Outthink. Outperform.

Minimal impact from medicine price control

We believe the proposed medicine price control measure is not expected to hurt Apex Healthcare (Apex) as it does not produce any single-source drugs, while contribution from the distribution of single-source drugs for its customers are not significant. While we look forward to maiden earnings contribution from its oral solid factory and remain upbeat on Apex's long-term prospects, we expect near-term earnings to be weak, given the estimated 1.5-2 year gestation period for the former. We make no changes to our earnings forecasts and maintain our HOLD call on Apex with a 12-month TP of RM2.11.

Expect minimal impact from the proposed medicine price control

The impending medicine price control measure is mainly focussed on curtailing the prices of single-source drugs to ensure the affordability of drugs. However, this will likely to be a non-event to Apex's manufacturing business as it does not produce any single-source drug. While it is involved in the distribution of single-source drugs for its customers, its entire distribution business is estimated to make up only c.7% of the group's core net profit in 2018. Based on our sensitivity analysis, every 10% decline in Apex's distribution revenue would reduce the group's core net profit by only 1% for 2019-21E. On a positive note, Apex may renegotiate the fee imposed with its customers in order to cushion this impact.

More opportunities ahead, but near-term outlook remains weak

Apex is currently in the midst of transferring high-volume products from its existing plant to SPP NOVO. With the new capacity from SPP NOVO, the group will be able to cater to more high volume production, especially government tenders. That said, we think its near-term earnings are likely to be weak given the estimated 1.5-2 year gestation period for SPP NOVO.

Orthopaedic devices manufacturing business on expansion mode

Given the rising demand for orthopaedic devices, Apex's 40%-owned associate Strait Apex, an orthopaedic devices contract manufacturer, is also looking at expanding its production capacity by renting a third facility, with a target to bring in equipment to the new facility by end-2019. Notably, the associate has managed to secure new customers due to trade tension as most of its customers are US multinational corporations (MNCs).

Maintain HOLD with TP of RM2.11 on near-term weakness

We maintain our earnings forecasts and HOLD call on Apex with an unchanged TP of RM2.11, based on 2020E target PER of 17x. On a side note, we note that the worsening haze, which has led to rising demand for masks, could potentially provide a one-off upside to Apex.

Earnings & Valuation Summary

FYE 31 Dec	2017	2018	2019E	2020E	2021E
Revenue	620.3	652.7	699.2	759.3	802.8
EBITDA	60.2	71.0	74.1	82.8	91.0
Pretax profit	56.0	69.3	69.2	77.8	86.0
Net profit	44.5	58.6	51.8	58.3	64.4
EPS(sen)	9.5	12.5	11.0	12.4	13.7
PER	22.0	16.7	19.0	16.9	15.3
Core net profit	45.0	60.2	51.8	58.3	64.4
Core EPS(sen)	9.6	12.8	11.0	12.4	13.7
Core EPS growth (%)	12.8	33.9	(14.0)	12.6	10.5
Core PER	21.8	16.3	19.0	16.9	15.3
Net DPS(sen)	3.0	3.4	3.5	4.0	4.4
Dividend Yield (%)	1.4	1.6	1.7	1.9	2.1
EV/EBITDA (x)	14.9	13.1	12.4	10.9	9.6
Debt to equity (x)	-	0.1	0.1	0.0	0.0
BPS (RM)	0.7	0.8	0.9	1.0	1.1
PBR (x)	2.8	2.5	2.3	2.1	1.9
Chg in EPS (%)			-	-	-
Affin/Consensus (x)			1.0	1.0	1.0

