

Shanghai Pharma (2607.HK)

Continuous National Layout of Distribution Business

Hong Kong | Pharmaceutical | Company report

17 July 2017

Investment Summary

As an industry giant in pharmaceutical circulation, with the help of the "two invoices" system promoted nationwide and the reform of replacing the business tax with a value-added tax, Shanghai Pharma's distribution business will achieve a higher growth rate than the industry average through internal and external drives, and its medium-term profit growth rate is expected to reach 15-20%. At the same time, the key variety strategy and the early layout of generic drug consistency evaluation will facilitate the stable increase of the pharmaceutical industry. In addition, the SOE reform is expected to form a catalyst. We give the company the valuation of 17x EPS in 2017, and the target price at HKD26.4, with "Accumulate" rating. (Closing price as at 13 July 2017)

Accumulate (Downgrade)

CMP: HKD 22.15

(Closing price as at 13 July 2017)

TARGET: HKD 26.40 (+19%)

COMPANY DATA

O/S SHARES (MN) :	2,689
MARKET CAP (HKDMN) :	77,211
52 - WK HI/LO (HKD):	23.6/16.7

SHARE HOLDING PATTERN, %

Shanghai Pharma Group:	26.65
------------------------	-------

Peer Comparison

Ticker	Company	MV (HK\$: mn)	PE-2017F	PE-2018F	PB
1093.HK	CSPC	72,043	26.84	21.61	7.13
2196.HK	Fosun Pharma	83,027	19.51	16.62	2.85
1099.HK	Sinopharm	97,263	16.81	14.55	2.60
3320.HK	CR Pharmaceutical	61,840	18.07	15.6	1.64
	Average		18.13	15.59	2.36
2607.HK	Shanghai Pharma	77,211	14.26	12.15	1.62

Source: Wind, Phillip Securities (HK) Research

PRICE PERFORMANCE, %

	1M	3M	1Y
Shanghai Pharma	-3.38	6.98	17.21
HSI	-4.12	-0.36	-4.93

PRICE VS. HSI



Source: Phillip Securities (HK) Research

Continuous Improvement in Profitability

In 1Q17, Shanghai Pharma recorded a revenue of RMB33.13 billion, an annual increase of 13.2%; net profits attributable to the parent company were RMB1 billion, an annual growth of 12.4%; net profits excluding non-recurring items were RMB940 million, an annual increase of 20.8%, which was mainly benefited from higher profit margin of pharmaceutical manufacturing and distribution business.

Specifically, the company's distribution revenue grows only 12.9% for the reason that Shanghai, Shandong and other places had a high base in 1Q16 because of increased contribution of innovation business. However, the distribution business' gross profit margin increased by 0.16% to 6.15%, and the operating profit margin increased by 0.02% to 2.64%. Meanwhile, the pharmaceutical manufacturing sector income increased by 20% to RMB3.79 billion, and the internal growth rate was approximately 10% excluding the VITACO consolidated factors. The sharp growth in results was mainly benefited from the increasing price of low price drugs and scarce drugs. The operating profit margin rose by 1.33% to 14.14%. Key products income increased by 15.1% year-on-year, and the gross profit margin increased by 1.8% to 69.8%, which met the expectation.

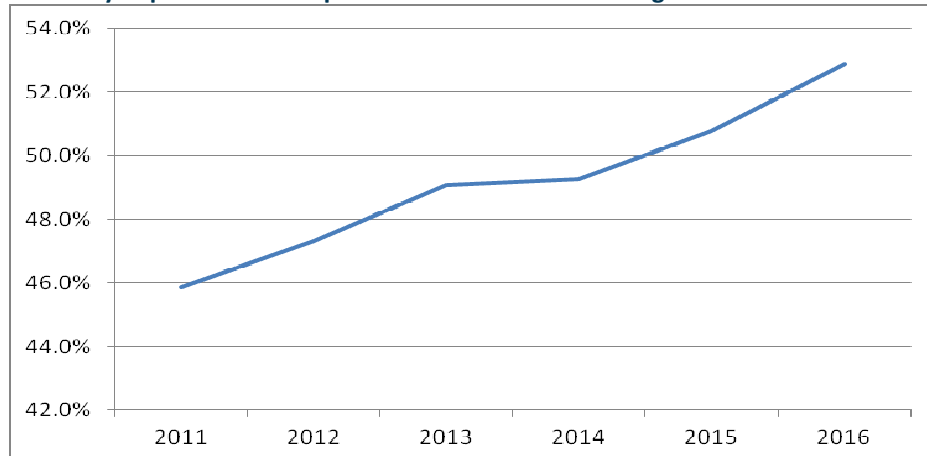
KEY FINANCIALS

CNY mn	FY15	FY16	FY17E	FY18E
Net Sales	105517	120765	139312	159924
Net Profit	2877	3062	3663	4299
EPS, CNY	1.07	1.19	1.36	1.60
PER, x	18.16	16.33	14.26	12.15
BVPS, CNY	11.13	11.76	12.76	13.95
P/BV, x	1.75	1.65	1.52	1.39
ROE, %	10.0	8.7	9.6	10.5
Debt/Equity (%)	119.9	124.6	129.9	132.6

Source: Company reports, Phillip Securities Est.

