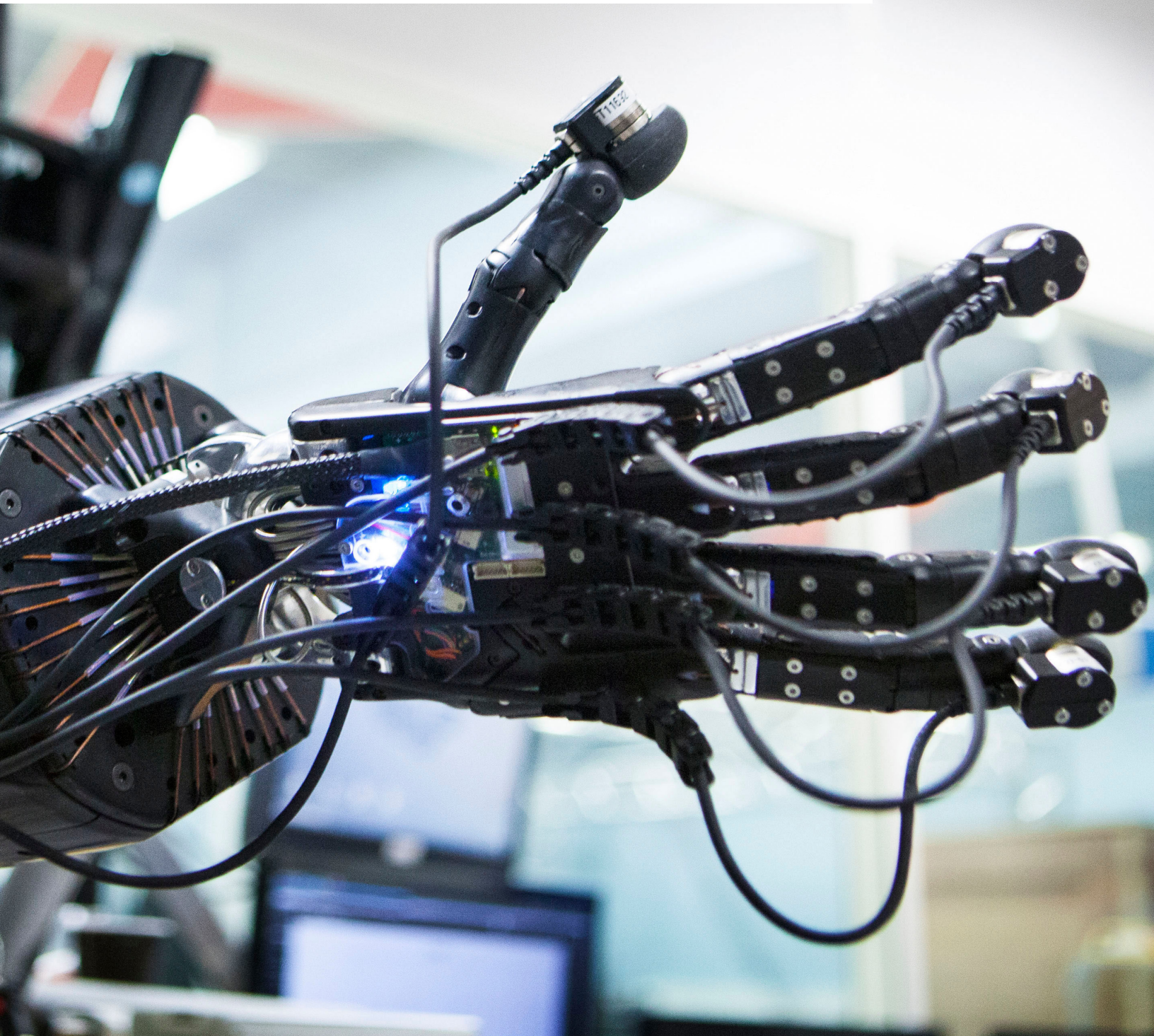


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Capturing the Value of
MedTech Ingenuity

The Case for Pricing Innovation



The pressure to create more innovative pricing strategies stems from the industry's shift from a market share to a profit margin focus. As MedTech companies continue to segment and rationalize their portfolios, new product bundles and pricing options can add new complexity. Nonetheless, tailoring offerings based on customer insights can create more value in the end.

