WOLFGANG FICKUS, CFA®

CHINA EQUITIES

CHINA'S BURGEONING MIDDLE CLASS BOOSTS OPPORTUNITIES IN HEALTHCARE

Wolfgang Fickus, CFA®
Member of the Investment Committee

Asia will be home to half of the global middle-class next year. China has been a major driving force behind this growth. The continent's transition from low- to high-income has been a slow and steady process, which is why Comgest likes it. Understanding this income trend's past contribution to our developed and emerging markets portfolios is key for investors in Comgest products. In the past decade, one-third of the sales growth of our European Portfolio holdings was driven by Asian clients. In our China portfolio, 90% of our holdings are exposed to the country's burgeoning middle-class segment.[1] While "Mr. Market" may occasionally be blindsided by the macroeconomic cycle in China, our eyes are focused on the long-term structural trends that have enabled the country's rise. Healthcare businesses, one of the nascent opportunities linked to the Chinese middle class, generally benefit from high barriers to entry, innovation and pricing power – all ingredients that Comgest seeks when analysing a company's long-term growth potential. And, as we explain in this paper, our view is that this sector offers a lot of compelling long-term stock picking opportunities.

— **Healthcare businesses generally benefit from high barriers to entry, innovation and pricing power – ingredients that Comgest seeks when analysing a company's long-term growth potential**

A LOW- TO HIGH-INCOME EVOLUTION

One crucial step towards becoming a high-income nation is the economic transition from an investment-driven to an innovation-, service- and consumer-driven growth model. The challenge for a country in achieving this is to maintain a constant increase in productivity over decades that will foster a middle class. Over time, the goal is that productivity will be increasingly driven by innovation and soft infrastructure, and less by investment in hard infrastructure. As *figures 1 and 2* illustrate, China is now at this critical tipping point, while Taiwan and South Korea have long surpassed it. According to the non-profit organisation World Data Lab, Asia will not only be home to half of the global middle class by next year, but also produce the next wave of economic progress.[2]

[1] As of end March 2019.
[2] Kharas, Homi and Kristofer Hamel, "A global tipping point: Half the world is now middle class or wealthier," The Brookings Institution, 27 Sep 2018 (https://brook.gs/2xMJ5c7)

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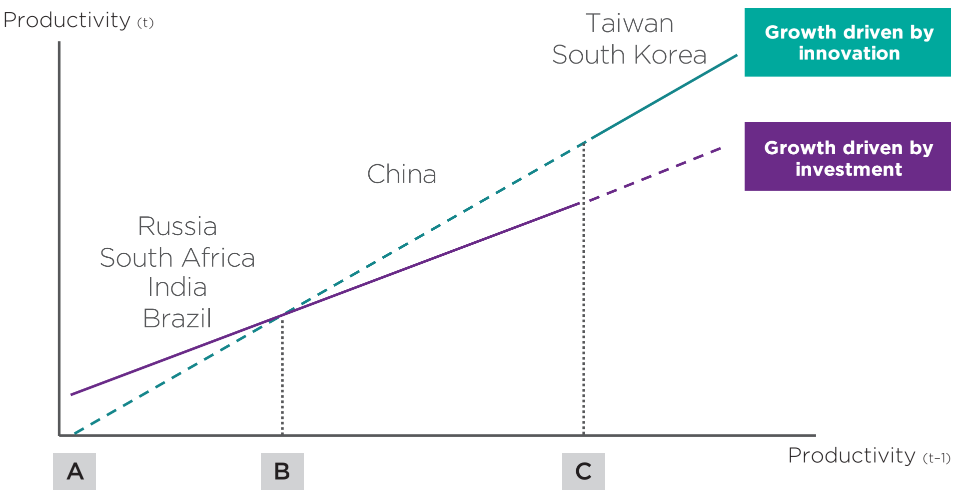
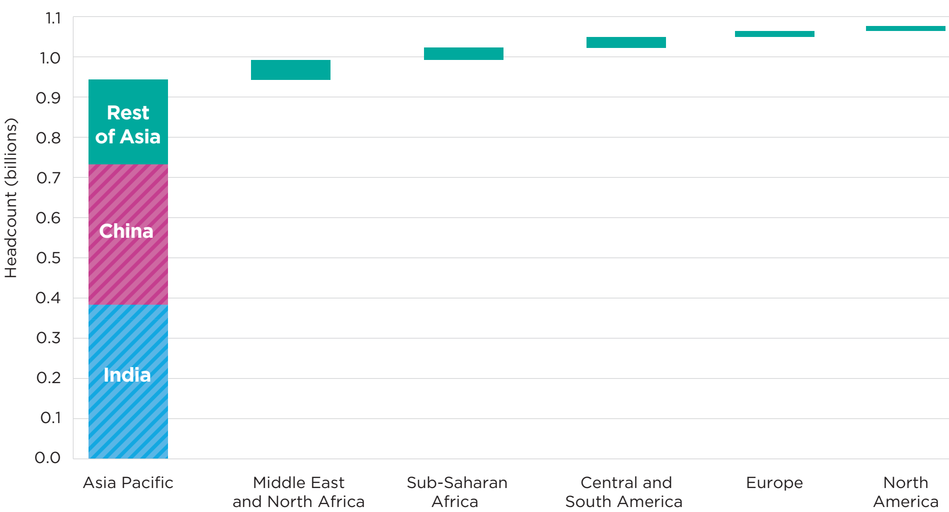
Figure 1. Emerging countries: the challenge of improving productivity



