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Just the medicine

While China's commitment to reshaping its healthcare system is creating further openings for foreign investors, it remains advisable to take the long view in this complex business ecosystem

As China makes the transition from an emerging-market economy based on low-cost labour and growth at breakneck speed to the next stage of development as a more advanced economy, the government has turned its attention to raising the living standards of its people. Improving healthcare has become a key focus of this policy.

The push to improve China's healthcare system opens up a range of potential investment opportunities, from hospitals and care homes to medical devices, biotech and insurance plans. Healthcare is now a ¥2.5 trillion ($400 billion) industry in China, and growing at a double-digit rate, with spending projected to reach $1 trillion (¥6.2 trillion) by 2020, according to consultancy firm McKinsey & Company.

"The market remains both significantly underpenetrated and underdeveloped," says Jason Zhang, Director of Healthcare at private equity firm Actis, who cites three main drivers for the transformation of the sector: increased government spending; the demographic pressures associated with an ageing population; and the demands of a growing middle class. "That is why we believe this is a sector with a long tailwind," he says.

At the same time, a number of factors can also make the Chinese healthcare sector a rather challenging one for prospective investors. For example, limitations remain on foreign ownership in some parts of the sector. The regulatory environment is also complicated and dynamic, adding to the lack of clarity, in some cases, for prospective foreign investors.

The impacts of societal change

While China's economy and society have been transformed by decades of rapid growth, the development of its healthcare infrastructure has, in some respects, struggled to keep pace; both the previous and current five-year plans have sought to close the gap between China's services and benefits and those offered by other maturing emerging markets.

The burgeoning Chinese middle class increasingly expects high-level health facilities and well qualified medical staff. However, large public hospitals in big cities attract both the best physicians and the majority of patients, which leaves them increasingly overburdened; meanwhile, middle-tier hospitals struggle to fill empty beds and, at the bottom end, rural clinics remain poorly funded and isolated sometimes from the rest of the medical system. There is no comprehensive primary care system, and the number of qualified physicians in proportion to the population remains low compared with that of other countries, with fewer than two doctors per 1,000 inhabitants in 2012, compared with more than three in Norway and nearly five in Austria, according to World Bank data.

Funding pressures are prevalent throughout the system: both doctors and hospitals are dependent on drug sales to supplement public funding, a state of affairs that critics say leads to overprescription of medicines. This, in turn, creates a growing cost burden on the country's healthcare system, as demographic changes lead to an increase in chronic conditions, and greater urbanisation affects lifestyles.

In addition, while the government is close to achieving its goal of providing universal basic healthcare to all citizens, many segments of the population continue to face significant out-of-pocket expenses for medical care. For public health insurance, there are currently three main programmes: the Urban Employee Basic Medical Insurance (UEBMI) and Urban Resident Basic Medical Insurance (URBMI) programmes, which are considered the most generous; and the New Rural Cooperative Medical Scheme (NRCMS). But many health expenses are not covered by these programmes, with the result that people pay a large percentage of health costs with their own money, with co-payments of as much as 35 per cent for those covered by NRCMS plans.