Source: Company, Bloomberg, Affin Hwang forecasts

Company Update

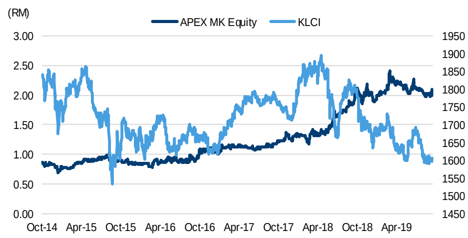
Apex Healthcare

APEX MK
Listing Market: Main
Sector: Healthcare & Pharmaceuticals

RM2.09 @ 19 September 2019
KLCI: 1,596.3

HOLD (maintain)
Upside: 1%

Price Target: RM2.11
Previous Target: RM2.11



Price Performance

	1M	3M	12M
Absolute	4.5%	-0.8%	10.0%
Rel to KLCI	4.5%	3.5%	24.1%

Stock Data

Issued shares (m)	471.7
Mkt cap (RMm)/(US$m)	985.8/235.2
Avg daily vol - 3mth (m)	0.1
52-wk range (RM)	1.88-2.46
Est free float	19.4%
BV per share (RM)	0.86
P/BV (x)	2.44
Net cash/(debt) (RMm)	77.86
ROE (%) (2019E)	13%
Beta	0.33
Derivatives	Nil
Shariah Compliant	Yes

Key Shareholders

Apex Pharmacy Holdings	40.3%
Washington H Soul Pattison	30.1%
Liew Yoon Yee	1.6%

Source: Company, Bloomberg

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Likely to be shielded from the impending medicine price control

Not in the manufacturing of single-source drugs

On 2nd May this year, the Cabinet announced that price control measures for pharmaceutical drugs would be implemented in 2019. The MoH will use external reference pricing (ERP) to benchmark drug prices in Malaysia, averaging the three lowest drug prices in three countries to determine ceiling prices. Ceiling prices will be imposed at the wholesale and retail levels. While the specific mechanism to be used has yet to be determined as it is still in the discussion stage, we understand that the intention is to curtail the prices of single-source drugs to ensure the affordability of drugs. For Apex's pharmaceutical manufacturing business, we think the group is shielded as it does not produce any single-source drug.

Distribution business might be affected, but likely to be minimal

While for its distribution segment, Apex is involved in the distribution for its customers' single-sourced products. As it charges a distribution fee based on a certain margin computed on the products' sales value, the implementation of price control for medicine is expected to have adverse impact on the group. That said, note that the entire distribution division only made up 23% of the group's revenue in 2018 with a very thin net profit margin estimated at 3% (vs. the group's blended core net profit margin of 9% in 2018). Based on our estimates, distribution business made up c.7% of the group's core net profit in 2018. Our sensitivity analysis shows that every 10% decline in Apex's distribution revenue would reduce the group's core net profit by only 1% for 2019-21E. On a positive, Apex may renegotiate the fee imposed with its customers in order to cushion the impact.

More opportunities ahead with SPP NOVO…

In the midst of transferring products to SPP NOVO

Post-receiving regulatory approval to start commercial production of SPP NOVO on 16th May, Apex has been working on transferring high-volume oral solid dosage products from its existing plant to its new oral solid dosage manufacturing plant, SPP NOVO. This involves migration and validation process to test the robustness of the equipment and process as the equipment, process and production volume for SPP NOVO are different as compared to its existing plant. So far the group has validated 3 products in different batches, and plans to transfer 7 products by end-2019.

Fig 1: Progress of SPP NOVO

Progress of SPP NOVO	Timeline
Received Certificate of Practical Completion (CPC)	31-Oct-2018
Completed construction of SPP NOVO	End-2018
Received Certificate of Completion and Compliance (CCC)	21-Dec-2018
National Pharmaceutical Regulatory Agency (NPRA) inspection	End-Apr 2019
Received NPRA approval	16-May-2019
Transferring high-volume oral solid dosage products to SPP NOVO	Present

