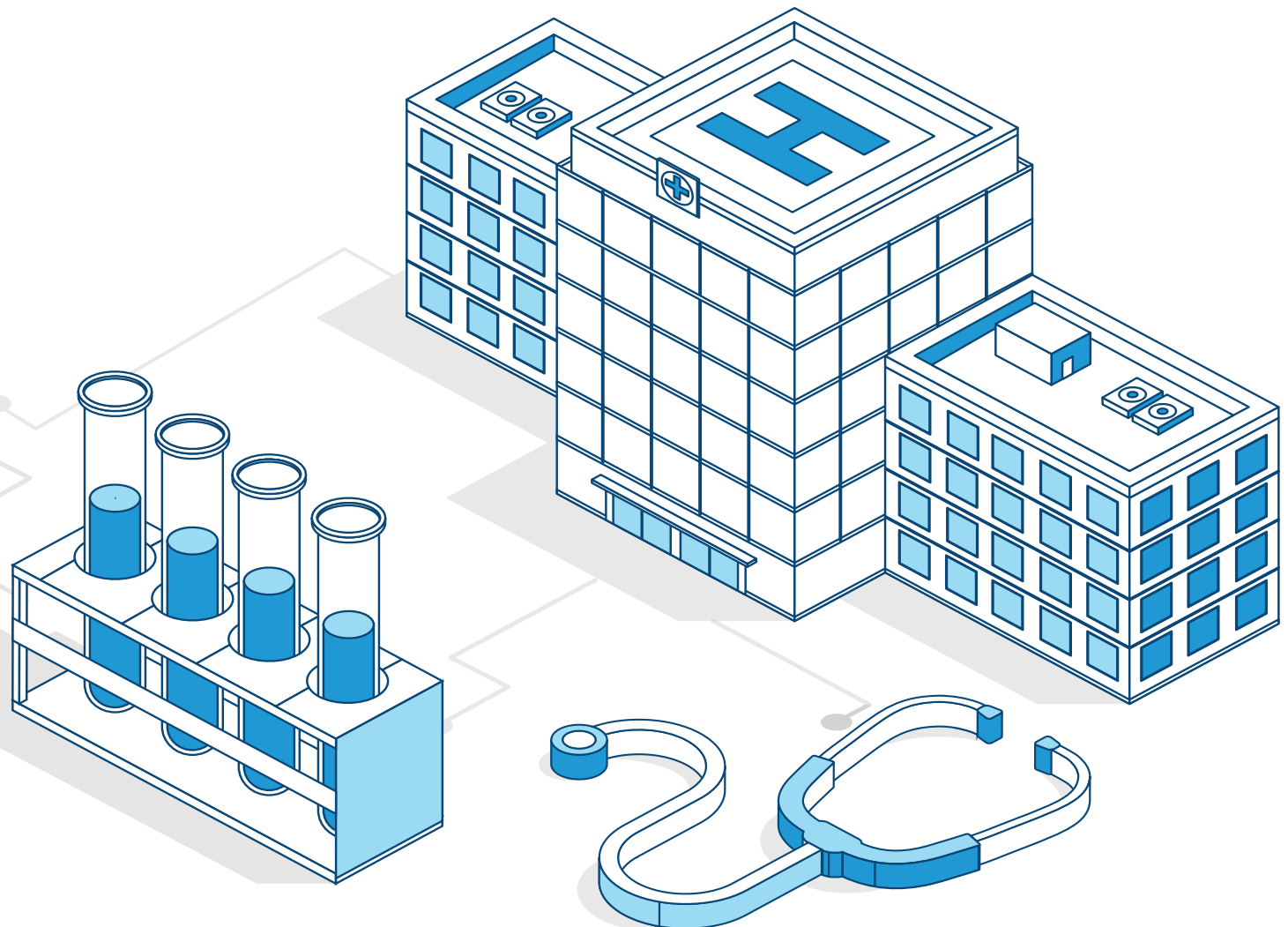


I. Overview

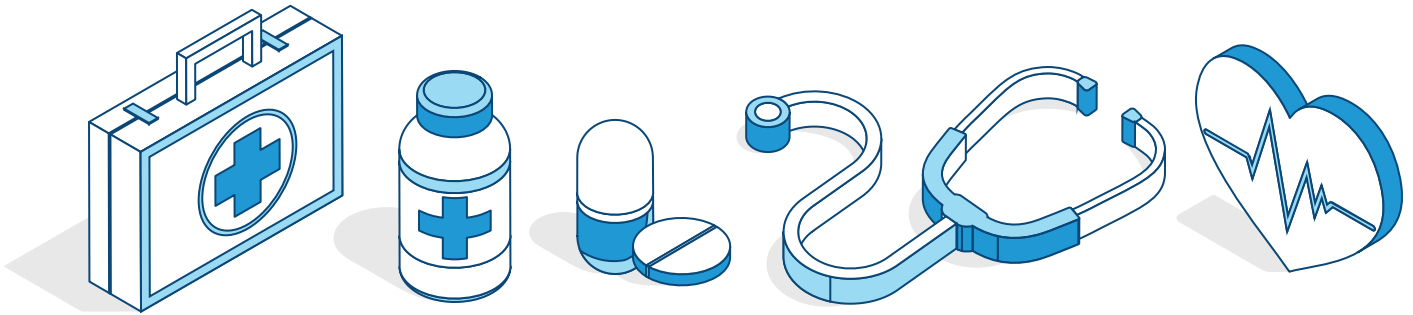
For a number of years now, China has been gradually implementing health care reform policies, such as Separation of Prescribing and Dispensing, QCE (Quality Consistency Evaluation), "4+7" VBP (volume-based purchasing), and DRGs (diagnosis related groups), which have accelerated the prescription outflow from the hospital market to the retail market.

