Maximizing Profit Capture for Medical Device Manufacturers

Gain control over your pricing strategies, value stories, and profit visibility

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Overview

Facing unprecedented changes from government health care reform, device approval regulations, changes to sales relationships, and shifts in buying power, medical device manufacturers are under extraordinary profit pressure. This paper explores the implications of these challenges and the four essential strategies required to gain control over pricing processes, define product value, and increase profit visibility. Armed with these strategies, the astute manufacturer will be in a position to defend price levels, manage inevitable pricing variations, and raise the bar of price accountability. Embracing a strategic pricing journey can yield sizable returns and above-market growth during a time of great industry upheaval.

Medical Device Industry Challenges & Opportunities

Challenges

Medical device manufacturers are facing unprecedented pricing and profit pressure in today's market. Several factors are shifting power toward the buyer including government health care reform; changes in the physician, vendor and economic buyer relationship; and third-party purchasing consultants, while regulatory changes point to the distinct possibility of negatively affecting profit margins.

Government Health Care Reform

The federal government pays nearly 50 percent of all medical outlays in the US[1]. With dark cost clouds and record budget deficits approaching, the government is desperate to find ways to cut medical costs. The most visible attempt is the passage of the U.S. Patient Protection and Affordable Care Act (PPACA) in 2010. Beginning in 2013, medical device companies will have to pay a 2.3 percent excise tax on gross revenues; in return, the government is trying to reassure manufacturers that the increase in insured patients will more than offset the new cost. However, for most device makers, it will require volume growth in excess of 20 percent to fully offset the tax and remain profit neutral.

[1] "National Health Expenditure Projections 2009-2019," Public share of National Health Expenditures, https://www.cms.gov/NationalHealthExpendData/downloads/proj2009.pdf, Page 1

In addition to new direct taxation, the federal government is escalating the regulatory requirements for premarket approvals (PMA) of new medical devices. The planned reform to the 501(k) approval process and the introduction of the new Class IIb category are expected to drive up R&D costs by adding time, complexity and uncertainty to an already challenging PMA process.

Moving Beyond the Physician

For medical device manufacturers that sell physician-preferred items (i.e., spine, stents, pacemakers, orthopedics), the physician/hospital/sales representative relationship is constantly morphing. Physicians are increasingly unwilling to fight to use a certain manufacturer's products because they are either now employed by a hospital or the hospital has told the doctors to stay out of the negotiations. Hospitals are also employing more sophisticated buyers who are more effectively bidding suppliers against one another to lower costs.

In addition, the federal government is conducting a pilot program to evaluate the cost impact on of bundling physician and hospital payments. This evaluation will be expanded to more procedures beginning in 2013, further aligning the physician and the economic buyer.

Third-Party Consulting Organizations

The third source of pressure is coming from consultants – third-party traditional consultant companies, internal consulting groups, or Group Purchasing Organizations (GPOs). Due to the mass membership of vendors (medical device manufacturers), GPOs such as Premier, Inc., The Broadlane Group, and HealthTrust can secure competitive pricing for hospitals, eliminating the need for hospitals to secure pricing with each vendor on their own. GPOs are looking to add additional value for their members by offering software tools to manage their contracts, supplier negotiations and spend analysis.

Contract confidentiality is routinely breached, and, while typically opaque, pricing is shared among hospitals via benchmarking services such as Emergency Care Research Institute (ECRI) and the GPOs. Suppliers have shown a lack of resolve in suing consultants or hospitals for sharing price information, so there is little reason to think this practice will slow down any time soon. For example, after Guidant Corporation sued Aspen Consulting and won a summary judgment in 2005, no other medical device company challenged Aspen's consulting practices.

Opportunities

While the challenges facing medical device manufacturers are intense, there are select market opportunities for innovative companies to leverage. These include the growth in the number of covered patients, an aging population and growth in developing markets. Vendors will need to position themselves to take advantage of this growth and secure their fair share in the marketplace.

