

China Traditional Chinese Medicine Co. [570.HK]

Roadshow takeaway — growth story remains intact; maintain BUY.

We recently held a roadshow for CTCM in Taiwan. CTCM management shared the latest business and industry updates with our clients, including the following highlights: 1) management expects CCMG to maintain strong growth; 2) it has a positive view of the CCMG market opening up; 3) it is determined to ramp up CTM decoction pieces in next few years; and 4) it is in active discussions with Pingan regarding collaboration possibilities on CTM decoction pieces and the healthcare complex. Overall, we believe the growth story remains intact. We raise our 2018/19E EPS forecast by 4.1%/3.9%, respectively, to reflect Company's stronger-than-expected determination to ramp up CTM decoction pieces. We lift our Target Price from HK\$7.0 (20x 2018E PER) to HK\$8.4 (20x 2019E PER) after rolling over the base year to 2019. Maintain BUY. The stock remains one of our top picks in the healthcare sector.

Investment Highlights

- CCMG growth momentum expected to continue:** After the roadshow, we maintain our positive view that CCMG will continue to deliver >20% CAGR in 2018-2020E because of 1) enhanced academic promotion, since the Company has set up a professional academic promotion team of 40-50 salesmen for CCMG; and 2) expected fast growth of sales through medicine dispensing machines. This sales channel currently accounts for >30% of total CCMG sales and can reduce hospitals' TCM decoction pieces management cost and greatly facilitate CCMG prescriptions. We expect the sales percentage from medicine dispensing machines to account for 50% of total CCMG sales in 2019.
- Positive on CCMG opening up:** Management holds a positive view of the CCMG market opening up, and we basically share the same view: 1) the market opening up (currently only Guangdong province is totally open, i.e. all hospitals can sell CCMG) will have limited impact on sales to Grade II and III hospital, but lower-tier hospitals, where CCMG previously could not be sold, present a huge incremental virgin market. Compared with CTM decoction pieces, which are difficult to manage regarding inventory, quality and prescriptions by lower-tier CTM physicians, CCMG is much more convenient, i.e. CCMG can replace the CTM decoction pieces market in lower-tier hospitals when they are allowed; 2) CTCM will be able to penetrate the lower-tier CCMG market in some provinces where regional protectionism exists by acquiring local CCMG manufacturers to obtain local government support and associated qualifications; and 3) CTCM has completed ~150 CCMG standards (total ~600 need to be done; ~300 prescriptions are mostly used), and the Company aims to maintain a high standard to keep out new entrants.
- Targeting CTM decoction pieces:** In the next few years, CTCM will focus on CTM decoction pieces, which reported RMB399m in revenue in 2017, accounting for 4.8% of total revenue. We expect fast growth of CTM decoction pieces and expect this segment to contribute >10% total revenue and reach >RMB1bn in sales in 2018 (CTM decoction pieces leader Kangmei (600518.CH): >RMB6bn in sales), leveraging 1) the improving utilization rate of Fengliaoxing and Shanghai Tongjitang; and 2) more M&A (recall the recent Hongda Decoction Pieces deal). In the short term, the fast growth of sales of CTM decoction pieces will drag down the overall Company GPM, as its current GPM is ~20% (Kangmei: ~34%), as production is not fully industrialized and commercialized, but there is huge room for improvement. In the medium term, developing CTM decoction pieces can benefit CTCM from a vertical integration perspective (it is upstream of CCMG), and CTM decoction pieces can create synergy with CCMG by sharing sales channels.

Y/E Dec 31	2016A	2017A	2018E	2019E	2020E
Turnover (RMBm)	6,533	8,338	10,994	13,719	15,987
Net profit (RMBm)	967	1,170	1,430	1,721	2,034
Core net profit (RMBm)	974	1,170	1,430	1,721	2,034
Core net margin (%)	14.9	14.0	13.0	12.5	12.7
Core EPS (RMB)	0.220	0.264	0.296	0.342	0.404
YoY (%)	51.3	20.2	12.0	15.6	18.2
PER (x)	26.7	22.2	19.8	17.2	14.5
PBR (x)	2.4	2.3	1.7	1.5	1.4
ROE (%)	8.6	9.7	9.9	9.9	10.6
EV/EBITDA (x)	16.6	12.9	10.4	8.1	6.3

