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October 30, 2013

Stock Rating  
**Overweight**

Industry View  
**In-Line**

## Sinopharm Group

### 3Q Outperformed; Well Placed in Policy Storm

**Quick Comment: Conclusion:** We are encouraged to see Sinopharm's 3Q results, outshining peers in an unfavorable policy environment, and benefiting from its national network and cost control. The solid earnings momentum should continue into 4Q, in our view.

#### Sales growth helped by geographic and product mix:

Sinopharm grew a healthy 23%YoY in 3Q despite policy headwinds across the industry, vs. 20% in 1H13. M&A contributed 3% of growth in 9M13, vs. 18% for the organic business. We attribute the strong momentum to the faster growth in less developed regions especially from lower-tier hospitals in tier 2 and 3 cities. Regional growth: Northeast 20.1%YoY, North 24.9%, East 17.3%, Central 37.17%, South 16.93%, Southwest 32.88%, and Northwest 17.24%. Management thinks the impact on the industry in October from anti-corruption policies should be less than it was in August and September, and expects 4Q sales to be on track.

**Gross margin stabilized:** 3Q13 GM stabilized vs. 2Q, after having dropped significantly in 1Q and 4Q12, on: 1) very limited impact from drug tenders recently; and 2) improving product mix. The company is replacing low-margin products with high-margin ones. Portion of direct sales to hospitals, as % of total, further rose by 1.5% vs. 2012 year-end. % of MNC products stayed flat, at ~46-47%. 4Q GM might decline, given seasonality.

**Finance costs ratio flat excl. FX loss:** Sinopharm incurred FX loss of Rmb50mn (Rmb18mn in 3Q) in 9M13. Excluding FX loss, the finance cost ratio should stay flat vs. 1H. Of total finance costs of Rmb1.1bn in 9M, expenses for discounting notes receivables accounted for 24-25%, AR factoring 15%, interest expense 60%. Cash conversion cycle lengthened by 5 days vs. 2012.

#### Minority interest to decline over the long run:

Management plans to increase its interest in subsidiaries gradually to lower the minority interest. The capital increase in Shenzhen Accord will likely be completed in late 2013 or early 2014.

**Please see inside for more details.**

#### Key Ratios and Statistics

**Reuters: 1099.HK Bloomberg: 1099 HK**  
**China Drug Distribution**

Shr price, close (Oct 29, 2013)	HK\$21.05
52-Week Range	HK\$28.10-18.06
Sh out, dil, curr (mn)	2,403
Mkt cap, curr (mn)	Rmb39,723
EV, curr (mn)	Rmb49,827
Avg daily trading value (mn)	Rmb83

Fiscal Year ending	12/12	12/13e	12/14e	12/15e
ModelWare EPS (Rmb)	0.82	0.94	1.10	1.28
Consensus EPS (Rmb)\$	0.80	0.94	1.11	1.33
Revenue, net (Rmb mn)	135,787	164,670	193,457	223,859
EBITDA (Rmb mn)	5,429	6,993	8,561	10,014
ModelWare net inc (Rmb mn)	1,974	2,367	2,820	3,291
P/E	23.7	17.7	15.1	12.9
P/BV	2.7	2.3	2.1	1.8
RNOA (%)	18.1	16.5	15.0	16.5
ROE (%)	12.6	13.9	15.1	15.9
EV/EBITDA	10.5	8.1	6.7	6.2
Div yld (%)	1.3	1.7	2.0	2.3
FCF yld ratio (%)	2.6	(10.8)	6.6	(4.1)
Leverage (EOP) (%)	28.3	58.0	47.0	57.7

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).

\$ = Consensus data is provided by Thomson Reuters Estimates.

