Tianjin Zhongxin Pharmaceutical Group Corporation Limited

Date: 10 November 2017

Non Rated

TIAN SP
600329:CH
Price: US$1.000 (as at 9th November 2017)

Share price	1M	3M	6M	1Y
TJZX	4.9%	13.2%	102.0%	63.5%
Straits Times Index	4.0%	5.3%	2.8%	21.2%

Market capitalisation	S$2.3 billion
Current price	US$1.005 CNY17.28
Shares outstanding	565,700,000
Free Float	54.2%
Major shareholders	Tianjin Pharmaceutical Holdings 43.8%
Listing venues	Singapore Stock Exchange Shanghai Stock Exchange

Source: Company data, Bloomberg, SAC Advisors

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State-owned TCM manufacturer

A state-owned Traditional Chinese Medicine ("TCM") manufacturer. Tianjin Zhong Xin Pharmaceutical Group Corporation Limited and together with its subsidiaries, ("**TJZX**", "**Company**" or the "**Group**") is the core pharmaceutical manufacturing arm of Tianjin Pharmaceutical Group Corporation Limited. With a long operating history, the Company is recognised as a state-class high-tech enterprise featured with innovations in traditional Chinese medicine. They were listed on the Singapore Exchange in 1997 and on the Shanghai Stock Exchange in 2001.

TCM as a national strategy. In 2016, the State Council issued the Outline of the Strategic Plan on the Development of Traditional Chinese Medicine (2016 – 2030), which made TCM development a national strategy, with systemic plans for TCM development in the new era. According to the white paper, the plans were described as "a grand blueprint" that focuses on the revitalisation of TCM, adding that they ushered in a new era of development for TCM.

SOE reforms improve corporate governance and shareholder returns. This has been alluded to by the management team during our site visit to their premises and in their latest annual report. The move is in response to the circular released by China's Securities Regulatory Commission: "No.3 Guideline for the Supervision of Listed Companies – Cash Dividend Distribution of Listed Companies" which was released at the end of 2013. In accordance with the circular, the Company has moved from having no fixed dividend policy in previous years to establishing a "scientific, sustainable and stable profit distribution policy". Moving forward, we believe this will translate into more shareholder friendly practices. We have in fact already seen some of these practices being implemented, for FY16, the dividend payout ratio amounted to 48.7% vs. 31.9% in FY15.

Key risk: Implementation of the two-invoice system.

Key Historical Financials

Year ended December (RMB'million)	FY2012	FY2013	FY2014	FY2015	FY2016
Revenue	5,130	6,010	7,087	7,081	6,179
% Growth	N/A	17.2%	17.9%	(0.1%)	(12.7%)
Gross profit	1,750	1,873	2,102	2,044	1,944
Gross profit margin	34.1%	31.2%	29.7%	28.9%	31.5%
Profit/(loss) before tax	476	417	431	535	466
Profit/(loss) before tax margin	9.3%	6.9%	6.1%	7.6%	7.5%
Profit/(loss) attributable to owners	400	354	383	454	410
EPS/(LPS) (RMB cents)	0.54	0.48	0.48	0.60	0.55
P/E (x)	7.3	13.6	12.2	11.7	11.0
Net Debt/Equity	24.2	22.6	9.4	Net cash	Net cash

^EPS is computed based on the profit from continuing operations attributable to owners of the company divided by total shares outstanding

Investment Highlights

A state-owned TCM manufacturer. TJZX is the core pharmaceutical manufacturing arm of Tianjin Pharmaceutical Group Corporation Limited. With a long operating history, the Company is recognised as a state-class high-tech enterprise featured with innovations in traditional Chinese medicine. They were listed on the Singapore Exchange in 1997 and on the Shanghai Stock Exchange in 2001.

TJZX's core business is in Chinese traditional medicine, and boasts a complete industrial chain and product chain. They currently own 25 branch companies, six fully owned subsidiaries, seven controlled subsidiaries and 12 associates with minor stakes.

