# EMERGING OPPORTUNITIES IN CHINA'S HEALTHCARE SECTOR

**The potential of China's healthcare sector has long intrigued investors. The size of the country's rapidly aging population, coupled with the still-low level of healthcare spending, suggests that opportunities abound. However, the recent move by the Chinese government to slash generic drug prices is a reminder that experience and expertise are required when navigating the changing landscape and identifying the genuine opportunities that exist.**

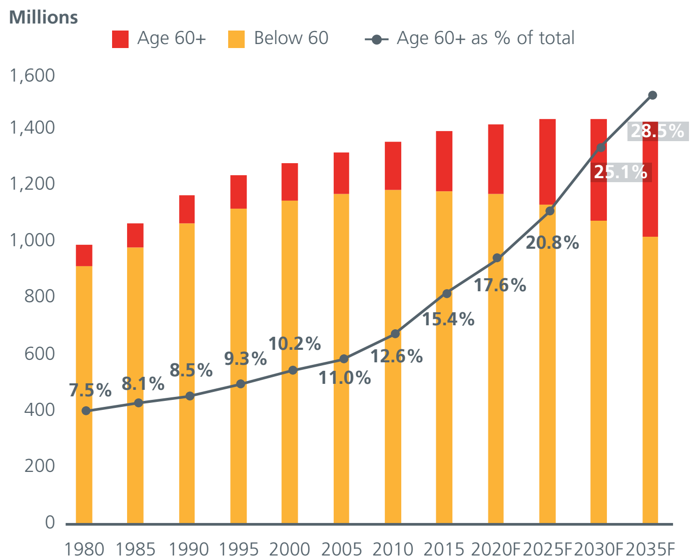
**Xiang Xu**
Senior Analyst, Equities
Eastspring China

The long-term outlook for China's healthcare sector is underpinned by its ageing population and burgeoning healthcare spending.

By 2035, China's senior citizen population (age over 60) is expected to reach 409 million, representing 28.5% of the total population (see Fig. 1). China's younger population is, however, smaller due to the lingering impact of the country's one-child policy. Younger people will carry a higher financial burden to cover the healthcare costs of their ageing relatives in the future.

Healthcare spending, however, represented just 5.0% of China's gross domestic product (GDP) in 2016, significantly less than the US which spent 17.1%[2]. As China's consumer patterns converge with the developed markets, its healthcare spending could reach RMB 18.04 trillion (USD 2.53 trillion) by 2035[3].

**Fig. 1. Population history and projections for China[1]**



This translates into a robust annualised growth rate of 8.4% (see Fig. 2), outpacing the country's economic growth which is hovering at 6.0%.

At the same time, as China's life expectancy and affluence levels increase, chronic diseases – such as diabetes – will eventually outweigh acute infectious diseases.

This makes the demand for drugs and medical services more inelastic, and less likely to be affected by external shocks such as the US-China trade dispute.

Meanwhile, China's healthcare stocks – dominated by drug makers (see Fig. 3) – only represent about 7.0% of China's A-shares market.

This under-representation of China's vast healthcare market, which only began privatising in the 1990s, suggests that there will be significant opportunities for investors as the market matures.

That said, changing regulations suggest that investors will need to tread carefully to identify potential winners and losers as industry dynamics shift.

## A CLOUDY OUTLOOK FOR PHARMACEUTICALS

Thanks to regulatory preferences, China's top generic drug makers have enjoyed outsized profit margins of about 18.0%, almost double the global average of 9.5%[5].

This privileged position, however, is set to disappear following the launch of a bulk-purchase drug programme.

In an attempt to slash generic drug prices and free up funding for new drug reimbursements, the National Healthcare Security Administration (NHSA) embarked on the National Centralised Drug Procurement programme in December 2018.

Under this arrangement, more than 11 major cities (one-third of the national market), including Beijing, Guangzhou, Shanghai and Shenzhen[6], will combine their purchases of 31 generic drugs (drugs whose patents have expired) and force drug makers to bid for contracts.

