

Sinopharm Group Co -----Maintain NEUTRAL

3Q13 results: EPS growth in line for margin erosion and share dilution

EPS: ◀▶ TP: ▶▶

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- Sinopharm 3Q13 revenue grew to RMB 42.5 bn, up 23.4% YoY and beating the industry average (Shanghai Pharma reported distributor revenue growth of 11.5% YoY during the same period).
- The company continues to optimise product mix to improve gross margins but we believe gross margin erosion is a sector-wide trend and may not change in the near term. Our channel check shows that some big pharmaceutical companies are starting to switch from national distributors to regional leaders
- However the EPS grew only 9.5% during 1-3Q13 primarily due to: (1) Gross margin erosion; (2) finance expenses up 33.0% YoY to Rmb343.2 mn, which includes foreign exchange loss of ~Rmb56 mn; (3) minority interest rises due to high profit growth in certain subsidiaries and (4) ~3.5% share dilution.
- We reiterate NEUTRAL. Management maintained its revenue growth guidance but we believe EPS growth will continue to be lower than revenue growth given gross margin erosion and share dilution by equity placement.

Bbg/RIC	1099 HK / 1099.HK	Price (30 Oct 13, HK\$)	21.35		
Rating (prev. rating)	N (N)	TP (prev. TP HK\$)	21.60 (21.60)		
Shares outstanding (mn)	828.34	Est. pot. % chg. to TP	1		
Daily trad vol - 6m avg (mn)	5.56	52-wk range (HK\$)	27.5 - 18.4		
Daily trad val - 6m avg (US\$ mn)	14.4	Mkt cap (HK\$/US\$ mn)	17,685.1/ 2,281.2		
Free float (%)	25.0	Performance	1M	3M	12M
Major shareholders	Sinopharm Group (51%)	Absolute (%)	9.7	1.7	(14.9)
		Relative (%)	7.1	(7.4)	(22.4)
Year	12/11A	12/12A	12/13E	12/14E	12/15E
Revenue (Rmb mn)	102,225	135,787	161,592	191,960	228,941
EBITDA (Rmb mn)	4,096	5,429	7,024	8,123	9,375
Net profit (Rmb mn)	1,561	1,974	2,394	2,838	3,387
EPS (Rmb)	0.66	0.82	0.95	1.07	1.25
- Change from prev. EPS (%)	n.a.	n.a.	0	0	0
- Consensus EPS (Rmb)	n.a.	n.a.	0.94	1.11	1.33
EPS growth (%)	24.1	24.0	15.3	13.3	16.0
P/E (x)	25.3	20.4	17.7	15.6	13.5
Dividend yield (%)	1.2	1.5	1.7	1.9	2.2
EV/EBITDA (x)	3.6	3.7	2.6	2.0	1.7
P/B (x)	2.5	2.4	1.9	1.7	1.4
ROE (%)	11.4	12.1	12.3	11.6	11.5
Net debt(cash)/equity (%)	3.7	28.0	16.1	7.0	4.5

Note 1: ORD/ADR=5.00. Note 2: Sinopharm Group Co. Ltd. is a distributor and provider of supply chain services for pharmaceutical and healthcare products. The Company operates in three segments: pharmaceutical distribution; retail pharmacy; other business operations.

[Click here](#) for detailed financials

Figure 1: Sinopharm 1-3Q13 revenue YoY growth by region

Region	Turnover Growth %
Northeast China	20.1
North China	24.9
East China	17.3
South China	16.9
Southwest China	32.9
Northwest China	17.2

Source: Company data

3Q13 revenue growth beat industry average

Sinopharm 3Q13 revenue grew to Rmb42.5 bn, up 23.4% YoY, at a faster pace than industry average—Shanghai Pharma reported revenue growth of 11.5% YoY during the same period. This was faster than its own growth of 20.3% in 1H13, driven by the company's effort to: (1)

optimise revenue mix with more revenue coming from hospitals and higher-margin drugs and (2) penetration into low-tier markets (especially medium/small cities and rural areas in Central and West China).

