

China healthcare



Industry Update

Comment on draft consultation

Key points:

- Government issues a draft reform of the country's healthcare system on 14 October for consultation
- Proposed system has received very negative feedback from the pharmaceutical industry according to news reports
- We believe the "appointed manufacturers" system will not solve the problem of China's ineffective distribution system, but it will stifle competition and R&D of new products
- We favour companies with high (branded)/low end product mix to facilitate multi-tiered sales strategy including **Sino Bio-Pharma (1177 HK HK\$0.76, BUY)** and **United Laboratories (3933 HK, HK\$2.42, BUY)**

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News flow. The government issued a draft reform of China's medical reform for public consultation on 14 October. The reform aims to improve the government's healthcare funding and lower medical expenses for consumers. The basic initiative is to boost individual medical spending by extending medical insurance coverage to all China's residents and widening of the healthcare network. A contentious issue in the plan is a proposal to appoint certain pharmaceutical companies to supply basic medicines to hospitals at pre-set prices to lower medical expenses. According to various news reports, this proposed solution has received negative feedback pharmaceutical industry. They reason is that government bodies are not in tune with the market developments of new drug products and treatments. Therefore, many of the appointed basic medicines will not be used by hospitals, leading to wastage of production resources. Moreover, the government will not respond fast enough to the selection of new, more effective drugs launched onto the market.

Implications. We believe that the strong backlash from the pharmaceutical community will prompt the government to rethink the value of the "appointed manufacturers" solution, which in our view, would: 1) stifle competition; 2) severely disrupt the industry's value chain; 3) reduce profitability; 4) discourage R&D of new products. Moreover, the solution fails to solve the sector's core problem of its ineffective distribution system, weighed down by multi-tiered distributors.

Winners/Losers. We favour companies with a good mix of high end (branded)/low end products and production scale which facilitate a tiered sales strategy, involving joining the appointed manufacturer program at the low end and, simultaneously, selling branded products at the high end. Pharmaceutical companies with these attributes include **Sino Bio-Pharma (1177 HK HK\$0.76, BUY)** and **United Laboratories (3933 HK, HK\$2.42, BUY)**. A large sales/marketing force is even more important in this scenario, as it would facilitate the distribution of higher-end products in rural areas. With rural disposable incomes up 19.6% YoY in Jan-Sep 2008 and the government's goal of doubling them by 2020, demand for quality, well branded pharmaceuticals will rise in rural areas.

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