INSTITUTIONAL EQUITY RESEARCH

Kangmei Pharmaceutical (600518.CH)
More Cooperation with Regional Government

Shanghai | Pharmaceutical | Company report

5 October 2016

BUY (Maintain)
CMP: CNY 16.22
(Target price as at 4 Oct 2016)
TARGET: CNY 20.10 (+23.9%)

COMPANY DATA
O/S SHARES (MN) : 4,947
MARKET CAP (CNYMN) : 80,240
52 - WK HI/LO (CNY): 18.65/ 12

SHARE HOLDING PATTERN, %
Kang Mei Industrial Co. Ltd.: 31.27

PRICE PERFORMANCE, %
1M 3M 1Y
Kangmei -2.31 6.35 18.76
SCI 0.02 4.07 20.06

PRICE VS. HS300
Source: Phillip Securities (HK) Research

KEY FINANCIALS
CNY mn FY14 FY15 FY16E FY17E
Net Sales 15846 17870 22390 27586
Net Profit 2286 2757 3415 4218
EPS, CNY 0.52 0.62 0.69 0.85
PER, x 31.19 26.16 23.49 19.02
BVPS, CNY 3.80 4.27 5.94 6.58
P/BV, x 4.27 3.80 2.73 2.46
ROE, % 17.74 18.54 14.17 13.62
Debt/Equity (%) 66.75 102.28 79.69 73.91

Source: Company reports, Phillip Securities Est.
Research Analyst
Fan Guohe
(+ 86 21 51699400-110)
fanguohe@phillip.com.cn

More Cooperation with Regional Government
Recently, Kangmei Pharmaceutical Co., Ltd. has entered into a strategic cooperation with Chongqing Municipal Government to jointly cultivate authentic medicinal herbs, produce TCM decoction pieces, TCM formula granule, and Chinese patent medicine, provide "Internet + medical treatment" services, and reform public hospitals. This is another significant strategic cooperation with a major region following Yunnan Province, Qinghai Province, Puning City of Guangdong Province, Pu’er City of Yunnan Province, Yulin City of Guangxi Province, Bao’an District of Shenzhen City, Huaiji County of Guangdong Province, and so on.

Specifically, Chongqing Chemical & Pharmaceutical Holding (Group) Company and Kangmei Pharmaceutical will jointly invest RMB1.5 billion, wherein, Kangmei will invest RMB975 million, to establish Kangmei Pharmaceutical (Nanchuan) Production and Processing Base which is expected to be the largest TCM deep processing base in south-western China. Chongqing boasts 5,832 varieties of Chinese herbals, 1.63 million tons of Chinese herbals, and 200 million acres of herb planting area. By virtue of these rich resources, the cooperation project will integrate the production of TCM decoction pieces, TCM formula granule, and Chinese patent medicine, wherein, the annual output of TCM decoction pieces will be about 100,000 tons, while TCM formula granule, about 3 billion packs with 450 types. We believe that the cooperation will improve the company’s product structure, promote its integrative industry chain of TCM, and continue to consolidate the company’s leading position in TCM industry.

Improved Recognition of Intelligent Pharmacy
In addition, both sides will jointly invest RMB300 million to set up Kangyu Medicine, wherein, the company will account for 65% of the total investment. Intelligent Pharmacy cooperates again with a provincial government, proving its increasing recognition by the market. Previously, Intelligent Pharmacy shops have been set up in first-tier cities like Guangzhou, Shenzhen, and Beijing. Looking forward, they will be expanded to Yunnan Province and Chongqing. If it can be operated successfully, it will be copied and promoted in Guangdong Province, Guangxi Province, Qinghai Province, and other places.