**Fig. 2: China's healthcare spending projections[3]**

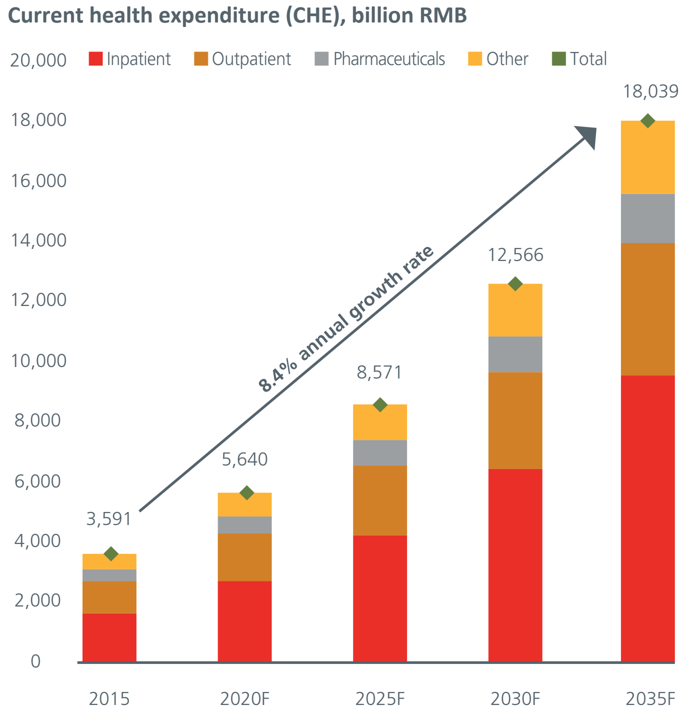



**Fig. 3: Healthcare's sub-sectors in China A-shares[4]**

| Healthcare sub-sectors | Number of companies | Market capitalisation (bn, RMB) |
|---|---|---|
| Pharmaceuticals | 83 | 1,200 |
| Chinese medicine | 66 | 700 |
| Biologics* | 21 | 400 |
| Equipment | 54 | 600 |
| Distribution | 23 | 250 |
| Services (Eg. CROs**) | 15 | 350 |
| **Total** | **262** | **3,500** |

Notes: *Biologics such as blood products and vaccines. **CRO refers to contract research organisations.

So far, this programme has succeeded in cutting drug prices by 52% on average (see Fig. 4).

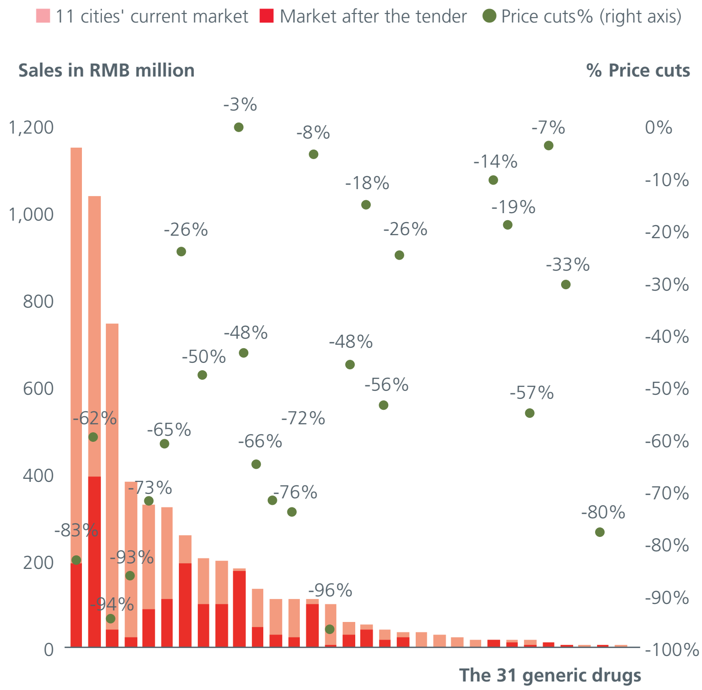
As a result of the programme, the sales of novel medicines and "me-too" drugs – drugs produced by modifying existing ones for more effective therapies – are likely to account for an increasing share of drug sales in China going forward (see Fig. 5).

