

TRENDS REINFORCED

Perspective from
Franklin Templeton
Emerging Markets Equity



HEALTH CARE: THE NEXT WAVE OF INNOVATION IN CHINA

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COVID-19 has cast a spotlight on health care systems around the world, with China in particular attracting attention due in part to its relative success in virus suppression and leading role in supplying medical products globally. In some instances, trends already in place are being reinforced. Structurally, we see increased innovation emerging in the health care sector, similar to the dynamism that characterized the early days of China's technology boom. We believe several forces are at play:

- The right place: China's health care demand is swelling alongside an aging population, growing lifestyle diseases, and rising incomes. At the same time, increasingly open capital markets are channeling funds to health care companies with rising research and development (R&D) spending.
- The right time: The government is pushing for innovation, efficiency, and self-sufficiency in health care to meet mounting medical needs. Various policies are lowering costs, while also addressing product quality and safety.
- The right people: China is drawing overseas-educated Chinese scientists and entrepreneurs back to its shores. High-profile returnees, coupled with an abundant pool of homegrown talent, are propelling domestic drug and medical device development.

In our view, these forces have aligned to create a compelling long-term health care investment environment in China, while in the near term, the pandemic is accelerating the process of localization. Governments globally are seeking to reduce reliance on complex foreign supply chains for essential health care products, presenting both opportunities and challenges for Chinese companies.



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SIGNS OF A GOLDEN AGE

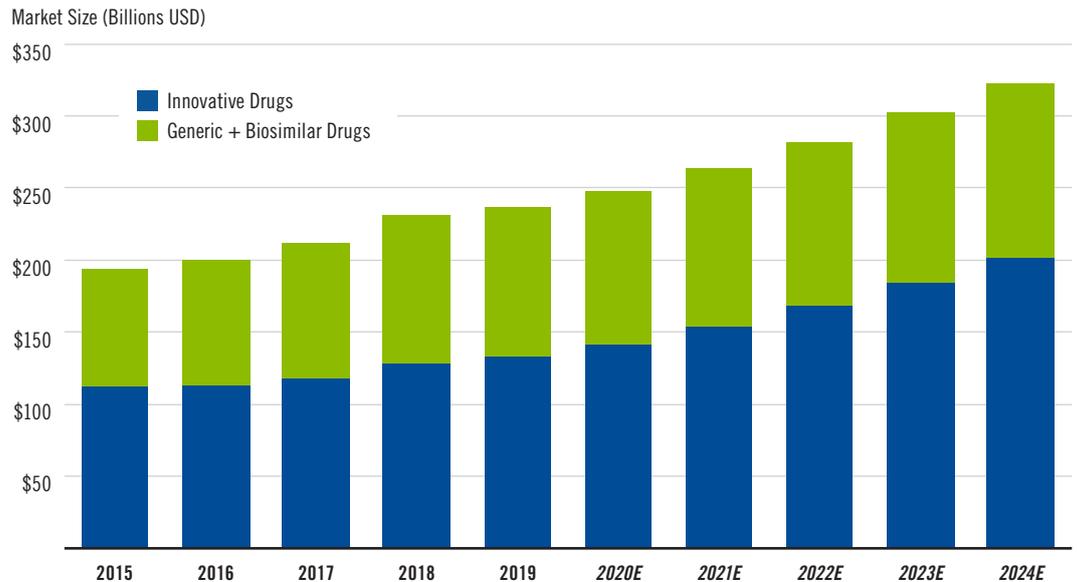
Until COVID-19 hit, China's health care sector had largely been overshadowed by the rapid rise of internet-driven giants such as Tencent and Alibaba. The pandemic has underscored the importance of health care, reinforcing existing structural trends that could drive a new wave of innovation in China.

The right place

China's health care demand is growing as its 1.4 billion-strong population ages. Unhealthier lifestyles are also contributing to rising cases of cancer, strokes and other diseases. These trends, plus higher disposable incomes, are boosting the total addressable market for health care.

EXHIBIT 1: CHINA'S PHARMACEUTICAL MARKET IS EXPANDING

2015–2024E



Source: Hangzhou Tigermed Consulting, Post Hearing Information Pack, July 2020. There is no assurance that any estimate, forecast or projection will be realized.

E=Estimated

Capital markets are opening up to health care companies seeking funds for R&D. Hong Kong's stock exchange revised its listing rules to accept biotechnology firms without revenues, while Shanghai's newly created Science and Technology Innovation Board (Star Market) is also enabling pre-revenue companies to go public.

The right time

The government is strengthening the health care system in the face of mounting medical needs. It is fostering innovation through favorable tax policies for companies with consistent R&D investments, as well as stronger intellectual property protection.

A drive to improve efficiency is underway. To accelerate the use of generic drugs and free up budgets for innovative treatments, China mandated bioequivalence tests requiring generics to match the originals in quality. Regulatory changes like these at the drug research level that ensure quality and safety could have spillover benefits of reduced environmental, social and governance risks. The country also introduced a bulk purchase program to lower the prices of generics, while encouraging drug makers to focus on novel treatments.

Equally striking are China's policies to pursue self-sufficiency in health care, especially against a backdrop of tensions with the United States. Chinese officials have set ambitious targets for the local development of advanced drugs and devices that could reduce China's reliance on Western markets, while turning it into a globally competitive health care player.

