

# United Laboratories



## Value goes beyond 6-APA

### Key points:

- True leader in China's pharmaceutical industry - the world's largest producer of 6-APA intermediates and China's leading antibiotics supplier.
- Vertically integrated business model provides margin stability, minimizing raw material impacts under normal fluctuation circumstances.
- Finished products - core of its business model generating HK\$642.8m in 1H FY12/08A in revenue (up 42.7% YoY) or 32.6% of total revenue.
- Beneficiary of China's rural medical coverage reform and increasing medical subsidies in urban areas, with a 30% expansion in finish products capacity in FY12/08 and strong revenue growth in this segment.
- Aggressive expansion of sales team for finished products - from 800 in FY12/06 to 1,800 in FY12/07, 2,200 in 1H FY12/08 and 2,400 by end-FY12/08.
- Aggressive 6-APA capacity expansion to satisfy demand in midstream bulk medicines and downstream finished products.
- Sizeable overseas exposure (23.4% of revenues in FY12/07A), including supplying to global giant, Wyeth.
- Three-year net profit CAGR from FY12/07A to FY12/10F of 20.6%.
- Recent price weakness presents a buying opportunity. Our sum-of-the-parts valuation yields a target price of HK\$6.0, representing 9.0x FY12/09F P/E.

**Company background.** United Laboratories International (ULI) is a vertically-integrated producer and distributor of intermediate antibiotics, bulk medicines and finished products. Listed on the main board of the Hong Kong Exchange on 15 Jun 2007, with an offer price of HK\$2.75 per share, it is China's largest 6-APA producer and one of the world's largest (about 35% of the global market in 2007).

**Vertically integrated product line.** ULI started out in 1990 as a producer of finished antibiotics and expanded upstream to make own raw material products. The company now has six production facilities in Chengdu, Zhuhai, Zhongshan, Kaiping, Inner Mongolia and Hong Kong. It makes: 1) intermediate products such as 6-APA and 7-ACA; 2) bulk medicines: penicillin series, cephalosporin series and  $\beta$ -lactamase inhibitor series; 3) finished products such as penicillin and cephalosporin antibiotics. In FY12/07A, the three segments accounted for 10.2%, 52.5% and 37.3%, respectively, of total sales and in 1H FY12/08 21.3%, 46.1% and 32.6%. The company makes intermediate products and bulk medicines for internal and external (domestic and exports) use. Its customers are typically finished product manufacturers.

**BUY (int. coverage)**

### China Pharmaceuticals

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### Stock data

<b>Price</b>	<b>HK\$3.86</b>
<b>Target price</b>	HK\$6.00 (+55%)
<b>12 mth range</b>	HK\$2.10-7.20
<b>Market cap.</b>	US\$593.9m
<b>Daily t/o, 3 mth</b>	US\$1.1m
<b>Free float %</b>	28.4%
<b>Ticker</b>	3933.HK/3933 HK

### Financial summary

Year to Dec	06A	07A	08F	09F	10F
T/O (HK\$m)	2,080.52	2,594.93	2,962.34	1,957.4	634.2
NP (HK\$m)	173.8	510.5	681.5	796.8	896.1
EPS (HK\$m)	0.145	0.425	0.568	0.664	0.747
EPS $\Delta$ %	49.1	193.6	33.5	16.9	12.5
P/E (x)	26.6	9.1	6.8	5.8	5.2
P/B (x)	3.5	1.9	1.7	1.4	1.2
EV/EBITDA (x)	52.3	11.6	8.5	6.8	5.5
Yield (%)	-	4.4	5.1	6.0	6.8
ROE (%)	15.0	27.1	26.3	26.2	25.4
ROCE (%)	18.3	26.9	29.4	29.5	30.1
N. Gear. (%)	80.7	33.0	49.0	26.0	13.1

### Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	(16.1)	(3.9)	(3.3)
Actual price changes (%)	(22.1)	(21.0)	(6.8)

	08F	09F	10F
Consensus EPS (HK\$)	0.590	0.800	1.01
Previous forecasts (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

### Price Chart



**Table 1: ULI's main production facilities**

Location	Major types of products	2007 Annual capacity
Chengdu, Sichuan	Intermediate products	4,096 tonnes
Zhuhai, Guangdong	Bulk medicines	4,612 tonnes
Inner Mongolia	Intermediate products	-
Zhongshan & Hong Kong	Finished products	1,186m capsules, 46m granule bags, 10.5m bottles
Kaiping, Guangdong	Capsule casings	n/a

Source: Company data

**Table 2: ULI's main product lines**

Category	Penicillin Line	Cephalosporin Line	β-Lactamase Line
Intermediates	6-APA	7-ACA	T-octylammonium clavulanate
Bulk medicines	Semi-synthetic penicillin type	Cephalosporin type	β-lactamase inhibitor type
Finished products	Semi-synthetic penicillin antibiotics	Cephalosporin antibiotics	β-lactamase inhibitor antibiotics

Source: Company data

**Table 3: Turnover breakdown**

Year to Dec (HK\$m)	2006	%	2007	%	1H 2008	%
Intermediate products	197.4	9.5	265.7	10.2	419.0	21.3
Bulk medicines	1,077.3	51.8	1,362.3	52.5	909.9	46.1
Finished products	805.8	38.7	967.0	37.3	642.8	32.6
Total	2,080.5	100.0	2,594.9	100.0	1,971.7	100.0

Source: Company data

### Finished products

**Prices exceed NDRC caps.** To reward ULI for its contribution to China's pharmaceutical industry, and its high product quality and efficacy, the government granted the company concessions in 2002 to set prices of five of its finished antibiotics (see Table 4) above standard caps imposed by the National Development and Reform Commission (NDRC). The company is only required to inform the State Food and Drug Administration (SFDA) and NDRC of any price changes. ULI produced China's first oral penicillin in early 1990s and conducted over 10,000 clinical free skin tests to prove its efficacy. It also worked with the State Food and Drug Administration (SFDA) to develop test methods for the Amoxicillin polymer, which has since been included into "Chinese Pharmacopoeia (ChP)".

