



Economics Weekly September 14, 2016

Co-head of Research

Philip Chan

Tel: 852-2147 8805

Email: philipchan@abci.com.hk

Analyst

Paul Pan

Tel: 852-2147 8829

Email: paulpan@abci.com.hk

Up and rising in China's pharma industry

- Favorable fiscal policy and expansion in health insurance coverage boost demand in the pharma industry
- Wide CPI-PPI gap and higher-than-average retail sales growth indicate favorable market environment in the downstream pharma players, including those in the distribution and retailing of pharma products and services
- Pharma manufacturers are cautious in increasing FAI
- Market valuation of Hang Seng Mainland Healthcare Index stand at 17.4x 2016E P/E and 2.57x 2016E P/B

Fiscal policy by the government favors the pharma industry.

According to the Ministry of Finance, fiscal public expenditure increased by 12.7% YoY in 8M16. Meanwhile, fiscal expenditures on medical and healthcare grew by 19.8% YoY to RMB 878.7bn in 8M16, accounting for 7.6% of total fiscal expenditures. Growth in fiscal expenditures on medical and healthcare was 8.1 ppt high than fiscal expenditure growth in education over the same period. The central government's determination to raise society's living standard and strengthen social security protection network is palpable. We believe the relative high growth in fiscal expenditures on medical and healthcare will benefit the value chain in the pharmaceutical industry (Exhibit 1).

Health insurance – a flourishing sector bringing sustainable business opportunities.

Growth in health and accident insurance premium income has been accelerating in 2016. Total health and accident insurance premium income rose 43% YoY to RMB 305bn in 2015. In 7M16, total health and accident insurance premium income surged 78% YoY to RMB 319bn, exceeding the total premium income in 2015. Substantial rise in cash flow generated from the health and accident insurance premium income will eventually course through the supply chains in the pharmaceutical industry when insurance claims increase (Exhibit 2).

Inflation data (CPI) shows strong demand in the downstream pharmaceutical industry.

CPI of medicines and medical services were higher than that of the national one, meaning that distributors/retailers have been raising the prices of pharma products or medical services. CPIs of consumer goods and services were up 1.9% YoY and 2.1% YoY for 8M16. CPIs of Chinese medicines, Western medicines, and medical and healthcare services were up 4.7% YoY, 3.6% YoY, and 3.3% YoY for 8M16, respectively. The increase in fiscal expenditures and expanding coverage of health and accident insurance help enhance the consumers' affordability for pharma products and related services. (Exhibit 3-5)

Retail sales of medicines grew faster than national retail sales of consumer goods.

Retail sales of Western & Chinese medicines grew by 12.6% YoY in 8M16 or 2.4 ppt higher than the national retail sales of consumer goods. Continuous income growth, the increase in government support, and the expansion of health and accident insurance coverage will subsequently enhance the purchasing power



of end-users of medicines (Exhibit 7).

Demand for imported pharmaceutical products remains strong.

According to China's Customs, total imports fell 2.9% YoY in 8M16. However, import of pharma products went up by 17.2% YoY in volume and 15.3% YoY in value for 8M16. Meanwhile, imports of fruits, grains, soy bean, and edible plant oils fell 4.1% YoY, 34.0% YoY, 1.0% YoY and 15.6% YoY in value, respectively, for the same period. The relatively strong domestic demand for imported pharma products reflect the increasing purchasing power of domestic end-users and the fact that domestic demand cannot be fulfilled by supply from the local pharma product producers alone (Exhibit 8).

Centralized procurement policy weakens bargaining power of pharma manufacturers. Unlike downstream distributors/retailers, which are able to increase their selling prices at relative ease, it is more difficult for upstream pharma manufacturers to conduct similar adjustments. We believe the centralized drug procurement in medical institutions and pharmacy chains has weakened the bargaining power of pharma manufacturers. Ex-factory PPI of pharma manufacturers was up 0.3% YoY for 8M16, while the CPI-PPI gap of pharma products was 3.3%-4.4%, suggesting an attractive gross margin for downstream drug distributors and pharmacy operators. (Exhibit 6)

Value-added growth exceeding the national average implies decent profit growth in the pharma manufacturing industry

Value-added growth of pharma manufacturing industry was 10.6% YoY in 8M16, or 4.6ppt higher than the national average industrial value-added growth. The higher value-added growth in the pharma manufacturing industry implies manufacturers have achieved higher revenue and profit growth over the same period. (Exhibit 9)

Double-digit growth in revenue and profit in the pharma manufacturing industry.