Source: Company, Affin Hwang

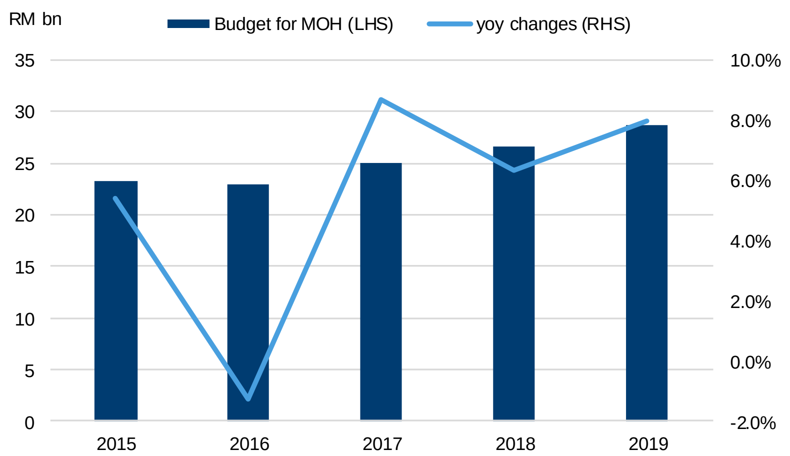
Eyeing opportunities in government tenders

Revenue contribution from government contracts to the group grew 70% yoy to RM63m in 2018 (10% of group revenue in 2018 vs. 6% of group revenue in 2017). Recall that the group has only started to be more active in government tenders as it did not have sufficient capacity to take on such orders previously. With the commencement of commercial production at SPP NOVO, the group will be able to cater to more high volume production, especially government-sector tenders that come out from time to time throughout the year. The new capacity also comes at the right time, providing the group an edge to grab a larger pie in government contract, especially as the government tries to address the monopoly in drug distribution in the country.

Rising government healthcare expenditure bode well for the group

The Malaysian government's growing emphasis on quality healthcare and social welfare protection would also see the government continuing to allocate higher budget for healthcare in the upcoming Budget 2020, which should bode well for Apex. The 2019 budget allocation for Ministry of Health (MoH) of RM29bn, which represents a 7.8% increase over the RM27bn for 2018, is a significant change relative to its 3-year (2015-2018) CAGR of 4.5% in budget allocation for MoH. In addition, Apex is also eyeing more opportunities from Singapore's rising budget for healthcare allocated to meet the growing demands of its ageing population. According to Singapore's Minister for Finance, the government healthcare spending is expected to grow to SGD11.7bn in FY19, which represents a 10.4% increase from SGD10.6bn in FY18.

Fig 2: Malaysia's budget allocation for MOH



Source: Ministry of Finance Malaysia, Affin Hwang

… but near-term outlook remains muted

Near-term earnings likely to remain weak on start-up expenses

While the commencement of product sales manufactured by SPP NOVO should lead to higher revenue to the group and help to partly mitigate the start-up expenses in second half of the year, we expect the new plant to be in a gestation period in the near-term given the high start-up expenses and lower margin from government tenders. To recap, the group's core net profit declined 10% yoy in 6M19 due to higher operating and finance expenses arising from the start-up of SPP NOVO, despite recording higher revenue (+4% yoy).

Associate's business on expansion mode

Secured new customers as a result of trade tension

The group's 40%-owned associate, Straits Apex Sdn Bhd's contribution grew strongly by 121% yoy in 2Q19, which offset the significant decline in 1Q19 (-57% yoy). The volatility has largely to do with the associate having secured a new customer and in the process of setting up facility and testing for the new customer in 1Q19. Notably, the contract manufacturer of surgical grade orthopaedic devices has managed to secure new customers as a result of the US-China trade tension as most of its customers are US multinational corporations (MNCs). Cumulatively, the contributions from its associate grew 31% yoy in 6M19.

