



Asia  
China  
Health Care  
Health Care

Industry  
**Shanghai Pharma**

Date  
1 November 2017

Results

## In-line quarter led by manufacturing business

### Solid OCF generation in 3Q17

Shanghai Pharma reported revenue / core profit of RMB33.3bn / 685m in 3Q17, representing YoY growth of 7.9% / 0.5% respectively, moderating from 1H17 growth of 10%/11%. Growth in the distribution arm was dragged down by two invoice policy and broad reform headwinds, while anemic profit growth was due to the high base last year from JV contributions. The manufacturing segment remained the bright spot with 22% growth in 3Q17, or 11% on an organic basis. Contributions from Vitaco and acquired assets in 3Q17 were approximately RMB280m and RMB65m, respectively. We highlight the solid cash generation abilities of SPH, with RMB1.1bn OCF inflow in 3Q17, compared with RMB850m inflow in 3Q16. We maintain Buy on SPH-H on its valuation and growth outlook; Hold for SPH-A.

### Distribution decelerated, while manufacturing continues to deliver

Pharma distribution registered a growth deceleration in 3Q17, registering YoY growth of -9.6%, compared to 10%/16% in 1H17/2016. On the contrary, organic growth at the manufacturing arm accelerated to 11% YoY in 3Q17, compared to 7%/5% in 1H17/2016. Executives expect to capture opportunities arising from the outflow of prescription drugs, supported by the derivative business, including commercial healthcare insurance and Yiyao e-commerce.

### Margin expansion driven by higher DS contributions

GM/OPM increased to 12.1% and 3.9% in 3Q17, compared to 11.3%/3.4% in 3Q16. Gross margin expansion was driven by a growth acceleration at DS and a lower contribution from the IDS segment. OPM improvements are largely attributed to lower selling/marketing expenses and improving operational efficiency. Going forward, management expects financing costs to trend upward slightly, on the back of an upward interest rate revision cycle. AR and inventory days were largely stable, registering 97/51 days in 3Q17, compared with 96/49 days in 3Q16. AP days increased from 83 days in 3Q16 to 100 days this quarter, suggesting enhanced operational liquidity despite reform challenges.

### Maintaining PT of HKD24.5 for SPH-H and RMB21.3 for SPH-A; risks

We derive our target price from 16.5x 2018E EPS. We believe SPH deserves a slight premium for its high earnings visibility and future acquisition opportunities, compared to peers trading at 15x with 12% growth in 2018E (vs. the 10% we

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#### Companies featured

	2016A	2017E	2018E	
Shanghai Pharmaceuticals (2607.HK),HKD20.15				Buy
P/E (x)	13.9	16.1	14.7	
EV/EBITDA (x)	9.1	7.8	6.8	
Price/book (x)	1.3	1.4	1.3	
Shanghai Pharmaceuticals (601607.SS),CNY25.02				Hold
P/E (x)	15.6	23.6	21.5	
EV/EBITDA (x)	11.1	11.4	10.0	
Price/book (x)	1.7	2.0	1.9	

Source: Deutsche Bank

Deutsche Bank AG/Hong Kong

Deutsche Bank does and seeks to do business with companies covered in its resDistributed on: 01/11/2017 05:51:07 GMT aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MCI (P) 083/04/2017. THE CONTENT MAY NOT BE DISTRIBUTED IN THE PEOPLE ' S REPUBLIC OF CHINA ("THE PRC") (EXCEPT IN COMPLIANCE WITH THE APPLICABLE LAWS AND REGULATIONS OF PRC), EXCLUDING SPECIAL ADMINISTRATIVE REGIONS OF HONG KONG AND MACAU.



model for SH Pharma). Upside/ downside risks include price cuts, M&A progress and ASP erosion in flagship products.



