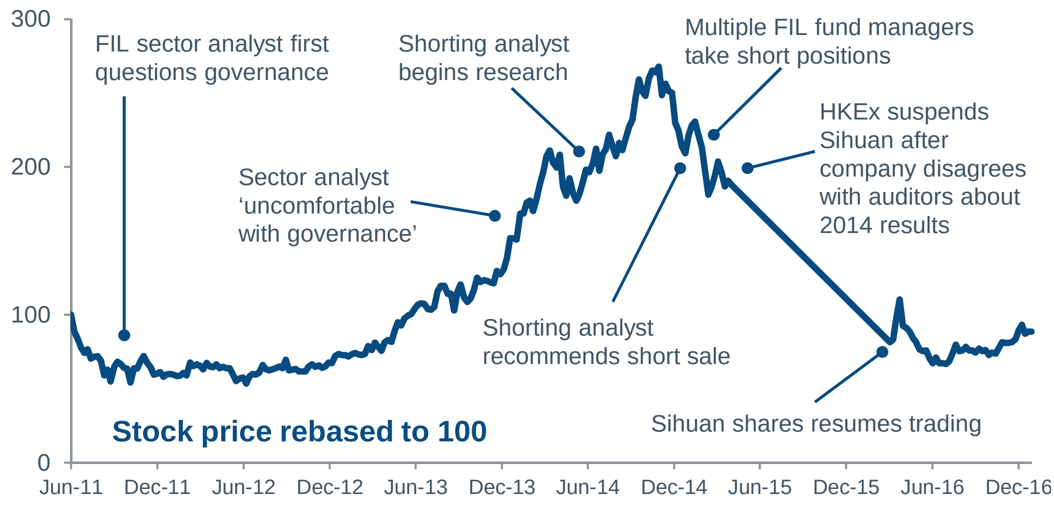
PERSPECTIVE **MAY 2017**

Sihuan Pharmaceuticals; a corporate governance case study

Sihuan Pharmaceuticals was the darling of the Chinese stock market in 2014, growing to become the country's biggest healthcare company by market capitalisation by the end of that year. Three months later, the stock was abruptly suspended from the Hong Kong Stock Exchange (HKEx) after the company failed to publish audited financial accounts for the year.

We already had a negative fundamental view on the sustainability of the business model and avoided buying the stock. As Sihuan's share price appreciated amid a buying frenzy, a growing list of corporate governance issues - such as questionable business practices and management integrity - convinced us to sell the stock short.

Chart 1: Sihuan's unravelling



Source: Datastream, Fidelity International, 4 May 2017

Industry:
Pharmaceuticals

Market Cap:
USD 8.2bn (Nov 2014)
USD 4.3bn (May 2017)

Country:
China

What is Sihuan?

Sihuan is a pharmaceuticals supplier with a strategy geared towards China's complicated tendering and pricing system. Management started the company in 2001, growing it via acquisitions of cardiovascular drug makers and protecting those investments by securing a number of 20-year patents on their production.

The company was repeatedly successful in navigating China's provincial-level drug pricing hurdles, which are then followed by highly political tendering processes involving the selection of two to five suppliers for each drug. Individual hospital administrations within regions then decide which drugs to list from the provincial shortlist.

However, it is doctors that have the final say in the success or failure of a drug through their power to choose which medicines to prescribe from the hospital lists. To promote their products to doctors, Sihuan used third-party distributors instead of a more conventional in-house sales force. These distributors were motivated by the significant mark-up in selling price from the factory price.

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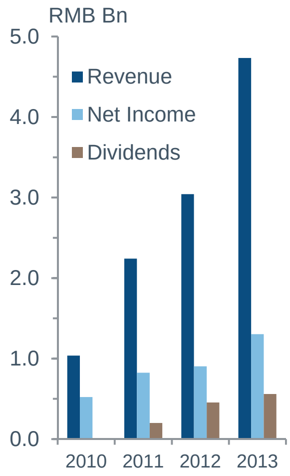
The business model proved a sensation, propelling Sihuan to the number one spot in China's cardio-cerebral vascular (CCV) market, edging out global behemoths Pfizer and Sanofi. Sihuan had carved out a 10.8% (USD 1.5bn) market share of the RMB 83bn (USD 13.7bn) CCV industry. This dominance in the segment was almost entirely responsible for Sihuan's third position in China's overall hospital market. In 2010, Forbes listed the company as the fourth most promising enterprise in China and first among pharmaceutical companies.

Sihuan's bullish shareholders were growth and momentum investors, who either believed in the company's long-term growth story or were riding the wave while it lasted. The growth drivers were:

- Patent protections which provided the company with pricing power - the ability to increase prices without seeing a significant drop-off in demand.
- Skilled leaders fluent in the art of navigating the Chinese medical system - this required the effective lobbying of regional governments and regulatory bodies, as well as building and maintaining a network of loyal doctors to prescribe the medicines.
- Secular tailwinds of an aging population, a related increase in the incidence of cardiovascular diseases and a low medical penetration of the population offered the prospect of a growing consumer base.