Sources: Company, CGIS Research

China Healthcare Sector

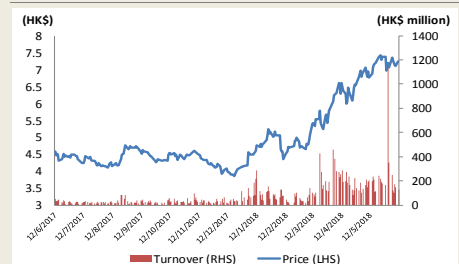
BUY

(Unchanged)

Close: HK\$7.24 (June 11, 2018)

Target Price: HK\$8.4 (+16%)

Price Performance



Market Cap	US4646.5m
Shares Outstanding	5035.8m
Auditor	KPMG
Free Float	55.94%
52W range	HK\$3.86-7.43
3M average daily T/O	US\$25.3m
Major Shareholding	China National Pharmaceutical Group Corporation (32.06%)

Sources: Company, Bloomberg

Harry He—Analyst

(852) 3698-6320

harryhe@chinastock.com.hk

Wong Chi Man, CFA—Head of Research

(852) 3698-6317

cmwong@chinastock.com.hk

Key financials

Balance Sheet

As at Dec 31 (RMBm)	2016A	2017A	2018E	2019E	2020E
Cash & cash equivalents	3,423	4,788	8,174	9,210	10,638
Inventories	1,894	3,552	2,060	2,513	2,729
Accounts receivable	2,716	3,024	4,762	5,788	6,868
Others	37	20	20	20	20
Current assets	8,070	11,384	15,017	17,532	20,255
Property, plant and equipment	2,356	2,740	3,237	3,668	4,033
Intangible assets	6,764	6,704	6,773	6,841	6,906
Goodwill	3,456	3,486	3,486	3,486	3,486
Others	390	571	571	572	573
Non-current assets	12,966	13,501	14,068	14,568	14,999
Total assets	21,037	24,885	29,085	32,099	35,254
Accounts payable	2,304	3,857	3,863	4,960	5,848
ST borrowings	1,001	639	600	600	600
Others	202	200	200	200	200
Current liabilities	3,507	4,695	4,663	5,760	6,647
Long-term debts	2,909	4,515	4,482	4,482	4,482
Others	1,866	1,860	1,860	1,860	1,860
Long-term liabilities	4,774	6,375	6,342	6,342	6,342
Total liabilities	8,281	11,070	11,005	12,102	12,990
Shareholders' equity	11,588	12,437	16,541	18,262	20,296
Minority interests	1,168	1,378	1,540	1,735	1,968
Total equity	12,756	13,815	18,081	19,997	22,264

Cash Flow

Year ended Dec 31 (RMBm)	2016A	2017A	2018E	2019E	2020E
Profit before tax	1,304	1,567	1,890	2,276	2,692
Depr & amortization	337	423	333	401	470
Change in working cap.	(349)	(413)	(240)	(381)	(409)
Income tax paid	(204)	(293)	(298)	(359)	(425)
Others	378	(49)	206	151	126
Operating cash flow	1,465	1,236	1,890	2,088	2,454
Capex	(760)	(711)	(900)	(900)	(900)
Cash for acquisition of subsidiaries	(742)	0	0	0	0
Change in other assets	(998)	1,104	0	0	0
Investment cash flow	(2,500)	393	(900)	(900)	(900)
Net change in debt	1,460	1,244	(72)	0	0
Proceeds from new shares	0	0	2,674	0	0
Others	(332)	(458)	(206)	(152)	(127)
Financing cash flow	1,128	786	2,396	(152)	(127)
Net change in cash	92	2,414	3,386	1,037	1,427
Cash at beginning of the year	2,102	2,373	4,788	8,174	9,210
Effect from foreign exchange	(47)	(31)	0	0	0
Cash at the end of the year	2,373	4,788	8,174	9,210	10,638

