EXECUTIVE INSIGHTS

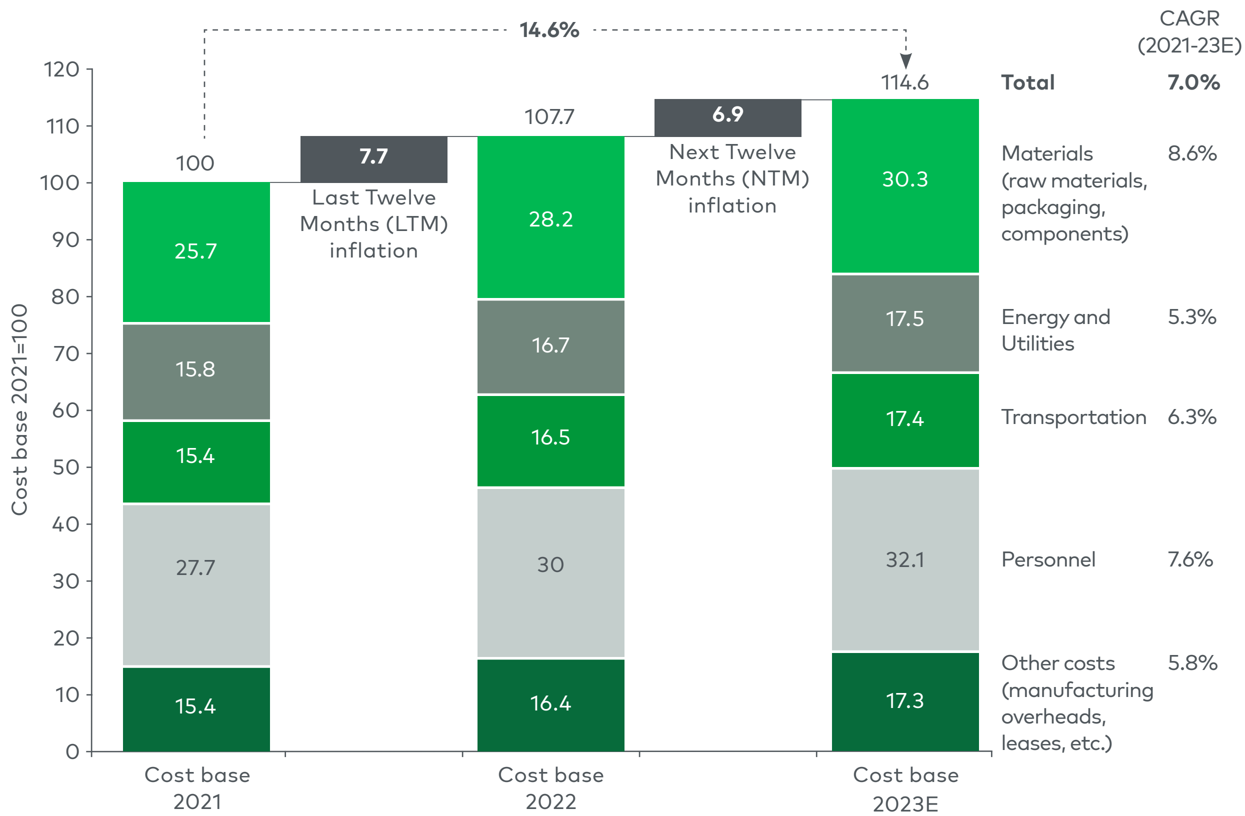
Pricing Best Practices for the Medtech Industry: There's No Time Like the Present

Medtech companies are under significant pressure from several macroeconomic factors, including inflation and supply chain disruption. Over the past decade, total Organization for Economic Cooperation and Development (OECD) producer price index[1] annual growth rates have hovered around 1%-3%, yet in 2022, producer prices skyrocketed and outpaced expectations, growing ~20% year over year. Component shortages — such as semiconductors, especially critical in many medtech categories such as imaging, cardiac (e.g., pacemakers) and patient monitoring devices, among others — are constraining production volumes and further driving up medtech cost structures.

At the same time, rapid and dramatic foreign exchange rate fluctuations (e.g., the U.S. Dollar Index has seen close to a 20% rise over the past year) have also contributed to significant swings in pricing for both materials and finished products in select key global markets. Similarly, air and ocean freight are experiencing significant capacity and shipment delays, resulting in supply chain challenges, including delayed production schedules, longer lead times and more expensive material inputs.

Medtech companies historically have consolidated production sites and optimized supply chains to minimize inventory impact on their balance sheets, leaving globalized supply chains now operationally and financially more vulnerable. A recent L.E.K. Consulting survey indicates healthcare cost bases have increased ~8% over the past year and are expected to increase ~6% through 2023, with the largest increases coming from raw materials and personnel (see Figure 1).

