

Trends in the Future of China's Retail Pharmacy Industry

Yutong Hu^{1,a,*}

¹*School of Slavonic and East European Studies, University College London, London, WC1E6BT, United Kingdom*

a. Aletta.hu.21@ucl.ac.uk

**corresponding author*

Abstract: Retail pharmacies are the largest market for the sale of medicines in China. In recent years, outbound mergers and acquisitions have become an essential means of promoting the growth of the pharmaceutical industry, considering the industry's increasing concentration and degree of the chain. Furthermore, the background of the rise of domestic e-commerce combined with the stimulus of the covid-19 pandemic has ushered in a golden period for online pharmacy development. In addition, from the perspective of the policy environment, the prescription outflow trend will also drive the development of the pharmacy industry. In the future, the competition between online and physical pharmacies will become more intense. Chinese leading pharmaceutical companies have all made strategic moves to respond to changes in the industry. By introducing an example of a leading domestic company acquiring a small pharmacy, this paper aims to provide insight to investors into the strategic thinking of pharmacies in the context of the current industry development in China.

Keywords: pharmaceutical industry, retail pharmacy, China

1. Introduction

In China, the retail pharmacy industry is a crucial link in the pharmaceutical industry chain that carries on from the top to the bottom. For 2022, China's retail pharmacy market reached RMB 542.1 billion in sales, up 10.2% year-on-year, the highest increase in nearly five years. In December, the retail pharmacy market grew explosively in a single month in December, driven by medicines and supplies related to epidemic prevention, with monthly sales exceeding RMB80 billion, an increase of over 80% year-on-year [1]. Sales to public hospitals and primary care terminals fell by nearly 12 per cent in 2020 amid the epidemic's impact; sales to pharmacies grew by 3.2 per cent year-on-year, increasing to 26.3 per cent of sales, although the total antibiotic consumption decreased during COVID-19 [2].

This paper will focus on a typical M&A deal launched by a leading Chinese retail pharmacy company during the pandemic --- The acquisition of Hua Tuo Pharmacy by LBX Pharmacy Chain Joint Stock Company (referred to as LBX pharmacy) --- to discuss the opportunities and risks behind the strategic transformation of the expansion of the retail pharmacy industry in China.

The remaining parts of this paper are organised as follows: Section 2 will first briefly introduce the retail pharmacy industry in China, from an Industry overview and market size analysis to a discussion of future growth prospects. Based on related policy, a forecast of the development of the retail pharmacy industry will also be discussed in this section. Section 3 will talk about the business ecosystem by analysing the industry's competitive landscape. In addition, this section will focus on

assessing the competitive outlook of the transaction post-acquisition and the strategic move of LBX pharmacy. The purpose of M&A deal of LBX pharmacy will also be discussed in this section.

2. A Summary of the Retail Pharmacy Industry in China

2.1. Industry Overview and Market Size Analysis

China's pharmaceutical industry chain is divided into three segments: pharmaceutical manufacturing, distribution, and consumption. Retail pharmacies are a key link in the pharmaceutical distribution section. China's pharmaceutical retail industry is mainly divided into two markets: medical terminals and retail pharmacies, and pharmaceutical retail pharmacies are divided into three business models: single pharmacies, chain pharmacies and network pharmacies.

Compared to single-unit pharmacies, the advantages of chain pharmacies are reflected in their cost control, brand influence and operational management strategies. Chain pharmacies have a larger purchasing volume, which gives them greater bargaining power when purchasing goods, resulting in lower purchasing costs.

Figure 1 illustrates the change in the number of physical pharmacy sales and online pharmacy sales from 2015 to 2021. Moreover, each part's corresponding yearly growth rate has also been shown. In terms of the size of sales, physical pharmacy sales (4315 billion RMB) were much higher than online pharmacy sales (144 billion RMB) in 2015. However, due to the boom of online pharmacy sales starting in 2015, the sales of online pharmacies (2234 billion RMB) reached half of the physical pharmacy sales (5716 billion RMB) in 2021. The graph shows that the growth rate of physical pharmacy sales has decreased yearly from 8.6% to 2.51% during the 2015-2021 period. On the other hand, the growth rate of online pharmacy sales is much higher than the growth rate of physical pharmacy sales, with an average of around 60%.

