Corporate Visit

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Guangzhou Pharmaceuticals: A new direction

Recommendation: Not Rated | **China Pharmaceuticals**

Price	**HK$6.96**	**Yield (12/06A)**	1.1%
12 mth range	HK$4.26-9.55	**ROE (12/06A)**	7.8%
Market cap.	US$196.2m (H-shares)	**Net gearing (12/06A)**	36.7%
No. shares o/s	219.9m (H-shares)	**Net debt/sh. (12/06A)**	HK$0.492
Daily t/o, 3 mth	US$1.1m	**BV/sh. (12/06A)**	HK$1.10
Free float %	43.6%	**Consensus EPS**	
Major shareholder	Baring Hong Kong China Fund – 23.2%	**- 12/07F**	HK$0.364
Ticker	0874.HK/ 874 HK	**- 12/08F**	HK$0.453

Key points:

- JV with Alliance Boots, to be completed in 1Q FY12/08, will: 1) boost GP's wholesale and retail business; 2) create distributorship opportunities in China; 3) improve in margins and 4) accelerate expansion.
- GP to benefit from the industry's recent consolidation and restructuring.
- Wanglaoji new distribution channels, via fast food outlets (such as KFC) and airlines, should help maintain its high growth rate in FY12/08.
- Trading at an undemanding 19.0x FY12/07F and 15.5x FY12/08F P/E, based on consensus estimates. The H-share price of HK$6.96 is at a 50.0%+ discount to its A-share counterpart.

Established drug maker, distributor and retailer. Guangzhou Pharmaceuticals (GP) is a vertically integrated pharmaceutical manufacturer, engaged in distribution and retail in China. It has a portfolio of more than 450 western medicines, traditional Chinese medicines (TCM) and healthcare products. It is the exclusive manufacturer and distributor of around 20 TCMs, including some time-honoured brands such as 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).

JV with Alliance Boots nearing completion. Announced in Jan 2007, the sale of 50.0% of GP's wholly owned subsidiary, Guangzhou Pharmaceutical Cooperation Group (GP Corp), to Alliance BMP (80%-owned by Alliance Boots and 20% by Beijing Med-Pharm) is expected to be completed in 1Q FY12/08. Alliance BMP will inject RMB485.1m into GP at the end of December and this capital will be re-injected into the JV. The deal will improve GP's brand positioning (Alliance Boots) and execution ability (Philadelphia-based Beijing Med-Pharm specializes in the introduction of pharmaceutical products into China) in the following ways:

- ***Boost wholesale and retail network*** – Alliance Boots will place a CFO to run the JV. The capital injection will fund the expansion of the JV's wholesale and retail network nationwide while Alliance Boots' management expertise will improve its 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 shift part of its product portfolio to the JV giving it exclusive distribution rights.
- ***Improvement in P&L margins*** – In 1H FY12/07A, GP Corp generated RMB4,253.0m in revenue but its net margin was wafer thin at 0.8%. We expect the partnership with Alliance BMP to help improve the margin. As a comparison, China Nepstar (NPD US), a US-listed OTC pharmacy retailer, commands a net margin of around 6%. The deconsolidation of the results from the P&L to the JCE level will mean a substantial improvement in the P&L margins of the listco.

- ***Relief of working capital*** – GP Corp historically ties up much of GP's working capital. On the balance sheet, the subsidiary accounts for around 50.0% (~RMB700.0m) of the listco's inventories and around 80.0% (~RMB777.0m) of debt. Therefore, moving GP Corp 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 hold only 50.0%, the JV will be more independent from its parent, which will allow it greater operating flexibility and to react faster to the market's dynamics and competition.

GP – a likely winner of consolidation and restructuring. In our view, GP is likely to emerge as a winner in China's pharmaceutical industry consolidation and restructuring. The company is already one of the country's largest pharmaceutical distributors and the current consolidation will boost its bargaining power. New restructuring measures, such as the central procurement tender system currently on trial in southern China, will further benefit GP.

