JEFFERIES FRANCHISE NOTE
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Initiating Coverage

China (PRC) | Healthcare | Pharmaceuticals

26 November 2018

Jefferies

EQUITY RESEARCH CHINA

Pharmaceuticals
Traditional Chinese Medicine - A Chinese National Treasure

Key Takeaway

Development of the TCM industry has been on the agenda of the 13th Five-Year Plan. TCM is a vital part of the China healthcare system and it accounted for 40% of the total pharmaceutical market in 2017. With chemical drugs and biologics facing policy headwinds and uncertainties, we believe TCM, especially decoction pieces and CTCMG, are less susceptible to suppressive policies and can continue with their robust growth in the next three years.

CTCMG - one of the fastest growing sectors of China's healthcare industry. As a modernized form of decoction pieces, concentrated TCM granules (CTCMG) has the advantage of convenience and controllable quality. Although the market has been controlled by the government by issuing only 6 nationwide pilot licenses, it has still been growing rapidly in China: 28.1% CAGR in 12-17. Due to its low penetration and advantages over traditional decoction pieces, we believe the CTCMG industry can still deliver annual growth rate of over 20% in the next three years.

Decoction pieces - consolidation opportunity in a highly fragmented market. There are over 1,000 manufacturers for this Rmb200bn market and the market leader only has 3% market share in 2017. This highly fragmented market leads to the problem of low quality standards and difficulties in regulation. The government has moved forward in improving the overall standard requirements and to eliminate redundant capacity. We believe this would be a rapid expansion opportunity for players with proven quality standards. Nevertheless, we expect annual growth in mid-teens for the industry.

TCM finished drugs - expansion potential for manufacturers with proven quality. TCM finished drugs has been the worst performing industry of the three due to various restrictive policies in recent years. However, we believe the worst is over and the government would like to rationalize the usage of TCM finished drugs and improve the overall quality standards. We believe leading players with proven quality standards can still enjoy faster than industry growth.

Initiate coverage on CTCM (570 HK) with BUY and TP HK$7.0. Our top pick for the sector. As the dominant market leader in CTCMG industry, the Company can surf on the robust growth potential. Besides, the Company has also expanded into decoction pieces industry for synergies and rapid expansion potential. The cooperation with PingAn would add extra momentum on business expansion. We expect core net profit CAGR of 26.4% in 17-20E. Our TP implies 19E/20E PER of 17.4x/13.5x.

Initiate coverage on Shineway (2877 HK) with BUY and TP HK$13.3. One of the newcomers for CTCMG industry and we think can enjoy explosive growth from opening new markets. Core TCM finished drugs have reached the trough and shown promising rebound potential. We forecast core net profit CAGR of 21.0% in 17-20E. Our TP implies 19E/20E PEr of 14.2x/12.1x.

Initiate coverage on Consun (1681 HK) with BUY and TP of HK$6.8. Exclusive product in EDL and NRDL for the treatment of chronic kidney disease possesses stable growth potential. Successful in revitalizing Yulin OTC branded products which have become an integral part of the Company. We expect core net profit CAGR of 16.7% in 17-20E. Our TP implies 19E/20E PER of 10.1x/8.8x.

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^Prior trading day's closing price unless otherwise noted.

Company Name	Ticker	Mkt. Cap (MM)	Rating	Price^	Price Target	Cons. Next FY	Current EPS Estimates 2018	2019	2020	Valuation (P/E) 2019	2020
Shineway	2877 HK	HK$8.3B	BUY	HK$10.00	HK$13.30	RMB0.85	RMB0.67	RMB0.83	RMB0.97	12.0x	10.3x
CTCM	570 HK	HK$26.9B	BUY	HK$5.35	HK$7.00	RMB0.37	RMB0.29	RMB0.36	RMB0.46	14.9x	11.6x
Consun	1681 HK	HK$4.8B	BUY	HK$5.50	HK$6.80	RMB0.63	RMB0.52	RMB0.60	RMB0.69	9.2x	8.0x

Please see analyst certifications, important disclosure information, and information regarding the status of non-US analysts on pages 95 to 100 of this report.

Executive Summary

TCM - a Chinese national treasure

An integral part of China healthcare system

Decoction pieces and CTCMG are among the fastest growing sectors in healthcare industry

As stated by President Xi, Traditional Chinese Medicine (TCM) is a Chinese national treasure and the government is in full support in developing the industry. In fact, TCM has been an integral part of the China healthcare system and accounted for around 40% of the total pharmaceutical sales in China. The sector delivered revenue CAGR of 9.3% in 12-17, generally in line with the overall sector growth. Decoction pieces and concentrated TCM granules (CTCMG), are two of the fastest growing subsectors within the healthcare space, delivered CAGR of 17.8% and 28.1%, respectively, in 12-17.

CTCMG – rapid expansion potential

We expect annual growth of over 20% for CTCMG industry in the next three years

CTCMG can be viewed as a modernized form of TCM decoction pieces. It has advantages of convenience and controllable quality standards over decoction pieces. One of the major difficulties in promoting TCM is the inconvenience and uncontrollable quality issue with traditional decoction pieces. Many believe that CTCMG would be an essential part in promoting TCM. The market is currently dominated by five players with only six nationwide licenses issued by the government. CTCMG market is still small and only accounted for less than 2% of the total TCM market. The growth momentum is still expected to continue with annual growth rate of over 20% in the next three years.

Decoction pieces – fragmented and fast growing market

Market consolidation opportunity in a highly-fragmented market

Decoction pieces is a Rmb200bn market but it is highly fragmented. With over 1,000 manufacturers, the market leader has a market share of only 3%. This highly fragmented industry has led to problems of low quality standards and difficulties to regulate. In view of this, the government is moving towards increasing the quality standard for the industry and removal of redundant capacity. This gives significant expansion opportunity for manufacturers with proven quality standard. The sector is expected to grow in mid-teens region in the next three years.

TCM finished drugs – industry consolidation opportunity for leaders

Adversely affected by policies, quality players can still enjoy faster growth

TCM finished drugs, the largest part of TCM industry, accounted for over 70% of the TCM industry but its growth has been restricted by various government policies like usage control in the last two years. However, we believe the government intention was mainly on a more rational usage of finished drugs, improving quality standard and eliminating redundant players. Although overall industry growth would be affected by the policies, we believe market leaders with proven quality standards can still benefit from the industry consolidation opportunity.

Relatively inert to industry headwinds

Unlikely target for restrictive policies

We believe the TCM sector, especially decoction pieces and CTCMG, are relatively inert to adverse government policies like ASP cut and cost control: (1) TCM industry is a government supported development direction, (2) CTCMG is a relatively small portion, controlling cost would have minimal impact to the overall healthcare system, (3) margins of decoction pieces are relatively thin. So when comparing to other chemical drugs and biologics, we believe TCM industry is relatively inert to policy headwinds.

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CTCM (570 HK)– our top pick for the industry

As a dominant market leader in CTMCG industry, it would enjoy robust growth, we believe. The expansion into decoction business for synergies with existing business would add additional growth momentum. We forecast revenue CAGR of 25.7% and core net profit CAGR of 26.4% in 17-20E. Currently trading at 19E/20E PER of 13.3x/10.4x. Given its leading position and growth opportunity, this valuation will provide a good risk-return. Initiate BUY with TP HK$7.0 based on DCF model (WACC: 13.2%, terminal growth of 3.0%). Our TP implies 19E/20E PER of 17.4x/13.5x.

Table 1: Earnings summary - CTCM

Rmb	2016A	2017A	2018E	2019E	2020E
Revenue (mn)	6,533	8,338	11,092	13,503	16,554
Change (% YoY)	76.1%	27.6%	33.0%	21.7%	22.6%
Core net profit (mn)	974	1,147	1,405	1,801	2,318
Change (% YoY)	81.7%	17.8%	22.5%	28.2%	28.7%
Core EPS	0.22	0.26	0.29	0.36	0.46
Change (% YoY)	50.5%	17.8%	11.6%	24.3%	28.7%
ROE (%)	8.3%	9.4%	9.0%	10.7%	12.5%
PER (x)	21.0	17.8	16.6	13.3	10.4
PBR (x)	2.0	1.9	1.5	1.4	1.3

Source: Jefferies estimates, company data

Shineway (2877 HK) – explosive growth opportunity from new business

The Company is a newcomer for the CTCMG industry and can enjoy explosive growth potential from opening new markets, in our view. Core TCM finished drugs business should have reached the trough and to return to growth again with completed distribution channel restructuring and new products being included in the NRDL and EDL. We forecast revenue CAGR of 23.6% and core net profit CAGR of 21.0% in 17-20E. The Company is currently trading at 19E/20E PER of 10.7x/9.2x. We believe the market has been overly pessimistic towards the core TCM finished drugs business. Initiate at BUY with TP HK$13.3 based on DCF model (WACC: 14.1%, terminal growth of 2.0%). Our TP implies 19E/20E PER of 14.2x/12.1x.

Table 2: Earnings summary - Shineway

Rmb	2016A	2017A	2018E	2019E	2020E
Revenue (mn)	1,993	1,920	2,610	3,139	3,622
Change (% YoY)	-3.0%	-3.7%	36.0%	20.2%	15.4%
Core net profit (mn)	582	453	557	685	802
Change (% YoY)	-11.0%	-22.1%	22.8%	23.1%	17.1%
Core EPS	0.70	0.55	0.67	0.83	0.97
Change (% YoY)	-11.0%	-22.1%	22.8%	23.1%	17.1%
ROE (%)	10.5%	7.8%	9.1%	10.5%	11.4%
PER (x)	12.7	16.3	13.2	10.7	9.2
PBR (x)	1.3	1.3	1.2	1.1	1.0

Source: Jefferies estimates, company data

Consun (1681 HK) – deeply undervalued

The Company has defensive exclusive TCM product for treatment of chronic kidney disease. OTC business arm Yulin should deliver stable low teens growth in the next three years. We forecast revenue CAGR of 13.2% and core net profit CAGR of 16.7% in 17-20E. The Company is one of the lowest valued healthcare companies in Hong Kong and is trading at 19E/20E PER of 8.2x/7.1x. We see upside potential given the defensive nature of its product portfolio and stable growth outlook. Initiate with BUY and TP of HK$6.8 based on DCF model (WACC: 13.2%, terminal growth: 2.0%). Our TP implies 19E/20E PER of 10.1x/8.8x.

Table 3: Earnings summary - Consun

Rmb	2016A	2017A	2018E	2019E	2020E
Revenue (mn)	1,224	1,661	1,864	2,120	2,407
Change (% YoY)	47.2%	35.7%	12.2%	13.8%	13.5%
Core net profit (mn)	309	379	451	524	602
Change (% YoY)	23.1%	22.6%	19.1%	16.2%	14.9%
Core EPS	0.32	0.44	0.52	0.60	0.69
Change (% YoY)	25.9%	36.6%	17.3%	16.1%	14.9%
ROE (%)	17.5%	22.7%	21.2%	21.7%	21.4%
PER (x)	15.4	11.3	9.5	8.2	7.1
PBR (x)	2.5	2.5	2.0	1.8	1.5

Source: Jefferies estimates, company data

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Table 4: Market data

	CTCM (570 HK)	Shineway (2877 HK)	Consun (1681 HK)
52 Week Range	HK$7.57-HK$3.84	HK$18.25-HK$6.57	HK$9.75-HK$4.99
Total Entprs. Value	HK$28.9B	HK$4.7B	HK$4.1B
Market Cap.	HK$26.8B	HK$8.3B	HK$4.9B
Share Out. (MM)	5035.8	827	875.2
Float (MM)	2797.8	277.5	364.1
Avg. Daily Vol.	14,859,760	1,348,217	2,399,594

Source: Jefferies

Table 5: Peers valuation table

			Price	Mkt cap		PER(x)		PEG		PBR(x)			ROE(%)	
Company	**Ticker**	**Ratings**	**HK$**	**HK$mn**	**FY17A**	**FY18E**	**FY19E**	**FY18E**	**FY17A**	**FY18E**	**FY19E**	**FY17A**	**FY18E**	**FY19E**
CTCM	**570**	**BUY**	**5.35**	**26,942**	**18.5**	**16.6**	**13.3**	**0.78**	**1.9**	**1.5**	**1.4**	**9.4**	**9.0**	**10.7**
Shineway	**2877**	**BUY**	**10.00**	**8,270**	**16.2**	**13.2**	**10.7**	**0.63**	**1.3**	**1.2**	**1.1**	**7.8**	**9.1**	**10.5**
Consun	**1681**	**BUY**	**5.50**	**4,814**	**11.1**	**9.5**	**8.2**	**0.57**	**2.5**	**2.0**	**1.8**	**22.7**	**21.2**	**21.7**
CSPC	1093	BUY	15.90	99,190	34.4	27.6	20.4	0.88	6.5	5.5	4.6	18.1	20.0	22.3
Sino Biopharm	1177	NR	7.07	89,349	33.2	26.8	22.6	1.42	6.7	5.2	4.3	23.9	26.0	24.5
Fosun Pharm	2196	NR	26.85	76,995	18.0	20.4	17.0	2.38	2.3	2.1	2.0	13.6	10.6	11.5
Baiyunshan	874	NR	30.85	63,590	24.6	13.1	15.0	0.71	2.4	2.0	1.8	10.3	16.2	14.0
3SBio	1530	NR	12.14	30,881	31.1	24.3	19.0	1.10	3.8	3.3	2.8	12.5	14.6	16.1
Livzon	1513	NR	28.00	24,402	19.3	16.2	14.1	-0.51	1.8	1.6	1.5	29.1	9.8	10.4
SSY	2005	NR	7.97	24,022	36.1	25.5	20.5	0.95	7.1	5.7	4.7	21.7	23.5	24.7
Luye	2186	NR	6.36	20,829	19.7	14.2	12.1	0.71	2.5	2.1	1.8	13.6	16.5	16.5
Tong Ren Tang	1666	NR	10.76	13,781	18.4	16.8	15.7	2.26	2.4	1.9	1.7	13.1	11.9	11.3
HEC Pharm	1558	NR	27.00	12,205	17.8	12.5	11.3	0.59	3.6	3.0	2.6	21.9	26.6	24.5
				Average	**25.2**	**19.7**	**16.8**	**1.0**	**3.9**	**3.2**	**2.8**	**17.8**	**17.6**	**17.6**

Source: Bloomberg, Jefferies estimates

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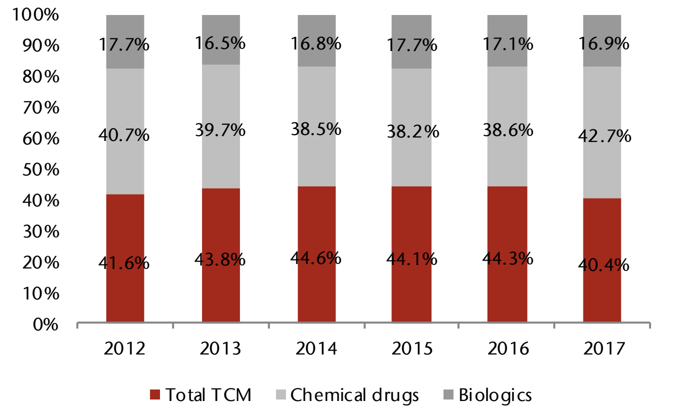
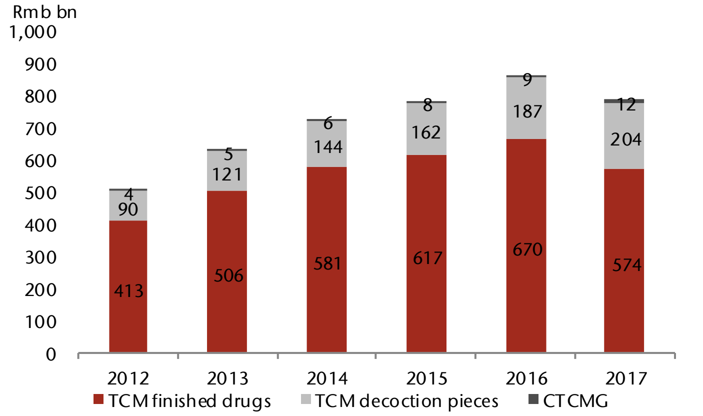
At a glance ...

Chart 1: TCM accounted for around 40% in pharmaceutical market in China



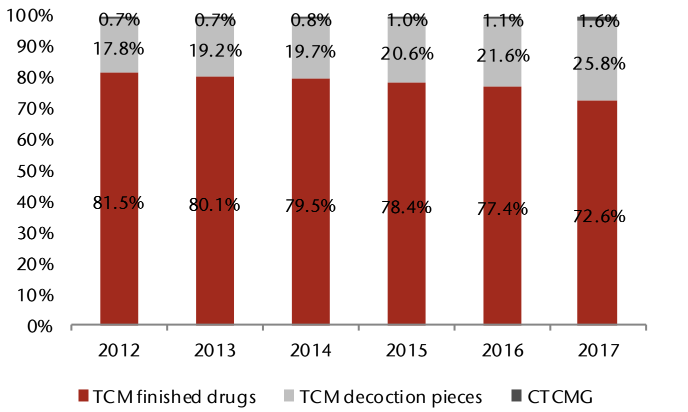
Source: National Bureau of Statistics, PICO, Jefferies

Chart 2: TCM finished drugs dragged down growth of the whole total TCM industry in 2017



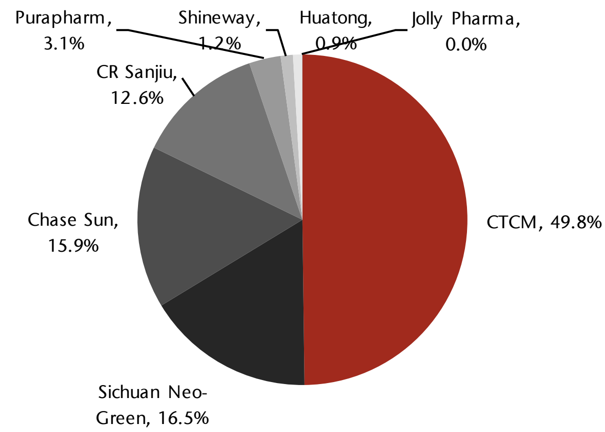
Source: National Bureau of Statistics, PICO, Jefferies

Chart 3: Contribution from TCM finished drugs dropped down to 72.6% in 2017



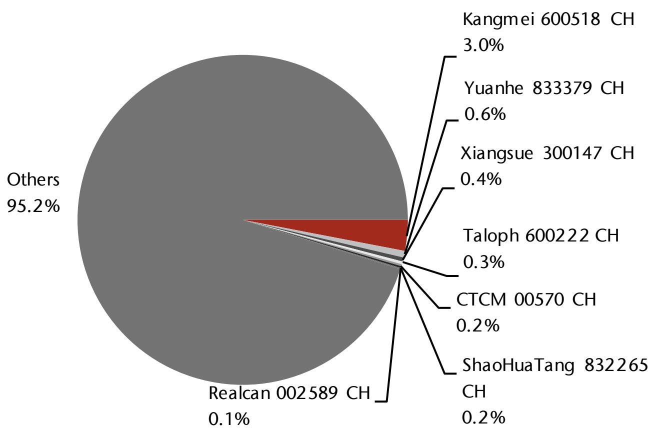
Source: National Bureau of Statistics, PICO, Jefferies

Chart 4: CTCMG market share (2017)



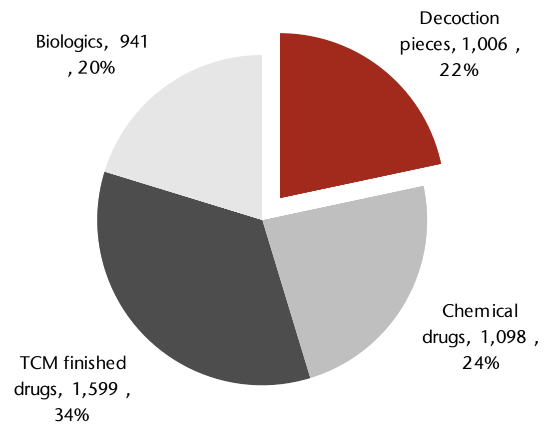
Source: Jefferies estimates, company data

Chart 5: The market leader only has 3% of decoction market in 2017



Source: National Bureau of Statistics, company data

Chart 6: Over 1,000 decoction pieces manufacturers in China, accounted for 22% of total (2016)



Source: National Bureau of Statistics

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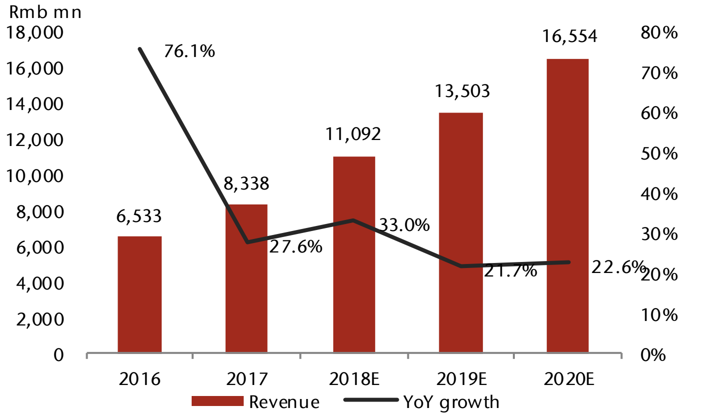
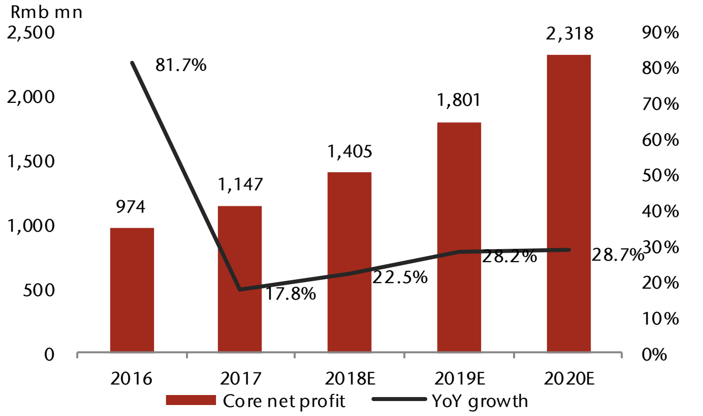
CTCM at a glance ...

Chart 7: CTCM: we forecast revenue CAGR of 25.7% ...



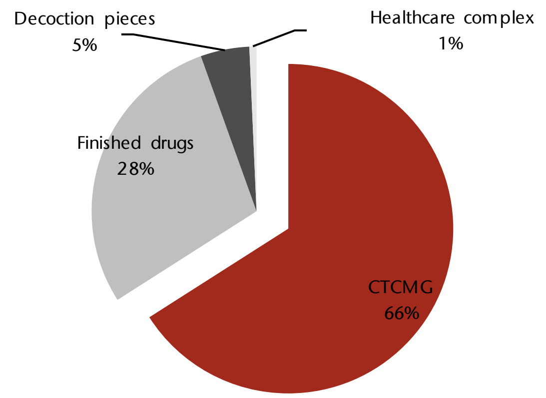
Source: Jefferies estimates, company data

Chart 8: ... and core net profit CAGR of 26.4% in 17-20E



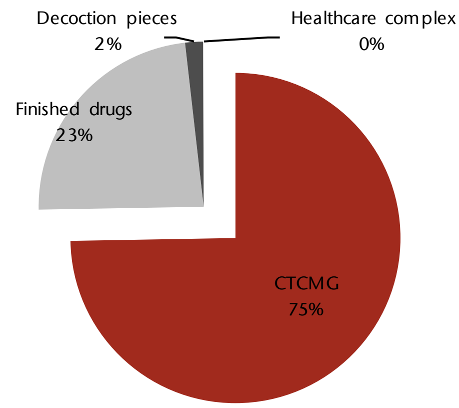
Source: Jefferies estimates, company data

Chart 9: CTCMG accounted for 66% of revenue ...



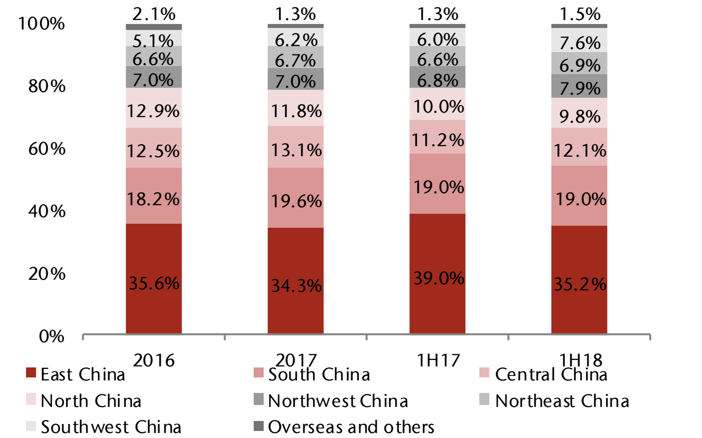
Source: Jefferies, company data

Chart 10: ... and 75% of operating profit in 2017



Source: Jefferies, company data

Chart 11: East and South China are the key regions



Source: Jefferies, company data

Chart 12: Shareholding structure of CTCM

Source: HKEx, Jefferies

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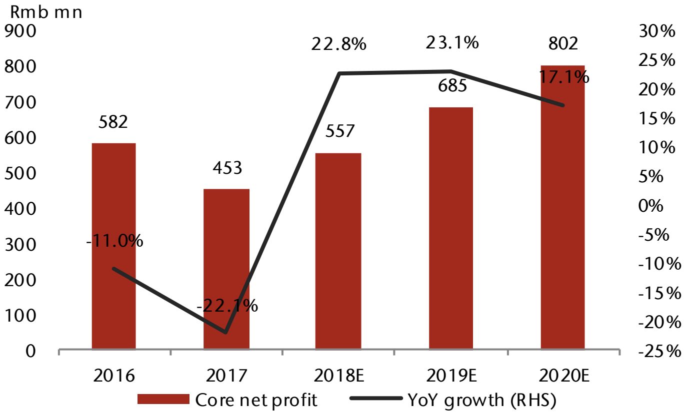
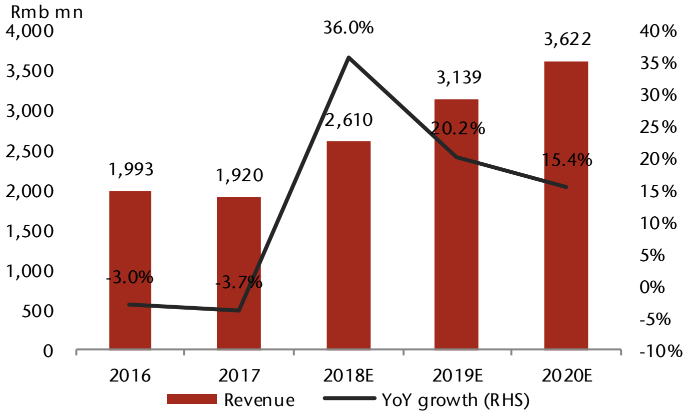
Shineway at a glance ...

Chart 13: Shineway: core net profit to deliver CAGR of 21.0% in 17-20E...



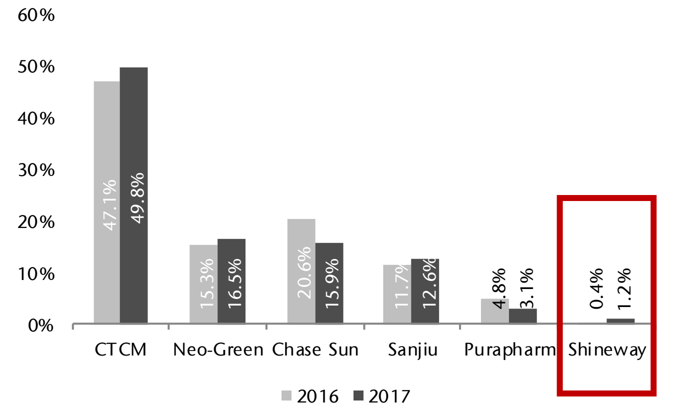
Source: Jefferies estimates, company data

Chart 14: ... to be supported by 23.6% revenue CAGR within the same period



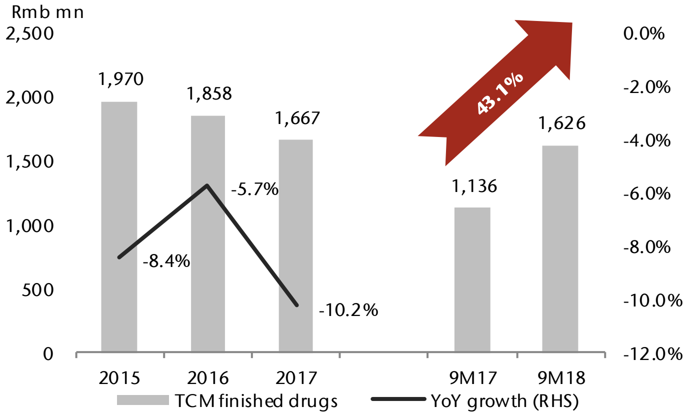
Source: Jefferies estimates, company data

Chart 15: Shineway has become the largest player after the six licensees, and is catching up fast



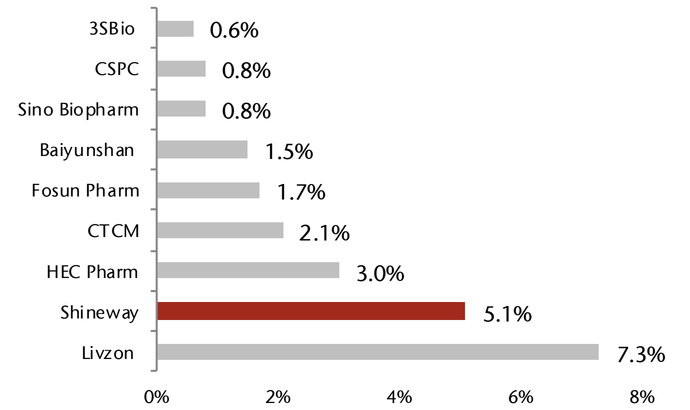
Source: Jefferies estimates, company data

Chart 16: TCM finished drugs shown strong rebound trend since 2018



Source: Jefferies, company data

Chart 17: Shineway is one of the highest yield healthcare stocks in HK



Source: Jefferies, company data

Chart 18: Shareholding structure

Source: HKEx, Jefferies

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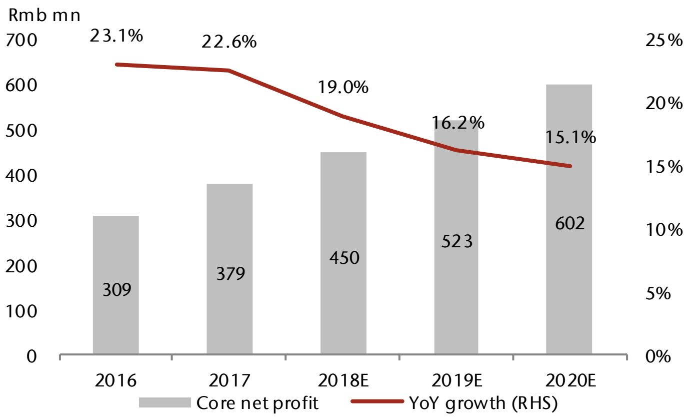
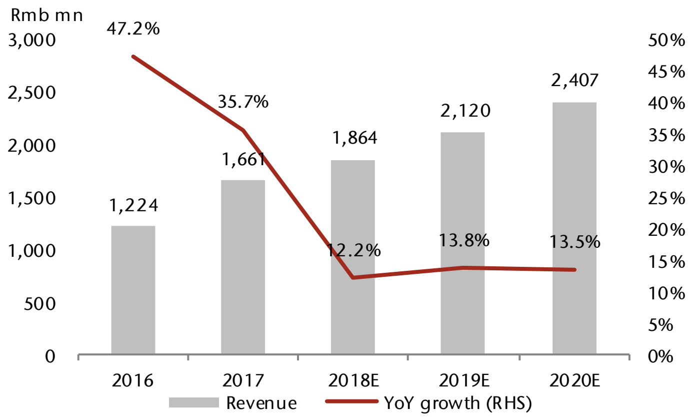
Consun at a glance ...

Chart 19: Consun: We expect core net profit CAGR of 16.7%...



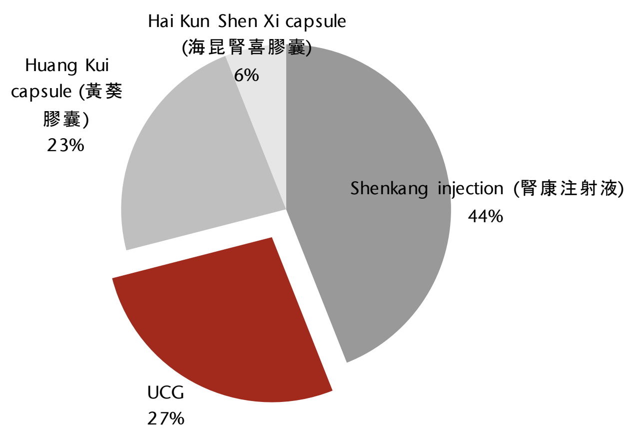
Source: Jefferies estimates, company data

Chart 20: ... and revenue CAGR of 13.2% in 17-20E



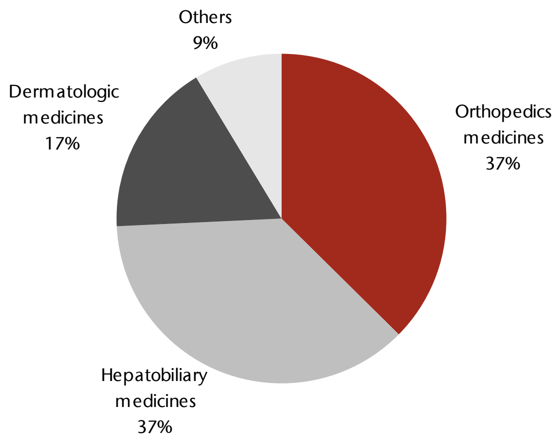
Source: Jefferies estimates, company data

Chart 21: UCG was the largest oral TCM for CKD in 2017



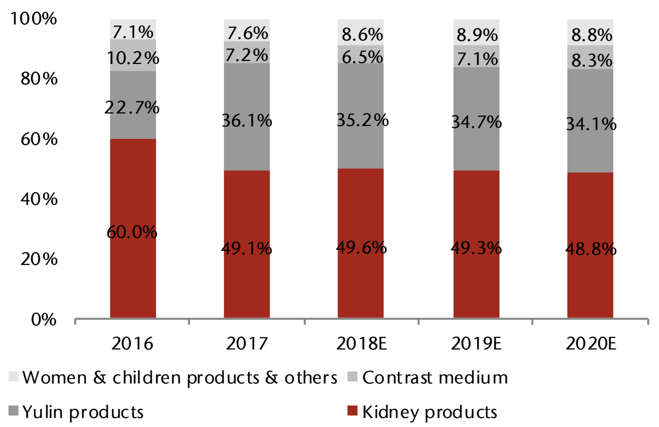
Source: Chinese Pharmaceutical Association, Jefferies, company data

Chart 22: Yulin revenue breakdown in 2017



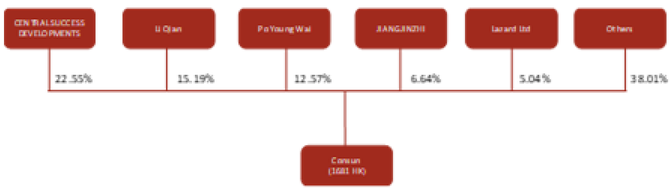
Source: Jefferies, company data

Chart 23: Revenue contribution breakdown by segments



Source: Jefferies estimates, company data

Chart 24: Shareholding structure



Source: HKEx, Jefferies

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TCM – a Chinese national treasure

As a practice with over 5,000 years of history in China, Traditional Chinese Medicine is a style of traditional medicine that includes various forms of herbal medicine, acupuncture, massage (tui na), exercise (qigong), and dietary therapy. TCM is an essential part of the healthcare system in China and has been playing a vital part in health management, disease control and prevention. TCM is becoming increasingly popular and recognized worldwide as a kind of alternative medicine.

The TCM is based on the beliefs that the human body is a miniature version of the larger, surrounding universe and the harmony between two opposing yet complementary forces, yin and yang. Diseases result from an imbalance between these two forces. Five elements, fire, earth, wood, metal and water, represent all phenomena, including the stages of human life, and explain the functioning of the body. Qi, a vital energy that flows through the body, performs multiple functions in maintaining health.

TCM medication is based on synergistic property of multiple herbs and constituents. Based on syndromes and patient characteristics, and guided by the TCM theory, TCM practitioners prescribe formulae which contains a combination of various kinds of medicinal that, when combined, will bring about the maximum of therapeutic efficacy.

Three main types of TCM medicinal: (1) TCM decoction pieces, (2) concentrated TCM granules, (3) TCM finished drugs

There are roughly 13,000 medicinal used in China and over 100,000 formulae recorded in the ancient literature. Plant elements and extracts are by far the most common elements used. In the classic Handbook of Traditional Drugs from 1941, 517 drugs were listed – out of these, 45 were animal parts and 30 were minerals. For many plants used as medicinal, detailed instructions have been handed down not only regarding the locations and areas where they grow best, but also regarding the best timing of planting and harvesting them. There are currently three main types of TCM medicinal in China: (1) TCM decoction pieces, (2) Concentrated TCM granules, and (3) TCM finished drugs.

Tailor made formulae for each patient

TCM decoction pieces: TCM decoction pieces are manufactured from TCM raw material after processes including purification, soaking, steaming, cutting and grinding. Typically, each formula contains 9 – 18 types of decoction pieces. Some of these are considered as main herbs, some as ancillary herbs. Some ingredients are added to cancel out toxicity or side-effects of the main ingredients; on top of that, some medicinal require the use of other substances as catalysts.

TCM medical practitioners prescribes tailored formulae to each patient according to different needs. Patients need to decoct the TCM pieces which include immersing in water, first boiling and second boiling. The whole decoction process may take one to two hours.

Modern form of decoction pieces that remove inconvenience in medication preparation

Concentrated TCM granules: Concentrated traditional Chinese medicine granules (CTCMG) is a relatively new form of replacement over TCM decoction pieces. It has been widely used in other Asian countries like Japan and Korea. CTCMG is extracted and concentrated from single TCM raw material. It has standardized specification, quality and dosage, and can retain the characteristics and active ingredients of the original herbal medicine, therefore fulfilling prescription needs of TCM medical practitioners. Moreover, it is more convenient for patients in taking medication, just by dissolving the granules in water instead of the long boiling process of traditional decoction pieces.

Standardized formulas for different diseases and purposes

TCM finished drugs: TCM finished drugs is a kind of traditional Chinese medicine with standardized herbal formulas. All TCM finished drugs of the same name will have the same proportions of ingredients, and manufactured in accordance with the PRC Pharmacopoeia. Finished drugs are extracted in stainless steel extractors to create either a water decoction or water-alcohol decoction, depending on the herbs used. They are extracted below 100 degrees Celsius to preserve essential ingredients. Common dosage form of modern TCM finished drugs include injections, oral forms of capsules, soft capsules and tablets.

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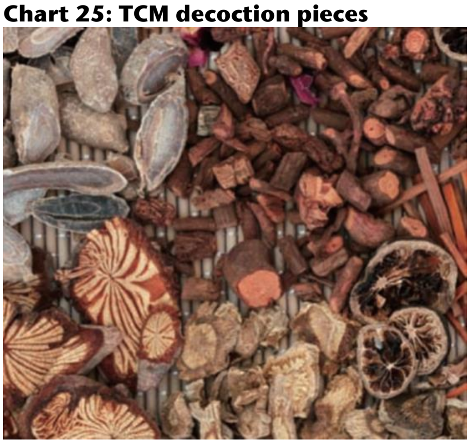
Chart 25: TCM decoction pieces



Source: Company Data

Chart 26: CTCMG

Source: Company Data

Chart 27: TCM finished drugs

Source: Company Data

Supportive policy environment for TCM

In recent years, Chinese policies have been encouraging the development of Traditional Chinese Medicine, which in general providing a more supportive environment over other pharmaceutical subsectors. We believe this supportive environment would attract more capitals into the industry and support a healthy and robust development for the sector.