Gross margin improving, but still under pressure

Sinopharm delivered 3Q gross margin of 8.30%, higher than 1H margin of 7.90% but lower than 3Q12 margin of 8.40%. Overall, the pharmaceutical distribution industry is going through margin erosion in the tough anti-corruption environment, in our view.

Our channel check shows that some big pharmaceutical companies have started to switch from national distributors to regional leaders—this may further squeeze pharma distributors' margins.

Top-line growth outpaced bottom-line growth

Sinopharm's revenue growth of 23.4% is higher than EPS growth of 9.5% in 1-3Q13 primarily due to: (1) Gross margin erosion; (2) finance expenses being up 33.0% YoY to Rmb343.2 mn, which includes foreign exchange loss of ~Rmb56 mn (~Rmb4.8 mn in 1-3Q12). After adjusting the foreign exchange loss impact, profit after tax grew 19% YoY; (3) minority interest rises due to high profit growth in certain subsidiaries; and (4) ~3.5% share dilution.

4Q results unlikely to surprise; reiterate NEUTRAL rating

Management maintained guidance of outgrowing the sector by 300-500 bp and expects sector to see 15-18% growth in 2013. We believe EPS growth will continue to be lower than revenue growth due to: (1) the ongoing gross margin erosion and finance cost pressure; (2) seasonally higher 4Q selling expense in 4Q; and (3) share dilution from equity placement.

Figure 2: Sinopharm 3Q13 results highlight

(Rmb mn)	3Q12	3Q13	YoY%	1-3Q12	1-3Q13	YoY%
Revenue	34,426	42,495	23.4	100,988	122,562	21.4
COGS	(31,535)	(38,967)	23.6	(92,644)	(112,709)	21.7
Gross profit	2,891	3,528	22.0	8,344	9,852	18.1
Selling expense	(987)	(1,077)	9.1	(2,758)	(3,142)	13.9
Administration expense	(555)	(643)	15.9	(1,766)	(1,990)	12.7
EBIT	1,348	1,808	34.1	3,820	4,720	23.6
Other expense/income	(161)	(300)	86.3	2	(128)	-5935.1
Finance expenses	(258)	(343)	33.0	(877)	(1,120)	27.7
EBT	929	1,165	25.3	2,945	3,473	17.9
Tax	(183)	(253)	38.2	(670)	(765)	14.2
Less: minority interest	238	345	45.1	808	990	22.5
Net profit	508	566	11.4	1,467	1,718	17.1
EPS-diluted	0.21	0.23	9.5	0.61	0.69	13.1

Operating cash flow -27 29 205.9 550 903 64.3

Key ratios (%)

Gross margin	8.40	8.30	8.26	8.04
Selling expense ratio	2.87	2.54	2.73	2.56
Administration expense ratio	1.61	1.51	1.75	1.62
EBIT margin	3.92	4.25	3.78	3.85
Finance expenses ratio	0.75	0.81	0.87	0.91
Effective tax rate	19.69	21.71	22.74	22.03
Net margin	1.48	1.33	1.45	1.40

Source: Company data, Credit Suisse estimates.

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Companies Mentioned (Price as of 30-Oct-2013)

Sinopharm Group Co (1099.HK, HK\$21.35, NEUTRAL, TP HK\$21.6)

Disclosure Appendix

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1099.HK	Closing Price	Target Price	
Date	(HK\$)	(HK\$)	Rating
23-Aug-11	17.50	30.00	O
15-Mar-12	21.60	28.00	
16-Mar-12	21.20		*
26-Mar-12	21.70	28.00	O
25-Jan-13	24.50	26.00	N *
26-Mar-13	26.05	30.00	O
29-Apr-13	22.90	28.00	
27-Aug-13	19.40	21.60	N

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Price Target: (12 months) for Sinopharm Group Co (1099.HK)

Method: Our HK\$21.60 target price for Sinopharm Group Co is based on 16x 2014E EPS (earnings per share), given that we forecast 15% EPS CAGR in the next three years.

Risk: Key investment risks to our HK\$21.60 target price for Sinopharm Group include: 1) working capital commitments, 2) margin pressure for drug price control, 3) the market's negative reading on financial cost increase and operating cash flow volatility.

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