Corporate Flash

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Guangzhou Pharmaceutical: Leader in spring wind

Recommendation: BUY (initiating coverage) — **China Pharmaceuticals**

Price	**HK$5.18**
Target price	HK$8.80 (+70%)
12 mth range	HK$5.08-9.55
Mkt cap. (H-shs)	US$1,379.6m
Daily t/o, 3 mth	US$0.84m
Free float %	43.6%
Ticker	0874.HK/874 HK

Year to Dec	Net profit RMBm	EPS RMB	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
05A	197.8	0.244	-	19.7	1.4	20.6	1.5	7.5	15.1	30.2
06A	218.1	0.269	10.2	17.9	1.3	19.8	1.7	7.8	10.1	20.6
07F	273.3	0.337	25.3	14.3	1.2	19.5	2.1	8.9	9.9	15.0
08F	391.0	0.482	43.1	10.0	1.0	17.9	3.0	11.1	8.1	5.9
09F	440.7	0.543	12.7	8.9	1.0	15.7	3.4	11.2	9.7	14.4

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -14.5%, -23.8%,NA
Actual price changes (1 mth, 3 mth, 12 mth): -3.0%, -23.7%, +162%
Consensus EPS (07F-08F): RMB0.34, RMB0.46

Key points:

- Vertically integrated pharmaceutical manufacturer and China's second largest distributor with a network covering 2,000 hospitals, 5,000 distributors and 1,000 retailers.
- Offers exposure to China's burgeoning internal consumption sector with its strong Wanglaoji (王老吉) beverage products and over-the-counter (OTC) drugs (about 80% of revenue).
- JV with leading international pharmacy-led health and beauty group Alliance Boots and Beijing Med-Pharm (BJGP US) to provide growth catalysts for its distribution business.
- Earnings growth accelerate with adjusted net profit of RMB263.7m, RMB345.1m and RMB442.0m between FY12/07F to FY12/09F, represents a YoY growth of 20.9%, 30.8% and 28.1% respectively.
- Initiate coverage with a BUY call and target price of HK$8.80. Our sum-of-the-parts valuation values GPs' Wanglaoji JV at a conservative 30.0x FY12/08F P/E and the remaining pharmaceutical business at 16.0x FY12/08F P/E. The counter is currently trading at an undemanding 10.0x FY12/08F P/E.

Investment summary. Guangzhou Pharmaceutical (GP) offers exposure to China's burgeoning domestic consumption boom through its Wanglaoji beverage and OTC healthcare products. One of China's largest pharmaceutical distributors, GP has become leaner after selling 40.09% in its distribution subsidiary to form a JV with Alliance Boots. The company has steadily reduced costs after its current chairman joined in 2004 and we expect its adjusted net profit growth to re-accelerate from 20.9% YoY (RMB263.7m) in FY12/07F to 28.1% YoY (RMB442.0m) in FY12/09F, fuelled by: 1) sustained runaway growth of its Wanglaoji products; 2) growth and margin improvement in its Alliance Boots distribution JV; 3) steady growth in its core blockbuster drugs; 4) growing contribution in emerging drugs and 5) shrinking losses in previously loss making subsidiaries. We like the company for its limited downside risk and share price appreciation potential, which makes it an attractive play within a volatile market.

Established drug maker, distributor and retailer. GP is a vertically integrated pharmaceutical maker in China. Through its nine main subsidiaries and one JV, it manufactures, distributes and retails pharmaceutical products. It makes more than 400 types of western and traditional Chinese medicines (TCM) and has a distribution portfolio of over 4,000 medicinal and healthcare products. It is the exclusive manufacturer and distributor of around 20 TCMs, including some time-honoured brands such as Cai Zhi Lin (采芝林), Pan Gao Shou (潘高寿), Jing Xiu Tang (敬修堂), Chen Li Ji (陈李济) and Wang Lao Ji (王老吉). The company is derives about 80% of its revenue from sales of over-the-counter (OTC) drugs.

China's second largest distributor. According to independent research institute PICO, Guangzhou Pharmaceutical Corp (GPC), the company's main distribution subsidiary, was China's second largest distributor in terms of revenue in 2006, after Shanghai Pharmaceutical (600849 CH). Its nationwide network covers 2,000 hospitals, 5,000 distributors and 1,000 retailers. It also sells via 115 healthcare pharmacies in southern China comprising 27 Jianmin (健民) stores for western medicines (under subsidiary GP Corp) and 88 Caizhilin (采芝林) stores for TCM (under subsidiary Chinese Medicine Corp). Each of GP's manufacturing subsidiaries maintains its own marketing and distribution force allowing them to be profit centres in their own right and minimizing conflict of interest issues.

