

Last Closing: HK\$3.14

Upside: +8%

Target Price: HK\$3.40

Healthcare Sector

China Traditional Chinese Medicines (570.HK)

Emerging TCM contender

UP

MP

OP

Initiation of coverage

Financial Highlights

HKD '000	2010	2011	2012	2013E	2014E	2015E
Revenue	939,178	1,015,935	1,268,143	1,715,712	3,314,859	3,867,764
Net profit	60,925	72,072	207,134	193,058	361,819	444,999
Diluted EPS	0.035	0.040	0.116	0.094	0.143	0.176
Revenue (YOY%)	40%	8%	25%	35%	93%	17%
Net profit (YOY%)	38%	18%	187%	-7%	87%	23%
Diluted EPS (YOY%)	25%	15%	187%	-19%	51%	23%
Revenue vs. consensus				-24%	-4%	-5%
Net profit vs. consensus				-38%	-21%	-20%
Diluted EPS vs. consensus				-34%	-24%	-25%
P/E		77.7x	27.0x	33.3x	22.0x	17.9x
P/B		7.2x	6.7x	2.2x	2.5x	2.3x
Dividend yield (%)		0.0%	2.4%	0.0%	0.5%	0.6%

Source: Company, BOCOM Int'l estimates (Priced on 12/5/2013)

- We are initiating coverage on CTCM (570.HK) with a LT Buy rating. We believe its recent M&A activities involving China National Pharmaceutical Group Corporation (CNPGC, Sinopharm (1099.HK)'s parent company) and Tongjitang will propel CTCM to be a serious TCM contender. However, the stock is currently trading at our 2014E P/E of 22.0x vs. industry average of 17.5x, leading us to believe CTCM's near-term prospects are largely priced in.

- CTCM could be a serious contender in the TCM space in the long run: With a major strategic shareholder like CNPGC, CTCM has the potential to be one of the largest TCM players in China. We expect: 1) CNPGC to provide more M&A opportunities and better distribution network, and 2) Tongjitang to enhance CTCM's product portfolio with cross-selling potential to create synergies. We are also anticipating growth from the four products that entered the 2013 EDL recently. R&D opportunities such as its TCM anti-depression drug, Yu Ping Feng re-evaluation, Sheng Tong Ping variation dose and a TCM myocardial infarction in the pipeline could drive LT growth.

- Concerns/Risks: 1) Low cash levels may lead to share dilution/higher interest expenses for the next M&A; 2) Winteam's products may be harder to penetrate into hospitals compared with Tongjitang's products entering drugstores/OTC; 3) It may take another 1-2 years to see full optimization of the new enlarged platform.

- Valuation: Our target price of HK\$3.40 is derived from the average of our DCF method (HK\$4.00) and PEG method (HK\$ 2.80). We believe while our DCF method can capture the longer-term benefits, our PEG method better reflects the current market sentiment.

- Catalysts: 1) M&A (companies/drugs) opportunities, 2) cross-selling opportunities, and 3) network expansion.



- CTCM has established itself as a serious TCM contender after recent M&A activities with CNPGC and Tongjitang.
- Positives: 1) more M&As, 2) cross selling and other synergies, 3) higher sales from recently entered EDL drugs, and 4) R&D pipeline to drive LT growth.
- Concerns: 1) We expect the next M&A could dilute shares and/or increase debt; 2) Winteam's products are harder to reach hospitals; 3) May take 1-2 years before full optimization of the enlarged platform.
- Our TP of HK\$3.40 implies +8% upside.

Stock data

52-week high	4.63
52-week low	1.55
Market capitalization (US\$mn)	1,056
Number of shares (mn)	2,534
1 month average daily volume (mn)	3.2
1 month performance (%)	0%
YTD performance (%)	103%
50-day moving average	3.33
200-day moving average	3.41
14-day relative strength index	43

