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## Equalweight Downgrade

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## Policy risk

### Pharmaceuticals: Sector outlook

米内网数据显示，2018 年上半年国内药品终端市场销售额同比增速为 6.9%，较 2017 年全年 7.6% 的增速有所下滑。我们认为药品销售增速放缓主要由于政府对于医保支出的严格控制。我们预计国内药品销售额未来三年复合增速维持在约 7%。

**上市医药制造企业表现优于同行。**我们总结了 29 家香港上市的医药制造企业的业绩表现，平均收入增速从 17 年上半年的 16.1% 提升至 18 年上半年的 28.3%，平均净利润增速从 17 年上半年的 23.2% 下降至 18 年上半年的 19.2%。对于已经公布半年报的 194 家 A 股上市医药制造企业，平均扣非净利润于 18 年上半年同比增长 18.5%（17 年上半年增长 17.9%），高于 18 年上半年国内医药制造业的整体净利润增速（14.4%）。我们认为未来国内医药制造行业的集中度将进一步提高。受两票制的影响，小型药企或将面临运营压力。并且，大型药企研发实力强，在仿制药一致性评价方面具备优势。

**医药流通企业面临财务成本上升的压力。**对于 3 家香港上市的医药流通企业，其分销业务的平均收入增速从 16 年上半年的 13.4% 下降至 18 年上半年的 10.0%。与此同时，14 家 A 股医药流通企业分销业务收入的平均增速从 17 年上半年的 13.4% 下降至 18 年上半年的 5.3%。随着两票制的执行，大型医药流通企业的纯销业务实现了较快增长，同时，由于纯销业务应收账款天数长，企业也面临整体应收账款天数延长的压力。公立医院由于“零加成”政策的实施，利润空间遭到挤压，倾向于向流通企业要求延长付款天数。此外，我们注意到国内公司债的平均利率从 17 年 7 月的 4.98% 提升至 18 年 2 月的 6.14%，今年 8 月下降至 4.98%。

**医疗服务企业的盈利波动较大。**华润凤凰医疗（01515:HK-未评级）18 年上半年净利润同比下滑 38%，主要由于去年公司持有联合医务（00722:HK-未评级）股份的一次性收益，18 年上半年的核心净利润同比增长 7%。新世纪医疗（01518:HK-未评级）18 年上半年净利润同比下滑 45.8%，主要由于北京地区新开诊所带来运营开支的增长。此外，瑞慈医疗（01526:HK-未评级）与和美医疗（01509:HK-未评级）18 年上半年盈利水平下降，主要由于现有业务以及新业务扩张造成运营开支增加。香港上市的医疗服务企业的平均收入增速从 17 年上半年的 9.9% 提升至 18 年上半年的 18.3%，18 年上半年的平均净利润同比下滑 41.8%（17 年上半年同比增长 12.6%）。

**下调评级至标配。**年初至今摩根士丹利中国医药指数下滑 4%，摩根士丹利中国指数下跌 12%。目前摩根士丹利中国医药指数的动态市盈率为 24 倍，约为历史平均水平。此外，摩根士丹利中国指数的动态市盈率为 12 倍，约为历史平均水平。考虑到近期受 11 个试点城市带量采购政策，仿制药价格面临降价的影响，我们将行业评级由超配下调至标配。我们推荐长期持有研发实力强并且现有产品组合增长稳健的公司，例如中国生物制药（01177:HK-买入），三生制药（01530:HK-买入）和石药集团（01093:HK-买入）。

## Investment Highlights:

China's drug retail sales growth moderated to +6.9% YoY in 1H18 (vs +7.6% YoY in 2017), according to Menet. We attribute the slowdown in drug sales growth mainly to restrictions on basic medical insurance expenditure. We forecast China's drug sales to expand at a Cagr of c.7% over the next three years. We believe Sino Biopharmaceutical (01177:HK – BUY), CSPC Pharmaceutical (01093:HK – BUY), and 3SBio (01530:HK – BUY) will be long-term winners, thanks to their strong research and development (R&D) capability and the solid growth of their existing product portfolio. However, given potential policy-driven price cuts for generics having passed consistency evaluation in 11 pilot areas, we downgrade our sector rating from Overweight to Equalweight.

**Listed pharmaceutical companies outperformed.** The average top-line growth of the 29 Hong Kong-listed pharmaceuticals manufacturers accelerated from +16.1% YoY in 1H17 to +28.3% YoY in 1H18, while average net profit growth slowed from +23.2% YoY in 1H17 to +19.2% YoY in 1H18. We note the average recurring net profit of the 194 A-share listed pharmaceutical companies grew 18.5% YoY in 1H18 (vs +17.9% YoY in 1H17), beating the industry average (+14.4% YoY). We believe China's pharmaceutical industry will further consolidate, as implementation of the "two-invoice scheme" increases operational cost pressure on small players. Moreover, large pharmaceutical companies benefit from strong R&D capability and are likely to complete quality consistency evaluations for generic drugs ahead of smaller players.

**Increased financial burden on distributors.** The average distribution sales growth of the three Hong Kong-Listed pharmaceutical distributors decelerated from +13.4% YoY in 1H16 to +10.0% YoY in 1H18. Moreover, the average distribution revenue growth of the 14 A-share listed pharmaceutical distributors also moderated from +13.4% YoY in 1H17 to +5.3% YoY in 1H18. Following the roll-out of the "two-invoice scheme", large distributors have experienced faster growth in direct sales to medical institutions, albeit at the expense of longer receivable days. Public hospitals tend to ask for extended payment terms as they face profitability erosion due to the "zero mark-up" policy. In addition, we note the average interest rate of corporate bonds rose from 5.0% in July 2017 to 6.1% in February 2018, before falling back to 5.0% in August 2018.