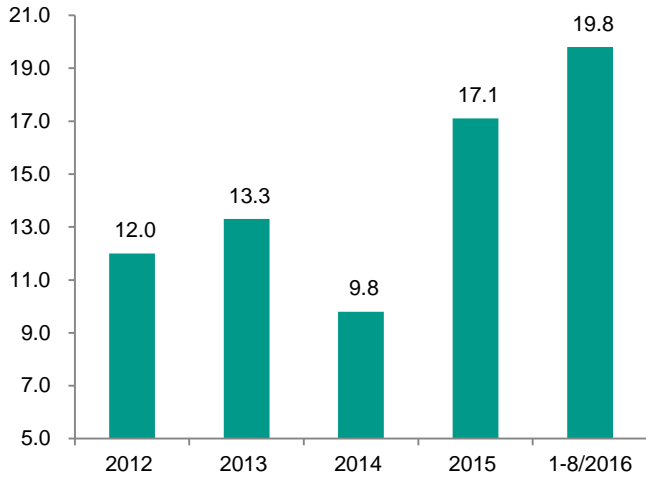
According to NBS, total revenue and profit of industrial enterprises expanded by 3.3% YoY and 6.9% YoY in 7M16, of which the pharma manufacturing industry recorded a higher-than-average increase. Revenue and profit of pharma manufacturers grew by 10.0% YoY and 13.8% YoY to RMB 1,515.14 bn and RMB 157.33bn. The higher growth in profit than in revenue suggests profit margin has been rising in the pharma manufacturing industry amid the slowdown in economic growth.

Pharmaceutical manufacturers are optimistic although they are cautious on asset expansion.

The fixed assets investment (FAI) of the pharma manufacturing industry grew by 9.0% YoY in 8M16, or 6.2 ppt higher than FAI growth in the manufacturing industry over the same period. Although sustainable profitability of the pharma industry should provide incentives for the pharma manufacturers to increase investments, they are cautious against the risk of overcapacity. FAI growth in the pharma manufacturing industry slowed from 12.1% YoY in 1Q16 to 11.7% in 1H16 and 9.0% YoY in 8M16. Foreign investors, however, are bullish on the outlook of the pharma industry. According to Ministry of Commerce, foreign direct investment (FDI) in the pharma manufacturing industry and the medical equipment manufacturing industry increased by 91.4% YoY and 80.5% YoY in 7M16 (Exhibit 10).

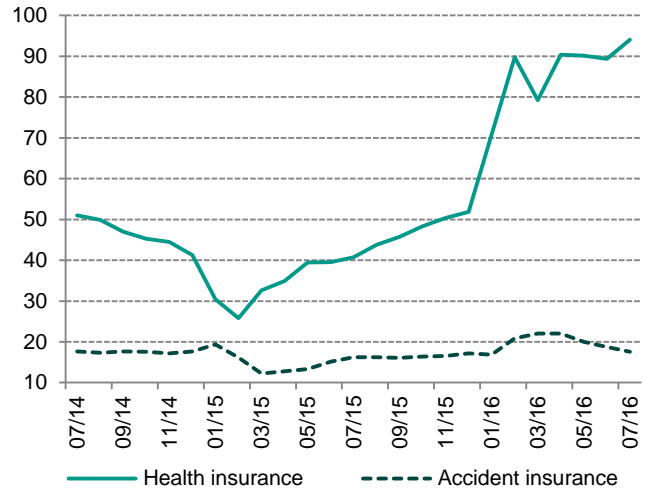


Exhibit 1: China's fiscal expenditures on medical treatment and healthcare (YoY %)



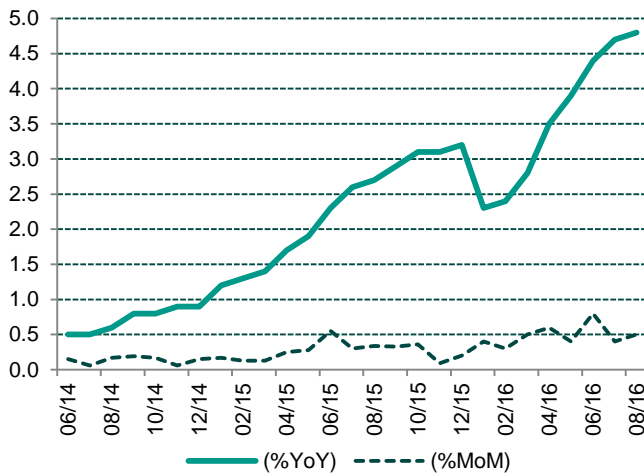
Source(s): Ministry of Finance, ABCI Securities

