30 October 2017

HSBC Global Research

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Yestar Healthcare (2393 HK)

Initiate at Buy: Scoring high marks in diagnostics

EQUITIES
HEALTH CARE PROVIDERS

Hong Kong

- Benefits from rising demand for medical diagnostics in China
- A comprehensive sales network supports rapid growth
- Initiate at Buy, with a PEG-based target price of HKD4.10

A big change. Yestar made a major change to its business model in 2014. China's market leader in making industrial film for companies like Fujifilm, a business where growth was slowing, entered the in-vitro diagnostic (IVD) industry by buying businesses that make devices for testing biological samples; in the process it become a major distributor for Roche Diagnostics (Not Rated), the IVD market leader. The move was successful and at the end of 2016 the IVD business generated 49% of Yestar's revenue. The share price has dropped around 20% since 31 July, after the company failed to meet what we think were rather ambitious guidance numbers. We think this represents a good entry level.

Testing, testing. IVD is the biggest sub-sector in China's medical device industry and is growing rapidly. A combination of government policies and a richer, older population should drive demand for diagnostic testing by government hospitals, especially as they need to boost their revenues now that they can no longer charge big mark-ups when selling drugs to patients. In China, 65% of the elderly suffer from at least one chronic disease, up from 50% a decade earlier. We expect diagnostic services to generate 20-25% of hospital revenues by 2020e, up from the current 15%.

Forecasts and catalysts. Yestar is China's leading distributor of Roche diagnostic products and, following a series of acquisitions, it also makes IVD products sold through a sales forces that covers more than 1,000 hospitals. As a result, we estimate Yestar's IVD distribution business to increase at a CAGR of 28% over 2017-19e. This, in turn, should support a revenue CAGR of 18% and an earnings CAGR of 34% for the company over the same period. We are 15% below consensus for 2017e net profit and 12% below for 2018e, based on our higher estimates of the amortization costs arising from acquisitions. Catalysts include stronger-than-expected growth in the IVD industry and further expansion through acquisitions.

Valuation and risks. We initiate coverage with a Buy rating and a target price of HKD4.10, implying 28.1% upside from current levels. The TP is based on a 1 PEG (2017e PE/2017-19e CAGR 34%), implying a 2017e PE of 34x. Our PEG is at a 9% discount to Yestar's historical average of 1.1, given the uncertainties relating to government policies and the declining contribution from the film and imaging business. Downside risks include government policy, faster-than-expected digitalization in the industrial image business, and lower prices for medical devices.

INITIATE AT BUY

TARGET PRICE (HKD)	PREVIOUS TARGET (HKD)
4.10	–

SHARE PRICE (HKD)	UPSIDE/DOWNSIDE
3.20	+28.1%

(as of 25 Oct 2017)

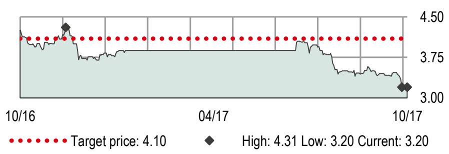
MARKET DATA

Market cap (HKDm)	6,961	Free float	100%
Market cap (USDm)	892	BBG	2393 HK
3m ADTV (USDm)	1	RIC	2393.HK

FINANCIALS AND RATIOS (RMB)

Year to	12/2016a	12/2017e	12/2018e	12/2019e
HSBC EPS	0.09	0.11	0.14	0.19
HSBC EPS (prev)	-	-	-	-
Change (%)	-	-	-	-
Consensus EPS	0.12	0.14	0.17	0.21
PE (x)	29.4	25.8	19.3	14.4
Dividend yield (%)	1.4	1.7	1.8	2.4
EV/EBITDA (x)	11.4	8.4	8.0	5.7
ROE (%)	21.7	19.4	18.2	18.1

52-WEEK PRICE (HKD)



Source: Thomson Reuters IBES, HSBC estimates

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Financials & valuation: Yestar Healthcare Holding

Buy

Financial statements

Year to	12/2016a	12/2017e	12/2018e	12/2019e
Profit & loss summary (RMBm)				
Revenue	3,022	3,640	4,281	5,061
EBITDA	539	647	684	851
Depreciation & amortisation	-93	-87	-81	-76
Operating profit/EBIT	446	560	603	774
Net interest	-63	-67	-64	-54
PBT	384	494	539	720
HSBC PBT	0	0	0	0
Taxation	-114	-168	-183	-245
Net profit	201	230	307	412
HSBC net profit	201	230	307	412
Cash flow summary (RMBm)				
Cash flow from operations	296	483	228	556
Capex	-12	-15	-15	-15
Cash flow from investment	-651	-15	-405	-15
Dividends	77	89	98	134
Change in net debt	866	-715	79	-674
FCF equity	228	408	154	491
Balance sheet summary (RMBm)				
Intangible fixed assets	1,439	1,372	1,310	1,253
Tangible fixed assets	123	118	114	110
Current assets	2,431	3,140	3,073	3,827
Cash & others	1,273	1,788	1,509	1,983
Total assets	4,456	5,094	4,960	5,653
Operating liabilities	1,289	1,493	1,048	1,283
Gross debt	1,949	1,749	1,549	1,349
Net debt	676	-40	40	-634
Shareholders' funds	942	1,423	1,940	2,604
Invested capital	1,430	1,348	1,940	1,924

Ratio, growth and per share analysis

Year to	12/2016a	12/2017e	12/2018e	12/2019e
Y-o-y % change				
Revenue	23.1	20.4	17.6	18.2
EBITDA	48.1	20.0	5.7	24.4
Operating profit	46.0	25.5	7.6	28.5
PBT	37.1	28.6	9.1	33.7
HSBC EPS	14.2	14.2	33.5	34.3
Ratios (%)				
Revenue/IC (x)	2.5	2.6	2.6	2.6
ROIC	30.1	29.8	26.7	28.4
ROE	21.7	19.4	18.2	18.1
ROA	8.2	7.7	7.9	9.6
EBITDA margin	17.8	17.8	16.0	16.8
Operating profit margin	14.8	15.4	14.1	15.3
EBITDA/net interest (x)	8.6	9.7	10.7	15.7
Net debt/equity	71.0	-2.8	2.0	-24.3
Net debt/EBITDA (x)	1.3	-0.1	0.1	-0.7
CF from operations/net debt	43.9		574.7	
Per share data (RMB)				
EPS Rep (diluted)	0.09	0.11	0.14	0.19
HSBC EPS (diluted)	0.09	0.11	0.14	0.19
DPS	0.04	0.04	0.05	0.07
Book value	0.43	0.65	0.89	1.20

Key forecast drivers

Year to	12/2016a	12/2017e	12/2018e	12/2019e
IVD	1,478	2,513	3,266	4,148
Medical film and imaging printing products	1,544	1,127	1,014	913

Valuation data

Year to	12/2016a	12/2017e	12/2018e	12/2019e
EV/sales	2.0	1.5	1.3	1.0
EV/EBITDA	11.4	8.4	8.0	5.7
EV/IC	4.3	4.0	2.8	2.5
PE*	29.4	25.8	19.3	14.4
PB	6.3	4.2	3.1	2.3
FCF yield (%)	4.2	7.5	2.8	9.0
Dividend yield (%)	1.4	1.7	1.8	2.4

* Based on HSBC EPS (diluted)

Issuer information

Share price (HKD)	3.20
Target price (HKD)	4.10
Reuters (Equity)	2393.HK
Bloomberg (Equity)	2393 HK
Market cap (USDm)	892

Free float	100%
Sector	Health Care Providers
Country	Hong Kong
Analyst	Zhijie Zhao
Contact	+852 2996 6591

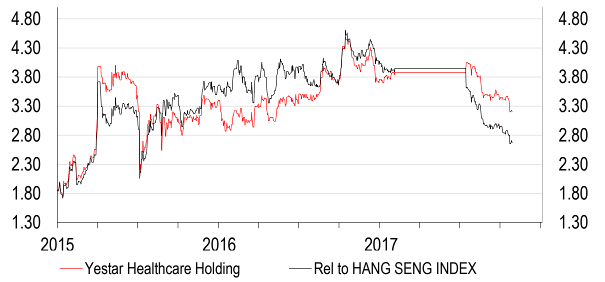
ESG metrics

Environmental Indicators	
GHG Intensity (kg/USD)	n/a
Energy Intensity (kWh/USD)	n/a
CO2 reduction policy	Yes
Social Indicators	
Employee costs as % of sales	n/a
Employee turnover (%)	n/a
Diversity policy	No

Governance Indicators	
No. of board members	8
Average board experience (years)	4
Female board members (%)	25
Board members Independence (%)	25

Source: Company data, HSBC

Price relative



Source: HSBC

Note: Priced at close of 25 Oct 2017

Contents

Investment summary

- A major distributor of Roche Diagnostics products
- Growth fuelled by rising demand for diagnostics and acquisitions
- Initiate at Buy, with a target price of HKD4.10

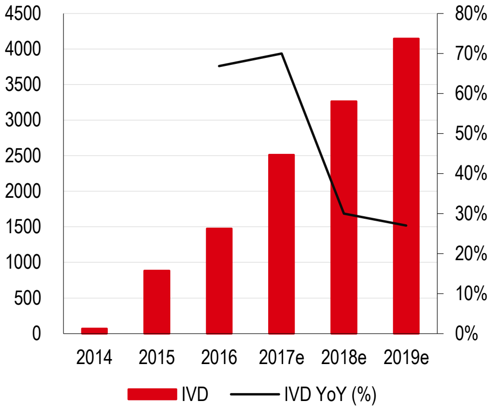
From industrial film producer to IVD distributor

When Yestar was established in 1971, its main business was making photographic paper and industrial imaging products. In 2014, the company made the move into IVD, a fast-growing part of the medical device market, through a series of acquisitions. IVD devices are used to test biological samples such as blood, saliva, and tissue. IVD products include analytical equipment, chemicals and reagents, disposables, and the software that supports the analytical processes in medical laboratories and research facilities.

Yestar is now one of the biggest IVD distributors in China. It is the largest distributor of Roche diagnostic products, a world leader in IVD, which accounts for around 20% of the IVD market in China.

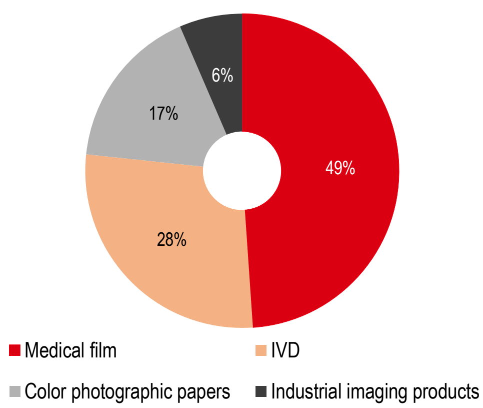
Yestar has three major businesses: (1) the distribution of IVD products; (2) the production and distribution of medical films; and (3) the production and distribution of non-medical films. IVD is now the biggest revenue earner. Over 2012-16, sales of Yestar's medical consumable business – IVD distribution and medical films – increased at a CAGR of 33% to RMB2.3bn, or 77% of total revenue. During this period IVD distribution revenue grew from RMB68m in 2014 to RMB1,478m in 2016, accounting for 49% of group revenue.

