

## United Laboratories Int'l: United up and down stream

**Recommendation: Not Rated**

**Hong Kong Industrials**

Price	HK\$3.63	Yield (12/06A)	n/a
12 mth range	HK\$2.75-7.20	ROE (12/06A)	13.2%
Market cap.	US\$554.7m	Net gearing (12/06A)	35.2%
No. shares o/s	1200m	Net debt/sh. (12/06A)	n/a
Daily t/o, 3 mth	<US\$0.36m	BV/sh. (12/06A)	n/a
Free float %	28.3%	Consensus EPS	
Major shareholder	Choy Family – 71.6%	- 12/07F	HK\$0.310
Ticker	3933.HK/ 3933 HK	- 12/08F	HK\$0.430

### Key points:

- Vertically-integrated antibiotic producer developed from a downstream player.
- Allowed to set prices of five antibiotic products above NDRC price caps
- Key beneficiary of rising raw material prices in China's pharmaceutical sector
- Sales staff of 1,800 and finished product distribute to 180 distributors, including Shanghai Pharmaceutical.
- Beneficiary of the government's drive to improve rural medical services, which will fuel demand for generic medicines.
- Rapidly expanding overseas market (CAGR of 93.6% in FY12/04A-12/06A).
- Undemanding valuation of 10.0x FY12/08F P/E, based on our back-of-pad estimate.

**Background.** United Laboratories International (ULI) is a vertically-integrated producer and distributor of intermediate antibiotics, bulk medicines and finished products. The company was listed on the main board of the HKEx on 15 Jun 2007, with an offer price of HK\$2.75 per share.

**Wide range of products.** ULI makes: 1) intermediate products such as 6-APA and 7-ACA; 2) bulk medicines - penicillin series, cephalosporin series and lactamase inhibitor series and 3) finished products such as penicillin and cephalosporin antibiotics. Its intermediate products and bulk medicines are considered general raw materials for the pharmaceutical industry. In 1H FY12/07A, the three segments accounted for 9.5%, 51.8% and 38.7% of its total sales, respectively.

**1H profit up 108.3%.** In 1H FY12/07A, sales rose 28.2% YoY to HK\$1,216.0m and net profit 108.3% YoY to HK\$174.3m, driven mainly by the bulk medicine segment. Bulk medicine segment sales were up 52.0% YoY to HK\$707.7m due to the rising price of amoxicillin and penicillin, and operating profit surged 651.8% to HK\$171.4m. Sales of finished products increased 11.0% to HK\$450.3m, while operating profit fell 11.0% to HK\$102.0m. Higher raw material costs eroded margins. Sales of intermediate products declined 24.9% to HK\$58.0m because the company's Chengdu plant reduced its production for upgrading its environmental treatment systems.

**Table 1: Turnover breakdown**

Year to Dec (HK\$m)	FY05	YoY chg (%)	FY06	YoY chg (%)	1H FY07	YoY chg (%)
Intermediate product	53.9	n/a	197.4	266.2	58.0	24.9
Bulk medicine	896.4	40.1	1,077.3	20.2	707.7	52.0
Finished product	770.1	37.5	805.8	4.6	450.3	11.0
<b>Total</b>	<b>1720.4</b>	<b>43.4</b>	<b>2080.5</b>	<b>20.9</b>	<b>1,216.0</b>	<b>28.2</b>

Source: Company data

**Price setting power for antibiotics.** Since 2002, the State Food and Drug Administration (SFDA) has allowed ULI to set prices of five of its finished antibiotics (Amoxicillin Capsules 250mg and 500mg, Ampicillin Capsules 250mg and 500mg and Amoxicillin Granules) above standard price caps imposed by the National Development and Reform Commission (NDRC) in recognition of their high quality and efficacy, and the company's contribution to China's pharmaceutical industry. ULI produced China's first oral penicillin in early 1990th and conducted over 10,000 clinical free skin tests to prove its efficacy. It worked with the SFDA to develop the test method for the Amoxicillin polymer, which has since been included into "Chinese Pharmacopoeia (ChP)". The company still requires SFDA / NDRC approval for any price adjustment. Sales of these products reached HK\$441.6m in FY12/06A, representing 54.8% of total sales of finished products and 21.2% of total sales.