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For some time, product innovation has been a ticket to achieving results for Medical Technology (MedTech) companies. Building better mouse traps was the order of the day and MedTech companies could confidently capture the value of their innovations with basic pricing strategies such as cost-plus or benchmarking against competitors. But these days are coming to an end. If MedTech companies don't adapt to the dramatic market changes beginning to sweep across the industry globally, they will likely further diminish the ability to capture the value of their offerings.

Significant market changes are underway and can only intensify with time. Healthcare providers are under significant pressure to justify the clinical and economic value of their spending. At the same time, non-traditional players are bursting onto the scene with innovative products fortified by new business models. M&A activity in the sector is accelerating, creating the need to wring value from large product portfolios and justify high valuations to investors. Patients act like consumers, often avoiding products and services whose value is unclear or perceived as too costly.

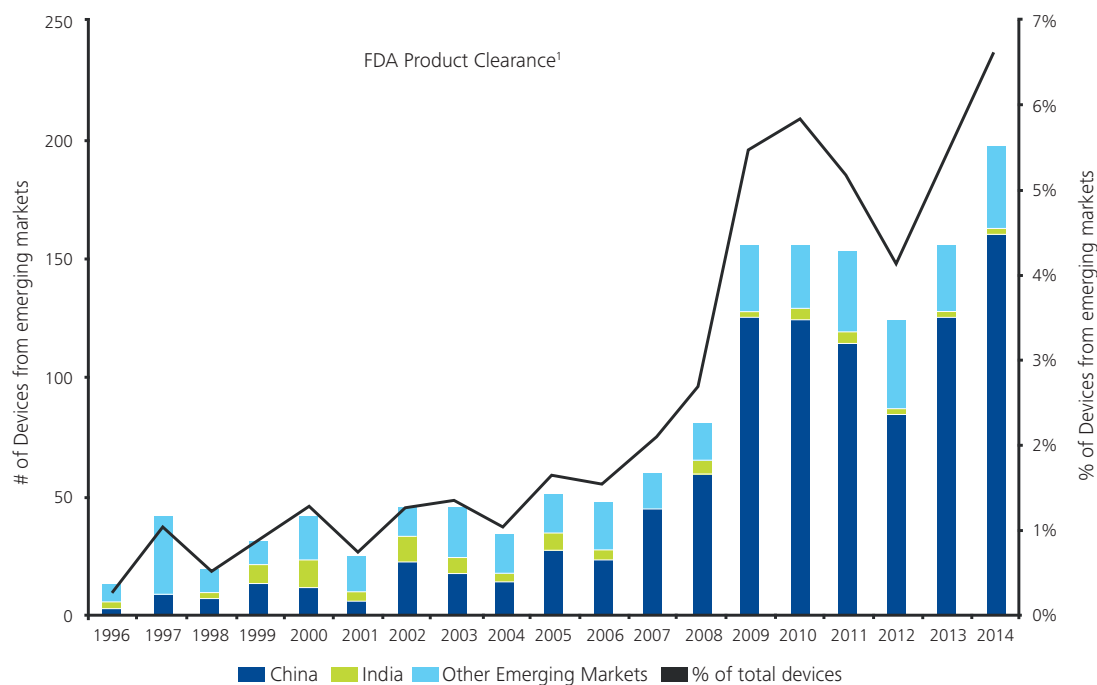
In addition, most MedTech companies still see health economics—the integration of clinical and economic rationale—as a very technical pursuit and, as a result, don't use it as a source of effective pricing strategies. The shortfall comes at the same time that the industry is shifting its focus from market share to profit margins—a challenge that can be addressed by innovation in pricing.

Despite these changes and challenges, a recent Deloitte survey found that only 8 percent of MedTech pricing executives plan to move beyond traditional pricing approaches. Only 23 percent intend to make the case for the economic value of their company's products.

To thrive, even survive, MedTech companies should expand their innovation ambit to include pricing innovation. Because the challenge may seem daunting and risky, this article details pricing strategies that blend established techniques with new approaches. The blend helps MedTech companies change at a pace they can manage while bolstering their ability to compete.

Figure 1: Medical devices from emerging markets cleared by the FDA

In addition, low-cost competitors with comparable technology and lower labor cost threaten margins in certain commoditized product categories.



Source: FDA 510K Clearance, fda.gov, March, 2015

A Vastly Different Business Climate

The race for market share during the last decade is increasingly becoming a race to protect net revenue and margin. When product innovation was the primary driver of success, MedTech companies could increase market share without experiencing downward price pressure.

However, four significant global macro trends in healthcare are putting pressure on prices that can increasingly erode net profit and margins if MedTech companies aren't prepared. The following four megatrends will likely continue unabated into the foreseeable future.

