

## Shanghai Pharmaceutical - H

4Q better than expected; Stay N on difficult operating environment for a weak drug manufacturing business

SPH reported FY14 results slightly ahead of consensus estimates. We understand new management has taken various steps to streamline operations and improve efficiency, but we still see core net profit growth of 4.55% Y/Y as underwhelming. We remain cautious about SPH's near-term growth prospects given its large generic portfolio and concentration of distribution business in maturing market. We think the shares will take a breather after the run-up since news of establishing an online JV that management guided to break even in three years. We reiterate Neutral and keep our H-share Dec-15 PT at HK\$18.

- FY14 review.** Total revenue was Rmb92.4bn (+18.1%Y/Y), slightly ahead of JPMe of Rmb91.2bn. Drug manufacturing sales were Rmb11.1bn, +3.69% Y/Y, vs. +8.8% Y/Y in 2013. Sales of 64 key products rose 3.54% to Rmb6,678mn (GM of 63.64%, +0.31ppt Y/Y). Distribution sales rose 20.57% Y/Y, with organic growth of ~15%, 1-2ppts above the industry average.
- Margin trend and profitability.** While the manufacturing GM went up by 0.16ppt and the distribution GM by 0.02ppt, the overall GM went down by 0.74ppt to 12.09% due to the much higher growth of distribution. While the manufacturing OPM rose by 0.41ppt, the distribution OPM declined by 0.20ppt, causing the overall OPM to decline by 0.04ppt to 3.67%. Net profit rose 9.3% Y/Y to Rmb2,243mn. Excluding one-off gains and non-recurring costs, management estimated SPH's core earnings would have risen by 15% Y/Y.
- Other updates:** SPH will continue to implement its three-year development plan (deemed success so far). SPH has taken over management for many hospital pharmacies and sees this, DTP, and collaboration with large hospitals to jointly run pharmacies as key for future growth. The online drug business will become another key focus of development.

### Shanghai Pharmaceutical - H (Reuters: 2607.HK, Bloomberg: 2607 HK)

Rmb in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E
Revenue (Rmb mn)	68,078	78,223	91,182	104,858	112,976
Net Profit (Rmb mn)	2,053	2,243	2,608	2,876	2,873
EPS (Rmb)	0.76	0.83	0.97	1.07	1.07
DPS (Rmb)	0.24	0.26	0.30	0.33	0.33
Revenue growth (%)	24.0%	14.9%	16.6%	15.0%	7.7%
EPS growth (%)	(4.5%)	9.3%	16.3%	10.3%	(0.1%)
ROCE	8.1%	8.3%	9.0%	9.5%	9.1%
ROE	7.6%	7.9%	8.8%	9.2%	8.6%
P/E (x)	19.9	18.2	15.7	14.2	14.2
P/BV (x)	1.5	1.4	1.3	1.3	1.2
EV/EBITDA (x)	9.7	9.6	8.5	7.7	7.6
Dividend Yield	1.6%	1.7%	2.0%	2.2%	2.2%

Source: Company data, Bloomberg, J.P. Morgan estimates.

**Neutral**

2607.HK, 2607 HK

Price: HK\$18.98

Price Target: HK\$18.00

**China**

**Healthcare**

**Sean Wu** <sup>AC</sup>

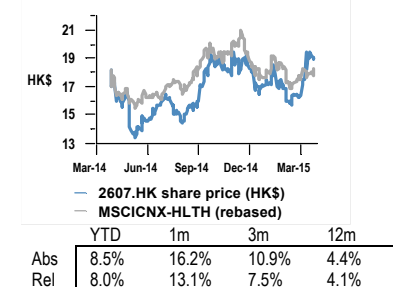
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### Price Performance



Company Data	
Shares O/S (mn)	2,689
Market Cap (Rmb mn)	40,888
Market Cap (\$ mn)	6,581
Price (HK\$)	18.98
Date Of Price	26 Mar 15
Free Float(%)	-
3M - Avg daily vol (mn)	3.12
3M - Avg daily val (HK\$ mn)	55.44
3M - Avg daily val (\$ mn)	7.1
MSCI CNX-HLTH	153.02
Exchange Rate	7.75
Fiscal Year End	Dec
Price Target (HK\$)	18.00
Price Target End Date	31-Dec-15

See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.