To sum up, in the discussion of Figure 1, although the market is mainly occupied by physical pharmacies (including both single and chain pharmacies), the growth rate of online pharmacy sales is increasing significantly from 2015 to 2021. This is mainly due to the rapid development of e-commerce platforms in China in recent years. The penetration rate of online medicine purchases continues to rise, and Internet e-commerce is advancing, squeezing the performance of retail pharmacies.

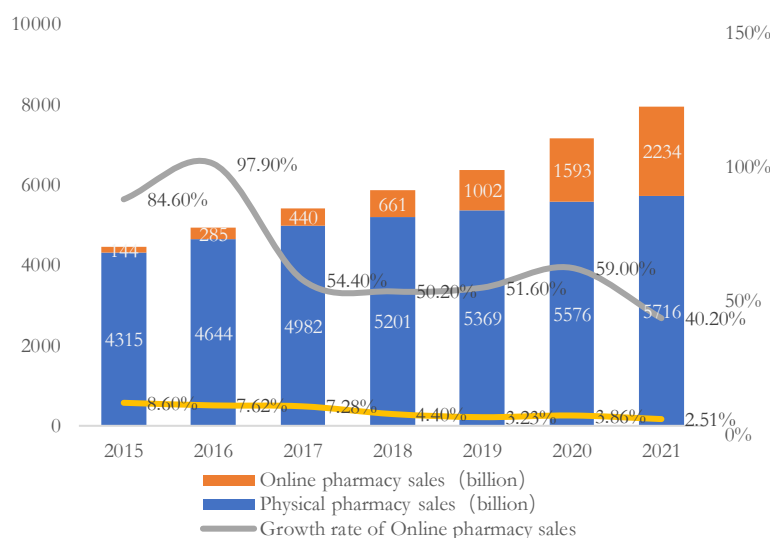


Figure 1: Total sales of online and physical pharmacy and the corresponding growth rate in 2015-2021. Data source: [3]. Photo credit: Original.

2.2. Future Development of the Industry

With the increasing maturity and regulation of the pharmaceutical industry, physical retail pharmacies' numbers and chain rates are on a significant upward trend. There are several factors behind such expansion. Firstly, from a policy environment perspective, the trend of prescription drug outflow is a main driver of the chain rate. Su Jingqin found that adapting to the policy regime is an important reason for Chinese firms to undertake successive M&As [4]. Prescription outflow means that hospitals open their prescription lists to the public so patients can use them to buy prescription drugs at retail pharmacies. For example, the "Guiding Opinions on Establishing and Improving the 'Dual Channel' Management Mechanism for National Health Insurance Negotiated Drugs" issued by the National Health Insurance Administration in 2021 states the importance of Utilizing the advantages of widely distributed, highly marketable and flexible services of designated retail pharmacies, as it complements each other with designated medical institutions to form a synergy of supply protection' [5].

The second factor is the accelerated consolidation of the retail pharmacy industry by the capital market. As the industry becomes increasingly competitive, the importance of reducing operating costs has been highlighted, and many small and micro pharmacies have been merged and restructured, gradually increasing the concentration of the industry. Jiang Guanhong argues that enhancing a firm's market power and resource allocation efficiency is one of the main reasons for mergers and acquisitions and that mergers and acquisitions positively impact a firm's market power [6]. The acquisition led by LBX Pharmacy will be discussed in the next section as a classic example.

To sum up, the industry is currently in a phase of rapid concentration, fueled by policy and capital, with outward growth being the main path for the growth of large chain pharmacies. As the diagram below illustrates, the number of retail pharmacy shops is increasing slightly year on year, but the chain rate is increasing rapidly, indicating a high market consolidation rate.