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

Gradually improved GPM of pharmaceutical manufacturing business

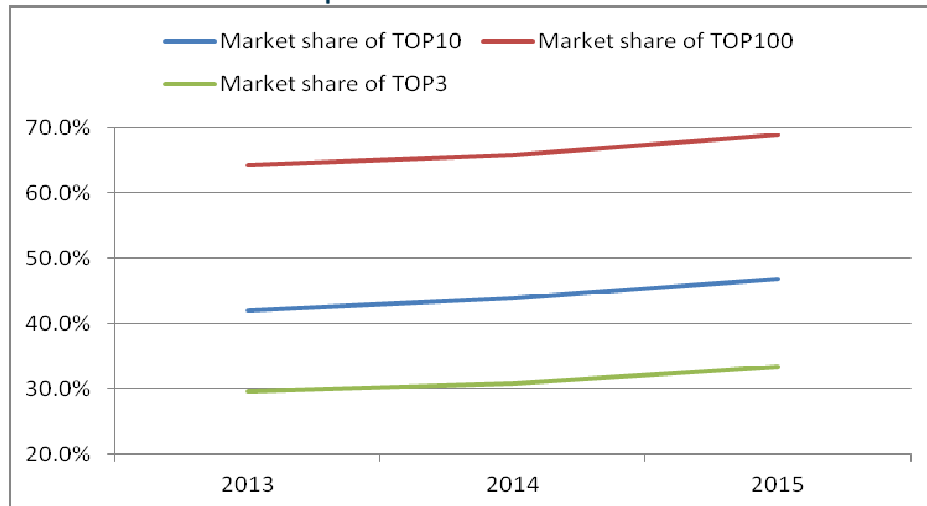


Source: Company reports, Phillip Securities (HK) Research

Continuous National Layout of Distribution Business

According to the NHFPC's planning program, the "two invoices" system will be carried out all over the country in 2018. At present, only six provinces including Anhui and Sichuan have implemented the "two-invoices" system, and it is expected that the concentration of distribution industry will be rapidly upgraded. The three major drug-distribution enterprises take up approximately 35% market share currently, and anticipate a rise to more than 50% within three years. As the third largest pharmaceutical distributor in China, Shanghai Pharma is expected to benefit from this trend and will become stronger.

Market share breakdown of pharmaceutical commerce business in China



Source: CAPC, Phillip Securities (HK) Research

The existing distribution network of Shanghai Pharma covers 21 provinces and is expected to expand to 28 provinces (except Qinghai, Tibet and Xinjiang). So far, the company has been implementing the M&A strategy, in which the south-west and north-east regions are the first round of key mergers and acquisitions. In 2H16, the company expanded business to Yunnan and Heilongjiang. In 1Q17, it also continued to acquire Xuzhou Pharma, Xuzhou Huaihai Pharma, both of whose income scales are approximately RMB3 billion, increase its equity ratio in Guangzhou Zhongshan Medical Pharmaceutical to 82.6%, and keep optimizing the layout

