

China Traditional Chinese Medicine (570.HK)

Concentrated TCM Granules Will Continue to Grow Rapidly

Hong Kong | Pharmaceutical | Company report

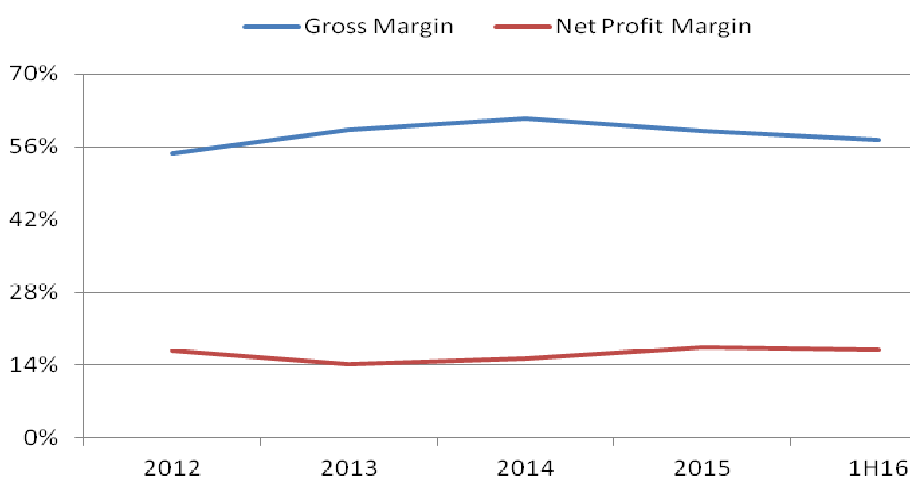
12 September 2016

Rapid Growth in H1 2016

In 1H16, the revenue and profit attributable to shareholders of China Traditional Chinese Medicine (CTCM) both witnessed a substantial growth, soaring by 125% and 101.8% to RMB 3.2 billion and RMB 490 million, respectively. Also, EPS rose from RMB 0.08 to RMB 0.11, a YOY increase of 36.1%.

After the Company completed the acquisition of the concentrated traditional Chinese medicine (TCM) granules in Q4 2015, concentrated TCM granules business has become the Company's primary business. Revenue and net profit of the business reached RMB 2.05 billion and RMB 381 million, representing a YOY increase of 21.9% and 27.4%, respectively, contributing to over 60% of the total revenue and nearly 70% of the total net profit. Furthermore, the increase in gross profit margin of this business was mainly attributable to the decrease in purchasing costs, and to change of agency to direct sales of some products.

Earning capabilities of CTCM



Source: Company reports, Phillip Securities (HK) Research

However, revenue and net profit of the Company's original TCM finished drugs business fell by 19.5% and 32.9% to RMB 1.14 billion and RMB 160 million, respectively. This mainly results from the introduction of "two invoices" policy and medical insurance cost control, and from reduction of inventories by dealers. Moreover, the tender price of the Company's products dropped by 3-4% on average, and second bargain was implemented in a number of provinces. The Company expected that de-stocking will continue in the second half of 2016, and that after the end of 2016, its revenue growth will catch up with the industry average.

Accumulate (Initially)

CMP: HKD 3.98

(Closing price as at 8 Sep 2016)

TARGET: HKD 4.40 (+10.6%)

COMPANY DATA

O/S SHARES (MN) :	4,432
MARKET CAP (HKDMN) :	17,639
52 - WK HI/LO (HKD):	6.42/ 2.89

SHARE HOLDING PATTERN, %

China National Pharmaceutical Group Corporation (HongKong):	36.00
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PRICE PERFORMANCE, %