With the mandate for universal coverage, the PPACA is projected to add 32 million additional covered patients in the United States[2]. This represents approximately a 12 percent increase over current levels[3], resulting in modest growth in the overall market for medical devices. In addition, the U.S. population over 65 years of age is projected to expand by 30 percent over the next 10 years[4]. These patients consume a disproportionally large amount of medical services, and will require advanced solutions for chronic conditions. Finally, developing global markets are seeing expanded access to health care procedures, particularly in Asia and Latin America.

Pricing Strategies to Maximize Profit Capture

So what can medical device manufacturers do to survive and grow in light of this very dynamic environment? It begins with building a set of pricing and profit management strategies to gain control over pricing processes, value stories and profit visibility. Armed with these strategies, the astute manufacturer will be in a position to defend price levels, manage inevitable pricing variations, and improve the quality of pricing decision making.

Strategy #1: Optimize New Product Pricing

Innovation has been the lifeblood of many medical device manufacturers. In the past, a more favorable pricing environment provided a greater margin of error in capturing value from new products. Today, getting it right at launch has never been more critical.

Optimizing new product pricing begins with a direct focus on provider return on investment (ROI). How will this new offering improve the ability of the doctor and hospital to earn a higher profit, either through increased procedure volume, reduced length of stay, or greater unit margins? It is essential for manufacturers to translate product features into economic benefits, focus on the enhanced performance of the new product, and build a health economic “value bridge” from the old solution to the new solution.

[2] “Cost Estimate for Pending Health Care Legislation.” Congressional Budget Office. March 20, 2010.

[3] “Income, Poverty, and Health Insurance Coverage in the United States: 2009,” US Census Bureau, September 2010: 253.6 million people in US with health insurance in 2009.

[4] “National Health Expenditure Projections 2009-2019,” https://www.cms.gov/NationalHealthExpendData/downloads/proj2009.pdf, Table 1

New Product Pricing: Provider Value Bridge

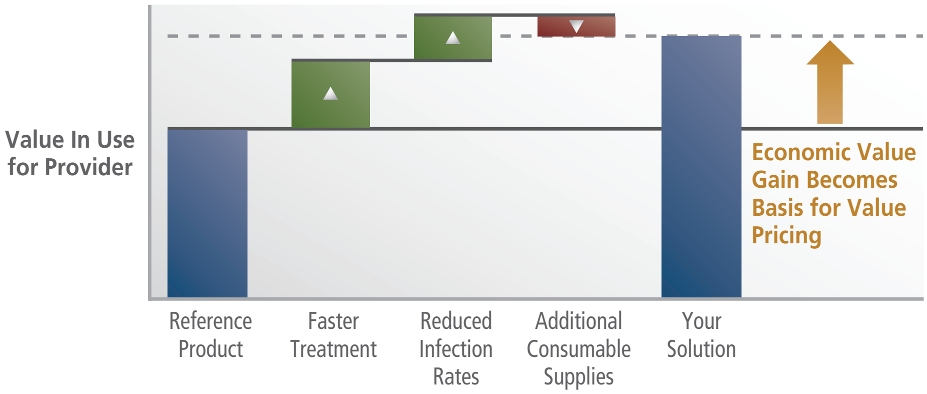


Figure 1

The other vital party is the payer. Understanding the economics through the eyes of the payer brings clarity to the value message. Demonstrating that a new medical device more quickly achieves treatment goals and lowers the overall cost of care will ensure maximum purchase consideration.

The ideal time to build the price and value alignment is early in the new product development process. It is important to engage "value managers" (experienced product managers, market insights personnel, and/or seasoned sales leaders) at the front end of the development cycle to develop the value story. Ensuring that the target price point is included as a key requirement of a successful delivery helps prevent product "cost creep" during the R&D process.

Nailing the incremental provider value is also key to the development of successful reimbursement strategies and for shaping the complete reimbursement pathway, from coding to coverage to collection. It is essential that the marketing leader responsible for the new product launch is knowledgeable of the reimbursement process, and guides the health economics team on product messaging, competitive landscape and commercial objectives. Knowing the degree of value advantage versus a reference product will also inform the decision to pursue new reimbursement codes (breakthrough solutions) or work within the existing codes (incremental products) to achieve the product goals.