Figure 1. Sales ramp-up of Yestar's IVD distribution business



Source: Company data, HSBC estimates

Figure 2. IVD distribution of Yestar accounted for 49% revenue in 2016



Source: Company data, HSBC

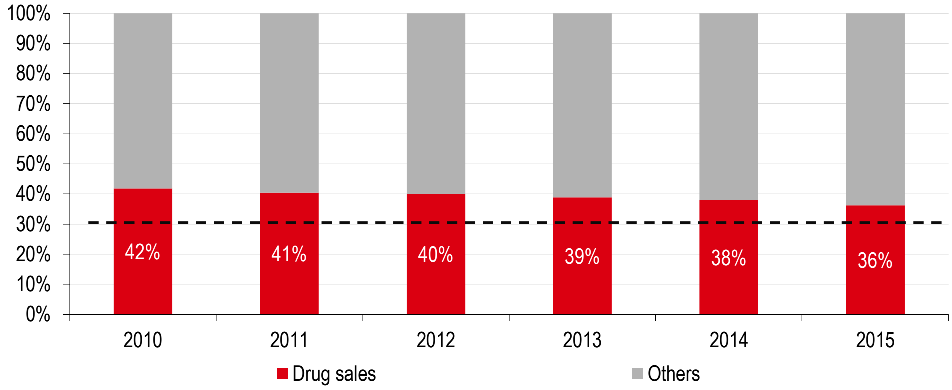
Meanwhile, the manufacture and distribution of industrial film remains a "cash cow". Yestar has a 55% share of the colour photographic papers market and a 37.3% share in industrial imaging products. With limited capital expenditure requirements and a light debt burden, this part of the business ensures stable cash flow for the company, even though the industry has limited growth potential.

A beneficiary of Chinese medical reform

The importance of government policy should not be underestimated in China's pharma market. Selling drugs to patients at a large mark-up used to account for up to 50% of hospital revenues. The regulator is in the process of reducing the cost of drugs for patients and has introduced a "zero mark-up" policy. This, along with other efforts to control the cost of drugs and increase the pay of doctors, is making hospitals change their revenue mix.

Drug sales from their pharmacies used to account for more than 40% of total revenue in top tier hospitals. The government wants this to fall to 30% by 2020. This means that hospitals are looking to generate revenues from other sources and we think diagnostic services such as IVD will be among the beneficiaries as China's population is ageing and fast food, smoking, and pollution have caused a rise in cancers, chronic heart and lung diseases, and diabetes. See *China Pharmaceuticals: 2H17 outlook,* 9 August, for more details about medical reform.

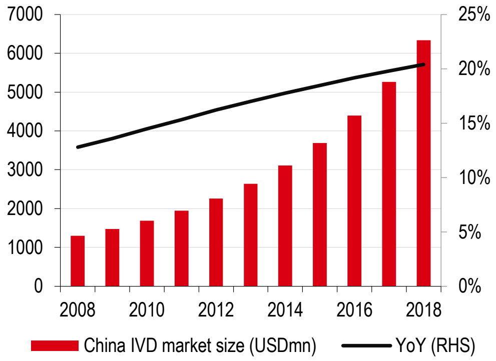
Figure 3. Share of drug sales is declining in hospitals



Source: NHFPC, HSBC

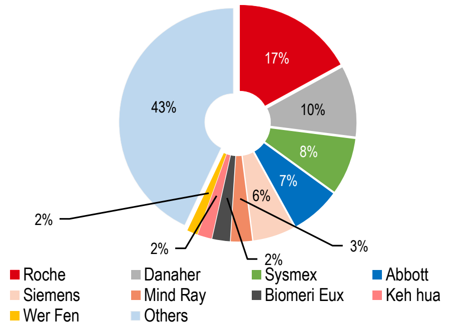
We think diagnostic services may jump from 15% to 20-25% of public hospitals' revenue mix by 2020. As IVD is the biggest sub-sector of the diagnostic industry, Yestar is well-positioned to grow its business as it controls around 15% of Roche's distribution network, which is the largest in China. We expect revenue from Yestar's IVD distribution business to increase at a CAGR of 28% over 2017-19e.

Figure 4. Growth of China's IVD market will accelerate in 2015-20e



Source: Roche, HSBC

Figure 5. Roche is the largest diagnostic solution provider in China



Source: Company data, HSBC

Expansion through acquisitions

Yestar broke into the IVD distribution industry through a series of acquisitions. Between 2014 and 2016 it acquired five companies to consolidate the market in southern China. In 2017, it bought Beijing Kaihongda to expand into the Beijing and Inner Mongolia market. By 1H17, Yestar's sales network covered more than 1,000 public hospitals in nine provinces. Roche is now Yestar's biggest client, contributing more than 90% of the revenue generated by its IVD distribution business.

When completing the deals, the acquired companies committed to guaranteeing a certain level of profit for three years. Failure to meet the guaranteed profit target will result in cash compensation to Yestar. Yestar acquired 70% of the shares of these companies and committed to purchasing the remaining 30% once the three-year period of profit guarantees is completed.

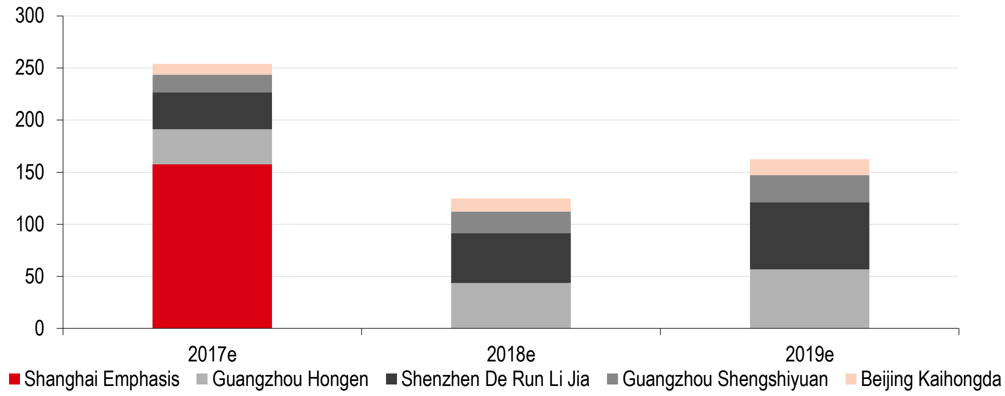
Table 1. Yestar built up its sales network through acquisitions

Company	Brands	Operational area	# Hospitals/clinics	Acquired time
Jiangsu Uno	Roche, Becton Dickinson	Jiangsu & Anhui	330	14-Nov
Shanghai Emphasis	Roche, ThermoFisher	Shanghai	258	15-Aug
Guangzhou Hongen	Roche	Guangdong, Fujian, Hainan, Hunan	291	16-Oct
Guangzhou Shengshiyuan	Roche, Sekisui, Luminex	Guangdong, Hainan	116	16-Oct
Shenzhen De Run Li Jia	Roche	Shenzhen	47	16-Nov
Beijing Kaihongda	Roche	Beijing, Inner Mongolia	NA*	17-Sep

*Not yet disclosed.
Source: Yestar, HSBC

We expect Yestar to continue extending its distribution coverage through acquisitions. We believe that the delivery of these guaranteed profits and the low turnover rate of senior management in the acquired companies shows that Yestar can successfully consolidate new assets gained through acquisition.

Figure 6. Total profit guarantee of recent acquisitions over 2017-19e (RMBm)



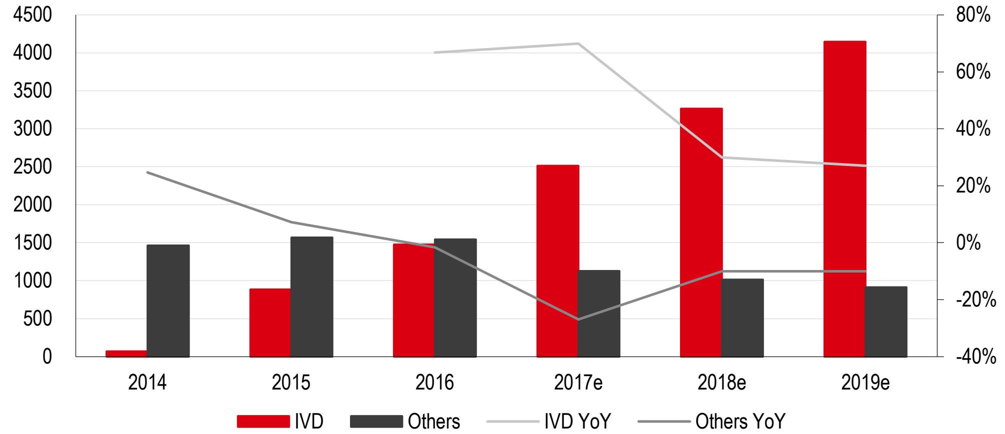
Source: Company data, HSBC estimates

Financial analysis

We forecast that Yestar's revenue will grow 20%, 18%, and 18% y-o-y over 2017-19e, respectively, led by the expansion of the IVD business, which we think will grow at a CAGR of 28% during the period. We expect the IVD business to account for 82% of total revenue by 2019e, up from 49% in 2016.

- **IVD:** The business is well placed to benefit from sector growth and further acquisitions. We expect IVD revenue to reach RMB2.5bn in 2017e, RMB3.3bn in 2018e, and RMB4.1bn in 2019e.
- **Non-IVD:** This part of the business includes medical film and imaging printing products. As a result of digitalization, we expect sales to decline 27% y-o-y in 2017e and 10% y-o-y over 2018-19e.

Figure 7. Yestar revenue breakdown (RMBm)



Source: Company data, HSBC estimates

As the IVD business expands, profitability should rise too. The operating margin of medical consumables is 15.1% as of 2016, vs. 6.8% for the non-medical film production business. Although rising amortization expenses generated by acquisitions may weigh on the profitability of the IVD business, we still expect the net profit of this segment to grow by more than 40% y-o-y on average over 2017-19e, driving an earnings CAGR of 21%.

Table 2. Yestar income statement

(RMBm)	2013	2014	2015	2016	2017e	2018e	2019e
Revenue	1,173	1,531	2,455	3,022	3,640	4,281	5,061
y-o-y	23%	31%	60%	23%	20%	18%	18%
IVD		68	886	1,478	2,513	3,266	4,148
Non-IVD	1,173	1,463	1,569	1,544	1,127	1,014	913
COGS	(964)	(1,268)	(1,937)	(2,255)	(2,632)	(3,050)	(3,553)
Gross profit	209	263	517	766	1007	1231	1508
y-o-y	25%	26%	96%	48%	31%	22%	23%
GP margin	18%	17%	21%	25%	28%	29%	30%
Selling and distribution costs	(52)	(57)	(83)	(117)	(146)	(214)	(278)
y-o-y	6%	9%	46%	40%	25%	47%	30%
Administrative expenses	(63)	(59)	(142)	(227)	(328)	(415)	(456)
y-o-y	53%	-7%	142%	60%	45%	27%	10%
Finance costs	(6)	(6)	(26)	(63)	(67)	(64)	(54)
y-o-y							
Other income and gains	7	11	21	31	35	10	10
Other expenses	(2)	(6)	(7)	(8)	(9)	(9)	(10)
Income tax expense	(28)	(44)	(81)	(114)	(168)	(183)	(245)
Profit for the year	65	104	199	270	326	356	475
y-o-y	13%	58%	92%	36%	21%	9%	34%
Net margin	6%	7%	8%	9%	9%	8%	9%
Non-controlling interests	(0)	(3)	(36)	(69)	(96)	(49)	(64)
% of Non-controlling interests	0%	3%	22%	34%	42%	16%	15%
Net profit to the shareholders	65	101	163	201	230	307	412
y-o-y	15%	55%	61%	24%	14%	34%	34%

Source: HSBC estimates

We are 15%, 12%, and 2% below consensus for net profit over 2017-19e based on our estimates of the amortization costs arising from acquisitions. We are more conservative on 2017-18e revenue for the industrial film production and distribution business due to the digitalization of the photographic industry. Our overall revenue estimates are slightly above consensus in 2019e due to rising diagnostic demand and growing synergies from acquisitions.

