Sinopharm Group Co. Ltd.

National coverage offers reform risk insulation...

Earnings Review | NEUTRAL

Equity | China | Pharmaceuticals
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Bank of America Merrill Lynch

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Better-than-expected 3Q Sales growth

Sinopharm reported a slightly better-than-expected 3Q13 result with top line growth of 23.4% vs. 26.9% in 2Q13. However, Net Profit growth was much slower due to: 1) higher minority interest this quarter, and 2) a RMB 50mn one -time non-operating gain the same period last year. As a whole, first nine month's Revenue/ Earnings grew 21.4%/ 17.0% respectively vs. 20.3% / 20.0% in the 6 months to 1H13. A relatively better insulated position to regulatory risk pressures versus other distributor or pharmaceutical companies is why we remain Neutral on Sinopharm.

Healthy top line growth thanks to national coverage

Several regional distributors have already reported weak 3Q13 Results due to the headwinds brought by the Government's anti-corruption campaign. Sinopharm, however, still delivered higher than industry average top line growth, mainly due to strong Central and Western area sales growth which mitigated the slowdown in the Eastern area. Management commented that they would expect continuing impact of anti-corruption campaign in 4Q but with a declining intensity.

Margin trending down and financial cost increased

Gross Margin is slightly down this quarter with this likely to remain the trend through to the end of the year due to pressures on drug price. Sales and Marketing expense decreased this quarter but is expected to step up again in 4Q. Financial cost increased due to an increased level of business with third tier hospitals which combined with a 5 day increase in cash conversion cycle put pressure on financing.

Valuation reasonable, Neutral rating maintained

We maintain our FY13 Revenue forecast but cut Net Income by -2% to reflect a weaken earnings growth profile. We retain our PO of HKD23.00, based on 20x/16x of FY13/14 EPS estimates. We believe the 20x PE multiple represents the markets willingness to pay for the growth profile upfront given current regulatory risks.

Stock Data

Price	HK$21.35
Price Objective	HK$23.00
Date Established	22-Oct-2013
Investment Opinion	B-2-7
Volatility Risk	MEDIUM
52-Week Range	HK$18.06-HK$28.10
Mrkt Val / Shares Out (mn)	US$7,071 / 2,568.0
Average Daily Volume	5,318,991
BofAML Ticker / Exchange	SHTDF / HKG
Bloomberg / Reuters	1099 HK / 1099.HK
ROE (2013E)	12.5%
Net Dbt to Eqty (Dec-2012A)	28.0%
Est. 5-Yr EPS / DPS Growth	18.5% / 18.4%
Free Float	45.0%

Estimates (Dec)

(HK$)	2011A	2012A	2013E	2014E	2015E
Net Income (Adjusted - CNY mn)	1,561	1,973	2,406	2,888	3,505
EPS	0.802	1.02	1.16	1.39	1.69
EPS Change (YoY)	31.5%	27.0%	14.1%	20.0%	21.4%
Dividend / Share	0.293	0.255	0.290	0.348	0.423
Free Cash Flow / Share (CNY)	-0.722	-2.40	1.64	2.03	2.52

Valuation (Dec)

	2011A	2012A	2013E	2014E	2015E
P/E	26.6x	21.0x	18.4x	15.3x	12.6x
Dividend Yield	1.4%	1.2%	1.4%	1.6%	2.0%
EV / EBITDA*	13.87x	9.25x	7.67x	6.46x	5.40x
Free Cash Flow Yield*	-3.95%	-13.39%	9.77%	12.12%	15.04%

* For full definitions of *iQmethod* SM measures, see page 5.

iQprofile SM Sinopharm Group Co. Ltd.

