China Theme #2: Healthcare Spending

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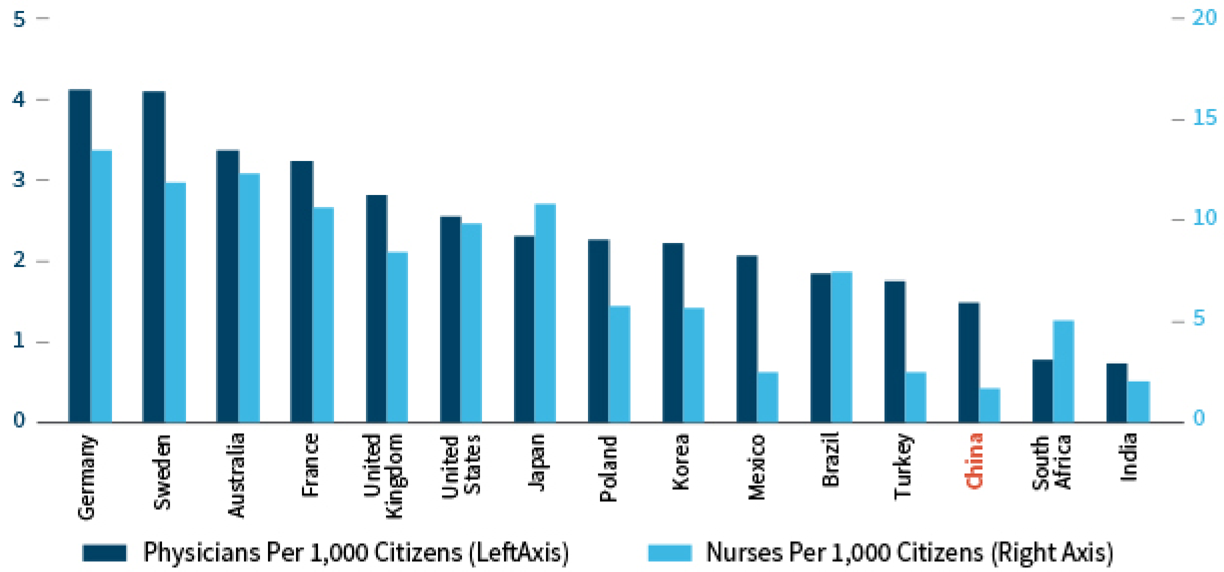
Healthcare is underdeveloped in China relative to its global peers, in both total and per-capita spending. This creates the potential for growth—and makes healthcare spending just one of two interesting themes that is creating opportunities for quality growth managers in the China A-Share market.

Rising Disease, Underserved Market

The prevalence of chronic diseases in China—such as diabetes, hypertension, and cancer—has risen significantly in the past two decades. Yet China is a largely underserved healthcare market, with the number of physicians and nurses per 1,000 citizens among the lowest in the world. The chart below illustrates.