Development of TCM industry has been one of the major targets in the 13th Five Year Plan

The State Administration of TCM formulated and issued its 13th Five-Year plan for the development of TCM industry in August 2016. The Plan sets forth specific primary development targets for the TCM industry in China, including to significantly develop TCM services, accelerate the development of TCM healthcare services, promote innovation of TCM, strengthen the development of qualified personnel, promote TCM culture, promote the protection and development of TCM, explore new forms of Chinese medicine services and promote the overseas development of TCM.

The 13th Five-Year Development Plan of Pharmaceutical Industry (《医药工业”十三五”发展规划》) released in November 2016 also sets forth specific development targets for the traditional Chinese medicine industry as part of the 13th Five-Year Plan, including enhancing the industrial innovation, improving the quality and safety levels, promoting the application of Chinese herbal medicine ecological production technology, improving internationalization of the industry and focusing on the development of endangered rare medicinal materials breeding technology.

The implementation of PRC TCM law (《中华人民共和国中医药法》) implemented since July 2017 solidified the development direction for TCM in China. It stated clearly to support production of TCM drugs, inclusion of TCM into the NRDL, support TCM innovation and modernization and promoting TCM practices.

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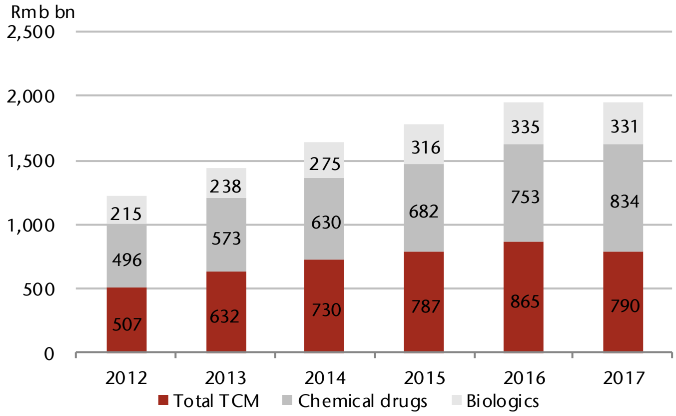
TCM growth dragged down by finished drugs

TCM accounted for 40% of the drug market in China in 2017

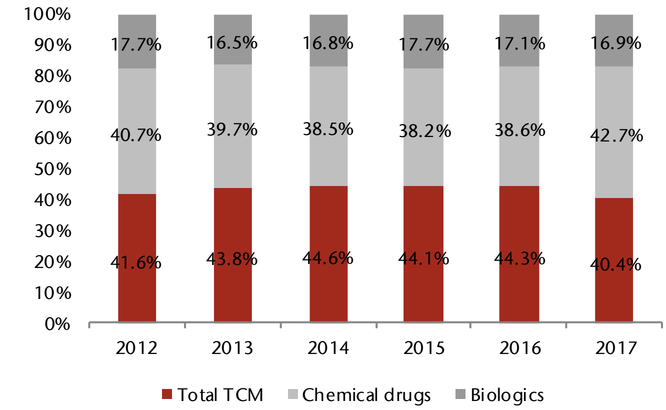
TCM has been an integral part of the China healthcare system and the sales of TCM drugs accounted for 40% of the drug market, reaching Rmb790bn in 2017, according to National Bureau of Statistics. TCM delivered strong CAGR of 14.3% in 2012-16, outperformed the 12.5% of the total drug market. However, the TCM finished drugs subsector has been severely hit by the restrictive policies and as a result, the TCM sector recorded an 8.7% YoY drop in 2017, driven mainly by a 14.4% plunge from TCM finished drugs.

Chart 28: Growth of total TCM revenue slowed down considerably in recent years ...



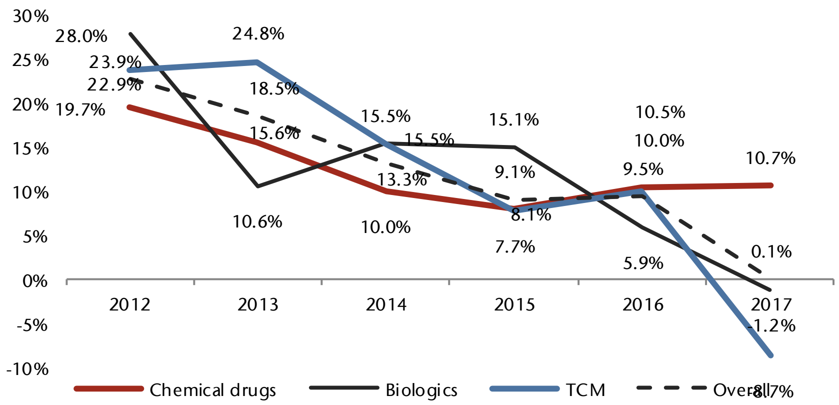
Source: National Bureau of Statistics, PICO, Jefferies

Chart 29: ... and its portion dropped from 44.3% to 40.4% in 2017



Source: National Bureau of Statistics, PICO, Jefferies

Chart 30: Total TCM revenue delivered CAGR of 14.3% in 2012-16 but dropped 8.7% in 2017



Source: National Bureau of Statistics, Jefferies

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Strong growth from decoction pieces and CTCMG

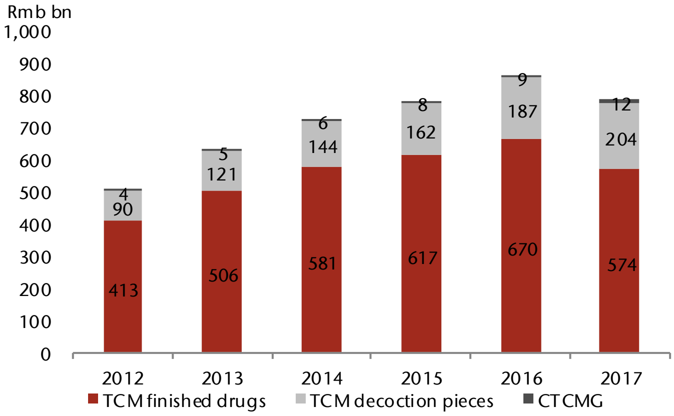
TCM finished drugs accounted for 73% of TCM sales, or 30% of China drug market in 17 but has been hit by restrictive policies.

TCM finished has been the largest part of TCM revenue and accounted for over 80% of total TCM revenue in 2012. However, due to its weaker growth than decoction pieces and CTCMG, its contribution has dropped to 72.6% in 2017. As severely hit by policies like the restriction usage of adjuvant drugs and medical insurance coverage restriction, TCM finished drugs delivered a weak CAGR of 6.8% in 2012-17.

Decoction pieces and CTCMG has delivered robust CAGR of 17.8% and 28.1% in 12-17

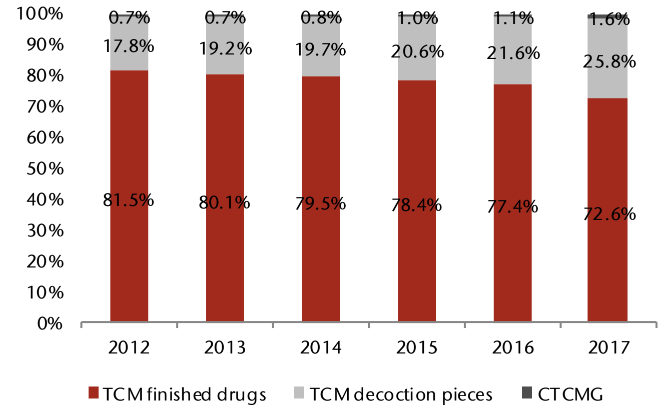
On the other hand, policy direction in general supported the development of decoction pieces and CTCMG with policies like exclusion from hospital drug sales ratio and drug price mark-up, decoction pieces delivered strong CAGR of 17.8% within the same period. For CTCMG, due to its low base and advantages over decoction pieces, it delivered a CAGR of 28.1% within the same period. TCM finished drugs, decoction pieces and CTCMG respectively accounted for 72.6%, 25.8% and 1.6% of total TCM sales in China and 29.3%, 10.4% and 0.6% of total drug sales in China in 2017.

Chart 31: TCM finished drugs dragged down growth of the whole sector ...



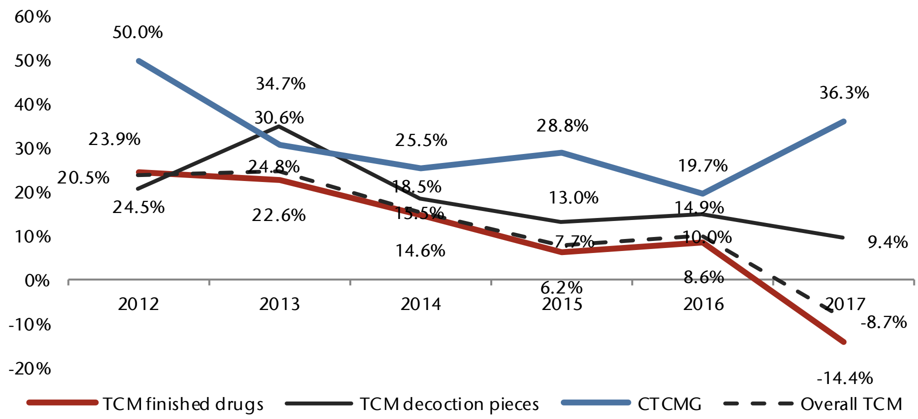
Source: National Bureau of Statistics, PICO, Jefferies

Chart 32: ... contribution from TCM finished drugs dropped down to 72.6% in 2017



Source: National Bureau of Statistics, PICO, Jefferies

Chart 33: Decoction pieces and CTCMG maintained strong growth over the years



Source: National Bureau of Statistics, PICO, Jefferies

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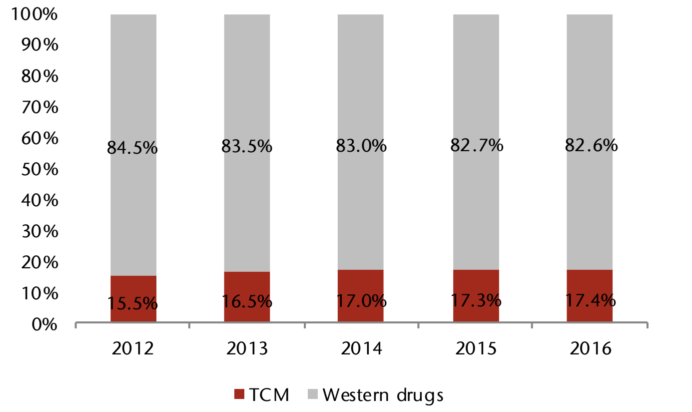
TCM is becoming more popular in hospitals

TCM is increasing penetration into lower tier hospitals

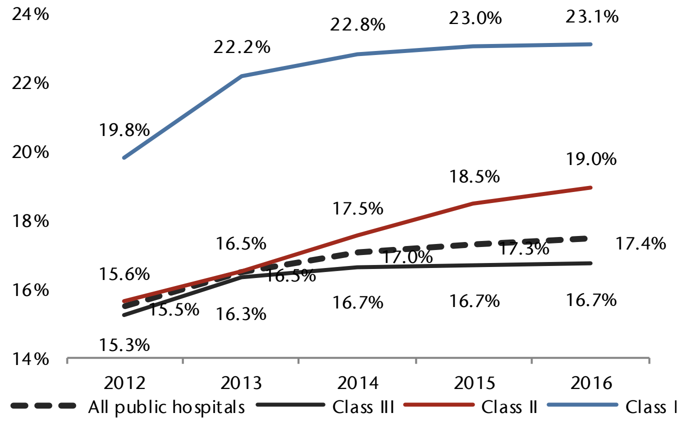
Due to the faster growth, TCM is picking up more share in the hospital drug market. Its portion has increased from 15.5% in 2012 to 17.4% in 2016. For class III hospitals, TCM portion increased from 15.3% in 2012 to 16.7% in 2014 and stayed flat in the next two years. We believe the growth of decoction pieces and CTCMG has been cancelled out by the restriction and controlled usage of TCM finished drugs in class III hospitals. On the other hand, the growth trend in class II and I hospitals was more prominent: contribution of TCM has increased from 15.6% in 2012 to 19.0% in 2016 for class II hospitals and from 19.8% in 2012 to 23.1% in 2016 for class I hospitals. Due to the supportive policies and increasing popularity in TCM, we believe the growing trend of TCM will continue.

Chart 34: TCM is gradually taking up shares in hospital drug sales ...



Source: NHFPC, Jefferies

Chart 35: ... and the trend is more prominent in class II and class I hospitals

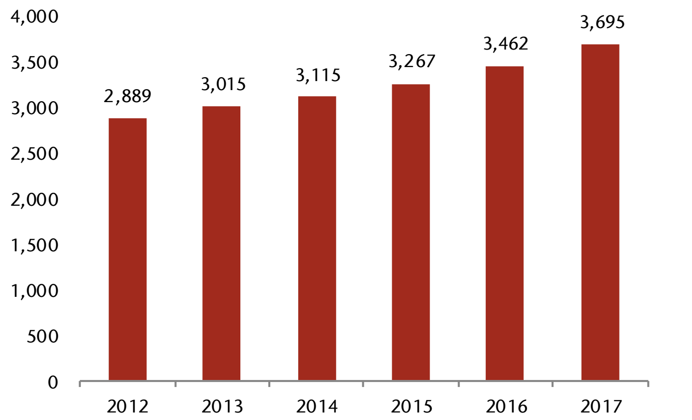


Source: NHFPC, Jefferies

Increasing scale and number of TCM hospitals in China

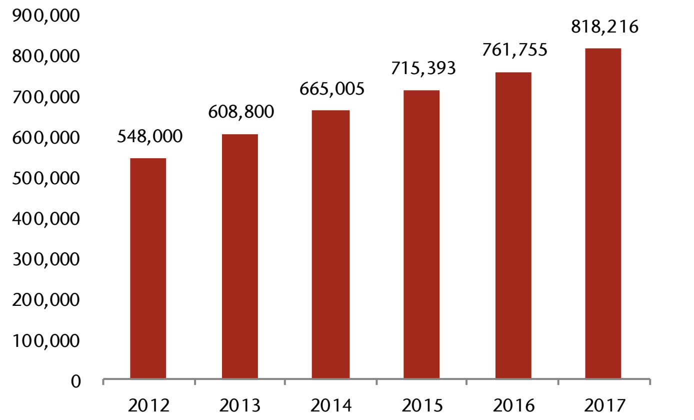
The increasing usage of TCM is indeed supported by a steady growth in TCM hospitals in China. The number of TCM hospitals increased from 2,889 in 2012 to 3,695 in 2017, representing a CAGR of 5.0% within the period. Number of TCM hospital beds attained a faster CAGR of 8.3% within the same period. We believe the faster growth rate of hospital beds implies a growth in scale of TCM hospitals. The average number of beds in TCM hospitals increased from 189.7 in 2012 to 221.4 in 2017. We believe not only the growth in number of hospitals, but also the increasing scale of TCM hospitals helped propelling the growth of usage of TCM.

Chart 36: Number of TCM hospitals increased with CAGR of 5% in 2012-17...



Source: NHFPC, Jefferies

Chart 37: ... and number of TCM beds grew with a faster CAGR of 8.3% within the same period



Source: NHFPC, Jefferies

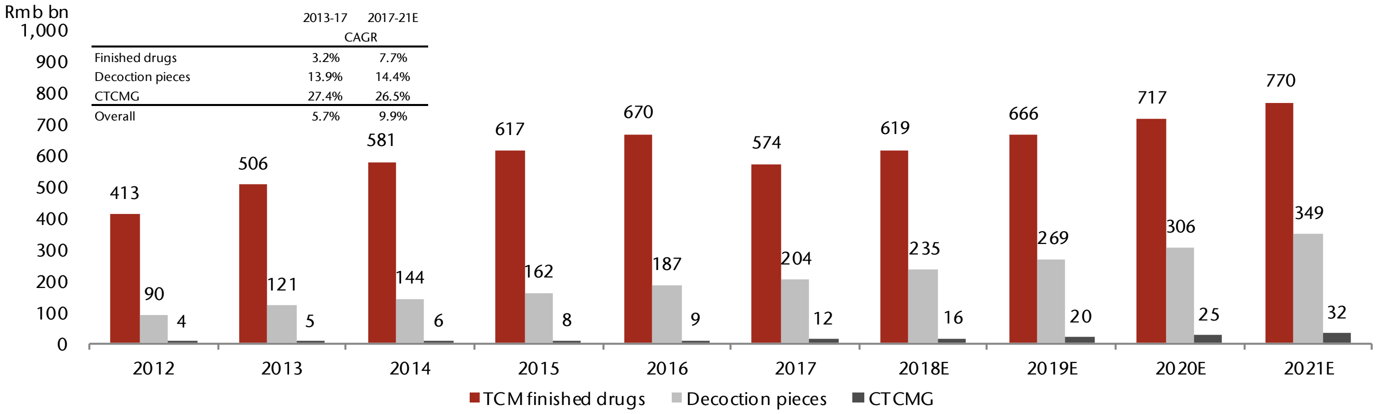
Strong potential for decoction pieces and CTCMG

Being hit by policy headwind, TCM finished drugs sector only delivered a CAGR of 3.2% in 2013-17, and as a result, dragged down the overall CAGR of TCM sector to 5.7% within the same period. On the other hand, decoction pieces delivered a strong CAGR of 13.9% in 13-17, mainly supported by policies and increasing acceptance of TCM. For CTCMG, due to its small base and advantages over traditional decoction pieces, it delivered rapid growth with CAGR of 27.4% within the mentioned period.

Decoction pieces and CTCMG are expected to continue their robust growth

We believe the worst has been over for TCM finished drugs and leading players should benefit from industry consolidation trend. However, we do not expect significant growth potential for the overall TCM finished drugs sector. For decoction pieces and CTCMG, with the continuation of supportive policies and increasing acceptance of TCM, decoction pieces sector and CTCMG sector is expected to deliver CAGR of 14.4% and 26.5%, respectively, in 17-21E.

Chart 38: Decoction pieces and CTCMG to have CAGR of 14.4% and 26.5% in 17-21E



Source: National Bureau of Statistics, PICO, Jefferies

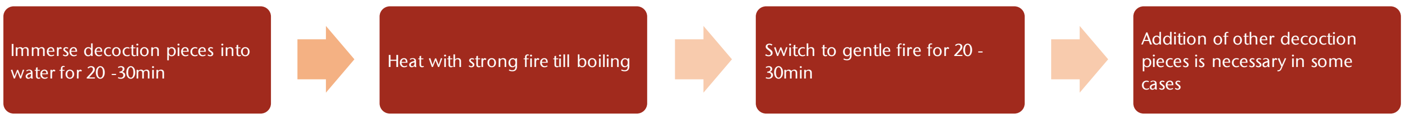
CTCMG: pros outweigh cons

CTCMG: more convenient and controllable quality standards

CTCMG can be viewed as a modernized form of TCM decoction pieces. It has advantages of convenience, controllable quality standards over decoction pieces. One of the major difficulties in promoting TCM is the inconvenience and uncontrollable quality issue with traditional decoction pieces. Many believe CTCMG would be an essential part in promoting TCM. Leverage on its advantages together with the low penetration, we believe CTCMG can continue to deliver robust growth in coming years.

- **Convenient and time saving.** Patients or medical practitioners need to decoct traditional decoction pieces before use and the process is quite complicated which includes: fire control, order for adding ingredients and second decoction process. The whole process may take one to two hours, which limits the usage of TCM in modern society. Meanwhile, patients only have to dissolve the CTCMG in a glass of water and take the medication.

Chart 39: Typical decoction process may take 1 – 2 hours



Source: Jefferies

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Quality standards are drafted under modernized method

- **Controllable quality standards.** One of the major constraints in promoting TCM is the huge range of quality of decoction pieces. This variation may result in unpredictable outcome for the medication. For the same ingredient, quality can vary from batch to batch depending on factors like plantation geographic area, weather, period of plantation and preparation method. Moreover, due to the poorly maintained quality standard, impurities like heavy metal or sulfur may remained with the decoction pieces. For CTCMG, quality standards are drafted under modernized method and there is no significant variation in quality from batch to batch. With predictable quality and ingredient, CTCMG can ensure predictable efficacy for medications.

CTCMG is around 30-40% more expensive than decoction pieces and is only covered by medical insurance in some provinces

- **Strong growth undisturbed by its higher price and low insurance coverage.** Due to higher manufacturing cost and extra marketing activities needed for promoting CTCMG, the product in general is around 30-40% more expensive than traditional decoction pieces. Moreover, decoction pieces are included in the NRDL but CTCMG is only reimbursable in several provinces. The difference in price level may limit the promotion of CTCMG in some less wealthy or rural regions. However, the strong growth of CTCMG seemed undisturbed by this low insurance coverage. We believe that this was due to the relatively low price of TCM: typical cost for CTCMG may be at Rmb200-500 per week. The convenience brought about by CTCMG should outweigh the extra cost for prescription.

Table 6: Eight provinces excluded CTCMG from the medical insurance

Medical insurance status	Provinces	
Officially included	Beijing (2009), Hebei (2015, limited to Shineway), Zhejiang (2016), Yunnan (2018)	4 provinces
Officially included, reimbursed as decoction pieces	Sichuan (2018), Jiangxi (2018)	2 provinces
Unofficially included	Anhui, Ningxia, Jiangsu, Shandong	3 provinces
Unofficially included, reimbursed as decoction pieces		Other 15 provinces
Officially excluded	Fujian (2017), Helongjiang (2018), Shanghai, Tibet, Henan (2018), Hubei, Xinjiang, Chongqing	8 provinces

Source: Jefferies

Older generation may still prefer decoction pieces over CTCMG

- **Time is needed to change medical practitioners practice and believes.** Although CTCMG is the concentrates or extracts of decoction pieces and has been proven in many studies that they have the same active ingredients, many still believe decoction pieces have better efficacy over CTCMG, especially for some older generation TCM practitioners. They believe that the interactions of different ingredients during decoction process are the key for the efficacy of TCM, which are absent from CTCMG. Moreover, TCM practitioners can design more specific prescription with decoction pieces, e.g., maturity, quality or preparation method of different ingredients. We believe extra time is needed for CTCMG to prove its effectiveness to the medical practitioners, especially with the benefits brought about by standardised quality.

Still an oligopolistic industry

Only 6 official licenses were granted for the manufacturing and sales of CTCMG in China

CTCMG has been widely used in other regions like Japan, Korea and Taiwan but China has only started pilot production and regulating the product in 2001 with the issuance of "Temporary regulations on concentrated TCM granules" (《中药配方颗粒暂行规定》). Six pilot production licenses were granted to Jiangyin Tianjiang (江阴天江), Efong (一方制药), Beijing Tcmages (北京康仁堂), Shenzhen Sanjiu (深圳三九), Sichuan Neo-Green (四川新绿色) and Purapharm (培力) in 2001 – 2003. No national official licenses were granted since then. As of today, although many provincial pilot licenses were granted, the six licensees are still the only official licenses to manufacture and sell CTCMG in China.

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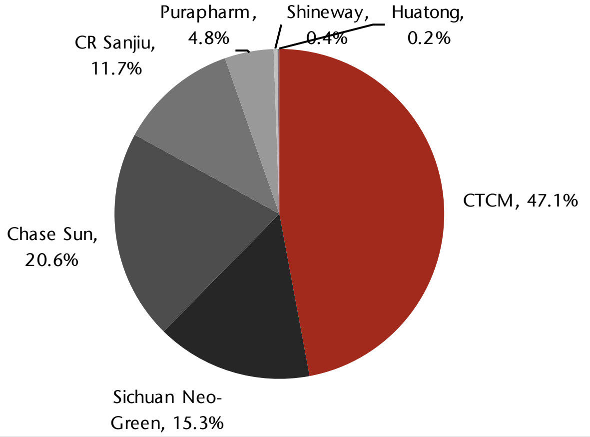
CTCM is the market leader in CTCMG industry with around 50% market share

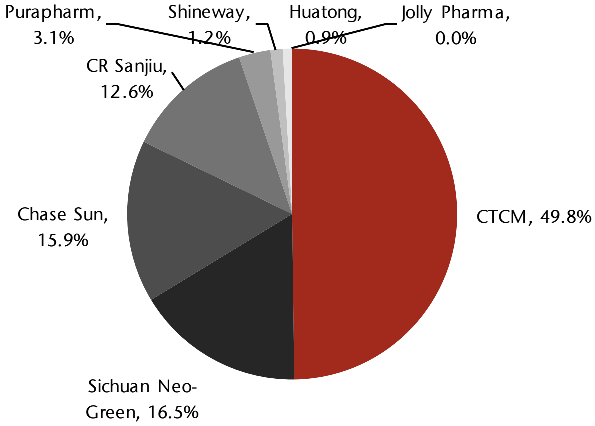
CTCM (570 HK) holds two licenses from Jiangyin Tianjiang and Efong and is the dominating player of the industry with around 50% market share. Neo-Green, Chase Sun (300026 CH) and Sanjiu (000999 CH) come after CTCM with mid-teens market share. Although holding one of the six official pilot license, Purapharm's (1498 HK) market share remained in low single digit and is catching up by new players with provincial pilot licenses like Shineway (2877 HK), Huatong (002758 CH) and Jolly (600518 CH).

Chart 40: CTCMG market share (2016)



Source: Company data, Jefferies estimates

Chart 41: CTCMG market share (2017)



Source: Jefferies estimates, company data

Not opening till the establishment of universal standards.

The government issued "Notice on management of concentrated TCM granules" (《关于规范中药配方颗粒管理的通知》) in 2010, which stated clearly that only TCM hospital of class II or above can prescribe CTCMG. However, due to its advantages over traditional decoction pieces, there is urging demand and needs in lower tier hospitals. Voices are pushing for the opening up of the market, issuing more licenses to support the growth of the industry.

Unlike chemical drugs, quality of TCM granules can vary due to the different planting conditions of raw materials and even varying parameters of preparation process, which in turn would affect the efficacy of the medications. Quality control is utmost important but yet the difficult part for CTCMG. It is believed that the government original target was having the six pilot licensees to have common standards of around 500-600 most commonly used granules before the actual opening up of the market. However, after over 10 years of development, we still do not see any official standards coming out for concentrated TCM granules.

The government may partially open up the market after launching 100-150 types of commonly used CTCMG

The government released the draft of "Regulation on concentrated TCM granules"(《中药配方颗粒管理办法(征求意见稿)》) in Dec 2015, which stated upon approval by provincial authorities, manufacturers with required standards will be allowed to produce and sell concentrated TCM granules. It was also expected that prescription of concentrated TCM granules will be opened to all healthcare institutions. It was previously rumored that the government would set the standard of around 100-150 types of CTCMG and then opening up the market before the end of 2018, but there is no sign of it as of the date of this report.

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We do not expect intensifying competitions even with the opening of the market

Higher than expected entry barrier: (1) quality standard, (2) distribution network, (3) CAPEX

Moreover, we believe the entry barrier for CTCMG is indeed higher than the market expected. Even with over 30 provincial pilot licenses over the years, we see limited companies making progress in entering the market. Entry barriers include (1) high quality standard is needed, (2) established distribution network and market position of current players, (3) CAPEX requirement.

Within the first two to three years, new comers can only sell the approved products, whereas the six licensees can continue their business with full range of products. We believe the market will truly be opened up after the standardization of the most commonly used granules.

Oligopolistic market to continue in the next few years

In other words, we believe the six licensees can continue to enjoy their oligopoly status with significant market growth in the next few years. They will continue to solidify their leading position by rapidly building up their distribution network. Therefore, we believe the current market leaders can still maintain their position even with the opening of the market in the next few years.

Table 7: Even with over 30 provincial licenses are issues, only 3 – 4 manufacturers are making progress

Company	Ticker	License	Approval year	Major market	Types of granules	2017 capacity (tonne)	Planned additional capacity	2017 revenue (Rmb mn)	2017 market share
CTCM	570 HK	Jiangyin Tianjiang	2001	Jiangsu, Zhejiang	730	14,300	10,700	5,500	49.8%
		Efong	2001	Guangdong	700				
Sichuan Neo-Green	N/A	Sichuan Neo-Green	2002	Sichuan, Chongqing, Yunnan	>700	4,000	N/A	1,824	16.5%
Chase Sun	300026 CH	Beijing Tcmages	2002	Beijing, Tianjin	500	2,500	N/A	1,753	15.9%
CR Sanjiu	000999 CH	Shenzhen Sanjiu	2002	Guangdong, Shandong	>600	N/A	N/A	1,391	12.6%
Purapharm	1498 HK	Purapharm	2003	Hong Kong	>600	1,500	1,000	342	3.1%
Shineway	2877 HK		2015	Hebei	703	600	1,400	132	1.2%
Huatong	002758 CH		2015	Zhejiang (Shaoxing)	~600	200	1,000	100	0.9%
Zuoli	300181 SZ		2017	Zhejiang	>300 (plan)	1,600	N/A	2	0.0%
Kangmei	600518 CH		2017	Guangdong	450	2,400	3,000	N/A	N/A
Other ~30 licenses			2007-2017		N/A	N/A	N/A	N/A	N/A

Source: Jefferies, company data

- **High quality standard is needed.** One of the critical difference between decoction pieces and CTCMG is the stability of quality, decoction pieces quality or active ingredient may vary from patch to patch, for CTCMG, the manufacturers need to maintain a uniform quality for all its products. The technical-know-how and quality control is a challenge for an average decoction pieces manufacturer to enter the industry.

- **Established market position for existing players.** The existing six licensees have been developing CTCMG market for more than 10 years. They have established distribution networks and brand image in major target hospitals like TCM hospital of class II of above. In recent years, they have been increasing their penetration into lower tier hospitals This established market position provides a high entry barrier for follow up players in expanding market.

- **CAPEX requirement.** According to Companies, CAPEX for developing each type of CTCMG is at around Rmb2mn-5mn. So, for meeting the minimum standard requirement of 150 -200 types of granules, a CAPEX of Rmb300mn – 1,000mn is needed. This CAPEX requirement would certainly wall off smaller players from entering the industry.

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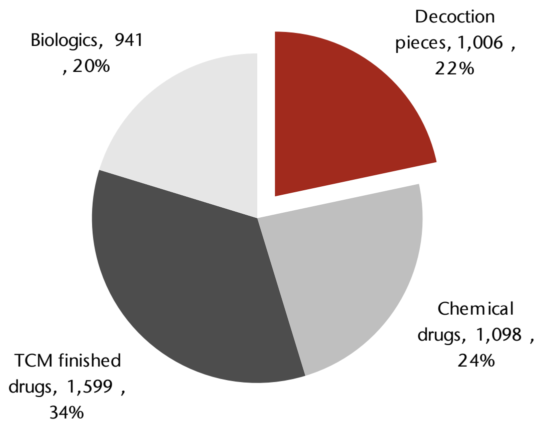
Decoction pieces: industry consolidation opportunity

Industry consolidation opportunity for this highly fragmented market

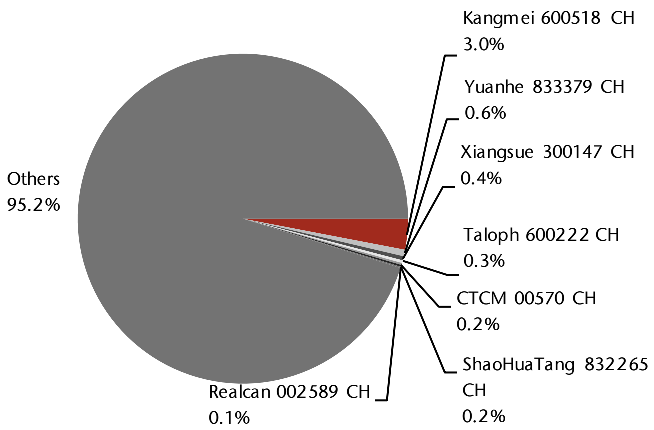
Although with significant growth potential, TCM decoction pieces industry was loosely regulated and highly fragmented. There are around 1,000 decoction pieces manufacturing company in China, accounting for 22% of drug manufacturers in China, while the sector only accounted for around 10% of drug sales in China. The market leader Kangmei only accounted for 3% of the whole decoction pieces market. This loosely regulated industry has led to many quality issues of decoction pieces. In view of this, the government has initiated various policies with the aim of improving the quality of decoction pieces. We believe with these policies in place, many low-quality manufacturers will be forced out of market and significant industry consolidation will be the result. Market leaders will benefit from the process.

Chart 42: Over 1,000 decoction pieces manufacturer in China, accounted for 22% of total



Source: National Bureau of Statistics

Chart 43: The market leader only has 3% of decoction market in 2017



Source: National Bureau of Statistics, Company data

High frequency of on-site inspection to eliminate low quality manufacturers

NMPA suspended 248 GMP licenses in the past three years

In August 2018, the NMPA issued “Work plan on remediating decoction pieces quality” (《中药饮片质量集中整治工作方案》), with the aim of improving the overall quality of decoction pieces. Within October 2018 – September 2019, the government will start frequent investigation on the origin of raw materials, manufacturing process, packaging, distribution and quality of decoction pieces manufacturers. The personnel involved will bear legal responsibility. In the past three years, a total of 248 GMP licenses have been suspended by the CFDA with the failure in complying with standards, accounting for 52.3% of the total suspended licenses. It is obvious that the government would like to increase the standard of the decoction pieces industry. Although these manufacturers still have chances to revoke their suspension by complying with required standards, these manufacturers are mostly small companies and the CAPEX related with facility improvement would not be cost efficient and many smaller players are expected to be forced out of business, resulting in a round of industry consolidation.

Besides onsite inspection, in July 2018, SAMR drafted the Revised Draft of Chinese Medicinal Herbs Production Quality Management Standard (Draft for Comment) (《中药材生产质量管理规范（征求意见稿）》, clearly defining the quality management of Chinese medicinal herbs and the traceability of TCM companies. TCM manufacturers need to ensure their product quality and implement traceability system to medicinal herbs.

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Chart 44: NMPA suspended 248 GMP licenses in the last three years, accounted for 53% of total

Source: NMPA, Jefferies

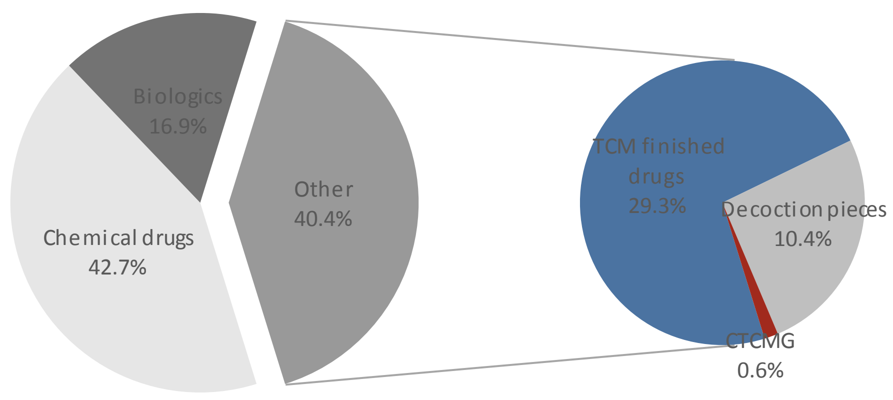
We do not expect removal of supportive policies

As mentioned in previous paragraphs, growth of decoction pieces and CTCMG has been greatly supported by various policies like mark-up policies and exclusion from calculation of drug sales ratio in hospitals. Many investors concern that the supportive policies may be removed under the latest policy environment and thus negatively affecting the growth potential of both sectors. Moreover, some concerns about the spreading of ASP cut measures to decoction pieces and CTCMG. However, we believe that TCM development is under the national development direction, in addition to (1) relative small portion to the China healthcare system, and (2) fluctuation of raw material price.

Removing supportive for this small sub-segment does not help in improving the overall situation

- **Relative small portion to the China healthcare system.** Although all TCM together accounted for over 40% of China drugs market in 2017, decoction pieces and CTCMG together only accounted for 11% of the drug market. Unlike TCM finished drugs which have been over prescribed due to historical reasons, the impact of decoction pieces and CTCMG on the burden of China healthcare system is still negligible. We believe there is no urgency or necessity in regulating the supportive policies for the sector at the time being.

Chart 45: Decoction pieces and CTCMG together only accounted for 11% of drugs market in 2017

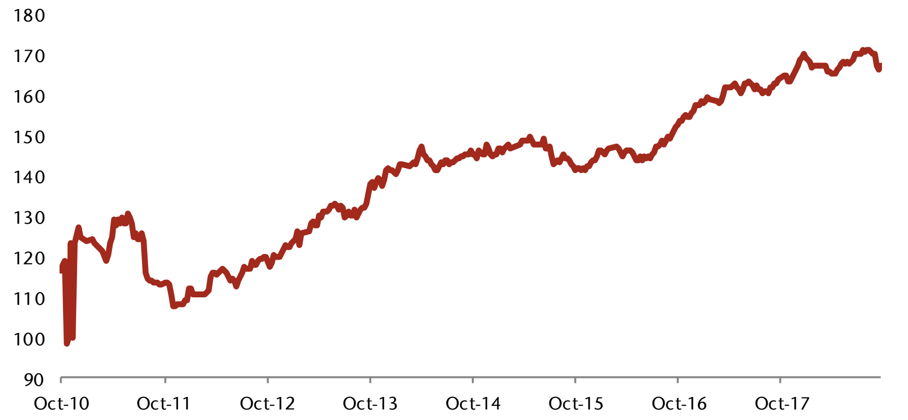


Source: National Bureau of Statistics, Jefferies

Fluctuation in raw material price and various quality level make it difficult to set a discrete price ceiling for decoction pieces

- **Fluctuation of raw material price.** Manufacturing costs of decoction pieces and CTCMG are highly dependent on price of herbal medicines, which is highly volatile, unlike the case for chemical drugs and biologics, which are relatively stable. As herbal medicines typically accounted for over 60% of COGS for decoction pieces, fluctuation in raw material price normally hamper the profitability of decoction pieces manufacturers. If any price ceiling or price cut is initiated on decoction pieces, some manufacturers may switch from using high quality raw material to low quality material, which in turn would affect the efficacy and as a result, development of TCM industry. Therefore, we believe any price control on decoction pieces and CTCMG would not be practical.

Chart 46: Fluctuation in medicinal herbal price exerted extra burden on the cost of manufacturers

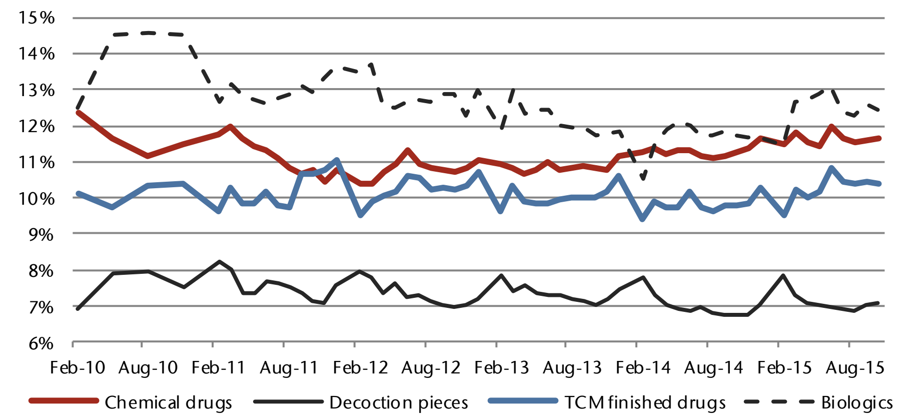


Source: Ministry of Commerce, Jefferies

The lowest margin sub-segment in China pharmaceutical industry

- **Relatively low margin business.** Unlike chemical drugs, biologics or TCM finished drugs industry, decoction pieces manufacturing is a relatively low margin business. Its profit margin is at around 6 – 7% over the years, whereas the margins for chemical drugs and biologics are well above 10%. With this low margin, we do not believe decoction business will become the target of major ASP control.

