AN ALERT FROM THE BDO CENTER FOR HEALTHCARE EXCELLENCE & INNOVATION

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U.S. HEALTHCARE COULD BE THE BOOSTER SHOT XI JINPING'S "HEALTHY CHINA" PLAN NEEDS

What Chinese Private Equity, U.S. Target Companies Need to Know

Two years ago, the Chinese government spelled it out: The country needs to develop a world-class healthcare sector to meet the needs of its population. China's current five-year economic plan, approved in 2015 and adopted last year, designates a "Healthy China" as a priority, and encourages both inbound and outbound private investment in the healthcare and senior-care sector.

The vaccine for a lagging healthcare sector? It appears to be opportunities in U.S. healthcare.

Chinese investors have been increasing their outbound investment in the U.S., seeking greater access to advanced technology, innovation and expertise.

Outbound private equity investment aimed at boosting the "Healthy China" movement in 2017 has accelerated. CITIC Bank and the investment firm Sanpower Group started a $2.9 billion fund targeting biotech M&A deals around the world. Sanpower Group, which bought the Valeant Pharmaceuticals unit that makes a cellular immunotherapy drug for prostate cancer in June, has said it's planning more acquisitions that will give it control of advanced technologies. Tahoe Investment Group, formerly known as Fujian Thai Hot Investment Co. purchased a 51 percent stake in Alliance HealthCare Services, a leading U.S. provider of radiology and oncology services. China's C-Bridge Capital has been hiring executives from the U.S. biotech and Big Pharma world to identify investment opportunities. California-based Sci-Clone Pharmaceuticals, maker of the hepatitis drug Zadaxin, was taken private by a consortium of investors including Chinese private equity firm CDH Investments, Hong Kong-based GL Capital Management, and the Bank of China, along with the U.S. hedge fund Ascendant Capital Partners.

HOW DO I GET MORE INFORMATION?

For more information about cross-border investments and the risks investors and target companies need to mitigate, contact:

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Between January and September 2017, Chinese companies announced $4.3 billion in U.S. healthcare deals, more than double the $1.9 billion for the same period in 2016, according to *Bloomberg* data.

How can participants on both the buy and sell sides benefit? This is the beginning of an expansion strategy that will bring about quality-of-life improvements to a Chinese population of 1.4 billion. At the same time, both investors and target companies must navigate unfamiliar risks especially in relation to regulation. Cultural differences can also come into play. Investors don't always have a complete map of the regulatory system in the U.S., the tax implications, or whether they're paying an overvalued price. Target companies, meanwhile, need to protect themselves against IP infringement and understand what it will take to expand into China.

Increasingly, Chinese investors coming into the U.S. healthcare sector are seeking strategic alliances with U.S. companies that offer cutting-edge products, services, business models and distribution channels, with the goal of bringing them to China. There are many players seeking to do this: asset managers, alternative investment funds and healthcare companies, many from the mainland but also those from the greater China area that includes Hong Kong and Taiwan.

As the strategic importance of the industry grows, U.S. private equity firms are also growing active in this space with more healthcare-focused funds coming into China. U.S. private equity firm Siguler Guff & Company, which has had an office in Shanghai since 2006, noted in a January report that the dynamics of the Chinese healthcare sector make it attractive for private equity investors, not only because of the rapid growth prospects but also because it is both difficult and expensive for Chinese investors to gain exposure to the industry through listed securities in China and other emerging markets.

3 CHINA MARKET VARIABLES MAKING FOR A HIGHLY-VALUED BUSINESS

Aging Population, Environmental Hazards & Lifting of One-Child Policy

China's population faces a growing number of health-related issues that its domestic market does not have the capacity to handle. The U.S. Department of Commerce estimates that total healthcare expenditures in China will rise from $640 billion in 2015 to $1.1 trillion by 2020. The population is aging, creating the need for long-term care facilities and nursing homes, along with the latest advances in pharmaceuticals and medical technologies. Poor air quality and other environmental hazards are causing a rise in chronic diseases, specifically cardiac disease and cancer, creating the need for cancer centers and regenerative medicine. And with the lifting of the one-child policy, many older parents are considering having more children, leading to a growing demand for in-vitro fertilization.

