

Kangmei Pharma (600518.SH)

Robust 17Q3 Results with Consolidating Leading Position in TCM Decoction Pieces Market

Mainland China | Pharmaceutical | Company report

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Investment Summary

- Robust results in third quarter with improving profit margin;
- Share based incentive plan demonstrates strong management confidence;
- Strategic cooperation relation with BGI underpins future development;
- Smart pharmacy and acquisition of Guangdong Hengyuan further consolidate the leading position in TCM decoction pieces market.

Business Overview

Strong results in 17Q3. As up to the end of September, Kangmei Pharma recorded revenue/net profit of RMB19.5bn/3.15bn (+18.59%/+21.58% YoY), and net operating cash flow rose by 130.65% reporting RMB1.5bn due to sales hike. Gross profit margin increased by 1.4ppt compared with that in 16Q3 and net profit margin increased by 0.71ppt. We attribute expanding profit margin to improving weights of three segments which have higher GPM (namely TCM decoction, drug trade and medical instruments). We expect that GPM continues to improve with controlling segments with lower profit margin and accelerating the development of businesses including TCM decoction.

Figure: Results in 3Q16 & 3Q17

RMB mn	3Q16	3Q17	Change
Revenue	16,456.06	19,514.53	+18.59%
Gross Profit	4,775.65	5,936.94	+24.32%
<i>GPM</i>	29.02%	30.42%	+1.4ppt
Operating Income	3,582.49	4,430.99	+23.68%
<i>OPM</i>	21.77%	22.71%	+0.94ppt
Net Profit	2,591.74	3,150.98	+21.58%
<i>NPM</i>	15.75%	16.15%	+0.71ppt

Figure: Revenue breakdown by segments and GPM

RMB mn	2016.6			2017.6		
	Turnover	Weight %	GPM %	Turnover	Weight %	GPM %
TCM decoction pieces	1,986	17.8	35.3	2,697	20.4	32.87
TCM trade	3,980	35.6	24.49	3,806	28.78	24.67
Self-made drug	112	1.0	21.43	75	0.57	24.17
Medicine trade	3,536	31.6	28.54	4,453	33.68	29.64
Medical instruments	358	3.2	20.54	802	6.06	30.65
Healthcare product	500	4.47	44.55	576	4.35	44.17
Food	296	2.64	1.38	331	2.5	7.09
Property & others	413	3.7	45.33	483	3.65	45.9
Total	11,181	100	29.02	13,222	100	30.42

Source: Company, Phillip Securities

Accumulate

CMP: RMB 22.65

(Closing price as at 9 Nov 2017)

TARGET: RMB 25.20 (+11.26%)

COMPANY DATA

O/S SHARES (MN) :	4,946.74
MARKET CAP (RMBMN) :	112,043.74
52 - WK HI/LO (RMB):	23.28 / 16.95

SHARE HOLDING PATTERN , %

Kangmei Investment Holdings Ltd.	33.16
Minmetals Trust	4.69
CSF	4.54

PRICE PERFORMANCE , %

	1M	3M	1Y
Kangmei	12.12	6.32	28.53
SHA	1.08	4.13	9.03

RETURN VS. HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

RMB mn	FY15	FY16	FY17E	FY18E
Net Sales	18,067	21,642	25,803	30,162
Net Profit	2,757	3,340	4,082	4,749
EPS, RMB	0.62	0.67	0.83	0.96
PER, x	36.36	33.96	27.45	23.59
BVPS, RMB	3.59	5.29	6.46	7.14
P/BV, x	6.30	4.29	3.50	3.17
ROE, %	15.54	13.95	12.77	13.45

Source: Company reports, Phillip Securities Est.

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Restricted stock incentive plan. The company published restricted stock incentive plan on Oct 28, which set revenue growth targets at 15%/30%/45% in 17/18/19, based on the topline in 2016. The incentive plan involves 641 senior staff making up 4.66% of total staff and 28.43mn restricted shares, which account for 0.57% of total company shares, priced at RMB10.57. The incentive scheme is believed to stimulate staff's incentive to work more proactively, and we see strong confidence of the management to boost sales in following years.

