

# Guangzhou Pharma



**SELL (from BUY)**

## No cure in sight

### Key points:

- RMB22.8m loss in 3Q FY12/08A
- Acute excess inventory problem
- Wanglaoji herbal tea sales up 29.0%YoY but margin shrinks
- Distribution business up 5.6% but margin under pressure
- Our net profit estimates cut to RMB124.8m for FY12/08F and RMB146.8m for FY12/09F
- Downgraded to SELL from BUY, with a target price of HK\$1.40, representing 7.0x FY12/09F P/E

**3Q results.** Guangzhou Pharma (GP) announced its 3Q FY12/08A results based on PRC accounting standards. Revenue was down 36.8% YoY at RMB658.4m. The company reversed its accounting treatment of the Alliance BMP Distribution JV and Wanglaoji JV by deconsolidating them (consolidated numbers were reported in 1H FY12/08A). Net loss reached RMB22.8m from net profit of RMB55.7m in 3Q FY12/07A. We estimate that manufacturing revenue dropped 46.7% YoY to RMB274.8m in 3Q FY12/08A. The distribution JV's revenue rose 5.6% YoY to RMB1,993.6m but pretax profit fell 19.8% YoY to RMB31.2m. The revenue of WLJ JV increased 29.0% YoY to RMB568.8m and pretax profit declined 21.0% YoY to RMB26.8m. Other business decreased 15.5% YoY to RMB383.6m with a slight loss in pretax profit.

**Excess inventory.** The company's excess inventory problem is more severe than we expected. In Jan-Sep 2008, the sales of Xiaokewan (消渴丸) dropped about 25.0% YoY to RMB300m, Xiasanju (夏桑菊) 35.0% to RMB115m and Huatuozaizaowan (华佗再造丸) 38% to RMB100m. The company is cutting production to reduce supply and clear the stock. It expects the situation to improve in the beginning of 2009 for Zhongyi 中一 (maker of Xiaokewan 消渴丸) and Chenliji 陈李济 (maker of Wu Ji Bai Feng Wan 乌鸡白凤丸). However, reducing the excess inventory at Xingqun 星群 (maker of Xiasanju 夏桑菊) could take until end-2009 and Qixin 奇星 (maker of Huatuozaizaowan 华佗再造丸) until even the beginning of 2010.

**Distribution JV.** We expect a moderate contribution from its distribution JV given that: 1) such JVs typically require some restructuring before moving forward; 2) its distribution business margins are under pressure.

**Wanglaoji JV.** We expected the Wanglaoji JV to remain the main cash generator. However, its growth has started to slow down (29.0% YoY top line growth for its peak season in 3Q, compared with 30.9% YoY growth in 1H FY12/08A) and margins have come under pressure.

**Downgrade to SELL.** We believe that the situation is unlikely to reverse in 4Q and that the company may, at best, break even. GP relies on its distributors to undertake the bulk of marketing efforts and its lack of control over its own brand equity is creating an

## China Pharmaceuticals

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**Kennedy Tsang/Helena Qiu**

(852) 2533 3713/3709

kennedytsang/helenaqiu@sbi2capital.com

### Stock data

|                  |                 |
|------------------|-----------------|
| Price            | HK\$1.90        |
| Target price     | HK\$1.40 (-26%) |
| 12 mth range     | HK\$1.66-9.20   |
| Market cap.      | US\$477.1m      |
| Daily t/o, 3 mth | US\$0.4m        |
| Free float %     | 52.2%           |
| Ticker           | 0874.HK/874 HK  |

### Financial summary

| Year to Dec   | 06A    | 07A    | 08F      | 09F     | 10F      |
|---------------|--------|--------|----------|---------|----------|
| T/O (RMBm)    | 10,241 | 12,261 | 3,584.93 | 6,955.4 | 10,548.8 |
| NP (RMBm)     | 218.1  | 320.3  | 124.8    | 146.8   | 215.8    |
| EPS (RMB)     | 0.269  | 0.395  | 0.154    | 0.181   | 0.266    |
| EPS Δ %       | 10.2   | 46.9   | (61.1)   | 17.6    | 47.0     |
| P/E (x)       | 6.2    | 4.2    | 10.9     | 9.2     | 6.3      |
| P/B (x)       | 0.47   | 0.43   | 0.40     | 0.39    | 0.37     |
| EV/EBITDA (x) | 6.9    | 5.7    | 27.7     | 24.7    | 15.7     |
| Yield (%)     | 5.0    | 7.4    | 2.8      | 3.2     | 4.8      |
| ROE (%)       | 7.8    | 10.6   | 3.8      | 4.3     | 6.0      |
| ROCE (%)      | 10.1   | 11.5   | 0.0      | 0.4     | 2.3      |
| N. Gear. (%)  | 13.3   | 6.3    | cash     | 1.2     | 2.6      |