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<p><b>Key catalysts for the stock price:</b></p> <ul style="list-style-type: none"> <li>• Corporate restructuring and announcement of LT management incentives</li> <li>• Tender wins</li> <li>• Major M&amp;A deals</li> <li>• Quarterly results</li> </ul>	<p><b>Upside risks to our view:</b></p> <ul style="list-style-type: none"> <li>• Tender wins in major provinces of key products with lower-than-expected price cuts</li> <li>• Corporate restructuring yields unexpected incentives for management to perform and deliver.</li> <li>• Well received M&amp;A</li> </ul>	<p><b>Downside risks to our view:</b></p> <ul style="list-style-type: none"> <li>• A slower pace of acquisition of new distributors</li> <li>• A faster pick-up in sales volume of EDL drugs, resulting in lower margins for both distribution and manufacturing</li> <li>• Acquisitions becoming prohibitively expensive</li> </ul>
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Key financial metrics	FY13	FY14E	FY15E	FY16E
Revenues (LC)	78,223	91,182	104,858	112,976
Revenue growth (%)	14.9%	16.6%	15.0%	7.7%
EBITDA (LC)	4,082	4,773	5,366	5,483
EBITDA margin (%)	5.2%	5.2%	5.1%	4.9%
Tax rate (%)	19.4%	20.0%	20.5%	21.0%
Net profit (LC)	2,243	2,608	2,876	2,873
EPS (LC)	0.834	0.970	1.069	1.068
EPS growth (%)	9.3%	16.3%	10.3%	-0.1%
DPS (LC)	0.3	0.3	0.3	0.3
BVPS (LC)	10.8	11.3	12.0	12.8
Operating cash flow (LC mn)	315	1,625	1,906	1,877
Free cash flow (LC mn)	(595)	(296)	517	893
Interest cover (x)	18.7	21.3	20.9	20.0
Net margin (%)	2.9%	2.9%	2.7%	2.5%
Sales/assets (X)	1.4	1.5	1.5	1.5
Debt/equity (%)	18.9%	18.3%	17.3%	16.4%
Net debt/equity (%)	-20.6%	-15.0%	-11.6%	-9.6%
ROE (%)	7.9%	8.8%	9.2%	8.6%
Key model assumptions	FY13	FY14A	FY15E	FY16E
Mfr. GM			47.8%	47.3%
Distribution GM			6.2%	6.2%
Effective tax rate			20.5%	21.0%

Source: Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY15E	FY16E	FY15E	FY16E
1% chg in drug sales vole growth	2.30%	2.20%	1.90%	2.00%
1ppt increase selling exp ratio	5.0%	8.1%	4.5%	7.2%
1ppt change in mfr. GM	0.5%	0.4%	0.8%	1.0%
1ppt change in distribution margin	20.0%	18.0%	18.0%	16.2%

Source: J.P. Morgan estimates.

