

# Guangzhou Pharm



## Key player in diabetes market

BUY (unchanged)

### Key points:

- FY12/07A results were in line with expectations.
- Xiaokewan is China's second most popular oral drug to treat Type II diabetes, with unique positioning as a Western Chinese medicine. GP has recently patented the drug for 20 years.
- We expect Xiaokewan to benefit from China's growing number of diabetes sufferers.
- Sales of Wanglaoji herb tea increased 77.2% in FY12/07 and we expect the momentum to stay strong in the next few years.
- 50:50 JV with Alliance Boots and Beijing Med-pharm will boost subsidiary GPC's network and will be consolidated into listco.
- We have lifted our net profit estimates to RMB407.0m for FY12/08F and RMB442.1m for FY12/09F and maintain BUY call on the counter, with a target price of HK\$8.80.

### China Pharmaceuticals

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Kennedy Tsang/Helena Qiu

(852) 2533 3713/3709

kennedytsang/helenaqiu@sbie2capital.com

### Stock data

Price	HK\$5.48
Target price	HK\$8.80 (+61%)
12 mth range	HK\$4.60-9.55
Market cap.	US\$1058.5m
Daily t/o, 3 mth	US\$0.79m
Free float %	43.6%
Ticker	874.HK/0874 HK

### Financial summary

Year to Dec	06A	07A	08F	09F	10F
Turnover (RMBm)	10241.0	12260.7	9615.2	11485.6	13289.7
Net profit (RMBm)	218.1	320.3	407.0	442.1	525.1
EPS (RMBm)	0.269	0.395	0.502	0.545	0.648
EPS Δ %	10.2	46.9	27.1	8.6	18.8
P/E (x)	18.4	12.5	9.8	9.1	7.6
P/B (x)	1.38	1.26	1.12	1.03	0.88
EV/EBITDA (x)	19.2	16.5	17.0	12.7	10.8
Yield (%)	1.7	2.5	3.0	3.3	3.9
ROE (%)	7.8	10.6	12.0	11.8	12.4
ROCE (%)	10.1	11.5	9.4	13.0	13.8
N. Gear. (%)	20.6	15.1	14.5	20.3	21.8

**Adjusted FY12/07A results in line.** Guangzhou Pharmaceutical's (GP) revenue increased 19.7% YoY to RMB12,260.7m and net profit 46.9% to RMB320.3m, above expectations, boosted by tax savings (estimated at RMB36.0m) at three subsidiaries. Excluding the tax savings, the results were in line with our estimates. Its gross margin narrowed 0.6pcp YoY 16.4% while the net margin widened 0.5pcp YoY to 2.6%.

**Strong growth momentum.** Manufacturing revenue grew 17.4% YoY to RMB2,832.8m, with margins widening 0.6pcp to 12.9%. Wholesale, retail and import/export segments grew a combined 20.4% YoY to RMB9,427.9m, with the blended segment margin contracting 0.2pcp to 1.8%. GP's manufacturing subsidiary Zhongyi, which makes Xiaokewan, continued to drive earnings with a 15.0% YoY growth to RMB750.0m. Chen Li Ji grew 30.6% YoY to RMB230.7m. GP's 48.05%-owned Wang Lao Ji JV's net profit rose 47.5% YoY to RMB469.2m. On the distribution side, main subsidiary Guangzhou Pharmaceutical Corp (GPC) recorded revenue of RMB8,530.7m, up 15.5% YoY.

**Xiaokewan - unique Type II diabetes drug.** GP's Xiaokewan is one of China's most popular oral drugs for treating Type II diabetes. In FY12/07A, we estimate that the product's sales rose 18.7% YoY to RMB527.0m, making it the second most popular of its type in China, behind Bayer's "Acarbose Tablets(拜糖苹)". It was the first oral Western Chinese medicine for Type II diabetes approved by the State Food and Drug Administration (SFDA) (1981). According to our channel checks, the SFDA has not approved any other Western Chinese medicine of this type since around 1990, making Xiaokewan a unique product in the market.

**Type II diabetes - emerging problem.** According to estimates, China has around 40m diabetes patients, with the majority suffering from Type II diabetes and only around 25% taking medication because: 1) many are unaware of their condition or 2) find the medication too expensive. The number of sufferers is expected

### Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-14.3	-13.0	-22.2
Actual price changes (%)	-11.9	-21.5	-5.7

	08F	09F
Consensus EPS (RMB)	0.482	0.512
Previous forecast(RMBm)	391.0	440.7
Previous EPS (RMB)	0.482	0.543

to grow about 20% annually. We believe that with Xiaokewan's strong brand, Western Chinese medicine positioning and lower price relative to its imported counterparts, place it well to tap this emerging market. We expects its sales to grow 15% a year over the next few years.