In fact, the sales of new drugs on the National Reimbursement Drug List (NDRL) – a list of preferred medicines covered by the government's health insurance programme – grew 38% in 2018, higher than the general industry sales growth rate of 15%[9].

To adapt to this shifting landscape, pharmaceutical companies must optimise their product structure, lower production costs, increase investment in research, and develop more new drugs to compensate for the fall in revenue from generics.

During this transition phase, smaller pharmaceuticals will likely undergo consolidation.

**Fig. 4: Scope and price cuts of 31 generic drugs under the pilot central bulk-purchase programme in 11 Chinese cities[7]**




## EMERGING OPPORTUNITIES IN OTHER HEALTHCARE SUB-SECTORS

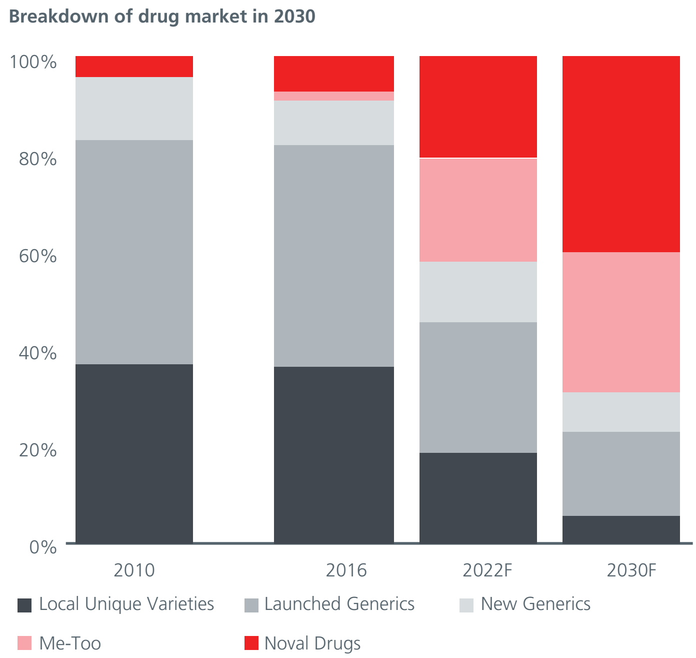
Pharmaceutical companies, are however, not the only way to benefit from China's growing healthcare needs.

In late 2015, China Food and Drug Administration (CFDA) undertook reforms to speed up innovative drug approvals. The reforms have since paid off and are now under the ambit of the National Medical Products Administration (NMPA).

In 2017, 40 new NDRL drugs were approved, followed by another 51 approvals in 2018[10]. This is a bigger number than the total approved by the agency over the last decade.

With more 'reimbursement quotas' released from the bulk-procurement programme and fast-track approvals on the horizon, we expect to see stronger motivation towards discovering new and patented drugs. This is especially true for those drugs with clinical benefits, and therefore, more likely to get approval.

**Fig. 5: Upcoming structural changes in China's drug markets[8]**



Contract research organisations (CROs), as in the service "sub-sector" in Fig. 3, are, therefore, well-placed to benefit from this trend (see Fig. 6). These companies provide outsourcing research support to pharmacevpanies and the medical device industry.

CROs that specialise in clinical trials can even offer drug sponsors the expertise required for taking a new drug or device from its conception until the NMPA's approval, without the drug sponsor having to maintain permanent staff for such services.