Key Income Statement Data (Dec)	2011A	2012A	2013E	2014E	2015E
(CNY Millions)					
Sales	102,225	135,787	161,541	193,683	233,825
Gross Profit	8,355	10,943	12,762	15,301	18,472
Sell General & Admin Expense	(4,887)	(6,298)	(7,029)	(8,369)	(10,033)
Operating Profit	3,636	4,863	5,982	7,206	8,738
Net Interest & Other Income	(616)	(985)	(1,178)	(1,431)	(1,718)
Associates	107	135	155	179	205
Pretax Income	3,128	4,014	4,959	5,953	7,225
Tax (expense) / Benefit	(725)	(934)	(1,141)	(1,369)	(1,662)
Net Income (Adjusted)	1,561	1,973	2,406	2,888	3,505
Average Fully Diluted Shares Outstanding	2,356	2,403	2,568	2,568	2,568
Key Cash Flow Statement Data					
Net Income	1,561	1,973	2,406	2,888	3,505
Depreciation & Amortization	323	1,076	1,184	1,303	1,433
Change in Working Capital	(2,327)	(5,217)	(1,743)	(1,802)	(1,858)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	1,462	2,385	2,879	3,408	4,046
Cash Flow from Operations	1,019	217	4,726	5,797	7,125
Capital Expenditure	(2,721)	(5,983)	(516)	(576)	(644)
(Acquisition) / Disposal of Investments	(147)	(148)	2	0	0
Other Cash Inflow / (Outflow)	37	NA	(5)	(4)	(4)
Cash Flow from Investing	(2,831)	NA	(519)	(580)	(648)
Shares Issue / (Repurchase)	435	951	1,413	1,696	2,058
Cost of Dividends Paid	(570)	(493)	(601)	(721)	(875)
Cash Flow from Financing	302	1,223	(2,412)	(2,350)	(2,295)
Free Cash Flow	(1,702)	(5,766)	4,210	5,221	6,481
Net Debt	758	6,358	2,982	(1,305)	(6,761)
Change in Net Debt	15,862	2,231	(3,403)	(4,315)	(5,485)
Key Balance Sheet Data					
Property, Plant & Equipment	5,363	6,399	7,062	7,791	8,593
Other Non-Current Assets	6,032	7,431	7,293	7,148	6,998
Trade Receivables	29,728	41,084	45,009	49,316	54,045
Cash & Equivalents	13,091	9,722	11,490	14,329	18,484
Other Current Assets	13,414	15,210	17,048	19,229	21,812
Total Assets	67,628	79,847	87,901	97,813	109,931
Long-Term Debt	5,182	5,192	4,672	4,205	3,785
Other Non-Current Liabilities	1,766	1,807	1,789	1,774	1,759
Short-Term Debt	8,667	10,888	9,799	8,819	7,937
Other Current Liabilities	31,624	39,217	43,223	47,897	53,336
Total Liabilities	47,239	57,104	59,485	62,695	66,817
Total Equity	20,388	22,743	28,416	35,119	43,114
Total Equity & Liabilities	67,627	79,847	87,901	97,813	109,931
iQmethod* SM - Bus Performance					
Return On Capital Employed	10.4%	10.0%	11.1%	12.0%	12.8%
Return On Equity	11.4%	12.0%	12.5%	12.1%	12.0%
Operating Margin	3.6%	3.6%	3.7%	3.7%	3.7%
EBITDA Margin	3.9%	4.4%	4.4%	4.4%	4.3%
iQmethod* SM - Quality of Earnings					
Cash Realization Ratio	0.7x	0.1x	2.0x	2.0x	2.0x
Asset Replacement Ratio	8.4x	5.6x	0.4x	0.4x	0.4x
Tax Rate (Reported)	23.2%	23.3%	23.0%	23.0%	23.0%
Net Debt-to-Equity Ratio	3.7%	28.0%	10.5%	-3.7%	-15.7%
Interest Cover	3.9x	3.4x	3.7x	3.8x	4.0x
Key Metrics					
Analyst Exchange Rate	0.83	0.81	0.81	0.81	0.81

* For full definitions of *iQmethod* SM measures, see page 5.

Company Description

Sinopharm Group Co. Ltd. is the largest distributor and a leading provider of supply chain services for pharmaceutical and healthcare products. It operates the largest national pharmaceutical distribution network in China, based on its 2008 revenue according to China Association of Pharmaceutical Commerce (CAPC). Its three major business segments are: (1) Pharmaceutical distribution, (2) Retail pharmacy and (3) Other business operations.

Investment Thesis

Being the largest drug distribution company in China, offering high-quality, value-added services, we believe Sinopharm is well positioned to benefit from the surge in healthcare demand in China and the coming wave of consolidation in the highly fragmented domestic drug distribution industry.

