Merger and Acquisition Activity in the Chinese Pharmaceutical Industry

Editor's Note: Managed care pharmacists view the pharmaceutical industry through a powerful lens as they seek the best products to improve the health status of their enrolled populations. Recently, pharmacists have had to ponder how the pharmaceutical industry will fare as it undergoes its most profound change since its origination in the early 1900s. They see the global pharmaceutical giants consolidating, actively marketing existing product lines, developing new promising biotechnological agents, and preparing for political battles over looming price controls in the United States.

While the United States remains the largest and most profitable market for pharmaceuticals, much of the industry's transformation is in reality the preparation for the rapid expansion of the global marketplace—in particular, expansion in the developing world.

Before 1949, China was considered the "sick man of Asia"—a characterization no longer true in infectious disease patterns, nor economically. As this nation's gross national product (GNP) advances—as with other third-world nations with growing middle-class populations—the demand for modern medicines naturally follows. The global pharmaceutical giants are coming to recognize the importance of opportunities presented abroad, which may eventually impact their strategies for the U.S. market.

— J. Warren Salmon, Ph.D., JMCP Contributing Editor

Mergers and acquisitions (M&As) are an ever-growing phenomenon of the current worldwide pharmaceutical industry, and firms in the People's Republic of China are no exception.[1] In this most populous nation of the world, M&As are likely to profoundly restructure the pharmaceutical industry—and the changes will be compounded by changes in China's overall business environment related to its World Trade Organization (WTO) entry.[2]

The pharmaceutical industry is very important to China, as it is to any developing nation, partly because it holds the potential to contribute to public health. Moreover, the pharmaceutical industry can be one of the most profitable industries in an economy. If a domestically anchored set of firms can compete with the usually more costly products imported from the global pharmaceutical giants, the developing nation's balance of payments can be contained, while economic development advances. This brief article is a guide to understanding current developments in the Chinese pharmaceutical industry.

■■ Background

It is well known that China has been in transition from a centrally planned to a market-based economy since the beginning of the 1990s. The national government has been trying to push "the enterprise-structure-modernization" movement to establish property rights and to separate ownership from management. Almost all pharmaceutical firms in China, except foreign-owned ones, are state-controlled, meaning some measure of state ownership, mostly more than 51% stock share. Two stock exchanges were established in 1989 and in 1990. There are now more than 50 pharmaceutical companies listed on them, including ones with government ownership.

The Chinese pharmaceutical industry consists of a synthesis sector and a traditional-Chinese-medicines sector. In 1996 the output of chemicals synthesized was 85 billion RenMinBi, or rmb, ($10.3 billion) and the output of traditional Chinese medicine was 19.8 billion rmb ($3.9 billion), both rather small by U.S. standards of volume.[1] The latter sector has collaborative potentials for the development of biologicals with the global pharmaceutical firms in pharmacognosy and pharmaceutics for the extraction of active ingredients, making new formulations, dosage, and delivery forms.

More than 7,000 companies generate this pharmaceutical output—almost 10 times the number of firms in the United States, while the total output in China is one-sixth that of the United States. In 1995, the 10 leading pharmaceutical companies in China accounted for 10% of the total output of the entire industry.

As a developing nation, the Chinese pharmaceutical industry lags significantly behind both technologically and economically. However, pressures grow stronger every year to produce sufficient medications for the more than one billion people who seek advanced drugs and have been economically advancing in order to buy them. The Chinese economy is said to be growing over 7% annually. *Scrip* magazine notes that, although per capita drug spending is expected to be only U.S. $6 in 2000, China's enormous population means that the total market value compares well with the rest of the Pacific Rim.[3] The richest 90 million urban Chinese have preferred foreign brand-name drugs, and are willing to pay far more than is charged for alternatives from Chinese firms; drug consumption of urban residents is rapidly rising.[4]

■■ M&A Activity

Previously, national producers of pharmaceuticals had a virtual monopoly, until Chinese economic reforms, world trade relaxation, and changes inside the industry gave way to a more competitive situation. M&A as a trend appeared in China in the 1980s and gained speed in the following decade. Small-scale production in the Chinese pharmaceutical industry is ready to give way to a new concentration and centralization. In the 1990s, there were 15–40 M&A cases each year, and the number is growing annually.

Local government departments in charge of the pharmaceutical companies within their administrative districts initiate about one-third of the mergers. In these cases, usually all state-controlled pharmaceutical companies within a district are united into one company, usually called a group. There are many Sino-foreign joint ventures—in 1993, 612 joint ventures were formed.[5] But no mergers took place between foreign pharmaceutical companies and Chinese manufacturers, except combinations with some Hong Kong-based companies. For example, the Zhong Ce, a company from Hong Kong, has brought together more than five mainland pharmaceutical companies in the past few years.