Table 3. HSBC estimates vs. Consensus

(RMBm)	2017e	2018e	2019e
HSBC revenue	3,639.6	4,280.7	5,061.2
Consensus	3,918	4390	4925
Difference	-7.1%	-2.5%	2.8%
HSBC net profit	229.6	306.6	411.7
Consensus	269.7	346.7	418.7
Difference	-14.9%	-11.6%	-1.7%

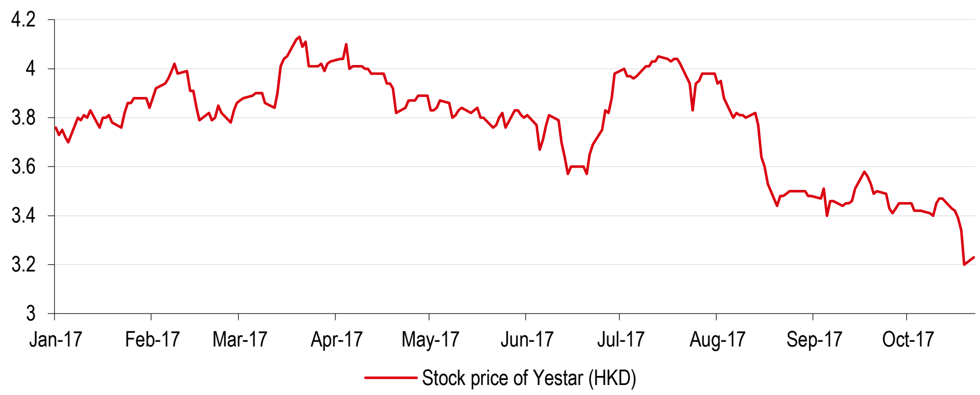
Source: Bloomberg, HSBC estimates

Valuation

Yestar has underperformed the HKSI this year, with its stock price declining from HKD4.10 to HKD3.20. We attribute this to: (1) higher-than-expected amortization costs reported in the 2017 interim results; (2) concern about the decline in the industrial film manufacturing business; and (3) the implementation of the two-invoice system for medical consumables. This system involves the issuing of the manufacturer's invoice to the distributor followed by the distributor's invoice to the end customer (the hospital). The aim is to improve transparency in drug prices and eliminate excessive profit margins associated with multi-tier distribution models. We think that the concerns are overdone as the introduction of the two-invoice system will take time to implement in the medical consumables distribution business. The higher priority is the drug distribution industry.

We believe that current price (0.9x PEG with 34x 2017e PE and 34% 2017-19e CAGR) prices in the amortization costs and the potential decline in the industrial film manufacturing business, but does not take into account the strong growth in the IVD business.

Figure 8. Yestar stock price chart



Source: Bloomberg, HSBC

We initiate coverage with a Buy rating and a target price of HKD4.10, implying 28.1% upside from the 25 October closing price of HKD3.2. The target price is based on a 1 PEG (2017e PE/2017-19e CAGR of 34%), implying a 2017e PE of 34x. Our PEG is at a 9% discount to Yestar's historical average PEG of 1.1, given the uncertainties related to medical consumables cost control and the declining contribution from industrial film production.

Catalysts: Stronger-than-expected IVD industry growth and faster-than-expected market expansion through acquisitions.

Key downside risks

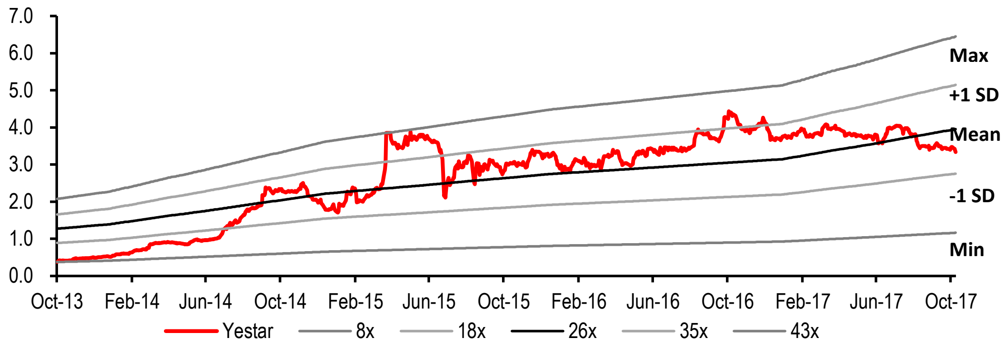
Control of medical device expenditure: By 1H17, more than 10 provinces had implemented or partially implemented tenders for medical consumables. Based on what has happened with national drug tenders, we expect policy makers to focus on circulating tender information across the country and cut tender prices by benchmarking the lowest national prices. However, we see this as a longer-term issue as the control of drug costs is the priority for both the government and public hospitals.

Implementation of two-invoice system: To simplify the drug distribution process and to reduce the mark-up of retail prices, the government has launched the two-invoice system, permitting the issuance of only two invoices along the supply chain from drug manufacture to hospitals or to the retailer. A secondary distribution business, or the issuance of a third invoice, is therefore illegal, see *2H17 outlook: In the midst of recovery*, 9 August, 2017 for more details. Again, we see this as a long-term risk, as the government will focus on the drug distribution industry in 2018-19e. A policy move such as this is likely to favour distributors like Yestar because they have a comprehensive sales network and strong logistical support relative to smaller operators.

Faster-than-expected digitization: We expect flat growth for imaging products. If the digitization is faster than expected, this part of the business will face negative growth over the next few years.

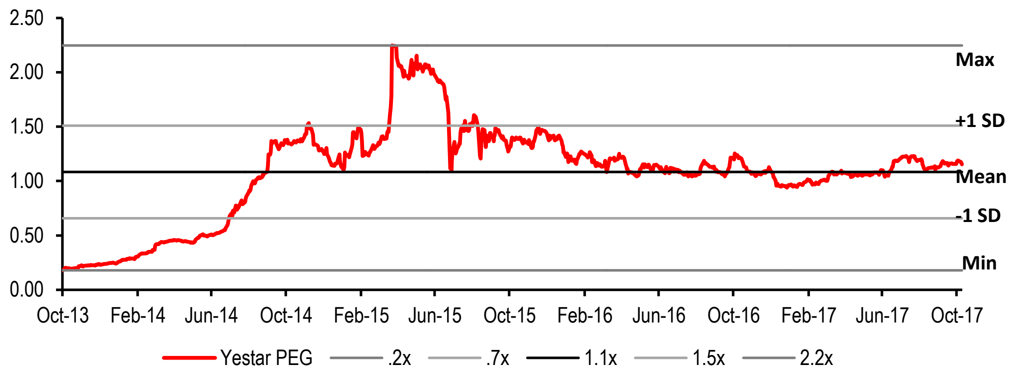
Customer concentration risk: Sales of Roche's diagnostic and IVD products contributed more than 90% of Yestar's revenue in 2016, which suggests that any potential conflict with Roche or loss of Roche's competitive positioning in IVD products could result in risk to IVD revenue. While we raise cooperation with Roche as a potential risk, it could also be viewed as an opportunity as Yestar may further expand its market share while helping Roche consolidate its fragmented distribution network. With more than 100 distributors on hand, it is also in Roche's interest to encourage acquisition between distributors to build up a more organized sales network.

Figure 9. Yestar PE band



Source: Wind

Figure 10. Yestar PEG band



Source: Wind

Financial analysis, valuation, and risks

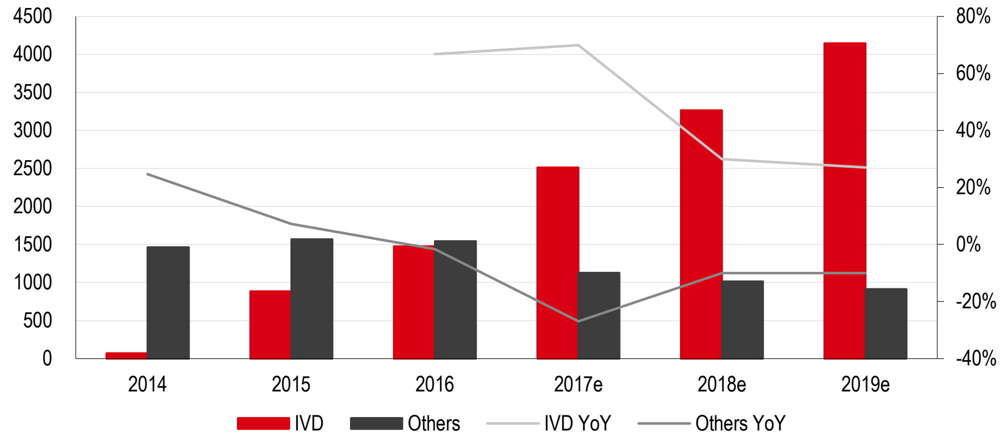
Earnings forecasts

Revenue

We forecast revenue of RMB3.6bn in 2017e, RMB4.3bn in 2018e, and RMB5.1bn in 2019e, a three-year CAGR of 17%. The revenue split is as follows:

- **IVD:** Generated 49% of revenue in 2016. We expect the IVD business to grow at a CAGR of 27% over 2017-19e. We expect revenue from IVD to reach RMB2.5bn in 2017e, RMB3.3bn in 2018e, and RMB4.1bn in 2019e.
- **Non-IVD:** We expect sales to decline 27% y-o-y in 2017e and 10% y-o-y for 2018-19e.

Figure 11. Yestar revenue breakdown (RMBm)



Source: Company data, HSBC estimates

Table 4. Revenue forecasts

Revenue breakdown (RMBm)	2013	2014	2015	2016	2017e	2018e	2019e
IVD		68	886	1,478	2,513	3,266	4,148
y-o-y			1,198%	67%	70%	30%	27%
Non-IVD (Medical film and imaging printing products)	1,173	1,463	1,569	1,544	1,127	1,014	913
y-o-y	23%	25%	7%	-2%	-27%	-10%	-10%
Medical film	474	653	773	839			
y-o-y	61%	38%	18%	9%			
Imaging printing products	699	810	796	704			
y-o-y	6%	16%	-2%	-11%			
Total revenue	**1173**	**1531**	**2455**	**3022**	**3640**	**4281**	**5061**
y-o-y	**23%**	**31%**	**60%**	**23%**	**20%**	**18%**	**18%**

Source: HSBC estimates

Table 5. IVD profit breakdown

Company	2014	2015	2016	2017e	2018e	2019e
Jiangsu Uno	45	54	64	76.8	96.0	120.0
y-o-y		20%	19%	20%	25%	25%
Shanghai Emphasis		156	187	225	281.3	351.6
y-o-y			20%	20%	25%	25%
Guangzhou Hongen				48	62.4	81.1
y-o-y					30%	30%
Shenzhen De Run Li Jia				51	68	92
y-o-y					33%	35%
Guangzhou Shengshi-yuan				23.8	29.8	37.2
y-o-y					25%	25%
Beijing Kaihong				2.5	18	21.6
y-o-y					0%	20%
Total	45.0	210.0	251.0	427.1	555.5	703.5
y-o-y		367%	20%	70%	30%	27%

Source: Company data, HSBC estimate

Table 6. HSBC estimates vs. Consensus

(RMBm)	2016e	2017e	2018e
HSBC revenue	3,639.6	4,280.7	5,061.2
Consensus	3,918	4,390	4,925
Difference	-7.1%	-2.5%	2.8%
HSBC net profit	231.5	314.7	419.0
Consensus	269.7	346.7	418.7
Difference	-14.2%	-9.2%	0.1%

Source: Bloomberg, HSBC estimates

Margin analysis

The growth in the higher-margin IVD business will be offset by flat numbers from its imaging business. We expect Yestar's gross margin to increase to 29% in 2019e from 25% in 2017e.