In addition, the COVID-19 outbreak has led to the suspension of outpatient clinic services, resulting in a dramatic decline in the number of inpatients, which has further promoted the shift of prescription drug sales out of hospitals. These new circumstances provide alternative retail channels that are of increasing strategic importance for pharma companies.

Moreover, as innovative models such as B2C, O2O, and internet hospitals become mature, more online retail usage scenarios are emerging, setting higher requirements for retail strategies.

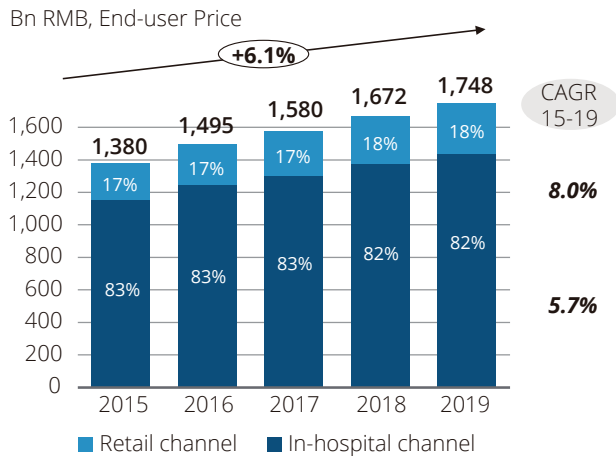


II. Status and challenges



From 2015 to 2019, China's pharma retail market has maintained a CAGR of about 8.0%, surpassing the 6.1% CAGR of the overall market.¹The main drivers are increasing accessibility of retail drugs, growth of total pharmacy visits, and increase of average expenditure per visit.

Chart 2-1: China pharma market size, retail vs. in-hospital (2015-2019)

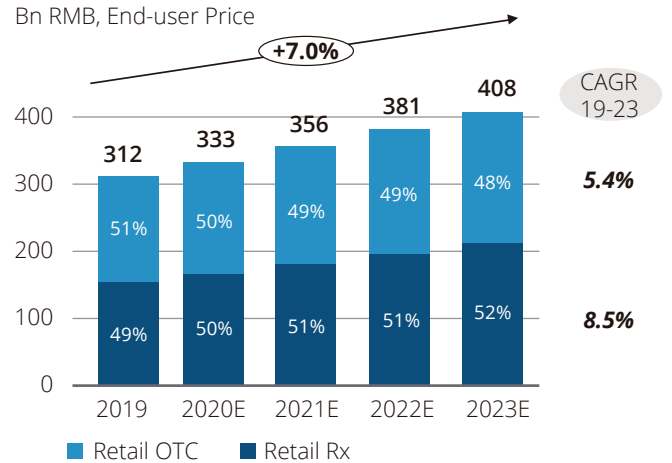


Source: Sinohealth, expert interview, Deloitte analysis

Note: The pharma retail market comprises sales of prescription drugs and OTC drugs, but excludes medical devices, TCM (Traditional Chinese Medicine) and health products. Its sales channels include offline retail pharmacies, e-commerce pharmacies, and internet hospitals, but exclude hospital-run pharmacies.

Based on estimations before the COVID-19 outbreak, the China pharma retail market's 2019-2023 CAGR is expected to fall to 5.5%² due to the influence of "4+7" VBP expansion, acceleration of prescription outflow, and further BMI (basic

Chart 2-2: China retail pharma market forecast (2019-2023)