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Even prior to the publishing of the white paper, a series of major policy decisions have been made and a number of plans have been adopted to promote TCM development since the Communist Party of China's ("**CPC**") 18th National Congress in 2012. In 2016 for instance, the CPC Central Committee and the State Council issued the Outline of the Healthy China 2030 Plan, a guide to improving the health of the Chinese people in the next 15 years.

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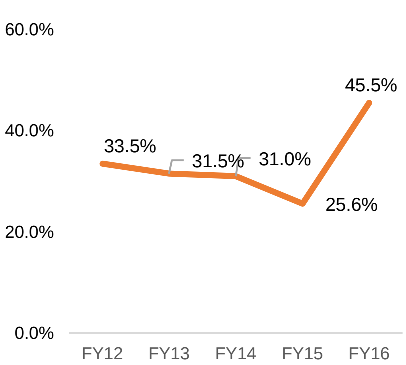
Business Overview:

TJZX holds 858 patents, including 461 for inventions, 60 for exclusive prescriptions and 41 for exclusive preparation formulas. It also owns 560 varieties of preparations in 17 types, 602 certificates of approval for preparations, and 9 certificates of approval for crude drugs. Among them, 4 Chinese medicines have been honoured as National Treasure-like creations; Su Xiao Jiu Xin Pill, Niu Huang Jiang Ya Pill, Niu Huang Jiang Ya Capsule and Jin Wan Hong have been classified as state secret of their respective prescriptions and ingredients.

Dividend Payout Ratio



Source: Company data, SAC Advisors

Investment Highlights

Chinese pharmaceuticals facing reform with implementation of the two-invoice system (两票制) **which provides stability to the industry.** The State Council is implementing a “two-invoice system” for pharmaceutical distribution that will roll out nationwide in 2018. The new rules will allow a maximum of two invoices between a manufacturer and hospital - each manufacturer will sell to a distributor and that distributor will sell directly to hospitals, eliminating multi-tiered distribution which will contain healthcare costs.

This move by the State Council, is in response to the wide array of logistical, financial, and commercial activities in multi-tier networks. Many generate high margins, which lead to higher healthcare costs. The rationale for this change is compelling in our view as fewer distribution layers will lead to more transparent and smaller distributor margins.

The two-invoice system in effect, has already been implemented. The policy is a building block of some local governments’ reform efforts to consolidate distributors and reduce medical product costs. In April 2016, Fujian was the first province to fully implement the two-invoice system for pharmaceuticals.

Company Background

- TJZX is the core pharmaceutical manufacturing arm of Tianjin Pharmaceutical Group Corporation Limited. With a long history, the Company is recognised as a state-class high-tech enterprise featured with innovations in TCM. It was listed on the Singapore Exchange in 1997 and on the Shanghai Stock Exchange in 2001.

- TJZX takes TCM as its core business, boasting a complete industrial and product chain. It currently owns 25 branch companies, 6 fully owned subsidiaries, 11 controlled subsidiaries and 10 associates with minor stakes. Among the 52 units, 7 are companies that are involved in distribution of chemical drug, bio-medicine and other strategic sectors and operated jointly with world famous pharmaceutical giants like SmithKline and Baxter, while the rest are branches and subsidiaries that are mainly engaged in traditional Chinese medicine manufacturing and medical commerce.

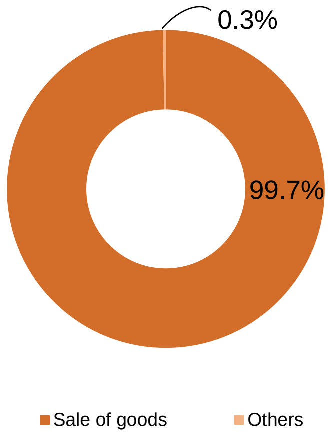
Tianjin Zhongxin Site Visit

Source: SAC Advisors

- Da Ren Tang, Le Ren Tang and Long Shun Rong, known as China Time-honored Brands under the flag of the Company, have all won the honorable title of “Famous Chinese Trade Mark”, and the brand of Song Bo for No. 6 Chinese Medicine Plant, a modern Chinese medicine making icon, has also been awarded the honorable title. All this has helped Zhong Xin Pharmaceutical to advance to a leading enterprise in protecting China Time-honored Brands.

