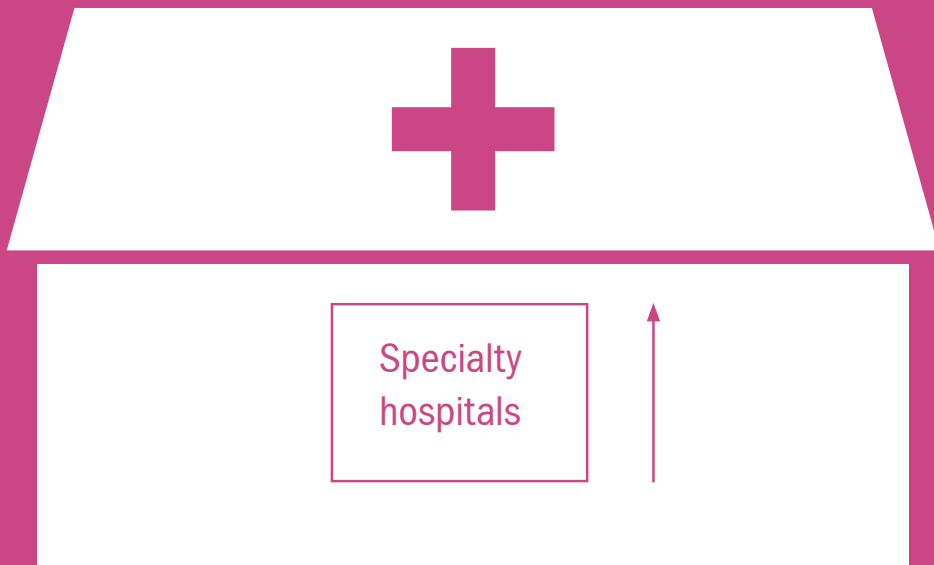


THINK ACT

BEYOND MAINSTREAM




ENTERING CHINA'S PRIVATE HOSPITAL SEGMENT


Perspectives on Opportunities, Challenges and Potential Entry Points


MAY 2014

Roland Berger
Strategy Consultants

THE BIG 3

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 We believe that there should be a systematic three-step market entry evaluation and execution process
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 China's private hospital sector has entered a period of fast track development. Increasingly, policy restrictions are no longer the main hindrance. Instead, finding a winning commercial model will be key.
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"Private
hospital ownership
breakdown"
p. 8

Although China's private hospital sector only accounts for a small share of the healthcare services market, its growth momentum will continue to strengthen as the investment environment improves and investment patterns diversify. Growth in the sector is being driven by overall market demand, loosening regulations, as well as diversification and specialization. In the future, the sector will see new hospital chains, expansion of existing hospitals, improvement of services, and shifting specialization focus. Foreign participation in this market is nascent but growing. Market entrants prefer specialty hospitals, especially in areas such as plastic surgery, OB/GYN, and orthopedics. For those looking to enter the market, we recommend a systematic three-step process that encompasses the development of a strategic basis, pre-investment due diligence, and a well-planned post-investment improvement process.

Part A. Overall trends and investment hotspots in China's private hospital sector

1. Overall trends

Private hospitals in China have proliferated rapidly in recent years. In 2012, private hospitals accounted for 40% of all hospitals, up from just 17% in 2005. The ratio of private to public hospitals has been rising in the past few years primarily due to the privatization of smaller and financially distressed public hospitals run by local governments and SOEs. **A**

Though there are now more of them, private hospitals still provide less than 10% of total services, mainly due to their smaller size and lower utilization rates. Their key challenges include low patient recognition, lack of qualified physicians, low BMI (Bureau of Medical Insurance) coverage, and weaker support from local authorities in issues such as land use, taxation, and government subsidies. **B**

What, then, does the future hold for the sector? We believe the most relevant trends include:

1) Expanding scale and improving service quality:

- Major investors who favor large, advanced hospitals will

expand their presence in the Chinese market

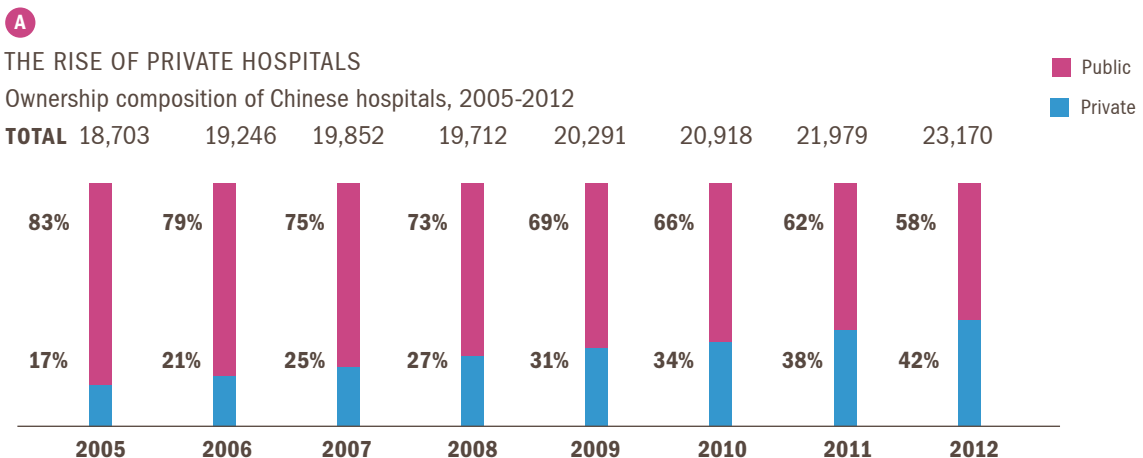
- Many small, lower-end private hospitals will be gradually phased out as government supervision strengthens and competition intensifies

2) Emergence of new hospital chains:

- In the last decade of development, several hospital chains have emerged in the market, such as Aier, an ophthalmology hospital chain. Going forward, hospital chains are likely to expand even further due to higher patient awareness, more stable physician teams, and cost advantages

3) Shifting specialization focus:

- Traditional private investment hotspots such as dentistry and ophthalmology have become saturated after years of development. Foreign and private participation will focus on other specializations, including inpatient rehabilitation and oncology, that do not rely heavily on physicians and for which there is huge demand and service gap is significant



A Roland Berger survey found that mid-sized hospital chains are the preferred targets for investment and market entry. Rehabilitation, OB/GYN, and oncology are the top three specializations. **C**

2. Policy trends

The policies regulating investment in private hospitals are improving, bringing with them significant long-term opportunities for public hospital reform. As a result, more players will become involved in hospital investment, including SOEs, POEs (privately-owned enterprises), and foreign investors. Private hospitals' contribution to overall healthcare services volume is projected to increase steadily.

In 2010, the State Council relaxed entry barriers for private hospitals, identifying private hospitals as the preferred ownership structure for new healthcare institutions. In the same year, United Family International Medical Group and Shanghai Huashan Hospital signed a cooperation to jointly manage Huashan Pudong Hospital International Division. The next year, The State Council set a target of 20% of China's healthcare service volume and hospital beds to be provided by private hospitals. Lanseed Hospital, Mainland China's first independently financed medical institution, opened around that time.

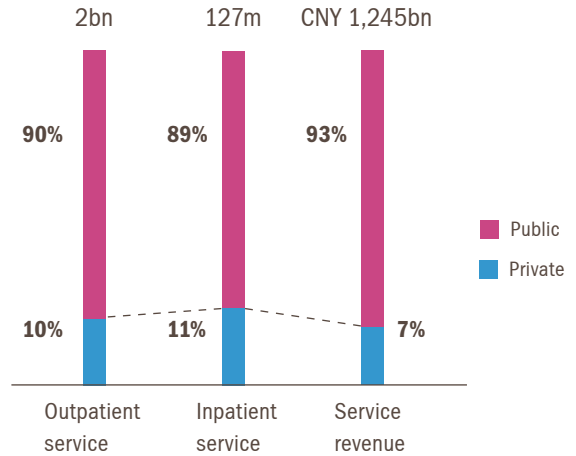
More detailed regulations to guide the implementation of policies related to private hospitals are emerging along six main fronts:

1. Taxation: Profit-making hospitals became exempt from corporate taxes in 2009
2. Land and construction: Document No. 58 issued by the State Council categorized qualified private hospitals as being eligible for favorable land acquisition and construction policies
3. Hospital rating: Private hospitals are allowed to participate in ratings and become certified as "AAA" hospitals
4. R&D: Private hospitals are encouraged to participate in the assessment of teaching hospitals. The government also offers R&D support for building certain specializations

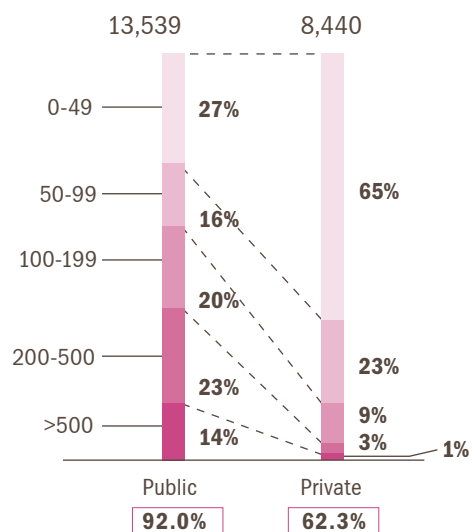
B

LIMITED SERVICE CONTRIBUTION OF PRIVATE HOSPITALS

1 Service volume and revenue by hospital ownership structure, (2012), [CNY]



2 Beds per hospital & average utilization rate by ownership structure, 2011



seen as "critical"