Existing brands to drive profit growth. Over the past few years, several key products have driven much of the company's growth. The sales of Guangzhou Zhongyi (Zhongyi), its subsidiary which makes Xiaokewan (消可丸), a well known and popular oral drug for the treatment of Type II diabetes, increased 20.0% from FY12/05A to FY12/06A and net profit 35.6% in the period. Its revenue reached RMB380.0m in 1H FY12/07A and we estimate that Xiaokewan generated about 80% of it. Outside of GP's distribution subsidiaries, Zhongyi is its largest revenue contributor. In 1H FY12/07A, Zhongyi accounted for 6.4% of GP's total revenue and 30.9% of its overall net profit. It has other products coming off a relatively small base though growing fast. In FY12/07A sales of An Shen Bu Nao Ye (安神补脑液) increased 65.0%, Qian Lie Tong Pian (前列通片) increased 47.2% and Xu Han Ting (虚汗停) increased 83.0%, Xiao Er Qi Xin Cha(小儿七星茶冲剂) increased 28.6% compared to a year ago. We expect this to sustain the company's overall growth momentum and offset slowing growth in products with a large revenue base

Favorable industry environment. After the implementation of government-led industry-wide restructuring initiatives and with the State Food and Drug Administration's (SFDA) new, more stringent drug registration process, we expect fewer new products to come on the market. This will help extend the product life cycle of incumbent famous branded blockbusters and increase focus on distribution strength. GP, as one of China's largest distributors/wholesalers with a number of blockbuster products (Xiaokewan, Wanglaoji and Huatuozaizaowan) will benefit. Other macro stimuli include government trials to flatten the tiered distribution system, which will favour large distributors such as GP, and rising disposable incomes, which will lead to a increase in healthcare spending.

Table 1: Historical turnover percentage breakdown

Year to Dec (RMBm)	1H 07A (RMBm)	% of revenue	% of Manufacturing revenue	% of distribution revenue
Manufacturing	1,322.7	20.2	100.0	-
Guangzhou Xing Qun	209.5	3.2	15.8	-
Guangzhou Zhongyi	380.0	5.8	28.7	-
Guangzhou Chen Li Ji	127.1	1.9	9.6	-
Guangzhou Qi Xing	207.5	3.2	15.7	-
Guangzhou Jin Xiu Tang	123.7	1.9	9.4	-
Guangzhou Pan Gao Shou	167.2	2.5	12.6	-
Others	107.7	1.6	8.2	-
Distribution/trading	5,236.6	79.8	-	100.0
Guangzhou Pharmaceutical Corp	4,253.0	64.8	-	81.2
Chinese Medicine Corp	659.6	10.0	-	12.6
Guangzhou Pharma Import and Export Corp	169.1	2.6	-	3.2
Others	154.9	2.4	-	3.0
Elimination	(571.8)			
Total	**5,987.5**			

Source: Company data

Table 2: Historical turnover growth

Year to Dec (RMBm)	FY05	FY06	YoY chg (%)	1H FY06	1H FY07	YoY chg (%)
Manufacturing	**2,187.7**	**2,452.1**	**12.1**	**1,146.4**	**1,322.7**	**15.4**
Guangzhou Xing Qun	273.5	328.3	20.0	188.5	209.5	11.1
Guangzhou Zhongyi	569.9	651.9	14.4	301.1	380.0	26.2
Guangzhou Chen Li Ji	222.4	176.6	-20.6	120.9	127.1	5.1
Guangzhou Qi Xing	352.6	356.5	1.1	197.0	207.5	5.3
Jing Xiu Tang	159.4	207.3	30.1	99.4	123.7	10.0
Guangzhou Pan Gao Shou	240.9	271.6	12.7	151.1	167.2	10.7
Others	369.0	459.9	24.6	88.4	107.7	21.8
Distribution/trading	**7,672.6**	**9,066.0**	**18.2**	**4,541.9**	**5,236.6**	**15.3**
Guangzhou Pharmaceutical Corp	6,436.8	7,384.4	14.7	3,715.9	4,253.0	14.5
Chinese Medicine Corp	789.8	1,093.0	38.4	511.2	659.6	29.0
Guangzhou Pharma Import and Export Corp	305.4	321.0	5.1	164.3	169.1	2.9
Others	140.6	267.6	90.3	150.5	154.9	2.9
Elimination	(833.9)	(1277.0)		(606.4)	(571.8)	
Total	9,026.3	10,241.0	13.4	5,101.9	5,987.5	17.3

Source: Company data

Distribution JV with Alliance Boots. In Feb 2007, GP announced its drug distribution JV with Alliance Boots and Beijing Med-Pharm (BJGP US). In the deal, GP will sell part of GPC to Alliance BMP (80%-owned by Alliance Boots and 20%-owned by Beijing Med-Pharm), with each holding 50.0% of the resulting JV.

Details. GP currently owns 90.09% of GPC, with the remainder held by minority shareholders including employees/management. Alliance BMP will come into 50.0% of the JV by:

- acquiring 9.91% from minority shareholders for RMB60.0m
- effectively acquiring 40.09% from GP for RMB485.1m

Based on GPC's FY12/06A net profit (after minority interest) of RMB61.1m and adjusted NAV of RMB605.0m, the Alliance Boots acquisition valuations are as follows:

- 9.91% tranche from minority shareholders - 8.9x FY12/06A P/E and 1.0x P/B
- 40.09% tranche from Guangzhou Pharmaceutical - 19.8x and 2.0x P/B

Partner value. Alliance Boots is a leading international pharmacy-led health and beauty group, engaged in both wholesale and retail. Formed on 31 July 2006 through the merger between Alliance UniChem and Boots Group, it employs around 100,000 people and has a distribution network across Europe, as well as retail healthcare outlets in Ireland, Italy, the Netherlands, Norway, Thailand and the United Kingdom. Alliance Boots own self-branded products are sold through retailers in Europe, the US, the Middle East and Asia.