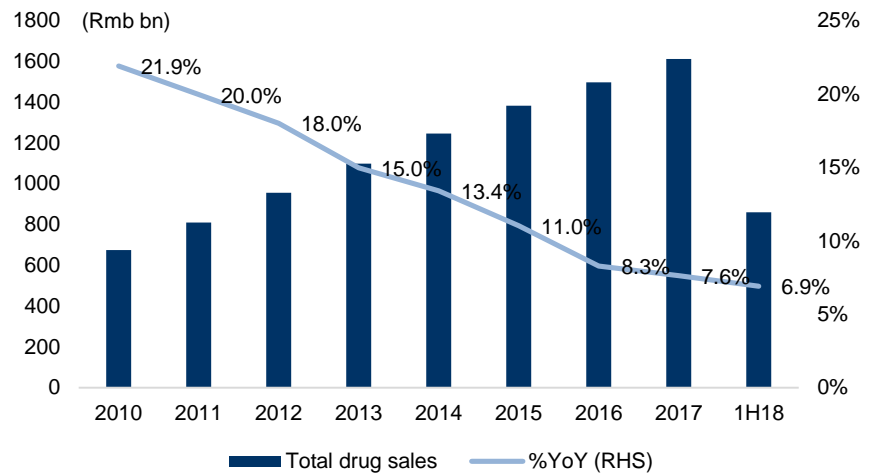
**Medical services providers' earnings volatility.** China Resources Phoenix Healthcare (01515:HK – BUY) saw its net profit decline 38% YoY in 1H18, mainly due to one-off gains from its stake in UMP Healthcare (00722:HK – N-R) in 1H17. Excluding non-recurring items, the firm's core earnings increased 7% YoY in 1H18. We note New Century Healthcare (01518:HK – N-R) also recorded a net profit decline in 1H18 (-45.8% YoY), due to an increase in operating costs as newly established clinics in Beijing started operations in 2018. Meanwhile, Rici Healthcare (01526:HK – N-R) and Harmonicare Medical (01509:HK – N-R) also posted substantial earnings decline in 1H18, due to rising operational costs amid expanding businesses. On average, Hong Kong-listed health care services providers saw their revenue grow 18.3% YoY in 1H18 (vs +9.9% YoY in 1H17), while average net profit declined 41.8% YoY in 1H18 (vs +12.6% YoY in 1H17).

**Downgrade to Equalweight.** The MSCI China Healthcare Index decreased 4% YTD and currently trades at 24x one-year forward PE (close to its historical average), while the MSCI China Index lost 12% YTD and currently trades at 12x one-year forward PE (also close to its historical average). Given potential policy-driven price cuts for generics having passed consistency evaluation in 11 pilot areas, we downgrade our sector rating from Overweight to Equalweight. Nonetheless, we believe Sino Biopharmaceutical (01177:HK – BUY), CSPC Pharmaceutical (01093:HK – BUY), and 3SBio (01530:HK – BUY) will be long-term winners, thanks to their strong R&D capability and the solid growth of their existing product portfolio.

## Moderating drug retail sales growth

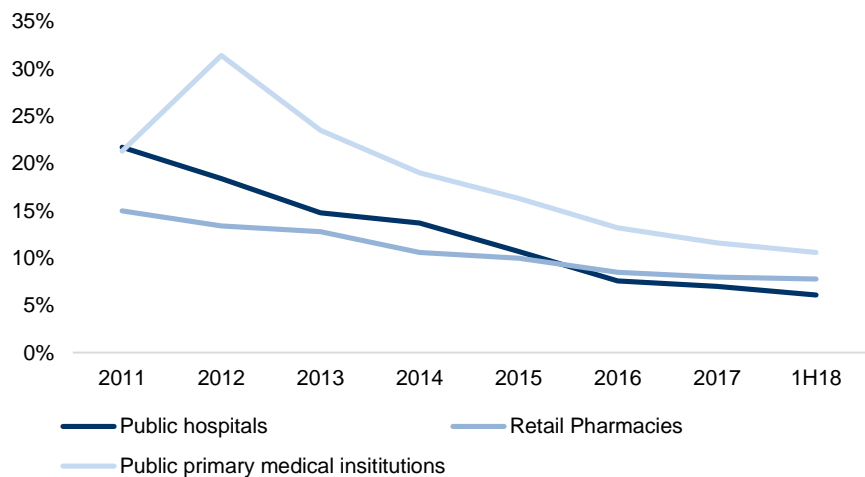
China's drug retail sales growth moderated to +6.9% YoY in 1H18 (vs +7.6% YoY in 2017), according to Menet, while public hospitals experienced the slowest growth among retail channels (+6.1% YoY in 1H18; vs +7.0% YoY in 2017).