A Relentless Drive to Contain Costs

Worldwide, governments, payers, and providers and even patients are upping demands that MedTech products deliver demonstrable value and are priced accordingly. In the US, the Obama administration is requiring that, by 2018, 50 percent of Medicare payments must be based on the value that the product or treatment delivers. In France, MedTech companies with annual revenues in excess of €20 million must provide health authorities with a medico-economic evaluation of products to justify reimbursement.

In Asia, Chinese authorities are trying to reduce costs by pushing top hospitals to purchase domestically produced MedTech devices.⁴ Japanese healthcare officials are revising reimbursement rates every two years to tame the country's escalating healthcare expenses.⁵

Centralized purchasing, which has been common in the US for many years and is expanding across Europe, is also adding to downward pricing pressure. In Germany, more than 60 percent of hospital demand comes from group purchasing organizations.⁶ In France, 60 percent of medical products are purchased by state-run hospitals.⁷

New Players are Changing the Competitive Landscape

The MedTech industry's solid growth is attracting major investments from non-traditional players and spurring low-cost competitors to expand globally. Increased competition will create ever-increasing downward pressure on prices.

Google, for example, has established a research lab, Google X, devoted to innovative products such as an armband that will detect cancer. It has also partnered with Johnson & Johnson to develop surgical robotics. Low-cost producers from China and India are making inroads into global markets (figure 1).⁸ More than half of 2013 revenue of China's Mindray, for instance, came from outside of China.⁹



M&A is Accelerating

MedTech M&A activity in 2015 has maintained momentum and is increasing as companies seek to fortify their margins with broader portfolios, greater scale and favorable tax jurisdictions. Because of the high valuations of many of the mergers over the past few years, the new entities will likely have to capture the full value of combined portfolios, including the latent value of products whose full value hadn't been captured prior to the merger.

Baxter's acquisition of Gambro in 2012, for example, has created a global powerhouse of renal products. The 2015 Biomet-Zimmer merger gave the two companies significant scale in the orthopedics market. The merger of Medtronic and Covidien this year is expected to cut annual expenses by \$850 million.¹⁰ The 2015 acquisition of Johnson & Johnson's Dublin-based Cordis by Cardinal Health is further evidence of companies creating greater focus on specific therapeutic areas.

The Chinese government has given local companies the directive to expand globally and become multinational companies. Companies such as Mindray are entering the premium segment of the Chinese, US and EU markets and are becoming formidable competitors offering affordable products with competitive quality.

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Patients as Value-Conscious Consumers

Patients are taking charge of their healthcare and increasingly aware of the costs and value of treatment options. In the US, patients are investigating prices and skipping treatments and preventative care tests when their insurance plans have high deductibles.¹¹

On the other hand, consumers are willing to pay out of pocket when the treatment justifies the expense. For example, many active Baby Boomer cataract surgery patients are paying for premium intraocular lenses (an additional \$1,000 per eye) to achieve spectacle independence (post-surgery in case of astigmatism) and maintain a healthy lifestyle.¹² Pregnant women often pay \$200 out of their own pockets for 3-D and 4-D ultrasound tests.¹³