e = Morgan Stanley Research estimates

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Sinopharm Group

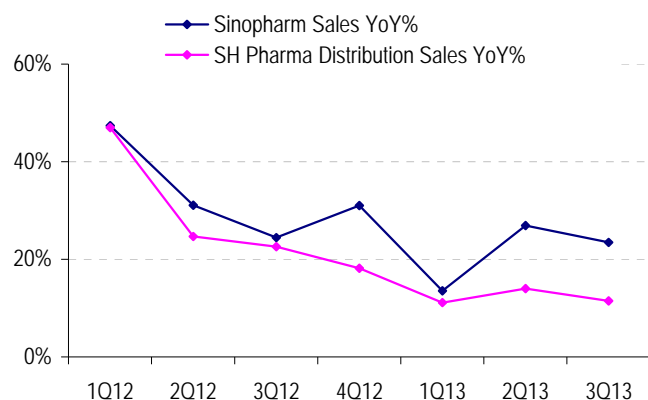
## 3Q13 Snapshot

Sales grew 23%YoY to reach Rmb42.5bn in 3Q13. GM was almost flat, both YoY and sequentially. SG&A expense ratio of 4.26% increased from 4.15% in 2Q13 but decreased YoY vs. 4.69% in 3Q12. Operating margin of 3.68% improved vs. 3.28% last year. Finance cost ratio, however, increased to 0.98% YoY vs. 0.83% in 3Q12 and 0.88% in 2Q13 to Rmb415mn. Net income and EPS growth was 12% YoY and 9% YoY, respectively. Net margin declined 14bps YoY and 12bps vs. 2Q13.

Cash and cash equivalents of Rmb13.5bn dropped 15% compared to 2Q13. AR days lengthened to 98 days from 88 and 92 in 2Q13 and 3Q12 while AP days were 75 days vs. 68 and 76 in 2Q13 and 3Q12, respectively. Inventory days were 2 days longer vs. 2Q.

Exhibit 1

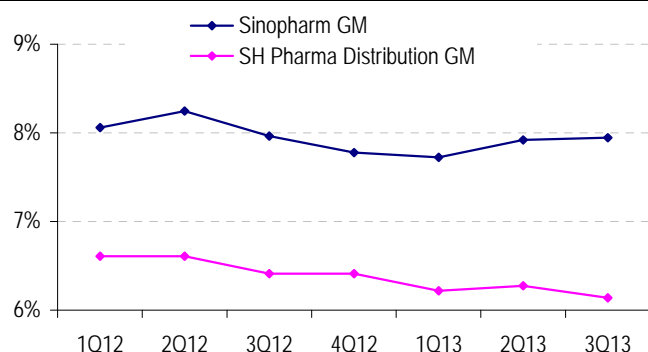
### Sales Growth Comparison between Sinopharm and SPH Distribution Business



Source: Company data, Morgan Stanley Research

Exhibit 2

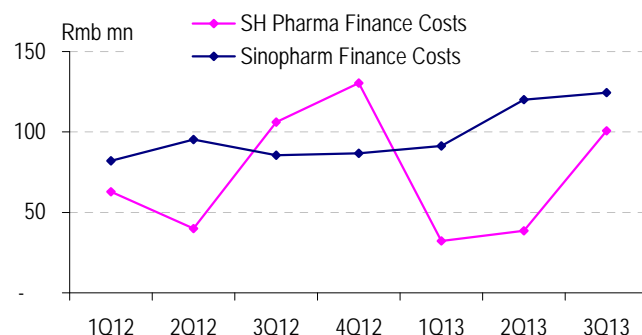
### Gross Margin Comparison between Sinopharm and SPH Distribution Business



Source: Company data, Morgan Stanley Research

Exhibit 3

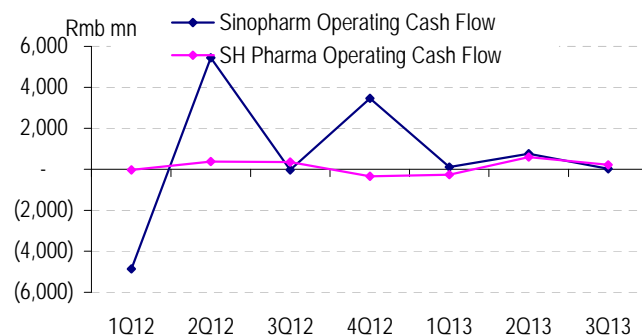
### Finance Cost Comparison between Sinopharm and Shanghai Pharma



