

More hospital privatization and M&A ahead

Company	Ticker	Close (HKD)	Mkt cap (HKD Bn)	EPS Growth (%)		PER (x)		PBR (x)		Gross Margin (%)	
				FY1	FY2	FY1	FY2	FY1	FY2	Latest	FY1
CSPC	1093 HK	7.11	415	37	31	25.4	19.8	4.5	3.9	38.2	42.3
FOSUN PHARM	2196 HK	25.45	612	2.1	17.9	25.2	21.4	2.6	2.4	43.7	43.7
CTCM	570 HK	6.18	262	20.8	62.6	26.4	16.3	2.1	1.9	61.5	58.9
SINO BIOPHARM	1177 HK	9.64	476	33.7	18.7	26.0	21.8	5.7	4.6	76.4	76.6
SHANGHAI PHARM-H	2607 HK	16.62	540	12.8	12.4	13.2	11.7	1.3	1.1	12.1	11.8
SINOPHARM-H	1099 HK	28.95	800	17.7	19.0	17.9	15.0	2.1	1.8	8.2	8.2

Sources: Bloomberg, CSCI Research

- For providing affordable public medical insurance and increasing insurance coverage, local governments are expected to keep tightening drug tender prices, in our view
- To alleviate the financial pressure for subsidizing public hospitals, we expect the central government to encourage private investment in hospitals via accelerating enhancing related policies and regulations. We are positive to see more public hospital privatization in 2016.
- We believe Concentrated Chinese Medicine Granule (CCMG) will gradually replace Chinese herbal medicines and the existing licensed CCMG manufacturers have enormous first-mover advantages.

A few months ago, General Office of the State Council released a new five year road-map for reform of China's healthcare sector, the National Planning Guideline for the Healthcare Service System (2015–2020) (《2015-2020 全国医疗卫生服务体系规划纲要》). The guideline sets the ambitious target of providing universal access to effective, safe, and low-cost healthcare by 2020. In spite of the significant progress in establishing a universal coverage system over the past decade, the healthcare reform failed to solve issues including funding public medical insurance and introducing private investment in China's healthcare service market.

Multiple policies released at central and local government levels in this year indicate an accelerating sector reform. We think 2016 should be the year with big changes in the China's healthcare industry.

Main goals of The National Planning Guideline for the Healthcare Service System (2015-2020) as follows:

- Opening access to develop private hospitals
- Increasing the number of private hospital beds across all medical institutions to alleviate burden on public hospitals
- Developing comprehensive medical insurance with better coverage
- Restricted use of medical devices
- Establishing traditional Chinese medicine hospitals at the county and municipal level

In such a price-cutting and budget-controlling environment, drug price erosion is highly likely to happen or may even exceeds market expectation again. As big pharm's near-term profits will be further eroded, we prefer healthcare service providers like Fosun Pharm (2196.HK) and CCMG manufacturers.

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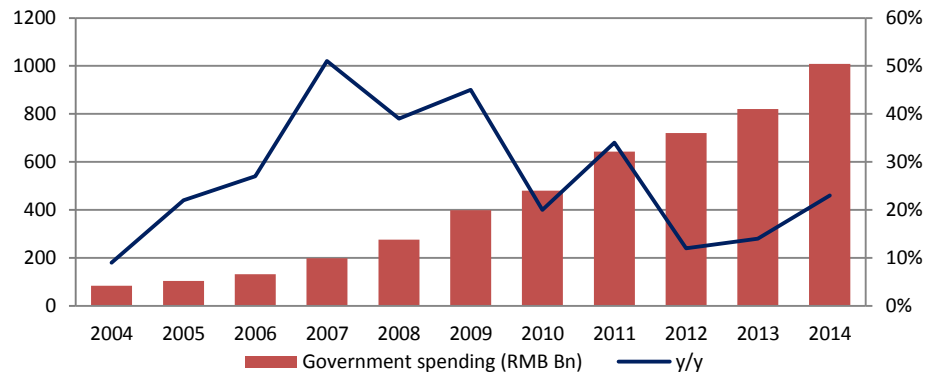
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The widening funding gap and insurance coverage

By the end of 2014, the Urban Employee Basic Medical Insurance scheme (UEBMI) and the Urban Resident Basic Medical Insurance scheme (URBMI) have covered 598mn urban residents, accounting for approximately 80% of the total registered urban population, and the New Rural Cooperative Medical Scheme (NRCMS) covered approximately 802mn rural residents, accounting for approximately 99% of the total registered rural population. The government spending on healthcare has correspondingly grown to over Rmb1trn in 2014.