We expect to see higher SG&A costs due to intense marketing activities as Yestar focuses on expanding into new provinces over the next few years. Financial costs may also be higher due to more loans for funding acquisitions. We expect the net margin over 2016-18e to increase slightly to 7.9% from 6.7% in 2016.

Table 7. IVD Amortization estimates (HKDm)

Company	Acquisition date	2014	2015	2016	2017e	2018e	2019e
Jiangsu Uno	Nov-14	4	16	16	23	23	23
Shanghai Emphasis	Aug-15		25	61	61	87	87
Guangzhou Hongen	Jan-17				22	22	22
Shenzhen De Run Li Jia	Jan-17				29	29	29
Guangzhou Shengshi-yuan	Feb-17				10	11	11
Beijing Kaihong	Sep-17				1	7	7
Total		4.1	41.6	77.0	146.3	179.1	179.1

Source: Company data, HSBC estimates

Table 8. Earnings forecasts

(RMBm)	2013	2014	2015	2016	2017e	2018e	2019e
Revenue	1173.3	1531.4	2454.7	3021.8	3639.6	4280.7	5061.2
y-o-y	23%	31%	60%	23%	20%	18%	18%
Gross profit	209.4	263.5	517.4	766.3	1007.4	1231.2	1508.4
y-o-y	25%	26%	96%	48%	31%	22%	23%
GP margin	18%	17%	21%	25%	28%	29%	30%
Selling and distribution costs	(52.4)	(57.0)	(83.4)	(116.8)	(145.6)	(214.0)	(278.4)
y-o-y	6%	9%	46%	40%	25%	47%	30%
Administrative expenses	(62.9)	(58.7)	(141.9)	(226.6)	(345.8)	(428.1)	(480.8)
y-o-y	53%	-7%	142%	60%	53%	24%	12%
Finance costs	(5.8)	(5.7)	(25.7)	(62.6)	(74.2)	(70.6)	(59.6)
y-o-y							
Profit for the fear	65.3	103.5	198.5	269.9	327.6	363.6	482.7
y-o-y	13%	58%	92%	36%	21%	11%	33%
Net margin	6%	7%	8%	9%	9%	8%	10%
Non-controlling interests	(0.3)	(2.6)	(35.8)	(68.9)	(96.2)	(48.9)	(63.7)
% of Non-controlling interests	0%	3%	22%	34%	42%	16%	15%
Net profit to the shareholders	65.1	100.9	162.8	201.0	231.5	314.7	419.0
y-o-y	15%	55%	61%	24%	15%	36%	33%

Source: Company data, HSBC estimates

Cash flow statement and balance sheet

The company borrowed USD200m in September 2016 at an annual interest rate of 6.9%, which increased company cash level to RMB1.7bn in 2017e. We expect Yestar to be in a net debt position in 2017-18e and to return to a net cash position in 2019e. The inventory days will increase to 77 from 74 and account receivable days will decrease to 80 from 85 in 2017e, as the company is trying to clear up the stock in its sales channel.

We expect investment outflows to be RMB16.2m in 2017e, RMB405.2m in 2017e, and RMB15.2m in 2019e, which will cause fluctuations in cash and cash equivalents. This is due to the company buying back the remaining 30% of shares in Shanghai Emphasis. In April 2015, Yestar acquired 70% of Shanghai Emphasis for HKD1,155.7m and promised to buy the remaining shares for HKD390m in 2018. We have factored in RMB390m of cash outflows for investing activities in 2018e.

Table 9. Cash flow and balance sheet analysis

(RMBm)	2013	2014	2015	2016	2017e	2018e	2019e
Cash and cash equivalents	283	195	506	1273	1459	1000	1258
Borrowings	117	106	420	1684	1484	1284	1084
Net debt/equity	-48%	-27%	-9%	43%	2%	18%	-9%
Operating cash flow	36	113	165	296	483	228	556

Source: HSBC estimates

Valuation

2393 HK – Buy, target price RMB4.10

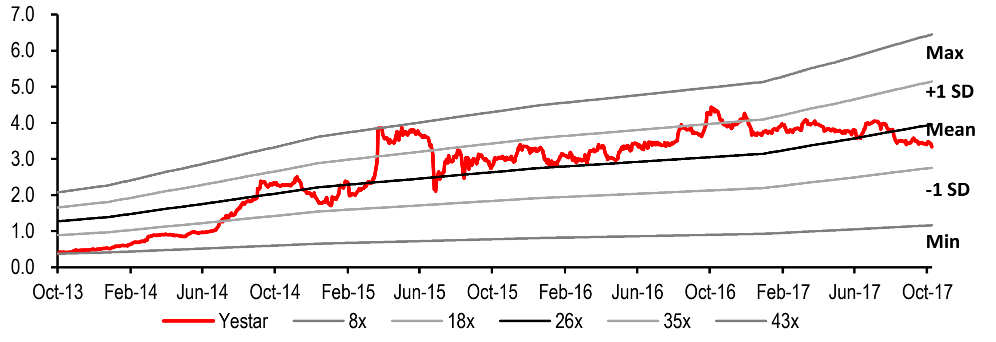
We initiate coverage with a Buy rating and a target price of HKD4.10, implying 28.1% upside from the 25 October closing price of HKD3.20. The target price is based on a 1 PEG (2017e PE/2017-19e CAGR), implying a 2017e PE of 34x. Our PEG is at a 9% discount to Yestar's historical average PEG of 1.1 and 33% below comparable PEG of 1.5, given the declining contribution from the film production business. Catalysts: Stronger-than-expected IVD growth and new acquisitions.

Table 10. Comp table of Yestar

Wind code	Company	Rating	Target price (lcy)	Upside/ Downside (%)	Mkt cap (USDm)	Current price (lcy)	Turnover (USDm)	PE (x) 2017e	PE (x) 2018e	PE (x) 2019e	EPS 2017e	EPS 2018e	EPS 2019e	CAGR	PEG 17ePE/2017-19CAGR	PB (x) 2017e	ROE (%) 2017e
2393.HK	Yestar	Buy	4.1	28%	892.3	3.2	0.9	25.8	19.3	14.4	0.11	0.14	0.19	31.4	0.8	4.2	19.4
1612.HK	Vincent Med	Not Rated	n/a	n/a	70.3	0.9	0.0	15.6	13.4	11.6	0.06	0.06	0.07	16.0	1.0	1.4	8.5
1302.HK	Lifetech	Not Rated	n/a	n/a	1082.2	2.0	2.0	41.5	41.5	33.2	0.04	0.04	0.05	11.8	3.5	n/a	17.8
1358.HK	PW Medtech	Not Rated	n/a	n/a	337.8	1.7	0.6	8.9	8.4	7.5	0.16	0.17	0.19	9.0	1.0	0.9	10.0
3600.HK	Modern Dental	Not Rated	n/a	n/a	301.2	2.4	0.1	12.8	10.7	9.1	0.18	0.22	0.26	18.5	0.7	1.2	10.1
853.HK	Microport	Not Rated	n/a	n/a	1475.2	7.9	1.8	36.3	24.8	21.2	0.03	0.04	0.05	30.9	1.2	4.0	11.3
Average								23.0	19.8	16.5	0.09	0.11	0.12	17.2	1.5	1.9	11.6

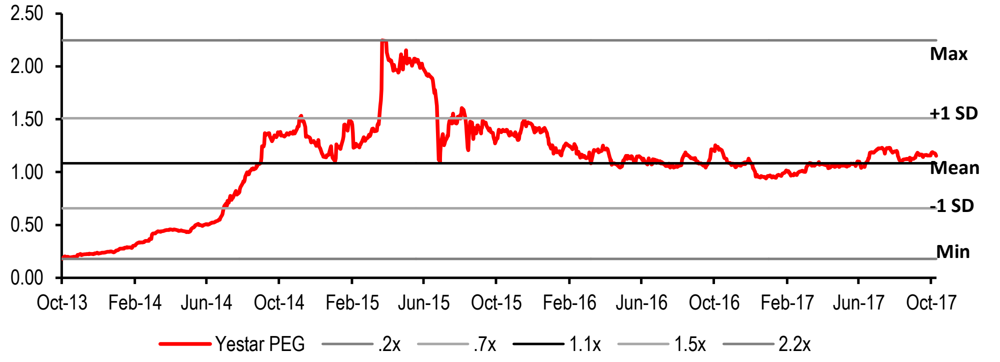
Note: Priced as of market close on 25 October 2017.
Source: Wind, HSBC estimates

Figure 12. Yestar PE band



Source: Wind

Figure 13. Yestar PEG band



Source: Wind

DCF model

We use DCF as a cross-check to our primary valuation methodology. Our DCF-based model suggests a fair value of HKD4.20. Our key assumptions are: a WACC of 5.1%, a risk-free rate of 2.5%, and an equity risk premium of 6% based on HSBC estimates; our equity beta of 0.51 is based on Bloomberg, and a terminal growth rate of 3%.

Our DCF-based fair value of HKD4.2 is in line with our PEG-based target price of HKD4.10.

Table 11. Free cash flow assumptions

(RMBm)	2014	2015	2016	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e
Free Cash flow	91	125	291	475	218	546	340	353	367	334	342

Source: HSBC estimates

Table 12. DCF assumptions

Assumptions	
Risk-free rate	2.5%
Equity risk premium	6.0%
Beta	0.51
Cost of equity	4.9%
Taxation	34%
Cost of debt	7.0%
Cost of debt after tax	5%
Target debt ratio	70%
% equity	30%
WACC	5.1%

Source: HSBC estimates

Risks

Control of medical device expenditure: By 1H17, more than 10 provinces had implemented or partially implemented tenders for medical consumables. Based on what has happened with national drug tenders, we expect policy makers to focus on circulating tender information across the country and cut tender prices by benchmarking the lowest national prices. However, we see this as a longer-term issue as the control of drug costs is the priority for both the government and public hospitals.

Implementation of two-invoice system: To simplify the drug distribution process and to reduce the mark-up of retail prices, the government has launched the two-invoice system, permitting the issuance of only two invoices along the supply chain from drug manufacture to hospitals or to the retailer. A secondary distribution business, or the issuance of a third invoice, is therefore illegal. Again, we see this a long-term risk, as the government will focus on the drug distribution industry in 2018-19e.

Faster-than-expected digitization: We expect flat growth for imaging products. If the digitization is faster than expected, this part of the business will face negative growth over the next few years.

Customer concentration risk: Sales of Roche's diagnostic and IVD products contributed more than 90% of Yestar's revenue in 2016, which suggests that any potential conflict with Roche or loss of Roche's competitive positioning in IVD products could result in risk to IVD revenue. While we raise cooperation with Roche as a potential risk, it could also be viewed as an opportunity as Yestar may further expand its market share while helping Roche consolidate its fragmented distribution network. With more than 100 distributors on hand, it is also in Roche's interest to encourage acquisition between distributors to build up a more organized sales network.

Industry outlook

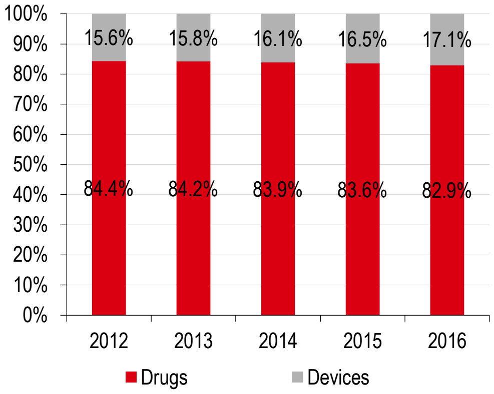
- Zero mark-up policies and drug cost controls will accelerate the growth of China's IVD industry
- An ageing population should boost diagnostic demand
- The control of medical device expenditure is a long-term concern

A beneficiary of drug cost control policies

China's medical device sector is still relatively undeveloped compared to the pharmaceutical industry. It's about 20% of the size of the pharma market in China, much smaller than in other parts of the world where the ratio is between 50% and 100%. This is partly because hospitals in China have long relied on drug sales to generate revenue. In the 1990s, revenue from pharmacies accounted for more than 50% of the revenue of public hospitals. Consequently, medical services such as surgery, in-patient care, and diagnostic services were significantly undervalued.