However, from September 2011 we had some fundamental concerns with the stock, which meant our portfolios avoided it. As these concerns grew, some Fidelity funds took short positions. Here, we detail the governance red flags that informed these investment decisions.

Chart 2: Sihuan's meteoric rise



Source: Company filings, FIL, January 2015

Red flag #1:Unsustainable business model

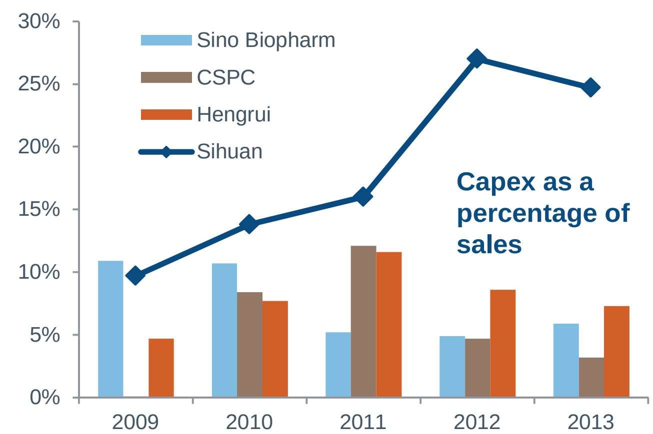
Low product efficacy

The clinical data on the effectiveness of Sihuan's key products was unconvincing and discussions with doctors and expert networks confirmed those doubts. This implied that the growth of Sihuan was not driven by the quality of its product portfolio but instead through other means that could prove temporary.

Weak product pipeline

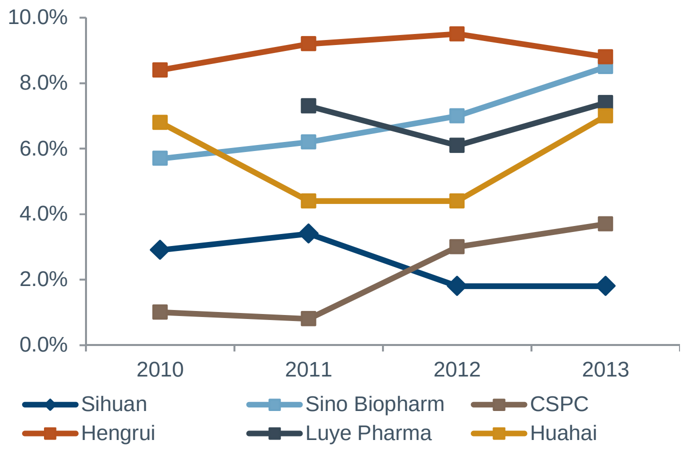
Without a high-quality, high-efficacy product range, Sihuan needed new, more effective products. Although the company was spending much more on capital expenditures than peers (chart 3), curiously very little was allocated to R&D (chart 4). Sihuan amassed its product portfolio through acquisitions and its low R&D investment meant that its organic ability to deliver new products was weak. To maintain its growth, Sihaun would need to continue to acquire potentially expensive drugs. This put Sihuan's ability to scale up the business at risk.

Chart 3: Capex spending higher than peers



Source: Company filings, FIL, January 2015

Chart 4: R&D spending lower than peers



Note: Estimated R&D costs as a percentage of sales
Source: Company filings, Macquarie Research, FIL, January 2015

Red flag #2: Questionable business practices

Dependence on government rebates

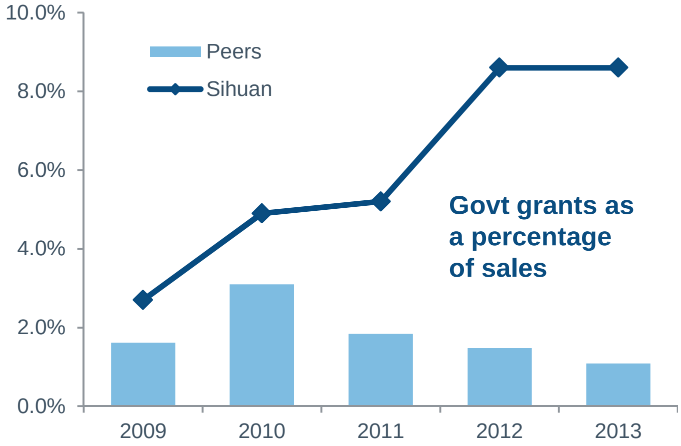
Sihuan received disproportionately high government grants compared to its peers (chart 5), and while peer grants were falling, Sihuan's continued to remain elevated. In 2013, 80% of Sihuan's net profit came from local government rebates, while the remaining 20% was from land purchase reimbursements. This dependence on rebates exposed Sihuan to policy changes.

Growing distribution costs

The company's distribution costs were growing much faster than sales and faster than any other major cost (chart 6). Usually a company reduces costs as a proportion of sales as it grows due to the economic benefits of scale. While most of Sihuan's major costs were displaying this trend, its distribution costs were showing the opposite.

