

# KPC Pharmaceuticals (600422.CH)

## Marketing reforms boosted up rapidly grown results

Shanghai | Pharmaceutical | Company report

3 November 2015

KPC Pharmaceuticals announced that the Company recorded growth of net profit of 40-60% in the previous three quarters, with the net profit of RMB203 million in the same period last year and the earning per share was RMB0.596. The main reason of growth of profit is the implementation of a series of measures including fine-tuned marketing reform, which boosted up the sales growth of various highlighted products. We believe that the Company's marketing reform could bring a new round of growth to the core products of the Company.

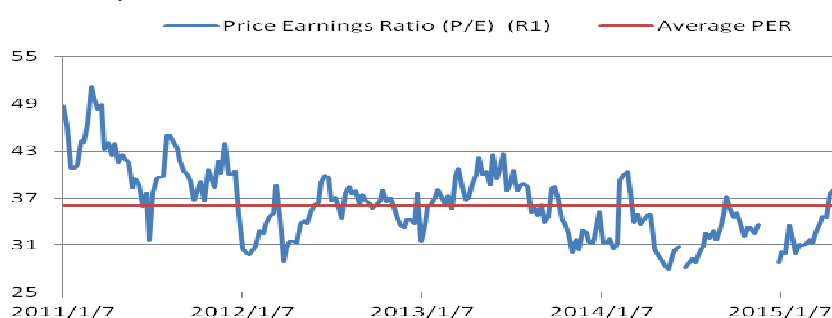
The main products of KPC include three natural botanical drugs, namely Xuesaitong series, Tianxuanqing series and Coartem series. Generally speaking, there is still sufficient growth momentum for the Company's products. Xuesaitong series belongs to of cardiovascular drugs of Panax notoginsenosides group. In the current market of Panax notoginsenosides group, even though the market share of Zhongheng Group is as high as 55%, it is adversely affected by the recent bribery case and thus its market share may shrink in the future. It may be beneficial to KPC which ranks the third in the market currently. It is also worth to note that domestic supply of Pseudo-ginseng nearly doubles the demand and such situation is unlikely to change in short term. The price level of Pseudo-ginseng would remain at low level, which helps to enhance the profitability of products of Xuesaitong series.

This year, KPC adopts the new strategy of positioning itself as a provider of internationalized medicine focusing on cardiovascular drugs and specializing in chronic diseases. The Company would take botanical drugs as its core and comprehensively develop high-end chemical and biological drugs. TEVA is a pharmaceutical company which ranks among the top 20 worldwide. In the 15 years following KPC's acquisition of the rest of 49% equity of Baker Norton, TEVA would still appoint KPC as the sole registered and distribution agent in China. Long term supply agreement would be established. The registration of TEVA's future products in China would still bring considerable growth for KPC. What's more, the Chinese market of diabetes drugs is expected to have persistent fast growth. KPC is now entering the innovation of diabetes drugs and future development should be promising.

### Increased shareholding by management demonstrated confidence on the Company

KPC Pharmaceuticals's main business of original natural botanical drugs demonstrated steady internal development and the marketing reform is expected to enhance sales of products. In addition, the price of raw material of Pseudo-ginseng still maintains at low level, so the Company's performance could keep fast growth. Meanwhile, the Company has specific strategical transformation and goals for external development. Therefore, sustainable long-term development would be expectable. Recently, the executives and management level of the Company increased their holding of the Company's share at the price of around RMB30. Such act reflected that all members of the Company had strong confidence on the future development. We set the target price at RMB42.63, which is correspondent to 40x of 2015e EPS, and maintain the rating of "Buy". (Closing price as at 30 Oct 2015)

### Historical P/E valuation



Source: Bloomberg, Phillip Securities (HK) Research

### BUY (Maintain)

CMP: CNY 33.67  
(Closing price as at 30 Oct 2015)  
TARGET: CNY 42.63 (+26.6%)

#### COMPANY DATA

O/S SHARES (MN) :	394
MARKET CAP (CNYMN) :	13,276
52 - WK HI/LO (CNY):	51.50/ 23.71

#### SHARE HOLDING PATTERN , %

Hofon Science and Technology Pharmaceutical :	29.79
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#### PRICE PERFORMANCE , %

	1M	3M	1Y
KPC	13.74	0.92	26.26
SCI	2.25	11.53	-16.48

#### PRICE VS. SCI



Source: Phillip Securities (HK) Research

#### KEY FINANCIALS

CNY mn	FY13	FY14	FY15E	FY16E
Net Sales	3561	4094	4805	5543
Net Profit	232	292	420	512
EPS, CNY	0.71	0.86	1.07	1.30
PER, x	47.3	39.3	31.6	25.9
BVPS, CNY	5.15	5.64	8.90	9.80
P/BV, x	6.53	5.97	3.78	3.44
ROE, %	17.2	15.9	14.6	13.2
Debt/Equity (%)	53.57	47.54	35.50	37.93

Source: Company reports, Phillip Securities Est.