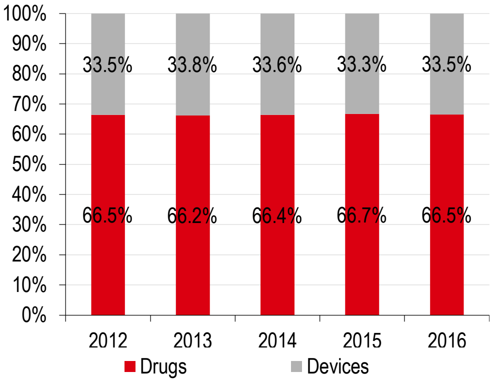
As discussed earlier, the government wants to cut the price of drugs paid by patients. The mark-up between ex-factory drug prices and hospital prices has been cut to zero, and the proportion of hospital revenue from drugs has been capped at 30% (see *China Pharmaceutical: Spring is in the air*, 8 March). By the end of 2017, all major hospitals should have complied with the zero mark-up policy and the share of drug sales will decrease to 30% in every public medical institution across the country.

Figure 14. China drug sales vs. device sales



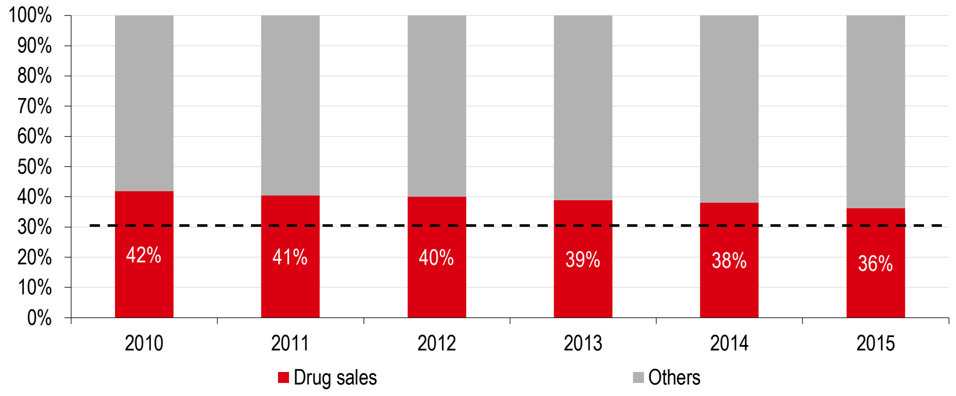
Source: MIIT, HSBC

Figure 15. Global drug sales vs. device sales



Source: EvaluateMedTech, HSBC

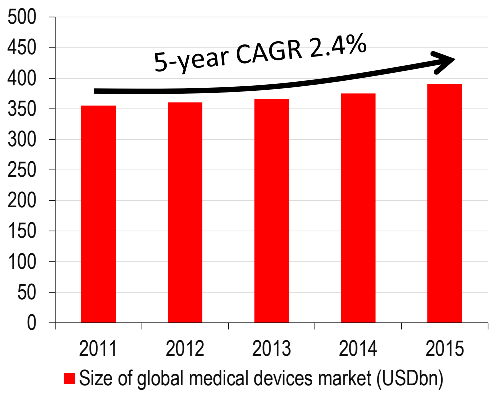
Figure 16. Breakdown of income at Chinese public hospitals



Source: NHFPC, HSBC

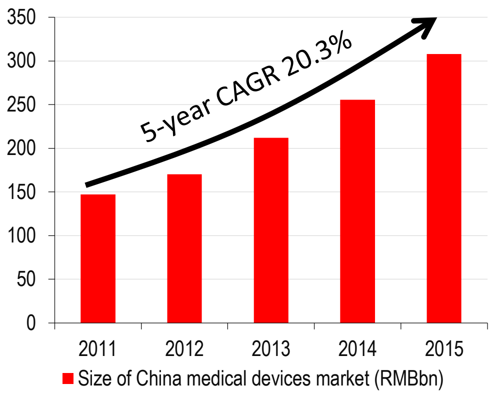
This presents opportunities for medical device businesses. To compensate for losses in drug sales, hospitals need to promote their medical services. From 2011 to 2015, China's IVD industry grew at a CAGR of 20%, ten times the rate of global IVD growth. We expect this boom to continue as part of the process of rebalancing hospital revenue mix. We expect the contribution of medical services – including surgery, inpatient care, and diagnosis – to increase to 15% from 20% at present.

Figure 17. Growth of global medical device industry



Source: HSBC

Figure 18. Growth of China medical device industry



Source: HSBC

The rise of China's IVD industry

In-vitro diagnosis is the biggest sub-sector in the medical device industry. IVD devices are used in tests that can detect diseases, conditions, or infections by collecting and examining specimens taken from the human body. IVD products include reagents, medical consumables and machines. Although IVD-related expenditure accounts for only 2% total healthcare spending, it can affect more than 60% of clinical decisions made. Among seven available diagnostic measurements, chemical diagnosis, immunodiagnosis and molecular diagnosis are the most popular.

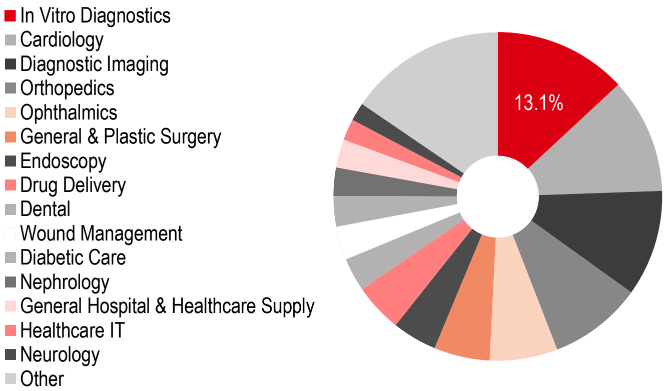
Table 13. Classification of IVD devices by test methodology

Technology	Methodology	Examples
Clinical Chemistry	Demonstrating the presence of physiologically significant substances in the blood, urine, tissue and body fluids with application to the diagnosis of disease and therapy selection.	General chemistry analyser Urine analyser Blood gas analyser
Culture	Detecting and quantifying bacteria related to microbial infections in urine, blood and other body fluids.	Solid culture Liquid culture
Flow Cytometry	Making, processing, and displaying one or more measurements on individual cells obtained from a cell suspension.	Flow cytometers
Glucose Strip Monitoring	Self-evaluating whole blood glucose levels outside the clinical laboratory using a POC device.	POC Glucometer
Immunoassay	Matching antibody-antigen response to indicate the presence or level of a protein, frequently used in point-of-care (POC) testing and blood banking.	ELISA Lateral flow
Mass Spectrometry	Determining the identity of a chemical based on its mass using mass analysers/mass spectrometers.	MALDI-TOF MS LC/MS GS/MS TOF LC/MS
Molecular Diagnostics	Examining nucleic genetic material (DNA/RNA) for sequences that may indicate a presence or susceptibility to disease.	PCR/qPCR Sanger NGS
Tissue Diagnostics	Examining prepared and stained tissue or cells by a pathologist.	IHC ISH

Source: DeciBio, HSBC

The global IVD market was valued at USD48.4bn in 2015. Ageing populations, increased incidence of chronic diseases, and growth of targeted therapies points to sustainable growth. Based on estimates by EvaluateMedTech the CAGR of the global IVD industry will be 5.6% for 2015-22. A few multinational giants, including Roche, Abbott, Danaher, Siemens, and Thermo Fisher, dominate the industry, holding a combined market share of more than 50%.

Figure 19. IVD is the biggest sub sector of the medical device industry

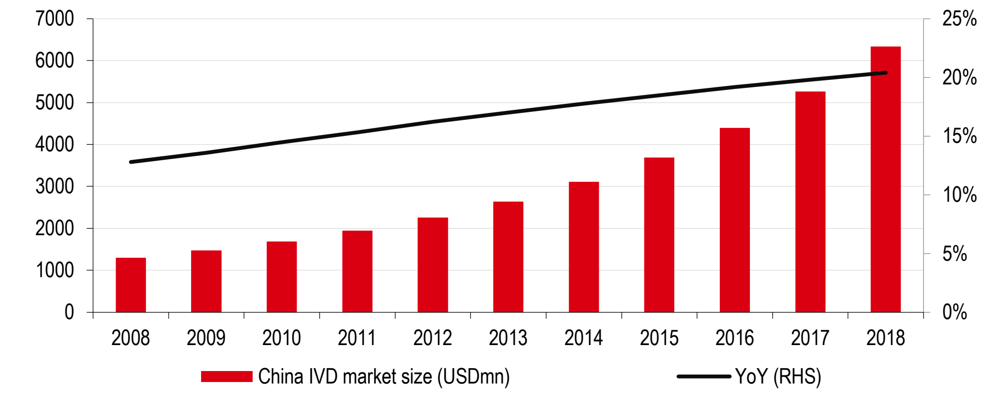


Source: EvaluateMedTech World Preview 2016, HSBC

China's IVD market

China's domestic IVD market reached USD3.7bn in 2015, accounting for less than 10% of the global market. Although still relatively small, the industry has been growing at around a CAGR of 15% over the past decade due to higher medical expenditure per person and a rapidly ageing population. We see the implementation of cost control policies and robust growth in the number of patients as the two key drivers.

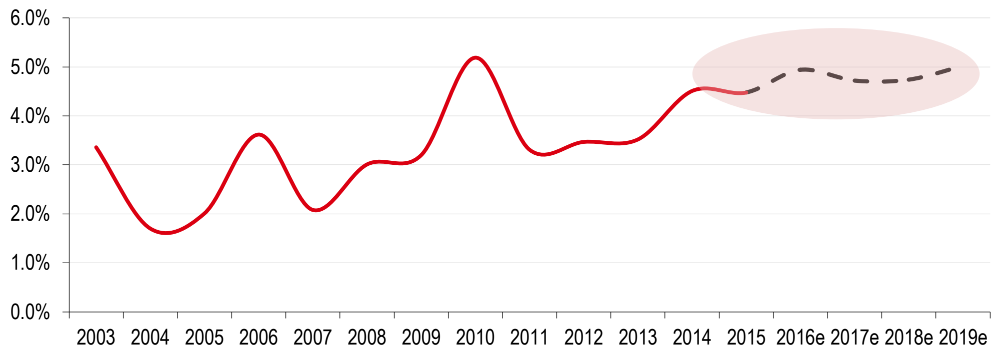
Figure 20. Growth in China's IVD industry is accelerating



Source: Blue paper book of China IVD development, HSBC

According to China's National Health and Family Planning Commission (NHFPC), the growth rate of the ageing population (people aged over 65) increased from 3.5% in 2013 to 4.5% 2014. The proportion of this group rose from 9.1% of the population in 2011 to 10.5% in 2015. People are getting richer as well as older, so the greying population will support robust growth in inpatient numbers over the next 5-10 years. The market for chronic disease is an area of particularly strong growth – according to the NHFPC, 65% of elderly people suffer from at least one chronic disease, up from 50% a decade earlier.