Stock Data

Price to Book Value	2.0x

Financial Statement

Table 1: Sinopharm Income Statement

(RMB mn)	2011A	2012A	1H13A	2013E	2014E	2015E
Total Sales	102,225	135,787	80,066	161,541	193,683	233,825
% change	*47.7%*	*32.8%*	*20.3%*	*19.0%*	*19.9%*	*20.7%*
Pharma Distribution	95,489	128,320	75,854	151,417	181,701	219,858
% of Total Sales	*93%*	*95%*	*95%*	*94%*	*94%*	*94%*
% change	*47%*	*34%*	*21%*	*18%*	*20%*	*21%*
Retail pharmacy	3,045	3,983	2,275	4,897	5,908	7,006
% of Total Sales	*3.0%*	*2.9%*	*2.8%*	*3.0%*	*3.1%*	*3.0%*
% change	*78%*	*27%*	*28.6%*	*23%*	*21%*	*19%*
Other business operations	3,691	4,429	1,938	5,227	6,074	6,961
% of Total Sales	*3.6%*	*3.3%*	*2.4%*	*3.2%*	*3.1%*	*3.0%*
% change	*36%*	*20%*	*2%*	*18%*	*16%*	*15%*
Total Costs of Sales	93,870	124,844	73,742	148,779	178,382	215,353
% change	*48%*	*33%*	*20.7%*	*19%*	*20%*	*21%*
Total Gross Profit	8,355	10,943	6,324	12,762	15,301	18,472
% change	*43%*	*31%*	*16%*	*17%*	*20%*	*21%*
% Overall GM	*8.17%*	*8.06%*	*7.90%*	*7.90%*	*7.90%*	*7.90%*
Other income	169	219	84	219	244	269
Dist and selling exp	(2,923)	(3,730)	(2,065)	(4,183)	(4,976)	(5,961)
% change	*49.1%*	*27.6%*	*-25.1%*	*12.1%*	*19.0%*	*19.8%*
as a % of total revenue	*2.86%*	*2.79%*	*2.58%*	*2.59%*	*2.57%*	*2.55%*
G&A exp	(1,965)	(2,568)	(1,347)	(2,846)	(3,393)	(4,073)
% change	*27.2%*	*30.7%*	*-23.7%*	*10.8%*	*19.2%*	*20.0%*
as a % of total revenue	*1.92%*	*1.91%*	*1.68%*	*1.76%*	*1.75%*	*1.74%*
Total Op profit	3,636	4,863	2,997	5,952	7,176	8,708
% change	*51.0%*	*33.7%*	*-17.8%*	*22.4%*	*20.6%*	*21.3%*
% op margin	*3.56%*	*3.58%*	*3.74%*	*3.68%*	*3.70%*	*3.72%*
Other income/ (exp), gains/(loss)-net	202	287	23	297	307	317
Finance costs - net	(818)	(1,272)	(777)	(1,532)	(1,804)	(2,111)
- Finance income	115	149	71	149	149	149
- Finance costs	(933)	(1,420)	(848)	(1,680)	(1,953)	(2,260)
Share of post-tax profits of associates	107	135	64	135	155	179
Profit before-tax	3,128	4,014	2,308	4,852	5,834	7,092
% change	*30.4%*	*28.3%*	*14.5%*	*20.9%*	*20.2%*	*21.6%*
Tax	(725)	(934)	(512)	(1,116)	(1,342)	(1,631)
% effective tax rate	*23.2%*	*23.0%*	*22.2%*	*23.0%*	*23.0%*	*23.0%*
Profit after-tax	2,403	3,079	1,796	3,736	4,492	5,461
% change	*31.3%*	*324.4%*	*17.4%*	*21.3%*	*20.2%*	*21.6%*
% net margin	*2.35%*	*2.27%*	*2.24%*	*2.31%*	*2.32%*	*2.34%*
Attributable to equity holders	1,561	1,973	1,151.6	2,354	2,830	3,440
% change	*29.1%*	*26.4%*	*20.0%*	*19.3%*	*20.2%*	*21.6%*
% net margin	*1.53%*	*1.45%*	*1.44%*	*1.46%*	*1.46%*	*1.47%*
- MI	842	1,106	644	1,382	1,662	2,020
MI as a % of Profit after-tax	*35.0%*	*37.0%*	*35.9%*	*37.0%*	*37.0%*	*37.0%*
EPS (basic and fully diluted) in RMB	0.66	0.82	0.46	0.92	1.10	1.34
% change	*24.2%*	*23.9%*	*15.2%*	*11.6%*	*20.2%*	*21.6%*
EPS (basic and fully diluted) in HKD	0.80	1.02	0.58	1.14	1.37	1.66