Greater Health Care Ecosystem to be Developed by Private Placement Projects
The company has been committed to the field of Chinese medicine for years and takes the lead to complete the industry chain of TCM from source to terminal. Moreover, since 2013, the company has promoted the modes of pharmacy custody and Intelligent Pharmacy to rapidly develop pharmaceutical distribution business. It is expected to become a large enterprise integrating both pharmaceutical industry and commerce. Since 2014, the company is committed to promoting "Internet + healthcare" strategy, online services including Kangmei mobile medicine, medicine e-mail, bulk price index, and information management center, off-line services including Kangmei self-support hospital, pharmacy, logistics companies, medicine market, and cooperative medical institutions, as well as Kangmei Pay, insurance, financial leasing, and future TCM futures exchange. What’s more, by the end of June, the company had completed non-public offering with a total of RMB8.1 billion and continued to promote Internet+ strategy. It is expected to form a greater on-line and off-line health care ecosystem.
Continually grown performance

Kangmei Pharmaceutical has taken leading position in TCM industry. Meanwhile, its major shareholders subscribe for private placement projects with enormous amounts, highlighting their high confidence for future development. We give the company the target price of RMB20.1, equivalent to EPS 29.1x in 2016, with the "Buy" rating maintained. (Closing price as at 4 Oct 2016)

Historical P/E Valuation of Kangmei

Risks

Progress of strategic cooperation falls short of expectation;
Lack of talents affects business layout.
## Financials

### Periodicity:

|-------------|------|------|------|-------|-------|

### Valuation Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016F</th>
<th>2017F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price Earnings</td>
<td>37.72</td>
<td>31.19</td>
<td>26.16</td>
<td>23.49</td>
<td>19.02</td>
</tr>
<tr>
<td>Price to Book</td>
<td>7.13</td>
<td>4.27</td>
<td>3.80</td>
<td>2.73</td>
<td>2.46</td>
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<tr>
<td>Dividend Yield</td>
<td>0.80%</td>
<td>0.99%</td>
<td>1.17%</td>
<td>1.29%</td>
<td>1.60%</td>
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</tbody>
</table>

### Per share data (CNY)

<table>
<thead>
<tr>
<th>Ratio</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016F</th>
<th>2017F</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS Adjusted</td>
<td>0.43</td>
<td>0.52</td>
<td>0.62</td>
<td>0.69</td>
<td>0.85</td>
</tr>
<tr>
<td>Book Value Per Share</td>
<td>2.27</td>
<td>3.80</td>
<td>4.27</td>
<td>5.94</td>
<td>6.58</td>
</tr>
<tr>
<td>Dividends Per Share</td>
<td>0.13</td>
<td>0.16</td>
<td>0.19</td>
<td>0.21</td>
<td>0.28</td>
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</tbody>
</table>

### Growth & Margin

<table>
<thead>
<tr>
<th>Ratio</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016F</th>
<th>2017F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue growth</td>
<td>19.41%</td>
<td>19.47%</td>
<td>12.77%</td>
<td>25.29%</td>
<td>23.21%</td>
</tr>
<tr>
<td>Gross profit growth</td>
<td>23.44%</td>
<td>20.27%</td>
<td>20.72%</td>
<td>23.78%</td>
<td>23.23%</td>
</tr>
<tr>
<td>Net profit growth</td>
<td>30.43%</td>
<td>21.61%</td>
<td>20.60%</td>
<td>23.88%</td>
<td>23.16%</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>25.56%</td>
<td>25.74%</td>
<td>27.55%</td>
<td>27.22%</td>
<td>27.20%</td>
</tr>
<tr>
<td>Operating Margin</td>
<td>18.75%</td>
<td>19.24%</td>
<td>20.12%</td>
<td>20.32%</td>
<td>20.30%</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>14.17%</td>
<td>14.43%</td>
<td>15.43%</td>
<td>15.25%</td>
<td>15.29%</td>
</tr>
<tr>
<td>Dividend Payout Ratio %</td>
<td>30.23%</td>
<td>30.77%</td>
<td>30.65%</td>
<td>30.42%</td>
<td>30.49%</td>
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</tbody>
</table>

