

China Medical System (867.HK)

Drug Tender Leading to ASP Drop and New Acquisition to Enrich Pipeline

Hong Kong | Pharmaceutical | Company report

23 November 2018

Investment Summary

On Nov 14, the Chinese government approved the pilot program of centralized drug purchase, which will negatively affect CMS drug prices and lead to a potential profitability decline. We highlight the strong growth potential of CMS in long run and also the introduction of new products which will enrich the pipeline mix. We lowered the rating to Neutral with TP of HKD9.98. (Closing price at 21 Nov 2018)

Business Overview

Volume-based procurement policy was approved. VBP emphasizes that when bidding or negotiating the centralized purchasing of drugs, the purchasing quantity should be clearly defined, so that enterprises can quote price with consideration of the specific quantity. On Nov 14, the Chinese government adopted the pilot program for centralized drug purchase. In opposite to tenders without purchasing quantity (which tends to lead to no actual purchase later), VBP is expected to facilitate final purchasing, thus increase the sales of drugs, though generally reduce the drugs price.

ASP of two main drugs will be adversely affected. The bid drugs should be ones passing the BE tests. The company will have two main products that may face fierce competition due to peers passing BE tests, namely, Deanxit (for treatment of depression) and Plendil (for the treatment of hypertension and angina pectoris). In a previous con-call, CMS illustrated that if it does not accept the price cut and quit tenders in 11 pilot cities, 20-40% market of the two would be transferred from hospitals to OTC market. Thus the sales revenue of the two will be reduced by 8.4-11.2% and the company's overall revenue will be reduced by 3.6-4.8%. If the policy effect extends from 11 pilot projects to the whole country and 20-40% market is transferred to OTC, the overall revenue may decline by 11.1-14.9%.

Purchase of R&D products. Except for Deanxit and Plendil, there are almost no competitors in other products of CMS, so we regard their market growth potential still strong. In Sep, the company announced the acquisition of exclusive, permanent R&D and commerce rights of VAXIMM AG, which owns pharmaceutical products (including VXM01, the leading product at present), in China, Singapore, Philippines, Korea, Malaysia and other designated Asian countries. VXM01 is an oral T cell immunotherapy consisting of live attenuated Salmonella typhimurium carrying eukaryotic expression plasmid encoding vascular endothelial growth factor receptor 2 (VEGFR2) gene. VXM01 will be mainly developed for the treatment of recurrent glioblastoma (GBM) at this stage. It has been designated as an orphan drug for glioma by EU and FDA of the United States.

Neutral (Downgrade)

CMP HKD9.70

(Closing price at 21 Nov 2018)

TARGET HKD9.98 (+3%)

COMPANY DATA

O/S SHARES (MN)	2,487
MARKET CAP (HKDMN)	24,126
52 - WK HI/LO (HKD)	19.73 / 8.40

SHARE HOLDING PATTERN, %

Director Lam Kong	43.53
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PRICE PERFORMANCE, %

	1M	3M	1Y
CMS	-3.00	-28.63	-38.66
HIS	-0.69	-6.55	-12.90

RETURN VS. HSI



Source: Aastocks, Phillip Securities (HK) Research

KEY FINANCIALS

RMB mn	FY16	FY17	FY18E	FY19E
Net Sales	4,900.8	5,348.8	5,826.5	6,396.6
Net Profit	1,375.9	1,674.8	1,836.3	2,016.0
EPS, RMB	0.55	0.67	0.74	0.81
PER, x	15.55	12.83	11.67	10.63
BVPS, RMB	2.50	2.95	3.39	3.88
P/BV, x	3.45	2.92	2.54	2.22
ROE, %	22.16	22.79	21.78	20.91

Source: Company, Phillip Securities Est.

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18H1 results. Total turnover fell by 1.2% to RMB2,655mn, while excluding two-invoice system revenue it increased by 10.3% yoy to RMB2,974.3mn. Gross profit increased by 13.3% to RMB1,883.7mn (excluding TIS effect up by 9.5% yoy to RMB1,744.9mn). In Jun 2018, its cash and bank deposits amounted to RMB1,097.8mn and bank acceptance drafts cashable at any time amounted to RMB245.5mn. The interim dividend is RMB0.1536 per share, up by 18.8% yoy.

