

CSPC Pharmaceutical

Uniquely Innovative R&D engine; OW

Overweight

Previous: Not Rated

1093.HK, 1093 HK

Price: HK\$7.71

Price Target: HK\$9.00



We assume coverage of CSPC with an OW rating and a Dec-17 PT of HK\$9.0 (OW rating and HK\$9.10 Dec-2015 price target prior to NR designation). CSPC is a top quality innovative pharma player with a diversified product portfolio focused on CCV and oncology, while we believe its streamlined API business and rich pipeline offer sustainable upside. We expect a net profit CAGR of 21% in 2015-2018. Trading at 18x our 2017 P/E, we view current valuation as offering an attractive risk return profile for long-term investors.

- **Robust growth for NBP:** We expect NBP to grow above 30% in 2016 and 2017, driven by: 1) continuous channel for soft capsule formulation; 2) higher sales growth of injections on more tender wins;
- **Accelerated growth for oncology drugs:** Different from pharma companies facing huge price pressure from tenders, we believe the tender process will accelerate CSPC's sales growth as most of its oncology drugs have been in the market less than five years. We expect sales growth for oncology products at ~50% upon winning more tenders.
- **Strong pipeline to sustain future growth:** CSPC has more than 170 drugs under R&D, 15 are Class 1 new drugs, 52 are Class 3 new drugs, and 17 US ANDA drugs. Management expects to receive approvals for 10 drugs by the end of 2016. Also clinical trials/BE studies for 25 drugs, including SKLB1028, sunitinib, and sorafenib. All support long-term growth potential, in our view.
- **Valuation:** We believe CSPC will outgrow the industry given its minimum risk of price cut pressure & balanced product portfolio. Our Dec 17 PT of HK\$9.0 implies 20% upside potential, 21x 2017 PE.
- **Risks:** 1) unexpected sales slowdown for NBP; 2) larger than expected price cut from tenders; 3) delay or failure of R&D pipeline.

China

Healthcare

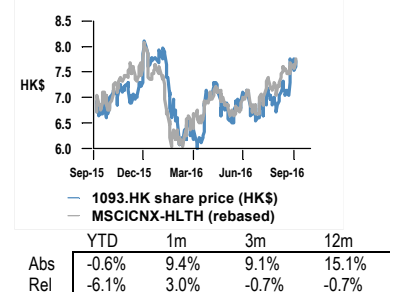
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Price Performance



CSPC Pharmaceutical (Reuters: 1093.HK, Bloomberg: 1093 HK)

HK\$ in mn, year-end Dec	FY12A	FY13A	FY14A	FY15A	FY16E
Revenue (HK\$ mn)	4,146	9,949	10,955	11,394	12,482
Net Profit (HK\$ mn)	2,162	973	1,268	1,665	2,088
EPS (HK\$)	1.48	0.17	0.21	0.28	0.35
DPS (HK\$)	0.10	0.08	0.10	0.11	0.14
Revenue growth (%)	72.2%	139.9%	10.1%	4.0%	9.6%
EPS growth (%)	397.2%	(88.8%)	29.6%	31.3%	25.4%
ROCE	14.0%	10.1%	14.7%	17.7%	19.8%
ROE	57.4%	11.7%	16.3%	19.8%	22.3%
P/E (x)	5.2	46.5	35.9	27.4	21.8
P/BV (x)	6.8	6.1	5.6	5.2	4.5
EV/EBITDA (x)	47.7	24.2	19.2	15.5	12.9
Dividend Yield	1.3%	1.0%	1.3%	1.4%	1.8%

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

Company Data

Shares O/S (mn)	5,909
Market Cap (HK\$ mn)	45,557
Market Cap (\$ mn)	5,874
Price (HK\$)	7.71
Date Of Price	05 Sep 16
Free Float(%)	-
3M - Avg daily vol (mn)	9.79
3M - Avg daily val (HK\$ mn)	69.32
3M - Avg daily val (\$ mn)	8.9
MSCI CNX-HLTH	146.86
Exchange Rate	7.76
Price Target End Date	31-Dec-17

See page 36 for analyst certification and important disclosures, including non-US analyst disclosures.

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Key catalysts for the stock price:	Upside risks to our view:	Downside risks to our view:
<ul style="list-style-type: none"> • New product approvals • Phase 2 trial of NBP in the US • Sales ramp up for Jingyouli and Qinggan Huayu capsules • Quarterly earnings • Announcement of major collaborations 	<ul style="list-style-type: none"> • Unexpected quick firming up of VC prices • NBP approved for secondary prevention of ischemic stroke officially in the near term • Label expansion of NBP and Oulaining into other indications 	<ul style="list-style-type: none"> • Unexpected sales slowdown for CSPC's key products and further erosion of VC ASP • Larger than expected sales force turnover. • Unexpected safety issues seen with some newer products

Key financial metrics	FY15	FY16E	FY17E	FY18E
Revenues (LC '000)	11,393,726	12,482,343	14,041,035	15,416,356
Revenue growth (%)	4.0%	9.6%	12.5%	9.8%
EBITDA (LC '000)	2,749,067	3,296,834	3,850,054	4,450,436
EBITDA margin (%)	24.1%	26.4%	27.4%	28.9%
Tax rate (%)	20.5%	20.5%	20.5%	20.5%
Net profit (LC '000)	1,679,626	2,105,749	2,510,957	2,953,518
EPS (LC)	0.281	0.350	0.418	0.492
EPS growth (%)	31.5%	25.4%	19.2%	17.6%
DPS (LC)	0.11	0.14	0.16	0.19
BVPS (LC)	8%	15%	15%	16%
Operating cash flow (LC '000)	2,250,575	2,080,210	2,148,665	4,059,957
Free cash flow (LC '000)	1,434,884	1,186,584	1,143,450	2,956,281
Interest cover (x)	0.0	0.0	0.0	0.0
Net margin (%)	14.7%	16.9%	17.9%	19.2%
Sales/assets (X)	0.84	0.85	0.88	0.84
Debt/equity (%)	54.1%	45.6%	36.6%	37.4%
Net debt/equity (%)	-32.1%	-31.4%	-33.0%	-50.9%
ROE (%)	20.5%	22.9%	23.7%	24.1%
Key model assumptions	FY16E	FY17E	FY18E	FY19E
Vc ASP change	0.0%	0.0%	0.0%	-3.2%
Sales growth of NBP injections	45%	45.0%	20.0%	16.0%
Jingyouli sales (HK\$ 'mn)	146,080	197,208	246,510	295,812

Source: Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY16E	FY17E	FY16E	FY17E
10% ASP increase for Vitamin C	2.10%	2.10%	2.10%	2.10%
10% upside to base forecast of NBP	3.70%	3.50%	3.70%	3.50%
Effective tax rate increase by 100bp	0%	-1.10%	0.00%	-1.10%
GM: 50bp Increase	1.80%	1.70%	1.80%	1.70%

Source: J.P. Morgan estimates.

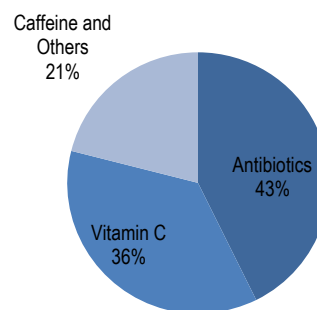
Comparative metrics	CMP	Mkt Cap	P/E (x)		EV/EBITDA (x)		P/BV (x)		YTD
	LC	\$Mn	FY16E	FY17E	FY16E	FY17E	FY16E	FY17E	Stock perf.
CSPC PHARMACEUTI (NC)	7.6	5,929	22.0	18.1	14.2	12.0		2.0	(2.5)
CHINA MEDICAL SY (NC)	13.1	4,201	21.0	17.4	19.0	15.4		3.3	15.8
CHINA SHINEWAY (NC)	8.17	871	10.2	10.2	4.3	4.3	1.1	6.8	(14.8)
JIANGSU HENGRU-A (NC)	44.38	15,596			30.3	24.3		6.6	8.7
SSY GROUP LTD (NC)	2.56	939	15.3	13.7	10.5	9.5	2.6	1.0	28.0
SHANGHAI PHARM-H (NC)	21.35	8,079	15.5	14.0	11.8	10.7		12.9	29.9
SIHUAN PHARM (NC)	1.72	2,221	7.8	7.8	4.7	4.4		1.4	(59.3)
SINO BIOPHARM (NC)	5.01	4,788	18.4	16.0	9.6	8.4		1.6	(28.6)
THE UNITED LABOR (NC)	3.25	682	18.2	12.1	7.8	7.3		4.4	(24.2)

Source: Bloomberg; Price as of 09/02/2016

Valuation and price target basis

Our Dec-17 price target of HK\$9.0 is based on DCF. We have applied a terminal growth rate of 4%, at the high end of the 3%-6% growth rate used for health care stocks as we see CSPC outgrow its peers for an extended long period of time.

2016E Product Mix



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

JPM vs. consensus, change in estimates

EPS (LC)	FY16E	FY17E
JPM old	0.283	0.363
JPM new	0.350	0.418
% chg	23.8%	15.0%
Consensus	0.346	0.421

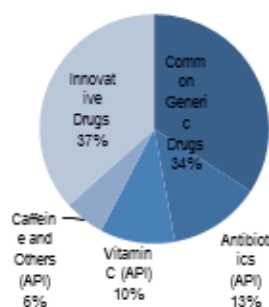
Source: Bloomberg, J.P. Morgan estimates.

Investment summary

CSPC Pharmaceutical Group Ltd. is an investment holding company of subsidiaries that are principally engaged in the manufacture and sale of pharmaceutical products. It operates in three business segments: manufacture and sale of intermediate and bulk drugs, including vitamin C series and caffeine; finished drugs, including innovative drugs like NBP, Jinyouli and Yuanning and generics such as OuLaining; and other pharmaceutical related business and development activities.

CSPC is a leading pharmaceutical company in China, operating in 3 business segments: Innovative drugs, generics and bulk drugs. Since CSPC acquired OYY, NBP and XNW from its parent company in 2012, it has transformed itself into a provider of branded drugs as opposed to only bulk drugs earlier. The company's innovative drug business consists of flagship high margin products NBP, Oulaining and Xuanning whose sales grew at 36% YoY, 16% YoY and 16% YoY in Q12016. The market size for NBP is expected by the company to grow by a CAGR of 20% during 2011-2020 to reach Rmb69bn in 2020. The market size for Xuanning has been growing at a CAGR of 20% during 2010-14 and is expected by the company to grow by 9% annually in the future. We expect continuous strong sales growth above 30% for these key products given their large potential market size and channel penetration.