**Competitive advantage.** ULI's price setting power is a significant competitive advantage in our view as it allows the company to achieve above average margins. In FY12/07A, its finished product segment's operating margin was 24.3% compared with the industry average of around 15.0%. Distributors also prefer ULI's products given their higher selling prices. We estimate that the five concession products generated HK\$485.0m revenue, or 50.2% of the company's finished product revenue in FY12/07A.

**Table 4: 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 granules	125mg*12	8.0	10.2
Ampicillin capsule	500mg*12	8.1	13.8
Ampicillin capsule	250mg*24	9.0	15.6

Source: NDRC & Company data

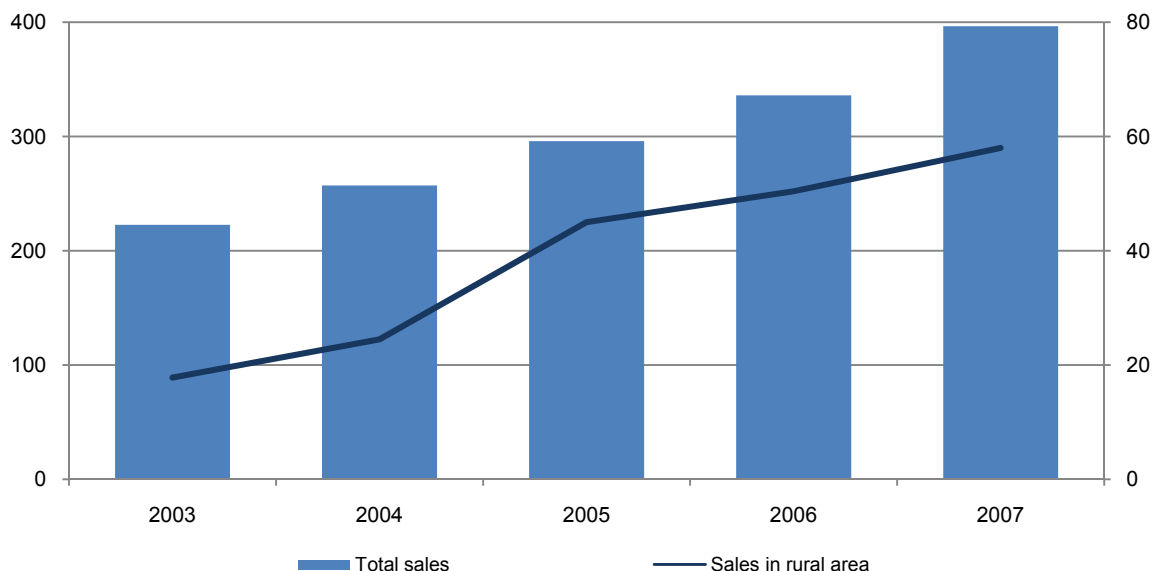
**China's leading antibiotics supplier.** ULI's oral Amoxicillin (阿莫仙) and oral Ampicillin (安必仙) ranked among the top five finished antibiotic products purchased in 2004-2006 by 257 hospitals surveyed by the China Pharmaceutical Association. 阿莫仙 and 安必仙 were no. 1 for each of the three years. In that particular survey, 安必仙 accounted for 85.1-90.5% of the same type antibiotics purchased by the sample hospitals and 阿莫仙 for 50.5-65.3% over the survey period.

**Sales force expansion.** The company's sales team grew from 800 at end-2006 to 1,800 at end-2007 and 2,200 at end-1H 2008. Its finished products are sold mainly through 180 distributors, comprising some of the country's largest players such as Shanghai Pharmaceutical Ltd, China's largest pharmaceutical distributor by revenue. ULI chose to expand its sales force when 6-APA prices were high thus mitigating the temporary margin squeeze from costs associated with the additional personnel. In FY12/07A, its operating margin for finished products narrowed 3.0pcp YoY to 24.3%, due to increased sales and distribution costs, and surging

raw material prices. Its overall operating margin that year expanded 10.6pcp YoY to 25.4% thanks to the increasing profitability of its intermediates and bulk medicine segments.

**Targeting rural areas.** With its expanded sales team, we believe the company will 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. The introduction of the rural cooperative medical scheme in 2003 drove medicine sales in rural areas from RMB17.8b in 2003 to RMB58.0b in 2007 (CAGR of 34.4%), according to the Chinese Medicine Commerce Committee. We expect the sales to surge under the plan to make medical insurance coverage available to all citizens by 2010 (11<sup>th</sup> Five-year Plan) and increase subsidies (the Ministry of Health has indicated that central government subsidies will double to RMB80.0/year per person).

**Chart 1: 2003-2007 total medical sales and sales in rural areas (RMB,Billion)**



Source: Chinese Medical Commerce Committee

**Solid product portfolio and new drugs pipeline.** In addition to its Amoxicillin and Ampicillin products, ULI's portfolio of finished products includes Tazobactam Sodium and Piperacillin Sodium for injection (联邦他唑仙) (recorded sales HK\$118.0m in FY12/07A, up 36.3% YoY), and Cephalosporin for injections (recorded sales of HK\$97.0m, up 101.8% YoY). The company also has 25 finished products at various stages of development, including Isophane protamine human insulin injection, which is the most promising, in our view. The drug treats Type I & II diabetes, an emerging health problem in China with about 40m diabetes patients (up about 20.0% annually) and only a fraction currently under medication.

**Strong research.** ULI has an R&D team of 120 people and cooperates with Tsinghua University and China National Pharmaceutical Group Corp.