**Patent IP for Xiaokewan.** In Nov 2007, Xiaokewan obtained patents for its "medical composition for diabetes curing and its preparation method" and "method of controlling the quality and quantity" for 20 years. This will further strengthen Xiaokewan's positioning in the market. Its maker, Zhongyi, as a result of the patents, has received the "Certificate of High and New Technology Enterprise" and had its tax rate lowered to 15.0% from 33.0% for two years from 2007, which could be extended continuously.

**Wanglaoji - high growth.** Sales of the Wanglaoji JV increased 47.5% YoY to RMB976.5m and net profit 73.1% YoY to RMB 125.3m and we expect the JV to maintain the momentum. Wang Lao Ji herbal tea drove growth, up 77.2% YoY to RMB609.0m. GP's "green label" Wanglaoji herbal tea sales are still only a fraction of that of the "red label" series and therefore still have significant upside potential. Our checks suggests that the "red label" will spend heavily on advertising and marketing in 2008 and we expect the "green label" series to leverage the goodwill created by the overall Wanglaoji brand.

**Other blockbuster drugs.** In 12/07A, the sales of Hua Tuo Zao Zao Wan(华佗再造丸), to treat strokes, increased 10.6% YoY to RMB218m, of Xiao Er Qi Xin Cha(小儿七星茶), for stomach upset in babies, increased 29.4% to RMB90m, of Xu Han Ting(虚汗停), for incessant sweating due to asthenia, increased 50.5% to RMB50.6m, and of An Shen Bu Nao Ye (安神补脑液) 63.3% to RMB56.0m. The sales of Xia San Ju granules(夏桑菊颗粒) declined 4.5% to RMB199.0m.

**JV with Alliance Boots and Beijing Med-Pharm.** GP's distribution JV with Alliance BMP (80%-owned by Alliance Boots and 20% by Beijing Med-Pharm) was completed in 28 Jan 2008. The company will consolidate GPC's results into its P&L according to its percentage holding. We do not expect immediate results from this JV and believe it will contribute to GP in: 1) distribution of Alliance Boots' pharmaceutical and beauty related healthcare products in China; 2) M&A expertise - help with the expansion of the distribution network in China; 3) best practice and management know-how; and 4) OEM opportunities.

**Tax benefits.** In addition to Zhong Yi, subsidiaries Xing Qun Pharmaceutical Co.(Xing Qun) and Chen Li Ji Pharmaceutical Co. (Chen Li Ji) Co obtained the "certificate of high and new technology enterprises" and the preferential tax rate of 15% in 2007, which generated tax savings of RMB36.0m in FY12/07. The normal effective tax rate is 20-22%.

**Table 1: FY12/07A results summary**

12 months to Dec.	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	EPS (RMB)	DPS (RMB)
FY06	10241.0	1741.9	17.0	349.2	34.0	218.1	0.269	0.084
FY07	12260.7	2015.5	16.4	456.8	27.8	320.3	0.395	0.119
YoY (%)	19.7	15.7		30.8		46.9	46.9	41.7

Source: Company data

**Table 2: Turnover breakdown**

Year to Dec (RMBm)	FY07	% of revenue	% of Manufacturing revenue	% of distribution revenue
Manufacturing	2,907.4	23.7	100.0	-
Guangzhou Xing Qun	347.5	2.8	12.0	-
Guangzhou Zhongyi	750.0	6.1	25.8	-
Guangzhou Chen Li Ji	230.7	1.9	7.9	-
Guangzhou Qi Xing	373.2	3.0	12.8	-
Guangzhou Jin Xiu Tang	228.2	1.9	7.8	-
Guangzhou Pan Gao Shou	309.5	2.5	10.6	-
Wang Lao Ji Pharmaceutical	469.2	3.8	16.1	-
Others	199.1	1.6	6.8	-
Distribution/trading	10,554.1	86.1	-	100.0
Guangzhou Pharmaceutical Corp	8,530.7	69.6	-	80.8
Chinese Medicine Corp	1,327.1	10.8	-	12.6
Guangzhou Pharma Import and Export Corp	291.6	2.4	-	2.8
Others	404.7	3.3	-	3.8
Elimination	(1,200.7)			
<b>Total</b>	<b>12,260.7</b>			

