

China Traditional Chinese Medicine (570.HK)

Destocking of Chinese Traditional Medicine Basically Ends

Hong Kong | Pharmaceutical | Company report

25 January 2017

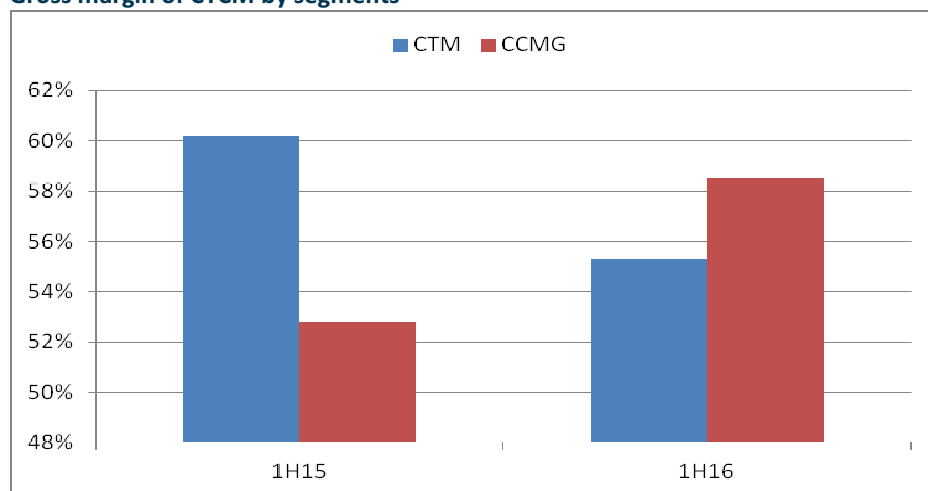
Concentrated Chinese Medicine Granule (CCMG) Market Access Liberalization Remains to Be Seen

After the acquisition of Tianjiang Pharmaceutical in 2015, China Traditional Chinese Medicine (CTCM) has taken the leading position in the domestic CCMG sector. Overall, with outstanding security, effectiveness, convenience and the sustained 15% drug-price addition policy, CCMG may take a part of the Chinese traditional medicine market. Also, currently all TCM hospitals are eligible to sell CCMG, while in the past only those of secondary or above levels did. The CCMG market will maintain high growth, and the company, as a leader, will benefit from its expansion.

Previously only five enterprises produced CCMG, but the market-access policies are likely to be loosened, causing market concerns about disorderly competition. We believe, against the backdrop of the supply-side structural reform, CCMG national standards will be set relatively high in order to ensure TCM quality and protect the brand. Furthermore, within the three years (2017-2019) during formulating the industry standard guidelines, all companies in the industry will be encouraged to conduct research and develop industry standards for more than 500 CCMG products, which only five enterprises are able to sell at present. New manufacturers can only sell CCMG products after meeting the industry standards during the transition period, and are required to undergo a six-month production stability test prior to commercial production. Therefore, we expect new entrants to have very limited impact on the current market pattern.

CTCM has enhanced its core competitiveness through R&D, with the research of high-performance liquid chromatography (HPLC) of more than 150 varieties completed, and will continue to improve corporate internal quality standards. In the meantime, the company will support CCMG's high profitability through the centralized procurement of 105 medicinal materials. In addition, the CCMG marketing network has nearly covered all provinces in China, among which 18 provinces have recorded a sales volume of over RMB100 million. With the further marketing reform in such aspects as academic promotion and incentive system, the marketing advantage of CCMG will be consolidated. It is notable that the company plans to invest RMB2 billion in the next three years to expand production capacity, of which extraction capacity will rise from 28,500 tons to 60,000 tons and granulation capacity from 8,000 tons to 16,000 tons, and this will further enhance the company's scale edge and consolidate its leading position.

Gross margin of CTCM by segments



Source: Company reports, Phillip Securities (HK) Research

Buy (Upgrade)

CMP: HKD 3.60

(Closing price as at 23 Jan 2017)

TARGET: HKD 5.08 (+41%)

COMPANY DATA

O/S SHARES (MN) :	4,432
MARKET CAP (HKDMN) :	15,761
52 - WK HI/LO (HKD):	4.52/2.89

SHARE HOLDING PATTERN , %

China National Pharmaceutical Group Corporation (HongKong):	36.00
---	-------

PRICE PERFORMANCE , %

	1M	3M	1Y
CTCM	2.60	-11.47	-11.25
HSI	-2.33	-9.38	-34.68

PRICE VS. HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY14	FY15	FY16E	FY17E
Net Sales	2650	3709	6520	7522
Net Profit	413	633	914	1118
EPS, CNY	0.16	0.17	0.21	0.25
PER, x	19.55	18.52	15.44	12.63
BVPS, CNY	1.26	2.48	2.88	3.06
P/BV, x	2.54	1.28	1.11	1.04
ROE, %	13.9	8.7	7.4	8.5
Debt/Equity (%)	63.7	54.0	53.8	53.8

Source: Company reports, Phillip Securities Est.