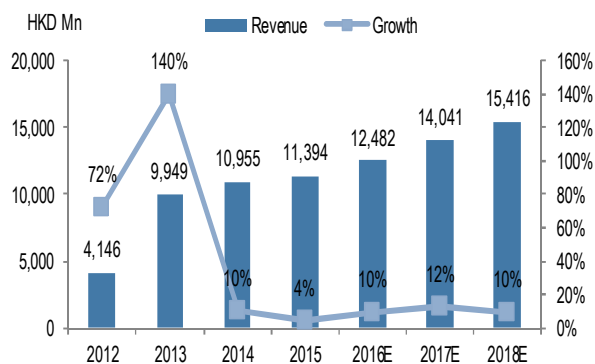
Revenue breakdown by business segment (2015)



Source: Company data

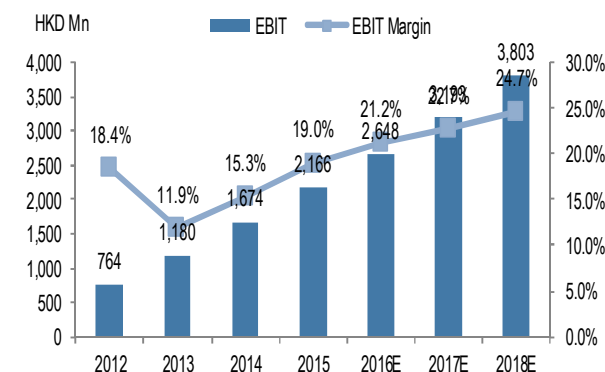
Oncology drugs, launched in 2015, consist of 4 products which have enjoyed robust growth since launch. Oncology drug revenue grew 34% in 2015 and we expect revenue to grow further by 52% in 2016 and 47% in 2017 as these products are relatively new and will have accelerated volume growth ahead with more tender winning & inclusion on reimbursement list. Going ahead we expect that CSPC will focus most of its efforts on the innovative drugs business as the company develops new products through R&D. Also it is a high margin business, which provides the company monopoly pricing for a longer period of time. CSPC is also exploring opportunities in other markets globally. It has applied for US FDA approval of NBP. Factoring in all these factors – healthy growth in innovative drugs, strong R&D pipeline and international expansion – we expect a healthy 11%/21% top/bottomline CAGR in 2016-2018.

Figure 1: CSPC Pharmaceutical – Revenue Growth 2012-2018E



Source: J.P. Morgan estimates for FY16E to FY18E, Company data for FY12-FY15

Figure 2: CSPC Pharmaceutical – EBIT/EBIT Margin 2012-2018E



Source: J.P. Morgan estimates for FY16E to FY18E, Company data for FY12-FY15

2Q16 results takeaways:

CSPC reported solid 2Q16 results with sales and EPS growth of 7%/25% (or 13% and 32% in Rmb): of which, finished drugs grew by +17% with innovative drugs sales growth of 29% YoY and common generic growth of +6% YoY. For APIs, Vitamin C increased by 13% driven by strong volume, but antibiotics API dropped 35% owing to pricing pressure.

Robust NBP sales to continue: NBP series grew by 40% in HKD or 47% on a constant currency basis in 2Q16. Of which, NBP capsules grew by 25% and NBP injectables grew a particularly strong +72%, driven by: 1) better academic education for doctors as included in its guidelines; 3) expanding sales team and hospital coverage. We expect growth to remain strong in 2H16 after it won more provincial tenders.

Slower oncology growth explained: However, the oncology franchise grew by 28% in 2Q16, slower than management expectation due to a slow tender process and more effort on the expansion of hospital/physician coverage. . Xuanning growth remained stable at +14%, but Oulaining injectables slowed down to only 3%, due to a sales strategy change to focus more on capsule formulation.

Faster growth of common generic business: In 2015, CSPC set up a dedicated sales team targeting the third terminal market, covering mostly common generics. The sales team of 300 ppl delivered Rmb340mn sales in 2015, and Rmb620mn in 1H16 after it expanded to 700 ppl, through education for doctors at community hospitals, drugstores and patients. Management plans to reach 1,500 sales ppl by the end of 2016, 4,500 in 2017, and 10,000 in the next three years. The net margin may reach 40% for this segment, and it could be a potential growth driver over the long term, in our view.

Better margin performance: gross margin expanded by 1.2% to 50.0% in 2Q16, up from 48.8% in 1Q16 on faster growth of finished products with favorable product mix (64.4% vs.63.8% in 1Q16 on better product mix) , stable caffeine business (32.7% vs.32.3% in 1Q16) and higher profitability of VC (7.1%vs.5.4% in 1Q16)

R&D progressed: Management expects to receive final production approvals for three important products including bortezomib (likely to be first-to-market generics) by 2016, which could further improve product portfolio and drive future growth.

Valuation: P/E Bands

Figure 3: CSPC vs MSCI China Healthcare Index



Source: Bloomberg

Figure 4: CSPC Price chart



Source: Bloomberg

Figure 5: CSPC Forward P/E chart



Source: Bloomberg

Investment Positives

Continuous Strong Growth Momentum of NBP –Blockbuster CCV Drug

NBP (butylphthalide series), the most important asset of CSPC's innovative drug portfolio, were classified as 1.1 innovative drugs by the CFDA. NBP is a patented drug (patent expiry: 2030) indicated as a first-line treatment for acute ischemic stroke (AIS) with independent pricing, helping to increase cerebral blood flow in the ischemic area. It was listed as the recommended drug on the "Guideline for Acute Ischemic Stroke Treatment Guideline" by Chinese Medical Association. NBP has two formulations:

1. NBP soft capsule was launched in 2005 and included in national NRDL and available in over 1,400 hospitals. Daily cost is around Rmb600 with 20 days treatment cost of Rmb1,200.
2. NBP injection was approved and launched in 2010, yet only included in 7 provinces and won the tenders in 15 provinces as of now. A 14 day NBP injection costs around Rmb10, 000, much higher than capsules. Now NBP injection is only available in 600 hospitals, thus the speed up of new tenders will help volume growth of NBP injection, in our view. CSPC is actively promoting 90 days therapy with the combination usage of NBP injection and capsule.

We see tremendous growth ahead for NBP series driven by the high prevalence of ischemic stroke in China. According to IMS data, stroke is one the leading causes of death in China and causes approximately 1.5 million deaths each year. Currently, there are over 7 million stroke patients in China and the number of stroke patients is forecasted by IMS China to reach 20 million by 2020, or market size of Rmb69 billion.

Figure 6: CSPC – China Stroke Market Grow at a CAGR of 20% in 2020E

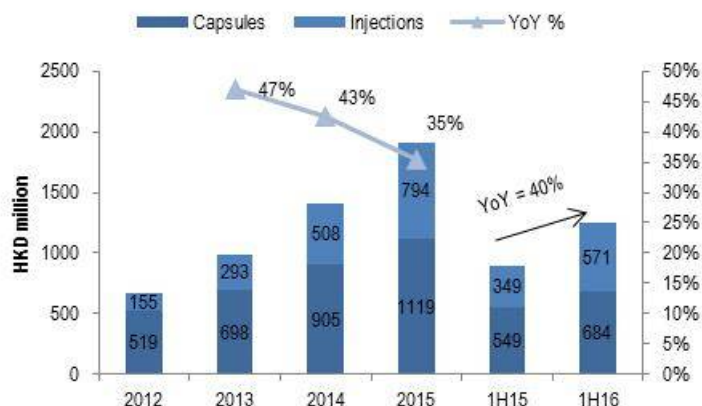


Source: IMS China; Company data,

The revenue of the NBP series was HK\$1,255mn in 1H16, + 40%Y/Y with NBP capsule growing at 25% YoY and injection growing at 64% YoY on a constant currency basis. Management expects to maintain at least 30% sales growth for NBP series in 2016 and onwards.

In addition, NBP is being developed for secondary stroke prevention and treatment of cognitive dysfunction. If NBP is successful, we expect NBP to join Xue Shuan Tong as a US-level blockbuster in China by 2023, and we believe NBP sales can continue to grow robustly at a 25% CAGR for the next few years, driven by: 1) continuous penetration of lower tier hospitals and regions for soft capsule formulation; 2) accelerating sales growth of higher-priced injections as it wins tenders in more provinces.

Figure 7: CSPC - Impressive sales growth of NBP series



Source: Company reports

In addition to NBP series, CSPC also acquired two main innovative drugs from its parent company Oulining (Oxiracetam) for the treatment of Alzheimer’s disease and dementia and Xuanning (Levamlodpine Maleate) for hypertension and, which

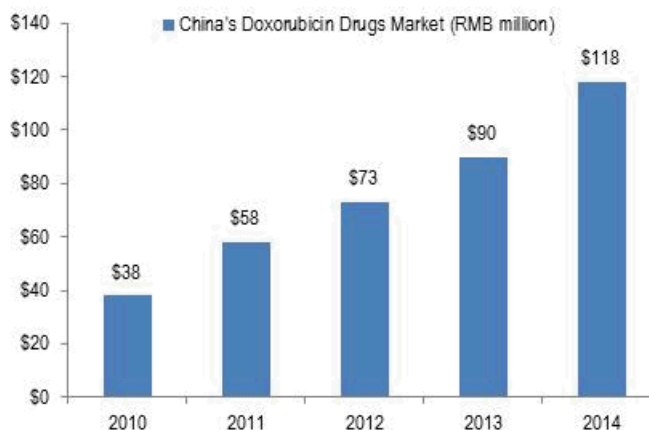
generated FY2015 sales of HK\$971mn and HK\$329mn for Y/Y growth of 33% and 28%, respectively. While not exclusive drugs like NBP, CSPC maintains certain advantages with an independent pricing for Xuaning and as the sole manufacturer of lyophilized powder injection formulation of OuLaining. We see strong growth ahead for these two product series, given the ageing population and about 160 million people afflicted with hypertension that will need life-time treatment.

Accelerating Growth Oncology drugs franchise ahead

CSPC also has been focusing on developing its oncology drugs portfolio and now have launched four oncology drugs, namely, Duomeisu, Jinyouli, Aillieng, Nuolining with total sales of HK\$250 million in 1H2016, up 28% YoY. As most of the oncology drugs have been launched in the market less than five years and only included in a few provincial reimbursement lists, we expect the volume growth to accelerate upon winning more tenders in the coming years. Mgmt. expects the sales growth of oncology drug portfolio to exceed 50% in 2016 and onwards.