Chart 47: Decoction pieces manufacturers in average are only having margin of 7-8%



Source: National Bureau of Statistics, Jefferies

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TCM finished drugs – consolidation opportunity for leading players

Due to unclear medical efficacy and mechanism of TCM finished drugs, control of medical insurance expenses and various safety issues related to the usage of TCM injections, many believe that TCM finished drugs would have very little room in the future and may possibly be eliminated from use in the healthcare system.

However, with various policies and regulations announced, we believe TCM finished drugs are still in the core of the healthcare system in China. As a modernized form of TCM, finished drugs still bear significant usage potential and importance that can complement Western medicines. We believe the government would like to regulate the industry, reduce unnecessary usage of TCM, eliminate low quality TCM finished drugs and manufacturers. The short-term growth of the industry will in no doubt be limited due to all these policies but in the long run, leading TCM finished drugs manufacturers with products of proven efficacy would indeed be benefited from the industry consolidation potential and maintain a faster than industry growth.

Improving standards for TCM injections

Increasing standards and eliminating small players from the industry

As stated in "Opinions on approval reform for encouraging drug and medical device innovation" ("关于深化审评审批制度改革鼓励药品医疗器械创新的意见") released in Oct 17, reassessing the quality and standard of existing approved injections would be finished in the next 5 – 10 years. TCM injections as one of the major source of adverse drug reactions, we believe they would be at the top of the agenda in being reassessed. Manufacturers need to undergo clinical trials in accessing the ingredients, mechanisms, safety, efficacy and quality controllability of injection products. Similar to bioequivalence test of chemical generic drugs, we believe the re-assessment would indeed increase the overall quality of injection products. Meanwhile, we believe the tests would involve significant capital and therefore, only the large and established manufacturers would be able to perform the tests and be remained in the industry.

Loosely regulated industry with significant number of adverse reactions

Over 1,200 TCM injection licenses under 300 manufacturers

Since the launch of the first TCM injection, bupleurum injection in the 1940s, the government supported the rapid development of TCM injections, which resulted in over 1,400 types on TCM injections in 1980s. There is currently over 1,200 licenses of around 140 types of TCM injections under around 300 manufacturers registered with the CFDA. This high number and loosely regulated products are the main reason behind the safety issues related to the usage of TCM injections.

Typical TCM injections usually involved several types of herbal medicine as ingredient. As quality and impurities of these ingredients vary from batch to batch, under loose quality control and manufacturing process, the impurities would remain in the TCM injection. Unlike oral TCM, even if the impurities remained in the drugs, the gastric and intestinal barrier can keep human bodies unharmed from these impurities. However, TCM injections go directly into the blood stream of human bodies and any impurities would easily circulate around with the blood stream. This is one of the main reasons behind the large number of safety issues related to TCM injections. Therefore, what should be done is not simply banning the usage of TCM injections, but improving the regulatory requirement and standard of TCM injections.

According to the "Annual drug adverse effect monitoring report (2017)" (《国家药品不良反应监测年度报告（2017 年）》), TCM injections accounted for 8.8% of the 1.43mn adverse effect reports received by the CFDA.

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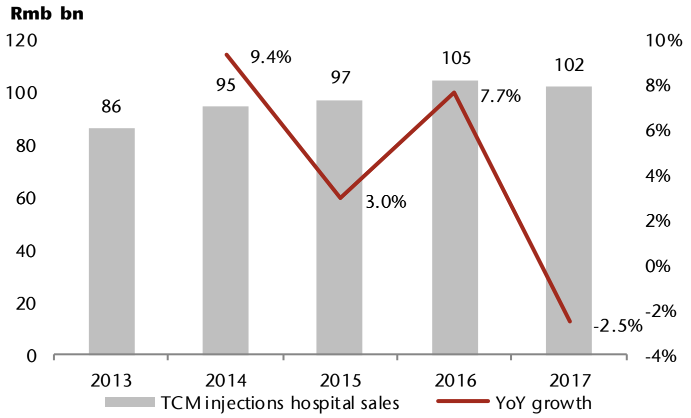
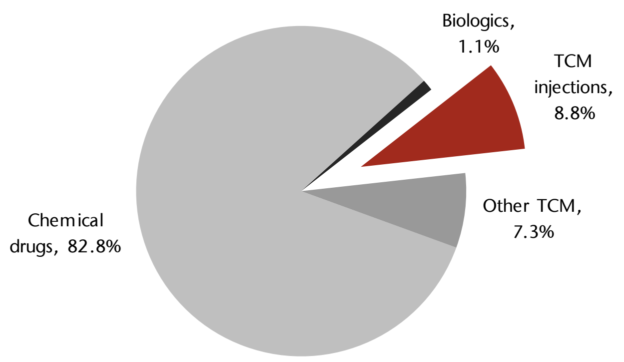
Chart 48: TCM injection sales plunged in 2017due to various policies



Source: Menet, Jefferies

Chart 49: TCM injections accounted for 8.8% of adverse reaction in 2017



Source: NMPA, Jefferies

TCM injections are still included in the NRDL, which shown the importance of the products to the healthcare system

NRDL restricted the usage of TCM injections but not removing

In the latest round of National Reimbursement Drug List (NRDL), 45 TCM injections are included, and 37 of which has usage limitations and mostly are restricted to be used in hospitals of Class II or above. Only one TCM injection has been excluded in the new NRDL. We believe the maintenance of the number of TCM injections in the latest NRDL represents the importance of TCM injections to the healthcare system.

The limitation to the usage of TCM injections which we believe is more due to the control of medical insurance expenses and reducing the over prescription problem of TCM injection. Although we believe this may lead to slower growth in the short run, the trend should lead to more healthy growth of the overall TCM injection industry.

Number of TCM finished drugs increased by 32% in the latest EDL

Besides NRDL, in the latest Essential Drug List (EDL) published in October 2018, total number of TCM finished drugs increased from 203 to 268, up by 32.0%. The number of Western drugs increased from 317 to 417, up by 31.5%. With this new EDL, we can see government's stance on TCM finished drugs: they are still the essential part of the healthcare system and the usage of high quality TCM finished drugs should not be limited. TCM finished drugs if not more important, they are at least as important as Western medicine for the China healthcare system.

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CTCM (570 HK)

Developing into a TCM giant

BUY

Price target	**HK$7.00**
Price	**HK$5.35**

Bloomberg:	**570 HK**
Reuters:	**570.HK**

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Table 8: Financial summary

Rmb	2016A	2017A	2018E	2019E	2020E
Revenue (mm)	6,533	8,338	11,092	13,503	16,554
Change (% YoY)	76.1%	27.6%	33.0%	21.7%	22.6%
Core net profit (mm)	974	1,147	1,405	1,801	2,318
Change (% YoY)	81.7%	17.8%	22.5%	28.2%	28.7%
Core EPS	0.22	0.26	0.29	0.36	0.46
Change (% YoY)	50.5%	17.8%	11.6%	24.3%	28.7%
BV/share	2.30	2.47	3.09	3.34	3.67
Net debt (mm)	1,763	623	(1,599)	(2,173)	(3,821)
ROE (%)	8.3%	9.4%	9.0%	10.7%	12.5%
PER (x)	21.8	18.5	16.6	13.3	10.4
PBR (x)	2.1	1.9	1.5	1.4	1.3

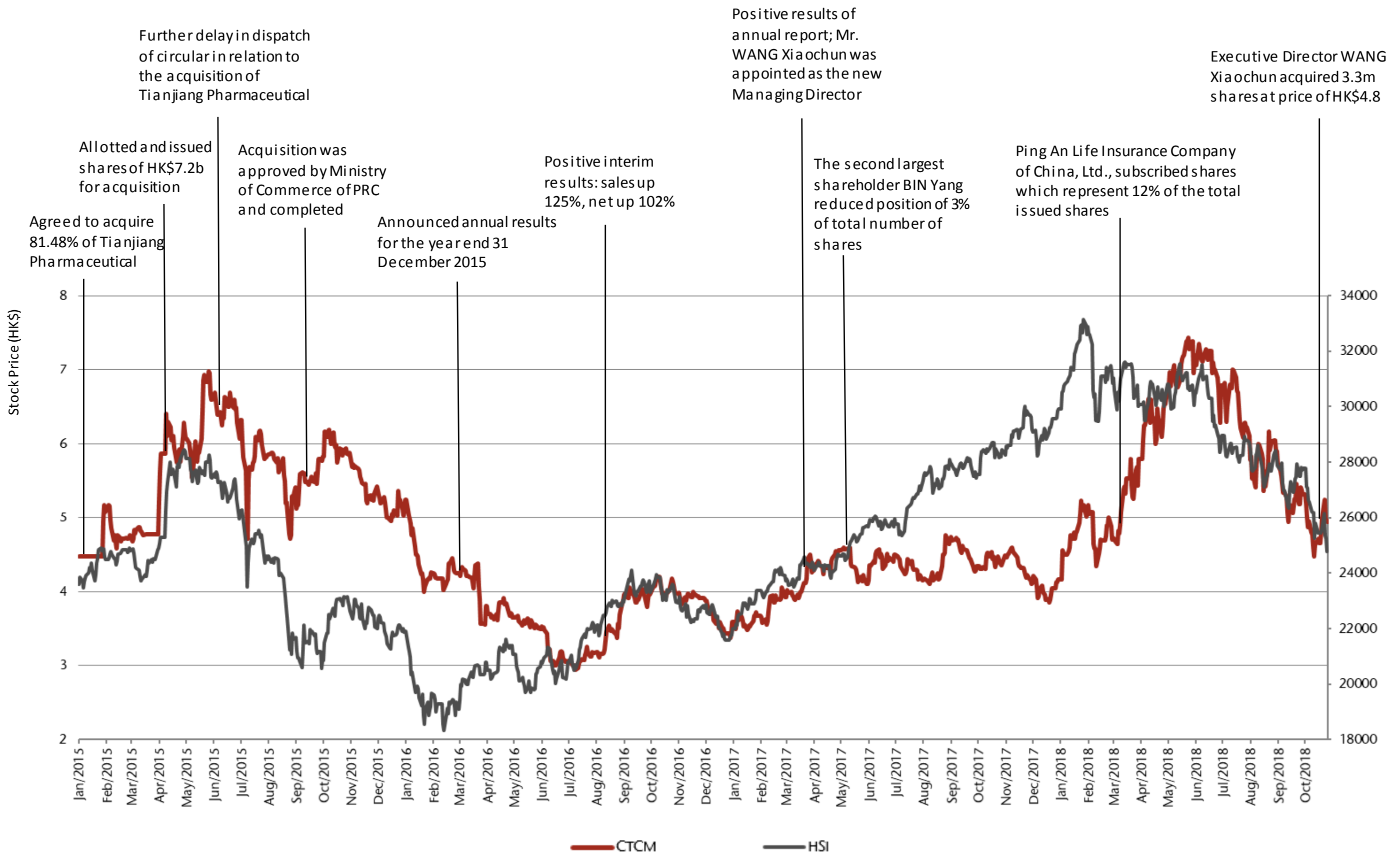
Source: Jefferies estimates, company data

Table 9: Market data

52 Week Range	HK$7.57-HK$3.84
Total Entprs. Value	HK$28.9B
Market Cap.	HK$26.8B
Share Out. (MM)	5035.8
Float (MM)	2797.8
Avg. Daily Vol.	14,859,760

Source: Jefferies

Chart 50: Share price performance and major events



Source: Jefferies, company data

CTCM (0570 HK) - Developing into a TCM giant

Around 50% market share in CTCMG industry and we expect 25.7% revenue CAGR in 17-20E for this business

CTCMG – one of the fastest growing subsectors in pharmaceutical industry

CTCM entered into the industry in late 2014 by the acquisition of 87.3% equity interest in Jiangyin Tianjiang. The business delivered strong organic growth of 20.7% in 14-17. CTCM holds two of the six national pilot production licenses for CTCMG business and the Company is the market leader with around 50% market share. CTCMG is one of the fastest growing subsectors in the pharmaceutical industry due to its (1) convenience and controllable standard over traditional decoction pieces, (2) low penetration, and (3) supportive policies. As the dominant market leader, we expect CTCM to benefit the most from the industry growth and forecast revenue CAGR of 25.7% in 17-20E.

Market overly concerned about uncertainties

Instead of focusing on the growth potential of CTCMG industry, investors are disturbed by uncertainties in the industry: (1) potential opening of market may intensify competitions, and (2) possibility on removal of supportive policies. However, we believe the market has overly concerned about these uncertainties.

Entry barrier to wall off competitors: (1) high quality standard, (2) distribution network, and (3) CAPEX

- **We believe opening of market would not significantly intensify competitions.** Many believe that official opening of the market would attract significant number of new players which would intensify competition for the industry. However, provincial government has already granted over 30 licenses to different manufacturers since 2007 and we only see one to two new players that are actively engaging in the business. We believe the market has underestimated the entry barrier for the industry which include: (1) high quality standard and technical-know-how, (2) distribution network, and (3) CAPEX.

CTCMG accounted for less than 1% of the pharmaceutical industry and the impact of restriction is so small that would not help the overall healthcare system

- **We do not think the government would likely to remove supportive policies and the impact would not be fatal.** Unlike Western medicines, decoction pieces and CTCMG still enjoy supportive policies in hospitals like excluding in the calculation of hospital drugs sales ratio, price markup and supported by medical insurance. We believe the government is unlikely to remove the policies as (1) TCM is a general development direction under 13th five year plan, (2) CTCMG only accounted for less than 1% of the whole pharmaceutical sector, removing policies would not make a significant impact to the whole sector. Besides, we do not expect removing supportive policies would be fatal to the industry: in provinces without insurance coverage like Heilongjiang, Henan and Shanghai, the Company still recorded robust growth.

Industry consolidation opportunity for decoction pieces business

Extending reach into decoction pieces industry

Decoction pieces industry also delivered strong growth CAGR of 13.9% in 13-17 due to increasing acceptance of TCM and supportive policies. However, this is a highly fragmented market and the market leader only has a share of 3% in 2017. Due to the potential and synergy with existing business, the Company expanded its decoction business by a series of acquisition since 2016. Going forward, we expect organic growth in mid-teens regions and the business to account for 10.4% of total revenue in 2020E.

Leverage on Ping An experience and partners on expansion opportunities

Ping An as strategic investor

CTCM completed the placement of 12% enlarged shares to Ping An for a total consideration of HK$2.677mn and Ping An became the second largest shareholder of the Company. Leverage on Ping An's extensive experience and projects on healthcare industry, CTCM could explore more expansion opportunity.

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Revenue CAGR of 25.7% and core net profit CAGR of 26.4% in 17-20E

We forecast core net profit CAGR of 26.4% in 17-20E

With the robust growth potential of CTCMG and industry consolidation potential from decoction pieces, we believe the Company to deliver revenue CAGR of 25.7% in 17-20E. and core net profit CAGR of 26.4%. Due to the consolidation of lower margin decoction pieces business, core net margin will drop from 13.8% in 2017 to 12.7% in 2018E but to recover gradually to 14.0% in 2020E due to the faster growth of high margin CTCMG business.

Trading at 19E/20E PER of 13.3x/10.4x, undervalued given its leading position and growth potential

Valuation

CTCM is only trading at 19E PER of 13.3x, which is significantly lower than peers average of 16.8x. We believe investors have been overly concerned about policy uncertainties and given the Company's leading position in the TCM industry and strong core net profit growth potential, we believe the current low valuation is unjustified. We initiate coverage on the Company with BUY and TP of HK$7.0 based on our DCF model (WACC: 13.2%, terminal growth: 3.0%). Our TP implies 19E/20E PER of 17.3x/13.5x.

Investment risks

(1) Significant fluctuation in medicinal herbal price

(2) More intense than expected market competition for CTCMG business

(3) Unexpected removal of supportive policies for TCM

(4) Larger than expected price pressure

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Market leader in CTCMG business

CTCM owns 2 of the 6 official pilot licenses in manufacturing CTCMG in China

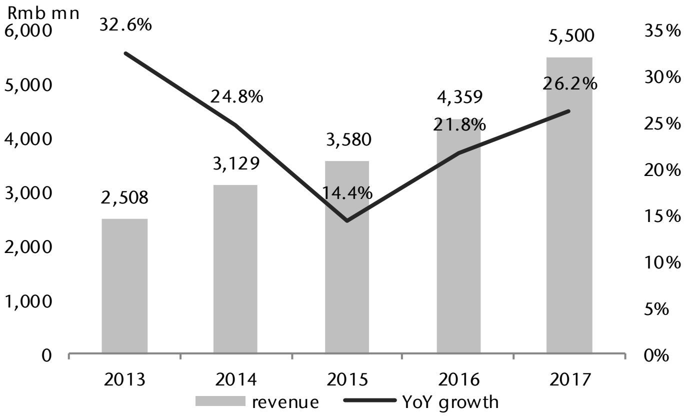
China Traditional Chinese Medicine Co. (CTCM) entered into the CTCMG industry in late 2014 by series of acquisition of 87.3% equity interest on Jiangyin Tianjiang Pharmaceutical. Tianjiang was the dominating market leader in CTCMG industry with around 50% market share and held two pilot licenses on CTCMG business: Tianjiang and Efong.

Tianjiang was founded in 1992 in Jiangsu Province and thus prioritizes in Eastern China market. It was one of the first "experimental manufacturing enterprises of CTCMG" approved by CFDA, and the first manufacturer of CTCMG that received the State Good Manufacturing Practice (GMP) for pharmaceutical products of the PRC certification. Efong was established in 1993 in Guangdong Province and mainly covers Southern China. It was designated as a first experimental base to take a lead to research and develop CTCMG. It was GMP certificated by the China's SFDA since 2003.

CTCMG business delivered robust growth and the Company holds around 50% of the market

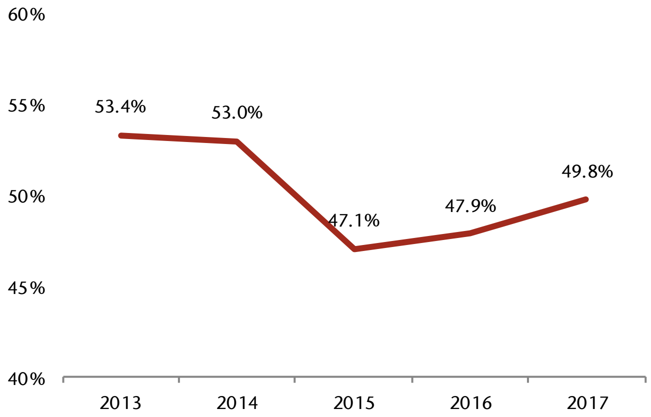
CTCMG business of the Company delivered a CAGR of 21.7% in 2013-17, significantly outpaced the 5.7% of the TCM industry and 7.9% of the overall drug industry. The Company was the dominating player in CTCMG industry with around 53% of market share in 2013 and 14. However, the market share went down to 47.1% due to a slowdown in revenue growth which we believe was due to business consolidation activities after the acquisition by the end of 2014. Since then, growth of the Company's CTCMG business picked up and the market share went back to 49.8% in 2017. With full value chain integration, localization and ample capital supportive for expansion, we expect the robust growth of CTCMG business to continue and to remain as the most important business for CTCM.

Chart 51: CTCMG business delivered CAGR of 21.7% in 2013-17



(*) - CTCMG business consolidated into the P&L since 2015
Source: Jefferies, company data, PICO

Chart 52: CTCM remained as the largest player in the last five years



Source: Jefferies, company data, PICO

Since the acquisition of Tianjiang, CTCMG has become an important part for the Company and accounted for 66% of total revenue and 74.7% of operating profit in 2017. As a result, the performance of the Company is directly driven by the performance of CTCMG business. Going forward, though we expect there would be some growth from decoction business through M&As, we still believe CTCMG would be the most important growth catalyst for the Company.

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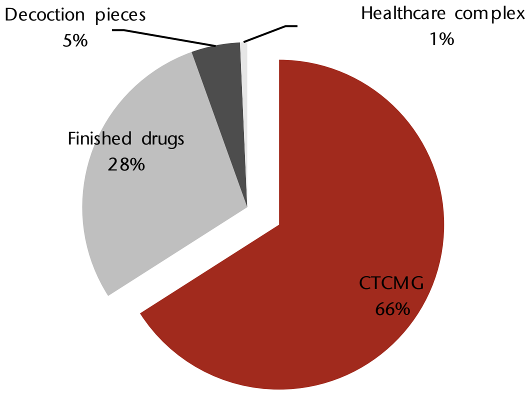
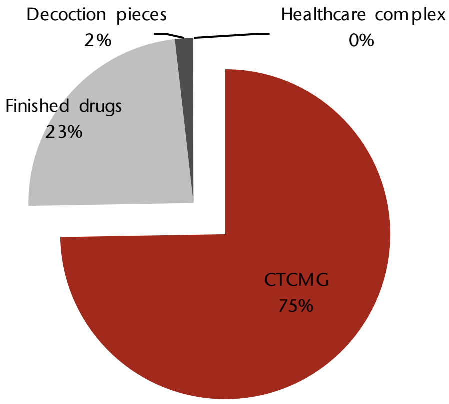
Chart 53: CTCMG accounted for 66% of revenue …



Source: Jefferies, company data

Chart 54: … and 75% of operating profit in 2017



Source: Jefferies, company data

Aggressive expansion into decoction pieces industry

Decoction pieces business has been a small portion of CTCM's revenue before 2016. So as to tap into the market potential of decoction pieces industry and to complete the industry value chain, CTCM entered into the industry by a series of acquisitions since 2H16, with total consideration exceeded Rmb1.3bn.

Table 10: Series of acquisitions on CTCMG and decoction pieces since 2H16

Completion date	Company	Equity interest	Business	Geographical presence	Consideration (Rmb mn)
14-Nov-16	Tongjitang Herbal	100%	Manufacture and sale of decoction pieces	Southwest China	60.9
7-Dec-16	Shanghai Tongjitang	100%	Manufacture and sale of decoction pieces	East China	510.0
12-Jan-18	Sichuan Jiangyou	100%	Manufacture and sale of decoction pieces	Sichuan	81.7
24-Jan-18	Heilongjiang Sinopharm	100%	Distribution of TCM and chemical drugs	Heilongjiang	61.4
31-Jan-18	Beijing Huatai	100%	Production facilities	Beijing	139.6
8-Feb-18	Beijing Huamiao	100%	Manufacture and sale of decoction pieces	Beijing	216.6
TBC	Jiangsu Jiangkang	51%	Manufacture and sale of decoction pieces	Jiangsu	46.9
TBC	Heilongjiang Shuanglanxing	51%	Manufacture and sale of finished drugs and CTCMG	Heilongjiang	35.1
TBC	Sichuan Sanqiang	51%	CTCMG	Sichuan	78.1
TBC	Chengtian Jinling	51%	Manufacture and sale of decoction pieces and CTCMG	Fujian	69.6
TBC	Bozhou Hongda	51%	Manufacture and sale of decoction pieces	Anhui	50.0
				Total	1,349.9

Source: Jefferies, company data

Growing importance of decoction pieces to the Company

After the acquisitions, decoction pieces business has become an important part of the Company's business. It recorded revenue of Rmb104mn/399mn/640mn in 2016/17/1H18 respectively. It contributed 11.7% of total revenue in 1H18, up from just 1.2% in 2016. On the other hand, due to its business nature, decoction pieces business has lower gross margin and operating margin than CTCMG business. Decoction pieces business of the Company only has gross margin of 15-20% and operating margin of 5-10%, significantly lower than 55-60% gross margin and >20% operating margin of CTCMG business.

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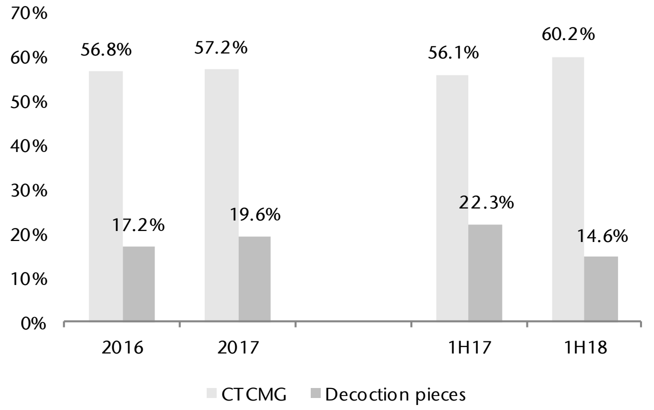
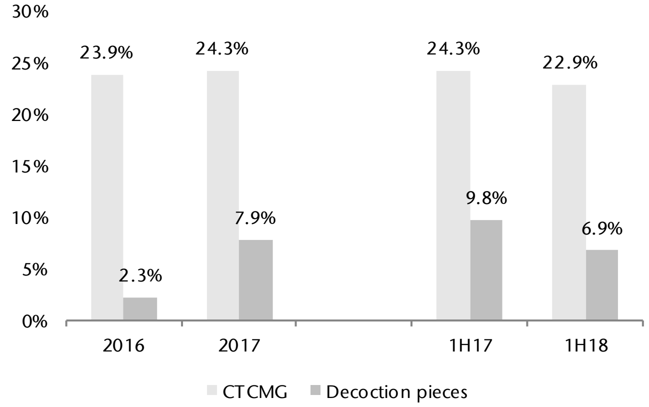
Chart 55: Gross margin of decoction pieces is significantly lower than CTCMG …



Source: Jefferies, company data

Chart 56: … and similar situation for operating margin for the Company



Source: Jefferies, company data

Management set an aggressive revenue target of Rmb5bn for decoction pieces business, which represents 17-22E CAGR of 65.8%

Due to its synergy with CTCMG business, industry growth and consolidation opportunity, we believe decoction pieces business will be another important growth driver for the Company. As decoction pieces industry is an extremely fragmented industry, with the support from the parent company, China National Pharmaceutical Group Corporation (CNPGC), we believe CTCM has the potential to become one of the leaders in decoction pieces industry by both organic growth and M&As. Management has a target for decoction pieces to reach revenue of Rmb5bn by 2022, representing a CAGR of 65.8% in 2017-22E. On the other hand, with the expected business integration and consolidation, Management is targeting an operating margin of low to mid-teens for decoction pieces industry in the longer run.

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Full value chain integration of the TCM industry

CTCM looked for expansion opportunities in both the upstream and downstream of the TCM industry chain to enhance its competitiveness, quality standards and product offerings. The Company is putting great emphasis on expanding its presence in upstream Chinese medicinal herb resources, warehousing and logistics, production capacity enhancement and sales network extension.

Securing plantation sites for quality, traceability and cost stabilization

In July 2018, the National Medical Products Administration (NMPA, the original CFDA) drafted the Revised Draft of Chinese Medicinal Herbs Production Quality Management Standard (Draft for Comment) (《中藥材生產質量管理規範（徵求意見稿）, clearly defining the quality management of Chinese medicinal herbs and the traceability system of TCM companies. Establishing a TCM product quality source tracking system is vital to the development of the industry, which include all phases of production from plantation, localized initial processing, production of decoction pieces and production of CTCMG and finished drugs, to logistics and marketing.

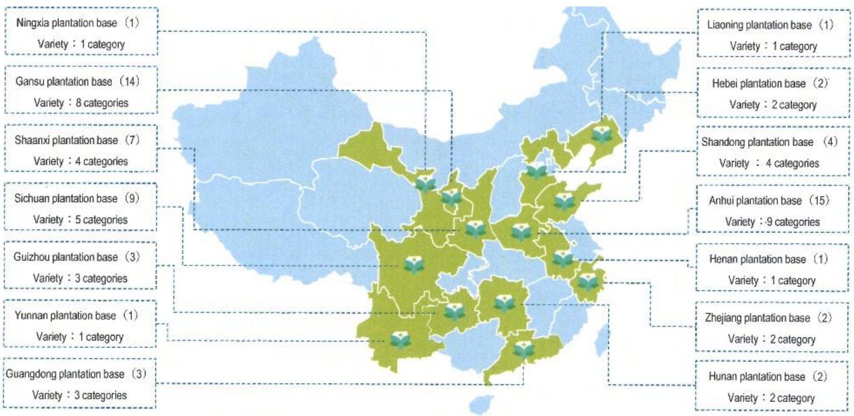
The Company currently has 46 species that are self-planted and aims to have 120 species covering raw material of 70-80% revenue to be self-planted in the long run

Since 2016, the Company has started to build a nationwide TCM industrial chain with the aim to establish a complete quality source tracking system to produce medicinal herbs. As of the end of June 2018, the Company has plantation bases in 14 provinces and a total 46 species of medicinal herbs are planted. In the long term, the Company aims to have around 120 species planted, covering raw material of 70-80% of total revenue.

Inhouse plantation to mitigate the climbing medicinal herbal price

Apart from quality assurance and traceability system, inhouse planted medicinal herbs would also help stabilizing cost structure of the Company. As mentioned in previous sections, price of medicinal herbs has grown in average 70% in the last seven years or around 8% per year. Inhouse planted herbs can thus help stabilizing the raw material cost and margin performance of the Company.

Chart 57: CTCM currently has 65 plantation bases in 14 provinces producing 46 types of medicinal herbs



Source: Jefferies, company data

Localization to deal with regional protectionism

Setting up branches in different provinces to deal with regional protectionism

Regional protectionism is a general phenomenon for TCM decoction pieces and CTCMG industry, e.g., Hebei provinces only included CTCMG from Shineway into the insurance system, Zhejiang province excluded CTCMG from other provinces into their lower-tier hospitals. It is believed that the local government would like to protect local manufacturers for taxation and employment reasons. CTCM tackles regional protectionism by becoming local, either setting up factories or production sites or acquiring local manufacturers in target provinces to become 'local'.

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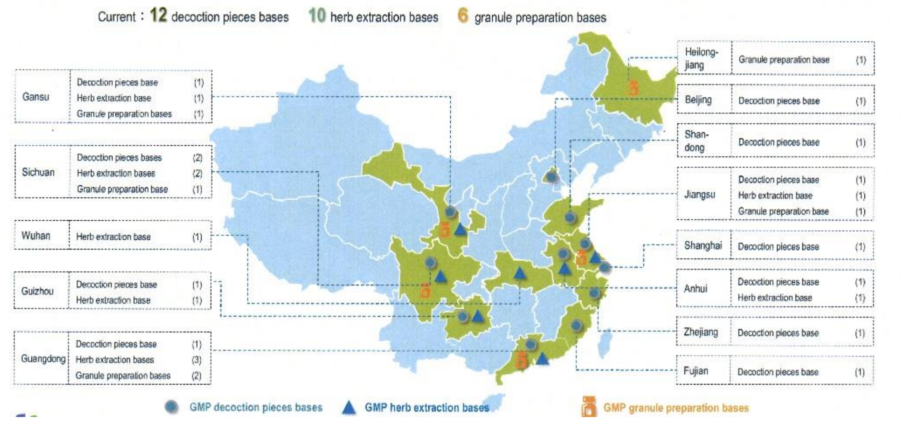
CTCM targets to have bases in 23 provinces or cities by the end of 2019

As of the end of June 2018, the Company has 10 medicinal herb extraction bases in seven provinces, 6 granule preparation bases in 5 provinces, and 12 decoction pieces bases in 12 provinces. The Company has production facilities in 13 provinces in China. According to the Company development plan, bases will be completed in a total of 23 provinces or cities nationwide in 2019. Estimated TCM extraction capacity will reach about 80,000 tonnes, production capacity of granule preparations will be about 25,000 tonnes, and the production capacity of TCM decoction pieces will be about 80,000 tonnes.

The Company has obtained provincial pilot production licenses in 5 provinces and expect to obtain two more by the end of 2018

Besides, apart from its two-existing national-level licenses on CTCMG, the Company has obtained pilot production licenses in Sichuan, Shaanxi, Heilongjiang, Chongqing and Fujian, and expects to obtain further pilot licenses in Beijing and Hubei by the end of the year. This will help the Company in breaking local protection barriers and expanding market coverage.

Chart 58: CTCM currently has bases in 13 provinces and aim to expand to 23 by the end of 2019



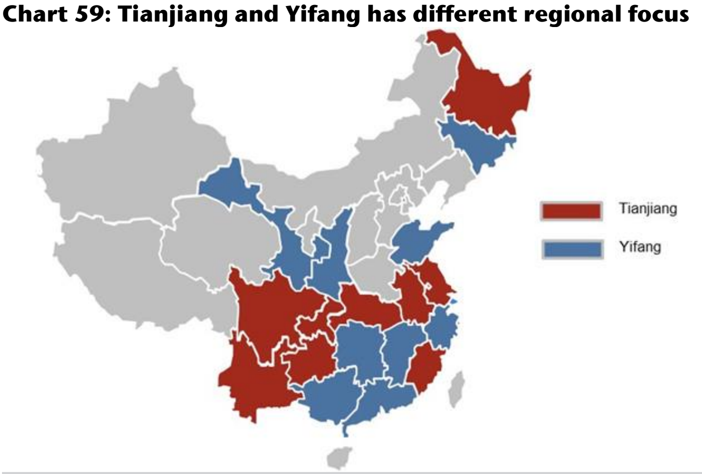
Source: Jefferies, company data

East and South China together accounted for 54.2% of total CTCMG sales of the Company in 1H18

Nationwide coverage with strong presence in East and South China

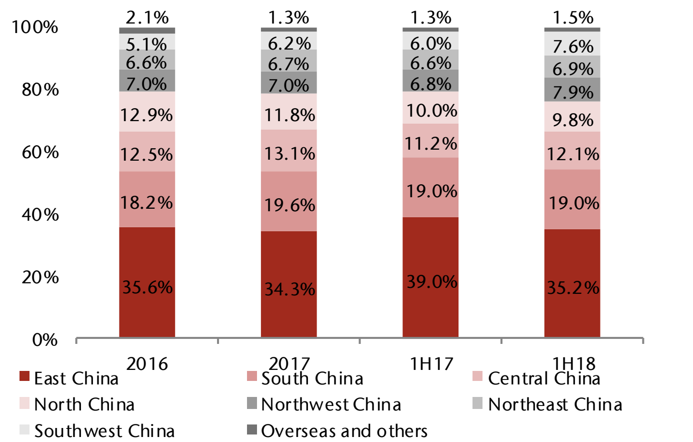
The two operating arms for decoction pieces and CTCMG, Tianjiang and Yifang has different regional market focuses. Tianjiang headquartered in Jiangyin, Jiangsu and is present in Heilongjiang, Sichuan, Yunnan, Chongqing, Guizhou, Anhui, Fujian and Hubei. Yifang headquartered in Foshan, Guangong and is present in Gansu, Shandong, Zhejiang, Shaanxi, Jiangxi, Hunan, Jilin and Guangxi. In terms of revenue, East China and South China are the biggest region and together accounted for 54.2% of total CTCMG sales in 1H18.

Chart 59: Tianjiang and Yifang has different regional focus



Source: Jefferies, company data

Chart 60: East and South China are the key regions



Source: Jefferies, company data

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Increasing penetration into lower tier hospitals

The two operating arms of CTCM, Tianjiang and Yifang, employ different distribution models: Tianjiang uses direct sales team and organizes forum to target doctors. Apart from a direct sales team, Yifang also employs third party distributors for sales and promotion of products. As of the end of 2017, Tianjiang and Yifang together covered 2,057 class III hospitals, 1,585 class II hospitals, 736 grassroot medical institutes and 1,122 third party distributors.

The Company covered 87.9% of Class III hospitals

CTCM has covered most class III hospitals for its CTCMG business and only covered 18.8% of class II and 3.6% of lower tier hospitals. We believe this coverage pattern was mainly due to the policy that CTCMG was only allowed in hospitals of class II or above. With the increasing acceptance of CTCMG and expected opening up of the market, we believe the next growth driver for the Company will be on increasing market penetration into lower tier hospitals.

Table 11: CTCM has covered most class III hospitals in China

	Class III	Class II	Others	Total
Number of hospitals covered by CTCM	2,057	1,585	736	4,378
Total number of hospitals in China	2,340	8,422	20,294	31,056
Penetration rate	**87.9%**	**18.8%**	**3.6%**	**14.1%**

Source: Jefferies, company data, NHFPC

Warehousing expansion to ensure stable raw materials supply and price

Targeting to increase medicinal herbal inventory to 1 year with the construction of 4 warehouses

As CTCMG business is expected to deliver strong growth in coming years, together with the entrance into the decoction pieces industry, there is a necessity for the Company to have a stable raw material cost and supply. As of the end of June 2018, the Company has about 16,000 tons of medicinal herbs in stock, which is equivalent to three to five months of stock reserves. The Company targets to maintain a stock reserve of one year with the construction of new warehousing and trading companies.

The Company currently has two warehousing and trading companies for medicinal herbs. It plans to build four additional GSP-compliant warehousing and trading platforms in Longxi (Gansu), Bozhou (Anhui), Mianyang (Sichuang) and Guilin (Guangxi). The four warehousing and trading platforms will not only store the Group's Chinese medicinal herbs and decoction pieces, but also provide inspection and warehousing services to other Chinese medicinal herb operators, and will conduct transactions nationally.

Leading R&D and quality standards in CTCMG

Actively involved in the setting of national standards

Since the issuance of Technical Requirements for Quality Control and Standards for Concentrated TCM Granules (Draft for Comment) (中藥配方顆粒質量控制與標準制定技術要求(徵求意見稿) in August 2016 by the Pharmacopoeia Committee, the Company has been developing standards for CTCMG in accordance with the Pharmacopoeia Committee's schedule and requirements. The Company has been active in the development process and has conducted research on 170 varieties and submitted results of 123 varieties to the Pharmacopoeia Commission for review as of the end of June 2018.

As mentioned in previous session, the standards will serve as a major barrier for competitors to enter the industry once the market is opened. The Company is the largest player in CTCMG industry and has been active in setting the new standards. We believe the Company would have advantages in complying with the standards and walling off future competitors by setting a reasonably high standard.

To ensure sustainable development, the Company also carried out other research projects on concentrated CTCMG. These included: (1) pharmaceutical and evidence-based research on CTCMG, and continued promotion of research in the efficiency differences between mixing ingredients before and after decocting; (2) research and development of CTCMG with homology of medicine and food to expand the product reserves; (3) consumer-driven improvements to the flavor of existing granule varieties, and development of CTCMG suitable for children.

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Introduced PingAn as strategic investor

Placed 12% enlarged shares to Ping An at HK$4.43 per share, a total consideration of HK$2,677mn

CTCM completed the placement of 604.3mn shares to Ping An Life Insurance in May 2018 at a total consideration of HK$2,677.0mn, equivalent to the issue price of HK$4.43 per share. The issue price represented a 19.9% discount to the closing price of HK$5.53 as of the end of 15 March 2018. Ping An Life Insurance became the second largest shareholder after China National Pharmaceutical Group Corporation (CNPGC) after the issuance and holds 12.0% of the enlarged shares. As long as the shareholding of Ping An exceeds 5% of the total number of shares, Ping An is entitled to nominate one non-executive Director to the Board.

Ping An has made a number of successful investments in the pharmaceutical and healthcare industries in recent years. CTCM intends to introduce Ping An as a long-term strategic partner, which will help to bring together the Company's expertise in the TCM medicinal herbs, decoction pieces, CTCMG and finished drugs businesses, and Ping An Group's customer base, sales network, and technology, platform and resources advantages in the pharmaceutical and healthcare sector for developing the TCM business.

Potential cooperation with Tsumura, a leading Japanese Kampo medicine manufacturer)

In particular, it is the Group's intention to explore and promote strategic cooperation in TCM-related businesses with Ping An Group through a joint venture being established by Ping An Group and Tsumura & Co. (a Japanese leading Kampo medicine manufacturer) as the primary strategic partner, which is expected to bring the global advanced research and development and production technology in the TCM industry to the Group, create synergies and further enhance the value of the Company.