Other healthcare players also present attractive opportunities. These include:

- ***Specialist medical services:*** *Chinese consumers are demanding more personalised and higher quality healthcare services. This has led to robust growth in private health check-ups, as well as other specialist medical services such as ophthalmology and dental care.*
- ***Medical equipment providers:*** *Closely tied with domestic demand, these are potential beneficiaries of the US-China trade tensions, since they provide alternatives for imported equipment.*

## SEIZING THE OPPORTUNITIES; NAVIGATING THE CHALLENGES

China's healthcare stocks sold off significantly in December 2018 over concerns of earnings downgrades following the bulk-procurement programme for generic drugs.

The S&P/CITIC Health Care index, for example, fell 10.6% in December 2018, and recovered 18.5% in the first six months of 2019, during which the CSI 300 index recorded a stronger return of 28.3%[12].

Whilst the healthcare sector has historically traded at a premium to the broader market, the recent underperformance has reduced the 52-week rolling price-earnings (P/E) premium to a low of 10.6x (see Fig.7).

**Fig. 6: Market size and growth outlook for healthcare sub-sectors[11]**

Industry size (RMB) and momentum estimates

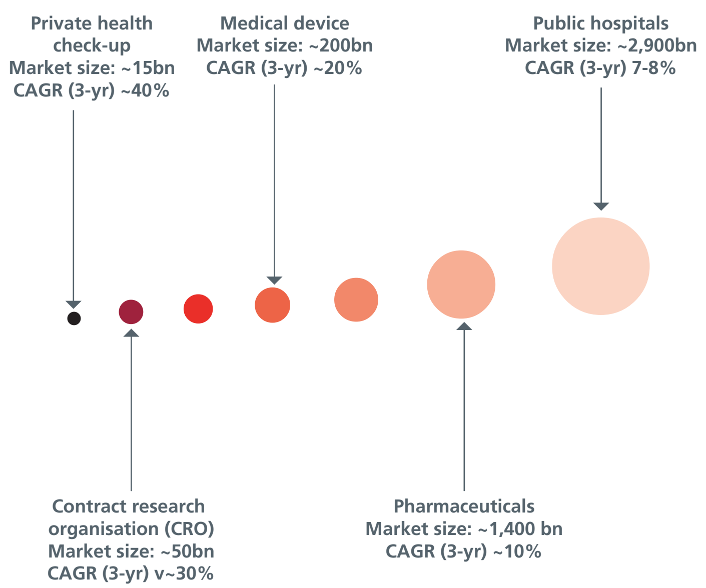
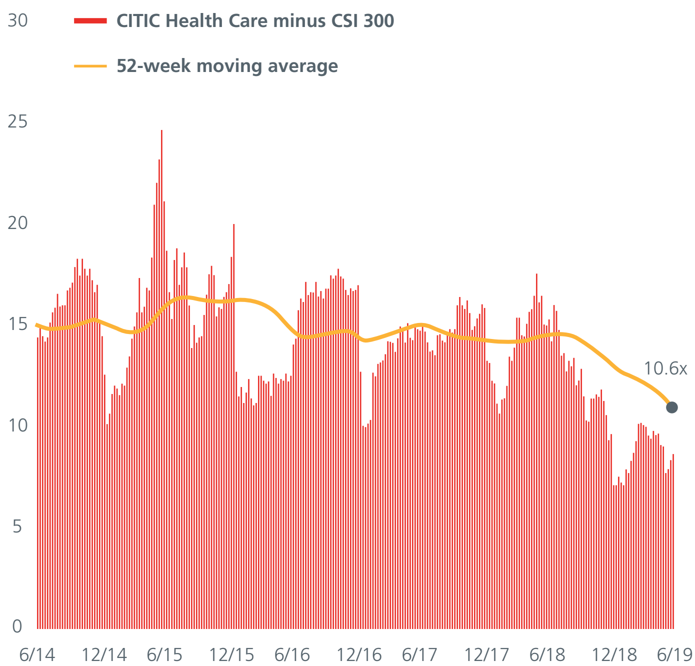



**Fig. 7: Valuation premiums of China's healthcare A-shares[13]**

Price-to-earnings (x) premium



Not all healthcare stocks are the same, however. Investors looking to take advantage of the relatively cheap valuations need to be aware of the potential corporate governance risks.