### **Intermediates and bulk Medicines**

**World's largest 6-APA producer.** ULI is one of China's largest active pharmaceutical ingredient (API) producers. It started the API business in 1998 with facilities in Zhongshan and Zhuhai. The company is also the world's largest supplier of 6-APA intermediates. We estimate that after including its 5,000 tonne/year Inner Mongolia plant, ULI accounts for 36.9% of China's 6-APA manufacturing capacity, which represents about 29.5% of the global total (China accounts for between 80-90% of global production of 6-APA). The company is also a prominent player in the production of semi-synthetic penicillin type bulk medicines, a midstream derivative of 6-APA.

**Exports.** ULI sells its intermediate and bulk medicine products to Germany, South Korea and India. Its Amoxicillin bulk medicines have obtained the Certificate of Suitability (COS) from the European Directorate for the Quality of Medicines, making the company China's only manufacturer with COS and GMP certification for this product. Overseas sales in FY12/07A were up about 36.4% YoY at HK\$607.2m, with about 50% generated in Asia, 33.3% in Europe and 16.7% in India. Its main overseas clients include DSM Anti-Invectives India Ltd., HELM AG, Daewoong Chemical Co and Indukern Chemie A.G. The company began 6-APA sales in the US in 2007. For FY12/07A, overseas sales accounted for 23.4% of overall revenues. The segment grew at a 3-year CAGR of 72.4%.

**Table 5: China 6-APA production capacity**

Company	Capacity (tonnes/yr)	% of the total
United Laboratories	8,500	36.9
China Pharmaceutical	4,000	17.4
Huabei Pharmaceutical	2,100	9.1
Alabindu (Datong) Biochemical	1,900	8.3
Shijiazhuang Pharmaceutical	1,400	6.1
Harbin Pharmaceutical Group	1,100	4.8
Hebei Junlin Pharmaceutical	850	3.7
Zhang Jiakou Pharmaceutical	820	3.6
Shandong Lukang Pharmaceutical	340	1.5
Others	2,000	8.7
<b>Total</b>	<b>23,010</b>	<b>100.0</b>

Source: [www.healthoo.com](http://www.healthoo.com), Company data, SBI E2-Capital

**Table 6: ULI intermediate and bulk medicine production capacity (beginning 2008)**

Product	Capacity (tonnes/yr)
Intermediates	
6-APA	3,467
7-ACA and others	629
Bulk Medicines	
Semi-synthetic penicillin type	3,769
Cephalosporin type	662
β-lactamase inhibitor type	181

Source: Company data

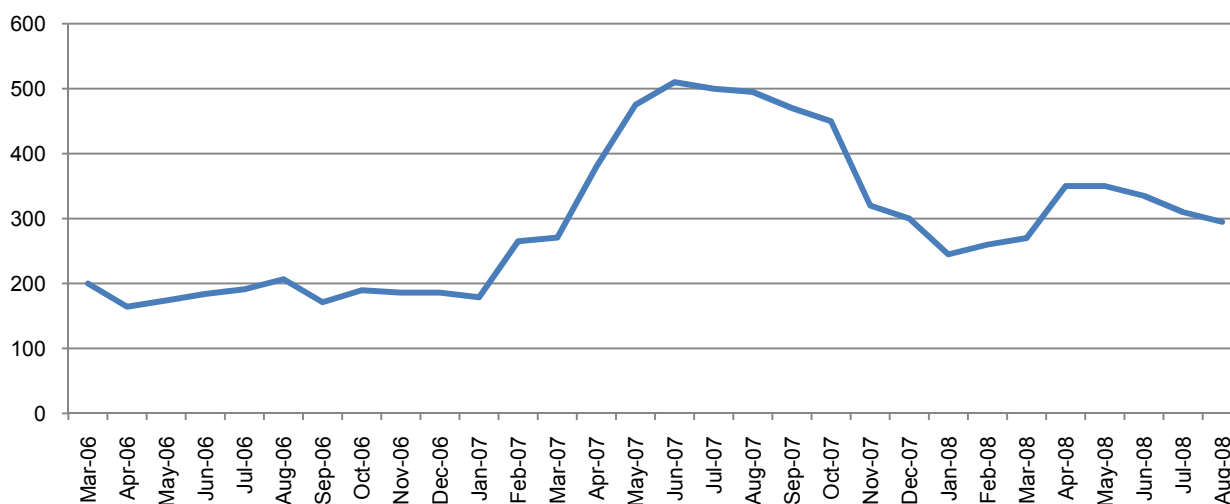
**Supplier to Wyeth.** ULI commenced supplying 6-APA to global pharmaceutical giant Wyeth in FY12/08. While volumes are not large, ~40 tonnes for FY12/08 and eventually expected to ramp up to around 100 tonnes per year, it does demonstrate the quality of ULI's products and its brand awareness amongst the international arena. ULI spent two years to gain supplier qualifications with Wyeth. Management indicated that despite the relatively low volumes involved, the margins for this supply contract is significantly higher than standard 6-APA supply contracts.

**Market consolidation.** 6-APA prices surged from around RMB200/kg (incl. VAT) in Jan 2007 to a high of RMB500/kg in Jun 2007 and Amoxicillin bulk medicine prices from around RMB250/kg to RMB480/kg in the period as many API manufacturers suspended production for upgrades of their wastewater discharge systems in anticipation of stricter standards (ULI cut output at its Chengdu plant from Mar to May 2007 to upgrade its discharge system). In 2H 2008, the prices retreated somewhat but still remain high as many small players exited the market.

**Key beneficiary of rising 6-APA and bulk medicine prices.** In FY12/07A, ULI's sales of external intermediates rose 34.6% YoY to HK\$265.7m and bulk medicine 26.5% YoY to HK\$1,362.3m. Its operating margin widened 18.9pcp to 22.0% for intermediates and 6.0pcp to 11.4% for bulk medicines.