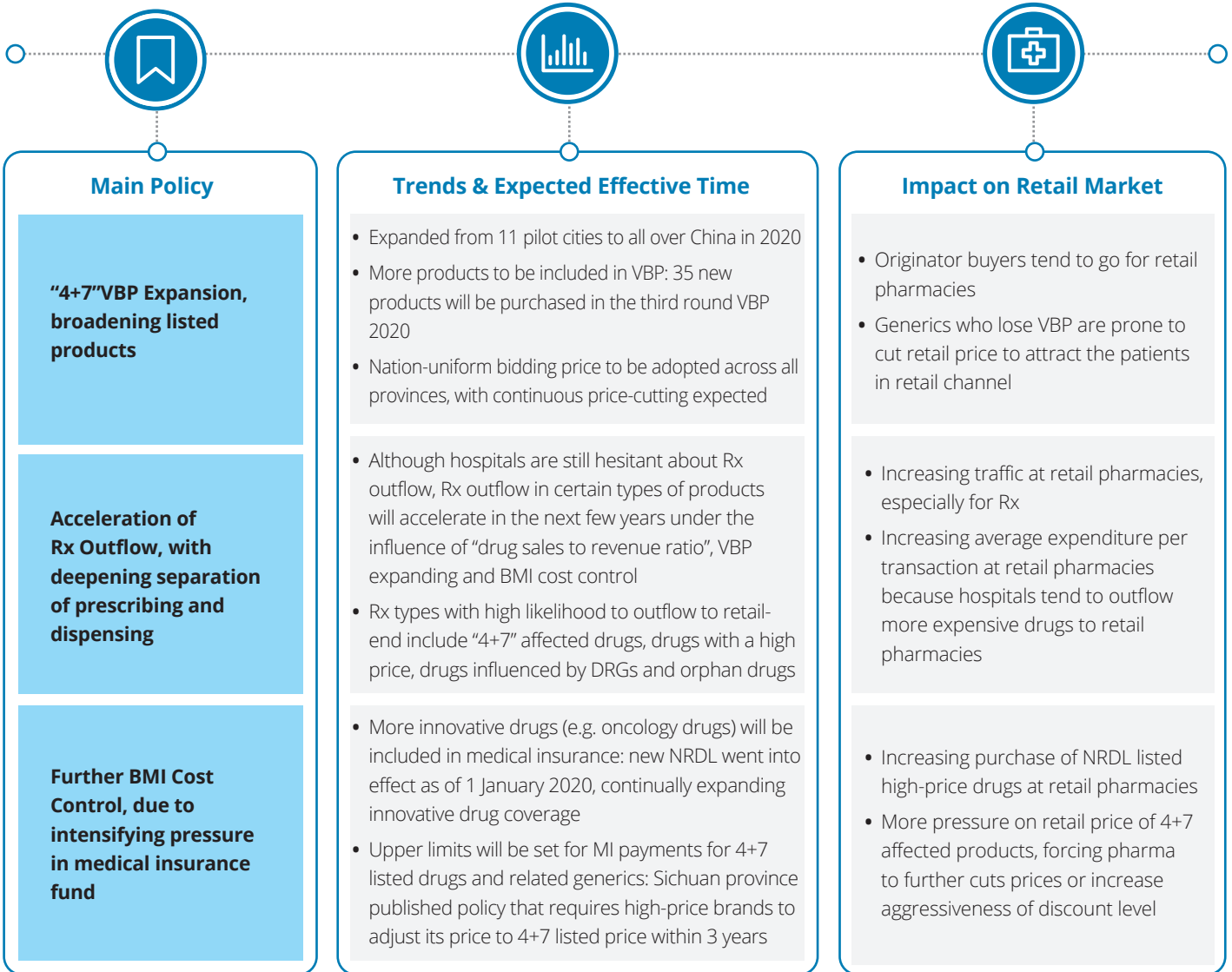


Source: IQVIA, Sinohealth, iyiou.com, expert interview, Deloitte analysis

medical insurance) cost control. However, the COVID-19 outbreak is expected to further accelerate the outflow of prescriptions from hospitals to retail channels, raising the 2019-2023 CAGR to 7.0%.³

Chart 2-3: Policy trends and impact on the pharma retail market

In the next 2-3 years, new policies will generate convoluted impact on retail pharmaceutical market, **volume & price will rise and fall respectively.**



Note: 1. MI=Medical Insurance 2.BMI = Basic Medical Insurance
Source: Expert interview, Deloitte Analysis

Meanwhile, the industry is observing three main structural changes taking place within the retail market:

1. Prescription drugs driving growth

From 2019 to 2023, the retail prescription drug market is estimated to maintain a CAGR of 8.5%. The main drivers include the expansion of prescription outflow, the development of

internet hospitals, and the deregulation of online pharma sales. In comparison, the growth of OTC drugs is expected to be lower, with an estimated CAGR of just 5.4% (See figure 2-2).

It is important to note that different types of prescription drugs show varied "retail potential" due to their specific attributes. For drugs indicated

for common diseases, chronic diseases, and urgent conditions, patients usually determine the use of prescription drugs on their own, making these drugs naturally suitable for retail channels. For innovative drugs, although highly dependent on prescriptions from hospital physicians, their high price and the

hospital's heavy cost controls limit their availability from hospital pharmacies, making DTP (direct to patients) pharmacies an important channel to sell. Other types of prescription drugs, such as adjuvant drugs and chronic disease drugs that require intensive physician intervention, are often bought in hospital pharmacies and have strong "clinical attributes"; therefore their "retail potential" remains relatively weak.

2. Demand differences between urban and county markets are becoming more apparent

In recent years, the retail pharmacies' demand differences between urban and county markets have gradually emerged. The urban market is larger in size and has higher income per store, but it is increasingly saturated and needs new growth engines. On the contrary, the county market, although still relatively smaller in size, is seeing its

market concentration and income per store increase rapidly, with remarkable market potential for pharma companies to capture.

3. Online pharma retail has entered a rapid development stage

The online pharma retail sales in China only accounted for about 2.2% of total retail sales in 2018, with the same ratio of 3% to 4% in the OTC segment and less than 1% in the prescription drugs segment. However, explosive growth is expected after 2019, mainly driven by the consumer trend of buying online more frequently, promotion efforts from online health care services providers, and, particularly, the policy deregulation accelerated by the COVID-19 epidemic.