### Key ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016F</th>
<th>2017F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets</td>
<td>9.35%</td>
<td>9.12%</td>
<td>8.35%</td>
<td>7.51%</td>
<td>7.71%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>16.63%</td>
<td>17.74%</td>
<td>18.54%</td>
<td>14.17%</td>
<td>13.62%</td>
</tr>
<tr>
<td>Liability ratio</td>
<td>45.93%</td>
<td>40.03%</td>
<td>50.56%</td>
<td>44.35%</td>
<td>42.50%</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
<td>15.07%</td>
<td>15.55%</td>
<td>14.99%</td>
<td>15.00%</td>
<td>15.00%</td>
</tr>
</tbody>
</table>

### Income Statement (CNY: mn)

<table>
<thead>
<tr>
<th>Category</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016F</th>
<th>2017F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>13,263</td>
<td>15,846</td>
<td>17,870</td>
<td>22,390</td>
<td>27,586</td>
</tr>
<tr>
<td>- Cost of Goods Sold</td>
<td>9,873</td>
<td>11,768</td>
<td>12,947</td>
<td>16,296</td>
<td>20,082</td>
</tr>
<tr>
<td>Gross Income</td>
<td>3,391</td>
<td>4,078</td>
<td>4,923</td>
<td>6,094</td>
<td>7,505</td>
</tr>
<tr>
<td>- Selling, General &amp; Admin Expenses</td>
<td>904</td>
<td>1,030</td>
<td>1,328</td>
<td>1,545</td>
<td>1,903</td>
</tr>
<tr>
<td>Operating Income</td>
<td>2,486</td>
<td>3,048</td>
<td>3,595</td>
<td>4,549</td>
<td>5,601</td>
</tr>
<tr>
<td>- Interest Expense</td>
<td>406</td>
<td>491</td>
<td>589</td>
<td>766</td>
<td>904</td>
</tr>
<tr>
<td>- Net Non-Operating Losses (Gains)</td>
<td>-134</td>
<td>-150</td>
<td>-237</td>
<td>-235</td>
<td>-265</td>
</tr>
<tr>
<td>Pretax Income</td>
<td>2,214</td>
<td>2,707</td>
<td>3,243</td>
<td>4,018</td>
<td>4,963</td>
</tr>
<tr>
<td>- Income Tax Expense</td>
<td>334</td>
<td>421</td>
<td>486</td>
<td>603</td>
<td>744</td>
</tr>
<tr>
<td>Net Profit</td>
<td>1,880</td>
<td>2,286</td>
<td>2,757</td>
<td>3,415</td>
<td>4,218</td>
</tr>
</tbody>
</table>

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 4 Oct 2016)
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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**Contact Information (Regional Member Companies)**

### Kangmei Pharmaceutical (600518 CH)

<table>
<thead>
<tr>
<th>Total Return</th>
<th>Recommendation</th>
<th>Rating</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;+20%</td>
<td>Buy</td>
<td>1</td>
<td>&gt;20% upside from the current price</td>
</tr>
<tr>
<td>+5% to +20%</td>
<td>Accumulate</td>
<td>2</td>
<td>+5% to +20% upside from the current price</td>
</tr>
<tr>
<td>-5% to +5%</td>
<td>Neutral</td>
<td>3</td>
<td>Trade within ± 5% from the current price</td>
</tr>
<tr>
<td>-5% to -20%</td>
<td>Reduce</td>
<td>4</td>
<td>-5% to -20% downside from the current price</td>
</tr>
<tr>
<td>&lt;&lt;-20%</td>
<td>Sell</td>
<td>5</td>
<td>&gt;20% downside from the current price</td>
</tr>
</tbody>
</table>
SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

HONG KONG
Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites: www.phillip.com.hk

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website: www.phillip.co.th

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

AUSTRALIA
PhillipCapital Australia
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96188238
Fax (613) 92002272
Website: www.phillipcapital.com.au

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

JAPAN
PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website: www.phillip.co.jp

CHINA
Phillip Financial Advisory (Shanghai) Co. Ltd
No 436 Hengfeng Road,
Greentech Unit 604,
Postal code 200070
Tel (86-21) 51699400
Fax (86-21) 63532643
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website: www.phillip.co.th

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005