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Capturing the new 'value' segment in medical devices

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The growing demand for products that are "good enough" and competitively priced has pushed medical-product manufacturers to develop strategies to attract and retain this new segment of customers.

The medical-device industry is facing challenging headwinds. As governments and health insurers worldwide implement measures to control costs, public hospitals are operating on tighter budgets, while private facilities are receiving lower reimbursements. These measures are triggering a transformation of the purchasing process that will change the way that medical products are bought and valued.

In the developed world, decisions that used to be the sole preserve of doctors are now also made by regulators, hospital administrators, and other nonclinicians. This broader set of influencers comes with different objectives (for example, the prioritization of cost effectiveness or even just costs). The result of this phenomenon is a shift from individual outcomes to a focus on population-level effectiveness, such as the overall improvement seen within a population for a given level of spending. Meanwhile, emerging markets, once seen as a safe haven for premium products thanks to their growing middle classes and rising investments in healthcare, are leapfrogging developed economies and introducing cutting-edge purchasing processes and pricing mechanisms.

At the same time, the medical-products industry has become more competitive. Established blockbuster categories such as wound care, coronary stents, and orthopedic devices are becoming more crowded as they mature. As high-impact scientific innovation in these categories has become harder to identify, smaller companies, such as Draco in Germany, are gaining market share by offering very low prices and innovative business models. The greater price transparency enabled by the growing use of tenders in Europe and the United States is giving an advantage to low-cost players like these.

All these trends are combining to create demand for products that are "good enough" and competitively priced. Our estimates indicate that this new segment is growing twice as fast as the industry as a whole in some categories. Aware of the emerging opportunity, global medical-product manufacturers have been looking to capture it and protect themselves from disrupters that could eventually move upstream—for instance, Mindray in China. However, few have yet managed to build a sustainable business around the new segment while protecting their premium offering. Indeed, in some markets, manufacturers have offered heavy discounts without sufficiently differentiating their premium offerings, leading to double-digit-percentage annual declines in pricing in some categories such as stents.

Before companies can develop a comprehensive strategy to serve value-oriented customers, they need to address tough questions about tiered portfolios, differentiated offerings, go-to-market models, ways of working with customers, business development, M&A, cost of goods sold, and implications for the supply chain.

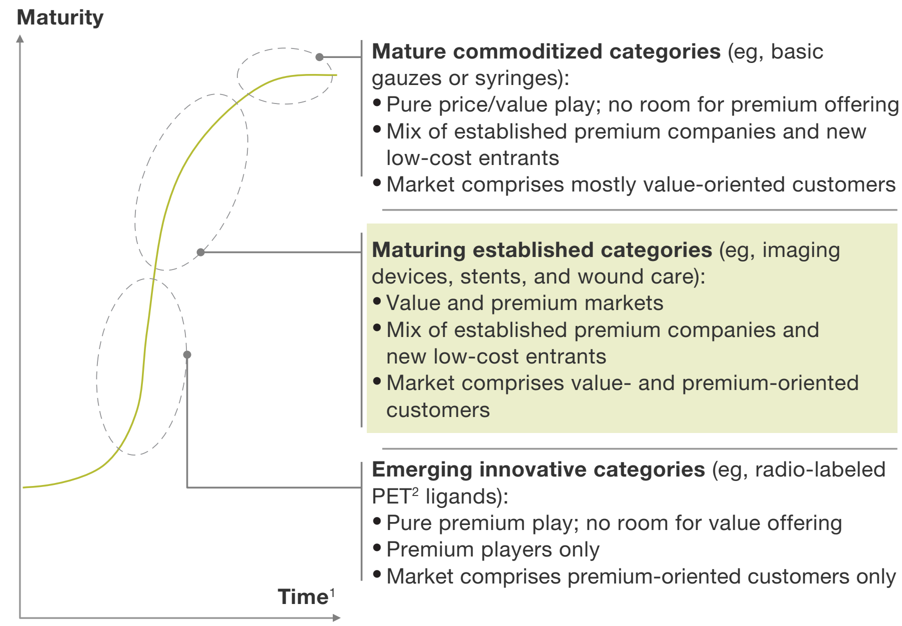
Products and priorities for the new segment

The past few years have seen a rise in "value" customers—those who gravitate to products that are good enough and competitively priced. Unlike customers who seek premium products, value customers are willing to sacrifice a degree of innovation, quality, and service in return for a lower price. This trade-off can be seen in many different industries: Dunkin' Donuts customers know the coffee will not have milk foam, and Ryanair passengers do not expect first-class service during flights, for instance.

While value customers are concerned about price, they also have standards for product quality, efficacy, safety, and service. However, they are generally reluctant to pay for additional features or services once their basic expectations of a product have been satisfied. Many recent medical-product tenders in Europe illustrate the rise of the value customer. For example, in some regions of Spain, the technical specifications are rudimentary and account for only a small proportion—often less than 20 percent—of the award criteria.