Figure 1: Annual government spending on healthcare (2004-2014)



Source: MOF, CSCI Research

According to Green Book of Health Reform and Development 2014, UEBMI will be end in red from 2017 and its deficit will widen to Rmb735bn by 2024. The funding status of NRCMS may be even worse, as its deficit gap expected to widen to 15.38% in 2020.

In the meantime, the Chinese government continues to expand China's critical illness insurance coverage and to amend regulations on drug payment standards. On July 22, Premier Li Keqiang announced at a State Council executive meeting that critical illness insurance is to be expanded to cover the entire country before the end of this year. The reimbursement rate of critical illness insurance should reach up to 50%, with the possibility of gradually increasing in the coming years.

Thus, there is no doubt that China will keep tightening drug tender prices in order to provide affordable public medical insurance and to increase insurance coverage. As the reform policies aim to further lower drug prices and reduce proportions of drug sales in public hospitals, we think the golden age of China pharmaceutical industry may have passed.

Figure 2: Pharmaceutical industry's main business revenue in the first half of 2015

Sub-sectors	Revenue (Rmb Bn)	1H15 YoY (%)	1H14 YoY (%)
化学药品原料药制造 API manufacturing	217.6	8.7%	11.9%
化学药品制剂制造 Chemical finished drug manufacturing	327.6	10.2%	12.7%
中药饮片加工 Chinese herbal medicine processing	75.7	12.0%	16.7%
中成药制造 TCM manufacturing	279.6	5.2%	14.1%
生物药品制造 Biopharmaceutical manufacturing	134.4	8.4%	12.9%
卫生材料及医药用品制造 Sanitary materials and medical equipment manufacturing	84.7	11.5%	18.1%
制药机械制造 Pharmaceutical machinery manufacturing	7.9	7.8%	10.3%
医疗仪器设备及器械制造 Manufacturing of medical instruments, apparatus and devices	108.1	12.1%	15.2%
医药工业总计 Total	1,235.6	8.9%	13.7%

Source: MIIT, CSCI Research

Figure 3: Pharmaceutical industry's total profit in the first half of 2015

Sub-sectors	Revenue (Rmb Bn)	1H15 YoY (%)	1H14 YoY (%)
化学药品原料药制造 API manufacturing	16.0	12.2%	21.2%
化学药品制剂制造 Chemical finished drug manufacturing	39.3	12.7%	16.0%
中药饮片加工 Chinese herbal medicine processing	5.3	14.6%	9.7%
中成药制造 TCM manufacturing	30.2	11.9%	17.2%
生物药品制造 Biopharmaceutical manufacturing	17.6	18.8%	6.2%
卫生材料及医药用品制造 Sanitary materials and medical equipment manufacturing	7.9	16.4%	12.7%
制药机械制造 Pharmaceutical machinery manufacturing	0.7	-0.6%	2.9%
医疗仪器设备 & 器械制造 Manufacturing of medical instruments, apparatus and devices	9.2	4.7%	12.6%
医药工业总计 Total	126.2	12.9%	14.7%

Source: MIIT, CSCI Research

The reform policy aims to further lower drug sales

The tender progress is likely to be accelerated later this year, given that the National Health and Family Planning Commission (NHFPCC) has released a notice requiring all provinces to start the provincial tenders before the end of Nov 2015. We expect 3-5 more provinces like Fujian and Shanxi to finish tender by the year-end.

Therefore, we expect to see further erosion of drug prices (include patent and independent pricing drugs). As a result, we will see less prescription of supplementary or little clinical benefit products. The pricing pressure will continue, since the government determinates to control medical reimbursement expenses.