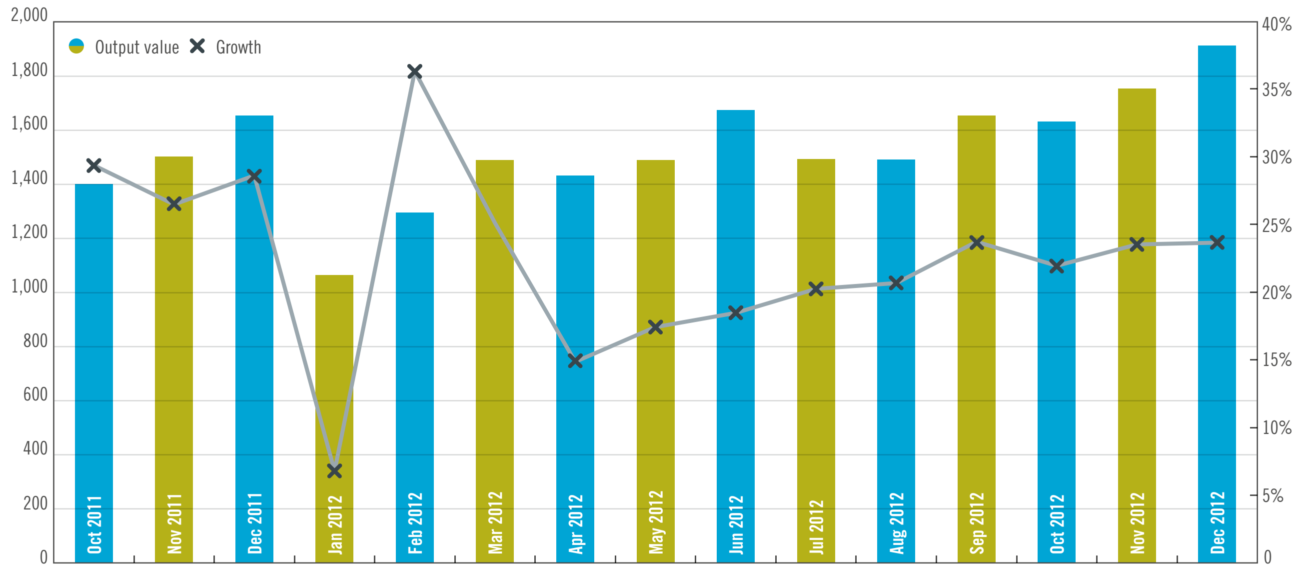
Total spending on health as a percentage of gross domestic product (GDP) in China was just 5.4 per cent in 2012, compared with 9.3 per cent in Brazil and 8.8 per cent in South Africa. China's spending represents an increase of just 0.6 percentage points from a decade earlier. In an effort to respond to these growing pressures, the Chinese government

INVESTMENT OPPORTUNITIES: HEALTH

China's health sector is undergoing extensive reforms to improve quality of care and broaden access

XIXINXING/CORBIS

Output value of the health sector from October 2011 to December 2012 (¥ billion)



SOURCE: CHINA INVESTMENT YEARBOOK 2013

has made better-quality services for its population a primary focus. A key plank of the government's 12th Five-Year Plan, which covers the period to 2015, is the provision of more reliable social safety nets for residents of the country's rural regions. This includes the development of an integrated primary care system that combines urban community health centres on the one hand and multi-tiered rural medical networks on the other. It has said that it would like to see 20 per cent of hospital care being provided by private hospitals, which is likely to require the conversion of existing hospitals as well as the construction of new ones. The government has also proposed to train 150,000 new general practitioners (GPs) by 2015.

China's government has also identified the biotech industry, defined to include medical devices and diagnostics, as well as traditional Chinese medicine (TCM), as one of seven strategic industries under the current Five-Year Plan, and has allocated ¥12 billion ($1.9 billion) of subsidies. Furthermore, it has said that it is looking to consolidate the market into a few domestic pharmaceutical giants, and is calling for the top 100 pharmaceutical companies to make up 50 per cent of total pharmaceutical sales in China by 2015, and for the top 10 wholesalers to account for 95 per cent of drug distribution. The plan committed to spending ¥850 billion ($139 billion) between 2009 and 2011 to upgrade the health service; in 2012, the government said it had actually spent ¥1.5 trillion ($245 billion) on improving health services.

While the government has declared that it wants to attract more foreign capital to the healthcare sector, the country's transition to a more advanced stage of development means that it is equally hungry for expertise, according to Kit Kwok, a Corporate Partner with global law firm DLA Piper in Shanghai. Zhang of Actis elaborates: "You have to ask yourselves what value you can bring to Chinese companies and how you can help them to grow. If you want to invest in a company, it is not sufficient to tell them a story; you have to show a track record."

