Aug 26, 2015
Company Report
Initiation
Rating : BUY
TP: HK$ 2.88

Share price (HK$)	2.40
Est. share price return	20.0%
Est. dividend yield	2.4%
Est. total return	22.4%

Analyst:
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Key data

52Wk H/L (HK$)	2.80/2.16
Issued shares (mn)	800.0
Market cap (HK$ mn)	1,920
Avg daily shares turnover since listing Jul 13 (HK$ mn)	7.25
Major shareholders:	
Mr. & Mrs. Lai	65.67%
Zhongrong Int'l Trust	5.91%

Source(s): The Company, ABCI Securities

Business data in FY14

Revenue mix by segment:	**Prop**	**Chg.**
Pharma mfg	49.5%	42.3%
Pharmacy	50.5%	9.1%
Revenue mix by products:		
A. Own-branded	61.5%	33.9%
1.Modern decoction pieces	*26.3%*	*139.1%*
2. Traditional decoction pieces	*6.7%*	*-2.1%*
3. Chinese patent medicines	*28.5%*	*1.5%*
B. Non-own branded	38.5%	9.6%

Gross profit mix by segment:	**Prop**	**Chg.**
Pharma mfg	54.0%	58.7%
Pharmacy	46.0%	13.0%
Gross profit mix by products:		
A. Own-branded	70.7%	48.5%
1.Modern decoction pieces	*37.9%*	*136.8%*
2. Traditional decoction pieces	*7.6%*	*3.6%*
3. Chinese patent medicines	*25.2%*	*3.7%*
B. Non-own branded	29.3%	8.1%

Source(s): The Company, ABCI Securities

Zhongzhi Pharmaceutical (3737 HK)

Small player on fast-track growth

- We expect net profit to grow at a CAGR of 39.7% from FY14-FY17E
- Highly differentiated products help protect profit margins
- Increased output of high-margin products and success of chain pharmacy operation in new markets to drive profit growth
- O2O business may provide an upside shock in earnings and valuation

Niche market and product differentiation as winning strategies. The Group was the largest chain pharmacy operator in Zhongshan in terms of the number of pharmacy and revenue in 2012-2014. It has a 16.3% market share, exceeding the second largest player by 11.8ppt. Its patented techniques for the production of modern decoction pieces differentiate its products from competitors and enabled a lucrative gross profit margin of 77.6% in FY14. As the Chinese medicine and decoction pieces markets are highly fragmented, we believe developing a niche market and product differentiation are crucial for profit growth in coming years. The strategies have been proved successful, as sales of modern decoction surged 44.5%YoY in 1H15 and contributed to 29% of total revenue.

Expanding capacity of high-margin products to sustain long-term growth. We expect the Group's pharmaceutical manufacturing business to grow at a CAGR of 26.2% in revenue and 32.4% CAGR in gross profit from FY14-FY17E after expanding the production for modern decoction pieces in 2016E.

Replicating the success of pharmacy operation in neighboring cities of Zhongshan. We expect the Group's operation of chain pharmacy business to grow at a CAGR of 27.4% in revenue and a CAGR of 27.8% in gross profit from FY14-FY17E, assuming the Group can follow through its plan to establish 200 self-operated pharmacies in neighboring cities by 2018.

O2O business may provide an upside earnings shock in the future. According to CFDA's website, the Group has obtained the GMP, GSP, Internet Pharmaceutical Information Service Certificate, and Internet Medicine Dealership Certificate, which would allow it to expand its business to the online realm.

Healthy balance sheet and good earning quality. The Group maintained a net cash position in FY13, FY14 and 1HFY15. Its net operating cash flow was at 1.2x/1.4x FY13 /FY14 net profits.

Valuation range. Referencing the forward P/E rating of peer group, we value the Group's pharmaceutical manufacturing business segment and chain pharmacy operation segment at 13.0x and 12.0x of their corresponding profit projections for FY16. We set our 12-mth TP at HK$ 2.88/share, which represents14.8x/12.5x FY15E/FY16E P/E or 3.28x/2.84x FY15E/FY16E P/B.

Business challenges and risks: (1) Production capacity constraint in FY15E-16E; (2) Intensifying market competition; (3) Validity of contractual arrangements of decoction pieces production; (4) Availability of resources to execute business expansion plan; (5) Share price risks due to low liquidity of shares or other unforeseeable factors.

