

Kangmei Pharmaceutical Co., Ltd. (600518 CH)

Layout in the Entire Industrial Chain of Traditional Chinese Medicine

Shanghai | Pharmaceutical | Company report

23 December 2014

Steady Growth of Performance

Kangmei Pharmaceutical is a large modern medical resource-based enterprise and a national key high-tech enterprise with the production of traditional Chinese medicinal decoction pieces as its core and the businesses covering the entire industrial chain of traditional Chinese medicine. By virtue of rich resource layouts and channel advantages and so on, company revenue and net profit from 2001 to 2013 were recorded with the compound growth of respectively 30%+ and 40%+. Since 2014, the company has continued its steady and robust growth, mainly benefiting from the high increases of traditional Chinese medicinal decoction pieces, western medicine trade and health products and food businesses.

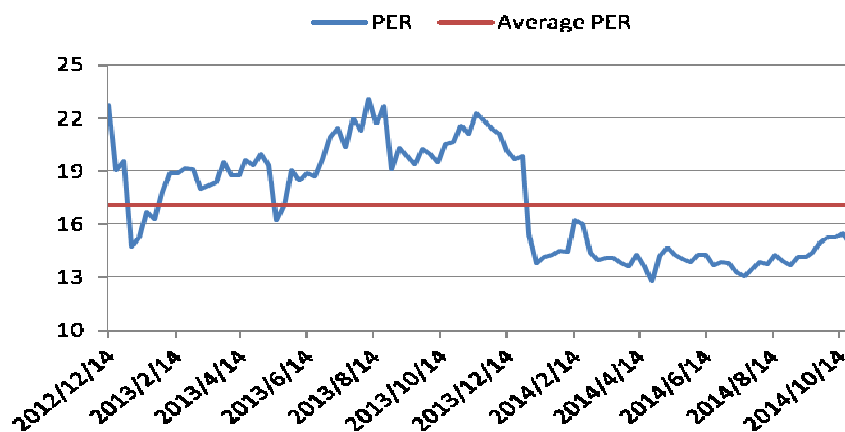
Kangmei has basically penetrated the upstream, midstream and downstream industries of the industrial chain of traditional Chinese medicine, up to medicinal herb cultivation and trade, down to production and development and terminal sale, which is gradually forming the control of the resources and circulation market of traditional Chinese medicinal herbs, and enjoys the advantage with its leading position in the same trade, and may obtain a certain right to speak in the field of traditional Chinese medicine.

The company has built a multi-channel marketing network. Kangmei has become the second listed pharmaceutical enterprise involved in direct marketing, plus the professional advantage of its direct marketing group. It is expected that the direct marketing channel will realize geometric growth, up to above one billion. In addition, e-commerce business of the company also steps into a fast lane, further forming an all-round sale pattern, which is expected to boost the acceleration in the growth of various businesses.

Valuation stands at a low level compared to the peer

The company possesses an advantage of the entire industrial chain of traditional Chinese medicine. The capacity bottleneck of decoction pieces is gradually being eliminated, downstream consumer products have a rapid increase, and e-commerce platforms will also provide channel support, which make continuous growth hopefully. Currently, its valuation corresponding to the performance of 2014 is less than 15 times, a low point in the industry. We grant it 18X 2014EPS, and the target price can be CNY 19.80, with "Buy" rating initially.

Historical P/E Valuation



Source: Bloomberg, Phillip Securities (HK) Research

BUY (Initially)

CMP CNY16.22

TARGET CNY19.80 (+22%)

COMPANY DATA

O/S SHARES (MN) :	2,199
MARKET CAP (CNYMN) :	35,663
52 - WK HI/LO (CNY):	19.71/ 13.80

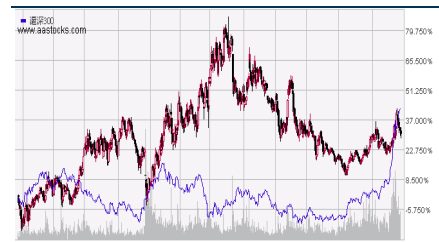
SHARE HOLDING PATTERN, %

Kang Mei Industrial Co. Ltd. :	30.42
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PRICE PERFORMANCE, %

	1 个月	3 个月	1 年
Kangmei	5.32	4.98	-8.10
HS300	-26.08	-37.68	-57.09

PRICE VS. HS300



Source: Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY12	FY13	FY14E	FY15E
Net Sales	11107	13263	16225	19476
Net Profit	1441	1880	2418	3050
EPS, CNY	0.66	0.86	1.10	1.39
PER, x	24.76	18.97	14.75	11.69
BVPS, CNY	4.81	5.47	6.31	7.37
P/BV, x	3.37	2.97	2.57	2.20
ROE, %	14.54	16.63	18.67	20.28
Debt/Equity (%)	69.69	84.96	73.91	73.91

