

Hua Han: Tapping all of China pharma's growth story

Recommendation: Not Rated China Pharmaceuticals

Price	HK\$2.50	Yield (6/06A)	0.8%
12 mth range	HK\$1.0-2.80	ROE (6/06A)	16.2%
Market cap.	US\$284.1m	Net gearing (6/06A)	Cash
No. shares o/s	880.7m	Net debt/sh. (6/06A)	n/a
Daily t/o, 3 mth	<US\$0.1m	BV/sh. (6/06A)	HK\$0.960
Free float %	22.7%	Consensus EPS	
Major shareholder	Peter Y. Zhang (35.06%)	- 6/07F	HK\$0.164
Ticker	0587.HK/ 587 HK	- 6/08F	HK\$0.219

Key points:

- Positioned to tap China's pharmaceutical/healthcare growth on several fronts, Hua Han focuses on naturally sourced drugs for women. Its portfolio comprises: 1) prescription drugs; 2) OTC drugs and 3) healthcare products.
- Potential blockbuster drug, Human Nerve Growing Factor (HNGF), has already obtained SFDA's approval for "Category I" new medicines, as well as exclusive intellectual property rights and national patent rights. Sales are expected to commence in FY3/08.
- Hua Han's female healthcare products are distributed in pharmaceutical and supermarket chains in China including Carrefour and Wal-Mart. In Dec 2006, they were launched in Hong Kong and are sold through more than 170 points of sale under the Watsons network.
- The company has a portfolio of around 100 products (with SFDA product permits already obtained) still to be launched.
- The stock is trading at 15.2x FY6/07F and 11.4x FY6/08F P/E on a consensus basis, a substantial discount to comparables. Given the company's unique positioning and promising growth prospects, the counter deserves to trade at least in line with and arguably at a premium to peers.

Pharmaceutical products for women. Founded in 1992 and listed in Dec 2002 on the HKEx, Hua Han Bio-Pharmaceutical Holdings Limited (Hua Han) is engaged in the research and development, manufacture and sales of naturally-sourced prescription and over-the-counter (OTC) drugs, as well as healthcare products for women. The company derives its revenues from two main segments: 1) sales of Chinese and Western pharmaceutical and healthcare products and 2) trading of pharmaceutical products. At the end of 1H FY6/07A, sales of pharmaceutical products accounted for 73.2% of revenue and pharmaceutical trading for the remainder.

Table 1: Hua Han's revenue breakdown (1H FY6/07)

Revenue segment	Revenue (HK\$m)	% of revenue
Pharmaceutical sales (manufacturing)	267.9	73.2
Trading of pharmaceutical products	98.2	26.8
	366.1	100.0

Source: Company data

Balanced portfolio, wide network. Currently, the company has about 220 products, comprising 170 medicinal and 50 healthcare products. Less than 20% of its medicinal products are included in the National Health Insurance Scheme (NHIS) catalogue. In 1H FY6/07A, prescription drugs accounted for 56.4% of revenues, OTC

drugs for 21.1% and healthcare products for 22.5%. Hua Han has an extensive distribution network across all channels, comprising 3,000+ hospitals, 70,000 pharmaceutical chains and 2,000 supermarkets.

Table 2: Hua Han's product breakdown for pharmaceutical sales

Product	Distribution channels	% of pharmaceutical sales
Prescription drugs	3,152 hospitals	56.4
OTC drugs	70,000 pharmaceutical chains	21.1
Healthcare products	70,000 pharmaceutical chains & 2,000 supermarkets	22.5
		100.0

Source: Company data

Raw material base in Guizhou. Hua Han's core production facilities are located in Guizhou, one of China's four main herbal plantation bases (others are Sichuan, Yunnan and Guangxi). The company maintains a plantation of around 3,468.5 acres, growing *Camptotheca Acuminata*, Matrine and Baibu, for its drug products. It said the plantation supplies around 25% of its total raw material needs, and the remainder is sourced from local farmers. Its two plants in Guizhou, with a total of 26 production lines, are separately GMP certified. Their present average utilization rate is about 40-50%. Another production line is located in Guangdong and is used to manufacture healthcare products.