Med-Pharm synergies cannot be overlooked. While many have focused on the contribution of Alliance Boots, we believe that Beijing Med-Pharm will also bring certain synergies into the JV. The company, which has a proprietary regional network, is an end-to-end solutions provider for US and western pharmaceutical companies looking to introduce their products into China. It has equity stakes in pharmaceutical wholesalers and distributors in Beijing, Shanghai and Hong Kong, regions where the use of western medicines is more prevalent. Med-Pharm's management is formerly from Xian-Janssen Pharmaceutical Ltd., a Sino-foreign JV with Johnson & Johnson (JNJ US). In Mar 2007, the company signed a letter of intent to acquire a minority stake in PICO, a healthcare information company. PICO is subsidiary of the SFDA's South Economic Research Institute. This access to the extensive database of China's healthcare market will no doubt benefit the GPC JV when formulating strategies or introducing new drugs to the market.

Advantages from the JV. In our view, the JV will significantly boost GP's prospects. While GPC generates significant top line sales (RMB4,253.0m in 1H FY12/07A), its margins are extremely low at only 0.8% (net profit of RMB32.6m), compared with 2-6% for international pharmaceutical wholesalers and retailers. Thus, there is a tremendous room for improvement in terms of network and operation efficiency. As part of the agreement, GP will reinvest the RMB485.1m into the JV. The new JV will benefit GP in the following ways:

- ***Boost wholesale and retail network*** – Alliance Boots will place a CFO in the JV. The capital injection will fund the expansion of the JV's wholesale and retail network nationwide while Alliance Boots' management expertise and wholesale know-how will help to streamline operations and improve efficiency.
- ***Distribution of Alliance Boots products*** – Alliance Boots already sells some products in China and when the JV deal is completed, we expect it to progressively shift its product portfolio into the JV, granting it exclusive distribution rights. We expect this to be done on a product basis starting in the Guangdong region.
- ***Improvement in balance sheet and P&L*** – The deconsolidation of the results from the P&L to the JCE level will mean: 1) strengthening of the balance sheet; 2) improving margins of the consolidated P&L and 3) improving receivables and payables.
- ***Relief of working capital*** – GPC historically used to tie up much of GP's working capital and it was the main reason behind the group's negative operating cashflow in FY12/06A. Moving GPC off the balance sheet will significantly improve the company's financial health and free up working capital to develop and restructure other subsidiaries.
- ***Operating flexibility*** – With GP holding 50.0% (from 90.1%), the JV will be more independent from its SOE parent. This is a positive in our view as it will reduce a lot of the "red tape" involved in the decision making process allowing greater operating flexibility in reacting to the market's dynamics and competition.
- ***Preferred partner for overseas pharmaceutical companies*** – We expect Beijing Med-Pharm to use GPC's nationwide network to introduce new US and western pharmaceutical products into China.

JV's expansion strategy. The deal was closed on 28 Jan 2008. In our view, the new management will aggressively focus on developing its distribution and wholesale network. In 1H FY12/07A, GPC derived some 86.6% of its distribution revenue from China's southern regions. Therefore, especially with Beijing Med-Pharm's input, we believe it is well positioned to expand outside its core stronghold to eastern and south western areas.

Wanglaoji to drive growth. In 1H FY12/07A, the sales of Wanglaoji tea doubled to about RMB340.0m, as its distribution network expanded beyond Guangdong province. Sales of core tea products accounted for around 64% of Wanglaoji Corp JV's revenues. Sales of the 48.05%-owned JV jumped 59.5% YoY to RMB528.2m and net profit 45.0% YoY to RMB52.9m in 1H FY12/07A. Wanglaoji has been one of GP's key profit growth drivers over the past few years with a CAGR of 109.5% between FY12/05A to FY12/07F. Though officially a Chinese herbal tea, Wanglaoji has effectively become a "beverage" for Chinese consumers. GP's Wanglaoji JV is the exclusive manufacturer and distributor of the "green label" packet and bottle beverage products, which were launched in 2003 (the rights to the Wanglaoji "red can" belong to Carnaud Metal Box (HK) Ltd.). However, Wanglaoji JV and its products have a number of advantages over the "red can". They retail at RMB1.80-2.20 per carton, compared with the red can's RMB3.60-3.80. The green bottle can leverage the brand value of the red can and save on marketing/advertising expenses, reducing product launch risks and fast tracking its growth development.

Table 2: Turnover breakdown (2)

Year to Dec (RMBm)	FY05	FY06	YoY chg(%)	1H FY06	1H FY07	YoY chg (%)
Wanglaoji JV	244.7	661.9	170.5	331.2	528.2	59.5

Source: Company data

Wanglaoji margins are better than competitors. Its explosive growth has been driven by a combination of: 1) high demand for beverages in China; 2) positioning of Wanglaoji herbal tea as a beverage and 3) expanding distribution network. Wanglaoji JV's growth outpaces that of other beverage producers such as Tingyi (322 HK) and Uni-President (220 HK) and its margins are also better.