Wanglaoji going from strength to strength. GP's 48.05%-owned Wanglaoji Corp is the exclusive manufacturer and distributor of the "green label" Wanglaoji herbal tea in China. In 1H FY12/07A, the sales of Wanglaoji tea doubled to about RMB 340.0m, as its distribution network expanded beyond Guangdong province. Wanglaoji Corp is currently developing new distribution channels to sell its tea fast food outlets (such as KFC) and airlines. In 1H FY12/07A, its sales jumped 59.5% YoY to RMB528.2m and net profit 45.0% YoY to RMB52.9m. We expect its high growth rate to be maintained in FY12/08F.

1H FY12/07A results. GP's sales rose 17.3% YoY to RMB5,987.5m and net profit 17.3% YoY to RMB151.2m. The key segments of manufacturing and wholesale recorded healthy growth rates of 15.3% YoY (RMB1,275.8m) and 19.5% YoY (RMB4,406.4m), respectively. The blended gross margin narrowed 0.8pcp to 15.4% due to product mix changes. On a segmental basis, the operating margin of manufacturing and wholesale widened to 17.4% (from 17.0%) and 1.96% (from 1.81%), respectively.

Table 1: Turnover breakdown

Year to Dec (RMBm)	FY05	YoY chg (%)	FY06	YoY chg (%)	1H FY07	YoY chg (%)
Manufacturing	2,141.7	*11.5*	2,412.2	*12.6*	1,275.8	*15.3*
Wholesale	6,345.3	*18.8*	7,267.4	*14.5*	4,406.4	*19.5*
Retail	318.7	*14.3*	335.9	*5.4*	176.5	*(3.6)*
Import and export	220.7	*29.4*	225.6	*2.2*	128.8	*2.8*
Total	**9,026.3**	*17.1*	**10,241.0**	*13.5*	**5,987.5**	*17.4*

Source: Company data

Beneficiary of uniform tax policy. The company will benefit from China's new tax policy. We expect its current effective tax rate of 34.4% to be lowered to around 25.0-28.0% in FY12/08F, providing an additional earnings boost.

Valuation. The company is currently trading at an undemanding 19.0x FY12/07F and 15.5x FY12/08F P/E based on consensus estimates. Its H-shares, priced at HK$6.96, are at a 50%+ discount to its A-shares.

Corporate governance. GP is an H-share company. The shares outstanding currently comprise 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%).

Table 2: P&L

Year to Dec (RMBm)	04A	05A	06A	1H 06A	1H 07A
Turnover	7709.6	9026.3	10241.0	5101.9	5987.5
Cost of sales	(6313.6)	(7473.0)	(8472.2)	(4275.1)	(5063.3)
Gross profit	1395.9	1553.4	1768.8	826.8	924.2
Other income and gains	65.1	91.6	75.2.	44.1	39.2
Selling and distribution costs	(557.4)	(616.8)	(778.2)	(391.6)	(445.6)
Administrative expenses	(666.7)	(641.4)	(656.5)	(275.4)	(260.5)
Other operating expenses	(27.6)	(16.5)	(14.5)	(3.6)	(3.2)
Operating profit	209.4	370.3	394.8	200.3	254.2
Finance costs, net	(47.2)	(53.6)	(45.4)	(26.5)	(34.1)
Share of profits and losses of jointly controlled entities		-	-	17.6	25.5
Share of profits of an associated	(0.6)	(1.2)	(0.3)	(1.5)	0
Exceptionals			-		-
Profit before taxation	161.7	315.5	349.2	189.8	245.5
Taxation	(110.3)	(107.8)	(118.6)	(52.5)	(84.4)
Profit from continuing operations					
Profit from discontinued operations			-	-	-
Profit after tax	51.4	207.7	230.6	137.3	161.1
Minority interests	(8.6)	(9.9)	(12.5)	(8.5)	(9.9)
Profit attributable to shareholders	42.8	197.8	218.1	128.8	151.2
%chg		*362.1*	*10.3*		*17.4*
Dividends	(20.3)	(56.8	(68.1)	-	-

Source: Company data