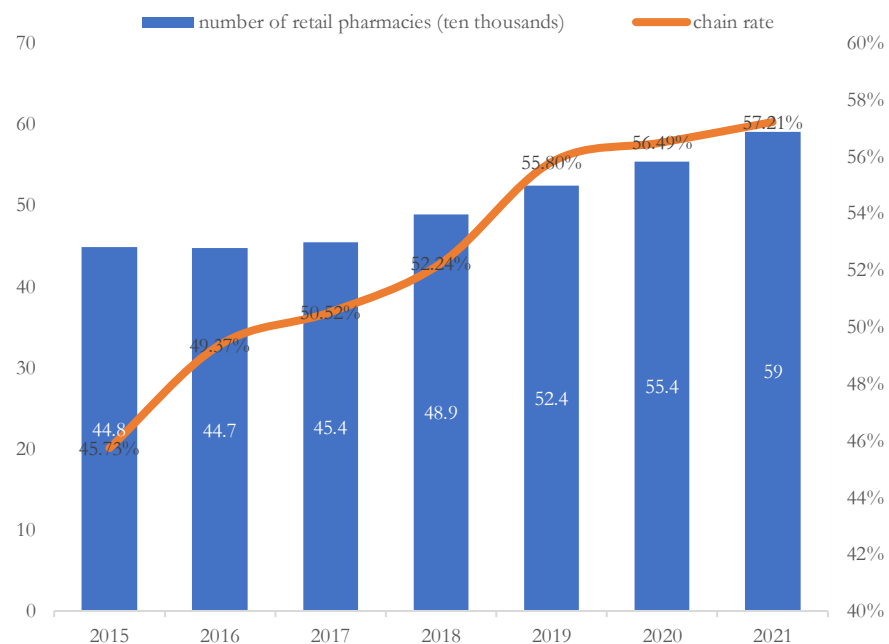


Figure 2: The number of retail pharmacies and the chain rate from 2015 to 2021 .Data source: [7].
Photo credit: Original.

Figure 2 illustrates the number of retail pharmacies and the chain rate in China from 2015 to 2021. In 2015, there were 448 thousand retail pharmacies in China, and the number increased gradually year by year at a steady pace. Meanwhile, the chain rate grows more rapidly compared to the number of retail pharmacies, increasing from 45.73% in 2015 to 57.21% in 2021. Such a phenomenon indicates that given a similar amount of retail pharmacies, more and more pharmacies are becoming chains through mergers and acquisitions and franchising.

In addition, with the rapid development of e-commerce platforms, the in-depth integration of online and offline is also expected to become a trend in the future development of the pharmacy industry. The sales channels of retail pharmacies have been further expanded through online prescriptions. Physical pharmacies become willing to lay out the online channel in advance and cooperate with e-commerce platforms such as Ali to cope with the intense competition that may come from online channels.

3. The Business Ecosystem

3.1. The Competitive Landscape

As of 2021, nine pharmaceutical retail companies have a market capitalization of \$20 billion [4] or more. In terms of total sales, the top three domestic retail pharmacy leaders are Sinopharm Corporation Limited, DaShenLin Pharmaceutical Group Corporation Limited and LBX Pharmacy Chain Joint Stock Company.

Table 1: The total sales in 2021.

Rank	Companies	Total sales (billion)
1	Sinopharm Corporation Limited	241.6
2	DaShenLin Pharmaceutical Group Corporation Limited	174.9
3	LBX Pharmacy Chain Joint Stock Company (The acquirer)	158.2
19	HuaTuo Pharmacy (Target company)	19.3
Data source: [7]		

Table 1 illustrates the total sales of the top three listed pharmacies and the target company of LBX pharmacy in 2021. As seen from the table, Sinopharm Corporation Limited has a total sale of 241.6 billion RMB in 2021, which is almost 1.5 times that of the second company. In terms of market share pattern, the company has a leading place in the Northern area, such as Beijing. The total sales of the second and third companies are close to each other; DaShenLin Pharmaceutical Group Corporation Limited (Dashenlin pharmacy) has 174.9 billion in total sales, and LBX Pharmacy Chain Joint Stock Company (LBX Pharmacy). Dashenlin Pharmacy is the largest pharmacy chain in Southern China; the company's strength is in South China, with a focus on expanding into the Yangtze River Delta (Bohai Sea Rim). The LBX pharmacy is developing in three main regions: South Central, East China and North China. Among them, the operating revenue of Central China was RMB 2.528 billion, while the operating revenue of South China was only 1/5 of that of Central China, which was only RMB 590 million, making the dominant position of Central China more obvious [8]. To sum up, because of the huge geographical area of China, leading companies generally occupy different regions of the market. Thus, large chain leaders are all looking to move from being regional leaders to national leaders.

For those large, listed pharmacies with a clear advantage in terms of revenue volume, outbound M&A has become an important means of driving the industry's growth. The single-unit pharmacies and medium-sized pharmacy chains are known as hot targets.

3.2. Strategic Purpose and Value

LBX Pharmacy is one of China's leading pharmaceutical retail pharmacies; the company's main business is a retail chain of pharmaceuticals and health-related products.

