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China M&A Round-Up

Cross-border investment trends

What's the Deal?

China Healthcare Health Check

Against the background of a very significant drop in China's outbound investment in 2018, following a drop in 2017 from the 2016 peak, there appears to be an interesting and important shift in M&A targets toward healthcare-related assets. So far in 2018, not only are healthcare-related acquisitions in the US the fastest growing sector but they have become the single largest sector for Chinese buyers. In the first half of 2018, health and biotech investments into the US were 58% of the nearly $2 billion incoming, up from 9% of a much larger inflow in 2017.[1] In a sense, healthcare and biotech are survivors of multiple pressures coming to bear on China's outbound investment.

While the total investment amounts for 2018 Jan-May are modest, the three-year trend toward health and biotech is notable. The reasons for this shift and the sustainability of the trend are useful to consider from sector, financial, and technology perspectives. In the history of China's reform era, health care has

always been a focus. The demographic trends of increased urbanization, an aging population, widespread tobacco use (a World Bank estimate for 2014 put smokers among adult males at 47.6%), and environmental pollution have created a sense of urgency around the imperative to improve the efficiency, availability, and quality of health care.

Historic solutions from the founding of the PRC

Throughout the Mao era, China depended on an ultra-low investment model and decentralization of responsibility for health care. Among the key schemes, programs like the Commune-based Cooperative Medical Scheme placed responsibility for funding and provisioning healthcare for Chain's largely rural population at the lowest level of the system, with almost total reliance on Chinese traditional medicine. For urban populations, there was the parallel Government Insurance Scheme and Labor Insurance Scheme, which similarly placed responsibility at the lowest levels of the work unit in government or SOEs.[2]

These systems were notably successful, and China entered the reform era with a healthcare profile atypical of low income countries. Early in reform, China's healthcare profile came to resemble more developed economies, largely facing chronic illnesses rather than acute, infectious ones. Commentaries often note China's success in reducing poverty, but achievements in healthcare provision with very limited resources are equally impressive.[3]

Early in reforms, both the rural and urban support systems quickly faded, and there was an abrupt shift of responsibility for health care that once lay with communes, and state-owned enterprises in pre-reform China to the public sector at the municipal and provincial level. Many aspects of Deng Xiaoping's reforms involved dual tracks, the state sector and the market sector. For healthcare, this meant a "plan track" supported by public funds and a "private track," offering higher tech, more elite services for those who could afford it or have elite Party, military, or government positions. There was a growing gap in replacing the collapsing pre-reform system with new alternatives, and by 1998 China reached a nadir in its support of healthcare for the population.[4] This shift raised the visibility of the challenges and made health care reform a compelling research topic for top tier think tanks like the Development Research Center (DRC) of the State Council.

Today, a combination of an expanding but still immature private insurance market, intensely stressed national, provincial, and municipal resources for health care, rising expectations of the public, legacy features of public hospital provisions, and technology advances have brought China's health care issues front and center. Availability of adequate health care to all citizens is a priority of the leadership, and an expectation of the rural and urban publics. China will likely

not abandon this fundamental commitment. But an enduring competition for resources between investment in growth (manufacturing capacity, infrastructure, etc.) and investment in social services (education, health care, retirement) has chronically left the latter underfunded.[5]

The last two decades have produced two outcomes, the emergence of a substantial and expensive private health care system and a constellation of customary but unregulated payment flows required to getting adequate access to services and pharmaceuticals in the public system. China's healthcare spend exceeded 6.2 trillion yuan in 2017 and has been estimated to reach 8 trillion by 2020.[6] While this is a four-fold increase over a decade, spend is still a relatively small 6% of GDP.

If anything, the presence and visibility of world class healthcare in the private service sector has increased pressure to improve and expand the public-sector offerings. Consistent with the overall theme of Made in China 2025, commonly the approach is to localize and reduce the high technology costs associated with pharmaceuticals, medical devices, and diagnostic and therapeutic services across the board. To achieve that goal, M&A is playing a critical role.

Accommodations

As China opened its doors to the outside world in the early 1980s, it energetically promoted Chinese medicine as an effective alternative to Western medicine. The practice of Chinese medicine has some attractive characteristics, and it was very inexpensive. In China, Western medicine was also expanding quickly, first with the introduction of common pharmaceuticals like antibiotics and then with the rapid spread of clinics and private hospitals.