Service providers likely to see strong growth

The biggest growth areas fall into two main categories: the provision of healthcare services, most notably the operation of hospitals, primary care centres and care homes; and healthcare products, including pharmaceuticals, biotech and medical devices. Other sub-sectors, such as IT services and insurance coverage, represent small but emerging parts of the sector.

The Chinese Government is keen to encourage investment in the hospital network and nascent primary care system. It has placed special emphasis on evening out the provision of resources between urban and rural areas, and on relieving pressures on the largest public hospitals. Improving the country's medical infrastructure will require an influx of capital and expertise; given that just 12 per cent of Chinese hospital beds are in privately owned facilities, there are likely to be numerous opportunities for investment, although the process could be both challenging and time-consuming.

"It takes time, because converting ownership of land and [helping healthcare workers make the transition] from government to private employees is likely to encounter lots of resistance from various stakeholders," says Lewis Ho, Head of the Asian life sciences practice at law firm Dechert.

Investment in new facilities is likely to be concentrated at the higher end of the market in the near term, which will also exacerbate the competition for high-quality medical staff with foreign training, according to industry experts. Local companies and foreign investors have both proved eager to enter this space, in some cases via joint ventures, in which the local partner acquires land for the construction of new facilities, while the foreign investor contributes operational expertise.

One active investor in the sector is United Family Healthcare, a US company providing community-based healthcare and secondary care, which recruits doctors and clinical staff worldwide. Other investors are looking to address the shortage of qualified medical staff: Health Education England recently signed a Memorandum of Understanding with Peking University to train GPs.

Meanwhile, according to Kwok, other foreign investors are leveraging their expertise in particular specialties – such as cardiology, orthopaedics and dialysis – at individual hospitals, in an effort to create added value.

China's approaching demographic changes, in which the percentage of people over 65 has been forecast to grow to nearly 12 per cent by 2020, from eight per cent in 2004, has also focused attention on the need for care facilities in a country where they have been virtually non-existent.

The government recently relaxed some regulations pertaining to private investment in the 'eldercare' market and encouraged third parties, including voluntary organisations and charities, to operate them, according to Natalie Liao, Executive Director of the non-profit British Chinese Society of Health Informatics. A small group of companies, including care home chains and private equity groups, are also believed to be exploring this area, although the investment is likely to remain small until a successful, scalable business model is identified, experts say. As is the case in the hospital sector, the best opportunities for foreign investors are likely to come from contributing operating expertise, or, potentially, developing wholly owned management companies.

Cultural knowledge will be as important as familiarity with the regulatory environment, says Liao, adding that the Chinese market is likely to require slightly different models, such as apartments that are part of bigger communities, enabling residents to maintain links with their children, grandchildren and other family members.

Susan Hendrickson, a Philadelphia-based partner with Dechert, says that she is aware of several projects already under development, ranging from 'senior living campuses' to hybrid assisted-living and continued-care retirement communities, the largest of which is in Shanghai. Hendrickson says that most investors she has seen are from the United States and Australia, and that the number of projects is still 'in the tens' and concentrated in first-tier cities. "Clients are experimenting with what might work," she says. "Whoever gets it right is going to do extremely well."

China's burgeoning middle class expects high-level health facilities and highly qualified medical staff

The drugs and medical devices market

In the case of the pharmaceutical sector, both local and foreign companies have been expanding their presence for some time, buoyed by the reliance of hospitals and physicians on sales of medicines for much of their revenues.