5. Professional qualifications: Document No. 58 promulgated equal treatment of professional qualification assessments and training for public and private hospitals
6. Capital type: Diversified capital is encouraged in the structuring of private hospitals. There is no preference for public, private, or foreign capital

A number of policy trends related to public hospitals are having a profound impact on the landscape of private hospitals as well. In 2009, the "Policy for the acceleration of healthcare reform" set a new tone for the reform of public hospitals, encouraging diversification of ownership structures and further development of DRGs and fixed budget pre-pay mechanisms. In 2010, sixteen cities launched public hospital reform programs, which require clear ownership structures and corporate governance systems. In Kunming, for example, the city's medical institutions were more than 70% privately owned by 2012, housing more than 50% of all hospital beds.

Going forward, new DRG-based hospital payment systems will lead to the restructuring of more public hospitals, giving private medical institutions and private capital the opportunity to participate in the restructuring of public healthcare institutions. The experiences of other countries are particularly relevant. In Germany, for example, the implementation of DRGs highlighted inefficiencies in public hospitals, triggering a bout of mass privatization. In 2010, the number of private hospitals in Germany exceeded that of public hospitals for the first time. **D**

Improved coverage of commercial insurance will bring more opportunities for private hospitals to enter into partnerships with commercial insurance providers. Currently, coverage and service gaps are large, suggesting significant opportunities.

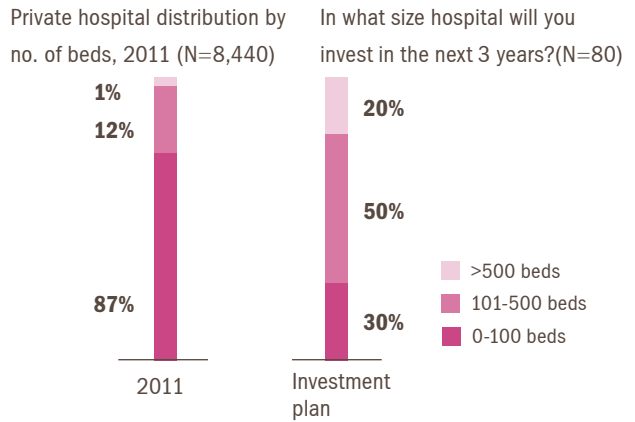
3. Investment and foreign participation trends

Although local players still dominate the private hospital investment landscape, foreign investors are actively exploring entry options. Major international

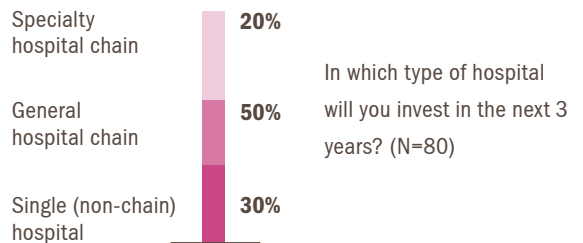
C

ACCORDING TO A ROLAND BERGER SURVEY, MID-SIZED HOSPITAL CHAINS ARE PREFERRED TARGETS FOR INVESTMENT. REHAB, OB/GYN, ONCOLOGY ARE THE TOP 3 AREAS

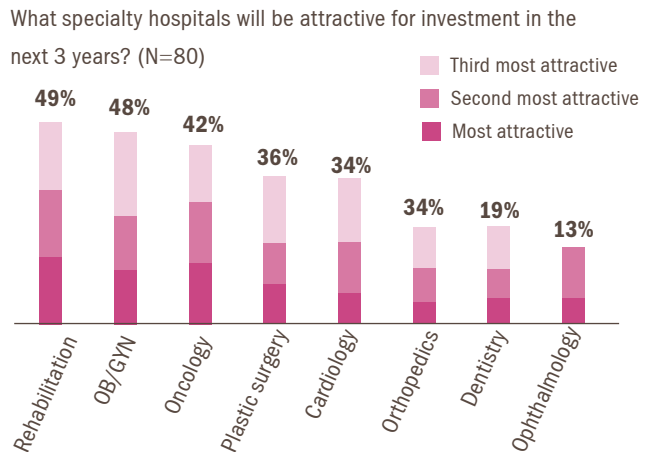
1 Expanding scale and improving service quality



2 Emergence of hospital chains



3 Shift of specialization focus



hospital management groups have yet to establish a strong presence but are actively planning to expand in the Chinese market. SOEs have the advantage in public hospital privatization due to their close relationships with governments and their local roots. Large pharmaceutical companies, looking to expand along their value chains, are also active in this sector. It is worth noting that purely foreign-owned entities are still not allowed to hold a 100% stake in local investments, nor may they build wholly-foreign owned "greenfield" hospitals. **E**

