Stock Idea

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Apex Healthcare Bhd

BUY

Target	RM3.84
Previous	-
Price	RM2.91

Major Shareholders (%)	
Apex Pharmacy Holdings	40.5%
Washington H Soul Pattinson	30.3%

Stock Information	
Market cap (RMm)	272.7
Shares Capital (m)	93.7
OSK 188 Ticker	AHEALTH
Industry	Consumer

Company Description

Apex Healthcare is a pharmaceutical company that manufactures off-patent drugs and also distributes 3rd part drugs.

Recession-Proof Drug Maker With Growth Potential

Apex Healthcare Bhd (AHB) is an off-patent pharmaceutical company and third-party drug distributor with operations in Singapore, Malaysia, Vietnam and Indonesia. Its fundamentals are underpinned by exciting future opportunities, higher margins as the contribution from its own-brand products expands, and its compelling dividends. We have a Target Price (TP) of RM3.84, pegged at its ten-year average PER of 9.5x, which suggests a potential upside of 32% from the current share price.

Off-patent generic drug manufacturer. AHB is an off-patent pharmaceutical company operating in Singapore, Malaysia, Vietnam and Indonesia. It also owns and operates a manufacturing plant in Melaka. The company makes over 100 products in the form of tablets, capsules, powders, oral liquids, creams, ointments and sterile eye drops for the domestic and export markets. Its products are sent to 16 countries in the Asia Pacific, the Middle East and Africa.

Expanding own brands for higher margins. Besides its in-house brands, AHB's distribution arm Apex Pharma also carries third party brands. Currently, 30% and 70% of its total revenue come from own-brand products and third party products respectively. The company aims to expand its own-brand products to enhance margins, and is now developing the Avex, Avo, and Kaps product lines. Currently, its Melaka facility is running at almost full capacity, though production can be increased by adding another work shift.

Positive industry outlook. Generic drug sales are rapidly rising, especially in emerging markets. Rising standards of living, the fast-growing aging and adolescent age groups, higher incidences of chronic diseases and new developments in the healthcare industry have lifted the demand for pharmaceutical drugs. According to the 2011 IMS Market Prognosis report, the share of patented brands that accounted for about 70% of global pharmaceutical spending in 2005 is expected to fall to 53% in 2015 when more patents expire while spending on generic drugs will rise from 20% in 2005 to 39% in 2015.

Solid growth. AHB reported steady top-line growth of a compounded annual growth rate (CAGR) of 9.9% for the past 8 years. Going forward, we expect the group's earnings to grow at a CAGR of 16.6%. We are optimistic about AHB's future earnings growth potential, thanks to: i) higher contributions from its own-brand products, thereby generating higher margins, (ii) continuously strong sales of its cough mixture and cardiovascular products, iii) benefits from patent expiration of drugs and iv) positive impact from friendly regulatory policy changes.

BUY with RM3.84 FV. In a nutshell, we like AHB for its: **i)** prudent management, **ii)** good dividend payout track record, **iii)** solid balance sheet, **iv)** potential business opportunities from off-patent drugs sales, and **v)** higher margins from its own-brand products. We are initiating coverage on AHB with a BUY call at RM3.84 price target, based on its ten-year average PER of 9.5x.

FYE Dec (RMm)	FY09	FY10	FY11	FY12f	FY13f
Revenue	282.7	313.7	366.0	405.9	456.5
Net Profit	22.1	32.9	28.1	31.9	37.9
% chg y-o-y	49.9	48.8	-14.8	13.6	18.9
Consensus	-	-	-	n.a	n.a
EPS (sen)	29.5	35.2	30.0	34.0	40.5
Gross DPS (sen)	19.8	16.0	17.2	18.0	20.0
Gross dividend yield (%)	6.8	5.5	5.9	6.2	6.9
ROE (%)	13.6	18.0	14.1	14.9	16.2
ROA (%)	9.3	12.4	9.7	11.0	12.0
PER (x)	9.9	8.3	9.7	8.5	7.2
BV/share (RM)	2.2	2.0	2.1	2.3	2.5
P/BV (x)	1.3	1.5	1.4	1.3	1.2