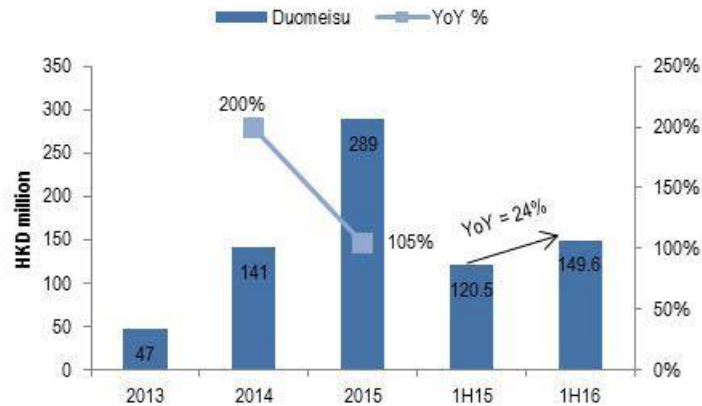
For example, CSPC launched doxil (Duomeisu™) in 2012, the second doxorubicin hydrochloride liposome injection for the treatment of lymphoma, multiple myeloma, and other malignant tumors. According to the PDB data base, the market size of Doxorubicin drugs was growing at a CAGR of 33% from Rmb38million in 2010 to Rmb118 million in 2014. Sales of Duomeisu were growing at a CAGR of over 105% to reach HK\$289mn in 2015, up from merely HK\$47million in 2013. We believe this product carries substantial market potential and should become a major product for CSPC as it wins more tenders (now it is only reimbursed in 2 provinces).

Figure 8: Large Doxorubicin drugs market



Source: Company reports

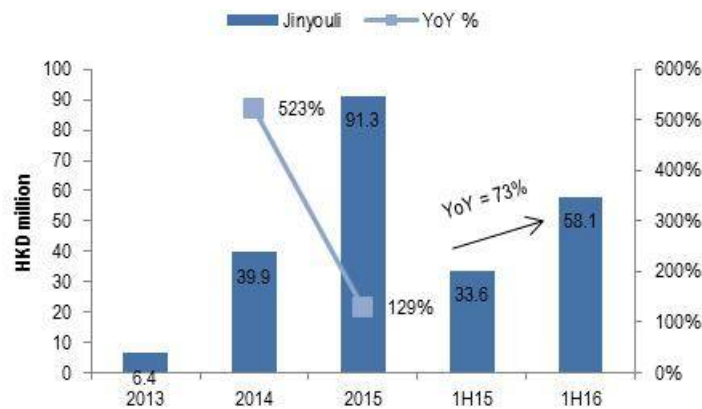
Figure 9: CSPC - Robust sales growth of Duomeisu



Source: Company reports

CSPC acquired Jinyouli (PEG-rhG-CSF), a Class 1 innovative, and the only approved long-acting G-CSF by the CFDA in China, from Shijiazhuang Baike Pharma in March 2013. Jinyouli is indicated for the treatment of neutropenia induced by chemotherapy and its convenient dosing should allow it to quickly garner market share away from daily-dosing short-acting G-CSF, such as the one produced by Beijing SL Pharma. As a reference, Neulasta®, a PEG-G-CSF manufactured by Amgen but not available in China, generated sales of US\$4.4bn in 2014, before it went off patent in October 2015. Given its marketing exclusivity, Jinyouli sales were ramping up quickly at a CAGR of 105% during 2013-2015.

Figure 10: CSPC - Robust sales growth of Jinyouli



Source: Company reports

Strong R&D pipeline to support long term sustained growth

Currently, CSPC has more than 170 products under R&D, covering CCV, neurology, oncology, diabetes and anti-infective therapeutic areas, of which 15 Class 1 new drugs, 38 generic drugs (under trial or pending registration), 40 generic drugs (received clinical trial approval and pending to start clinical trial) and 22 U.S. ANDA drugs

The most promising innovative pipeline products include:

1. rE4 and DBPR108, both for type II diabetes, which is estimated to have a market size over Rmb20 billion in China; Of which, rE4, a Class I biopharmaceutical product has completed Phase II clinical trial.
2. Pinocembrin, a Class 1 innovative medicine for acute stroke;
3. Compound levamlodipine maleate and atorvastatin calcium tablet for high blood pressure and hyperlipidemia;
4. baicalein tablet, a Class 1 innovative anti-viral influenza drug.

Under oncology drug pipeline, CSPC has submitted the production approval for Bortezomib injection. Notably, Bortezomib (brand name: Velcade by Takeda and J&J) was first launched in China with sales of nearly Rmb10billion in 2014, the patent of Velcade will expire in May, 2017. According to management, CSPC may become the first one to launch the first to market generic of Velcade in 2017.

In 1Q16, CSPC received approval for cefamandole nafate for injections. Management still expects to receive approvals for 10 drugs by the end of 2016. Also approved were clinical trials/BE studies for 25 drugs, including key drugs like SKLB1028, sunitinib, and sorafenib. Furthermore mitoxantrone hydrochloride liposome injections received clinical trial approval by the US FDA in April 2016. In the 1H16, CSPC submitted clinical trial applications for 2 products to CFDA and obtained 3 product approvals namely Cefamandole nafate for injection, Doxorubicin hydrochloride liposome injection and Pitavastatin calcium raw material. CSPC also submitted clinical trial approvals for 30 products (including Class 1 drug: SKLB1028 capsules). In total, CSPC has 27 products pending CFDA approval and 19 products under bioequivalence study or clinical study.

In addition, the company will launch 3-4 new generic drugs each year, diversifying its product mix. Launches of these new products should strengthen the company's finished products franchise, improve its sales force productivity, and enhance the company's competitiveness against major companies such as Jiangsu Hengrui.

Figure 11: CSPC - an enviable strong R&D pipeline

Drug	Indication	Pre-clinical trial	Phase I	Phase II	Phase III	Phase IV	Registration
Class 1 New Drugs							
rE4	Diabetes	→	→	→			
Compound levamlodipine and atorvastatin calcium tablet	Hypertension, hyperlipidemia	→	→	→	→		
Pinocembrin injection	Acute stroke	→	→	→			
L-Butylphthalide tablet and injection	Acute stroke	→	→	→			
Baicalin tablet	Viral influenza	→	→	→			
DBPR108	Diabetes	→	→				
SKLB1028	Oncology	→	→				
8 products		→	→				

Drug	Preclinical trial	Clinical Trial	Registration
Generic Drugs			
28 products – pending production approval	→	→	→
9 products – undergoing BE study or clinical trial	→	→	
29 products – granted clinical trial approval	→		
44 products – completed pre-clinical trial, pending clinical trial approval	→		
U.S ANDA drugs (International registration)			
10 products	→	→	→
1 products	→	→	
10 products	→		

Source: Company data, J.P. Morgan

Table 1: R&D Pipeline: (Class 1 New Drugs)

	Drug Name	Drug Class	Applications	Status	Expected approval	Market Size	Competitors
1	rE4: recombinant GLP-1 receptor agonist injection	Class 1 biopharmaceutical product	Diabetes	Completed Phase II clinical trial	2019	Diabetes medicine market in major hospitals in China reached RMB13.4 billion in 2011, increased by 17.87% from 2010. There are approx. 100 million patients with diabetes in China.	Exenatide liraglutide (chemical method)
2	Compound levamlodipine and atorvastatin calcium tablet: cardiovascular oral formulation	Class 1 chemical drug	Hypertension Hyperlipidemia	Phase III clinical trial	2018	China's antihypertensive drug market has an estimated capacity of RMB30 billion in 2013. According to the PDB database, 2012 annual sales of hypertension drugs in hospitals of 22 sample cities reached RMB4.5 billion, with CAGR (2008-2012) around 15.97%. There are over 200 million patients with hypertension in China.	Amlodipine, nifedipine, atorvastatin calcium and other CCB class drugs, rosuvastatin statins and other statins.
3	Pinocembrin injection: cerebral vascular drugs	Class 1 chemical drug	Acute stroke	Phase II clinical trial	2018	There are over 2 million new stroke patients each year in China, causing approx. 1.5 million deaths each year; Currently, there are approx. 7 million stroke patients in China.	Neuroprotective agents like Gangliosides, Edaravone; Cinpezide; Traditional Chinese medicine like Breviscarnin, Ginkgo Leaf
4	L-Butylphthalide tablet & injection	Class 1 chemical drug	Acute stroke	Completed Phase I clinical trial	2021	There are over 2 million new stroke patients each year in China, causing approx. 1.5 million deaths each year; Currently, there are approx. 7 million stroke patients in China.	Neuroprotective agents like Gangliosides, Edaravone; Cinpezide; Traditional Chinese medicine like Breviscarnin, Ginkgo Leaf
5	Baicalein tablets: oral antiviral	Class I TCM	Viral influenza	Applying for Phase II & III clinical trial	2018	Anti-influenza virus medicine market sales reached RMB20 billion in 2011.	Lianhuaqingwen Qingkailing and antiviral pills, anti-virus oral antiviral agents
6	DBPR108	Class 1 chemical drug	Diabetes	Phase I clinical trial	2020	Diabetes medicine market in major hospitals in China reached RMB13.4 billion in 2011, increased by 17.87% from 2010. There are approx. 100 million patients with diabetes in China	Phosphate sitagliptin, vildagliptin, saxagliptin, Alogliptin, Linagliptin Teneligliptin, etc.
7	SKLB1028	Class 1 chemical drug	Oncology	Phase I clinical trial	2022	NSCLC medicine market in China reached RMB4 billion in 2011. The market can be over RMB4.5 billion if added AML.	Gefitinib, Erlotinib, Icotinib, Permetrexed, Endostatin

Source: Company data.

Table 2: CSPC - R&D pipeline (Generic Drugs)

	Drug Name	Drug Class	Applications	Approval Process
1	Cefamandole nafate for injection	Class 6 chemical drug	Anti-infection	Approval obtained in March 2016
2	Bortezomib for injection	Class 3+6 chemical drug	Oncology	Applied for production approval
3	lloperidone tablets	Class 3+3 chemical drug	Schizophrenia	Applied for production approval
4	Dronedaron hydrochloride tablets	Class 3+6 chemical drug	Antiarrhythmic	Applied for production approval
5	Mitoxantrone hydrochloride liposome injection	Class 3+3 chemical drug	Oncology	Clinical trial
6	Paclitaxel for injection (albumin-bound)	Class 1 and Class 3 chemical drug	Oncology	Clinical trial
7	Dasatinib tablets	Class 3+6 chemical drug	Oncology	Clinical trial
8	Gefitinib tablets	Class 3+6 chemical drug	Oncology	Clinical trial
9	Pramipexole hydrochloride tablets	Class 3+6 chemical drug	Parkinson's Disease	Clinical trial
10	Sunitinib malate capsules	Class 3+6 chemical drug	Oncology	Granted clinical trial approval
11	Sorafenib tosylate tablets	Class 3+6 chemical drug	Oncology	Granted clinical trial approval
12	Afatinib dimaleate tablets	Class 3+3 chemical drug	Oncology	Granted clinical trial approval
13	Ceritinib capsules	Class 3+3 chemical drug	Oncology	Granted clinical trial approval
14	Ticagrelor tablets	Class 3+6 chemical drug	Coronary syndrome	Granted clinical trial approval
15	Rivaroxaban tablets	Class 3+6 chemical drug	Thrombus	Granted clinical trial approval
16	Amlodipine besilate, valsartan and hydrochlorothiazide tablets	Class 3.2 chemical drug	Hypertension	Granted clinical trial approval
17	Desvenlafaxine succinate extended-release tablets	Class 3+6 chemical drug	Anti-depression	Granted clinical trial approval
18	Saxagliptin tablets	Class 3+6 chemical drug	Diabetes	Granted clinical trial approval
19	Esomeprazole magnesium enteric-coated capsules	Class 3+5 chemical drug	Gastroesophageal reflux disease	Granted clinical trial approval
20	Sofosbuvir tablets	Class 3+3 chemical drug	Hepatitis C	Granted clinical trial approval

Source: Company data.