Source: Company data, Morgan Stanley Research

Exhibit 4

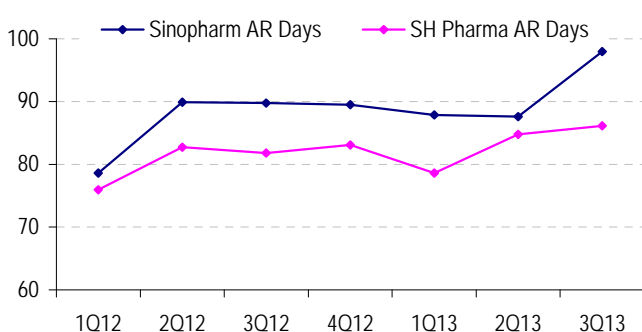
### Operating Cash Flow Comparison between Sinopharm and Shanghai Pharma



Source: Company data, Morgan Stanley Research

Exhibit 5

### AR Days Comparison between Sinopharm and Shanghai Pharma



Source: Company data, Morgan Stanley Research

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Exhibit 6

## Sinopharm: Quarterly Income Statement

RMB ('000)	2009	2010	2011	1Q12	2Q12	3Q12	4Q12	2012	1Q13	2Q13	3Q13
Revenue	52,668,164	69,233,670	102,224,807	32,972,435	33,589,861	34,425,666	34,798,873	135,786,836	37,433,809	42,632,552	42,495,470
COGS	(48,278,930)	(63,433,831)	(93,939,491)	(30,315,099)	(30,819,541)	(31,683,539)	(32,092,061)	(124,910,240)	(34,542,534)	(39,256,748)	(39,119,466)
Gross profit	4,389,234	5,799,839	8,285,316	2,657,337	2,770,320	2,742,127	2,706,812	10,876,596	2,891,275	3,375,804	3,376,004
Sales expenses	(1,404,129)	(1,960,019)	(2,922,793)	(876,451)	(894,464)	(987,457)	(971,342)	(3,729,715)	(981,090)	(1,083,566)	(1,077,276)
Administration expenses	(1,139,345)	(1,508,543)	(1,902,736)	(546,488)	(591,790)	(628,060)	(716,342)	(2,482,680)	(594,797)	(661,656)	(733,478)
Operating profit	1,845,760	2,331,277	3,459,787	1,234,398	1,284,066	1,126,609	1,019,128	4,664,201	1,315,387	1,630,582	1,565,249
Non-operating income	(97,699)	63,054	(334,978)	(282,505)	(230,900)	(186,755)	44,777	(655,383)	(265,159)	(377,458)	(395,805)
Financial expenses	(216,366)	(242,048)	(762,316)	(273,809)	(318,025)	(284,965)	(289,506)	(1,166,305)	(304,195)	(400,343)	(415,141)
Losses of devaluation of asset	(54,001)	(39,484)	(64,685)	(68,560)	(24,481)	(53,264)	25,964	(120,341)	(37,932)	(74,593)	(54,568)
Changing income of fair value	188	442	4,276				62	62			
Investment income	69,973	203,661	230,325	33,660	38,743	52,323	47,220	171,947	31,971	48,114	38,602
Others											
Non-operating income	123,440	165,111	295,084	28,648	107,583	103,473	269,165	508,869	48,669	75,336	41,126
Non-operating expenses	(20,934)	(24,627)	(37,662)	(2,444)	(34,719)	(4,322)	(8,129)	(49,615)	(3,672)	(25,972)	(5,823)
Pre-tax income	1,748,061	2,394,330	3,124,809	951,893	1,053,167	939,854	1,063,904	4,008,818	1,050,228	1,253,124	1,169,444
Income tax	(423,214)	(566,703)	(709,421)	(226,429)	(251,075)	(192,170)	(254,775)	(924,449)	(234,403)	(274,888)	(255,672)
Tax rate	24.2%	23.7%	22.7%	23.8%	23.8%	20.4%	23.9%	23.1%	22.3%	21.9%	21.9%
Net income	1,324,847	1,827,628	2,415,387	725,464	802,092	747,684	809,130	3,084,370	815,826	978,236	913,772
Minority interest	461,386	619,479	843,814	266,594	303,440	238,040	300,115	1,108,190	289,313	354,949	345,398
Net profit attributable to shareholder	863,460	1,208,149	1,571,573	458,870	498,652	509,644	509,014	1,976,180	526,513	623,287	568,373
EPS	0.48	0.53	0.67	0.19	0.21	0.21	0.21	0.82	0.22	0.24	0.23
YOY%											
Revenue		31%	48%	47%	31%	24%	31%	33%	14%	27%	23%
COGS		31%	48%	47%	31%	24%	32%	33%	14%	27%	23%
Gross profit		32%	43%	47%	33%	30%	18%	31%	9%	22%	23%
Sales expenses		40%	49%	52%	21%	39%	8%	28%	12%	21%	9%
Administration expenses		32%	26%	38%	36%	33%	19%	30%	9%	12%	17%
Operating profit		26%	48%	47%	41%	22%	29%	35%	7%	27%	39%
Non-operating income		-165%	-631%	313%	174%	157%	-141%	96%	-6%	63%	112%
Financial expenses		12%	215%	149%	51%	50%	15%	53%	11%	26%	46%
Pre-tax income		37%	31%	23%	28%	11%	56%	28%	10%	19%	24%
Net profit attributable to shareholders		40%	30%	14%	30%	12%	53%	26%	15%	25%	12%
EPS		10%	26%	8%	28%	11%	55%	23%	15%	16%	9%
Margin											
Gross margin	8.33%	8.38%	8.10%	8.06%	8.25%	7.97%	7.78%	8.01%	7.72%	7.92%	7.94%
SG&A as % of revenue	4.83%	5.01%	4.72%	4.32%	4.42%	4.69%	4.85%	4.58%	4.21%	4.09%	4.26%
Sales expenses	2.67%	2.83%	2.86%	2.66%	2.66%	2.87%	2.79%	2.75%	2.62%	2.54%	2.54%
Administration expenses	2.16%	2.18%	1.86%	1.66%	1.76%	1.82%	2.06%	1.83%	1.59%	1.55%	1.73%
Operating margin	3.50%	3.37%	3.38%	3.74%	3.82%	3.27%	2.93%	3.43%	3.51%	3.82%	3.68%
Financial expenses	0.41%	0.35%	0.75%	0.83%	0.95%	0.83%	0.83%	0.86%	0.81%	0.94%	0.98%
Minority interest	34.83%	33.90%	34.93%	36.75%	37.83%	31.84%	37.09%	35.93%	35.46%	36.28%	37.80%
Net margin	1.64%	1.75%	1.54%	1.39%	1.48%	1.48%	1.46%	1.46%	1.41%	1.46%	1.34%