Results and Valuation

FY ended Dec 31	2012	2013	2014	2015F	2016F	2017F	2012-14 CAGR (%)	2014-17E CAGR(%)
Revenue (RMBmn)	410.1	482.8	595.6	704.0	836.4	1,213.8	20.5	26.8
Chg (%YoY)	-	*17.7*	*23.4*	*18.2*	*18.8*	*45.1*	-	-
Net profit (RMBmn)	17.3	37.6	86.7	128.7	152.1	236.5	124.1	39.7
Chg (%YoY)	-	*118.1*	*130.3*	*48.4*	*18.2*	*55.4*	-	-
Pro-forma FD EPS (RMB)	0.029	0.063	0.144	0.161	0.190	0.296	124.1	26.9
Chg (%YoY)	-	*118.1*	*130.3*	*11.3*	*18.2*	*55.4*		
Pro-forma FD P/E (x)	-	-	13.74	12.34	10.44	6.72		
NBV (RMB/share)	0.154	0.217	0.201	0.727	0.840	0.973		
FD P/B (x)	-	-	9.85	2.73	2.36	2.04		
Post-listing DPS (RMB/share)	-	-	-	0.048	0.057	0.089		
Yield (%)	-	-	-	2.43	2.87	4.47		
ROAE (%)	-	33.8	69.0	36.6	24.3	32.6		
Net cash (RMBmn)	0.0	13.1	43.0	411.9	480.7	475.7		

Forex: RMB0.82717/HK$; Source(s): The Company, ABCI Securities estimates

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1HFY15 Results Review

Zhongzhi Pharmaceutical Holdings Limited ("the Group") was listed in HKEx in July 2015. The Group reported its 1HFY15 interim results on Aug 25. The results highlight its business performance for 6 months prior to its listing. Its revenue and net profit for 1H15 represented 49% and 48% of our annual forecasts for FY15.

Its balance sheet in the latest interim results is unable to reflect its improved financial position in which a net proceed of HK$452.9 mn was raised after its IPO in July.

Exhibit 1: 1H15 results review

Half-year (RMB mn)	1HFY14	2HFY14	1HFY15	Chg(YoY)	Chg(HoH)	1HFY15 result comments
Revenue breakdown:						
Pharma mfg	140.1	154.7	175.8	25.5%	13.6%	Boosted by modern decoction pieces
Chain pharmacies	147.9	152.8	171.5	15.9%	12.2%	Mainly boosted by per store sales
Total revenue	**288.1**	**307.5**	**347.3**	**20.6%**	**12.9%**	Represents 49.0% of our annual forecast
Of which,						
Modern decoction pieces	70.7	85.8	102.1	44.5%	19.0%	Accounts for 29% of total revenue in 1H15
Gross profit breakdown:						
Pharma mfg	82.6	90.3	111.8	35.4%	23.8%	
Chain pharmacies	71.6	75.8	80.2	12.0%	5.8%	
Total gross profit	**154.1**	**166.1**	**192.0**	**24.6%**	**15.6%**	Represents 48.6% of our annual forecast
Other income & gains	2.2	4.3	3.4	53.6%	-21.3%	
S&D expenses	(70.1)	(78.7)	(83.9)	19.7%	6.7%	
Admin expenses	(20.0)	(30.2)	(25.4)	27.5%	-15.8%	It included RMB2.5mn IPO expense
Other expenses	(4.6)	(7.4)	(5.5)	18.5%	-26.8%	
Operating profit	61.7	54.1	80.6	30.7%	49.0%	
Finance costs	(0.5)	(0.5)	(0.5)	0.8%	9.6%	
Pre-tax profit	**61.2**	**53.6**	**80.1**	**30.9%**	**49.3%**	
Tax	(13.4)	(14.8)	(18.0)	34.7%	21.8%	
Net profit	**47.8**	**38.9**	**62.1**	**29.9%**	**59.8%**	Represents 48% of our annual forecast
EBITDA	68.6	59.6	87.9	28.2%	47.6%	
Basic EPS (RMB)	0.0797	0.0648	0.1035	29.9%	59.8%	Pre-listing EPS
Issued shares (mn)	600.0	600.0	600.0	-	-	Post-IPO issued shares: 800.0mn
Revenue composition:						
Pharma mfg	48.6%	50.3%	50.6%			Almost 50-50 composition
Chain pharmacies	51.4%	49.7%	49.4%			
Gross profit composition:						
Pharma mfg	53.6%	54.4%	58.2%			Mfg business outweighs retail business
Chain pharmacies	46.4%	45.6%	41.8%			
Gross profit margin:						
Pharma mfg	58.9%	58.4%	63.6%	+4.7 ppt	+5.2 ppt	Increased sales of high- margin modern decoction pieces products
Chain pharmacies	48.4%	49.6%	46.8%	-1.6 ppt	-2.8 ppt	Increased sales of relatively low-margin of non-own brand products
Overall gross margin	53.5%	54.0%	55.3%	+1.8 ppt	+1.3 ppt	
Operating profit margin	21.4%	17.6%	23.2%	+1.8 ppt	+5.6 ppt	
Per-tax profit margin	21.2%	17.4%	23.1%	+1.8 ppt	+5.6 ppt	
Net profit margin	16.6%	12.6%	17.9%	+1.3 ppt	+5.2 ppt	1H15 ROAA:19.35%; ROAE: 45.34%
Revenue/average assets	-	-	108.2%			High asset turnover ratio
S&D exp/revenue	24.3%	25.6%	24.2%			Stable S&D expenses relative to sales
Admin exp/revenue	6.9%	9.8%	7.3%			Affected by IPO expenses
R&D exp/revenue	1.4%	2.3%	1.5%			
Finance cost/revenue	0.2%	0.2%	0.2%			
Effective tax rate	21.8%	27.5%	22.5%			
Average turnover days:						
Trade receivables			58			Extend credit period to large customers
Inventories			49			Drop from 2 mths in FY14
Trade payables			31			Stable at ~ 1 mth