Fig 1: China's drug retail sales (2010-1H18)



Source: Menet, SWS Research

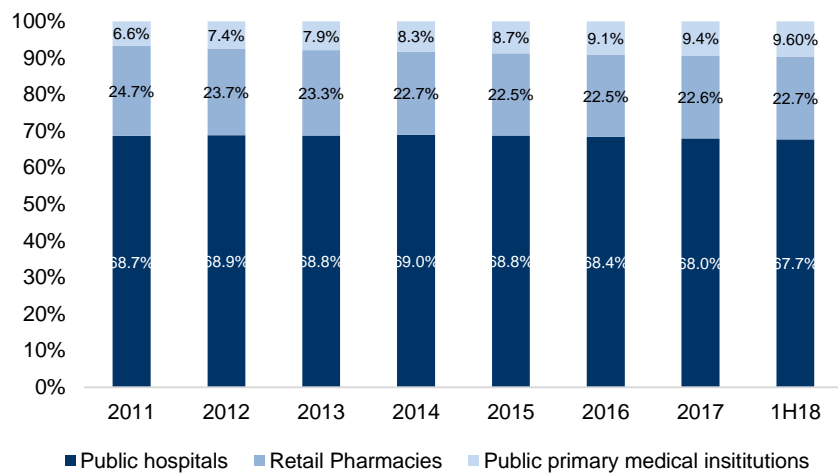
Fig 2: Drug retail sales growth by channel (2011-1H18)



Source: Menet, SWS Research

However, data from Menet shows that public hospitals still occupied a dominant 67.7% market share in the Chinese drug market in 1H18, while the market share of public primary medical institutions continued to increase to 9.6% in 1H18 and that of retail pharmacies increased to 22.7%. This indicates that an increasing number of patients are directed from Class-II and -III hospitals to primary medical institutions, following the roll-out of the "hierarchical medical system". The Chinese government is encouraging patients to receive treatment in primary medical institutions by offering cheaper medical service fees and better reimbursement.

Fig 3: China's drug sales breakdown by distribution channel (2011-1H18)



Source: Menet, SWS Research

We believe the slowdown in drug sales growth is mainly attributable to restrictions on basic medical insurance expenditure. In order to keep China's basic medical insurance fund expenses under control, authorities have taken a number of measures, including cancelling drug mark-ups, rolling out the "two-invoice scheme", lowering drug prices, and limiting the use of adjuvant drugs.

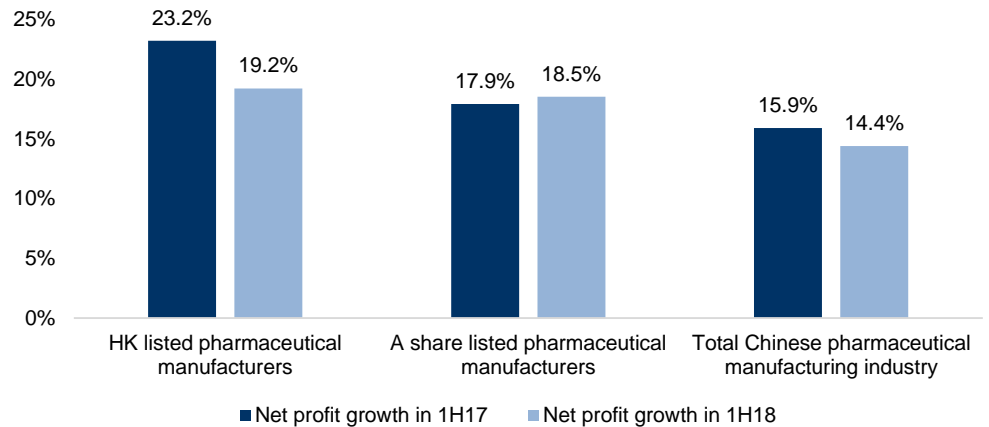
Chinese authorities aim to roll out the "two invoice scheme" nationwide by end-2018. As a result, most provinces have already implemented the new scheme. In addition, the central government required all public hospitals to cancel drug mark-ups by 30 September 2017. In order to offset losses, public hospitals tend to ask for higher drug price discounts from manufacturers and distributors. We forecast China's drug retail sales to grow at a c.7% Cagr over the next three years.

### Listed pharmaceutical companies outperformed

The average top-line growth of the 29 Hong Kong-listed pharmaceuticals manufacturers accelerated from +16.1% YoY in 1H17 to +28.3% YoY in 1H18, while average net profit growth slowed from +23.2% YoY in 1H17 to +19.2% YoY in 1H18. We note the average recurring net profit of the 194 A-share listed pharmaceutical companies grew 18.5% YoY in 1H18 (vs +17.9% YoY in 1H17), beating the industry average (+14.4% YoY).

According to the National Bureau of Statistics (NBS), China's pharmaceutical manufacturing industry recorded 13.5% YoY revenue growth and 14.4% YoY net profit growth in 1H18. We note listed pharmaceutical companies outperformed the industry, indicating market share gains for large players.

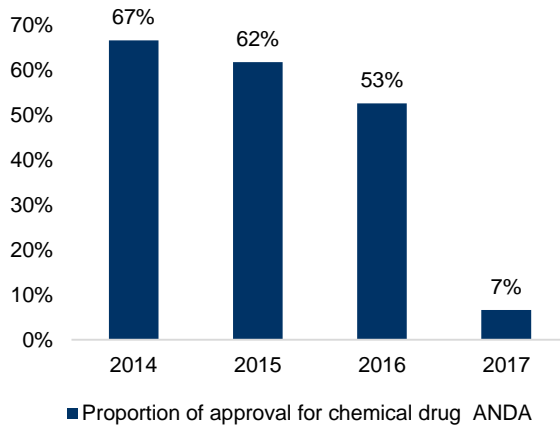
Fig 4: Chinese pharmaceutical companies' net profit YoY growth in 1H17 and 1H18