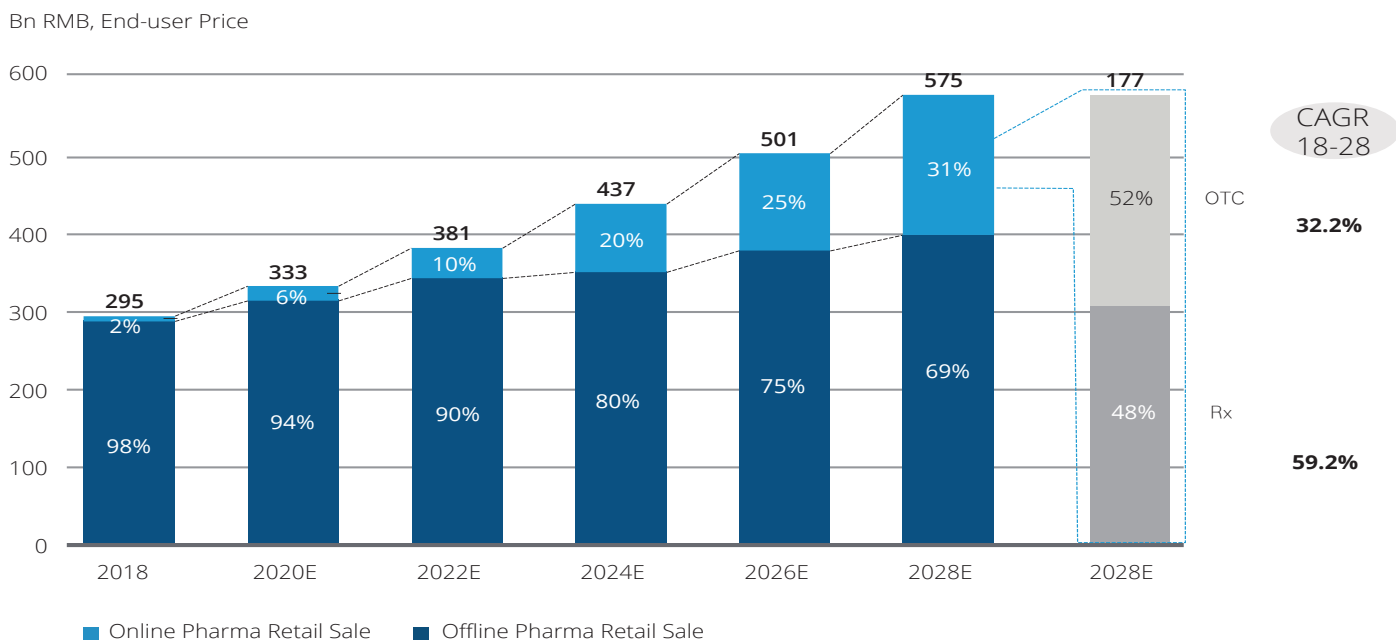
After the COVID-19 outbreak, China's National Health Commission announced a policy on February 2020, encouraging citizens to actively

pursue online consultation instead of outpatient visits—an initiative that dramatically increased total traffic for online hospitals. For example, Ping An Health, one of the leading online hospitals in China, witnessed an up to four times increase in its new user registration per day.⁴ And in March, the National Health Commission and National Health Insurance Bureau published policies to gradually deregulate medical insurance reimbursement restrictions on online consultation and drug purchase, which is expected to further uplift the growth of the online pharma retail market.



Under these trends, China's online pharma retail sales are expected to grow to around RMB 177 billion by 2028, accounting for 30.8% of total pharma retail sales.⁵

Chart 2-4: China Online Pharma Retail Market Forecast (2018-2020)



Source: Expert interview, Deloitte Analysis

III. Four transformations

These structural changes in the retail market have led to the following four industry transformations, bringing new opportunities and challenges for pharma companies: **differentiating demands among urban retail pharmacies; escalating needs for effective coverage in county markets; emerging usage scenarios for online drug sales; and diversifying collaboration models with retail distributors.**

Transformation 1

Differentiating demands among urban retail pharmacies. Urban retail pharmacies' demands are increasingly differentiated, where pharma companies need targeted strategies to address.

Facing fierce competition, increasing industry concentration, and a demand for professional patient services, retail pharmacies in urban markets have to establish unique brand images and value propositions, which in turn require pharma companies to provide tailored product and service offerings to their retail pharmacy customers, including:

1. Patient traffic attraction

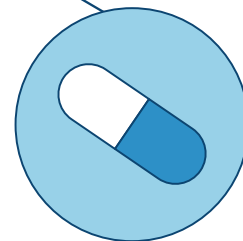
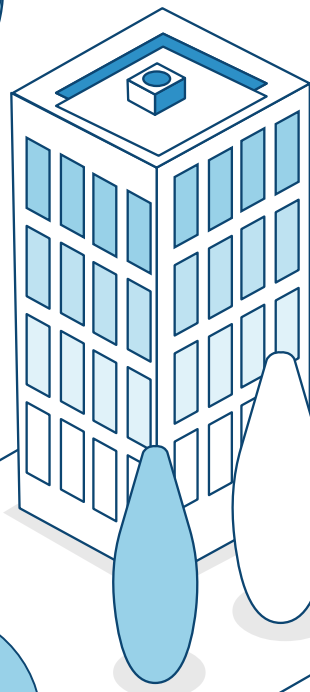
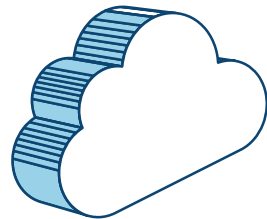
With prescriptions outflowing from the hospital market to the retail market, chain pharmacies need pharma companies to help draw patient/prescription traffic away from hospitals to their stores. Typically, patient traffic is attracted towards in-hospital pharmacies outsourced to chain pharmacies, hospital-side branch of chain pharmacies, or "internet hospitals + pharmacies."

