

## Shandong Luoxin: Execution efficiency

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**Recommendation: Not Rated**

**China Pharmaceuticals**

<b>Price</b>	<b>HK\$1.71</b>	<b>Yield (12/06A)</b>	1.2%
<b>12 mth range</b>	HK\$0.325-1.85	<b>ROE (12/06A)</b>	32.1%
<b>Market cap.</b>	US\$133.5m	<b>Net gearing (12/06A)</b>	Cash
<b>No. shares o/s</b>	164.1m H-shares/444.4m A-shares	<b>Net debt/sh. (12/06A)</b>	na
<b>Daily t/o, 3 mth</b>	<US\$0.1m	<b>BV/sh. (12/06A)</b>	HK\$0.347
<b>Free float %</b>	27.0%	<b>Consensus EPS</b>	
<b>Major shareholder</b>	Linyi Luoxin (Chairman Liu Baoqi) 37.73%	<b>- 12/07F</b>	na
<b>Ticker</b>	8058.HK/ 8058 HK	<b>- 12/08F</b>	na

### Key points:

- FY12/06A net profit surged 62.9% YoY to RMB60.2m on a shift to higher-margin system-specific drugs and robust turnover growth.
- Displaying strong execution abilities, the company launched almost 40 drugs in FY12/06 and aims to launch around 30 products in FY12/07.
- Received a 20-year patent for its Rhodiola medicine in May 2006. Currently awaiting the State Food and Drug Administration's (SFDA) product permit approval. Management plans to commence production in FY12/08.
- Targeting a dual strategy of volume growth and new product launches in FY12/07, Luoxin is expanding its sales network to capitalize on market opportunities generated by China's aging population and new rural healthcare initiatives to be rolled out by the Chinese government.

**Business model.** Shandong Luoxin (Luoxin) is principally engaged in the development, manufacture and sale of different types of prescription/OTC medicines under its own brands in four major categories: 1) antibiotics; 2) anti-viral medicines; 3) system-specific medicines to treat digestive/cardiovascular/respiratory ailments and 4) other chemical medicines, including anti-neoplastic medicines. The company's principal production facilities are located in the "High and New Technology Experimental Zone" of Linyi, Shandong, and GMP-certified for several manufacturing processes. At the end of FY12/06A, antibiotic drugs represented the largest sales segment, accounting for 71.9% of revenues, while higher-margin system-specific medicines accounted for 22.5%.

**Table 1: Revenue breakdown by product lines**

Product category	FY12/06 revenue (RMBm)	YoY % chg	% of turnover
Antibiotics			
Cephalosporines antibiotics	156.1	0.7	49.1
Quinolones antibiotics	57.9	166.6	18.2
Macrolides antibiotics	11.8	(26.2)	3.7
Other antibiotics	2.8	(80.8)	0.9
	228.6	10.2	71.9
Anti-viral medicines	6.8	71.1	2.2
System specific medicines	71.5	144.8	22.5
Other chemical medicines	11.0	22.0	3.5
<b>Total</b>	<b>317.9</b>	<b>27.3</b>	<b>100.0</b>

Source: Company data

**FY12/06A results strong despite challenging industry conditions.** Luoxin's FY12/06A results were strong despite tough operating industry conditions. Turnover was up 27.3% YoY at RMB317.8m, while gross profit rose 34.7% YoY to RMB142.0m. Gross margin widened by 2.4 pcp YoY to 44.6% and net profit surged 62.9% YoY to RMB60.2m. Revenue from system-specific medicines rose 144.8% YoY to RMB71.5m while Quinolones antibiotics sales of RMB57.9m represented a 166.6% YoY increase from a year ago. The company paid a full year dividend of RMB0.02 per share, unchanged from the previous year and representing a payout ratio of 20.2%.

**Aggressive expansion of products since IPO and higher blended margins fuels growth.** Since listing in Oct 2005, the company expanded its product lines from 137 to 200 at the end of FY12/06, in the four categories enumerated above. The launch of almost 40 drugs in FY12/06 was one of the key reasons behind its strong results. The second reason was that the changing product mix, increasingly favouring higher-margin system-specific drugs, led to a higher blended gross margin. According to the management, gross margins for system-specific drugs are 80%+, compared with 30%+ for antibiotics.

**Table 2: No. of products breakdown**

Product category	Dec 2006	Prior to IPO in Dec 2005
Antibiotics	108	70
Anti-viral medicines	13	9
System specific medicines	35	20
Other chemical medicines	44	38
	<b>200</b>	<b>137</b>

Source: Company data

**Patent approval for Rhodiola, potential to be blockbuster drug.** The company received a 20-year patent for its Rhodiola medicine in May 2006. Rhodiola for injection is a herbal medicine product (in lyophilized powder form) for curing of cardiovascular diseases. The drug is now awaiting SFDA product permit approval. Management estimates that it could generate RMB1.0b in revenue over its life cycle. Luoxin is establishing an "extraction workshop" to manufacture the product. The plant should be completed in by the end of FY12/07 and commence production in FY12/08.