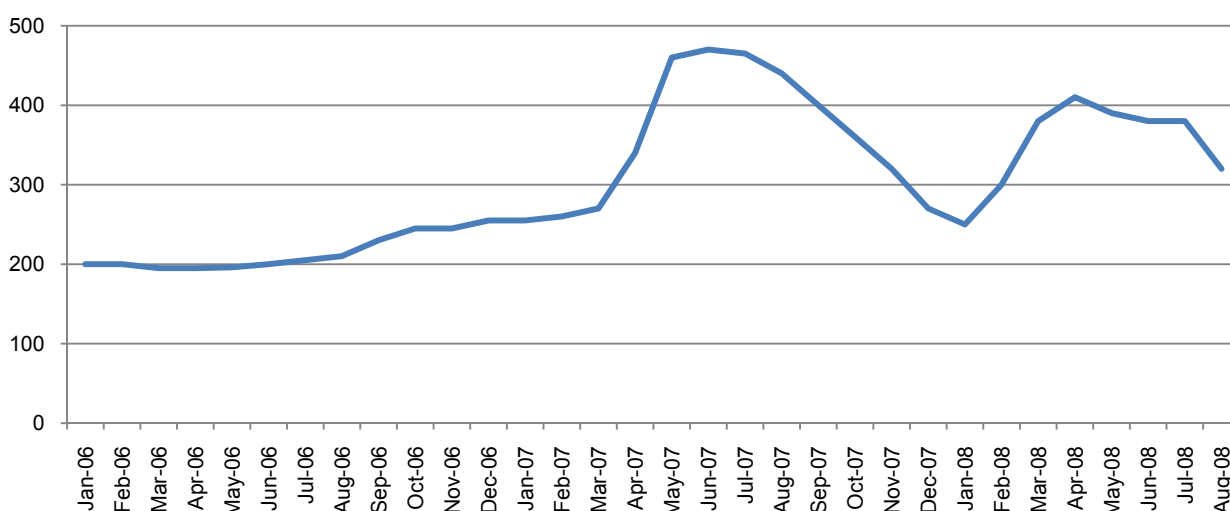
**Inner Mongolian plant completed in 2007.** The company completed in 2007 a new facility in Inner Mongolia with an annual 6-APA production capacity 5,000 tonnes, which will allow it to lower production costs. According to the management, the cost of producing 6-APA in Inner Mongolia is ~10-12% lower than in Chengdu. The new plant came on stream in Feb 2008.

**Chart 2: 2006-2008 6-APA VAT inclusive price (RMB/kg)**



Source: [www.healthoo.com](http://www.healthoo.com)

**Chart 3: 2006-2008 Amoxicillin bulk medicine VAT inclusive price (RMB/kg)**



Source: [www.healthoo.com](http://www.healthoo.com)

**Solid outlook for 6-APA and Amoxicillin.** The price of 6-APA and Amoxicillin bulk medicines have rebounded to around RMB340/kg (incl. VAT) and RMB390/kg, respectively, since Feb 2008, due to a seasonal rise in demand and Huabei Pharmaceutical's decision to reduce production to upgrade its discharge system and move its plant away from the Shijiazhuang city area. Currently, 6-APA prices are in the sustainable RMB290-300/kg levels due to seasonal factors and would be expect to rise towards year-end. Manufacturers typically carry out their annual maintenance work in the slower 3Q.

**New environmental standards.** According to the Water Pollution Discharge Standards for the Chemosynthesis Pharmaceutical Industry (制药工业污染物排放标准) issued on 1 Aug 2008, new plants will need to achieve a wastewater discharge of 120 COD (chemical oxygen demand), while existing plants will have a grace period to reduce their discharge standard from the current 300 COD to 120 COD by 2010. We expect the new stricter standards to: 1) force out small players; 2) accelerate consolidation and 3) raise entry barriers. ULI will escape largely unaffected as all of its environmental systems are designed to meet the new standards.

**Table 7: ULI's environmental compliance (relevant facilities)**

Plant facility	Cur Plant Prod. Std. (COD)	Cur Plant Design Std. (COD)	New Reg Std. (COD)	Timing to Achieve New Std.
Chengdu (intermediates)	200	100	120	2010
Zhuhai (bulk medicines)	100	100	100	2010
Inner Mongolia (intermediates/bulk medicines)	200	100	120	2010

Source: Company data

**Business model brings margin stability.** Given the extent of its vertical integration, the company has a natural hedging mechanism allowing it to mitigate the impact of fluctuating upstream intermediate and bulk medicine prices, which are essentially commodities. This may be best illustrated by operating margin trends in its bulk medicine and finished products segments, which move in opposite directions, partly offsetting the impact of raw material price fluctuations. In our view, this will generally hold for normal price fluctuations of 6-APA and Amoxicillin bulk medicine prices.

**Table 8: Segment margin trends**

Year to Dec (%)	2005	Change (pcp)	2006	Change (pcp)	2007	Change (pcp)
Bulk medicines	8.4	-	5.4	Down 3.0	11.4	Up 8.4
Finish products	26.1	-	27.3	Up 1.2	24.3	Down 3.0

Source: Company data

### **1H FY12/08A results**

**Interim net profit up 72.1%.** ULI's 1H FY12/08A net profit surged 72.1% YoY to HK\$300.0 on a 62.1% YoY rise in revenue to HK\$1,971.7m. Its gross margin narrowed 3.7pcp YoY to 40.0%, mainly due to product mix changes (higher revenue contribution of intermediates and bulk medicines). The net margin was relatively steady, up 0.9pcp YoY at 15.2%.

**Table 9: 1H FY12/08A results summary**

6 months to Jun	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS (HK\$)	DPS (HK\$)
1H FY07	1,216.0	531.2	43.7	209.4	16.8	174.3	0.188	n/a
1H FY08	1,971.7	788.9	40.0	368.0	18.5	300.0	0.250	n/a
YoY (%)	62.1	48.5		75.7		72.1	33.0	

Source: Company data

**Broad-based growth.** External sales of intermediates and bulk medicines increased 622.8% and 28.6% YoY to HK\$419.0m and HK\$910.0m respectively, on substantial increases in sales volumes of 6-APA and Amoxicillin bulk medicines, thanks to the new Inner Mongolia plant. There was a negligible impact from the Sichuan earthquake (ULI's Chengdu plant incurred only nominal sales losses). Sales of finished products increased 42.7% YoY to HK\$642.7m thanks to the company's expanded sales network. In our view, ULI is beginning to realise the benefits of a larger sales force and favourable government policies, leading to increased demand for its finished products. Sales of Amoxicillin and Ampicillin capsules were up 28.0% and 12.9% YoY respectively. Other sales drivers in 1H included Tazobactam (up 43.6% YoY) and Cefuroxime Axetil Tablet (up 92.8% YoY).