Source(s): the Company, ABCI Securities

Investment Highlights

Winning strategies: Niche market and product differentiation

Net profit of Zhongzhi Pharmaceutical Holdings Limited ("the Group") grew at a CAGR of 124% from FY12-FY14, while its ROAA surged from 33.8% in FY13 to 69.0% FY14. We believe these remarkable results could be attributed to two winning strategies– niche market and product differentiation.

As the Chinese medicine industry is highly fragmented with numerous small players, we believe establishing a business niche through geographical coverage and product differentiation are crucial for small players to compete with the larger counterparts. The Group has successfully established its niche by gaining a strong foothold in a regional market (pharmacy market in Zhongshan) and developing a highly differentiated product line- the modern decoction pieces.

Although the Group's pharmacy business has a limited market share in China, its pharmacy network was the largest in Zhongshan by the number of pharmacies and retail sales value in 2013 that accounted for 16.3% of the market share in the region. Its market share in Zhongshan was higher than the second largest pharmacy chain operator, Zhongshan Da Sen Lin Chain Drugstore Co., Ltd (中山市大参林连锁药业有限公司), by 11.8ppt.

The Group operates its retail pharmacies under the "Zeus (中智)" brand. As a leading pharmacy operator in Zhongshan, its brand is well recognized by local residents. With a relatively high market share in the region, the Group's pharmacies also serve as an ideal distribution channel for drug manufacturers aiming to penetrate into the Zhongshan market. The Group has a strong bargaining power in the procurement and reselling of drug products in its pharmacies. We regard the chain pharmacy operation in Zhongshan as a cash cow business. For the Group, the number of pharmacies in the area was stable from 2012-2014, while revenue and gross profit derived from chain pharmacy operation rose by 12.5% and 16.8% CAGRs over the same period. The Group operates it pharmacy chain with an asset-light business model. Of the 201 pharmacies operated by the Group in Zhongshan in Mar 2015, 200 were operated in leased premises. Nonetheless, the rental burden remains manageable. In FY14, operating lease expenses accounted for 3.1% of total revenue, while operation of chain pharmacies contributed to 50.5% of total revenue and 46.0% of total gross profit. Gross profit margin of pharmacy chain improved from 42.9% in FY12 to 49.0% during the same period.

Its patented techniques to produce modern decoction pieces differentiate the Group's products from its peers while enabling a high gross profit margin (77.6% in FY14 for the modern decoction pieces products) and strong sales growth (a CAGR of 164.3% from 2012-2014). Sales of modern decoction pieces contributed 26.3% of total revenue and 37.9% of total gross profit to the Group in FY14.

Expanding production facilities of modern decoction pieces to boost profit growth of pharmaceutical manufacturing business

In the short term, we believe the Group will prioritize to expand production facilities of modern decoction pieces. We expect production capacity for this specific product line will be constrained in 2015E-16E. Utilization rate of the production line was high at 78% in 2014 although the Group had expanded the output capacity from 53 tonnes in 2012 to 212 tonnes in 2014 (a CAGR of 100%). Hence, we expect the strong growth momentum experienced in FY12-14 will moderate in FY15E-16E due to the capacity constraint.

The Group plans to install new production facilities for the modern decoction pieces in 2016E. The benefits of these new production facilities will be reflected in the business results starting from 2017E. The Group expects the output of modern decoction pieces to grow by 20% each year in 2015E and

2016E, which are reasonable in our view considering its existing capacity. In 2012-2014, sales value of modern decoction pieces grew faster than the output volume, suggesting the Group had allocated more production resources to produce higher value-added decoction pieces. Hence, we believe it will continue to optimize production resources to produce more value-added modern decoction in coming years.

