

Strong pipeline, but earnings void in FY07

China Pharmaceutical

Sino-Biopharmaceutical (1177 HK, HK\$1.08)

Not Rated

Company background. Sino-Biopharmaceutical (SB), through its subsidiaries, is an integrated pharmaceutical enterprise engaged in the research and development, manufacture and sale of proprietary chemical medicines and modern Chinese medicines in China. The company developed its pharmaceutical business through a M&A process, acquiring previously unprofitable state-owned pharmaceutical companies and turning them around by restructuring their management and refining their R&D processes and product lines. SB's key subsidiaries include 35%-owned Beijing Tide Pharmaceutical (Tide), 60%-owned Jiangsu Chia Tai-Tianqing Pharmaceutical (JCTT) and 51%-owned Nanjing Chia Tai-Tianqing Pharmaceutical (NJCTT). SB's proprietary drugs portfolio focuses on two core areas – hepatitis and cardio-cerebral diseases. The company is also actively developing medicines for oncology, diabetes, analgesia and respiratory ailments.

Table 1: SB's subsidiaries

Subsidiary	Effective holding (%)	Description
Jiangsu Chia Tai-Tianqing (JCTT)	60	Modern Chinese medicines for the treatment of hepatitis, chemical medicines and modern healthcare products
Nanjing Chia Tai Tianqing (NJCTT)	51	PVC-free soft bags for intravenous injections for the treatment of angiopathy cardio cerebral diseases
Beijing Tide (Tide)	35	Modern Chinese medicines and chemical medicines for treatment of angiocardiovascular diseases
Beijing Chia Tai Green Continent (CTGC)	75	R&D of new medicines and modern healthcare products for the treatment of cardiovascular and respiratory diseases
Jiangsu Qingjiang	15	R&D of antibiotics, integrated bulk drugs, Chinese patent medicines and pharmaceutical products
Chia Tai Qingchunbao (CTQ)	5	Healthcare products for the treatment of angiocardiovascular and digestive diseases
Lianyungang Chia Tai Tianyi Medicine	60	Trading for pharmaceutical products

Source: Company data

Focus on blockbuster drugs. SB aims to develop and sell “blockbuster” drugs, that is, proprietary chemical medicines or modern Chinese medicines that can deliver revenues in excess of HK\$100m annually. The company's flagship product is Kaishi, a targeted and sustained release injection for treating cardio-cerebral diseases with revenues of HK\$318.7m in FY12/05A and HK\$235.0m¹ in as at 3Q FY12/06A. In the hepatitis segment, Ganlixin injections and capsules generated HK\$192.1m as of 3Q FY12/06A. In all, hepatitis related drugs accounted for 64.2% of revenues, cardio-cerebral 22.1%, oncology 4.8% and analgesia 1.5% as of 3Q FY12/06A.

Solid sales force. The company sells its drugs to regional distributors, who resell them to hospitals and pharmacies. With a prescription dominated drug portfolio, SB derives 80% revenues from hospitals and 20% from pharmacies. The main purpose of SB's sales force, comprising 1,300+ sales and medical representatives across more than 30 provinces, is to promote and enhance knowledge of the company's products to end users such as hospital administrators and doctors, as well as line-up and manage regional and local distributors.

¹ Kaishi is manufactured by 35%-owned Beijing Tide Pharmaceutical. Note that only 35% of the sales from this subsidiary is consolidated into SB's financials by means of proportionate consolidation.

Table 2: Sino-Biopharmaceutical's drug portfolio

Product focus	Flagship products
Hepatitis	Ganlixin injections and capsules, Tianqingfuxin injections and capsules, Tianqingganping enteric capsules, Tianqingganmei injections
Cardio-cerebral	Kaishi injections, Spring injections, Tianqinggan injections
Oncology	Tianqingyitai injections, Renyi injections
Analgesic	Kaifen injections
Diabetes	Metformin hydrochloride sustained release tablets
Respiratory system	Tianqingzhenshu tablets

Source: Company data

Strong R&D pipeline positions SB for the future. One of SB's key advantages is its strong blockbuster drugs pipeline and R&D capability. The company's has 60-80 drugs currently under development, with around 20 being potential blockbusters. Annual R&D expenditure is 8-10% of revenues. Non-blockbuster drugs that SB invests in are typically complementary products to the company's existing drug portfolio. SB aims to release six to seven new products each year.

Encouraging signs from new products, but 3Q FY12/06 results affected by regulatory environment. Similar to other peers, a stricter regulatory environment in China's pharmaceutical industry affected SB's 3Q FY12/06A results. For the first nine months of the year, revenues fell 9.5% YoY to HK\$536.9m, while net profit rose 23.5% YoY to HK\$94.9m on a proforma basis, after stripping out contribution from discontinued operations and CTF disposal gains. However, excluding interest income, net profit dropped 43.4% YoY. While gross margins expanded a slight 0.2 pcp YoY to 79.5%, the decreased sales volume, coupled with a 8.4% YoY increase SG&A costs had a de-leveraging effect and squeezed the bottom line. Though cardio-cerebral and hepatitis drugs revenues contracted 10.3% and 14.2% YoY to HK\$118.7m and HK\$344.5m respectively, newly launched products such as Mingzheng capsules and Tingqinganmei (hepatitis) as well as Kaifen injections (oncology) recorded encouraging growth. We project these drugs have the potential to become blockbusters over time.

