

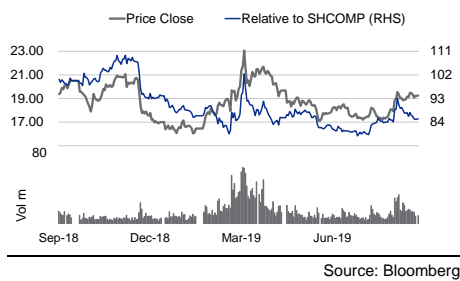


China

HOLD (Initiation)

Consensus ratings*: Buy 16 Hold 2 Sell 2

Current price:	Rmb19.25
Target price:	Rmb20.00
Previous target:	n.a.
Up/downside:	3.9%
CGS-CIMB / Consensus:	n.a.
Reuters:	601607.SS
Bloomberg:	601607 CH
Market cap:	US\$6,985m
	Rmb49,442m
Average daily turnover:	US\$28.75m
	Rmb201.2m
Current shares o/s:	2,842m
Free float:	64.0%
*Source: Bloomberg	



Price performance	1M	3M	12M
Absolute (%)	8.4	8.8	-4.9
Relative (%)	1.1	3.6	-17.9

Major shareholders	% held
Shanghai Shangshi	33.6

Shanghai Pharmaceuticals-A

Less attractive than its H shares; initiate with HOLD

- Overall, we are positive on Shanghai Pharma's (SPH) fundamentals.
- However, the current AH spread of ~43% is at historical high, making SPH's A shares less attractive than its H shares.
- Our Target Price for SPH's A shares is Rmb20.0 (13x 2019F PER, 1sd below the historical average, comparable to our H-share target multiple, which is also 1sd below the average). We initiate SPH's A shares with a HOLD rating.

Manufacturing expected to continue its growth momentum

The manufacturing segment delivered 24% YoY revenue growth in 1H2019 to RMB11.9bn. Strong revenue growth came from the fast ramp-up of 60 key products, whose sales came in at RMB6.77bn, up 31.3% YoY. Despite price pressure, the gross margin was 57.76%, up 0.1ppt from 1H2018, due to 1) fast growth of the 60 high-margin products; and 2) more stringent cost management on raw material procurement and manufacturing centralization. Going forward, we project revenue growth of 20%/17%/15% in 2019/20/21F, respectively. We expect the segment margin to be largely stable, as ~40% of the manufacturing segment is Chinese Traditional Medicines, and most of SPH's chemical generics are in the low-cost drug catalogue, which are largely immune from Group Purchase Organization (GPO) pressure.

Distribution margin pressure can be relieved somewhat

The distribution segment delivered top-line growth of RMB80.19bn in 1H2019, up 21% YoY, and the gross margin was 6.49%, down 0.19 ppt from 1H2018. The distribution segment's robust revenue growth was due to the industry's organic growth (management guided ~8% YoY for 1H2019) and SPH's M&A. The gross margin for the distribution segment was down 0.19 ppt in 1H2019. We believe the margin pressure came from drug price cuts. Going forward, we expect more margin pressure, considering 1) more stringent medical reimbursement standards and more stringent prescription requirements for physicians; 2) a gradual impact of the GPO on drugs, as the first round of the GPO was implemented only in late March in a few cities, so it had nearly no impact on the gross margin of 1H2019. However, we think 1) better-than-expected synergy with Cardinal; 2) continuing industry consolidation under the two invoice system; and 3) a higher percentage of direct sales and a product mix change will help mitigate gross margin pressure.

Catalysts ahead

We believe near-term catalysts include 1) a growing stake increase by Shanghai Shangshi (SPH's largest shareholder, holding a 33.6% stake); 2) news flow on its R&D pipeline; and 3) updates on collaboration with BIOCAD.