Source: Company Data, Morgan Stanley Research

## **Company Description**

Sinopharm is the biggest distributor of pharmaceutical and healthcare products in China and has the largest drug distribution network with a 10.8% market share in 2008. The company's robust growth in recent years has far exceeded the industry average (2003-08 sales CAGR of 34% vs. 16%), widening the market share gap with the No. 2 player from less than 0.1ppt in 2003 to 6.1ppt in 2008.

## **China Drug Distribution**

**Industry View: In-Line**



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(as of September 30, 2013)

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October 30, 2013

Sinopharm Group

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
<b>Overweight/Buy</b>	<b>1002</b>	<b>34%</b>	<b>410</b>	<b>38%</b>	<b>41%</b>
<b>Equal-weight/Hold</b>	<b>1278</b>	<b>44%</b>	<b>493</b>	<b>46%</b>	<b>39%</b>
<b>Not-Rated/Hold</b>	<b>114</b>	<b>4%</b>	<b>28</b>	<b>3%</b>	<b>25%</b>
<b>Underweight/Sell</b>	<b>526</b>	<b>18%</b>	<b>140</b>	<b>13%</b>	<b>27%</b>
<b>Total</b>	<b>2,920</b>		<b>1071</b>		

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## Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 10/1/10 : O/A; 7/7/11 : O/I

Price Target History: 8/26/10 : 36; 7/7/11 : 32; 8/26/11 : 30

Source: Morgan Stanley Research      Date Format : MM/DD/YY      Price Target --      No Price Target Assigned (NA)  
 Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) ■  
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View  
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)  
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## Industry Coverage:China Drug Distribution

Company (Ticker)	Rating (as of)	Price* (10/30/2013)
<b>Bin Li</b>		
Shanghai Pharmaceutical (2607.HK)	E (06/05/2012)	HK\$16.1
Shanghai Pharmaceutical (601607.SS)	E (06/05/2012)	Rmb13.89
Sinopharm Group (1099.HK)	O (01/05/2010)	HK\$21.35

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\* Historical prices are not split adjusted.