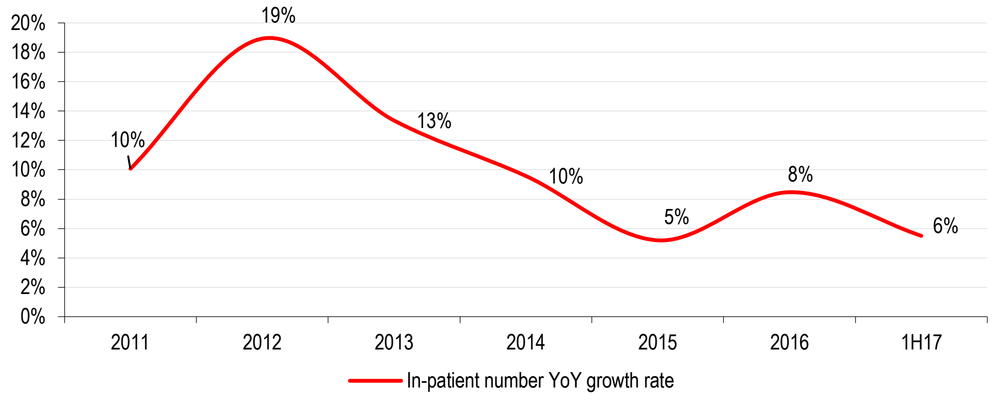
Figure 21. Growth rate of aged population



Source: HSBC estimates

The most recent NHFPC statistics support this view. In 2016, in-patient numbers rose 8% y-o-y, up from 5% in 2015. After a year of high growth, 1H17 in-patient growth remains robust at 6% y-o-y. Growth in the number of patients in first and second tier urban hospitals outpaced the rest as medical resources are more concentrated in these cities. In 1H17, we travelled to seven provinces and cities – Sichuan, Chongqing, Hunan, Hubei, Jiangsu, Shanghai, and Zhejiang – to interview doctors, and the anecdotal evidence confirmed that patient numbers are on the rise.

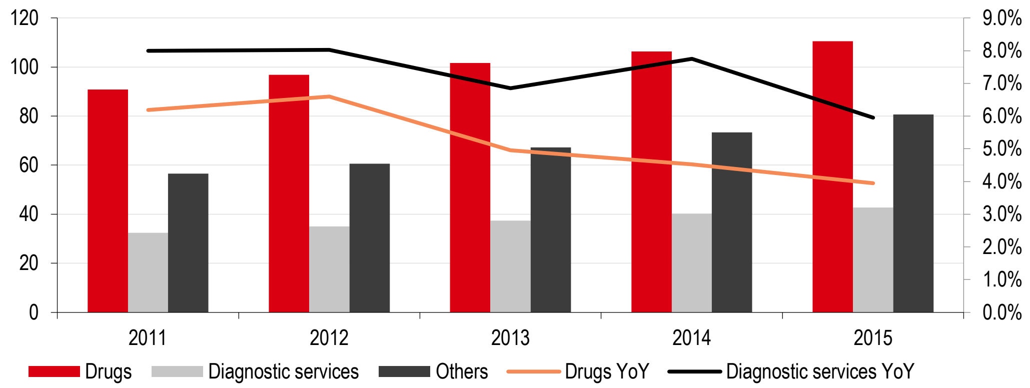
Figure 22. In-patient growth is starting to rebound after a year of high growth



Source: NHFPC, HSBC

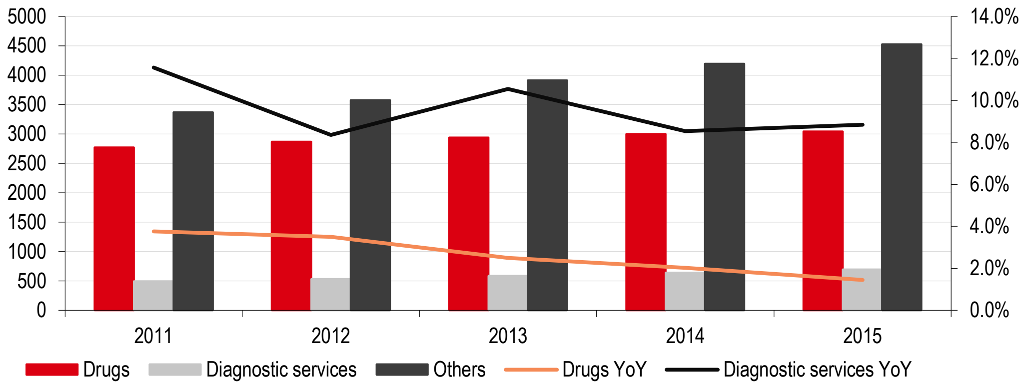
As mentioned earlier, drug cost control policies may also help boost diagnostic demand. Diagnostic departments currently contribute around 15% of hospital revenues. This varies in different parts of the country. It can be lower in the north, where implementation of cost control has been slower than in the south of the country. For example, in Shenzhen the revenue share of the diagnostic department has climbed to 30%. As public hospitals have to cut the share of drug sales to 30% of total revenue, we expect hospitals in the north to catch up. Overall, we think the national average will rise 20-25%.

Figure 23. Breakdown of out-patient expenditure per capita



Source: NHFPC, HSBC

Figure 24. Breakdown of in-patient expenditure per capita



Source: NHFPC, HSBC

Long-term concerns

Despite potential gains from drug cost control policies, we also see potential threats from the two-invoice system and the control of diagnostic expenditure. Initiated by the State Council in 2016, the system requires the issuance of only two invoices along the supply chain from drug manufacturers to hospitals, banning secondary distributors. The implication is that only distributors with a comprehensive sales network and strong logistical support can survive.

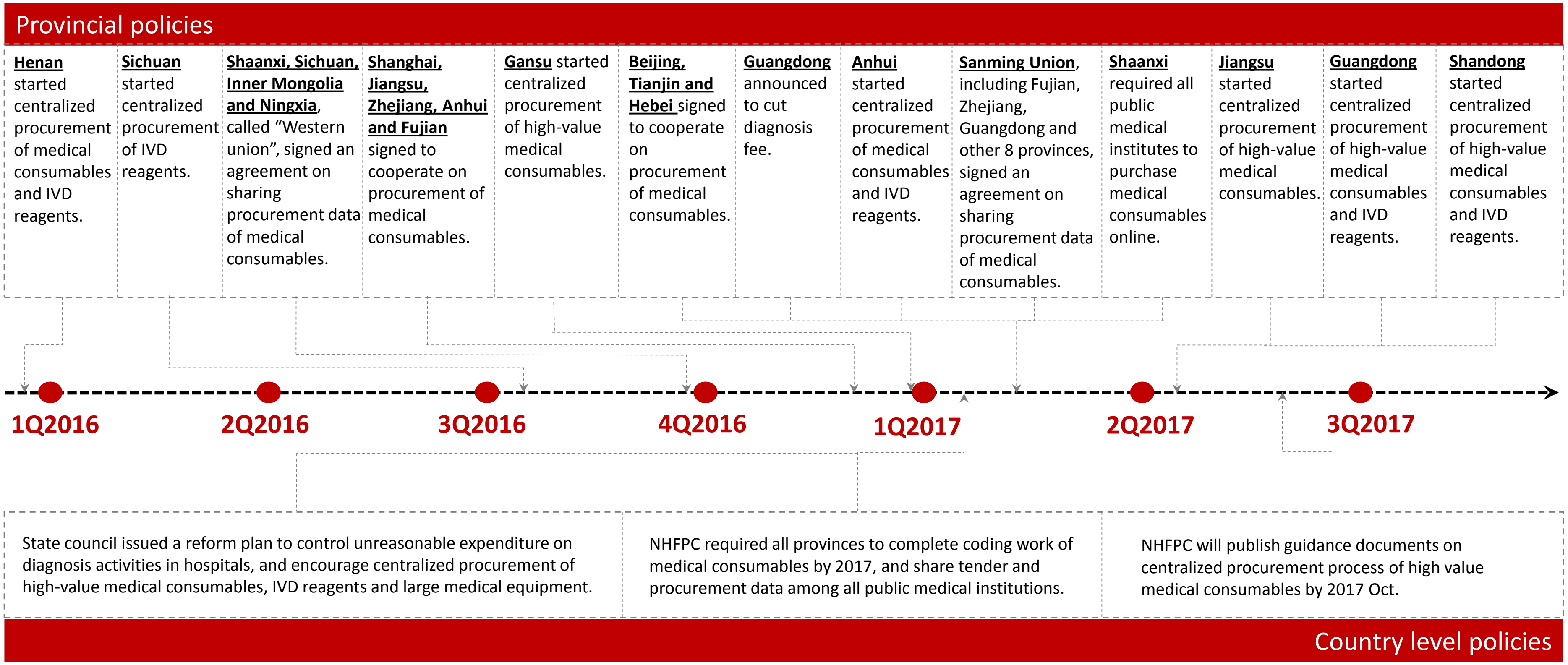
However, for now the two-invoice system is targeting drug distribution more than medical devices. By September 2017, four provinces – Shaanxi, Liaoning, Qinghai, and Fujian – had fully implemented the two invoice system for both drugs and medical devices. A few other provinces – including Heilongjiang, Shanxi, Shandong, Henan, Hubei, Guizhou, and Guangdong – are testing the water. We believe that pressure on medical devices will stay at a low level until late 2018. Even after the two-invoice system is fully implemented, distributors with a comprehensive logistics network will be able to adapt and may even benefit from market concentration.

Figure 25. Implementation of device two-invoice system

Source: Local NHFPC, HSBC

The control of diagnostic costs is another long-term concern. By 1H17, more than 10 provinces had implemented or partially implemented tenders for medical consumables. Based on what happened with national drug tenders, we expect policy makers to focus on circulating tender information across the country and cut tender prices by benchmarking the lowest national prices. See the table on the next page for tender details.

Figure 26. Summary of tender policies for medical consumables



Source: HSBC

Yestar Healthcare

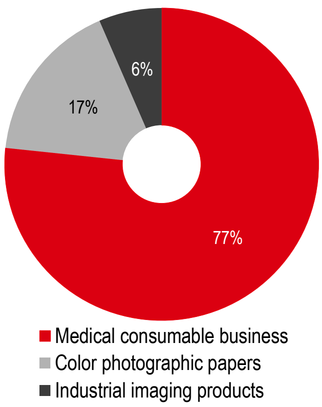
- A leading medical consumables distributor for Roche Diagnostics
- Expect growth to remain organic in 2017-19e due to rising diagnostic demand and extending IVD distribution network
- Initiate at Buy with a target price of HKD4.10

From industrial film to IVD

Yestar broke into the IVD industry by acquiring Jiangsu Uno, a distributor for Roche with a strong presence in the Yangtze delta in 2014. Prior to that, the company dominated the colour photographic and industrial imaging market in China. The company ramped up its IVD distribution business through a series of acquisitions over 2014-16. Growing more than 50% y-o-y over the past three years, IVD sales grew from zero to RMB2.3bn, or 49% of total revenue in 2016. The marketing and distribution of Roche products is now the core business, although IVD products from ThermoFisher, Sekisui, and Luminex were added recently.

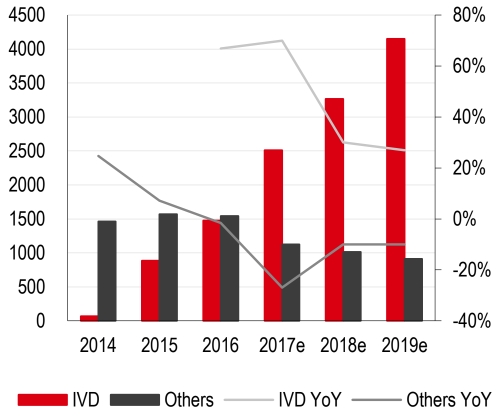
Meanwhile, Yestar's traditional business has maintained its industry leading position, guaranteeing cash support for its development of IVD distribution. Yestar has worked with Fujifilm for more than four decades in both China and ASEAN, producing and distributing their colour photographic, industrial and medical films. It is currently the second largest medical film producer and the largest producer of colour photographic and industrial imaging products.