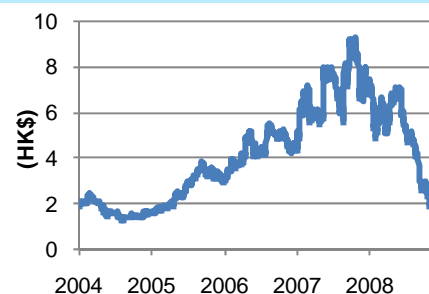
### Price Performance

|                          | 1 mth | 3 mth | 12 mth |
|--------------------------|-------|-------|--------|
| Relative to HSI (%)      | -23.4 | -40.0 | -54.5  |
| Actual price changes (%) | -34.1 | -58.5 | -76.1  |

|                         | 08F   | 09F   | 10F   |
|-------------------------|-------|-------|-------|
| Consensus EPS (RMB)     | 0.325 | 0.290 | 0.325 |
| Previous forecast(RMBm) | 319.0 | 379.7 | 490.9 |
| Previous EPS (RMB)      | 0.393 | 0.468 | 0.605 |

### Price Chart



adverse effect. After three years of its steadily improving SG&A efficiency, the company appears to have lost controls of its internal systems. We cut our net profit estimates to RMB124.8m for FY12/08F and RMB146.8m for FY12/09F and expect its headwinds to increase. With internal controls in disarray, we believe we are unlikely to see any material turnaround before 2Q FY12/09. We downgrade GP to SELL from BUY, with a target price of HK\$1.40, representing 7.0x FY12/09F P/E.

**Table 1: P&L**

| Year to Dec (RMBm)                  | 06A       | 07A        | 08F       | 09F       | 10F       |
|-------------------------------------|-----------|------------|-----------|-----------|-----------|
| Turnover                            | 10,241.0  | 12,260.7   | 3,584.9   | 3,695.5   | 4,054.8   |
| Cost of sales                       | (8,472.2) | (10,245.3) | (2,708.3) | (2,806.8) | (3,079.6) |
| Gross profit                        | 1,768.8   | 2,015.5    | 876.6     | 888.7     | 975.1     |
| Other income and gains              | 75.2      | 80.2       | 51.0      | 22.2      | 24.3      |
| Selling and distribution costs      | (778.2)   | (1,057.3)  | (599.9)   | (579.5)   | (595.3)   |
| Administrative expenses             | (656.5)   | (554.2)    | (329.0)   | (317.3)   | (307.6)   |
| Other operating expenses            | (14.5)    | (4.5)      | 0         | 0         | (2.0)     |
| Operating profit                    | 394.8     | 479.8      | (1.2)     | 14.1      | 94.5      |
| Finance costs, net                  | (45.4)    | (59.7)     | (25.1)    | (13.5)    | (13.5)    |
| Share of profits of an associate    | (0.3)     | 7.9        | 0.4       | -         | -         |
| Share of profit from JV             |           |            | 135.5     | 147.5     | 152.3     |
| Exceptionals                        | -         | 28.8       | 64.0      | -         | -         |
| Profit before taxation              | 349.2     | 456.8      | 173.5     | 148.0     | 233.3     |
| Taxation                            | (118.6)   | (127.0)    | (41.6)    | (1.3)     | (16.2)    |
| Profit after tax                    | 230.6     | 329.9      | 131.9     | 146.7     | 217.1     |
| Minority interests                  | (12.5)    | (9.5)      | (7.2)     | 0.0       | (1.3)     |
| Profit attributable to shareholders | 218.1     | 320.3      | 124.8     | 146.8     | 215.8     |
| %chg                                | 10.3      | 46.9       | (61.0)    | 17.6      | 47.0      |
| Dividends                           | (68.1)    | (100.5)    | (37.4)    | (44.0)    | (64.7)    |

Note: assume Distribution JV & WLJ JV would be deconsolidated in 2008F, 2009F&2010F.

Source: Company data

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**SELL** : absolute downside of >10% over the next six months

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