Source: Comgest, based on the theory of Aghion and Bircan, "Transcending the Middle-Income Challenge – Asian Development Outlook 2017," Asian Development Bank, April 2017 (http://bit.ly/2AHuApH).

Figure 2. Regional Contribution to Next Billion Middle Class (2015–2022)



Source: Kharas, Homi. "The unprecedented expansion of the global middle class an update", The Brookings Institution, February 2017 (https://brook.gs/2u6zwBA).

A key action is that as wealth rises, so too does the development of soft and advanced infrastructure, education, rule of law, intellectual property protection, sound government policies and institutions, and increased macroeconomic stability. Some examples of this include increased investment in human capital and R&D, a transition from an agriculture-based economy to one

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focused on industry and services, as well as a competitive and high value-added export industry. The higher that a country climbs the income ladder, there is less likelihood it will fall back. For Comgest, this process provides us with long-term visibility for our bottom-up stock picking decisions.

In our experience of studying long-term structural and productivity trends, we've seen how the market can be distracted by headline gross domestic product (GDP) growth. In our view, if a primary driver for economic growth is an increase in population, then investors should look closely at productivity trends. However, a demographic dividend can turn into a liability if a majority of the population remains poor due to poor soft infrastructure. This is what we refer to as the "middle-income trap".[3]

Investors could also focus on short-term GDP growth swings, which are cyclical – not structural – in nature. China is arguably in this situation today with a slowing growth cycle that has been exacerbated by deleveraging and an ongoing trade conflict with the United States. But does this short-term slowdown matter if China continues to ascend the income ladder? We don't believe so and are continuing to focus on the positive long-term structural trends for our stock picking.

FINDING THE GROWTH

Over the past decade, Asia's rapid development has shaped both our emerging and developed markets portfolios. One-third of sales growth over the past decade from the companies in our European portfolio has come from Asia, which makes it the second largest contributor to growth – well ahead of the 22% share of sales growth from the European continent itself, as *figure 3* demonstrates. Today, 21% of the sales of our European portfolio holdings are generated with Asian clients, more than twice as much as 10 years ago.