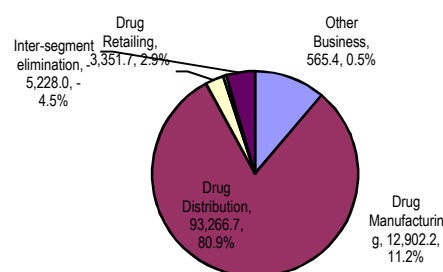
Comparative metrics	CMP LC	Mkt Cap \$Mn	P/E (x)		EV/EBITDA (x)		P/BV (x)		YTD Stock perf.
			FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	
SHANGHAI PHARM-H (N)	19.06	8,680	16.5	14.7	14.1	12.6		11.1	8.9
SHANGHAI PHARM -A (N)	21.96	8,681	23.6	20.7	13.8	12.1		11.2	33.1
FOSUN PHARMA-H (OW)	26.10	9,027	19.0	16.0	29.6	24.3		8.8	(6.5)
FOSUN PHARMA-A (OW)	24.97	9,027	21.5	17.9	29.3	23.7		9.9	18.3
BAIYUNSHAN PH-H (NC)	25.95	6,669	19.9	16.7	21.1	17.5		9.3	10.7
GUANGZHOU BAIY-A (NC)	34.40	6,669	29.5	24.1	23.2	20.1		9.2	
SINOPHARM-H (OW)	30.20	10,777	18.9	15.5	10.0	8.5		13.4	10.0
JOINTOWN PHARM-A (NC)	27.35	7,226	85.9	70.1	49.1	40.9		5.0	51.4
NANJING PHARMA-A (NC)	9.99	1,443	99.9	50.0	19.3	14.3	6.8	1.7	38.9
CHINA SHINEWAY (NC)	11.16	1,190	10.0	9.4	6.1	5.6		6.7	(5.3)

Source: Bloomberg, J.P. Morgan; Price as of 03/26/2015

#### Valuation and price target basis

Our Dec-15 PT of HK\$18.0 for the H share is based on DCF. We have conservatively applied a terminal growth rate of 4%, at the low end of the 3-6% growth rate we use for healthcare stocks.

#### Revenue mix (2015E)



Source: J.P. Morgan estimates.

#### JPMe vs. consensus, change in estimates

EPS (LC)	FY15E	FY16E
JPMe old	1.069	1.068
JPMe new	1.069	1.068
% chg	0.0%	0.0%
Consensus	0.924	1.041

Source: Bloomberg, J.P. Morgan.

**Cash flow and balance sheet analysis:** SPH generated net cash inflow from operating activities of Rmb1,335.7mn, compared to cash inflow of Rmb973mn in 2013. Net operating cash flow increased by Rmb452mn, with Rmb184mn of the increase coming from distribution segment.

**Table 1: SPH – FY13 financial results variance analysis**

Rmb mn	2013	2014A	2014E	Growth	Variance	Consensus	Variance
Drug Manufacturing	10,709	11,103	11,817	3.7%	-6.0%		
Drug Distribution	68,010	82,000	80,228	20.6%	2.2%		
Drug Retailing	2,992	3,376	3,197	12.8%	5.6%		
Other Business	412	36	486	-91.3%	-92.6%		
Turnover	78,223	92,399	91,182	18.1%	1.3%	90,996	1.5%
Gross profit	10,037	11,176	11,596	11.3%	-3.6%		
GPM	12.8%	12.1%	12.7%	-0.7 ppt	-0.6 ppt	12.1%	0.0 ppt
Operating profit	2,749	3,394	3,360	23.5%	1.0%	3,299	3%
Net profit	2,243	2,591	2,608	15.5%	-0.7%	2,495	4%
EPS	0.834	0.964	0.970	15.5%	-0.7%	0.924	4%

Source: Company data, J.P. Morgan and Bloomberg estimates.

**Table 2: Cash conversion cycle**

	2014	2013
Inventory days	54.3	55.9
Receivable days	75.0	70.5
Payable days	84.1	84.4
Cash collection cycle	45.2	41.9

Source: Company reports

As of December 31, 2014, SPH had cash and cash equivalents of Rmb13.3bn, down from Rmb14.6bn as of Dec. 31, 2011. SPH had debt of Rmb4.9bn for a gearing ratio of 15% on total equity of Rmb32.6bn.