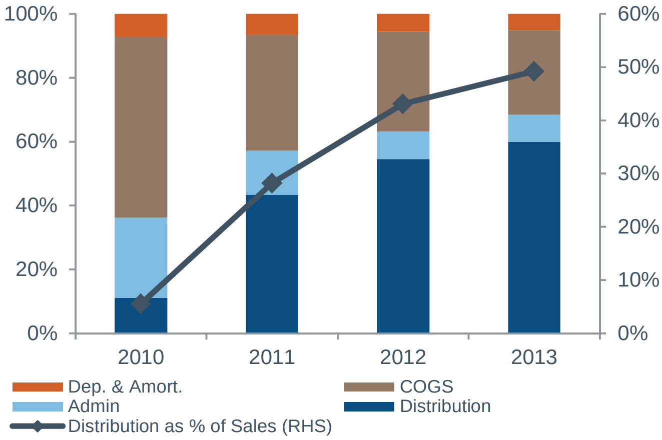
It was difficult to pin down why Sihuan's distribution costs were rising compared to revenues. Because Sihuan outsourced its sales force, distribution acted as a murky catch-all accounting term, hiding details such as incentivisation expenses for agents and possibly doctors.

Chart 5: Disproportionately high government grants



Source: Company filings, FIL, January 2015

Chart 6: The rising cost of distribution



Note: Costs as a percentage of total major costs
Source: Company filings, FIL, January 2015

Red flag #3: Low trust in management

Conversations with management and assessments of their public announcements revealed that:

- Some statements were simply implausible such as the sudden disclosure that it was commercialising anti-ebola drug jk-05 during the West African Ebola crisis of 2014. The drug had no publicly available clinical data, and China had no known live ebola virus stocks to research treatments or the required laboratories to develop them.[1]
- Management presentations focussed heavily on the share price but paid scant attention to the underlying business operations or strategy.
- Decisions to outsource the sales force, minimise R&D investment and focus on government and hospital lobbying, suggested management was prioritising short-term business wins over building a healthy long-term enterprise.

These points combined to erode our trust in the management.

Catalysts

While our analysis raised these concerns, the market remained positive on Sihuan, driving its share price to ever greater heights. However, there were several catalysts that we thought could trigger a change in sentiment.

- **Corruption clampdown** - Chinese president Xi Jinping assumed office in March 2013 promising to crack down on corruption. Corporate excesses began to be curbed by the government and regulators. GlaxoSmithKline, a British pharmaceuticals company, was hit by a record GBP 297 million fine for bribery in October 2014. Sihuan's prominence and potentially large doctor incentivisation programmes made it a prime candidate in any new investigation.
- **Healthcare budget cuts** - China's healthcare spending had rocketed from USD115 per head in 2007 to USD 375 in 2013[2]. Pressure on local government finances looked likely to force them to limit healthcare subsidies, implying price cuts for Sihuan.
- **New tendering cycle** - The end of 2014 saw the start of nine new provincial drug tenders and more would follow in 2015. Sihuan would need to compete to renew access to hospitals in an environment where their political modus operandi could be rendered ineffective by the anti-corruption drive.

Outcome

Sihuan's shares were suspended from the Hong Kong Stock Exchange (HKEx) on the 27 March 2015, precipitating its fall from grace. The company had failed to publish audited accounts within three months of the end of the business year after its auditors refused to sign off the financial statements. One of the auditor's qualms was Sihuan's accounting for distribution expenses.

70% decline in share price between November 2014 and March 2016

In August 2015, the company released its delayed 2014 accounts, with major restatements around sales and marketing expenses of previous years. An investigation led by the audit committee found the company had conducted off-book transactions through bank accounts opened in the names of employees.

Sihuan board member, Zhang Jionglong, was arrested in November 2015 by the Independent Commission Against Corruption. He was subsequently released on bail while investigations continued. Details of the investigation were not disclosed.

In March 2016, the company resumed trading on HKEx after fulfilling the resumption conditions which included launching an independent forensic investigation.

Sihuan's share price fell 70% from its peak of HKD 6.28 on 25 October 2014 to HKD 1.91 when it resumed trading.

Conclusion

Sihuan contained a number of corporate governance red flags that completely undermined the investment case. An unsustainable business model, short-termist business practices, suspect accounting and an unreliable management team combined to raise serious concerns about the company's viability.

We believed that several catalysts could reverse the positive sentiment on the stock: a corruption clampdown in China, provincial healthcare budget cuts and new drug tendering cycles where the company's political skill would be less pervasive.

In the end, the auditor's refusal to approve the 2014 accounts hastened a sharp shift in fortune for Sihuan. The event triggered a loss of confidence so that when the shares resumed normal trading nearly a year later, the company had lost 70% of its market value, allowing several of our funds to benefit profit from short positions.

The story of Sihuan is a reminder of the role that examining corporate governance plays within the core investment process. Not only can analysing governance help avoid bad investments which subsequently turn sour, but diligent investors can sometimes profit from these situations when they occur.

References

[1]Chinese company develops ebola treatment - Financial Times, 9 October 2014

[2]World Bank database

Important Information

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