Favorable policies benefit leading pharma companies

Since 2016, many provincial tenders have used price ceilings based on the average lowest tender prices from prior tenders in other provinces, such as Sanming, in Fujian provinces also, secondary negotiation and two invoice system to reduce the drug price. We believe this will inspire drug companies with innovative capabilities and large & balanced product portfolios such as CSPC to use more flexible pricing strategies in order to list their products in insurance schemes.

Different from other pharmaceutical companies with existing/old products with serious price cuts through the tender process, we believe CSPC should benefit from faster tender process as most of the drugs in the oncology portfolio have only been marketed for less than five years, and sales volume is expected to pick up upon winning new tenders.

Global ambition to empower domestic dominance

In 1H13, CSPC submitted an Investigational New Drug (IND) Application for NBP soft capsules to the U.S. FDA. Now, U.S. FDA has approved the protocol for Phase II clinical trial application. In addition, CSPC has applied for ANDA for 9 additional products, including donepezil (Aricept® by Pfizer) for dementia, with approval of tramadol hydrochloride tablets secured in March 2013. By 2018, the company mgmt. expects to receive 10 ANDA approvals. Although we do not expect the overseas sales to contribute significantly in the near term, the approvals of ANDAs may allow for future overseas sales to complement domestic sales. More importantly, CSPC may use ANDA approvals to argue for independent pricings based on higher-quality, which should expand the company's commercial interest in China, in our view.

Figure 12: CSPC - R&D pipeline (Generic Drugs) for U.S. ANDA Drugs

ANDA approvals			
	Drug Name	Applications	Status
1	Tramadol hydrochloride tablets	Pain-killer	Approved and launched
2	Benzonatate soft capsules	Cough	Approved and launched
3	Donepezil hydrochloride tablets	Alzheimer's disease	Approval obtained in September 2015

Pending ANDA approvals			
	Drug Name	Applications	Expected approval date
1	Clopidogrel hydrochloride tablets	Thrombosis	2016
2	Metformin hydrochloride film coated tablets	Diabetes	2016
3	Cefadroxil capsules	Anti-infection	2016
4	Gabapentin tablets	Epilepsy	2016
5	Azithromycin tablets	Anti-infection	2017
6	Cefixime tablets	Anti-infection	2017
7	Cefotaxime sodium for injection	Anti-infection	2017
8	Ceftriaxone sodium for injection	Anti-infection	2017
9	Montelukast sodium chewable tablets	Asthma	2018
10	Montelukast sodium tablets	Asthma	2018

Source: Company data.

Investment Risks

Regulatory control over pharmaceutical products

The pharmaceutical industry is among the most regulated in China. As the ultimate insurer, the government is strongly biased to regulate the volume and profit from the sale of drugs by hospitals to patients. CSPC could be directly or indirectly affected by many of the new rules and regulations under the ongoing healthcare reforms, and this is a risk to the company's operations, in our view. The government has cut drug prices repeatedly in recent years. As many of CSPC drugs are included in the national drug reimbursement list, CSPC's key products, NBP capsules and Xuanning are included in the 2009 NDRL and are clearly subject to government price controls. All drugs, excluding prescription drugs available from specialty pharmacies, must go through provincial tenders to be procured by hospitals. As previously noted, Guangdong Government has put out draft proposals for EDL and non-EDL drug tenders that have potential to substantially lower drug prices. While CSPC's exclusive drugs such as NBP and Oulaining lyophilized powder may make the company less susceptible to cut-throat competitive pricing pressures, the government may still demand price cuts directly.

Commodity business may drag down profit growth

While CSPC's API businesses carry by and large better cost structure and should be more profitable than competitors, their profit-making abilities are not immune from the cyclical nature of API businesses. While in good years, the API businesses may make CSPC look very profitable, in lean years, API businesses may obscure the otherwise very strong performance of CSPC's finished drug businesses. The presence of API businesses may also make valuation more difficult for investors, which could lead investors to give unfair discount on the company's valuation. For example, the United Labs has done reasonably well with its finished drug business as it ramped up Insulin sales and launched new Alzheimer's drug, but the company's stock price has been hurt by chronically low prices for 6-APA and bulk amoxicillin, from which CSPC has mostly exited. CSPC still maintains facilities for 6-APA and bulk amoxicillin in Shijiazhuang but it is mainly for internal consumption that supports the company's capacity of 7 billion capsules of amoxicillin – generating about HK\$200mn worth of sales of finished amoxicillin products for the company.

Pipeline setback and delays in obtaining regulatory approvals

CSPC features one of the strongest R&D teams among its China peers and it has numerous pipeline products under development. R&D projects are inherently risky and many pipeline products may fail in clinical trials and not make it into the market. The flop of highly-anticipated products in the trials may bring negative headlines to the company and depress stock performance. Even if products are approved, they may fail to realize market potential due to unexpected competition or unsuccessful sales and marketing efforts. NBP is a unique patented drug developed in China that has never been available elsewhere. While it has demonstrated impressive clinical efficacies in clinical trials in China, including well-controlled Phase 3 trials, it may still underperform in US Phase 2 or future Phase 3 trials, which may negatively impact NBP sales in China.

DCF valuation and Dec-17 PT of HK\$9.0

Our Dec-17 price target is based on a DCF valuation that assumes a market premium of 6.0% and risk-free rate of 4.2% (yield on 10-year government notes in China). We assume a beta of 0.89 based on regression analysis performed by Bloomberg. Accordingly, we assume a WACC of 9.6%. We estimate free cash flow for CSPC until 2020 and assume a terminal growth rate of 4.0%.

We also analyze the DCF price sensitivity to WACC, and the terminal multiple.

Table 3: CSPC — Base-case DCF analysis indicates an equity value per share of HK\$9.0

	2012	2013	2014	2015	2016E	2017E	2018E	2019E	Terminal
Cash flow estimates									
Sales	4,146,444	9,949,103	10,955,077	11,393,726	12,482,343	14,041,035	15,416,356	16,761,800	17,968,367
EBIT	763,576	1,179,978	1,674,368	2,166,453	2,704,213	3,213,743	3,770,242	4,222,202	4,608,941
NOPAT	719,777	935,660	1,326,219	1,722,891	2,150,550	2,555,758	2,998,319	3,357,744	3,665,302
Capex, net	(204,204)	(597,115)	(806,998)	(815,691)	(893,626)	(1,005,215)	(1,103,676)	(1,199,998)	(1,185,912)
Depreciation	185,795	630,530	575,043	572,036	582,649	617,882	661,765	711,831	767,138
Change in working capital	(280,132)	(742,672)	(84,948)	(46,088)	(682,953)	(1,054,938)	369,910	(1,039,720)	202,279
Free Cash Flow	421,236	226,403	1,009,316	1,433,148	1,156,620	1,113,486	2,926,317	1,829,857	3,448,807
WACC calculation									
Liabilities as a % of EV		0%			DCF Assumptions:				
WACC		9.6%			Terminal growth		4.0%		
					Risk-free rate		4.2%		
					Market risk		6.0%		
Enterprise NPV		52,504,179			Beta		0.89		
+ Net cash (debt), current		836,558			Cost of debt		8.0%		
- Minorities (Market value)		(74,552)							
+/- Other items		0			Implied exit P/E multiple (x)		14.9x		
= Equity value		53,266,185							
/ Number of shares		5,911,018							
= Equity value per share (HK\$)		9.0							

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

Table 4: CSPC — Sensitivity analysis based on WACC and perpetual terminal growth rate

		Terminal growth rate						
		2.5%	3%	3.5%	4.0%	4.5%	5.0%	5.5%
WACC	8.1%	9.3	10.2	11.2	12.5	14.2	16.4	19.4
	8.6%	8.5	9.2	10.1	11.1	12.4	14.0	16.2
	9.1%	7.8	8.4	9.1	9.9	11.0	12.2	13.8
	9.6%	7.2	7.7	8.3	9.0	9.8	10.8	12.1
	10.1%	6.7	7.2	7.7	8.2	8.9	9.7	10.7
	10.6%	6.3	6.7	7.1	7.6	8.1	8.8	9.6
	11.1%	5.9	6.2	6.6	7.0	7.5	8.1	8.7

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

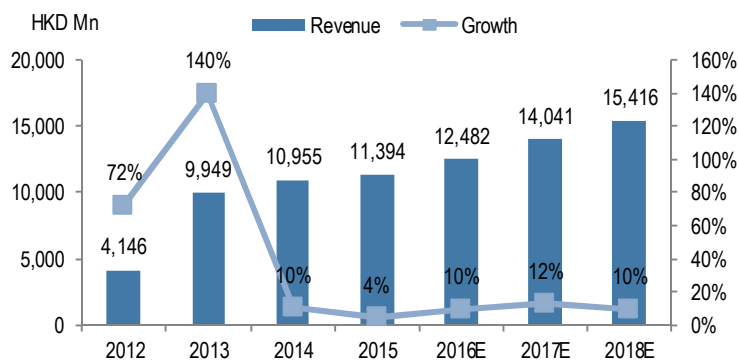
Financial analysis

Revenue forecasts

We provide detailed forecasts for the key products such as NBP, Oulianing, Xuanning, and oncology drugs etc. Revenue for the year 2015 was HKD 11.394 billion, representing a decent Y-O-Y increase of 4%. Finished drugs and bulk drugs account for 68.4% and 31.6% of the group's sales respectively. The company also has a strong pipeline of upcoming drugs, due in part to its investment in R&D (~3% of sales). In 1H16, revenue grew by 7.3% to RMB6, 146mn and finished drugs and bulk drugs accounted for 71.3% and 24.8% of the sales respectively. The R&D investment was also around 3.1% of the sales.

Overall, we expect sales to increase by a CAGR of 10.6% during 2016-18. Sales growth, as per our estimates, will be 10%, 12% and 10% in 2016, 2017 and 2018 respectively, up from 4% in 2015 owing to the growth in innovative drug business.