Exhibit 2: Insurance premium growth in China (YTD YoY %)



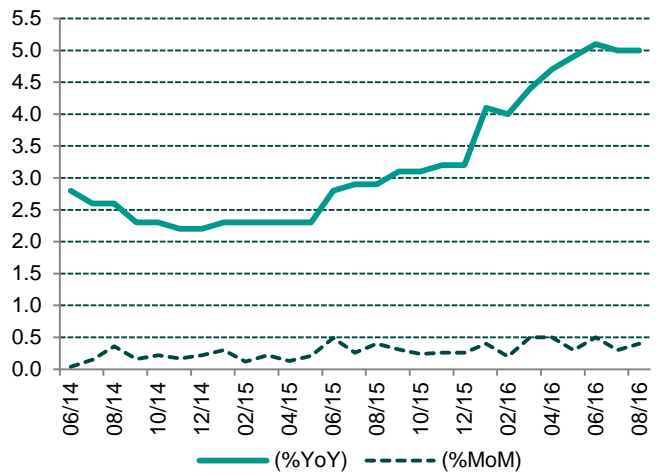
Source(s): CIRC, ABCI Securities

Exhibit 3: CPI of Western medicines



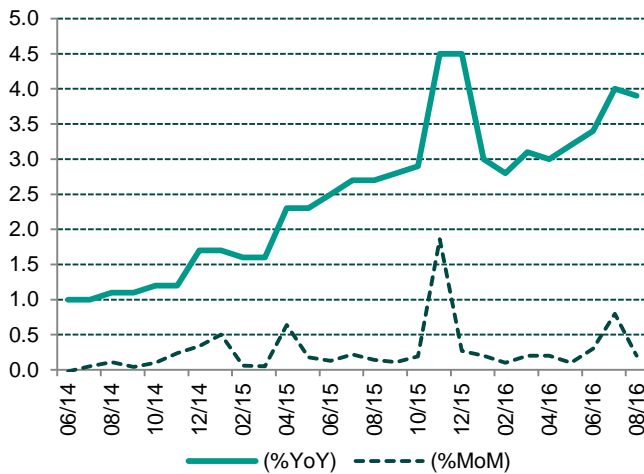
Source(s): NBS, ABCI Securities

Exhibit 4: CPI of Chinese medicines CPI



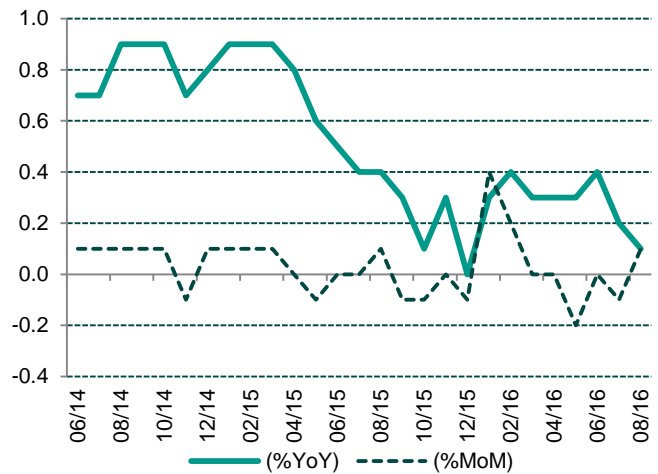
Source(s): NBS, ABCI Securities

Exhibit 5: CPI of medical healthcare services



Source(s): NBS, ABCI Securities

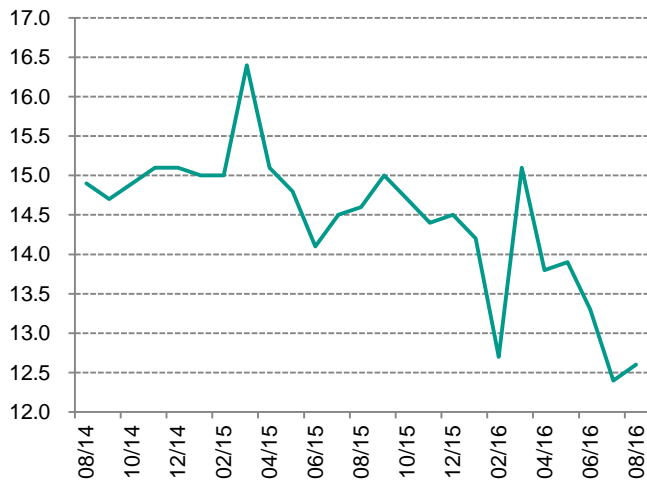
Exhibit 6: PPI of pharma manufacturing - ex-factory