Once the value story is developed, don't keep it a secret – invest time and effort into communicating the value proposition clearly to providers and payers. Begin value selling efforts internally with the sales team, and don't assume they already "get it." Equip the sales force with the messages and reimbursement collateral materials they need to have resonating discussions with hospitals and purchasing agents to define price-value tradeoffs during tough negotiations.

Challenges Addressed

- Product commoditization pressure
- Recouping rising R&D costs
- Recovering 2.3 percent device tax

Strategy #2: Equip Yourself to Manage Price Variability

With ever-escalating pressures from buyers, price variability is inevitable as medical device companies seek to optimize individual deals and agreements. The key is to strategically manage this price variability, and to avoid prolific, one-off exceptions that can ultimately drive down average prices and destroy company value.

Challenges Addressed

- Product commoditization pressure
- Eroding average selling prices
- Proliferation of low price points across customer base

Utilizing a well-designed customer segmentation framework is the first step toward establishing structure and logic to manage price variability in the market. Customer segmentation simply recognizes differences in value perceptions, motivations and willingness-to-pay among groups of similar buyers, and forms the basis for creating tiered offerings at various price points.

A leading segmentation practice involves bucketing customers into relative strategic importance (e.g., A-B-C) along one axis, while classifying their key decision drivers (e.g., minimum specifications, joint solutions seeker, etc.) along the other. This approach helps define a manageable number of segments with different price and feature combination from which product and service tiers can be developed (e.g., payment terms, contract duration, technical services, bundles, etc.). Today's leading pricing software solutions can provide a foundation for developing rich segmentation models using historical sales, and customer and contract data, upon which pricing targets and negotiating thresholds can be developed.

Managing Price Variability with Segmentation

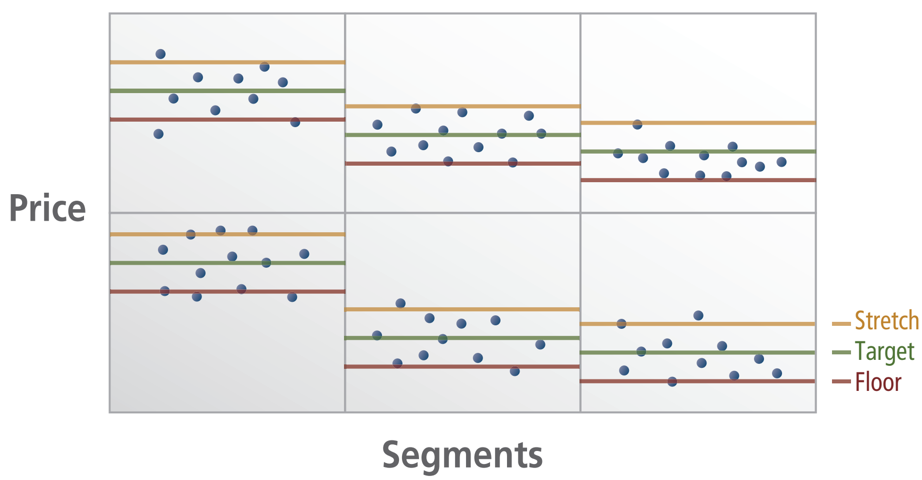


Figure 2

Sticking to a segmented pricing strategy drives pricing consistency, and therefore price stability, in the market, as well as better alignment between pricing actions and business performance objectives.

Strategy #3: Improve Deal Structuring

Even with a solid segmentation framework in place, purchasing decision makers will inevitably challenge your pricing strategies. Where negotiations, price exceptions and concessions are called for, the negotiation should be made with a thorough review of the relevant facts. With a rigorous, fact-based negotiation process in place, providers and field representatives are less likely to make emotional or outlandish requests, and the device manufacturer is more likely to extract fair value. These facts should serve as the basis for the deal structure: a combination of products, service levels, commercial terms and performance commitments.