Capacity expansion to cater to growing demand

Given the rising demand for orthopaedic devices, Straits Apex is looking to expand its production capacity by renting a third facility with around 50,000-60,000 sq. ft. of additional space in Prai. Currently it operates a main production facility in Prai Industrial Estate and a clean room facility for packaging in Penang Island. The quantum of increase in capacity are not certain at the moment as the associate just signed the tenancy for the third factory and haven't bright in any equipment to the factory. The group aims to bring in equipment to its third factory by end of 2019. According to Absolute Markets Insights, global orthopaedic device market is expected to grow at a CAGR of 3.6% over the period of 2019-2027 and reach US$58.4bn by 2027E, owing to cutting-edge technological advancements.

Potential one-off puff from haze

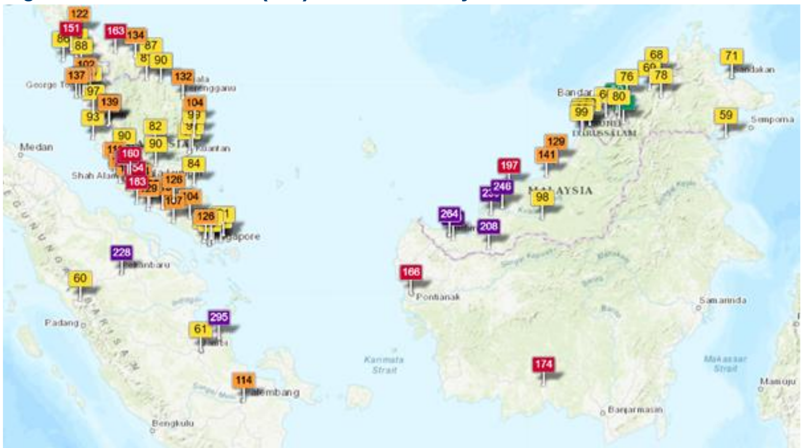
Worsening haze

The haze has worsened in several parts of Malaysia recently due to the dense smoke blown in from forest fires in Indonesia. The Air Pollution Index (API) readings soared to >200 in some of the states in Malaysia, with Kuching being the worst, which resulted in Malaysia being ranked among the top 10 countries with the world's worst API, according to the World Air Quality Index (Fig 1). The World Health Organization (WHO) had on 30 August issued a warning to vulnerable communities due to the air pollution. This is not just an environmental issue but a public health issue. According to the ***largest international study*** on the short-term impact of air pollution on death conducted to date by measuring particulate matter and daily death rates in 652 cities in 24 countries, more air pollution means more deaths, even with short exposure to low levels of air pollution.

A potential beneficiary, but could be minimal

Our channel checks found that most of the stores and pharmacies in Malaysia have run out of masks given the rising demand as people are now more aware of the importance of using masks to protect themselves from the haze that has blanketed the nation. This is especially for ***N95-type face masks***, one of the masks that offer the best protection as they are designed to filter at least 95% of the tiny, 0.3-micron particles. We think that Apex could potentially benefit from this, as it is involved in distribution and wholesale for 3M, the company that produces one of the relatively affordable N95-type masks. While this could provide a positive bump to Apex's 3Q19 earnings, note that it is a one-off event and could be minimal to the group's full-year earnings (c.2% to Apex's 2019E earnings).

Fig 3: Air Pollution Index (API) values in Malaysia



Source: World Air Quality Index

Fig 4: Air Quality Levels descriptions

AQI	Air Pollution Level	Health Implications	Cautionary Statement (for PM2.5)
0 - 50	Good	Air quality is considered satisfactory, and air pollution poses little or no risk	None
51 -100	Moderate	Air quality is acceptable; however, for some pollutants there may be a moderate health concern for a very small number of people who are unusually sensitive to air pollution.	Active children and adults, and people with respiratory disease, such as asthma, should limit prolonged outdoor exertion.
101-150	Unhealthy for Sensitive Groups	Members of sensitive groups may experience health effects. The general public is not likely to be affected.	Active children and adults, and people with respiratory disease, such as asthma, should limit prolonged outdoor exertion.
151-200	Unhealthy	Everyone may begin to experience health effects; members of sensitive groups may experience more serious health effects	Active children and adults, and people with respiratory disease, such as asthma, should avoid prolonged outdoor exertion; everyone else, especially children, should limit prolonged outdoor exertion
201-300	Very Unhealthy	Health warnings of emergency conditions. The entire population is more likely to be affected.	Active children and adults, and people with respiratory disease, such as asthma, should avoid all outdoor exertion; everyone else, especially children, should limit outdoor exertion.
300+	Hazardous	Health alert: everyone may experience more serious health effects	Everyone should avoid all outdoor exertion