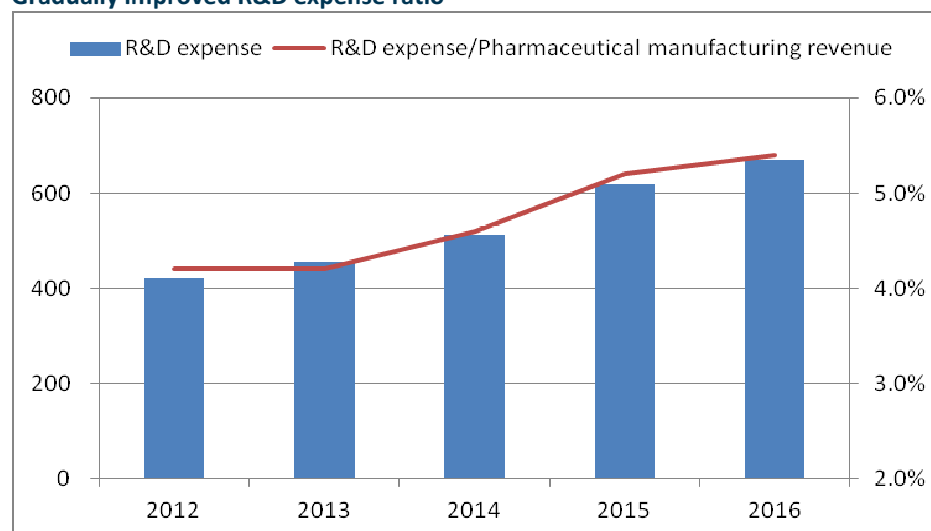
in Jiangsu and Guangdong. We expect that the company's distribution business will hopefully achieve the growth in revenue and gross margin and promote the performance increase by 15-20% for the commercial sector with the help of "two invoices" system and the reform of replacing the business tax with a VAT.

Pharmaceutical Manufacturing Business May Steadily Rise

The company's pharmaceutical manufacturing business has been developing stably, and the average growth rate was approximately 7% over the past five years. But the growth is expected to increase this year. First of all, the company will adhere to the key variety strategy, whose production and marketing focus on higher profitability, greater market demands and greater potentials with more entry barriers. Now its products with sales over 100 million in 60 key varieties are up to 26.

Second, the consistency evaluation of company is expected to pull ahead. Shanghai Pharma has prepared for the policy as early as 2013. So far, related work of sixty or seventy varieties has been started. At the end of 2016, the company signed the strategic cooperation agreement with 10 Tertiary A hospitals such as Shanghai Huashan Hospital and Ruijin Hospital, and determined the cooperation intention of 32 varieties of BE (bioequivalence), so that it fully ensured the clinical base. We expect that the company's generic drug consistency evaluation will hopefully complete the overall testing at the end of 2018, and some products are expected to take the lead in completing the assessment, thereby winning greater market shares.

Gradually improved R&D expense ratio



Source: Company reports, Phillip Securities (HK) Research

Risks

The national expansion of distribution business is below expectations;
 The SOE reform is below expectations;
 R&D expenses increases sharply.

Financials

FYE	2014	2015	2016	2017F	2018F
Valuation Ratios					
Price Earnings	20.16	18.16	16.33	14.26	12.15
Price to Book	1.88	1.75	1.65	1.52	1.39
Dividend Yield	1.5%	1.7%	1.8%	2.1%	2.5%
Per share data(RMB)					
EPS Adjusted	0.96	1.07	1.19	1.36	1.60
Book Value Per Share	10.35	11.13	11.76	12.76	13.95
Dividends Per Share	0.29	0.33	0.36	0.41	0.48
Growth & Margin					
Revenue growth	18.4%	14.2%	14.5%	15.4%	14.8%
Gross Profit growth	11.3%	12.2%	10.8%	16.3%	16.1%
Net Profit growth	15.5%	11.0%	6.4%	19.6%	17.4%
Profitability Ratios					
Gross Margin	12.1%	11.9%	11.5%	11.6%	11.7%
Net Profit Margin	2.8%	2.7%	2.5%	2.6%	2.7%
Dividend Payout Ratio %	30.1%	30.8%	31.0%	30.1%	30.0%
Key Ratios					
Return on Assets	4.3%	4.1%	3.9%	4.2%	4.5%
Return on Equity	9.6%	10.0%	8.7%	9.6%	10.5%
Effective Tax Rate	21.3%	19.4%	17.4%	17.8%	17.8%
Liability ratio	51.7%	54.5%	55.5%	56.5%	57.0%
Income Statement(RMB: mn)					
Revenue	92,399	105,517	120,765	139,312	159,924
- Cost of Goods Sold	81,223	92,979	106,868	123,152	141,165
Gross Income	11,176	12,538	13,897	16,160	18,759
- Selling, General & Admin Exp	8,112	8,906	10,112	11,591	13,242
Operating Income	3,063	3,631	3,785	4,569	5,517
- Interest Expense	585	613	473	520	575
- Net Non-Operating Losses (G)	-1,332	-1,179	-1,353	-1,400	-1,450
Pretax Income	3,800	4,172	4,639	5,434	6,377
- Income Tax Expense	808	807	809	967	1,135
Income Before XO Items	2,992	3,364	3,830	4,467	5,242
- Minority Interests	401	487	633	804	944
Net Profit	2,591	2,877	3,062	3,663	4,299

Source: Company, Phillip Securities (HK) Research Estimates
(Financial figures as at 13 July 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