Figure 13: Sales Growth CAGR of 11%, 2016-2018E



Source: Company data, J.P. Morgan estimates

Table 5: Revenue and growth forecast for Key products

	2014	1H15	2015	1Q16	1H16	2016E	2017E	2018E
NBP	1,413	898	1,255	601	1,239	2,494	3,281	3,840
YoY % NBP	38%	39%	40%	36%	22%	30%	32%	17%
Oulianing	789	470	531	266	634	1,165	1,340	1,541
YoY % Oulianing	33%	21%	13%	16%	27%	20%	15%	15%
Xuanning	329	203	233	117	248	481	553	636
YoY % Xuanning	28%	32%	15%	16%	25%	20%	15%	15%
Oncology	250	195	250	111	495	745	1,096	1,370
YoY % Oncology	0%	74%	28%	32%	67%	52%	47%	25%

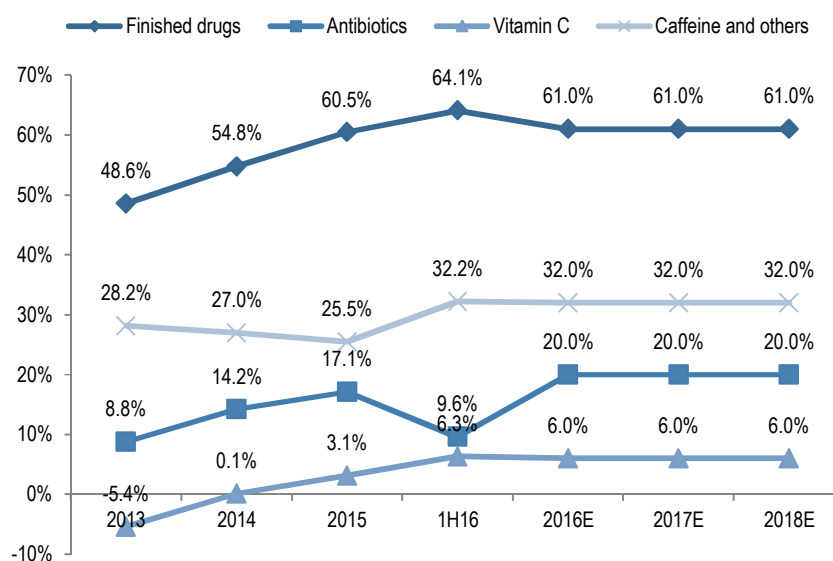
Source: Company data, J.P. Morgan estimates

Gross margin trend

Overall gross margin improved significantly in 1H16 as compared to 1H15. For 1H16 GM was 49.4% as compared to 45% up 440 bp from 1H15. The most impressive improvement was in Caffeine and others up by 6.7 percentage points.

We forecast the overall GM based on a blended mix of the gross margin for the new innovative drug and that for legacy CPG API business. We expect GM to trend up because of rising contribution from high-price high GM products such as injectable NBP and Jinyouli although we do see overall price cutting pressure for drugs. As for CPG Group, we expect GM to climb up even more because: 1) Low margin API business for antibiotics is divested; 2) improved production capabilities in Bulk Drug business, and 3) increased ASP of Caffeine and related products.

Figure 14: CSPC – Overall gross margin trend



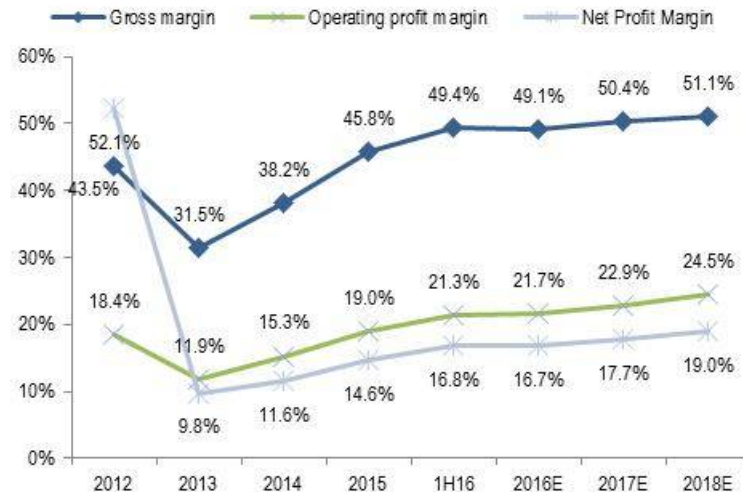
Source: J.P. Morgan estimates Company data.

Operating expenses ratio to stay relatively stable

Selling expenses went up from 2013-2015 due to divestiture of high revenue low selling business of 6-APA and bulk amoxicillin. The ratio was 19.9% in 2015 and we believe it will remain stable in the future with growing marginally to 20.5% in 2016 and then coming down to 20.0% in 2018. Selling expenses may trend up a bit as the company rolls out new products which will not generate significant sales but require heavy sales and marketing investment.

Due to increasing contribution from the innovative drugs, operating margin and net margin improved to 19.0% and 14.6% in 2015 as compared to 15.3% and 11.6% the year before. In 1H16, the operating margins and net margins improved by 2.6pp and 2.5pp respectively, and stood at 21.3% and 16.8% respectively. We expect net margin further expand to 16.7%, 17.7% and 19% in 2016, 2017 and 2018, on continuous leverage.

Figure 15: CSPC - Margin trend analysis



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

Expect 21% EPS CAGR between 2015-2018E

We expect strong EPS growth for CSPC in next few years. Given the low ASP and competitive environment seeing many suppliers struggling, upside to VC business could bring substantial earnings power. Also, the caffeine business is experiencing mild price increases and some players cutting down production. This should help drive revenue for CSPC. In the Bulk drug business CSPC has market leading positions with more efficient and technologically advanced production facilities, which allows it to enjoy lower costs.

In addition, we see strong sales momentum for key products in finished drug business to continue, and supplemented by new products, Robust Sun may have further upside to its operating margin. It is relatively straightforward to forecast below OP line items. Overall, we expect CSPC to record EPS of HK\$0.352, HK\$0.421, and HK\$0.496 for the next three years, with growth of 25%, 19% and 18% respectively in 2016, 2017 and 2018.

Figure 16: CSPC - EPS and growth

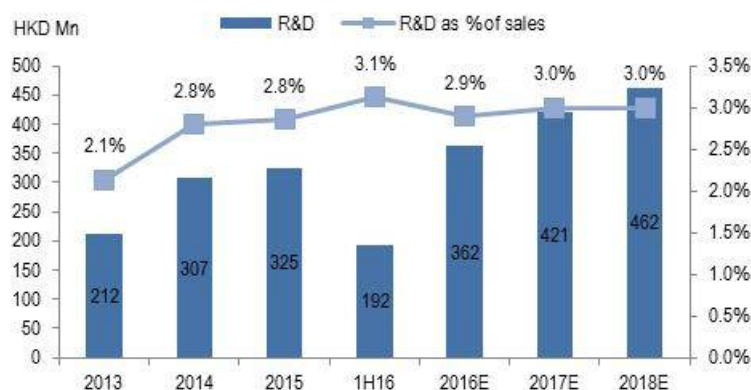


Source: J.P. Morgan estimates, Company data.

R&D Expenses

The group continued to spend money in R&D for development of new products in innovative drugs category which enjoys high ASPs and profit margins. Management is committed to spend 8-10% of total revenue from innovative drug on R&D annually. Currently it has around 170 products in pipeline. It spent HK\$325mn on R&D in 2015 as opposed to HK\$307mn in 2014, representing a 2.8% YoY growth. In 1H16, it spent HKD192mn in R&D which accounted for 3.1% of sales. We forecast that due to the increasing price pressure on generics and APIs, CSPC will continue to spend 2.9%, 3.0% and 3.0% in 2016, 2017 and 2018 respectively representing a CAGR of 12.44% during 2015-18.

Figure 17: R&D expense and % of revenue



Source: Company data; J.P. Morgan estimates

Balance Sheet and Cash Flow

We forecast balance sheet based on earnings results and key turnover ratios for AR, inventory and account payable days turnover. In 2015, the company's sales days outstanding were 62 days, down from 67 days in 2014 but inventory turnover period did lengthen a bit to 107 days from 99 days in 2014. Current ratio of the Group improved further from 1.8 a year earlier to 2.2 as at 31 Dec. 2015.

In 2015, CSPC generated operating cash flow of HK\$2,250.5mn, higher than the HK\$2,151.2mn generated in 2014. In 1H16, CSPC generated RMB951mn operating cash flow.

Capital expenditure in relation to the additions of production facilities amounted to HK\$816mn, compared to HK\$807mn for 2014. We forecast the company would increase capital expenditure to HK\$894mn in 2016, HK\$1,005mn in 2017 and HK\$1,104mn in 2018, as it continues to invest in developing its Generics business to take advantage of patent expires and the low priced drug policy of PRC government.

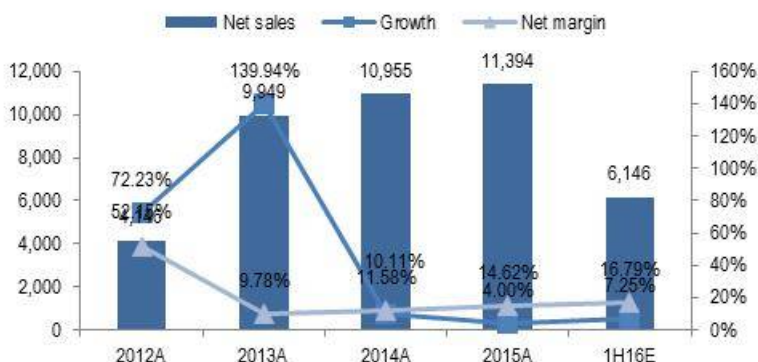
As at 2015, CSPC has cash and bank balances of HK\$2,299mn, increasing substantially from HK\$1,468mn in 2014 and total debt amounted to HK\$1,463mn, up from HK\$1,226 in 2014. Total borrowing comprised of bank loans worth HK\$1,382mn and loans from related company of HK\$81mn. In 1H16, the cash and bank balance was RMB2,173mn and the total debt was RMB1,462mn. Net gearing ratio was 28% vs. 3% at 2014. The debt was 44% denominated in HK dollars, 16% in US dollars and 40% in RMB.

Company Overview

CSPC is a leading pharmaceutical group in China. CSPC, through its subsidiaries, is primarily engaged in development, manufacture, marketing and sales of medicines and pharmaceutical related products in two major business segments including finished drugs (innovative drugs and common generic drugs) and bulk drugs. CSPC has nearly 1,000 finished drugs products including antibiotics, cardio-cerebrovascular drugs, antipyretic analgesic drugs, digestive system drugs, oncology drugs and traditional Chinese medicine.