Source: Company data, Bloomberg

1 Year Performance chart



Source: Company data, Bloomberg

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Financial summary

Figure 1: Financial summary

Income Statement									
HKD '000	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Total Revenue	939,178	1,015,935	1,268,143	1,715,712	3,314,859	3,867,764	4,447,928	4,892,721	5,284,139
Gross profit	523,904	548,406	693,228	1,008,191	1,976,357	2,317,796	2,668,757	2,935,633	3,170,483
SG&A expenses	(427,225)	(459,193)	(434,527)	(740,998)	(1,497,071)	(1,741,836)	(2,008,973)	(2,234,334)	(2,413,081)
Operating income	96,679	89,213	258,701	267,193	479,286	575,960	659,784	701,298	757,402
Other income (net)	20,503	11,479	28,764	23,095	57,716	71,095	66,719	73,391	79,262
Finance costs	(1,952)	(6,237)	(21,481)	(46,864)	(83,478)	(89,556)	(88,745)	(86,569)	(83,616)
Profit Before Taxes	115,230	94,455	265,984	243,424	453,524	557,498	637,757	688,120	753,048
Tax Rate	25%	22%	20%	20%	20%	20%	20%	20%	20%
Net Income	60,925	72,072	207,134	193,058	361,819	444,999	509,062	549,262	601,088
Diluted EPS	0.0353	0.0404	0.1161	0.0943	0.1428	0.1757	0.2010	0.2168	0.2373
Margins									
YOY%	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Gross margin	55.8%	54.0%	54.7%	58.8%	59.6%	59.9%	60.0%	60.0%	60.0%
Operating margin	10.3%	8.8%	20.4%	15.6%	14.5%	14.9%	14.8%	14.3%	14.3%
Profit before tax margin	12.3%	9.3%	21.0%	14.2%	13.7%	14.4%	14.3%	14.1%	14.3%
Net margin	6.5%	7.1%	16.3%	11.3%	10.9%	11.5%	11.4%	11.2%	11.4%
Balance Sheet									
HKD '000	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Cash and ST Investments	211,890	47,273	165,118	529,218	20,094	48,948	155,534	412,071	647,825
Short Term Receivables	219,849	428,302	640,780	1,066,547	2,021,267	2,217,378	2,657,064	2,704,822	3,086,015
Inventories - Total	168,973	233,935	198,614	436,938	589,858	599,158	765,686	735,643	885,792
Total Current Assets	600,712	709,510	1,004,512	2,032,703	2,631,220	2,865,485	3,578,283	3,852,536	4,619,631
Property, Plant & Equipment - Net	279,245	340,954	454,245	691,142	795,965	858,052	930,969	1,007,444	1,083,919
Intangible Other Assets	307,752	310,290	299,522	2,562,580	2,562,580	2,562,580	2,562,580	2,562,580	2,562,580
Deferred Tax Assets	12,612	12,744	24,617	54,244	50,232	57,078	58,493	57,344	60,455
Total Non-current Asset	805,464	913,238	912,308	3,504,325	3,605,135	3,674,068	3,748,401	3,823,727	3,903,313
Total Assets	1,406,176	1,622,748	1,916,820	5,537,028	6,236,355	6,539,553	7,326,684	7,676,263	8,522,944
Accounts Payable	85,824	97,621	101,377	437,919	735,563	623,313	936,508	779,296	1,073,772
ST Debt & Current Portion of LT Debt	109,294	340,570	511,104	669,768	669,768	669,768	669,768	669,768	669,768
Total Current Liabilities	489,089	596,849	800,722	1,349,672	1,692,667	1,594,366	1,922,197	1,776,206	2,080,558
Long Term Debt	0	0	0	850,000	950,000	950,000	950,000	950,000	950,000
Total Non-current Liabilities	67,903	61,584	73,007	940,384	970,079	970,079	970,079	970,079	970,079
Total Liabilities	547,401	648,946	855,991	2,290,056	2,662,746	2,564,445	2,892,276	2,746,285	3,050,637
Non-Equity Reserves	9,591	9,487	17,738	240,890	240,890	240,890	240,890	240,890	240,890
Minority Interest	13,525	15,577	21,059	85,901	86,901	87,901	89,045	90,279	91,630
Common Equity	835,659	948,738	1,022,032	2,920,181	3,245,818	3,646,317	4,104,473	4,598,808	5,139,788
Total Equity	858,775	973,802	1,060,829	3,246,972	3,573,609	3,975,108	4,434,407	4,929,978	5,472,308
Total Liabilities & Shareholders' Equity	1,406,176	1,622,748	1,916,820	5,537,028	6,236,355	6,539,553	7,326,684	7,676,263	8,522,944
Cash Flow Statement									
HKD '000	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Net Income/Starting Line	115,230	94,455	265,984	243,424	453,524	557,498	637,757	688,120	753,048
Depreciation, Depletion & Amortization	54,214	57,106	46,693	59,200	82,016	92,623	105,000	119,234	134,890
Operating profit before change in working capital	164,717	159,138	309,548	136,404	619,018	739,678	831,503	893,923	971,555
Funds from/for Other Operating Activities	(59,910)	(184,018)	(40,416)	(327,549)	(809,997)	(317,660)	(293,018)	(174,928)	(236,865)
Cash from Operating Activities	72,626	(54,689)	228,080	(194,574)	(356,870)	317,621	424,154	593,741	590,844
Capital Expenditures Additions to Fixed Assets	(74,610)	(104,202)	(123,222)	(137,257)	(132,594)	(154,711)	(177,917)	(195,709)	(211,366)
Cash from Investing Activities	(324,481)	(244,562)	(224,070)	(133,745)	(129,309)	(154,307)	(176,702)	(192,317)	(205,021)
Long Term Borrowings	130,914	520,122	692,205	850,000	100,000	-	-	-	-
Common Dividends (Cash)	0	0	(133,756)	-	(36,182)	(44,500)	(50,906)	(54,926)	(60,109)
Cash from Financing Activities	153,171	217,746	10,693	799,623	(22,945)	(134,460)	(140,867)	(144,887)	(150,069)
Net Change in Cash	(91,450)	(77,658)	14,696	471,305	(509,123)	28,854	106,586	256,537	235,754
Net Cash - Ending Balance	120,012	42,354	57,050	528,355	19,231	48,085	154,671	411,208	646,962