**New expansion boosts capacity.** Luoxin has used its IPO proceeds to expand its production capacity, including: 1) powder production lines increased from two to seven (from 150m to 500m units); 2) new workshop to produce Cephalosporin products for oral consumption; 3) workshop for bulk drugs production to expand annual capacity to 1,200 tonnes; and 4) new workshop for production of lyophilized powder for injection, raising annual capacity from 10m to 60m units.

**Extensive distribution network.** The company's nationwide network covers 27 provinces and four centrally-administered municipalities. With an expanding sales force (currently at 300), Luoxin markets its products to downstream distributors, hospitals and medical institutions, OTC market as well as bulk drug manufacturers. In FY12/06, it derived about one-third of its overall revenue from Shandong province and one-fifth from Guangdong.

**R&D with other partners.** Luoxin has in in-house R&D team of 20 and conducts its R&D by leveraging the expertise of third party institutes. The company is working closely with 10 universities/institutes in China to jointly develop medicinal products. R&D expenses are paid upfront by milestones and the terms generally contain refund clauses.

**Volume growth and new product launches in FY12/07.** Luoxin will target a dual strategy of volume growth and new product launches in FY12/07. It will aim to drive volume growth for the new products launched in FY12/06 and actively marketed high-margin products, such as system-specific medicines and new-generation antibiotics. The newly launched drugs are all registered in the Insurance Catalogue and 100% reimbursed if prescribed. Meanwhile, the company will also continue to develop new medicines (including Rhodiola) and expand its sales network to capitalize on market opportunities generated by China's aging population and new rural healthcare initiatives to be rolled out by the Chinese government. Management plans to launch about 30 drugs this year, a strong schedule compared with peers. Currently, Luoxin has some 10 drugs awaiting SFDA's product permit approval.

**Company background and corporate governance.** The founder, Chairman Liu Baoqi spent a number of years within the health division of the PLA in Fujian as a pharmacist, before returning to Linyi, Shandong, in 1996 to start a pharmaceutical trading business (Linyi Luoxin). He came to own 37.7% in the company via Linyi Luoxin through a series of SOE-to-private corporate restructuring and acquisitions in 1997 and 2001, respectively. Liu Zhenhai and Liu Zhendong (his nephews) are the next largest shareholders, each owning 5.7%. The company's H-shares were listed on GEM in Dec 2005. The company plans to carry out its A-share reform this year. Other

substantial shareholders are industry-related, with Lingyi and Pingyi People's Hospitals each holding 3.3%. PricewaterhouseCoopers was the IPO auditor but the company has switched to HLB Hodgson Impey Cheng since early 2006 as PWC and the management could not reach consensus regarding auditing fees.

**Valuation.** There are no consensus forecasts for the company. Luoxin currently trades at a historical 17.0x FY12/06 P/E and 4.9x P/B.

**Risks.** 1) Further regulation/policy changes by the NDRC and/or SFDA; 2) Rhodiola drug not receiving product permit from SFDA; 3) failure to capture market share through new drug product launches; 4) new drugs development failure during R&D leading to a break in product pipeline.