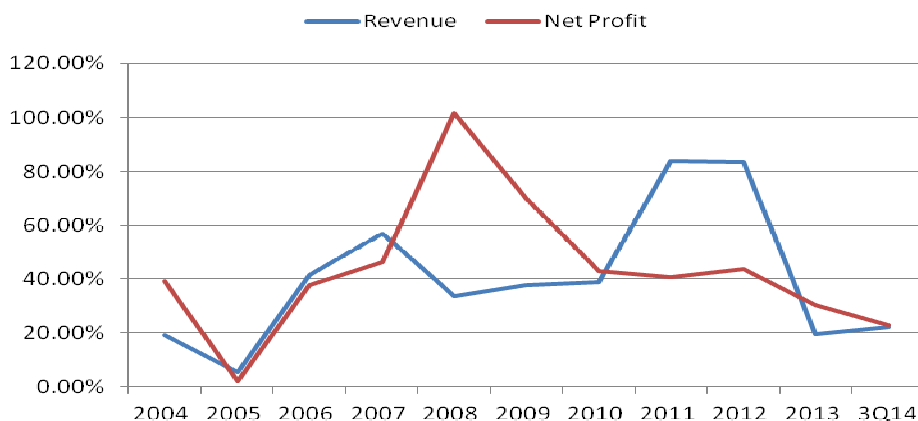
Source: Company reports, Phillip Securities Est.

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Steady Growth of Performance

As shown in the third-quarter report in 2014 of Kangmei Pharmaceutical, the recorded business revenue in this period was CNY 11.577 billion yuan, with the year-on-year growth of 22.16%; the net profit belonging to shareholders of the listed company was 1.498 billion yuan, with the year-on-year increase of 8.02% and the earnings per share of 0.681 yuan; and net profit excluding non-recurring items was 1.482 billion yuan, with the year-on-year rise of 7.53%. It is worth mentioning that on October 10, the company got again the notice about the continuation of high-tech enterprise. If it is estimated with a tax rate of 15%, the company's net profit, in fact, increases at an annual rate of 22%, maintaining a relatively high growth speed.

Continually grown performance



Source: Company, Phillip Securities (HK) Research

Specifically, the company's traditional Chinese medicinal decoction pieces, Western medicine trade and health food businesses have realized high increases. Firstly, the revenue of the traditional Chinese medicinal decoction pieces in the first three quarters had a year-on-year rise of 50%, continuing the growth acceleration compared with the increase of 39% in the first half year. At present, Beijing production base of traditional Chinese medicinal decoction pieces has acquired GMP certificate. It is expected that the capacity of 6,000 tons will be put into production successively. Bozhou base and other bases are also handling procedures such as production authentication. Secondly, benefiting from hospital pharmacy trusteeship, the revenue of Western medicine trade business had a year-on-year increase exceeding 80%. Thirdly, the revenue growth of health products was about 100%. The direct marketing business of the company in cooperation with the PICC was officially launched, with the revenue contribution being over 200 million yuan in the first three quarters.

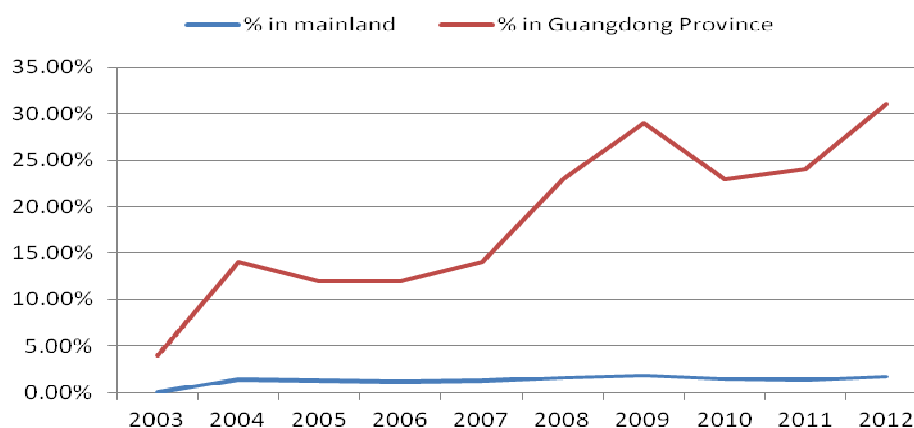
Meanwhile, the company's profitability remained steady, the combined gross margin reduced by 0.15 percentage points, marketing expense ratio basically kept balance, management fee rate reduced by 0.23 percentage points and financial fee rate increased by 0.24 percentage points.

Layout of the Entire Industrial Chain of Traditional Chinese Medicine

In recent years, Kangmei has actively implemented a strategy of the entire industrial chain of traditional Chinese medicine and has begun to take shape, occupying a leading position in the sector. The company has built GAP and standardized planting bases with an area exceeding 50 thousand mu in Yunnan, Sichuan, Jilin, Gansu and so on, involving pseudo-ginseng and Panax ginseng, etc. And it has set up nine production bases of traditional Chinese medicinal decoction pieces in Guangdong,

Beijing, Shanghai, Sichuan, Jilin, Anhui, Gansu and so forth. Thus, a nationwide production layout is basically completed.