Source: Company, BOCOM Int'l

Investment positives

Recent M&A activities with Tongjitang and CNPGC (Sinopharm parent group) should propel CTCM to be a serious TCM contender

The company was acquired by Sinopharm's parent company CNPGC in Feb 13 and later acquired Tongjitang in May 13.

The company name was changed from Winteam to China Traditional Chinese Medicine (CTCM), which, in our view, better reflects the nature of the expanded company.

These two deals allowed CTCM to be more competitive in terms of both products and network:

- 1) CNPGC provides more M&A opportunities: Sinopharm's parent group hopes to build the largest medical conglomerate including Sinopharm (largest distribution network) and Zhongsheng (largest biotech/vaccine manufacturer). CTCM, according to the same strategy, could be one of the largest TCM players. Moreover, CNPGC is a nationwide platform, and can introduce more potential M&A targets to CTCM.
- 2) Sinopharm can provide a better network: Sinopharm has its network of hospitals and drugstores. We believe CTCM products can penetrate into the network easier than other manufacturers.
- 3) Tongjitang enhances CTCM's product portfolio: With Tongjitang, CTCM has both Rx and OTC products. This allows healthy exposure to the TCM industry. Moreover, synergies can be unlocked such as cross selling each other's products in their own networks. We note Tongjitang covers 5,000 hospitals in 29 provinces in China with 1,800 sales people.

Four EDL products just entered the 2013 EDL:

The company has 26 exclusive products in the NDRL and 7 exclusive products in the EDL. Amongst the 7 EDL products, three entered EDL in 2009 and have seen high volume growth. Four other products entered in 2013 and management expects high volume growth in the near term as well.

R&D opportunities

- 1) TCM anti-depression drug

Tongjitang has a TCM drug for anti-depression that is in Phase III clinical trial. The company indicated it has taken 7-8 years to develop the drug and it could be launched in 1H14. The drug is for mild depression patients.

- 2) Yu Ping Feng re-evaluation

Management intends to have Yu Ping Feng re-evaluated by the authorities in 2014. The cost for the re-evaluation could be around HK\$20mn. The re-evaluation could allow Yu Ping Feng to be categorized as an Rx drug with specific therapeutic area (recurring/chronic upper respiratory disease), which facilitates more sales in top-tier hospitals. The current sales split for Yu Ping Feng is 70% tier-II medical institutions,

20% top-tier hospitals and 10% OTC. Yu Ping Feng is likely to reach HK\$1bn sales if re-evaluation is successful.

Management noted XLGB did similar work before (started re-evaluation work in 2007) which boosted sales substantially. Management noted although XLGB is a traditional Chinese medicine, more than half of its sales are prescribed by western doctors.

