

# China Medical System [867.HK]

**ASP pressure + concerns about the business model; downgrade to HOLD**

We had a discussion with China Medical System (CMS) following the sharp correction in its share price. We believe its key products—Deanxit and Plendil—will be affected by the GPO (Group Procurement Organization). Although these two drugs (~43% of CMS's total revenue) are not directly listed in the first-round GPO list, they are expected to join the ASP cut competition when they finish the consistency evaluation. Other than ASP risks, we believe the key concern for this CSO (contracted sales organization) is the impact on the value of its business model under the GPO. Simply speaking, secured volume under the GPO will damage the value of the CSO, whose core value lies in academic promotion and marketing to boost drugs volume. Therefore, in addition to a potential ASP cut for Deanxit and Plendil, its CSO business model carries systematic de-rating risks. Although it is hard to quantify the negative impact right now, we prepared a scenario analysis to estimate the impact (Figure 1&2). Under various scenarios, 2019E operating profit may be revised down by 2%-14%. We kept our earnings numbers for now, but give CMS a much lower multiple to reflect the potential risks. We lower our Target Price from HK\$17.5 (16x 2019E PER) to HK\$12.1 (11x 2019E PER, 2sd below its historical average, Figure 3). Our new Target Price implies a 2019E PER of 12.5x under the worst case scenario, i.e. downward earnings revision of 14%. Downgrade from BUY to HOLD. We suggest investors avoid CMS until there is more clarity on the policy side.

## Investment thesis

**Scenario analysis:** Our scenario analysis estimates the potential earnings impact on CMS in 2019 1) accepting an ASP cut with secured volume, and 2) not accepting an ASP cut and sacrificing secured volume. Our analysis results are sensitive to the following assumptions: 1) how much ASP pressure is shared by upstream manufacturers through lower ex-factory prices; 2) what percentage of selling expenses is saved. We estimate ~50% of CMS's selling expenses are related to *Deanxit* and *Plendil* (D+P). Also selling expense savings depend on the areas affected by the GPO (11 cities, later extended nationwide); 3) the change in the cost of goods sold is a function of the sales volume of *Deanxit* and *Plendil* and ex-factory price changes; and 4) calculations are adjusted to avoid distortion caused by the two-invoice system numbers.

Our analysis results indicate the following:

- ◆ Optimistic case: When D+P volume increase >30%, together with upstream manufacturers' lowering ex-factory prices by 20%, with 20% saving in selling expenses, the impact caused by a 40% ASP cut can be largely offset.
- ◆ Worst case: If the Company does not accept an ASP cut and sacrifices secured volume, operating profit in 2019E may be revised down by ~14% (Figure 2 case 2).
- ◆ The best strategy for CMS is to accept the ASP cut, or in about two years when the GPO is executed nationwide, CMS's earnings may be impacted by ~14%, which is even worse than the most bearish case in Scenario 1 (40% ASP cut with 10% volume increase). At least there is room for negotiation in the ASP cut case, as its upstream manufacturers may share the ASP pressure.

Y/E Dec 31	2016A	2017A	2018E	2019E	2020E
Turnover (RMB m)	4,901	5,349	6,275	7,295	8,364
Net profit (RMBm)	1,376	1,675	2,079	2,415	2,732
Core net profit (RMB m)*	1,396	1,675	2,079	2,415	2,732
Core net margin (%)	28.5	31.3	32.9	32.9	32.5
Core EPS (RMB)	0.561	0.673	0.830	0.965	1.092
% Change	38.7	20.1	23.3	16.2	13.2
PER (x)	16.6	13.8	11.2	9.7	8.5
PBR (x)	3.7	3.2	2.7	2.3	2.0
ROE (%)	22.3	22.9	23.9	23.6	22.9
EV/EBITDA (x)	14.6	11.2	8.7	7.2	5.9

\* adjusted by CGIS research

Sources: Company, CGIS Research

## China Healthcare Sector

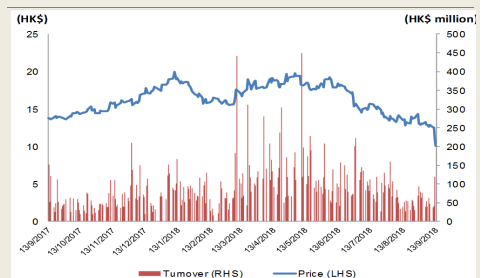
**HOLD**

(Downgrade from BUY)

Close: HK\$10.58 (Sep 14, 2018)

Target Price: HK\$12.1 (+14.4%)

## Price Performance



Market Cap	US\$3,352m
Shares Outstanding	2,487.2m
Auditor	Deloitte
Free Float	49.7%
52W range	HK\$10.12-19.96
3M average daily T/O	US\$10.35m
Major Shareholding	Lam Kong (46.04%)

