Chinese healthcare companies to deliver extravagant dividends

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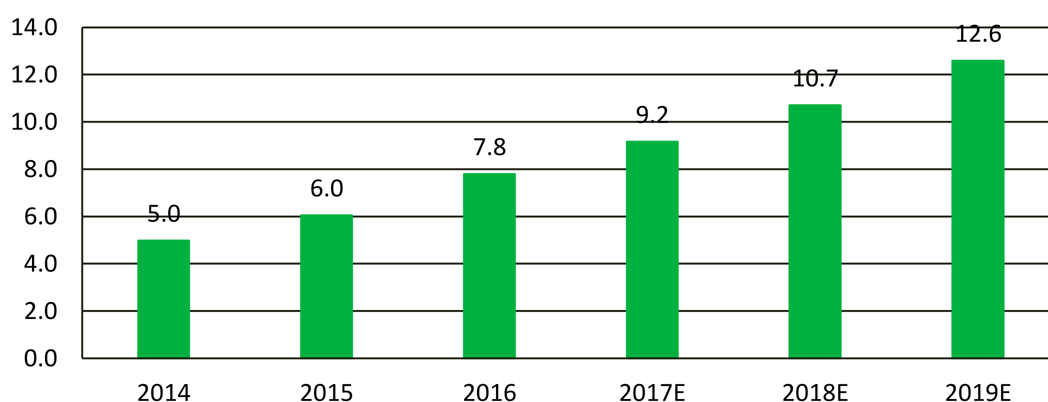
- Chinese healthcare aggregate dividends are estimated to grow by 61.5% over a three-year period to reach CNY 12.6bn in 2019.
- Acceleration in payouts is directly driven by robust earnings outlook, as companies adopt performance-linked payout practices.

The Chinese healthcare sector has delivered increasing dividends in recent years, growing from around CNY 5.0bn to CNY 7.8bn over the period between 2014 and 2016. The growth in dividends in recent years was mostly attributed to higher earnings, which stemmed from demographic changes, favourable policies, and the ability of companies to gain access to markets due to the expanding coverage of public health insurance. Buoyed by a robust earnings outlook and the influence from the Chinese government to increase payouts, we see the positive momentum in dividend growth to continue, and are forecasting dividends from the sector to surge to CNY 12.6bn in 2019.

Aggregate dividends from Chinese healthcare sector (CNY bn)



Source: IHS Markit, FactSet. Dividends from A shares only. Excludes one-off payment

Higher earnings to lift dividends

In this study, we examine all healthcare companies under our coverage, and have excluded **Shandong Buchang Pharmaceuticals** due to insufficient data.

The sector has a robust earnings outlook, as street analysts are expecting profit to jump by 67.1% on a per share basis over the next three years. Accordingly, we are bullish on dividends from the sector as dividends are set to grow alongside with higher earnings due to the adoption of performance-linked dividend policies by the majority of the companies.

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We noted that Healthcare companies in China generally have stable payout ratios despite the volatility in costs relating to Research and Development (R&D). In other words, the respective management teams do not deviate too far from the payout ratios in preceding years, and tend to be consistent in the proportion of earnings that is distributed as dividends.

Government and institutional investors' expectation for higher dividends

In recent years, the China Securities Regulatory Commission has encouraged listed companies to pay more cash dividends to accompany its major goal for long term value investments, and to bring the cash payout level to the standard of developed financial markets. Indeed, we are seeing State-owned Enterprises, such as **Yunnan Baiyao Group** (Yunnan Baiyao) taking the lead to adhere to this initiative, and are expecting more companies in China to follow suit.

Elsewhere, MSCI's inclusion of China A-Share to its flagship Emerging Market index with effect from June 20th, 2017 and the launch of the HK-SH, HK-SZ stock connect have raised institutional investors' expectation of having a stable yield income from the thriving healthcare sector in China. Paying higher dividends will meet these expectations, and will prompt investors to pay more attention to these companies.