## 3Q17 recap

We highlight the following key updates during 3Q17:

- **Impact of two-invoice system:** Management expects the gradual implementation to continue to exert pressure on its IDS segment, while the DS businesses are likely to enjoy above-industry growth and further margin expansion. We estimate the net loss to its IDS business could be close to RMB10bn in FY2018, as reform implementation accelerates. Nevertheless, GM is likely to continue to trend higher as the percentage of DS increases in the next few quarters. We remind investors that DS/IDS remain steady at c. 70% / 30%, respectively.
- **Distribution:** DS delivered significant outperformance vs. IDS in provinces with policy implementation. According to the company, it achieved 8%+/ 14.7%/ 24.3% in Anhui/ Hunan and Shaanxi provinces respectively. For Anhui in particular, DS growth stood above 8% while IDS recorded only 4.5% during the same period. In the aforementioned three provinces, SPH achieved market share expansion as a result of a favorable policy.
- **Manufacturing business:** SH Pharma achieved organic growth acceleration in its manufacturing franchise at 11%/ 7%/ 5% in 3Q17/ 1H17/ 2016, respectively. Notably, sales from Vitaco registered RMB280m in 3Q17, while two more acquisitions from Gansu and Tianjin generated RMB65m to the top line.
- **On M&A:** Shanghai Pharma is actively reviewing favorable targets for acquisitions, with the following selection criteria: 1) an expanding footprint in previously non-covered regions; 2) companies with a competitive edge in specific disease TA. On overseas acquisitions, SH Pharma will focus mainly on companies with specialty pharma, patented drugs or products with high entry barriers.
- **Geographical breakdown:** Zero mark-up policy in Beijing reduced overall ASP by 9-10% during Apr-Sep 17, and volume growth stood at approximately 10%, maintaining flat YoY growth for Beijing revenue. Executives believe that the majority of the negative impact is already reflected in the first few months. Going forward, SH Pharma expects stable growth in the distribution arm from the Beijing region.



Model updated: 01 November 2017

**Running the numbers**

Asia
China
Health Care

**Shanghai Pharmaceuticals**

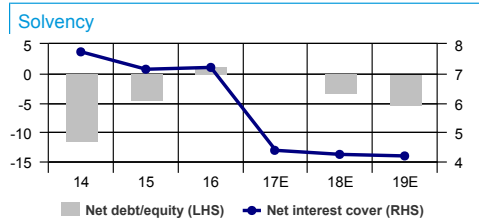
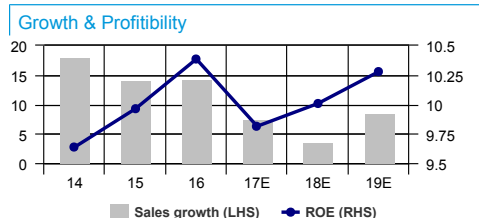
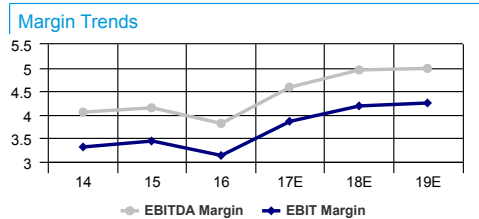
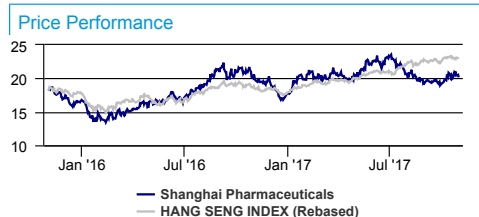
Reuters: 2607.HK      Bloomberg: 2607 HK

**Buy**

Price (31 Oct 17)	HKD 20.15
Target Price	HKD 24.50
52 Week range	HKD 16.80 - 23.55
Market cap (m)	HKDm 54,182 USDm 6,944.6

**Company Profile**

Shanghai Pharmaceuticals is the second-largest pharmaceutical distributor and third-largest pharmaceutical manufacturing company in China. Its pharmaceutical business includes chemical, biopharmaceutical and TCM products. Additionally, the company has the largest retail drug store operation in the eastern region of China.



