
Developing capital markets make China an exciting option

Emerging markets | February 2021



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With Chinese New Year celebrations getting underway and 2021 being the Year of the Ox – a symbol of strength and determination – we look at the prospects for Chinese equities

The past several years has seen investors inundated with negative headlines about trade wars and international tensions. But what has been much overlooked is the significant progress China has made in developing its capital markets, which has made investing there more exciting than ever for foreign investors.

Over the past few years both the Stock Connect and Bond Connect programs have continually increased access to the A-share universe; eligible northbound stocks¹ have grown from around 500 at inception to around 1,600 now, including many domestic and global blue-chip leaders.² We have also seen the proposed relaxation of QFII (Qualified Foreign Institutional Investor) rules³, which notably removes any investment quota, simplifies regulatory requirements and opens up investments in the derivatives market. Additionally, China has allowed security firms like JP Morgan and Goldman Sachs among others to have fully owned subsidiaries which will work to strengthen the quality and robustness of the overall capital market. These are just a few of the developments which we believe will provide a positive backdrop to investing in China over the next decade.

Towards the end of 2020, China set out its fourteenth Five-Year Plan, which will be finalised in March 2021. One of the key themes will be the idea of “dual circulation”. This aims to balance the renewed emphasis of internal circulation, which promotes the idea of stimulating domestic consumption and self-reliance in technology and supply chains, with external circulation which highlights the significance of continued integration with the international community on trade and capital markets.

¹ The trading of mainland-listed stocks, for example on the Shanghai and Shenzhen stock exchanges, from the Hong Kong Stock Exchange

² https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Eligible-Stocks/View-All-Eligible-Securities?sc_lang=en

³ King & Wood Mallesons, Latest relaxations in the qualified foreign institutional investor (“QFII”) and renminbi qualified foreign institutional investor (“RQFII”) regimes, 15 May 2020

An example which works to illustrate this directive and the investment opportunities it creates is healthcare. Given the demographic trends, it is all but certain the Chinese population will get older and richer, which will work to drive significant demand for healthcare and wellness both from a consumer and government standpoint. Complementing that demand backdrop is a series of game-changing actions on the supply side including: the government's emphasis on developing innovative drugs; China's equivalent of the Food and Drug Administration (FDA) expediting approvals and reimbursement for drugs, moving from a five-year process to an annual one; relaxing funding for biotech start-ups including the ability to list publicly in a pre-profit stage; and China being granted ICH (the International Council for Harmonisation of Technical Requirements for Pharmaceuticals for Human Use) Membership in 2017⁴, which is essentially the global organisation of FDAs and which has proved to be a "WTO" moment for Chinese healthcare.

Investment in venture deals exploded from less than \$1 billion in 2013 to in excess of \$11 billion in 2018⁵, and more than 30 firms have already been listed publicly.⁶ We have seen more than 80 internationally developed drugs from global biotech giants being in-licensed into China, compared with just 10 or so in 2014⁷, and have begun to see a rapid acceleration in the "out-licensing" of Chinese-developed innovative drugs into the US and Europe. In contrast to other sectors, the business environment for international cooperation has never been stronger and, more importantly for investors, the opportunity never better.

Naturally, investing in drugs and medical devices directly presents a huge opportunity, and with Columbia Threadneedle Investment's Central Research Team having followed many of the in-licensed drugs since inception, and given our understanding of the global competitive set, we have a huge competitive advantage. But there are other ways to ride the boom, for example investing in contract manufacturing organisations (CMOs) or contract development and manufacturing organisations (CDMO), where China has built true world leaders and have arguably some of the best business models across any industry not just healthcare. CRO/CDMOs help and support early-stage drug discovery to clinical research and all the way through drug production, while potentially earning ownership stakes and milestone payments due to the high value-add of their work. Using a gold rush analogy, if the biotech's are gold miners, then the CRO/CDMOs are the shovel makers who will win regardless of which miner uncovers the gold.

Another particularly compelling subsector is early screening and diagnostics. China's ageing population, coupled with inadequate healthcare infrastructure, mean two things: first, the push to identify diseases like cancer at earlier or even pre-cancerous stages, which will lead to better health outcomes and costs at a fraction of those when treating it later; and second, China's healthcare services market similarly lags much of the developed world, with the practice of having a family doctor almost non-existent, and dental and optical check-ups still heavily underpenetrated. This means there are tremendous opportunities both online and offline to address the coming demand.

Conclusion

Ongoing US-China tensions have indeed impacted sectors of the economy, particularly in certain areas of technology. However, when one door shuts another opens, and there are parts of the economy such as healthcare which have never had closer international cooperation at both a corporate and government level.

It is our goal at Columbia Threadneedle to move away from those areas with greater uncertainty and instead find and identify exciting opportunities for our investors. Coming from a bottom-up level there has never been a better opportunity set in which to invest in China, and with the continual opening of the capital markets we believe the opportunity will only continue to get more exciting.

⁴ FDA, China Joins ICH as Full Regulatory Member, Pledges to Implement Guidelines, 22 June 2107

⁵ VCBeat/Jefferies, 2019

⁶ https://www.hkex.com.hk/-/media/HKEX-Market/Join-Our-Markets/IPO/Biotech-Newsletter/HKEXBIOTECH_Newsletter_issue4_eng.pdf, October 2020

⁷ Nextpharma, 2020

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Issued 02.21 | Valid to 07.21 | 3440029