In addition to its commitment to the direct management model, LBX Pharmacy has actively explored the "Starfire project" cooperative model, which refers to a holding acquisition involving the founder team. The accelerated nationwide outflow of prescriptions has influenced the choice of M&A targets in the successive M&A decisions of LBX Pharmacy, i.e. to prioritise the acquisition of leading pharmaceutical retail companies above the blanket prefecture level in order to better expand its sales network nationwide and take up the incremental market share brought about by the outflow of prescriptions [9].

On the 25th of August 2021, LBX announced that the company would acquire 51% of Hua Tuo Pharmacy Pharmaceutical Chain Company Limited (referred to as "Hua Tuo Pharmacy") with its own capital of RMB 1.428 billion (including loans) [5]. Hua Tuo Pharmacy is one of the most influential pharmacies in North China; LBX Pharmacy believes that this acquisition will fill a relative gap in the company's marketing network coverage. In the announcement, it was stated that the P/E ratio of the transaction was higher than the average P/E ratio of 22.42 times (calculated using 2020's financial statement) for comparable transactions in the industry in the past three years due to the large scale of Hua Tuo Pharmacy and its high market share and brand influence in the main operating regions [10].

3.3. The Outcome of the Acquisition

However, the market did not react strongly to such a big acquisition. Three trading days after the disclosure of the acquisition, LBX pharmacy's share price did not show a big increase, opening with a 2.17% rise in the share price of RMB40 on the day following the announcement, which has since fallen back quickly, and the share price currently remains near 36-38 RMB [11].

On the 17th of March, LBX pharmacy announced that the acquisition would stop due to the 'Failure of the seller to complete the contractual obligations such as the divestment of the target company's assets. The LBX pharmacy's share price once fell to a record low of RMB34 per share, down nearly 35% since 2022.

The possibility of a failed acquisition had, in fact, been foreshadowed. The Shanghai Stock Exchange issued a letter of enquiry to the LBX pharmacy as soon as the acquisition announcement was revealed, asking the company to explain 'the reasons and reasonableness of the substantial premium for the subject company's valuation' [12].

4. Discussion

Firstly, the strategic starting point of acquiring leading regional pharmacies to increase overall market share is not a major mistake. As discussed above, boosted by capital and driven by policy, the first tier of listed pharmacy chains will inevitably move towards the acquisition of single pharmacies and medium-sized pharmacy chains. The first-tier pharmacies went public during 2014-2017; from the secondary market, listed pharmacy chains, with the advantage of financing, significantly accelerated the expansion pace after listing. Starting around 2018, M&A premiums for small and medium-sized pharmacies continue to be raised; pharmacy acquisition prices continue to soar. For example, in 2018, Gaoji Pharmacy and Yifeng pharmacy competed to acquire Xinxing Pharmacy, with Yifeng eventually acquiring 86.31% of Xinxing for RMB 1.384 billion, the largest M&A case in the industry

at that time [13]. Although the acquisition failed, the LBX pharmacy hoofed it and launched another acquisition. The announcement shows that the company intends to acquire RMB1.637 billion [14]. It shows that the LBX pharmacy does not negatively approach the idea of self-build + acquisition + franchise multi-model expansion. The 'Starfire Project' still believes to be a correct strategy move; the focus of sinking markets should be based on good completion of wide national market coverage. Meanwhile, it is also crucial to focus on deepening the network of shops in advantageous markets. This is still expected to be the main retail pharmacy industry development theme in the coming years.

5. Conclusion

In conclusion, this paper provides a comprehensive discussion on the retail pharmacy industry, which serves as a vital link in the pharmaceutical industry chain. Firstly, an analysis of the overall market performance of the retail pharmacy industry in China between 2015 and 2021 is presented. Through a thorough examination of various data, two prominent trends in the retail pharmacy industry have been identified.

The first trend pertains to the decline in growth rate and market shares of physical pharmacies, primarily due to the emergence of pharmaceutical e-commerce and shifts in consumer behavior. These changes have influenced residents' consumption habits, leading to a decrease in the popularity of traditional brick-and-mortar pharmacies. Consequently, physical pharmacies are facing significant challenges in maintaining their market position.