Prescription drug segment - cash cow. The prescription segment is the company's cash cow. It includes several well-entrenched products, including the "Yeasure (日舒安)" series (Yeasure) - anti-inflammatory products for women's genital infections. The company has patented it until 2025 and holds exclusive production rights in China. The Yeasure brand is well known in China and has won numerous pharmaceutical and brand awards. It generated sales of around HK\$100.0m in 1H FY6/07A. According to MENET (third party research institute), genital infections account for 42.9% for common female diseases in China. Hua Han's other products, such as Fuke Zaizaowan (婦科再造丸) and Huangqi Granules (黃芪顆粒), are used to treat other common diseases such as menstrual disorders and dysmenorrhea.

Table 3: Hua Han's products treat common diseases for women in China

Type	Occurrence rate (%)	Hua Han's products
Genital infection	42.9	"Yeasure (日舒安)" series
Menstrual disorder	34.5	Fuke Zaizaowan (婦科再造丸), Huangqi Granules (黃芪顆粒), Puerperant's Health Drink
Dysmenorrhea	15.5	Fuke Zaizaowan (婦科再造丸), Huangqi Granules (黃芪顆粒), Puerperant's Health Drink
Gynecological neoplasm	3.9	Camptothecine Series & Paclitaxel Injection (紫杉醇注射液)
Uterine or vaginal wall prolapse	1.9	
Others	1.3	
	100.0	

Source: Company data, MENET

Steady growth for prescription drugs. We believe that the company can maintain its prescription drug sales growth at about 10% YoY as less than 20% of its drugs are registered in the NHIS catalogue, meaning that it is less exposed to downward pricing adjustments by the NRDC and SFDA. Its Yeasure series, being "protected" products, are subject to less pricing pressure than general generics. At about RMB12 per bottle, Yeasure's ASP is not high and widely affordable. Sales of Paclitaxel Injection and Kangai Fuzheng Capsules, which began selling only in Dec 2005, are showing promising potential with a combined HK\$17.5m in revenues in 1H FY6/07A.

HNGF injection - potential blockbuster. The company's potential blockbuster drug, Human Nerve Growing Factor (HNGF) (人神經生長因子注射液), has already obtained SFDA's approval for "Category I" new medicines, as well as exclusive intellectual property rights and national patent rights. HNGF is a biological medicine used to treat injured nerve systems in diabetic neuropathy, cerebral palsy, or sequels of cerebral-vascular diseases. The drug adopts a biotechnological separation process to the placenta to obtain a high purity cell factor, which is used for replenishing nutrition, and re-conditioning damaged nerve cells. The technological know-how was acquired from a third party research institute (南京軍區軍事醫療研究所) in Sep 2006. The company is currently building a production plant, which should be completed at end-2007. HNGF is expected to be a key growth driver for the company, expected to generate about HK\$80.0m in its first year of sales.

OTC drugs – geographical expansion. Hua Han's OTC products for menstrual disorders and dysmenorrhea are sold under the Fuke Zaizaowan brand. The segment's revenue grew 29.7% YoY to HK\$56.5m with a sales focus on Guizhou and Sichuan. The company has already rolled out its OTC marketing plans for Yunnan, Chongqing, Shaanxi and Gansu and will set up sales channels in 10 other regions including Guangdong, Hubei and Beijing, as

well as rural areas. We expect the efforts to help boost the segment's top line by around 40-50% YoY over the 1 to 2 years.