**ASPs.** The average selling price (ASP) of 6-APA (excl. of VAT) to about RMB252/kg in 1H FY12/08A (1H FY12/07A: RMB269/kg and FY12/07A: RMB343/kg). This was expected given the abnormally high level in the previous year. The ASP of Amoxicillin bulk medicines was about RMB273/kg in 1H FY12/08A (1H FY12/07A: RMB291/kg and FY12/07A: RMB289/kg). The ASP of Cephalosporin type bulk medicines was relatively steady at RMB812/kg in 1H FY12/08A (1HFY12/07A: RMB 837/kgFY12/07A: RMB890/kg).

**Table 10: ASP data for key intermediates and bulk medicines (1H FY12/08A)**

1H FY12/08A	Intermediates	Bulk medicines	
	6-APA	Amoxicillin bulk medicine	Cephalosporin bulk medicine
Revenue (HK\$m)*	407.6	472.2	280.7
YoY chg	589.7	22.2	19.0
External sales volume (tonnes)	1,457.2	1,766.8	353.4
YoY chg	577.1	22.5	15.5
ASP (RMB/kg)	252.4	273.1	811.7
YoY chg	(6.3)	(6.1)	(3.0)

\*Revenue is for external sales and it factors the exchange rate (RMB1.00=HK\$1.02 in 1HFY12/07 and RMB1.00=HK\$1.11 in 1HFY12/08)

Source: Company data

**Operating expenses in check.** Selling and distribution expenses accounted for 13.7% of revenue in 1HFY12/08, down 1.9pcp. We believe that the operating leverage was mainly due to the expanding sales of intermediates and bulk medicines, which typically require less sales and marketing efforts than finished products. Administrative expenses to revenue ratio were 5.4%, compared with 5.7% a year ago. ULI's effective tax rate rose 1.7pcp to 18.5%, due to product mix changes and higher taxes at its Zhuhai bulk medicine plant.

**Capex.** At end-Jun 2008, the company had capex commitments amounting to HK\$512.5m and a capex budget of HK\$800.0m for FY12/08A. Its net debt position was HK\$1,310.8m (HK\$830.8m cash and cash equivalent).

**Hedging mechanism at work.** The interim results suggest that ULI's natural hedging mechanism is working. As Amoxicillin bulk medicine prices fell YoY, the operating margin for bulk medicines in 1H FY12/08A contracted 1.6pcp to 14.8%, while the operating margins for finished products expanded 1.7pcp to 24.4%.

### Capacity expansion plans

**Broad-based expansion.** The company plans to add 3,000 tonnes of 6-APA capacity in FY12/09F, bringing the total to about 11,500 tonnes, or around 45% of China's total production capacity in 2009, according to our estimates. The company will also add 3,000 tonnes to its amoxicillin bulk medicine capacity, increasing its finished product capacity by around 30.0% in FY12/08 and 15.0-50.0% in FY12/09. The increase in the output of downstream products will absorb a portion of the newly added upstream capacities.

**Aggressive but good strategy.** The 6-APA capacity expansion plan is aggressive but we expect the company to be rational in production volumes, reacting to actual demand. In our view, this strategy is good as adding capacity is relatively inexpensive for ULI due to its large scale and gives it flexibility in production to cater to 6-APA demand profiles (end user antibiotics, domestic and overseas demand for 6-APA and mid-stream derivatives). We also believe a trio of drivers including: 1) increasing domestic demand as smaller, non-environmental compliant producers are forced out; 2) increasing demand for generic medicines from favourable government policies and 3) increasing overseas exports, should also help to keep prices at a relatively high level.

**Table 11: ULI capacity expansion plans**

Year to Dec	2007A	%	2008F	%	2009F	%
Intermediate product (tonnes/yr)	4,096	n/a	9,096	~122	12,096	~33
Bulk medicine (tonnes/yr)	4,612	n/a	5,595	~21	8,595	~54
Finished product* (capsules,m/yr)	1,186	n/a	1,550	~30	1,780-2,325	~15-50

\*Finished product capacity is indicative only, as capacity increase is expected to be broad based across capsules, granule bags and bottles.

Source: company data, SBI E2-Capital

### Our estimates

We estimate the average price of 6-APA at RMB256/kg (excl.VAT) in FY12/08F, RMB252/kg in FY12/09F and RMB250/kg in FY12/10F, amoxicillin bulk medicines at RMB274/kg, RMB262/kg and RMB260/kg and Cephalosporin bulk medicines at RMB812/kg, RMB795/kg, and RMB788/kg, considering the price level in 1HFY12/08A and the newly issued government regulations, which should reduce the risk of API price declines.

Our estimates factor in the effect of the company's capacity expansion. The sales volume for 6-APA is 5,927 tonnes in FY12/08F, 6,880 tonnes in FY12/09F, and 7,454 tonnes in FY12/10F and the percentage of external sales 46.3%, 41.9%, and 41.5%, respectively. The sales volume for amoxicillin bulk medicines is 4,134

tonnes, 5,194 tonnes, and 5,659 tonnes for FY12/08F, FY12/09F and FY12/10F respectively and the percentage of external sales 90.0%, 30.0%, and 30.0%. Other API's volume should remain at similar levels as in FY12/07A.