Large AH premium makes SPH's A shares less attractive than its H shares

Currently, SPH's AH spread remains at 43%, which is a historical high (Figure 1), making SPH's A shares less attractive than its H shares. We believe the current large AH spread may indicate H-share investors are more conservative than A-share investors about the pharmaceutical industry growth slowdown and potential distribution segment gross margin pressure from the GPO. The Hang Seng AH Premium Index is also near 3-year high, partly because of the social unrest in Hong Kong. A high AH premium reduces the attractiveness of the SPH's A shares. Our target price of Rmb20 for SPH-A implies a 26.4% premium over our target price for SPH-H, not a big difference compared with the average A-H spread of 31% in the past few years.

Analysts

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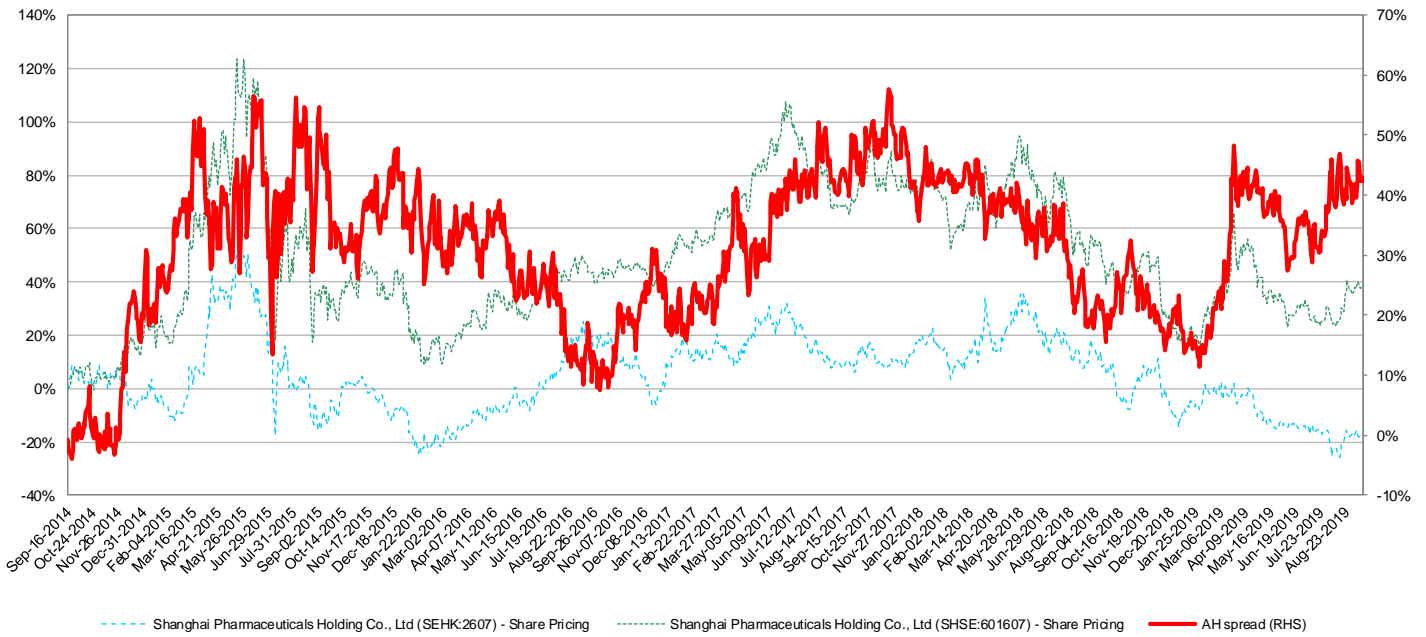
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Financial Summary

	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
Revenue (Rmbm)	130,847	159,084	177,250	196,305	216,041
Operating EBITDA (Rmbm)	5,550	6,650	8,052	8,743	9,487
Net Profit (Rmbm)	3,521	3,881	4,380	4,906	5,515
Normalised EPS (Rmb)	1.31	1.37	1.54	1.73	1.94
Normalised EPS Growth	10.1%	4.3%	12.9%	12.0%	12.4%
FD Normalised P/E (x)	14.70	13.72	12.49	11.15	9.92
DPS (Rmb)	1.31	1.37	1.54	1.73	1.94
Dividend Yield	6.8%	7.1%	8.0%	9.0%	10.1%
EV/EBITDA (x)	10.69	11.29	9.54	8.92	8.29
P/FCFE (x)	NA	NA	1,497	65	35
Net Gearing	4.8%	27.9%	28.0%	26.7%	24.5%
P/BV (x)	1.52	1.40	1.30	1.19	1.10
ROE	10.7%	10.6%	10.8%	11.1%	11.5%
% Change In Normalised EPS Estimates			1.01	1.02	1.03
Normalised EPS/consensus EPS (x)					

