

Fosun Pharmaceutical (600196; 02196.HK)

Heavy R&D input to start driving up profit gradually



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Rating

BUY**(Reiterate)**

Current price:

Rmb42.89

(HK\$47.55)

Target price:

Rmb52.85

(HK\$58.93)

Event:

The Company announced on 11 Jun 2018 that, alfacalcidol pill, a product by one of its subsidiaries, had passed the conformity evaluation and the Phase III clinical trial for rituximab injection with rheumatoid arthritis as the indication had kicked off.

Comments:

Alfacalcidol, which just passed the conformity evaluation, boasts huge market capacity. alfacalcidolis a major drug for osteoporosis and can mitigate chronic renal failure, hypoparathyroidism and vitaminD-resistant Rickets According to statistics from IQVIA, the market for alfacalcidol was worth c. Rmb460mn in China in 2017 (with the retail sales revenue estimated at Rmb500mn-Rmb1bn). Currently, like products include TEVA and Shanghai Xinyi Yan'an Pharmaceutical's Alfacalcidol soft Capsules (Afadisan and Yandinuo respectively) and innovator drug, Teijin Pharma's Bon-One. The Company claims a market share of only 7%. As Afadisan and Yandinuo are both capsules and the innovator drug, Bon-One, and the Company's product, Liqing, are tablets, it is expected to be more difficult for Alfacalcidol soft Capsule and Yandinuo to pass the conformity evaluation. **The Company boasts huge upside for its market share as the first drug maker whose alfacalcidol product passed the conformity evaluation.** Seen from the prices of alfacalcidol products, Bon-One and Liqing's bid-winning prices stand at c. Rmb3.46 and Rmb2.7 per tablet (0.25ug), which reflects the Company's advantage in product price. The Company's annual sales revenue from alfacalcidol tallied c. Rmb74mn in 2017 and is expected to exceed Rmb100mn over the next 1-2 years. It is expected to surpass Rmb300mn over the long term.

The Company's product mix is expected to be remarkably optimized as c. 10 generic drugs are expected to pass the conformity evaluation in 2018. In addition, CDE has accepted applications of the Company for conformity evaluations of another 8 drugs, which leaves peers behind the Company in the number of applications being accepted. We expect these drugs to pass the evaluations in 2018. Of which, Azithromycin, glimepiride etc. boast the potential to become blockbuster products. The Company's mix of generic drugs is expected to be optimized remarkably. Meanwhile, the Company's another 20+ drugs amid conformity evaluations are in the pipeline (as of the late of 2017, a total of 39 of its drugs were or were planned to be put through the evaluation) and they are expected to be approved by the regulatory gradually within the next 1-2 years.

Rituximab bio-similar, whose use is being expanded to cover rheumatoid arthritis, is expected to generate synergies with the Adalimumab in clinical extension. The Company has started with the Phase III clinical trial for Rituximab bio-similar with rheumatoid arthritis as the indication. Seen from the clinical trial plan, the Company hasn't undergone the head-to-head comparative research with the innovator drug so that its clinical trial has incurred relatively less expense. This was mainly because

the maker of innovator drug hasn't gotten approval for clinical trials of the drug for this indication. We expect the Company to file production/selling permits for its product as a new drug in China. However, given that the Company has already secured sufficient clinical trial data for head-to-head comparative research in this drug in the lymphoma field, it remains much better positioned in clinical extension of its product for indication such as rheumatoid arthritis. Going ahead, Rituximab bio-similar is expected to generate synergies with adalimumab bio-similar in clinical extension, offering more options for treatment of relevant diseases.

MaAb R&D is to start paying off soon. The Company is expected to unveil blockbuster product with annual sales revenue at Rmb1bn every year during the upcoming 5 years. The Company's drug R&D is to start paying off gradually. Of those products in the pipeline, Rituximab bio-similar (HLX01) has gone through unblinding amid the Phase III clinical trial and is expected to secure the regulatory approval for launch in 3Q2018. Its sales volume is expected to ramp up after it is made available in the market. 1) HLX01 boasts remarkable first-mover advantages as the Company leads peers in the progress in R&D of this product by more than 1 year. 2) Rituximab bio-similar has been put on the National Essential Drug List. The Company has strictly followed the principles for R&D of bio-similars so that its Rituximab will be directly put on the List after being unveiled in the market. 3) The Company has separately built a dedicated tumor drug marketing team over time, focusing on the Grade III hospitals (the best hospitals) nationwide. The hospitals in the primary markets are covered by its original tumor drug sales team. Its marketing teams for Rituximab are thus fully-fledged. 4) Roche, the producer of the originator Rituximab, has certain capacity bottleneck so that there is still huge gap between the supply and the clinical demand.