Table 4: Beverage drinks comparisons

Year to Dec	FY05		FY06		1H FY07	
	Sales YoY (%)	Net margin (%)	Sales YoY (%)	Net margin (%)	Sales YoY (%)	Net margin (%)
Wanglaoji JV	NA	13.2	170.5	11.0	59.5	10.0
Tingyi (322 HK)	25.8	6.7	26.3	6.4	35.2	6.4
Uni-President (220 HK)	14.9	3.9	20.6	1.9	6.6	5.8

Source: Company data

Three tiered expansion strategy. We expect this high growth rate of sales and net profit to be maintained over the next few years as the JV's strategy is to: 1) increase penetration in established regions; 2) expand to northeastern and northwestern parts of China and 3) develop new distribution channels. The Wanglaoji green label products are already selling through 40,000 supermarkets and they recently established new channels including selling its tea products to fast food outlets (such as KFC) and airlines.

Rabies vaccine will help Bai Di to breakeven. We believe a potentially promising new product for GP is its rabies vaccine, currently under development by Gangzhou Bai Di (Bai Di), a 95.7%-owned subsidiary of the company. The vaccine should be approved and registered by SFDA in 2H 2008. According to MoH, for the 3 consecutive months of April to June in 2007, rabies was the top ranked contagious disease in China. Chinese medical journals estimates demand for rabies vaccine in China was around 15m dosages in 2007, compared with the total supply (imports and domestic production) of around 8.5m dosages. Bai Di recorded net losses of RMB12.8m in FY12/06A and RMB4.6m in 1H FY12/07A as it has to date only been engaged in R&D services contracts. However, it has already constructed a plant with a production capacity of 1.5m dosages, and will obtain GMP certification for the facility on receipt of the vaccine's SFDA registration approval. At this stage, we are being conservative with our estimates for this product's contribution considering uncertainties related to regulatory approval and competition from most notably Liao Ning Chen Da Co. (600739 CH), which is building out its production capacity.

New chairman. The current chairman, Mr. Yang, came on board in 2004 as a result of GP's internal restructuring. He has since delivered value to shareholders in our view. Aside from successfully negotiating the Alliance Boots JV and re-invigorating turnover growth, he has introduced synergies among subsidiaries such as: 1) centralized procurement, packaging and advertising expenses; 2) market information sharing; 3) increasing participation in strategy and budget development and 4) centralizing administration resources. The measures have boosted GP's operating efficiency and reduced SG&A costs (as a percentage of turnover) since FY12/05A. The one-off rise in distribution costs in FY12/06A was due to the government's industry restructuring initiatives.

Table 5: SG&A expenditure FY03 to 1H FY12/07

Year to Dec (% of turnover)	FY03	FY04	FY05	FY06	1H FY06	1H FY07
Distribution cost	7.2	7.2	6.8	7.6*	8.1	7.4
Administration cost	8.7	8.7	7.1	6.4	6.2	4.4
Other Operating cost	0.3	0.4	0.2	0.1	0.1	0.1
Total	**16.2**	**16.3**	**14.1**	**14.1**	**14.3**	**11.9**

* *Rise in distribution costs in FY12/06 was the result of Chinese government's industry restructuring initiatives*

Source: Company data, SBI E2-Capital

Restructuring of the remaining subsidiaries. To cut costs, GP has been restructuring several subsidiaries, merging Guangzhou Huan Ye with its R&D subsidiary Guangzhou Han Fang (both are currently loss making) and making Guangzhou Pan Gao Shou share management and marketing resources with Guangzhou Xing Qun. These measures should limit the company's downside risk, while providing a platform to turn these companies around or re-accelerate growth. They also show the management's commitment to improving the overall profitability. Han Fang is GP's strategic subsidiary, being China's first research company to gain national accreditation for the research and development of extraction methods for Chinese medicines.

Distribution model is preferred to an OTC retail model. While the traditional approach to tapping China's burgeoning OTC market is through pharmacy retailers, we believe that distributors/wholesalers such as GP also constitute a viable vehicle as a significant portion of their products is sold to pharmacies and they have extensive networks. This distribution model is more scalable and less capital intensive than the retail pharmacy model as it requires less outlay such as rental and advertising expenses, allowing a distributor to use channel capital into providing value added services to product owners such as marketing and other third party logistics. The distribution model is also more flexible as it can own multiple channels. In GP's case, the company maintains distribution channels to: 1) OTC retailers; 2) hospitals and 3) lower tiered distributors.

Beneficiary of restructuring-led consolidation. GP is a key beneficiary of the government-led industry restructuring in 2005 and 2006 as SFDA and NDRC initiated a series of initiatives including: 1) trials on centralized tendering; 2) tightened governance by conducting trials to flatten the tiered distribution system; 3) price caps on medicines; 4) review of previously approved drug applications and 5) implementing a more stringent drug registration process. The overall effect has further strengthened GP's position within the pharmaceutical distribution value chain. Policies such as centralized tendering and limiting the number of tiered distributors are designed to promote industry champions and have a dual effect of reinforcing the bargaining power of GP while weeding out smaller players. The effect of lower prescription drug prices will serve to drive volume demand, which will also benefit GP's distribution business.