About Tsumura

Extensive experiences in TCM value chain development from medicinal herb cultivation to production distribution

Founded in 1894 and headquartered in Tokyo, Tsumura is the largest manufacturer of Kampo products (Kampo is a traditional form of medicine in Japan) with a leading market share of 83.9% in the domestic prescription Kampo product market in 2018. It has developed a value chain that encompasses everything from the cultivation and the procurement of the crude to quality management, research, extract manufacturing, distribution, and even promoting the spread of Kampo medicine. Of the Company's sales, 95.2% come from prescription Kampo products that are prescribed by physicians, while 2.5% are attributable to over-the-counter pharmaceuticals. All of the 129 Kampo formulations made by Tsumura are covered under the National Health Insurance (NHI) plan and are thus subject to the establishment of set prices by the Ministry of Health, Labour and Welfare.

Tsumura has expanded its business into overseas market and fostered a strong relationship with China. It has established five subsidiaries and joint ventures in China and announced to form a capital and business alliance with major Chinese insurance company Ping An Insurance (Group) Company of China, Ltd. Tsumura has commenced a business for selling crude drug pieces for decoction to the Chinese market in 2017, and has been advancing research and development on the production of traditional Chinese medicine compound granules. With the goal of cultivating the No. 1 traditional Chinese medicine brand in the Chinese market, it has aimed to achieve sales of RMB 10 billion in China in 2028.

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The worst is over for finished drugs

Finished drugs business is becoming less important to the Company

As negatively hit by adverse operating environment and policies like control on hospital drug sales ratio, control on usage of adjuvant drugs, restriction of the NRDL, channel destocking due to two invoice system, TCM finished drugs business delivered rather disappointing results in 2016. Due to its weakness and the strong growth of CTCMG and decoction pieces, its revenue contribution has dropped from 73.6% of total revenue in 2015 to just 23.9% in 1H18.

We believe the worst has been over for the sector and it has shown some degree of rebound since 2017, which we believe was mainly driven by the strong growth of OTC products and gentle recovery of prescription products. Riding on its exclusive quality products, well-known brand names and expansion of OTC business, although we do not expect TCM finished drugs to be a main growth driver for the Company, we still expect modest growth potential from the sector in the next three years.

Table 12: Strong OTC products to be the main driving force

	2016	2017	YoY change	1H17	1H18	YoY change
Core prescription products	1,180	1,223	3.6%	643	708	10.1%
Core OTC products	357	457	28.0%	265	333	25.7%
Others	525	701	33.5%	236	265	12.3%
Total	**2,062**	**2,381**	**15.5%**	**1,144**	**1,306**	**14.2%**

Source: Jefferies, company data

Diversified portfolio with strong brand names

CTCM has a strong TCM finished drug portfolio with over 900 products, of which 282 products are listed in the latest NRDL and 26 of the listed products are exclusive products. 147 products are listed in the National Essential Drug List (EDL), of which eight are exclusive products.

The Company has many well-known subsidiaries in China and inherits the ancient pharmacies that have been opened since the Ming Dynasty: Liang Zhonghong Wax Pills Clinic (梁仲弘腊丸馆), Fengliaoxing (冯了性), Tongjitang (同济堂) and Yuen Kut Lam (源吉林). The Company also owns 3 China time honored brands (中华老字号): Fengliaoxing, Dezhong (德众) and Tongjitang, 5 China well-known trademarks (中国驰名商标): Xianling (仙灵), Tongjitang, Xianling Gubao (仙灵骨葆), Dezhong and TianJiang Pharmaceutical(天江药业).

Exclusive quality products to remain as the core competency

10 exclusive products in EDL

In spite of the industry adverse operating environment, we believe the quality products with proven efficacy still processes significant market potential. CTCM currently has ten exclusive products being listed in the EDL These products are all core products of the Company and their efficacy is proven and processes significant value to the healthcare system. Moreover, their pricing is relatively low and therefore are less affected by policy headwinds.

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Table 13: Major products of the Company

Drugs		Indications	EDL	NRDL
Xianling Gubao Capsules	仙灵骨葆胶囊	For treatment of osteoporosis	✓	Cat A
Yu Ping Feng Grandules	玉屏风颗粒	For improvement of the immune system	✓	Cat A
Jingshu Granules	颈舒颗粒	For treatment of cervical spondylosis	✓	Cat A
Moisturizing and Anti-Itching Capsules	润燥止痒胶囊	Used to cure itchy skin, acne and constipation caused by disharmony of blood	✓	Cat B
Fengshi Gutong Capsules	风湿骨痛胶囊	Relieving joint pain	✓	Cat A
Zaoren Anshen Capsules	枣仁安神胶囊	Non-dependency medication targeting insomnia	✓	Cat B
Qili Capsules	七厘胶囊	For treating traumatic injuries	✓	Cat A
Waimaining Capsules	威麦宁胶囊	Antipyretic-detoxicate drugs	×	Cat B

Source: Company Data

Evidence based study to prove efficacies of TCM finished drugs

The Company has started blockbuster cultivation programs to drive the market strategy of academic promotion. The Company also started series of evidence-based research on 6 core products. Nevertheless, by making a substantial investment in evidence-based clinical research in advance, together with the mature academic promotion system, a sales promotion effect is gradually released.

Table 14: Evidence based studies for major products

	Name of clinical research project	Initiated hospital	Progress
Xianling Gubao Capsules (仙靈骨葆膠囊)	Post-market safety evaluation on Xianling Gubao Capsules (10,000 participants)	Beijing Wangjing Hospital	Expected to be completed by the end of 2020
	Research on Xianling Gubao Capsules for preventing bone mass loss caused by aromatase inhibitor for treatment of post-menopause breast cancer	Shanghai Longhua Hospital	Expected to be completed in the middle of 2019
Jingshu Granules (頸舒顆粒)	Multi-centered, randomized, double-blinded and placebo-controlled clinical research on the effectiveness, safety and economic effects of Jingshu Granules for treatment of nerve root type cervical spondylosis (神經根型頸椎病)	Beijing Union Medical College Hospital	Expected to be completed within the year of 2018
Fengshi Gutong Capsules (風濕骨痛膠囊)	Randomized, double-blinded, double-stimulation and multi-centered clinical research on Fengshi Gutong Capsules for treatment of ankylosing spondylitis	The Third Affiliated Hospital of Zhongshan University	Expected to be completed in April 2018
Yu Ping Feng Granules (玉屏風顆粒)	Randomized, double-blinded, placebo parallel controlled and multi-centered clinical research on the effectiveness and safety of Yu Ping Feng Granules for treatment of COPD (chronic obstructive pulmonary disease)	Guangzhou Institute of Respiratory Disease	Completed
	Randomized, double-blinded and multi-centered clinical research on the effectiveness and safety of Yu Ping Feng Granules for treatment of repeated respiratory tract infection in children (小兒反復呼吸道感染)	The First Affiliated Hospital of Tianjin Chinese Medicine University and Beijing Children's Hospital	Completed
	Multi-centered, randomized and placebo parallel controlled clinical trial for chronic urticaria with combined treatment of Yu Ping Feng Granules and Desloratadine Citrate Disodium Tablets	The Second Affiliated Hospital of Suzhou University	Completed
Moisturizing and Anti-Itching Capsules (潤燥止癢膠囊)	Multi-centered, randomized, double-blinded and placebo parallel controlled clinical research on Moisturizing and Anti-Itching Capsules for the treatment of chronic eczema	Dermatology Hospital affiliated to Chinese Academy Of Medical Science	Completed
Zaoren Anshen Capsules (棗仁安神膠囊)	Randomized, double-blinded, double-stimulation and multi-centered parallel controlled clinical research on the efficacy and safety of Zaoren Anshen Capsules for the treatment of insomnia combined with Zolpidem Tartrate	Zhejiang Provincial Hospital of TCM	Expected to be completed in December 2018

Source: Jefferies, company data

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Expanding the OTC business line

Apart from prescription products, the Company has begun to make more emphasis on OTC products, increased and improved efforts at promotion strategy, and increasing ASP for certain OTC products.

Table 15: Major OTC products

Drugs		Indications	EDL	NRDL
Bi Yan Kang Tablets	鼻炎康片	Effectively control the recurrence of rhinitis	✓	Cat A
Feng Liao Xing Dieda Medicinal Wine	冯了性风湿跌打药酒	For temporary relief of minor aches and pains of muscles and joints due to: Simple backache，Rheumatism，Sprains，Bruises，Strains	×	×
Chongcao Qingfei Capsules	虫草清肺胶囊	To nourish lung and reinforce qi,clear lung and eliminate phlegm, relieve cough and asthma	×	×
Yao Shen Herbal Paste	腰肾膏	To relieve soreness of loins and knees due to kidney deficiency	×	Cat B
Shent Tong Ping/Nifedipine Sustained-release Tablet (I)	圣通平/硝苯地平缓释片	For high blood pressure in angina pectoris	✓	Cat A
Vitamin C Yinqiao Tablets	维 C 银翘片	For influenza caused by fever headache, cough, dry mouth, sore throat	×	Cat B
Heiguteng Zhuifeng Huoluo Capsules	黑骨藤追风活络胶囊	To cure Rheumatism	×	Cat B
Shedan Chuanbei Powder	蛇胆川贝散	To calm breathing and resolves phlegm. Good for symptomatic relief for stopping cough	×	Cat B
Shedan Chenpi Powder	蛇胆陈皮散	For cough due to phlegm and heat, acute or chronic bronchitis due to phlegm and heat, asthma	×	Cat A
Tongluo Guzhining Paste	通络骨质宁膏	For treatment of hyperosteogeny and relieving joint pain	×	Cat B
Angong Niuhuang Pills	安宫牛黄丸	To clear heat and eliminate toxicity, and induce sedation and resuscitation	✓	Cat A

Source: Company Data

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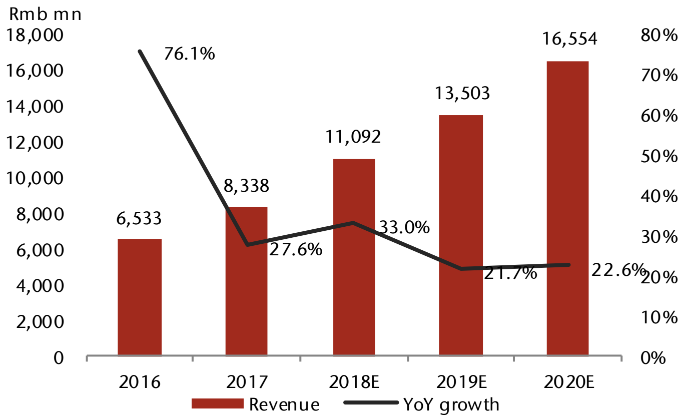
Financials

We expect core net profit CAGR of 26.4% in 17-20E

Core net profit growth to be supported by 25.7% revenue CAGR in 17-20E

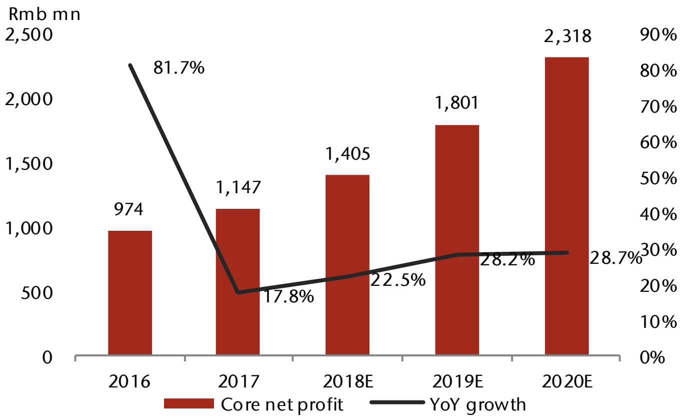
From the overall industry growth of CTCMG and decoction pieces, we forecast revenue CAGR of 25.7% in 17-20E. Although we expect some margin squeeze from the consolidation of lower margin decoction pieces business in 2018E, we also expect a gradual margin improvement in the next three years with the faster growth of high margin CTCMG business. As such, we believe the Company can deliver core net profit CAGR of 26.4% in 17-20E.

Chart 61: We forecast revenue CAGR of 25.7% ...



Source: Jefferies estimates, company data

Chart 62: ... and core net profit CAGR of 26.4% in 17-20E



Source: Jefferies estimates, company data

CTCMG to remain as the main growth driver and core business

CTCMG to deliver CAGR of 27.5% in 17-20E

Driven by the strong industry growth, as the market leader, we believe the Company's CTCMG business can maintain its robust growth in the next three years. We expect it to deliver revenue CAGR of 27.5% in 17-20E. It contributed 66% of total revenue in 2017 and the portion would go up to 68.8% in 2020E due to its strong growth potential. For decoction pieces business, we forecast revenue CAGR of 62.6% in 17-20E due mainly to the full-year consolidation of newly acquired business in 2018E. We expect organic revenue growth in mid-teens region for decoction pieces and the business should contribute around 10% of total revenue in the next three years. For finished drugs business, we forecast revenue CAGR of 12.5% in 17-20E due to the consolidation of newly acquired business in 2018E and organic revenue growth in low-teens region. Its contribution to total revenue will drop gradually from 28.6% in 2017 to 20.5% in 2020E.

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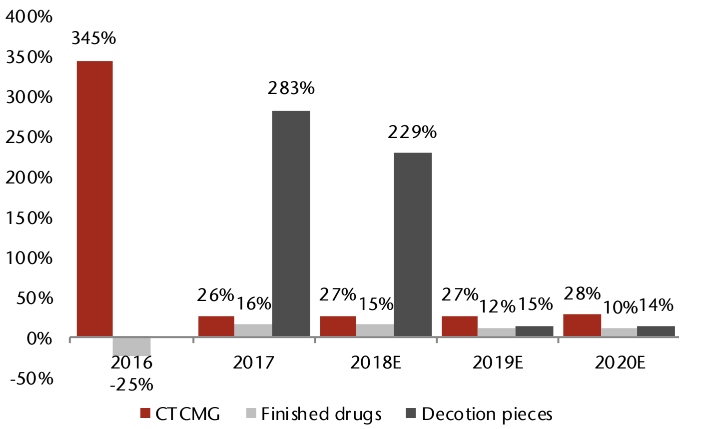
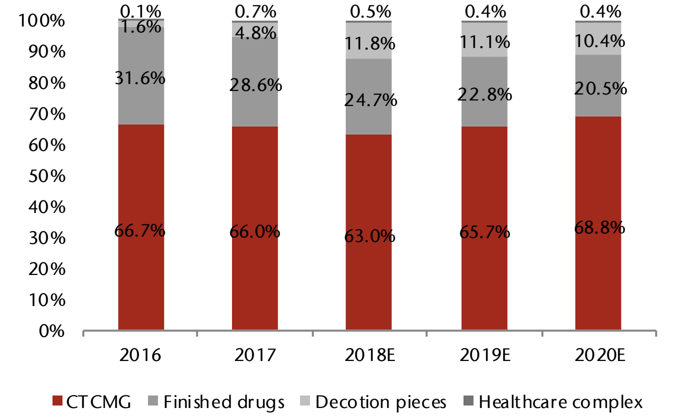
Chart 63: CTCMG will be the main organic growth driver …



Source: Jefferies estimates, company data

Chart 64: … and will remain the largest part of CTCM



Source: Jefferies estimates, company data

Table 16: CTCM revenue forecast breakdown

	2016 Rmb mn	2017 Rmb mn	2018E Rmb mn	2019E Rmb mn	2020E Rmb mn
CTCMG	4,359	5,500	6,990	8,872	11,391
Finished drugs	2,061	2,381	2,741	3,073	3,391
Decoction pieces	104	399	1,311	1,504	1,714
Healthcare complex	9	58	51	55	59
Total	**6,533**	**8,338**	**11,092**	**13,503**	**16,554**

Source: Jefferies estimates, company data

Table 17: CTCM revenue growth breakdown

	2016	2017	2018E	2019E	2020E
CTCMG	345.3%	26.2%	27.1%	26.9%	28.4%
Finished drugs	-24.5%	15.5%	15.1%	12.1%	10.3%
Decoction pieces	N/A	283.0%	228.8%	14.7%	14.0%
Healthcare complex	N/A	555.5%	-13.1%	8.0%	8.0%
Total	**76.1%**	**27.6%**	**33.0%**	**21.7%**	**22.6%**

Source: Jefferies estimates, company data

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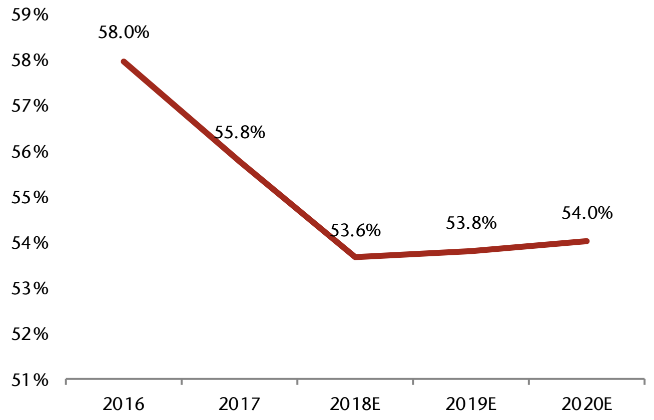
Margin squeeze in 2018E but to improve gradually

Margin improvement due to faster growth of high margin CTCMG business

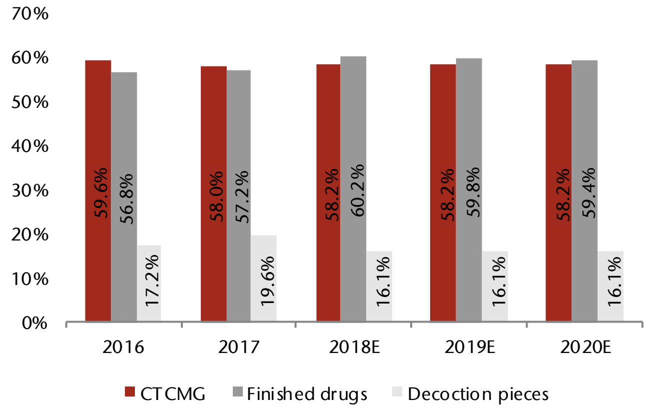
We expect margin squeeze to happen in 2018E, following a drop in 2017, due again to the consolidation of low margin decoction pieces business. For gross margin, it dropped from 58.0% in 2016 to 55.8% in 2017 due mainly to the consolidation of decoction pieces business and a drop in gross margin of CTCMG business within the period. We expect the consolidation of newly acquired decoction pieces business will drive gross margin further down to 53.6% in 2018E. However, due to the faster growth of high margin CTCMG business, we expect the overall gross margin will improve gradually to 53.8%/54.0% in 2019E/20E. For gross margin of individual business, we expect economies of scale and vertical integration of business will largely balance out the impact of medicinal herbal raw material price fluctuation, and therefore, expect the gross margin of CTCMG and decoction pieces business to stay at current level. For finished drugs, we expect low single digit price cut every year which would add slight pressure to the gross margin.

Chart 65: Gradual gross margin improvement in the next 3 years



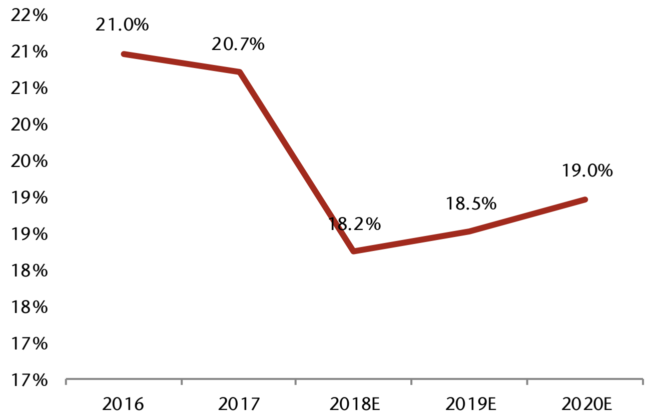
Source: Jefferies estimates, company data

Chart 66: Gross margin of individual business remains largely stable



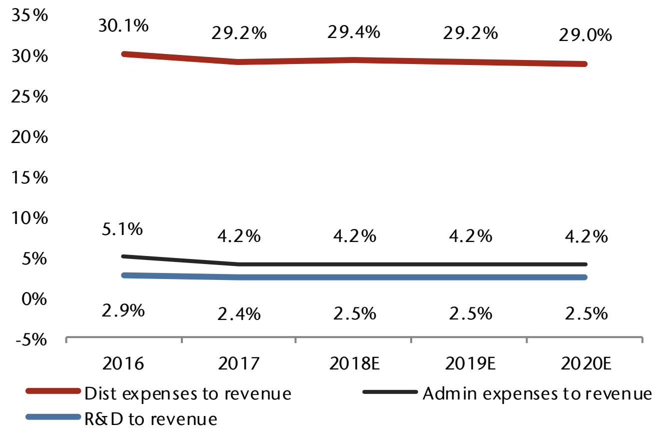
Source: Jefferies estimates, company data

Chart 67: Operating margin to show similar trend as gross margin



Source: Jefferies estimates, company data

Chart 68: Operating expenses ratio to stay largely stable in the next three years



Source: Jefferies estimates, company data

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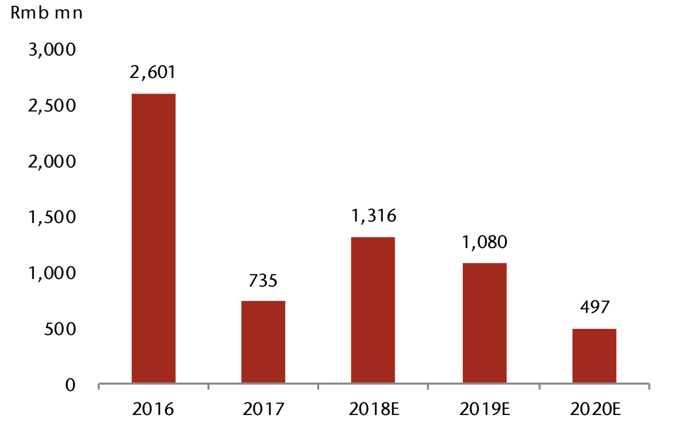
Significant CAPEX to be funded by internal resources

CTCM has been aggressive in expanding its presence and coverage in the TCM sector with M&As. So as to complete whole value chain integration and nationwide coverage, we expect significant CAPEX in the next three years. As of the end of 2017, the Company has Rmb4.5bn cash on hand, which should be enough for supporting CAPEX in the next three years.

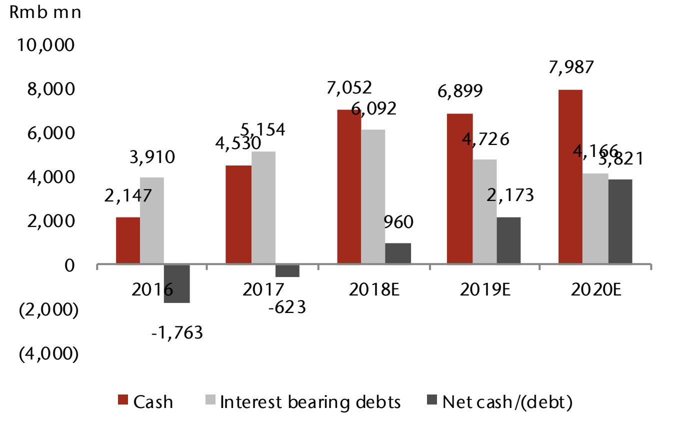
Meanwhile, CTCM has a net gearing ratio of 13.8%/4.5% in 2016/17. With the strong operating cash flow, we believe the Company will turn into net cash position starting 2018E. The healthy financial position should be able to support the Company in business expansion through meaningful M&As.

Chart 69: Significant CAPEX for 18E and 19E



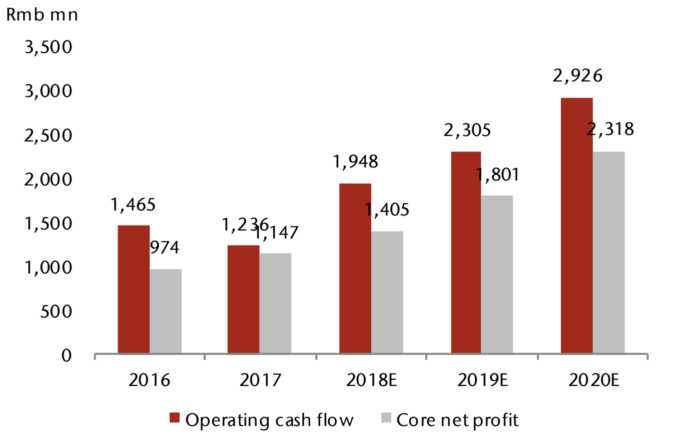
Source: Jefferies estimates, company data

Chart 70: To return to net cash position



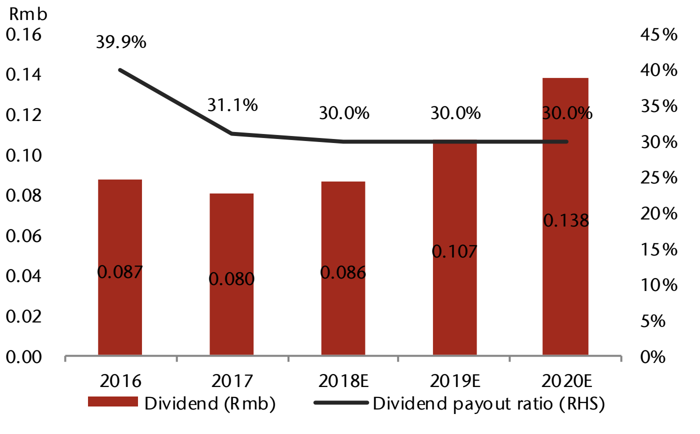
Source: Jefferies estimates, company data

Chart 71: Healthy financial position to be supported by strong operating cash flow



Source: Jefferies estimates, company data

Chart 72: Likely to maintain a dividend payout ratio of around 30% in the next three years



Source: Jefferies estimates, company data

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Valuation

With its long term strategic expansion plan, aggressive M&As and resource supports from parent company, we have no doubt that CTCM will remain as a significant presence in the TCM industry. Not only do we expect CTCM to remain as the market leader in CTCMG industry, it may also become one of the market leaders in decoction pieces industry following the ongoing industry consolidation opportunity. We see significant growth potential in CTCM's business and forecast core net profit CAGR of 26.4% in 2017-20E.

Given the Company's market leading position and strong growth potential, we believe the market has undervalued the Company. CTCM is only trading at 19E PER of 13.3x, which is significantly lower than peers' average of 16.8x. We initiate coverage on CTCM with BUY and TP of HK$7.0. We arrived at our TP with DCF model (WACC: 13.2%, terminal growth: 3.0%). Our TP implies 19E/20E PER of 17.4x/13.5x.

Table 18: DCF model of CTCM

	2019E	2020E	2021E	2022E	2023E
	Rmb mn	Rmb mn	Rmb mn	Rmb mn	Rmb mn
Net profit	1,801	2,318	2,998	3,789	4,674
Depreciation and amortization	594	657	697	737	779
Net interest after tax	91	70	55	41	38
CAPEX	(1,080)	(497)	(511)	(497)	(535)
Change in working capital	(435)	(436)	(738)	(822)	(884)
FCF	971	2,112	2,501	3,248	4,072
Terminal value					41,074
Corporate value	30,483				
Debt & Preferred Stock	6,092				
Bank deposit and pledged cash	7,052				
Equity Value	31,443				
Number of shares	5,039				
Value per share (Rmb)	6.24				
Value per share (HK$)	7.00				
Risk free rate	3.5%				
Beta	1.0				
Risk premium	10.6%				
Cost of equity	14.1%				
Cost of debt	6.0%				
WACC	13.2%				
Terminal growth rate	3.0%				

Source: Jefferies estimates, company data

Chart 73: Sensitivity analysis

Terminal growth / WACC	9.1%	9.6%	10.1%	13.2%	11.1%	11.6%	12.1%
1.5%	10.2	9.5	8.9	6.3	7.9	7.4	7.1
2.0%	10.8	10.0	9.3	6.5	8.2	7.8	7.3
2.5%	11.5	10.6	9.8	6.8	8.6	8.1	7.6
3.0%	12.3	11.3	10.4	7.0	9.0	8.5	8.0
3.5%	13.2	12.0	11.1	7.3	9.5	8.9	8.3
4.0%	14.3	13.0	11.8	7.6	10.1	9.4	8.7
4.5%	15.7	14.1	12.7	8.0	10.7	9.9	9.2

Source: Jefferies estimates

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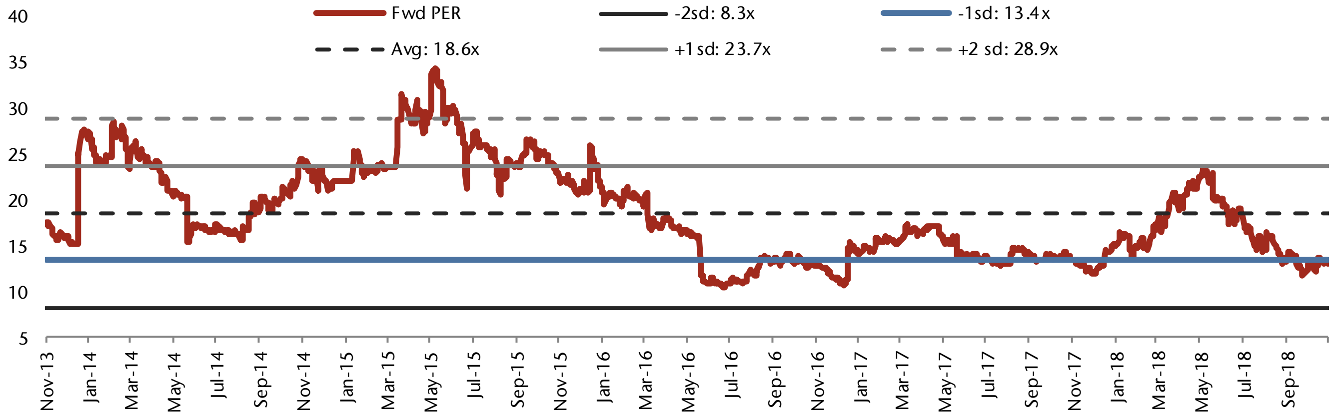
Chart 74: Rolling fwd PER band of CTCM



Source: Bloomberg, Jefferies estimates, company data

Investment risks

Significant fluctuation in medicinal herbal price

We believe CTCM has the bargaining power to pass on some cost increment to end users and the Company is working on increasing inventory level to mitigate the risk of volatility of medicinal herbal price. Until then, we believe a significant herbal price hike would still bring adverse impact to the margin performance of the Company.

More intense than expected market competition for CTCMG business

Although we do not expect significant number of new comers for the CTCMG business based on our analysis, existing players or the new comers may still use more aggressive expansion strategy in taking more market share from CTCM. It would be more difficult for CTCM to defend its market share if competitors become fiercer. The growth in revenue and profit will then be affected.

Unexpected removal of supportive policies for TCM

The fast growth of TCM industry was dependent on various supportive policies like price mark up, exclusion from hospital drugs sales ratio and inclusion in NRDL. Removal of any of these policies, or launching of new policies that hamper the growth of the industry would in turn negatively affecting the growth of the Company.

Larger than expected price pressure

As a relatively cheap form of medication, price of decoction pieces and CTCMG are unlikely targets for control. However, if intense price control policies are being implemented to the industry, the growth rate and profitability of CTCM would undoubtedly be affected.

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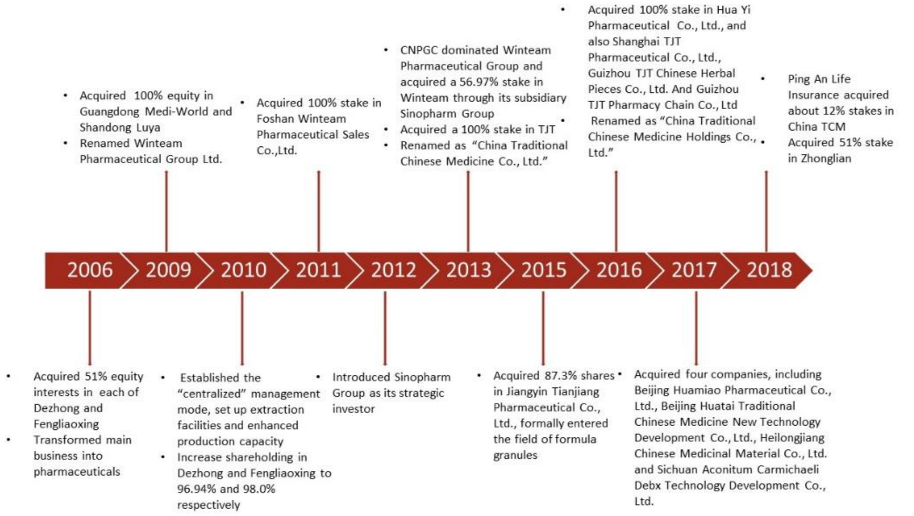
Company background

China Traditional Chinese Medicine Holdings Co., Ltd. (CTCM) is a leading Traditional Chinese Medicine (TCM) manufacturer and the core TCM platform of China National Pharmaceutical Group Corporation (CNPGC). The Company has a complete industry chain which integrates R&D, manufacturing and sales of TCM products. Through two major acquisitions of Guizhou Tongjitang Pharmaceutical and Jiangyin Tianjiang Pharmaceutical, CTCM has expanded its business to the whole TCM industry chain with TCM decoction pieces, concentrated TCM granules (CTCMG), finished drugs and healthcare services.

The Company offers more than 700 individual CTCMG products, over 60 classical formulated granule products, and 979 finished drugs. Two hundred eighty-two of 979 finished drugs are listed on 2017 National Drugs List for Basic Medical Insurance (NRDL), including 26 exclusive products, of which Xianling Gubao Capsules/Tablets, Yu Ping Feng Granules, Bi Yan Kang Tablets, Jingshu Granules, Moisturizing and Anti-Itching Capsules,Fengshi Gutong Capsules, Zaoren Anshen Capsules and Qili Capsules are exclusive products on the National Essential Drug List (EDL).

With GMP certified production lines, 48,000 tonnes of Chinese medicinal herbs can be processed and extracted annually. Annual production capacity is 14,300 tonnes of concentrated TCM granules, 40,000 tonnes of TCM decoction pieces, 10.2 billion packs of TCM finished granules, 5.65 billion tablets and 3.65 billion capsules.

Chart 75: CTCM development milestones



Source: Company Data

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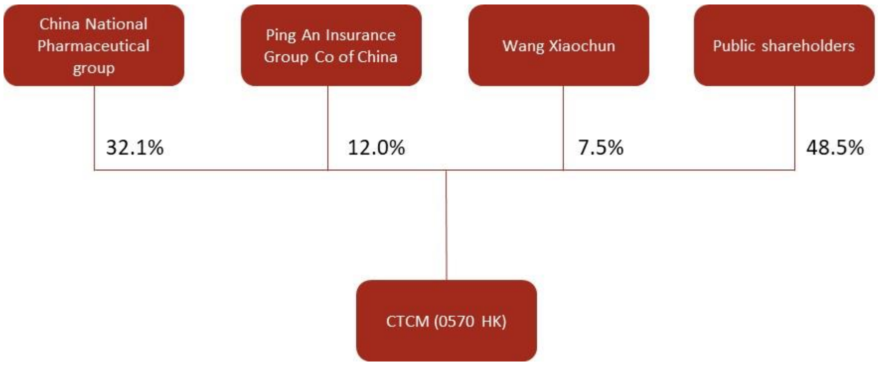
Chart 76: Shareholding structure



Source: HKEx

Table 19: Directors and key management of CTCM

Name	Title	Description
Wu Xian	Chairman and Executive Director	WU Xian, aged 51, is the Chairman of the Board with effect from 28 February 2013. Mr. WU graduated from Shanxi College of Finance and Economics with a bachelor's degree in economics in July 1985, and completed a master's course in business administration from Harbin University of Commerce in September 2002. Mr. WU has over 29 years of production and financial management experience in pharmaceutical and healthcare products industry. Mr. WU was previously the head of the planning and development department of Harbin Pharmaceutical Group Co., Ltd., deputy plant manager of Harbin Pharmaceutical Group Co., Ltd. General Pharm. Factory and deputy general manager of Harbin Pharmaceutical Group Bioengineering Co., Ltd. from November 1997 to June 2005. He was also the director and general manager of China National Medicines Guorui Pharmaceutical Co., Ltd. from July 2005 to August 2010. He has been the director, general manager and deputy secretary to the Party Committee of China National of Traditional & Herbal Medicine Co., Ltd. (formerly named as China National Corp. of Traditional & Herbal Medicine) since August 2010.
Wang Xiaochun	Executive Director	WANG Xiaochun, aged 50, was the chairman of the board of directors and the chief executive officer of Tongjitang Chinese Medicines Company, which was listed on the New York Stock Exchange in 2007 and subsequently privatised in 2011. He has been a director of Tongjitang Pharmaceutical (Hong Kong) Limited (a subsidiary of the Tongjitang Chinese Medicines Company) since 2008, a director of Unisources Enterprises Limited (a subsidiary of Tongjitang Chinese Medicines Company) since 2005 and the chairman of the board of directors and the president of Guizhou Tongjitang Pharmaceutical Co., Ltd. (a subsidiary of Tongjitang Chinese Medicines Company) since 1997. Mr. WANG received his bachelor's degree in law from the Southwest University of Political Science and Law in China in 1989.
Zhao Dongji	Deputy general manager and Executive Director	ZHAO Dongji, aged 50, has over 26 years of related working experience, including over 15 years of management experience in pharmaceutical and health products industry. Mr. ZHAO acted as the deputy head and head of Enterprise Management Department, head of Asset Management Department and Legal Department of Harbin Pharmaceutical Group Co., Ltd. from 2000 to 2011. He also acted as a director of Harbin Pharm Group Sanjing Pharmaceutical Shareholding Co., Ltd (a company listed on the SSE) from June 2004 to February 2011. Mr. ZHAO has served as the manager of Investment Management Department of China National Traditional Chinese Medicine Corporation (formerly named as China National Corp. of Traditional & Herbal Medicine) since 2011.
Huang He	Operation director and human resources manager	HUANG He, aged 39, graduated from Renmin University of China with a bachelor degree in International Accounting in July 2001 and a master degree in Accounting in July 2004. Ms. HUANG is an auditor and a senior human resources officer. She was the accountant of the finance department, the vice manager of the operation and audit department and the manager of the strategic planning department of Traditional & Herbal Medicine Company from July 2004 to December 2007; the manager of the audit department, the employee supervisor of the board of supervisors and the manager of the human resources department of China National Corporation of Traditional and Herbal Medicine from January 2008 to December 2013; the director of human resources and the manager of the human resources department of China National Traditional Chinese Medicine Corporation from January 2014 to January 2015.
ZHANG Qingsheng	Vice President	ZHANG Qingsheng, aged 57, was appointed as a vice president of the Company in July 2013, and the party secretary of the Company in October 2013 respectively. Mr. ZHANG has over 30 years of working experience, and he currently takes charge of the party committee, human resources and assist the Managing Director on investing activities management. Mr. ZHANG has served as several positions including vice president, director, chairman of the labor union and secretary of the board of directors of China National Corp. of Traditional & Herbal Medicines (currently known as China National Traditional Chinese Medicine Corporation) from 2005 to 2013.