Massive windfall in FY12/05 through disposal of CTF to Bausch & Lomb. On 26 Sep 2005, the company completed the disposal of its 55%-owned subsidiary Shangdong Chia Tai Freda Pharmaceutical (CTF) to Bausch & Lomb for HK\$200m (HK\$1,544.0m) and realized a gain of HK\$1,406.2m. CTF specialized in the development and manufacture of biopharmaceutical products for ophthalmic and osteoarthritis conditions. In our view, the disposal made sense given that: 1) ophthalmic drugs were not in line with SB's remaining drug portfolio; 2) it gave it the opportunity to realize its investment in CTF at a substantial premium (ROI was >300x after considering disposal gain and profits generated since acquisition in 1994) and 3) the chance to boost cash reserves to position it for further acquisitions.

Unfocused diversification brings risk. In Sep 2006, the company announced the formation of a 43%-owned JV with three other parties, including Shaanxi Coal Chemical (36%), to conduct the refining of coal into olefin products (ethylene and propylene) in Yulin City, Shaanxi Province. The contribution from SB will amount to RMB752m. While the management has a good track record in M&A activities and we acknowledge its reasoning that the production process for some of the chemical medicine's raw material is similar to the manufacturing process for refining coal to olefin products, we nevertheless feel that the business diversification may be a knee jerk reaction to the harsh operating environment in the pharmaceutical industry at the time. The decision was no doubt made easier with the company's cash gains after the disposal of CTF to Bausch & Lomb. Management indicates that this project is not expected to generate significant contribution until FY12/09.

Blockbuster drugs have potential, but earnings void in FY12/07F. Despite the arguably undisciplined business diversification, the key to SB's growth prospects remains its blockbuster drug pipeline. While new products such as Mingzheng, Tingqinganmei and Kaifen have the potential to become blockbuster drugs, we note that these products are unlikely to reach the HK\$100m until FY12/08 or beyond. In the meantime however, its existing cardio-cerebral and hepatitis drugs portfolios are facing pricing and regulatory pressure, which may mean a temporary earnings void in FY12/07, before new blockbuster drugs reignite growth in FY12/08. Though we believe that operating conditions should normalize in FY12/07, SB's is unlikely to see a significant earnings rebound in our view. Consensus forecast is for the company's net profit to reach HK\$138.2m in FY12/06F and HK\$145.1m in FY12/07F.

Dividend policy. Management generally maintains a 60-70% payout ratio. Interestingly, SB distributes dividend on a quarterly basis.

Valuation. SB trades at 17.7x FY12/06F and 16.9x FY12/07F P/E compared with a peer average of 18.5x and 14.8x (ex. China Pharmaceutical), on a consensus basis. As of 3Q FY12/06, the company was in a net cash position of HK\$1,770.6m. The equivalent HK\$0.782 cash per share represents 72.4% of the stock price. On an ex-cash basis, the company trades at 9.3x FY12/06F and FY12/07F 9.2x P/E.

Corporate governance issues. The company transferred from the GEM Board to the Main Board of the HKEx in Dec 2003. Ernst and Young is its financial auditor and major shareholders include: Chairman Tse Ping (47.7%), Goldman Sachs (9.5%) and Mr. Dhanin Chearavanont (6.3%).

Table 1: P&L

Year to Dec (HK\$m)	03A*	04A	05A	1-3Q05A	1-3Q06A
Turnover	821.7	664.3	756.1	593.3	536.9
Cost of sales	(168.7)	(133.2)	(139.4)	(122.6)	(110.1)
Gross profit	653.0	531.1	616.7	470.6	426.9
Other income and gains	9.3	7.1	28.6	5.6	55.3
Selling and distribution costs	(338.4)	(253.4)	(310.6)	(234.4)	(246.4)
Administrative expenses	(116.2)	(101.9)	(110.9)	(67.4)	(80.8)
Other operating expenses	(40.2)	(33.4)	(42.2)	(43.9)	(22.2)
Operating profit	167.5	149.5	181.6	130.5	132.8
Finance costs, net	(1.4)	(1.05)	(2.7)	(1.7)	(1.9)
Share of profits and losses of jointly controlled entities	7.4	-	-	-	-
Share of profits of an associated	-	-	-	-	-
Exceptionals	(0.3)	-	(66.3)	-	-
Profit before taxation	173.2	148.5	112.5	128.8	130.9
Taxation	(23.3)	(15.4)	(18.3)	(12.7)	(11.1)
Profit from continuing operations	149.9	133.1	94.2	116.1	119.9
Profit from discontinued operations	-	152.1	1,558.4	1,560.6	-
Profit after tax	149.9	285.2	1,652.6	1,676.7	119.9
Minority interests	(68.3)	(116.7)	(119.7)	(107.4)	(25.0)
Profit attributable to shareholders	81.6	168.5	1,532.9	1,569.3	94.9
% chg	n/a	106.5	809.8	n/a	(94.0)
Dividends	(49.8)	(109.2)	(250.6)	(216.6)	(67.9)

Source: Company data

* 1) discontinued operations of CTF has not been separated out in the FY12/03 results, 2) Tide, which has been incorporated as a JCE in the FY12/03 results were subsequently consolidated into the P&L by proportionate accounting in FY12/04 onwards.

Table 2: 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	313.5	HK\$1.08	17.7	16.9	4.0	132.8
China Pharmaceutical	1093 HK	250.4	HK\$1.27	90.7	26.5	1.4	6.6
China Shineway	2877 HK	636.2	HK\$6.00	14.8	13.3	-	21.8
C&O Pharmaceutical	COPT SP	147.4	SGD0.365	22.9	14.2	17.4	38.7
<i>Average</i>				36.5	17.7	7.6	49.9
<i>Average (ex. China Pharm)</i>				18.5	14.8		

Source: Bloomberg and SBI E2-Capital