Based on the production facilities expansion plan, we predict the sales of modern decoction pieces to grow at a CAGR of 46.2% from FY14 -FY17E and a CAGR of 46.5% in gross profit from FY14-FY17E. Based on the market and production expansion plan in coming years, we estimate contribution from the sales of modern decoction pieces will increase to 40.3% of total revenue and 53.8% of total gross profit by FY17E.

Replicating the model of pharmacy chain operation to neighboring cities

The Group plans to establish 200 pharmacies in Guangdong province outside Zhongshan by 2018. Although it lacks experience in operating pharmacies outside Zhongshan, we believe the risk is manageable as the new markets will be the neighboring cities of Zhongshan. The Group can leverage on its brand reputation as well as its logistic and warehousing system to penetrate into these new markets.

Assuming the Group will be able expand its pharmacy chain in coming years, we expect the revenue from operation of chain pharmacy to grow at a CAGR of 27.4% from FY14-17E and account for 51.2% of the total revenue in FY17E. Meanwhile, we predict the gross profit of chain pharmacy operation will grow at a CAGR of 27.8% from FY14-FY17E and account for 40.4% of total gross profit in FY17E.

Exhibit 2: New self-operated pharmacy to be established outside Zhongshan

New city market to penetrate (Relative location to Zhongshan)	FY2016E	FY2017E	FY2018E
Zhuhai (South of Zhongshan)	30		
Jiangmen (West of Zhongshan)	30		
Foshan (North of Zhongshan)		40	
Dongguan (East of Zhongshan)		40	
Other cities in Guangdong			60

Source(s): the Company

Online business may deliver strong boost in coming years

According to CFDA's website, the Group has obtained, among other licenses, a GMP license for production of pharmaceutical products for each of its two production plants in Zhongshan and a GSP license for each of its pharmacy chain in Zhongshan. CFDA has also granted Internet pharmacy certificate (粤 C20130005; http://zzdyf.cn; valid till June 6, 2018), Internet medicine dealership certificate (粤 C2013005; http://zzdyf.cn; valid till June 6, 2018), and Internet pharmaceutical information service certificate ((粤)-非经营性-2010-0241; valid till Nov 10, 2015) to the Group. We believe the Group has obtained the relevant licenses/certificates to develop its O2O business. According to our research on the two major e-commerce portals in China (Tmall.com and JD.com), the Group promotes its Zeus Pharmacy Flagship Store (中智大药房旗舰店) at Tmall.com and JD.com to market its own-branded products. The Group is utilizing the high traffic flow of China's popular e-commerce portals to expand its market presence in China. Although the revenue generated was limited (~RMB 0.4mn revenue) in previous years, we believe Internet pharmaceutical trading will become increasingly significant in the future. In particular, pharmacy operators with well-established offline logistics system and own-branded products, including the Group, will be better equipped to expand their businesses online.

The Group maintained a net cash position at end-2013 and 2014

The Group maintained a healthy balance sheet in the past two financial years. Its net cash position improved from RMB 13.1mn at end-2013 to RMB 43.0mn at end-2014 despite of dividend payment of RMB 96mn in 2014. Earnings quality was fair. Its net cash flow from operation activities were at 1.19x and 1.40x of its FY13 /FY14 net profit. Its auditor was Ernst & Young CPA. Total equity-to-total assets ratio was 40.6% at end-2014, suggesting the Group's has been relying heavily on shareholders' fund to operate and expand its business. Its asset-light business model enhances the Group's ROAA (29.1% in FY14), although it restricts the ability to obtain long-term credit facilities from the banks. In the medium term, the Group would need new financial resources to expand its production facilities and provide working capital for the expanded pharmacy network. Our earnings model assumes that the Group would be able to secure sufficient financial resources internally or externally to implement its business expansion strategies in coming years.

We expect net profit to grow at a CAGR of 39.7% from FY14-FY17E

We forecast net profit growth to slow from 130% YoY in FY14 to 48.4% YoY in FY15E and 18.2% in FY16E due to production capacity constraint. After the expansion of (1) its production capacity for its modern decoction pieces in 2016E; (2) geographical coverage of its pharmacy network in 2016E-17E, we predict net profit to grow by 55.4% YoY in FY17E. For 2014-17E, we predict net profit to grow at a CAGR of 39.7% from RMB 86.7mn in FY14 to RMB 236.5mn in FY17E. In our forecast, we have not factored in the potential boost delivered by its Internet pharmaceutical trading business.