There are several types of entrants in the market, including:

- **Institutional investors** such as CDH, which invested equity in Beijing New Century Children's Hospital, Ciming Health Checkup, Angel Group, and Bosheng Medical; and IDG, which invested equity in Rich Healthcare Management and Pai Group, among others
- **Investors with overseas backgrounds** such as Chindex, which focuses on the high-end market and has set up hospitals and clinics in Beijing, Shanghai, Wuxi, Tianjin, and Guangzhou
- **Foreign operators** such as United Family Healthcare
- **SOE and POE conglomerates** such as China Resources,

which invested equity in neurology and pediatric hospitals and reformed and acquired a public general hospital; and Fosun, which invested equity in two general hospitals in Hefei and Suqian and in one specialized hospital in Yueyang. Fosun also invested in Chindex together with TPG.

- **Pharmaceutical companies** such as Mayinglong, which operates five chain hospitals specializing in anorectal diseases

Investors and market entrants prefer specialty hospitals. Specializations such as plastic surgery, OB/GYN, and orthopedics are dominated by private hospitals.

There are two main reasons for this. First, specialty hospitals, whose clinical capabilities are less comprehensive, do not require the large-scale investment general hospitals do. Second, many of the service items specialty hospitals offer are not reimbursable and therefore require more of the customized, high-margin services public hospitals cannot competitively offer. **F**

It is worth noting that while investment in purely private hospitals is most common, PPP/trusteeship structures are being tested and public hospital reform will bring long-term opportunities. **1**

D
REFORM TRENDS FOR PUBLIC HOSPITALS

Evolving logic of hospital reform in Western countries provides a good reference for China's path forward

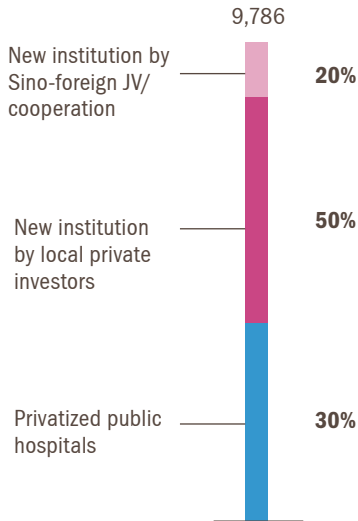
Hospital payment system reform	BMI payment pressure	DRG pilot program	Operational efficiency improvement needed in public hospitals	Introduction of corporate governance structures	Group management
				Privatization	
<ul style="list-style-type: none"> - Drug markup to be gradually eliminated - VIP services to be gradually eliminated or strictly controlled in public hospitals 	<ul style="list-style-type: none"> - BMI has been increasing rapidly for the past 5 years - BMI payment burden is growing in some cities 	<ul style="list-style-type: none"> - PPS and DRGs are effective ways to relieve the BMI payment burden - PPS and DRG pilot programs are being established in Shanghai and Beijing 	<ul style="list-style-type: none"> - Reform of the payment system will be a milestone for hospitals' operational efficiency - Hospitals with inefficient operations will be forced to change 	<ul style="list-style-type: none"> - Reform of public hospitals will be accelerated: Introduction of corporate governance structures - Privatization of public hospitals 	<ul style="list-style-type: none"> - Hospital groups will emerge to achieve economy of scale and improve branding

Hospital payment system reform Current payment system: and Mainly item-based payment Future payment system: Prospective payment system (PPS), diagnosis related group (DRG)