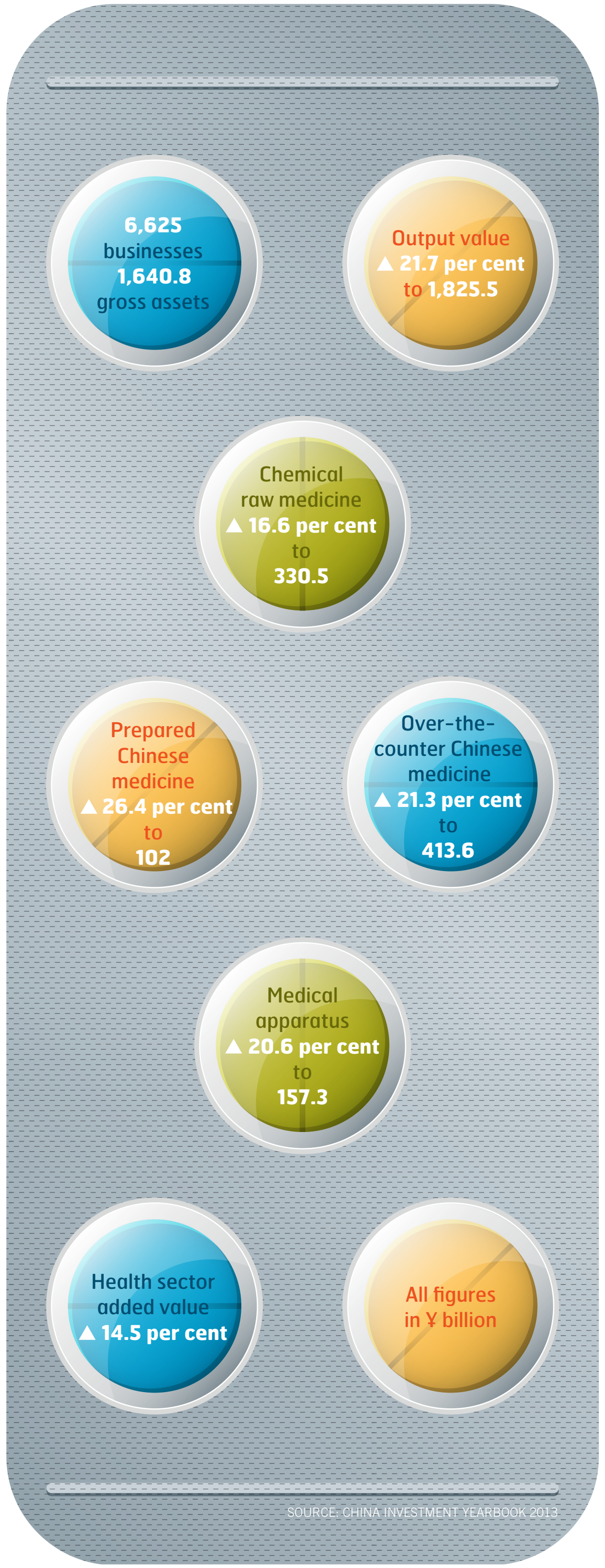
Large multinationals such as GlaxoSmithKline (GSK), Eli Lilly, Merck and AstraZeneca already have a strong presence in the country, and 13 of the top 20 global pharmaceutical firms have established research and development centres in China since 2006, according to McKinsey. China is already the world's third largest market for prescription and over-the-counter drugs.

The government has nevertheless indicated its desire to control the spiralling cost of medical treatment, and this will require substantial changes in the funding of hospitals, clinics and doctors, who currently depend on drug prescriptions for a significant proportion of their reimbursement. The government is also looking more closely at the relationship between pharmaceutical companies and healthcare providers, as is clear from the recent bribery accusations made against multinationals such as GSK (which has since been found guilty).

Attention has also focused on the Essential Drug List (EDL), which consists of drugs that are fully reimbursed by the central government, and the Nationally Reimbursed Drug List (NDRL), which includes both those on the EDL and higher-priced drugs that are only partially paid for by national and provincial governments. While inclusion on the lists offers a potentially guaranteed revenue stream for producers, efforts by government agencies to rein in costs means that those medicines on the list could face tougher price scrutiny.

Medical device manufacturers have seen the investment climate improving for some time, with domestic companies increasingly competing with some of the bigger multinationals with a presence in the country. Established foreign companies such as GE and Medtronic have strong brand names and comprehensive after-sales services, but local companies that were formerly suppliers to the larger brands, such as Shandong Weigao Group, are increasingly attractive, says Ho of Dechert. "We do see a two-tier market, in which the upper tier is dominated by foreign companies and the lower tier more favourable to Chinese companies," he says. "Local companies have extensive distribution networks to remote areas. Western companies would push the core technology that is not easily replicated by Chinese companies."

