

Hong Kong
ADD

Consensus ratings*: Buy 19 Hold 3 Sell 0

Current price:	HK\$3.59
Target price:	HK\$4.20
Previous target:	HK\$6.30
Up/downside:	17.0%
CGS-CIMB / Consensus:	N/A
Reuters:	
Bloomberg:	570 HK
Market cap:	US\$2,320m HK\$18,079m
Average daily turnover:	US\$6.14m HK\$49.1m
Current shares o/s:	4,432m
Free float:	30.0%

*Source: Bloomberg



Major shareholders	% held
CNPGC	36.0

China Traditional Chinese Medicine Correction overdone

- China TCM's share price fell 6.5% yesterday, but we don't think it was triggered by any new company-specific or industry events after checking with various channels.
- We understand that investors may be concerned about 1) the new management team's execution; 2) potential weaker-than-expected 1H2019 results due to rising expenses; and 3) the policy of restricting TCM prescriptions by Western physicians. We believe the recent correction is overdone at the current valuation.
- We lower our 2019/20E earnings by 7%/9.5% to reflect higher-than-expected administrative expenses and depreciation cost from the TCM (Traditional Chinese Medicine) industrial parks and the 2–4% earnings' impact from restrictions on TCM prescriptions by Western physicians.
- We use a lower PER multiple to reflect slower profit growth. We cut our TP from HK\$6.3 (historical average: 16x 2019E PER) to HK\$4.2 (11x 2019E PER, 1sd below the historical average).
- We maintain our ADD rating, as the current valuation of 9.5x 2019E PER is lower than the historical average by more than 1sd. CNPGC, the major shareholder, increased its stake in May at HK\$4.08 per share.

Restriction on TCM prescriptions by Western physicians has <4% impact on earnings

The drug monitoring list issued last week requires Western physicians to obtain qualifications certificates requiring 1–3 years' training before prescribing TCM. This policy will not impact the Company's CCMG and TCM decoction pieces business because Western physicians cannot issue such prescriptions. So only the Company's TCM finished drugs segment will be affected. This segment is expected to account for ~21% of 2019E total revenue. According to management, less than 20% of the TCM finished drugs are prescribed through Western physicians without sufficient training (i.e. >80% TCM finished drugs are sold through TCM prescriptions or the OTC channel). Therefore, we estimate only 2–4% of the Company's total earnings may be affected.

Earnings cut by 7%/9.5% for 2019/2020E

According to management, the investment in TCM industrial parks will lead to higher administrative expenses and depreciation cost in the next few years as they gradually commence operations. This will exert moderate pressure on profit in the near term, but it will enhance its market position and competitiveness in the medium term. We lower our 2019/20E earnings by 7%/9.5%, respectively, mainly to reflect such rising expenses and the 2–4% impact of the restriction on TCM prescriptions by Western physicians.

Historically low valuation

Currently, the Company is trading at only ~9.5/8.2/7.2x 2019/20/21E PER. This is a historically low valuation for the Company (Figure 1), and it is expected to deliver a 2018–2021E EPS CAGR of ~13.5%. We therefore believe concerns may be reflected in the share price. Catalysts include: 1) a further increase in the stake by CNPGC, which in an announcement in May expressed its intention to increase its stake in the next six months; 2) strong CCMG revenue growth in 1H2019, which will enhance investors' confidence in the Company's CCMG growth prospects; 3) advice by the Boston Consulting Group on corporate and management structure; and 4) gradually increasing confidence in the new management team. There is potential for a gradual re-rating.