Figure 1
Healthcare average impact of inflation on cost structures (2021-23E)



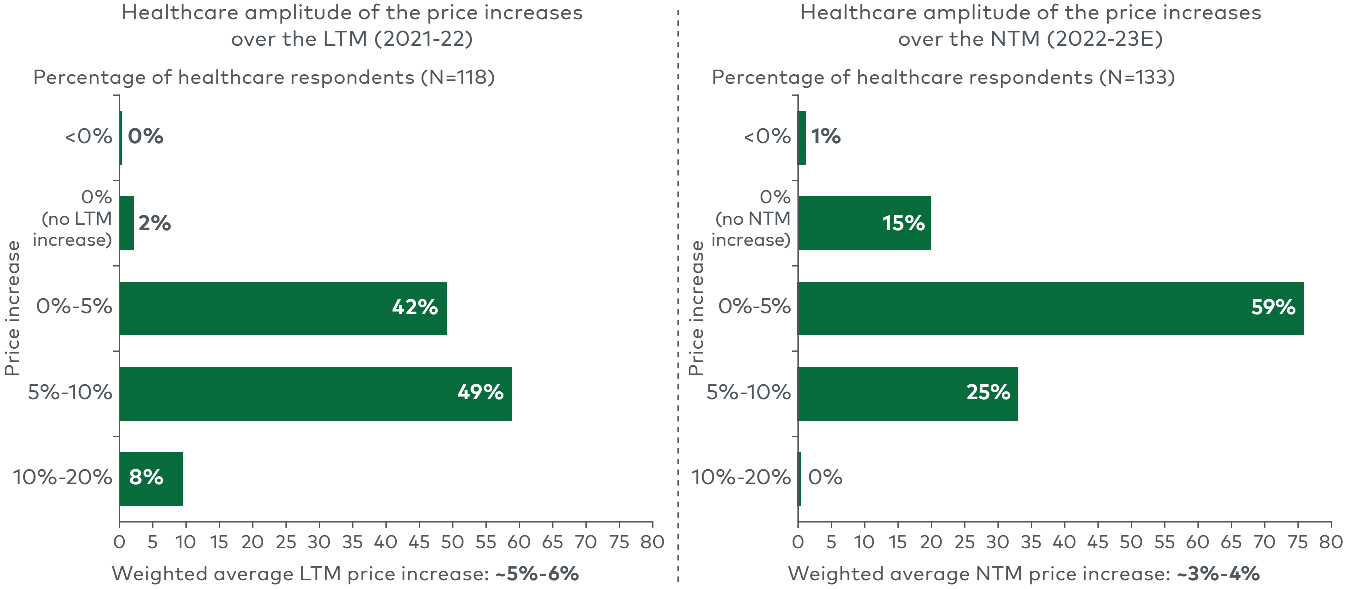
Note: Last Twelve Months (LTM) and Next Twelve Months (NTM) periods as of survey date (July-August 2022)
Source: Survey; L.E.K. research and analysis

Medtechs have been utilizing a variety of levers to counteract the margin pressures they are facing. Most have deployed traditional levers of cost reduction, including restructuring of the cost base (e.g., outsourcing to contract manufacturing organizations (CMOs), renegotiating with key suppliers), supply chain and network optimization, SKU rationalization, and currency hedges. However, cost engineering levers such as these often take significant time and investment to realize (e.g., sometimes involving product registration changes or revalidation of manufacturing processes) and alone are likely not sufficient to mitigate current margin pressures — especially in the short to medium term.

Conversely, pricing can be both an immediate and a meaningful lever for improving margins. Many healthcare companies, including medtechs, have already started to adjust prices and expect to continue to do so going forward (see Figure 2). L.E.K. believes that pricing is a powerful but nuanced lever that needs to be carefully and thoughtfully utilized, especially during inflationary periods.

Figure 2

Healthcare average impact of inflation on cost structures (2021-23E)



Note: Last Twelve Months (LTM) and Next Twelve Months (NTM) periods as of survey date (July-August 2022)
Source: Survey; L.E.K. research and analysis

