

Falling victim to commodity pricing

China Pharmaceutical

China Pharmaceutical (1093 HK, HK\$1.24)

Not Rated

Bulk drugs manufacturer. China Pharmaceuticals (CP) is one of the world's largest active pharmaceutical ingredients (API) or bulk drugs manufacturers. The company has a broad portfolio of products including penicillin, cephalosporin (7-ACA), vitamin C, as well as finished drugs. Typically, its customers are bulk drugs manufacturers which purchases CP's products for manufacturing of subsequent finished drugs. Revenues of CP totaled HK\$3,192.1m for FY12/05A and HK\$2,608.1m for the first nine months of FY12/06A.

Table 1: Revenue breakdown

Drugs	% of revenues (as at 3Q FY12/06)
Bulk Drugs	
Penicillin	28.3
Cephalosporin (7-ACA)	18.6
Vitamin C	16.5
Finished Drugs	36.1
Others	0.5
Total	100.0

Source: Company data

Worldwide distribution. The company distributes its products on a worldwide basis, though China accounts for the majority. As at 1H FY12/05A, China revenues accounted for 70.1%, while overseas sales, including Asia (ex. China), Europe and US accounted for 29.1%.

Competition is intense with over capacity prevalent. Competition for manufacturing of bulk drugs is fierce as entry barriers are relatively low and differentiation among similar products minimal. This had resulted in commodity pricing in many of CP's product categories. Over capacity is also prevalent. In the vitamin C segment, worldwide capacity is in the region of 130k tonnes/yr, though demand is only estimated at around 110k tonnes/yr. Of the global capacity, the 4 main China players account for around 80%, with CP providing a capacity of 30k tonnes/yr. The concentration of productions capacity in China further exacerbates competition.

Meanwhile, demand for penicillin is flatish. The use of antibiotics in China has been around for 80+ years and therefore growth for demand in penicillin is flatish, mainly stemming in penetration in rural areas. Currently, 70% of the company's penicillin sales is derived from China. Management sees growth avenue in export to countries such as India, where they concentrate more on finished drugs, rather than on bulk drugs.

3Q FY12/06 was particularly harsh on CP. The fiercely competitive bulk drugs industry showed on CP's 3Q FY12/06 results as the company suffered from both pricing pressure and margin squeeze. For the quarter, revenues rose 2.6% QoQ and 1.5% YoY to HK\$295.1m. A rebound in penicillin/amoxicillin prices and seasonally stronger sales volume lifted penicillin prices 25.0% QoQ to HK\$295.1m, though this was offset by continued declines in 7-ACA and Vitamin C prices, with segment revenues falling 13.1% QoQ and 15.5% QoQ respectively. Gross profit fell 18.1% QoQ to HK\$124.2m as margins declined in all segments save for penicillin. The company actually made a pretax loss of HK\$15.0m, compared to HK\$3.1m and HK\$16.5m in 2Q and 1Q FY12/06A respectively. Net loss for the quarter narrowed to HK\$5.7m aided by a HK\$8.9m tax gain.

Heavy finance costs helped drag down profitability. A 55.7% surge in finance costs for the first nine months of the year to HK\$76.1m further pressured CP's profitability. At the end of 1H FY12/06A, the company had a net debt of HK\$1,070.6m.

No further capacity expansion to lift revenues. With over capacity situation in the industry, CP does not plan to add further production capacity to lift revenues through higher volume sales. In fact, the company will be restraining production in Vitamin C in a bid to stabilize falling average selling prices. Nevertheless, there are still capex requirements as the company needs to invest around HK\$150m in FY12/07 to construct a sewage treatment plant to meet stricter environmental regulations.

