

China Healthcare Sector

Worse-than-expected price cut; eye on R&D names

Roll-out of volume-based procurement. National Healthcare Security Administration (NHSA) completed the first round of volume-based procurement in Dec 2018 while 25 generic drugs experienced an average 52% price cut. 11 cities started to carry out the procurement from 2Q19. On 24 Sep 2019, as scheduled, NHSA carried out a new round of tender for the 25 generic drugs covering the whole region of China, excluding the 11 cities that are already included in the first round of tenders. All manufacturers that have passed the equivalence evaluation are eligible to join the tender. The prices are further cut from the basis of the first round of volume-based procurement. This round of tender allows up to three companies to win the tenders while the first round only allows a single winner. If three players won the tender together, they could split 70% of the committed procurement volume. If two players won tenders together, they split 60% of the volume, and if a single player won the tender, it can receive 50% of the volume. The tender will be valid for two years if three players won tenders together, and valid for one year if one or two players won tenders.

- **Worse than expected price cuts.** A total of 77 companies attended the tender and 45 companies won tenders. Average tender prices were down 59% from the lowest procurement price in 2018 and down 25% from the basis of 4+7 tender prices. For drugs with four players or above joining the tenders, the percentage of price cuts were significant. For instance, the price of entecavir was further cut by 71% from the basis of 4+7 tender price. The price of tenofovir was further down 51% from the basis of 4+7 tender price. For drugs with three or less players, price cuts were minimal because the tender allows up to three winners.
- **Hansoh and Sino Biopharm are most impacted, minimal impact for CSPC.** Hansoh Pharma (3692 HK, Not Rated) won olanzapine (奥氮平) as the third winner with price down 35% from the 4+7 tender price. In 2018, Hansoh's olanzapine recorded RMB1,785mn sales, accounting for 23% of Hansoh's total revenue. Hansoh also won imatinib (伊马替尼) as second winner with minimal price cut. Imatinib accounted for 4% of Hansoh's total revenue in 2018. We also highlight that Hansoh's pemetrexed (培美曲塞) has not passed the equivalence evaluation and is not eligible for this round of tender. In 2018, pemetrexed reached RMB1,547mn sales and contributed 20% of Hansoh's revenue. Products affected by volume-based procurement accounted for around 47% of Hansoh's total revenue in 2019E. **Sino Biopharm (1177 HK, Not Rated)** lost tenders for entecavir (恩替卡韦) and tenofovir (替诺福韦). We estimated entecavir to contribute 13% of total revenue in 2019E and tenofovir to account for less than 1% of the total revenue in 2019E. Sino Biopharm won tenders for rosuvastatin (瑞舒伐他汀) as third winner and gefinib (吉非替尼) as second winner and irbesartan and hydrochlorothiazide (厄贝沙坦氢氯噻嗪), imatinib (伊马替尼) and flurbiprofen (氟比洛芬酯) as first winner. Due to fierce competition, tender prices of entecavir, tenofovir, rosuvastatin and irbesartan and hydrochlorothiazide were further cut by approximately 50-70% from the 4+7 tender prices. Overall, we estimate that products affected by volume-based procurement accounted for around 28% of Sino Biopharm's total revenue in 2019E. **CSPC (1093 HK, Buy, TP:HK\$20.62)** won tenders for clopidogrel (氯

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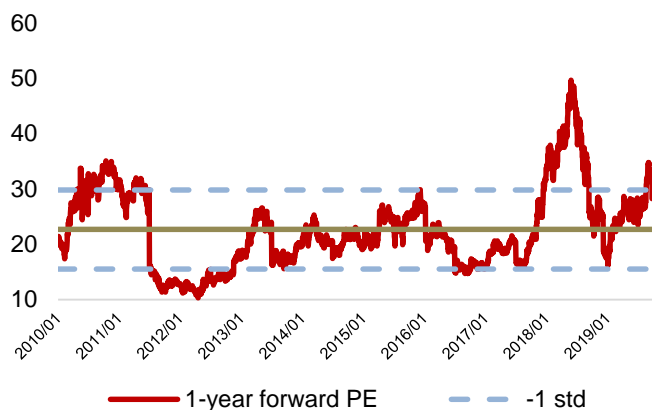
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吡格雷) as the first winner. Clopidogrel is newly launched and will contribute incremental income to CSPC. CSPC lost tenders for cefuroxime axetil (头孢呋辛酯) which has no meaningful impact to the revenue.

