

Huahai Pharmaceutical (600521.CH)

Optimistic Export Prospect of Preparations

Shanghai | Pharmaceutical | Company report

16 June 2017

Investment Summary

Huahai Pharmaceutical is the leading export company of domestic preparations. Since 2016, although revenue growth has met expectations, the expansion of sales channels and others increased the costs so that the company's earnings performance was below expectations. However, due to the obvious strength of the company's preparations in export, the stepping up efforts in overseas mergers and acquisitions, and a large reserve of the ANDA variety, the future prospects of the export of the preparation is still optimistic, with a tendency of faster growth in the contribution. At the same time, by virtue of "Deemed as passing the consistency evaluation" and other policy advantages, the products launched by the company in Europe and America are expected to switch to the domestic market and have priority in assessment. After the approval, it will also improve the company performance. We give an estimation of 40x EPS in 2017 and a target price of RMB24.2, with the "Buy" rating initially. (Closing price as at 14 June 2017)

BUY (Initially)

CMP: CNY 19.40

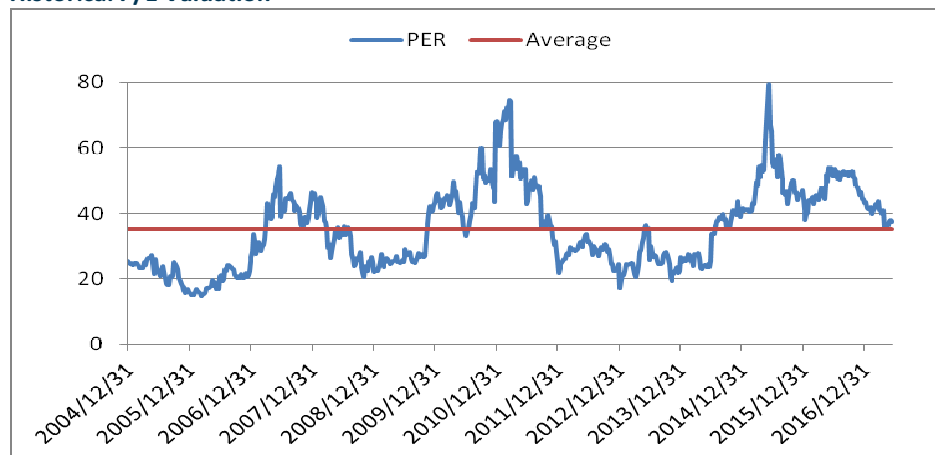
(Closing price as at 14 June 2017)

TARGET: CNY 24.20 (+24.7%)

COMPANY DATA

O/S SHARES (MN) :	1,043
MARKET CAP (CNYMN) :	20,226
52 - WK HI/LO (CNY):	27.49/ 18.09

Historical P/E Valuation



Source: Bloomberg, Phillip Securities (HK) Research

SHARE HOLDING PATTERN, %

Chen Baohua :	26.47
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PRICE PERFORMANCE, %

	1M	3M	1Y
Huahai Pharmaceutical	1.04	-12.97	-17.97
HS300	-0.49	-9.61	-28.12

PRICE VS. HS300



Source: Phillip Securities (HK) Research

Peer Comparison

Ticker	Company	MV (CNY:mn)	PE-TTM	PE-2017F	PE-2018F	PB
600267.SH	Hisun Pharmaceutical	10,592	-113.08	41.06	25.06	1.57
002262.SZ	Nhwa Pharmaceutical	14,209	43.75	36.33	28.65	6.52
002332.SZ	Xianju Pharmaceutical	7,385	49.62	35.58	26.05	3.29
600276.SH	Hengrui Medicine	143,157	52.7	45.54	37.59	10.84
			48.69	39.63	29.34	5.56
600521.SH	Huahai Pharmaceutical	20,226	38.96	32.07	26.19	4.60

Source: Wind, Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY15	FY16	FY17E	FY18E
Net Sales	3473	4093	4957	6049
Net Profit	442	501	622	762
EPS, CNY	0.43	0.49	0.60	0.74
PER, x	45.04	39.59	32.07	26.19
BVPS, CNY	3.51	4.22	4.65	5.19
P/BV, x	5.52	4.60	4.18	3.74
ROE, %	12.99	12.56	13.24	15.15
Debt/Equity (%)	48.25	46.93	49.25	49.25

Source: Company reports, Phillip Securities Est.