- Their core business is in the manufacturing of TCM, which accounts for nearly all - 99.7% in FY16 - of their revenue.

Revenue Breakdown (FY2016)



Source: Company data, SAC Advisors

Tianjin Zhongxin Site Visit

Source: SAC Advisors

National Treasures

Protection by the State

TJZX is devoted to innovative research, development and manufacture of a full range of good quality, high efficiency and quick-acting medicines. At present, it owns 560 varieties of preparations in 17 types, 602 certificates of approval for preparations, and 9 certificates of approval for crude drugs.

Among them, 4 Chinese medicines have been honored as National Treasure like creations; Su Xiao Jiu Xin Pill (for treatment of cardio-vascular ailments), invented by famous Chinese medicine manufacture expert Professor Zhang Chengui, who is also senior adviser of Zhong Xin Pharmaceutical and honorable director of its Technology Center, has been designated as a national confidential prescription.

Niu Huang Jiang Ya Pill (for treatment of hypertension), Niu Huang Jiang Ya Capsule (for treatment of hypertension) and Jing Wan Hong (for treatment of scald) have been classified as state secret of their respective prescriptions and ingredients; 6 products have become state-protected Chinese medicines; 111 product varieties are exclusively produced by the Company; 85 drugs have been listed in the National Basic Medicine Catalog, and 271 products are now available in the national medical insurance service system.

According to the management, TJZX's best selling medicine is the Su Xiao Jiu Xin Wan, a cardio-vascular prescription that contributed at least 25% of FY16 net profit. The pill is protected by the State and is recognized as a key drug in the treatment of cardio-vascular diseases. The medicine is on the A list of China's National Reimbursement Drug List, which means it is 100% covered under the national insurance scheme.

Su Xiao Jiu Xin Wan

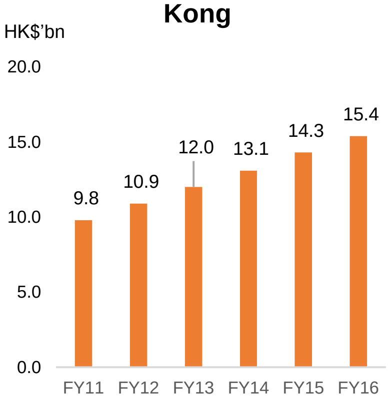
Source: SAC Advisors

Jin Wan Hong

Source: Company data

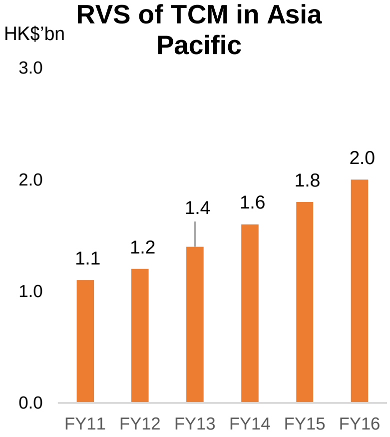
Industry Overview

Retail value sales (“RVS”) of TCM in Hong Kong



Source: Euromonitor, SAC Advisors

RVS of TCM in Asia Pacific



Source: Euromonitor, SAC Advisors

In 2015, the total output value of the TCM pharmaceutical industry was RMB 786.6 billion yuan (US$114.21 billion), accounting for 28.6% of the total generated by the country’s pharmaceutical industry, and becoming a new source of growth in China’s economy. And TCM is set to grow, since the CPC’s 18th National Congress in 2012, the Party and the government have granted greater importance to the development of TCM, and made a series of major policy decisions and adopted a number of plans in this regard. TCM is going global, according to the World Health Organization (“**WHO**”), 103 member states have given approval to the practice of acupuncture and moxibustion, while 29 have enacted special statutes on traditional medicine.