— **Our quality growth stock picks focus on higher income ("New China") stocks, i.e. healthcare, IT, communications and consumer sectors, which we believe could ride the tailwind of the country's economic transformation**

As per *figure 4*, in the past 13 years, China's rise has led to a notable swing in sector exposures in our China portfolio as our exposure to the traditional smokestack economy, i.e. industrials, energy, materials and utilities sectors, has decreased from 50% to less than 10%. With the domination of the higher income or "New China" stocks, i.e. healthcare, IT, communications and consumer sectors, we believe that our quality growth stock picks have the potential

[3] Aldaz-Carroll, Enrique et al. "How to avoid the middle-income trap: Lessons from Poland, a European Tiger," The Brookings Institute, 17 Dec 2018 (https://brook.gs/2ChRGWE).

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to ride the tailwind of the country's economic transformation. The luxury sector, in particular, has benefited from this growth machine including companies such as LVMH, Hermès, Compagnie Financière Richemont and L'Oréal. Chinese consumers contributed 75% to the luxury market growth over the past decade and one-third of global luxury sales now come from Chinese consumers versus only 9% a decade ago.[4] The question for investors is: what opportunities exist beyond the well-known IT, internet, luxury and consumer stocks?

Figure 3. Comgest's European Portfolio: Share of 2008–2018 sales growth by client destination

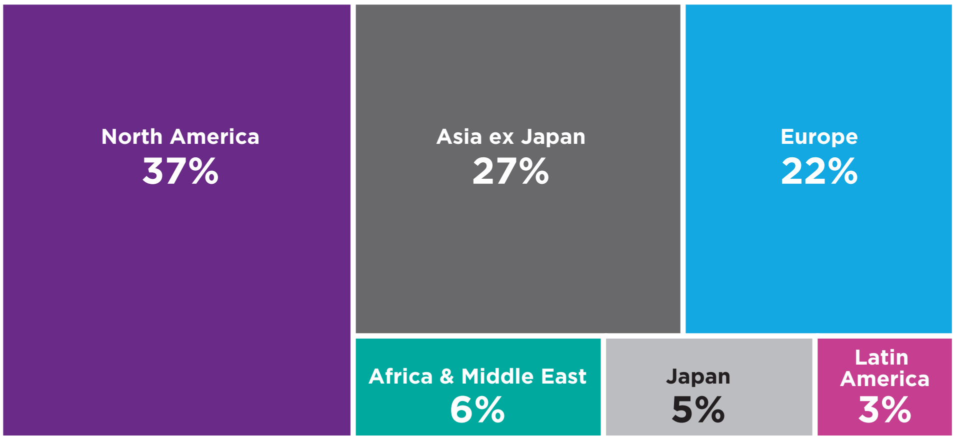
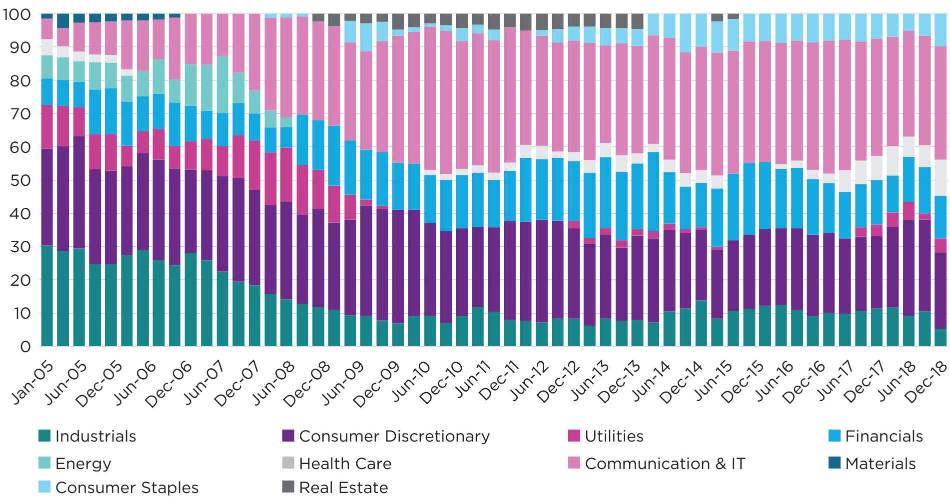


Figure 4. Sector exposure of Comgest's China portfolio



Source: Comgest / Factset, as of 31-Dec-2018.