Performance Below Expectation

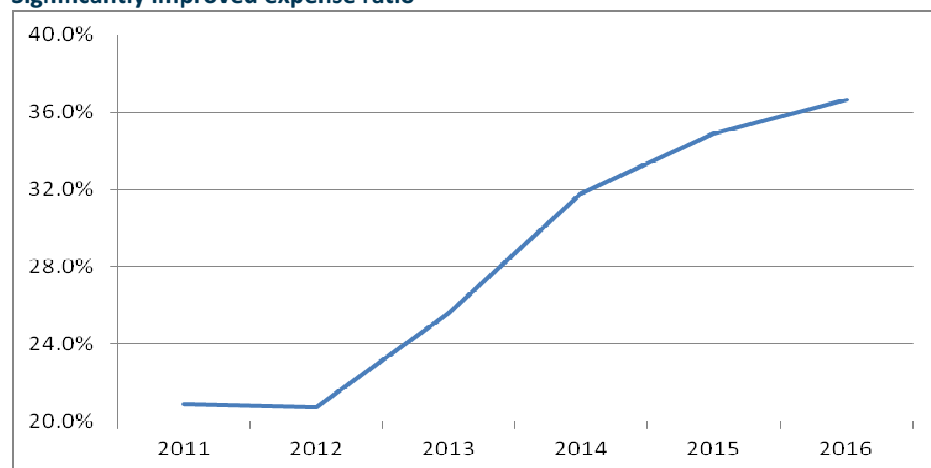
Huahai Pharmaceutical reported a revenue of RMB4.09 billion in 2016, up 16.9% yoy. Net profit excluding non-recurring items was RMB450 million, up 10% yoy, and the earnings per share was RMB0.49. The revenue was RMB1.13 billion in 1Q17, up 16.7%. Net profit excluding non-recurring items was RMB110 million, down 7.1%, and the earnings per share was RMB0.13. Overall, the company's revenue was in line with expectations, but the profit performance was below expectations.

Research Analyst
Fan Guohe
 (+ 86 21 51699400-110)
 fanguohe@phillip.com.cn

From the perspective of products, the company recorded RMB1.88 billion of API and intermediates, among which Pril API reported an income of RMB370 million, up 17.9% yoy in 2016, and the gross margin increased by 3.2 percentage points to 40.5%, while Sartan API achieved an income of RMB890 million, up 11.3% yoy, and the gross margin increased by 2.2 percentage points to 47.4%. The preparation business reported an income of RMB1.96 billion, up 22.4% yoy, but the gross margin decreased by 3.4 percentage points yoy to 56.7%, which was mainly caused by the decline in the price of foreign products, and the increase in the costs as a result of the launch of new production lines.

In addition, the dramatic increase in the company's expense ratio affected its performance. In 2016, Huahai US Inc., a subsidiary of the company, suffered a loss of RMB157 million, an increase of nearly RMB120 million comparing to that in 2015, as a result of the increase in R & D costs and litigation costs. Moreover, as the company made more efforts on the marketing and promotion of preparation products, the company's marketing expense ratio in 2016 also increased by 2.2 percentage points to 15%. In 1Q17, although the company's gross margin increased by 5.2 percentage points to 51%, the company's marketing expense ratio also increased by 8.3 percentage points to 18.9%.

Significantly improved expense ratio



Source: Company reports, Phillip Securities (HK) Research

Duloxetine was Approved in USA to Enrich Product Line

In May 2017, the Abbreviated New Drug Application (ANDA) filed by the company for duloxetine was approved. The product is administered as an enteric-coated capsule, and specifications are 20 mg, 30 mg and 60 mg. The product is mainly used for the treatment of depression and generalized anxiety. As we can see, the company's product line for mental illnesses will be more abundant, and preparations will also be updated to high-end.

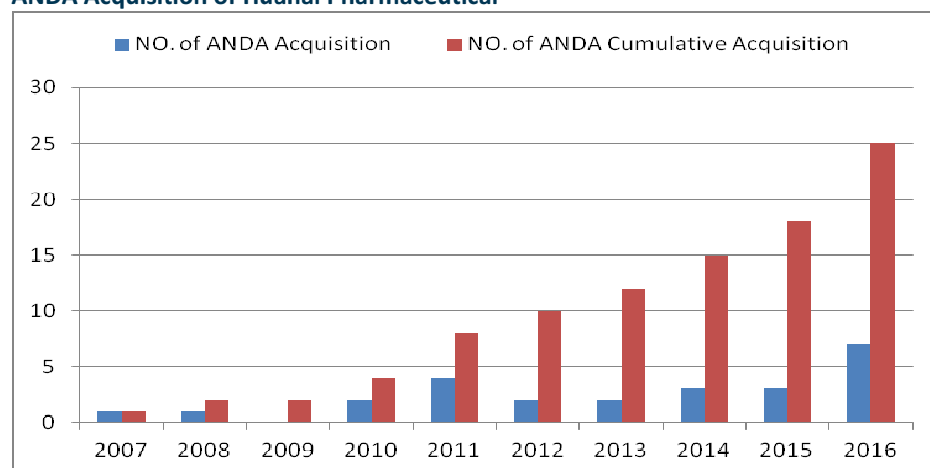
In general, the company's products were concentrated in high blood pressure previously, with only risperidone, paroxetine, lamotrigine etc. for mental illnesses. This time, Duloxetine has been approved to further enrich the product line for mental illnesses, and it is expected to form a product cluster to help brand and sales development in the future. Moreover, ANDA launched by Huahai previously were ordinary tablets or controlled release formulations, and the duloxetine capsule is a breakthrough in capsules this time. At the same time, its market scale is approx. USD2 billion in the U.S., but only about RMB350 million in China, so the market is vast. Moreover, the market structure of the drug is sound, but 70% of the market share was controlled by original research manufacturers. Generic drug manufacturers such as Zhongxi Pharmaceutical, Nhwa Pharmaceutical occupies a low market share, and the specification was only 20mg. Thanks to the approval of Huahai's ANDA, the specifications become more. Additionally, the products are in line with "Priority of Review and Approval", "Deemed as passing the Consistency Evaluation" and other standards. Consequently, it is expected to accelerate to step into the market and seize the market through high performance ratio and policy advantages, so as to achieve import substitution ultimately.