PRIVATE HOSPITAL OWNERSHIP BREAKDOWN

Private hospitals by funding source, 2012



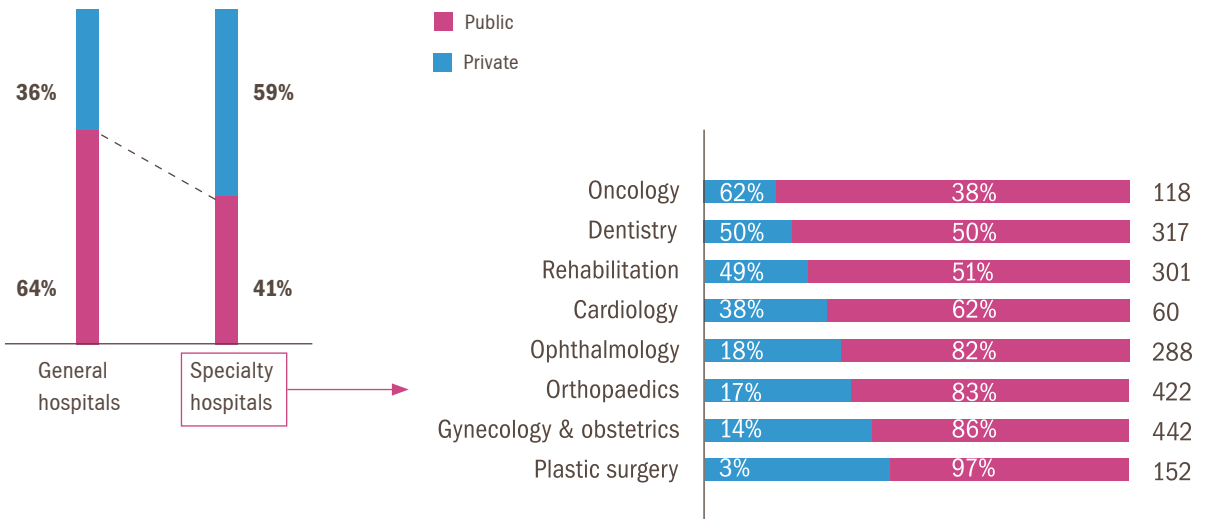
Currently, most foreign investors are from Hong Kong, Macau, and Taiwan. Leading international hospital management groups have yet to establish a strong presence, but are actively planning to expand in the Chinese market, SOEs have the advantage in public hospital privatization due to close relationships to the government relations and local roots, Large pharmaceutical companies are also active in this sector as they are trying to expand along the value chain

	Investor profile	Hospital positioning	Examples
New institution by Sino-foreign JV/cooperation	<ul style="list-style-type: none"> - Foreign hospital chain - Financial investors 	<ul style="list-style-type: none"> - Mostly focused on premium market - ~70% are specialty hospitals and ~80% have fewer than 200 beds 	<ul style="list-style-type: none"> - United Family Healthcare - Beijing DCN Orthopedic Hospital - Xiamen Chang Gong Hospital
New institution by local private investors	<ul style="list-style-type: none"> - Financial investors - Pharma/medical - Regional real estate developers - NGOs 	<ul style="list-style-type: none"> - ~90% target medium-mass market - Majority are specialty hospitals 	<ul style="list-style-type: none"> - Wuhan Asia Heart Hospital - Aier Ophthalmology Hospital - Nanjing Tongren (同仁) Hospital - Shanghai Hongkang (宏康) Hospital
Privatized public hospitals	<ul style="list-style-type: none"> - State-owned enterprises - Local hospital management companies - Pharma/medical 	<ul style="list-style-type: none"> - ~90% target middle-mass market - Majority are general hospitals 	<ul style="list-style-type: none"> - Suqian (宿迁) People's Hospital - Beijing JianGong (建工) Hospital

F

SPECIALTY FOCUS OF PRIVATE INVESTORS

Hospitals by specialty & ownership structure, 2011



There are two main reasons why private investment is concentrated in specialty hospitals, Specialty hospitals require smaller-scale investment and less comprehensive clinical capabilities, Many of the service items offered by specialty hospitals are not reimbursable and therefore require more customized, high-margin services in which public hospitals lack the advantage to compete

Current common practice → Future opportunity

Investment model	Private only	PPP/trusteeship	Public hospital reform
Description	Currently, different types of private care providers populate the market - Mass market specialty hospitals such as Mylike and Asian Hearts and general hospitals like Fosun - Premium hospitals such as United Family and New Century	PPP between public hospitals and private players (i.e., investors and private hospitals) - Public hospitals provide expertise and best-in-class physicians - Private players offer capital and incentives for efficiency improvement	Often, at the local government level, mismanaged public hospitals are privatized and full ownership transfers to private investors along with financial and operational control. Physicians and staff lose their "iron rice bowl" public sector employment status
Example	- Majority of private hospitals	- Yaxin Hospital - Wuhan No.7 Hospital	- Suqian (宿迁) People's Hospital - Beijing JianGong (建工) Hospital

2 Part B. Roland Berger's perspectives on potential entry strategy

We believe that there should be a systematic three-step market entry evaluation and execution process **A**

1. Strategic choices

There are several strategic angles to take into account before executing an entry. These include:

- **City tier**, the key metrics for which are unmet demand for high-end healthcare services, quality, value for money, accessibility, affordability, and convenience
- **Target patient segments**, requiring consideration of market potential and growth drivers of both high

end and mass segments

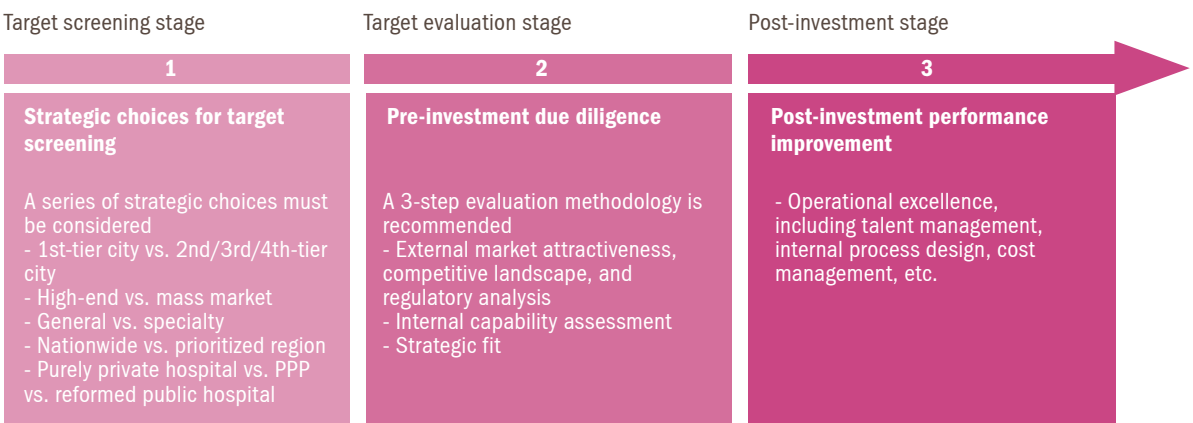
- **General vs. specialty**, requiring an evaluation of specialties' growth, competition, barriers to entry, and potential to replicate
- **Geographic focus**, requiring an analysis of the "size of the prize" as well as specific policy environments in different locales
- **Investment model**, i.e. PPP vs. greenfield private hospitals vs. reformed public hospitals

For city tier and target segment considerations, there is significant unmet demand for healthcare access, quality, and services across different segments.

In first-tier cities, strong demand across

A
ROLAND BERGER BELIEVES THAT THERE ARE THREE STAGES OF STRATEGIC THINKING FOR HOSPITAL INVESTORS IN CHINA

Source: Roland Berger analysis



B

GENERAL/SPECIALTY SELECTION

1 Hospital type selection

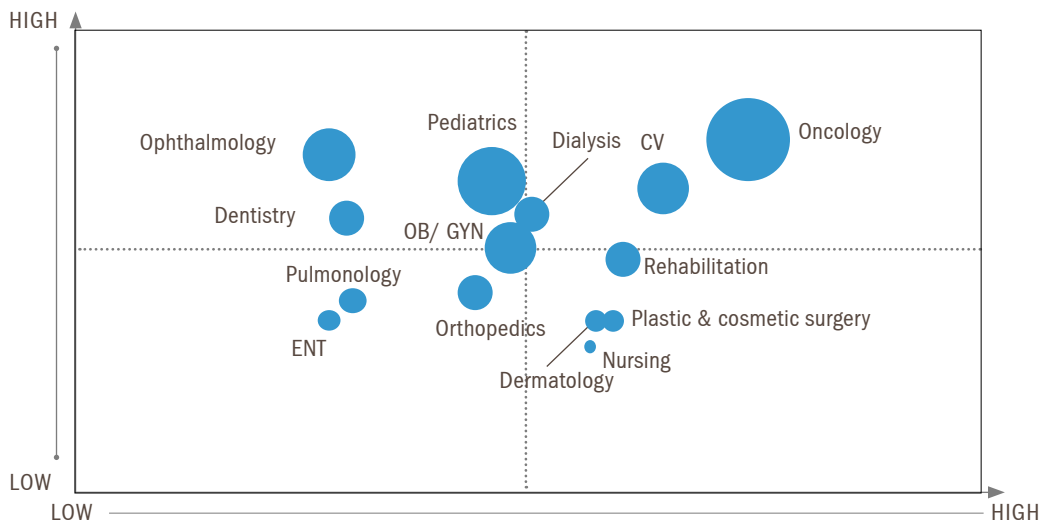
	Mainstream market	Scale	Profitability	Replication
General	×	×		
Specialty			×	×
General with specialty focus	×	×	×	×

* This table is intended for illustrative purposes

General hospitals target the mainstream market with economies of scale, but have slim profit margins and are difficult to replicate. Specialty hospitals usually have high profit margins and are easy to replicate. General hospitals with specialty focuses aim to combine the advantages of both general and specialty hospitals.

2 Specialty selection

MARKET ATTRACTIVENESS



* This table is intended for illustrative purposes

FEASIBILITY

Oncology, cardiovascular medicine, ophthalmology, OB/GYN, pediatrics, and orthopedics are specialties with markets exceeding CNY 5 bn and high growth rates. Investors should also consider feasibilities such as competitive landscape, capital requirements, etc.

therapeutic areas (TAs) comes from not only local residents but also patients with serious conditions who travel to first-tier cities seeking treatment. Public hospitals dominate, having advantages in reputation and medical resources, but they typically fall short in efficiency and service quality. Private hospitals have been carving out niches in the high-end market and selected specialties. The major gaps in this sub-market are personalized services and treatment.