### Outlook for manufacturing business

While management sees slower overall drug sales growth and lower drug prices from tenders, SPH remains confident in its manufacturing businesses as the company has actively invested in R&D. SPH spent Rmb512mn on R&D in 2014, accounting for 4.6% of pharmaceutical manufacturing sales, 30% on innovative drug development, 30% on first-to-market and others, and 40% on improving current product offerings. The company reported significant R&D progress in 2014.

SPH has invested heavily in a scaling-up manufacturing facility in Liaoning Benxi, which should allow the company to be very competitive for launching first-to-market generics and other competitive products.

For the future, management believes the strength of SPH lies in:

1. Continuing to strengthen the sales organization and improving sales and marketing capabilities as the company develops and perfects its three sales platforms for direct sales and indirect sales of Rx drugs and sales of OTC products.

2. Bolstering the market entries into various provinces through tenders and helping subsidiaries develop the best strategies for bidding and influencing expert opinions. The Group will play an increasingly important role in coordinating tender activities of products from subsidiaries.
3. Leveraging the company's vast generic portfolio and turning it from a weakness into a strength to actively pursue opportunities around the procurement of inexpensive drugs for which the retail ceiling prices were removed by the NDRC in 2014. Management wants to leverage its distribution strength in various areas to local governments to purchase a package of generics from the company at a certain discount – i.e. the rebirth of the Songjiang Model.
4. Improving internal the administration of manufacturing through precision management – the implementation of six sigma and other measures to improve manufacturing efficiency and improve the cost structure in order to lower manufacturing costs.
5. Actively pursuing M&A opportunities to complement organic growth.

## Investment Thesis, Valuation and Risks

### Shanghai Pharmaceutical - H *(Neutral; Price Target: HK\$18.00)*

#### Investment Thesis

SPH is a leading manufacturer of various products, including chemical drugs/APIs, TCMS, biological drugs and medical devices. It is also China's second-largest distributor of drugs and medical products, and holds the largest market share in its home base of Shanghai. SPH was established through a merger of the original Shanghai Pharma, mostly a drug distributor, with two A-share listed manufacturers, Shanghai Industrial Pharmaceutical Investment and Zhongxi Pharmaceutical in 2009. SPH seeks to extract synergies between its distribution and drug manufacturing businesses.

#### Valuation

Our Dec-15 price target of HK\$18.0 for the H-share is based on DCF. We have conservatively applied a terminal growth rate of 4%, at the low end of the 3-6% growth rate we use for health care stocks. Our PT implies a 2015E P/E of 13.3x.

Risk free rate:	4.20%
Market risk premium:	6.00%
Beta:	1.00
WACC	9.7%
Terminal "g":	4.00%

#### Risks to Rating and Price Target

Key risks to our rating and PT include a slower pace of acquisition of new distributors and a faster pick-up in sales volume arising from the implementation of the Essential Drug List, resulting in low points taken by SPH because of low profitability to manufacturers who would ask for a shared sacrifice of profits from distributors. In addition, we see risks from: 1) an unexpected industry-wide slowdown; 2) acquisitions becoming prohibitively expensive; and 3) further deterioration of the manufacturing businesses.