Profit and Loss

Year ended Dec 31 (RMBm)	2016A	2017A	2018E	2019E	2020E
CCMG	4,359	5,500	6,875	8,318	9,899
TCM finished drugs	2,174	2,381	2,619	2,750	2,888
TCM decoction pieces	-	399	1,400	2,500	3,000
TCM healthcare complex	-	58	100	150	200
Revenue	6,533	8,338	10,994	13,719	15,987
Cost of goods sold	(2,745)	(3,686)	(5,151)	(6,614)	(7,797)
Gross profit	3,788	4,652	5,843	7,105	8,189
Other gains / (losses)	82	120	45	55	64
Marketing expenses	(1,968)	(2,437)	(3,078)	(3,841)	(4,396)
Admin & other expenses	(517)	(552)	(715)	(892)	(1,039)
Operating profit	1,377	1,786	2,095	2,427	2,818
Net interest income / (expense)	(73)	(221)	(206)	(152)	(127)
Non-operating items	0	2	1	1	1
Pretax income	1,304	1,567	1,890	2,276	2,692
Income taxes	(217)	(256)	(298)	(359)	(425)
Non-controlling interests	(120)	(141)	(162)	(195)	(233)
Net profit	967	1,170	1,430	1,721	2,034
Core net profit	974	1,170	1,430	1,721	2,034
EBIT	1,264	1,647	1,934	2,232	2,586
EBITDA	1,714	2,210	2,428	2,829	3,288
EPS (RMB)	0.218	0.264	0.296	0.342	0.404
Core EPS (RMB)	0.220	0.264	0.296	0.342	0.404
DPS (HK\$)	0.100	0.106	0.089	0.103	0.121
Payout ratio	40.2%	40.0%	30.0%	30.0%	30.0%

Key Ratios

Year ended Dec 31	2016A	2017A	2018E	2019E	2020E
Growth (% YoY)					
Sales	76.1	27.6	31.9	24.8	16.5
Operating profit	80.9	29.8	17.3	15.8	16.1
EBITDA	86.0	29.0	9.9	16.5	16.2
Core net profit	81.8	20.2	22.2	20.4	18.2
Core EPS	51.3	20.2	12.0	15.6	18.2
Profitability (%)					
Gross margin	58.0	55.8	53.2	51.8	51.2
Operating margin	21.1	21.4	19.1	17.7	17.6
EBITDA margin	26.2	26.5	22.1	20.6	20.6
Core net profit margin	14.9	14.0	13.0	12.5	12.7
ROA	4.8	5.1	5.3	5.6	6.0
ROE	8.6	9.7	9.9	9.9	10.6
Balance sheet ratios					
Current ratio (X)	2.3	2.4	3.2	3.0	3.0
Quick ratio (X)	1.0	1.1	1.8	1.7	1.6
Cash ratio (X)	0.7	1.1	1.8	1.7	1.6
Trade & bill receivables days	69	63	69	74	76
Trade & bill payable days	53	34	69	48	47
Inventory turnover days	208	220	163	126	123
Total debt to equity ratio (%)	24.2	42.2	32.8	21.9	16.5
Net debt to equity ratio (%)	4.2	2.9	Net cash	Net cash	Net cash

Source: CGIS Research estimates

Figure 1: Peer valuation

Company	Ticker	Price HK\$	Mkt cap HK\$m	PER(x)			PBR(x)			ROE(%)			EV/EBITDA (x)		
				2017	2018E	2019E	2017	2018E	2019E	2017	2018E	2019E	2017	2018E	2019E
TRAD CHI MED*	570	7.24	36,459	22.2	19.8	17.2	2.3	1.7	1.5	9.7	9.9	9.9	12.9	10.4	8.1
TONG REN TANG-H	1666	13.48	17,265	21.2	19.0	17.2	2.8	2.2	1.9	13.1	12.1	12.0	n.a	n.a	n.a
CHINA SHINEWAY	2877	16.34	13,513	27.3	18.3	15.0	2.0	1.8	1.7	7.1	10.1	11.6	15.0	9.9	7.5
CONSUN PHARMACEU	1681	7.85	6,867	13.5	12.0	10.2	2.4	2.4	2.0	21.4	24.4	24.5	8.4	7.1	5.6
PURAPHARM CORP L	1498	2.50	619	8.9	n.a	n.a	1.0	n.a	n.a	12.1	n.a	n.a	n.a	n.a	n.a
TONGRENTANGCM	3613	16.60	13,896	28.5	24.1	21.0	5.4	4.7	4.0	21.1	21.4	21.3	19.9	16.8	14.1
Simple average				19.9	18.4	15.9	2.7	2.8	2.4	14.9	17.0	17.3	14.4	11.2	9.1
Median				21.2	18.6	16.1	2.4	2.3	2.0	13.1	16.8	16.7	15.0	9.9	7.5