Source: Bloomberg, Wind, National Bureau of Statistics, SWS Research

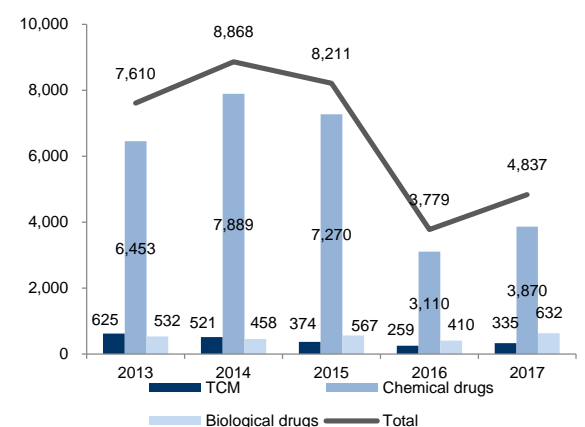
We believe China's pharmaceutical industry will further consolidate, as implementation of the "two-invoice scheme" increases operational cost pressure on smaller players. Meanwhile, the National Medical Products Administration (NMPA, formerly known as CFDA) has largely tightened criteria for new drug registration since 2015. We note the average approval rate for abbreviated new drug applications (ANDAs) declined from 53% in 2016 to 7% in 2017. The number of drug registration applications also decreased from 8,211 in 2015 to 4,837 in 2017. As a result, the significantly higher R&D barrier has benefited large pharmaceutical companies, thanks to their strong R&D investment.

Fig 5: Average approval rate for ANDAs (2014-2017)



Source: CFDA, SWS Research

Fig 6: New drug applications (2013-2017)



The NMPA requires that quality consistency evaluation for generics (289 drug varieties) be completed before 2018. To date, only 69 of them (24% of the total) have completed the evaluation according to our estimation. In addition, according to the government, only the first three players to pass the quality consistency evaluation will remain in the market as the other players will be excluded from tenders. As such, we expect the domestic generics market to consolidate rapidly in coming years. We also expect large players to gain market shares from expensive original drugs and low-quality generics.

The average gross margin of Hong Kong-listed pharmaceutical companies improved from 66.3% in 1H17 to 71.1% in 1H18. The average selling, general, and administrative (SG&A) expense ratio increased from 35.8% in 1H17 to 37.5% in 1H18. The average R&D expense ratio also increased from 4.5% in 1H17 to 5.8% in 1H18. We expect the R&D expense ratio to further rise in coming years due to pharmaceutical companies' increased focus on R&D and additional expenses related to quality consistency evaluations of generics.

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We believe Sino Biopharmaceutical (01177:HK – BUY), CSPC Pharmaceutical (01093:HK – BUY), and 3SBio (01530:HK – BUY) will be long-term winners, thanks to their strong R&D capability and the solid growth of their existing product portfolio.