Research Analyst

Fan Guohe

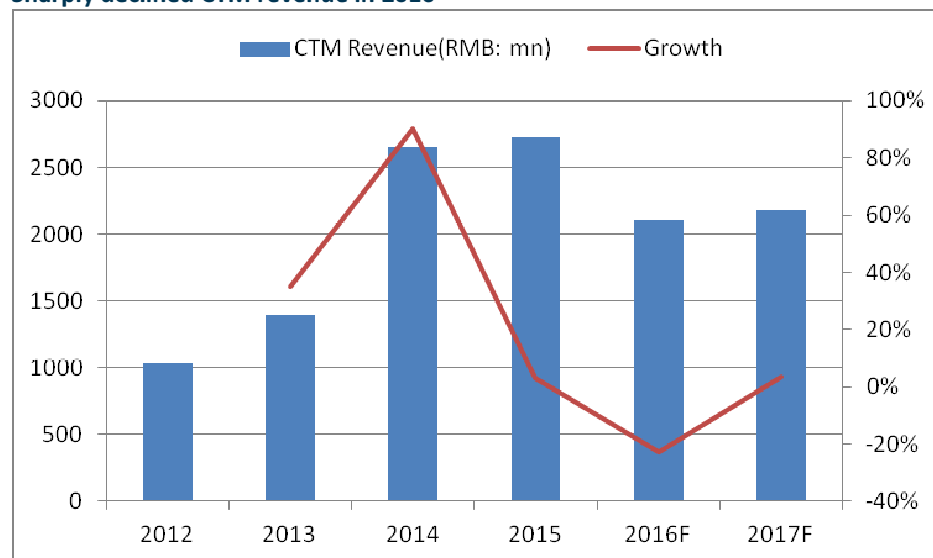
(+ 86 21 51699400-110)

fanguohe@phillip.com.cn

Destocking of Chinese Traditional Medicine Basically Ends

In H1, the revenue and net profit from the company's original Chinese traditional medicine business fell by 19.5% and 32.9% to RMB1.14 billion and RMB160 million, respectively, due to the introduction of "two invoices" policy and medical insurance cost control and reduction of inventories in channels, as well as the drop in tender price of the company's products by 3 to 4% on average, and the second bargain in some provinces. In H2, the deepening of destocking led to the decline in drug products over 20% YoY and the scale shrinkage triggered the sharp fall in profits.

Sharply declined CTM revenue in 2016



Source: Company reports, Phillip Securities (HK) Research

However, currently destocking pressure has been basically released, with distributors' channel inventory falling from 4 months turnover at the end of 2015 to around 2 months, and the inflection point has appeared. We expect, in 2017, the company's Chinese traditional medicines will develop steadily, or even resume single-digit growth.

Valuation Reaches Margin of Safety

The company has resumed dividend and will maintain a payout ratio of more than 30%, which is expected to enhance the market recognition. We adopt the Sum of the Parts Valuation (SOTP), and give the company's CCMG business and Chinese traditional medicine business 20X P/E ratio and 10X P/E ratio, respectively. The target price is HK\$5.08, with the "Buy" rating. (Closing price as at 23 Jan 2017)

Peer Comparison

Stock Code	Company	MV(HKD:mn)	PE-TTM	PE-2016F	PE-2017F	PB
2196.HK	Fosun Pharma	66,908	19.61	19.95	17.52	2.74
1093.HK	CSPC Pharma	53,565	26.92	25.60	20.79	5.98
3320.HK	CR Pharmaceutical	52,601	23.86	19.52	14.82	2.33
1177.HK	Sino Biopharmaceutical	46,250	23.76	22.97	21.14	5.28
0874.HK	Baiyuanshan	42,806	19.26	19.62	15.50	1.55
0867.HK	China Medical System	31,787	23.53	21.11	17.44	4.73
1513.HK	Livzon Pharma	24,849	21.64	22.73	18.79	2.55
Average			22.65	21.64	18.00	3.59
0570.HK	CTCM	15,732	15.32	13.67	11.51	1.17

Source: Wind, Phillip Securities (HK) Research

Risks

Further price drop in products;
Competition intensifies more than expected.