Moderating conditions ahead, but uncertain outlook clouds future. While the penicillin price rebound (from a low of US\$9.15/kg in 1H 2006 to around HK\$11.40/kg in Dec 2006) and cost savings from the company's Inner Mongolia plant will go far to restore profitability in CP going forward, the outlook for other segments remain unclear. Though vitamin C prices appear to be stabilising, it remains to be seen whether the lower utilization of plant capacity and rising raw material costs will crimp gross margins. Meanwhile, prices for 7-ACA have continued to decline on a QoQ basis (from US\$96.90/kg in 4Q FY12/05 to US\$67.27/kg in 3Q FY12/06A). The company has a clear growth driver in the finished drugs segment with its vitamin C health supplement product, though we expect competition intensity to rise relatively quickly as others introduce similar products onto the market. Furthermore, continuing implementation of anti-corruption measures by the government and lowering of price ceilings may affect revenue growth in its legacy antibiotics products. We expect CP to breakeven in 4Q FY12/06, with earnings rebound in FY12/07 with operating conditions moderating. Consensus net profit for FY12/06F and FY12/07F is HK\$21.9m and HK\$65.5m respectively.

Dividend policy. CP does not maintain a general dividend policy. We note that the company had not distributed dividends over the past two years.

Valuation. CP currently trades at 89.3x FY12/06F and 26.1x FY12/07F P/E compared with an industry average of 19.4x and 14.8x respectively. Though the company is trading at a significant discount on a P/B basis (0.76x), the valuation premium appears rich given that CP focuses on the sub-sector commoditized bulk drugs and generic drugs. Furthermore, CP is significantly geared (net gearing ratio of 42.9% as at 1H FY12/06A) while the majority of its comparables are in a net cash position. The counter does trade at similar valuations as comparables listed in China, though we note that there is typically a valuation premium for counters listed on the A-Shares market.

Table 2: P&L

Year to Dec (HK\$m)	03A	04A	05A	1-3Q05A	1-3Q06A
Turnover					
Penicillin	548.9	360.8	528.1	312.9	737.5
Cephalosporin	455.9	504.7	855.1	605.5	485.3
Vitamin C	684.1	626.1	1,109.9	545.3	431.0
Finished drugs	786.1	947.38	9.3	819.6	941.3
	2,478.4	2,450.6	3,192.1	2,288.2	2,608.0
Cost of sales	-1,553	1,819.8	2,498.5	1,770.7	2,161.9
Gross profit	924.9	630.8	693.5	517.6	446.1
Other income and gains	-9.5	14.7	21.1	15.6	26.9
Selling and distribution costs	-94.5	-131.5	-182.7	-124.3	-166.3
Administrative expenses	-200.2	-230.0	-293.2	-215.7	-223.4
Other operating expenses	-21.5	-10.9	-20.5	-16.1	-5.9
Operating profit	618.3			177.0	77.3
Finance costs, net	-25.4	-27.9	-68.1	-46.0	-71.6
Share of profits and losses of jointly controlled entities	7.6	3.4	-1.0	-0.5	-1.0
Profit before taxation	600.5	248.4	148.9	130.4	4.6
Taxation	-94.9	-3.2	7.3	-6.6	5.8
Profit after tax	505.6	245.3	156.3	123.8	10.5
Minority interests	-1.4	0.4	0.2	0.19	-0.4
Profit attributable to shareholders	504.1	245.0	156.5	123.8	10.9
% chg					
Dividends	215.3	0	0	0	0

Source: Company data

Table 3: Valuation comparisons

Company Name	Ticker	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Nxt Yr P/E (x)	Est Yield (%)	ROE (%)
Pharmaceuticals							
Sino-Biopharmaceutical	1177 HK	319.3	HK\$1.11	19.0	18.3	3.9	132.8
China Shineway	2877 HK	610.7	HK\$5.85	14.2	12.8	-	21.8
C&O Pharmaceutical	COPT SP	153.5	SGD0.39	23.9	14.8	16.6	38.7
Asiapharm	APHM SP	255.0	SGD0.80	20.5	12.1	-	29.0
<i>Average</i>				<i>19.4</i>	<i>14.8</i>	<i>5.1</i>	<i>55.6</i>
Bulk Drugs							
North China Pharmaceutical	600812 CH	440.4	RMB3.34	334.0	27.8	-	n/a
Northeast Pharmaceutical	000597 CH	948.0	RMB4.81	n/a	n/a	-	1.5
<i>Average</i>				<i>334.0</i>	<i>27.8</i>	<i>-</i>	<i>1.5</i>
China Pharmaceutical	1093 HK	242.6	HK\$1.24	87.9	25.6	-	1.2

Source: Bloomberg and SBI E2-Capital