Fig 7: Results summary of Hong Kong-listed pharmaceutical companies in 1H18

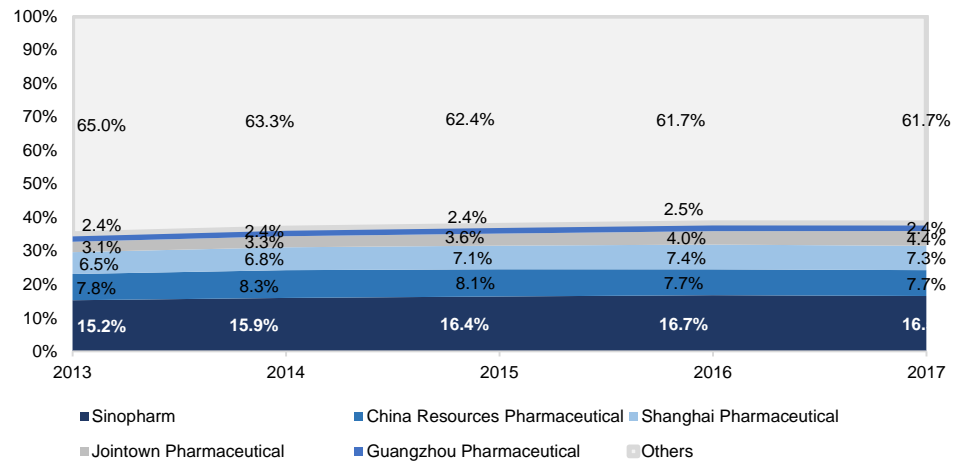
Name	Ticker	Market cap (HK\$m)	Net profit change (%)		Revenue change (%)		Net profit margin (%)		EBIT margin (%)		Gross profit margin (%)		SG&A ratio (%)		R&D expense ratio (%)		Financing expense ratio (%)		Net gearing ratio (%)	
			1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18
CSPC PHARMACEUTICAL GROUP LT	1093 HK	103,260	27.1	41.1	17.2	49.8	18.2	17.2	22.5	20.9	57.3	63.9	30.1	37.1	4.5	6.4	0.2	0.3	-18.2	-39.4
SINO BIOPHARMACEUTICAL	1177 HK	93,393	25.7	24.1	10.6	30.0	14.7	14.0	21.4	24.9	79.0	80.9	45.8	45.7	15.4	13.7	0.5	0.5	-43.6	-23.5
SHANGHAI FOSUN PHARMACEUTI-H	2196 HK	80,688	12.6	-7.6	19.9	42.7	20.5	13.3	11.7	14.9	56.7	58.0	29.8	41.2	5.6	5.8	3.2	3.8	22.6	46.3
GUANGZHOU BAIYUNSHAN PHARM-H	874 HK	60,483	39.2	126.1	2.1	33.7	10.5	17.8	7.9	10.8	36.8	31.6	25.2	19.2	1.2	1.6	0.0	0.2	-61.4	-26.2
SHANDONG WEIGAO GP MEDICAL-H	1066 HK	36,088	68.6	0.0	-6.8	39.4	21.8	15.7	25.7	21.1	62.4	60.3	35.8	37.7	4.5	3.4	0.6	2.7	-16.9	11.8
3SBIO INC	1530 HK	32,203	36.9	30.9	30.8	27.4	23.0	23.7	39.8	33.8	85.4	80.3	46.6	44.0	6.6	8.2	3.5	3.4	26.5	14.7
GENSCRIPT BIOTECH CORP	1548 HK	29,211	13.6	3.6	19.1	77.0	23.6	13.8	24.0	21.7	67.7	72.5	38.5	34.0	7.5	24.8	NA	0.0	-64.1	-94.5
CHINA TRADITIONAL CHINESE ME	570 HK	26,388	22.0	27.0	21.9	40.1	15.4	13.9	22.1	19.9	55.6	53.7	27.3	28.6	3.1	2.7	NA	NA	15.8	10.7
CHINA MEDICAL SYSTEM HOLDING	867 HK	26,415	23.1	19.0	23.4	-1.2	30.0	36.1	31.2	32.9	61.9	70.9	25.9	31.4	0.0	0.0	1.1	1.6	37.1	8.3
LIVZON PHARMACEUTICAL GROU-H	1513 HK	24,489	23.2	25.7	13.1	6.9	12.0	14.1	13.0	15.6	64.3	62.0	44.8	42.2	6.6	7.3	0.1	0.1	-29.5	-57.2
LUYE PHARMA GROUP LTD	2186 HK	22,368	-9.2	46.1	24.3	19.1	20.8	25.5	27.8	31.0	77.1	79.7	47.5	43.0	6.8	9.0	1.2	2.3	4.0	19.9
SSY GROUP LTD	2005 HK	21,822	36.9	54.7	19.5	57.9	21.7	21.3	28.2	26.6	54.9	63.1	26.8	37.3	2.1	2.2	1.7	1.3	39.4	8.4
MICROPORT SCIENTIFIC CORP	853 HK	15,873	355.8	11.2	9.5	42.6	9.8	7.7	13.5	10.2	72.9	70.8	43.7	43.3	11.8	12.2	3.0	2.7	35.0	51.7
TONG REN TANG TECHNOLOGIES-H	1666 HK	14,857	-3.3	4.0	2.7	0.8	15.0	15.4	21.7	23.8	51.6	52.4	26.5	26.3	NA	NA	0.2	0.2	-34.0	-30.6
SIHUAN PHARMACEUTICAL HLDGS	460 HK	14,964	14.5	-9.1	3.8	-11.2	58.5	59.9	66.3	59.6	70.7	80.2	23.6	36.0	NA	NA	0.0	NA	-35.8	-33.6
CHINA GRAND PHARMACEUTICAL A	512 HK	14,957	85.8	53.2	27.7	42.2	9.1	9.7	14.5	15.9	50.7	57.7	36.3	42.5	2.0	3.3	3.7	NA	124.8	108.6
YICHANG HEC CHANGJIANG PHA-H	1558 HK	14,555	40.4	110.2	19.2	123.8	45.6	42.8	48.8	47.5	81.6	83.9	26.5	34.2	3.6	7.3	NA	NA	-47.2	-37.5
BEIJING TONG REN TANG CHINES	3613 HK	12,958	12.6	19.5	15.1	21.8	41.3	40.5	47.8	47.0	73.8	72.2	23.4	22.6	NA	NA	NA	NA	-71.2	-71.7
THE UNITED LABORATORIES INTE	3933 HK	11,150	NA	-16.5	12.7	13.6	3.3	2.4	3.2	3.5	35.4	41.8	25.4	23.8	1.3	2.6	4.2	NA	82.1	76.0
SHANGHAI HAOHAI BIOLOGICAL-H	6826 HK	8,442	16.0	20.3	62.3	25.8	29.0	27.8	32.4	29.4	79.0	79.2	46.1	47.6	5.3	5.1	NA	NA	-54.5	-37.9
CHINA SHINWAY PHARMACEUTICA	2877 HK	9,047	-33.8	40.4	-12.9	60.8	22.5	19.7	26.1	18.4	62.0	71.2	36.9	48.4	3.2	5.6	0.0	0.0	-60.9	-62.2
LIFETECH SCIENTIFIC CORP	1302 HK	8,109	62.3	-20.0	12.6	40.4	47.9	27.3	36.2	41.7	80.2	82.7	32.0	33.8	15.4	16.6	0.0	0.0	-40.7	-18.3
ASCLETIS PHARMA INC	1672 HK	8,259	NA	NA	NA	332.8	-65.7	29.6	NA	-20.5	NA	97.6	41.6	43.4	150.7	51.9	NA	0.0	NA	-74.3
CONSUN PHARMACEUTICAL GROUP	1681 HK	5,732	27.1	18.5	70.3	13.0	24.0	25.2	31.8	32.8	75.7	75.0	40.8	38.7	1.4	1.2	0.5	1.7	-5.8	-30.2
LEE'S PHARMACEUTICAL HLDGS	950 HK	4,032	3.0	0.6	5.6	19.6	26.3	22.2	32.0	25.7	67.2	66.6	37.0	32.1	7.8	11.2	NA	NA	-20.8	-19.8
SHANDONG XINHUA PHARMACEUT-H	719 HK	3,737	132.8	15.5	19.6	12.1	4.5	4.6	6.1	NA	26.5	NA	15.0	NA	4.1	NA	1.2	NA	53.3	NA
SHANGHAI FUDAN-ZHANGJIANG-H	1349 HK	3,692	7.9	5.7	12.5	8.7	18.2	17.7	23.5	14.4	91.2	87.6	66.5	60.3	16.3	14.9	NA	NA	-42.8	-37.4
ESSEX BIO-TECHNOLOGY LTD	1061 HK	3,528	24.4	28.3	20.2	28.3	17.6	17.6	22.1	21.6	81.7	81.8	60.6	60.2	0.8	1.0	1.1	0.6	-21.1	-29.8
DAWNRAYS PHARMACEUTICAL HOLD	2348 HK	3,030	13.3	11.6	3.6	14.6	34.4	33.4	40.4	41.7	65.3	62.9	19.5	18.5	4.2	5.4	0.0	0.0	-31.8	-33.2
Median			23.2	19.2	16.1	28.3	20.8	17.8	24.8	22.7	66.3	71.1	35.8	37.5	4.5	5.8	0.6	0.5	-20.9	-28.0