Revenue for the year 2015 was HKD 11.394 billion, representing a Y-O-Y increase of 4%. Finished drugs and bulk drugs account for 68.4% and 31.6% of the group's sales respectively. In 1H16, the revenue grew by 7.3% to RMB6,146mn and Finished drugs and bulk drugs accounted for 71.3% and 24.8% of the sales respectively. The R&D investment was also around 3.1% of the sales. The company also has a strong pipeline of upcoming drugs, due in part to its investment in R&D (~3% of sales). It has 15 Class 1 drugs, 38 Generic drugs (under trial), 40 generic drugs (received trial approval and pending clinical trial) and 22 U.S. ANDA drugs under pipeline.

Figure 18: Revenue and Net Margin growth. 2012-2015

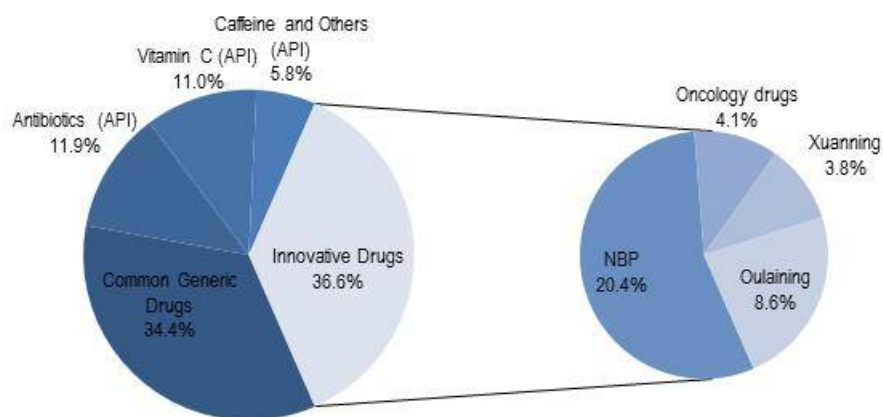


Source: Company data

Business Segments

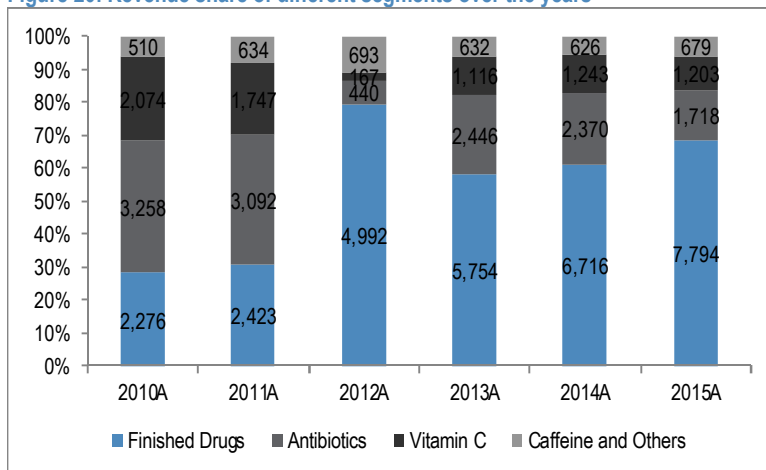
CSPC has 2 major business segments: Finished drugs and Bulk Drugs. Finished drugs make up for 71.3% of the total group's revenue and the rest 28.7% comes from Bulk Drugs.

Figure 19: Revenue distribution 1H16



Source: Company data,

Figure 20: Revenue share of different segments over the years



Source: Company data, JP Morgan

Finished Drugs

Finished drugs are the drugs which are directly sold to the end consumers like capsules, tablets and liquids etc. Finished drug products of the group are mainly sold in China. The target market for this segment includes hospitals, clinics, healthcare institutions and retail pharmacy stores. Revenue for Finished drugs in 2015 was HKD 7,793 million, up by 16% from 2014. Out of this 48% came from Innovative drugs and the rest 52% from Generic drugs. In 1H16, the revenue from finished drugs was HKD4379mn representing an increase of 15% YoY. Out of this Innovative drugs constituted 52% and the rest was bulk drugs.

Finished drugs are further categorized as Innovative drugs and Common Generic Drugs.

1. **Innovative drugs** comprise of NBP, Oulaining, Xuanning, Duomeisu, Jinyouli, Ailineng and Nuolining. The revenue from innovative drugs accounted for HKD 2,268 million, up 28.3% in 1H2016, up from HKD 1,728 million.

Table 6: Major Innovative Drugs

Drug Name	Common Name	Chinese Name	Description
NBP	Butylphthalide	恩必普	<ul style="list-style-type: none"> Indication: acute ischemic stroke Exclusive, patent-protected product
Oulaining	Oxiracetam	欧来宁	<ul style="list-style-type: none"> Indication: mild to moderate memory and mental impairment resulting from vascular dementia, senile dementia and brain trauma "First-to-market" generic, exclusive oxiracetam powder formulation
Xuanning	Levamlodipine maleate	玄宁	<ul style="list-style-type: none"> Indication: hypertension, chronic stable angina and variant angina NRDL
Oncology Drugs	Duomeisu	Doxorubicin hydrochloride liposome injection	<ul style="list-style-type: none"> Indication: cancer (multiple myeloma, lymphoma, ovarian cancer, breast cancer) "Second-to-market" generic drug
	Jinyouli	PEG-rhG-CSF injection	<ul style="list-style-type: none"> Indication: cancer (multiple myeloma, lymphoma, ovarian cancer, breast cancer) "Second-to-market" generic drug
	Ailineng	Elemene injection	<ul style="list-style-type: none"> Indication: nerve glioma and brain metastases, and adjuvant treatment of malignant pleural and peritoneal effusion "Second to market" generic drug
	Nuolining	Imatinib mesylate tablet	<ul style="list-style-type: none"> Indication: Ph+CML and Ph+ALL "Third-to-market" generic drug

Source: Company data, J.P. Morgan

Major Products Portfolio:

NBP

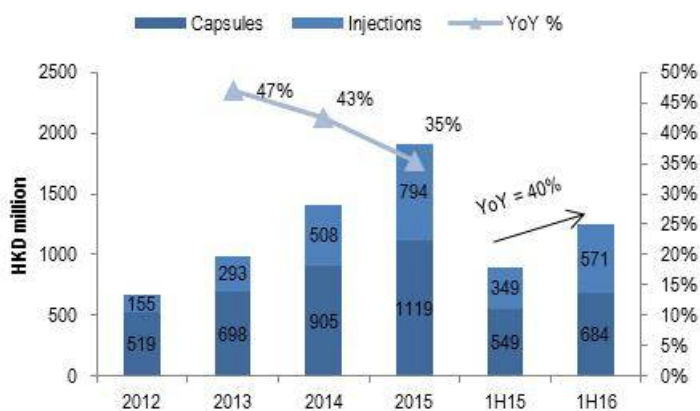
NBP series is a patent protected Class I drug in China. It is primarily used for treating acute ischemic stroke and it's the fastest growing product for this treatment. It was launched in soft capsule form in 2005 and injection form in 2010. NBP has also been promoted to class II recommendation and level B evidence during 2015. Its revenue increased by 40% YoY in 1H2016 to HKD 1,255 million from HKD 898 in 1H2015. Revenue from Capsules, which contributed to 55 % of the NBP revenue, increased by 25% YoY and Revenue by Injections increased by 63% YoY in 1H 2016.

Table 7: NBP description

Drug Category	Class 1 new drug	
Major Ingredient	Butylphthalide	
Formulation	Soft capsule and injection	
Indication	Acute ischemic stroke	
Awards	2009 - State Science and Technology Progress Award (Second Class) 2011 - Golden Award for Outstanding Chinese Patented Invention 2014 - China Grand Awards for Industry	
	NBP Soft Capsule	NBP Injection
Launched	2005	2010
Reimbursement	NRDL	7 provinces

Source: Company data, J.P. Morgan

Figure 21: Sales of NBP capsules and injections



Source: Company data, J.P. Morgan

Oulaining

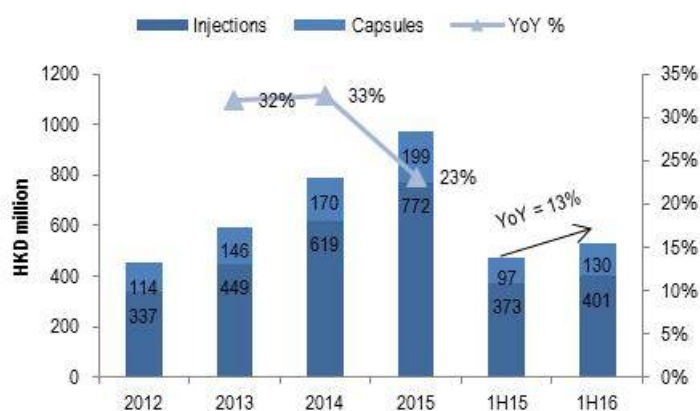
Oulaining is primarily used for treating mild to moderate memory and mental impairment due to vascular dementia, senile dementia and brain trauma. It's available in the form of capsule and lyophilized powder injection. Oulaining lyophilized injection is currently an exclusive product in China. The revenue from Oulaining increased by 13% YoY to HKD 531 million in 1H 2016 up from HKD 470 million in 1H 2015. Revenue from injections, which account for 76% of the Oulaining revenue in 1H 2016, was HKD 401 million in 1H 2016 up by 7% YoY. Revenue from capsules was HKD 130 million, up by 33% YoY.

Table 8: Oulaining Description

Major Ingredient	Oxiracetam	
Formulation	Capsule and powder injection	
Indication	Mild to moderate memory and mental impairment resulting from vascular dementia, senile dementia and brain trauma	
Awards	2013 - Hebei Province Science and Technology Progress Award (First Class)	
	OLN capsule	OLN powder injection
Launched	2004	2010
Reimbursement	12 provinces	21 provinces

Source: Company data

Figure 22: Sales of Oulaining



Source: Company data

Xuanning

Xuanning is used for treatment of hypertension and angina pectoris. It's available in two forms: tablet and dispersible tablet. Its revenue went up by 15% in 1H 2016 to HKD 233million.

Table 9: Xuanning Description

Major Ingredient	Maleate levamlodipine
Indication	Hypertension
Formulation	Tablet and dispersible tablet
Awards	2013 - State Technological Invention Award (Second Class)
Remarks	Obtained 9 patents related to the preparation of Maleate Levamlodipine and related products, including 1 patent granted in the U.S.
Launched	2004
Reimbursement	NRDL

Source: Company data,

Figure 23: Sales of Xuanning



Source: Company data

Oncology Drugs

CSPC manufactures and sells 4 major oncology drugs; Duomeisu, Jinyouli, Ailineng and Nuolining. All of them are injections except Nuolining, which is a tablet. The revenue from Oncology drugs increased by 28% YoY to HKD250 million in 1H 2016.