**Table 2: ULI pricing vs NDRC pricing (Aug 2006)**

Drug	Dosage and packaging	NDRC retail ceiling price (RMB)	ULI retail price (RMB)
Amoxicillin capsule	250mg*24	9.0	15.7
Amoxicillin capsule	500mg*24	15.8	27.4
Amoxicillin capsule	500mg*12	8.1	13.8
Ampicillin capsule	250mg*24	9.0	15.6

Source: NDRC & Company data

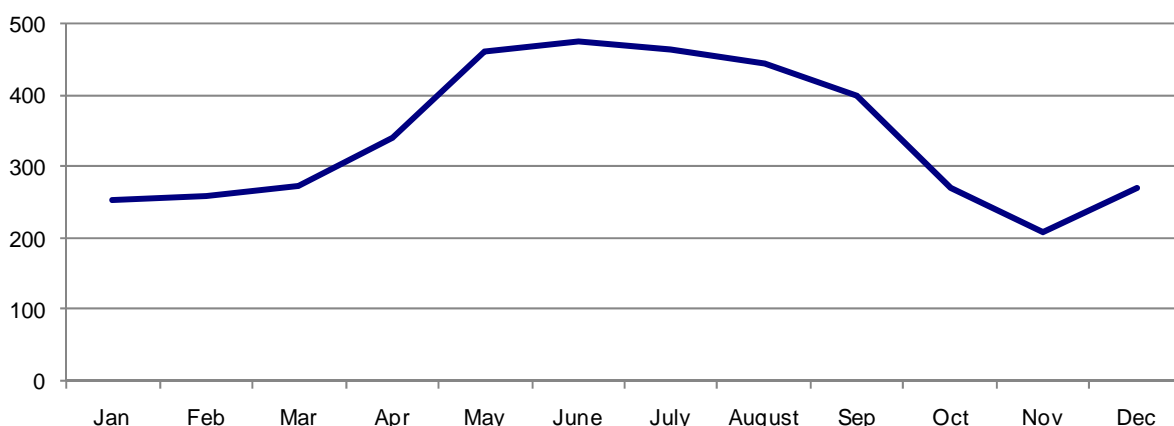
**From downstream to vertically integrated antibiotic maker.** ULI started out as a producer of finished antibiotic products and over the years expanded upstream to make own raw material products to better control costs within its supply chain. The company has six factories in Hong Kong, Zhuhai, Zhongshan, Kaiping, Chengdu and Inner Mongolia, each responsible for different products. The Inner Mongolia plant was commissioned in Jan 2008 and its output is currently limited.

**Table 3: Production capacity**

Location	Major types of products	Size (sq.m)	Annual capacity
Chengdu, Sichuan	Intermediate products	398,784.5	4,096 tonnes
Zhuhai, Guangdong	Bulk medicine	239,487.3	4,431 tonnes
Inner Mongolia	Intermediate products	667,000.0	5,000 tonnes
Zhongshan & Hong Kong	Finished products	70,576.9	1,186m capsules, 46m granule bags, 10.5m bottles
Kaiping, Guangdong	Capsule casings	8,312.0	n/a

Source: Company data

**Beneficiary of the rising amoxicillin price.** After the introduction of China's "pharmaceutical industry pollutant discharge standards" in Jan 2007, many raw material producers were weeded out from the market. Those still in the game had to temporarily shut down operations to upgrade their environmental systems, which drove the price of amoxicillin raw materials from RMB190/kg in Jun 2006 to RMB250-260/kg in Jan 2007 and RMB470/kg in Jul 2007. Currently, the price has stabilized at RMB310-350/kg. ULI and China Pharmaceuticals (1093 HK, HK\$2.55, NR) are the largest players in this market. According to our channel checks, ULI accounted for 30-40% of China's amoxicillin raw material market and China Pharmaceuticals for 30-35%. ULI has already upgraded its facilities to meet the discharge standards and, with its new Inner Mongolia plant adding 5,000 tonnes in extra 6-APA / 7-ACA capacity, is well prepared to meet growing demand.

**Chart 1: 2007 Amoxicillin raw material price trend**

Source: news.pharmnet.com.cn

**Distribution network.** The company has a sales and marketing team of around 1,800 and sells to about 180 distributors. Its antibiotics finished products are distributed through some of the country's largest players, including Shanghai Pharmaceutical Ltd, China's largest pharmaceutical distributor by revenue. We believe the company looks set to be a major beneficiary of the government's policy to improve medical services in rural areas, which we expect to fuel demand for generic medicines such as antibiotics. ULI's main bulk medicine customers are Harbin Pharmaceuticals, Baiyuanshan Pharmaceuticals (000522 CH) and Yuekang Pharmaceuticals.

**Expanding overseas.** ULI sells its products in Germany, South Korea and India, with overseas sales up at a two-year CAGR of 93.6% from HK\$118.8m in FY12/04A to HK\$445.2m in FY12/06A. Its main overseas clients include DSM Anti-Infectives India Ltd, HELM AG, Daewoong Chemical Co and Indukern Chemie A.G.

