

## *Fundamentals on the up*

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### Key points:

- \* The Chinese government pledges RMB850b in 2009-2011 for healthcare reforms
- \* Key reforms: 1) healthcare safety net to cover 90% of all residents by 2011; 2) subsidies up at RMB120/person by 2010 from RMB80/person; 3) the establishment of the national system of essential drugs and national health records and 4) reform of public hospitals
- \* We expect even more effort and investment aimed to improve China's healthcare system and to: 1) make access to doctors easier and more affordable; 2) widen the social safety net; 3) narrow the income gap between urban and rural areas and 4) stimulate domestic consumption
- \* Key beneficiaries: Shandong Weigao (8199 HK, HK\$11.44, BUY), United Labs (3933 HK, HK1.90, BUY), Sino-Biopharm (1177 HK, HK\$1.20, HOLD) and Shineway (2877 HK, HK\$4.72). Companies least likely to benefit are service providers such as China Renji (648 HK, HK\$0.028, HOLD) and Hua Xia Healthcare (8143 HK, HK\$0.045).

**Medical reform documents passed.** China's State Council passed the "Opinions on the Reform of China's Healthcare System" and the "Solutions for the Reform of China's Healthcare System in 2009-2011" on 21 Jan 2009. The documents call for the investment of RMB850.0b over three years to improve the country's healthcare system and medical insurance coverage for urban and rural residents. Key items are as follows:

- Accelerate expansion of the healthcare insurance safety net to make basic medical insurance available to 90% of the population (urban employees, urban residents and rural residents) by 2011;
- Increase government healthcare subsidies to RMB120/person by 2010 from RMB80;
- Establish a national system of essential drugs (essential drugs list, supply chain management mechanism) and incorporate them into the Insurance Catalogue;
- Develop a system for the provision of primary healthcare services and strengthen the network of county-level hospitals, township hospitals, urban community health service centres and village clinics in remote areas;
- Establish a unified national health record system; and
- Speed up the reform of public hospitals, with pilot schemes to commence in 2009 and gradual implementation of reforms to start in 2011.

**Other related initiatives.** The reforms come on the back of other healthcare-related initiatives announced recently, such as:

- Elimination of the 7-15% mark up on pharmaceutical drugs by public hospitals (but hospitals will be allowed to impose pharmaceutical service charges). We expect the National Development and Reform Commission to adjust some service fees and increase government subsidies;
- Build/upgrade 3,700 community healthcare centres and 11,000 community healthcare service points in urban areas. Build 2,400 community service centres in underdeveloped areas;
- Support for the upgrade of some 2,400 county-level hospitals and 5,000 rural health centres; build 29,000 rural health centres; and
- Centralisation of the procurement of essential drugs for public hospitals in provinces, autonomous regions and municipalities and encourage for-profit/private hospitals to participate in this procurement.

**Our view.** The healthcare reform guidelines are generally in line with our expectations. We expect the Chinese government to step up its efforts and investment to improve the country's healthcare system to: 1) make access to doctors easier and more affordable; 2) widen the social safety net; 3) narrow the income gap between urban and rural areas and 4) stimulate domestic consumption. At end-2007, the government's healthcare expenditure represented only 20.3% of the total healthcare expenditure in 2007, significantly below other countries. We expect the government to significantly increase its investment into healthcare in the coming years. We are BUYers of the pharmaceutical / healthcare sector due to its attractive valuation and supportive government policies. News of the reform policies should stimulate the sector as a whole. Our favorites are: **Shandong Weigao (8199 HK, HK\$11.44, BUY)**, **United Labs (3933 HK, HK\$1.90, BUY)**, while we think other potential beneficiaries are **Sino-Biopharm (1177 HK, HK\$1.20, HOLD)** and **Shineway (2877 HK, HK\$4.72)**. Meanwhile, companies expected to benefit least include service providers such as China Renji (648 HK, HK\$0.028, HOLD) and Hua Xia Healthcare (8143 HK, HK\$0.045).

**Table 1: Qualitative analysis of the impact of new policies**

Company	Ticker	Area	Key product/ service	Remarks
Guangzhou Pharm	874 HK	OTC products, MCMs	Xiao Ke Wan, Wang Lao Ji	Poor control of supply chain, inventory overhangs and greater exposure to OTC products should limit ability to leverage benefits of government healthcare investment
China Pharm	1093 HK	Generic drugs, APIs	Vitamin C, penicillin, OTC products and antibiotic drugs	CP's antibiotic drugs segment should receive boost from new policies but contribution at operating level remain small due to low margins
Sino-Biopharm	1177 HK	Cardiovascular, hepatitis drugs	Kaishi injection, Ming Zheng capsule Ganlixin injection and capsule	SB's drugs have good brand name and solid distribution penetration allow it to further leverage government's healthcare build out
Shineway	2877 HK	MCMs	Shen Mai injection, Qing Kai Ling injection, Wufu Xin Nao Qing soft capsule	Potentially a main beneficiary of the new healthcare policies as its MCM drugs are low priced and targeted at rural market
United Labs	3933 HK	Generic drugs, APIs	Amoxicillin capsules, 6-APA, Semi-synthetic penicillin bulk medicine	Main beneficiary of healthcare policies given their antibiotics strong positioning within China and its 2,000 strong marketing distribution force
Mingyuan	233 HK	Diagnostic kits	C-12 protein chip cancer marker	New policies should allow MY's core C-12 sales to maintain a steady rate of growth though there is execution risks with respect to its foray into the healthcare diagnosis services
Shandong Weigao	8199 HK	Medical devices	Consumable medical products, drug eluting stents, orthopaedic product; blood purification consumables	One of the main beneficiaries of governments' investments into building/upgrading healthcare facilities such as hospitals, clinics and health centres
China Renji	648 HK	Cancer treatment services	Gamma radiotherapy treatment of tumours	Limited beneficiary of new policies given its main service revenues are derived from established coastal cities such as Shanghai and Beijing
Hua Xia Healthcare	8143 HK	General hospital services	Hospital management service	Limited beneficiary as regulations concerning hospital services reform and foreign ownership of hospitals remain unclear

Source: SBI E2-Capital

**Table 2: Valuation table**

Company name	Ticker	Mkt Cap (US\$m)	Price (HK\$)	Cur Yr P/E (x)	Nxt Yr P/E (x)	P/B (x)	ROE (%)	N. Gear (%)
<b>Pharmaceutical</b>								
Guangzhou Pharm*	874 HK	664.6	2.49	14.7	12.5	0.6	10.6	5.8
China Pharm	1093 HK	474.9	2.21	4.4	5.3	0.9	15.9	42.6
Sino-Biopharm*	1177 HK	350.1	1.20	10.7	8.7	1.3	11.4	Cash
Shineway	2877 HK	503.1	4.72	7.2	5.9	1.6	25.6	Cash
United Labs*	3933 HK	290.7	1.88	4.2	3.4	0.8	27.1	49.7
<i>Average</i>				8.2	7.2			
<b>Medical devices</b>								
Mingyuan	233 HK	130.2	0.34	5.7	4.3	1.1	18.0	Cash
Shandong Weigao*	8199 HK	1,692.2	12.20	21.5	15.0	8.3	30.4	Cash
<i>Average</i>				13.6	9.7			
<b>Healthcare services</b>								
China Renji*	648 HK	41.8	0.028	4.0	3.1	0.3	1.7	Cash
Hua Xia Healthcare	8143 HK	10.1	0.045	n/a	n/a	0.2	n/a	Cash
<i>Average</i>				4.0	3.1			

Source: Bloomberg Estimates, SBI E2-Capital

\* SBI E2-Capital estimates

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