Figure: CMS Product Mix

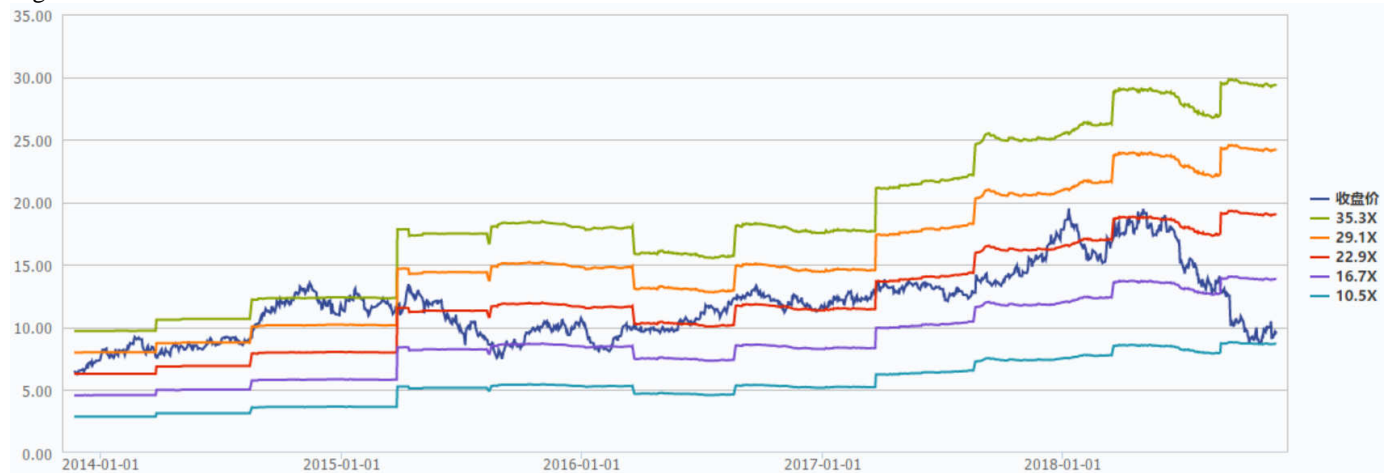
Drugs	Function	Year of Introduction	Hospital Coverage	% in Sales	NDRL
Plendil	Hypertension and stable angina pectoris	2016	26,000	24.1%	Yes
Deanxit	Mild to moderate depression and anxiety	1997	21,000	17.7%	Yes
Ursofalk	Cholesterol gallstones in the gallbladder, cholestatic liver disease and biliary reflux gastritis	1998	9,400	17.9%	Yes
XinHuoSu	Acute heart failure	2008	1,900	7.7%	Yes
Salofalk	Ulcerative Colitis and Crohn's disease	2008	3,900	5.5%	Yes
Bioflor	Diarrhea in adults and children	2010	3,000	4.9%	-
Stulln	Senile macula degeneration and asthenopia	2007	7,000	4.1%	-
DanShen-Tong	Antisepsis and anti-inflammation	2015	4,000	2.8%	Yes
Hirudoid	Blunt traumata	2015	6,000	2.4%	PDRL
NuoDiKang	Activating blood circulation, freeing blood vessels, alleviating pain, Coronary heart disease and angina	2015	3,700	1.9%	Yes
Combizym	Dyspepsia	2015	1,300	1.3%	Yes
GanFuLe	Liver cancer, cirrhosis and liver fibrosis	2008	-	0.8%	Yes
Imdur	Anti-ischemic	2016	8,000	0.7%	Yes
Parlodel	Hyperprolactinaemia	2014	1,300	-	Yes
Lamisil	Superficial fungal infection	-	-	-	Yes
Movicol	Constipation	-	-	-	-
Total	-	-	-	92.4%	-