Traditional Chinese Medicine in China

According to a Euromonitor report, as at the end of 2011, there were over 2,300 manufacturers engaged in producing Chinese medicine products in China. The contribution of Chinese medicines and herbs together to China’s gross domestic product had also been increasing over the past few years, and reached approximately 0.9% in 2011. The growth is driven by both the growing domestic and international demand.

Moving forward, we believe that such growth will continue to be driven by the improving recognition of the Chinese medicine industry as a result of the following key factors: (i) government support for the development of the Chinese medicine industry, (ii) improving regulation and supervision of the Chinese medicine industry, and (iii) growth in the export of Chinese medicine products.

Favourable regulatory environment to promote growth of TCM

In 2016, the State Council issued the Outline of the Strategic Plan on the Development of Traditional Chinese Medicine (2016 – 2030), which made TCM development a national strategy, with systemic plans for TCM development in the new era. Stressing the innovative development of TCM for health preservation, the white paper laid out China’s aspirations to enable every Chinese citizen to have access to basic TCM services by 2020, and have TCM services encompass all areas of medical care by 2030. According to official statistics, the medical care services provided by TCM institutions in the national total increased from 14.3% to 15.7% from 2009 to 2015.

The support for TCM however, is not a recent development, in early 2012, the Proposal on Promoting the Development of Traditional Chinese Medicine Trade in Services was established and issued by 14 ministries of China which contained a package of measures, including financial investment, taxation support, financial subsidy and measures to improve international recognition, to be introduced to support the development of the Chinese medicine industry.

Industry Overview

Improving regulation and supervision of the Chinese medicine industry promotes confidence

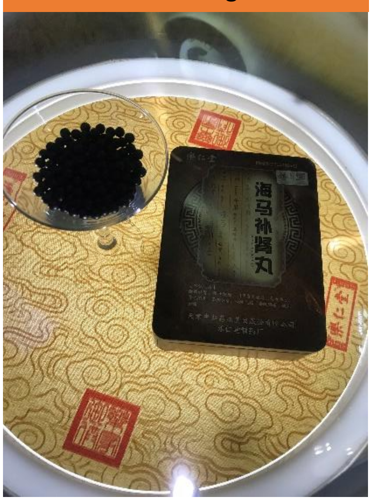
Counterfeit medicines and poor-quality medicines in the market have long caused customers to refrain from adopting Chinese medicine treatment and products. As such, the improvement in Chinese medicine standards in China will contribute to the increasing confidence and acceptance of Chinese medicine treatments and products. In recent years, the government has released the following regulations to step up the overall regulation and supervision of the industry. Relevant regulations included "Regulations of the PRC on Traditional Chinese Medicine", "Notice on Strengthening Supervision and Administration of Chinese herbs" and the recent "Outline of the Strategic Plan on the Development of Traditional Chinese Medicine".

Development of TCM

The recent white paper released by the State Council outlined the support the State will give to the development of TCM in China. Specifically, the establishment of a TCM medical system will cover both the urban and rural areas. An urban TCM medical care network, mainly comprising hospitals for TCM (including ethnic minority medicine and integrated Chinese and Western medicine), TCM clinics and general hospitals' TCM clinical departments, and community health centres, has been formed. A rural TCM medical care network has been established, mainly composed of county-level TCM hospitals, TCM clinical departments of general hospitals (specialized hospitals and maternal & child health centers), TCM departments of township-level health centers, and village health clinics, which provides basic TCM healthcare services.

Statistics collected at the end of 2015 show that there were 3,966 TCM hospitals across the country, including 253 hospitals of ethnic minority medicine and 446 hospitals of integrated Chinese and Western medicine; there were 452,000 practitioners and assistant practitioners of TCM (including practitioners of ethnic minority medicine and integrated Chinese and Western medicine); there were 42,528 TCM clinics, including 550 for ethnic minority medicine and 7,706 for integrated medicine; there were 910 million visits that year to TCM medical and health service units across the country and 26,915,000 inpatients treated.