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Fiscal year end 31-Dec

	2014	2015	2016	2017E	2018E	2019E
<b>Financial Summary</b>						
DB EPS (CNY)	0.80	0.94	1.09	1.06	1.16	1.29
Reported EPS (CNY)	0.96	1.07	1.19	1.19	1.30	1.42
DPS (CNY)	0.38	0.38	0.43	0.42	0.45	0.50
BVPS (CNY)	10.3	11.1	11.8	12.5	13.4	14.3
Weighted average shares (m)	2,689	2,689	2,689	2,689	2,689	2,689
Average market cap (CNYm)	36,734	41,687	40,639	46,033	46,033	46,033
Enterprise value (CNYm)	33,527	40,102	41,861	46,611	45,093	43,969

**Valuation Metrics**

P/E (DB) (x)	17.0	16.5	13.9	16.1	14.7	13.3
P/E (Reported) (x)	14.2	14.5	12.7	14.4	13.2	12.0
P/BV (x)	1.34	1.22	1.29	1.37	1.28	1.20
FCF Yield (%)	nm	nm	nm	5.2	7.3	6.6
Dividend Yield (%)	2.8	2.5	2.8	2.4	2.7	2.9
EV/Sales (x)	0.4	0.4	0.3	0.4	0.3	0.3
EV/EBITDA (x)	8.9	9.2	9.1	7.8	6.8	6.0
EV/EBIT (x)	10.9	11.0	11.1	9.3	8.0	7.1

**Income Statement (CNYm)**

Sales revenue	92,399	105,517	120,765	129,846	134,467	145,881
Gross profit	11,176	12,538	13,897	16,045	17,061	18,631
EBITDA	3,749	4,377	4,609	5,960	6,662	7,275
Depreciation	551	576	617	725	809	885
Amortisation	135	170	207	220	221	189
EBIT	3,063	3,631	3,785	5,014	5,632	6,201
Net interest income/(expense)	-396	-509	-525	-1,145	-1,328	-1,481
Associates/affiliates	413	617	1,233	647	712	783
Exceptionals/extraordinary	0	0	0	0	0	0
Other pre-tax income/(expense)	720	433	426	101	54	58
Profit before tax	3,800	4,172	4,919	4,617	5,069	5,562
Income tax expense	808	807	809	920	1,014	1,112
Minorities	401	487	633	491	568	623
Other post-tax income/(expense)	0	0	-280	0	0	0
Net profit	2,591	2,877	3,196	3,206	3,488	3,827
DB adjustments (including dilution)	-430	-347	-271	-350	-360	-370
DB Net profit	2,161	2,530	2,926	2,856	3,128	3,457

**Cash Flow (CNYm)**

Cash flow from operations	578	611	1,218	3,643	4,410	3,919
Net Capex	-1,291	-1,720	-2,119	-1,266	-1,061	-889
Free cash flow	-713	-1,110	-901	2,376	3,349	3,029
Equity raised/(bought back)	0	0	0	11	0	0
Dividends paid	-1,024	-1,030	-1,156	-1,122	-1,221	-1,339
Net inc/(dec) in borrowings	807	2,163	1,675	2,621	2,000	2,000
Other investing/financing cash flows	-525	64	84	-759	-734	-707
Net cash flow	-1,455	87	-298	3,128	3,394	2,983
Change in working capital	-2,339	-2,704	-2,488	-694	130	-742