[4] Altagamma (https://bit.ly/2KGehBK).

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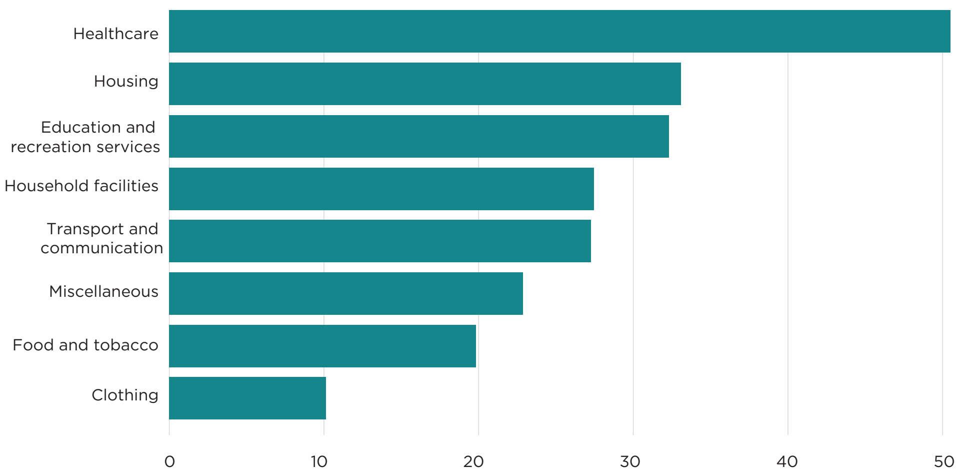
HEALTHCARE: EXPANDING OPPORTUNITIES

— **Per capita healthcare spending in China is less than 15% of the European average and less than 5% of the U.S. average**

When we refer to "New China," industries such as healthcare come to mind as one of the earliest, yet still expanding, opportunities for investment. Given that economic moats in the healthcare industry are driven by innovation, this is one of those industries that China needs to develop in order to reach the next rungs of the income ladder and improve the quality of life of its citizens. In fact, healthcare spending per capita in China is a fraction of what is spent in developed markets – less than 15% of the European average and less than 5% of the U.S. average.[5] But socio-economic trends are driving demand. China's population is ageing quickly. According to Chinese government data, annual healthcare spending for someone >65 years old (RMB 1,072/year) is currently more than three times that of those aged 25–34 (RMB 326/year).[6] With chronic diseases becoming more widespread, out-of-pocket spending is likewise increasing.

Figure 5 shows that as a result of these trends, healthcare spending has been the fastest-growing per capita spending category in China over the past years. More importantly for Comgest's approach, this sector offers the high barriers to entry that we seek for our investee companies. Thus, the weight of these stocks in our China portfolio now exceeds that of industrials or consumer staples sectors that have mature growth profiles.

Figure 5. Where Chinese Consumers are Spending More (change in per capita expenditure for Q1–Q3 in 2015 and 2018 (%))



Source:National Bureau for Statistics China. © FT

[5] The World Bank (https://bit.ly/2yUZmdS).
[6] As of end 2018.