Figure 27. Revenue structure of FY16



Note: Medical consumables include dental film and IVD distribution.
Source: Company data, HSBC

Figure 28. Surging IVD revenue (RMBm)



Source: Company data, HSBC estimates

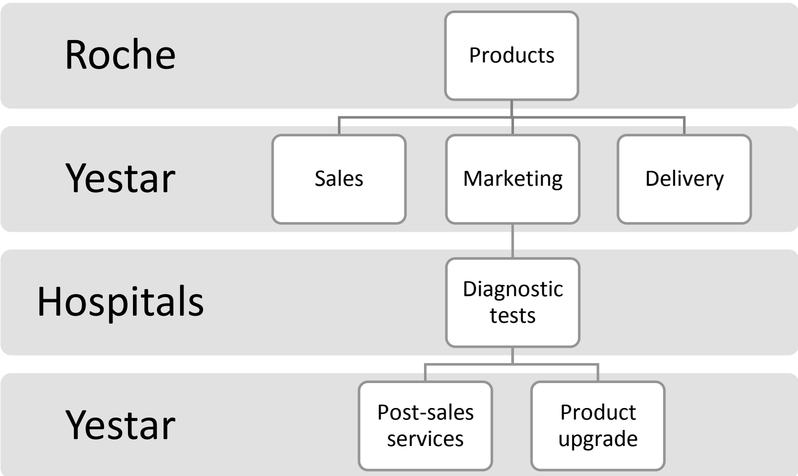
Table 14. Business of Yestar

Sector	IVD	Medical film	Colour photographic; industrial imaging products
Business nature	Distribution	Manufacture Distribution	Manufacture Distribution
Brands	Roche, Becton Dickinson, Luminex, Sekisui, ThermoFisher	FujiFilm, Yestar	FujiFilm, Yestar
Market share		Second largest player in China; 20-22% market share	Colour photographic: largest player in China, 55% share; Industrial imaging products: largest player in China, 37% market share
Suppliers	Roche, Becton Dickinson, Luminex, Sekisui, ThermoFisher		
Customers	Hospitals, clinics and wholesalers	Fujifilm Group; Hospitals, clinics, and wholesalers	Colour photographic: wholesalers, end users; Industrial imaging products: Fujifilm Group, Wholesalers and end users

Source: Company data, HSBC

As a leading distributor of Roche products, Yestar offers both sales and client services. Promotions and marketing help to build relations with clients and after settling the terms of the procurement deal, Yestar's sales team then tracks the needs of hospitals and organises delivery. Yestar is also responsible for post sales services, including repairs to Roche medical equipment. In return, Roche support the marketing activities and offers training about Roche diagnostic machines and reagents.

Figure 29. IVD distribution model



Source: HSBC

Yestar now distributes all of Roche's major products, including diagnostics devices and reagents used in blood diagnostics, molecular diagnostics, tissue diagnostics, and near patient testing (for more about Roche, please refer to the appendix). Having consolidated the southern China market by acquiring five local distributors in 2014-16, Yestar has expanded to Beijing and Inner Mongolia by acquiring 70% of the shares of Beijing Kaihongda Technology for RMB105m. By 3Q17, the company's distribution network covered more than 1,000 hospitals in seven provinces, representing around 30% of China's healthcare market.

Figure 30. Yestar's IVD sales network

Source: Company data, HSBC

Four strengths as a distributor

(1) Broad sales network and strong logistics support. As mentioned before, Yestar's network covers more than 1,000 hospitals in Beijing, Inner Mongolia, Anhui, Jiangsu, Hunan, Guangdong, and Fujian. It is one of the largest Roche distributors, accounting for 15% of Roche's sales network. With 200 sales and post sales service providers, the company monitors client demand on a daily basis. Yestar and its subsidiaries also have a logistics team that enables the company to deliver 70% of products directly to clients. Its close relationship with hospitals means that it does not have to use distributors, a big advantage in the current policy climate. It also strengthens the company's bargaining power to Roche.

Table 15. Yestar's distribution network

Province/city	2015	2016	y-o-y %
Anhui	64	70	9%
Fujian		59	
Guangdong		327	
Hainan		21	
Jiangsu	206	260	26%
Shanghai	228	258	13%
Shenzhen		47	
Total	498	1042	109%

Source: Company data, HSBC

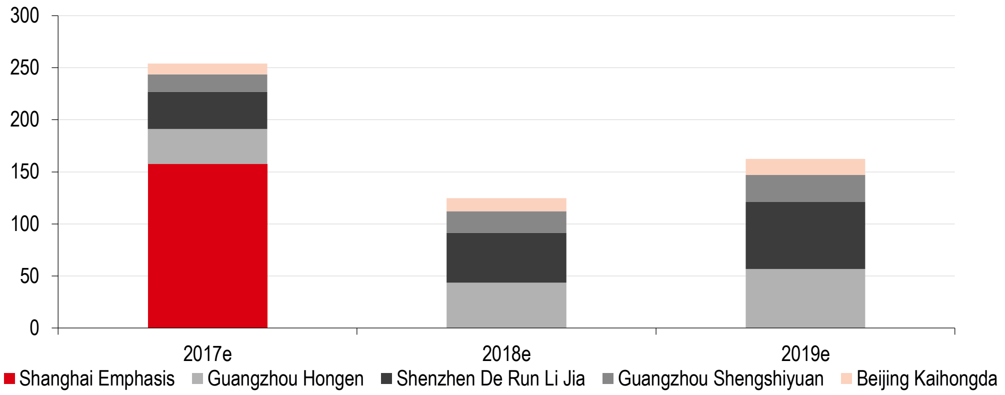
Table 16. Yestar's acquisition history

Company	Brands	Operational area	# Hospitals/clinics	Acquired
Jiangsu Uno	Roche, Becton Dickinson	Jiangsu & Anhui	330	14-Nov
Shanghai Emphasis	Roche, ThermoFisher	Shanghai	258	15-Aug
Guangzhou Hongen	Roche	Guangdong, Fujian, Hainan, Hunan	291	16-Oct
Guangzhou Shengshiyuan	Roche, Sekisui, Luminex	Guangdong, Hainan	116	16-Oct
Shenzhen De Run Li Jia	Roche	Shenzhen	47	16-Nov
Beijing Kaihongda	Roche	Beijing, Inner Mongolia	NA*	17-Sep

*Not yet disclosed.
Source: Company data, HSBC

(2) Acquisition experience. The IVD business is built on a series of acquisitions. Yestar acquired Jiangsu Uno in 2014 and Shanghai Emphasis in 2015, laying a strong foundation for its business in the Yangtze Delta. The company expanded to Guangdong and Inner China in 2016 by acquiring three other Roche distributors. In September 2017, it expanded into Beijing and the Inner Mongolia market by purchasing 70% of the shares in Beijing Kaihongda, a local Roche distributor focusing on the grass-roots hospital market. We think Yestar's ability to incorporate the acquired companies into its own business is a key competitive advantage. We expect the company to continue to grow in north China, a market where diagnostic demand has long been supressed.

Figure 31. Acquired companies: Profit guarantees for 2017-19e (HKDm)

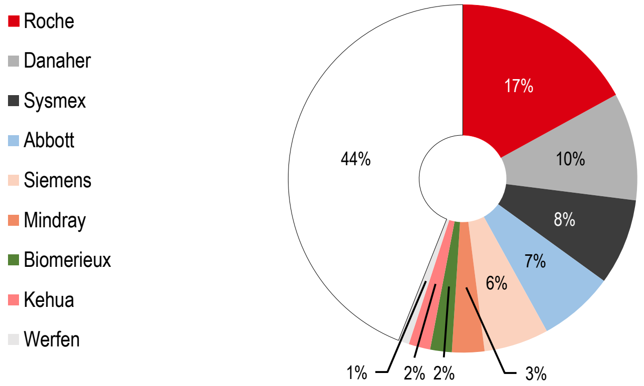


Source: Company data, HSBC estimates

(3) A distributor of the leading IVD brand in China. As the largest diagnostic solution provider with around 20% market share, Roche has a strong brand, particularly in top-tier hospitals. Its diagnostic system has the broadest disease coverage and most accurate test results for all major IVB tests. As discussed earlier, we expect drug cost control policies in public hospitals to help release long-supressed diagnostic demand and support organic growth of the IVD industry. Yestar is well placed to benefit.

The consolidation of Roche's distribution network provides Yestar with another window of opportunity. Rather than building its own sales network, Roche uses licensed distributors to help them connect with hospitals. In 2014, the number of distributors peaked at more than 140. The fragmented distribution network resulted in competition between distributors, making it hard to control the retail prices of Roche products. Roche may simplify its distribution network and focus on only the most resourceful distributors. This would also benefit Yestar.

Figure 32. Roche's market share in China



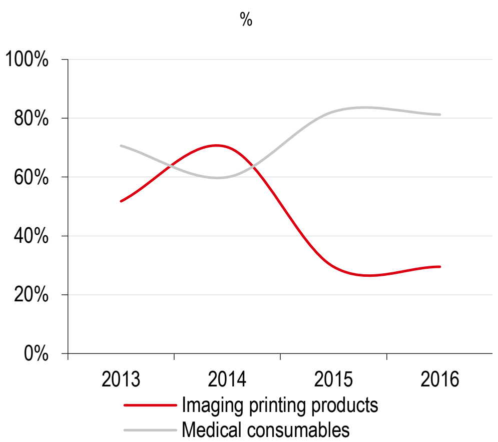
Source: Roche

(4) Good track record with upstream manufacturers. Yestar has been a partner of Fujiflim for more than four decades, developing China's imaging market together since 2001. Yestar is the largest distributor of Fujifilm products in China. We believe the company can replicate this success with Roche.

Industrial film business is a cash cow

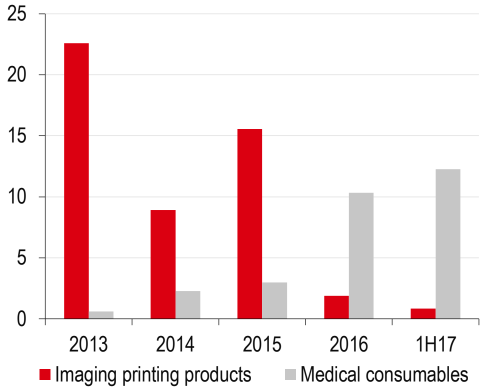
Although it has limited upside, the production and distribution of industrial film provides a stable cash flow that helps to fuel the growth of its IVD business. After starting off by producing industrial and photographic film for Fujifilm, the company now has more than 55% of the colour photographic paper market and 37% of the industrial imaging market in China. It is also the second largest medical film producer with 20-22% market share. In addition to Fujifilm, Yestar also runs its own brand "Yes!Star" for dental films and NDT X-ray films. The favourable competitive landscape ensures stable earnings even when demand for film is slowing.

Figure 33. Yestar: Liabilities to assets %



Source: Company data, HSBC

Figure 34. Yestar: Capital expenditure (RMBm)

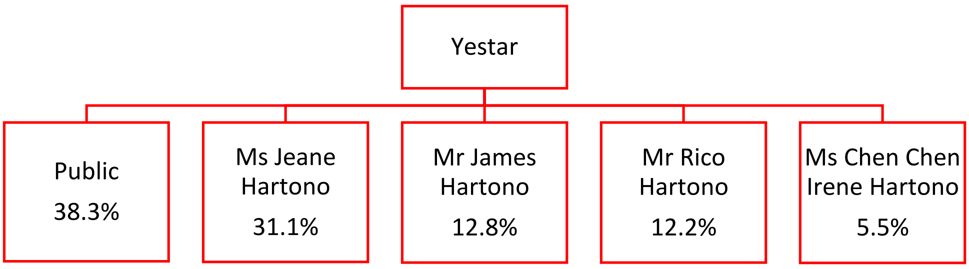


Source: Company data, HSBC

As a mature sector, Yestar's industrial film-making business has limited capital expenditure and a light debt burden. Clients need to pay a deposit before product delivery, its cash collection cycle is shorter than its IVD distribution business. We view it as a source of cash flow for further expansion in the IVD distribution network.