**New products.** ULI has about 100 staff in the R&D division and, as many pharmaceutical companies, cooperates with third-party medical research institutions such as the chemical engineering department of Tsinghua University and the Sichuan Industrial Institute of Antibiotics of China National Pharmaceutical Group Corp. In Sep 2007, ULI received SFDA approval and launched Adefovir dipivoxil capsules for Hepatitis B. Three other products (Isophane - protamine human insulin injection for type I & II diabetes, Imipenem - cilastatin sodium for injection and Meropenem - for injection to treat infections) are awaiting SFDA approval.

**Key differentiator.** ULI has two key advantages compared with China Pharmaceuticals: 1) effective transition of production best practices and qualities thanks to its organic development from downstream upstream. China Pharmaceuticals was an upstream bulk medicine producer and expanded to downstream finished products through acquisitions of parental assets in 2002. The operating profit margin of ULI's finished products is 22.7%, while China Pharmaceuticals' finished products segment is still in the red and 2) better management and cost control. Despite generating similar revenue, ULI employs 5,000 staff and China Pharmaceuticals 10,000 (about 800 in sales and marketing). In 1H FY12/07A, ULI's net margin was 14.3% compared with its rival's 5.3%.

**Table 4: Margin comparison (1H FY12/07A)**

(%)	Operating margin Intermediate product / bulk medicine	Operating Margin Finished product	Blended gross margin	Blended net margin
ULI	14.9	22.7	43.7	14.3
China Pharma	13.6	loss	27.2	5.3

Source: Company data

**Valuation.** The counter's valuation is undemanding. Based on our back-of-pad estimates, it is currently trading at 10.0x FY12/08F P/E.

Table 5: P&amp;L

Year to Dec (HK\$m)	04A	05A	06A	1H06A	1H07A
Turnover	1,200.1	1,720.4	2,080.5	948.6	1,216.0
Cost of sales	(801.6)	(1,120.7)	(1,344.2)	(605.4)	(684.8)
Gross profit	398.5	599.8	736.3	343.2	531.2
Other income and gains	35.5	12.9	9.9	10.3	10.2
Selling and distribution costs	(125.3)	(261.2)	(284.1)	(148.3)	(190.2)
Administrative expenses	(94.0)	(104.9)	(123.0)	(54.5)	(68.9)
Other operating expenses	(14.7)	(15.4)	(37.8)	(9.3)	(32.4)
Operating profit	200.0	231.1	301.3	141.4	249.9
Finance costs, net	(18.7)	(47.4)	(85.5)	(38.3)	(40.4)
Share of results of an associate	(5.1)	(8.3)	(2.7)	(2.7)	-
Gain on disposal of an associate	-	-	8.6	8.6	-
Profit before taxation	176.3	175.5	221.8	109.1	209.4
Taxation	(26.9)	(42.5)	(47.9)	(25.4)	(35.1)
Profit after tax	149.4	132.9	173.8	83.7	174.3
Minority interests	(17.2)	(16.4)	-	-	-
Profit attributable to shareholders	132.1	116.6	173.8	83.7	174.3
% chg		(11.7)	49.1	n/a	108.2

Source: Company data, SBI E2-Capital

Table 6: 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 (%)
<b>HK-listed Pharmaceuticals</b>							
China Pharm	1093 HK	China	519.4	HK\$2.55	9.0	9.3	0.6
Shandong Luoxin	8058 HK	China	403.9	HK\$5.20	n/a	n/a	32.1
Sino Biopharmaceutical	1177 HK	China	441.9	HK\$1.49	17.3	12.7	7.5
Dawnray Pharma	2348 HK	China	86.6	HK\$0.84	n/a	n/a	13.2
United Laborator	3933 HK	China	554.7	HK\$3.63	11.6	8.3	15.0
Guangzhou Pharmaceutical	874 HK	China	1533.1	HK\$6.26	16.9	11.7	7.8
Uni-Bio Group	690 HK	China	494.4	HK\$0.50	24.5	16.3	11.0
<i>Average</i>					15.9	11.7	
<b>China-listed Pharmaceuticals</b>							
North China Pharmaceutical	600812 CH	China	1,554.3	RMB10.74	102.3	51.9	3.5
Northeast Pharmaceutical	000597 CH	China	833.5	RMB19.50	28.3	26.0	5.2
<i>Average</i>					65.3	39.0	
<i>Average (HK &amp; China)</i>					26.2	19.5	

Source: Bloomberg