Duomeisu

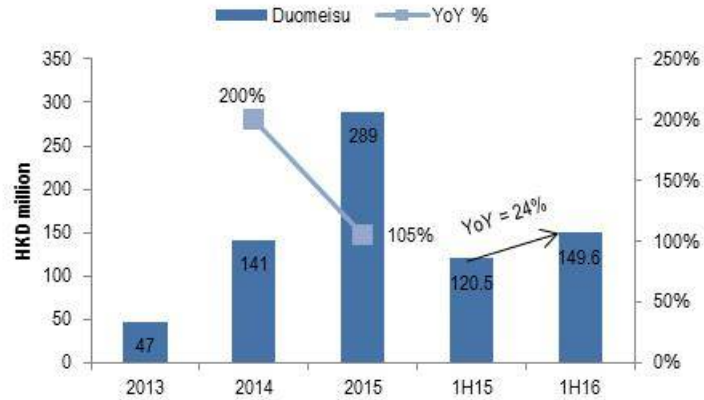
Duomeisu is used as a first-line chemotherapy drug for treatment of lymphoma, multiple myeloma, ovarian cancer and breast cancer. It's also used as a second-line chemotherapy drug for treating patients with improving progress of AIDS related Kaposi's sarcoma. Its revenue increased by 224% in 1H 2016 to HKD 149.6 million up from HKD 120.5 in 1H 2015.

Table 10: Duomeisu Description

Major Ingredient	Doxorubicin hydrochloride liposome, a new type of anthracycline
Formulation	Injection
Indication	Lymphoma, multiple myeloma, ovarian cancer, breast cancer and other malignant tumors
Launched	2012 (Second to launch in China)
Reimbursement	2 provinces

Source: Company data

Figure 24: Sales of Duomeisu



Source: Company data

Jinyouli

Jinyouli is the first long-acting growth factor drug in China. It's a long-acting white blood cell booster used for preventing leucopenia and infection induced due to chemotherapy. Its revenue for 1H 2016 was HKD 58.1 million, up by 73% YoY.

Table 11: Jinyouli Description

Major Ingredient	PEGylated recombinant human granulocyte colony stimulating factor (PEG-rhG-CSF)
Formulation	Injection
Indication	Prevention of leucopenia and infection induced by chemotherapy treatment
Remarks	First approved long-acting growth factor drug in China
Launched	2012 (First to launch in China)
Reimbursement	3 provinces

Source: Company data

Figure 25: Sales of Jinyouli



Source: Company data

- 1) **Common generic drugs:** CSPC has more than 150 major drugs in common drugs portfolio covering various therapeutic areas, including anti-biotic, health supplement, chronic diseases etc. The revenue from generic drugs increased by 3.9% YoY to HK 2,112 million in 1H 2016 .

Table 12: Types of Common generic drugs sold by CSPC

Drug Name	Common Name	Chinese Name	Indication
Ouyi	Cefadroxil	欧意	Oral cephalosporins
	Antipyretic detoxicate		It has good anti-inflammatory, antifebrile and antiviral effects. It is a TCM antibiotic medicine and can be prescribed for multiple indications
Gubang	Alendronate Sodium Tablet	固邦	Osteoporosis
Weihong	Azithromycin, macrolide antibiotics	维宏	Applicable to various kinds of infections caused by sensitized bacteria, including upper respiratory tract infection such as otitis media, sinusitis, pharyngitis, tonsillitis; lower respiratory tract infection such as bronchitis, pneumonia; skin and soft tissues infection
Guoweikang	Vitamin C tablets	果维康	
Glimepiride	Sulfonylurea oral hypoglycemic	格列美脲	Used when dietary control, exercise therapy and weight loss are not sufficient to control blood glucose for type-2 diabetes
Meropenem		美罗培南	Used for respiratory system, urinary, reproductive system and soft tissue infections, as well as meningitis and sepsis, etc.
Shuxuening	TCM injection extracted from Ginkgo leaves	舒血宁	Ischemic cardio-cerebral vascular disease, coronary heart disease, angina pectoris, cerebral embolism, cerebral angiospasm etc.
Antibiotics	Amoxicillin capsules	抗生素	

Source: Company data, J.P. Morgan

Bulk Drugs (API)

Bulk drug products are basically raw materials which are used to prepare finished goods. This segment accounts for 28.7% of the revenue for the group. The 3 main bulk drugs are antibiotics, vitamin C and caffeine in the bulk powder form. Bulk drugs are primarily sold to pharmaceutical companies, food and beverages manufacturers and distributors in China as well as in overseas markets including U.S., Germany, Japan and India.

The Antibiotics (API) & Vitamin C (API) are the leading products of CSPC. They are produced through the biological fermentation of corn, starch and other natural agricultural products. At present, its annual productivity of Vitamin C is 30000tons/year and ranks first in the world.

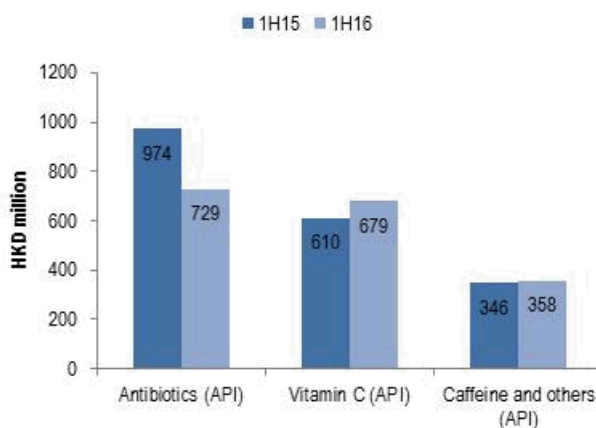
Revenue from bulk drugs in 2015 was HKD 3,601 billion down from HKD 4,239 billion the year before. Out of this 47.5% was from Antibiotics, 33.5% from Vitamin C and 19% from Caffeine and others. In 1H 2016, the revenue from Bulk drugs was HKD 1,766million down by 8.5% YoY.

Table 13: Types of Bulk Drug APIs sold by CSPC

Drug Name	Description
Antibiotics	<p>Cephalosporin</p> <ul style="list-style-type: none"> Major products: 7-ACA, ceftriaxone sodium, cefuroxime acid Market share over 25% <p>Penicillin</p> <ul style="list-style-type: none"> Major products: Penicillin G salt, 6APA, amoxicillin
Vitamin C	<ul style="list-style-type: none"> Major products: vitamin C, vitamin C - sodium, vitamin C - calcium and granular vitamin C Global market share over 35% Proportion of export over 75% Long-term business relationship with global top-tier clients including Coca-Cola, Abbott, Kraft Foods and Nestle
Caffeine	<ul style="list-style-type: none"> Global market share over 40% Caffeine production has a high entry barrier as it is specially regulated by the Chinese Government Long-term business relationships with global top-tier clients including Coca-Cola, Pepsi and Red Bull

Source: Company data, J.P. Morgan

Figure 26: Revenue from Bulk Drugs

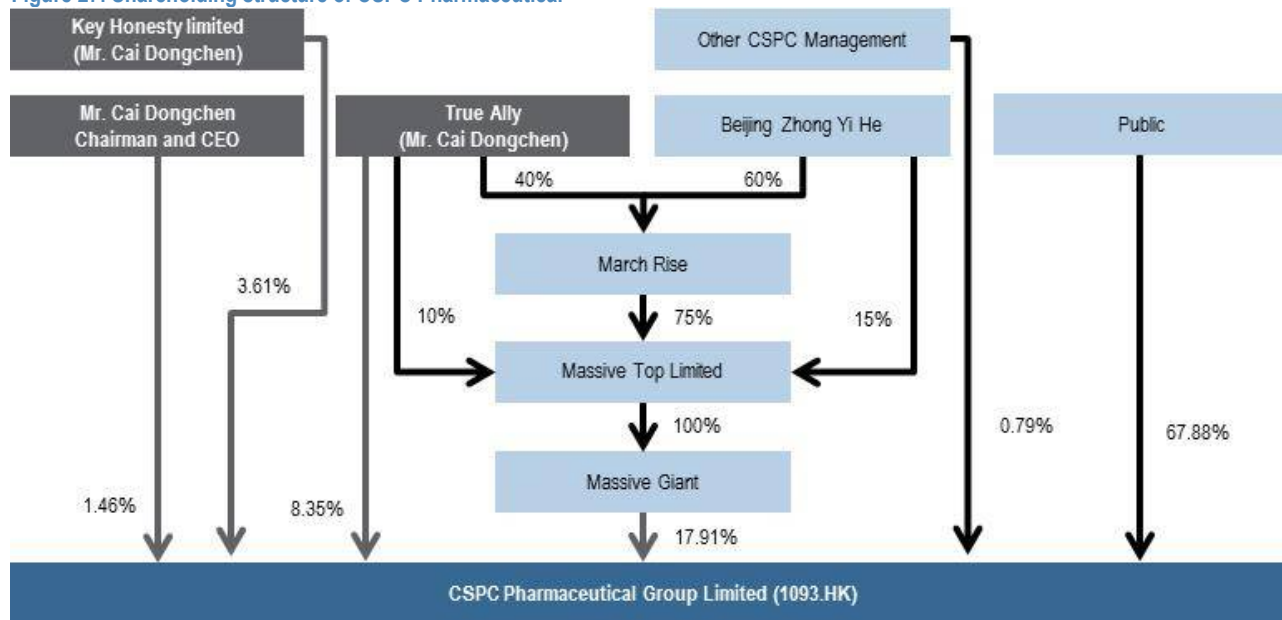


Source: Company data, J.P. Morgan

Shareholding Structure

Mr. Cai Dongchen, Chairman and CEO, owns 31.33% of the shares of the company. Out of this, he owns 1.46% directly and the rest is owned by various holding companies under direct or indirect control of Mr. Cai Dongchen. Other CSPC management own another 0.79% of the shares. And out of the other 67.88% of public shares, JP Morgan Chase & CO. and UBS are the largest shareholders with 6.04% and 6.03% shares respectively.