Background

An off-patent drug manufacturer. AHB is an off-patent drug manufacturer and third-party drug distributor. It has operations in Singapore, Malaysia, Vietnam and Indonesia, carrying brands such as Xepa, Avex, Avo, etc as well as Agnesia medicated powder. Its four business segments are manufacturing pharmaceutical products under Xepa-Soul Pattinson (Malaysia) Sdn Bhd (Xepa); marketing, wholesaling and distribution under Apex Pharmacy Marketing Sdn Bhd (Apex Pharma); international markets under Apex Pharma Marketing Pte Ltd in Singapore and PT Penta Valent in Indonesia; and retailing of pharmaceutical products under Apex Retail Sdn Bhd.

AHB's manufacturing plant in Cheng Industrial Estate, Melaka has a built-up area of 180,000 sf. It is equipped with laboratories, production floors, a warehouse and office. The company manufactures over 100 products comprising tablets, capsules, powders, oral liquids, creams, ointments and sterile eye drops. Throughout the years, the company has built an extensive distribution channel and penetrated a broad customer base including private clinics, wholesalers, private and public hospitals, pharmacies, health-food stores, druggists, supermarkets, hypermarkets, department stores, estates, factories and government institutions in Malaysia. Supply is supported by eight warehouses located strategically in major towns to ensure efficient logistics accessibility and in-time delivery. The company also exports its products to 16 countries in the Asia Pacific, the Middle East and Africa.

Figure 1 : AHB's warehouses

Source : Company

Figure 2 : AHB's export markets

Source : Company

Investment Case

Strong branding in cough mixture. Over the years, AHB has developed a good reputation for its multi-product cough medicine, gaining market share via its Sedilix series of cough mixtures. Its newly-released Sedilix-Rx and Cough-en Rx cough mixtures have wide market acceptance, which further strengthens its pole position in the market.

Figure 3 : Some of the brands carried by AHB and type of cough medicines available in the market

Source : Company

Growing importance of cardiovascular products. AHB's cough mixture products contributed about 5% of total revenue in FY11. Currently, its cardiovascular product sales are building momentum, accounting for less than 5% of the company's total revenue in FY11, the second largest contributor after cough mixture products.

Expanding own-brands to fetch higher margins. Besides in-house brands, its distribution arm Apex Pharma also carries third party brands like 3M, Ranbaxy, Ziwell, Cipla, Actavis, MD Pharm, etc. Third party products currently account for approximately 70% of total revenue, while the remainder comes from own-brand products. The company aims to expand its own-brand products to increase margins. Generally, its own brands deliver 40-50% of gross profit margins while third party brands fetch relatively lower margins in the single digits to mid-teens. AHB's own brands under development are Avex, Avo, and Kaps. Currently, its Melaka facility is running at almost full capacity, though production can be increased by adding another work shift.

Rebuilding its retail segment. In 2005, AHB exited the bulk of its retail business and sold all its outlets (which numbered 26) except one, to Watson Personal Care Stores SB, citing reasons including stiff competition, difficulty in retaining pharmacists and a new direction to concentrate in its core businesses. It re-tested its retail business prospects by opening a pharmacy via a 60:40 partnership with a pharmacist in City Square Mall, Johor Bahru in 2010. The partnership (AHB with 60% and the pharmacist with 40%) successfully retained its knowledge workers and engaged in more positive relationships with its clientele. Going forward, AHB plans to expand its retail presence via more joint ventures with other pharmacists.

Exciting opportunities ahead. According to Evaluate Pharma, over USD267bn worth of drug sales will be losing their patents from 2011-2016. Generally, once drugs lose patent protection, lower-priced generic drugs absorb their sales and claim sizeable market shares. AHB plans to develop drugs that are going off-patent soon, and is leveraging on its R&D expertise to develop products in selected categories.