The second trend involves the ongoing expansion efforts undertaken by leading industry players, resulting in higher market concentration and chain rates. One notable example illustrating this trend is the merger and acquisition activity spearheaded by LBX Pharmacy. Similar to LBX Pharmacy, numerous listed pharmacy companies have capitalized on financing opportunities to pursue mergers and acquisitions, thereby aiming to enhance their market share and strive for national leadership.

Looking ahead, the future development of the pharmacy industry is expected to witness a profound integration of online and offline channels. This convergence is anticipated to become the prevailing trend, requiring pharmaceutical retailers to actively explore the business models of pharmaceutical e-commerce. In addition to accelerating mergers and acquisitions in the offline realm, industry players must proactively embrace and leverage the potential of e-commerce to remain competitive in the evolving market landscape. By adopting a comprehensive approach that encompasses both online and offline strategies, pharmaceutical retailers can position themselves favorably for sustained growth and success in the long run.

References

- [1] China Retail Pharmacy Market Analysis (2022). https://mp.weixin.qq.com/s?__biz=MjM5NjQ2ODMwMA==&mid=2651110811&idx=2&sn=04dfe3b89a555bfc280e36feb41cc20&chksm=bd18deb88a6f57ae1bc79adf318372fd810bfce82b1f484783198c47edfb90d19e275bb4a0f4&scene=27
- [2] Yang, Y.; Geng, X.; Liu, X.; Wen, X.; Wu, R.; Cui, D.; Mao, Z. (2022). Antibiotic Use in China's Public Healthcare Institutions during the COVID-19 Pandemic: An Analysis of Nationwide Procurement Data, 2018–2020. *Front. Pharmacol.* 2022, 13, 813213.
- [3] Sinolink Securities. (2022). *Equity Research Reports of Alibaba Health Information Technology Limited*. pp.4. <https://www.hanghangcha.com/pdf.html>
- [4] Liu, J.; Su, J. (2013). Research on Motivation of China M&A Tide: Based on the Comparison of the Western Theories with Chinese Enterprises. *School of Management, Dalian University of Technology*. 2013,16(02):57-63.
- [5] National Healthcare Security Administration. (2021). Guidance from the National Health Care Commission on establishing and improving the "dual channel" management mechanism for drugs negotiated by the National Health Insurance. https://www.gov.cn/zhengce/zhengceku/2021-05/10/content_5605595.htm
- [6] Jiang, G. (2021). How Did Merger and Acquisitions Boost the Market Power-Evidence from Chinese Firms. *School of Economics of Xiamen University, Xiamen*. 2021(05):170-188. <http://epub1.yittgd.top/kns8/defaultresult/index>

- [7] Ministry of Commerce of The People's of Republic of China. (2022). *Statistical Report on Pharmaceutical Circulation Industry*.pp.2,31. <http://scyxs.mofcom.gov.cn/article/c/202209/20220903345957.shtml>
- [8] Xie, T. (2022). *Research on the Motivation and Performance of the Continuous Mergers and Acquisitions of LBX*
- [9] Yu,M. (2021). *Study on the Performance of continuous mergers and acquisitions of large pharmacies under the background of prescription Outflow*. <http://epub1.yyttgd.top/kns8/defaultresult/index>
- [10] JRJ News. (2021). *LBX Pharmacy to Acquire Hua Tuo Pharmacy, Receives Question Letter from SSE for High Premium, High Goodwill, Performance Betting*. <https://baijiahao.baidu.com/s?id=1709131671929178919&wfr=spider&for=pc>
- [11] *Historical share price of LBX pharmacy* (2021). <https://data.eastmoney.com/stockcalendar/603883.html>
- [12] Shanghai Stock Exchange. (2021). *In relation to the acquisition of 51% equity interest in Hebei Hua Tuo Pharmacy by LBX Pharmacy Chain Joint Stock Company on the Acquisition of 51% Equity Interest in Hebei Hua Tuo Pharmacy*. <http://www.sse.com.cn/disclosure/credibility/supervision/inquiries/enquiry/c/8143126234629003.pdf>.
- [13] Sohu News. (2018). *Back-to-back announcements from Yifeng, significant progress in the acquisition of Xinxing*. https://www.sohu.com/a/256403466_377305
- [14] *Announcement on the Progress of the Acquisition of 71.9643% Equity Interest in Hunan Huiren Great Health Industry Development Company Limited by LBX Pharmacy* (2022). <https://data.eastmoney.com/notices/detail/603883/AN202204211560656539.html>