3) Sheng Tong Ping exclusive pricing

ShengTongPing (nifedipine) is CTCM's chemical hypertension drug. The drug (10g) has entered Guangdong EDL and is categorized as the province's low-cost drug, which allows CTCM to sell the drug at the tender price (15% off the government's ceiling price).

However, outside Guangdong, the drug is not listed as a low-cost EDL drug, so competition is fierce (i.e. CTCM must compete in price with other generic manufacturers instead of selling it at 15% off government's ceiling price).

Within the nation (Guangdong + other provinces), volume growth in 1H13 was +20% YOY, and ASP was -18% YOY, implying sales growth for the period was +2% YOY.

To address this pricing competition, CTCM is currently working on a bioequivalence test for Sheng Tong Ping (30g), vs. Bayer's Adalat (Bayer is the drug's originator). The test result should come out before 2014 and will be submitted to CFDA. If the quality of CTCM's drug is proven to be comparable with Bayer's Adalat, CTCM can apply for an independent pricing, which will fare them better than other generic manufacturers. However, management mentioned the chance for getting independent pricing is 50/50 because Sheng Tong Ping's mechanism is different from Bayer's. Despite low ASP, management is still selling Sheng Tong Ping outside Guangdong to maintain the sales channels. There could be upside if the drug is approved for independent pricing.

If the independent pricing is approved in 2H14, Sheng Tong Ping could reach HK\$200mn in 2014. Management expects HK\$500mn sales contributed by Sheng Tong Ping by 2017.

4) Myocardial infarction

The company is working on a TCM drug for MI; however, it is a long-term project. Management indicated the drug will enter R&D Phase I soon.

Management is bullish:

We have yet to factor cross-selling and/or synergies in our model. Hence, our figures may be below consensus and/or management's guidance. We prefer to see more evidence before giving the acquisition too much credit. The company mentioned CTCM could reach sales of HK\$3.8bn in 2014. Although the company did not provide bottom line guidance, management does not expect its net margin to vary much from the industry net margin of 10% (implying ~HK\$400mn). In 2015, the company targets HK\$5bn sales and HK\$10bn sales in 2017, again using industry net margin average of 10%, which could mean HK\$500mn and \$1bn in net income for the two years, respectively.

Investment concerns/risks

Low cash level may lead to share dilution/higher interest expenses when conducting additional M&A activities

We note the company has a high gearing ratio (~45-50%) in 2012 to 2015E. That means if the company were to acquire another Tongjitang-sized company, there would be share dilution and/or increase in borrowings. We note our 2014E interest cost forecast of HK\$87mn is about 24% of our 2014E net income of HK\$362mn.

Winteam's products may be harder to penetrate into hospitals compared with Tongjitang's products entering drugstores/OTC

We note Winteam's products are mostly OTC products (i.e. lower ticket priced items); hence, it could be harder to incentivize doctors/hospitals to sell. Moreover, Tongjitang's hospital networks are largely focused in the specialty osteoporosis area, so Winteam's OTC products may take time to penetrate into other departments.

It may take another 1-2 years to see results

We believe it could take CTCM 1 to 2 years to optimize its platform that includes: 1) gathering enough cash to acquire more companies and 2) successful cross-selling (Winteam's OTC products into Tongjitang's hospital network and Tongjitang's products into Winteam's OTC channels).

Near-term prospects largely priced in

Current stock prices imply a 2014E P/E of 22.0x higher than the industry average of 17.8x by +22%. Given near term concerns including: 1) uncertainties about Winteam's OTC sales growth, 2) higher Bi Yan Kang advertising spending, 3) increased finance costs, and 4) near-term spending on sales staff/integration costs and our belief of little synergies from Winteam+Tongjitang in the near term, we believe the near-term prospects have been largely priced in.

Perception of being a state-owned company

After being owned by NPCG, CTCM is now an SOE. Some investors may have an impression on SOE that execution may be slower and less responsive. However, we note NPCG has not intervened with the operations yet, so we may still consider the company's operations to be run like a privately owned company for now.

SG&A to remain high

We expect SG&A as a % of sales to remain high for a few reasons: 1) more products to be rolled out, 2) nationwide coverage to happen (sooner or later to be a nationwide platform), and 3) continued integration with new acquisitions in terms of drugs or companies.