We expect the growth of finished products to be driven mainly by increasing sales volumes, while price levels will be relatively stable. Sales of the five finished products under price concessions, which remain the company's cash cow, should grow 30.0% in FY12/08F, 20.0% in FY12/09F, 20.0% in FY12/10F thanks to ULI's expansion into the rural market and consumers' increasing consumption ability. They would be account for 45.4%, 41.7%, and 38.4% of total finished products revenue in FY12/08F, FY12/09F and FY12/10F, respectively. We estimate that Tazobactam Sodium and piperacillin sodium for injection will grow 42.0%, 35.0%, and 25.0% in FY12/08F, FY12/09F and FY12/10F, respectively, given ULI's ability to rapidly expand its market share. Finished products should grow 44.2%, 30.9%, 22.8% in FY12/08F, FY12/09F and FY12/10F, respectively, driven by the company's increasing sales force, expanding distribution channels and new product launches.

We expect the cost of sales to decline to 58.5%, 54.8%, 54.5% of total sales in FY12/08F, FY12/09F and FY12/10F, respectively, due to the scalability and lower costs in Inner Mongolia. We assume SG&A expense rate will be relatively stable between 17.0% and 20.0% due to the balance of scale effect and increasing marketing force and staff payment. The effective tax rate should be at 18.0%, 20.0%, 22.0% in FY12/08F, FY12/09F and FY12/10F, respectively, given the Inner Mongolia plant's tax holiday in 2008 and 2009 (50% reduction in the tax rate for three more years), the Chengdu plant's tax holiday in 2007 and 2008 (50% reduction in the tax rate for three more years), the Zhuhai plant's rates of 18% in 2008, 21% in 2009 and 24% in 2010 and the Zhongshan plant's full tax payments in 2008, 2009 and 2010.

The management guided that its dividend payment will be kept at 35.0% level each year.

In total, we estimate the top line at HK\$3,962.3m, HK\$4,195.7m and Hk\$4,634.2m for FY12/08F, FY12/09F and FY12/10F respectively, and the bottom line at HK\$681.5m, HK\$796.8m and HK\$896.1m.

**Table 12: ASP assumptions for key intermediates and bulk medicines**

Year to Dec	07A	08F	09F	10F
<b>Intermediates</b>				
6-APA				
External sales volume (tonnes)	753	2,744	2,881	3,096
ASP (RMB/kg)	343	256	252	250
<b>Bulk medicines</b>				
Amoxicillin				
External sales volume (tonnes)	2,567	3,721	3,636	3,961
ASP (RMB/kg)	289	274	262	260
Cephalosporin				
External sales volume (tonnes)	440	596	440	440
ASP (RMB/kg)	890	812	795	788

Source: Company data, SBI E2-Capital



Table 13: P&amp;L

Year to Dec (HK\$m)	06A	07A	08F	09F	10F
<b>Turnover</b>	<b>2,080.5</b>	<b>2,594.9</b>	<b>3,962.3</b>	<b>4,195.7</b>	<b>4,634.2</b>
Cost of sales	(1,344.2)	(1,389.2)	(2,318.0)	(2,298.5)	(2,524.3)
<b>Gross profit</b>	<b>736.3</b>	<b>1,205.8</b>	<b>1,644.3</b>	<b>1,897.2</b>	<b>2,110.0</b>
Other income and gains	9.9	25.8	25.0	16.0	19.2
Selling and distribution costs	(284.1)	(381.5)	(488.9)	(562.5)	(625.6)
Administrative expenses	(123.0)	(173.3)	(209.5)	(241.1)	(268.1)
Other operating expenses	(37.8)	(38.4)	(10.0)	(10.0)	(10.0)
<b>Operating profit</b>	<b>301.3</b>	<b>638.3</b>	<b>960.9</b>	<b>1099.6</b>	<b>1,225.4</b>
Finance costs, net	(85.5)	(80.0)	(129.8)	(103.6)	(76.6)
Share of results of an associate	(2.7)	-	-	-	-
Gain on disposal of an associate	8.6	-	-	-	-
<b>Profit before taxation</b>	<b>221.8</b>	<b>558.3</b>	<b>831.1</b>	<b>996.0</b>	<b>1,148.9</b>
Taxation	(47.9)	(47.9)	(149.6)	(199.2)	(252.8)
<b>Profit after tax</b>	<b>173.8</b>	<b>510.5</b>	<b>681.5</b>	<b>796.8</b>	<b>896.1</b>
Minority interests	-	-	-	-	-
<b>Profit attributable to shareholders</b>	<b>173.8</b>	<b>510.5</b>	<b>681.5</b>	<b>796.8</b>	<b>896.1</b>

Source: Company data, SBI E2-Capital

**Initiating coverage with BUY call, target price HK\$6.00.** We like ULI for its vertically integrated model (which brings margin stability), its leadership in 6-APA and finished antibiotic products in China and its overseas export exposure. We initiate coverage with a target price of HK\$6.00, representing 10.0x FY12/08F and 9.0x FY12/09F P/E, derived from a sum-of-the-parts valuation comprising 10.0x FY12/09F P/E for its finished products and 8.0x FY12/09F P/E for its API products. Hong Kong-listed pharmaceutical companies are currently trading at average 7.4x 1- year forward P/E. Given ULI's market position, profitability and scalability, we believe it deserves a premium.

#### Comparison with China Pharmaceuticals (1093 HK)

**Key differentiator.** ULI has two key advantages compared with China Pharmaceuticals (CP): 1) effective transition of production best practices and qualities thanks to its organic development from downstream upstream. CP was an upstream bulk medicine producer and expanded downstream to finished products through acquisitions of parental assets in 2002. ULI's operating profit margin for finished products is 24.3% and CP's 0.4% in FY12/07A; and 2) marketing efforts. ULI's selling and distribution cost was 14.7% of total revenue in FY12/07A, compared with CP's 7.6%, while ULI's administrative cost was 6.7% of total revenue, compared with CP's 9.5%. In FY12/07A, ULI's net margin was 19.7%, compared with its rival's 9.6%.