Tax reform and RMB appreciation - added bonus. GP will also benefit from both the unification of corporate tax policies and RMB appreciation. The company paid an effective tax rate of 34.4% in 1H FY12/07A and we conservatively expect it to drop to 28.0% in FY12/08F and beyond.

Re-accelerating growth. GP's growth drivers include: 1) runaway growth in Wanglaoji products; 2) growth and margin improvement in its Alliance Boots distribution JV; 3) steady growth in its core blockbuster products; 4) growing contribution in emerging products and 5) turnaround of previously loss making subsidiaries. Excluding an RMB82.0m one-off gain for the disposal of its stake in GPC as part of the Alliance Boots JV deal, (which will be booked in FY12/07F and FY12/08F), we project GP to record adjusted net profit of RMB263.7m, RMB345.1m and RMB442.0m between FY12/07F to FY12/09F, representing a YoY growth of 20.9%, 30.8% and 28.1%, respectively. We estimate that GP's raw material costs accounted for around 37% of manufacturing COGS and raw material price increases were one of the main reasons for the 2.2pcp YoY drop in the gross margin in 1H FY12/07A. We expect inflationary pressure to continue and have conservatively factored in a slight gross margin contraction into our P&L model. However, this contraction will be offset by efficiency gains from economies of scale. Our P&L model calls for an adjusted net margin of 2.3%, 7.0% and 7.7% over the three-year period.

Initiate coverage with BUY, target price HK$8.80. We like GP for its leadership position, strong brand awareness, exposure to China's consumption sector and upside in its distribution business. We initiate coverage with a target price of HK$8.80, representing 20.7x FY12/08F and 16.1x FY12/09F P/E and derived from a sum-of-the-parts valuation comprising 30.0x FY12/08F P/E for its Wanglaoji JV and 16.0x FY12/08F P/E for its pharmaceutical business. Hong Kong-listed pharmaceutical/medical companies with leadership position is trading at an average of 15.1x 1-year forward P/E while F&B companies are trading at an average of 27.6 1-year forward P/E. Our valuation is pragmatic against pharmaceutical peers (currently trading at 15.1x one-year forward P/E). The counter is currently undemanding, trading at 10.0x FY12/08F P/E, at a 65.7% discount to its A-shares counterpart.

Relationship and history with parent. Guangzhou Pharmaceutical Holdings Ltd, wholly owned by the Guangzhou Municipal Government, is the listco's parent. In Sep 1997, it injected eight TCM manufacturers and three medical distribution companies into GP in preparation for a listing. GP's H-shares were listed on HKEx in Oct 1997 and A-shares in Shanghai in Feb 2001.

Corporate governance. GP is an H-share company, with shares outstanding at 219.9m H-shares, 162.9m listed A-shares and 428.1m unlisted A-shares. Significant shareholders of H-shares include: 1) Baring Hong Kong China Fund (23.2%); 2) Wellington Management Co. Ltd. (8.0%); 3) Greenwoods Asset Management (7.6%); 4) Deutsche Bank AG (7.0%); 5) Martin Currie (5.6%) and 6) Value Partners (5.0%). The company has not undertaken any fund raising exercises since its H-shares and A-shares listing. PricewaterhouseCoopers is its auditor.

Dividend policy. GP's management has committed to maintaining a payout ratio of 30.0%.

Risks. 1) slowdown in Wanglaoji growth; 2) further regulatory adjustments by SFDA and NDRC; 3) acceleration of inflation leading to higher-than-expected raw material costs; 4) increased losses by loss making subsidiaries.

Table 6: P&L

Year to Dec (RMBm)	04A	05A	06A	07F	08F	09F
Turnover	7,709.6	9,026.3	10,241.0	11,705.8	4,971.4	5,759.5
Cost of sales	(6,313.6)	(7,473.0)	(8,472.2)	(9,901.0)	(3,877.3)	(4,450.0)
Gross profit	1,395.9	1,553.4	1,768.8	1,804.8	1,094.2	1,209.5
Other income and gains	65.1	91.6	75.2.	77.5	29.8	34.6
Selling and distribution costs	(557.4)	(616.8)	(778.2)	(879.1)	(365.4)	(387.2)
Administrative expenses	(666.7)	(641.4)	(656.5)	(586.4)	(409.7)	(438.9)
Other operating expenses	(27.6)	(16.5)	(14.5)	(4.2)	(2.2)	(2.8)
Operating profit	209.4	370.3	394.8	412.7	346.7	415.2
Finance costs, net	(47.2)	(53.6)	(45.4)	(51.2)	(5.4)	(5.4)
Share of profits and losses of JCE		-	-	54.3	113.8	161.4
Share of profits of an associate	(0.6)	(1.2)	(0.3)	-		
Exceptionals			-	16.4	65.6	
Profit before taxation	161.7	315.5	349.2	432.2	520.7	(571.2)
Taxation	(110.3)	(107.8)	(118.6)	(141.2)	(113.9)	(114.7)
Profit from continuing operations						
Profit from discontinued operations			-			
Profit after tax	51.4	207.7	230.6	291.0	406.8	456.5
Minority interests	(8.6)	(9.9)	(12.5)	(17.8)	(15.8)	(15.8)
Profit attributable to shareholders	42.8	197.8	218.1	273.3	391.0	440.7
% chg		362.1	10.3	25.3	43.1	12.7
Dividends	(20.3)	(56.8)	(68.1)	(82.0)	(117.3)	(132.2)