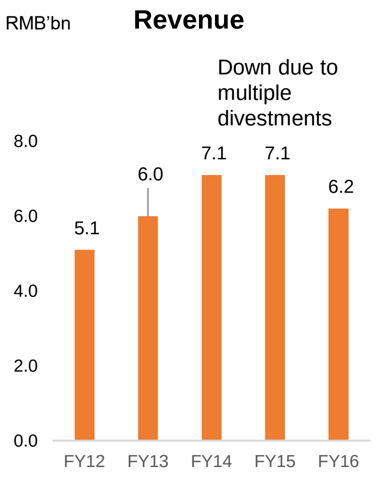
Hai Ma Bu Sheng Wan



Source: SAC Advisors

Financial Summary

Business rationalisation improves overall margins

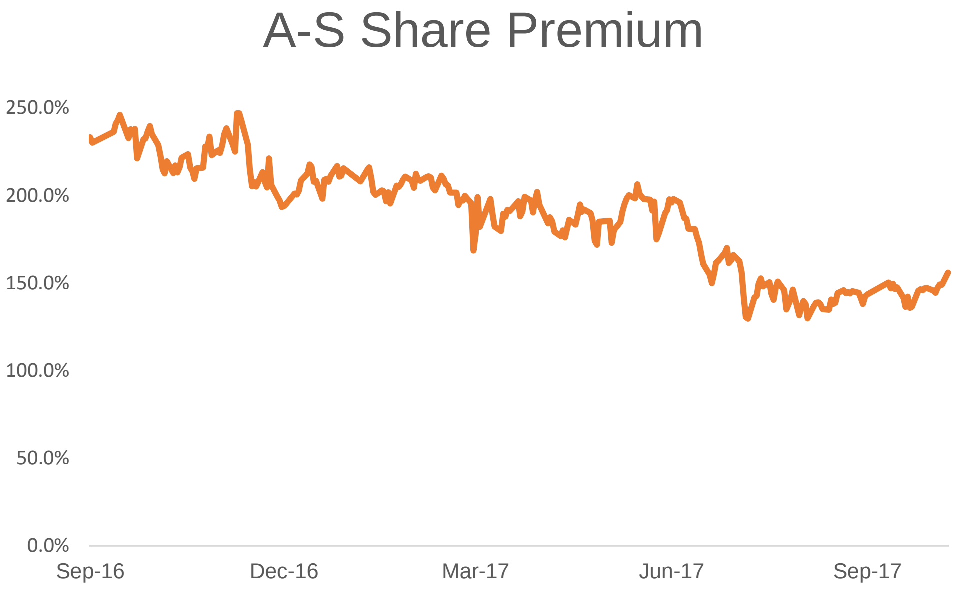


Source: Company data, SAC Advisors

Management's decision to dispose off their loss making and low margins businesses under their distribution business saw their revenue come off in FY15 and FY16. The result of this is the improvement in gross margins by nearly 3% from 28.9% in FY15 to 31.5% in FY16.

Discount to TJZX-A

TJZX is currently trading at a substantial discount to their A-shares, Tianjin Zhongxin (600329.CN) ("**TJZX-A**"), even though the premium spread has been narrowing in the last one year, TJZX-A is still trading at an over 150% premium to the Singapore-listed shares.



Source: Company data, SAC Advisors

Management

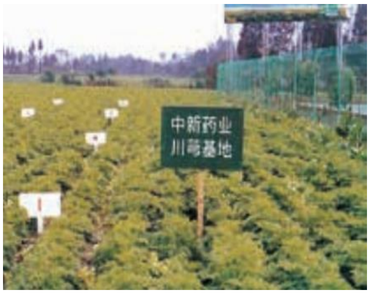
Mr. Wang Zhi Qiang is the Chairman of the Board of Directors. He is the general manager, with responsibility for the manufacturing operations of the Company. He had previously held the positions of deputy manager and manager in Medical Group Heping Company and Yier Subsidiary and was appointed the deputy general manager of Medicine Group Company in 1998.