Figure 4 : SWOT Analysis

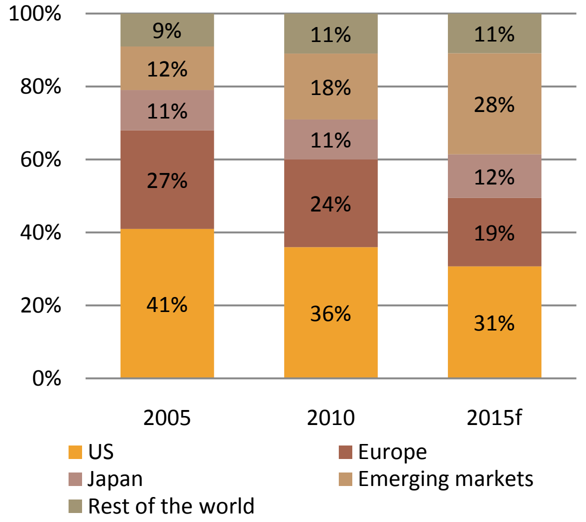
Strengths	Weaknesses
Market leader in cough mixture	Stiff pricing competition among off-patent players
High barriers of entry into the pharmaceutical industry	Difficulty in brand differentiation among off-patent players
Opportunities	**Threats**
Leverage on patent expiry of best-selling drugs	Evolving foreign regulatory environment against the foreign industry players' interests
Own-brands product expansion	Technology improvements may cause certain drugs to become obsolete
Government support on friendly policy changes	Counterfeit drugs may seize market share

Source : OSK Retail Research

Industry

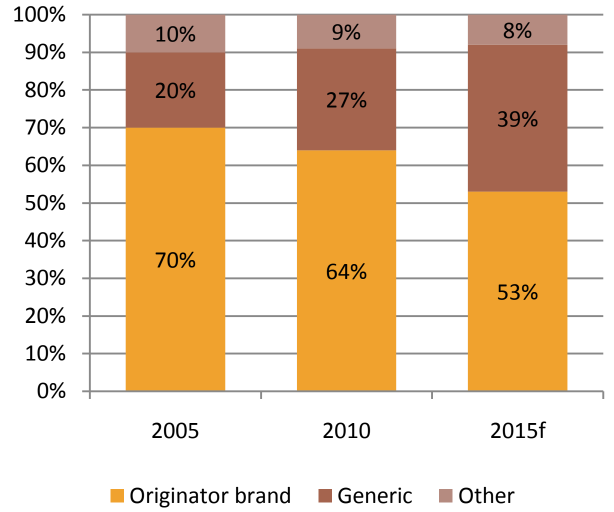
High demand from emerging countries. Generic drug sales are rapidly rising, especially in emerging markets. Rising standards of living, aging and growing populations, increases in chronic disease and developments in the healthcare industry have lifted the demand for drug usage. According to the IMS Market Prognosis report in 2011, emerging markets will contribute about 28% of total spending on medicines by 2015, up 12% in 2005. On the other hand, the share of patented brands that accounted for about 70% of global pharmaceutical spending in 2005 is expected to fall to 53% in 2015 when more patents expire. Generic drugs spending will rise from 20% in 2005 to 39% in 2015.

Figure 5 : A shift in spending pattern on medicines



Source : IMS Market Prognosis

Figure 6 : Global pharmaceutical spending by segment



Source : IMS Market Prognosis

Patent expiration - a game changer. Generic drug manufacturers are eyeing new business opportunities from the transfer of sales from best-selling drugs going off-patent in the next 10 years. Pharmaceutical companies will be able to leverage on patent expirations by developing and launching off-patent generic products under their own brands. The development of a generic product is a more calculable venture than research on new drug that has more uncertainties. Hence, generic drugs often sell at significantly lower prices than the originator brands as they do not incur research and development (R&D) costs. Usually, generic drug manufacturers will try to differentiate their products by optimising the formulations, packaging and size variants, etc to ensure no price war would erode margins.

