

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.

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.

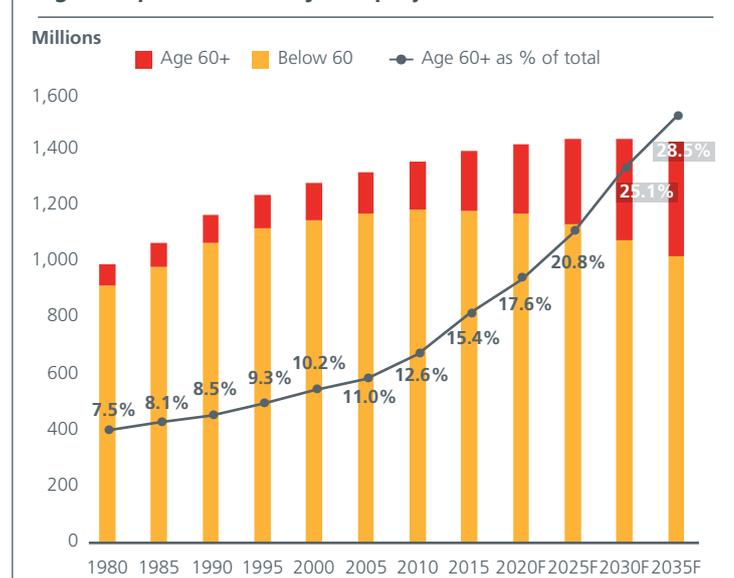
Healthcare spending, however, represented just 5.0% of China's gross domestic product (GDP) in 2016, significantly less than the US which spent 17.1%². As China's consumer patterns converge



Xiang Xu
Senior Analyst, Equities
Eastspring China

with the developed markets, its healthcare spending could reach RMB 18.04 trillion (USD 2.53 trillion) by 2035³.

Fig. 1. Population history and projections for China¹



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 Shenzhen⁶, 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 projections³

Current health expenditure (CHE), billion RMB

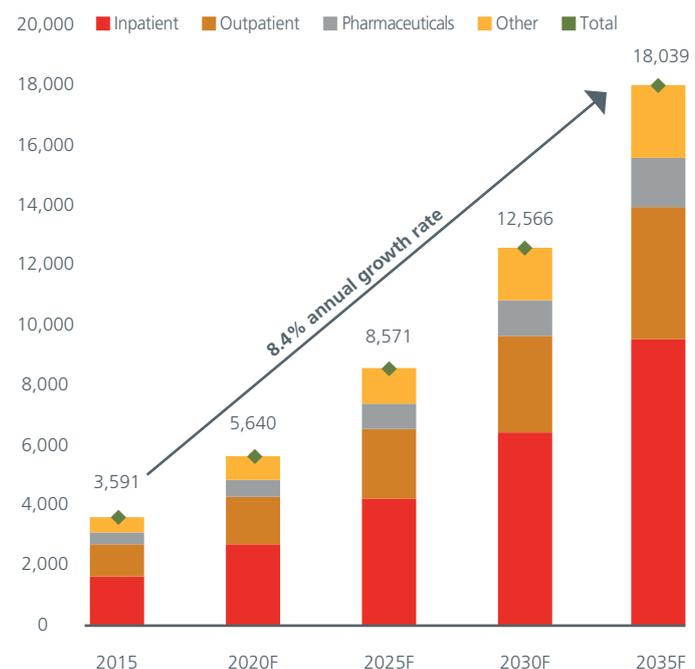


Fig. 3: Healthcare's sub-sectors in China A-shares⁴

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.

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 2018¹⁰. 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. 4: Scope and price cuts of 31 generic drugs under the pilot central bulk-purchase programme in 11 Chinese cities⁷