Key figures: China's health sector, 2012



Companies producing and looking to sell medical devices nevertheless confront a challenging licensing regime, in which there can be delays to getting products registered, although cities or provinces pushing investment more firmly might be able to fast-track the licensing process. The importance of establishing proper sales channels also gives an advantage to those with local partners, many of which may already have their own intellectual property, sales and distribution channels.

TCM is a more selective industry that is gaining interest from foreign investors. In February 2014, Bayer Group paid as much as $650 million (¥4,050 million) for Dihon Pharmaceutical Group, a specialist producer of over-the-counter herbal products based in Yunnan province. With relatively few TCM companies trading outside China, however, it can be hard for foreign portfolio investors to gain exposure.

Possibilities in emerging support services

A key element of the 12th Five-Year Plan has been expansion of the number of Chinese citizens with at least basic health coverage, and around 95 per cent of the country's population now belongs to one of the three main national insurance programmes. Yet, there is scope for the significant expansion of private insurance plans. Efforts to expand provision in this area have been slow to develop, because of uncertainties over pricing and the ongoing transformation of reimbursement regimes for hospitals and other healthcare providers.

Creating new hospital facilities and new tiers of care, including the creation of a primary care system, requires more extended insurance coverage and decisions about who should pay for the care. It will also require comprehensive databases to help providers assess risk, and a renegotiation of existing barriers to provision; those Chinese insurers willing to enter the market might look to redelegate some risks to foreign companies at a later point.

Another potential growth area, meanwhile, is IT services for managing patient records and, in the future, monitoring telemedicine portals. Liao notes that this market is currently dominated in China by a home-grown IT system supplier, Neusoft, which provides systems for 5,000 acute hospitals in 60 large cities. In September 2014, Chinese internet company Tencent Holdings took a stake in popular drug information platform DXY.com, then, the following month, invested $100 million in healthcare platform Guahao.com. Earlier in 2014, e-commerce giant Alibaba and Yunfeng Capital bought control of healthcare data firm Citic 21CN Co for HK$1.33 billion ($171 million).

"The driving force is that China is looking for leading technology and product services all over the world, and if international companies have very good products and technology, there will be a very good market for that," says Liao.

While direct investors must contend with property and regulatory challenges, portfolio investors can find it more difficult to identify adequate investment opportunities. A limited number of Chinese healthcare companies have listed

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A children's hospital in Futian district, Shenzhen. The Chinese Government has made improving primary care part of the 12th Five-Year Plan

on the Hong Kong Stock Exchange, and quotas remain for foreign companies looking to buy shares in Chinese companies listing on mainland exchanges such as Shanghai and Shenzhen, which provide the best opportunities to build exposure to the healthcare sector in China, according to Dmitriy Vlasov, Senior Adviser at asset manager East Capital. He notes that the quota for foreign investors is currently around $50 billion (¥311 billion), representing less than two per cent of the total market capitalisation of listed companies in China, although the government has been gradually expanding access to these markets to non-Chinese portfolio holders.

Recent initial public offerings in Hong Kong – such as the listings of private hospital group Phoenix Healthcare and iKang Healthcare Group, which offers preventive care plans to large companies – have been well received, although valuations have been high, says Vlasov. "Investors are willing to pay quite high premiums to get exposure," he observes.

The government's commitment to reshaping the Chinese healthcare system creates a number of potential entry points for investors across a wide range of areas. Yet, the uncertainties posed by the continuing transition process hold risks. The extent of the changes the state is undertaking cover nearly every element of healthcare provision, and most of them are interconnected to such an extent that policies affecting one part will naturally have reverberations elsewhere within the system.

"Coming into this space, you need to understand the whole macro system because the healthcare space is very complicated. How are you going to price your products and services? Can you get them on the reimbursement list? How are people going to pay? Your operational model may work, but, if you are going to be properly rewarded, you need to understand the whole ecosystem before you can succeed," points out DLA Piper's Kwok.