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— **Venture capital and private equity financing in healthcare is abundant and the market is expected to grow with a CAGR of 10% over the next decade**

On the supply side, China has a strong talent base. With over two million expat returnees in the last six years, there are now approximately 250,000 of those returnees working in healthcare according to consultant ChinaBio. Venture capital and private equity financing in this field is abundant and the market is expected to grow with a CAGR of 10% over the next decade.[7]

A CONDUCIVE REGULATORY ENVIRONMENT TO INNOVATION IN HEALTHCARE

The backdrop to this strong growth picture is the radically improved regulatory environment, which still has a lot of evolving parts. The improved environment matches China's objective to offer better quality healthcare. Some of the recent changes include:

- **More centralisation and competitive price pressure:** The establishment of the State Medical Insurance Bureau (SMIB), which was created out of a merger of three public medical insurance systems into one as well as the recent "4+7 Cities" scheme which centralises drug procurement in 11 Chinese metropolises.[8] China's goal is to make healthcare services affordable by centralising procurement and making the system more efficient. Competitive price pressure is the government's attempt to reign in drug costs.
- **New focus on innovative drugs and quality:** The multiple updates issued in the National Reimbursement Drug List (NRDL) in 2017 and 2018 follow a six-year hiatus and opened the door for drugs with a high clinical value (many from western pharmaceutical companies). A consistency evaluation identifies quality generic drugs within the country's fragmented healthcare market.
- **Faster drug approval:** Priority reviews of innovative drugs have shortened approval times that benefit both western healthcare providers and Chinese innovators.

[7] ChinaBio Group, State of China Life Science – 2019, 6 Jan 2019.
[8] Shen, David. "China announces pilot scheme for pharmaceutical tendering with minimum procurement quantities." Allen & Overy LLP, 5 Dec 2018 (https://bit.ly/2Xo9WZM).

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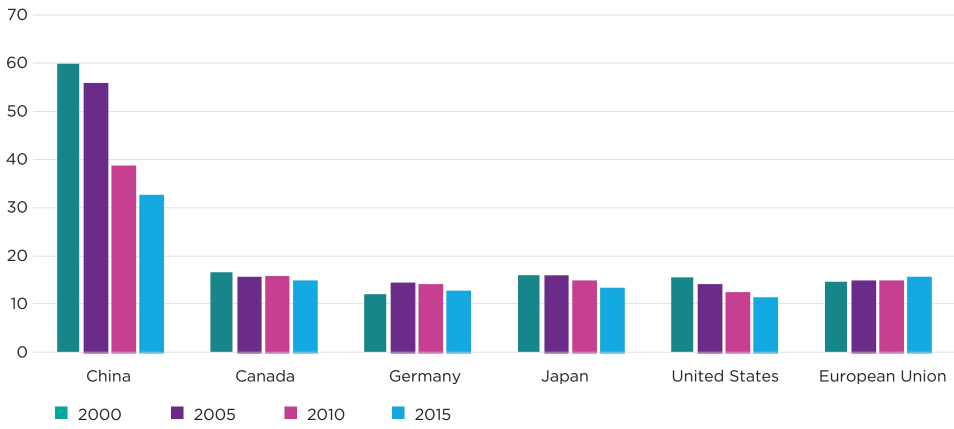
– **Better insurance coverage:** A state social healthcare insurance scheme has quickly expanded its coverage to 100% of China's 1.3 billion population and is the main funding source for 70% of total healthcare costs – an increase from 40% two decades ago. Commercial healthcare insurance has seen explosive growth – that is still continuing – as it provides extra protections for middle class families with regard to high-priced drugs and private medical services, as seen in *figure* 6.

Figure 6. Out of pocket healthcare spending (%)



Source: The World Bank (https://bit.ly/2yUZmdS).

— Enhancements to China's regulatory environment means it is more conducive to innovation than ever before – potentially leading to a competitive Chinese pharmaceutical industry

The regulatory push to improve healthcare coverage is necessary as per the socio-economic trends previously mentioned. For example, China has the largest diabetic population in the world, but treatments for diabetes are outdated and lag the U.S. by nearly 20 years. Newer forms of medication contribute 40% to the anti-diabetes market in the U.S., but only 2% in China. The enhancements to the country's regulatory environment means that it is more conducive to innovation today than it has ever been – and this offers China the chance to develop a competitive Chinese pharmaceutical industry.