**Balance Sheet (CNYm)**

Cash and other liquid assets	11,608	12,039	11,967	15,095	18,489	21,472
Tangible fixed assets	5,473	6,580	7,460	8,803	9,854	10,650
Goodwill/intangible assets	6,356	6,872	8,685	8,537	8,392	8,288
Associates/investments	2,934	3,916	4,501	5,128	5,820	6,583
Other assets	37,970	44,938	50,131	52,668	52,883	59,733
Total assets	64,341	74,344	82,743	90,231	95,439	106,726
Interest bearing debt	8,059	10,492	12,477	15,099	17,099	19,099
Other liabilities	25,183	30,044	33,431	35,712	36,085	42,261
Total liabilities	33,241	40,536	45,908	50,817	53,184	61,360
Shareholders' equity	27,822	29,930	31,623	33,718	35,985	38,472
Minorities	3,277	3,878	5,212	5,702	6,270	6,893
Total shareholders' equity	31,099	33,808	36,834	39,420	42,255	45,366
Net debt	-3,550	-1,547	510	4	-1,390	-2,373

**Key Company Metrics**

Sales growth (%)	18.1	14.2	14.5	7.5	3.6	8.5
DB EPS growth (%)	4.5	17.1	15.6	-2.4	9.5	10.5
EBITDA Margin (%)	4.1	4.1	3.8	4.6	5.0	5.0
EBIT Margin (%)	3.3	3.4	3.1	3.9	4.2	4.3
Payout ratio (%)	39.5	35.8	36.2	35.0	35.0	35.0
ROE (%)	9.6	10.0	10.4	9.8	10.0	10.3
Capex/sales (%)	1.4	1.6	1.8	1.0	0.8	0.6
Capex/depreciation (x)	1.9	2.3	2.6	1.3	1.0	0.8
Net debt/equity (%)	-11.4	-4.6	1.4	0.0	-3.3	-5.2
Net interest cover (x)	7.7	7.1	7.2	4.4	4.2	4.2

Source: Company data, Deutsche Securities estimates



Model updated: 01 November 2017

### Running the numbers

Asia

China

Health Care

## Shanghai Pharmaceuticals

Reuters: 601607.SS Bloomberg: 601607 CH

### Hold

Price (31 Oct 17) CNY 25.02

Target Price CNY 21.30

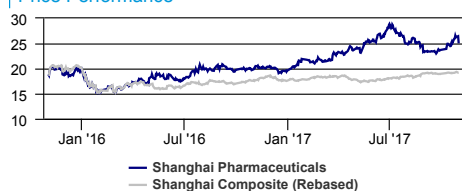
52 Week range CNY 19.08 - 28.88

Market cap (m) CNYm 67,277  
USDm 10,150

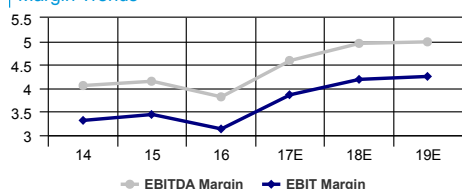
### Company Profile

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### Price Performance



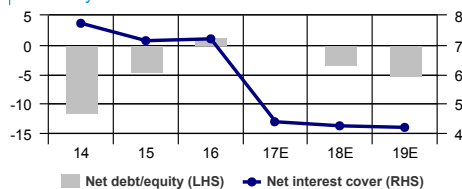
### Margin Trends



### Growth & Profitability



### Solvency



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Fiscal year end 31-Dec

### Financial Summary

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DPS (CNY)	0.38	0.38	0.43	0.42	0.45	0.50
BVPS (CNY)	10.3	11.1	11.8	12.5	13.4	14.3
Weighted average shares (m)	2,689	2,689	2,689	2,689	2,689	2,689
Average market cap (CNYm)	35,986	56,775	49,875	67,277	67,277	67,277
Enterprise value (CNYm)	32,780	55,189	51,096	67,855	66,336	65,213

### Valuation Metrics

P/E (DB) (x)	16.7	22.4	15.6	23.6	21.5	19.5
P/E (Reported) (x)	13.9	19.7	14.3	21.0	19.3	17.6
P/BV (x)	1.58	1.79	1.66	2.00	1.87	1.75
FCF Yield (%)	nm	nm	nm	3.5	5.0	4.5
Dividend Yield (%)	2.8	1.8	2.3	1.7	1.8	2.0
EV/Sales (x)	0.4	0.5	0.4	0.5	0.5	0.4
EV/EBITDA (x)	8.7	12.6	11.1	11.4	10.0	9.0
EV/EBIT (x)	10.7	15.2	13.5	13.5	11.8	10.5