Sources: Company, Bloomberg

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Figure 1: Scenario 1

**Scenario 1: Accept ASP cut with volume increase and savings in selling expenses**
**Key assumptions**

	Deanxit+ Plendil (D+P) ASP cut	Volume increase	CMS revenue impact
Case 1	-40%	10%	-14.6%
Case 2	-40%	20%	-12.0%
Case 3	-40%	30%	-9.5%
Case 4	-40%	40%	-6.9%



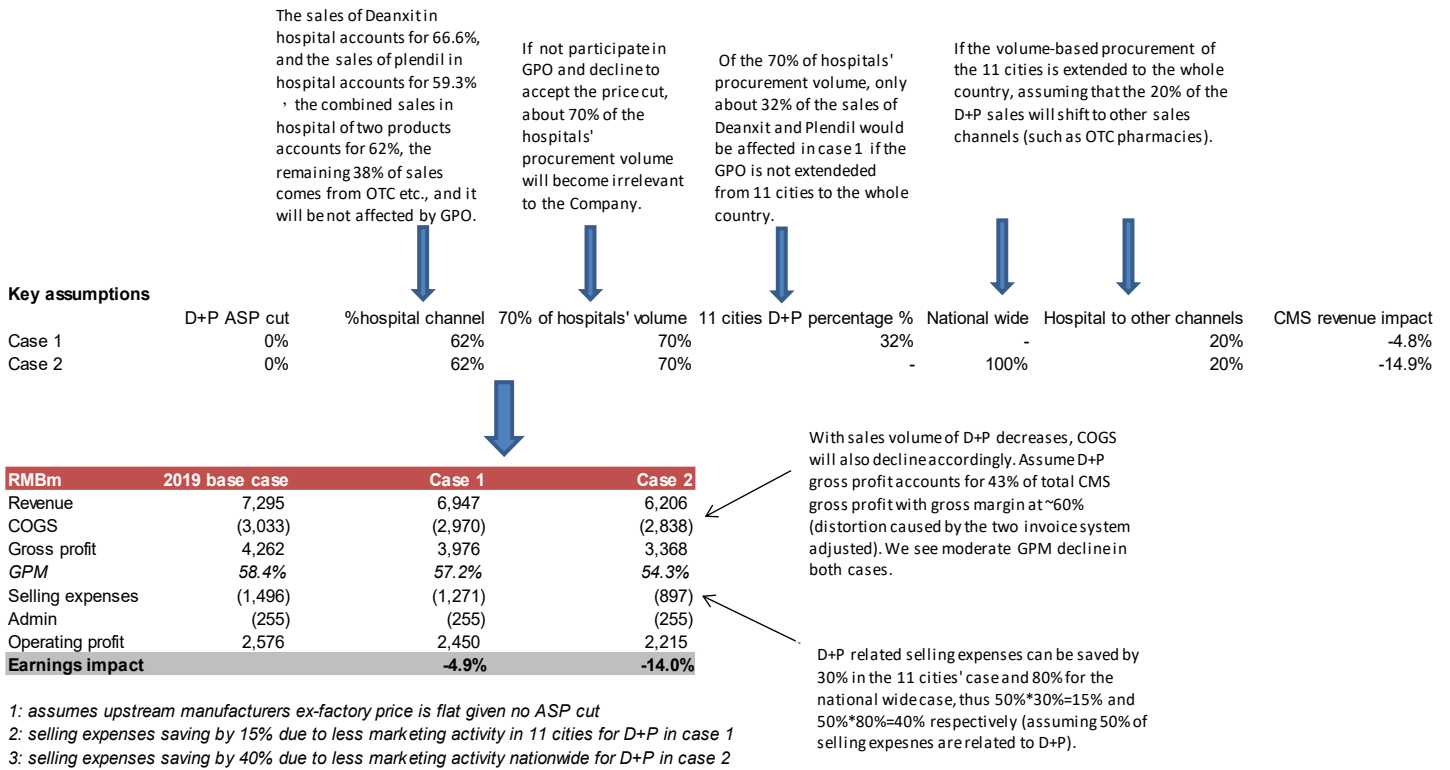
RMBm	2019E base case	Case 1	Case 2	Case 3	Case 4
Revenue	7,295	6,229	6,417	6,605	6,793
COGS	(3,033)	(2,531)	(2,635)	(2,739)	(2,844)
Gross profit	4,262	3,698	3,782	3,866	3,950
GPM	58.4%	59.4%	58.9%	58.5%	58.1%
Selling expenses	(1,496)	(1,196)	(1,196)	(1,196)	(1,196)
Admin expenses	(255)	(255)	(255)	(255)	(255)
Operating profit	2,576	2,246	2,330	2,414	2,498
<b>Earnings impact</b>		<b>-12.8%</b>	<b>-9.6%</b>	<b>-6.3%</b>	<b>-3.0%</b>