Relative good stock price performance after IPO

The Hang Seng Index has declined 27% from April high to Aug 25, share price of Zhongzhi Pharma is also dragged. We compare the price performance of pharma stocks listed this year, Zhongzhi Pharma outperform other newly listed pharma stocks. We believe the outstanding price performance of Zhongzhi Pharma is due to the reasonable IPO price and the expected profit growth of the Group in coming years.

Exhibit 3: Price performance of newly listed pharma related stocks

Code	Stock	Main business /products	Listing date (M/D/Y)	Final IPO px (HK$)	IPO net proceeds (HK$mn)	At IPO px, proforma FY14 FD P/E (x)	At IPO px, proforma FY14 FD P/B (x)	8/25/2015 Share price (HK$)	Share price change since IPO
6896	GOLDEN THROAT HO	Lozenges mfg	07/15/15	4.60	764.7	21.93	3.80	4.14	-10.0%
3737	**ZHONGZHI PHARMA**	**Chinese medicine mfg & pharmacy**	**07/13/15**	**2.46**	**452.9**	**18.16**	**3.26**	2.40	**-2.4%**
1498	PURAPHARM CORP	Chinese medicine mfg	07/08/15	5.98	288.9	39.04	3.17	4.15	-30.6%
2666	UNIVERSAL MEDICA	Medical equipment finance lease	07/08/15	8.18	3,296.0	24.26	2.19	6.07	-25.8%
1509	HARMONICARE MEDI	Obstetrics & gynecology hospital service	07/07/15	7.55	1,359.1	44.83	4.68	6.20	-17.9%
574	PA SHUN PHARMACE	Pharma mfg & pharmacy	06/19/15	1.22	254.3	21.24	2.54	0.82	-32.8%
1530	3SBIO INC	Bio-pharma mfg	06/11/15	9.10	4,970.0	62.77	3.73	7.35	-19.2%
6826	SHANGHAI HAOHA-H	Biomedical materials mfg	04/30/15	59.00	2,254.6	41.15	3.15	44.50	-24.6%
1858	BEIJING CHUNLI-H	Orthopedic medical device mfg	03/31/15	13.88	228.2	20.74	1.98	9.71	-30.0%

Source(s): HKEx, ABCI Securities

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Chinese Medicine Industry Outlook

Zhongzhi– a Chinese medicine manufacturer with a chain pharmacy operation

The pharmaceutical manufacturing business of the Group consists of three major product categories: (1) the Chinese patent medicines; (2) traditional decoction pieces; (3) modern decoction pieces.

Chinese patent medicines are manufactured with Chinese herbs as major ingredients based on the formulas set out in the Chinese Pharmacopoeia or the Drug Standards. The products are in forms such as oral solutions, pills, capsules, powder, and syrup.

The Chinese Pharmacopeia and the Drug Standards also set out the standards for decoction pieces, specifying the quantity of different ingredients required to be used for different decoction pieces. Decoction pieces can be further divided into (i) traditional decoction pieces and (ii) modern decoction pieces.

Traditional decoction pieces refer to Chinese herbs after being processed through various procedures, such as boiling, steaming, frying, chopping and slicing. These are generally used by pharmaceutical manufacturers for the production of Chinese patent medicines and consumers for making soups or cooking.

Modern decoction pieces mainly comprise (i) granules of cell wall-broken decoction pieces that involve the use of ultrafine pulverization techniques; (ii) formulation granules; or (iii) paste or syrup manufactured using the extraction and concentration techniques.

National output to grow at a CAGR of 21.2% from 2014 - 2018E

According to NBSC, production value of Chinese medicines in the PRC grew at a CAGR of 31.3% from 2009-2013. According to Ipsos, a market research and consulting company, the production value Chinese medicines in the PRC will grow at a CAGR of 21.2% from 2014 -2018E.

National retail sales value to grow a CAGR of 22.2% from 2014 -2018E

According to NBSC, retail sales value of Chinese medicines in the PRC grew at a CAGR of 23.9% from 2009-2013. Ipsos predicts retail sales value of Chinese medicines in the PRC will grow at a CAGR of 22.2% from 2014-2018E. The retail sales value of Chinese medicines in the PRC reached RMB 307.1 bn in 2014.

Hence, Ipsos predicts the average growth rate of value of production and retail sales of Chinese medicines will slow in the 5-year period between 2014-2018E, compared to the 5-year period in 2009-2013.

Growth drivers of the Chinese medicine industry

Continued growth of the Chinese medicine industry in China can be attributed to the following factors:

1. Rising disposable income. According to NBSC, average annual per capita disposable income in China grew at a CAGR of 11.9% from 2009- 2013. According to Ipsos, the growth rate will slow down to a CAGR of 9.0% from 2014 -2018E.