2. Patient management services

As a differentiation strategy to increase patient stickiness and repurchase rate, chain pharmacies tend to leverage support from pharma companies to provide more patient management programs as after-sales services, including patient education, free consultations, disease screening, etc.

3. Consumer data analytics and precision marketing

Although most chain pharmacies have accumulated a large body of consumer data, they generally lack the ability to analyze and gain insights from these data. The chain pharmacies, therefore, need pharma companies for support on data analytics and precision marketing.



4. Pharmacy management and personnel training

For years, chain pharmacies in different regions gradually show up diversified demand of training support for their management and personnel. The pharma companies, therefore, need to iterate their service offerings of training support to a more targeted and customized design.

5. Gross profit/transfer price

Certain chain pharmacies have started shifting gear from a “value positioning”

towards “premium positioning,” which requires more value-added service offerings from pharma companies. However, the transfer price and gross profit from pharma companies remains a key consideration among these chain pharmacies when choosing drug suppliers. The pharma companies, therefore, need to balance their pricing and services policy and offer the most customized mix to different chain pharmacy customers.



In summary, the chain pharmacies in China are showing up increasingly customized demand of service offerings from pharma companies, due to their differentiating winning aspirations, company positioning, development stage, corporate governance, and organizational cultures. The industry has witnessed some pharma companies begin to take a holistic approach to review the demand of chain pharmacy customers, classify customers into different archetypes, and design the offerings to each archetype of customer. Furthermore, pharma companies have also started to revisit their organizational capabilities and resources allocation to each archetype of pharmacy customer. Foreseeably, how pharma companies can empower their chain pharmacy customers to differentiate in competition will be the first key winning theme in the pharma retail market.

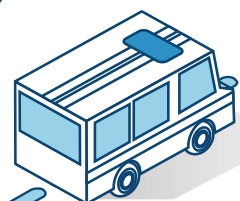
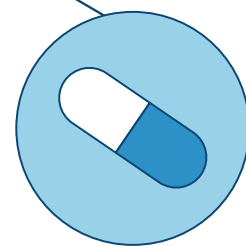
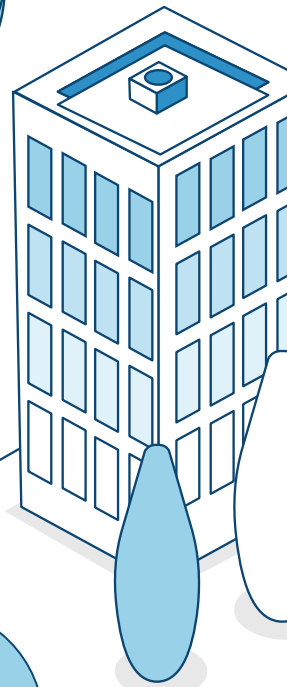
Transformation 2

Escalating needs for effective coverage in county markets. With opportunities and challenges coexisting in county markets, pharma companies need to design diverse and innovative models to enhance effective coverage.

Although smaller than its urban counterpart, China's county pharma retail market is developing rapidly. In 2018, county markets accounted for 61% of the country's total population and more than 51% of the country's total pharmacy numbers,⁶ but only contributed about 40% of retail market

share.⁷ Nevertheless, its 3-year CAGR reached 47%, 1.7 times that of the urban market.⁸

Historically, county-level retail pharmacies have lagged behind their urban counterparts. Most pharmacies in county markets are part



of small to medium-sized chains or standalone stores. Their management efficiency, service professionalism, and profitability still have room to improve.

For pharma companies, China's county market represents a vast unpenetrated space with a higher cost of coverage and promotion than the urban market. In the past, pharma companies often adopted a "hands-off" model to maximize the cost-efficiency of county market coverage. Through this model, pharma companies covered county markets through distributors rather than themselves, often resulting in insufficient promotion efforts and weak business growth.

Over the past two years, some pharma companies have tried to cooperate more deeply with distributors in the county market. With a new collaboration model where distributors act as "muscle" (build up dedicated salesforce for specific products) and pharma companies play the role of the "brain" (support on management of distributors' salesforce), these pharma companies are able to provide better promotional and value-added services for retail chain customers in county markets. In the future, whether pharma companies can keep putting forth innovative business models for county markets is the second key winning theme in the pharma retail market.

Transformation 3

Emerging usage scenarios for online drug sales. While patients typically purchase drugs online under four usage scenarios, pharma companies need to prepare themselves in advance for scenarios of "Online Hospital" and "Online Rx Outflow."