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Table 19: Directors and key management of CTCM

Name	Title	Description
HUANG Zhangxin	Vice President	HUANG Zhangxin, aged 49, was appointed as a vice president of the Company in November 2013, in charge of work relating to the production and R&D of the products. Mr. HUANG has engaged in management of drug research and development, manufacturing and sales business for over 20 years. He served as director of Research and Development, assistant to general manager and deputy general manager of Winteam Pharmaceutical Group Limited; deputy general manager of Guangdong Medi-World Pharmaceutical Co., Ltd., and deputy general manager of Shunde Nanfang Bio-Pharmaceutical Co., Ltd. Mr. HUANG obtained the qualification of pharmaceutical engineer, and was awarded as Foshan City Advanced Innovation Character third prize and Shunde Technology Progress second prize.
SITU Min	Chief Financial Officer	SITU Min, aged 48, was appointed as the Director of Investment of the Company in October 2013 and has served as acting Chief Financial Officer of the Company since April 2016. Mr. SITU previously served in the Board of Wing Shan International Limited and Winteam Pharmaceutical Group Limited from September 2001 to February 2013. He is a fellow member of the Association of Chartered Certified Accountants and is also a member of Chinese Institute of Certified Public Accountants. Mr. SITU has extensive experience in financial management, and corporate finance and acquisitions.

Source: Company Data

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Financial statements

Table 20: Income statement

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	**6,533**	**8,338**	**11,092**	**13,503**	**16,554**
CTCMG	4,359	5,500	6,990	8,872	11,391
Finished drugs	2,061	2,381	2,741	3,073	3,391
Decoction pieces	104	399	1,311	1,504	1,714
Healthcare complex	9	58	51	55	59
Cost of sales	(2,745)	(3,686)	(5,142)	(6,238)	(7,611)
Gross profit	**3,788**	**4,652**	**5,950**	**7,266**	**8,944**
Other income and gains	68	64	76	86	96
Distribution expenses	(1,968)	(2,437)	(3,259)	(3,947)	(4,780)
Administrative expenses	(330)	(349)	(467)	(566)	(685)
R&D expenses	(187)	(202)	(277)	(338)	(414)
Operating profit	**1,370**	**1,727**	**2,023**	**2,501**	**3,161**
Share of profit of associate / JV	0	2	2	2	2
Finance income / (expenses)	(59)	(189)	(157)	(111)	(85)
Exceptional	(8)	27	0	0	0
Pre-tax profit	**1,304**	**1,567**	**1,868**	**2,392**	**3,078**
Profits tax	(217)	(256)	(277)	(354)	(456)
Minority interest	(120)	(141)	(186)	(237)	(304)
Net profit	**967**	**1,170**	**1,405**	**1,801**	**2,318**
Core net profit	**974**	**1,147**	**1,405**	**1,801**	**2,318**
EBITDA	**1,705**	**2,150**	**2,532**	**3,095**	**3,818**
EPS (Rmb)	0.22	0.26	0.29	0.36	0.46
Core EPS (Rmb)	**0.22**	**0.26**	**0.29**	**0.36**	**0.46**
DPS (Rmb)	0.09	0.08	0.09	0.11	0.14
BVPS (Rmb)	2.30	2.47	3.09	3.34	3.67

Source: Jefferies estimates, company data

Table 21: Balance sheet

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
Non-current assets	**12,966**	**13,501**	**14,562**	**15,050**	**14,892**
Fixed asset	2,021	2,394	3,627	4,289	4,304
Prepaid lease payments	334	346	340	334	328
Goodwill	3,456	3,486	3,486	3,486	3,486
Intangible assets	6,764	6,704	6,535	6,366	6,198
Other non-current assets	390	571	573	575	577
Current assets	**8,070**	**11,384**	**15,498**	**16,751**	**19,469**
Cash	2,147	4,530	7,052	6,899	7,987
Trades, bills & other receivables	2,716	3,024	3,930	4,536	5,179
Inventories	1,894	3,552	4,238	5,038	6,025
Other current assets	1,313	278	278	278	278
Current liabilities	**3,507**	**4,695**	**6,308**	**9,042**	**9,919**
Borrowings	1,001	639	966	2,729	2,413
Trades, bills & other payables	2,304	3,857	5,142	6,113	7,306
Other current liabilities	202	200	200	200	200
Non-current liabilities	**4,774**	**6,375**	**6,347**	**3,857**	**3,613**
Borrowings	2,909	4,515	4,487	1,996	1,753
Other non-current liabilities	1,866	1,860	1,860	1,860	1,860
Total net assets	**12,756**	**13,815**	**17,405**	**18,903**	**20,829**
Minority interest	**1,168**	**1,378**	**1,816**	**2,053**	**2,357**
Shareholders' equity	**11,588**	**12,437**	**15,589**	**16,850**	**18,472**

Source: Jefferies estimates, company data

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Table 22: Cash flow summary

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
EBIT	**1,370**	**1,727**	**2,023**	**2,501**	**3,161**
Depreciation and amortization	334	423	508	594	657
Change in working capital	(47)	(574)	(307)	(435)	(436)
Income tax paid	(204)	(293)	(277)	(354)	(456)
Others	11	(48)	-	-	-
Net cash from operating activities	**1,465**	**1,236**	**1,948**	**2,305**	**2,926**
Capex	(2,602)	(735)	(1,054)	(1,080)	(497)
Acquisition of subsidiaries	-	-	-	-	-
Others	101	1,128	(196)	62	68
Net cash from investing activities	**(2,500)**	**393**	**(1,250)**	**(1,018)**	**(429)**
Change of debts	1,821	1,193	299	(727)	(560)
Issuance of new shares	(162)	80	2,168	-	-
Dividend paid	(245)	(338)	(422)	(540)	(695)
Others	(285)	(150)	(222)	(173)	(153)
Net cash from financing activities	**1,128**	**786**	**1,823**	**(1,440)**	**(1,408)**
Net change in cash	**92**	**2,414**	**2,521**	**(153)**	**1,088**
Cash at the beginning of the year	2,102	2,147	4,530	7,052	6,899
Exchange difference	(47)	(31)	-	-	-
Cash at the end of the year	**2,147**	**4,530**	**7,052**	**6,899**	**7,987**

Source: Jefferies estimates, company data

Table 23: Key ratios

YE Dec 31	FY16A	FY17A	FY18E	FY19E	FY20E
Sales mix (%)					
CTCMG	*66.7*	*66.0*	63.0	65.7	68.8
Finished drugs	*31.6*	*28.6*	24.7	22.8	20.5
Decoction pieces	*1.6*	*4.8*	11.8	11.1	10.4
Healthcare complex	*0.1*	*0.7*	0.5	0.4	0.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Profit & loss ratios (%)					
Gross margin	58.0	55.8	53.6	53.8	54.0
EBITDA margin	26.1	25.8	22.8	22.9	23.1
Net margin	14.8	14.0	12.7	13.3	14.0
Core net margin	14.9	13.8	12.7	13.3	14.0
Effective tax rate	16.7	16.3	14.8	14.8	14.8
Growth (%)					
Revenue	*76.1*	*27.6*	33.0	21.7	22.6
CTCMG	345.3	26.2	27.1	26.9	28.4
Finished drugs	*N/A*	*283.0*	228.8	14.7	14.0
Decoction pieces	*(24.5)*	*15.5*	15.1	12.1	10.3
Healthcare complex	*N/A*	*555.5*	(13.1)	8.0	8.0
Gross profit	72.1	22.8	27.9	22.1	23.1
EBITDA	110.6	26.1	17.7	22.3	23.3
Operating profit	110.1	26.0	17.2	23.6	26.4
Net profit	54.6	21.0	20.0	28.2	28.7
Core net profit	81.7	17.8	22.5	28.2	28.7
Balance sheet ratios					
Current ratio (x)	2.3	2.4	2.5	1.9	2.0
Trade receivables turnover days	166	121	109	111	105
Trade payables turnover days	90	130	136	128	121
Inventory turnover days	208	270	276	271	265
Net debt to total equity ratio (%)	13.8	4.5	Net cash	Net cash	Net cash
Returns (%)					
ROE	8.3	9.4	9.0	10.7	12.5
ROA	4.6	4.7	4.7	5.7	6.7

Source: Jefferies estimates, company data

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Shineway (2877 HK)

Begin again

BUY

Price target	**HK$13.30**
Price	**HK$10.00**

Bloomberg:	**2877 HK**
Reuters:	**2877.HK**

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Table 24: Financial summary

Rmb	2016A	2017A	2018E	2019E	2020E
Revenue (mm)	1,993	1,920	2,610	3,139	3,622
Change (% YoY)	-3.0%	-3.7%	36.0%	20.2%	15.4%
Core net profit (mm)	582	453	557	685	802
Change (% YoY)	-11.0%	-22.1%	22.8%	23.1%	17.1%
Core EPS	0.70	0.55	0.67	0.83	0.97
Change (% YoY)	-11.0%	-22.1%	22.8%	23.1%	17.1%
BV/share	6.80	7.04	7.39	7.92	8.51
Net debt (mm)	(3,218)	(3,532)	(3,636)	(3,984)	(4,408)
ROE (%)	10.5%	7.8%	9.1%	10.5%	11.4%
PER (x)	12.7	16.3	13.2	10.7	9.2
PBR (x)	1.3	1.3	1.2	1.1	1.0

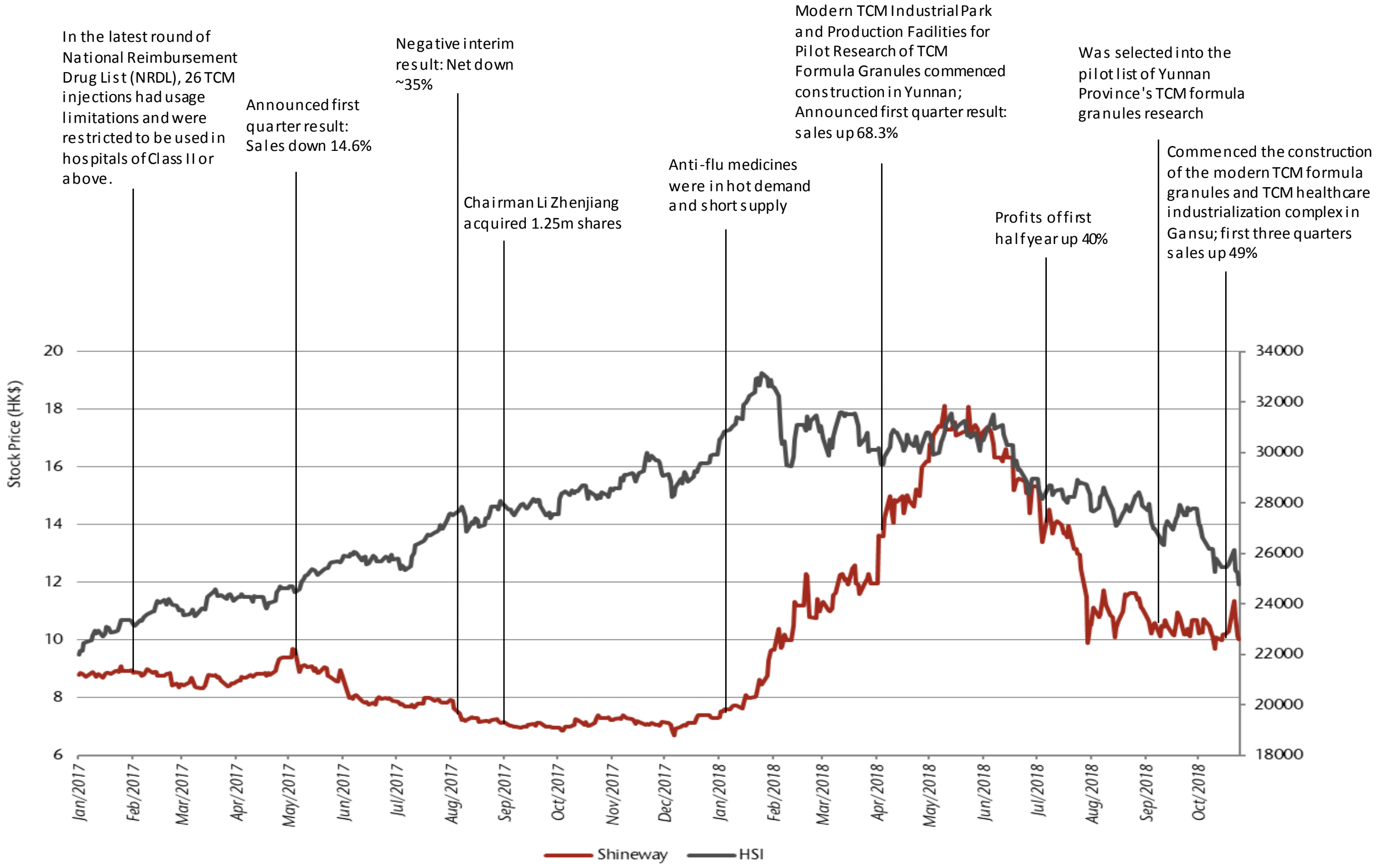
Source: Jefferies estimates, company data

Table 25: Market data

52 Week Range	HK$18.25-HK$6.57
Total Entprs. Value	HK$4.8B
Market Cap.	HK$8.4B
Share Out. (MM)	827
Float (MM)	277.5
Avg. Daily Vol.	1,348,217

Source: Jefferies

Chart 77: Share price performance and major events for Shineway



Source: Jefferies, company data

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Shineway (2877 HK) – Begin again

Leading CTCMG player in Hebei Province

A challenger for CTCMG industry

Shineway is one of the only few new comers to the CTCMG industry. The Company started selling CTCMG in Hebei Province in 2014 and it is the only brand that is being included in the Drug Reimbursement List of Hebei Province. Due to its strong presence and exclusive medical insurance coverage in the province, we believe Shineway is the largest CTCMG player within the province. The business delivered promising growth potential and revenue CAGR of 113.4% in 15-17. With the plan in expanding into other provinces, we believe its strong growth to continue and to have a CAGR of 72.0% in 17-20E.

Promising rebound trend shown by the TCM finished drug business

Reached the end of tunnel for finished drugs business

Core business of Shineway, TCM injections, soft capsules and granules, have been severely hit by policies like usage restriction in NRDL and control on hospital drugs sales ratio. Coupled with internal sales team restructuring, revenue of core business has been dropping for three consecutive years. We believe the business has already reached the trough and with the completion sales team restructure, new product inclusion into the NRDL and EDL, the core business would be able to deliver growth again. We are expecting revenue CAGR in high teens region for the three segments in 17-20E.

To benefit from industry consolidation trend with leading quality standards

Benefiting from industry consolidation with proven efficacy and high quality standard

We believe the restrictive policies aims to promote reasonable usage of TCM, improve standards and eliminate redundant capacities. With quality standard recognized by the government and also evidence based studies on key products, Shineway should benefit from the industry consolidation trend.

We expect core net profit CAGR of 21.0% in 17-20E

With the improvement in core business and robust growth from CTCMG business, we expect Shineway to return to growth in 2018. We forecast core net profit CAGR of 21.0% and revenue CAGR of 23.6% in 17-20E. We expect a largely stable gross margin for the products in the next three years but a slight drop in operating margin due to the expected increase in R&D expenses ahead. Core net margin would drop from 23.6% in 17 to 21.3% in 18E and then improve gradually to 22.2% in 20E.

Valuation

Coupled with strong growth and expansion potential in CTCMG business and new product inclusion into the NRDL and EDL, Shineway would be able to deliver growth again after three years of business contraction. Shineway is currently trading at 2019E/20E PER of 10.7x/9.2x and we believe the market has been overly pessimistic towards the outlook of injection business. We initiate coverage on Shineway with BUY and TP or HK$13.3 based on our DCF model (WACC: 14.1%, terminal growth: 2.0%). Our TP implies 2019E/20E PER of 14.2x/12.1x.

Investment risks

(1) Failing in opening new markets for CTCMG business

(2) More stringent control on the usage of TCM injections

(3) Slower than expected ramp up of new products in NRDL

(4) Fluctuation in raw material price

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Challenger for CTCMG industry

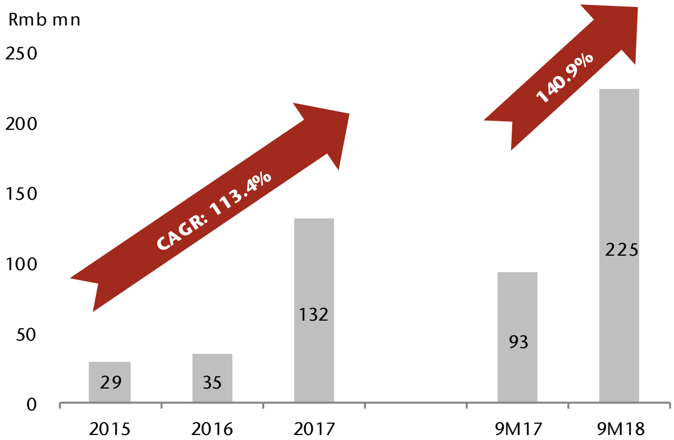
Started selling CTCMG in Hebei Province since 2014

Shineway started selling CTCMG in Hebei Province since 2014 and it is the only CTCMG brand that is exclusively included in the Drugs Reimbursement List of Hebei Province. It currently manufactures more than 600 types of CTCMG and the Company has covered 137, or over 70% of hospitals in Hebei Province. A total of 163 units of smart medicine dispensing systems of the Company were installed in these hospitals, with one to two units in each hospital on average and in general, an average of four to eight units were installed in Class III hospitals.

Has developed into the market leader in Hebei Province

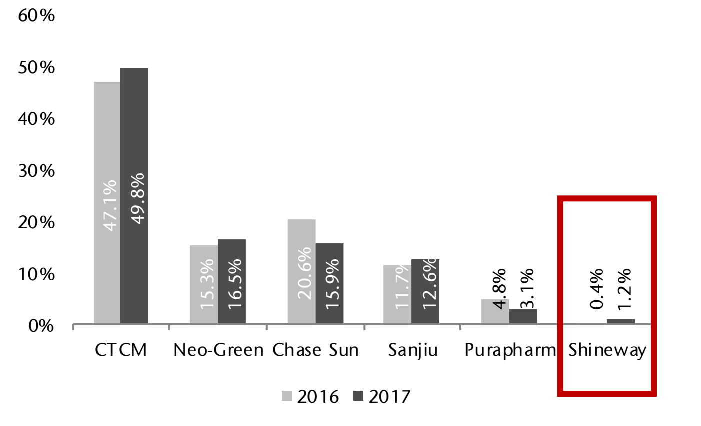
Since its launch by the end of 2014, the product has shown promising growth potential and delivered revenue CAGR of 113.4% in 15-17. Due to its strong presence and exclusive medical insurance coverage in the province, we believe Shineway is the largest CTCMG player within the province. With the strong presence, Shineway became the most significant player after the six official licensees, with 1.2% market share in CTCMG industry in 2017, up from just 0.4% in 2016.

Chart 78: CTCMG delivered strong growth since its launch in 2014



Source: Jefferies estimates, company data

Chart 79: Shineway has become the largest player after the six licensees, and is catching up fast



Source: Jefferies estimates, company data

Significant potential from new market entrances

Expanding into Yunnan and Gansu by construction of new facilities in these provinces

Shineway has a revenue of over Rmb200mn in 9M18 and with a market share of 1.2% by only selling CTCMG in Hebei province alone. We see significant growth potential for the Company on expanding into other provinces. The Company has started construction of new facilities in Yunnan and Gansu for expanding its CTCMG network into these two provinces. Unlike other established players, we believe every single new province processes significant growth potential due to its current small size.

The Company has started the construction of a modern TCM Industrial Park in Yunnan, which consists of production facilities for pilot research of CTCMG, Jing Jin Ji Lian Chuang Medicine Research Institute, R&D and production projects of modern TCM drugs. It is expected that the production facilities will commence operation in October 2018.

Besides Yunnan, the Company has also started construction of CTCMG and TCM healthcare industrialization complex in Gansu Province. The complex will utilize advanced intelligent integrated green technologies in TCM extraction and production primarily to manufacture TCM formula granules and other healthcare products.

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Shineway was selected into the pilot list of Yunnan Province's TCM formula granules research Yunnan Shineway Spirin Pharmaceutical, a wholly-owned subsidiary of Shineway, was selected into the pilot list of Yunnan Province's TCM formula granules research, and received financial support from Yunnan Provincial Project Fund. Shineway's production facilities in the Chuxiong Prefecture of Yunnan Province is also expected to be completed by October this year to add another 1 billion bags (grams) of TCM formula granules capacity. These latest developments signify that Shineway's venturing into the Yunnan Province's TCM formula granules market has officially commenced.

High quality standard for high quality products

High quality standard from technical-know-how and experience from core injection business

The core business of Shineway is on TCM injection products, which requires the highest manufacturing and quality standard for modern TCM. The Company is applying its quality control philosophy from manufacturing of TCM injections, to the R&D and production processes of CTCMG products. Leveraging state-of-the-art production techniques, the Company ensures a consistent material basis of CTCMG. Meanwhile, the Company also joins hands with colleges and universities, scientific research institutions and clinical hospitals in exploring basic pharmacodynamics and clinical application of CTCMG. We believe this high-quality standard is one of the main reasons for the Company to stand out from other follow-up manufacturers after the first six licensees.

Shineway's modern TCM extraction workshop is a national high-tech industrialization demonstration project of the largest production scale and the highest technical standard nationwide. The Company owns the only full-course automatically controlled production line for TCM extraction which uses unique pre-processing technologies for Chinese herbal pieces to guarantee stable product quality across different batches of CTCMG. Meanwhile, the Company adopts fine granules (smaller in size compared to granules) as CTCMG, which secures faster dissolution that comes to resemble decoction absorption. The Company applies international leading techniques such as TCM fingerprint, near-infrared online monitoring, dynamic countercurrent extraction, fully dynamic refluxing extraction, supercritical fluid extraction (SFE), to CTCMG production. As a result, Shineways's CTCMG can retain the performance of the original Chinese herbal pieces in terms of effective constituents, correlation between properties, tastes and meridian entries, indications and the efficacy, and stay safe, efficacious, stable and under control for every batch of the same kind of CTCMG.

Shineway is also actively involved in formulating the national standards of CTCMG

At present, Shineway is actively involved in formulating the national standards of CTCMG to drive its standardization. Furthermore, the "Hebei Province Chinese Medicine Prescription Granules Engineering Technology Research Centre" jointly established by Shineway and Hebei University of Chinese Medicine also serves as cornerstone for innovative research and quality assurance on CTCMG.

Aggressive expansion plan to cater growth potential

Shineway has doubled its production capacity for CTCMG from 300 tonnes to 600 tonnes in Hebei province by the end of 2017. The Company has further expanded its capacity to 2,000 tonnes in Aug 2018. In addition to the 1,000 tonnes capacity in Yunnan province, we expect Shineway to have a capacity of 3,000 tonnes for CTCMG by the end of 2018. In addition to the 1,000 tonnes capacity being constructed in Gansu province, the total capacity of Shineway is expected to reach 4,000 tonnes in 2020. Shineway will become one of the largest manufacturers in terms of capacity and well positioned to unleash the growth potential of CTCMG industry.

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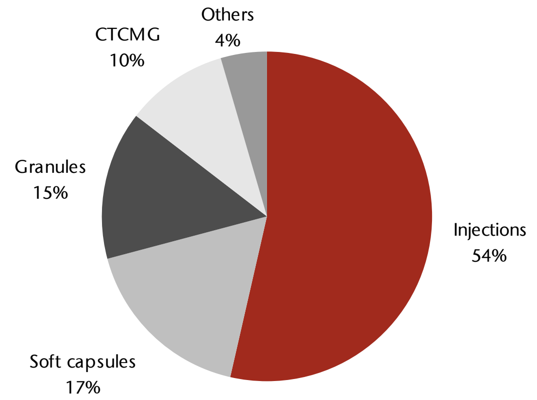
Finished drugs: returning to growth

Shineway's TCM finished drug business has been the core part of the Company and can be classified according to their dosage form: (1) injections, (2) soft capsules, and (3) granules. Injection products are the largest part of the Company and they accounted for 54% of total revenue in 1H18, followed by 17% of soft capsules and 15% of granules. TCM finished drugs together accounted for 86% of total revenue in 1H18.

Finished drugs showed signs of recovery after dropping for 3 consecutive years

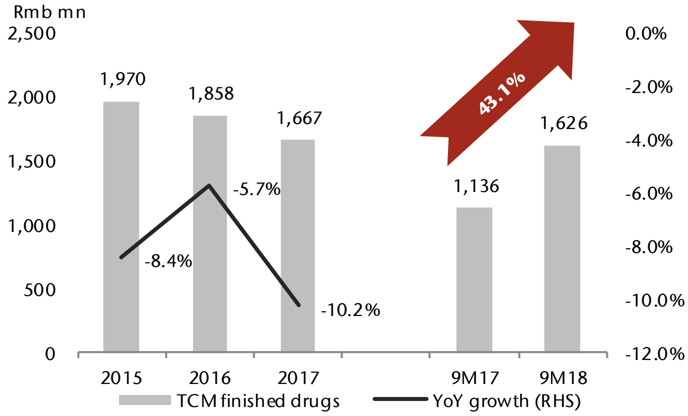
As affected by adverse policy environment and internal sales team restructuring, revenue of TCM finished drugs has dropped for three consecutive years since 2015. However, with the completion of sales team restructuring, strong growth of exclusive products and industry consolidation, the business segment has shown strong rebound trend in 9M18. TCM finished drugs revenue grew 43.1% YoY in 9M18. We believe Shineway's finished drug business has finally reached the end of tunnel and should be able to return to growth in the next three years.

Chart 80: TCM finished drugs accounted for 86% of revenue in 1H18



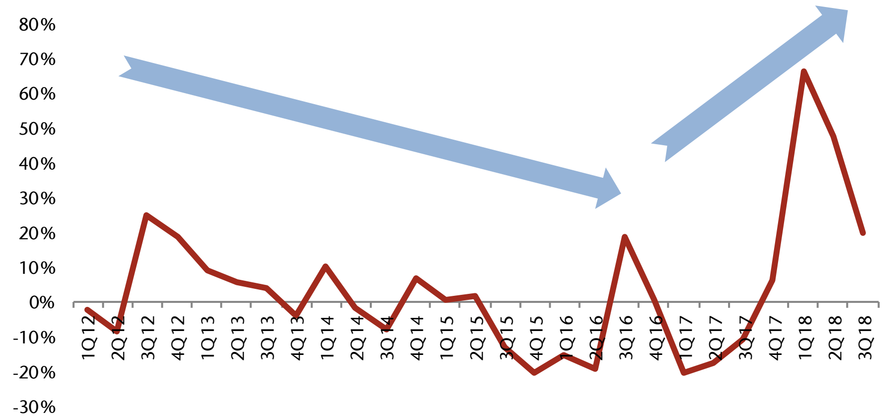
Source: Jefferies, company data

Chart 81: TCM finished drugs shown strong rebound trend since 2018



Source: Jefferies, company data

Chart 82: Core business reached the trough in 1Q17, and maintained growth trend for 4 consecutive quarters since 4Q17, the first time since 2013



Source: Jefferies, company data

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Table 26: Major products of Shineway

Drug		Indication	EDL	NRDL	2017 revenue contribution
Injections					
Qing Kai Ling Injection	清开灵注射液	For treatment of viral diseases, including respiratory tract infection, viral hepatitis, cerebral haemorrhage and cerebral thrombosis.	✓	Cat A	16.5%
Shu Xie Ning Injection	舒血宁注射液	For cardiac-cerebral vascular diseases due to blood deficiency, coronary heart disease, angina pectoris, cerebral embolism and cerebral vascular convulsion, etc.	×	×	15.5%
Shen Mai Injection	参麦注射液	For treatment of coronary heart disease, viral myocarditis and pulmonaryheart disease.	✓	Cat A	9.9%
Soft capsules					
Wu Fu Xin Nao Qing Soft Capsule	五福心脑清软胶囊	For prevention and treatment of coronary heart disease and cerebral arteriosclerosis.	×	×	9.3%
Huo Xiang Zheng Qi Soft Capsule	藿香正气软胶囊	For prevention and treatment of heat stroke, stomach-ache, nausea and diarrhea, acclimatization sickness.	✓	Cat B	4.5%
Qing Kai Ling Soft Capsule	清开灵软胶囊	For treatment of high fever, viral influenza and respiratory tract infections.	✓	Cat B	1.4%
Dan Deng Tong Nao (Hard and Soft) Capsule	丹灯通脑胶囊和软胶囊	For treatment of stroke caused by congestion, appropriate for treatment and recovery of ischemic infarction.	×	×	0.8%
Granules					
Pediatric Qing Fei Hua Tan Granule	小儿清肺化痰颗粒	For children infected by respiratory tract infections.	×	×	4.3%
Huamoyan Granule	滑膜炎颗粒	For treatment of both acute and chronic synovitis and treatment after joints surgeries.	✓	Cat B	3.1%
Others					
Compound Liquorice Tablet	复方甘草片	For antitussive and expectorant.	✓	×	1.7%

Source: Jefferies, company data

Injections: affordable to patients even without insurance coverage

The new NRDL issued in 1Q17 restricted the use of 26 kinds of TCM injections in Class II or above hospitals for stated therapeutic purposes so as to be eligible for reimbursement. Shineway's core products, Qing Kai Ling injection, Shen Mai injection and Shu Xie Ning injection was also included in the restriction, and as a result, growth of Shineway's injection products were severely hit in 1H17 due mainly to channel destocking. However, TCM injection products rebounded since 2H17 and maintained strong growth since then. We believe (1) some demands had been shifted to class III and II hospitals, (2) TCM injections are low price items and patients can afford without medical insurance.

Table 27: Low pricing for Shineway's injection products

Product	Dosage per treatment	ASP	Cost per treatment (Rmb)
Qing Kai Ling	20-40ml	Rmb1/10ml	2-4
Shen Mai	20-100ml	Rmb12.5/20ml	12.5-62.5
Shu Xie Ning	20ml	Rmb14/5ml	56

Source: db.yaozh.com, Jefferies, company data

Overall injections revenue dropped 11.5% YoY in 2017, with revenue from grass root institutions dropped 27% YoY. On the other hand, revenue from Class III and II hospitals increased 6.2% and 13.3%, respectively. As a result, revenue from class III and II hospitals increased from 40% in 2016 to 50% in 2017. Nevertheless, we believe the weak performance from grass-root institutions was mainly due to channel destocking due to uncertainties in operating environment in 2017. 1H18 injections from grass root institutions surged 78.6% YoY. We view this as a restocking rebound in grass root institutions. As a whole, we believe TCM injections can maintain a reasonable growth in coming years.

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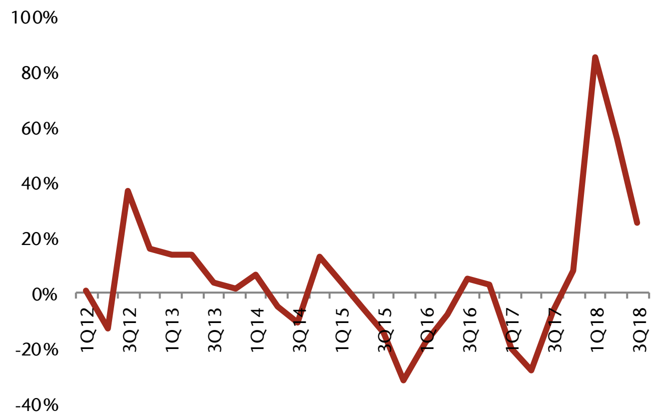
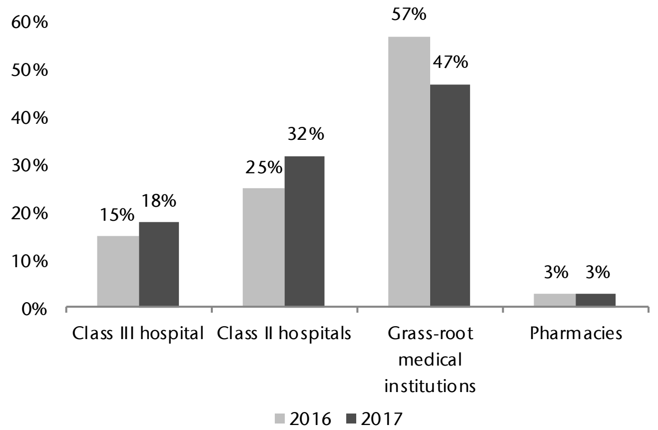
Chart 83: Growth of injections rebounded since 2H17



Source: Jefferies estimates, company data

Chart 84: Significant portion of sales went from grass root institutions to Class III and II hospitals



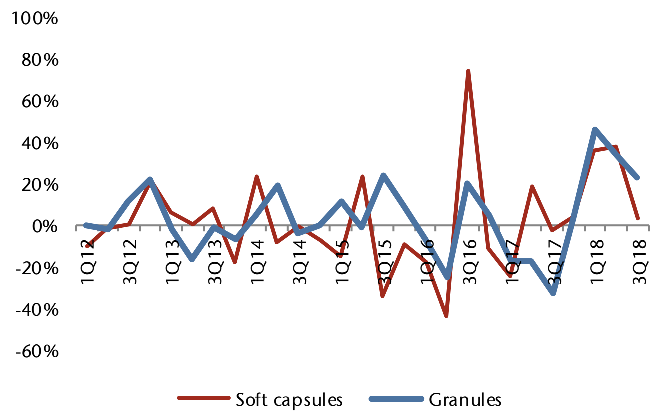
Source: Jefferies estimates, company data

Soft capsules and granules: unleashing potential after sales channel restructuring

Revenue rebounded after sales channel restructuring in 2H17

The Company completed sales channel restructuring and retail price adjustments for various soft capsules and granules in 2017. The consolidation of sales channels and retail pharmacies led to a decline in revenue in 2017. However, with the completion of sales channel restructuring, revenue growth rebounded since 2H17. We believe driven by (1) expansion of distribution channel, (2) rationalizing retail selling prices, and (3) inclusion of key production into NRDL and EDL, soft capsule and granule products would be able to deliver stronger than industry growth in coming years.

Chart 85: Soft capsules and granules returned to growth since 2H17



Source: Jefferies, company data

Chart 86: Rapid sales growth from pharmacy chain stores

Source: Jefferies, company data

Sales channel expansion

The Company continued to expand its sales coverage to more pharmacy chain stores. The Company has been entering long-term strategic alliance with several national pharmacy chains. As of the end of June 2018, the Company covered around 150,000 retail pharmacies, of which 100,000 are pharmacy chain stores and 50,000 are single store pharmacies. The number increased by 10,000 and 5,000, respectively, since the beginning of 2017.

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Increasing penetration into lower tier hospitals

Expanding hospital coverage

Expanded hospital coverage energizes exclusive orally taken products The Group is actively deploying more resources on exclusive orally taken products at hospital terminals. Through more academic promotion and evidence-based researches, hospital sales team is set to leverage on urban Class III hospitals as the academic benchmark to promote the exclusive orally taken products, including Huamoyan Granule, Qing Kai Ling Soft Capsule, Shujin Tongluo Granule, Jiangzhi Tongluo Soft Capsule and Dan Deng Tong Nao Capsule to public hospitals at county levels and urban Class II hospitals. It is the Company's target that these 10 exclusive orally taken products will be sold in 1,368 hospitals in the year of 2018.

Retail price rationalization

Besides sales channel expansion, the Company has also rationalized the retail selling prices of various products. By maintaining uniform and steady retail prices, pharmacies' profitability and incentives in selling Shineway's products are enhanced.

New momentum: exclusive dosage form included in NRDL and EDL

In the latest NRDL and EDL, two of Shineway's exclusive dosage forms, Qing Kai Ling soft capsule and Huamoyan granule, have been included. Being included in the EDL means the drugs are able to satisfy the priority healthcare need of the population and people should have access at all times in sufficient amounts. The two products being selected not only proved their quality standards, we believe they can also enjoy significant volume boost in the next three years. Though they are still small now, we believe they can still add additional growth momentum to the Company.

Chart 87: Qing Kai Ling soft capsule

Source: Company Data

Chart 88: Huamoyan granule

Source: Company Data

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Evidence based studies to prove the efficacy of TCM finished drugs

Large scale evidence based studies to support the efficacy of products

Shineway positively undertakes the basic research for the medicinal materials and the re-evaluation work for the safety of the Chinese medicine injection to further strengthen the safety of the Chinese medicine injection and the controllability on its quality. Long before the re-evaluation of injection products requested by the State Council, Shineway has already taken the lead by corroborating with Tsinghua University to carry out researches on the substance base and re-evaluation on the safety of TCM injections. Currently, the work on substance base and quality assurance standards of all Shineway's TCM injection products have been completed. In addition, the three major TCM injections, Qing Kai Ling Injection, Shen Mai Injection and Shu Xie Ning Injection, have each completed 30,000 cases of evidence based clinical studies on their safety.

Table 28: Evidence based studies proving the standard of Shineway's products

Products	Name of clinical research projects	Initiated hospital	Progress
Qing Kai Ling injection	Post market safety evaluation of Qing Kai Ling injection (30,000 participants)	Research Institute of Basic Clinical Medicine, China Academy of Chinese Medical Sciences	Completed
Shen Mai injection	Post market safety evaluation of Shen Mai injection (30,000 participants)	Guangdong TCM Hospital	Completed
Shu Xie Ning injection	Post market safety evaluation of Shu Xie Ning injection (30,000 participants)	Beijing University of Chinese Medicine Dongfang College, Shanghai Renji Hospital, The First Hospital of Shanxi Medical University, The Second Hospital of Hebei Medical University	Completed
Yiqitongluo granule	Safety and efficacy evaluation of Yiqitongluo granule (2,400 participants)	The First Hospital of Jilin University	Completed
Huamoyan granule	Efficacy evaluation of Huamoyan granule on the treatment of osteoarthritis (480 participants)	The Third Hospital of Hebei Medical University, Hebei General Hospital	Expected to be completed in October 2018

Source: Jefferies, company data

High quality standard

With leading quality standard in TCM injections and finished drugs

Shineway was rated as the National technological Innovation Demonstration Enterprise and National Demonstration Enterprise on the Integration of Information Technology and Industrialization, and also included in the first batch of the National Intellectual Property Superior Enterprises. Shineway was also approved by the National Development and Reform Commission as the National and Local United Engineering Laboratory for the Development Technology of the New Chinese Medicine injection (中药注射剂新药开发技术国家地方联合工程实验室). Shineway was awarded the Second Prize of the National Science and Technology Advancement Award (国家科技进步二等奖) in the comprehensive quality control system for traditional Chinese medicine injections and its application in Qing Kai Ling, Shu Xie Ning and Shen Mai Injections (中药注射济全面质量控制及在清开、舒血宁、参麦注射液中的应用).

We believe these awards and recognitions received by Shineway from the government are evidence that the products of Shineway is safe and of higher quality over competitors. Under the adverse market environment, we believe the Company can expand its share through its recognized quality products.