Valuation

Our target price of HK\$3.40 is derived from the average of our DCF method (HK\$4.00) and PEG method (HK\$2.80). We believe while our DCF method can capture the longer term benefits, our PEG method better reflects the current market sentiment.

DCF: Our DCF assumptions include a COE of 8.8%, a WACC of 9.8% and terminal growth rate of 3%.

Figure 2: DCF

DCF											
COE		WACC	8.8%	8.8%	8.8%	9.8%	9.8%	9.8%	10.8%	10.8%	10.8%
Risk Free rate	3.31%	Perpetuity	2%	3%	4%	2%	3%	4%	2%	3%	4%
Beta	1	2013E-2025E	\$7,455,528	\$7,455,528	\$7,455,528	\$7,203,207	\$7,203,207	\$7,203,207	\$6,965,966	\$6,965,966	\$6,965,966
Equity Risk premium	3.50%	2026E-2030E	\$1,664,235	\$1,664,235	\$1,664,235	\$1,511,058	\$1,511,058	\$1,511,058	\$1,373,452	\$1,373,452	\$1,373,452
Adjusted industry risk premium	2%	Terminal	\$1,758,614	\$2,081,777	\$2,539,454	\$1,229,615	\$1,424,137	\$1,685,677	\$875,841	\$997,745	\$1,155,476
COE	8.8%	NAV	\$10,878,378	\$11,201,541	\$11,659,217	\$9,943,880	\$10,138,401	\$10,399,942	\$9,215,260	\$9,337,163	\$9,494,894
		Share count	2,533,000	2,533,000	2,533,000	2,533,000	2,533,000	2,533,000	2,533,000	2,533,000	2,533,000
		NAV/share	\$4.29	\$4.42	\$4.60	\$3.93	\$4.00	\$4.11	\$3.64	\$3.69	\$3.75
WACC											
WACC = Re x E/V + Rd x (1-corporate tax rate) x D/V											
Re	8.81%										
E	3,573,609										
D	1,619,768										
V	5,193,377										
Rd	15%										
Tc	20%										
WACC	9.8%										

Source: Company, BOCOM Int'l

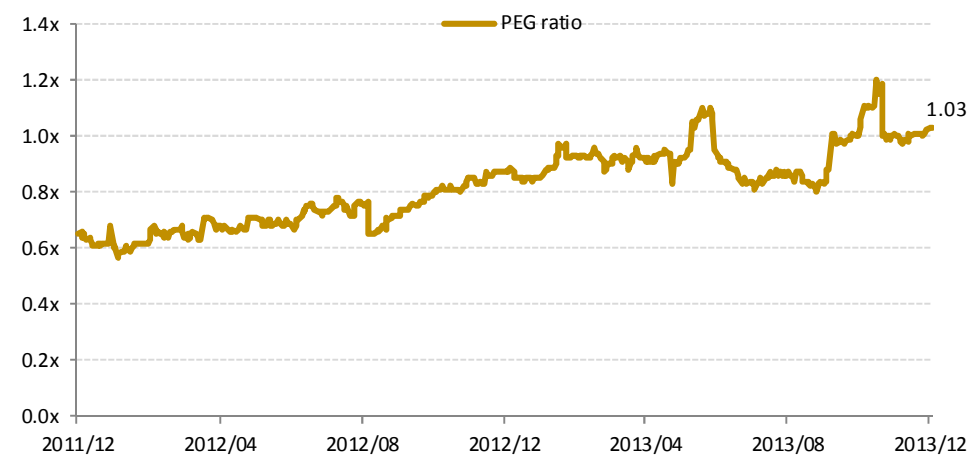
Figure 3: Sensitivity analysis

WACC	Terminal rate		
	2.0%	3.0%	4.0%
8.8%	\$4.29	\$4.42	\$4.60
9.8%	\$3.93	\$4.00	\$4.11
10.8%	\$3.64	\$3.69	\$3.75

Source: BOCOM Int'l

PEG method: Using our 14E and 16E EPS of HK\$0.143 and HK\$0.201, respectively, we estimate the 14-16E EPS CAGR to be 19%. On top of the 19% EPS CAGR, we assign the industry average PEG ratio of 1.03x. This implies the company should trade at 19.6x 2014E EPS of HK\$0.143 as we derive our PEG based stock price of HK\$2.80.

Figure 4: Off-shore listed companies' PEG ratio



Source: BOCOM Int'l

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