Financials

FYE	2013	2014	2015	2016F	2017F
Valuation Ratios					
Price Earnings	32.84	19.55	18.52	15.44	12.63
Price to Book	2.93	2.54	1.28	1.11	1.04
Dividend Yield	0.0%	0.0%	0.0%	2.0%	2.5%
Per share data(RMB)					
EPS Adjusted	0.10	0.16	0.17	0.21	0.25
Book Value Per Share	1.09	1.26	2.48	2.88	3.06
Dividends Per Share	0.00	0.00	0.00	0.07	0.08
Growth & Margin					
Revenue growth	-	90.0%	40.0%	75.8%	15.4%
Gross Profit growth	-	99.0%	33.5%	68.2%	16.4%
Net Profit growth	-	108.1%	53.3%	44.4%	22.2%
Profitability Ratios					
Gross Margin	59.2%	62.0%	59.1%	56.6%	57.1%
Net Profit Margin	14.2%	15.6%	17.1%	14.0%	14.9%
Dividend Payout Ratio %	0.0%	0.0%	0.0%	31.5%	31.7%
Key Ratios					
Return on Assets	6.0%	7.9%	5.3%	4.8%	5.5%
Return on Equity	11.1%	13.9%	8.7%	7.4%	8.5%
Effective Tax Rate	16.1%	14.4%	15.4%	15.0%	15.0%
Liability ratio	44.0%	38.9%	35.1%	35.0%	35.0%
Income Statement(RMB: mn)					
Revenue	1,395	2,650	3,709	6,520	7,522
- Cost of Goods Sold	569	1,007	1,515	2,830	3,227
Gross Income	826	1,643	2,194	3,691	4,295
- Selling, General & Admin Exp	580	1,127	1,586	2,791	3,219
Operating Income	264	552	652	985	1,176
- Interest Expense	35	63	70	60	55
Pretax Income	238	489	769	1,210	1,466
- Income Tax Expense	38	70	118	181	220
Income Before XO Items	199	419	651	1,028	1,246
- Minority Interests	1	-2	18	114	128
Net Profit	198	413	633	914	1,118

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 23 Jan 2017)

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

GENERAL DISCLAIMER

This publication is prepared by Phillip Securities (Hong Kong) Ltd ("Phillip Securities"). By receiving or reading this publication, you agree to be bound by the terms and limitations set out below.

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

The information contained in this publication has been obtained from public sources which Phillip Securities has no reason to believe are unreliable and any analysis, forecasts, projections, expectations and opinions (collectively the "Research") contained in this publication are based on such information and are expressions of belief only. Phillip Securities has not verified this information and no representation or warranty, express or implied, is made that such information or Research is accurate, complete or verified or should be relied upon as such. Any such information or Research contained in this publication is subject to change, and Phillip Securities shall not have any responsibility to maintain the information or Research made available or to supply any corrections, updates or releases in connection therewith. In no event will Phillip Securities be liable for any special, indirect, incidental or consequential damages which may be incurred from the use of the information or Research made available, even if it has been advised of the possibility of such damages.

Any opinions, forecasts, assumptions, estimates, valuations and prices contained in this material are as of the date indicated and are subject to change at any time without prior notice.

This material is intended for general circulation only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. The products mentioned in this material may not be suitable for all investors and a person receiving or reading this material should seek advice from a financial adviser regarding the suitability of such products, taking into account the specific investment objectives, financial situation or particular needs of that person, before making a commitment to invest in any of such products.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any product described in this material is suitable or appropriate for the recipient. Recipients should be aware that many of the products which may be described in this publication involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Nothing in this report shall be construed to be an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in this research should take into account existing public information, including any registered prospectus in respect of such security.

Disclosure of Interest

Analyst Disclosure: Neither the analyst(s) preparing this report nor his associate has any financial interest in or serves as an officer of the listed corporation covered in this report.

Firm's Disclosure: Phillip Securities does not have any investment banking relationship with the listed corporation covered in this report nor any financial interest of 1% or more of the market capitalization in the listed corporation. In addition, no executive staff of Phillip Securities serves as an officer of the listed corporation.

Availability

The information, tools and material presented herein are not directed, intended for distribution to or use by, any person or entity in any jurisdiction or country where such distribution, publication, availability or use would be contrary to the applicable law or regulation or which would subject Phillip Securities to any registration or licensing or other requirement, or penalty for contravention of such requirements within such jurisdiction.

Information contained herein is based on sources that Phillip Securities (Hong Kong) Limited ("PSHK") believed to be accurate. PSHK does not bear responsibility for any loss occasioned by reliance placed upon the contents hereof. PSHK (or its affiliates or employees) may have positions in relevant investment products. For details of different product's risks, please visit the Risk Disclosures Statement on <http://www.phillip.com.hk>.

© 2017 Phillip Securities (Hong Kong) Limited

Contact Information (Regional Member Companies)

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

FRANCE

King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
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