Source: Bloomberg, Company data, SWS Research

## Increased financial burden on distributors

Hong Kong-listed pharmaceutical distributors are China's top-three players, with a combined market share of c.32% in 2017. The average growth of their pharmaceutical distribution business slightly accelerated from +9.7% YoY in 1H17 to +10.0% YoY in 1H18. Meanwhile, the average distribution revenue growth of the 14 A-share listed pharmaceutical distributors also moderated from +13.4% YoY in 1H17 to +5.3% YoY in 1H18.

Fig 8: Market share breakdown of the Chinese pharmaceutical distribution industry

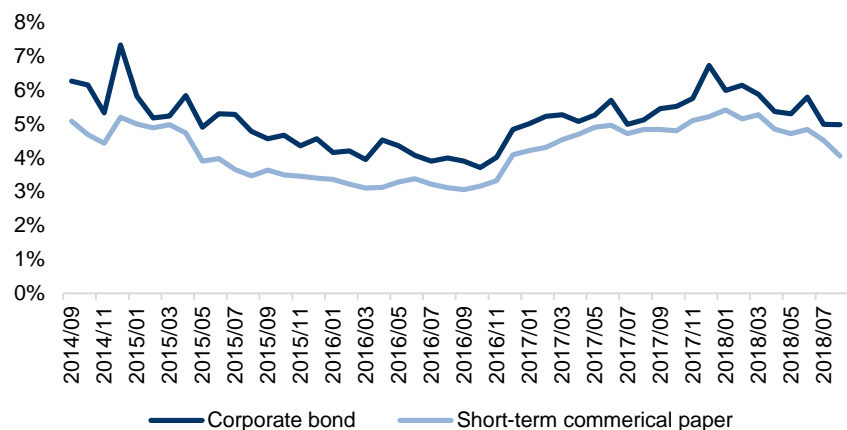


Source: National Bureau of Statistics, Company data, SWS Research

Most provinces have already implemented the “two-invoice scheme”. We note large pharmaceutical distributors have experienced faster growth in direct sales to medical institutions, while facing a decline in sales to third-party distributors, leading to an increase in gross profit margin, but also extended receivable days. Public hospitals, which suffer from profitability erosion due to the “zero mark-up” policy, tend to ask distributors for longer payment terms.

As a result, listed distributors’ balance sheet weakened in 1H18. The average net gearing ratio of Hong Kong-listed pharmaceutical distributors increased from 30.9% in 1H17 to 36.2% in 1H18, while the average financial expense ratio climbed from 0.9% in 1H17 to 1.1% in 1H18. Meanwhile, the average net gearing ratio of the 14 A-share listed pharmaceutical distributors increased from 30.6% in 1H17 to 44.8% in 1H18, while the average financial expense ratio climbed from 0.5% in 1H17 to 0.7% in 1H18. Moreover, we note the average interest rate of corporate bonds rose from 5.0% in July 2017 to 6.1% in February 2018, before falling back to 5.0% in August 2018.

Fig 9: Average interest rate of corporate bonds and short-term commercial paper



Source: Wind, SWS Research



Fig 10: Results summary of Hong Kong-listed pharmaceutical distributors in 1H18

Name	Ticker	Market cap (HK\$bn)	Revenue change of pharmaceutical distribution segment (%)		Operating profit margin of pharmaceutical distribution segment (%)		Net profit change (%)		Revenue change (%)		Net profit margin (%)		EBIT margin (%)		Gross profit margin (%)		SG&A ratio (%)		Financing expense ratio (%)		Net gearing ratio (%)	
			1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18
SINOPHARM GROUP	1099 HK	104,596	9.0	6.2	4.3	4.3	9.3	-3.1	9.4	7.1	2.0	1.8	4.0	4.3	7.9	8.7	3.7	4.2	0.8	1.1	48.6	46.1
CHINA RESOURCES PHARMACEUTICAL	3320 HK	77,174	10.2	10.2	4.5	5.3	10.7	24.3	9.4	13.3	2.2	2.4	5.9	6.2	15.1	18.0	8.8	11.3	1.2	1.4	28.3	28.1
SHANGHAI PHARMACEUTICAL	2607 HK	61,169	9.8	13.5	2.7	2.8	11.1	5.6	10.1	15.3	2.9	2.7	3.3	4.3	12.3	14.1	7.9	8.9	0.6	0.8	15.9	34.2
Average			9.7	10.0	3.8	4.1	10.4	8.9	9.7	11.9	2.4	2.3	4.4	4.9	11.8	13.6	6.8	8.1	0.9	1.1	30.9	36.2