OPPORTUNITIES IN CHINA'S HEALTHCARE MARKET

Novo Nordisk, a global leader in diabetes care, is one stock that is benefiting from the improved Chinese regulatory environment for innovative drugs. Novo Nordisk boasts a market share of 87% in China with its GLP-1 drug, Victoza®[9]. The 2017 NDRL opened the door to China for this innovative drug. Thanks to the success of

[9] Victoza® is a first-line treatment option for adult patients with type 2 diabetes and cardiovascular disease (https://bit.ly/2RnwAMp); data as of end 2018.

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Victoza®, China contributed close to 20% of 2018 sales growth for Novo Nordisk. The drug only represents 1.3% of the total Chinese diabetes market, which is a small fraction when compared to Western markets.[10]

Roche is another company exposed to the Chinese healthcare trend. Roche's three biggest products include Herceptin®[11], Avastin®[12] and MabThera®/Rituxan®[13], and were also added to the NRDL in 2017. In December 2018, Roche's newest breast cancer drug, Perjeta®[14], was approved by the NMPA (China's equivalent of U.S. Food & Drug Administration). Thanks to China, Roche's international sales growth accelerated to 14% in H2 2018, which helped the group grow 9% organically despite strong biosimilar competition in Europe.

At Comgest, we look for companies with a high level of R&D spending and a strong distribution footprint. Within the healthcare value chain in China there are high levels of fragmentation and competition, as well as an evolving regulatory environment, threats from Western drug companies, low spending on R&D and generic drugs by domestic pharmaceutical companies. These factors make disciplined stock picking crucial for the Chinese market.

— Comgest looks for companies with a high level of R&D spending and a strong distribution footprint

Another healthcare stock to mention is **3SBIO.** It was founded during the 1990s by a Chinese scientist, Dr. Jing Lou, upon his return from the U.S., and is now a leading Chinese biopharma company. 3SBIO holds a dominant position, 41% of market share as of end 2018, for recombinant human erythropoietin (EPIAO). Similarly, the company not only holds a market share of 60% for thrombopoietin (TPIAO), their biggest product[15], but also produces the only human recombinant TPIAO in the world. Both of these drugs stimulate red blood cell and platelet production to treat anaemia resulting from chronic kidney failure, chemotherapy, thrombocytopenia[16] and surgery. Their pipeline includes innovative drugs such as a long-acting EPIAO, a Herceptin® biosimilar (added to the priority review list in China to treat breast cancer) and a

[10] As of end 2018.
[11] Herceptin® is a targeted therapy approved for the treatment of people with certain HER2+ cancers (https://bit.ly/2ILdFHG).
[12] Avastin® is designed to block the blood supply that feeds the tumour, which can stop it from growing (https://bit.ly/2KnRaM5).
[13] MabThera®/Rituxan® is approved for the treatment of various blood cancers (https://bit.ly/2MTXmxG).
[14] Perjeta® (pertuzumab) is approved in combination with Herceptin® (trastuzumab) and chemotherapy for patients with HER2+ early breast cancer that has a high likelihood of coming back (https://www.perjeta.com/patient.html).
[15] As of end 2016.
[16] A rare, but potentially serious blood disorder triggered by an autoimmune process that causes a deficiency of blood platelets. According to Novartis, 1 in 50,000 adults suffer from ITP (immune thrombocytopenia) per year

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Rituxan® biosimilar. 3SBIO's range of biosimilars and biological products is rounded off by in-licensed insulins and GLP-1 to participate in the growth of the anti-diabetes market, a market-leading anti-inflammatory drug Yisaipu[17] and the most recently licensed Avastin®.

