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Strange Bedfellows

Mainland China pharma companies have been IPO darlings, but are investors overlooking market weaknesses?

K.C. SWANSON

Last year was a banner year for Chinese pharma companies: five of them debuted on U.S. stock markets. While the IPO boomlet is less than a year old, it has already had lasting consequences in China, where several newly listed companies, flush with cash, have started making acquisitions.

Yet in some respects Wall Street and the Chinese drug industry make for strange bedfellows. The industry has a reputation as a sleepy backwater, heavily reliant on generics and hamstrung by a lack of innovation and strict government control. Some worry that the stock market's demands for high quarterly growth will push companies into making wrongheaded acquisitions. It's still too early to tell how Wall Street's strictures will sit with the pharmaceutical industry. But it's easy to see why investors would be seduced by its long-term growth outlook.

Chinese consumers spent about $47 billion on drugs in 2006, with spending growing at a compound rate of nearly 20 percent between 2002 and 2006, according to Frost & Sullivan. The market research firm estimates spending on pharmaceuticals in China will continue to grow by an average of 20 percent annually between 2007 and 2011, compared to a global growth rate of only about 5 percent for the same period.

This upbeat outlook helps explain the warm reception accorded to pharmaceutical IPOs by U.S. markets. Typical was Nepstar, China's biggest pharmacy chain. Defying broader stock market jitters in early November, it priced its IPO at a 29 percent premium to the proposed range, raising $334 million. Then it saw its shares gain another 8 percent on their first day of trading on the Big Board.

Institutional investors have gotten into the act, too. Well before its IPO, Nepstar had already won $25 million in investment from Goldman Sachs. WuXi PharmaTech, a contract research organization that debuted on the New York Stock Exchange last August, earlier secured backing from Fidelity's Greater China venture fund. Other 2007 stock debuts included 3SBio, which develops and sells biopharmaceuticals; Tongjitang Chinese Medicines Company, which makes traditional Chinese medicine; and Simcere Pharmaceutical, a generic drug supplier.

Yet amid the flood of listings, industry watchers highlight the need for caution. Chinese pharmaceutical companies have "really been rushing to IPO in the U.S. before the enthusiasm disappears," says James Shen, publisher of Pharma China, an English-language industry newsletter. "It's really kind of surprised me a bit, especially because the market environment in China right now for the pharma industry isn't really that favorable for companies yet." The product pipeline for new drugs isn't very strong, he adds.

Also, many drugs are subject to government price controls at the central and provincial levels. Last year, when the central government pushed through nationwide price reductions on 400 drugs, their average retail price plummeted by 30 percent.

Meanwhile, consolidation is underway as hotshots with IPO cash have started scooping up smaller rivals. Only five months after its April NYSE listing, Simcere took a $15-million, 51 percent stake in fellow drug maker Boda. In late November, Simcere paid $4.4 million for Master Luck, majority owner of Nanjing Tung Chit Pharmaceutical, which makes cancer drugs. And in September, a subsidiary of Tongjitang, which listed in March on the Big Board, bought Guizhou Long-Life Pharmaceutical Company for $5.6 million in cash. But the biggest and boldest deal has been WuXi's purchase of contract research firm Apptec in January 2008, in which it will pay $151 million and assume $11.7 million in debt to acquire the U.S. company.

Indeed, the highly fragmented pharmaceutical industry seems like a natural candidate for M&A. Nepstar, which operates the biggest nationwide pharmacy network with almost 1,800 outlets, still accounts for less than 0.5 percent of the retail market. It has outlined plans to spend some of its IPO windfall on acquisitions, especially in Beijing and Shanghai, where local regulations make it tough to open new outlets.

Jinsong Du, a healthcare equity analyst at Credit Suisse, believes this is just the beginning of a wave of M&A in the healthcare sector, one that will see solid support from Beijing via incentives such as R&D subsidies for bigger healthcare companies. The government also plans to implement stricter good manufacturing practices (GMP) this year, a move that could weed out weaker players. "The government seems to believe a less fragmented healthcare industry is easier to control on safety and other issues," Du wrote in a recent report.

But Shen says he's a little concerned about the pace of acquisitions. "There's very strong pressure from Wall Street to see high growth each quarter from these companies, but organic growth will be quite difficult under the present market environment. So one of the ways to grow is to rush out and buy companies." However, good pharmaceutical companies are in short supply, he says. Indeed, the best are likely to pursue IPOs themselves.

Yet government incentives and stricter regulations seem likely to encourage more acquisitions in the future, which might not always be the best move. “If companies rush into deals, it’s very likely they may make very bad decisions,” Shen says.