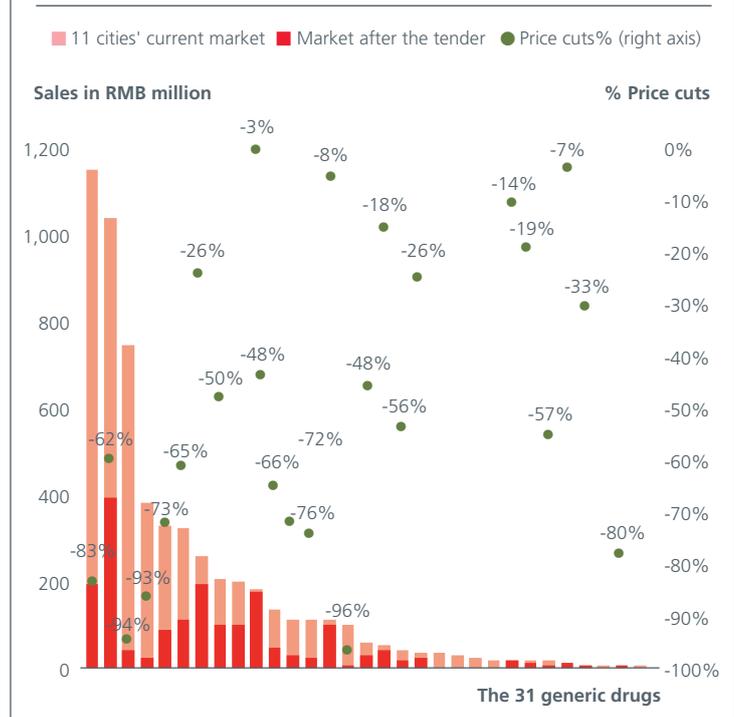
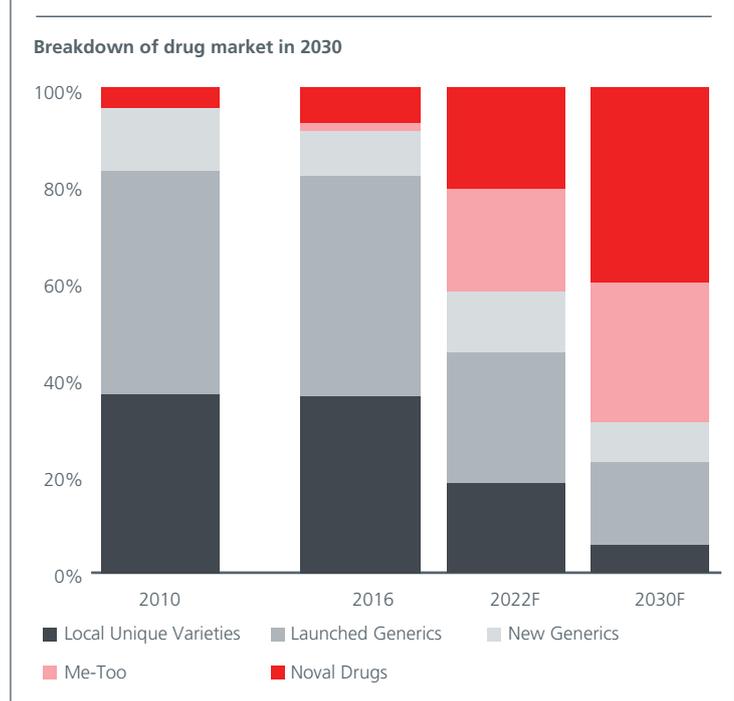


Fig. 5: Upcoming structural changes in China’s drug markets⁸



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 pharmaceuticals 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-sectors¹¹

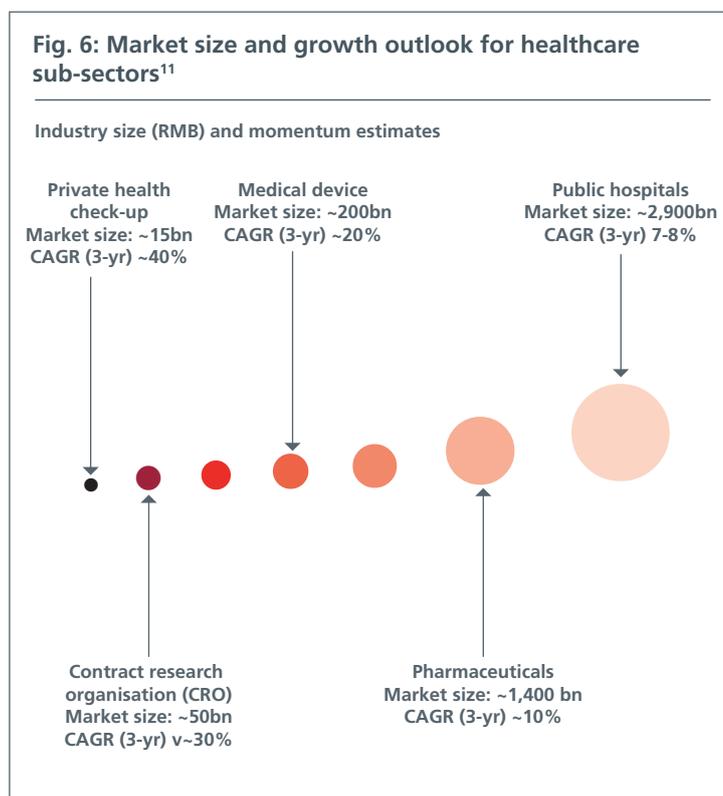
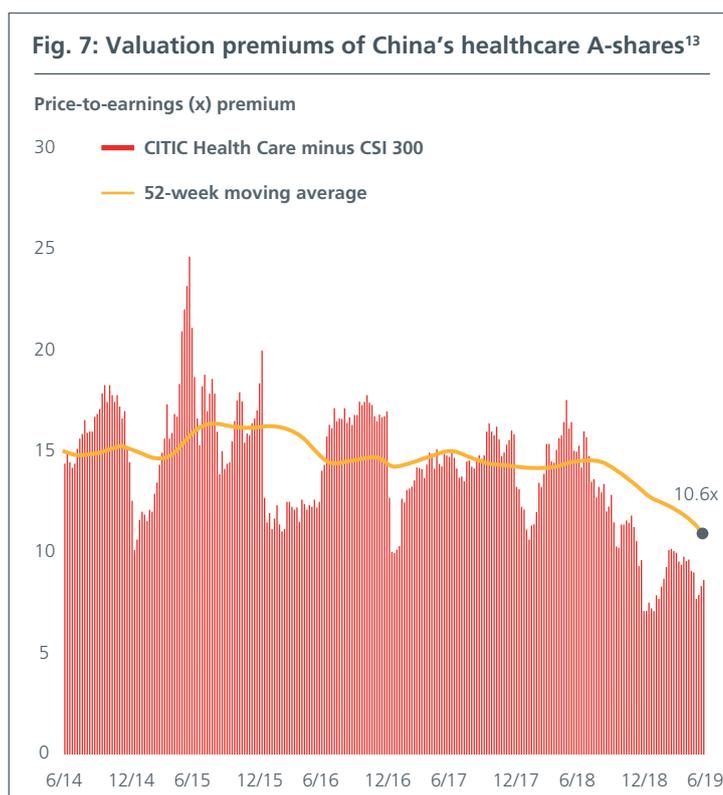