2. Increasing health consciousness and healthcare spending. According to NBSC, the average annual per capita consumption expenditure on Chinese medicines in China grew at a CAGR of 10.9% from 2009-2013. According to Ipsos, the growth rate will slow down to a CAGR of 8.5% from 2014 -2018E.

3. Growing urbanization. Urbanization rate grew from 48.3% in 2009 to 53.7% in 2013. According to Ipsos, the average annual per capita consumption expenditure on Chinese medicines of the urban population grew at a CAGR of 6.9% from 2009-2013. Hence, accelerating urbanization will boost demand for Chinese medicines.

4. Aging population. The population aged 60 or above grew at a CAGR of 1.2% from 2009-2013. According to Ipsos, the growth rate will increase to CAGR of 4.5% from 2014-2018E.

5. Increasing government support to the Chinese medicine industry. The basic medical insurance plan reimburses certain costs of the medicines included in the National List of Essential Drugs. In 2013, the PRC government has broadened such list to further include 309 types of Chinese patent medicines and 7 types of decoction pieces. Consequently, the public have better access to medical services and it is expected that relevant expenditures on medical services and products will be largely covered by the medical insurance and/or government subsidies, hence increasing the consumption of Chinese medicines. Pursuant to the Drug Pricing Reform Notice, the price control on all pharmaceutical products, except for anesthetics and certain types of psychiatric drugs, will be lifted from June 1, 2015. This will encourage pharmaceutical manufacturers to increase the supplies of pharmaceutical products in the market.

Entry barriers

Key entry barriers of the Chinese medicine industry in China include:

1. Capital investment
2. R&D capability
3. Product portfolio
4. Product quality
5. Distribution and marketing network

We believe these entry barriers will limit the number of newcomers in the Chinese medicine industry. They will also present challenges for existing players striving to expand their market shares.

Competition landscape

The Chinese medicine industry in PRC is highly fragmented with a large number of market players of various sizes. In 2013, there were more than 1,500 Chinese patent medicine manufacturers and ~1,900 decoction pieces manufacturers in the PRC. By sales revenue, the top 5 manufacturers of Chinese patent medicines and decoction pieces accounted for ~3.9% and 5.9% of the respective market shares in 2013. There were ~433,900 pharmacies in the PRC with a total sales revenue of ~ RMB 255.8 billion in 2013.

The Group’s sales revenue of Chinese patent medicine and decoction pieces accounted for less than 0.1% of the respective total market revenues. In terms of the number of pharmacies and sales revenue, the Group’s market shares in the PRC were ~ 0.04% and 0.1% in 2013.

Hence, market competition in the Chinese medicine industry is intense. To differentiate from competitors, it becomes crucial for market players to demonstrate strong capability in the following areas:

1. Scale of operation and integration
2. Branding
3. New product development

Winning strategies: Niche market and product differentiation

As the Chinese medicine industry is highly fragmented with numerous small players, we believe a targeted geographical coverage and product differentiation are crucial for small players to compete with the larger ones.

The Group has successfully established its competitive edges in a niche market (Zhongshan) with a highly differentiated product line (modern decoction pieces). The Group's pharmacy business has a small market share in China but accounted for 16.3% of the market share in Zhongshan in 2013. Its patented techniques to produce modern decoction pieces also differentiate the Group's products from its peers, allowing it to achieve a high gross profit margin (77.6% in FY14 for modern decoction pieces) as well as strong growth in sales revenue (CAGR of 164.3% from 2012-2014).

Annual GDP growth of Zhongshan from 2009-2013 ranged from 10.0%-13.5% and its population increased at a CAGR of ~3.8% from 3.0 million in 2009 to 3.2 million in 2013, according to Ipsos. The average annual per capita disposable income and the average annual per capita consumption expenditure in Zhongshan grew at 10.4% and 8.4% CAGRs from 2009-2013.

According to Ipsos, total retail sales of Chinese medicines in Zhongshan, where the Group's pharmacies are located, grew at a CAGR of 17.8% from 2009-2013. Ipsos predicts the growth will increase to a CAGR of 18.2% from 2014-2018E, supported by the social-economic trends and the willingness of Zhongshan residents to improve their living standard.