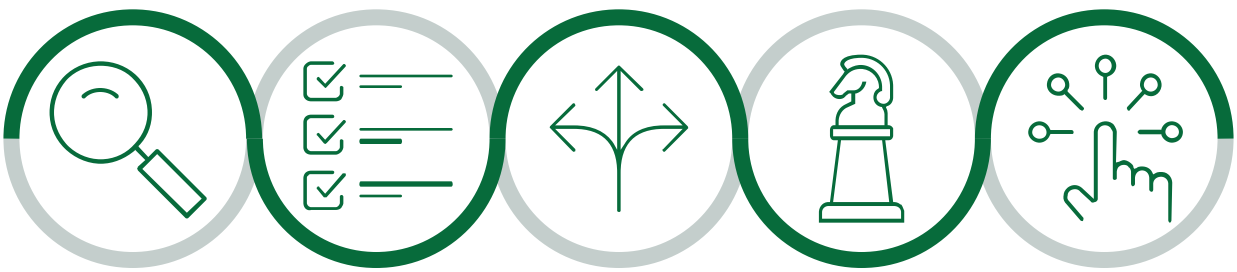
It is noteworthy that price has been a persistent challenge for medtechs to "get right." Medtechs face a plethora of different contracts across a complex product portfolio, ranging from "high-flow" products purchased and used daily to capital equipment that might only be procured once or twice a decade at varied price points. In L.E.K.'s experience, the relationship between price and underlying drivers such as customer value creation, volume and market share is complex. Pricing dynamics are further complicated by influential intermediaries, such as group purchasing organizations (GPOs) in the U.S. and in some European markets like Germany and/or complex dealer networks in the medical markets of Asia-Pacific (e.g., China and Japan). Contracts are also often multiyear agreements with relatively limited ability to adjust price before contract expiry (at least historically), which adds margin pressure to medtechs in inflationary periods such as the present.

Further, the complexities of medical device reimbursement can significantly alter pricing considerations but often lag device launches. Medtech hospital customers, particularly in the U.S., have also been experiencing significant declines in operating margins — amid labor cost increases, volatile procedure volumes and patient mix, receding impact of government relief payments, and lagging reimbursement adjustments — heightening customer focus on cost containment. Furthermore, increasing health system scale from over a decade of consolidation in the U.S. and the growing centralization of supply chain decision-making (in an effort to generate procurement synergies) have granted hospitals greater negotiating leverage than ever before.

Given these market headwinds and dynamics and their clear, secular impact on margin rates, magnitude and stability, it is important for medtechs to address the thorny and complicated issue of optimizing their pricing. In this current inflationary environment, providers acknowledge the reality of price changes, which offers an opportunity to renegotiate and optimize pricing. Medtechs need to use this opportunity to reevaluate their pricing strategy more broadly rather than succumb to the temptation to use price as a blunt instrument for short-term wins.

In L.E.K.'s experience, there are several "dos and don'ts" that serve as effective guiding principles for pricing strategy. We typically recommend employing them as part of a systematic approach to pricing strategy, which we call the 5 D's: Diagnose, Define, Develop, Design, Deploy (see Figure 3).

Figure 3
5 D's: Diagnose, Define, Develop, Design, Deploy



1. Diagnose
Diagnose critical exposure and leverage points

2. Define
Define the dimensions of your tailored pricing strategy

3. Develop
Develop segment-specific flexible price levels

4. Design
Design a strategy to ensure successful internal and external execution

5. Deploy
Deploy, manage and monitor an evergreen pricing model that responds dynamically to market changes

Pricing dos

- ✓ Segment customers on meaningful dimensions to set appropriate pricing rules
- ✓ Over-communicate with customers to set expectations and ensure minimal surprises
- ✓ Use contractual mechanisms such as commodity index clauses
- ✓ Monitor key performance metrics and conduct periodic strategy reviews to ensure an evergreen pricing model

Pricing don'ts

- ✗ Avoid pricing bluntly across all customers for a given product without evaluating variation in expected price sensitivity and willingness to pay
- ✗ Be careful not to employ a set-it-and-forget-it mentality
- ✗ Avoid changing prices without a clearly defined catalyst and appropriate targeted strategy
- ✗ Be careful not to dismiss key stakeholder (e.g., customers, channel partners) feedback during pricing strategy development and iteration

1. Diagnose critical exposure and leverage points

Medtechs have a multitude of customers, channel partners, products and SKUs, leading to a multitude of pricing data points. A variety of analyses (e.g., analyses of historical price trends and correlations, regression-based analyses) can identify quick wins and the opportunity to pursue a purposeful, rigorous pricing strategy. Examples of quick wins, especially in this inflationary period, include rationalizing SKUs with low margins, identifying products with the greatest differentiation and/or price insensitivity and potential receptivity to a greater premium, and identifying customers with discounts out of line with their volume and/or product margin mix.

2. Define the dimensions of your tailored pricing strategy

A one-size-fits-all approach to pricing should optimally be avoided. As a result, medtechs need to define the dimensions that reflect customer behavior and the strength of the product value proposition. Potential dimensions include customer segment (e.g., institution type, degree of centralized purchasing), customer relationship strength (e.g., share of wallet, longevity of customer relationship), customer volume/scale, customer GPO affiliation, and product family or packaging type.