Figure 4: Drug tendering processes

Province /City	Market Size (RMB Bn)	Market Share	Tenders	Progress	Province /City	Market Size (RMB Bn)	Market Share	Tenders	Progress
Beijing	130	8.66%	EDL Non-EDL	Completed Draft Rules	Shanxi	34	2.28%	EDL Non-EDL	Draft Rules Not started
Shanghai	121	8.04%	EDL Non-EDL	Completed Completed	Fujian	32	2.10%	EDL Non-EDL	Draft Rules Draft Rules
Guangdong	119	7.94%	EDL Non-EDL	\ \	Liaoning	30	1.98%	EDL Non-EDL	Draft Rules Not started
Zhejiang	116	7.75%	EDL Non-EDL	Completed Completed	Shanxi	29	1.96%	EDL Non-EDL	Draft Rules Not started
Jiangsu	110	7.30%	EDL Non-EDL	Not started Not started	Heilongjiang	25	1.63%	EDL Non-EDL	Draft Rules Results Released
Anhui	105	6.97%	EDL Non-EDL	Completed Completed	Guangxi	22	1.46%	EDL Non-EDL	Not started Not started
Shandong	83	5.55%	EDL Non-EDL	Completed Completed	Jilin	22	1.45%	EDL Non-EDL	Completed Completed
Chongqing	61	4.09%	EDL Non-EDL	\ \	Jiangxi	22	1.45%	EDL Non-EDL	Draft Rules Draft Rules
Henan	61	4.04%	EDL Non-EDL	Not started Not started	Guizhou	18	1.20%	EDL Non-EDL	Draft Rules Draft Rules
Yunnan	59	3.92%	EDL Non-EDL	Not started Not started	Hainan	17	1.14%	EDL Non-EDL	Draft Rules Results Released
Hubei	54	3.56%	EDL Non-EDL	Results Released Results Released	Xinjiang	14	0.92%	EDL Non-EDL	Not started Not started
Sichuan	53	3.53%	EDL Non-EDL	Results Released Results Released	Gansu	11	0.70%	EDL Non-EDL	Completed Not started
Hunan	51	3.43%	EDL Non-EDL	Completed Completed	Inner Mongolia	6	0.40%	EDL Non-EDL	Not started Not started
Tianjin	50	3.35%	EDL Non-EDL	Not started Not started	Tibet	4	0.25%	EDL Non-EDL	Not started Not started
Hebei	40	2.67%	EDL Non-EDL	Draft Rules Draft Rules	Ningxia	3	0.19%	EDL Non-EDL	Completed Not started
					Qinghai	1	0.07%	EDL Non-EDL	Completed Not started

Source: CSCI Research

Further, we expect the restriction on second-time price negotiations after tender (二次议价) to be gradually scrapped in some provinces. In particular, public hospitals in pilot cities are permitted to procure drugs at prices lower than the provincial bidding prices. This means that public hospitals in pilot cities are not bounded by provincial bidding prices.

In such a price-cutting environment, we prefer healthcare service providers like Fosun Pharm (2196.HK) and CCMG manufacturers. We think they are more resistant to policy risks and expect some favorable policies to be launched in 2H15-16.

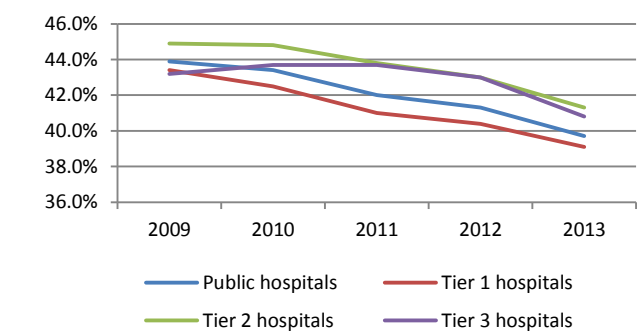
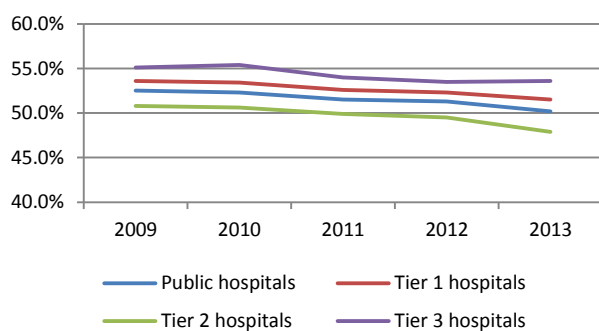
More privatization are expected to emerge