Financial Summary	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
Turnover (RMBm)	8,338	11,259	14,051	16,857	19,636
Net profit (RMBm)	1,170	1,439	1,677	1,933	2,196
Core net profit	1,158	1,439	1,677	1,933	2,196
YoY(%)	19.0%	24.2%	16.6%	15.3%	13.6%
Core net margin (%)	13.9	12.8	11.9	11.5	11.2
Core EPS (RMB)	0.261	0.298	0.333	0.384	0.436
YoY(%)	19.0%	14.2%	11.6%	15.3%	13.6%
PER (x)	12.1	10.6	9.5	8.2	7.2
PBR (x)	1.1	0.9	0.8	0.7	0.6
ROE(%)	9.6	10.3	10.2	10.6	10.8
EV/EBITDA (x)	6.4	5.1	4.5	3.8	2.9

Analysts
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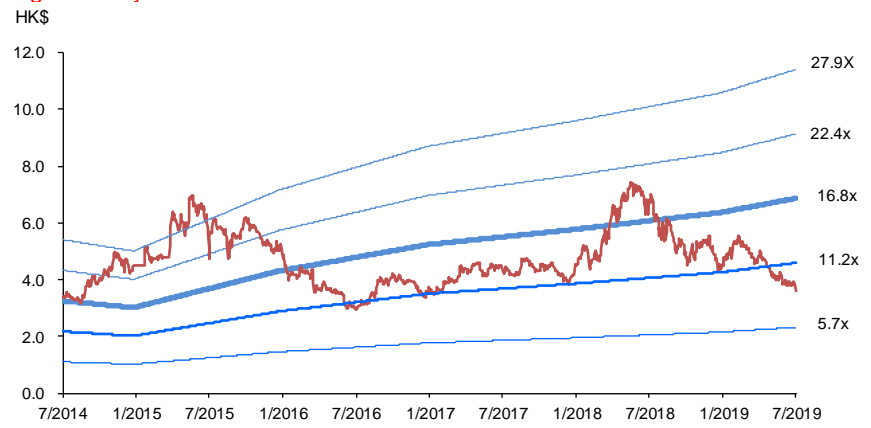
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SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

Figure 1: 5-year PE band



Source: CGIS Research

BY THE NUMBERS

Profit & Loss					
(Rmbm)	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
CCMG	5,500	7,151	8,938	10,905	13,086
TCM finished drugs	2,381	2,771	2,993	3,172	3,331
TCM decoction pieces	399	1,275	2,000	2,600	3,000
TCM healthcare complex	58	63	120	180	220
Revenue	8,338	11,259	14,051	16,857	19,636
Cost of goods sold	(3,686)	(5,065)	(6,510)	(7,962)	(9,266)
Gross profit	4,652	6,194	7,540	8,894	10,370
Other gains / (losses)	124	278	74	85	0
Marketing expenses	(2,437)	(3,417)	(4,117)	(4,956)	(5,773)
Admin & other expenses	(552)	(899)	(1,082)	(1,349)	(1,571)
Operating profit	1,786	2,156	2,416	2,675	3,026
Net interest income / (expense)	(221)	(292)	(228)	(138)	(108)
Share of loss of an associate	2	(7)	1	1	1
Pretax income	1,567	1,857	2,188	2,538	2,919
Income taxes	(256)	(290)	(306)	(355)	(409)
Non-controlling interests	(141)	(128)	(204)	(249)	(299)
Net profit	1,170	1,439	1,677	1,933	2,211
Core net profit	1,158	1,439	1,677	1,933	2,211
EBITDA	2,210	2,685	3,109	3,450	3,839
EPS (RMB)	0.264	0.298	0.333	0.384	0.439
Core EPS (RMB)	0.261	0.298	0.333	0.384	0.439
DPS (HK\$)	0.083	0.110	0.134	0.154	0.177
Payout ratio	27.5%	32.1%	35.0%	35.0%	35.0%