Awards. The company's Yeosure Natural Medicine Lotion was granted awards for its quality and sales track record of more than 13 years in the domestic hospital market. After being named in 2005 as "China's renowned brand" by the Social Survey Institute of China (SSIC) in a survey of gynecological medicinal products, it received the title of "Top Ten Most Influential Brands in Gynecological Medicines in China" during the Second Annual Conference on China Brands' Influences in Beijing in 2006. Together with Fuke Zaizaowan, it was granted the title of the "Number 1 Brand in China Gynecological Medicines" in the "Top Brand Assessment in the National Pharmaceutical Industry" survey in 2006.

Feminine medicinal healthcare products - a new market. "Magic" (美即), its main brand in the healthcare segment targets: 1) facial treatment; 2) eye treatment and 3) body treatment. The products are manufactured in a single line factory in Guangdong, and the company is setting up an additional line, expected to be completed in Jun/Jul 2007. Launched in 2005, the products are distributed in pharmaceutical and supermarket chains in China, including Carrefour and Wal-Mart. The number of points of sales (POS) increased from 350 at the beginning of FY6/06 to 800 at the end of this reporting period, with a focus on the key markets of Guangzhou, Shenzhen, Beijing and Shanghai. To date, the portfolio includes about 100 products, with 50 already launched on the market. In Dec 2006, Hua Han's Magic products were launched in Hong Kong and are sold at more than 170 POS under the Watsons network. Other strategic cooperation partners include 1000 colour Department Store, PARK'n'SHOP and Jusco.

Magic to focus on brand-building. Hua Han has formed strategic alliances with renowned Korean universities and R&D corporations, through its wholly-owned subsidiary in Korea to enhance the quality of the Magic series. The partnership aims to strengthen the brand's image and technical quality. The subsidiary is responsible for trademark and patent registrations of the Magic brand and products in Korea, and for formation of strategic alliances.

Partnerships and acquisitions to leverage R&D. Hua Han has an in-house R&D division with 34 full-time specialists. It conducts its R&D through: 1) acquisitions of third party research; 2) partnerships with universities and research institutes and 3) in-house development. The company has made three major acquisitions in the past and currently has seven major R&D partnerships. Hua Han earmarks 2.0-4.0% of its annual turnover for R&D, and aims to boost the figure to 10%. It has a portfolio of around 100 products (with SFDA permits already obtained) still to be launched. It aims to launch around 5-10 products annually.

Table 4: Hua Han's acquisition track record

Acquisition	Timing	Products
Guiyang De Chang Xian Pharmaceutical	Oct 2004	Female gynecological products including Fuke Zaizaowan
Guangdong Qunhe Pharmaceutical	Jul 2004	Female medicinal healthcare products including "Magic" branded products
Chengdu Hechuang Pharmacy	Jun 2003	Pharmaceutical trading company

Source: Company data

1H FY6/07A financial results. In 1H FY6/07A, revenue was up 21.0% YoY at HK\$366.1m as net profit grew 10.7% YoY to HK\$68.1m. Excluding the trading business, sales of self-manufactured products rose 19.9% YoY to HK\$267.9m. The gross margin narrowed 0.3pcp YoY to 44.0% and net margin 1.7 pcp YoY to 18.6%. The net profit contraction was largely due to increased finance costs. In terms of segment revenue, pharmaceutical drugs were up 5.1% YoY at HK\$151.1m, OTC drugs 21.1% at HK\$56.5m and healthcare products 82.4% YoY at HK\$60.3m. At end-1H FY6/07A, the company was in a net cash position of HK\$406.0m (HK\$0.46 cash per share).

Strong growth from all segments going forward. Hua Han is armed with a series of growth drivers in its OTC and healthcare products, backed by a cash cow business in its prescription drug sales. We expect its prescription drugs business to grow at around 8-10% YoY, OTC drugs around 40-50% YoY and healthcare products around 70-100% YoY over the next 1 to 2 years. The potential success of Hua Han's Category I drug HNGF will provide a further growth impetus to the company's top line.