Source: Company data, SBI E2-Capital

Table 7: Valuation comparison

Company name	Ticker	Country	Mkt Cap (US$m)	Last price (local)	Est Curr Yr P/E (x)	Est Next Yr P/E (x)	ROE (%)
HK-listed pharmaceuticals/medical leaders							
Mingyuan Medicare	233 HK	China	449.4	HK$1.20	29.5	20.9	13.9
Guangzhou Pharma	874 HK	China	1,379.6	HK$5.18	14.5	10.7	7.8
China Pharma	1093 HK	China	382.5	HK$2.10	6.6	6.9	0.6
Sino Biopharmaceutical	1177 HK	China	383.0	HK$1.40	15.0	11.0	7.5
Uni-Bio Group	690 HK	China	523.8	HK$0.50	26.0	17.3	11.0
Golden Meditech	8180 HK	China	606.4	HK$3.00	12.4	12.0	9.7
Shandong Weigao	8199 HK	China	1,676.7	HK$13.90	40.5	27.2	27.0
Average					*20.6*	*15.1*	
China-listed pharmaceuticals							
Yunan Baiyao Group	000538 CH	China	2,353.9	RMB38.00	58.7	45.8	29.5
Beijing Tongrentang	600085 CH	China	1,658.4	RMB29.20	47.6	39.9	6.6
Guangzhou Baiyunshan	000522 CH	China	873.0	RMB14.10	45.4	29.6	-
Guangzhou Pharma	600332 CH	China	1,271.6	RMB15.10	41.0	34.3	7.9
Average					*48.2*	*37.4*	
Average (HK & China)					*30.7*	*23.2*	
HK-listed F&B related							
Uni-President	220 HK	China	1,914.6	HK$4.20	31.1	22.5	5.8
Tingyi	322 HK	China	8,065.9	HK$11.10	39.0	32.8	16.7
Average					*35.1*	*27.6*	

Source: Bloomberg

Industry Data

Beverage and RTD tea industry. Driven by increasing domestic consumption, China's beverage industry is booming. According to ACNielsen, beverage sales grew at a CAGR of 12.9% to RMB47.2b in 2004-2006, while volume consumption grew at a CAGR of 14.8% to 12.1b in the period. Despite this, China's per capita consumption is 25.2 litres compared with 262 litres in the US, 121 litres in Japan and 223 litres in Germany. In particular, ready-to-drink (RTD) tea products are experiencing the strongest growth, with sales surging at a

CAGR of 32.2% to RMB7.4b in 2004-2006 and consumption at a CAGR of 36.2% to 1.5b litres. In our view, Wanglaoji herbal tea has been a prime beneficiary of this surging demand.

Table 8: 2004-2006 China beverage sales value

Segment	2006 (RMBm)	Market share (%)	2004-2006 CAGR (%)
Carbonated soft drinks	17,934	38.0	9.6
Juice	11,835	25.1	12.5
Bottled water	7,431	15.7	14.0
RTD tea	7,400	15.7	32.2
Functional drinks	2,601	5.5	-3.1
Total	47,201	100.0	12.9

Source: ACNielsen

Table 9: 2004-2006 China beverage sales volume

Segment	2006 (m litres)	Market share (%)	2004-2006 CAGR (%)
Carbonated soft drinks	4,451	36.9	10.4
Juice	3,556	29.4	15.9
Bottled water	2,292	19.0	17.1
RTD tea	1,452	12.0	36.2
Functional drinks	327	2.7	-11.0
Total	12,079	100.0	14.8

Source: ACNielsen

China's healthcare expenditure to continue growing. According to the Ministry of Health, China's total expenditure on healthcare grew at a CAGR of 13.6% in 2000-2005 to RMB866.0b, as rising wealth and income levels drove demand for healthcare services. While government healthcare spending remains low compared with developed countries, we expect it to increase significantly over the next few years, benefitting GP. In Mar 2007, the central government earmarked RMB31.3b for healthcare, up 86.8% from 2006. In the 11th Five-year Plan, the authorities aim to make medical insurance coverage available to all residents in the country by 2010.

Table 10: Health expenditure

	1980	1990	1995	2000	2003	2004	2005	2006
Total health expenditure (RMBb)	14.3	74.7	215.5	458.7	658.4	759.0	866.0	985.6
Government health expenditure (RMBb)	5.2	18.7	38.7	71.0	111.7	129.3	155.3	177.4
Social health expenditure (RMBb)	6.1	29.3	76.8	117.2	178.9	222.5	258.6	321.3
Personal health expenditure (RMBb)	3.0	26.7	100.0	270.5	367.9	407.1	452.1	486.9
Government health expenditure (%)	36.2	25.1	18.0	15.5	17.0	17.1	17.9	18.0
Social health expenditure (%)	42.6	39.2	35.6	25.5	27.2	29.3	29.9	32.6
Personal health expenditure (%)	21.2	35.7	46.4	59.0	55.8	53.6	52.2	49.4

Source:MoH

Strong growth in pharmaceutical products. The restructuring initiatives implemented by the SFDA and NDRC had resulted in a deceleration of YoY industry revenue growth from 26.3% in 2005 to 16.3% in 2006. However, it appears that the impact of most of these restructuring has largely been absorbed and industry growth has begun to normalise. We note that China's pharmaceutical industry has rebounded in 2007. For the first nine months of 2007, pharmaceutical sales increased 26.6% YoY to RMB416.3b. The growth has been broad based with chemical medicines, bio-chemical medicines and Chinese medicines growing at 27.2%, 27.6% and 23.7% YoY respectively. This macro trend is echoed at the micro level with the growth momentum of many listed pharmaceutical companies picking up and SFDA resuming product approvals.