* denotes CGIS research estimate

Source: Bloomberg, CGIS Research

Disclaimer

This research report is not directed at, or intended for distribution to or used by, any person or entity who is a citizen or resident of or located in any jurisdiction where such distribution, publication, availability or use would be contrary to applicable law or regulation or which would subject China Galaxy International Securities (Hong Kong) Co., Limited ("Galaxy International Securities") and/or its group companies to any registration or licensing requirement within such jurisdiction.

This report (including any information attached) is issued by Galaxy International Securities, one of the subsidiaries of the China Galaxy International Financial Holdings Limited, to the institutional clients from the information sources believed to be reliable, but no representation or warranty (expressly or implied) is made as to their accuracy, correctness and/or completeness.

This report shall not be construed as an offer, invitation or solicitation to buy or sell any securities of the company(ies) referred to herein. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. The recipient of this report should understand and comprehend the investment objectives and its related risks, and where necessary consult their own independent financial advisers prior to any investment decision.

Where any part of the information, opinions or estimates contained herein reflects the personal views and opinions of the analyst who prepared this report, such views and opinions may not correspond to the published views or investment decisions of China Galaxy International Financial Holdings Limited and any of its subsidiaries ("China Galaxy International"), directors, officers, agents and employees ("the Relevant Parties").

All opinions and estimates reflect the judgment of the analyst on the date of this report and are subject to change without notice. China Galaxy International and/or the Relevant Parties hereby disclaim any of their liabilities arising from the inaccuracy, incorrectness and incompleteness of this report and its attachment/s and/or any action or omission made in reliance thereof. Accordingly, this report must be read in conjunction with this disclaimer.

Disclosure of Interests

China Galaxy Securities Co., Ltd. (6881.HK; 601881.CH) is the direct and/or indirect holding company of the group of companies under China Galaxy International.

China Galaxy International may have financial interests in relation to the subjected company(ies) the securities in respect of which are reviewed in this report, and such interests aggregate to an amount may equal to or more than 1 % of the subjected company(ies)' market capitalization.

One or more directors, officers and/or employees of China Galaxy International may be a director or officer of the securities of the company(ies) mentioned in this report.

China Galaxy International and the Relevant Parties may, to the extent permitted by law, from time to time participate or invest in financing transactions with the securities of the company(ies) mentioned in this report, perform services for or solicit business from such company(ies), and/or have a position or holding, or other material interest, or effect transactions, in such securities or options thereon, or other investments related thereto.

China Galaxy International may have served as manager or co-manager of a public offering of securities for, or currently may make a primary market in issues of, any or all of the entities mentioned in this report or may be providing, or have provided within the last 12 months, significant advice or investment services in relation to the investment concerned or a related investment or investment banking services to the company(ies) mentioned in this report.

Furthermore, China Galaxy International may have received compensation for investment banking services from the company(ies) mentioned in this report within the preceding 12 months and may currently seeking investment banking mandate from the subject company(ies).

Analyst Certification

The analyst who is primarily responsible for the content of this report, in whole or in part, certifies that with respect to the securities or issuer covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject, securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by the analyst in this report.

Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the securities covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the securities covered in this research report three business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong-listed companies covered in this report; and (4) have any financial interests in the Hong Kong-listed companies covered in this report.

Explanation on Equity Ratings

BUY : share price will increase by >20% within 12 months in absolute terms

SELL : share price will decrease by >20% within 12 months in absolute terms

HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

Copyright Reserved

No part of this material may be reproduced or redistributed without the prior written consent of China Galaxy International Securities (Hong Kong) Co., Limited.

China Galaxy International Securities (Hong Kong) Co. Limited, CE No.AXM459

20/F, Wing On Centre, 111 Connaught Road Central, Sheung Wan, Hong Kong. General line: 3698-6888.