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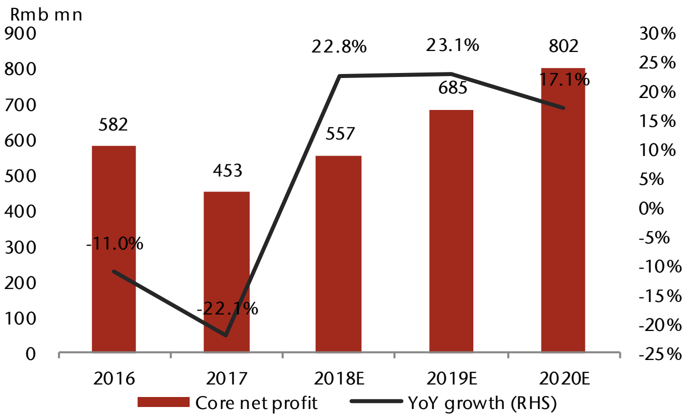
Financials

Returning to growth in 18E

We expect core net profit CAGR of 21.0% in 17-20E

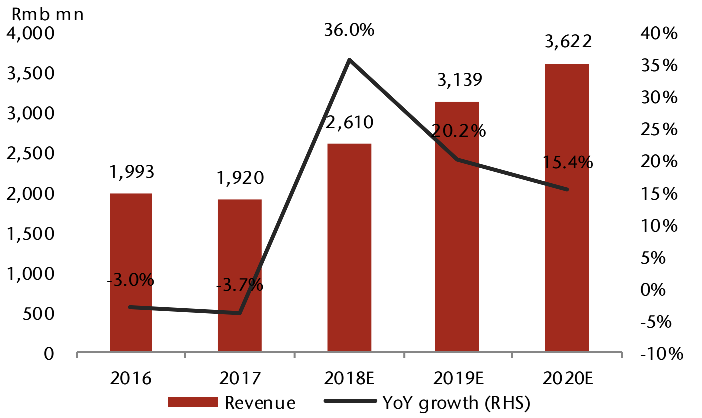
With the rebound of core TCM finished drugs business and strong growth of CTCMG business, we believe core net profit of Shineway can return to growth in 2018 after dropping for three consecutive years. We forecast core net profit to grow 22.8%/23.1%/17.1% YoY in 18E/19E/20E, respectively, supported by revenue growth of 36.0%/20.2%/15.4% within the periods. We expect gross margin improvement with the faster growth of high margin CTCMG products in the next three years. Besides, we are also expecting operating efficiency improvement and as a result, gradual core net margin improvement in the next three years.

Chart 89: Core net profit to deliver CAGR of 21.0% in 17-20E...



Source: Jefferies estimates, company data

Chart 90: ... to be supported by 23.6% revenue CAGR within the same period



Source: Jefferies estimates, company data

Revenue growth to be supported by CTCMG and rebound of core products

CTCMG the fastest growing segment; Core products to deliver high teens growth

After three years of industry consolidation and adverse operating environment, we believe core TCM finished products will return to growth in 2018 and to deliver revenue CAGR of 18.9% in 17-20E. Meanwhile, the new business, CTCMG, will continue to be the fastest growing business of Shineway, delivering CAGR of 72.0% within the same period. As such, CTCMG will become a more significant part of Shineway, contributing 18.6% of total revenue in 20E, up from just 6.9% in 2017. Injections will continue to be the largest business but contribution will drop from 51.2% in 2017 to 46.2% in 20E.

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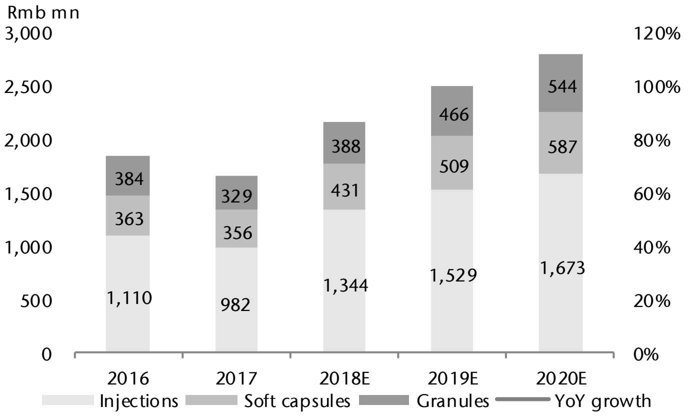
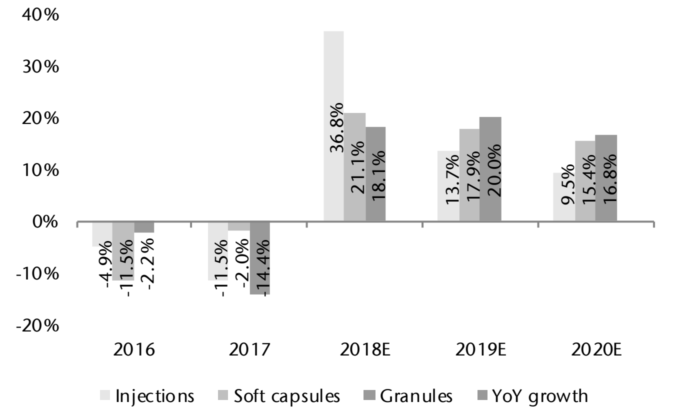
Chart 91: Revenue breakdown of Shineway



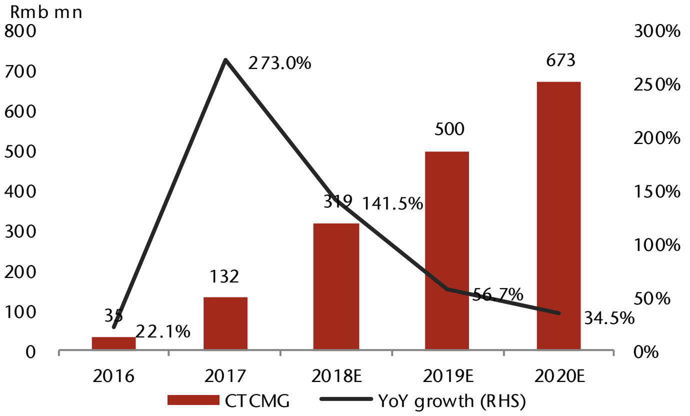
Source: Jefferies estimates, company data

Chart 92: Growth breakdown by segments



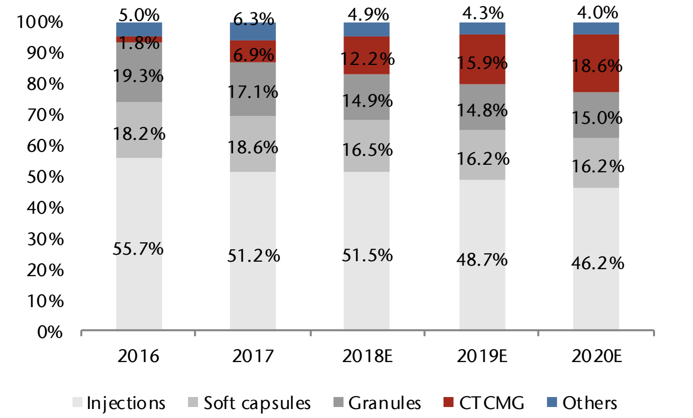
Source: Jefferies estimates, company data

Chart 93: CTCMG to deliver robust growth …



Source: Jefferies estimates, company data

Chart 94: … and to become a significant business segment



Source: Jefferies estimates, company data

Table 29: Revenue breakdown by segments

	2016	2017	2018E	2019E	2020E
	Rmb mn	Rmb mn	Rmb mn	Rmb mn	Rmb mn
Injections	1,110	982	1,344	1,529	1,673
Soft capsules	363	356	431	509	587
Granules	384	329	388	466	544
CTCMG	35	132	319	500	673
Others	100	120	127	135	144
Total	**1,993**	**1,920**	**2,610**	**3,139**	**3,622**

Source: Jefferies estimates, company data

Table 30: Revenue growth breakdown by segments

	2016	2017	2018E	2019E	2020E
Injections	-4.9%	-11.5%	36.8%	13.7%	9.5%
Soft capsules	-11.5%	-2.0%	21.1%	17.9%	15.4%
Granules	-2.2%	-14.4%	18.1%	20.0%	16.8%
CTCMG	22.1%	273.0%	141.5%	56.7%	34.5%
Others	79.8%	19.6%	6.0%	6.4%	6.6%
Total	**-3.0%**	**-3.7%**	**36.0%**	**20.2%**	**15.4%**

Source: Jefferies estimates, company data

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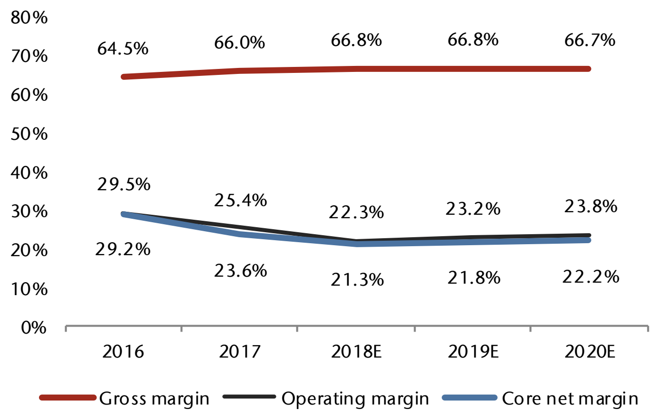
Gradual margin improvement from product mix and operating efficiency

We factored in mild ASP pressure for TCM finished drugs

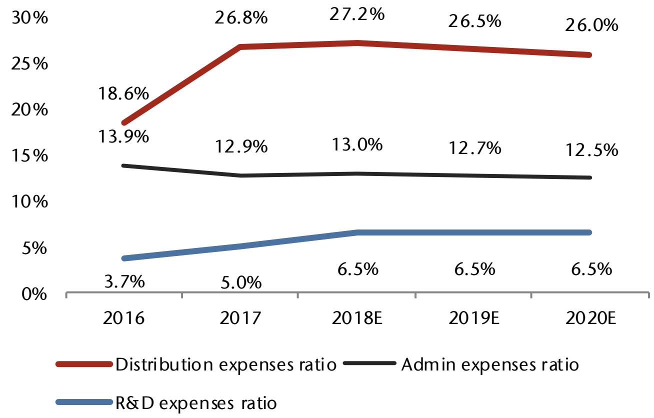
We expect mild ASP pressure for core TCM finished drugs and relatively stable ASP for CTCMG. With the faster growth of high-margin CTCMG, we expect the overall gross margin will slightly improve from 66.0% to 66.7% in 2020E. However, we expect an increased in R&D expense ratio in coming years for R&D projects of TCM finished drugs, overall operating margin would drop from 25.4% in 2017 to 22.3% in 2018E, and then improve gradually to 23.8% in 2020E, due mainly to operating efficiency improvement. Core net margin would show similar trend as operating margin, dropping from 23.6% in 2017 to 21.3% in 2018E and then improve gradually to 22.2% in 2020E.

Chart 95: Gradual improvement in margins



Source: Jefferies estimates, company data

Chart 96: Relatively stable operating expense ratios



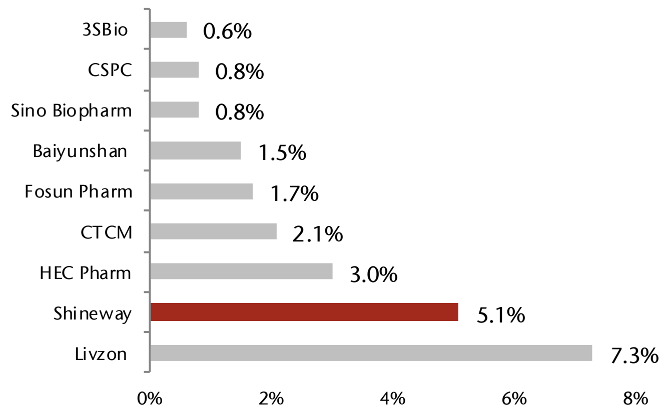
Source: Jefferies estimates, company data

Zero debt and Rmb3.6bn cash on hand

Rmb4.53 per share cash on hand

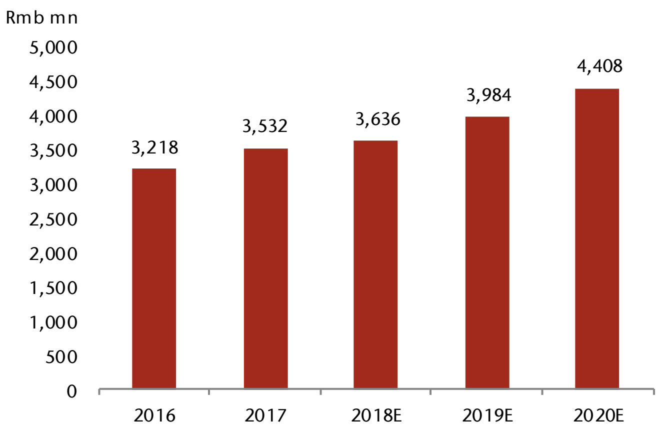
Shineway has a long history of healthy financial position, it has maintained a net cash position since its IPO listing in 2004. As of the end of June 2018, it has Rmb3.6bn cash on hand (Rmb4.53 per share) and no interest-bearing debt. With the strong operating cash inflow and relatively small CAPEX, Shineway has been able to maintain a dividend pay-out ratio of around 40%, making it one of the highest yield healthcare stocks listed in Hong Kong.

Chart 97: Shineway is one of the highest yield healthcare stocks in HK



Source: Jefferies, company data

Chart 98: Ample cash on hand



Source: Jefferies estimates, company data

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Valuation

We believe the worst has been over for Shineway's TCM injections and the business is likely to return to gentle growth. Coupled with strong growth and expansion potential in CTCMG business and new product inclusion into the NRDL and EDL, Shineway would be able to deliver growth again after three years of business contraction. We forecast core net profit CAGR of 21.0% in 17-20E, supported by revenue CAGR of 23.6% within the same period. Shineway is currently trading at 2019E/20E PER of 10.7x/9.2x and we believe the market has been overly pessimistic towards the outlook of injection business. We initiate coverage on Shineway with BUY and TP or HK$13.3 based on our DCF model (WACC: 14.1%, terminal growth: 2.0%). Our TP implies 2019E/20E PER of 14.2x/12.1x.

Table 31: DCF model for Shineway

	2019E	2020E	2021E	2022E	2023E
	Rmb mn	Rmb mn	Rmb mn	Rmb mn	Rmb mn
Net profit	685	802	909	1,065	1,187
Depreciation and amortisation	209	217	225	233	242
Net interest income after tax	(153)	(169)	(163)	(210)	(236)
CAPEX	(123)	(132)	(128)	(134)	(128)
Change in working capital	(173)	(155)	(162)	(176)	(157)
FCF	446	563	681	778	909
Terminal value					7,655
Corporate value	6,167				
Debt & Preferred Stock	0				
Bank deposit and pledged cash	3,576				
Equity Value	9,743				
Number of shares	827				
Value per share (Rmb)	11.78				
Value per share (HK$)	**13.30**				
Risk free rate	3.5%				
Beta	1.0				
Risk premium	10.6%				
Cost of equity	14.1%				
Cost of debt	6.0%				
WACC	14.1%				
Terminal growth rate	2.0%				

Source: Jefferies estimates

Chart 99: Sensitivity analysis

Terminal growth / WACC	12.6%	13.1%	13.6%	14.1%	14.6%	15.1%	15.6%
0.5%	13.7	13.3	12.9	12.6	12.3	12.0	11.7
1.0%	14.0	13.5	13.2	12.8	12.5	12.2	11.9
1.5%	14.3	13.8	13.4	13.0	12.7	12.4	12.1
2.0%	14.6	14.1	13.7	13.3	12.9	12.6	12.3
2.5%	14.9	14.4	14.0	13.5	13.1	12.8	12.4
3.0%	15.3	14.8	14.3	13.8	13.4	13.0	12.7
3.5%	15.8	15.2	14.6	14.1	13.7	13.3	12.9

Source: Jefferies estimates

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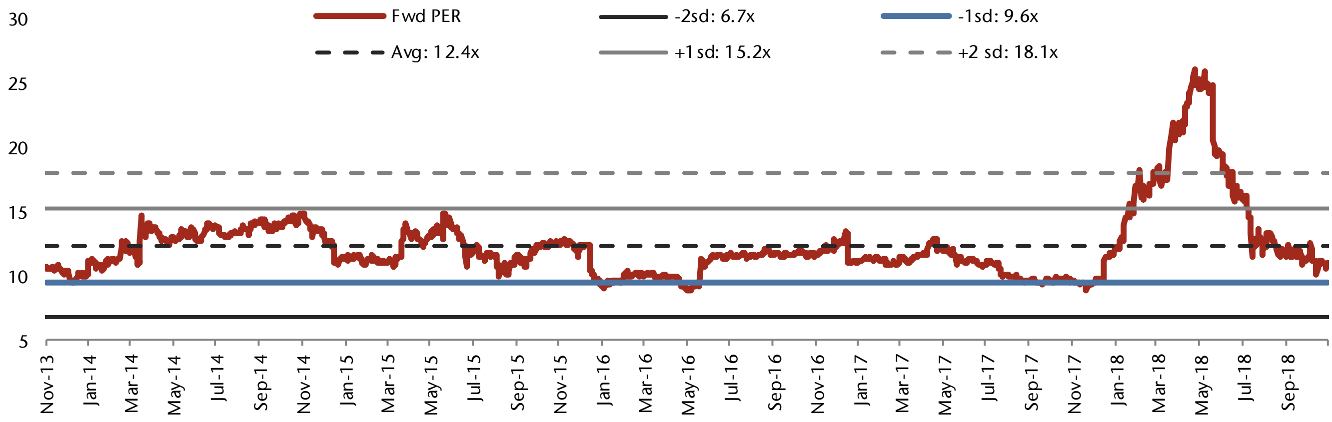
Chart 100: Rolling fwd PER band for Shineway



Source: Bloomberg, Jefferies estimates, company data

Investment risks

Failing in opening new markets for CTCMG business

Currently the CTCMG business of Shineway only concentrates in Hebei Province. Despite its leading position in the province, the Company need to open up new markets to unleash more potential of the new business. The Company has recently set step into Yunnan and Gansu provinces. The ability to expand and ramp up in new provinces will be a vital part for the continuous growth of the business. If the Company fail to do so, the long-term growth potential of the business would be severely affected.

More stringent control on the usage of TCM injections

The NRDL has restricted the usage of TCM injections to class II or above hospitals, and restricted the usage to some specific diseases. We believe this led to more reasonable usage of TCM injections but also hampered the growth of the industry. If the government to roll our more stringent measures on the industry, we believe the overall growth rate of TCM injections would be affected.

Slower than expected ramp up of new products in NRDL

With the slowdown of TCM injections, CTCMG and products that are newly admitted into NRDL and EDL would be the new growth drivers to Shineway. As there are still uncertainties with the actual implementation of the new EDL, any slower-than-expected ramp up of this new growth drivers would have negative impact to the overall growth of Shineway.

Fluctuation in raw material price

Like other TCM manufacturers, medicinal herbs are the key ingredients for the products and the fluctuation in raw material price would have significant impact to the overall profitability of the Company. As most of the revenue of Shineway is still from finished drugs and the price of which was largely regulated. Shineway is not efficient in converting increasing in raw material cost to end users. So any sharp rise in key raw material cost would have negative impact to the margins of the Company.

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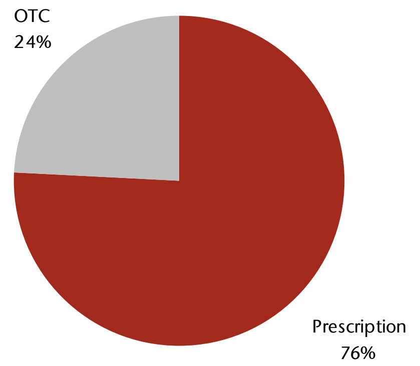
Company background

China Shineway Pharmaceutical Group Limited and its subsidiaries are principally engaged in research and development, production and sales of modern Chinese medicines mainly in the format of injections, soft capsules and granules.

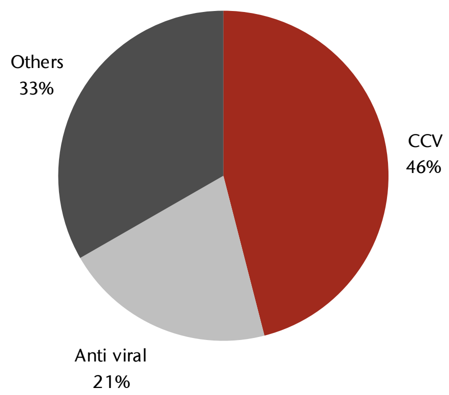
In 2017, prescription and over-the-counter medicines accounted for 75.8% and 24.2% of total turnover, respectively. These medicines are primarily applied for the treatments of (i) cardiovascular and cerebrovascular diseases (CCV), (ii) respiratory system diseases, (iii) colds and fevers, and (iv) digestive system diseases that commonly affect the middle and old aged people and/or children; and (v) viral diseases. In 2017, 46.0% of the turnover was derived from the products for the treatment of CCV diseases. The products for anti-viral treatment and other products contributed approximately 20.7% and 33.3%, respectively, of total turnover.

Chart 101: Revenue breakdown by channel (2017)



Source: Company Data

Chart 102: Revenue breakdown by disease (2017)



Source: Company Data

A total of 75 medicines of Shineway are included in 2017 NRDL. In addition, 23, 14 and 3 medicines are respectively included in national low-price medicine catalogues, provincial low-price medicine catalogues as well as catalogues of emergency drugs for direct online procurements by hospitals without the need of tendering. A total of 16 products regularly manufactured are exclusive products.

Shineway's sales network covers over 30 provinces, cities and autonomous regions across the country. As at the end of 2017, the Group's sales team had over 2,400 sales personnel, covering over 4,800 Class II and III hospitals, approximately 150,000 grass-root medical institutions, and approximately 100,000 retail pharmacies. The Group also had 150 first-tier distributors and 2,500 sales agents.

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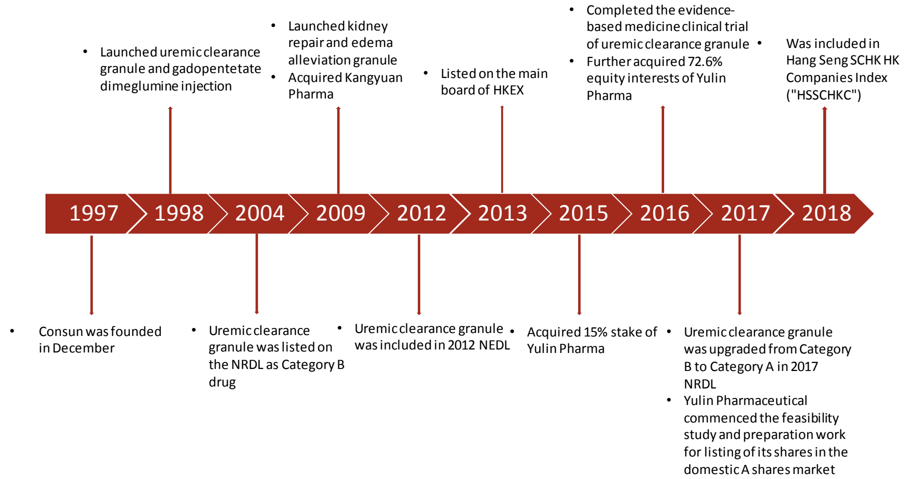
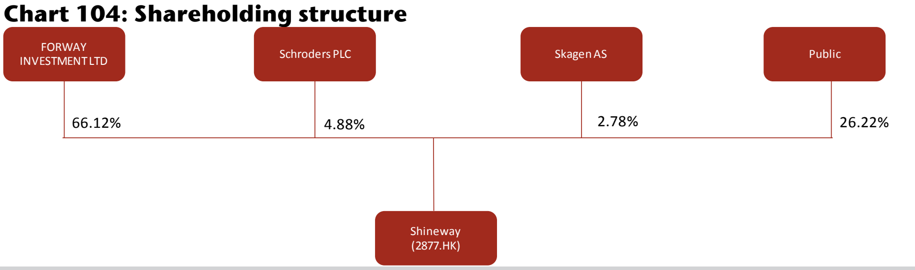
Chart 103: Milestones



Source: Company Data

Chart 104: Shareholding structure



Source: HKEx, Bloomberg

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Table 32: Directors and key managements

Name	Title	Description
LI Zhenjiang	Executive Director	LI Zhenjiang, aged 61, is an executive Director and one of the founders of the Group. Mr. Li obtained an EMBA degree from the Yangtze Commercial Institute. Mr. Li joined the predecessor of the Group in 1974 and has been the Chairman and President of the Group and its predecessor since 1984 with responsibility for business development and strategy. He has more than 20 years' experience in the operation and management of modern Chinese medicine enterprises. Mr. Li takes charge of the overall management of the Group and is also specifically responsible for the Group's research and development activities. Mr. Li is the vice-chairman of the PRC Chinese Medicine Association. Mr. Li is also directors of several members of the Group.
XIN Yunxia	Executive Director	XIN Yunxia, aged 53, is an executive Director and one of the founders of the Group. Ms. Xin graduated from the Yangtze Commercial Institute with an EMBA degree. Ms. Xin is primarily responsible for the Group's human resources management and operation. Ms. Xin joined the predecessor of the Group in 1981, focused on administration. She was the Deputy General Manager (human resources management) of Shineway Medical immediately prior to the corporate reorganisation in preparation of the listing of the Company in 2004. Ms. Xin has more than 20 years' experience in business management in the industry with the Group.
LI Huimin	Executive Director	LI Huimin, aged 49, is an executive Director. He obtained an EMBA degree from Chinese University of Hong Kong in 2016. He is primarily responsible for the marketing and sales of the Group's products and, since joining the predecessor of the Group in 1992, focused on sales and marketing. Immediately prior to the corporate reorganisation in preparation of the listing of the Company in 2004, Mr. Li was the sales and marketing manager of Shineway Medical. He has developed a deep understanding of sales management in the PRC Chinese medicine industry with more than 15 years' experience. Mr. Li is a vice-chairman of Hong Kong Chinese Prepared Medicine Traders Association since 2010.
LEE Ching Ton Brandelyn	Executive Director	LEE Ching Ton, aged 34, is an executive Director appointed in 2012. She has studied in the United Kingdom and Australia, majoring in business administration. Ms. Lee has solid knowledge in finance principles. Ms. Lee has worked in areas relating to corporate development in the Company, thus has accumulated a definite amount of administration and management experience. She has been the Company's Executive Assistant since August 2010. Ms. Lee is the daughter of Mr. Li Zhenjiang, the chairman and the executive Director.
CHEN Zhong	Executive Director	CHEN Zhong, aged 50, is an executive Director appointed on 1 December 2014. He is qualified as a chief senior engineer and is a certified pharmacist. He graduated from Hebei Medical University in 1990 with a bachelor's degree in pharmacy. Mr. Chen joined the predecessor of the group in 1990 and is currently the vice president of the Shineway Pharmaceutical Group Limited (formerly known as Shineway Pharmaceutical Company Limited) ("Shineway Pharmaceutical"), director of Hebei Shineway Pharmaceutical Company Limited ("Hebei Shineway"), director of Xizang Shineway Pharmaceutical Company Limited and director of Shineway Pharmaceutical (Hainan) Company Limited. He is responsible for quality control on production and technology management activities of the Company's group with over 20 years of experience.
HUNG, Randy King Kuen	Director of Investor Relation	HUNG, Randy King Kuen, aged 51, is the Director of Investor Relation of the Group. Mr Hung has more than 20 years of experience as CFO, executive director and independent non-executive director of various listed companies in Hong Kong. He was an executive director of the Group from 2005 to 2010, and was appointed as a non-executive director of the Group in 2011 and continued to serve as an independent non-executive director of the Group from 2014 to March 2017. Mr. Hung is a fellow CPA of Hong Kong and a licensed CPA of the State of California, USA. He holds an MBA degree from University of London and a Bachelor degree in Accounting and a Certificate of Programming and Data Processing from the University of Southern California. He has extensive experience in IPO, corporate finance and investor relation.
LEE Bun Ching, Terence	Financial Controller and Company Secretary	LEE Bun Ching, aged 44, is the Financial Controller and Company Secretary of the Group. Mr. Lee is a member of the Hong Kong Institute of Certified Public Accountants and American Institute of Certified Public Accountants. He holds a bachelor's degree in Accounting and Financial Analysis and a master's degree in Economics and Finance from the University of Warwick in the United Kingdom. Mr. Lee has extensive work experience in the field of auditing, accounting, finance and taxation. Prior to joining the Group, he served as the Group Accounting Controller of a listed company in Hong Kong for over 3 years. Between 1996 and 2007, Mr. Lee worked in a reputable international accounting firm and was a Senior Manager when he left in 2007. He joined the Group in 2011.

Source: Company Data

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Financial statements

Table 33: Income statement

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	**1,993**	**1,920**	**2,610**	**3,139**	**3,622**
Injections	1,110	982	1,344	1,529	1,673
Soft capsules	363	356	431	509	587
Granules	384	329	388	466	544
CTCMG	35	132	319	500	673
Others	100	120	127	135	144
Cost of sales	(707)	(653)	(868)	(1,042)	(1,204)
Gross profit	**1,286**	**1,267**	**1,742**	**2,097**	**2,417**
Other income and gains	24	79	59	65	74
Distribution expenses	(371)	(515)	(710)	(831)	(942)
Administrative expenses	(277)	(247)	(340)	(398)	(452)
R&D expenses	(74)	(97)	(170)	(204)	(235)
Operating profit	**589**	**488**	**581**	**729**	**862**
Share of profit of associate / JV	0	0	0	0	0
Finance income / (expenses)	101	102	115	127	141
Exceptional	6	(2)	0	0	0
Pre-tax profit	**695**	**588**	**696**	**856**	**1,003**
Profits tax	(106)	(136)	(139)	(171)	(201)
Minority interest	0	0	0	0	0
Net profit	589	452	557	685	802
Core net profit	**582**	**453**	**557**	**685**	**802**
EBITDA	**784**	**687**	**783**	**938**	**1,079**
EPS (Rmb)	0.71	0.55	0.67	0.83	0.97
Core EPS (Rmb)	0.70	0.55	0.67	0.83	0.97
DPS (Rmb)	0.32	0.32	0.30	0.37	0.44
BVPS (Rmb)	6.80	7.04	7.39	7.92	8.51

Source: Jefferies estimates, company data

Table 34: Balance sheet

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
Non-current assets	**2,214**	**2,105**	**2,030**	**1,943**	**1,858**
Fixed asset	1,466	1,402	1,367	1,321	1,277
Prepaid lease payments	161	156	156	156	156
Goodwill	159	159	159	159	159
Intangible assets	348	308	268	227	187
Other non-current assets	80	80	80	80	80
Current assets	**4,251**	**4,560**	**4,983**	**5,562**	**6,194**
Cash	3,218	3,532	3,636	3,984	4,408
Trades, bills & other receivables	682	703	924	1,084	1,231
Inventories	294	280	378	449	511
Other current assets	56	45	45	45	45
Current liabilities	**673**	**709**	**765**	**823**	**876**
Trades, bills & other payables	615	657	713	770	824
Other current liabilities	58	52	52	52	52
Non-current liabilities	**166**	**135**	**135**	**135**	**135**
Other non-current liabilities	166	135	135	135	135
Total net assets	**5,627**	**5,821**	**6,113**	**6,548**	**7,042**
Shareholders' equity	**5,627**	**5,821**	**6,113**	**6,548**	**7,042**

Source: Jefferies estimates, company data

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Table 35: Cash flow statement

YE Dec 31 (Rmb mn)	**FY16A**	**FY17A**	**FY18E**	**FY19E**	**FY20E**
EBIT	**589**	**488**	**581**	**729**	**862**
Depreciation and amortization	195	195	201	209	217
Change in working capital	46	35	(264)	(173)	(155)
Income tax paid	(102)	(136)	(139)	(171)	(201)
Others	6	(2)	-	-	-
Net cash from operating activities	**734**	**580**	**380**	**594**	**723**
Capex	(185)	(90)	(126)	(123)	(132)
Others	105	88	115	127	141
Net cash from investing activities	**(80)**	**(1)**	**(11)**	**4**	**9**
Change of debts	-	-	-	-	-
Issuance of new shares	-	-	-	-	-
Dividend paid	(265)	(265)	(265)	(250)	(308)
Others	-	-	-	-	-
Net cash from financing activities	**(265)**	**(265)**	**(265)**	**(250)**	**(308)**
Net change in cash	389	314	**104**	**348**	**424**
Cash at the beginning of the year	2,826	3,218	3,532	3,636	3,984
Exchange difference	3	-	-	-	-
Cash at the end of the year	**3,218**	**3,532**	**3,636**	**3,984**	**4,408**

Source: Jefferies estimates, company data

Table 36: Key ratios

YE Dec 31	**FY16A**	**FY17A**	**FY18E**	**FY19E**	**FY20E**
Sales mix (%)					
Injections	55.7	51.2	51.5	48.7	46.2
Soft capsules	*18.2*	*18.6*	16.5	16.2	16.2
Granules	*19.3*	*17.1*	14.9	14.8	15.0
CTCMG	*1.8*	*6.9*	12.2	15.9	18.6
Others	*5.0*	*6.3*	4.9	4.3	4.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Profit & loss ratios (%)					
Gross margin	64.5	66.0	66.8	66.8	66.7
EBITDA margin	39.3	35.8	30.0	29.9	29.8
Core net margin	29.2	23.6	21.3	21.8	22.2
Effective tax rate	15.3	23.2	20.0	20.0	20.0
Growth (%)					
Revenue	(3.0)	(3.7)	36.0	20.2	15.4
Injections	(4.9)	(11.5)	36.8	13.7	9.5
Soft capsules	(11.5)	(2.0)	21.1	17.9	15.4
Granules	(2.2)	(14.4)	18.1	20.0	16.8
CTCMG	22.1	273.0	141.5	56.7	34.5
Others	79.8	19.6	6.0	6.4	6.6
Gross profit	(5.5)	(1.5)	37.5	20.3	15.3
EBITDA	(9.2)	(12.4)	13.9	19.9	15.0
Operating profit	(15.5)	(17.1)	19.1	25.4	18.2
Core net profit	(11.0)	(22.1)	22.8	23.1	17.1
Balance sheet ratios					
Current ratio (x)	6.3	6.4	6.5	6.8	7.1
Trade receivables turnover days	93	103	89	104	104
Trade payables turnover days	114	126	109	121	121
Inventory turnover days	164	161	139	157	155
Net debt to total equity ratio (%)	Net cash	Net cash	Net cash	Net cash	Net cash
Returns (%)					
ROE	10.5	7.8	9.1	10.5	11.4
ROA	9.1	6.8	7.9	9.1	10.0

Source: Jefferies estimates, company data

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Consun (1681 HK)

Undervalud TCM manufacturer

BUY

Price target	**HK$6.80**
Price	**HK$5.50**

Bloomberg:	**1681 HK**
Reuters:	**1681.HK**

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Table 37: Financial summary

Rmb	2016A	2017A	2018E	2019E	2020E
Revenue (mn)	1,224	1,661	1,864	2,120	2,407
Change (% YoY)	47.2%	35.7%	12.2%	13.8%	13.5%
Core net profit (mn)	309	379	451	524	602
Change (% YoY)	23.1%	22.6%	19.1%	16.2%	14.9%
Core EPS	0.32	0.44	0.52	0.60	0.69
Change (% YoY)	25.9%	36.6%	17.3%	16.1%	14.9%
BV/share	2.01	2.00	2.43	2.76	3.22
Net debt (mm)	(673)	(421)	(754)	(899)	(1,146)
ROE (%)	17.5%	22.7%	21.2%	21.7%	21.4%
PER (x)	15.4	11.3	9.5	8.2	7.1
PBR (x)	2.5	2.5	2.0	1.8	1.5

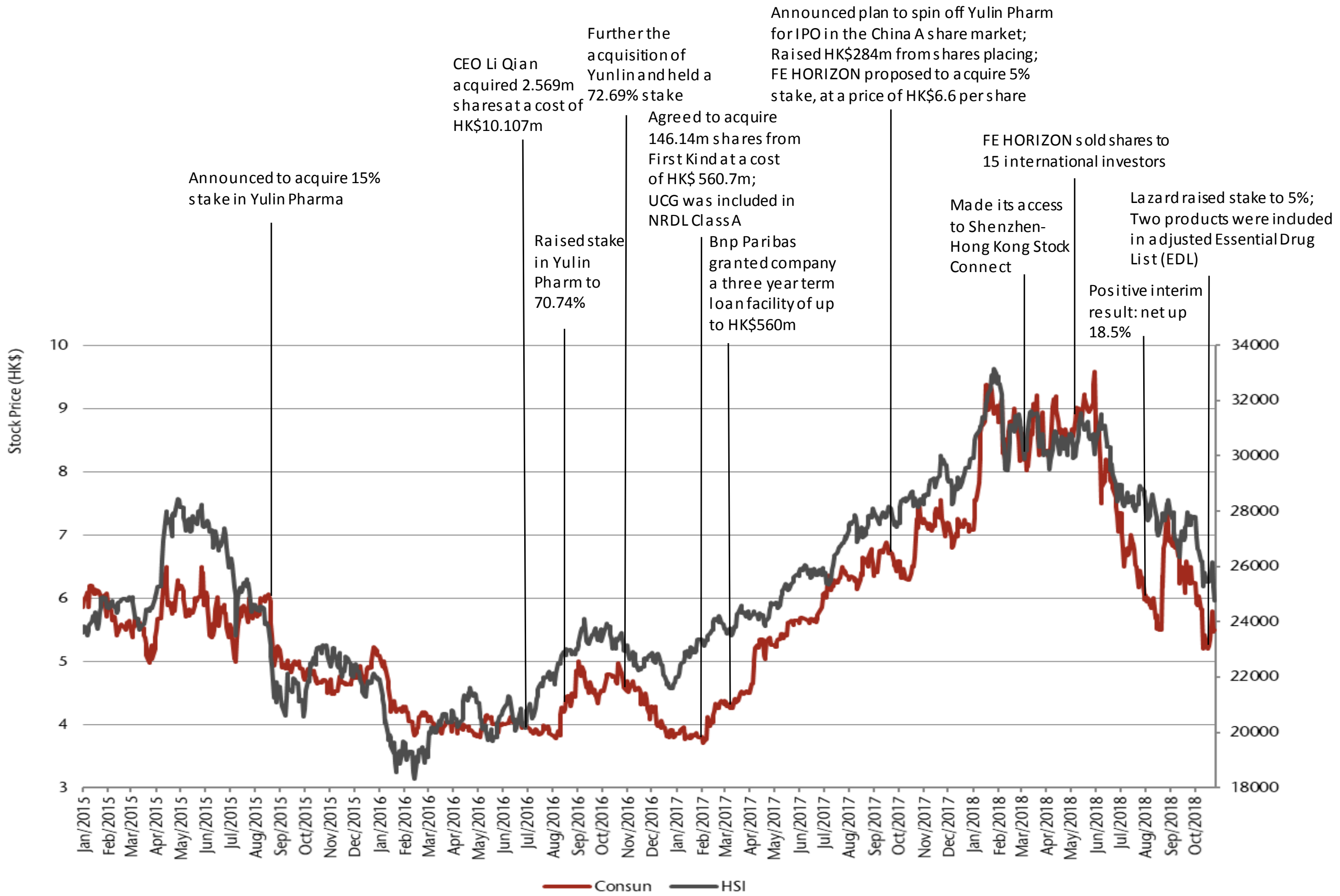
Source: Jefferies estimates, company data

Table 38: Market data

52 Week Range	HK$9.75-HK$4.99
Total Entprs. Value	HK$4.1B
Market Cap.	HK$4.9B
Share Out. (MM)	875.2
Float (MM)	364.1
Avg. Daily Vol.	2,399,594

Source: Jefferies

Chart 105: Share price performance and key events



Source: Jefferies, company data

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Consun (1681 HK) – Undervalued TCM manufacturer

Exclusive clinically proven TCM product for CKD

Defensive position from a clinically proven exclusive TCM drug for treatment of CKD

The core product of Consun, Uremic Clearance Granule (UCG), is a modern TCM medicine for slowing down the worsening of chronic kidney disease (CKD). UCG has been proven by evidence based clinical study that it is a safe and effective cure to slow down the renal hypofunction of chronic kidney disease patients. The product is included in the latest EDL and cat A of NRDL and it holds 27% of TCM CKD drugs market in China in 2017. With the organic growth of the industry and increasing penetration, we forecast revenue CAGR of 13.0% in 17-20E and kidney products will account for around 49% of total revenue in the next three years.

Revitalizing a time-honored brand – Yulin

Return to a modest growth after explosive growth in 16 and 17

Consun acquired 72.6% of Yulin by a series of acquisition in 2015 and 2016 for a total consideration of Rmb883mn. Yulin is a well-established traditional Chinese medicine enterprise but was poorly managed. Consun was successful in revitalizing the brand and delivered robust growth in 16 and 17. Going forward, based on increasing efficiency in marketing activities, same store sales growth and ASP increment, we forecast revenue CAGR of 11.0% for Yulin business in 17-20E.