In the past few years, four major usages scenarios have gradually emerged for online drug sales:

1. Direct purchase

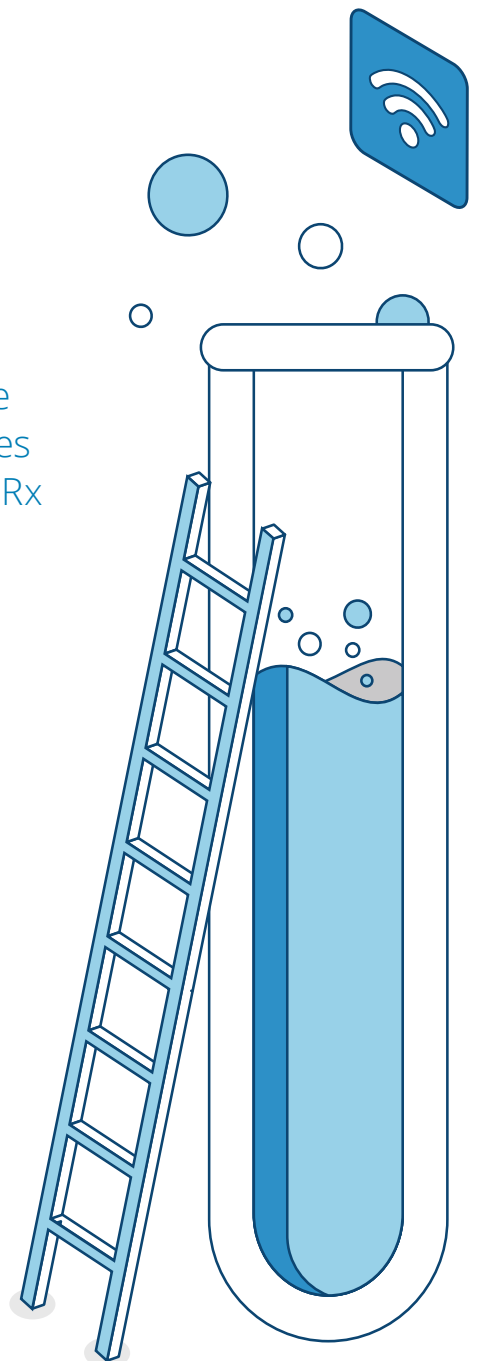
This scenario mostly involves patients with common or chronic diseases but no urgent need. Drugs are usually bought directly through B2C platforms like JD.com and Tmall.com.

2. Urgent purchase

This scenario typically involves patients with common diseases and an urgent need for medication. Drugs are usually bought and delivered through O2O platforms like Meituan, Eleme and Dingdang.

3. Online hospital

This is a common scenario for patients needing consultation or prescription renewals through telemedicine. Diagnosis and drug purchases are made through internet hospitals, such as Ping An Health, haodf.com and guahao.com. Compared with other scenarios, prescription volume of this scenario is limited by the type of diseases allowed for by telemedicine and physicians' prescription preference. For now, regulators already allow "e-prescription after the first online visit" for common diseases. While controversy still exists over whether other diseases will be allowed within the next five years, a general trend of deregulation is expected.



4. Online Rx outflow

This scenario mostly involves patients who visit physicians offline and renew prescriptions online. After initial offline consultations, patients can be guided to online channels to complete drug purchases. Because this scenario requires additional marketing efforts to attract patients from offline settings to

online channels, current involvement from pharma companies is still limited, and patient traffic remains small. However, with policies such as VBP and DRGs driving more prescriptions outflow from hospitals to retail channels, this scenario is strategically important for sales of VBP-related products and marketing investment to leverage this scenario should be closely considered by pharma companies.



Over the past few years, pharma companies' marketing efforts of online pharma retail mainly focused on usage scenarios of "Direct Purchase" and "Urgent Purchase," which together accounted for about 85% of online drug sales.⁹ In 2019, with the development of internet hospitals and the expansion of VBP, usage scenarios of "Online Hospital" and "Online Rx Outflow" have drawn increasing strategic attention from pharma companies. Moreover, driven by the COVID-19 outbreak, the National Healthcare Security Administration and National Health Commission issued the Guidelines on the Promotion of Internet + Medical Insurance Services during the Prevention and Control of the COVID-19 Epidemic in February 2020. This new regulation gives a green light to medical insurance reimbursement for online healthcare services and drug purchases for follow-up visits of common diseases and chronic diseases.

On 31 March, the first successful online payment through medical insurance was made by an internet hospital in Hubei Province, breaking a long-established restriction and in doing so indicating a bright future for online pharma sales.

While the COVID-19 outbreak highlights the importance of online channels, Deloitte's recent survey on enterprises'

response to the outbreak found that many companies plan to increase investment in online channels.

For pharma companies, how to design appropriate business models and allocate suitable resources for different online usage scenarios is the third key winning theme in the pharma retail market.