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Equity raised/(bought back)	0	0	0	11	0	0
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Net cash flow	-1,455	87	-298	3,128	3,394	2,983
Change in working capital	-2,339	-2,704	-2,488	-694	130	-742

### Balance Sheet (CNYm)

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Total assets	64,341	74,344	82,743	90,231	95,439	106,726
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Net debt	-3,550	-1,547	510	4	-1,390	-2,373

### Key Company Metrics

Sales growth (%)	18.1	14.2	14.5	7.5	3.6	8.5
DB EPS growth (%)	4.5	17.1	26.7	-10.9	9.5	10.5
EBITDA Margin (%)	4.1	4.1	3.8	4.6	5.0	5.0
EBIT Margin (%)	3.3	3.4	3.1	3.9	4.2	4.3
Payout ratio (%)	39.5	35.8	33.3	35.0	35.0	35.0
ROE (%)	9.6	10.0	11.3	9.8	10.0	10.3
Capex/sales (%)	1.4	1.6	1.8	1.0	0.8	0.6
Capex/depreciation (x)	1.9	2.3	2.6	1.3	1.0	0.8
Net debt/equity (%)	-11.4	-4.6	1.4	0.0	-3.3	-5.2
Net interest cover (x)	7.7	7.1	7.2	4.4	4.2	4.2

Source: Company data, Deutsche Securities estimates



# Appendix 1

## Important Disclosures

\*Other information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Shanghai Pharmaceuticals	601607.SS	25.02 (CNY) 31 Oct 2017	14
Shanghai Pharmaceuticals	2607.HK	20.15 (HKD) 31 Oct 2017	13, 14

\*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg, and other vendors. Other information is sourced from Deutsche Bank, subject companies, and other sources. For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at <http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr>. Aside from within this report, important conflict disclosures can also be found at <https://gm/db.com/equities> under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

## Important Disclosures Required by U.S. Regulators

Disclosures marked with an asterisk may also be required by at least one jurisdiction in addition to the United States. See Important Disclosures Required by Non-US Regulators and Explanatory Notes.

14. Deutsche Bank and/or its affiliate(s) has received non-investment banking related compensation from this company within the past year.

## Important Disclosures Required by Non-U.S. Regulators

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13. As of the end of the preceding week, Deutsche Bank and/or its affiliate(s) owns one percent or more of a class of common equity securities of this company.

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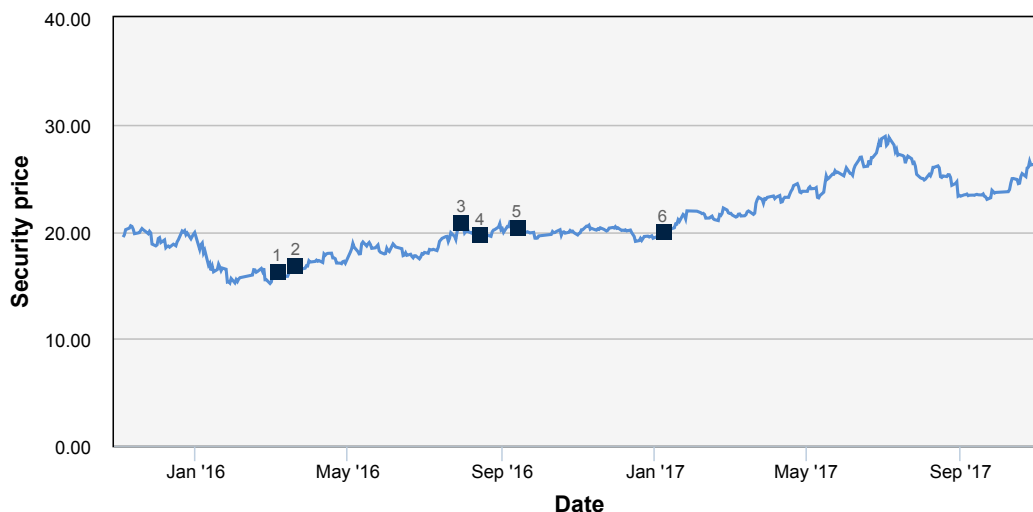
## Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst about the subject issuers and the securities of those issuers. In addition, the undersigned lead analyst has not and will not receive any compensation for providing a specific recommendation or view in this report. Jack Hu