Export Prospect of Preparations is Optimistic

Huahai Pharmaceutical preparations export business is in a leading position in China, and the income from export business contributes to 2/3 of the company's revenue currently. The company has built a mature high-tech solid formulations generic drug research and development, declaration and registration platform. The sales platforms also cover more than 95% of the US sales network, so we believe that the leading position of its preparations export will be consolidated.

At present, the company has 29 products that have obtained an ANDA number, of which 22 products are selling in the United States. Furthermore, seven products such as Ramo triazine, ropini Nile, donepezil are in a leading position in the market. At the same time, the company has 12 products whose launch has been approved in 24 EU countries, which has proved its excellent preparation strength. It is also worth mentioning that approval of the company's ANDA has shown signs of speeding up. The variety under application reaches as high as 40. Patent challenging has also become normalized. We expect the contribution of preparation export to the company's revenue will continue to improve.

ANDA Acquisition of Huahai Pharmaceutical



Source: Company reports, Phillip Securities (HK) Research

In addition, the company is intensifying its efforts in application for approval of launch in the domestic market and consistency approval for its products sold in the US and European markets. Valsartan entered the priority review in December, 2016 thanks to its overseas sales. This product is the first oral drug to be submitted for overseas-to-domestic application, and the Center for Drug Evaluation is currently exploring applicable legislation. After its launch in the future, more products may follow suit and be launched in the domestic market.

Risks

The application of domestic and foreign preparations registration are below expectations;
Fluctuations in API prices exceed expectations.

Financials

Periodicity:	2014	2015	2016	2017F	2018F
Valuation Ratios					
Price Earnings	74.18	45.04	39.59	32.07	26.19
Price to Book	6.15	5.52	4.60	4.18	3.74
Dividend Yield	0.59%	0.79%	0.93%	1.03%	1.29%
Per share data(CNY)					
EPS Adjusted	0.26	0.43	0.49	0.60	0.74
Book Value Per Share	3.15	3.51	4.22	4.65	5.19
Dividends Per Share	0.12	0.15	0.18	0.20	0.25
Growth & Margin					
Revenue growth	13.09%	34.86%	17.86%	21.12%	22.02%
Gross profit growth	15.89%	48.06%	17.96%	27.66%	20.77%
Net profit growth	-28.41%	72.50%	13.19%	24.16%	23.21%
Gross Margin	44.47%	48.82%	48.86%	51.50%	52.00%
Operating Margin	12.70%	13.94%	12.20%	13.30%	13.50%
Net Profit Margin	9.96%	12.74%	12.24%	12.54%	12.59%
Dividend Payout Ratio %	44.12%	35.71%	36.73%	33.07%	33.75%
Key ratios					
Return on Assets	5.92%	8.83%	8.18%	8.94%	10.15%
Return on Equity	8.53%	12.99%	12.56%	13.24%	15.15%
Liability ratio	27.58%	32.55%	31.94%	33.00%	33.00%
Effective Tax Rate	17.96%	16.62%	19.43%	19.00%	19.00%
Income Statement(CNY: mn)					
Revenue	2,575	3,473	4,093	4,957	6,049
- Cost of Goods Sold	1,430	1,777	2,053	2,404	2,904
Gross Income	1,145	1,695	2,000	2,553	3,146
- Selling, General & Admin Expense	818	1,211	1,500	1,894	2,329
Operating Income	327	484	499	659	817
- Interest Expense	26	20	36	50	58
- Net Non-Operating Losses (Gains)	-19	-33	-53	-60	-70
Pretax Income	313	524	567	700	859
- Income Tax Expense	56	87	110	133	163
Income Before XO Items	257	437	457	567	696
Net Profit	257	442	501	622	762

Source: Company, Phillip Securities (HK) Research Estimates
(Financial figures as at 14 June 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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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