Table 11: Pharmaceutical product revenues

9M 2007	Revenue (RMBb)	YoY Chg (%)
Chemical raw materials	97.7	25.6
Chemical medicines	92.9	27.2
Bio-chemical medicines	30.9	27.6
Chinese medicines	74.2	23.7
Medical equipment	38.9	21.6
Healthcare material	18.0	32.6
Others	63.7	32.0
Total	416.3	26.6

Source: PICO

OTC industry. China's OTC sub-sector is growing at a rapid rate, driven by favorable demographics such as aging population and cultural trends. The Chinese, by nature, are health conscious and tend to self medicate. Thus, rising disposable incomes fuel demand for self-medication and preventative healthcare products, driving the growth of the OTC market. According to the Frost & Sullivan, China's revenue from non-hospital drugstores is expected to grow from RMB91.6m in 2006 to RMB226.4m to 2011, or from 28.4% to 41.0% of total revenue in the period. The Chinese government has been encouraging the development of non-hospital drug stores. In Mar 2007, the Ministry of Health issued new regulations requiring hospitals to allow prescriptions to be filled at non-hospital drugstores, which is expected to boost sales of OTC chains.

Table 12: China's pharmaceutical expenditure by distribution source

(RMBb)	02	03	04	05	06	07F	08F	09F	10F	11F
Hospital pharmacies	136.3	153.6	174.1	203.6	231.5	254.1	278.9	298.2	318.8	325.9
Non-hospital drugstores	51.2	60.0	68.5	79.0	91.6	107.3	125.8	152.4	184.5	226.4
Total retail drug sales	187.5	213.6	242.6	282.6	323.1	361.4	404.7	450.6	503.3	552.3
% non-hospital drugstores	27.3	28.1	28.2	28.0	28.4	29.7	31.1	33.8	36.7	41.0

Source: Frost & Sullivan

P & L (RMBm)	05A	06A	07F	08F	09F
Year to Mar					
Turnover	**9,026.3**	**10,241.0**	**11,705.9**	**4,971.4**	**5,759.5**
% chg	17.1	13.5	14.3	(57.5)	15.9
Gross profit	1,553.4	1,768.8	1,804.8	1,094.2	1,209.5
EBITDA	508.9	534.4	543.0	542.1	614.9
Depre./amort.	(138.6)	(139.6)	(130.3)	(195.4)	(199.7)
EBIT	370.3	394.8	412.8	346.7	415.2
Net int. income/(exp.)	(53.6)	(45.4)	(51.2)	(5.4)	(5.4)
Exceptionals			16.4	65.6	
Associates	(1.2)	(0.3)	(0.0)	0.0	0.0
Jointly-controlled entit.	0.0	0.0	54.3	113.8	161.4
Pre-tax profit	**315.5**	**349.2**	**432.2**	**520.7**	**571.2**
Tax	(107.8)	(118.6)	(141.2)	(113.9)	(114.7)
Minority interests	(9.9)	(12.5)	(17.8)	(15.8)	(15.8)
Net profit	**197.8**	**218.1**	**273.3**	**391.0**	**440.7**
% chg	361.8	10.2	25.3	43.1	12.7
Dividends	(56.8)	(68.1)	(82.0)	(117.3)	(132.2)
Retained earnings	141.0	150.0	191.3	273.7	308.5
EPS (RMB) - Basic	0.244	0.269	0.337	0.482	0.543
EPS (RMB) - F.D.	0.244	0.269	0.337	0.482	0.543
DPS (RMB)	0.070	0.084	0.101	0.145	0.163
No. sh.s o/s (m) - W.A.	(810.9)	(810.9)	(810.9)	(810.9)	(810.9)
No. sh.s o/s (m) - Y.E.	(810.9)	(810.9)	(810.9)	(810.9)	(810.9)
No. sh.s o/s (m) - F.D.	(810.9)	(810.9)	(810.9)	(810.9)	(810.9)
Margins (%)					
Gross	17.2	17.3	15.4	22.0	21.0
EBITDA	5.6	5.2	4.6	10.9	10.7
EBIT	4.1	3.9	3.5	7.0	7.2
Pre-tax	3.5	3.4	3.7	10.5	9.9
Net	2.2	2.1	2.3	7.9	7.7