At the heart of any deal is the set of products and services being purchased. While this seems rather apparent, many manufacturers overlook establishing a logical progression of offerings from an opening price point, to a mid-level performance option, up through a premium-positioned solution. Having this series in place helps decision makers understand the price and value continuum, and forces them to make their own tradeoffs.

Once a provider has selected from the array of offerings, a deal can be structured. Working within the pricing guidelines established in the segmentation exercise, commercial terms can be negotiated with mindful and fact-driven tradeoffs among price, volume, product mix, payment timing and delivery options, among other dimensions. The key is to never get away from flexing on price while flexing on value provided. When a lower price is requested, respond by taking away elements of value in the deal structure. This may take the form of a lower-tier product, faster payment terms, elimination of marketing funds, or reduced levels of account servicing, for example.

Another central point of negotiation is the "share of wallet" – or percent of the provider's purchase requirements – associated with the deal structure. Greater price flexibility is typically appropriate for a 90 percent share of wallet versus a nominal market access level where less than 20 percent of a provider's purchase requirements will be realized. This area is often a point of risk for the manufacturer, however, as commitments are quickly and easily made by the purchaser, who knows the manufacturer has little intention or resolve to follow up on these agreements. Avoid being counted among this group. Instead, make a true commitment to define clear expectations and repercussions during negotiations, measuring contract compliance, and taking the necessary actions to avoid rewarding unprofitable behaviors.

Challenges Addressed

- Unjustified price requests
- Product commoditization pressures
- Unrealized performance commitments

Strategy #4: Upgrade Profit Visibility

Many medical device manufacturers are flying blind when it comes to understanding the complete profit picture by customer or by segment. In a recent Kalypso survey of device companies, only 38 percent could "strongly agree" that they have a clear and consistent view of net price by customer (after discounts, promotions, rebates, etc.).

Challenges Addressed

- Recovering 2.3 percent device tax
- Eroding average selling prices
- Lack of transparency to full profit picture

A leading practice is to develop a price waterfall that depicts profit performance in a meaningful and actionable manner. This means harvesting and aggregating the various on-invoice and off-invoice discount items, along with the essential cost-to-serve buckets, to arrive at a bottom-line pocket margin (amount of profit left in pocket after all adjustments). It is recommended to begin with the largest, most available and controllable discount and cost buckets, and invest the most time there. Go deep on the critical few buckets rather than try to account for every last item. It is important to remain practical and resist the urge to go for unattainable precision with a 10-step waterfall, when most of the leverage exists in a handful of variable price and cost buckets.

Gaining Profit Visibility with a Price Waterfall

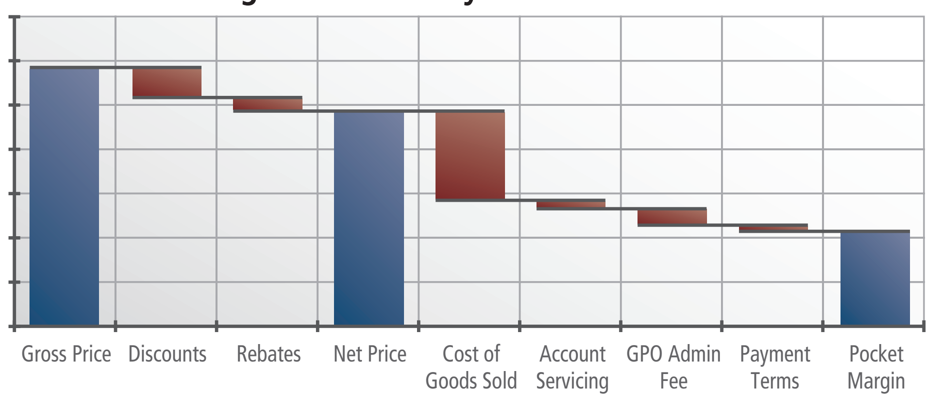


Figure 3

Gaining a clear view of the bottom-line impact of pricing decisions is an essential battle strategy during this unprecedented time of industry change. Leaders and executives must have confidence to make tough pricing decisions in a manner consistent with their profit and market objectives. Building these capabilities will require time and scarce resources, but there is tremendous ROI that flows from equipping an enterprise to make informed pricing decisions.