Kangmei's Share in the Chinese Herbal Pieces Market



Source: CNBS, Company, Phillip Securities (HK) Research

In addition, the company has merged and acquired professional markets of traditional Chinese medicinal herbs in Bozhou, Anhui, etc., the newly-built national largest Kangmei (Bozhou) Huatuo International Chinese Medicine City has been put into use, and currently the company has managed the professional trading markets of traditional Chinese medicine which occupy over 75% of the national trading volume. At the same time, the company newly builds Kangmei Hospital, merges and acquires and integrates many domestic public hospitals, and trusts nearly one hundred hospital pharmacies. Furthermore, it invests the construction of Ophiocordyceps Sinensis Global Trading Center in Xining, Qinghai Province and builds Sino-ASEAN Kangmei Yulin Chinese Medicinal Herbs (Spices) Trading Center in Yulin, Guangxi Province. Generally speaking, Kangmei Pharmaceutical has basically penetrated the upstream, midstream and downstream industries of the industrial chain of traditional Chinese medicine, up to medicinal herb cultivation and trade, down to production and development and terminal sale, which is gradually forming the control of the resources and circulation market of traditional Chinese medicinal herbs, and may obtain a certain right to speak in the field of traditional Chinese medicine.

Build A Multi-Channel Marketing Network

Apart from traditional channels, the company also obtains national direct marketing business license and becomes the second listed pharmaceutical enterprise involved in direct marketing. In light of the rarity of direct marketing license, the company's direct marketing group possesses professional advantages. We expect that its direct marketing channel is hopeful to realize geometric growth, achieving a level of over one billion yuan.

Meanwhile, the e-commerce business of the company also steps into a fast lane. Since a large trading platform of traditional Chinese medicinal herbs (e Medicine Valley) was launched online, depending on more than 30 warehousing logistics centers nationwide, the company has established nearly 20 standards of listed variety, with the business electron plate reaching over 10 billion yuan. Meanwhile, subsidiary "Kangmei Mall" and O2O trading platform of traditional Chinese medicinal herbs "Kangmei Chinese Medicine City" have also been put into operation online. Generally speaking, the company has constituted an all-round sale pattern including hospital direct supply, OTC selling, wholesale distribution, chain store selling, terminal retail, e-commerce, direct marketing and so on, which is expected to boost the acceleration of the growth of various businesses.

Catalyst

Newly-added capacity of traditional Chinese medicinal decoction pieces is released rapidly;

The growth in the fields of health products and foods exceeds expectations;

The expansion of direct marketing channel is faster than expectation.

Risks

The trading business of medicinal herbs has excessively great demand for cash flow;

The scale of projects in process is enormous.

Financials

Periodicity:	2011	2012	2013	2014F	2015F
Valuation Ratios					
Price Earnings	34.81	24.76	18.97	14.75	11.69
Price to Book	3.86	3.37	2.97	2.57	2.20
Dividend Yield	0.31%	1.23%	1.60%	2.03%	2.57%
Per share data(CNY)					
EPS Adjusted	0.47	0.66	0.86	1.10	1.39
Book Value Per Share	4.21	4.81	5.47	6.31	7.37
Dividends Per Share	0.05	0.20	0.26	0.33	0.42
Growth & Margin					
Revenue growth	-	83.49%	19.41%	22.33%	20.04%
Gross profit growth	-	51.92%	23.44%	25.78%	23.86%
Net profit growth	-	43.40%	30.43%	28.65%	26.10%
Gross Margin	29.87%	24.73%	25.56%	26.29%	27.12%
Operating Margin	21.42%	17.67%	18.75%	19.49%	20.32%
Net Profit Margin	16.60%	12.98%	14.17%	14.91%	15.66%
Dividend Payout Ratio %	10.73%	30.53%	30.41%	30.00%	30.00%
Key ratios					
Return on Assets	8.57%	8.68%	9.35%	10.43%	11.66%
Return on Equity	14.18%	14.54%	16.63%	18.67%	20.28%
Liability ratio	39.31%	41.07%	45.93%	42.50%	42.50%
Effective Tax Rate	14.84%	14.84%	15.07%	15.00%	15.00%
Income Statement(CNY: mn)					
Revenue	6,053	11,107	13,263	16,225	19,476
- Cost of Goods Sold	4,245	8,361	9,873	11,960	14,194
Gross Income	1,808	2,747	3,391	4,265	5,282
- Selling, General & Admin Ex	512	784	904	1,103	1,324
Operating Income	1,297	1,963	2,486	3,161	3,958
- Interest Expense	269	360	406	460	529
- Net Non-Operating Losses (-153	-91	-134	-145	-160
Pretax Income	1,180	1,693	2,214	2,846	3,589
- Income Tax Expense	175	251	334	427	538
Income Before XO Items	1,005	1,441	1,880	2,419	3,051
- Minority Interests	0	0	1	1	1
Net Profit	1,005	1,441	1,880	2,418	3,050

Source: Company, Phillip Securities (HK) Research Estimates

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm 5\%$ from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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