Yestar shareholding structure

Figure 35. Current shareholding structure



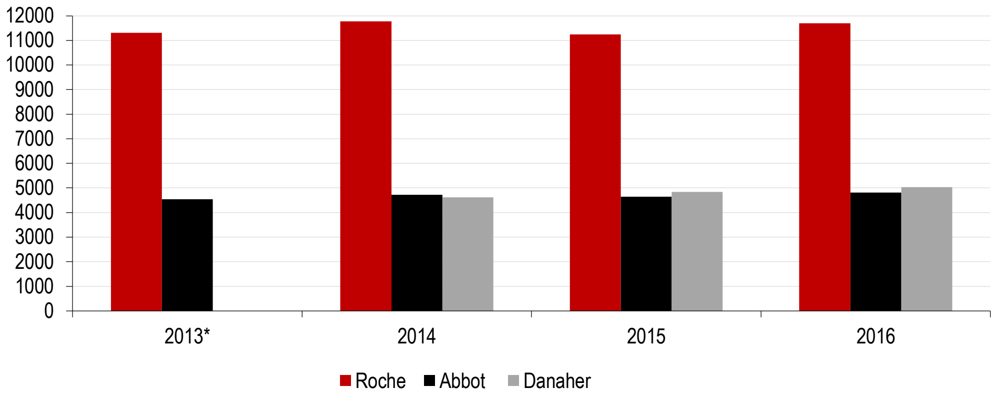
Source: Company data

Appendix: Roche (ROG VX)

The global leader in diagnostic solutions

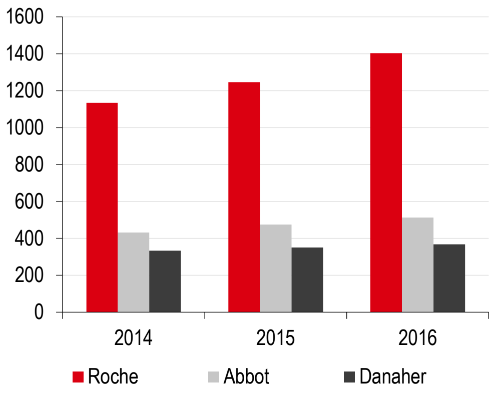
Roche's diagnostic division recorded revenue of USD12bn in 2016, the most among global IVD producers. Its dominance is built on its strong R&D capacity. In traditional diagnostic fields, including chemology and immunodiagnosis, Roche has the broadest disease coverage and highest test accuracy among its peers. For instance, its COBAS 8000 analysis system enables customized automated test solutions by combining various test modules in more than 30 ways. The system covers around 200 different tests in total while each module can process 2,000 tests per hour. Roche is also the first company to commercialise Polymerase Chain Reaction (PCR), the foundation of modular diagnostics. Its COBAS system can not only get quantitative test results for major viruses, including HIV, HBV, and HCV, but also conduct oncology tests for genome types like EGFR, KRAS, and BRAF mutations. Most of the test systems are closed, indicating that only reagents from Roche are adopted by the machine.

Figure 1. Revenue of top IVD manufacturers 2013-16



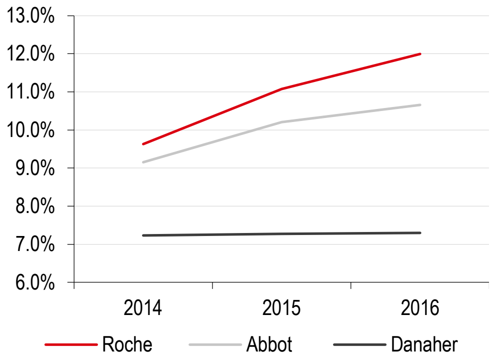
Note: *Diagnostics and life science revenue are combined in 2013 for Danaher in its financial report.
Source: Company data, HSBC

Figure 2. R&D input of top IVD player



Source: Company data, HSBC

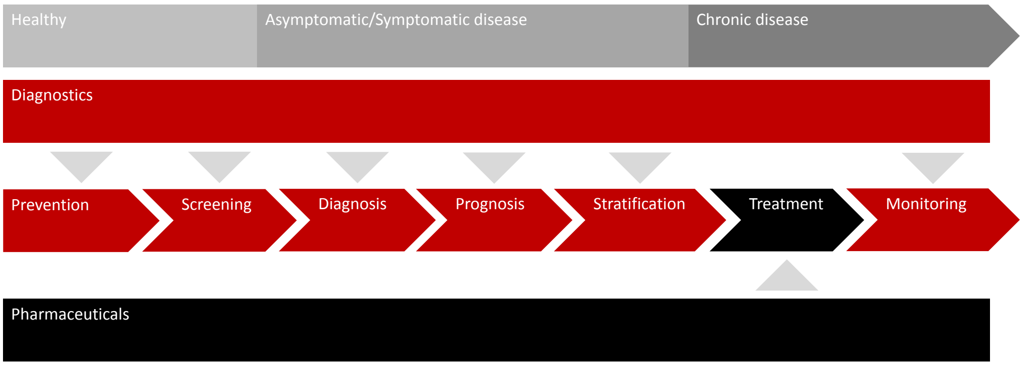
Figure 3. R&D input of top IVD player as a % of sales



Source: Company data, HSBC

In addition to its leading edge R&D, Roche also enjoys cross-sector synergies generated from its position in pharmaceuticals and hospital management. The company developed its COBAS IT solution to facilitate management of workflow and key data in diagnostic departments and point-of-care in hospitals. The company's pharmaceutical arm has helped it build its reputation in all major clinical departments. We believe that having a presence in each link of the hospital value chain – from prevention to treatment and monitoring of diseases – helps build brand power and create cross-selling opportunities.

Figure 4. IVD is an integrated part of the medical-decision making process



Source: Company data, HSBC

Roche is the industry leader in China, with a 17% market share in 2015. Between 2013 and 2016 its diagnostics business in Asia grew around 15% y-o-y, led by China. Given the size of the market, Roche invested RMB2.5bn to build its first Asian IVD production plant in Suzhou over 2014-17 and construction is expected to be completed by 2018. As the most recognized IVD brand in Chinese top-tier hospitals, Roche aims to further penetrate the grass roots market and compete with local IVD players. It aims to increase its share of the Chinese IVD market to 25% by 2020.

A comprehensive national network of distributors is the key reason behind Roche's success in China. Rather than approach each hospital individually, Roche hired distributors to knock on the doors of clients, distribute products, monitor client needs, and provide post sale services. The company also offers training as well as support for their marketing activities. Roche now has around 140 distributors in China. While the expansion of the distribution network has helped Roche open up the Chinese market it has also made it hard to control the retail prices of its products. It may be in Roche's interest to simplify its distribution team by focusing on a few leading distributors.

Investment thesis: Roche (ROG VX CHF228; TP CHF203.00; Reduce)

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Oncology leader, but biosimilar competition to have a negative impact in the meantime
Roche is the global No 1 in oncology and will likely remain so, thanks to its significant investments in R&D. This year it is set to face biosimilar competition, initially for Rituxan and Herceptin, but in due course for Avastin as well. Given that these three drugs account for c40% of Roche's revenues and we estimate 65% of profits, the potential negative impact could be significant. Although the dynamics in oncology, especially in the US, are different from other therapeutic areas, the damage inflicted on sales of branded biologics by biosimilars in Europe has been notable.

New products/R&D pipeline vs. biosimilar erosion. The issue for Roche over the next 3-4 years is how much of the erosion of Avastin, Herceptin, Rituxan (the "big 3"), Lucentis, and Xolair can be replaced by Roche's second generation/new products (Gazyva, Perjeta, Tecentriq, Alecensa, Ocrevus, and emicizumab).

Competitive uncertainty. Taking a step back from being either too bearish on the biosimilar erosion curve or too bullish on what is a good pipeline of new drugs, investors in Roche face multiple uncertainties. First, the erosion curve, especially for the big three drugs is uncertain (we believe erosion in Europe will be markedly quicker than the US) and that could be better or worse than consensus forecasts. Second, especially in Immuno-Oncology (IO), there are no guarantees that Tecentriq or any of its combinations with other drugs will be more effective or more favourably positioned than any of the IO mono- or combination therapies already approved in indications where Tecentriq is being trialled. In our view, a major issue for investors to consider is whether a drug being second, third, or fourth in a large indication, with similar data (or lack of significantly better data), will be a competitive disadvantage. And Tecentriq, with two indications approved to date, is well behind Keytruda and Opdivo, which have both been approved in ten different indications (although not all the same indications).

Reduce with TP of CHF203. We base our risk-adjusted DCF fair value target price on a WACC of 7%, using a risk-free rate of 2.5%, a blended equity risk premium of 4.5%, and a beta of 1. Our valuation has no terminal value or terminal growth rate. Our TP of CHF203 implies 12.3% downside from current levels. While Roche could be rated Reduce or Hold on HSBC's rating system, given that the full impact of biosimilars has yet to be seen in Roche's financials and the prospect of negative data from the IMpower150 study, due before year-end, in our view, a Reduce rating is more appropriate. **Upside risks** include a more benign pricing environment in the US (and elsewhere), significant delays to the commercialisation of biosimilar versions of Roche's biologics-based oncology drugs, significantly higher sales from drugs approved in 2016, and accretive M&A

Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

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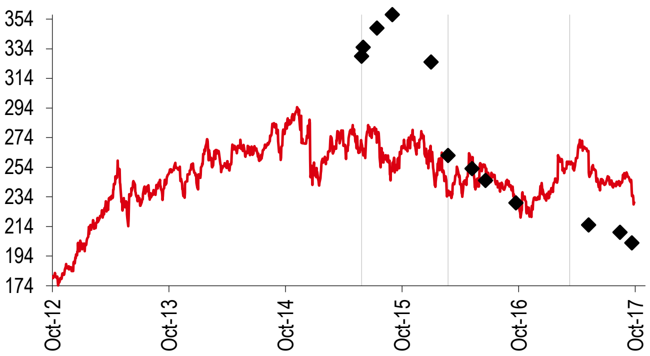
Share price and rating changes for long-term investment opportunities

Roche (ROG.S) share price performance CHF Vs HSBC rating history



Source: HSBC

Rating & target price history

From	To	Date	Analyst
N/A	Buy	25 Jun 2015	Steve McGarry
Buy	Hold	22 Mar 2016	Steve McGarry
Hold	Reduce	07 Apr 2017	Steve McGarry
Target price	**Value**	**Date**	**Analyst**
Price 1	329.00	25 Jun 2015	Steve McGarry
Price 2	335.00	30 Jun 2015	Steve McGarry
Price 3	348.00	13 Aug 2015	Steve McGarry
Price 4	357.00	30 Sep 2015	Steve McGarry
Price 5	325.00	29 Jan 2016	Steve McGarry
Price 6	262.00	22 Mar 2016	Steve McGarry
Price 7	253.00	06 Jun 2016	Steve McGarry
Price 8	245.00	18 Jul 2016	Steve McGarry
Price 9	230.00	21 Oct 2016	Steve McGarry
Price 10	215.00	06 Jun 2017	Steve McGarry
Price 11	210.00	12 Sep 2017	Steve McGarry
Price 12	203.00	20 Oct 2017	Steve McGarry

Source: HSBC

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Disclosure checklist

Company	Ticker	Recent price	Price date	Disclosure
ROCHE	ROG.S	230.10	27 Oct 2017	7
YESTAR HEALTHCARE HOLDINGS CO	2393.HK	3.20	27 Oct 2017	7

Source: HSBC

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