The Company boasts products full in the pipeline as it was among the top two in the A share health care universe by R&D input in 7 years out of the past decade. We expect the Company to launch the following generic drugs (the first ones of like products) over the next three years, Rituximab bio-similar (first generic drug) in 3Q2018, Herceptin bio-similar (first generic drug), CAR-T (which may well be the first CAR-T that is launched in China), the 3rd generation of insulin and Adalimumab bio-similar (which could be launched in early 2020 and is expected to race like-products to be the first generic drug) in 2019 and Bevacizumab bio-similar (the first generic drug for metastatic colorectal cancer) in 2020. All of those products will be blockbusters with annual market-wide sales revenue in exceed of Rmb10bn with Rituximab, Trastuzumab and CAR-T's markets likely to be worth Rmb2bn p.a.).

Risks: Failure of drug R&D; decline in drug tender price; disappointing implementation of the two-invoice system.

BUY retained. We expect its profit to expand quarter by quarter given the gradual launch of its products in the pipeline and recovery of Sinopharm Group (01099.HK)'s profit. We reiterate our 2018-2020E EPS estimates of Rmb1.51/1.76/2.08. After looking at comparables' valuations and considering the valuation premium that the Company deserves as a leader in the pharmaceutical segment, we apply 35x 2018E PE to its A shares (or 32x PE to its H shares) and arrive at the TP of Rmb52.85 and HK\$58.93 (based on the HKD exchange rate against RMB of 0.82) for its A and H shares respectively. We retain our BUY rating.

Item/Year	2016	2017	2018E	2019E	2020E
Turnover (Rmb mn)	14,629	18,534	23,080	27,174	32,604
Growth rate (YoY, %)	16	27	25	18	20
Net profit (Rmb mn)	2806	3124	3762	4401	5196
Growth rate (YoY, %)	14	11	20	17	18
EPS (Rmb)	1.12	1.25	1.51	1.76	2.08
Gross margin (%)	54.1	58.9	59.2	59.3	59.9
ROE (%)	11.1	10.5	11.3	11.9	12.4
PE (x)	38	34	28	24	21
PB (x)	4	4	3	3	3
EV/EBITDA (x)	25	24	18	16	14

Source: Wind, CITICS Research forecast

Note: Closing price as of 11 Jun. 2018

Income Statement (Rmb mn)

Indicator	2016	2017	2018E	2019E	2020E
Turnover	14,629	18,534	23,080	27,174	32,604
Operating cost	6,718	7,609	9,426	11,049	13,065
Gross margin	54.1%	58.9%	59.2%	59.3%	59.9%
Business tax & surcharge	153	223	238	209	251
Operating expense	3,704	5,791	7,247	8,587	10,401
Operating expense ratio	25.32%	31.24%	31.40%	31.60%	31.90%
Administrative expense	2,312	2,749	3,231	3,804	4,565
Administrative expense ratio	15.80%	14.83%	14.00%	14.00%	14.00%
Financial expense	401	555	627	662	640
Financial expense ratio	2.74%	2.99%	2.72%	2.44%	1.96%
Investment revenue	2,125	2,307	2,307	2,636	2,850
Operating profit	3,399	3,896	4,652	5,474	6,494
Operating profit margin	23.24%	21.02%	20.16%	20.14%	19.92%
Non-operating income	195	13	200	200	200
Non-operating expenditure	23	27	20	20	20
Total profit	3,572	3,882	4,832	5,654	6,674
Income tax	350	476	483	565	667
Income tax rate	9.8%	12.3%	10.0%	10.0%	10.0%
Minority interests	416	461	587	687	811
Net profit attributable to shareholders	2,806	3,124	3,762	4,401	5,196
Net margin	19.18%	16.86%	16.30%	16.20%	15.94%
EPS (Rmb)	1.12	1.25	1.51	1.76	2.08