As the privately funded healthcare sector expanded, it was almost entirely delivering Western medicine, and many of the global pharmaceutical companies, imaging equipment makers, and diagnostic equipment makers moved aggressively first into the elite healthcare sectors, which included private facilities and high-level Party and military facilities, and then more gradually into the public hospitals. When WHO-level events transpired in China, like the SARS outbreak in 2002-2003, the response was also mainly based on Western medicine.[7] Demographics, urbanization, and this fundamental shift in practice toward Western medicine helped drive a rapid gearing up of health care costs. China also became an excellent location for epidemiology studies and drug trials. Connectivity grew quickly between Chinese researchers and providers and global centers of excellence. The sheer size and growth rate of China's healthcare spend attracted the attention of many major global players in all subsectors of healthcare.

Technology

Since the beginning of reforms, many Chinese leaders have emphasized "scientific" decision-making and technology in all undertakings, whether securing energy resources to fuel growth and mobility, feeding China's large population, or providing healthcare to the public. A major caveat was the foreign ownership of important technology, both due to the costs associated with it and the security issues around dependence. In pursuit of economic development, China opened the door widely to foreign technology, helping enable growth of high tech manufacturing capacity in everything from steel to consumer electronics. But in the provision of social services, including healthcare, the door was only provisionally opened, and that remains the case up to today.

Where technology and process were mastered, China often proved capable of building massive manufacturing or service capacity quickly. China grew manufacturing for commoditized antibiotics so quickly that it became the largest exporter of several bulk drugs made in excess of domestic demand.[8] China undertook to localize vaccine manufacturing, and more recently has supported genetic sequencing and gene-based therapeutic experimentation, where China's scale quickly made it the fastest, most productive gene sequencer in the world.[9] Large Chinese genetics players emerged as commercial enterprises on the global stage.

Foreign participants

Access to the market for foreign companies and their services became more complex as the market became bigger. For pharmaceuticals and devices, for example, there are two stages of approval needed. First, there is approval from the Chinese FDA to certify the safety and efficacy of the product. More critical to reach the scale that the market promised is a second step, listing on the provincial level reimbursement schedules, so that public insurance would provide coverage and the product could reach the larger publicly funded patient base. This is a fragmented process at the provincial level, and generally a growing burden on public insurance.

This is evident in a relatively expensive category like cancer drugs. In fact, a recent hit movie in China, *Dying to Survive*, describing the plight of a leukemia patient who smuggled drugs from India, called out the high cost of cancer treatment and even prompted the Premier of the State Council, Li Keqiang, to call publicly for more efforts to reduce the cost of cancer drugs.[10] In May, China removed import tariffs on anti-cancer drugs, and public health officials promised to fast-track the approval process of new drugs.[11] Already the impact has been seen in the accelerated approval of several new imported cancer drugs for China's market. But the real import of Premier Li's comments was to encourage the domestic

ownership of key IP if not the domestic development of it. Import of high cost drugs had been persistently weak from the foreign makers' perspective. In fact, a recent private analysis of sales of top anti-cancer drugs, based on the financial reports of the producers, indicated that sales of these products to China contributed an average of only about 2% to their total global sales.

Li identified cancer as the number one challenge to public health in China and threat to limited family resources. Relying on imports or even domestically manufactured products with high technology licensing costs paid abroad is not a viable solution for the larger public. Demographic realities and environmental factors suggest that demand will increase at a rate exceeding both GDP growth and population growth. China's triad of solutions: targeted M&A abroad, localization of domestic makers and distributors, and indigenous innovation.

M&A and the new landscape

What is being accomplished indigenously is well represented by China's big Internet companies, already developing efficient tools to support record keeping, cost analysis, referral activities through the multi-tier clinic and hospital system, as well as AI and robotic solutions from diagnostics through therapies. Foreign pharma companies and tech companies are contributing by expanding their business scope in China to support digital healthcare services.[12] Many of China's large genetics companies are energetically researching and trialing tailored treatments. These are among numerous initiatives but indigenous innovation by itself will likely not be enough.

Acquisitions of all manner of entities and consolidation that can contribute to a more efficient and affordable healthcare system in China are underway. Some are of foreign entities already active in the Mainland, like large distributors of foreign pharmaceuticals and devices. Many are of foreign entities including specialized diagnostic clinics, diagnostic systems, high tech capital equipment makers like gene sequencers, small early stage drug developers, implant makers, and healthcare related IT technology companies.

Made in China 2025 is explicitly supportive of overseas acquisitions as an important activity in meeting China's technology-related healthcare needs and supporting solutions. Even amid the significant slowdown in overall outbound M&A, a Deloitte study[13] argued that healthcare M&A would continue and would grow, a report that itself was cited in China's state-run media as part of the public messaging that the leaders were hard at work on solving the healthcare challenges.[14] Amidst the pressures coming from all sides bearing on cross-border technology acquisition, we expect healthcare to remain a very robust transaction arena.

Endnotes

[1]https://rhg.com/research/arrested-development-chinese-fdi-in-the-us-in-1h-2018/
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