Table 14: Margin comparison (FY12/07A)

	ULI	YoY (%)	CP	YoY (%)
API revenue (HK\$m)	2,660.9	34.3	2,839.4	44.2
Finished product revenue (HK\$m)	967.0	20.0	1,464.0	16.6
API operating profit (HK\$m)	424.7	380.0	435.0	286.0
Finished product profit (HK\$m)	235.0	6.9	6.4	(79.0)
API margin (%)	16.0	-	15.3	-
Finished product margin (%)	24.3	-	0.4	-
Net profit	510.5	193.6	477.4	2947.7
Net margin	19.7	-	9.6	-

API revenues and operating profits for China Pharmaceutical excludes Vitamin C revenues.

Source: Company data

#### Industry Overview

**High growth rate restored.** The SFDA and NDRC's initiatives throughout 2005-2007 to restructure and clean up China's pharmaceutical industry have had the desired effect. After a correction year in 2006, the industry growth rates rebounded in 2007 as the more stringent regulatory environment forced consolidation and weaker players out of the market. In 2007, pharmaceutical sales increased 24.9% YoY to RMB639.3b, across all sectors such as chemical medicines (up 23.6%), chemical raw materials (25.1%) and Chinese medicines (24.1%). Sales of medical equipment surged 22.2% and healthcare materials 31.4%.

Table 15: Pharmaceutical product revenues

	2007 Revenue (RMBb)	YoY Chg (%)	1-2M 2008 Revenue (RMBb)	YoY Chg (%)
Chemical raw materials	149.7	25.1	25.6	30.0
Chemical medicines	168.5	23.6	30.4	21.9
Bio-chemical medicines	49.5	21.6	9.2	28.6
Chinese medicines	158.5	24.1	27.2	20.2
Medical equipment	59.3	22.2	10.0	29.1
Healthcare material	29.9	31.4	4.3	31.5
Others	23.9	-	3.9	35.3
<b>Total</b>	<b>639.3</b>	<b>24.9</b>	<b>110.6</b>	<b>25.3</b>

Source: PICO

**Government policies to continue promoting industry growth.** Government policies continue to promote and underpin the industry's growth especially in rural areas. According to the Ministry of Finance, the central government's investment in healthcare will rise 25.2% YoY to RMB83.1b in 2008.

**Drivers abundant in the value chain.** One of the reasons we are especially bullish on China's medical sector is that we see macro drivers within each segment of the vertical supply chain (APIs, finished drugs, medical devices and healthcare), such as:

#### Active pharmaceutical ingredients (APIs)

- Consolidation - weeding out of small non-compliant manufacturers and raising entry barriers as a result of the lowering of wastewater discharge standards from 300 COD to 120 COD.
- China's dominance - the largest API producer in the world, accounting for about 80% global output.

#### Finished drugs

- Medical coverage initiatives – within the 11<sup>th</sup> Five Year Plan China aims to achieve 100% medical coverage in rural areas and improve urban medical coverage, driving spending and demand for finished drugs.
- Increased investment – the central government's healthcare budget rose 25.2% YoY to RMB83.1b for 2008.

#### Medical devices

- Consolidation - centralization of products and distribution power among market leaders.
- Export opportunities – regulatory approvals easier to obtain by medical device companies than by finished drugs manufacturers.

#### Healthcare

- Foreign investment – China is opening up its healthcare sector to foreign investment to speed up its development and improve efficiency, creating opportunities for first movers with unique business models and resources to become a leader.

**Risks.** 1) Further government regulatory reforms in the pharmaceutical/healthcare market; 2) economic slowdown denting drug consumption; 3) API capacity increases by competitors leading to lower sales prices; 4) dramatic decreases in 6-APA and Amoxicillin bulk medicine prices.

Table 16: Valuation table

Company name	Ticker	Country	Mkt Cap (US\$m)	Price (HK\$)	Cur Yr P/E (x)	Nxt Yr P/E (x)	P/B (x)	ROE (%)	Yield (%)
<b>China Pharmaceuticals</b>									
<u>HK listed</u>									
Guangzhou Pharmaceuticals	874 HK	China	902.4	HK\$4.28	8.0	7.5	1.0	10.6	1.8
China Pharmaceuticals	1093 HK	China	491.3	HK\$2.49	7.6	7.5	1.1	15.9	1.7
Sino-Biopharmaceuticals	1177 HK	China	386.3	HK\$1.44	10.5	8.0	1.5	11.4	4.1
Shineway	2877 HK	China	583.5	HK\$5.50	8.8	7.2	1.9	25.6	4.2
Shandong Luoxin	8058 HK	China	247.1	HK\$3.16	9.6	7.1	5.3	45.8	0.5
Tong Ren Tang Tech	8069 HK	China	222.8	HK\$8.80	8.4	6.9	1.2	13.4	-
<i>Average</i>					8.8	7.4			
<u>Others</u>									
C&O Pharmaceutical	COPT SP	China	122.1	S\$0.26	8.6	6.5	1.5	15.7	-
China Nepstar	NPD US	China	703.2	US\$6.60	16.9	11.9	3.4	-	-
Simcere Pharmaceutical	SCR US	China	802.5	US\$12.84	14.4	11.5	5.1	24.8	-
<i>Average</i>					13.3	10.0			
United Laboratories	3933 HK	China	593.9	HK\$3.86	6.6	4.8	2.0	27.1	3.7