Strategic cooperation agreement signed with BGI. The company announcement on Nov 1st declared that a strategic cooperation agreement was signed with BGI (300676.SZ) to co-establish research institution or firm in future. We expect that two companies are going to build cooperative relationship in nurturing talents, technology research and platform development. BGI, with a focus on research and applications in the healthcare, agriculture, conservation, and environmental fields, is a leading genomic organization and has established subsidiaries over the world. Leveraging on BGI's technical strength, Kangmei is expected to facilitate the development of TCM products, and accelerate the research of gene detection, standardization and clinical evaluation of traditional Chinese medicine, which will benefit long-run growth of the company.

Consolidation of leading position in TCM decoction pieces market. On Oct 28, the company announced the acquisition of Guangdong Hengyuan Pharma with a price no more than RMB140mn. Hengyuan was engaged in production and distribution of TCM decoction pieces with revenue/net profit of RMB203mn/9.14mn in 2016. Meanwhile, the smart pharmacy business continues to make progress. In the first half, Kangmei's smart pharmacies start into operation in Guangzhou, Shenzhen, Beijing, Chengdu and Shanghai, which involving disposing hospital prescription, offering ready-to-use decoction and delivering service. We see that the company further consolidates the leading position in TCM decoction pieces market and enhances exposure to end customers through smart pharmacies.

Hospital operation business. After the acquisition of Meihokou City Central Hospital, Kangmei acquired Kaiyuan City Central Hospital in 1H17. Meanwhile, the company operates Kangmei Hospital and another five hospitals in Jilin Province. The company can charge management fee and takes over the supply chain business at the same time. Given strong cash flow of hospitals and increasing residents' healthcare expenditure, we expect hospital operation business to become future growth momentum. Under two invoice system, outsourcing operation and supply chain can help hospitals to improve efficiency and better control purchasing cost. Kangmei has an integrated value chain covering whole industry, so we expect that it leverages on capital advantage and professional resource platform to further explore the hospital operation market.

Investment Thesis, Valuation & Risk

Our valuation model gives target price of RMB25.5, based on assumption that revenue growth rate will be 19%/17% in 17E/18E. Given the TCM decoction pieces are not affected by zero mark-up policy (remaining 25% markup), this business is expected to enjoy favorable policy and growing market demand. Meanwhile, we also see future divers coming from the improvement of business structure, attractive stock incentive plan and promising hospital business. We estimate the net profit to be RMB4.08bn/4.75bn in 17E/18E, representing forward PE 27.45x/23.59x in 17E/18E. (Closing price as at 9 Nov 2017)