China's Physician and Nursing Staff Levels Below Average



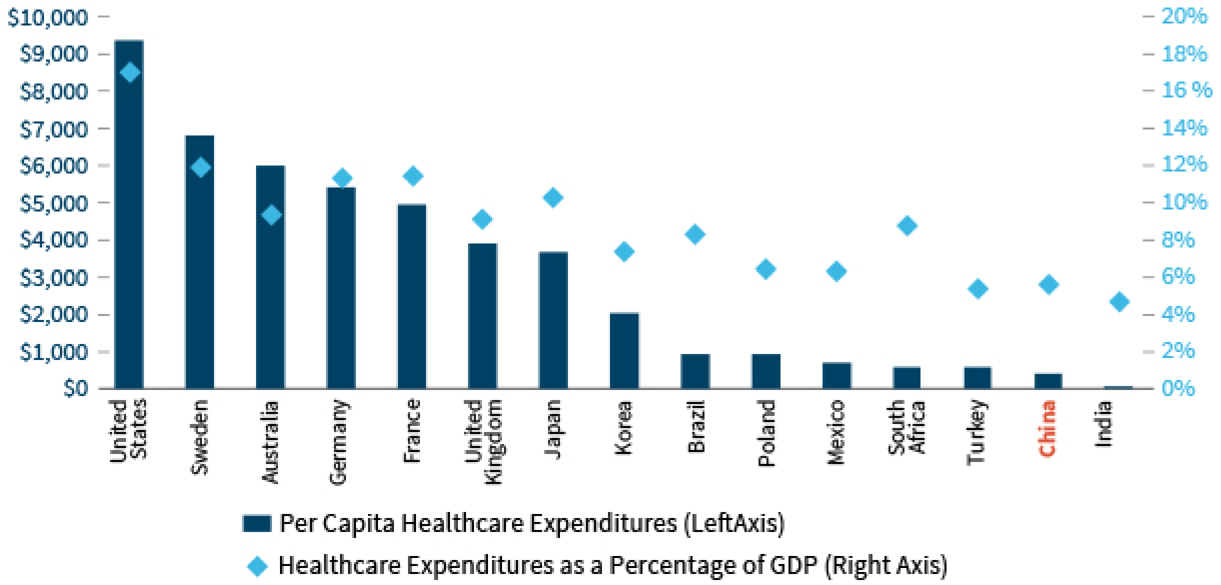
Sources: World Health Organization, William Blair, as of December 2016.

Not surprisingly, the Chinese healthcare industry has grown rapidly over the past decade, with an estimated compound annual growth rate of 17% from 2006 through 2018. The total industry market value is expected to reach nearly $800 billion in 2018.[1]

We expect this robust growth to continue, underpinned by China's low healthcare spending. As the chart below illustrates, Chinese citizens on average spend only a few hundred dollars per year on healthcare, among the lowest in the world, and a small fraction of the United States' nearly $10,000 per-capita healthcare spending.

Total healthcare spending is also low, with its contribution to gross domestic product about 5%, one of the lowest in the world.

Chinese Healthcare Expenditures Among World's Lowest



Sources: World Health Organization, William Blair, as of December 2016.

It is also notable that the China A-Share market has nearly 90% of the market cap of listed Chinese healthcare companies,[2] making the China A-Share market particularly attractive to investors who want to take advantage of the secular growth in China's healthcare spending.

Example: A Frontrunner in Innovative Medicine

An innovative drug manufacturer in China has been consistently growing its revenue and net profit by more than 20% per year for more than a decade.

Cancer drugs contribute to 43% of its total sales, reflecting the increasing prevalence of cancer in China over the past decade, which the Chinese government has sought to fight with an accelerated drug-approval process.

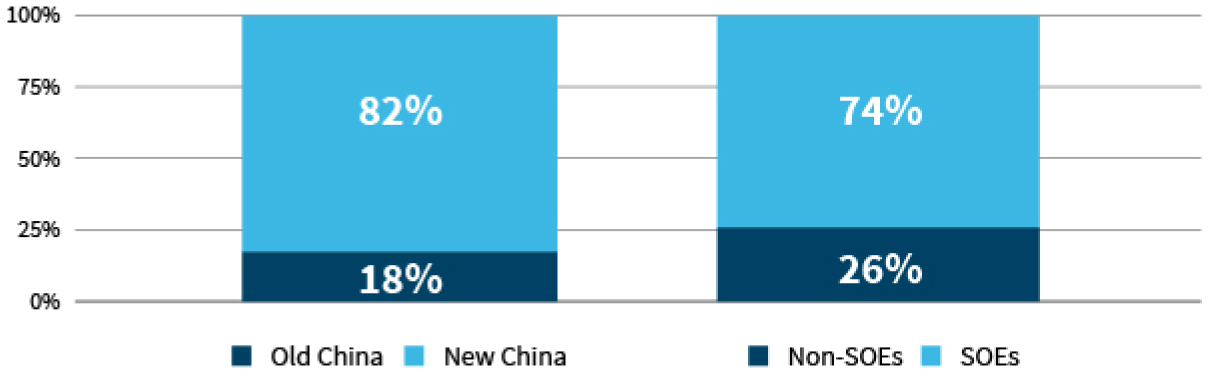
The company is a leader in R&D; R&D spending as percentage of total revenues rose from 8.9% in fiscal 2014 to 13.0% in fiscal 2017. Its large R&D spending has led to a strong product pipeline, with 10 major drugs under development and most expected to reach the market over the next two to three years.