Cash Flow					
(Rmbm)	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-20F
Profit before tax	1,567	1,857	2,188	2,538	2,919
Depr & amortization	423	529	693	775	812
Change in working cap.	(567)	(1,252)	(1,319)	(1,578)	(1,637)
Income tax paid	(293)	(296)	(306)	(355)	(409)
Others	105	353	228	137	107
Operating cash flow	1,236	1,190	1,483	1,516	1,792
Capex	(704)	(1,346)	(1,735)	(635)	(635)
Cash for acquisition of subsidiaries	0	0	0	0	0
Change in other assets	1,097	(200)	0	0	0
Investment cash flow	393	(1,546)	(1,735)	(635)	(635)
Net change in debt	1,244	(1,517)	(3,134)	(500)	(700)
Proceeds from new shares	0	2,175	0	0	0
Others	(458)	1,115	(228)	(138)	(108)
Financing cash flow	786	1,772	(3,362)	(638)	(808)
Net change in cash	2,414	1,417	(3,614)	243	350
Cash at beginning of the year	2,147	4,530	6,439	2,825	3,068
Effect from foreign exchange	(31)	29	0	0	0
Cash at the end of the year	4,530	6,439	2,825	3,068	3,418

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

BY THE NUMBERS... cont'd

Balance Sheet					
(Rmbm)	Dec-17A	Dec-18A	Dec-19F	Dec-20F	Dec-21F
Cash & cash equivalents	4,788	6,439	2,825	3,068	3,418
Inventories	3,552	4,483	5,149	6,631	7,586
Accounts receivable	3,024	3,467	4,386	5,035	5,940
Others	20	97	97	97	97
Current assets	11,384	14,486	12,457	14,832	17,041
Property, plant and equipment	2,387	4,298	5,308	5,141	4,942
Intangible assets	6,704	6,613	6,632	6,646	6,656
Goodwill	3,486	3,569	3,569	3,569	3,569
Others	924	1,321	1,335	1,349	1,361
Non-current assets	13,501	15,802	16,844	16,705	16,528
Total assets	24,885	30,287	29,302	31,537	33,569
Accounts payable	3,857	4,148	4,414	4,967	5,188
ST borrowings	639	3,909	1,000	800	600
Others	200	576	576	576	576
Current liabilities	4,695	8,633	5,990	6,343	6,364
Long-term debts	4,515	2,225	2,000	1,700	1,200
Others	1,860	1,919	1,919	1,919	1,919
Long-term liabilities	6,375	4,144	3,919	3,619	3,119
Total liabilities	11,070	12,777	9,909	9,962	9,484
Shareholders' equity	12,437	15,551	17,229	19,162	21,373
Minority interests	1,378	1,959	2,163	2,413	2,712
Total equity	13,815	17,511	19,392	21,575	24,085

Key Ratios					
Year ended Dec 31	Dec-17A	Dec-18F	Dec-19F	Dec-20F	Dec-21F
Growth (% YoY)					
Sales	27.6	35.0	24.8	20.0	16.5
Operating profit	29.8	20.7	12.0	10.7	13.1
EBITDA	29.0	21.5	15.8	11.0	11.3
Core net profit	19.0	24.2	16.6	15.3	14.4
Core EPS	19.0	14.2	11.6	15.3	14.4
Profitability (%)					
Gross margin	55.8	55.0	53.7	52.8	52.8
Operating margin	21.4	19.1	17.2	15.9	15.4
EBITDA margin	26.5	23.8	22.1	20.5	19.5
Core net profit margin	13.9	12.8	11.9	11.5	11.3
ROA	5.0	5.2	5.6	6.4	6.8
ROE	9.6	10.3	10.2	10.6	10.9
Balance sheet ratios					
Current ratio (X)	2.4	1.7	2.1	2.3	2.7
Quick ratio (X)	1.1	1.2	0.5	0.5	0.6
Cash ratio (X)	1.1	1.2	0.5	0.5	0.6
Trade & bill receivables days	126	105	102	102	102
Trade & bill payable days	305	288	240	215	200
Inventory turnover days	270	289	270	270	280
Net debt to equity ratio (%)	2.9	Net cash	1.0	Net cash	Net cash

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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