Ms. Wang Lei is the Executive Director and Deputy General Manager of the Group. From July 1993 to March 2001, she successively held the posts of the Technician in workshop, Cadre in the Sale Department, and Chief in the after sale service section of TJZX Da Ren Tang Pharmaceutical Factory. For the period from March 2001 to April 2004, she was firstly appointed as Deputy Director of Planning Division and then as the Deputy Director of Industry Department in the Company. From April 2004 to January 2013, she served as the Deputy Director, Executive Deputy Director, Secretary of the Party Committee, Director cum Deputy Secretary of the Party Committee in succession and further promoted as Director cum Secretary of the Party Committee from January 2013 to date in Tianjin Zhong Xin Le Ren Tang Pharmaceutical Factory. From 15 May 2013 to 23 June 2013, she was also a Supervisor of the Board of Supervisors of the Company. From June 2014 to present, she is working as the Deputy General Manager of the Company.

Future Plans – Two-pronged approach

Strengthen quality of raw materials

The Group will seek to build up their supply chain capability to ensure a stable supply of their main raw materials for their production. The move will also ensure that the quality of their raw materials are not compromised.



Source: Company data

The importance of ensuring the stable delivery of raw materials is also set out under the Outline of the Strategic Plan on the Development of Traditional Chinese Medicine (2016 – 2030), where a number of laws and regulations have been enacted and implemented on strengthening the protection of TCM wild medicinal resources. In addition, a number of national and local nature reserves have been established. Research has also been conducted on the protection of rare and endangered Chinese medicinal resources, and artificial production or wild tending have been carried out for certain scarce and endangered resources.

Expanding TCM globally

The Group is targeting to speed up the pace of going global by cultivating new emerging markets and new customers. This move is in-line with the government's push in promoting the globalisation of TCM, which has been adopted in 183 countries and regions around the world.

In recent years, the Chinese government has worked closely with the WHO to contribute to progress in TCM around the world. In a bid to promote standard management of TCM internationally and ensure its safety, China has facilitated the founding of the ISO/TC249 Traditional Chinese Medicine in the ISO. With its secretariat in Shanghai, it has now issued a series of ISO standards on TCM.

Key Risks

Implementation of the two-invoice system

The State Council's implementation of the two-invoice system in 2018 will bring about more stability to the industry as the new rules will allow a maximum of two invoices between a manufacturer and hospital. The move will eliminate multi-tiered distribution which increases the overall distribution costs. While the move will not substantially impact TJZX as they rely on their own distribution network, the move might affect the end-pricing to their customers.

Income Statement (RMB'mn)

	Fiscal Year Ended				
	FY12	FY13	FY14	FY15	FY16
Revenue	5,130	6,010	7,087	7,081	6,179
Less: Cost of sales	(3,380)	(4,137)	(4,985)	(5,037)	(4,235)
Gross Profit	1,750	1,873	2,102	2,044	1,944
Other income	105	84	43	146	114
Marketing and distribution costs	(1,108)	(1,206)	(1,366)	(1,266)	(1,270)
Research and development costs	(58)	(62)	(71)	(73)	(66)
Administrative expenses	(287)	(264)	(276)	(269)	(287)
Finance costs	7,641	10,107	15,762	(2,811)	(10,714)
Others	128	48	51	(11)	51
Profit before income tax	476	417	431	535	466
Less: Income tax	(59)	(56)	(51)	(79)	(58)
Profit/(loss), net of tax	417	361	379	456	408
Profit/(loss) attributable to owners of company	400	354	383	454	410
Earnings/(Loss) per share:					
-Basic (RMB cents)	0.54	0.48	0.48	0.60	0.55
-Diluted (RMB cents)	0.54	0.48	0.48	0.60	0.55

Cash Flow Statement (RMB'mn)

