

Shanghai Pharma (2607.HK)

To Benefit from the Matthew Effect Enhanced by Policy

Hong Kong | Pharmaceutical | Company report

24 February 2017

Investment Summary

Thanks to the nationwide implementation of the "two invoices" policy, Shanghai Pharma, an industry giant, will grow faster than industry average in distribution business with endogenous and external power. The pharmacy retail layout will also become a growth point. In addition, early preparation for the quality conformance assessment for generic drugs and the possibility of several varieties entering National Drug Reimbursement List (NDRL) in 2017 are expected to boost the growth of the pharmaceutical manufacturing business. And the SOE reform is expected to form a catalyst. We give an estimation of 16x EPS in 2017 with a target price of HKD24.5, and the rating is upgraded to "Buy". (Closing price as at 22 Feb 2017)

Buy (Upgrade)

CMP: HKD 19.80
(Closing price as at 22 Feb 2017)
TARGET: HKD 24.50 (+23.7%)

COMPANY DATA

O/S SHARES (MN) :	766
MARKET CAP (HKDMN) :	62,174
52 - WK HI/LO (HKD):	22.35/13.82

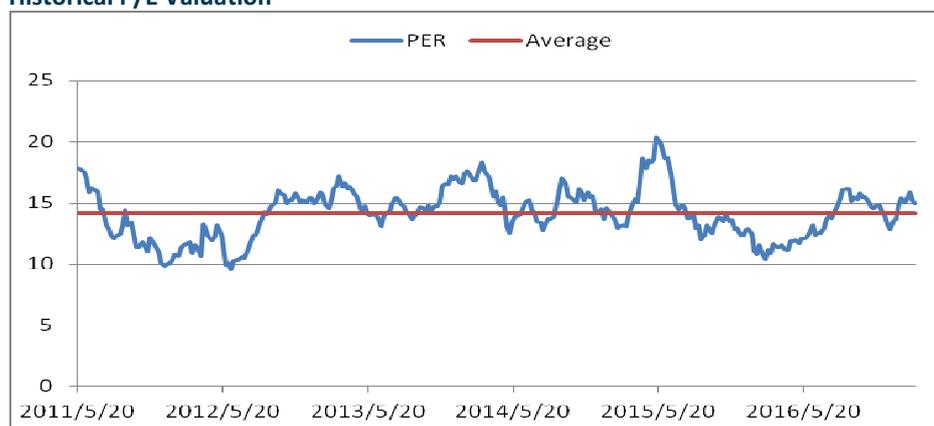
SHARE HOLDING PATTERN, %

Shanghai Pharma Group:	26.65
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PRICE PERFORMANCE, %

	1M	3M	1Y
Shanghai Pharma	-3.43	3.36	32.39
HSI	-8.14	-2.31	9.28

Historical P/E Valuation



Source: Bloomberg, Phillip Securities (HK) Research

PRICE VS. HSI



Source: Phillip Securities (HK) Research

Peer Comparison

Stock Code	Company	MV (HK\$: mn)	PE-TTM	PE-2016F	PE-2017F	PB
2196.HK	Fosun Pharma	69,396	20.82	21.41	18.95	2.91
1093.HK	CSPC	57,499	28.89	27.31	22.01	6.42
3320.HK	CR Pharmaceutical	54,298	24.63	20.15	15.30	2.40
1099.HK	Sinopharm	100,446	19.13	19.17	17.00	2.66
	Average		23.37	22.01	18.32	3.60
2607.HK	Shanghai Pharma	62,174	14.53	14.69	13.05	1.45

Source: Wind, Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY14	FY15	FY16E	FY17E
Net Sales	92399	105517	123382	139283
Net Profit	2591	2877	3255	3642
EPS, CNY	0.96	1.07	1.21	1.35
PER, x	18.2	16.4	14.5	12.9
BVPS, CNY	10.35	11.13	12.01	12.99
P/BV, x	1.69	1.57	1.46	1.35
ROE, %	9.6	10.0	9.3	9.7
Debt/Equity (%)	106.9	119.9	122.2	122.2