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## Marketing reforms boosted up rapidly grown results

KPC Pharmaceuticals announced that the Company recorded growth of net profit of 40-60% in the previous three quarters, with the net profit of RMB203 million in the same period last year and the earning per share was RMB0.596. The main reason of growth of profit is the implementation of a series of measures including fine-tuned marketing reform, which boosted up the sales growth of various highlighted products.

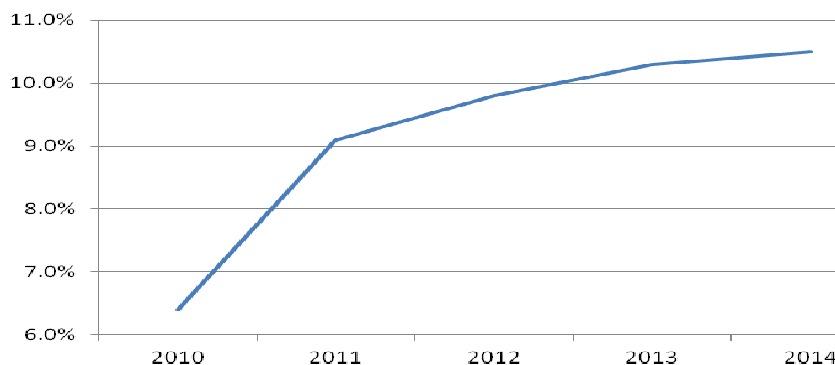
Since 2013, the marketing reform of KPC is divided into two areas, namely internal and external. Internally, the Company implemented departmentalization by products, including Luotai(Xuesaitong), Tianxuanqing, Xuesaitong soft capsules, special oral medication and generic drugs, and flattened the organization structure of the Company. What's more, the Company's mode of promotion changed: from province-level agents narrowed down to city/county-level. In some key markets, it even specified to a single or several hospitals. The Company also re-developed the market niche not yet covered by the province-level agents previously, dismissed the agents with unsatisfactory business results, and also strengthened the academic support for the agents. By adopting progressive adjustment of salary system for frontline sale teams, income is more closely related to business results, and thus initiativeness of staffs is enhanced. Middlemen were eliminated in the sales channels through serial reform and transaction cost was reduced and the Company's profitability was boosted. This also improved the Company's ability to control the market end, and at the same time, broadened the coverage of the Company's products. We believe that the Company's marketing reform could bring a new round of growth to the core products of the Company.

## Market share of product line of Xuesaitong is expected to expand

The main products of KPC include three natural botanical drugs, namely Xuesaitong series, Tianxuanqing series and Coartem series. Generally speaking, there is still sufficient growth momentum for the Company's products.

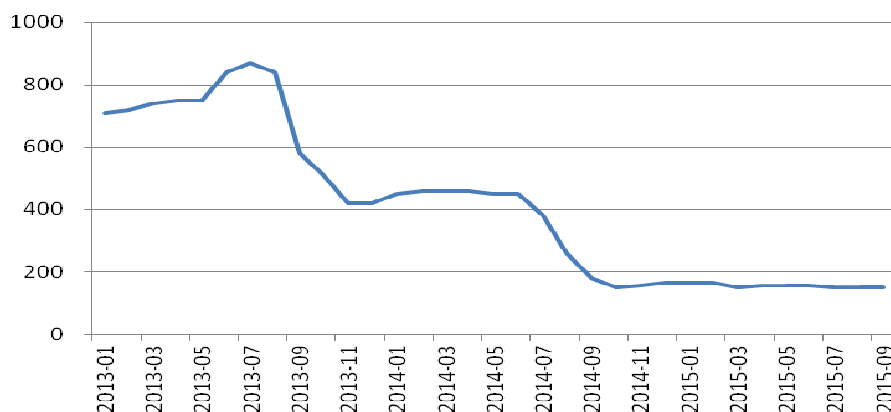
Firstly, Xuesaitong series belongs to of cardiovascular drugs of Panax notoginsenosides group. With the aging population and the change of diet structure, the prevalence rate and the mortality rate of cardiovascular diseases demonstrated an uptrend in China. Thus, the market for cardiovascular drugs is expanding consistently. Moreover, cardiovascular diseases are chronic diseases which require long-term use of drugs. The side effects of processed traditional Chinese medicine are limited and it is a distinguish advantage. In terms of market structure, there are only two producers to produce Xuesaitong (freeze-dried powder for injection) and Xuesaitong soft capsules and this creates an advantageous oligopoly market. In addition, in the current market of Panax notoginsenosides group, even though the market share of Zhongheng Group is as high as 55%, it is adversely affected by the recent bribery case and thus its market share may shrink in the future. It may be beneficial to KPC which ranks the third in the market currently. It is also worth to note that domestic supply of Pseudo-ginseng nearly doubles the demand and such situation is unlikely to change in short term. The price level of Pseudo-ginseng would remain at low level, which helps to enhance the profitability of products of Xuesaitong series.