Source(s): NBS, ABCI Securities

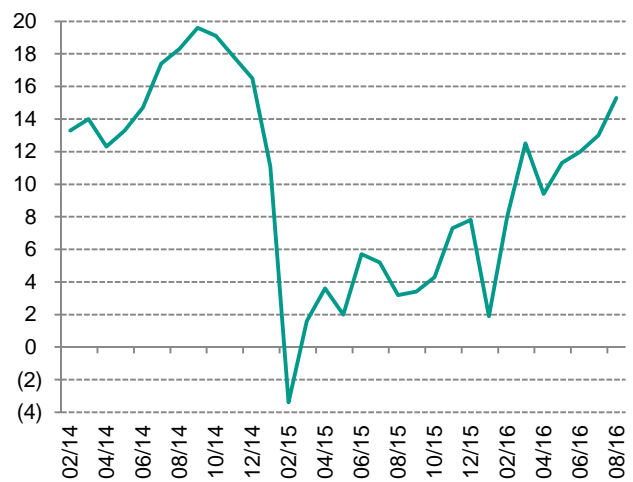


Exhibit 7: Retail sales of medicines (YTD YoY %)



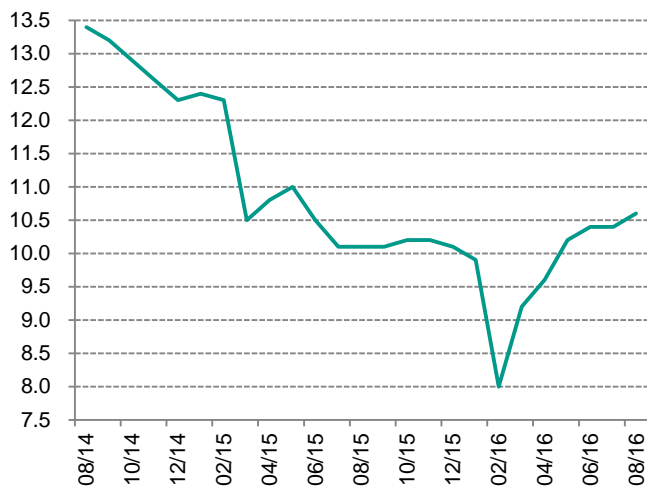
Source(s): NBS, ABCI Securities

Exhibit 8: Import of pharma products (YTD YoY %)



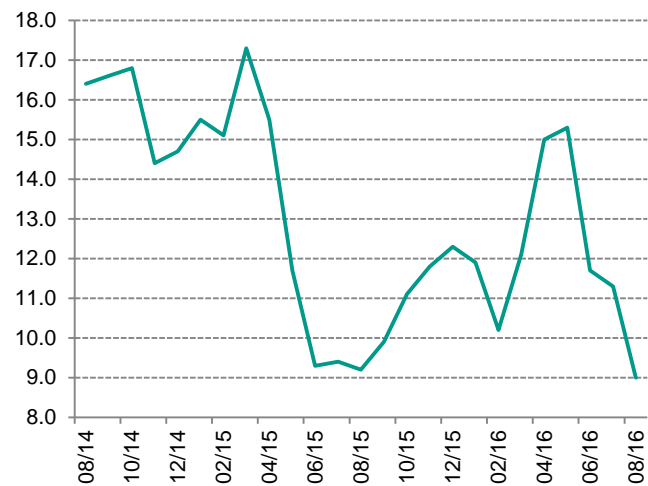
Source(s): China's Customs, ABCI Securities

Exhibit 9: Value-added growth of the pharma manufacturing industry (YTD YoY %)



Source(s): NBS, ABCI Securities

Exhibit 10: FAI in pharma manufacturing industry (YTD YoY %)



Source(s): NBS, ABCI Securities

Exhibit 11: Revenue composition of various sub-sectors in the China pharma industry