## Shanghai Pharmaceutical - H: Summary of Financials

Income Statement						Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	78,223	91,182	104,858	112,976	-	- EBIT	3,479	4,042	4,493	4,532	-
% change Y/Y	14.9%	16.6%	15.0%	7.7%	-	- Depr. & amortization	604	731	873	951	-
Gross Profit	10,037	11,596	13,059	13,838	-	- Change in working capital	(1,190)	(1,256)	(1,319)	(1,353)	-
% change Y/Y	10.3%	15.5%	12.6%	6.0%	-	- Taxes	0	0	0	0	-
EBITDA	4,082	4,773	5,366	5,483	-	- Cash flow from operations	315	1,625	1,906	1,877	-
% change Y/Y	5.7%	16.9%	12.4%	2.2%	-	- Capex	(1,085)	(2,100)	(1,593)	(1,200)	-
EBIT	3,479	4,042	4,493	4,532	-	- Net Interest	(218)	(224)	(257)	(274)	-
% change Y/Y	6.1%	16.2%	11.2%	0.9%	-	- Other	1,387	(100)	0	0	-
EBIT Margin	4.4%	4.4%	4.3%	4.0%	-	- Free cash flow	(595)	(296)	517	893	-
Net Interest	(218)	(224)	(257)	(274)	-	- Equity raised/(repaid)	0	0	0	0	-
Earnings before tax	3,261	3,818	4,236	4,258	-	- Debt raised/(repaid)	1,091	74	78	82	-
% change Y/Y	5.6%	17.1%	10.9%	0.5%	-	- Other	(529)	0	0	0	-
Tax	(634)	(764)	(868)	(894)	-	- Dividends paid	(874)	(1,016)	(1,120)	(1,119)	-
as % of EBT	19.4%	20.0%	20.5%	21.0%	-	- Beginning cash	13,301	12,645	10,993	10,122	-
Net income (reported)	2,243	2,608	2,876	2,873	-	- Ending cash	12,645	10,993	10,122	9,612	-
% change Y/Y	9.3%	16.3%	10.3%	(0.1%)	-	- DPS	0.26	0.30	0.33	0.33	-
Shares outstanding	2,689	2,689	2,689	2,689	-						
EPS (reported)	0.83	0.97	1.07	1.07	-						
% change Y/Y	9.3%	16.3%	10.3%	(0.1%)	-						
Balance sheet						Ratio Analysis					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	12,645	10,993	10,122	9,612	-	- Gross margin	12.8%	12.7%	12.5%	12.2%	-
Accounts receivable	18,540	21,611	24,852	26,777	-	- EBITDA margin	5.2%	5.2%	5.1%	4.9%	-
Inventories	10,997	13,257	14,634	15,416	-	- Operating margin	4.4%	4.4%	4.3%	4.0%	-
Others	333	2,092	3,719	6,096	-	- Net margin	2.9%	2.9%	2.7%	2.5%	-
Current assets	42,515	47,953	53,327	57,901	-	- Sales per share growth	14.9%	16.6%	15.0%	7.7%	-
						- Sales growth	14.9%	16.6%	15.0%	7.7%	-
LT investments	2,699	2,834	2,976	3,124	-	- Net profit growth	9.3%	16.3%	10.3%	(0.1%)	-
Net fixed assets	5,017	6,511	7,373	7,777	-	- EPS growth	9.3%	16.3%	10.3%	(0.1%)	-
Total Assets	59,359	65,874	72,110	77,081	-	- Interest coverage (x)	18.7	21.3	20.9	20.0	-
Liabilities						- Net debt to equity	(20.6%)	(15.0%)	(11.6%)	(9.6%)	-
Short-term loans	5,924	5,924	5,924	5,924	-	- Working Capital to Sales	0.2	0.2	0.2	0.2	-
Payables	19,572	22,814	26,236	28,267	-	- Sales/assets	1.4	1.5	1.5	1.5	-
Others	203	2,462	3,220	4,104	-	- Assets/equity	2.0	2.1	2.2	2.2	2.2
Total current liabilities	25,699	31,200	35,381	38,295	-	- ROE	7.9%	8.8%	9.2%	8.6%	-
Long-term debt	125	125	125	125	-	- ROCE	8.3%	9.0%	9.5%	9.1%	-
Other liabilities	1,486	1,561	1,639	1,721	-						
Total Liabilities	27,311	32,886	37,145	40,141	-						
Shareholders' equity	32,048	32,988	34,965	36,940	-						
BVPS	10.79	11.29	12.03	12.76	-						

Source: Company reports and J.P. Morgan estimates.