Source: World Air Quality Index

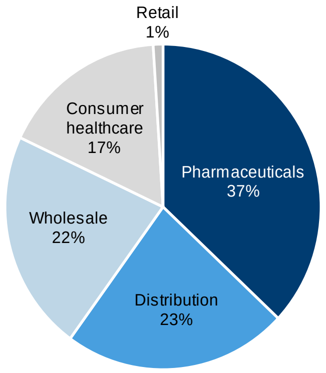
Valuation and Recommendation

Maintain HOLD with a TP of RM2.11

All in, while we look forward to the contribution from SPP NOVO and remain upbeat on Apex's long-term prospects, the group's near-term earnings are expected to remain weak given the estimated 1.5-2 year gestation period for SPP NOVO (our forecast: 14% yoy decline in 2019E core earnings). We maintain our earnings forecasts and HOLD call on Apex with an unchanged TP of RM2.11, based on 2020E target PER of 17x. Upside risk: lower-than-expected start-up expenses for SPP NOVO. Downside risks: higher-than-expected start-up expenses and product recall risk.

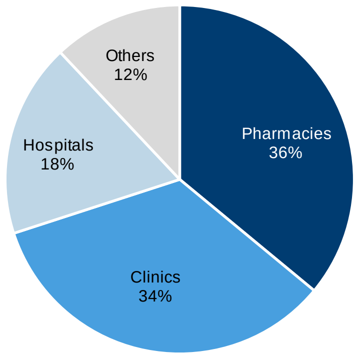
Focus charts

Fig 5: Revenue breakdown by divisions (2018)



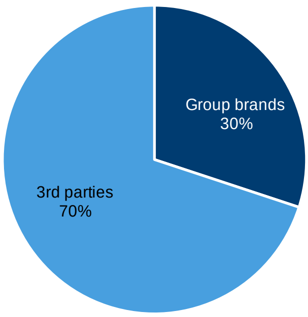
Source: Company, Affin Hwang

Fig 6: Revenue breakdown by channels (2018)



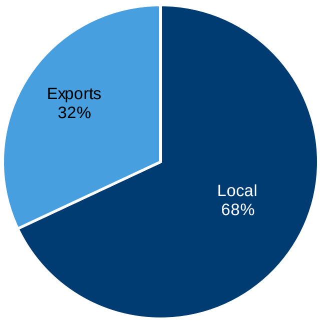
Source: Company, Affin Hwang

Fig 7: Revenue breakdown by brands (2018)



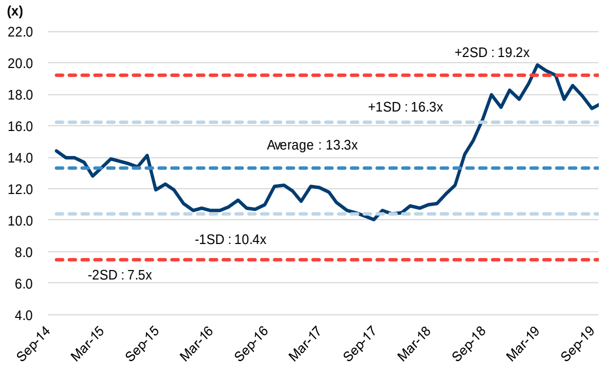
Source: Company, Affin Hwang

Fig 8: Revenue breakdown by markets (2018)