In industries such as apparel, automotive, and food, the value customer has been rising for more than a decade, and this has led to a clear "tiering" of brands and offerings. As cost pressures continue to increase in the medical-product sector, we expect the value customer to have a similar effect—but only in certain categories. Highly innovative products that have just entered the market will fall into the premium-differentiated category and still command high prices. But once competitors emerge and offer similar products at much lower prices, customers will begin viewing the products as commodities. In categories with numerous products and few differentiating features, customers may choose on the basis of price alone (Exhibit 1).

Exhibit 1 The value segment is more relevant in mature product categories.



[1]The time a product takes to reach maturity depends on its category.
[2]Positron emission tomography.

At the moment, medical-device companies offer customers four levels of products and services:

- *Premium differentiated.* These products and services are differentiated by efficacy, outcomes, or care delivery and are usually supported by high-touch selling and servicing models. Because they are innovative and provide proven benefits, they command high prices.

- *Premium undifferentiated.* Although incrementally innovative, these products and services are not clinically differentiated from competitors' offerings. Our research suggests that this category will suffer intense erosion in price and share. The many premium companies that profit from these products because of strong customer relationships or a brand image attractive to consumers will be at greatest risk from the trends described in this article.

- *Value.* The features and services this group provides are tailored to meet customer expectations for good-enough products and usually sell at much lower prices than premium products. The sales model for these offerings may involve online support or light-touch representatives who call on clients.

- *Basic.* These products do their job but offer minimal service. They compete purely on price and are often used in settings where providers seek to supply a basic service rather than optimize outcomes. In McKinsey's estimation, this segment is growing faster than the premium segment in many product categories. However, we believe it offers fewer opportunities because it is more competitive and has lower profit margins.

Playing to win: Developing a strategy for the value segment

To win in the value segment, companies need to evaluate the likely risks and economic impact of different business models to find the one that works best for their organization.

Deciding on a business model

Armed with insights into market dynamics and promising product categories, premium players may feel they are sufficiently prepared to capture the value segment. All too often, though, they lack a strong strategy for doing so. One common mistake is to offer significant discounts on premium products to respond to market pressures, without doing enough to reduce costs structurally. Although this strategy may secure volumes in the short term, it has a devastating effect on the longer-term viability of the product category—stents being a case in point.

As an alternative, we suggest that companies entering the value segment adopt one of three business models focused on preserving profits:

- *Lean-selling model.* This approach involves designing the least expensive sales model possible and limiting service support. Low costs enable lower prices, for instance, as seen in insurance, where the introduction of direct online sales with no broker involvement has enabled some companies to dramatically reduce their costs and their prices. This model is suitable for medical products such as wound dressings and disposables with simple sales cycles, recurring purchases, and limited service-support needs. It can also be used to manage products nearing the end of their life cycle after more innovative products have been introduced. For example, Medtronic launched its spinoff NayaMed to sell end-of-life-cycle pacemakers and defibrillators through a web-based channel.

- *No-frills service.* This model hinges on selling good products at lower prices by reducing service levels in areas such as distribution and clinical support. It differs from the previous model in that it requires a strong sales organization focused on capturing new accounts. It is appropriate for product categories with a complex sales cycle, high switching costs, and high service levels, such as orthopedic devices and negative-pressure wound therapy.

- *Plain products.* In this model, companies offer low-cost products either by "de-engineering" existing premium products—removing high-end features to make them cheaper to produce—or by developing new offerings. Their sales and servicing models are left intact. Renault's low-cost Dacia car brand is one example of this approach. In medical devices, it can be applied to two product categories: those that offer considerable scope for reducing the cost of goods sold because they have a large number of components and processes, and those that have complex sales cycles or require critical servicing support, such as imaging equipment. Carestream Health, which acquired OREX, a manufacturer of X-ray value products, to complement its portfolio of computed-radiography systems, is one medical-device maker that has moved into plain products.

Although these new business models seem straightforward, they require companies to make important decisions about underlying strategy, especially in relation to five building blocks: product type, operational support model, sales model, clinical support and services, and brand name (Exhibit 2).

Exhibit 2 Companies need to weigh decisions on the building blocks for business models.