Sector	2015			1H16		
	Revenue (RMB 100mn)	Chg (%YoY)	% of total	Revenue (RMB 100mn)	Chg (%YoY)	% of total
Manufacture of chemical drug materials	4614	9.8	17.2	2363	9.6	17.3
Manufacture of chemical drugs	6816	9.3	25.4	3587	11.1	26.3
Chinese herbal medicine processing	1700	12.5	6.3	866	13.0	6.4
Chinese medicine production	6167	5.7	22.9	3051	8.2	22.4
Biopharmaceutical manufacturing	3164	10.3	11.8	1491	9.3	10.9
Sanitary materials and medical supplies manufacturing	1859	10.7	6.9	979	10.6	7.2
Pharmaceutical special equipment manufacturing	182	8.9	0.7	79	6.5	0.6
Medical equipment and device manufacturing	2382	10.3	8.9	1220	12.6	9.0
Pharmaceutical Industry	26885	9.0	100.0	13636	10.1	100.0

Source(s): MIIT, ABCI Securities

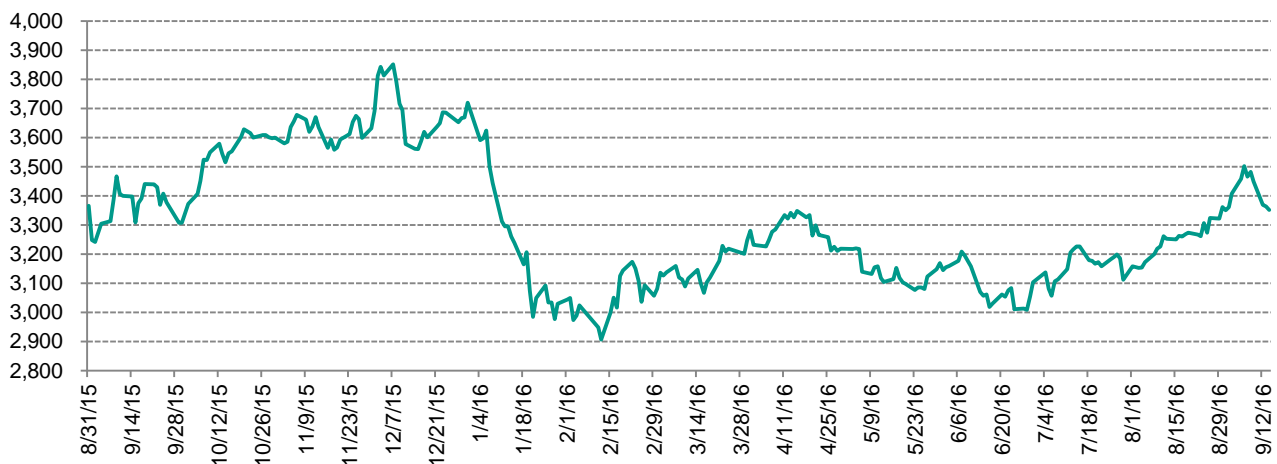


Exhibit 12: Profit composition of various sub-sectors in the China pharma industry

Sector	2015 Profit (RMB 100mn)	Chg (%YoY)	% of total	1H16 Profit (RMB 100mn)	Chg (%YoY)	% of total
Manufacture of chemical drug materials	351	15.3	12.7	207	33.3	14.3
Manufacture of chemical drugs	817	11.2	29.5	453	16.2	31.2
Chinese herbal medicine processing	124	18.8	4.5	60	13.3	4.2
Chinese medicine production	668	11.4	24.2	326	6.1	22.5
Biopharmaceutical manufacturing	387	15.8	14.0	186	5.1	12.8
Sanitary materials and medical supplies manufacturing	170	13.0	6.1	88	9.3	6.1
Pharmaceutical special equipment manufacturing	19	1.6	0.7	6	-4.3	0.5
Medical equipment and device manufacturing	233	5.3	8.4	122	29.3	8.4
Pharmaceutical Industry	2768	12.2	100.0	1450	14.6	100.0