**JPM Q-Profile**

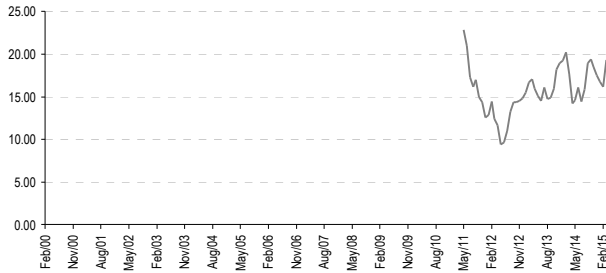
Shanghai Pharmaceuticals Holding Co. Ltd. Class H (CHINA / Health Care)  
 As Of: 23-Mar-2015



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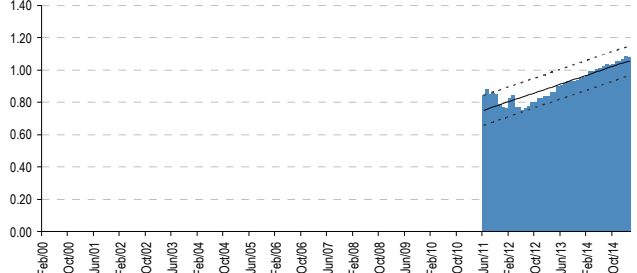
**Local Share Price**