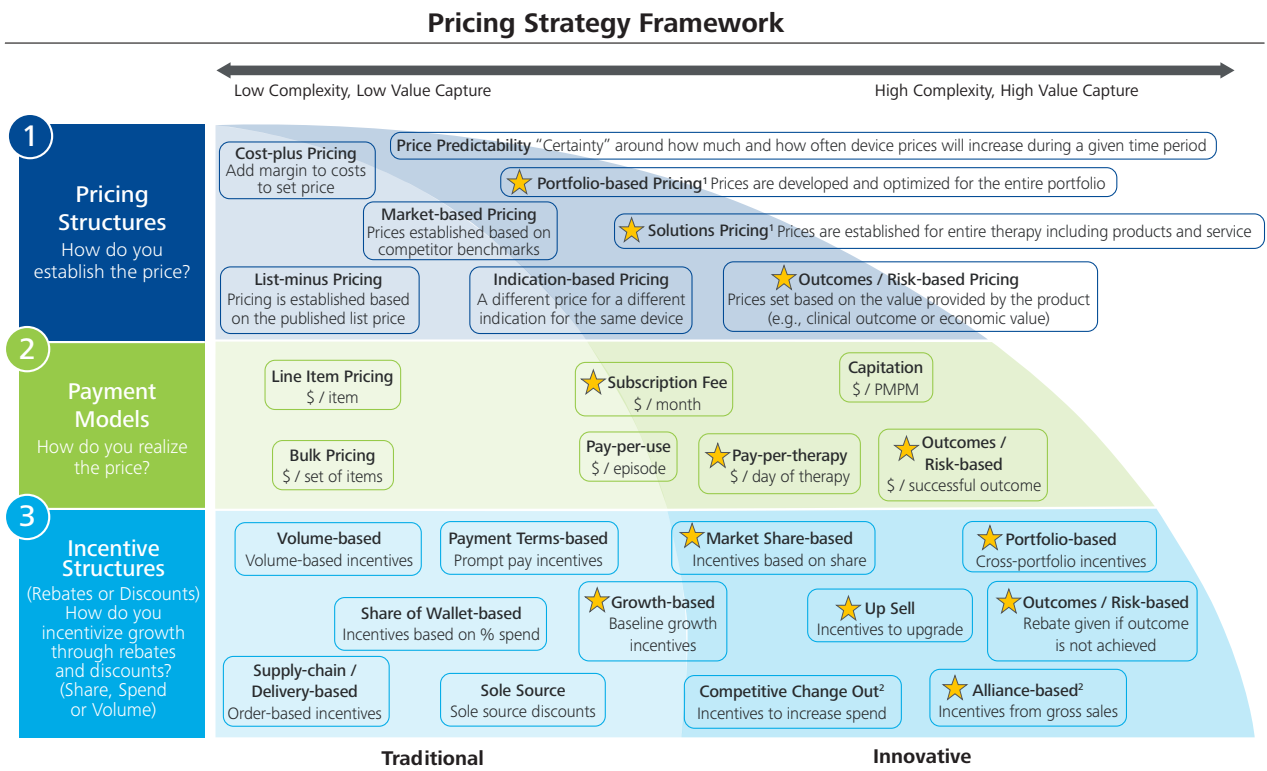
The MedTech industry's traditional pricing approaches will provide little or no defense against these megatrends. Industry players need to adopt more innovative pricing strategies to protect net revenue and margins and outmaneuver their competitors.

From Setting Price to Creating Pricing Strategies

For years, product and customer profitability have not been a major concern for many MedTech companies. In times of prosperity, customers were king and products and services were often offered below the total cost of bringing them to market. However, as profit margins become the focus, getting pricing basics right should be the first priority of MedTech companies.

When businesses in this sector put a price on a new product, they often look at competitor prices and set theirs at a reasonable point above them. They may also examine their own costs to assure that prices provide acceptable margins. But competition is mounting and buyers are becoming more aggressive in their propositions, by, for example, issuing RFPs more frequently and reducing the effective timeframe for prices established in the process. As competition heats up, setting prices against those of competitors can easily knock the company and its products out of the running.

Figure 2: Strategies and tactics for MedTech pricing innovation



1. May have Government Price Reporting implications in US
2. Contract is carefully constructed to avoid legal / compliance issues

★ New options that Med Tech companies can evaluate

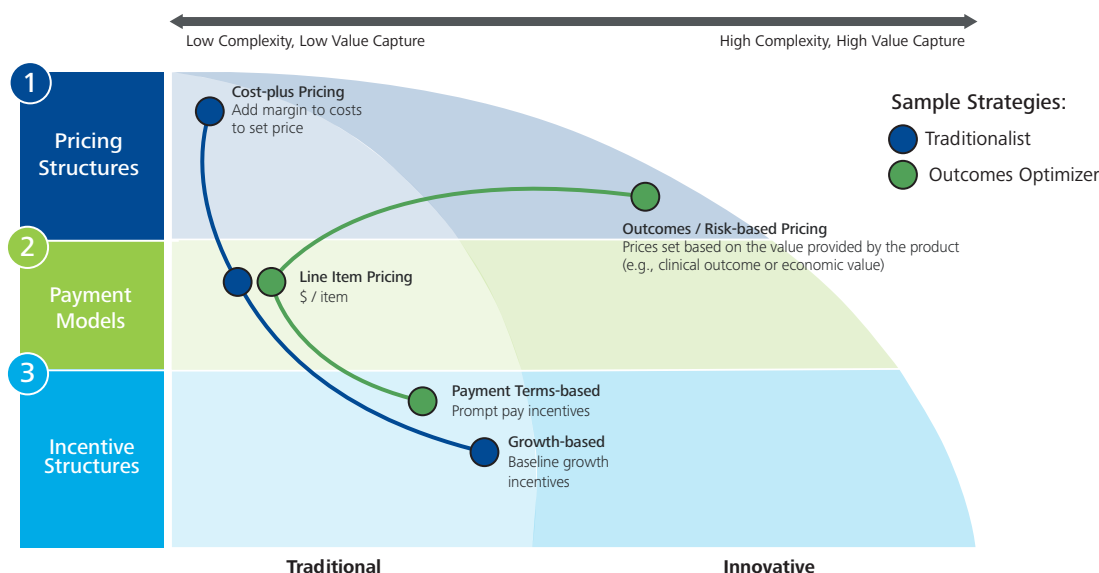
To bolster the competitive success of their products, MedTech companies need to create innovative pricing strategies that beat competitors by demonstrating the product’s unique value and providing incentives for customers to continue buying. In our experience, businesses have three levers they can pull to create powerful pricing strategies. As figure 2 shows, these strategies don’t require wholesale change in each of the three levers. Although pricing strategies can be complicated, they don’t have to be. Instead, companies can blend innovative techniques with traditional approaches:

- **Pricing structure**; How to set the price. These techniques can range from benchmarking against competitors to basing prices on the clinical outcomes that the product offers.
- **Payment model**; How to charge customers. Options span from line item and bulk pricing to risk sharing arrangements based on results.
- **Incentives**; How to spur growth. These techniques include discounts based on volume, and incentives to purchase across multiple product lines.

For example, a MedTech company could offer a new product that can reduce hospital readmission rates for a certain condition. The price can be based on what competitors charge and the company can use traditional line-item pricing for the payment model. The pricing innovation could take the form of rebates offered if the product doesn’t achieve the promised outcome of reducing hospital readmissions. Similarly, an effective pricing strategy for a portfolio of products could use existing list prices and offer bulk pricing on sets of products. The innovation could come into play with incentives to increase sales. For example, the company could offer discounts when customers reach certain spending levels.

The ability to pull different levers of a pricing strategy offers several innovative options. Three particularly powerful strategies that MedTech companies could consider are: outcomes-based pricing, portfolio pricing and solutions pricing.

Figure 3: Example of outcomes-based pricing



Source: Deloitte analysis

Outcomes-Based Pricing

In response to soaring healthcare costs, payers are making bold moves—changing the basis of reimbursements from product and service volume to the outcomes that products deliver. MedTech companies should match the bold moves by mastering outcomes-based pricing.

Outcomes-based pricing links a product’s price to its ability to achieve specific outcomes such as reduced hospital readmissions, shorter hospital stays, improved surgical results, and/or increased safety. Although a complex endeavor, an effective foray into outcomes-based pricing can be achieved with a blend of innovative and traditional pricing techniques (figure 3). To illustrate, imagine a MedTech company that has developed a new scanning

device that can replace manual inspections in hospital wards over time. The cost to manufacture the device is \$2,000.

Using traditional cost-plus pricing, the company might add 50 percent to its costs and set the price at \$3,000. But what if the organization looked at the impact of its product on a hospital’s costs? For example, the device can reduce length of stay while improving the quality of treatment. Let’s assume that the device saves a hospital \$20,000 annually. Using an outcomes-based pricing structure, the company could set a contracted price of \$22,000. It could then support that price with traditional line item pricing and incentives including rewards for prompt payment.