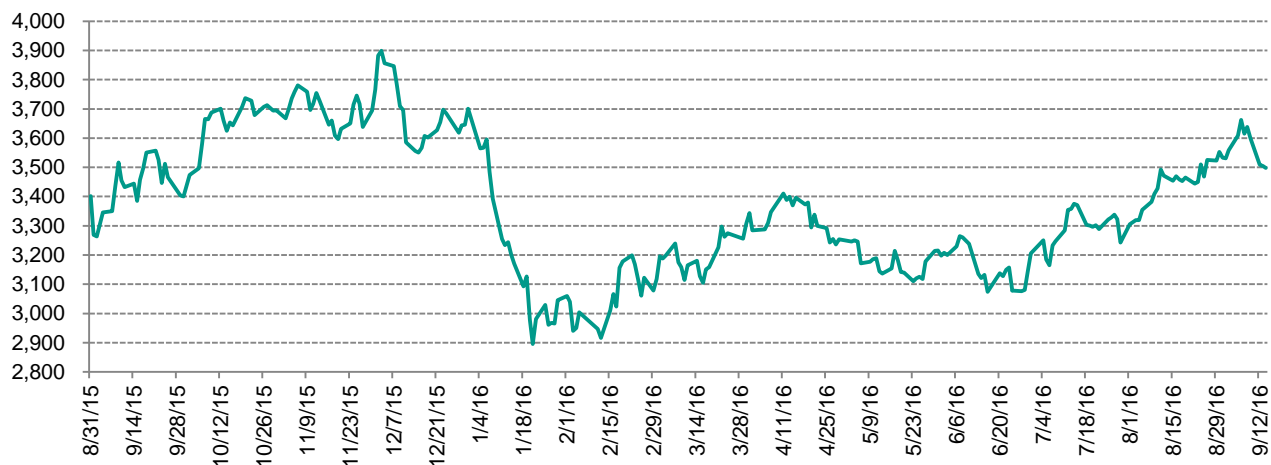
Source(s): MIIT, ABCI Securities

Exhibit 13: Hang Seng Healthcare Index (HSHCI)



Source(s): Bloomberg, ABCI Securities

Exhibit 14: Hang Seng Mainland Healthcare Index (MSMHI)



Source(s): Bloomberg, ABCI Securities



Exhibit 15: Hang Seng Mainland Healthcare Index – profitability ratio

Code	Stock	HK-listed Mkt cap (HK\$m)	ROAA (%)	ROAE (%)	5-yr avg ROAE (%)	Gross profit margin (%)	3-yr avg GP margin (%)	Asset/Equity (x)
1099	SINOPHARM-H	45,208	3.03	14.70	11.57	8.20	8.13	3.40
1093	CSPC PHARM	45,873	13.48	21.74	16.99	45.82	38.51	1.54
1177	SINO BIOPHARM	36,987	10.58	23.70	21.57	77.67	77.19	1.58
867	CHINA MEDICAL	32,384	14.88	21.50	22.59	57.58	56.10	1.20
1530	3SBIO INC	20,233	11.78	16.05	-	85.54	89.43	1.18
460	SIHUAN PHARM	17,729	10.61	12.21	15.50	70.35	65.03	1.10
570	TRAD CHI MED	17,239	5.57	8.21	12.56	59.15	60.12	1.54
2186	LUYE PHARMA	16,672	11.45	14.27	-	81.44	82.01	1.22
2607	SHANGHAI PHARM-H	15,663	4.13	10.37	9.41	11.88	12.28	2.20
1066	SHANDONG WEIG-H	9,720	9.29	11.49	12.88	59.40	59.11	1.25
Average	---	---	9.48	15.42	15.38	55.70	54.79	1.62
High	---	---	14.88	23.70	22.59	85.54	89.43	3.40
Low	---	---	3.03	8.21	9.41	8.20	8.13	1.10

Note:HK-listed mkt cap = HK-listed shares x share price

Source(s): Bloomberg, ABCI Securities

Exhibit 16: Market valuations of Hang Seng Mainland Healthcare Index

Code	Stock	Share price (HK\$)	2016E P/E (x)	2016E P/B (x)	2016E Yield (%)	2017E PER (x)	2017E P/B (x)	2017E Yield (%)
1099	SINOPHARM-H	37.90	19.83	2.69	1.51	17.44	2.37	1.71
1093	CSPC PHARM	7.58	21.84	4.49	1.72	17.92	3.88	2.08
1177	SINO BIOPHARM	4.99	18.28	3.77	0.96	15.99	3.12	1.14
867	CHINA MEDICAL	13.02	20.93	4.22	1.30	17.30	3.51	1.75
1530	3SBIO INC	7.99	22.90	2.77	-	17.31	2.41	0.09
460	SIHUAN PHARM	1.77	8.01	1.27	2.43	8.01	1.13	2.63
570	TRAD CHI MED	3.89	14.05	1.20	1.17	12.03	1.12	1.58
2186	LUYE PHARMA	5.02	16.17	2.14	-	14.29	1.87	0.30
2607	SHANGHAI PHARM-H	20.45	14.81	1.47	1.89	13.38	1.36	2.13
1066	SHANDONG WEIG-H	5.16	17.20	1.68	1.51	14.18	1.52	1.83
Average	---	---	17.40	2.57	1.25	14.78	2.23	1.52
High	---	---	22.90	4.49	2.43	17.92	3.88	2.63
Low	---	---	8.01	1.20	-	8.01	1.12	0.09