Looking forward, we believe government will accelerate its releasing policies of encouraging the private sector to invest in hospitals due to the financial pressure for subsidizing public hospitals.

In 2014, government subsidies for tier 3 hospitals increased by 21% YoY, but only 10% YoY and 6% YoY growth for tier-2 and tier-1 hospitals respectively. Local governments have to tighten their fiscal due to the slowing economy. Hiving off loss-making small-to-mid sized public hospitals is a sure way to alleviate the pressure on financial burden. We continue to expect more public hospital privatization in 2016.

Meanwhile, according to the Guidelines, the pilot public hospitals have to limit their drug budgets to lower than 30% of their total expenditures by 2017. Currently, public hospitals rely heavily on drug sales as their incomes. Drug sales account for 40% to 50% of total income of public hospitals. Smaller hospitals usually have higher dependence on pharmacy. The main reason for over prescription is that doctors at public hospitals are generally under-paid, thus forcing them to seek revenue from products, prescribing more drugs and receiving rebate from drug manufacturers.

Figure 5: Proportions of drug sales for outpatient average sales prices (ASP) **Figure 6: Proportions of drug sales for inpatient average sales prices (ASP)**



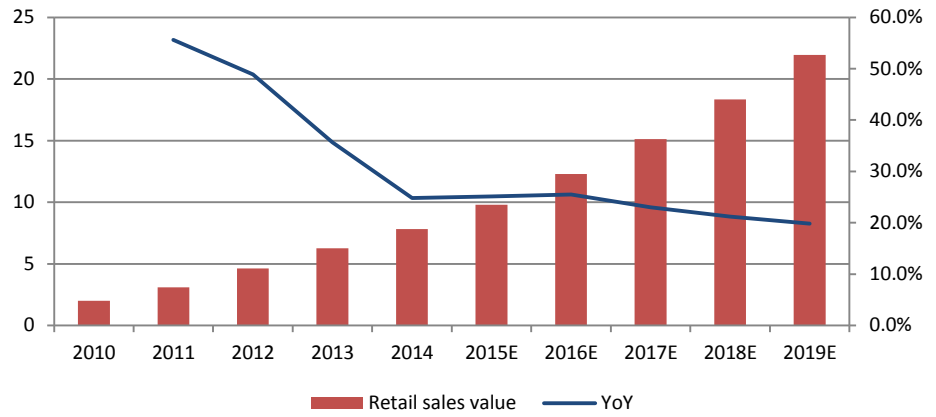
Sources: NHFPC, CSCI Research

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As the policies intend to remove the price mark-up on drugs and reduce proportion of drug sales, we expect that some small-to-medium sized public hospitals will face an increasingly challenging environment and many doctors will be willing to leave the public hospital system for market-based payment, which will benefit private hospital players.

Also, we recommend investors to keep a close eye on CCMG manufacturers. It is very possible for them to immune from the negative impact of price erosion in drug tenders. We believe CCMG will be included in more provincial insurance lists and gradually replace Chinese herbal medicines (with the current market size of Rmb200bn). We expect the to-be-released policies to open up the CCMG market in 2-3 years to more players. However, given its high technology and policy barrier, we think the existing licensed manufacturers have enormous first-mover advantages.

Figure 7: Market size of CCMG in China (Rmb Bn)



Source: Euromonitor, CSCI Research

Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

Outperform	Relative Performance >10%
Neutral	Relative Performance is -10% to 10%
Underperform	Relative Performance <10%

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