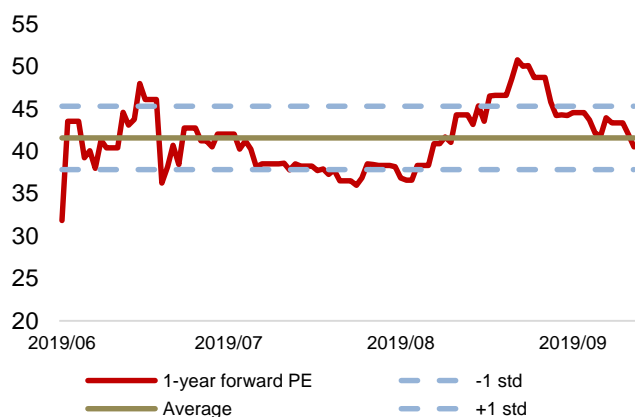
- **Remain long-term positive on companies with strong R&D.** Although generic drugs will face pricing pressure due to the roll-out of volume-based procurement, we believe innovative drugs and certain generics which are difficult to develop can still enjoy good competitive landscape and stable pricing. Hence, we believe companies with strong R&D capabilities, such as Sino Biopharmaceutical and Hengrui Medicine, will continue to outperform peers in the long term. Impact on earnings will depend on the timing of implementation which is still uncertain. We expect this round of tender to be implemented from early 2020E. MSCI China Healthcare Index is trading at 25x 1-year forward P/E, which is slightly above 10-year historical average of 22x 1-year forward P/E. We think the sector is trading at fair valuation. We recommend investors to bottom fish leading players such as Sino Biopharmaceutical, Hengrui Medicine and CSPC.

Figure 1: Sino Biopharm (1177 HK) 1-year forward P/E

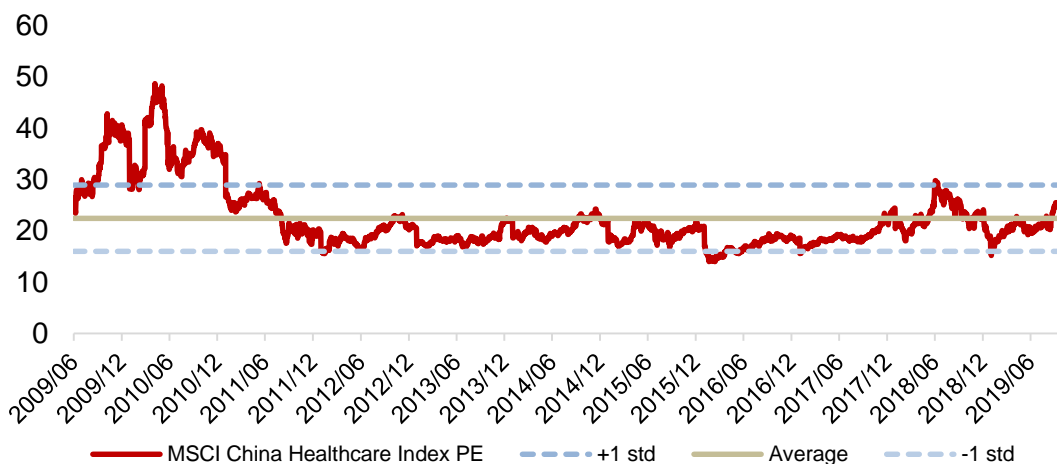
Source: Bloomberg, CMBIS

Figure 2: CSPC (1093 HK) 1-year forward P/E

Source: Bloomberg, CMBIS estimates

Figure 3: Hansoh (3692 HK) 1-year forward P/E

Source: Bloomberg, CMBIS

Figure 4: MSCI China Healthcare Index 1-year forward P/E

Source: Bloomberg and CMBIS

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