### Larger share of KPC in the Panax notoginsenosides market



Source: PDB, Phillip Securities (HK) Research

### Pseudo-ginseng price has seen a steep fall



Source: Wind, Phillip Securities (HK) Research

Secondly, Tianxuanqing series mainly applies to neurological diseases. Being the innovator of research and production of Tianxuanqing, the Company has a market share of 40%, which ranks the top in the market, with a rate of increase of more than 15%. The current points of sales mainly concentrate in Jiangsu Province, Shaanxi Province, Beijing and Yunnan Province etc. There is still much room for development in other areas. The Company is putting effort on promotion to hospital clients, the growth rate is expected to increase in the future. Moreover, the Company's Tianxuanqing gastrodin injection is the only brand having rewarded the qualification of excellent quality and excellent price. Its price doubles the ordinary gastrodin injection and has advantages in clinical promotion. The Company solely sells Acetastrodin tablets, which have price differentiation from the other ordinary gastrodin tablets.

Last but not least, Coartem is a kind of artemether drugs, which is the most effectively drugs to treat malaria up-to-date. The Company is the largest producer of artemether and related products worldwide, owning the whole supply chain of artemether including plantation, production, international sales network. Due to the current overcapacity, the utilization rate is merely 20%, and the price level of raw drug materials is also low. In the future, when the Company's medicine like artemether injection get the recognition by WHO, new growth would be brought to the Company and the profitability is expected to be improved.

### New strategy would focus on chemical drugs and biological drugs

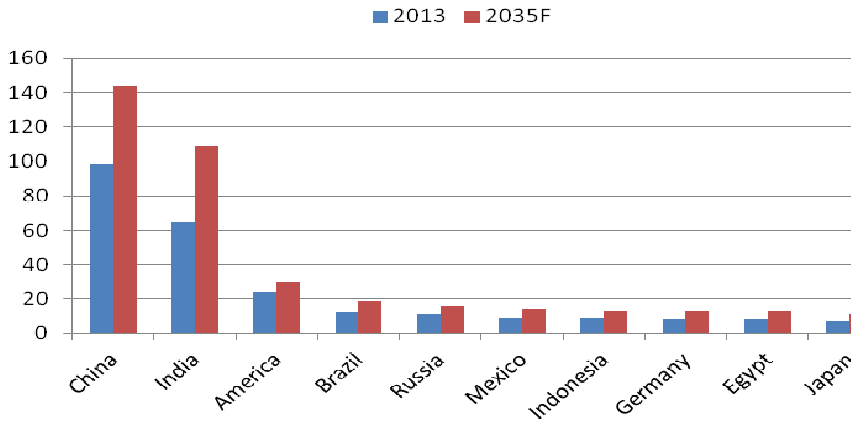
This year, KPC adopts the new strategy of positioning itself as a provider of internationalized medicine focusing on cardiovascular drugs and specializing in chronic diseases. The Company would take botanical drugs as its core and comprehensively develop high-end chemical and biological drugs. Therefore, the board of directors appointed Dr. Dai Xiaochang to be the new CEO. This would make the core management team more international.