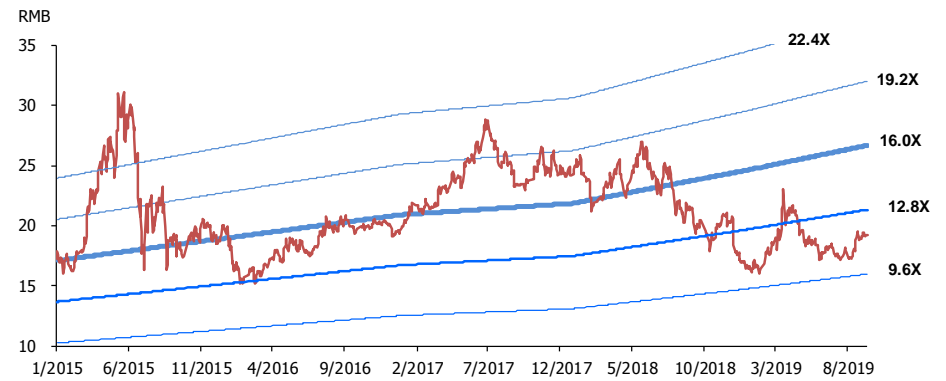
SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

Figure 1: SPH historical AH spread



SOURCE: Capital IQ, CGIS Research

Figure 2: SPH-A historical P/E band



SOURCE: Bloomberg, CGIS Research

Figure 3: SPH 1H2019 P&L

RMBm	1H18	1H19	YoY
<i>Manufacturing</i>	9,627	11,942	24.0%
<i>Distribution</i>	66,252	80,194	21.0%
<i>Retail</i>	3,134	3,837	22.4%
<i>Others</i>	600	823	37.2%
<i>Net off internal sales</i>	(3,734)	(4,220)	
Revenue	75,879	92,575	22.0%
COGS	(65,218)	(79,626)	22.1%
Gross profit	10,661	12,949	21.5%
Other income	135	229	69.5%
Selling expense	(5,218)	(6,430)	23.2%
Admin expense	(2,349)	(2,922)	24.4%
Impairment losses	1	(220)	n.a
Operating profit	3,230	3,606	11.6%
Other gains	86	(2)	n.a
Other expenses	(28)	(10)	-63.6%
Finnace cost	(633)	(806)	27.3%
Finnace income	96	122	27.0%
Results from associate	210	376	78.7%
Results from JV	143	156	9.3%
Pretax income	3,105	3,442	10.9%
Tax	(650)	(691)	6.4%
Net profit	2,455	2,751	12.0%
MI	422	464	10.1%
Profit to shareholders	2,033	2,286	12.4%

SOURCE: Company

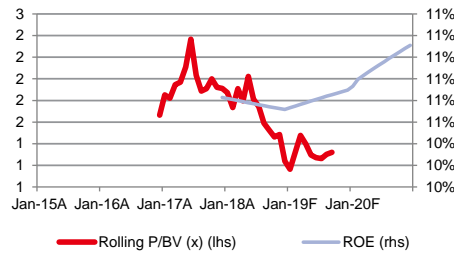
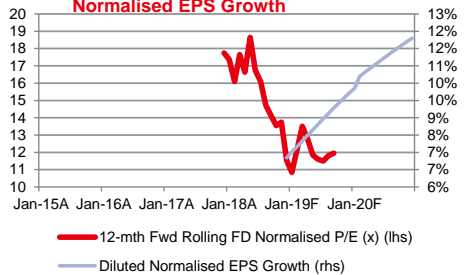
Solid 1H2019 results highlights