Stable contribution from contrast mediums

Gadopentetate dimeglumine (GD) injection is commonly used as a medical contrast medium in magnetic resonance image (MRI) formation. There are four manufacturers in China for the product and Consun is the third largest one with around 22% market share. We believe the product will grow with increasing penetration of MRI machines in China. Besides, the Company is expected to launch iopamidol injection, a X-ray contrast medium, in 2019. With the launch of new products and organic growth of existing product, we expect contrast medium business to deliver revenue CAGR of 18.5% in 17-20E.

Financials

We forecast core net profit CAGR of 16.7% in 17-20E

With the stable growth of core products, we expect revenue CAGR of 13.2% in 17-20E and core net profit CAGR of 16.7%. The faster growth of core net margin would mainly by driven by the improvement in operating efficiency and therefore gradual improvement of core net margin from 22.8% in 2017 to 25.0% in 2020E.

Valuation

One of the lowest valued healthcare companies in HK

Consun is currently trading at 19E/20E PER of 8.2x/7.1x, which is one of the lowest in the healthcare sector. Given the Company's strong exclusive product UCG and well-known OTC brand names, we believe the Company has been significantly undervalued. In fact, core business of Consun is relatively unaffected by policy headwind. We initiate BUY on the Company with a TP of HK$6.8 based on DCF model (WACC: 13.2%, terminal growth: 2.0%). Our TP implies 2018E/19E PER of 10.1x/8.8x

Investment risks

(1) Slower than expected growth of core business segments

(2) Relatively weak R&D capabilities

(3) Significant ASP pressure

(4) Delay in the launch of new products

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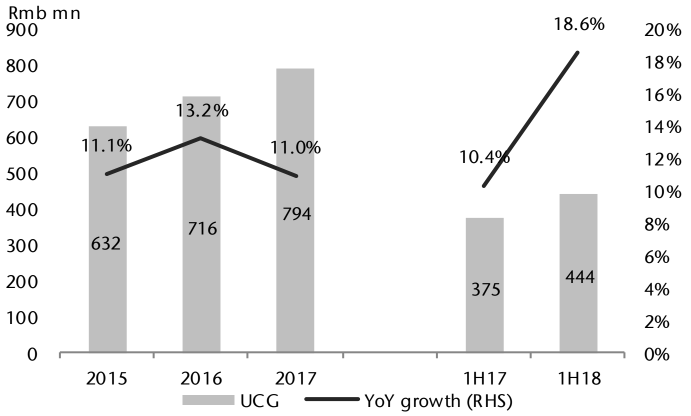
Clinically proven TCM for chronic kidney disease

Uremic clearance granule (UCG, 尿毒清颗粒) is the single most important product for Consun. Before the acquisition of Yulin, it accounted for 76.0% of Consun's total revenue in 2015. Even after the consolidation, UCG was still the largest product for Consun and accounted for 47.8% of total revenue in 2017.

Management expects potential revenue size of Rmb2bn for the product

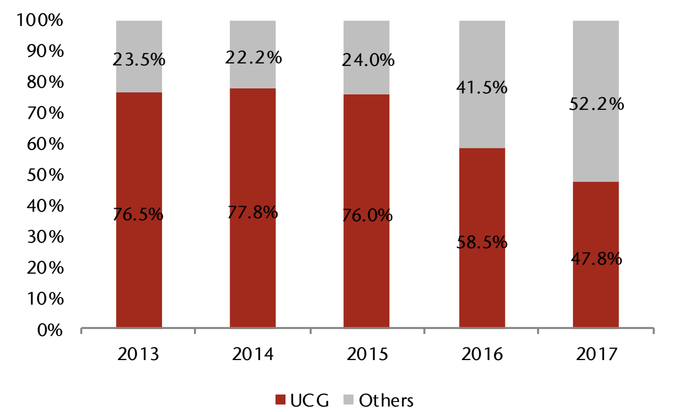
UCG delivered stable growth of low double digit region in the last three years. However, it picked up pace in 1H18 due mainly to the materialization of being elevated from category B to category A in NRDL. The product is essentially 100% reimbursed by the NRDL. We believe the product would be able to deliver mid-teens growth in coming years and to remain as the core part of Consun's business. Management expects the product to have market potential of around Rmb2bn.

Chart 106: UCG delivered stable growth



Source: Jefferies, company data

Chart 107: UCG is still the single most important product



Source: Jefferies, company data

UCG is a modern TCM medicine for slowing down the worsening of chronic kidney disease (CKD). UCG is able to lower blood serum creatinine, ureanitrogen, urinary protein and albumin levels, improve lipid metabolism disorders and lower glycosylation end products. It is able to clear oxygen free radicals, significantly increase the number of red blood cells, improve renal anemia, increase blood calcium level, lower blood phosphorus level, and improve calcium and phosphorus metabolism disorders. As a whole, UCG can effectively protect the residual renal function, thereby improving the conditions of patients with kidney disease, slowing down the worsening of chronic kidney failure, postponing the need to start the dialysis process and reducing the risk of complications.

Its major ingredients include atractylodes macrocephala koidz (白术), processed polygonum multiflorum root (制何首烏), poria cocos (茯苓), astragalus mongholicus (黃芪), the root of red-rooted, salvia (丹参), rheum officinale (大黃), and root bark of white mulberry (桑白皮).

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Over 10% of population in China has CKD

Chronic kidney disease (CKD) is divided into five stages of increasing severity. Patients with CKD at the second to fifth stages are classified as having chronic kidney failure. Those patients whose chronic kidney disease are at the fifth stage normally require dialysis therapy and kidney transplantation. Currently there are no medicines available that can cure CKD. All kidney medicines are aiming to slow down the worsening of the disease.

Over 70mn ppl in China are projected to have CKD from Stage 2 to Stage 5

According to "Prevalence of chronic kidney disease in China: a cross-sectional survey" (《中国慢性肾病流行病学调查》), a study involving 47,204 subjects, the overall prevalence of chronic kidney disease was 10.8% in China. Based on the study, although more than 150mn people in China are expected to have CKD, only around 12.5% or less than 20mn of the patients are diagnosed and the remaining are left undiagnosed.

Table 39: Estimated number of patients for different stage of CKD in China

	Description	Treatment options	Prevalence rate	Estimated population (mn)
Stage 1	Slightly diminished function. Kidney damage with normal or relatively high GFR (≥90 ml/min/1.73 m2) and persistent albuminuria.	Identifying cause and trying to reverse it	5.70%	79.8
Stage 2	Mild reduction in GFR (60–89 ml/min/1.73 m2) with kidney damage.	Monitoring creatinine level, blood pressure, and general health and well-being. Stopping or slowing the worsening of kidney function.	3.40%	47.6
Stage 3	Moderate reduction in GFR (30–59 ml/min/1.73 m2):	Stopping or slowing the worsening of kidney function.	1.60%	22.4
Stage 4	Severe reduction in GFR (15–29 ml/min/1.73 m2). Preparation for renal replacement therapy.	Planning and creating access site for dialysis. Receiving assessment for possible kidney transplantation.	0.10%	1.4
Stage 5	Established kidney failure (GFR <15 ml/min/1.73 m2), permanent renal replacement therapy needed.	Starting renal replacement therapy: dialysis or kidney transplantation.	0.03%	0.4
Total			**10.8%**	**151.6**

Source: Prevalence of chronic kidney disease in China: a cross-sectional survey, Jefferies, company data

Efficacy proven by evidence-based studies

UCG is a safe and effective cure to slow down the renal hypofunction of chronic kidney disease patients

Consun has already conducted series of clinical studies on the efficacy of UCG. According to a three-year study published in 2016 conducted by well-known renal disease expert and Academy of Engineering academician Chen Xiangmei (Efficacy and Safety of Niaoduqing Particles for Delaying Moderate-to-severe renal Dysfunction: A Randomized, Double-blind, Placebo-controlled, Multicenter Clinical Study), UCG is a safe and effective cure to slow down the renal hypofunction of chronic kidney disease patients, which is of milestone significance in the field of treatment of chronic kidney disease with TCM.

The 300-case, multi-centre, randomized, double-blind and placebo-controlled evidence-based study primarily measured glomerular filtration rate (eGFR) and serum creatinine (Scr) level in patients with CKD stage 3b-4. Statistics showed that after 24-week treatment, eGFR of UCG group decreased 0.63%, whereas the placebo group decreased 7.37%. eGFR levels in patients treated with UCG and those treated with a placebo decreased compared to baseline at 24 weeks. However, the decrease in the placebo‐treated patients was significant compared with baseline eGFR, whereas the difference in the UCG‐treated patients was not significant, suggesting that UCG treatment successfully delayed renal function decline in patients with CKD.

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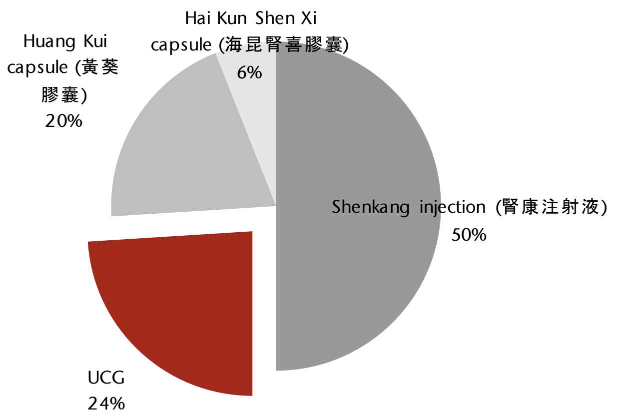
Rmb3bn market with limited competition

UCG is the only EDL drug in the top 4 best-selling TCM CKD drugs

According to statistics from Chinese Pharmaceutical Association, UCG holds 27% market share in TCM drugs for CKD in 2017, the largest oral TCM for CKD. Shenkang injection was the largest TCM CKD drug in 2017 with a market share of 44% but we believe its future growth potential has been limited with the usage restriction in Class II or above hospitals in the latest NRDL. Meanwhile, of the four top selling TCM CKD drugs, UCG is the only one that is listed in the EDL. We believe that UCG has been in an advantageous position in the market.

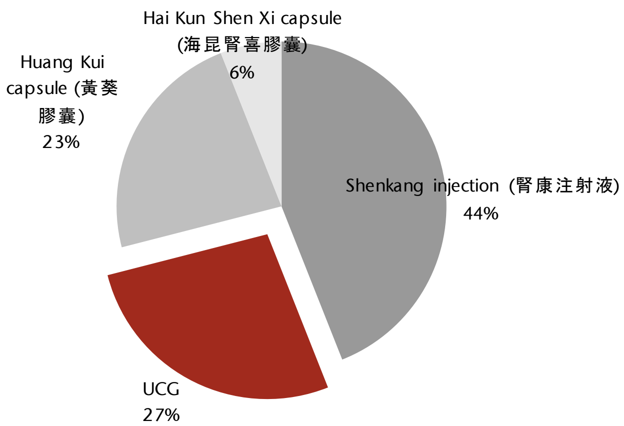
The total TCM CKD drug market was around Rmb3bn in 2017. If we also take Western TCM drug market into consideration, as TCM holds around 50% of the market, the total market size of CKD drug in China was over Rmb6bn. However, this market is a relatively stable market and we do not expect growth rate exceeding the general pharmaceutical industry growth of high single digit region.

Chart 108: UCG was the largest oral TCM for CKD in 2016 with 24% market share...



Source: Chinese Pharmaceutical Association, Jefferies, company data

Chart 109: ... and increased in 2017 with restriction of injections in hospitals



Source: Chinese Pharmaceutical Association, Jefferies, company data

Table 40: UCG is the only EDL and NRDL Cat A drug among the top 4 best selling TCM CKD drugs

Products	Manufacturers	Dosage form	NRDL?	EDL?
UCG (尿毒清)	Consun	Oral	A	Y
Shenkang injection (肾康注射液)	Xian Shi Ji Sheng Kang Pharma	Injection	B (Limited to patients with CKD in Class II or above hospitals)	N
Huang Kui capsule (黄葵胶囊)	SZYY Group Pharma	Oral	B	N
Hai Kun Shen Xi capsule (海昆肾喜)	Changlong Yaoye	Oral	B (Limited to decompensated CKD patients in hospitals)	N

Source: NMPA, Jefferies, company data

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Listed in both EDL and NRDL for CKD

UCG has been included in the Essential Drug List (EDL) since September 2012. According to regulations, government run hospitals and medical institutions at community and county levels can only prescribe medicines in the EDL, while other hospitals and medical institutions are required to prescribe a certain percentage of medicines in the EDL. Being included in the EDL implies the importance of the UCG in treating CKD in the medical system and it should be considered as one of the primary choice for treating CKD.

Elevated to NRDL Cat A and is 100% reimbursable

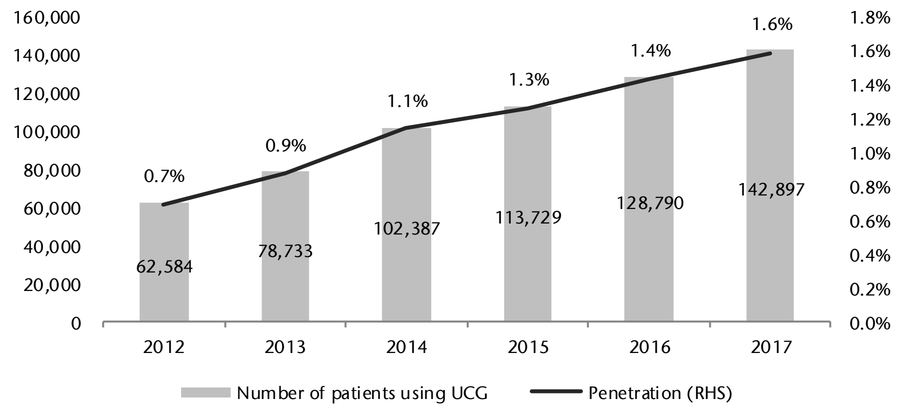
Besides being included in the EDL, UCG has been included in category B of the 2009 National Reimbursement Drug List (NRDL) and has been elevated to category A of the 2017 NRDL. The elevation from category B to category A means the reimbursement rate is elevated from partial reimbursement to 100% reimbursement.

Still low penetration in China

According to the Company, over 17,000 hospital and 600,000 patients in China take UCG. With estimated 71.8mn patients with stage II or above CKD and diagnosed rate of 12.5%, the penetration rate is only at 6.7%.

Meanwhile, assuming daily intake of 5 packages, 1,825 packages per year per patient, annual cost for UCG is at around Rmb6,500. Based on the annual consumption cost, UCG revenue of Consun and tax, the penetration of UCG is only at 1.6% among patients with CKD of stage II or above in 2017. Based on the assumptions, the penetration has already gone up from 0.7% in 2012 to 1.6% in 2017. With the inclusion in category A of NRDL, we believe the penetration of UCG would continue to go up.

Chart 110: Increasing penetration rate of UCG



Source: Jefferies estimates, company data

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Yulin business - the OTC arm

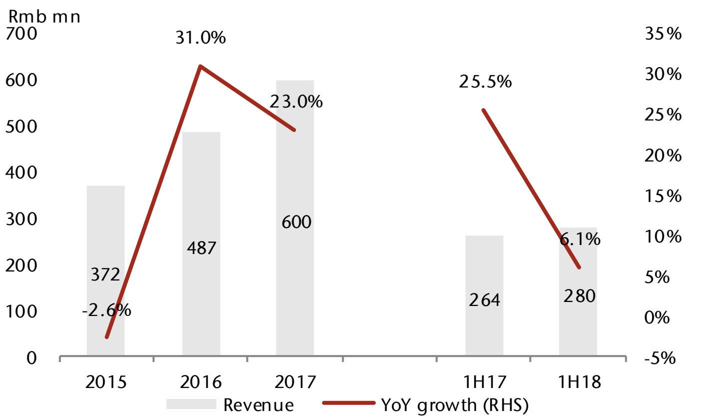
Acquired 73% of Yulin by Rmb883mn

Consun acquired Yulin business by a series of acquisitions: (1) won a bid to acquire 15% of equity interest in August 2015, (2) increased equity interest to 70.7% in 2016 by three rounds of acquisition, (3) further increased stake to 72.6% in 2H16 by capital injection. The total consideration for the acquisitions was Rmb882.7mn and the financial statement was consolidated since 2H16.

Expecting growth in low-mid-teens region in coming years

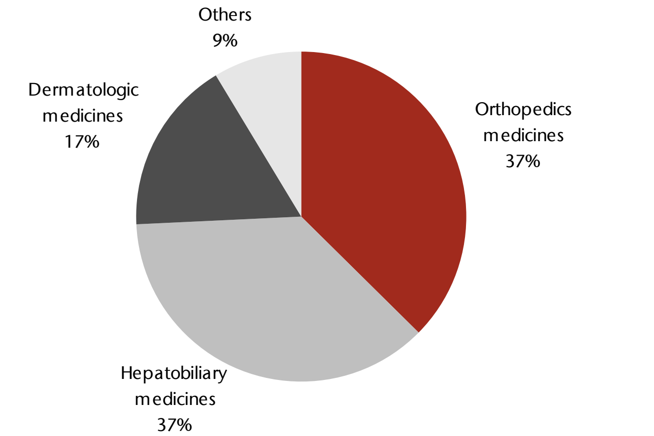
As a matter of fact, Yulin business was poorly managed before the acquisition and Consun could turn the business around and the business delivered robust growth in 2016 and 2017 as a result. In 1H18, the growth rate went down to 6.1% YoY, which was mainly due to the production facility suspension for in-depth repair and maintenance from 1 May to mid-June 2018. The production has returned to normal. We do not expect robust growth from the business as in 2016 and 2017 but we still expect growth rate in low-mid-teens region in the next three years.

Chart 111: Yulin business delivered robust growth post acquisition (*)



(*) assuming full year contribution in 2015 and 2016
Source: Jefferies, company data

Chart 112: Yulin revenue breakdown in 2017



Source: Jefferies, company data

Traditional enterprise with well-known brands

Established in 1950s, Yulin Pharmaceutical is a well-established traditional Chinese medicine manufacturing enterprise principally engaged in the R&D, production and sales of Chinese medicines and natural medicines. Yulin is one of the first batch of enterprises recognized as "Chinese Time-honoured Brands (中華老字號)" by the Ministry of Commerce in 2006 and "Chinese Well-known Trademark (中國馳名商標)" in 2007.

Yulin currently owns over 74 licenses of medicines in nine dosage forms. Among these medicines, 20 are exclusive products, 11 were listed in EDL, 27 were listed in NRDL and 12 were listed in low-price drug list, and over 10 types are exported to more than 30 countries and regions.

Revenue performance highly dependent on three core products

Top 3 products accounted for over 80% of revenue of Yulin

Although Yulin owns production licenses for over 70 types of medicines, it is only manufacturing 42 types. Among these 42 products, the top three products, Zheng Gu Shui (正骨水, orthopaedics product), Shiduqing capsule (湿毒清胶囊, dermatologic product), and Jigucao capsule (鸡骨草胶囊, hepatobiliary product) already accounted over 80% of its revenue in 2017. We believe these three products and brand names are the valuable assets of the Company and future growth potential will be highly dependent on these products.

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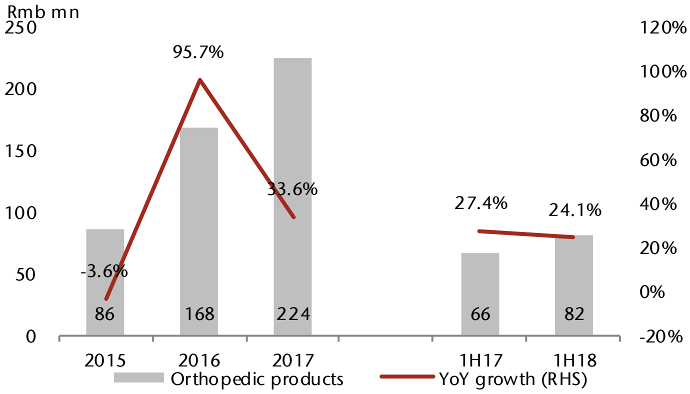
Chart 113: Orthopaedic product

Source: Company Data

Chart 114: Revenue growth of orthopaedic products

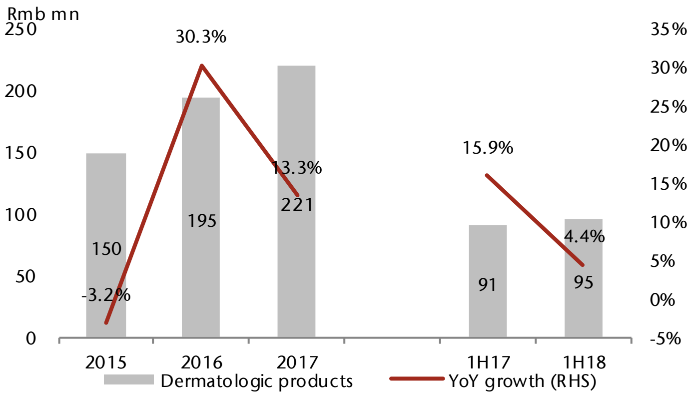


Source: Jefferies, company data

Chart 115: Dermatologic products

Source: Company Data

Chart 116: Revenue growth of dermatologic products

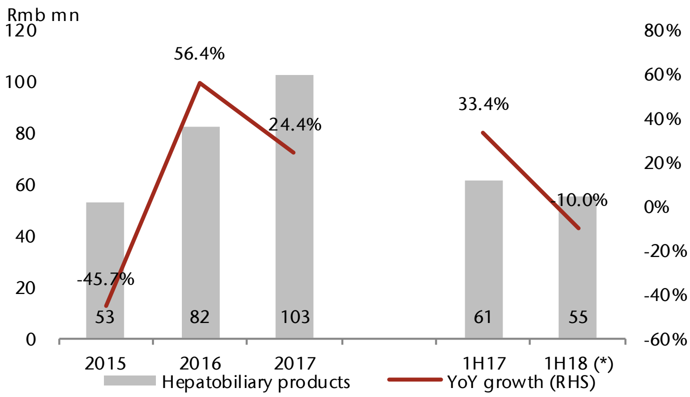


Source: Jefferies, company data

Chart 117: Hepatobiliary products

Source: Company Data

Chart 118: Revenue growth of hepatobiliary products



(*) – Jefferies estimated figure.
Source: Jefferies estimates, company data

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Yulin has a big distribution network in China ...

Growth from same store sales growth and ASP increment

Due to the nature of the business, Consun's original business was more specialized in promoting products in hospitals with academic promotion model. It has a sales team of around 900 people in promoting prescription drugs and it currently covers around 17,000 hospitals in China. After the acquisition of Yulin, the Company increased the number of OTC drug sales of Yulin from around 70 to close to 600, covering 330,000 drug stores in China.

... but the average sales per store is extremely low. So the next step would be in increasing per store sales.

Revenue from Yulin mainly concentrated in five to six provinces including Guangdong, Guangxi, Sichuan, Henan, Zhejiang and Heilongjiang. These six provinces accounted for over 50% of total revenue. Although the Company currently covers over 300,000 stores, some of them are with extremely low efficiency: with revenue of Rmb599.7mn in 2017, the average per store revenue was less than Rmb2,000. Instead of further expanding distribution network, the Company would focus on increasing per store revenue and cross-selling of products.

According to Management, due to historical reasons, Yulin's products have been priced unreasonably low. The Company would increase the ASP of individual products. Although without clear increment plan or magnitude guidance, we believe ASP increment will be an additional factor for the growth of Yulin.

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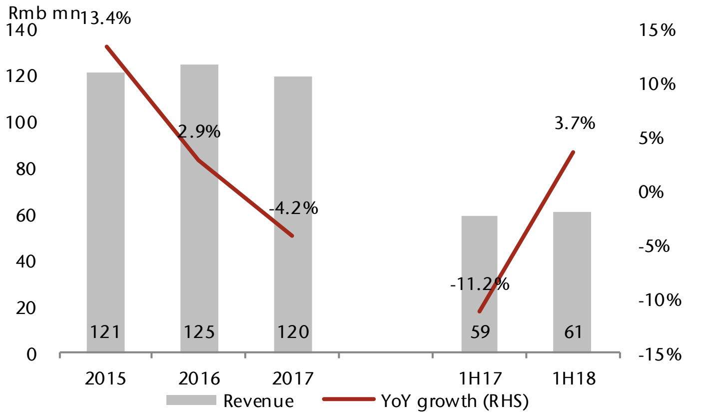
Contrast medium – stable performance

Consun's gadopentetate dimeglumine (GD) injection is commonly used as a medical contrast medium in magnetic resonance image (MRI) formation of central nervous system, abdomen, thorax, pelvic cavity, limbs, other organs and tissues of human body. As it can shorten the longitudinal relaxation time and transverse relaxation time of protons in tissues, it can enhance the definition and contrast of the magnetic resonance image.

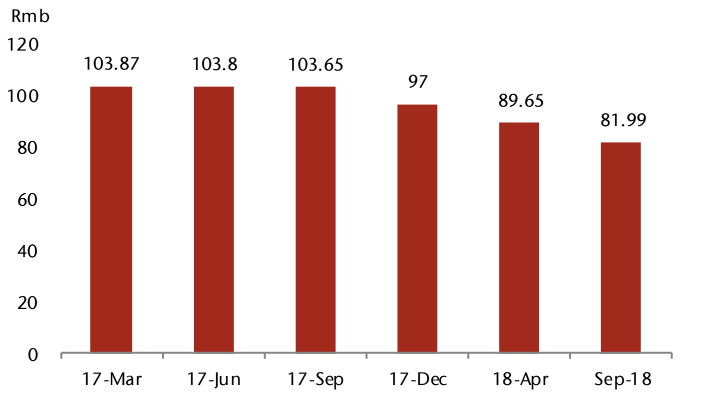
Despite the market potential, performance of Consun's contrast medium has been stagnant due mainly to losing drug tender in Guangdong in 2H16 – 1H17 and ASP drop in the same province in 1H18. As Guangdong has been the largest revenue source for the segment, performance of the sector has been adversely affected. We do not expect significant growth potential from the business until the expected launch of new product in 2019.

Chart 119: Stagnant growth of contrast medium business



Source: Jefferies, company data

Chart 120: Price in Guangdong has dropped 15% in 2018



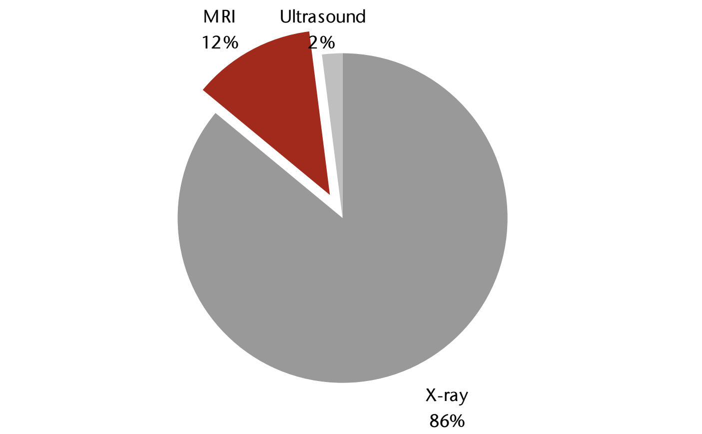
Source: db.yaozh.com, Jefferies

A small and concentrated market

Consun has 21.4% market share in GD injection

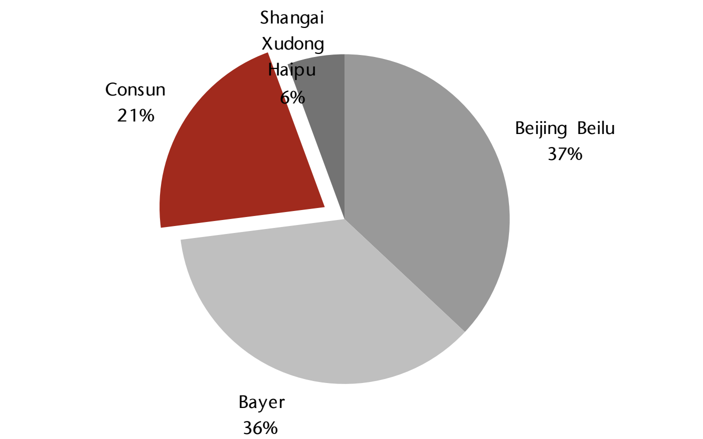
MRI contrast medium has a market of Rmb1.1bn in 2016, accounting for 12% of the total contrast medium market in China. GD injection is the most commonly used MRI contrast medium and accounted for around 75% of the MRI contrast medium market in 2016. Currently only four players in China manufacture GD injection, and Consun is the third largest player in 2016 with 21.4% of market share in 2016.

Chart 121: China contrast medium market amounted to Rmb9.3bn in 2016



Source: Menet, Jefferies, company data

Chart 122: Consun held 21.4% in GD injection market in 2016



Source: Sinohealth, Jefferies estimates, company data

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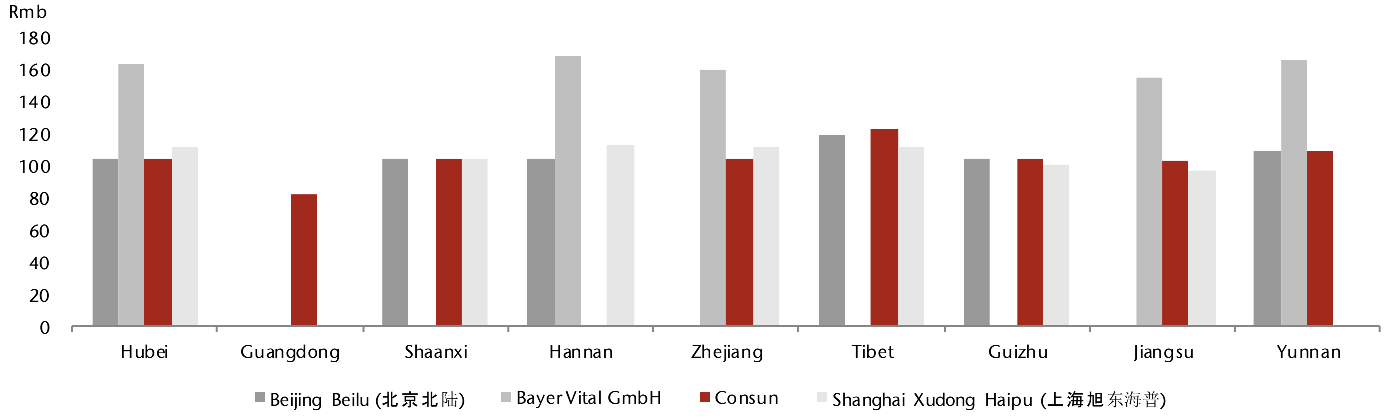
Chart 123: Consun's GD injection has been priced at competitive level in tenders in 2018



(*) – tender price on dosage 15ml:7.0 4g specification

Source: db.yaozh.com, NMPA, Jefferies

MRI penetration in China is still low: 6.6 per mm population, whereas 40 per mn population in the US

Growth potential from increasing MRI penetration in China. Consun's GD injection revenue growth was generally in line with the growth of number of MRI in China. Number of MRI installed in China grew with a CAGR of 20.0% in 2011-15, whereas Consun's GD injection revenue grew with CAGR of 23.8% in the same period. Although the number of installed MRI has been increasing rapidly, per million population installation rate is still relative low in China. As of 2015, per million population MRI installation rate in China was 6.6 units, whereas the number in developed countries reached 40 units. We can see there is still huge growth potential in the number of MRI in China and we therefore believe Consun's GD injection can continue its growth with the increasing penetration of MRI in China.

Target to launch iopamidol injection in 2019

Launching X-ray medical contrast medium in 2019. Consun targets to launch iopamidol injection in 2019. The Company has passed the on-site reviews on research and production as well as on-site production inspections for the product. It was originally expected to receive approval and launch in 1H18. However, due to recent policy changes, the Company need to support data with additional 3-6-month stability data. The Company targets to hand in the data by the end of this year and to receive approval in 2019. Iopamidol is a nonionic, low-osmolar iodinated contrast agent, primarily used for angiography throughout the cardiovascular system, adult and pediatric intravenous excretory urography, intravenous adult and pediatric contrast enhancement of computed tomographic (CT) head and body imaging.

Iopamidol market dominated by the original drug manufacturer. Iopamidol injection is one of the major class of X-ray medical contrast medium used in China with 9.6% of market share of the Rmb6.4bn contrast medium market in China in 2016. Its market grew with a CAGR of 11.3% in 2012-16. Currently only two manufacturers in China supplies iopamidol and the original drug manufacturer Bracco holds a dominant market share of 95.2% in 2016. Beijing Beilu entered the market in 2015 and holds the remaining 4.8% of the market.

Growth potential from replacing original drugs and increasing penetration. Consun's iopamidol injection has the potential to be the third product in China and we believe Consun has significant potential in replacing the original drug with aggressive pricing and positioning. Besides, similar to the case of MRI, CT installation rate is still relatively low in China. Number of CT installed in China grew with CAGR of 12.1% in 2011-15 but the per million population number of CT was only 15.7 units, significantly lower than 92.6 units and 32.2 units of Japan and US respectively. We therefore believe the market still have huge growth potential.

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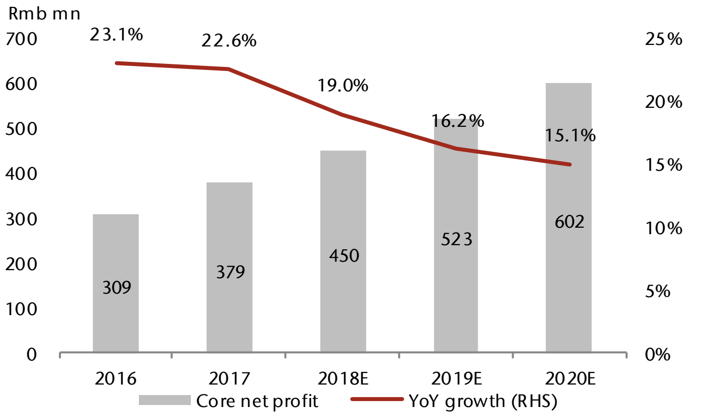
Financials

Stable growth ahead

Core net profit CAGR of 16.7% in 17 - 20E, to be supported by 13.2% revenue CAGR within the same period

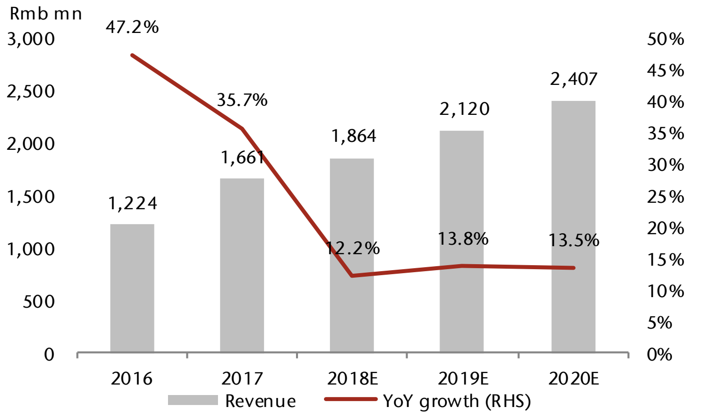
As an exclusive TCM product with proven efficacy in treating CKD, we believe UCG would deliver stable growth in the next three years. On the other hand, we expect Yulin business to grow by same store sales growth and ASP increment. For contrast agent business, although we expect limited growth potential from GD injection, the expected launch of new product in 2019 may bring additional momentum to the segment. We forecast core net profit CAGR of 16.7% in 17-20E for Consun, supported by 13.2% revenue CAGR within the same period.

Chart 124: We expect core net profit CAGR of 16.7% ...



Source: Jefferies estimates, company data

Chart 125: ... and revenue CAGR of 13.2% in 17-20E



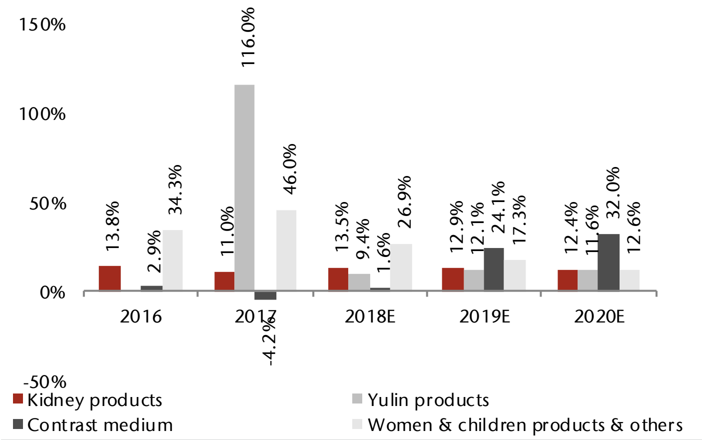
Source: Jefferies estimates, company data

UCG to remain as the most important product for Consun

We expect low-teens revenue CAGR for UCG and Yulin business in 17-20E

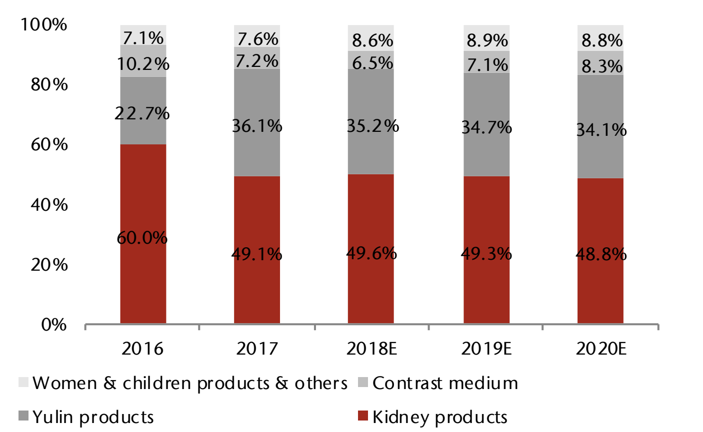
We expect kidney products (mainly UCG) to deliver revenue CAGR of 13.0% in 17-20E and to remain as the most important products for the Company, with revenue contribution slightly decreased from 49.1% in 2017 to 48.8% in 2020E. For Yulin business, we forecast a revenue CAGR of 11.0% in 17-20E and the revenue contribution to drop from 36.1% in 17 to 34.1% in 20E. For contrast medium, with the potential launch of new product in 2019, we expect revenue CAGR of 18.5% within the period. As a whole, we expect the total revenue to grow 12.2%/13.8%/13.5% in 18E/19E/20E.

