CHINA'S HEALTHCARE SECTOR ON SPEED

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The Chinese healthcare sector is changing and expanding at a speedy pace compared to the overall Chinese economy, therefore it pays off for investors to find new opportunities in this particular sector.

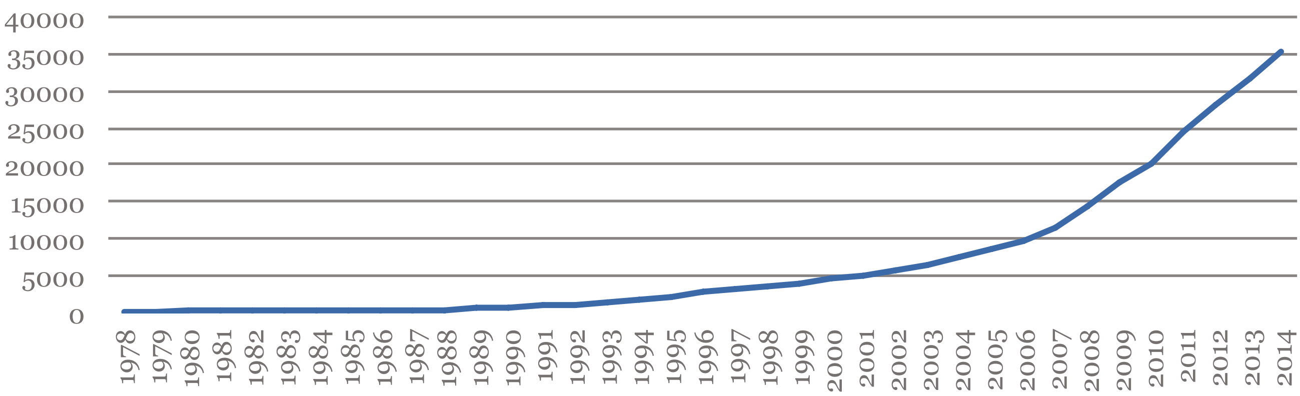
Traditional Chinese Medicine (TCM) can be dated back 2,500 years in history and is well-known for using herbs, acupuncture and massage. One could claim that the Chinese healthcare sector must have been mature for centuries, but the truth is that it's expanding in all directions, and evolving. One reason is the rapid aging in the Chinese population from an average of 67.9 years in 1981 to the current 75 years. This is a global trend, but the worldwide average life expectancy is 70 years which underlines the fast demographic change China is undergoing. Naturally, an aging population results in a higher demand for healthcare on a broad base. But in general, the public healthcare service in China is quickly improving, which means that a bigger share of the state budget is allocated to the sector and it's undergoing large reforms. In addition, the growing middle class suddenly secures a household income that allows it to pay for better healthcare, thus demanding a healthier living lifestyle. Now, China is more health-conscious than ever.

The Graph 1 below shows the yearly total health expenditure since 1981 until the latest number in 2014. After tremendous growth over the years, it stands only at 5.6 pct. of GDP compared to the 10 pct. global average (10.8 pct. in Denmark and 17.1 pct. in USA) so China is still behind its peers in developing a sophisticated healthcare sector and there is no doubt that the growth will simply continue.

Like in any other country, the healthcare market in China is split into service providers (mainly hospitals), distributors, and the pharmaceutical manufacturers. The 2,500-year-old TCM makes up a bigger chunk of the healthcare market versus what many expect, which makes the sector more challenging to analyse compared to the same sector in Western economies. But it's not just in China that traditional medicine makes up a fairly big share of the pharmaceutical sector. An analysis made by the Economist Intelligence Unit claims that 2.3 Billion people, or about 1/3 of the global population depend on local traditional medicine as it is still used in many emerging countries.

Let's set aside the argument for or against traditional medicine versus modern (or Western) medicine for now. The reality is that TCM is playing a large role in Chinese healthcare sector and its market share is even expanding. Hence, we just need to bear in mind that there is such a different component in the Chinese healthcare sector when appraising the market for investment opportunities.

TOTAL HEALTH EXPENDITURE (100 MILLION CNY)



Source: China Human Development Report, UNDP

In this context it was interesting that the Nobel Prize of Physiology or Medicine in 2015 went to Tu Youyou from China who invented artemisinin, which was originated and developed from TCM . For investors, it is worthwhile to note that many reforms the Chinese healthcare system is going through will inevitably be applicable to TCM as well as Western medicine.

The government's intention is to quickly modernize the healthcare sector and bring it up to the same level as in developed countries (though there is still some way to go). A very fundamental reform is related to the hospitals' revenue stream and to allow hospitals to raise patients' consultation fees. Until now, Chinese hospitals profit from selling medicines, while their consultation fees are usually at unreasonably low levels. Consequently, hospitals are more incentivised to purchase products from selected pharma distributors and / or manufacturers who pay out high trials instead of most effective products. With this reform, we expect that good pharmaceutical companies with research capability of developing innovative drugs will end up as the ultimate beneficiaries. Meanwhile, hospitals will be able to compensate the good doctors sufficiently for their skills.