Furthermore, being the sale channel of KPC's chemical drugs, Kunming Baker Norton originally was the joint venture of KPC and the international pharmaceutical giant, TEVA. The Company has recently acquired the rest 49% equity and now possesses 99% equity of Baker Norton. Since its establishment, Baker Norton followed the marketing mode of international pharmaceutical companies and made use of its international background and the advantage of marketing network. Baker Norton also continually introduces overseas products and acts as the agents, including alfalcidol soft capsules, amoxicillin and azithromycin etc. It is worth to point out that TEVA is a pharmaceutical company which ranks among the top 20 worldwide. In the 15 years following KPC's acquisition of the rest of 49% equity of Baker Norton, TEVA would still appoint KPC as the sole registered and distribution agent in China. Long term supply agreement would be established. The registration of TEVA's future products in China would still bring considerable growth for KPC.

In the area of biological drugs, the Company planned to devote RMB83.13 million in a collaboration with Professor Wang Qing-hua on the development of a high-end long-lasting

hypoglycemic drug namely GLP-1. It marks the Company’s entering the market of diabetes treatment and development into the area of biopharmaceutical. Currently, China has the highest number of diabetes, accounts for 25% of the worldwide diabetes cases. However, the total expenses of diabetes treatment merely account for 7% of the worldwide sum. Treatment expenses per capita in China only account for 27% of the worldwide per capita expenses. Therefore, the Chinese market of diabetes drugs is expected to have persistent fast growth. KPC is now entering the innovation of diabetes drugs and future development should be promising.

**China has the highest number of diabetes (mn)**



Source: IDF, Phillip Securities (HK) Research

**Catalyst**

Better-than-expected sales of drugs;  
Faster-than-expected progress of acquisition.

**Risks**

Price drop of drugs;  
Monitoring policies on Chinese medicine injection;  
Price of Pseudo-ginseng stops declining and starts increasing.

## Financials

FYE	2012	2013	2014	2015F	2016F
<b>Valuation Ratios</b>					
Price Earnings	60.13	47.29	39.29	31.59	25.92
Price to Book	11.27	6.53	5.97	3.78	3.44
Dividend Yield	0.9%	1.0%	0.5%	1.0%	1.2%
<b>Per share data(RMB)</b>					
EPS Adjusted	0.56	0.71	0.86	1.07	1.30
Book Value Per Share	2.99	5.15	5.64	8.90	9.80
Dividends Per Share	0.30	0.35	0.17	0.35	0.40
<b>Growth &amp; Margin</b>					
Revenue growth	-	19.0%	15.0%	17.4%	15.4%
Gross Profit growth	-	9.3%	18.1%	32.4%	16.2%
Net Profit growth	-	31.7%	26.2%	43.8%	21.9%
<b>Profitability Ratios</b>					
Gross Margin	31.2%	28.7%	29.5%	33.3%	33.5%
Net Profit Margin	5.9%	6.5%	7.1%	8.7%	9.2%
Dividend Payout Ratio %	51.9%	51.5%	19.8%	32.8%	30.8%
<b>Key Ratios</b>					
Return on Assets	9.6%	9.2%	9.9%	10.4%	9.6%
Return on Equity	20.7%	17.2%	15.9%	14.6%	13.2%
Effective Tax Rate	16.9%	16.9%	15.9%	16.0%	16.0%
Liability ratio	50.9%	34.9%	32.2%	26.2%	27.5%
<b>Income Statement(RMB: mn)</b>					
<b>Revenue</b>	<b>2,994</b>	<b>3,561</b>	<b>4,094</b>	<b>4,805</b>	<b>5,543</b>
- Cost of Goods Sold	2,059	2,539	2,887	3,207	3,686
<b>Gross Income</b>	<b>935</b>	<b>1,022</b>	<b>1,207</b>	<b>1,598</b>	<b>1,857</b>
- Selling, General & Admin Expenses	699	735	878	1,096	1,253
<b>Operating Income</b>	<b>237</b>	<b>286</b>	<b>329</b>	<b>502</b>	<b>604</b>
- Net Non-Operating Losses (Gains)	-18	-18	-48	-35	-48
<b>Pretax Income</b>	<b>242</b>	<b>284</b>	<b>366</b>	<b>527</b>	<b>642</b>
- Income Tax Expense	41	48	58	84	103
<b>Income Before XO Items</b>	<b>201</b>	<b>236</b>	<b>308</b>	<b>442</b>	<b>539</b>
- Minority Interests	19	4	15	22	27
<b>Net Profit</b>	<b>176</b>	<b>232</b>	<b>292</b>	<b>420</b>	<b>512</b>

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 30 Oct 2015)

**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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