Source: Company, Phillip Securities

Investment Thesis, Valuation & Risk

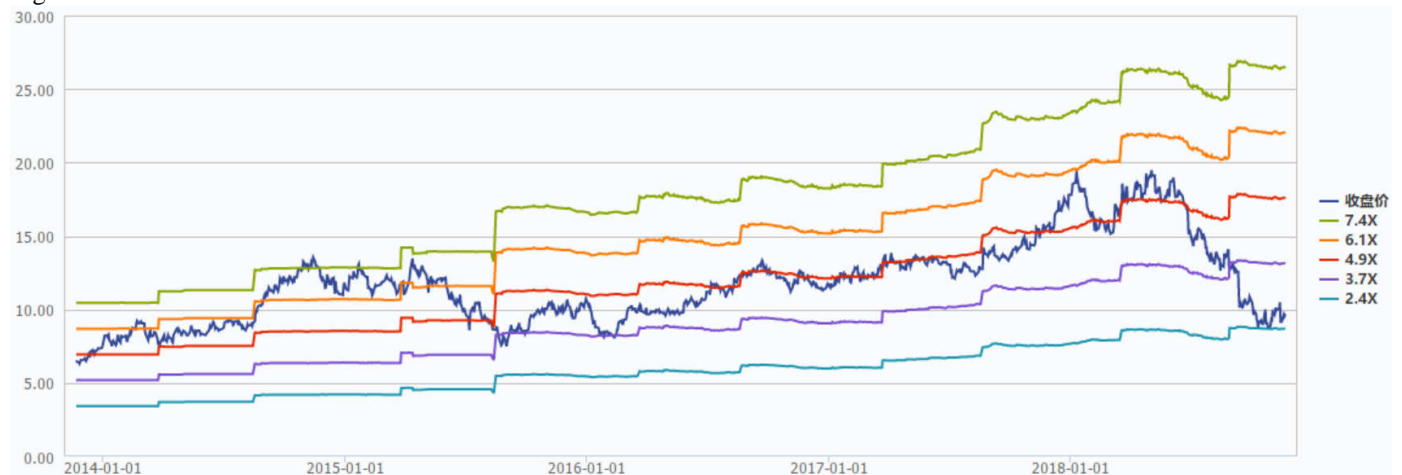
We lowered the target price to HK\$9.98. We slightly downgraded the revenue growth forecasts of Deanxit and Plendil, and adjusted EPS forecasts to be RMB0.74/0.81 in 2018E/19E. Based on target PE 12x (the peers' target median PE is 15x) we lower the target price to be HK\$9.98, Neutral rating. **Risks include:** R&D fails expectations; Policy risks; Exchange risk; New introduction fails expectations. (Ex rate=0.888RMB/HKD)

Figure: PE band



Source: Wind (as at 21 Nov), Phillip Securities

Figure: PB band



Source: Wind (as at 21 Nov), Phillip Securities

Financials

FYE	FY2015	FY2016	FY2017	FY2018E	FY2019E
Valuation Ratios					
Price to Earnings (P/E)	21.33	15.55	12.83	11.67	10.63
Price to Book (P/B)	4.04	3.45	2.92	2.54	2.22
Per Share Data					
EPS (RMB Cents)	40.37	55.40	67.14	73.83	81.05
Book Value Per Share (RMB)	2.13	2.50	2.95	3.39	3.88
Dividend Per Share (RMB Cents)	16.16	22.43	26.86	29.53	32.42
Growth (%)					
Revenue	20.65	37.92	9.14	8.93	9.78
Operating Income	21.32	48.11	24.72	5.97	9.78
Net Profit	-4.46	38.28	21.19	9.96	9.78
Margins (%)					
Gross Profit Margin	57.58	59.42	65.03	64.50	64.00
Operating Profit Margin	29.74	31.93	36.49	35.50	35.50
Net Profit Margin	28.04	28.12	31.22	31.52	31.52
Key Ratios					
ROE (%)	18.95	22.16	22.79	21.78	20.91
ROA (%)	17.62	16.99	16.45	15.24	14.64
Income Statement (RMB Mn)					
Revenue	3,553.4	4,900.8	5,348.8	5,826.5	6,396.6
- Cost of Goods Sold	1,507.3	1,988.9	1,870.5	2,068.4	2,302.8
Gross Income	2,046.1	2,911.9	3,478.3	3,758.1	4,093.8
- Operating Expenses	989.4	1,346.9	1,604.1	1,689.7	1,823.0
Operating Income	1,056.7	1,565.0	1,951.9	2,068.4	2,270.8
+ Net Non-Operating Gain/Loss	7.4	(64.6)	82.3	72.4	79.5
Pretax Income	1,064.1	1,500.4	1,808.4	1,996.0	2,191.3
- Income Tax Expenses	(67.6)	(122.5)	(138.5)	(159.7)	(175.3)
Net Profit	995.9	1,375.9	1,674.8	1,836.3	2,016.0

Source: Wind, Phillip Securities (HK) Research Estimates

Exchange rate is 0.888 RMB/HKD.

(Financial figures as at 21 Nov 2018)

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm 5\%$ from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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