3. Develop segment-specific, flexible price levels

Medtechs should develop their pricing strategy through analysis of segment-specific customer pricing elasticity (e.g., by evaluating historical customer behaviors and/or customer surveys) across their portfolios. When determining price levels, reimbursement dynamics are critical to consider; globally, there is significant variation in reimbursement structures for medtech products. In the U.S., for example, coverage of medtech products is part of the procedure reimbursement code, whereas in much of Asia-Pacific, there is virtually no reimbursement for innovative medtech products, with the entirety of the cost borne by the patient. Consequently, it is important for medtechs to evaluate the economic impact of price changes not only on their business, but also on key stakeholders' businesses (e.g., dealers, end customers) throughout the value chain to ensure the ecosystem is sustainable.

4. Design a strategy to ensure successful internal and external execution

Even with the most analytically rigorous, well-informed strategy, success is predicated on execution. Execution requires effective management of a range of internal and external stakeholders. Internally, medtechs can face barriers to pricing changes as front-line commercial teams often prioritize product sales to meet quotas, without commitment to pricing discipline, making it difficult to build momentum around better management of pricing.

Some medtechs already have effective governance processes in place, but many do not. Several dimensions of governance and organizational design can be important to address, including sales team incentives (e.g., incorporating profitability), well-established decision rights and clear pricing alleys for different levels of sales team members. Externally, medtechs need to ensure that any pricing increases have a well-laid-out, proactive communication plan for both customers and any channel partners affected. Commercial teams need to be equipped with the right customer messaging that articulates the pricing changes and reiterates the value proposition offered (including findings from health economic outcomes research (HEOR)). Medtechs can also support their customers by incentivizing volume consolidation (e.g., securing commitments for higher share of wallet where it is achievable) and providing good/better/best product alternatives where relevant.

5. Deploy, manage and monitor an evergreen pricing model

Once deployed, pricing management should be evergreen, as opposed to a one-off event. Medtechs should actively monitor inflation, other macroeconomic factors and the competitive context (including penetration of private-label and premium gaps between branded and private-label products), among other metrics. For many medtechs, pricing is not a strong "muscle" but a capability that may require (and merits) meaningful investment.

As medtechs continue to weather the challenges that come with inflationary, supply chain and global pressures impacting the industry, L.E.K. believes adherence to these best practices can inform a resilient, evergreen pricing strategy that puts them on firm footing for "normal" times as well.

For more information, please contact **medtech@lek.com**.

Endnotes

[1]Producer Price Index data
https://data.oecd.org/price/producer-price-indices-ppi.htm

About the Authors

Ilya Trakhtenberg

Ilya Trakhtenberg is a Managing Director in L.E.K. Consulting's Chicago office. Ilya has 10 years of experience as a management consultant and serves as a pragmatic, strategic adviser to corporate and private equity clients on growth strategy, marketing and sales excellence and M&A transaction support. He is a passionate thought leader on the intersection of technology and care delivery, the convergence and evolution of the healthcare ecosystem, and the growing role of consumerism in healthcare.

Patrick Branch

Patrick Branch is a Partner in L.E.K. Consulting's Tokyo office and a member of the firm's Life Sciences practice. He works with businesses and investors in the biopharmaceutical, medical device and broader healthcare sectors. He advises clients on a range of topics, including commercial strategy, corporate and business unit strategy, pricing and market access and M&A. Patrick joined L.E.K. in 2007 and has worked in the firm's Tokyo, Singapore, New York and Boston offices.

Monish Rajpal

Monish Rajpal is a Managing Director in L.E.K. Consulting's New York office. Monish joined the firm in 2008 and focuses on biopharmaceuticals and life sciences, medtech/medical devices and healthcare services, as well as the emerging overlap and convergence among these various sectors. He advises clients on a broad range of issues, including value proposition development and refinement, integrated health, pricing, market access and commercialization, and portfolio optimization and advancement.

Nathalie Herman

Nathalie Herman is a Principal in L.E.K. Consulting's New York office and a member of the firm's Healthcare practice. Nathalie focuses on medtech, the broader healthcare sector and healthcare's overlap with other sectors, such as packaging. She advises clients on a broad range of issues, including commercialization/go-to-market strategy, M&A and adjacency assessment.

About L.E.K. Consulting

We're L.E.K. Consulting, a global strategy consultancy working with business leaders to seize competitive advantage and amplify growth. Our insights are catalysts that reshape the trajectory of our clients' businesses, uncovering opportunities and empowering them to master their moments of truth. Since 1983, our worldwide practice — spanning the Americas, Asia-Pacific and Europe — has guided leaders across all industries from global corporations to emerging entrepreneurial businesses and private equity investors. Looking for more? Visit **www.lek.com**.