1: assumes upstream manufacturers share the ASP cut, ex-factory price is lowered by 20%

2: selling expenses saving by 20% (estimated D+P selling expenses accounted for 50% of CMS total selling expenses, and ~40% can be saved under GPO)

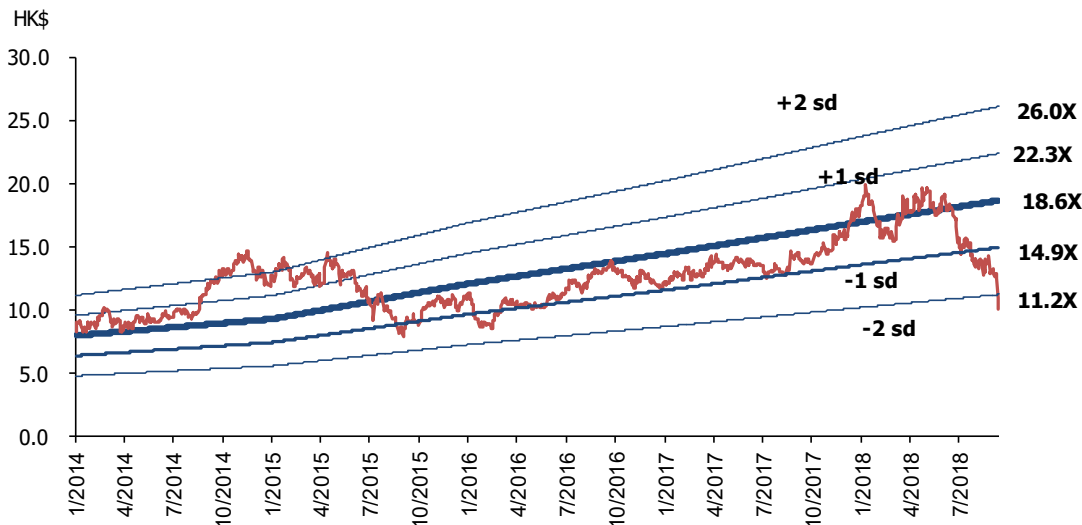
Source: CGIS research

Figure 2: Scenario 2

**Scenario 2: Not participate in GPO (no price cut) and sacrifice volume**


Source: CGIS research

Figure 3: PE band



Source: Bloomberg

## Key financials

### Balance Sheet

As at Dec 31 (RMBm)	2016A	2017A	2018E	2019E	2020E
Cash & cash equivalents	482	856	1,760	2,825	4,355
Inventories	509	460	646	758	874
Accounts receivable	1,682	1,487	1,820	2,079	2,384
Others	877	156	156	156	156
<b>Current assets</b>	<b>3,551</b>	<b>2,960</b>	<b>4,382</b>	<b>5,818</b>	<b>7,769</b>
Property, plant and equipment	362	479	521	559	591
Intangible assets	2,886	2,720	2,705	2,677	2,635
Others	2,993	3,978	4,015	4,057	4,056
<b>Non-current assets</b>	<b>6,241</b>	<b>7,189</b>	<b>7,253</b>	<b>7,305</b>	<b>7,294</b>
<b>Total assets</b>	<b>9,792</b>	<b>10,149</b>	<b>11,635</b>	<b>13,123</b>	<b>15,063</b>
Accounts payable	579	507	622	730	842
ST borrowings	1,612	65	216	203	213
Others	1,205	86	86	86	86
<b>Current liabilities</b>	<b>3,396</b>	<b>658</b>	<b>924</b>	<b>1,020</b>	<b>1,141</b>
Long-term debts	0	2,040	1,944	1,828	1,921
Others	128	122	126	120	146
<b>Long-term liabilities</b>	<b>128</b>	<b>2,162</b>	<b>2,070</b>	<b>1,948</b>	<b>2,066</b>
<b>Total liabilities</b>	<b>3,524</b>	<b>2,821</b>	<b>2,994</b>	<b>2,968</b>	<b>3,208</b>
Shareholders' equity	6,209	7,275	8,580	10,086	11,778
Minority interests	58	54	61	69	77
<b>Total equity</b>	<b>6,268</b>	<b>7,328</b>	<b>8,641</b>	<b>10,155</b>	<b>11,856</b>