Source(s): Bloomberg, ABCI Securities



China Economic Indicators

	2015						2016							
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Real GDP (YoY %)	---	---	6.9	---	---	6.8	---	---	6.7	---	---	6.7	---	---
Export Growth (YoY %)	(8.3)	(5.5)	(3.7)	(6.9)	(6.8)	(1.4)	(11.2)	(25.4)	11.5	(1.8)	(4.1)	(4.8)	(4.4)	(2.8)
Import Growth (YoY %)	(8.1)	(13.8)	(20.4)	(18.8)	(8.7)	(7.6)	(18.8)	(13.8)	(7.6)	(10.9)	(0.4)	(8.4)	(12.5)	1.5
Trade Balance (USD/bn)	43.0	60.2	60.3	61.6	54.1	60.9	63.3	32.6	29.9	45.56	49.98	48.11	52.31	52.05
Retail Sales Growth (YoY %)	10.5	10.8	10.9	11.0	11.2	11.1	10.2		10.5	10.1	10.0	10.6	10.2	10.6
Industrial Production (YoY %)	6.0	6.1	5.7	5.6	6.2	5.9	5.4		6.8	6.0	6.0	6.2	6.0	6.3
PMI - Manufacturing (%)	50.0	49.7	49.8	49.8	49.6	49.7	49.4	49.0	50.2	50.1	50.1	50.0	49.9	50.4
PMI - Non-manufacturing (%)	53.9	53.4	53.4	53.1	53.6	54.4	53.5	52.7	53.8	53.5	53.1	53.7	53.9	53.5
FAI (YTD) (YoY %)	11.2	10.9	10.3	10.2	10.2	10.0	10.2		10.7	10.5	9.6	9.0	8.1	8.1
CPI (YoY %)	1.6	2.0	1.6	1.3	1.5	1.6	1.8	2.3	2.3	2.3	2.0	1.9	1.8	1.3
PPI (YoY %)	(5.4)	(5.9)	(5.9)	(5.9)	(5.9)	(5.9)	(5.3)	(4.9)	(4.3)	(3.4)	(2.8)	(2.6)	(1.7)	(0.8)
M2 (YoY %)	13.3	13.3	13.1	13.5	13.7	13.3	14.0	13.3	13.4	12.8	11.8	11.8	10.2	11.4
New Lending (RMB/bn)	1,480	809.6	1,050	513.6	708.9	597.8	2,510	726.6	1,370	555.6	985.5	1,380	463.6	948.7
Aggregate Financing (RMB bn)	742	1,082	1,300	476.7	1,020	1,815.1	3,425.3	824.5	2,404.0	751.0	659.9	1,629.3	487.9	1470.0