	1M	3M	1Y
CTCM	27.22	24.84	-28.09
HSI	21.67	13.37	-39.76

PRICE VS. HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY14	FY15	FY16E	FY17E
Net Sales	2650	3709	6834	7907
Net Profit	413	633	1015	1205
EPS, CNY	0.16	0.17	0.23	0.27
PER, x	22.1	20.0	15.0	12.6
BVPS, CNY	1.26	2.48	2.90	3.08
P/BV, x	2.73	1.38	1.18	1.11
ROE, %	13.9	8.7	8.2	9.1
Debt/Equity (%)	63.7	54.0	53.8	53.8

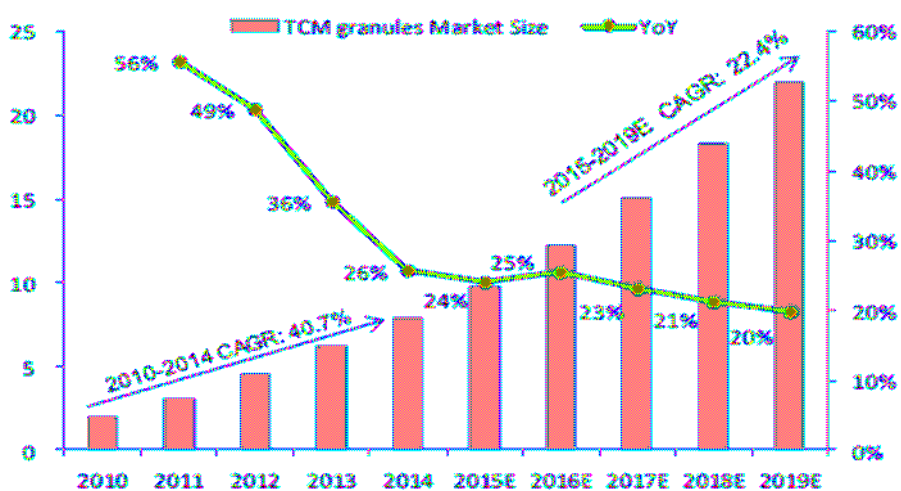
Source: Company reports, Phillip Securities Est.

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Concentrated TCM Granules Will Continue to Grow Rapidly

Last year, after the acquisition of Tianjiang Pharmaceutical, the Company took the leading position in the domestic concentrated TCM granules sector. Despite decline in growth of TCM industry, formula granules are a rising industry, with 23% CAGR from 2013 to 2015. Euromonitor forecast that the market size of domestic concentrated TCM granules will surge from RMB 7.8 billion in 2014 to RMB 18.3 billion in 2018, enjoying a favorable market prospect. Zhejiang Province announced in August 2015 that it started to pilot inclusion of concentrated TCM granules into medical insurance, demonstrating that the domestic government gradually recognized formula granules. More provinces are expected to follow suit, thereby significantly promoting the sales of formula granules. It is worth mentioning that county primary hospitals have completely abolished drug price addition, but excluding TCM decoction pieces. The regulations of cost addition of formula granules are also implemented in accordance with TCM decoction pieces. As a result, TCM decoction pieces will not be affected by price drop in drugs in the short term.

Market scale of Concentrated TCM Granules (CNY: bn)