China's healthcare market remains complicated and fragmented. Some local Chinese healthcare companies may have inscrutable and opaque financials; investors therefore will need to be able to detect and assess the associated business risks.

This is not the only caveat. Whilst healthcare is normally regarded as a defensive sector across economic cycles in developed markets, policy uncertainty and government's healthcare cost control, such as the bulk-procurement programme, may trigger risk appetite changes. That said, this may also create huge growth opportunities for certain sub sectors.

All in all, asset managers who can understand the implications of China's changing regulatory trends and identify emerging leaders are well positioned to fully tap into the potential of China's booming healthcare sector.

At present, we are selective in pharmaceuticals concentrating on generics produced using their own active pharmaceutical ingredients, as they might fare better in resisting price pressure.

With this in mind, we favour pharmaceutical companies with rich, innovative product pipelines. We also see opportunities in selected CROs as well as providers of specialist medical services and medical equipment.

Sources: [1]United Nations, Department of Economics and Social Affairs, data obtained on 12 June 2019. [2]https://www.theglobaleconomy.com/USA/ latest available data for 2016. [3]China's Health Expenditure Projections To 2035: Future Trajectory And The Estimated Impact Of Reforms, May 2019. https://doi.org/10.1377/hlthaff.2018.05324, by Tiemin Zhai, John Goss, Tania Dmytraczenko, Yuhui Zhang, Jinjing Li, and Peipei Chai. Authors' analysis of data from the China National Health Accounts Report, Institute for Health Metrics and Evaluation, and China Population and Development Research Center. NOTES Data are in constant 2014 prices. [4]Eastspring Investments, as at 10 June 2019, excluding companies whose main business line has changed or unclear. [5]Bloomberg, 2 Jan 2019. Even After a $46 Billion Plunge, China's Drugmakers May Have a Long Way to Fall. [6]China Daily: China unveils pilot 'group-buying' plan to cut drug prices, updated on 17 Jan 2019. [7]SMPA, PDB database, Guosen Research, and Eastspring Investments. [8]Eastspring Investment, Jun 2019. [9]CDE, PDB database, Eastspring Investments, Dec 2017. [10]Deloitte LLP, citing CDE published the priority review of drug inventory, batch 26 to 33, Centre for Drug Evaluation, NMPA, 29 January 2018-17 October 2018. [11]Eastspring Investments, Dec 2018. CAGR refers to compound annual growth rate. [12]Bloomberg, S&P/CITIC Composite Health Care Sector Total Return Index (202 A-shares), from 30 Nov to 31 Dec 2018, and from 31 Dec 2018 to 28 Jun 2019, total returns in Chinese renminbi. S&P/CITIC Composite Health Care Index is a market capitalization weighted index represents the entire A-Shares stocks listed on the Shanghai and Shenzhen Stock Exchanges that represents the health care sector using the Global Industry Classification Standard (GICS®). The CSI 300 Index is a free-float weighted index that consists of 300 A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges. [13]Bloomberg, Best P/Es for S&P/CITIC Composite Health Care Sector, CSI 300 Index, weekly data, as at 28 Jun 2019, in Chinese renminbi. S&P/CITIC Composite Health Care Index is a market capitalization weighted index represents the entire A-Shares stocks listed on the Shanghai and Shenzhen Stock Exchanges that represents the health care sector using the Global Industry Classification Standard (GICS®). The CSI 300 Index is a free-float weighted index that consists of 300 A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges.



eastspring investments

A member of Prudential plc (UK)