Wholesale business to focus on eastern and southern Chinese markets

We believe small players with limited production capacity and product scope should devote their efforts and resources to develop markets with a relatively high growth potential. The Group's wholesale business for its pharmaceutical manufacturing products has a relatively large exposure in eastern and southern China. In FY14, the two markets jointly contributed to 56% of revenue in the Group's pharmaceutical manufacturing business segment. Future growth of its wholesale business in these regions will be partially dependent on the retail sales growth of Chinese medicines. Total retail sales of Chinese medicines in these regions grew at a CAGR of 24.1% from 2009-2013, although Ipsos predicts the growth would slow down to a CAGR of 21.7% from 2014 -2018E.

Online market development

With the increasing penetration of Internet (broadband and mobile Internet) in China and the flourishing retail e-commerce, we believe existing players in pharmaceutical industry will encounter new opportunities and challenges. The first hurdle encountered by offline pharmaceutical companies to extend their business online is the obtainment of relevant licenses/certificates required by the China Food & Drug Administration (CFDA). The Group obtained an Internet medicine dealership certificate (license number C2013005) and an Internet pharmacy certificate (license number C20130005) granted by CFDA. Both licenses are valid from June 7, 2013 till June 6, 2018.

Integrated players (with manufacturing and pharmacy operations), such as the Group, can extend their business in the online realm more easily than the non-integrated ones as the former have their own-branded products and GSP-standard logistic support. The Group's online business will help it expand its geographical coverage efficiently.

Business Model Analysis

The Group engaged in pharmaceutical manufacturing in China and the operation of chain pharmacies in Zhongshan, Guangdong province.

The Group manufactured Chinese patent medicines and decoction pieces; their products are sold through wholesale channels (including contractual distributors, non-contractual distributors, and independent pharmacy chain operators) to different regions in China and the Group's self-operated pharmacies located in Zhongshan. Its pharmacies sell its own-branded products and non-own-branded products developed and supplied by other pharmaceutical manufacturers.

Exhibit 4: Revenue and gross profit composition of the Group

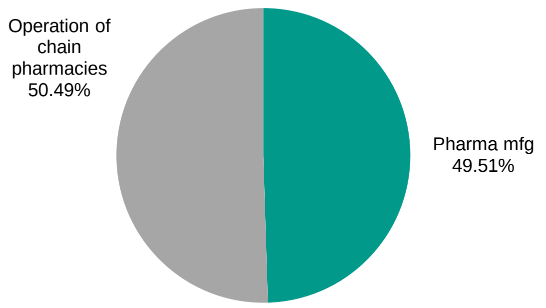
	FY2014 (RMB mn)	% of revenue	2012-14 CAGR	
Revenue composition by business segment:				
1. Pharma mfg	**294.8**	**49.5%**	**30.8%**	
1.1 Chinese patent medicines	159.6	26.8%	0.7%	
1.2 Decoction pieces (饮片)	135.2	22.7%	200.7%	
Traditional decoction pieces	*3.3*	*0.6%*	*16.2%*	
Modern decoction pieces	*131.9*	*22.1%*	*225.0%*	
2. Operation of chain pharmacies	**300.7**	**50.5%**	**12.5%**	
2.1 Own-branded products:	71.3	12.0%	14.6%	
Chinese patent medicines	10.3	1.7%	4.4%	
Decoction pieces	60.9	10.2%	16.6%	
Traditional decoction pieces	*36.3*	*6.1%*	*2.0%*	
Modern decoction pieces	*24.6*	*4.1%*	*57.5%*	
2.2 Non-own-branded products:	229.5	38.5%	11.8%	
Chinese patent medicines	83.4	14.0%	12.2%	
Western medicines	85.8	14.4%	12.4%	
Healthcare products	28.0	4.7%	4.0%	
Others	32.3	5.4%	17.1%	
Total revenue	**595.6**	**100.0%**	**20.5%**	
Revenue breakdown by product category:				
1. Own-branded products	366.1	61.5%	27.1%	
1.1 Chinese patent medicines	170.0	28.5%	0.9%	
1.2 Modern decoction pieces	156.5	26.3%	164.3%	
1.3 Traditional decoction pieces	39.6	6.7%	3.0%	
2. Non-own-branded products	229.5	38.5%	11.8%	
Total revenue	**595.6**	**100.0%**	**20.5%**	
	FY2014 (RMB mn)	**% of gross profit**	**2012-14 CAGR**	**FY14 margin**
Gross profit breakdown by business segment:				
1. Pharma mfg	172.9	54.0%	41.3%	58.6%
2. Operation of chain pharmacies	147.4	46.0%	20.2%	49.0%
Total gross profit	**320.3**	**100.0%**	**30.3%**	**53.8%**
Gross profit breakdown by product category:				
1. Own-branded products	**226.4**	**70.7%**	**37.4%**	**61.9%**
1.1 Chinese patent medicines	80.6	25.2%	-0.7%	47.4%
1.2 Decoction pieces	145.9	45.5%	95.3%	74.4%
Traditional decoction pieces	24.4	7.6%	9.9%	61.7%
Modern decoction pieces	121.4	37.9%	159.7%	77.6%
2. Non-own-branded products	**93.8**	**29.3%**	**16.8%**	**40.9%**
Chinese patent medicines	32.2	10.1%	15.7%	38.6%
Western medicines	30.8	9.6%	19.0%	35.8%
Healthcare products	16.8	5.2%	11.6%	60.0%
Others	14.1	4.4%	21.4%	43.7%
Total gross profit	**320.3**	**100.0%**	**30.3%**	**53.8%**