Case from the Field

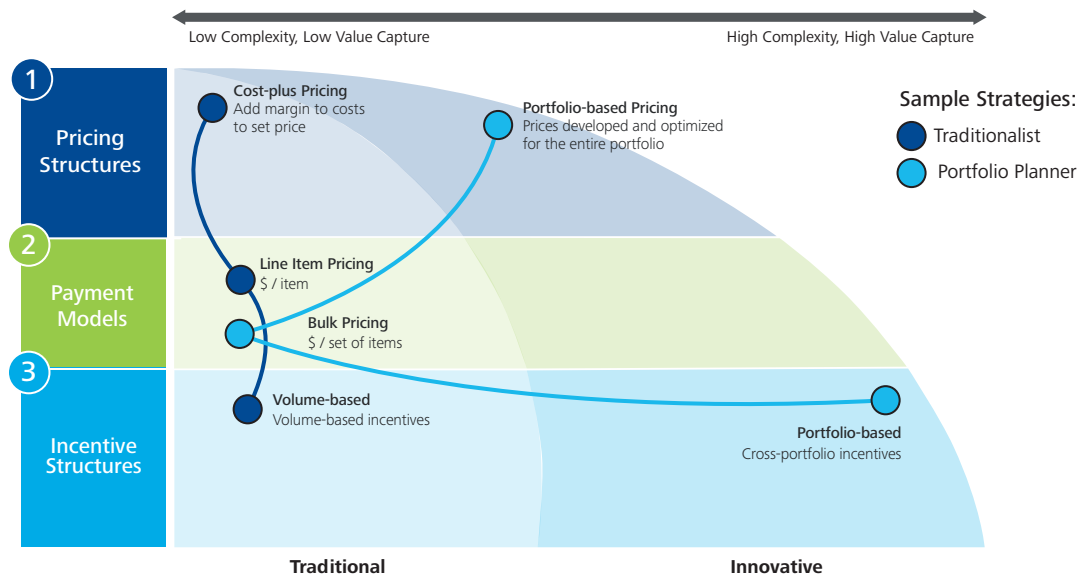
Consider St. Jude Medical. The company produces a cardiac rhythm management device that has four leads instead of three. The use of four leads minimizes the chances that a lead will become dislodged once the device is implanted in the patient. Reduced risk of dislodged leads improves outcomes of quadripolar CRT in chronic and acute cases of heart failure.

The company combined an innovative use of rebates as an incentive with traditional market-based pricing for the device and line-item pricing for the payment model. In a program it calls, “Do More. Re-Do Less.” the company will credit 45 percent of the net price if lead revision is required within one year.¹⁴

Needed Capabilities

To support outcomes-based pricing, organizations will need advanced analytics capabilities to measure outcomes and adjust for non-controllable factors. Companies will have to develop good relationships with customers in order to agree on how to adjust for non-controllable factors. Businesses must also have the data and tools at the ready to assess outcomes and track customer payments and rebates. In addition, organizations may have to boost administrative support, accept longer sales processes, and modify sales force incentives to encourage outcomes-based selling and mitigate downsides for the salesforce. Companies must also be able to monitor product selection and assure maximum profits.

Figure 4: Example of portfolio-based pricing



Source: Deloitte analysis

Portfolio-Based Pricing

MedTech companies often have one or two product categories that outperform others. The challenge for these companies, then, is to bring up the tail (i.e., products that have a low revenue or margin contribution). The issue is particularly acute in mergers and acquisitions where valuations are often high and companies have to sell a large portfolio of products to justify the valuations to investors.

Portfolio-based pricing increases sales by offering incentives to customers when they reach different levels of cross-portfolio spend during a specific time period. As is the case with outcomes-based pricing, a successful portfolio strategy can combine new with traditional techniques.

Consider a MedTech company that offers catheters and balloons. Using traditional pricing approaches, the company would market each separately. Using a portfolio-based pricing structure, however, the company could charge less for the catheters than they currently do and use that strategy to increase sales of balloons to customers who buy the products together. Under this scenario, the company captures more revenue and profit from balloons even though it is garnering less from catheters. Lowering the price of catheters also reduces customer acquisition costs. The company can then leverage any traditional form of incentives, such as volume discounts, that would spur sales (figure 4).

Case from the Field

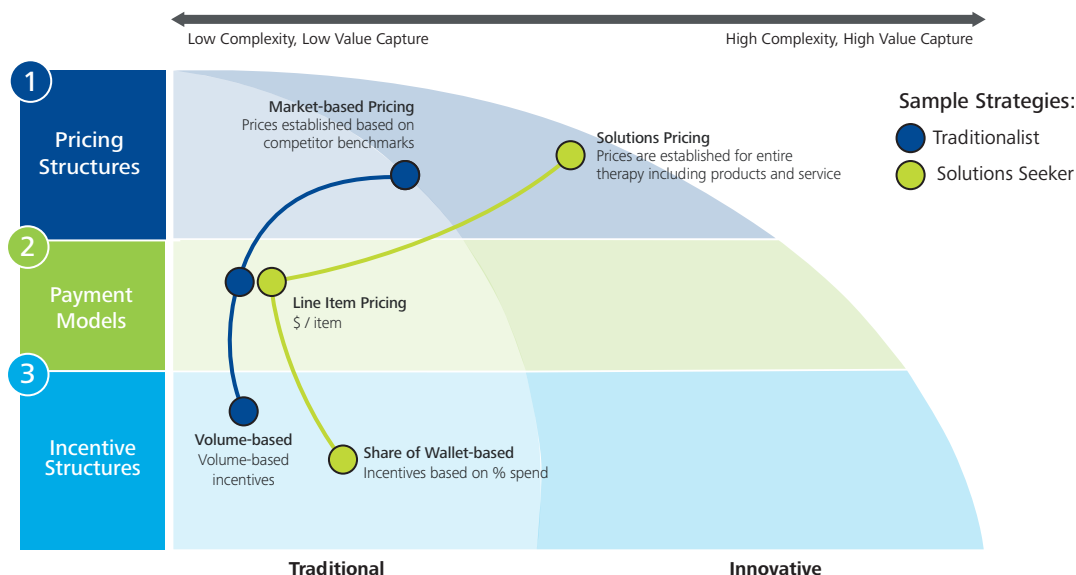
A niche MedTech company based in the US had nearly 20 product categories. A disproportionate amount of revenue came from a few of the products and the company wanted to gain deeper penetration with its customers across its entire product portfolio.