Source: Euromonitor, Phillip Securities (HK) Research

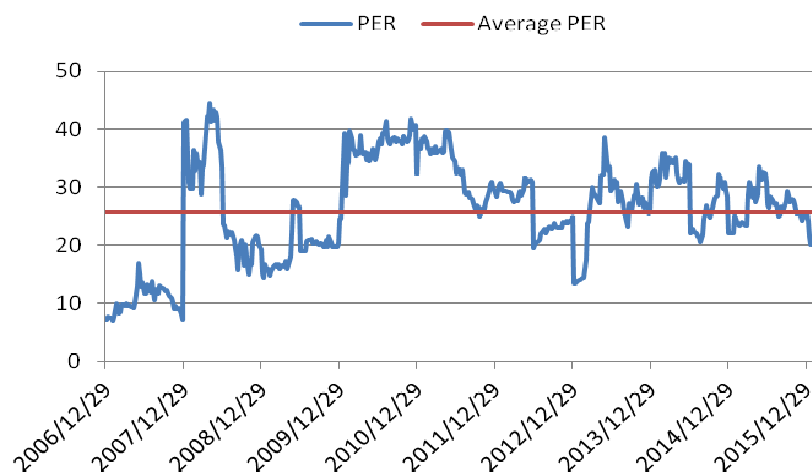
In respect of supply, although China is mulling over relaxing regulation of concentrated TCM granules' production permit, it is estimated that the six manufacturers with the approvals of concentrated TCM granules will experience a transition period of 2 to 3 years, and that the new competitors will need a relatively long time to own sufficient products. In contrast, Tianjiang Pharmaceutical boasts more than 700 products, and coupled with capital barrier, covers over 5,000 hospitals. Besides, CTCM owns a strong sales network. Therefore, we believe it is difficult for small- and medium-sized pharmaceutical companies to pose substantial threat to the growth of Tianjiang Pharmaceutical in the next two years, and that its revenue growth is still expected to exceed 20%.

Valuation

The Company also resumed dividend payout, with interim dividend standing at 6.44 HK cents. Besides, it indicated that in the event of no major investment,

it will maintain a 30% dividend payout rate. We estimate that this will help the Company to win market recognition. We adopt the Sum of the Parts Valuation (SOTP), and give the Company's concentrated TCM granules business and TCM finished drugs business 20X P/E ratio and 10X P/E ratio, respectively. The target price is HK\$ 4.4, and the "Accumulate" rating is given initially. (Closing price as at 8 Sep 2016)

Historical P/E Valuation



Source: Bloomberg, Phillip Securities (HK) Research

Risks

Further price drop in products;
The competition intensifies more than expected.

Financials

FYE	2013	2014	2015	2016F	2017F
Valuation Ratios					
Price Earnings	35.37	21.05	19.95	14.98	12.62
Price to Book	3.15	2.73	1.38	1.18	1.11
Dividend Yield	0.0%	0.0%	0.0%	2.7%	3.2%
Per share data(RMB)					
EPS Adjusted	0.10	0.16	0.17	0.23	0.27
Book Value Per Share	1.09	1.26	2.48	2.90	3.08
Dividends Per Share	0.00	0.00	0.00	0.09	0.11
Growth& Margin					
Revenue growth	-	90.0%	40.0%	84.2%	15.7%
Gross Profit growth	-	99.0%	33.5%	79.1%	15.7%
Net Profit growth	-	108.1%	53.3%	60.3%	18.7%
Profitability Ratios					
Gross Margin	59.2%	62.0%	59.1%	57.5%	57.5%
Net Profit Margin	14.2%	15.6%	17.1%	14.9%	15.2%
Dividend Payout Ratio %	0.0%	0.0%	0.0%	40.0%	40.0%
Key Ratios					
Return on Assets	6.0%	7.9%	5.3%	5.3%	5.9%
Return on Equity	11.1%	13.9%	8.7%	8.2%	9.1%
Effective Tax Rate					
Effective Tax Rate	16.1%	14.4%	15.4%	15.0%	15.0%
Liability ratio					
Liability ratio	44.0%	38.9%	35.1%	35.0%	35.0%
Income Statement(RMB: mn)					
Revenue	1,395	2,650	3,709	6,834	7,907
- Cost of Goods Sold	569	1,007	1,515	2,905	3,360
Gross Income	826	1,643	2,194	3,930	4,547
- Selling, General & Admin Exp	580	1,127	1,586	2,911	3,368
Operating Income	264	552	652	1,103	1,278
- Interest Expense	35	63	70	60	55
Pretax Income	238	489	769	1,328	1,568
- Income Tax Expense	38	70	118	199	235
Income Before XO Items	199	419	651	1,129	1,333
- Minority Interests	1	-2	18	114	128
Net Profit	198	413	633	1,015	1,205

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 8 Sep 2016)

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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