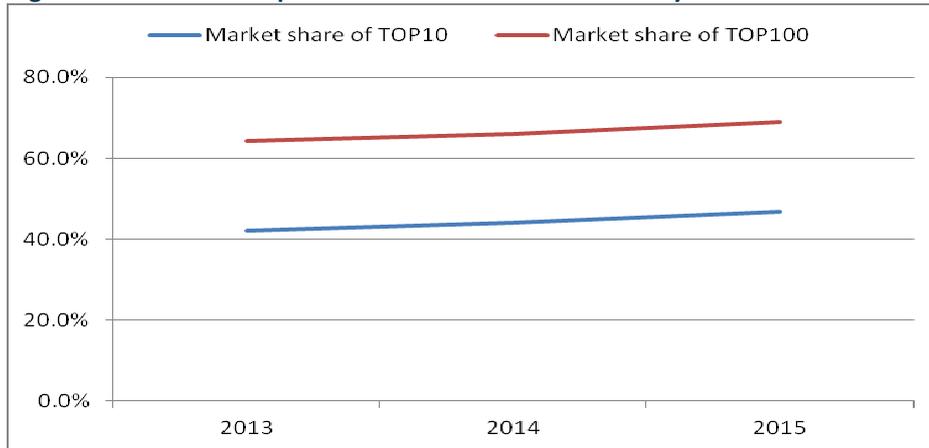
Source: Company reports, Phillip Securities Est.

The Matthew Effect Enhanced by Nationwide Implementation of "Two Invoices" Policy

In January 2017, National Health and Family Planning Commission officially issued the "national" two invoices policy scheme and anticipated its nationwide implementation in 2018. So far only six provinces including Anhui and Sichuan have officially carried out the scheme. If the nationwide implementation is enabled, the concentration of distribution industry will experience a rapid increase. The three major drug-distribution enterprises take up a mere 38% market share currently, and anticipate a rise to more than 50% within three years.

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Higher concentration of pharmaceutical distribution industry



Source: CAPC, Phillip Securities (HK) Research

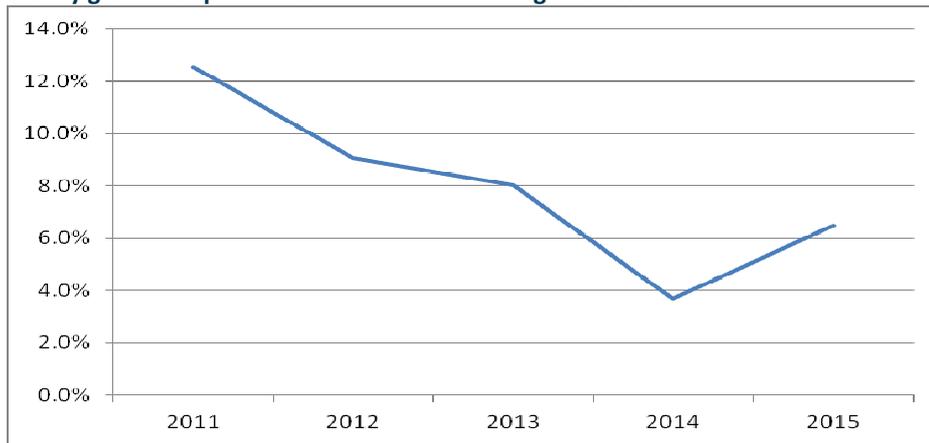
Shanghai Pharma, the third largest domestic drug-distribution dealer, now has distribution network scattered across 21 provinces. It is implementing M&A strategy for a platform in each province and for expansion to 28 provinces, of which the south-western and north-eastern regions will be the focus. In Q3 2016, the company expanded business to Yunnan and Heilongjiang. We believe the "two invoices" policy and the reform of replacing the business tax with VAT will accelerate the company's M&A, and the M&A will contribute a 3 to 4 ppts increment annually for the company. In the meantime, the profitability of distribution business is also estimated to remain stable by means of adjustment in the structure of distribution products and scale intensity.