Enable & Sustain

From a tactical standpoint, there are three essential requirements for operationalizing and perpetuating well-developed pricing and value management strategies: organizational alignment, tools and technology, and performance management. Without investments in these areas, a strategic pricing initiative can end up as a one-off project with no ability to sustain positive performance. Done correctly, these key enablers will produce a lasting competitive advantage to generate profit growth amidst a sea of challenges and uncertainty in the medical device industry.

Organizational Alignment

Perhaps most essential to enabling a high-functioning pricing capability is a well-aligned company. Internally, there must be a clear mandate from the CEO on the priority of improving profit performance through strategic price management. Given that pricing directly or indirectly affects all business functions, executive commitment and active leadership team support is a must.

Organizational alignment goes well beyond lip service, and includes a number of characteristics:

- Profit-focused incentive compensation systems that reward price quality
- Well-developed and executed change management plans
- Widely communicated (and rewarded) early wins to build organizational confidence
- Pricing decisions moved as close to the customer as possible, but not beyond roles with pricing accountability
- Defined pricing organization and value stewardship roles

Tools & Technology

Achieving pricing excellence requires an investment in systems and technology to collect accurate pricing and profitability data, identify profit-improvement opportunities, optimize price levels and facilitate the end-to-end price management process.

Companies increasingly employ supply chain management tools, benchmarking services and negotiation training, all aimed at commoditizing supplier’s products. Pricing professionals need to also employ sophisticated tools rooted in science and move away from offering price points based on “gut feel” or the threat of being kicked out of an account.

Leading pricing systems offer:

- Scientific segmentation algorithms to ensure customers are properly segmented
- Pricing analytics to improve full profit visibility and reduce price leakage
- Price optimization capabilities to generate prescriptive pricing guidance
- Deal management software to ensure consistent pricing rules are efficiently applied

By employing tools that use science to minimize emotional decisions, suppliers have a better probability of offering a price point that is relevant to the market with less risk of "following the competition" or emotional pleas to make pricing decisions.

Performance Management

An effective performance management process becomes the basis for ongoing conversations about how and where to improve performance. With that in mind, every medical device manufacturer should have a set of pricing metrics that measure the financial and operational health of pricing across the business. These metrics may include:

- Basic data, such as the average selling price, discount, and margin for key product
- Operational data, including the number of pricing exceptions, pricing turnaround time, and win/loss percentages
- Special measures to track the progress and impact of specific pricing initiatives

Another leading practice is to implement a performance follow-up process to evaluate deal decisions post mortem. This helps to determine if actual performance (volume, price, share, etc.) is consistent with target levels when the pricing decision was originally made. Hospitals increasingly demand capitated/pay-to-play deals, so suppliers must get more creative to stave off these dreaded capitated contracts. Contract compliance and rebate performance must be systematically tracked to ensure that any price decrease given to a customer drives the predicted and desired outcome. This critical feedback loop will reveal process and accountability gaps that threaten to unravel the hard work of establishing strategic pricing practices.

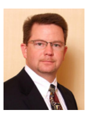
Conclusion

In a period of extraordinary industry change and uncertainty, medical device manufacturers have little choice but to embrace strategic price management as a key element of their business plans. A one percent change in price equates to an 11 percent change in profit for typical companies, and there is no greater leverage point to drive performance.

This paper explores strategies for optimizing new product pricing with value based pricing, managing price variability with segmentation, improving deal structuring through price-value tradeoffs, and upgrading profit visibility with price waterfalls. These actions represent a core set of activities that are proven to maximize value capture across a product portfolio. In addition, this paper examines essential enablers necessary to sustain high levels of pricing excellence: organizational alignment, tools and technology, and performance management.

[5] Marn, Michael V. , Roegner, Eric V., et. al. The Price Advantage. New Jersey: John Wiley & Sons, Inc., 2004.

About the Authors



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