### Cash Flow

Year ended Dec 31 (RMBm)	2016A	2017A	2018E	2019E	2020E
Profit before tax	1,500	1,808	2,245	2,608	2,951
Depr & amortization	176	196	253	271	289
Change in working cap.	(511)	133	(402)	(264)	(309)
Income tax paid	(49)	(160)	(169)	(206)	(202)
Others	45	94	2	(30)	(13)
<b>Operating cash flow</b>	<b>1,162</b>	<b>2,072</b>	<b>1,928</b>	<b>2,379</b>	<b>2,716</b>
Capex	(1,228)	(149)	(280)	(280)	(280)
Change in other assets	(305)	(206)	24	32	49
<b>Investment cash flow</b>	<b>(1,533)</b>	<b>(354)</b>	<b>(256)</b>	<b>(248)</b>	<b>(231)</b>
Net change in debt	1,148	493	55	(129)	103
Others	(527)	(1,838)	(822)	(937)	(1,058)
<b>Financing cash flow</b>	<b>622</b>	<b>(1,345)</b>	<b>(767)</b>	<b>(1,066)</b>	<b>(955)</b>
<b>Net change in cash</b>	<b>251</b>	<b>373</b>	<b>905</b>	<b>1,065</b>	<b>1,530</b>
Cash Beg.	229	482	856	1,760	2,825
Fx	2	1	0	0	0
Cash End.	482	856	1,760	2,825	4,355

### Profit and Loss

Year as of Dec 31 (RMBm)	2016A	2017A	2018E	2019E	2020E
Direct model	4,264	4,944	5,807	6,768	7,779
Agency model	359	360	418	473	525
Others	278	45	49	54	60
<b>Revenue</b>	<b>4,901</b>	<b>5,349</b>	<b>6,275</b>	<b>7,295</b>	<b>8,364</b>
Cost of goods sold	(1,989)	(1,871)	(2,582)	(3,033)	(3,495)
<b>Gross profit</b>	<b>2,912</b>	<b>3,478</b>	<b>3,693</b>	<b>4,262</b>	<b>4,869</b>
Other gains / (losses)	(42)	(79)	58	65	75
Marketing expenses	(1,174)	(1,382)	(1,286)	(1,496)	(1,715)
Admin expenses	(222)	(222)	(220)	(255)	(293)
<b>Operating profit</b>	<b>1,474</b>	<b>1,795</b>	<b>2,245</b>	<b>2,576</b>	<b>2,936</b>
Net interest income / (expense)	(23)	(65)	(39)	(12)	14
JV, associate and others	49	78	39	44	0
Pretax income	1,500	1,808	2,245	2,608	2,951
Income taxes	(123)	(138)	(173)	(201)	(227)
Non-controlling interests	2	(5)	(8)	(8)	(8)
<b>Net profit</b>	<b>1,376</b>	<b>1,675</b>	<b>2,079</b>	<b>2,415</b>	<b>2,732</b>
Non-recurring items	(20)	(0)	0	0	0
<b>Core net profit</b>	<b>1,396</b>	<b>1,675</b>	<b>2,079</b>	<b>2,415</b>	<b>2,732</b>
EBIT	1,491	1,805	2,260	2,592	2,953
EBITDA	1,667	2,001	2,513	2,863	3,241
EPS (RMB)	0.553	0.673	0.830	0.965	1.092
<b>Core EPS (RMB)</b>	<b>0.561</b>	<b>0.673</b>	<b>0.830</b>	<b>0.965</b>	<b>1.092</b>
DPS (RMB)	0.222	0.269	0.332	0.386	0.437
Payout	40.1%	39.9%	40.0%	40.0%	40.0%

### Key Ratios

Year to Dec 31	2016A	2017A	2018E	2019E	2020E
<b>Growth (% YoY)</b>					
Sales	37.9	9.1	17.3	16.3	14.7
EBIT	40.5	20.7	24.3	14.8	14.0
EBITDA	46.4	19.8	24.7	14.0	13.3
Core net profit	39.9	20.1	23.3	16.2	13.2
Core EPS	38.7	20.1	23.3	16.2	13.2
<b>Profitability (%)</b>					
Gross margin	59.4	65.0	58.8	58.4	58.2
EBIT margin	30.4	33.7	35.7	35.2	35.0
EBITDA margin	34.0	37.3	39.7	38.9	38.5
Core net profit margin	28.5	31.3	32.9	32.9	32.5
ROA	14.2	16.5	17.7	18.3	18.0
ROE	22.3	22.9	23.9	23.6	22.9
<b>Balance sheet ratios</b>					
Current ratio (X)	10	4.5	4.7	5.7	6.8
Quick ratio (X)	0.9	3.8	4.0	5.0	6.0
Cash ratio (X)	0.1	13	19	2.8	3.8
Trade & bill receivables days	106	108	96	98	97
Trade & bill payable days	89	106	80	81	82
Inventory turnover days	82	95	78	84	85
Total debt to equity ratio (%)	26.0	0.9	2.5	2.0	1.8
Net debt / (cash) to equity (%)	18.2	(10.9)	(18.0)	(26.0)	(35.2)

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BUY : share price will increase by >20% within 12 months in absolute terms

SELL : share price will decrease by >20% within 12 months in absolute terms

HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

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