In second-tier cities, there is growing demand from middle class consumers locally and in surrounding cities for quality care and services. Some seek better treatment in first-tier cities, but most patients are restricted by reimbursement schemes, which tend to be administered at the provincial level. In general, leading public hospitals are expanding in scale while private hospitals are seeking to differentiate themselves in service and care quality. "Value for money" and quality of service are most relevant for this sub-market.

In lower-tier cities, accessibility and affordability are key issues. While we see relatively few examples of successful foreign entry into these markets, the long-term opportunities are latent but significant. As of now, however, county-level hospitals are the government's key investment focus, leaving limited room for private hospital development.

For general vs. specialty considerations, we believe that investors and new entrants should prioritize specializations according to market attractiveness and feasibility. There are some general guidelines for prioritization.

First, general hospitals target the mainstream market and benefit from economies of scale, but have slim profit margins and are difficult to replicate. Specialty hospitals usually have high profit margins and are relatively easy to replicate. General hospitals that have specialty focuses aim to combine the advantages of both general and specialty hospitals.

If the decision is made to pursue specialty healthcare services, oncology, cardiovascular medicine, ophthalmology, OB/GYN, pediatrics, and orthopedics can be prioritized as specialties with

markets exceeding CNY 5 billion and high growth rates. **B**

For geographic selection, it is important to keep in mind the varying levels of private hospital development in each region, as well as the regional policy environments.

Roland Berger recommends an approach to geographic selection that segments the market into three types: "first-round reform cities", "current reform pilot cities", and "public hospital-dominated" cities.

For first-round reform cities, such as Suqian in Jiangsu Province, private hospitals have a significant share of the market and provide high-quality general and specialized services. While the policy environment is mature and infrastructure is more developed, competitive pressure is also highest.

Current "reform pilot cities", such as Kunming and Luoyang, may be the best choice for entry. In these markets, a significant number of general hospitals are private, private specialty hospitals are growing fast, and public hospital reform is a particularly relevant theme.

In "cities dominated by public hospitals", local public hospitals have rich healthcare resources, and while reform is a high priority, private hospitals (particularly specialized private hospitals) face many challenges in launching a sustainable model.

Investors should also consider the "demand" element when prioritizing geographic regions. Current and future disease incidence, payor (both private and public) policies, and patient awareness are all key factors.

2. Pre-investment due diligence

If investing or acquiring existing targets is the preferred entry strategy, Roland Berger suggests a thorough assessment framework to prioritize targets in key cities and regions.

The due diligence model needs to take into consideration the market attractiveness of the target's specific location, disease specialization, and internal capabilities as well as the competitive landscape,

regulatory environment, and strategic fit. **C**

3. Post-investment performance improvement

After the investment process is complete, the areas of operational excellence, talent management, and branding are most critical for post-investment performance improvement.

In operational excellence, the key issues to consider are the optimization of service flows, internal process design (medical and administrative), and organizational structure optimization (e.g. the elimination of redundant and non-performing roles).

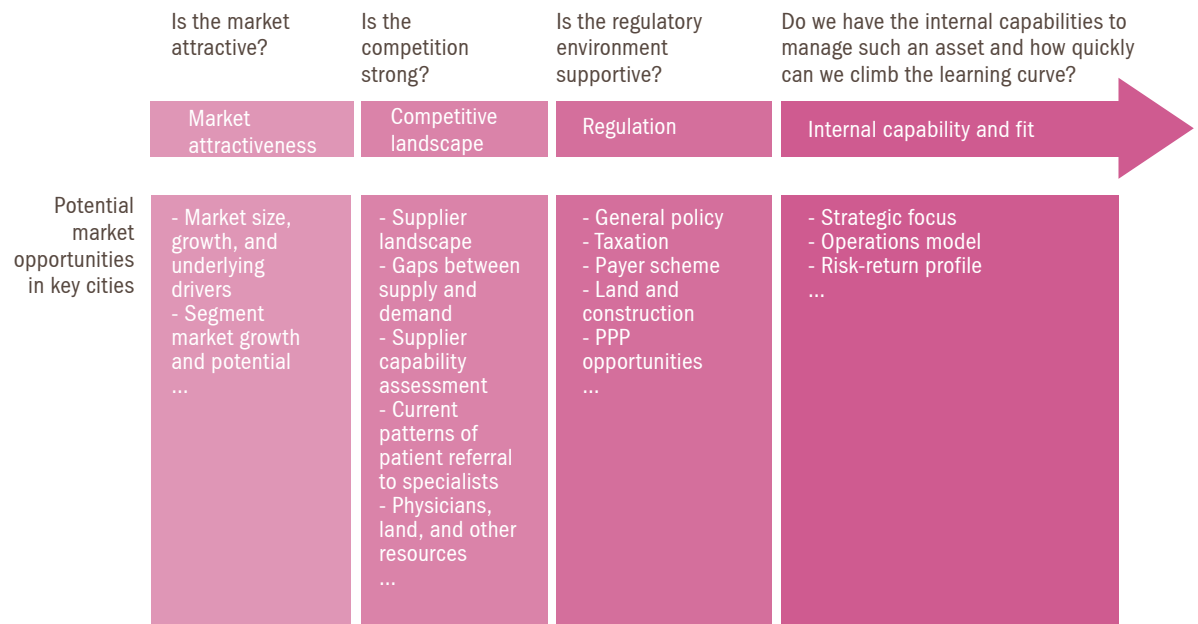
Talent-wise, the key issues are talent acquisition,