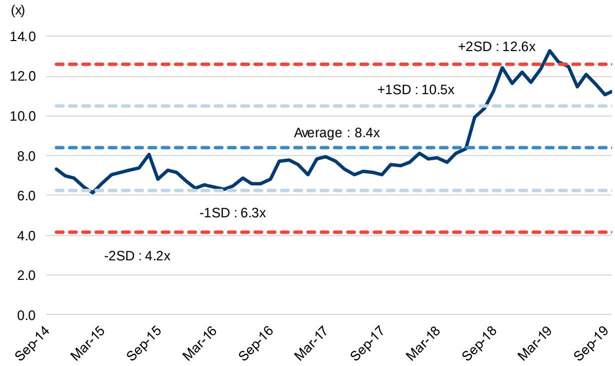
Source: Company, Affin Hwang

Fig 9: Apex's 5-year forward PER



Source: Company, Affin Hwang estimates

Fig 10: Apex's 5-year forward EV/EBITDA



Source: Company, Affin Hwang estimates

Apex Healthcare – FINANCIAL SUMMARY (FYE 31 Dec)

Profit & Loss Statement

FYE 30 Dec (RM m)	2017A	2018A	2019E	2020E	2021E
Revenue	620.3	652.7	699.2	759.3	802.8
Operating expenses	560.1	581.7	625.1	676.5	711.8
EBITDA	**60.2**	**71.0**	**74.1**	**82.8**	**91.0**
Depreciation	-9.5	-9.4	-12.0	-12.6	-13.3
EBIT	**50.7**	**61.6**	**62.1**	**70.2**	**77.7**
Net int income/(expense)	2.5	1.6	0.5	0.9	1.4
Associates' contribution	5.4	7.8	8.2	8.6	9.0
Pretax profit	**56.0**	**69.3**	**69.2**	**77.8**	**86.0**
Tax	-11.6	-10.6	-17.3	-19.5	-21.5
Minority interest	0.0	0.1	0.1	0.1	0.1
Net profit	**44.5**	**58.6**	**51.8**	**58.3**	**64.4**

Balance Sheet Statement

Other long term assets	32.7	33.7	41.8	50.2	59.1
Total non-current assets	**157.7**	**210.9**	**222.3**	**233.5**	**244.5**
Cash and equivalents	80.9	81.2	90.2	101.9	121.9
Stocks	69.0	83.1	87.0	93.9	100.7
Debtors	139.3	160.4	171.9	186.6	197.3
Other current assets	10.0	4.4	4.4	4.4	4.4
Total current assets	**299.2**	**329.0**	**353.4**	**386.8**	**424.3**
Creditors	106.5	117.7	123.1	133.0	142.6
Short term borrowings	0.0	5.9	5.9	5.9	5.9
Other current liabilities	3.6	1.5	1.5	1.5	1.5
Total current liabilities	**110.2**	**125.0**	**130.5**	**140.3**	**150.0**
Long term borrowings	0.0	24.0	19.0	14.0	9.0
Other long term liabilities	3.1	4.4	4.4	4.4	4.4
Total long term liabilities	**3.1**	**28.5**	**23.5**	**18.5**	**13.5**
Shareholders' Funds	**343.2**	**386.0**	**421.2**	**460.8**	**504.7**
Minority interest	**0.4**	**0.5**	**0.6**	**0.6**	**0.7**

Cash Flow Statement

FYE 30 Dec (RM m)	2017A	2018A	2019E	2020E	2021E
EBIT	50.7	61.6	62.1	70.2	77.7
Depreciation & amortisation	9.5	9.4	12.0	12.6	13.3
Working capital changes	-0.9	-16.3	-9.8	-11.9	-7.9
Cash tax paid	-11.4	-15.0	-17.3	-19.5	-21.5
Others	-1.6	0.8	-1.1	-0.9	-0.7
Cashflow from operation	**46.3**	**40.5**	**45.9**	**50.6**	**60.9**
Capex	-34.1	-62.4	-15.0	-15.0	-15.0
Others	4.5	-3.4	-0.3	-0.3	-0.3
Cash flow from investing	**-29.6**	**-65.8**	**-15.3**	**-15.3**	**-15.3**
Debt raised/(repaid)	0.0	29.9	-5.0	-5.0	-5.0
Dividends paid	-13.5	-15.2	-16.6	-18.7	-20.6
Others	0.0	31.1	-5.0	-5.0	-5.0
Cash flow from financing	**-13.5**	**15.9**	**-21.6**	**-23.7**	**-25.6**
Free Cash Flow	**12.3**	**-22.0**	**30.9**	**35.6**	**45.9**