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The government is looking to consolidate the pharmaceutical sector, asking for the top 100 companies to be responsible for 50 per cent of sales by 2050

The complexities of the Chinese legal and regulatory systems also present hurdles, especially at a time of such rapid change. Navigating the property ownership system can involve regional disparities and the inconsistent interpretation of state policies at the provincial level. Equally, safeguarding intellectual property requires foreign investors to take time and have the necessary resources.

Producers of pharmaceutical products or medical devices must understand the complexities of market access, including the processes of tendering, reimbursement and distribution. More widely, investors need to be aware of the potential legal ramifications of relationships that might initially seem benign. For instance, foreign hospitals looking to provide professional advice to Chinese hospitals or medical personnel, including via e-medicine, must be careful to avoid taking any action that could be construed as practising medicine in China without a licence or creating a "permanent establishment in China for tax purposes", explains Daniel Roules, Managing Partner for law firm Squire Sanders in Shanghai.

Foreign ownership rules are also in a state of transition. While foreign investors were previously limited to owning 70 per cent of a healthcare provider, the government began liberalising these rules in 2012. Investors from Hong Kong, Macau and Taiwan now have the right to 100 per cent ownership in some provinces, while foreign owners can hold stakes of 90 per cent of healthcare providers in Chengdu.

China's healthcare reforms offer a broad spectrum of opportunities for investors that are able to identify the areas where they can add value. Those investors who take a long view of their presence in China stand the best chances of success.

Message

Li Bin
Director of National Health and Family Planning Commission

Compared with 40.4 per cent in 2008, 33 per cent of the national health expenditure came from individuals in 2013. Private investment is encouraged to participate in the health industry, and public health services have continued to improve. With the national immunisation programme, maternal and child health has seen further improvement. For the effective prevention of infectious diseases, we sorted out 5,000 food standards and implemented 109 new standards in 2013. In 2012, 600,000 medical staff offered free community health services to more than 11 million residents. Telemedicine has seen obvious progress, and the features and advantages of Chinese traditional medicine have played a greater role.

The number of outpatients in health institutions increased by six per cent to 7.3 billion in 2013; and the number of discharged inpatients by 7.3 per cent to 191 million. The number of private hospitals saw an increase of over 1,500 to 11,300. The next stage of development will see further expansion in the following four areas. First, to encourage more private investment to run medical institutions and allow more foreign investors to take part in the health sector, including the establishment of foreign-invested hospitals. Second, to encourage more medical practitioners to work with different hospitals for the balance of medical resources in different areas, and the relevant regulation is in the process of public consultation now and will come into effect soon this year. Third, to further eliminate restrictions on medical services, and bring the social capital into full play. Fourth, to further reduce limits on large-scale medical equipments. What's more, we will simplify the process of approval and improve efficiency, getting rid of the unjustified regulations that prevent private investment into the health sector.

The fiscal input in health and family planning saw steady growth in 2013, with a 27 per cent increase from the previous year. A total amount of ¥216 billion from the national budget was put into use for developing this sector. The mechanism of fiscal subsidies saw further improvement. The subsidy standard in the New Rural Cooperative Medical System (NCMS) was raised to ¥280 per person annually, and the health reimbursement rate within the scope of policies reached around 75 per cent. The standard of national budget for the basic public health programmes has been increased to ¥30 per person annually.

Major activities in 2014

1. Further developing the national medical insurance system. With more fiscal input and a slight increase of individual contribution, we can further promote the funding mechanism that is supported by the government, employers and individuals.
2. Promoting the insurance system for serious illnesses for urban and rural residents. After the pilot projects in 28 provinces, the system will come into effect all over China in 2014.
3. Improving the medical assistance system for poverty-ridden residents.
4. Developing the emergency relief system, which was established with a national budget of ¥500 million last year.
5. Encouraging the growth of commercial health insurance.