Figure 7 : Major drug patents that expired in 2011

Brand name	Indication	Company	2010 US Sales (USDm)
Lipitor	cholesterol	Pfizer	5,329
Zyprexa	antipsychotic	Eli Lilly	2,496
Levaquin	antibiotics	Johnson & Johnson	1,312
Concerta	ADHD/ADD	Johnson & Johnson	929
Protonix	antacid	Pfizer	690

Source : IBIS World

Figure 8 : Major drug patents expiring in 2012

Patent Expiring in 2012	Condition	Company	2010 US Sales (USDm)
Plavix	anti-platelet	Bristol-Myers Squibb /Sanofi-Aventis	6,154
Seroquel	antipsychotic	AstraZeneca	3,747
Singulair	asthma	Merck	3,224
Actos	type 2 diabetes	Takeda	3,351
Enbrel	arthritis	Amgen	3,304

Source : IBIS World

Local pharmaceutical industry small but growing. In the last decade, Malaysia's pharmaceutical market grew between 8% and 10% annually. Nevertheless, it is relatively small and relies heavily on imported medicaments. There are 250 pharmaceutical premises registered to date, with 74 premises licensed to produce modern medicines and the remaining authorised to make local traditional and herbal medicines. According to the Malaysian Investment Development Authority (MIDA), 30% of the products made by the local pharmaceutical industry are for the domestic market, and the rest are exported to the Asia Pacific, Middle East, Africa, Latin America and Europe.

Healthcare sector set to benefit from policy changes. The government has identified healthcare services as one of the 12 National Key Economic Areas (NKEA) under the 10th Malaysia Plan (2011– 2015) generating revenue for the country. In 2010-2011, the government announced 13 entry point projects (EPPs) and two business opportunities under the NKEA. One of the EPPs focuses on business opportunities from best-selling drugs that are going off-patent in the next 10 years. Local pharmaceutical companies will be able to leverage on patent expirations by developing and launching newly-generic products under their own brands.

The Malaysian Healthcare Travel Council (MHTC) is currently developing marketing campaigns to promote healthcare tourism. MHTC and other agencies such as the Ministry of Finance and MIDA are drafting investment tax incentives to qualify local healthcare players as health travel-promoting facilities. MHTC is also working with the Tourism Ministry to improve strategic bilateral relations. Advertising guidelines have also been reviewed and hospitals are now allowed to publish patient testimonials in their marketing programmes. All in all, these policy changes will have long-term positive impact on the local pharmaceutical industry's development.

Financials

Solid growth. AHB has been reporting steady top-line growth since 2004, at a compounded annual growth rate (CAGR) of 9.9% for the past 8 years. However, its bottom-line was hit in 2004, 2006 and 2008 as net profit margins shrank to 5.2% to 6.0% compared with its average net profit margin of 7.4%. The drop in net profit margin in 2004 was due to the delay of the planned divestment of Apex Pharmacy Sdn Bhd. Net profit margins in 2006 were hit by higher operating costs at its new Subang Jaya warehouse. In addition, the higher base effect from 2005 has also affected the relative performance in 2006. There is a one-off gain of RM4.9m after the disposal of its retail business in 2005. Stripping off the non-recurring gain, 2006's net profit would be 16% higher than the preceding year. Despite the uncertain economic conditions in 2008, it recorded a net profit of RM14.8m. In 2010, the strong recovery in profit was driven by strong growth in AHB's own-brand sales and higher wholesaling business to private and government sectors.

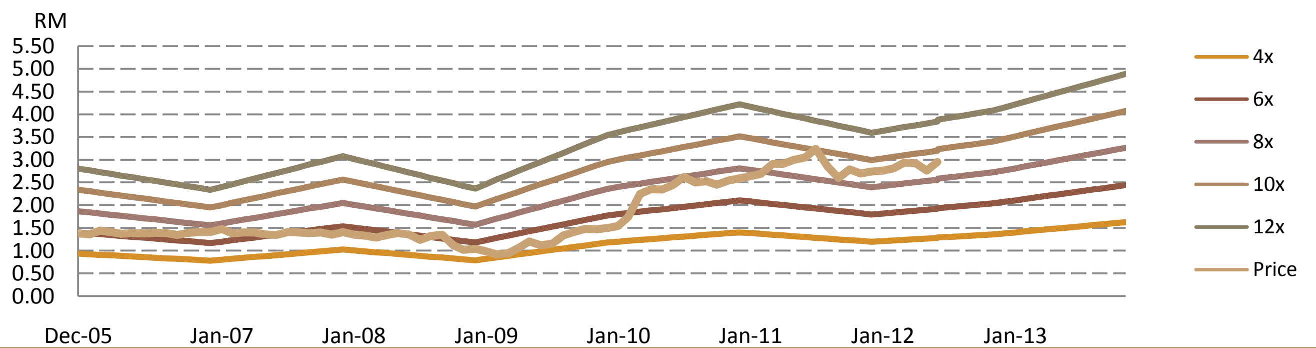
Going forward, we expect the group's earnings to grow at a CAGR of 16.6%. We are optimistic about the potential for AHB's future earnings to grow in view of: i) higher contributions from its own-brand products that fetch higher margins, ii) continuously strong sales in its cough mixture and cardiovascular products, iii) benefits from patent expiry of drugs, and iv) positive impact from friendly policy changes. The reported bottom-line results for 1QFY12 account for 20% of our projections, due to a one-off higher tax charge of RM2.5m upon the completion of the divestment of the investment in Xiamen Maidiken Science and Technology Co Ltd, China. We anticipate a better performance in the remaining quarters of FY12, underpinned by stronger sales.