development, as well as retention and the design of the incentives scheme. Partnerships with large public hospitals may be required to co-leverage top-tier KOL's and practitioners, since private hospitals do not yet hold the same appeal to young talent as do large 3A hospitals. Such an allure, however, can be built up through dedication to quality (and hence buildup of reputation) and performance-driven culture.

The last critical consideration is branding. While large scale ATL advertising is not recommended, targeted branding efforts such as cross-references with relevant partners (e.g. high-end providers focusing on physical exams) and small-scale advertisements in relevant magazines and other publications are desirable methods.

C
PRE-INVESTMENT DUE DILIGENCE METHODOLOGY

Source: Roland Berger analysis



3

Summary

China's private hospital sector has entered a period of fast track development. Increasingly, policy restrictions are no longer the main hindrance. Instead, finding a winning commercial model will be key.

Investors need a multi-faceted evaluation framework that takes into account factors such as overall model (PPP vs. private only vs. government partner in public hospital reform), entry model (acquisition, investment, partnership, greenfield), strategic basis (general vs. specialized, and geographic and tier preferences, etc.)

We believe the greenfield model is risky for foreign entrants. First-time market entrants need to identify strong potential partners or consider acquiring stakes in existing (successful) operators. A systematic due-diligence process is also required, followed by post-investment performance improvement that focuses on operational excellence, talent acquisition and retention, as well as branding and differentiation.

While challenges abound, now is the time for future winners to begin planting the seeds of success.

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Roland Berger Strategy Consultants, founded in 1967, is one of the world's leading strategy consultancies. With around 2,700 employees working in 51 offices in 36 countries worldwide, we have successful operations in all major international markets.

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HOW TO ADAPT IN CHINA'S EVOLVING PHARMA LANDSCAPE

In a new study, Roland Berger Strategy Consultants explores the changing stakeholder landscape in China's pharmaceutical market and urges pharmaceutical companies to revisit their commercial strategies and go-to-market approaches. Changes afoot in the Chinese healthcare system mean that pharmaceutical companies can ill-afford to look at the market through a static lens. To keep pace with change, they must gain a thorough understanding of the destabilizing systemic factors at play. Most importantly, a reexamination of market gaps and opportunities is necessary.



TRAVEL RETAIL IN ASIA

Roland Berger Strategy Consultants released its latest THINK ACT booklet, which explores the changing face of Chinese tourism and how leading brands are also changing to stay ahead of the game in travel retail. Chinese outbound tourism is still at an early stage of development, but with China's middle class doubling in size between 2010 and 2020, upward pressure on outbound travel and consumer spending will remain high for years to come. As Chinese tourism changes, so will brands begin to adjust to the new travel retail environment.

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ROLAND BERGER STRATEGY CONSULTANTS

www.rolandberger.com.cn
infochina@rolandberger.com.cn

BEIJING

20/F, Tower A, Gateway Plaza,
18 Xia Guang Li, Dong San Huan North Road,
Beijing, China, 100027
Tel :+86 10 8440 0088

SHANGHAI

23/F, Jing An Kerry Centre, Tower 1,
1515 Nanjing Road West,
Shanghai, China, 200040
Tel: +86 21 5298 6677

GUANGZHOU

10/F, 8 Middle Linhe Road,
Guangzhou, Guangdong, China, 510620
Tel: +86 20 2831 7508

HONG KONG

16/F, Nexus Building,
41 Connaught Road, Central,
Hong Kong
Tel: +852 3757 9480

TAIPEI

37/F, Taipei 101 Tower,
7 Xinyi Road, Section 5,
Taipei, Taiwan, 110
Tel: +886 2875 82835

**If you have any questions,
please feel free to contact us:**

TONY TANG, PRINCIPAL

Tony.Tang@rolandberger.com