The MedTech company turned to portfolio-based pricing. It was able to use traditional market-based prices with line-item pricing. As an innovative incentive, the company offered steadily larger discounts as customers increased overall purchases and bought from larger number of product categories.

Needed Capabilities

Portfolio-based pricing requires advanced analytics to track customer performance and support sales forecasting processes to account for non-controllable factors. Businesses may need new tools that track customer purchase commitments, rebates and provide data for compliance reporting. Government Price Reporting (GPR) is also a key consideration in structuring portfolio-based structures in the US. MedTech companies may also have to revamp sales compensation plans to encourage cross-selling and eliminate internal organizational barriers.

Figure 5: Example of solutions pricing



Source: Deloitte analysis

Solutions Pricing

MedTech companies increasingly see the value of shifting from selling products and absorbing service as a cost to offering solutions for both products and services that the customer values together. MedTech businesses are following two paths to create value through solutions:

- **Boosting disease area footprints:** For example, MedTech companies can offer procedure packs or move from diagnosis and treatment to supporting chronic conditions such as diabetes and heart disease. Prices are set at the level of disease area and encompass the entire package of products and services.
- **Offering non-clinical services:** For example, MedTech organizations can provide hospital management and operational support and/or financial services. Pricing is based on the value to the customer.

To illustrate, imagine a MedTech company that markets both consumables and more high-end products such as stents and active devices. The company is facing a decreasing share of wallet and to boost its revenue, it decides to help its hospital customers to reduce costs by offering integrated solution kits. Through market research, the MedTech company found that potential hospital customers valued time gain, inclusive maintenance services and faster patient turnarounds as the solution's main benefits. Moreover, Voice of the Customer research indicated that hospitals are willing to pay a higher price for the kit than the individual component parts. A traditional company would opt for cost-plus pricing in combination with bulk pricing and a share-of-wallet based incentive structure. By opting for integrated solutions, however, the company can combine the innovation of solution-based pricing structures with pay-per-therapy payment model, whilst applying a share-of-wallet based incentive structure.

Case from the Field

Consider the medical device company Medtronic. With its strong footprint in cardio and endovascular procedures and subsequent insights into the operations of a hospital's catheterization laboratory (cath lab), the company observed many hospitals facing issues to contain costs. To counter this issue, the company recently launched Hospital Solutions, a new business focused on providing services directly related to hospital operational efficiency, to manage and modernize cath labs. By doing so, the company was able to monetize its cath lab knowledge into new revenue streams whilst providing integrated solutions to answer customer needs.¹⁵

Needed Capabilities

To make solution selling a success, MedTech companies need to have these capabilities in place:

- Analytics capabilities to understand customer behavior including clinical and economic data
- Technology capabilities to monitor price and bundle and unbundle solution components according to customer needs
- Ability to closely monitor how well the solution is performing and managing the impact of regulatory requirements such as GPR, FDA and CE (European Conformity) approvals

Advancing Through Measured Steps

Each of the pricing strategies we have discussed is a complex endeavor with its own pros and cons. Outcomes-based pricing, for example, provides competitive advantage by differentiating products based on the results they deliver. However, outcomes can be difficult to quantify in certain medical conditions and businesses will have to control for factors such as surgeon skill and patient co-morbidities.

Portfolio pricing offers the potent advantage of increasing profits with existing customers without discounting highly profitable products. It can also promote cross-selling and unlock latent value in combined portfolios created through an M&A. Nonetheless, GPR in the US will require additional resources to meet compliance requirements. In addition, bulk pricing may not be an incentive for smaller customers who won't reach purchasing thresholds.