The right people

China's vast addressable market, plus supportive government policies, are enticing the return of Chinese scientists and entrepreneurs who studied and worked overseas. Many have joined the management teams of local companies, bringing with them global vision and strong technical skills.

Chinese universities are also adding to a large pool of highly trained talent. Together with high-profile returnees, they are driving drug and device development in China. We think they could help local companies evolve from fast imitators into best-in-class players.

OPPORTUNITIES ACROSS HEALTH CARE SECTORS

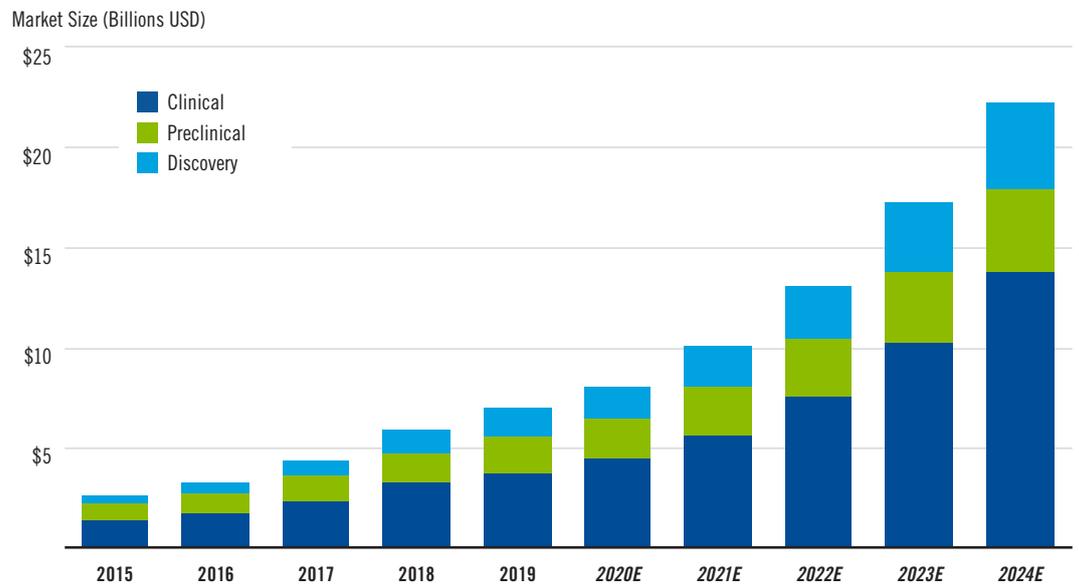
Drug development comes with its uncertainties, which can be even more pronounced for young Chinese biotech companies with varying strengths in management execution. Evaluating product pipelines can also be complex, given different disease epidemiologies, physician practices and competitive landscapes in China versus developed countries. Furthermore, the increased trend of localization works both ways, with Western governments keen to reduce reliance on Chinese suppliers of personal protective equipment, for example. Such challenges call for extensive research into company fundamentals and valuations, as well as a keen awareness of industry trends.

We see greater long-term potential in innovative drug makers with strong portfolios or pipelines of treatments, compared with generics companies that are likely to face price pressures from government reforms. Some Chinese biotech firms have shown remarkable speed in bringing novel treatments to market. A developer of immuno-oncology drugs that harness the immune system to fight cancer, last year, received approval of the US Food & Drug Administration (FDA) for its targeted therapy for a rare and aggressive form of lymphoma. It stood out as the first China-developed innovative drug that received the FDA's breakthrough therapy designation. The FDA's nod even came ahead of Chinese regulatory approval.

Companies in the pharmaceutical outsourcing industry also show promise. Contract research organizations (CROs) support drug makers by offering services such as preclinical studies, clinical trials, and drug production. We view the industry as a "pickaxe-and-shovel" play—just as suppliers of pickaxes and shovels benefited from a gold rush no matter which prospector struck gold, CROs potentially gain from the health care sector's growth and could be less exposed to individual company risks. A world leading biologics CRO with a global roster of clients has a "follow-the-molecule" business model and provides end-to-end solutions from drug discovery to commercialization. This model bolsters its earnings sustainability—as a project advances through the stages, its revenue contribution grows.

**EXHIBIT 2: CHINA'S
PHARMACEUTICAL CRO
MARKET CHARGES AHEAD**

2015–2024E



Source: Hangzhou Tigermed Consulting, Post Hearing Information Pack, July 2020. There is no assurance that any estimate, forecast or projection will be realized.

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Meanwhile, we also see examples of innovation in medical equipment makers—leading domestic suppliers, which already have a cost advantage over foreign competitors, whose growth could be encouraged on the back of government policies supporting localization. A maker of minimally invasive surgical equipment for orthopedics benefits from strong demand for spinal surgeries as an aging population battles osteoporosis. The company is seeking new growth drivers as it explores more uses for its existing surgical system, while investing in the development of a robotic-assisted navigation system. It is also breaking into sports medicine, where we see sizeable potential amid rising sports-related injuries and a growing awareness of them.

TIME FOR MORE ATTENTION

We think these companies reflect a new breed of innovative enterprises that could transform health care outcomes in the years ahead. Together with flourishing capital markets, favorable policies, and motivated talent, a vibrant ecosystem is potentially taking shape.

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