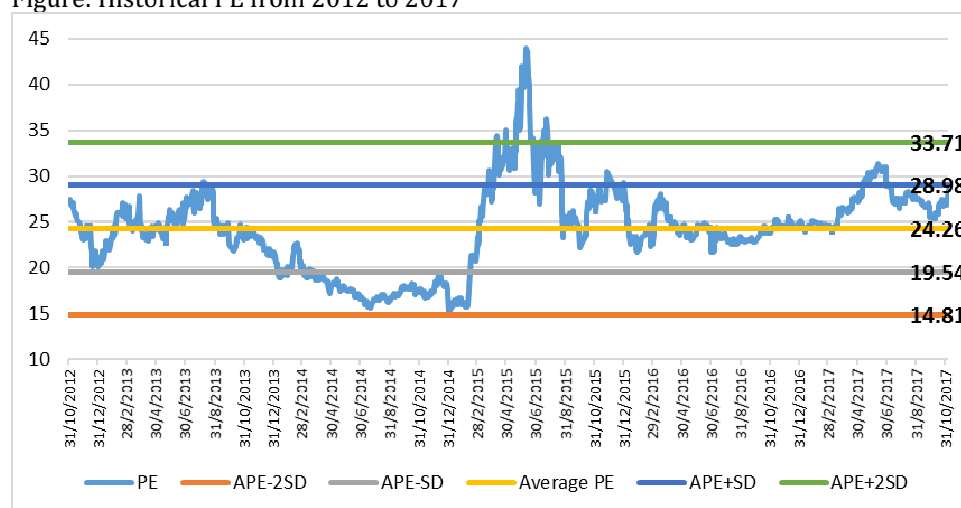
Figure: Key ratios of peers

Code	Company	Market Cap RMB mn	PE (TTM)	EPS RMB	GPM %	ROE %	ROA %
600518.SH	Kangmei Pharma	112,043.74	28.73	0.437	29.17	14.56	7.53
600332.SH	Baiyunshan	50,087.87	26.97	0.71	36.76	13.09	8.81
600557.SH	Kangyuan Pharma	9,493.32	24.87	0.31	74.69	11.89	7.82
600566.SH	Jumpcan Pharma	33,105.53	28.41	0.72	85.01	32.07	22.85
600535.SH	Tasly Pharma	40,766.35	31.08	0.70	32.17	18.81	8.36
600594.SH	Yibai Pharma	10,603.91	25.80	0.23	73.01	9.11	5.58
600422.SH	KPC Pharma	8,249.68	23.10	0.27	41.97	11.98	7.87
0570.HK	China-TCM	20,163.35	16.28	0.14	55.65	10.13	5.42

*EPS, GPM, ROE and ROA are from Wind, calculated using interim results in 1H17. (ROE & ROA are annualized.) Market cap is as at 9 Nov 2017.

Source: Wind, Phillip Securities

Figure: Historical PE from 2012 to 2017



Source: Bloomberg, Phillip Securities

Downside Risks	
	(1) Slow than expected expansion of smart pharmacy
	(2) Fast expansion reduces management efficiency
	(3) Slow than expected progress of cooperation with BGI

Financials

	2014	2015	2016	2017E	2018E
Valuation Ratios					
P/E	21.78	36.36	33.96	27.45	23.59
P/B	3.62	6.30	4.29	3.50	3.17
Per Share Data (RMB)					
EPS	1.04	0.62	0.67	0.83	0.96
Book Value Per Share	6.25	3.59	5.29	6.46	7.14
Dividend Per Share	0.32	0.19	0.21	0.25	0.29
Growth & Margin (%)					
Growth					
Revenue	19.39	13.28	19.79	19.23	16.89
Gross Profit	19.93	22.45	26.39	19.18	17.05
Operating Income	22.34	18.24	27.62	22.05	16.42
Net Profit	21.60	20.60	21.17	29.56	16.33
Margins					
Gross Profit Margin	26.21	28.34	29.90	29.89	29.93
Operating Profit Margin	18.98	19.45	20.30	22.13	22.05
Net Profit Margin	14.33	15.26	15.43	15.82	15.75
Key Ratios					
ROE (%)	15.91	15.54	13.95	12.77	13.45
ROA (%)	12.51	11.11	10.07	6.77	7.13
Income Statement (RMB mn)					
Revenue	15,949.2	18,066.8	21,642.3	25,803.2	30,161.5
- Cost of Goods Sold	(11,768.2)	(12,947.3)	(15,171.5)	(18,091.5)	(21,134.9)
Gross Income	4,181.0	5,119.6	6,470.8	7,711.7	9,026.6
- Operating Expenses	(1,079.6)	(1,452.6)	(1,791.2)	(2,000.1)	(2,304.4)
Operating Income	3,101.4	3,666.9	4,679.6	5,711.5	6,649.2
-Financing Cost	(434.9)	(449.0)	(721.9)	(903.1)	(995.3)
Net Non-operating Gain/Loss	40.8	24.7	29.9	39.8	-
- Income Tax Expenses	(421.3)	(486.2)	(650.8)	(775.7)	(904.6)
Net Profit to Firm	2,285.9	2,756.5	3,336.8	4,072.5	4,749.3
-Minority Interest	(0.01)	0.28	3.64	9.98	-
Net Profit	2,285.9	2,756.7	3,340.4	4,082.5	4,749.3

Source: Bloomberg, Phillip Securities (HK) Research Estimates

(Financial figures as at 9 Nov 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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