Preliminary view and valuation. Hua Han operates in a niche pharmaceutical sub-sector and has a comprehensive portfolio. With a potential blockbuster in the pipeline, it is in a unique position to tap China's pharmaceutical/healthcare growth on several fronts: gynecological pharmaceutical products, OTC sector, female healthcare. Trading at 15.2x FY6/07F and 11.4x FY6/08F P/E on a consensus basis and we believe the stock deserves to trade at least in line with and arguably at a premium to peers. Comparables are currently trading at 24.9x and 16.7x current-year estimate and forward one-year estimate P/E.

Corporate governance. Chairman/CEO/Founder Peter Y. Zhang is the largest shareholder with a 35.06% equity stake. A Singapore-based multinational pharmaceutical enterprise, Haw Par Pharm Holdings Ltd, is the second largest shareholder with a 20.80% stake, acquired by way of a new share subscription in Jun 2005 (HK\$0.86 per share), while Atlantis Investment Management Ltd holds 5.26%. The company previously issued a toxic CB to CSFB amounting to a total of HK\$93.6m (in three tranches) in Jul 2003, which has since been dissolved. It has an outstanding LT debt of HK\$454.2m drawn down from an existing credit facility during an aborted M&A attempt in Jun 2006. The loan is for three years, with an option to extend for two years.

Risks. i) Further regulation/policy changes introduced by NDRC and/or SFDA; ii) Delays in launching HNGF; iii) Hua Han fails to capture market through new drug product launch and iv) new drugs development failure during R&D stage leading to a break in Hua Han's product pipeline.

Table 5: Valuation comparisons

Company Name	Ticker	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Nxt Yr P/E (x)	Est Yield (%)	ROE (%)
Sino-Biopharmaceutical	1177 HK	427	HK\$1.35	24.2	22.3	3.1	132.8
China Pharmaceutical	1093 HK	451	HK\$2.16	40.2	18.8	0.9	6.6
China Shineway	2877 HK	556	HK\$5.12	11.6	9.8	-	19.6
C&O Pharmaceutical	COPT SP	223	SGD0.51	32.7	20.1	1.3	38.6
Guangzhou Pharm-H	874 HK	1,371	HK\$6.80	23.8	18.1	-	7.5
MingYuan Medicare	233 HK	295	HK\$0.85	17.0	11.5	1.9	16.0
Average				24.9	16.7	1.8	31.9
Hua Han	587 HK	284	HK\$2.50	15.2	11.4	0.9	16.3

Source: Bloomberg and SBI E2-Capital

Table 6: P&L

Year to Jun (HK\$m)	04A	05A	06A	1H 05A	1H 06A
Turnover	507.1	601.9	627.9	302.4	366.1
Cost of sales	(344.8)	(376.6)	(353.5)	(168.6)	(205.1)
Gross profit	162.3	225.3	274.5	133.8	161.0
Other income and gains	7.7	8.0	8.0	5.0	13.4
Selling and distribution costs	(22.9)	(48.0)	(73.8)	(32.4)	(42.2)
Administrative expenses	(26.9)	(50.7)	(42.8)	(23.1)	(22.6)
Other operating expenses	-	-	-	-	-
Operating profit	120.2	135.3	165.9	83.2	109.5
Finance costs	(5.7)	(7.9)	(11.3)	(5.5)	(16.5)
Share of profit/(losses) in associates	-	(0.4)	-	-	-
Exceptionals	(0.1)	(0.4)	-	-	-
Profit before taxation	114.4	126.0	154.5	77.7	93.0
Taxation	(18.1)	(23.4)	(27.1)	(14.3)	(20.7)
Profit after tax	96.2	102.6	127.4	61.4	72.2
Minority interests	(1.2)	(1.1)	(4.2)	1.9	4.1
Profit attributable to shareholders	95.0	101.4	123.1	63.4	72.2
% chg	n/a	6.4	21.4	n/a	13.9
Dividends	(13.2)	(17.4)	(17.6)	-	-

Source: Company data