With this long-term growth potential coming from China, it is not surprising, then, that valuations in the healthcare sector all over the world are heating up. In fact, the median EV/EBITDA multiple increased 21.9 percent to 15.0x in 2016 from 2015. The enthusiasm for healthcare-related companies cultivated a seller's market where capital is readily available for companies at any stage. Chinese investors may be willing to pay high valuations to build a strong healthcare portfolio, and a strategic investor would expect to grow the company in the Chinese market, and maybe globally, to achieve scale.

Over the shorter term, however, the influx of capital means that investors might find valuations getting out of hand. This is a concern for investors in the current U.S. political environment, as the uncertainties over health insurance policy make it difficult to establish a meaningful value for certain assets. That is one of the reasons Chinese private equity firms are bringing in managing partners with experience in the U.S. healthcare sector, as well as consortiums of buyers that include healthcare, biotech, or pharma corporations. Due diligence is critical, as always, to establish the value and merits of a deal.

BDO INSIGHTS: NAVIGATING BUY AND SELL-SIDE RISKS

Unfamiliar Regulatory Environments, IP Infringement & Tax Implications

Among other factors, investors need to consider whether the value of the target company is dependent on the efficacy of new technologies or drugs. Are clinical trials in place? If so, how well are the patients doing? And how will state and local regulations affect the way the company operates? While federal laws govern drug approval and much else within the U.S., the health information technology infrastructure varies from state to state, as do disease reporting requirements, insurance reimbursement practices, and patient privacy laws, all of which could affect a company's fortunes and capabilities. And, critical to a company's prospects are the costs and tax liabilities associated with running a business, which are also subject to municipal and state policies.

When it comes to U.S. federal tax regulations, the entire structure of the deal can make a big difference in the net returns. In many cases a foreign investor might do well to be a lender to the target company as well as a shareholder. It is not an intuitive practice, but loans will generate tax deductions in the U.S., plus they can provide early liquidity because the borrower must pay back principal even before the company begins paying back its investors.

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For U.S. healthcare companies seeking private equity capital from Chinese investors, it is important to conduct due diligence of the buyer to determine whether their interests are aligned. They must also consider issues including manufacturing, pricing, distribution, and compliance rules, as well as cultural differences and barriers. China is not necessarily looking for U.S. drugs, which might be too expensive for local markets, for example. Rather, the investor might be interested in coming up with a high-quality generic version to sell in China. Nor is an investor likely to be experienced in matters having to do with the production and supply chain, so it will become important to develop a network of China experts on the matter.

It is always recommended that U.S. firms doing business with a foreign partner or investor notify the Committee on Foreign Investment in the United States (CFIUS). CFIUS, an interagency task force chaired by the U.S. Department of the Treasury, reviews foreign direct investments that could result in the control of a U.S. business that has responsibility to any of the 16 government-designated sectors of U.S. critical infrastructure, including healthcare. CFIUS is authorized to review transactions that could result in control of U.S. business by a foreign entity (covered transaction) to determine the effect of such transaction on U.S. national security. While most of the investigations appear to revolve around technology, healthcare companies have become a focus because of the vulnerability of personally identifiable information (PII) or "protected data" of U.S. citizens, including government employees, stored on systems. CFIUS could, if it finds that a foreign entity has a prior history of pharma violations involving PII, authorize the deal to go through but require further mitigation measures outside of its standard review period of 30-75 days. Such authorization on a transaction would more than likely allow the investor to put money into a U.S. pharma company but would block the investor's access to the company's protected data which may include PII or patent information.

CROSS-BORDER ALLIANCES

Achieving a Win for All

Opportunities for U.S. healthcare companies to expand into China abound. Consider, for example, the influx of wealthy Chinese individuals who travel abroad to get the best medical care. The Chinese travel booking company **Ctrip.com International** estimates that mainland residents took some 500,000 such trips in 2016, more than five times the number in 2015, and they spent, on average, more than $7,000 per person. In our view, more Chinese equity capital in U.S. healthcare facilities, pharma companies, and medical technology could provide the means to bring more high-quality care to segments of the Chinese population that aren't able to travel abroad, while at the same time making it possible for cash-strapped U.S. hospitals to open satellite facilities in China. The current "Healthy China" push presents an unprecedented opportunity for the U.S. healthcare industry and its investors to grow.

People who know Healthcare, know BDO.