July 4, 2011

Dear clients and colleagues,

Following an overview of China's Twelfth Five-Year Plan in the last commentary, this week we focus on the healthcare sector.

Background

Healthcare reform in China has come a long way and experienced rapid changes in the past few years. After the Communist Party came into power in 1949, healthcare was virtually free for urban residents under a cradle-to-grave welfare program. In the countryside, small clinics were run by rural communes to provide farmers with basic medical care. In the 1970s, the policy focus was to reduce infant mortality, improve life spans and provide healthcare service through local primary care physicians to rural communes. During the following two decades, the economy boomed and the healthcare sector was given less priority than economic development. In the late 1990s, the government commercialized healthcare. The SARS episode in 2003 came as an alert of an inadequate healthcare system to the government who then started to plan for comprehensive reforms.

Current Situation

China's per capita healthcare spending is low in absolute terms (at US$167 in 2009, compared to US$7,075 in the U.S. and US$2,633 in Japan), but is forecasted to increase at a compound annual growth rate (CAGR) of 20.7% between 2009 and 2014. The drivers are both higher healthcare standard and aging population.

Compared with developed countries, China has a long tradition and strong presence of hospitals as the primary care providers vs. general practice which only started to appear in the late 1990s. The widespread belief is that specialists in hospitals are more skilled than generalists. According to the 2010 statistics from China's Ministry of Health, the total number of health institutions in China was 936,927, including hospitals (20,918), grass-roots health care institutions (901,709), specialized public health institutions (11,825) and other Institutions (2,465).

Healthcare in the Twelfth Five-Year Plan

The guideline is to further deepen the reform of the pharmaceutical and healthcare systems, to improve the basic medical and health care systems, and to more quickly reach the goal of making basic medical and health services available to all citizens. The longer-term target is to establish basic healthcare coverage for 90% of citizens by 2020.

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Two pillars of China's healthcare reform

Two pillars, the essential medicine system and the reform of state-run hospital, are designed to address the problem of high medical costs and low accessibility of medical services. Both are closely linked due to a long history of low government funding for state-run hospitals which often covers only 10% of the hospitals' operating costs. Doctors have generated income for hospitals by aggressively prescribing expensive, and sometimes unnecessary, medicines and treatments.

Opportunities

After studying the specifics of the Twelfth Five-Year Plan, we've identified several strong growth areas in which investors may participate.

1. Drug distribution

The government encourages industry consolidation in the drug distribution market. Investors may eye on industry leaders or potential takeover targets.

China aims to control healthcare costs by consolidating China's drug-distribution market. This market is expected to grow at a CAGR of 23% from 2009 to 2014. In 2009, there were over 13,400 pharmaceutical distributors in the nation, with the three largest – Sinopharm, Shanghai Pharma and Jointown Pharmaceutical, accounting for only 20.9% of the market. In comparison, the three largest distributors in the U.S. accounted for 97% of the market.

By 2015 China aims to create three national pharmaceutical distributors, each with annual revenues of at least RMB 100 billion; and to have the top 100 pharmaceutical wholesalers to account for at least 85% of sales in the drug market.

2. Medical device

The Plan indicates that domestically-made device will be the primary choice of government purchase. Investors may look for the domestic leaders in medical device.

Currently, majority of high end devices are imported. For example, 92% of CT sold in China in 2010 was made by GE, Siemens, Philips, Neusoft/Philips JV and Toshiba. 50% of MRI sold in China was made by GE, Siemens and Philips.

3. Drug development

The plan indicates that Chinese government and private sector will invest RMB 40 billion in new drug development. It defined ten therapeutic areas: 1) cancer, 2) cardio vascular diseases, 3) cerebral vascular diseases, 4) neurodegenerative diseases, 5) diabetes, 6) CNS diseases, 7) autoimmune diseases, 8) drug-resistant bacteria infection, 9) Tuberculosis, and 10) viral infection. Five large and new therapeutic areas were also identified: 1) Alzheimer's diseases, 2) obesity, 3) metabolic diseases, 4) anti-aging treatments, and 5) prevention of infections.

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The focus areas of Chinese biologic industry include: 1) bio-pharma, 2) bio-agriculture, 3) bio-energy, 4) bioenvironmental protection, and 5) biotechnology outsourcing service. Market potential of Chinese biologic industry is expected to reach RMB 4 trillion by 2015 and 8-10 trillion by 2020. For Bio-pharma sector, the key product development focus over 2011-2015 include: 1) preventive and therapeutic application of innovative biotechnology, 2) new vaccines, 3) diagnostic agents, and 4) innovative chemical drugs.

Risks

China's healthcare plan is likely to benefit the pharmaceutical sector in long term but near-term policy risk lies in regulatory uncertainty on drug pricing.

According to the health reform plan for 2011, the essential medicine system will cover all government-sponsored health institutions at the grassroots level by the end of the year. Essential drugs will be sold at such institutions at a 0% mark-up.

The nationwide price cut started in last December. The National Development and Reform Commission (NDRC) ordered price cuts on 174 drugs from 60 companies by an average of 17%, which aimed at easing high inflation including expensive healthcare costs. That action was particularly noteworthy because it involved patented medications from ex-China sources. Previously, innovative drugs were allowed the freedom to set their own prices.

On March 28, 2011, China slashed the maximum retail price again for more than 1,200 types of antibiotics and circulatory system drugs by an average of 21%. Industry analysts predict further price controls. As a result, some small drug manufacturing companies may run out of business due to fierce competition and thinner margin. A few very cheap drugs were reported disappearing from the market as it is no longer profitable to produce them.

There are always uncertainties associated with reforms. We will follow closely the evolution of the healthcare reform in China and keep you posted.

Have a good week.

The Global Alpha team

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