Figure 27: Shareholding structure of CSPC Pharmaceutical



Source: Company data, J.P. Morgan

Table 14: Top 10 shareholders of CSPC Pharmaceutical

Holding Entity	% Shares
Dongchen Cai	8.47%
JP Morgan Chase and Co	6.04%
UBS	6.03%
Commonwealth Bank of Australia	5.01%
Key Honesty Ltd	3.61%
Fil Ltd.	2.58%
Vanguard Group Inc.	2.21%
Blackrock	2.03%
Value Partners Ltd.	1.97%
T Rowe Price Associates	1.52%

Source: Company data, J.P. Morgan

SWOT Analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> • Large product portfolio with more than 1,000 products • More than 30 products have sales exceeding RMB 100 million • Production capacity for Vitamin C, penicillin, and caffeine rank first in the world • Strong R&D team with more than 170 drugs on pipeline in both China and US • Decrease in the cost of goods sold for the second consecutive year despite stable increase in sales • Gross margin and Operating margin have been consistently increasing over the past 2 years and are now at their all-time high 	<ul style="list-style-type: none"> • Future drug sales revenue depends on the ability to win drug tender • Revenue growth in 2015 was far below the average growth of the last 5 years, which could signal the weakening growth in the Chinese healthcare market
Opportunities	Threats
<ul style="list-style-type: none"> • Aging Chinese population, increased healthcare spending and increase in per capita disposable income will spur growth in Chinese healthcare sector in the coming years • Strategic M&A opportunities to further strengthen product portfolio within existing therapeutic areas, enter into new therapeutic areas as well as to further enhance sales • Increasing incidence rate of cancer, diabetes and other elderly diseases should lead to sizeable sales of innovative drugs sold by CSPP • Expand the existing reach into international market for both finished and bulk drugs 	<ul style="list-style-type: none"> • Uncertainties in the outcome of drug approval process of products in pipeline can adversely affect market launch timing • Strict regulations on drug pricing in China • Any potential harm or side effects from products which are not revealed during clinical trials can cause serious harm to the sales and brand equity • Huge Chinese pharmaceutical market size will likely attract international players which will intensify the already stiff market competition

Source: J.P. Morgan

Company History



Source: Company data, J.P. Morgan

Key Management Profile

CAI Dongchen, Chairman and CEO

Mr. Cai, aged 62, Chairman and Chief Executive Officer of the Company, was appointed as an executive director of the Company in 1998. Mr. Cai is also the chairman of the Nomination Committee of the Company and a director of certain subsidiaries of the Group. Mr. Cai has extensive technical and management experience in the pharmaceutical industry. Mr. Cai is a deputy of the 12th National People's Congress of the People's Republic of China (the "PRC").

CHAK Kin Man, Executive Director

Mr. Chak, aged 50, was appointed as an executive director of the Company in 2005. Mr. Chak is also a director of certain subsidiaries of the Group. Mr. Chak is a certified public accountant of the Hong Kong Institute of Certified Public Accountants and a fellow member of the Association of Chartered Certified Accountants. Mr. Chak has extensive experience in finance, accounting and investor relation.

PAN Weidong, Executive Director

Mr. Pan, aged 46, was appointed as an executive director of the Company in 2006. Mr. Pan is also a director of certain subsidiaries of the Group. Mr. Pan has extensive experience in finance and accounting.

WANG Shunlong, Executive Director

Mr. Wang, aged 51, was appointed as an executive director of the Company in 2008. Mr. Wang has spent three years as a visiting researcher at Eindhoven University of Technology in the Netherlands. Mr. Wang has extensive experience in corporate management and investment planning.

WANG Huaiyu, Executive Director

Mr. Wang, aged 52, was appointed as an executive director of the Company in 2010. Mr. Wang is also a director of certain subsidiaries of the Group. Mr. Wang has extensive technical and management experience in the pharmaceutical industry.

LU Jianmin, Executive Director

Mr. Lu, aged 57, was appointed as an executive director of the Company in 2010. Mr. Lu is also a director of certain subsidiaries of the Group. Mr. Lu has extensive technical and management experience in the pharmaceutical industry.

WANG Zhenguo, Executive Director

Mr. Wang, aged 46, was appointed as an executive director of the Company in 2012. Mr. Wang is also a director of certain subsidiaries of the Group. Mr. Wang has extensive technical and management experience in the pharmaceutical industry.

WANG Jinxu, Executive Director

Mr. Wang, aged 45, was appointed as an executive director of the Company in 2013. Mr. Wang is also a director of certain subsidiaries of the Group. Mr. Wang holds a doctorate in chemical engineering from Tianjin University, and has extensive experience in product research and development in the pharmaceutical industry.

Investment Thesis, Valuation and Risks

CSPC Pharmaceutical (*Overweight; Price Target: HK\$9.00*)

Investment Thesis

After acquiring OYY, NBP and XNW from its parent company in October 2012, CSPC Pharma (formerly China Pharmaceutical) has undergone a strategic transformation from a manufacturer of bulk medicine products to a provider of innovative drugs and branded generics, which, in our opinion, has made CSPC one of the more compelling investment opportunities in the China healthcare space. Although we are quite cautious on the drug subsector overall because of policy headwinds, including tenders and price cuts, the ongoing investigation of GSK and anti-bribery efforts by the Chinese government, we believe CSPC can withstand policy headwinds better than many of its peers because its strong portfolio of unique, innovative and branded generic products provides strong pricing power. In addition, the company's API businesses partly shield CSPC from government price control of finished drugs.

Valuation

Our Dec-17 price target of HK\$9.00 is based on a DCF valuation that assumes a market premium of 6.0% and a risk-free rate of 4.2% (yield on 10-year government notes in China). We assume a beta of 0.89, based on a regression analysis performed by Bloomberg. Accordingly, we assume a WACC of 9.6%. We estimate free cash flow for CSPC until 2020 and assume a terminal growth rate of 4.0%. Our PT implies a FY17E P/E of 21x, PEG of 1.0.

Risks to Rating and Price Target

Key risks to our rating and PT include 1) an unexpected sales slowdown for CSPC's key products; 2) further erosion of VC ASPs. 3) Pipeline delay and/or failure

CSPC Pharmaceutical: Summary of Financials

Income Statement						Cash flow statement					
HK\$ in millions, year end Dec	FY14	FY15	FY16E	FY17E	FY18E	HK\$ in millions, year end Dec	FY14	FY15	FY16E	FY17E	FY18E
Revenues	10,955	11,394	12,482	14,041	15,416	EBIT	1,674	2,166	2,704	3,214	3,770
% change Y/Y	10.1%	4.0%	9.6%	12.5%	9.8%	Depr. & amortization	595	590	601	636	680
Gross Profit	4,187	5,221	6,125	7,073	7,877	Change in working capital	(85)	(46)	(683)	(1,055)	370
% change Y/Y	33.7%	24.7%	17.3%	15.5%	11.4%	Taxes	(293)	(386)	(542)	(646)	(760)
EBITDA	2,269	2,757	3,305	3,850	4,450	Cash flow from operations	1,806	2,251	2,080	2,149	4,060
% change Y/Y	24.5%	21.5%	19.9%	16.5%	15.6%	Capex	(814)	(824)	(901)	(1,013)	(1,112)
EBIT	1,674	2,166	2,704	3,214	3,770	Net Interest	(54)	(56)	(56)	(56)	(56)
% change Y/Y	41.9%	29.4%	24.8%	18.8%	17.3%	Other	57	123	0	0	0
EBIT Margin	15.3%	19.0%	21.7%	22.9%	24.5%	Free cash flow	1,036	1,472	1,224	1,180	2,993
Net Interest	(54)	(56)	(56)	(56)	(56)	Equity raised/(repaid)	0	0	0	0	0
Earnings before tax	1,621	2,112	2,648	3,157	3,714	Debt raised/(repaid)	(254)	(11)	0	0	0
% change Y/Y	30.0%	30.3%	25.4%	19.2%	17.6%	Other	(20)	(3)	(56)	(56)	(56)
Tax	(337)	(432)	(542)	(646)	(760)	Dividends paid	(473)	(591)	(811)	(967)	(1,137)
as % of EBT	20.8%	20.5%	20.5%	20.5%	20.5%	Beginning cash	1,188	1,468	2,299	2,611	2,724
Net income (reported)	1,268	1,665	2,088	2,489	2,928	Ending cash	1,468	2,299	2,611	2,724	4,479
% change Y/Y	30.4%	31.3%	25.4%	19.2%	17.6%	DPS	0.10	0.11	0.14	0.16	0.19
Shares outstanding	5,908	5,909	5,909	5,909	5,909						
EPS (reported)	0.21	0.28	0.35	0.42	0.50						
% change Y/Y	29.6%	31.3%	25.4%	19.2%	17.6%						
Balance sheet						Ratio Analysis					
HK\$ in millions, year end Dec	FY14	FY15	FY16E	FY17E	FY18E	HK\$ in millions, year end Dec	FY14	FY15	FY16E	FY17E	FY18E
Cash and cash equivalents	1,468	2,299	2,611	2,724	4,479	Gross margin	38.2%	45.8%	49.1%	50.4%	51.1%
Accounts receivable	2,007	1,878	2,378	2,409	2,847	EBITDA margin	20.7%	24.2%	26.5%	27.4%	28.9%
Inventories	181	182	191	218	225	Operating margin	15.3%	19.0%	21.7%	22.9%	24.5%
Others	1,812	1,893	1,978	2,216	2,280	Net margin	11.6%	14.6%	16.7%	17.7%	19.0%
Current assets	6,606	7,648	8,480	9,300	11,450	Sales per share growth	9.4%	4.0%	9.6%	12.5%	9.8%
LT investments	0	0	0	0	0	Sales growth	10.1%	4.0%	9.6%	12.5%	9.8%
Net fixed assets	5,049	5,143	5,454	5,841	6,283	Net profit growth	30.4%	31.3%	25.4%	19.2%	17.6%
Total Assets	12,501	13,540	14,673	15,870	18,451	EPS growth	29.6%	31.3%	25.4%	19.2%	17.6%
Liabilities						Interest coverage (x)	41.7	48.9	58.7	68.3	79.0
Short-term loans	851	845	977	1,186	1,034	Net debt to equity	(17.0%)	(25.3%)	(24.4%)	(25.7%)	(34.4%)
Payables	2,330	2,489	2,474	1,917	2,833	Working Capital to Sales	0.3	0.4	0.4	0.4	0.5
Others	422	151	151	151	151	Sales/assets	0.9	0.9	0.9	0.9	0.9
Total current liabilities	3,602	3,484	3,602	3,254	4,019	Assets/equity	1.6	1.5	1.5	1.4	1.4
Long-term debt	602	1,011	731	731	731	ROE	16.3%	19.8%	22.3%	23.1%	23.6%
Other liabilities	145	232	232	232	232	ROCE	14.7%	17.7%	19.8%	20.9%	21.6%
Total Liabilities	4,350	4,727	4,565	4,217	4,982						
Shareholders' equity	8,079	8,738	10,015	11,538	13,330						
BVPS	1.37	1.48	1.69	1.95	2.26						

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

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CSPC Pharmaceutical (1093.HK, 1093 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
11-Sep-13	OW	4.04	5.50
06-Jan-14	OW	6.00	7.10
27-Aug-14	OW	6.62	8.10
26-May-15	OW	7.83	9.10
14-Aug-15	NR	7.21	--

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Sep 11, 2013.

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IB clients*	68%	65%	51%

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