Stocks highlights: Pharmaceutical

Pharmaceutical sales in China is estimated to register double-digit growth and reach CNY 2.3tr in 2019, driven by macro-economic growth and government's support in expanding public health reimbursement and accelerating market access for innovative pharmaceutical products. **Jiangsu Hengrui Medicine** (Hengrui) and **Shanghai Fosun Pharmaceutical** (Fosun), known for their R&D capabilities, have the strongest pipeline of innovative drugs and are expected to benefit the most from the policy reform.

Analysts have lifted their earnings expectation for Hengrui, as it currently has five new drugs pending approval in 2018. Meanwhile, as the company remains conservative towards capital-intensive investments and high-risk biologic developments, there is a possibility that Hengrui might increase its dividends in the forthcoming years. The company historical payout ratio is merely 10.3%, hovering around the lower bound of industry's payout range. We are expecting the payout ratio to increase moderately to 12% going forward.

In contrast, Fosun has a fixed payout ratio of 30% since 2012. The company has established its leading position on Chinese biologics space, and the management has indicated their plan to make further acquisitions on biologics related assets. This suggests that the company is unlikely to raise its payout ratio further, and we are expecting the payout ratio to remain stable at 30% over the short term.

Earnings prospect for generics pharmaceutical companies are however, not as optimistic as innovative players. For instance, despite the increase in volume, **Shanghai Pharmaceutical**'s earnings were affected by the price related regulation that was recently implemented by the government. While we are still expecting higher dividends, we noted that its growth rate lagged the median dividend growth rate of the industry by nearly 60%.

Dividends from **Chongqing Zhifei Biological Products** ("Chongqing Zhifei") are projected to come in at CNY 0.05 per share, implying our expectation of a fivefold increase from the dividends paid in FY16. The company released a preliminary report for 2017 and is expecting earnings to jump to around CNY 0.43bn. The surge in earnings is mostly attributed to the exclusive agreement signed between Chongqing Zhifei and US-based pharmaceutical giant Merck & Co., which provided Zhifei with the right to distribute and promote Merck's HPV Vaccine in China.

We are also optimistic about the outlook of **Guangdong Kangmei Pharmaceutical** (Kangmei) and are expecting the company to pay CNY 0.25 per share for FY17. With a target payout ratio of 30%, dividends are set to grow by at least 20% per annum from FY17 to FY19, exceeding the dividend growth rate demonstrated in recent years. The projected increase in dividends is mainly attributed to the bullish earnings outlook stemming from the strategic agreement signed between the company and the Guizhou government. This is the fourth time that the company has cooperated with provincial level governments, and like its preceding deals, street analysts are expecting the company to benefit significantly from the latest agreement.

Stocks highlights: Traditional Chinese Medicines (TCM)

It is noteworthy to mention that traditional Chinese medicine manufacturers, including **Beijing Tongrentang**, **Zhangzhou Pientzehuang Pharmaceutical**, Yunnan Baiyao, have all taken the opportunity to commercialise time-honoured products, which led to double-digit growth in operating cash flow in recent years. More recently, the China Food and Drug Administration indicated that there will be an exemption for certain TCM from future clinical trials. In light of this, TCM companies are expected to generate savings through lower R&D activities, which will help to support the growth in bottom line figures. We expect dividends to continue to grow progressively, on expectations that payout ratios will fall within their historical payout range between 30% and 40%.

Stocks highlights: Others (hospitals, medical devices)

We are also optimistic on the dividend outlook on the healthcare companies that have recently been added to the CSI300. On the back of the positive earnings outlook, we are forecasting progressive dividends growth for **Aier Eye Hospital Group** (Aier). Earnings growth are attributed to the company’s series of acquisitions of specialized eye care hospitals, which also helped in reduction in operating costs due to the economy of scale. Notwithstanding the increase in borrowing costs deriving from the borrowings made for making acquisitions, our estimated dividends translate to payout ratios that are within their historical payout range. Elsewhere, **Lepu Medical Technology** is poised to pay higher dividends, with an annual growth rate of 30% over the next two to three years. Our aggressive projection is based on the company’s dominant position in domestic cardiovascular devices and the change in demographic profiles. Indeed, street analysts are expecting earnings to grow by an average rate of 35% annually in the short term.

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