Source: Bloomberg, Company data, SWS Research

Fig 11: Results summary of A-share listed pharmaceutical distributors in 1H18

Name	Ticker	Market cap (Rmbm)	Revenue change of pharmaceutical distribution segment (%)		Gross profit margin of pharmaceutical distribution segment (%)		EBIT margin (%)		Gross profit margin (%)		SG&A ratio (%)		Financing expense ratio (%)		Net gearing ratio (%)		Net profit change (%)	
			1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18
HUADONG MEDICINE CO LTD-A	000963 CH	57,306	13.4	3.9	7.2	7.5	8.0	9.3	26.2	30.0	15.2	17.2	0.3	0.3	-2.8	-16.3	26.5	24.2
JOINTOWN PHARMACEUTICAL-A	600998 CH	27,733	21.1	17.1	NA	NA	3.6	3.4	7.9	7.9	4.5	4.7	1.0	0.9	87.7	76.6	155.7	-32.3
CHINA NATIONAL MEDICINES-A	600511 CH	19,365	5.6	6.6	7.0	9.2	4.5	5.1	6.8	9.0	2.2	3.7	0.5	0.5	-19.9	-23.2	10.8	14.8
CHINA MEHECO CO LTD -A	600056 CH	17,042	22.4	-7.2	6.7	8.7	6.0	7.1	13.1	22.2	5.1	13.0	0.2	0.3	-8.3	-1.1	30.3	26.4
REALCAN PHARMACEUTICAL CO -A	002589 CH	14,882	38.1	21.9	12.4	12.0	7.9	8.6	16.8	19.2	9.3	10.0	0.7	1.0	33.7	62.7	136.7	12.9
SHENZHEN NEPTUNUS BIOENG-A	000078 CH	10,137	43.5	NA	11.2	NA	6.4	5.9	12.7	12.3	6.2	6.8	1.2	1.7	85.0	127.5	135.3	38.7
GUANGXI LIUZHOU PHARMACEUT-A	603368 CH	7,474	24.4	1.6	9.3	8.2	5.4	5.7	9.1	10.0	3.2	3.5	0.2	0.4	-16.3	4.2	30.2	33.2
NANJING PHARMACEUTICAL CO-A	600713 CH	5,052	3.5	10.2	5.5	5.7	2.4	2.9	6.1	6.4	3.1	3.1	1.0	1.2	117.5	114.0	38.0	23.5
CACHET PHARMACEUTICAL CO-A	002462 CH	4,204	28.6	30.4	10.1	9.9	5.5	5.3	9.9	9.8	4.1	3.8	0.7	1.0	43.6	72.1	23.1	29.8
HPGC RENMINTONGTAI PHARMAC-A	600829 CH	4,106	-14.4	-14.5	NA	NA	4.1	4.8	10.9	12.4	6.1	6.8	0.2	0.2	39.7	44.8	10.8	-3.5
LUYAN PHARMA CO LTD-A	002788 CH	2,480	6.5	44.2	6.5	6.8	3.1	3.3	7.5	7.6	3.8	3.8	0.7	1.0	106.2	128.5	16.5	28.6
ZHEJIANG ZHENYUAN CO LTD-A	000705 CH	2,195	2.7	-5.9	12.5	5.5	2.9	2.5	15.3	19.1	10.6	15.3	0.1	0.0	-2.5	-1.7	65.2	0.2
SHANGHAI NO.1 PHARMACY CO-A	600833 CH	1,956	NA	NA	NA	NA	3.0	2.5	15.1	19.0	10.9	16.6	NA	NA	-33.9	NA	1.7	-13.6
ZHEJIANG HUATONG PHARMACEU-A	002758 CH	1,684	7.7	2.2	7.0	7.0	4.4	4.1	12.9	14.1	7.1	10.1	0.5	NA	27.5	19.1	17.1	-14.5
Median			13.4	5.3	7.2	7.9	4.4	5.0	11.8	12.3	5.6	6.8	0.5	0.7	30.6	44.8	28.3	19.2

Source: Wind, SWS Research

## Medical services providers' earnings volatility

We note the six medical services providers listed on the Hong Kong Stock Exchange have different business models. China Resources Phoenix Healthcare (01515:HK – BUY) and Guangdong Kanghua Healthcare (03689:HK – N-R) focus on the operation of private-public general hospitals, while New Century Healthcare (01518:HK – N-R), Harmonicare Medical (01509:HK – N-R), and Wenzhou Kangning Hospital (02120:HK – N-R) mainly operate private specialised hospitals, and Rici Healthcare (01526:HK – N-R) mainly operates medical examination centres, private general hospitals, and high-end specialised hospitals.

China Resources Phoenix saw its net profit decline 38% YoY in 1H18, mainly due to one-off gains from its stake in UMP Healthcare (00722:HK – N-R) in 1H17. Excluding non-recurring items, the firm's core earnings increased 7% YoY in 1H18.

We note New Century Healthcare also recorded a net profit decline in 1H18 (-45.8% YoY), due to an increase in operating costs as newly established clinics in Beijing started operations in 2018. Meanwhile, Rici Healthcare and Harmonicare Medical also posted



substantial earnings decline in 1H18, due to rising operational costs amid expanding businesses.

On average, Hong Kong-listed health care services providers saw their revenue grow 18.3% YoY in 1H18 (vs +9.9% YoY in 1H17), while average net profit declined 41.8% YoY in 1H18 (vs +12.6% YoY in 1H17).