Source: BofA Merrill Lynch Global Research

Price objective basis & risk

Sinopharm Group Co. Ltd. (SHTDF)

Our PO of HK$23.00 is based on 20x/16x of FY13/14 EPS estimates. We believe the 20x PE multiple is justifiable with Sinopharm's robust expected earnings growth (2013-14E) of 20%.
Downside risks: (1) M&A activities significantly slow down and Sinopharm is not able to expand into new regions and more hospitals, (2) Financing costs (short-term borrowing and factoring) increase rapidly. and (3) government policies that severely cut drug prices and impose measures that could significantly slow down overall drug market sales growth and negatively affect the profit margins of distributors.

Upside risks: (1) Better than expected industry growth (2) Lower financial cost (3) Accelerated M&A activities

Link to Definitions

Healthcare

Click here for definitions of commonly used terms.

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Greater China - Healthcare Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
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	WuXi PharmaTech (Cayman) Inc.	WX	WX US	Serena Shao
NEUTRAL				
	Biosensors International	BSNRF	BIG SP	Serena Shao
	China Shineway Pharmaceutical Group Ltd.	CSWYF	2877 HK	Serena Shao
	CSPC Pharmaceutical Group	CHJTF	1093 HK	Serena Shao
	Mindray-ADR	MR	MR US	Serena Shao
	Sinopharm Group Co. Ltd.	SHTDF	1099 HK	Serena Shao
UNDERPERFORM				
	China Nepstar Chain Drugstore Ltd-ADR	NPD	NPD US	Serena Shao
	Shandong Weigao	SHWGF	1066 HK	Serena Shao
	Sino Biopharmaceutical	SBMFF	1177 HK	Serena Shao
	The United Laboratories	ULIHF	3933 HK	Serena Shao

iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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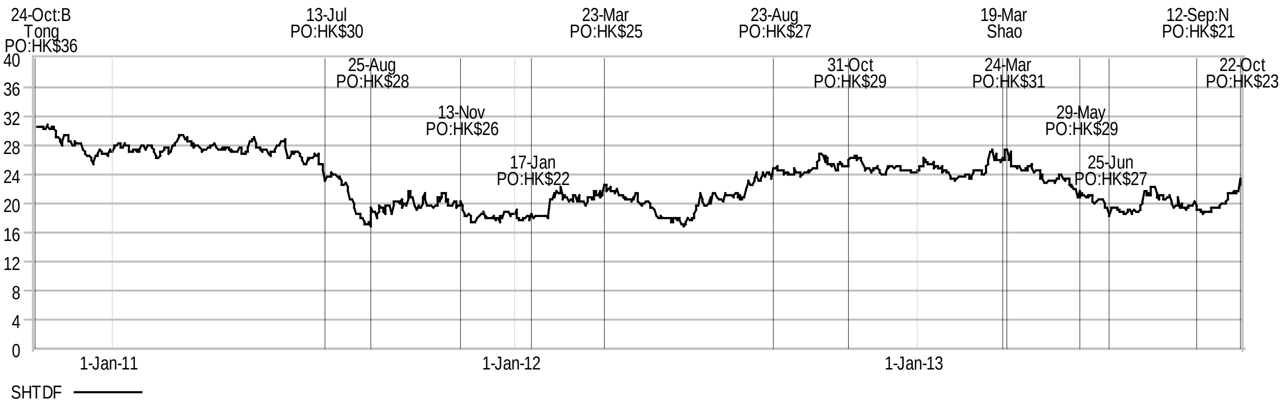
Important Disclosures

SHTDF Price Chart



B : Buy, N : Neutral, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of September 30, 2013 or such later date as indicated.

Investment Rating Distribution: Health Care Group (as of 30 Sep 2013)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	136	53.33%	Buy	101	74.26%
Neutral	54	21.18%	Neutral	40	74.07%
Sell	65	25.49%	Sell	36	55.38%

Investment Rating Distribution: Global Group (as of 30 Sep 2013)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1672	49.06%	Buy	1234	73.80%
Neutral	856	25.12%	Neutral	622	72.66%
Sell	880	25.82%	Sell	551	62.61%

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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