There are very few proven domestic biopharmaceutical companies in China since R&D investment is costly and unpredictable while manufacturing skills for biological drugs are elevated. The biological drug sector is very concentrated with Top 10 players occupying 60% of the market in China and around the world. The biggest players in the Chinese market are Novo Nordisk, Roche, Merck, Qilu, Sanofi, Lilly, 3SBio, and Novartis. As a result, we believe that low penetration levels, high efficacy and significantly lower projected prices versus western peers are strong arguments in favour of 3SBIO. Furthermore, now that 3SBio has built a strong presence, we believe that the company's growth is sustainable and long term – with sales and earnings per share (EPS) growing by 23.5% over the next five years.[18]

— **Private health insurance, particularly for critical illnesses, offers another means of benefiting from the flourishing Chinese healthcare market**

Private health insurance, particularly for such as critical illness insurance for cancer, offers another means of benefiting from the flourishing Chinese healthcare market. This niche market represents only 12% of the total Chinese insurance market, but it has been growing twice as fast as the overall insurance market at a CAGR of 41% from 2014–2018 according E&Y research.[19]

Ping An, is the market leader in private healthcare insurance in China and offers critical illness products. Their long-term health products accounted for 15.8% of gross written premiums in 2018, which is up from only 9.7% in 2015, or to put it another way – they accounted for 23% of premium growth over this same period. The leading healthcare platform in China is "Ping An Good Doctor", which aims to reform healthcare services by making them more efficient in terms of allocating medical resources, improving diagnoses and prescription drugs as well as using idle medical resources in public hospitals. The platform now has more than 200 million registered users and handles over 500,000 appointments a day.

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17 Yisaipu is used to treat rheumatoid arthritis, polyarticular juvenile idiopathic arthritis, and ankylosing spondylitis.
18 As of end March 2019; based on Comgest research of the portfolio holdings and our projection of each company's expected underlying growth rate over five years.
19 The Rise of Private Health Insurance in China, Ernst & Young, 2016, (https://go.ey.com/2FnpC5m).

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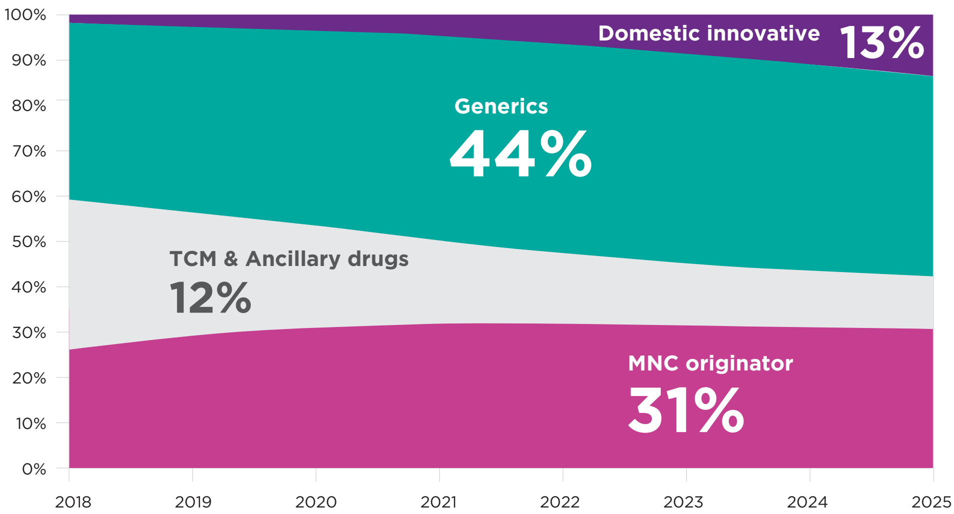
CONCLUSION

Figure 7 describes what could be an ideal environment for both Western and Chinese pharma companies in China's healthcare market. Based on stated government targets and recent healthcare reforms, all roads point towards innovation and, to return to our theme, the path to becoming a high-income country. In Comgest's view, this sector offers one of clearest routes to capture the growth offered by the rise of China.

Figure 7. China market share breakdown projection (drug sales)



Source: CitiResearch, IQVIA. TCM = traditional Chinese medicine. MNC = multinational companies.

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Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

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