Source: Bloomberg Estimates, SBI E2-Capital

P & L (HK\$m)	06A	07A	08F	09F	10F	Cash Flow (HK\$m)	06A	07A	08F	09F	10F
<b>Year to Dec</b>						<b>Year to Dec</b>					
<b>Turnover</b>	<b>2,080.5</b>	<b>2,594.9</b>	<b>3,962.3</b>	<b>4,195.7</b>	<b>4,634.2</b>	EBIT	301.4	638.3	960.9	1,099.6	1,225.5
% chg	20.93%	24.73%	52.69%	5.89%	10.45%	Depre./amort.	194.0	186.6	267.7	298.4	304.2
Gross profit	736.3	1,205.8	1,644.2	1,897.2	2,110.0	Net int. paid	(85.5)	(80.0)	(129.8)	(103.6)	(76.6)
						Tax paid	(54.3)	(72.0)	(149.6)	-	(199.2)
EBITDA	107.4	451.7	693.2	801.1	921.3	Dividends received	-	-	-	-	-
Depre./amort.	194.0	186.6	267.7	298.4	304.2	<b>Gross cashflow</b>	<b>368.0</b>	<b>683.3</b>	<b>790.5</b>	<b>1,089.5</b>	<b>992.7</b>
EBIT	301.4	638.3	960.9	1,099.6	1,225.5	Chgs. in working cap.	(82.5)	(323.0)	(441.6)	(39.6)	(53.8)
Net int. income/(exp.)	(85.5)	(80.0)	(129.8)	(103.6)	(76.6)	<b>Operating cashflow</b>	<b>285.5</b>	<b>360.3</b>	<b>348.9</b>	<b>1,049.9</b>	<b>938.8</b>
Exceptionals	8.6	-	-	-	-	Capex	(146.9)	(824.0)	(812.5)	(342.5)	(347.5)
Associates	(2.7)	-	-	-	-	<b>Free cashflow</b>	<b>138.5</b>	<b>(463.7)</b>	<b>(463.6)</b>	<b>707.4</b>	<b>591.4</b>
Jointly-controlled entit.	-	-	-	-	-	Dividends paid	-	-	(204.2)	(238.5)	(278.9)
<b>Pre-tax profit</b>	<b>221.8</b>	<b>558.3</b>	<b>831.1</b>	<b>996.0</b>	<b>1,148.9</b>	Net distribution to MI	-	-	-	-	-
Tax	(47.9)	(47.9)	(149.6)	(199.2)	(252.8)	Investments	(146.9)	(819.9)	(812.5)	(342.5)	(347.5)
Minority interests	-	-	-	-	-	Disposals	0.2	4.0	-	-	-
<b>Net profit</b>	<b>173.8</b>	<b>510.5</b>	<b>681.5</b>	<b>796.8</b>	<b>896.1</b>	New shares	-	825.0	-	-	-
% chg	49.13%	193.64%	33.51%	16.91%	12.47%	Others	(45.7)	762.6	1,529.5	(94.7)	63.2
Dividends		(204.2)	(238.5)	(278.9)	(313.6)	<b>Net cashflow</b>	<b>(53.9)</b>	<b>307.9</b>	<b>49.2</b>	<b>31.7</b>	<b>28.2</b>
Retained earnings	173.8	306.3	443.0	517.9	582.5	Net (debt)/cash - Beg.	147.1	93.3	401.2	450.4	482.1
EPS (HK\$) - Basic	0.193	0.480	0.568	0.664	0.747	Net (debt)/cash - End.	93.3	401.2	450.4	482.1	510.3
EPS (HK\$) - F.D.	0.145	0.425	0.568	0.664	0.747						
DPS (HK\$)		(0.170)	(0.199)	(0.232)	(0.261)	<b>Interim Results (HK\$m)</b>	<b>07A</b>	<b>08A</b>			
No. sh.s o/s (m) - W.A.	900.0	1,064.3	1,200.0	1,200.0	1,200.0	<b>Six months to Jun</b>					
No. sh.s o/s (m) - Y.E.	900.0	1,064.3	1,200.0	1,200.0	1,200.0	<b>Turnover</b>	<b>1,216.0</b>	<b>1,971.7</b>			
No. sh.s o/s (m) - F.D.	1,200.0	1,200.0	1,200.0	1,200.0	1,200.0	% chg	-	62.1%			
						Profit from operations	249.8	419.7			
<b>Margins (%)</b>						Interest expenses	(40.4)	(51.7)			
Gross	35.4	46.5	41.5	45.2	45.5	Associates					
EBITDA	5.2	17.4	17.5	19.1	19.9	Jointly-controlled entit.					
EBIT	14.5	24.6	24.3	26.2	26.4	<b>Pre-tax profit</b>	<b>209.4</b>	<b>368.0</b>			
Pre-tax	10.7	21.5	21.0	23.7	24.8	Tax	(35.1)	(67.9)			
						Minority interests	-	-			
						<b>Net profit</b>	<b>174.3</b>	<b>300.0</b>			
						% chg	-	72.1			
						EPS (HK\$) - Basic	0.188	0.250			
						DPS (HK\$)	-	-			
						<b>Shareholding Structure</b>					
									<b>Shares o/s (m)</b>	<b>%</b>	
						Management			859.6	71.63	
						Capital world Invest			66.2	5.51	
						Value Partners Ltd.			59.7	4.98	
						Other publics			214.5	17.88	
						<b>Total</b>			<b>1,200.0</b>	<b>100.0</b>	
						<b>Background</b>					
						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. It is China's largest 6-APA producer with an estimated market share of around 35% in 2007 and one of the largest in the world.					
						<b>Key Ratios</b>	<b>06A</b>	<b>07A</b>	<b>08F</b>	<b>09F</b>	<b>10F</b>
						Net gearing (%)	80.7	33.0	49.0	26.0	13.1
						Net ROE (%)	15.0	27.1	26.3	26.2	25.4
						EBIT ROCE (%)	18.3	26.9	29.4	29.5	30.1
						Dividend payout (%)	-	40.0	35.0	35.0	35.0
						Effective tax rate (%)	21.6	8.6	18.0	20.0	22.0
						Net interest coverage (x)	3.5	8.0	7.4	10.6	16.0
						A/R turnover (days)	125.4	119.8	109.8	129.8	124.8
						A/P turnover (days)	234.6	234.5	174.5	209.5	204.5
						Stock turnover (days)	84.0	117.5	110.5	135.5	130.5

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