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A healthier future for China?

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The Chinese government has raised the priority of healthcare. In particular, equality of healthcare, in tune with its current Five Year Plan emphasis on the improvement of rural livelihoods and standards of living.

Whilst China's economic growth has progressed at break neck speed, the quality of healthcare has arguably lagged behind significantly, leaving many worse off than they would have been decades ago. Under communism, healthcare was part of the cradle-to-grave welfare system, during which time China witnessed a decline in infant mortality and a modest increase in life expectancy.

Deng Xiaoping's economic reforms led to a shift in policy in the 1980s, leading to increasing private participation in the healthcare system. The result has been rising inequality of care, with costs growing beyond the means of most households.

China's healthcare service now has one of the highest 'out of pocket expense' ratios in the world at 52%. By comparison, Korea and Brazil are both at 39%, the US 13% and UK 12%. Only around 40% of the population has effective medical insurance. This means the majority of the population are not using the healthcare service.

The current system is also heavily geared towards the largest urban hospitals. 80% of the 2006 healthcare budget was spent in cities (mainly at large hospitals), while 60% of the population is rural. Chronic illnesses now account for around 74% of deaths, up from around 47% in 1973.

Policy now appears to at least partially reverse the current model, with increasing emphasis on rising government contribution. The health minister recently announced the Healthy China 2020 programme, which aims to provide universal national healthcare and promote equal access to public services with 90% coverage by 2010 and 100% by 2020. Although the 11th Five Year Plan was only specific on central government rural healthcare spending at RMB 45bn, we believe this is but a fraction of the potential spend.

In order to achieve its goal, the government recognises the need to increase its own participation (which has steadily declined to below 18% of GDP from near 40% in the 1970s), but also that of local governments and insurance companies. It has stated that it wants local governments to match the central government's contribution, implying a further RMB 45bn for rural spending alone. As cities will continue to account for the lion's share of spending, a further RMB225-450bn is probable. Credit Suisse estimates the overall size of China's healthcare market will reach 10% of GDP by 2020, up from less than 5% in 2007.

Investment Opportunities

Rexiter's Greater China team believes China healthcare is an attractive investment opportunity. We feel comfortable that the government is committed to healthcare spend and will prioritise it. Furthermore, we believe the figures discussed will turn out to be very conservative, given the importance attached to this area, especially for the rural communities. We also note that the recent headline grabbing RMB4 trillion fiscal stimulus package includes healthcare as one of its targeted areas for spending.

Our research identifies a number of listed healthcare 'plays' that should benefit from this structural trend, of which we find the medical devices companies of particular interest. In addition to the structural rise in general healthcare spend, we also observe factors that are specifically favourable for medical devices:

- Of the current plan (2006-2010) expenditures, we understand that the early spend focussed on renovation of buildings, so spending on medical devices has thus far been relatively modest and thus still nascent.
- The government is encouraging local medical device makers to gain market share. Initially when restrictions were eased on the imports of medical devices in the 1980s, the market was dominated by foreign products. William Hsaio of the Harvard School of Public Health estimates that over 50% of medical equipment in China is currently foreign made. Meanwhile, China has built up a meaningful domestic industry and will no doubt (in its own way) seek to support home grown players as their capabilities improve.
- Although not a structural factor, a decline in raw material prices is nevertheless worthy of mention. Amongst the companies we have studied, up to 60% of their costs are accounted for by raw materials (metals, plastics and chemicals). A turnaround in raw material prices is a major positive for the profitability of these companies, which goes a long way to counter the possibility of lower sales in the current poor economic environment.
- Credit Suisse estimates the market for medical devices in China to grow at 20-25% per annum over the next three years. The US Department of Commerce has a more modest 10-15% estimate, which still represents attractive growth prospects. We also expect end demand to be relatively resilient, even in the US and Europe. While a contraction in sales is a distinct possibility in these markets, the products are more staple than discreet. Cost structures for China medical devices manufacturers are also competitive compared with western counterparts and thus, they are better placed to weather pricing pressures and potentially benefit from substitution to cheaper alternatives.

We emphasise that investing in healthcare plays is a medium to long term proposition and the upside is led by fundamentals supported by structural positives as described above. Meanwhile, we note that valuations are not 'cheap' with large players in the sector trading in their low to mid teens, however, they nevertheless appear to offer 'good value' for the longer term investor.