Cash Flow Statement (Rmb mn)

Indicator	2016	2017	2018E	2019E	2020E
Net profit	2,806	3,124	3,762	4,401	5,196
Minority interests	416	461	587	687	811
Depreciation & amortization	739	946	1,134	1,197	1,160
Change in working capital	-288	-213	-838	-478	-992
Others	-1,562	-1,738	-1,713	-1,949	-2,171
Operating cash flow	2,110	2,580	2,931	3,859	4,004
CAPEX	-1,922	-2,171	-1,060	-1,060	-1,060
Investment revenue	422	535	2,307	2,636	2,850
Disposal of assets	1,114	1,447	0	0	0
Others	-2,061	-10,316	-2,700	-2,600	-2,600
Investing cash flow	-2,447	-10,504	-1,453	-1,024	-811
Stock issuance	2,728	3,018	0	0	0
Change in liabilities	1,127	9,358	-235	156	375
Dividend paid	-652	-699	-940	-1,100	-1,299
Others	-1,757	-1,768	-627	-662	-640
Financing cash flow	1,446	9,909	-1,803	-1,607	-1,564
Net increase in cash and equivalent	1,109	1,985	-325	1,228	1,629

Source: CITICS Quantitative Investment Analysis System

Balance Sheet (Rmb mn)

Indicator	2016	2017	2018E	2019E	2020E
Cash and cash equivalent	5,996	7,249	6,924	8,152	9,781
Inventory	1,671	2,751	2,743	3,323	4,154
Accounts receivable	1,965	3,248	3,410	4,125	5,161
Other current assets	1,133	1,810	2,055	2,296	2,673
Current assets	10,764	15,056	15,132	17,896	21,769
Fixed assets	5,140	6,556	6,374	6,129	5,822
Long-term equity investment	16,176	18,451	19,951	21,451	22,951
Intangible assets	3,080	7,248	7,248	7,248	7,348
Other long-term assets	8,608	14,660	15,975	17,190	18,405
Non-current assets	33,003	46,915	49,547	52,018	54,525
Total assets	43,768	61,971	64,680	69,914	76,294
Short-term borrowing	3,826	9,715	10,715	9,771	8,946
Accounts payable	1,025	1,652	1,646	2,005	2,496
Other current liabilities	5,258	5,234	4,775	5,507	6,313
Current liabilities	10,109	16,600	17,136	17,283	17,755
Long-term liabilities	2,183	5,580	6,380	7,280	8,280
Other long-term liabilities	6,226	10,050	8,014	8,214	8,414
Non-current liabilities	8,409	15,629	14,394	15,494	16,694
Total liabilities	18,517	32,230	31,530	32,776	34,448
Share capital	2,415	2,495	2,495	2,495	2,495
Capital reserve	7,858	9,078	9,078	9,078	9,078
Owner's equity	25,250	29,741	33,150	37,138	41,845
Minority interests	3,060	4,415	5,002	5,689	6,499
Liabilities & owner's equity	43,768	61,971	64,680	69,914	76,294

Major financial indicators

Indicator	2016	2017	2018E	2019E	2020E
Growth rate (%)					
Turnover	16.02	26.69	24.53	17.74	19.98
Operating profit	3.10	14.60	19.41	17.67	18.64
Net profit	14.05	11.36	20.39	17.01	18.04
Margin (%)					
Gross margin	54.07	58.94	59.16	59.34	59.93
EBIT Margin	11.91	11.66	12.73	12.97	13.26
EBITDA Margin	16.96	16.77	17.65	17.38	16.82
Net margin	19.18	16.86	16.30	16.20	15.94
Return (%)					
ROE	11.11	10.51	11.35	11.85	12.42
ROA	6.89	5.43	6.30	6.85	7.44
Others (%)					
Liability/asset ratio	42.31	52.01	48.75	46.88	45.15
Income tax rate	9.81	12.27	10.00	10.00	10.00
Dividend payout ratio	23.23	22.36	25.00	25.00	25.00

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		HOLD	Increase relative to market representative index between -10% and 5%
		SELL	Decrease relative to market representative index over 10%
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