Active Management Essential

In summary, we believe China offers a number of compelling investment themes, thanks to its burgeoning new economy and secular growth in consumption. But to capture the potential via China A-Shares, active management is essential.

China's new economy accounts for less than 20% of the CSI 300 Index from a market-cap perspective, as the chart below illustrates, and the old economy (including many state-owned enterprises, or SOEs) still accounts for a large part of the index.[3]

Active Management Essential in China

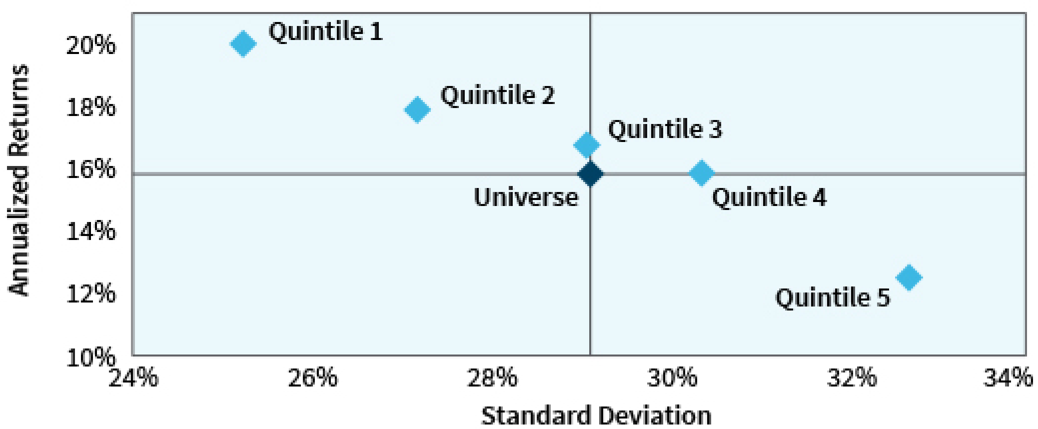


Sources: Goldman Sachs, William Blair, based on the CSI 300 Index, as of July 2017. New China includes GICS sectors healthcare and Information technology and GICS sub-industries education, publishing, advertising, movies & entertainment, travel & leisure, Internet retail, environmental services, and renewable electricity. SOEs are state-owned enterprises.

Moreover, we believe fundamental research with a quality focus is key to exploiting this attractive opportunity while limiting some of the risks inherent in the asset class.

Seeking high-quality companies with sustainable growth characteristics is paramount. Such companies may perform well in up markets, protect in down markets, and produce attractive, risk-adjusted returns, as the chart below illustrates.

China A Share Universe by Quarterly Quintiles



Source: William Blair. Data is from May 31, 2005, through June 30, 2018. **Past performance is not indicative of future returns.** Performance information is based on William Blair's proprietary models and does not in any way relate to the return of any William Blair product or strategy. The strategy may or may not hold the compaines included in the quality quintiles shown. Quality is defined as those companies with good balance sheet metrics, efficiency, and higher returns.

In searching for such companies, we look for organic value creation, peer-group leadership, consistent earnings growth, high return on capital and assets, positive earnings trends over time, and low leverage.

1. World Health Organization, as of December 2016.
2. Citi, as of September 2017.
3. The CSI 300 Index consists of 300 China A-share stocks listed on the Shanghai and Shenzhen Stock Exchanges.

China Themes Blog Series

- Part 1: China Theme #1: Growing Middle Class
- Part 2: China Theme #2: Healthcare Spending

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