Moreover, the drug retail distribution featuring DTP takes the lead in China and anticipates optimistic prospects. Prescription drug outflow will become the biggest growth point in retail industry, and the company's various business types, professional drug stores, drug stores jointly run with hospitals and public drug stores will help handle the business. Notably, the company boasts the country's largest DTP business with a sales volume of RMB2.5 billion in 2015 (around 30% of market share), and connections with the HIS system of more than 100 hospitals, both of which constitute its edge.

Pharmaceutical Manufacturing Business May Speed Up

The company's pharmaceutical manufacturing business has been stable, but the new industry policy is expected to speed it up. First, according to the conformance assessment policy for generic drugs, the first products that pass the assessment will gain significant edge in winning contract and market. Shanghai Pharma has prepared for the policy as early as 2013, which highlights great political sensibility and forward-looking ability of the management. So far, related work of sixty or seventy varieties has started, and the overall test is projected to be completed before the end of 2018. We believe some products are estimated to complete the assessment and capture market opportunities, thereby winning greater market share.

Steady growth of pharmaceutical manufacturing business



Source: Company reports, Phillip Securities (HK) Research

Second, key varieties such as Live Combined Bifidobacterium Lactobacillus and Enterococcus, Polysaccharide-Iron Complex and Reinforcing Kidney Tablet have been listed on the revised drug reimbursement list of eight provinces, and are expected to enter the revised NDRL of 2017 so as to bring new opportunities to the company's growth.

Risks

The national expansion of distribution business below expectations;
 The SOE reform below expectations;
 Sharp rise in R&D expenses.

Financials

FYE	2013	2014	2015	2016F	2017F
Valuation Ratios					
Price Earnings	21.01	18.18	16.38	14.48	12.94
Price to Book	1.82	1.69	1.57	1.46	1.35
Dividend Yield	1.5%	1.7%	1.9%	2.2%	2.5%
Per share data(RMB)					
EPS Adjusted	0.83	0.96	1.07	1.21	1.35
Book Value Per Share	9.65	10.35	11.13	12.01	12.99
Dividends Per Share	0.26	0.29	0.33	0.38	0.43
Growth & Margin					
Revenue growth	-	18.4%	14.2%	16.9%	12.9%
Gross Profit growth	-	11.3%	12.2%	14.4%	11.1%
Net Profit growth	-	15.5%	11.0%	13.1%	11.9%
Profitability Ratios					
Gross Margin	12.9%	12.1%	11.9%	11.6%	11.4%
Net Profit Margin	2.9%	2.8%	2.7%	2.6%	2.6%
Dividend Payout Ratio %	31.2%	30.1%	30.8%	31.4%	31.7%
Key Ratios					
Return on Assets	4.1%	4.3%	4.1%	4.2%	4.4%
Return on Equity	8.8%	9.6%	10.0%	9.3%	9.7%
Effective Tax Rate	19.5%	21.3%	19.4%	19.3%	19.2%
Liability ratio	48.5%	51.7%	54.5%	55.0%	55.0%
Income Statement(RMB: mn)					
Revenue	78,017	92,399	105,517	123,382	139,283
- Cost of Goods Sold	67,980	81,223	92,979	109,045	123,349
Gross Income	10,037	11,176	12,538	14,337	15,934
- Selling, General & Admin Exp	7,265	8,112	8,906	10,216	11,324
Operating Income	2,772	3,063	3,631	4,121	4,610
- Interest Expense	414	585	613	645	685
- Net Non-Operating Losses (G)	-860	-1,332	-1,179	-1,250	-1,350
Pretax Income	3,226	3,800	4,172	4,714	5,269
- Income Tax Expense	628	808	807	907	1,009
Income Before XO Items	2,597	2,992	3,364	3,806	4,260
- Minority Interests	384	401	487	552	618
Net Profit	2,243	2,591	2,877	3,255	3,642

Source: Company, Phillip Securities (HK) Research Estimates
(Financial figures as at 22 Feb 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

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