Current: 19.30



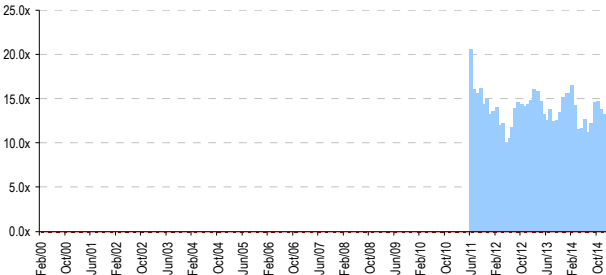
**12 Mth Forward EPS**

Current: 1.08



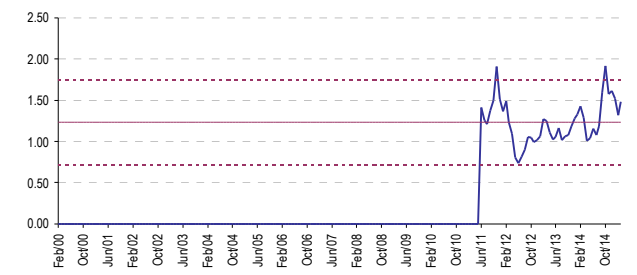
**PE (1Yr Forward)**

Current: 14.3x



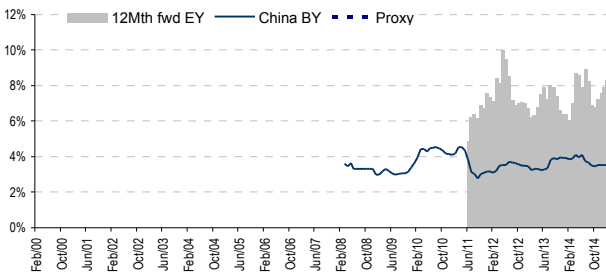
**P/E Relative to China Index**

Current: 1.48



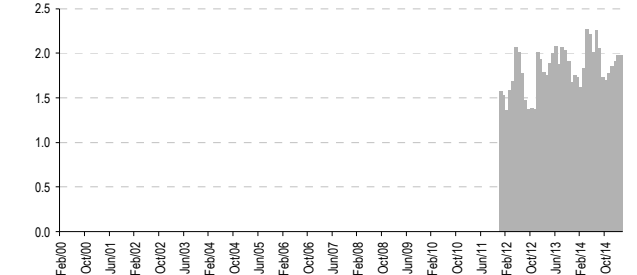
**Earnings Yield (& Local Bond Yield)**

Current: 7%



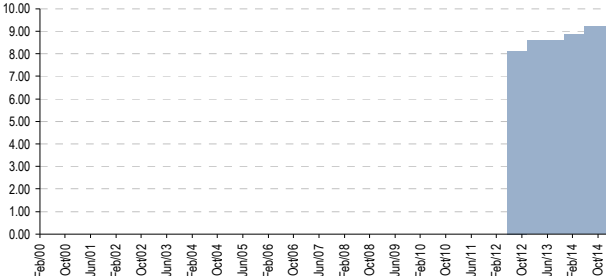
**Dividend Yield (Trailing)**

Current: 1.99



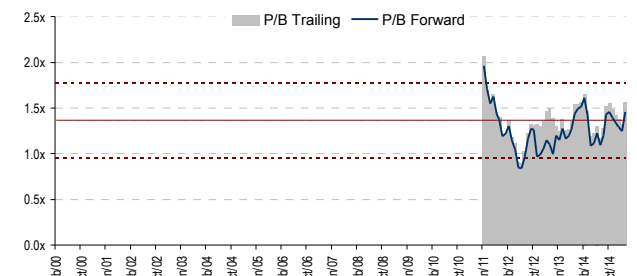
**ROE (Trailing)**

Current: 9.21



**Price/Book (Value)**

Current: 1.6x



**Summary**

<b>Shanghai Pharmaceuticals Holding Co. L</b>		<b>CHINA</b>		<b>TICKER 2607 HK</b>		<b>As Of: 23-Mar-15</b>					
<b>Health Care</b>						<b>Local Price:</b>		<b>19.30</b>			
						<b>EPS:</b>		<b>1.08</b>			
	<b>Latest</b>	<b>Min</b>	<b>Max</b>	<b>Median</b>	<b>Average</b>	<b>2 S.D.+</b>	<b>2 S.D. -</b>	<b>% to Min</b>	<b>% to Max</b>	<b>% to Med</b>	<b>% to Avg</b>
12mth Forward PE	<b>14.28x</b>										
P/BV (Trailing)	<b>1.56</b>	0.90	2.06	1.36	1.36	1.78	0.95	-43%	32%	-13%	-13%
Dividend Yield (Trailing)	<b>1.99x</b>	1.37	2.27	1.85	1.82	2.31	1.34	-31%	14%	-7%	-8%
ROE (Trailing)	<b>9.21</b>	8.12	9.21	8.60	8.74	9.51	7.97	-12%	0%	-7%	-5%

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

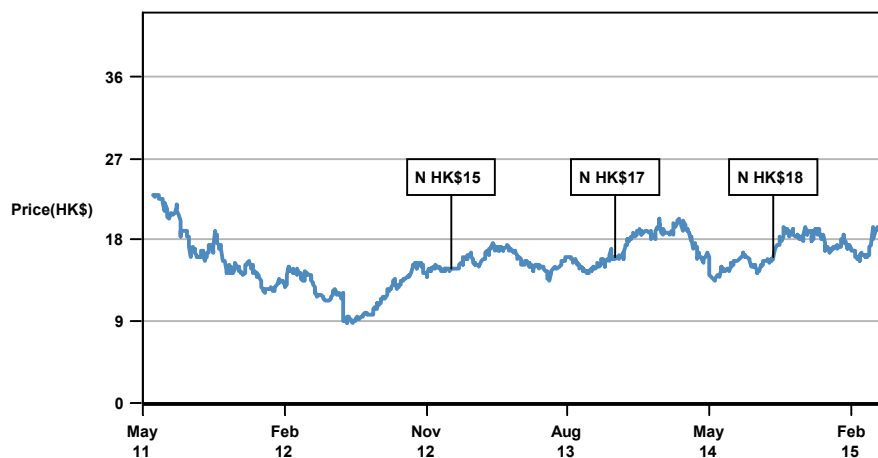
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Shanghai Pharmaceutical - H (2607.HK, 2607 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
18-Dec-12	N	14.70	15.00
29-Oct-13	N	16.04	17.00
31-Aug-14	N	16.02	18.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Dec 18, 2012.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

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