Furthermore, another reform has been introduced, a so-called "two-invoice system". It relates to the drug distribution in China where the reform aims to generate transparency in drug pricing and eliminate excessive profit margins associated with multi-tier distribution models. In the past, medicines go through several distributors before reaching hospitals. Instead of having many levels of distributors, the two-invoice system means the pharma manufacturer makes-out invoice "one" to the distributor followed by the distributor's invoice" two" to the end customer (the hospital). The two-invoice system is expected to be fully implemented among public hospitals across the country by the end of 2018.

This reform has important implications for the pharma manufacturers and distributors doing business in China, where I expect that many companies will have to adjust their business model. For example, first-tier distributors will probably expand geographic coverage by merging with, or acquiring, smaller operators further down the distribution chain. In addition, contract sales companies could find their services in demand due to the change in the distribution landscape.

The reform even means that drug manufacturers in the future might sell directly to hospitals with the assistance of qualified logistic service providers, which almost is a revolution in the industry. What the Chinese government wants to achieve, which most likely will happen, is namely a review of the pricing strategies.

I clearly expect that these large countrywide reforms and changes in the healthcare sector will certainly result in winners and losers - and finding the right companies to invest in truly can pay-off.

When searching for the gems, it is worthwhile studying the recent decision from China's Ministry of Human Resources and Social Security (MHRSS). The ministry lately released the long expected new version of the NRD list (National Reimbursement Drug List) which shows all the drugs covered by China's national insurance plan. The new NRD list now includes 2,535 individual drugs which is an expansion of 339 compared to the 2009 version. The list consists of 51 pct. classical Western chemical / biological drugs and 49 pct. TCM which once again underlines the uniqueness in the Chinese healthcare market. In addition to the NRD list, there is a secondary list including 45 high priced drugs that could potentially enter the NDR list later this year should the manufacturer be willing to negotiate down the price tag. The last 45 drugs I expect to have particular importance to some highly-specialised bio-tech pharmaceutical companies. But the new broader NRD list combined with the new "two invoice system" will be decisive for the sector during the coming years. The companies who are best positioned to benefit from the new market environment also include state-controlled companies which is obvious when looking at the four stocks I have selected as inspiration.

4 SELECTED CHINESE STOCKS

1093:HK CSPC Pharma.

The company's current drug portfolio of already launched and marketed products is strong. Furthermore, the firm has a strong pipeline of new products which enables the launch of a new class I drug each year in 2018 to 2022, thus fuelling the earnings growth in the long run. The stock is trading at 23 times 2017 forecast price-to-earnings. However, in view of an expected annual EPS growth of 20-25% in 2016 to 2020, backed by new drug launches and sales network expansion for current products, the current valuation is not overwhelming. We expect the company's high-value-added innovative drugs to record rapid sales growth in 2017 to 2019 plus we see the Vitamin C business as a bonus. The addition of CSPC's flagship injection product, NBP, to the NRD list is another upside that is expected to ensure the growth during the next 2 - 3 years. The publication of the NRD list included another pleasant news for CSPC as its long acting leukocyte medicine for cancer patients Jin You Li (JYL) unexpectedly was included on the list. With the costs for drug being covered by the national insurance, the JYL product could reach annual sales between RMB 500 million and 1 billion in the future.

2666:HK Universal Medical Financial & Technical Advisory.

The company offers a variety of services in the healthcare sector, ranging from medical equipment leasing (for example leasing expensive CT scanning equipment) to healthcare service advisory. The company started further enhancing its hospital supply-chain-management business in 2017.Having the government as one of the major shareholders, the firm is well positioned to secure additional public–private partnership (PPP) agreements so that it can export its advanced managerial and medical experience to many existing hospitals, which we expect to be the primary driver for revenue growth. The firm will benefit from the consolidation among both drug manufacturers and hospital groups, which makes its sales efforts more targeted and efficient Universal Medical is growing from a regional player to a national champion in comprehensive healthcare services in China.

570:HK China Traditional Chinese Medicine Holdings Co. Limited.

The company's major shareholder is China National Pharmaceutical Group, one of the largest state-owned groups. If a TCM manufacturer is going to benefit from the renewed government support for TCM, it will most likely be a state-owned one. The TCM market is rather fragmented at the moment, therefore, we expect a market consolidation through increased M&A activity. The firm is set to expand thanks to committed support from its parent group and to develop itself as a TCM market leader. After acquiring Tianjiang Pharmaceutical in 2015, China Traditional Chinese Medicine Holdings Co. Limited has already taken the leading position in the domestic market for Concentrated Chinese Medicine Granule (CCMG). The firm has enhanced its core competitiveness through R&D, within high performance liquid chromatography (HPLC) of more than 150 varieties completed and will continue to improve its internal quality standards. To maintain the CCMG product's high profitability, the firm is optimizing the centralized procurement of 105 medicinal materials.

1349:HK Shanghai Fudan Zhangjiang Bio-Pharmaceutical Co Ltd.

Despite its relatively small market cap, this is one of the leading-edge Chinese pharmaceutical companies armed with its own R&D in innovator drugs. The state-owned Shanghai Pharma is the largest shareholder which has expressed the intention for a further share placement in Chinese domestic A-share markets in addition to the firm's Hong Kong listing. A second listing can help the company to raise much needed capital for expansion. The company is located in Zhangjiang, which is the silicon valley of medicines in China and home to a big talent pool. The company's growth in the past years was mostly driven by new drugs that came to the market sporadically. With the work the firm did in the past, we expect to see new drugs being launched more frequently going forward which will generate higher growth.

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