Source: Company data

Table 3: Turnover growth

Year to Dec (RMBm)	FY06	FY07	YoY chg (%)
<b>Manufacturing</b>	<b>2,452.1</b>	<b>2,907.4</b>	<b>18.6</b>
Guangzhou Xing Qun	328.3	347.5	5.8
Guangzhou Zhongyi	651.9	750.0	15.0
Guangzhou Chen Li Ji	176.6	230.7	30.6
Guangzhou Qi Xing	356.5	373.2	4.7
Jing Xiu Tang	207.3	228.2	10.1
Guangzhou Pan Gao Shou	271.6	309.5	14.0
Wang Lao Ji Pharmaceutical	318.0	469.2	47.5
Others	141.9	199.1	40.3
<b>Distribution/trading</b>	<b>9,066.0</b>	<b>10,554.1</b>	<b>16.4</b>
Guangzhou Pharmaceutical Corp	7,384.4	8,530.7	15.5
Chinese Medicine Corp	1,093.0	1,321.1	21.4
Guangzhou Pharma Import and Export Corp	321.0	291.6	(9.2)
Others	267.6	404.7	51.2
Elimination	(1,277.0)	(1,200.7)	
<b>Total</b>	<b>10,241.0</b>	<b>12,260.7</b>	<b>19.7</b>

Source: Company data

**Valuation.** We revised up slightly net profit to RMB407.0m (from RMB391.0m) for FY12/08F and RMB442.1m (from RMB 440.7m) for FY12/09F to consider a slightly lower effective tax rate. We maintain BUY call on the counter, maintaining our target price at HK\$8.80. Our target price is derived based on a sum of the parts valuation, valuing GP's Wanglaoji JV at 30.0x FY12/08F P/E and 15.0x FY12/08 P/E for the remaining pharmaceutical business (excluding one-off items). The counter is currently trading at an undemanding 11.7x FY12/08F P/E excluding one-off items.

Table 4: P&amp;L

Year to Dec (RMBm)	05A	06A	07A	08F	09F	10F
Turnover	9,026.3	10,241.0	12,260.7	9,615.2	11,485.6	13,289.7
Cost of sales	(7,473.0)	(8,472.2)	(10,245.3)	(7,947.0)	(9,418.2)	(10,897.5)
Gross profit	1,553.4	1,768.8	2,015.5	1,668.2	2,067.4	2,392.1
Other income and gains	91.6	75.2	80.2	67.3	68.9	79.7
Selling and distribution costs	(616.8)	(778.2)	(1,057.3)	(829.2)	(1,015.2)	(1,169.5)
Administrative expenses	(641.4)	(656.5)	(554.2)	(437.1)	(523.8)	(598.0)
Other operating expenses	(16.5)	(14.5)	(4.5)	(4.4)	(3.2)	(6.6)
Operating profit	370.3	394.8	479.8	464.9	594.0	697.7
Finance costs, net	(53.6)	(45.4)	(59.7)	(30.1)	(30.1)	(30.1)
Share of profits of an associate	(1.2)	(0.3)	7.9	-	-	-
Exceptionals	-	-	28.8	53.2	-	-
Profit before taxation	315.5	349.2	456.8	488.0	563.9	667.6
Taxation	(107.8)	(118.6)	(127.0)	(73.7)	(112.8)	(133.5)
Profit after tax	207.7	230.6	329.9	414.3	451.2	534.1
Minority interests	(9.9)	(12.5)	(9.5)	(7.2)	(9.0)	(9.0)
Profit attributable to shareholders	197.8	218.1	320.3	407.0	442.1	525.1
%chg	362.1	10.3	46.9	27.1	8.6	18.8
Dividends	(56.8)	(68.1)	(100.5)	(122.1)	(132.6)	(157.5)

Source: Company data

Table 5: 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 (%)
<u>HK-listed pharmaceuticals/medical leaders</u>							
Mingyuan Medicare	233 HK	China	450.8	HK\$1.16	20.7	15.4	13.9
Guangzhou Pharma	874 HK	China	1,058.5	HK\$5.48	14.5	10.7	7.8
Sino Biopharmaceutical	1177 HK	China	424.4	HK\$1.45	11.2	10.4	7.5
Uni-Bio Group	690 HK	China	474.9	HK\$0.47	23.0	15.3	11.0
Shandong Weigao	8199 HK	China	1,554.4	HK\$10.66	27.5	23.1	30.4
<i>Average</i>					19.4	15.0	
<u>China-listed pharmaceuticals</u>							
Yunan Baiyao Group	000538 CH	China	1,615.3	RMB25.67	40.6	30.7	29.5
Beijing Tongrentang	600085 CH	China	1,159.2	RMB20.11	33.1	29.8	9.2
Guangzhou Baiyunshan	000522 CH	China	600.5	RMB9.66	21.9	17.8	20.5
Guangzhou Pharma	600332 CH	China	953.4	RMB10.62	22.1	20.6	7.8
<i>Average</i>					29.4	24.7	
<i>Average (HK &amp; China)</i>					23.8	19.3	
<u>HK-listed F&amp;B related</u>							
Uni-President	220 HK	China	1,857.9	HK\$4.12	27.3	19.7	5.8
Tingyi	322 HK	China	7,534.7	HK\$10.24	37.4	30.6	16.7
<i>Average</i>					32.3	25.2	

Source: Company data

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