- 1H2019 net profit was RMB2.286bn, up 12.4% YoY, accounting for 52.2% and 53.3% respectively of our and the Street's 2019E full-year estimates (vs. 52.4% for 1H2018), in line with our expectations and slightly beating market expectations.
- The manufacturing segment delivered 24% YoY revenue growth to RMB11.9bn with a 57.76% gross margin, up 0.1ppt from 1H2018. The strong revenue growth came from the fast ramp-up of the 60 key products, whose sales came in at RMB6.77bn, up 31.3% YoY.
- The distribution segment delivered top-line growth of RMB80.19bn, up 21% YoY, and the gross margin was 6.49%, down 0.19 ppt from 1H2018. The distribution segment's robust revenue growth was due to the industry's organic growth (management guided ~8% YoY for 1H2019) and SPH's M&A.
- We note that SPH enhanced its cash collections in 1H2019. Operating cash inflow in 1H2019 was RMB2.02bn, up 87% YoY from RMB1.08bn in 1H2018. Its major balance sheet items remained healthy.

Figure 4: CGIS research revenue projections

Year ended Dec 31 (RMBm)	2016A	2017A	2018A	2019F	2020F	2021F
<i>Manufacturing</i>	10,334	14,987	19,462	23,257	27,095	31,023
<i>Distribution</i>	104,865	116,150	139,445	153,389	167,961	183,077
<i>Retail</i>	5,113	5,640	7,202	8,642	10,198	11,830
<i>Net off internal sales</i>		(6,508)	(7,847)	(8,908)	(9,868)	(10,861)
<i>Others</i>	453	578	823	870	920	972
Revenue	120,765	130,847	159,084	177,250	196,305	216,041

SOURCE: Company, CGIS Research

BY THE NUMBERS
P/BV vs ROE

12-mth Fwd FD Normalised P/E vs FD Normalised EPS Growth

Profit & Loss

(Rmbm)	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
Total Net Revenues	130,847	159,084	177,250	196,305	216,041
Gross Profit	16,239	21,694	24,872	27,422	30,285
Operating EBITDA	5,550	6,650	8,052	8,743	9,487
Depreciation And Amortisation	(884)	(1,249)	(1,437)	(1,521)	(1,584)
Operating EBIT	4,666	5,402	6,615	7,222	7,903
Financial Income/(Expense)	(668)	(1,008)	(1,286)	(1,233)	(1,173)
Pretax Income/(Loss) from Assoc.	552	648	634	683	737
Non-Operating Income/(Expense)	655	302	342	366	416
Profit Before Tax (pre-EI)	5,205	5,343	6,306	7,039	7,883
Exceptional Items					
Pre-tax Profit	5,205	5,343	6,306	7,039	7,883
Taxation	(1,147)	(887)	(1,304)	(1,462)	(1,644)
Exceptional Income - post-tax					
Profit After Tax	4,058	4,456	5,001	5,577	6,239
Minority Interests	(537)	(575)	(621)	(671)	(725)
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Preference Dividends (Australia)					
Net Profit	3,521	3,881	4,380	4,906	5,515

Cash Flow

(Rmbm)	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
EBITDA	5,550	6,650	8,052	8,743	9,487
Cash Flow from Inv. & Assoc.					
Change In Working Capital	(2,547)	(8,950)	(3,064)	(3,355)	(3,343)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	210	355	398	424	476
Net Interest (Paid)/Received	(668)	(1,008)	(1,286)	(1,233)	(1,173)
Tax Paid	(904)	(887)	(1,304)	(1,462)	(1,644)
Cashflow From Operations	1,641	(3,839)	2,796	3,117	3,803
Capex	(515)	(1,990)	(1,700)	(1,450)	(1,450)
Disposals Of FAs/subsidiaries					
Acq. Of Subsidiaries/investments					
Other Investing Cashflow	(1,679)	(7,788)	(1,060)	(831)	(799)
Cash Flow From Investing	(2,194)	(9,778)	(2,760)	(2,281)	(2,249)
Debt Raised/(repaid)	22	0	0	0	0
Proceeds From Issue Of Shares					
Shares Repurchased					
Dividends Paid					
Preferred Dividends					
Other Financing Cashflow	3,139	16,653	(3,820)	(2,820)	(2,979)
Cash Flow From Financing	3,161	16,653	(3,820)	(2,820)	(2,979)
Total Cash Generated	2,608	3,036	(3,784)	(1,983)	(1,425)
Free Cashflow To Equity	(531)	(13,617)	37	837	1,554
Free Cashflow To Firm	116	(12,609)	1,323	2,070	2,727