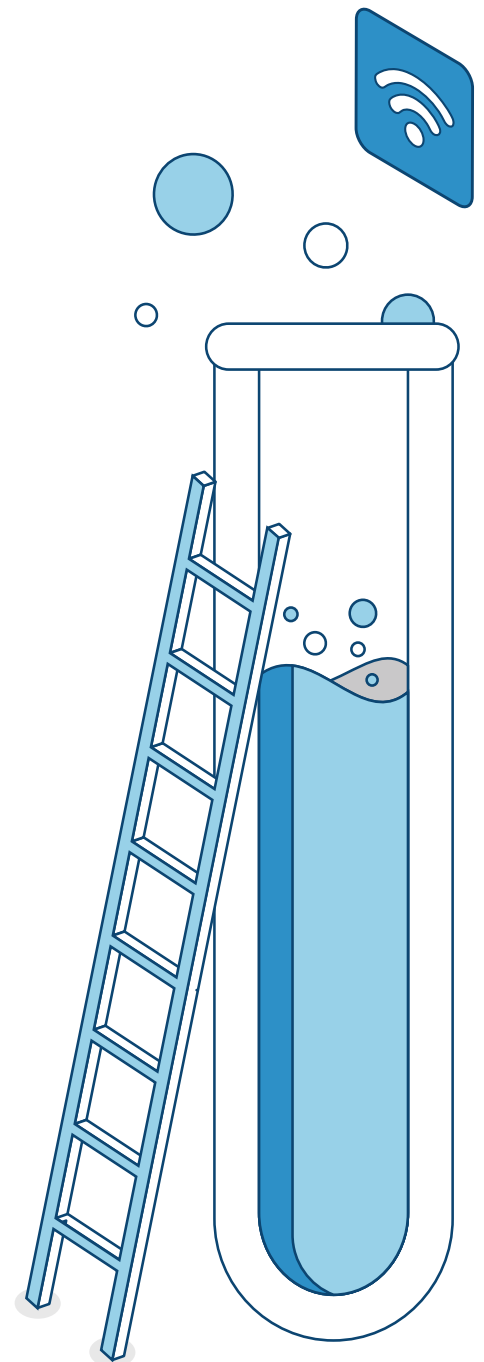
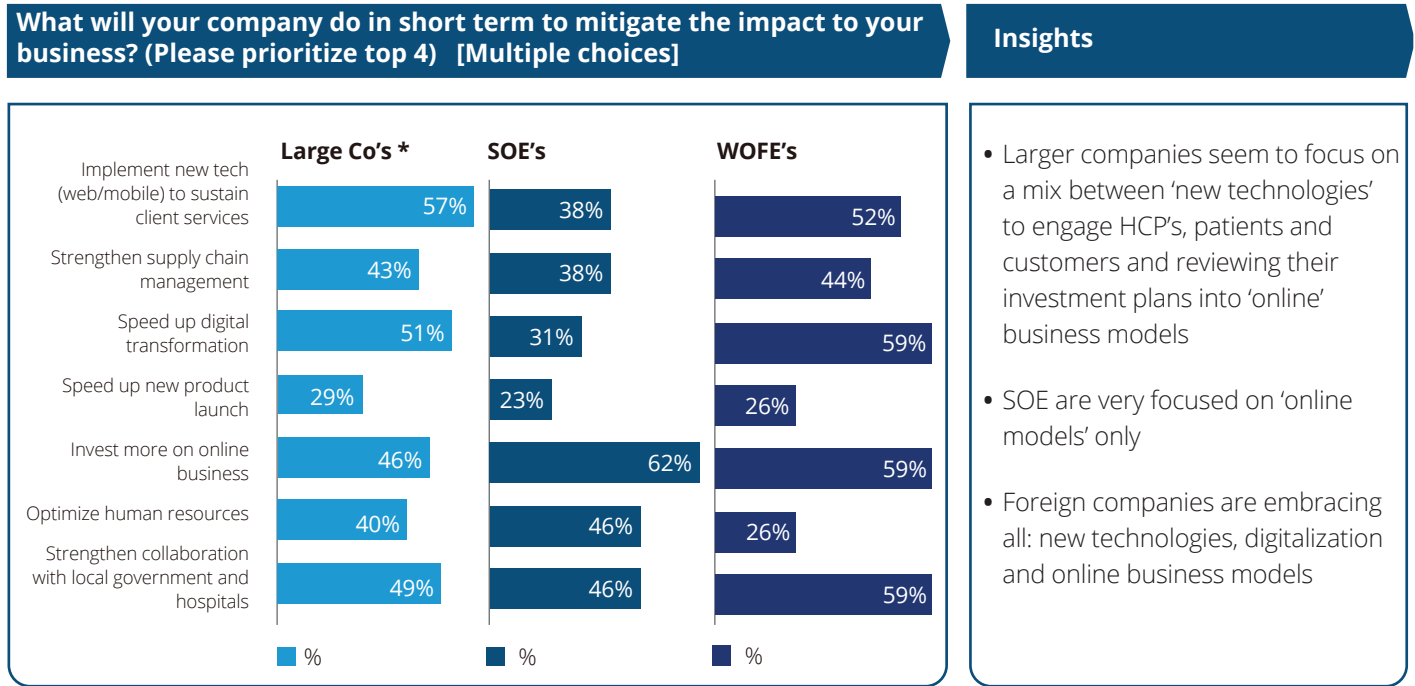


Chart 3-1: COVID-19 Survey : Larger companies faster to embrace new technologies



*Large Co's = Companies respondents with revenues above 5BRMB, (35/104)
 *WOFE = Foreign Owned Companies with revenues above 1BRMB, (27/104)
 Source: Deloitte COVID-19 survey for pharma Industry, February 2020

Transformation 4

Diversifying collaboration models with retail distributors. Pharma companies are exploring multiple collaboration models with retail pharma distributors, setting new requirements for pharma companies' capabilities and resource investments.

Traditionally, pharma companies and distributors collaborate mainly on "goods delivery," especially for the in-hospital market. However, the booming retail market makes pharma retail a key market segment for both pharma companies and distributors, with new requirements in distributorship models emerging across urban and county markets.

In the urban market, most distributors are traditionally in-hospital business focused, with very few of them specialized in retail business. This immature retail distributorship model results in challenges such as excessive

margin to be shared among multiple distributor layers, long response time in pharma companies' support policy implementation, and weak flexibility in collaboration among pharma companies, pharmacies, and distributors.