Fig 12: Results summary of Hong Kong-listed medical services providers in 1H18

Name	Ticker	Market cap (HK\$m)	Net profit change (%)		Revenue change (%)		Net profit margin (%)		Gross profit margin (%)		SG&A ratio (%)		Financing expense ratio (%)		Net gearing ratio (%)	
			1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18	1H17	1H18
CHINA RESOURCES MEDICAL HOLDI	1515 HK	9,258	149.3	-37.8	22.3	6.3	37.7	22.0	37.5	39.1	10.1	11.2	0.1	0.2	-21.8	-26.1
NEW CENTURY HEALTHCARE HOLDI	1518 HK	3,523	232.0	-45.8	7.4	11.8	19.7	9.6	48.8	41.9	17.8	22.8	1.5	-3.9	-52.6	-55.1
WENZHO KANGNING HOSPITAL -H	2120 HK	3,177	12.4	32.4	47.2	27.8	11.4	11.8	32.5	36.3	14.2	15.0	3.7	1.5	-6.9	2.1
GUANGDONG KANGHUA HEALTHCA-H	3689 HK	2,993	12.7	18.9	8.0	16.3	11.3	11.6	25.3	22.8	9.2	10.9	0.0	0.0	-71.8	-58.3
RICI HEALTHCARE HOLDINGS LTD	1526 HK	2,722	-265.1	-72.1	11.8	25.3	-9.0	-12.4	31.1	18.9	40.3	43.0	2.7	3.4	-19.9	35.4
HARMONICARE MEDICAL HOLDINGS	1509 HK	1,737	-71.7	-321.6	-1.7	20.3	2.7	-5.0	44.9	43.1	41.6	46.9	0.0	0.0	-62.0	-16.8
<b>Median</b>			<b>12.6</b>	<b>-41.8</b>	<b>9.9</b>	<b>18.3</b>	<b>11.3</b>	<b>10.6</b>	<b>35.0</b>	<b>37.7</b>	<b>16.0</b>	<b>18.9</b>	<b>0.8</b>	<b>0.1</b>	<b>-37.2</b>	<b>-21.5</b>

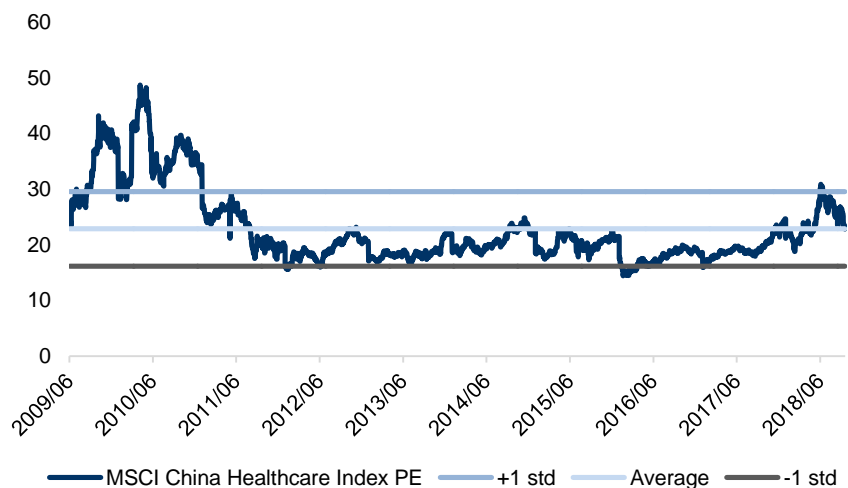
Source: Bloomberg, Company data, SWS Research

## Downgrade to Equalweight

The MSCI China Healthcare Index decreased 4% YTD and currently trades at 24x one-year forward PE (close to its historical average), while the MSCI China Index lost 12% YTD and currently trades at 12x one-year forward PE (also close to its historical average). Given potential policy-driven price cuts for generics having passed consistency evaluation in 11 pilot areas, we downgrade our sector rating from Overweight to Equalweight.

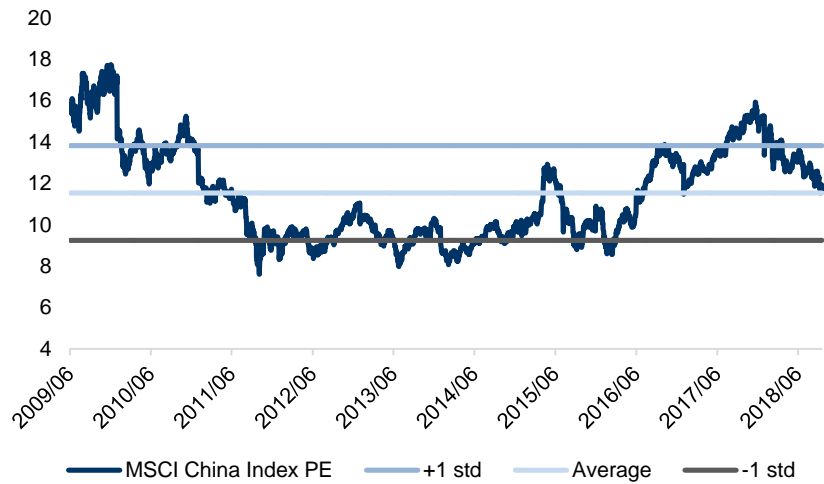
Given restrictions on basic medical insurance expenditure, we forecast China's drug sales to expand at a Cagr of c.7% over the next three years. We believe Sino Biopharmaceutical (01177:HK – BUY), CSPC Pharmaceutical (01093:HK – BUY), and 3SBio (01530:HK – BUY) will be long-term winners, thanks to their strong R&D capability and the solid growth of their existing product portfolio.

Fig 13: MSCI China Healthcare Index 1-year forward PE



Source: Bloomberg, SWS Research

Fig 14: MSCI China Index 1-year forward PE



Source: Bloomberg, SWS Research

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