Building blocks	Range of options			
1 Product type	Reduce price on existing products	Reposition end-of-life-cycle products	"De-engineer" premium products	Build new low-cost products from scratch
2 Operational support model	High-level support (eg, rapid response, just-in-time inventory management, flexible shipment terms)		Low-level support (eg, long lead time, no consignment stock, charging for freight, minimum shipment sizes)	
3 Sales model	Fully loaded sales force (as for premium)	Lower-cost sales force	Indirect channel (distributors)	Low-cost channel (digital)
4 Clinical support and services	Field-based support and training	Non-field-based support and training	No clinical support	
5 Brand name	Use existing brand name	Use endorsed brand name	Adopt new brand name	

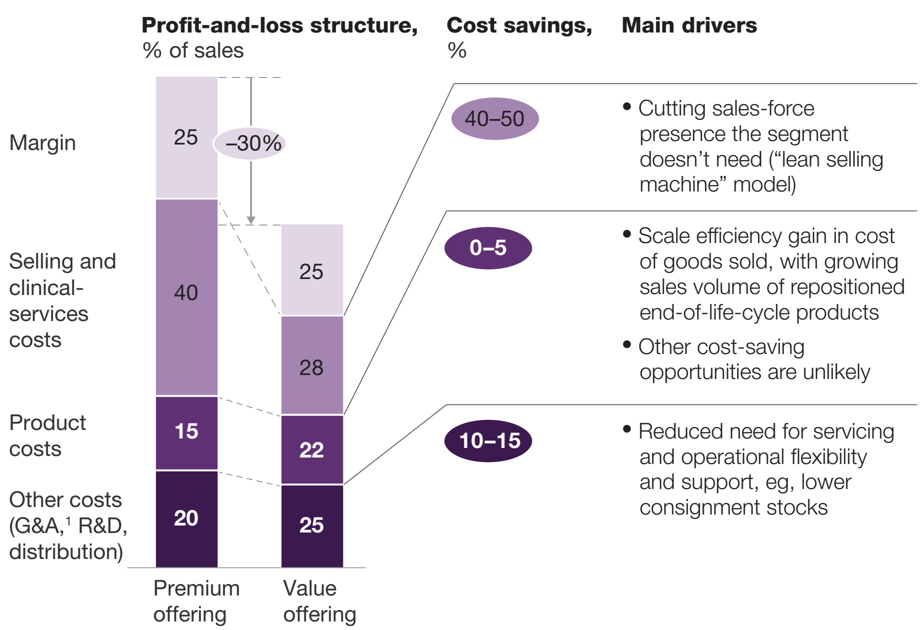
Companies face a wide range of options but need to be realistic about whether they have the capabilities to develop a new value offering themselves or whether suitable acquisition targets are available. Examining strategies that other players have adopted to enter the value sector can be a useful source of insights during the decision-making process.

Getting the economics right

When companies are evaluating business models, economic concerns are paramount. Prices for value products can be 20 to 40 percent lower than for premium products, so each model needs to be analyzed to establish how it reduces costs. Exhibit 3 shows an analysis of a value wound-care product that was priced 30 percent lower than its premium counterpart. By adopting a lean-selling model, the company expected to reduce its sales and servicing costs considerably, as well as to realize smaller savings in cost of goods sold, R&D, and distribution. Together, these cost reductions would more than compensate for the product's lower price.

Exhibit 3 One company expected cost savings from its lean-selling model.

Example, wound-care product



[1]General and administrative.

Assessing risks

Whatever business model companies select to enter the value segment, they will need to address three main concerns:

- *Minimizing cannibalization.* New value products could win share from a company's premium offerings and cut into its profits. Depending on the business model the company has adopted, there are various measures it can take to counteract this risk. For instance, a company taking a plain-products approach must ensure it has a deep understanding of premium customers and the features they prefer and ensure that these needs are not met by its value offerings. A company with a no-frills service model must identify customers who are keen to reduce costs and might be open to lower service levels. Regardless of the business model, companies usually benefit from using a dedicated lower-cost sales force to segment and target value accounts.

- *Defending against the competition.* To gain a competitive advantage in value products, premium companies must reach scale quickly. Again, the best path depends partly on the business model. Companies with a no-frills service model can use their brand-name credibility and existing account relationships to differentiate themselves from other low-cost entrants. Companies following a lean-selling approach should ensure their pipeline is well stocked with new products to avoid a situation where they offer only end-of-life-cycle products and competition is based solely on price.

- *Remaining flexible.* As market dynamics and customer needs evolve, companies must be prepared to reevaluate their business model. Those with a no-frills service model should continue to look for opportunities to reduce service costs and simplify new and existing products to make service and maintenance easier. Those following a lean-selling model may need to offer additional clinical support or more flexible inventory support for some key accounts.

War gaming or business-case assessment can help companies evaluate risks and opportunities. For instance, they could estimate the revenue flows from new-product sales and the effect of cannibalization or increased competition on profits. War gaming can also help companies assess whether value products are likely to erode their brand and damage their premium categories.

To mitigate risks, companies can pilot new products and business models in one market to gain competitive and customer insights that can help them refine their strategies. In some circumstances, though, they may prefer to undertake a large-scale global rollout to outpace competitors and capture first-mover advantage.

As decision makers become more cost conscious and competition intensifies, opportunities to serve value-oriented customers in medical devices are growing fast. To adapt to this new world, manufacturers need a deep understanding of the value segment’s needs and profit pools. The key to success does not always lie in changing the product itself but could involve altering sales models or service offerings. Companies should act now to determine what options are best for them and create a business model to enable them to thrive in the value segment.

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