Solution pricing is also subject to GPR reporting in the US and can also have a major impact on go-to-market efforts. For example, the effectiveness of the strategy rests on the ability of the sales force to forge close relationships with customers. As a result, sales models may have to change from selling products to managing accounts and partnerships.

Although the challenges are complex, MedTech companies can follow a straightforward, step-by-step process to determine the best pricing strategies for their products (figure 6). The effort culminates in a pilot to test assumptions, tradeoffs, and build organizational knowledge.

Step 1—Collaborate with Customers: Pricing strategies shouldn't be developed in conference rooms alone. Customers must be part of the process of creating a joint vision of how to share value.

Step 2—Evaluate Product Portfolio: Businesses should examine the products and customer needs to develop hypotheses about the best place to start.

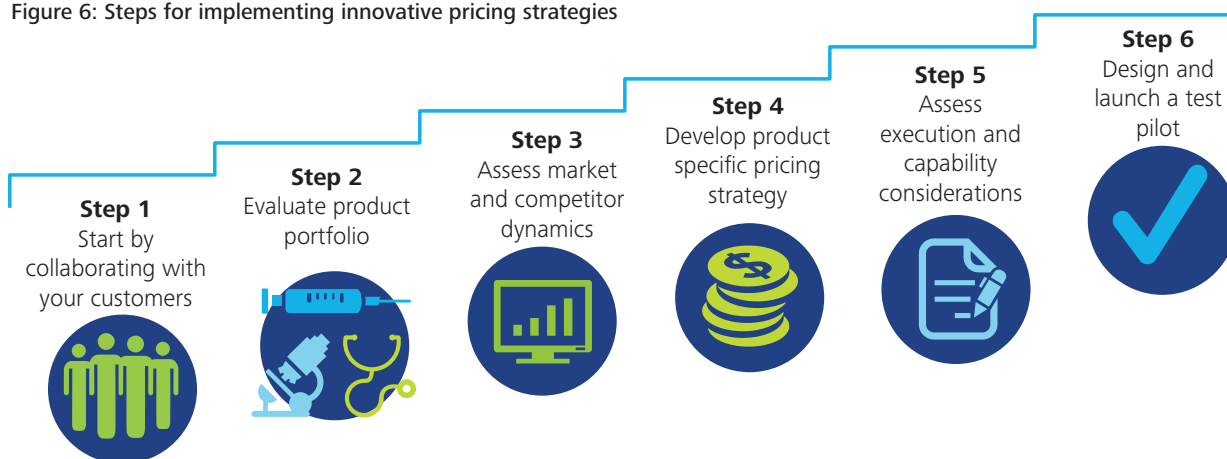
Step 3—Assess Market and Competitor Dynamics: Assumptions about the best places to start should be weighed against what competitors are likely doing or will do.

Step 4—Develop Product Specific Pricing Strategies: Having zeroed in on the best places to start and understanding competitor moves, MedTech companies can begin applying specific pricing strategies to their products as a pilot.

Step 5—Know Your Capabilities: Once the strategies are crafted, the business needs to assess what new capabilities it must develop.

Step 6—Design and Launch a Pilot: Finally, organizations should create a playbook for the pilot including team structure and governance. The company can then launch the pilot and document lessons learned.

Figure 6: Steps for implementing innovative pricing strategies



Source: Deloitte analysis

In Japan, reimbursement for major devices has dropped by approximately 25 percent in the last decade, according to Japan's Medical Device Institute. Medical materials have been the first line of attack for healthcare providers seeking to save money, and many are increasing their purchasing power through joint procurement efforts and increasing visibility into pricing data.

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Conclusion: Move Ahead of the Pack

The MedTech market is changing significantly, and those changes are underway now. Payers, providers and patients are increasingly demanding that the price of MedTech products have a direct relationship to the value that the product provides. Nontraditional players are making hefty investments and low-cost providers are rapidly expanding their global footprints—all of which will add more downward pressure to prices. M&A activity in the MedTech industry is on the rise and the new entities will have to capture the full value of combined portfolios to justify the valuations to respective investors.

These trends will likely continue to put pressure on prices which can cut into the net profit and margins of MedTech companies that don't pick up the mantle of pricing innovation. MedTech companies stand at a crossroads: They can wait and let the market define their fortunes, or they can take a leadership role by shaping the market and charting their own destinies.

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