Chart 126: Revenue growth breakdown by segments



Source: Jefferies estimates, company data

Chart 127: Revenue contribution breakdown by segments



Source: Jefferies estimates, company data

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Table 41: Revenue breakdown by segment for Consun

	2016	2017	2018E	2019E	2020E
	Rmb mn	Rmb mn	Rmb mn	Rmb mn	Rmb mn
Kidney products	734	815	925	1,045	1,175
Yulin products	278	600	656	736	821
Contrast medium	125	120	122	151	199
Women & children products and others	87	126	160	188	212
Total	**1,224**	**1,661**	**1,864**	**2,120**	**2,407**

Source: Jefferies estimates, company data

Table 42: Revenue growth breakdown by segment

	2016	2017	2018E	2019E	2020E
Kidney products	13.8%	11.0%	13.5%	12.9%	12.4%
Yulin products	N/A	116.0%	9.4%	12.1%	11.6%
Contrast medium	2.9%	-4.2%	1.6%	24.1%	32.0%
Women & children products and others	34.3%	46.0%	26.9%	17.3%	12.6%
Total	**47.2%**	**35.7%**	**12.2%**	**13.8%**	**13.5%**

Source: Jefferies estimates, company data

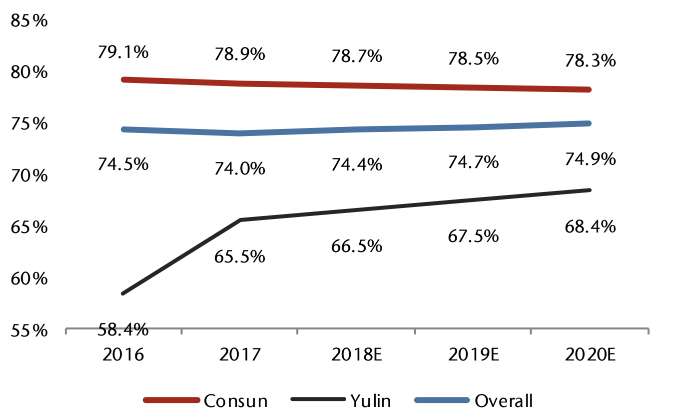
Slight improvement in margins due to expected Yulin price hike

Gross margin increment supported by expected ASP hike for Yulin products

We expect mild ASP pressure for Consun's ex-Yulin products (Kidney, contrast medium and others) and the gross margin of that part would drop slightly from 78.9% in 2017 to 78.3% in 2020E. Meanwhile, we expect in average low-single digit ASP increment potential for Yulin products in the next three years and as a result, the gross margin of Yulin products to increase from 65.5% in 2017 to 68.4% in 2020E. As a result, the overall gross margin of the Company would increase from 74.0% in 2017 to 74.9% in 2020E.

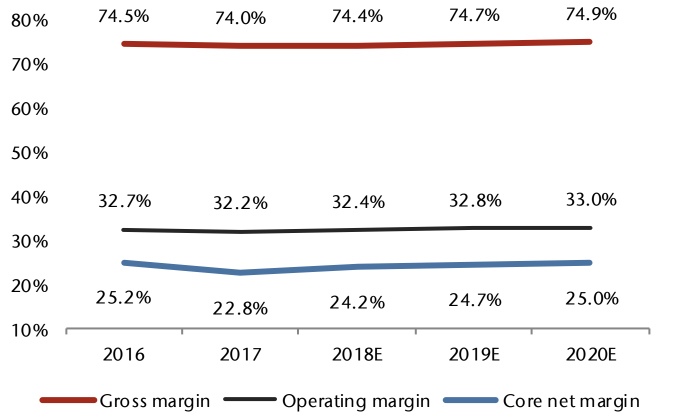
Due to a relatively stable operating expenses structure, we expect the operating margin and core net margin would show similar improvement trend as gross margin in the next three years.

Chart 128: We expect slight gross margin increment in the next three years...



Source: Jefferies estimates, company data

Chart 129: ... and similar trend in core net margin within the same period for Consun



Source: Jefferies estimates, company data

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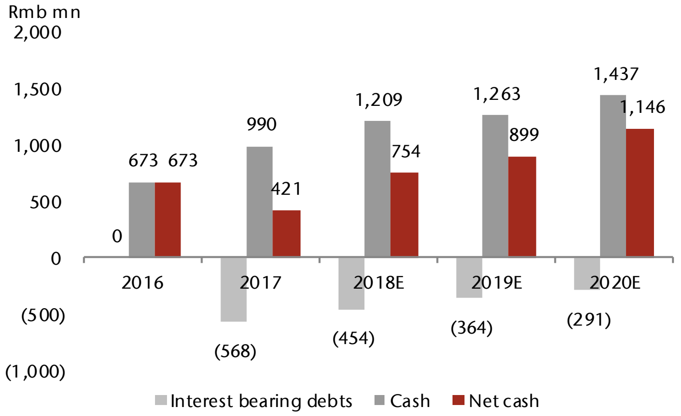
Healthy financial position

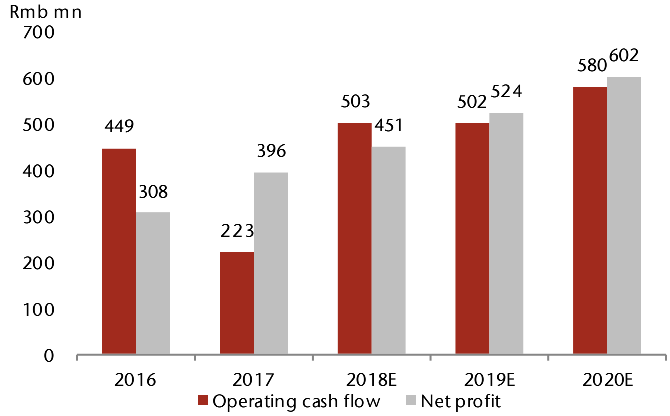
Consun has maintained a healthy net cash position since its listing in late 2013. Supported by the strong operating cash flow and relatively limited CAPEX, we expect the Company to continue its healthy financial position in the next three years. With the healthy financial position, we believe the Company can maintain its dividend payout ratio of around 30%.

Chart 130: We expect Consun to continue its healthy net cash position ...



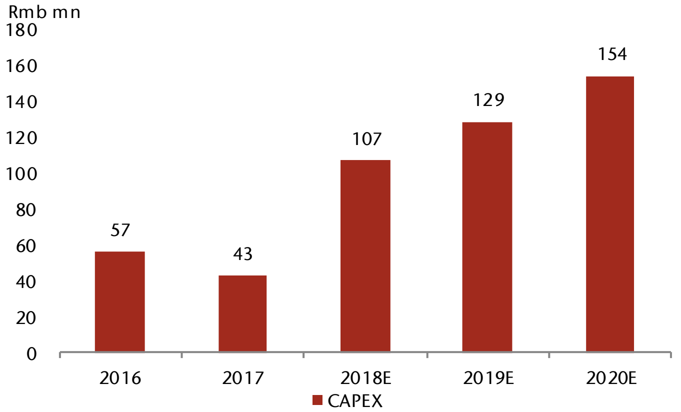
Source: Jefferies estimates, company data

Chart 131: ... to be supported by continuous profit growth and strong operating cash flow



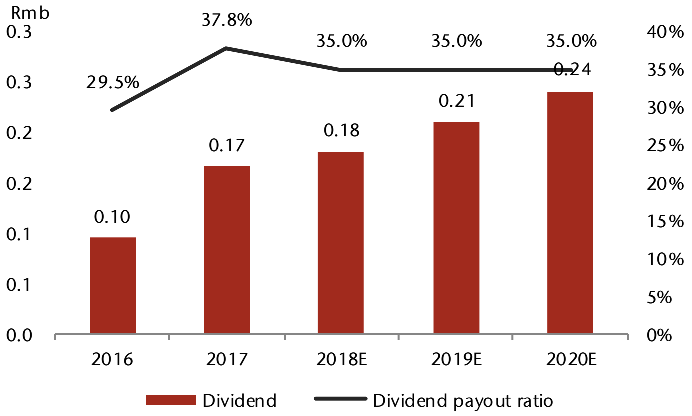
Source: Jefferies estimates, company data

Chart 132: Relatively small CAPEX need in the next three years



Source: Jefferies estimates, company data

Chart 133: To maintain a relative stable dividend policy with the healthy financial position



Source: Jefferies estimates, company data

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Valuation

Leverage on its clinically proven exclusive TCM product UCG, strong brand names from the acquisition of Yulin, we believe Consun would be able to deliver stable revenue growth in the next three years. We forecast core net profit CAGR of 16.7% in 17-20E on the back of revenue CAGR of 13.2%. We believe the market has been overly pessimistic towards the Company and it is trading at 18E/19E PER of 8.2x/7.1x. In fact, core business of Consun is relatively unaffected by policy headwind and the low valuation is unjustified. We initiate BUY on the Company with a TP of HK$6.8 based on DCF model (WACC: 13.2%, terminal growth: 2.0%). Our TP implies 2018E/19E PER of 10.1x/8.8x

Table 43: DCF model of Consun

	2019E Rmb mn	2020E Rmb mn	2021E Rmb mn	2022E Rmb mn	2023E Rmb mn
Net profit	524	602	688	778	869
Depreciation and amortization	72	80	88	97	105
Net interest after tax	(9)	(17)	(23)	(31)	(39)
CAPEX	(129)	(154)	(139)	(138)	(156)
Change in working capital	(116)	(123)	(134)	(130)	(189)
FCF	342	388	480	575	590
Terminal value					5,386
Corporate value	4,506				
Debt & Preferred Stock	454				
Bank deposit and pledged cash	1,263				
Equity Value	5,314				
Number of shares	875				
Value per share (Rmb)	6.07				
Value per share (HK$)	**6.80**				
Risk free rate	3.5%				
Beta	1.0				
Risk premium	10.6%				
Cost of equity	14.1%				
Cost of debt	6.0%				
WACC	13.2%				
Terminal growth rate	2.0%				

Source: Jefferies estimates

Chart 134: Sensitivity analysis

Terminal growth / WACC	11.7%	12.2%	12.7%	13.2%	13.7%	14.2%	14.7%
0.5%	7.1	6.8	6.6	6.3	6.1	5.9	5.7
1.0%	7.3	7.0	6.7	6.5	6.2	6.0	5.8
1.5%	7.5	7.2	6.9	6.6	6.4	6.2	5.9
2.0%	7.8	7.4	7.1	6.8	6.5	6.3	6.1
2.5%	8.0	7.7	7.3	7.0	6.7	6.5	6.2
3.0%	8.3	7.9	7.5	7.2	6.9	6.6	6.4
3.5%	8.7	8.2	7.8	7.4	7.1	6.8	6.5

Source: Jefferies estimates

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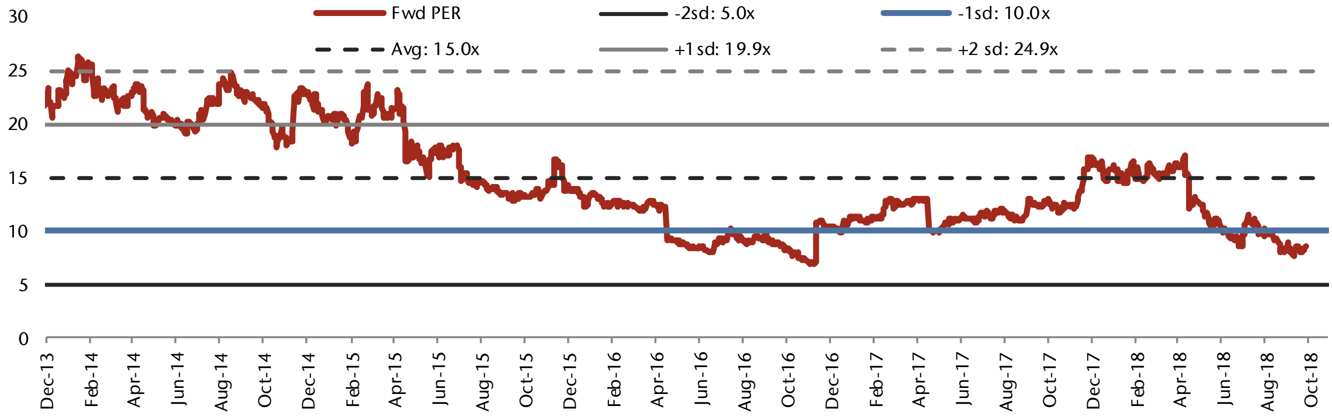
Chart 135: Rolling fwd PER band of Consun



Source: Bloomberg, Jefferies estimates, company data

Investment risks

Slower than expected growth of core business segments

The revenue growth of Consun is mainly supported by two major business segments: kidney products and Yulin business. We are expecting low-teens growth for both segments in the next three years. If there is significant slowdown in growth of any of the segment, the overall growth of the Company would significantly be affected.

Relatively weak R&D capabilities

When comparing with other pharmaceutical companies, Consun put relatively smaller efforts in R&D and the Company has a relatively small product pipeline. As mentioned, growth of Consun is highly dependent on kidney products and Yulin business. With the lack of new products, we do not see significant growth potential for Consun.

Significant ASP pressure

We are expecting mild ASP pressure for Consun's TCM finished drugs and low single digit ASP increment for Yulin products. If there is significant ASP pressure for Consun's TCM finished drugs either from policy or from drug tender, or the ASP hike of Yulin products is smaller than expected, the overall margin and business growth of Consun would be negatively affected.

Delay in the launch of new products

The launch of contrast medium iopamidol injection has been delayed from 1H18 to 2019. As mentioned, Consun has relatively small number of pipeline products, any delay in launching of new products would have significant impact on the growth of the Company.

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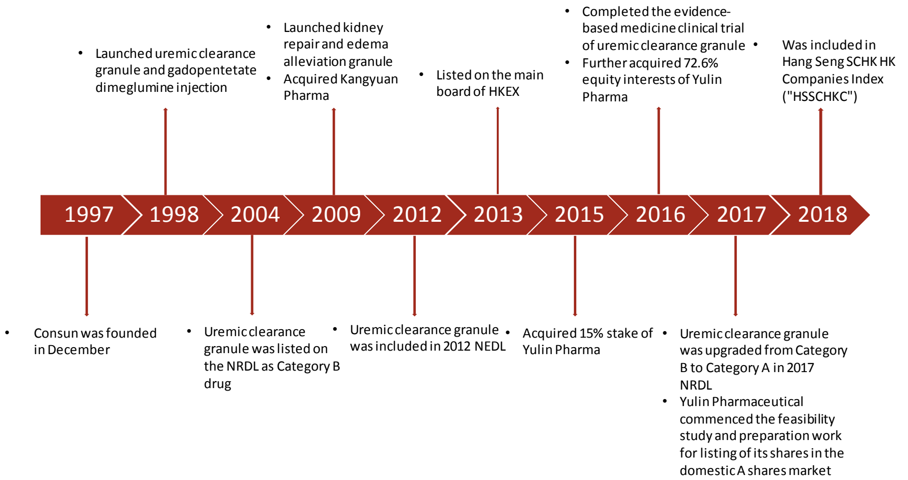
Company background

Consun Pharmaceutical Group is an integrated pharmaceutical company, which researches, manufactures, and sells Chinese medicines and medical contrast medium. It was founded in 1997 and is headquartered in Guangzhou. The company operates through two segments, Consun Pharmaceutical and Yulin Pharmaceutical. It primarily offers uremic clearance granules for treating kidney disease; and gadopentetate dimeglumine injection, a medical contrast medium for magnetic resonance imaging. The company also provides iron dextran oral solution in the field of iron supplement for women and children; and educational courses for medical practitioners. In addition, it develops digestive, orthopedic, dermatologic, and hepatobiliary medicines.

The company sells its kidney medicines and medical contrast medium through third party distributors to hospitals, medical institutions, and pharmacies. It had 154 types of products (41 of which were included in the EDL and 89 in the NRDL), indicating for medical contrast medium and treatments of CKD, dermatology, bone fracture, liver and gallbladder and digestive system. Its flagship product, UCG, ranked No.1 in oral TCM for treating CKD in China and GD injection ranked No.3 in MRI contrast medium in China in 2016.

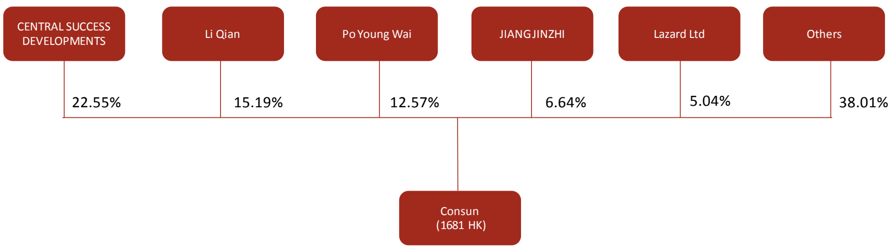
Consun Pharma acquired a 15% stake in Yulin Pharma in Aug 2015 and further increased its equity interests to 72.6% in Nov 2016. Yulin Pharma is a well-established traditional Chinese medicine manufacturer engaged in the research, production and sales of Chinese medicines and natural medicines. The Company expanded its OTC business and enriched its product portfolios through the acquisition of Yulin Pharma, which owned the renowned OTC products, such as Zheng Gu Shui, Shiduqing and Jigucao. Yulin Pharma generated ~36% of total revenue in FY2017.

Chart 136: Consun's milestones



Source: Jefferies, company data

Chart 137: Shareholding structure of Consun



Source: HKEx, Jefferies, company data

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Table 44: Directors and key managements

Name	Job	Description
AN Yubao	Chairman and Executive Director	AN Yubao, aged 75, is the chairman and an executive Director and a Controlling Shareholder. He is also the chairman of Guangzhou Consun Pharmaceutical Company Limited ("GZ Consun"), Consun Pharmaceutical (Inner Mongolia) Co., Ltd. ("Inner Mongolia Consun") and Yulin Pharmaceutical, and a director and the legal representative of Guangzhou Consun Pharmaceutical Research Company Limited ("Consun Research"). Mr. AN is primarily responsible for the overall management, operations, investment and the charting and reviewing of corporate directions and strategies of our Group. Mr. AN has nearly 20 years of experience in medical education and over 20 years of experience in the business of the pharmaceutical industry.
LI Qian	Executive Director and CEO	LI Qian, aged 53, is an executive Director and chief executive officer and one of the founders of the Group, and is also an executive director and the general manager of Yulin Pharmaceutical, primarily responsible for formulating and implementing the corporate strategies, overseeing production activities, business development, research and administrative management of the Group. Ms. LI has over 27 years of experience in the business of pharmaceutical industry. Prior to joining the Group, Ms. LI worked at Southern Medical University from October 1989 to April 1998. Ms. LI joined in 1997 when Consun Pharmaceutical was newly set-up, as the associate director of general manager's office, human resources manager, deputy executive general manager and deputy sales general manager of GZ Consun. Ms. LI has also served as a director and the general manager (which was redesignated as president in May 2008) of GZ Consun since November 1999.
ZHU Quan	Executive Director	Professor ZHU Quan, aged 78, is an executive Director. Professor ZHU is also a director and the chief scientist of GZ Consun and the general manager of Consun Research. Professor ZHU joined the Group in August 2006 as the chief scientist of GZ Consun. Professor ZHU is primarily responsible for the product research and development. Professor ZHU has over 30 years of experience in teaching and research at medical school and over 10 years of experience in the business of pharmaceutical industry. Professor ZHU has served as professor and Ph.D. candidate supervisor at Macau University of Science and Technology since September 2003. He served various positions, such as a deputy director of medicine department, a director of National Standardization Laboratory for Chinese Herbal Pharmacology, a Ph.D. candidate supervisor at Nanjing University of Chinese Medicine between October 1981 and November 2005.
TANG Ning	Vice President of GZ Consun	TANG Ning, aged 52, is a vice president of GZ Consun. Mr. TANG joined the Group in July 1998 as a business manager. Between July 1998 and June 2011, Mr. TANG served various positions at GZ Consun, such as business manager, regional marketing manager, marketing director, and president assistant. He has been the vice president of GZ Consun since June 2011. Prior to joining our Group, Mr. TANG worked at Cili County Baifang General Company between October 1987 and June 1998.
ZHOU Shangwen	Vice President of GZ Consun	ZHOU Shangwen, aged 48, is a vice president of GZ Consun. Mr. ZHOU joined the Group in April 2004 as a marketing manager for Guangdong province. Between April 2004 and June 2013, Mr. ZHOU served various positions at GZ Consun, such as regional marketing manager, marketing director for our kidney drugs and president assistant. Prior to joining our Group, Mr. ZHOU worked at Guangzhou Brain Hospital between July 1995 and March 1997. Mr. ZHOU graduated from Beijing Medical University (now known as Peking University Health Science Centre) in July 1995 with a bachelor's degree in mental health.
FANG Lanfen	Vice President of GZ Consun	FANG Lanfen, aged 55, is a vice president of GZ Consun. Ms. FANG joined the Group in July 1999 as a business manager. Between July 1999 to July 2013, Ms. FANG served various positions at GZ Consun, such as business manager, regional marketing manager and marketing director. Prior to joining, Ms. FANG worked at Guzhen County Hospital between July 1985 and September 1989, and at Water Resource Department of Anhui Province Hospital between September 1989 and July 1999. Ms. FANG graduated from Bengbu Medical College with a bachelor's degree in medical in July 1985.
FANG Peicheng	Chief Financial Officer and President Assistant of GZ Consun	FANG Peicheng, aged 39, is the chief financial officer and president assistant of GZ Consun. Mr. FANG joined the Group in August 2010 as an audit manager. He has been the audit and legal director since January 2013, president assistant of GZ Consun since January 2015, and the chief financial officer since June 2016. Prior to joining, Mr. FANG worked as audit supervisor at Xilong Chemical Company Limited between May 2008 and July 2010.
GAO Haien	Board secretary and the board secretary of GZ Consun	GAO Haien, aged 49, is the Board secretary and the board secretary of GZ Consun. Mr. GAO joined as the board secretary of GZ Consun. Mr. GAO has been the manager and legal representative of Guangzhou Consun Pharmaceutical and Inner Mongolia Consun since March 2013, and the manager and legal representative of Guangxi Yulin Pharmaceutical Group and Guangzhou Consun Pharmaceutical since August 2015. Mr. GAO also acted as a joint company secretary of the Company from 15 April 2014 to 31 May 2017. Prior to joining, Mr. GAO successively served as a general manager of the accessories store and the assistant to headquarters general manager of Shenzhen Sunyes Tools Co. Ltd.

Source: Company Data

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Financial statements

Table 45: Income statement

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	**1,224**	**1,661**	**1,864**	**2,120**	**2,407**
Kidney	734	815	925	1,045	1,175
Contrast medium	125	120	122	151	199
Women and children medicine and others	87	126	160	188	212
Yulin products	278	600	656	736	821
Cost of sales	(312)	(432)	(477)	(537)	(604)
Gross profit	**911**	**1,229**	**1,387**	**1,583**	**1,803**
Other income and gains	4	9	6	7	6
Distribution expenses	(374)	(540)	(587)	(675)	(761)
Administrative expenses	(104)	(118)	(145)	(157)	(183)
R&D expenses	(38)	(45)	(56)	(64)	(72)
Operating profit	**400**	**534**	**604**	**695**	**794**
Share of profit of associate / JV	4	0	0	0	0
Finance income / (expenses)	2	(11)	6	12	17
Exceptional	(2)	23	0	0	0
Pre-tax profit	**404**	**546**	**609**	**707**	**811**
Profits tax	(84)	(123)	(128)	(148)	(170)
Minority interest	(12)	(26)	(30)	(34)	(38)
Net profit	308	397	451	524	602
Core net profit	**309**	**379**	**451**	**524**	**602**
EBITDA	**430**	**598**	**638**	**732**	**836**
EPS (Rmb)	0.32	0.46	0.52	0.60	0.69
Core EPS (Rmb)	0.32	0.44	0.52	0.60	0.69
DPS (Rmb)	0.10	0.17	0.18	0.21	0.24
BVPS (Rmb)	2.01	2.00	2.43	2.76	3.22

Source: Jefferies estimates, company data

Table 46: Balance sheet

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
Non-current assets	**1,369**	**1,387**	**1,430**	**1,487**	**1,561**
Fixed asset	411	419	491	577	681
Prepaid lease payments	86	133	133	133	133
Goodwill	321	321	321	321	321
Intangible assets	490	460	431	401	372
Other non-current assets	61	55	55	55	55
Current assets	**1,390**	**2,185**	**2,448**	**2,628**	**2,936**
Cash	673	990	1,209	1,263	1,437
Trades, bills & other receivables	576	995	1,025	1,124	1,227
Inventories	141	200	215	242	272
Current liabilities	**547**	**970**	**875**	**866**	**862**
Borrowings	0	194	91	73	58
Trades, bills & other payables	483	680	687	696	707
Other current liabilities	63	97	97	97	97
Non-current liabilities	**151**	**538**	**527**	**454**	**396**
Borrowings	0	374	364	291	233
Other non-current liabilities	151	163	163	163	163
Total net assets	**2,061**	**2,064**	**2,477**	**2,794**	**3,239**
Minority interest	**301**	**317**	**348**	**382**	**420**
Shareholders' equity	**1,760**	**1,747**	**2,129**	**2,412**	**2,819**

Source: Jefferies estimates, company data

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Table 47: Cash flow summary

YE Dec 31 (Rmb mn)	FY16A	FY17A	FY18E	FY19E	FY20E
EBIT	**400**	**534**	**604**	**695**	**794**
Depreciation and amortization	40	67	65	72	80
Change in working capital	46	(275)	(37)	(116)	(123)
Income tax paid	(62)	(123)	(128)	(148)	(170)
Others	25	19	-	-	-
Net cash from operating activities	**449**	**223**	**503**	**502**	**580**
Capex	(57)	(43)	(107)	(129)	(154)
Others	149	3	22	25	27
Net cash from investing activities	**92**	**(40)**	**(85)**	**(104)**	**(127)**
Change of Debts	(90)	546	(114)	(91)	(73)
Issuance/(repurchase) of shares	(81)	(221)	-	-	-
Dividend paid	(115)	(176)	(69)	(241)	(196)
Others	(73)	(15)	(16)	(13)	(10)
Net cash from financing activities	**(358)**	**134**	**(199)**	**(344)**	**(279)**
Net change in cash	183	317	219	54	174
Cash at the beginning of the year	490	673	990	1,209	1,263
Exchange difference	-	-	-	-	-
Cash at the end of the year	**673**	**990**	**1,209**	**1,263**	**1,437**

Source: Jefferies estimates, company data

Table 48: Key ratios

YE Dec 31	FY16A	FY17A	FY18E	FY19E	FY20E
Sales mix (%)					
Kidney	60.0	49.1	49.6	49.3	48.8
Contrast medium	*10.2*	*7.2*	6.5	7.1	8.3
Women and children medicine and others	*7.1*	*7.6*	8.6	8.9	8.8
Yulin products	*22.7*	*36.1*	35.2	34.7	34.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Profit & loss ratios (%)					
Gross margin	74.5	74.0	74.4	74.7	74.9
EBITDA margin	35.1	36.0	34.2	34.5	34.7
Net margin	25.2	23.9	32.7	33.3	33.7
Core net margin	25.2	22.8	24.2	24.7	25.0
Effective tax rate	20.8	22.6	21.0	21.0	21.0
Growth (%)					
Revenue	47.2	35.7	12.2	13.8	13.5
Kidney	13.8	11.0	13.5	12.9	12.4
Contrast medium	2.9	(4.2)	1.6	24.1	32.0
Women and children medicine and others	34.3	46.0	26.9	17.3	12.6
Yulin products	#DIV/0!	116.0	9.4	12.1	11.6
Gross profit	35.9	34.9	12.8	14.1	13.9
EBITDA	40.1	39.0	6.7	14.8	14.1
Operating profit	36.0	33.6	13.0	15.1	14.3
Net profit	23.3	29.0	19.1	16.2	14.9
Core net profit	23.1	22.6			
Balance sheet ratios			2.8	3.0	3.4
Current ratio (x)	2.5	2.3	196	193	186
Trade receivables turnover days	138	168	55	58	58
Trade payables turnover days	70	63	159	142	164
Inventory turnover days	124	144	Net cash	Net cash	Net cash
Net debt to total equity ratio (%)	Net cash	Net cash			
Returns (%)			21.2	21.7	21.4
ROE	17.5	22.7	11.6	12.7	13.4
ROA	11.2	11.1	49.6	49.3	48.8

Source: Jefferies estimates, company data

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CTCM

Buy: HK$7.0 Price Target

Scenarios

Base Case

- Robust growth of CTCMG without significant changes in market landscape
- Decoction pieces to deliver mid-teens revenue growth
- Finish drugs to deliver low-teens revenue growth
- 17-20E core net profit CAGR of 26.4%
- Gradual margin improvement with faster growth of high margin business
- PT of HK$7.0 based on 5-year DCF model, terminal growth rate 3.0%, WACC 13.2%

Upside Scenario

- Opening of CTCMG market with limited new players entering the industry
- Aggressive expansion into decoction pieces with significant M&As
- Faster growth of OTC finished drugs business
- 17-20E core net profit CAGR of 29.5%
- TP of HK$8.3 based on 5-year DCF model, terminal growth rate of 4.0%, WACC 13.2%.

Downside Scenario

- More intense competitive landscape for CTCMG industry
- Slow than expected progress in expanding into decoction pieces industry.
- More stringent policy control on TCM finished drugs business
- 17-20E core net profit CAGR of 21.7%
- TP of HK$5.7 based on 5-year DCF model, terminal growth rate of 2.0%, WACC 13.2%

Investment Thesis / Where We Differ

- CTCMG to remain as the main growth driver for the Company
- We do not expect significant competitions for CTCMG market even with the opening of the industry
- Supportive policies for decoction pieces and CTCMG to continue
- Relatively inert to industry policy headwinds

Catalysts

- Opening of CTCMG market, increasing penetration into lower tier hospitals
- Rapid expansion in decoction pieces industry
- Industry consolidation potential with the support of parent company

Long-Term Analysis

Long-Term Financial Model Drivers

LT Earnings CAGR	**26.4%**
Organic Revenue Growth	**22.1%**
Acquisition Contribution	**0%**
Operating Margin Expansion	**4.3%**

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Shineway

Buy: HK$13.3 Price Target

THE LONG VIEW

Scenarios

Base Case

- Rapid expansion into CTCMG industry
- Returning to growth for TCM finished drugs business
- Stable margin performance with limited ASP pressure
- 17-20E core net profit CAGR of 21.0%
- PT of HK$13.3 based on 5-year DCF model, terminal growth rate 2.0%, WACC 14.1%

Upside Scenario

- More rapid expansion into new provinces for CTCMG industry
- Better-than-expected growth outlook for TCM finished business
- Margin improvement with stable ASP and faster growth of CTCMG business
- 17-20E core net profit CAGR of 25.4%
- PT of HK$15.8 based on 5-year DCF model, terminal growth rate of 3.0%, WACC 14.1%.

Downside Scenario

- Difficulties in expanding CTCMG business beyond Hebei province
- More stringent regulations on the usage of TCM injections
- ASP pressure to major products
- 17-20E core net profit CAGR of 16.2%
- PT of HK$11.1 based on 5-year DCF model, terminal growth rate of 1.0%, WACC 14.1%

Investment Thesis / Where We Differ

- Rapid expansion of CTCMG business and becoming one of the major players for the industry
- TCM finished drugs business has reached the trough and should deliver growth again starting 18E
- Expansion of TCM granules and soft capsules to complement the growth of injections

Catalysts

- Expanding into more provinces for CTCMG business
- Rapid expansion of products newly included in NRDL and EDL
- Explore expansion opportunity with the capital resources on hand

Long-Term Analysis

Long-Term Financial Model Drivers

LT Earnings CAGR	**21.0%**
Organic Revenue Growth	**23.6%**
Acquisition Contribution	**0%**
Operating Margin Expansion	**-2.6%**

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Consun

Buy: HK$6.8 Price Target

THE LONG VIEW

Scenarios

Base Case

- Stable growth outlook for kidney products
- Growth of OTC products driven by both same store sales growth and ASP increase
- Launch of new contrast medium product in 19E to add extra growth momentum
- 17-20E core net profit CAGR of 16.7%
- PT of HK$6.8 based on 5-year DCF model, terminal growth rate 2.0%, WACC 13.2%

Upside Scenario

- Faster growth of kidney products leverage on the complete coverage by NRDL
- Higher ASP increment and same store sales growth for OTC products
- 17-20E core net profit CAGR of 19.9%
- PT of HK$8.3 based on 5-year DCF model, terminal growth rate of 3.0%, WACC 13.2%.

Downside Scenario

- Slow down growth of kidney products and facing ASP pressure
- Limited ASP increment potential and sow down growth for OTC products
- Further delay in launching new contrast medium product to 20E
- 17-20E core net profit CAGR of 13.4%
- PT of HK$5.7 based on 5-year DCF model, terminal growth rate of 1.0%, WACC 13.2%

Investment Thesis / Where We Differ

- Stable growth potential from proven efficacy TCM oral medication for chronic kidney disease
- Expansion potential with OTC product line
- Significantly undervalued: one of the lowest valued HK listed healthcare companies

Catalysts

- Launch of new contrast medium product
- Potential spinning off OTC business
- Further expansion through potential M&As

Long-Term Analysis

Long-Term Financial Model Drivers

LT Earnings CAGR	**16.7%**
Organic Revenue Growth	**13.2%**
Acquisition Contribution	**0%**
Operating Margin Expansion	**3.5%**

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Company Description

CTCM

China Traditional Chinese Medicine Holdings Co. Limited, an investment holding company, engages in the research and development, production, and sale of Chinese medicine and pharmaceutical products in the People's Republic of China. The company offers granules, finished drugs, decoction pieces, and healthcare products. It is also involved in the extraction of Chinese medicinal herbs; preparation of traditional Chinese medicines; trading of pharmaceutical products; provision of traditional Chinese medical consultation services; and operation of pharmacies. The company sells its products to hospitals and retail pharmacies. The company was formerly known as China Traditional Chinese Medicine Co. Limited and changed its name to China Traditional Chinese Medicine Holdings Co. Limited in July 2016.

Shineway

China Shineway Pharmaceutical Group Limited is principally engaged in research and development, production and sales of modern Chinese medicines mainly in the format of injections, soft capsules and granules. The Group's products are primarily applied for the treatments of (i) cardiovascular and cerebrovascular diseases, respiratory system diseases, colds and fevers, and digestive system diseases that commonly affect the middle and old aged people and/or children; and (ii) viral diseases. A total of 75 medicines of the Group are included in National Basic Medical Insurance, Work-Related Injury Insurance and Maternity Insurance Drug Catalogue (2017 edition).

Consun

Consun Pharmaceutical Group Limited, an integrated pharmaceutical company, researches, manufactures, and sells Chinese medicines and medical contrast medium. It was founded in 1997 and is headquartered in Guangzhou. The company operates through two segments, Consun Pharmaceutical and Yulin Pharmaceutical. It primarily offers uremic clearance granules for treating kidney disease; and gadopentetate dimeglumine injection, a medical contrast medium for magnetic resonance imaging. Flagship product, UCG, ranked No.1 in oral TCM for treating CKD in China and GD injection ranked No.3 in MRI contrast medium in China in 2016.

Company Valuation/Risks

CTCM

Our PT of HK$7.0 is based on our DCF model (WACC: 13.2%, terminal growth: 3.0%). Risks: (1) significant fluctuation in medicinal herbal price, (2) more intense than expected market competition for CTCMG business, (3) unexpected removal of supportive policies for TCM, and (4) larger than expected price pressure.

Shineway

Our PT of HK$13.3 is based on our DCF model (WACC: 14.1%, terminal growth: 2.0%). Risks: (1) failing in opening new markets for CTCMG business, (2) more stringent control on the usage of TCM injections, (3) slower than expected ramp up of new products in NRDL, and (4) fluctuation in raw material price.

Consun

Our PT of HK$6.8 is based on our DCF model (WACC: 13.2%, terminal growth: 2.0%). Risks: (1) slower than expected growth of core business segments, (2) relatively weak R&D capabilities, (3) significant ASP pressure, and (4) delay in the launch of new products

CSPC Pharmaceutical

Our HK$24.40 price target is based on our DCF model. Risks: (1) intensifying market competition; (2) delay in launching new products; (3) significant ASP decline.

Analyst Certification:

I, Cyrus Ng, CFA, certify that all of the views expressed in this research report accurately reflect my personal views about the subject security(ies) and subject company(ies). I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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Investment Recommendation Record

(Article 3(1)e and Article 7 of MAR)

Recommendation Published November 25, 2018 , 16:49 ET.

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Underperform - Describes securities that we expect to provide a total return (price appreciation plus yield) of minus 10% or less within a 12-month period.

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Other Companies Mentioned in This Report

- China Shineway Pharmaceutical Group Ltd (2877 HK: HK$10.00, BUY)
- China Traditional Chinese Medicine Holdings Co Ltd (570 HK: HK$5.35, BUY)
- Consun Pharmaceutical Group Ltd (1681 HK: HK$5.50, BUY)
- CSPC Pharmaceutical (1093 HK: HK$15.90, BUY)

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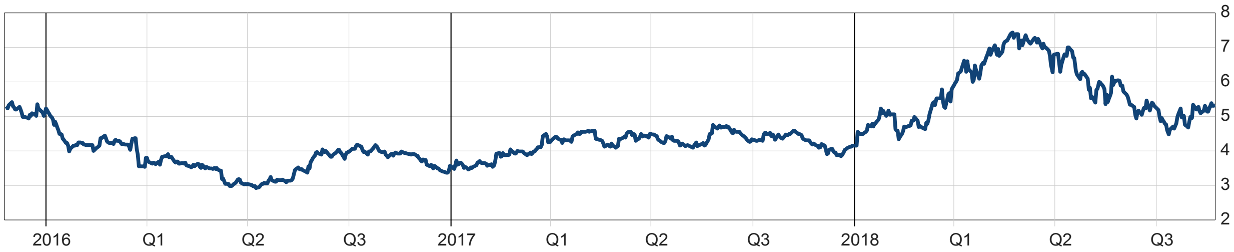
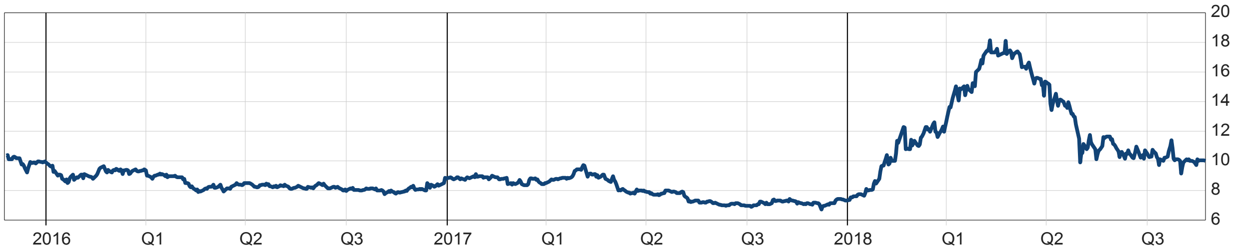
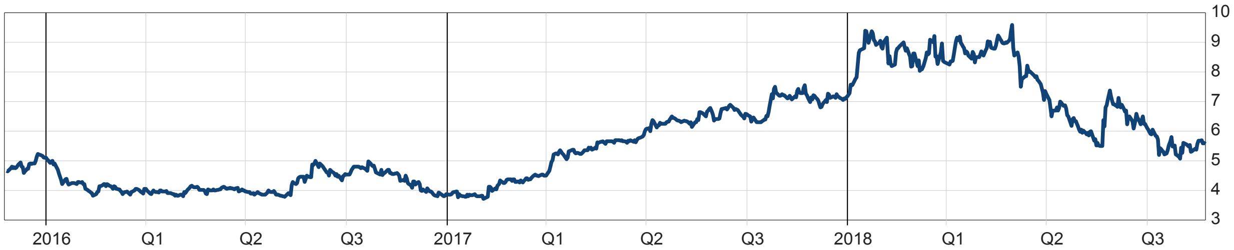
Rating and Price Target History for: China Traditional Chinese Medicine Holdings Co Ltd (570 HK) as of 11-22-2018



Rating and Price Target History for: China Shineway Pharmaceutical Group Ltd (2877 HK) as of 11-22-2018



Rating and Price Target History for: Consun Pharmaceutical Group Ltd (1681 HK) as of 11-22-2018



Rating and Price Target History for: CSPC Pharmaceutical (1093 HK) as of 11-22-2018

Notes: Each box in the Rating and Price Target History chart above represents actions over the past three years in which an analyst initiated on a company, made a change to a rating or price target of a company or discontinued coverage of a company.

Legend:

I: Initiating Coverage

D: Dropped Coverage

B: Buy

H: Hold

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UP: Underperform

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Distribution of Ratings

			IB Serv./Past 12 Mos.		JIL Mkt Serv./Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**	**Count**	**Percent**
BUY	1166	55.76%	94	8.06%	10	0.86%
HOLD	803	38.40%	14	1.74%	0	0.00%
UNDERPERFORM	122	5.83%	0	0.00%	0	0.00%

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