Clearly, the Chinese pharmaceutical industry has not kept pace with the larger economic globalization, with some barriers against foreign-owned pharmaceutical companies still to be broken down.

With President Clinton's signing of the trade law on October 11, 2000, granting China permanent normal trade relations, China now has the opportunity to be integrated into the world economy, joining the WTO with the European Union approval.[2] Because of China's size and trading power, the United States insists it eliminate subsidies and trade barriers, which protect sensitive state-run industries. Such modifications with the United States and European powers will likely transform the Chinese pharmaceutical market over time.

All of the recent mergers in China were finalized without new infusions of capital. More than half of the acquisitions do not require financial compensation from the acquirer, except that the acquirer must bear the debt of the acquired company. About two-thirds of the takeovers are of failing enterprises. Unlike within the worldwide pharmaceutical industry, very few of the mergers in China have been between so-called "leading companies." Two exceptions are Lukang Pharmaceutical Company and Xinhua Pharmaceutical Company, which merged into Xinhua Lukang Pharmaceutical Company; and Xinchang Pharmaceutical Co. Ltd., Xianju Pharmaceutical Co. Ltd., and Zhejiang Medical Co. Ltd. merging as Zhejiang Pharmaceutical Co. Ltd. (Group).

■■ Analyzing the Pharmaceutical Industry in China

A study on M&A activities among pharmaceutical companies in the People's Republic of China was conducted by Hongjun Yin, with a major conclusion that the function of government, both the central government and the local governments, was critical to its understanding.[1] Government has been the initiator, shareholder, policymaker, approver, and supervisor because of remnants of administrative methods inherited from central planning and because most of the pharmaceutical companies are state-owned.

Notwithstanding this, the central government has been facilitating a restructuring of the pharmaceutical industry to improve its competitive ability in the face of international pressures. Two structural problems remain. First, many companies have similar lines of products and strive as governmental entities for the low-profit/low-technology regional market divisions. Second, too many companies (and too many small ones) remain, making it difficult for them to compete effectively against international pharmaceutical giants.

Nevertheless, local governments support M&A behavior in the industry following the call of the central government, and to ameliorate local economic situations, such as provincial advancement and employment growth. Several leading provinces have defined the pharmaceutical industry as a key industry in the local economy and seek to have it lead in the future national pharmaceutical market.

■■ Future Trends

With WTO entry, China will further develop its capital markets, and capital formation will proceed among its pharmaceutical companies, as well as with its financial institutions. Thus, the M&A activities of drug companies may approach Western patterns. National policy concerning the Chinese pharmaceutical industry aims to sell off most of the smaller companies, while keeping control over the several large companies to foster competition with the international giants. Foreign investors may have new opportunities to purchase or form joint ventures with the small companies.

Whether the influence of government over business will wane in the future, and how quickly, will depend on China's leaders' determination to build a market-oriented economic system and to what extent government reforms will be implemented successfully. Generally speaking, government's close intervention meets with vigorous challenges, as the private sector gains strength daily. With greater numbers of domestic economists, among others, appealing for deeper reforms, there is likely to be a forward movement to promote the marketing of state-owned enterprises, thus propelling the transformation of the domestic pharmaceutical industry. Strategic problems for drug companies remain to be resolved on the difficult road ahead.[6] The modernization of China's health care system, however, will be concomitant with such advances in its pharmaceutical industry, and serve to facilitate a broader distribution of modern medicines to the populace. ■

Hongjun Yin, M.S., is a Ph.D. Student in Pharmacy Administration, and J. Warren Salmon, Ph.D., is Professor of Pharmacy Administration, both at University of Illinois at Chicago; Jinxin Chen, B.S., is Professor of Economics, China Pharmaceutical University Nanjing, People's Republic of China.

References

1. Yin H. The comparative research on mergers and acquisitions in pharmaceutical industry of China and America, unpublished thesis, China Pharmaceutical University, Nanjing, PRC, June 30, 2000.

2. Kahn J and Sanger DE. President Clinton signs China trade bill and warns Beijing to stick to pledges. New York Times October 11, 2000, p. 1.

3. Haydock I. Outsourcing: A growing trend in Asian distribution. SCRIP, November 1988, 25–26.

4. Chinese cities' drug consumption rising. SCRIP 2308, February 11, 1998, 19.

5. Luo AY, Salmon JW, and Lambert B. U.S. pharmaceutical firm prospects within the People's Republic of China. J Managed Care Pharm 2(3) (1996): 240–48.

6. Ahn MJ. Developing a profitable market share strategy for multinational companies in China. J Pharm Marketing and Management 13 (3) 2000: 1–29.