Historical recommendations and target price. Shanghai Pharmaceuticals (601607.SS)

(as of 10/31/2017)



Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

\*\* Analyst is no longer at Deutsche Bank

1.	03/07/2016	Hold, Target Price Change CNY 15,10 Jack Hu, Ph.D	4.	08/15/2016	Hold, Target Price Change CNY 18,10 Jack Hu, Ph.D
2.	03/21/2016	Hold, Target Price Change CNY 14,80 Linc Yiu**	5.	09/14/2016	Hold, Target Price Change CNY 19,80 Jack Hu, Ph.D
3.	07/31/2016	Hold, Target Price Change CNY 16,90 Jack Hu, Ph.D	6.	01/08/2017	Hold, Target Price Change CNY 21,30 Jack Hu, Ph.D

Historical recommendations and target price. Shanghai Pharmaceuticals (2607.HK)

(as of 10/31/2017)



Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

\*\* Analyst is no longer at Deutsche Bank

1.	01/31/2016	Hold, Target Price Change HKD 17,60 Jack Hu, Ph.D	6.	08/15/2016	Hold, Target Price Change HKD 20,10 Jack Hu, Ph.D
2.	03/07/2016	Hold, Target Price Change HKD 16,80 Jack Hu, Ph.D	7.	08/28/2016	Hold, Target Price Change HKD 22,00 Jack Hu, Ph.D
3.	03/21/2016	Hold, Target Price Change HKD 16,30 Jack Hu, Ph.D	8.	01/08/2017	Upgraded to Buy, Target Price Change HKD 24,00 Jack Hu, Ph.D
4.	04/29/2016	Hold, Target Price Change HKD 17,10 Jack Hu, Ph.D	9.	04/28/2017	Buy, Target Price Change HKD 25,10 Jack Hu, Ph.D
5.	07/31/2016	Hold, Target Price Change HKD 18,80 Jack Hu, Ph.D	10.	09/20/2017	Buy, Target Price Change HKD 24,50 Jack Hu, Ph.D



### Equity Rating Key

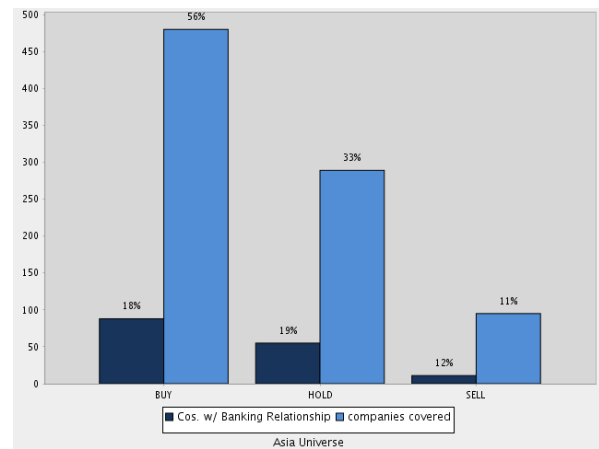
**Buy:** Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield ) , we recommend that investors buy the stock.

**Sell:** Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock.

**Hold:** We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Newly issued research recommendations and target prices supersede previously published research.

### Equity rating dispersion and banking relationships







## Additional Information

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