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

BY THE NUMBERS... cont'd
Balance Sheet

(Rmbm)	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
Total Cash And Equivalents	14,842	18,695	14,911	12,928	11,503
Total Debtors	36,530	48,015	46,184	58,142	56,672
Inventories	17,270	25,024	29,248	30,903	35,257
Total Other Current Assets	1	1,544	1,544	1,544	1,544
Total Current Assets	68,642	93,278	91,886	103,517	104,976
Fixed Assets	9,386	11,008	11,962	12,547	13,081
Total Investments	0	0	0	0	0
Intangible Assets	8,092	14,199	14,808	15,252	15,684
Total Other Non-Current Assets	8,224	8,395	8,732	9,089	9,465
Total Non-current Assets	25,702	33,601	35,502	36,888	38,230
Short-term Debt	13,792	22,031	20,000	19,000	18,000
Current Portion of Long-Term Debt					
Total Creditors	35,838	45,321	44,650	54,907	54,449
Other Current Liabilities	2	1,358	1,358	1,358	1,358
Total Current Liabilities	49,632	68,710	66,007	75,265	73,807
Total Long-term Debt	2,959	9,620	9,000	8,500	8,000
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	2,078	2,116	2,116	2,116	2,116
Total Non-current Liabilities	5,037	11,736	11,116	10,616	10,116
Total Provisions	0	0	0	0	0
Total Liabilities	54,669	80,446	77,123	85,881	83,923
Shareholders' Equity	34,031	39,014	42,225	45,811	49,847
Minority Interests	5,645	7,420	8,041	8,712	9,436
Total Equity	39,676	46,433	50,266	54,523	59,284

Key Ratios

	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
Revenue Growth	8.3%	21.6%	11.4%	10.8%	10.1%
Operating EBITDA Growth	21.7%	19.8%	21.1%	8.6%	8.5%
Operating EBITDA Margin	4.24%	4.18%	4.54%	4.45%	4.39%
Net Cash Per Share (Rmb)	(0.71)	(4.56)	(4.96)	(5.13)	(5.10)
BVPS (Rmb)	12.66	13.73	14.86	16.12	17.54
Gross Interest Cover	6.98	5.36	5.14	5.86	6.74
Effective Tax Rate	22.0%	16.6%	20.7%	20.8%	20.9%
Net Dividend Payout Ratio	28.1%	30.0%	30.0%	30.0%	30.0%
Accounts Receivables Days	95.42	96.99	96.99	97.25	96.99
Inventory Days	53.64	56.18	65.00	65.18	65.00
Accounts Payables Days	105.5	105.9	106.0	106.3	106.0
ROIC (%)	11.9%	12.4%	10.8%	10.9%	11.1%
ROCE (%)	8.83%	8.03%	8.41%	8.96%	9.45%
Return On Average Assets	5.34%	4.94%	4.95%	5.09%	5.23%

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

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We are transferring the rating mechanism from "BUY, SELL, HOLD" to "ADD, REDUCE, HOLD". Please refer to the definitions below.

Explanation on Equity Ratings (Existing mechanism (will be replaced by new mechanism by 01/09/19))

- BUY : share price will increase by >20% within 12 months in absolute terms
SELL : share price will decrease by >20% within 12 months in absolute terms
HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

Explanation on Equity Ratings (New mechanism)

- ADD : The stock's total return is expected to exceed 10% over the next 12 months.
REDUCE : The stock's total return is expected to fall below 0% or more over the next 12 months.
HOLD : The stock's total return is expected to be between 0% and positive 10% over the next 12 months.

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