Key Financial Ratios and Margins

FYE 30 Dec (RM m)	2017A	2018A	2019E	2020E	2021E
Growth					
Revenue (%)	7%	5%	7%	9%	6%
EBITDA (%)	8%	18%	4%	12%	10%
Core net profit (%)	13%	34%	-14%	13%	11%
Profitability					
EBITDA margin (%)	10%	11%	11%	11%	11%
PBT margin (%)	9%	11%	10%	10%	11%
Net profit margin (%)	7%	9%	7%	8%	8%
Effective tax rate (%)	21%	15%	25%	25%	25%
ROA (%)	10%	12%	9%	10%	10%
Core ROE (%)	14%	16%	13%	13%	13%
ROCE (%)	15%	15%	14%	15%	15%
Liquidity					
Current ratio (x)	2.7	2.6	2.7	2.8	2.8
Op. cash flow (RMm)	46.3	40.5	45.9	50.6	60.9
Free cashflow (RMm)	12.3	-22.0	30.9	35.6	45.9
FCF/share (RM)	0.03	-0.05	0.07	0.08	0.10
Asset management					
Debtors turnover (days)	82	84	87	86	87
Stock turnover (days)	51	56	60	59	59
Creditors turnover (days)	78	82	84	83	83
Capital structure					
Net gearing (%)	-24%	-13%	-15%	-18%	-21%
Interest cover (x)	n/a	n/a	n/a	n/a	n/a

Quarterly Profit & Loss

FYE 30 Dec (RM m)	2Q18	3Q18	4Q18	1Q19	2Q19
Revenue	155.9	165.3	163.1	178.2	159.3
Operating expenses	137.8	146.6	145.9	160.7	142.3
EBITDA	**18.1**	**18.6**	**17.2**	**17.6**	**17.0**
Depreciation	4.4	6.7	9.4	3.5	7.2
EBIT	**15.9**	**16.4**	**14.5**	**14.1**	**13.2**
Net int income/(expense)	1.5	1.4	1.3	1.3	1.5
Associates' contribution	1.5	2.3	2.4	0.8	3.3
Exceptional Items	-1.5	-1.4	-1.3	-1.6	-1.9
Pretax profit	**17.4**	**18.6**	**16.7**	**14.5**	**16.2**
Tax	-3.7	-3.7	0.1	-3.1	-3.0
Minority interest	0.0	0.0	0.0	0.0	0.0
Net profit	**13.7**	**14.9**	**16.8**	**11.4**	**13.2**
Core net profit	**14.0**	**15.3**	**17.7**	**11.4**	**13.3**
Margins (%)					
EBITDA	11.6%	11.3%	10.5%	9.8%	10.7%
PBT	11.1%	11.3%	10.3%	8.2%	10.2%
Net profit	8.8%	9.0%	10.3%	6.4%	8.3%

Source: Company, Affin Hwang forecasts

Important Disclosures and Disclaimer

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +10% over a 12-month period
HOLD	Total return is expected to be between -5% and +10% over a 12-month period
SELL	Total return is expected to be below -5% over a 12-month period
NOT RATED	Affin Hwang Investment Bank Berhad does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation

The total expected return is defined as the percentage upside/downside to our target price plus the net dividend yield over the next 12 months.

OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

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A Participating Organisation of Bursa Malaysia Securities Berhad

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