Balance Sheet (RMBm)	05A	06A	07F	08F	09F
Year to Mar					
Fixed assets	1,542.1	1,478.3	1,425.5	2,148.1	2,084.3
Intangible assets	49.5	40.6	30.2	24.3	20.0
Other LT assets	263.6	302.5	562.6	910.4	1,072.0
Cash	618.6	489.1	545.4	592.2	689.3
Accounts receivable	1,683.2	2,004.0	2,235.0	893.5	1,007.5
Other receivables					
Inventories	1148.6	1326.4	1527.6	512.1	563.5
Due from related co.s					
Other current assets	10.9	0.0	0.0	0.0	0.0
Total assets	**5,316.4**	**5,641.0**	**6,326.2**	**5,080.6**	**5,436.6**
Accounts payable	(1,359.7)	(1,537.9)	(1,792.1)	(829.2)	(880.4)
Other payable					
Tax payable	(25.4)	(42.5)	(33.9)	(38.2)	(36.1)
Due to related co.s					
ST debts	(917.8)	(888.2)	(971.6)	(145.7)	(145.7)
Other current liab.	0.0	0.0	0.0	0.0	0.0
LT debts	0.0	0.0	0.0	0.0	0.0
Other LT liabilities	(88.7)	(92.0)	(94.6)	(93.4)	(98.1)
Total liabilities	**(2,391.6)**	**(2,560.6)**	**(2,892.2)**	**(1,106.6)**	**(1,160.2)**
Share capital	810.9	810.9	1,592.0	1,592.0	1,592.0
Reserves	1,912.2	2,086.5	1,649.8	2,180.3	2,472.5
Shareholders' funds	**2,723.1**	**2,897.4**	**3,241.8**	**3,772.3**	**4,064.5**
Minority interest	201.7	183.0	192.1	201.7	211.8
Total	**2,924.8**	**3,080.4**	**3,434.0**	**3,974.1**	**4,276.3**
Capital employed	3,842.6	3,968.6	4,405.6	4,119.8	4,422.1
Net (debt)/cash	(299.2)	(399.1)	(426.2)	446.5	543.5

Cash Flow (RMBm)	05A	06A	07F	08F	09F
Year to Mar					
EBIT	370.3	394.8	412.8	346.7	415.2
Depre./amort.	138.6	139.6	130.3	195.4	199.7
Net int. paid	(51.2)	(46.3)	(49.3)	(5.4)	(4.5)
Tax paid	(121.9)	(113.7)	(145.4)	(113.9)	(114.7)
Others	(13.3)	6.5	61.2	(1.7)	(20.1)
Gross cashflow	**322.5**	**380.9**	**409.5**	**421.0**	**475.6**
Chgs. in working cap.	(256.7)	(400.3)	(203.2)	(125.2)	(114.3)
Operating cashflow	**65.7**	**(19.4)**	**206.3**	**295.8**	**361.3**
Capex	(125.8)	(88.3)	(132.0)	(132.0)	(132.0)
Free cashflow	**(60.0)**	**(107.7)**	**74.3**	**163.8**	**229.3**
Dividends paid	(48.7)	(20.3)	(55.3)	(82.0)	(117.3)
Net distribution to MI	(9.9)	(12.5)	(17.8)	(15.8)	(15.8)
Investments	(0.2)	11.7	18.7	0.0	0.0
Disposals					
New shares					
Others	(145.0)	(0.6)	36.3	308.0	0.8
Net cashflow	**(263.8)**	**(129.5)**	**56.3**	**374.1**	**97.0**
Net (debt)/cash - Beg.	882.4	618.6	489.1	218.2	592.2
Net (debt)/cash - End.	618.6	489.1	545.4	592.2	689.3

Interim Results (RMBm)	05A	06A
Six months to Sep		
Turnover	**4,596.2**	**5,194.0**
% chg	*15.2*	*13.0*
Profit from operations	216.2	218.0
Interest expenses	(30.2)	(26.5)
Associates	(0.4)	(1.7)
Jointly-controlled entit.	0.0	0.0
Pre-tax profit	**185.6**	**189.8**
Tax	**(54.7)**	**(52.5)**
Minority interests	**(7.9)**	**(8.5)**
Net profit	**123.0**	**128.8**
% chg	260.8	4.8
EPS (RMB) - Basic	0.244	0.269
DPS (RMB)	0.070	0.084

Shareholding Structure	Shares o/s (m)	%
H-shares	219.9	27.1
A-Shares	162.9	20.1
Unlisted A-Shares	428.1	52.8
Total	810.9	

Background

Guangzhou Pharmaceutical focuses on: 1) manufacturing and sales of Chinese Patent Medicine;2) wholesae,retail, import and export of western and chinese pharmacuetical products and medical apparatus;3) research and development of natural and biological medicines.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	30.2	20.6	15.0	5.9	14.4
Net ROE (%)	7.5	7.8	8.9	11.1	11.2
EBIT ROCE (%)	15.1	10.1	9.9	8.1	9.7
Dividend payout (%)	28.7	31.2	30.0	30.0	30.0
Effective tax rate (%)	34.2	34.0	32.7	21.9	20.1
Net interest coverage (x)	6.9	8.7	8.1	63.8	76.4
A/R turnover (days)	64.7	65.7	66.1	61.6	60.2
A/P turnover (days)	68.1	62.4	61.4	78.1	68.6
Stock turnover (days)	54.4	53.3	52.6	45.7	43.1

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months
BUY : absolute upside of >10% over the next six months
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