Fig. 7: Valuation premiums of China’s healthcare A-shares¹³



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: ¹United Nations, Department of Economics and Social Affairs, data obtained on 12 June 2019. ²<https://www.theglobaleconomy.com/USA/> latest available data for 2016. ³China'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. ⁴Eastspring Investments, as at 10 June 2019, excluding companies whose main business line has changed or unclear. ⁵Bloomberg, 2 Jan 2019. Even After a \$46 Billion Plunge, China's Drugmakers May Have a Long Way to Fall. ⁶China Daily: China unveils pilot 'group-buying' plan to cut drug prices, updated on 17 Jan 2019. ⁷SMIPA, PDB database, Guosen Research, and Eastspring Investments. ⁸Eastspring Investment, Jun 2019. ⁹CDE, PDB database, Eastspring Investments, Dec 2017. ¹⁰Deloitte 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. ¹¹Eastspring Investments, Dec 2018. CAGR refers to compound annual growth rate. ¹²Bloomberg, 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. ¹³Bloomberg, 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.

Disclaimer

This document is produced by Eastspring Investments (Singapore) Limited and issued in:

Singapore and Australia (for wholesale clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore, is exempt from the requirement to hold an Australian financial services licence and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Australian laws.

Hong Kong by Eastspring Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

Thailand by TMB Asset Management Co. Ltd. Investments contain certain risks; investors are advised to carefully study the related information before investing. The past performance of any fund is not indicative of future performance.

Indonesia by PT Eastspring Investments Indonesia, an investment manager that is licensed, registered and supervised by the Indonesia Financial Services Authority (OJK).

Malaysia by Eastspring Investments Berhad (531241-U).

United States of America (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is registered with the U.S Securities and Exchange Commission as a registered investment adviser.

European Economic Area (for professional clients only) and Switzerland (for qualified investors only) by Eastspring Investments (Luxembourg) S.A., 26, Boulevard Royal, 2449 Luxembourg, Grand-Duchy of Luxembourg, registered with the Registre de Commerce et des Sociétés (Luxembourg), Register No B 173737.

United Kingdom (for professional clients only) by Eastspring Investments (Luxembourg) S.A. - UK Branch, 125 Old Broad Street, London EC2N 1AR.

Chile (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Chilean laws.

The afore-mentioned entities are hereinafter collectively referred to as **Eastspring Investments**.

The views and opinions contained herein are those of the author on this page, and may not necessarily represent views expressed or reflected in other Eastspring Investments' communications. This document is solely for information purposes and does not have any regard to the specific investment objective, financial situation and/or particular needs of any specific persons who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments. It may not be published, circulated, reproduced or distributed without the prior written consent of Eastspring Investments. Reliance upon information in this posting is at the sole discretion of the reader. Please consult your own professional adviser before investing.

Investment involves risk. Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments.

Information herein is believed to be reliable at time of publication. Data from third party sources may have been used in the preparation of this material and Eastspring Investments has not independently verified, validated or audited such data. Where lawfully permitted, Eastspring Investments does not warrant its completeness or accuracy and is not responsible for error of facts or opinion nor shall be liable for damages arising out of any person's reliance upon this information. Any opinion or estimate contained in this document may subject to change without notice.

Eastspring Investments (excluding JV companies) companies are ultimately wholly-owned/indirect subsidiaries/associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America.



A member of Prudential plc (UK) 