Attractive dividend yields. For the past three years, AHB has been in a net cash position, thanks to its consistent revenue stream and continuous product expansion. Despite not having a dividend policy, the company's consistent dividend payout of above 40% for the last five years is rather impressive. Going forward, we expect the group to maintain a dividend payout of 45%-55%, which translates into dividend yield of above 6%.

Valuation & Comparison

BUY with RM3.84 FV. AHB's closest comparable peers are CCM Duopharma and Hovid Bhd. CCM Duopharma is relatively comparable with AHB in terms of market capitalisation, while Hovid is smaller at a market capitalisation of RM160m. Earnings-wise, CCM Duopharma has a higher gross profit margin of 45.8% compared to AHB's 26.0% in FY11. This is probably due to the fact that 70% of AHB's earnings were generated from third party products that fetch lower margins. Meanwhile, Hovid's past performance was weighed down by losses from Carotech. We are initiating coverage on AHB with a BUY call and a fair value of RM3.84, based on its ten-year average PER of 9.5x. All in all, we like AHB's: (i) prudent management, (ii) good dividend payout track record, (iii) solid balance sheet, and (iv) potential business opportunities from off-patent drugs and (v) higher margins from its own-brand products.

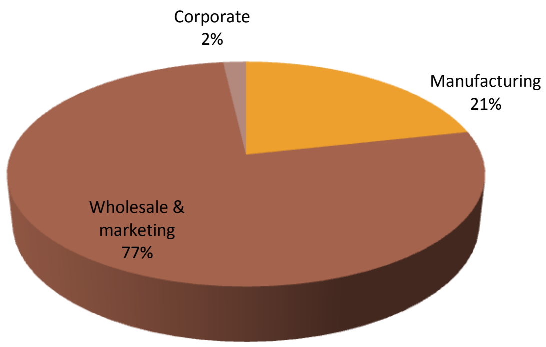
Figure 9 : AHB's PER band



Source : Company, OSK Retail Research

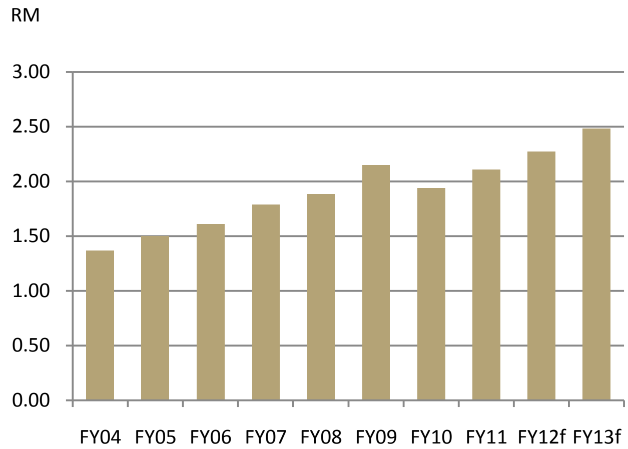
Appendix I: Financials

Figure 10: Revenue breakdown – 1QFY12



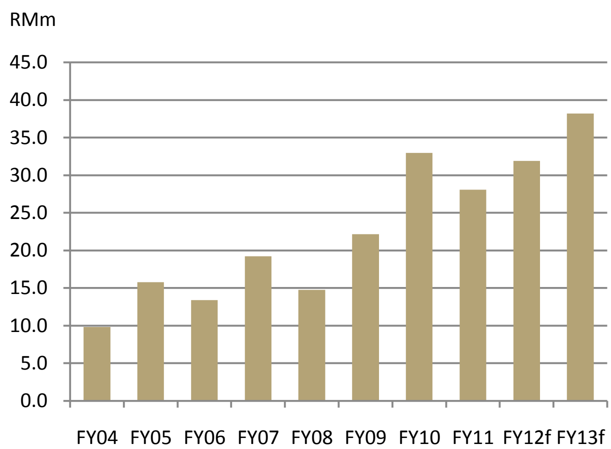
Source: Bursa Malaysia, OSK

Figure 11: NTA / share



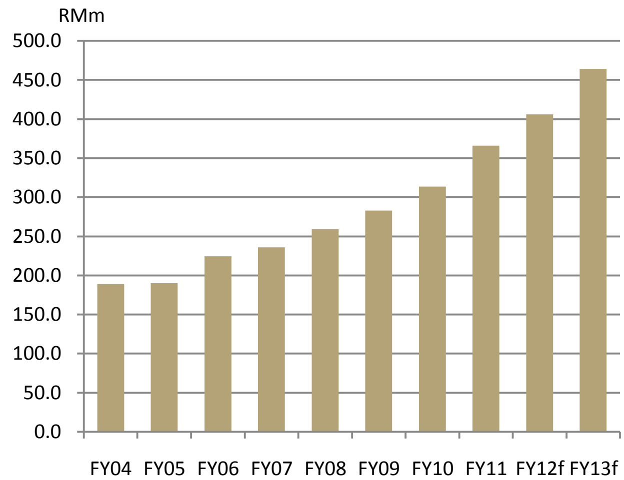
Source: Bursa Malaysia, OSK

Figure 12: Earnings trend



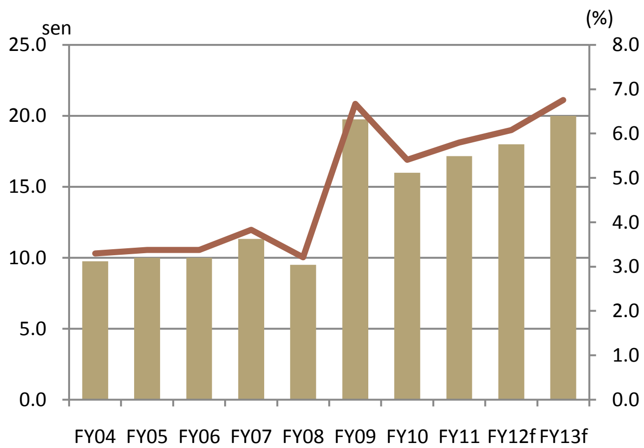
Source: Bursa Malaysia, OSK

Figure 13: Revenue trend



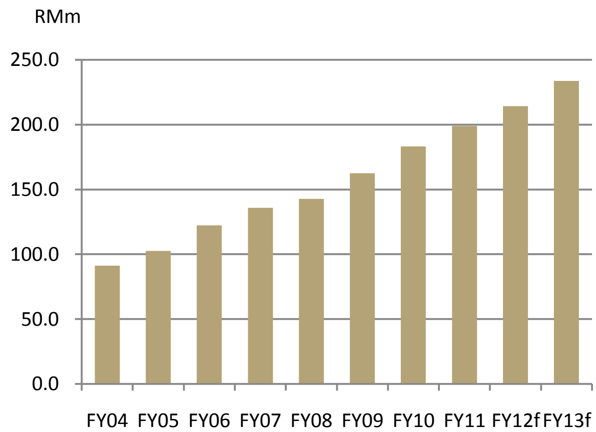
Source: Bursa Malaysia, OSK

Figure 14: Gross DPS & Dividend yield



Source: Bursa Malaysia, OSK

Figure 15: Shareholders' equity



Source: Bursa Malaysia, OSK

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Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels

Sell: Share price may fall by more than 10% over the next 12 months

Not Rated (NR): Stock is not within regular research coverage

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