P & L (RMBm)	04A	05A	06A	Cash Flow (RMBm)	04A	05A	06A
<b>Year to Dec</b>				<b>Year to Dec</b>			
<b>Turnover</b>	<b>169.0</b>	<b>249.7</b>	<b>317.8</b>	EBIT	52.2	63.5	98.9
% chg	-	47.7	27.7	Depre./amort.	4.9	5.9	8.8
Gross profit	97.3	105.4	141.9	Net int. paid	7.6	8.6	9.0
				Tax paid	(18.4)	(19.5)	(26.2)
EBITDA	<b>57.1</b>	<b>69.9</b>	<b>107.7</b>	Impairments	(11.0)	(12.1)	(15.8)
Depre./amort.	(4.9)	(5.9)	(8.8)	<b>Gross cashflow</b>	<b>35.3</b>	<b>46.4</b>	<b>74.7</b>
EBIT	<b>52.2</b>	<b>63.5</b>	<b>98.9</b>	Chgs. in working cap.	(61.9)	(24.5)	(19.5)
Net int. income/(exp.)	(5.6)	(7.1)	(7.7)	<b>Operating cashflow</b>	<b>(26.6)</b>	<b>21.9</b>	<b>55.2</b>
Exceptional	-	-	-	Capex	(7.3)	(46.3)	(39.4)
Associates	-	-	-	<b>Free cashflow</b>	<b>(33.9)</b>	<b>(24.4)</b>	<b>15.8</b>
Jointly-controlled entit.	-	-	-	Dividends paid	(48.2)	-	(12.2)
<b>Pre-tax profit</b>	<b>46.6</b>	<b>56.4</b>	<b>91.2</b>	Net distribution to MI	-	-	-
Tax	(18.4)	(19.5)	(31.0)	Investments	(20.1)	36.5	(14.7)
Minority interests	-	-	-	Disposals	-	-	-
<b>Net profit</b>	<b>28.2</b>	<b>36.9</b>	<b>60.2</b>	New shares	-	32.7	-
% chg	-	30.8	62.9	Others	22.1	(36.4)	14.6
				<b>Net cashflow</b>	<b>(82.0)</b>	<b>8.4</b>	<b>3.5</b>
Dividends	(48.2)	(12.2)	(12.2)	Net (debt)/cash - Beg.	131.0	49.0	57.4
Retained earnings	(20.0)	24.7	48.0	Net (debt)/cash - End.	49.0	57.4	60.9
				<b>Interim Results (RMBm)</b>	<b>04A</b>	<b>05A</b>	<b>06A</b>
EPS (HK\$) - Basic	0.061	0.079	0.099	<b>Six months to Jun</b>			
EPS (HK\$) - F.D.	0.061	0.079	0.099	<b>Turnover</b>		<b>108.5</b>	<b>147.0</b>
DPS (HK\$)	0.020	0.020	0.020	% chg		-	26.2
No. sh.s o/s (m) - W.A.	460.0	469.4	609.0	Profit from operations		25.2	42.6
No. sh.s o/s (m) - Y.E.	460.0	609.6	609.6	Interest expenses		(3.2)	(4.0)
No. sh.s o/s (m) - F.D.	460.0	609.6	609.6	Associates		-	-
				Jointly controlled entity.		-	-
<b>Margins (%)</b>				<b>Pre-tax profit</b>		<b>22.0</b>	<b>38.6</b>
Gross	57.6	42.2	44.6	Tax		(7.0)	(12.7)
EBITDA	33.8	28.0	33.9	Minority interests		-	-
EBIT	30.9	25.4	31.1	<b>Net profit</b>		<b>15.0</b>	<b>25.9</b>
Pre-tax	27.6	22.6	28.7	% chg		-	72.0
Net	16.7	14.8	18.9	EPS (HK\$) - Basic		0.035	0.042
				DPS (HK\$)		0.035	0.042
<b>Balance Sheet (RMBm)</b>	<b>04A</b>	<b>05A</b>	<b>06A</b>	<b>Shareholding Structure</b>			
<b>Year to Dec</b>					<b>Shares o/s (m)</b>	<b>%</b>	
Fixed assets	42.9	83.1	110.7	Linyi Luoxin (A-shares)	230.0	37.73	
Intangible assets	1.9	1.8	1.8	Liu Zhenhai (A-shares)	35.0	5.74	
Other LT assets	15.5	15.7	17.3	Liu Zhandong (A-shares)	35.0	5.74	
Cash	153.2	163.1	139.6	Other A-share holders	144.4	23.79	
Accounts receivable	16.2	27.5	38.1	Public (H-shares)	164.6	27.00	
Other receivables	19.5	23.3	16.4	<b>Total</b>	<b>609.0</b>	<b>100.00</b>	
Inventories	34.3	38.8	74.9				
Due from related co.s	-	-	-	<b>Background</b>			
Other current assets	-	-	-	Shandong Luoxin (Luoxin) is principally engaged in the development, manufacture and sale of different types of prescription/OTC medicines under its own brands in four major categories: 1) antibiotics; 2) anti-viral medicines; 3) system-specific medicines to treat digestive/ cardiovascular/ respiratory ailments and 4) other chemical medicines.			
<b>Total assets</b>	<b>283.4</b>	<b>353.3</b>	<b>398.8</b>				
Accounts payable	(39.0)	(20.0)	(43.0)	<b>Key Ratios</b>	<b>04A</b>	<b>05A</b>	<b>06A</b>
Other payable	(25.1)	(36.1)	(34.1)	Net gearing (%)	Cash	Cash	Cash
Tax payable	(0.9)	(1.7)	(5.3)	Net ROE (%)	30.0	22.6	32.1
Due to related co.s	-	-	-	EBIT ROCE (%)	-	27.2	34.2
ST debts	(104.2)	(105.7)	(78.7)	Dividend payout (%)	170.0	33.0	20.0
Other current liab.	-	(5.8)	(5.9)	Effective tax rate (%)	33.0	33.0	33.0
LT debts	-	-	-	Net interest coverage (x)	9.3	8.9	13.0
Other LT liabilities	-	-	-	A/R turnover (days)	35	40	44
<b>Total liabilities</b>	<b>(169.2)</b>	<b>(169.3)</b>	<b>(167.0)</b>	A/P turnover (days)	203	51	74
Share capital	46.0	61.0	61.0	Stock turnover (days)	-	92.5	118.0
Reserves	47.8	102.5	150.5				
<b>Shareholders' funds</b>	<b>93.8</b>	<b>163.5</b>	<b>211.5</b>				
Minority interest	-	-	-				
<b>Total</b>	<b>93.8</b>	<b>163.5</b>	<b>211.5</b>				
Capital employed	198.0	269.2	290.2				
Net (debt)/cash	49.0	57.4	60.9				