World Economic/Financial Indicators

Equity Indices				Global Commodities					Bond Yields & Key Rates		
	Closing price	Chg. WTD (%)	P/E	Unit	Price	Chg. WTD (%)	Vol (5-Day avg.)		Yield (%)	Chg. WTD (Bps)	
U.S.				Energy					US Fed Fund Rate		
DJIA	18,066.75	(0.10)	17.40	NYMEX WTI	USD/bbl.	45.19	(1.50)	685,162	0.50	0.00	
S&P 500	2,127.02	(0.04)	19.97	ICE Brent Oil	USD/bbl	47.32	(1.44)	270,480	3.50	0.00	
NASDAQ	5,155.26	0.57	40.13	NYMEX Natural Gas	USD/MMBtu	2.93	4.83	166,260	1.00	0.00	
MSCI US	2,027.52	(0.04)	20.65	China Qinhuangdao Port Thermal Coal ²	CNY/Metric Tonne	546.00	8.55	N/A	0.2390	1.08	
Europe				Basic Metals					US Treasury (1 Yr)		
FTSE 100	6,709.13	(1.00)	55.57	LME Aluminum Cash	USD/MT	1,548.25	(0.72)	12,486	1.2341	1.16	
DAX	10,415.75	(1.49)	24.16	LME Aluminum	USD/MT	1,565.00	(0.86)	42,622	1.7185	4.36	
CAC40	4,387.38	(2.32)	22.58	3 -mth. Rolling Fwd.	USD/MT				Japan 10-Yr Gov. Bond	(0.02) (0.60)	
IBEX 35	8,725.20	(3.33)	21.67	CMX Copper Active	USD/lb.	4,637.00	0.40	12,237	China 10-Yr Gov. Bond	2.7730 (3.70)	
FTSE MIB	16,537.90	(3.61)	38.69	LME Copper 3- mth Rolling Fwd.	USD/MT	4,650.00	0.37	44,508	ECB Rate (Refinancing)	0.00 0.00	
Stoxx 600	339.94	(1.61)	26.44	Precious Metals					1-Month LIBOR		
MSCI UK	1,940.37	(1.70)	58.73	CMX Gold	USD/T. oz	1,326.20	(0.62)	174,814	0.5277	0.08	
MSCI France	124.77	(2.10)	20.77	CMX Silver	USD/T. oz	19.13	(1.23)	60,676	3 Month LIBOR	0.8558 0.36	
MSCI Germany	132.63	(1.60)	23.72	NYMEX Platinum	USD/T. oz	1,043.90	(2.21)	15,715	O/N SHIBOR	2.1280 4.30	
MSCI Italy	47.06	(3.80)	39.00	Agricultural Products					1-mth SHIBOR		
Asia				CBOT Corn	USD/bu	330.00	(3.23)	161,721	2.6860	0.90	
NIKKEI 225	16,614.24	(2.07)	20.65	CBOT Wheat	USD/bu	400.50	(0.74)	54,286	3-mth HIBOR	0.5900 0.96	
S&P/ASX 200	5,227.69	(2.09)	23.59	NYB-ICE Sugar	USD/lb.	20.94	1.21	78,134	Corporate Bonds (Moody's)		
HSI	23,190.64	(3.77)	12.43	CBOT Soybeans	USD/bu.	946.25	(3.47)	98,749	Aaa	3.43 0.00	
HSCEI	9,542.52	(5.12)	8.18						Baa	4.36 2.00	
CSI300	3,238.73	(2.39)	14.92								
SSE Composite	3,002.85	(2.47)	17.42								
SZSE Component	10,454.24	(2.87)	31.55								
MSCI China	62.62	(2.82)	13.59								
MSCI Hong Kong	13,035.86	(3.20)	14.70								
MSCI Japan	800.19	(1.61)	16.90								

Note:

1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)
2. The price is Coal 5500 kcal/kg FOB Spot Price

Currency

	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.1224	1.3204	0.7472	102.70	0.9761	6.6731	7.7585	6.8645
Chg. WTD (%)	(0.08)	(0.47)	(0.92)	(0.01)	(0.05)	0.18	(0.02)	0.30



Disclosures

Analyst Certification

We, Chan Sung Yan, Philip, and PAN Hongxing, Paul, being the persons primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect our personal view about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. We and/or our associates have no financial interests in relation to any listed company (ies) covered in this report, and we and/or our associates do not serve as officer(s) of any listed company (ies) covered in this report.

Disclosures of Interests

ABCI Securities Company Limited and/or its affiliates may pursue financial interests to the companies mentioned in the report.

Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return - 6% \leq Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	$2.6 \leq 180$ day volatility/180 day benchmark index volatility
High	$1.5 \leq 180$ day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq 180$ day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

Disclaimer

This report is for our clients only and is for distribution only under such circumstances as may be permitted by applicable law. It has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. No representation or warranty, either expresses or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein. This report should not be regarded by recipients as a substitute for the exercise of their own judgment. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas as a result of using different assumptions and criteria. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. ABCI Securities Company Limited is under no obligation to update or keep current the information contained herein. ABCI Securities Company Limited relies on information barriers to control the flow of



農銀國際

ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

information contained in one or more areas within ABCI Securities Company Limited, into other areas, units, groups or affiliates of ABCI Securities Company Limited. The compensation of the analyst who prepared this report is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of ABCI Securities Company Limited as a whole, of which investment banking, sales and trading are a part. The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. The price and value of the investments referred to in this research and the income from them may fluctuate. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither ABCI Securities Company Limited nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Additional information will be made available upon request.

Copyright 2016 ABCI Securities Company Limited

No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of ABCI Securities Company Limited.

**Office address: ABCI Securities Company Limited, 13/F Fairmont House,
8 Cotton Tree Drive, Central, Hong Kong.**

Tel: (852) 2868 2183