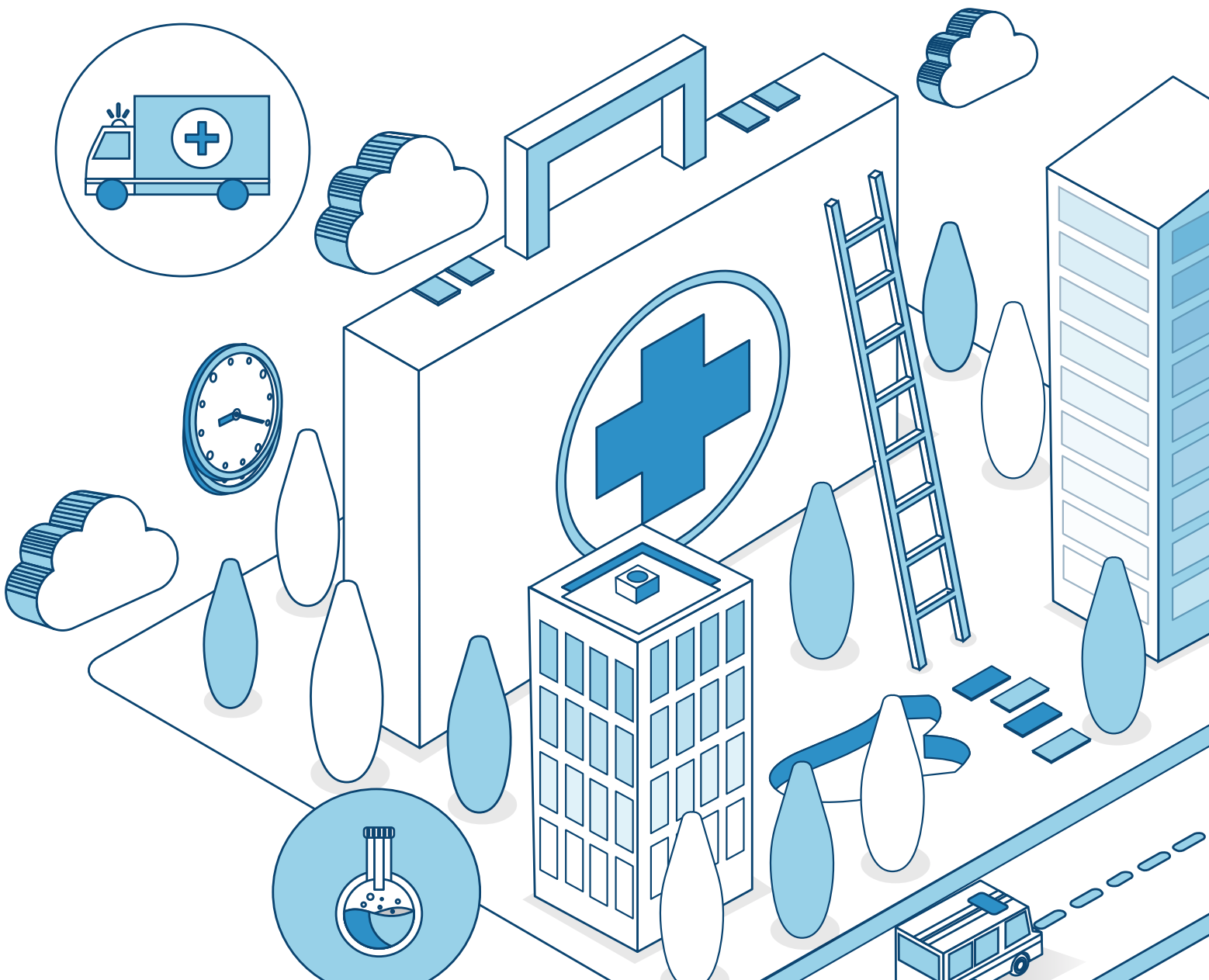
Meanwhile, in the county market, traditional retail distributorship models make it difficult to achieve effective coverage and promotion, making it difficult for constant growth.

Under this trend, many pharma companies started to explore innovative distributorship models

for both urban and county markets. The industry has already witnessed some innovative models such as exclusive distributorship, pharmacodistributor-pharmacy cooperative mechanisms, and the above mentioned "brain-muscle" partnerships in county markets. In these ways, the pharma companies can establish specialized, diversified pharma retail distributorship in both urban and county markets, further uplifting the growth of retail business. And this is the fourth key winning theme of pharma companies in the retail market.

IV. Conclusion

The above four transformations present both opportunities and challenges for pharma companies. However, pharma companies' success in pharma retail will be assured so long as they can uphold patient- and customer-centric principles, improve the strategic priority of retail business, gain deeper insights into chain pharmacy customers' evolving needs, provide tailored service offerings as per customer archetype, and upgrade their organizational capabilities and structures accordingly.



Endnotes

1. Sinohealth, Deloitte Analysis
2. Expert Interviews; Deloitte Analysis
3. Expert interviews, industry research papers, Deloitte Analysis
4. Expert interviews
5. Expert interviews, industry research papers, Deloitte Analysis
6. Sinohealth, Deloitte Analysis
7. Sinohealth, Deloitte Analysis
8. Sinohealth, Deloitte Analysis
9. Expert interviews, Deloitte Analysis

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