	Fiscal Year Ended				
	FY12	FY13	FY14	FY15	FY16
Profit/(Loss) before tax	476	417	431	535	466
Depreciation & amortisation	99	89	89	77	75
Change in working capital	(294)	(139)	(160)	(144)	37
Others	222	149	90	144	187
Net Cash (used in)/ from operations	59	217	269	324	390
Purchase of PPE	(41)	(72)	(70)	(93)	(116)
Others	69	(87)	178	(328)	210
Net Cash (used in)/ from investing	28	(160)	108	(420)	94
Net increase in equity	-	-	-	814	-
Net increase in debt	63	185	(273)	(367)	(19)
Others	(182)	71	(206)	145	(296)
Net Cash (used in)/ from financing	(119)	256	(479)	302	(315)

Balance Sheet (RMB'mn)

	Fiscal Year Ended				
	FY12	FY13	FY14	FY15	FY16
As at 31 Dec					
Property, plant and equipment	909	886	870	921	982
Investments in associates	654	525	542	531	561
Other non-current assets	358	664	643	618	926
Non-current assets	1,921	2,075	2,055	2,070	2,469
Inventories	772	817	860	974	909
Trade and other receivables	1,161	1,449	1,694	1,539	1,466
Other current assets	146	177	198	377	364
Cash and cash equivalents	420	745	631	1,108	1,153
Current assets	2,500	3,188	3,382	3,999	3,892
Total assets	4,320	5,262	5,437	6,069	6,361
Share capital	739	739	739	769	769
Share premium	414	414	414	1,199	1,199
Retained earnings	710	954	1,239	1,532	1,735
Other reserves	274	310	371	422	437
Equity attributable to owners of the Company	2,137	2,417	2,764	3,922	4,140
Non-controlling interests	142	158	183	183	163
Total equity	2,279	2,575	2,947	4,105	4,302
Trade payables, non-current	0	55	54	48	47
Other liabilities, non-current	57	80	75	76	83
Non-current liabilities	57	135	129	123	130
Income tax payable	35	12	9	10	17
Trade and other payables	1,175	1,173	1,380	1,230	1,269
Other liabilities, current	874	1,368	973	600	642
Current liabilities	2,085	2,553	2,362	1,840	1,929

Ratios

	Fiscal Year Ended				
	FY12	FY13	FY14	FY15	FY16
Profitability (%)					
Gross profit/(loss) margin	34.1%	31.2%	29.7%	28.9%	31.5%
Operating profit margin	N/A	N/A	N/A	N/A	N/A
Profit/(loss) before tax margin (continuing ops)	9.3%	6.9%	6.1%	7.6%	7.5%
Liquidity (x)					
Current ratio	1.2	1.2	1.4	2.2	2.0
Quick ratio	0.8	0.9	1.1	1.6	1.5
Interest coverage ratio	N/A	N/A	N/A	N/A	N/A
Net Debt to Equity	Net cash	14.8%	Net cash	23.2%	41.3%
Valuation (x)					
P/S	0.6	0.8	0.6	0.8	0.8
P/E	7.3	13.6	12.2	11.7	11.0
Core P/E at target price	N/A	N/A	N/A	N/A	N/A
P/B	1.5	2.0	1.6	1.4	1.1
P/NTA	1.5	2.0	1.6	1.4	1.1
Cash Conversion Cycle					
Trade receivable days	N/A	N/A	N/A	N/A	N/A
Inventory days	N/A	N/A	N/A	N/A	N/A
Trade payable days	N/A	N/A	N/A	N/A	N/A
CCC days	99	101	96	102	119
Returns					
Return on equity	22.0%	14.9%	13.7%	13.0%	9.7%
Return on capital employed	7.9%	8.1%	8.7%	8.6%	5.6%
Dividend payout ratio	33.5%	31.5%	31.0%	25.6%	45.5%

n.m.: not meaningful

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Party	Quantum of position
Nil	Nil

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Company	Nature of business relation	Date of business relation
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Analyst name	Quantum of position
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