Source(s): The Company, ABCI Securities

The Group's net profit grew at a CAGR of 124.1% from RMB 17.3 mn in FY12 to RMB 86.7 mn in FY14 mainly due to the following reasons:

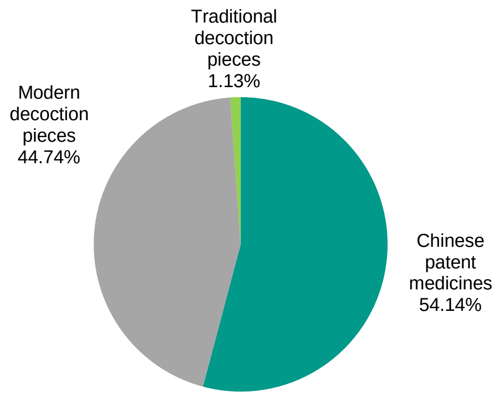
1. Revenue grew at a CAGR of 20.5% over the same period, thanks to increased sales of modern decoction pieces (164% CAGR over 2012-2014). The rapid sales growth of modern decoction pieces was resulted from strong direct sales to independent chain pharmacies, which grew at a CAGR 122.4% in 2012-2014 by value.
2. Overall gross profit margin rose to 53.8% in FY14 from 46.0% in FY12, thanks to increasing sales of modern decoction pieces with a high profit margin.
3. Effective cost control in selling and distribution expenses that dropped to 25% of total revenue in FY14 vs. 29.7% in FY12.

Exhibit 5: Revenue mix in FY14 (RMB 595.6 mn)



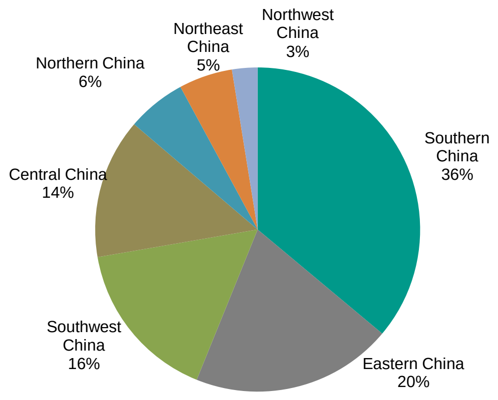
Source(s): The Company

Exhibit 6: Revenue mix of pharmaceutical manufacturing business by product in FY14 (RMB 294.8 mn)



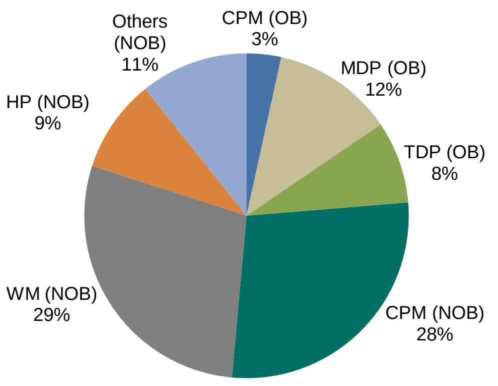
Source(s): The Company

Exhibit 7: Revenue mix of pharmaceutical manufacturing in FY14 by region (RMB 294.8 mn)



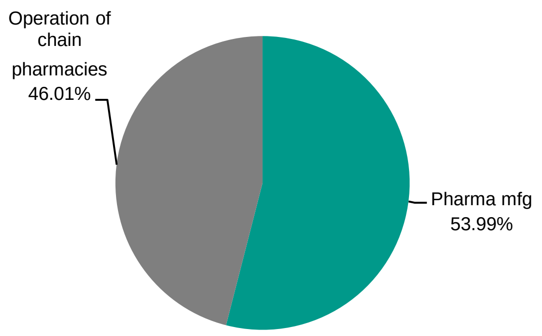
Source(s): The Company

Exhibit 8: Revenue mix of retail pharmacies by product in FY14 (RMB 300.73 mn)



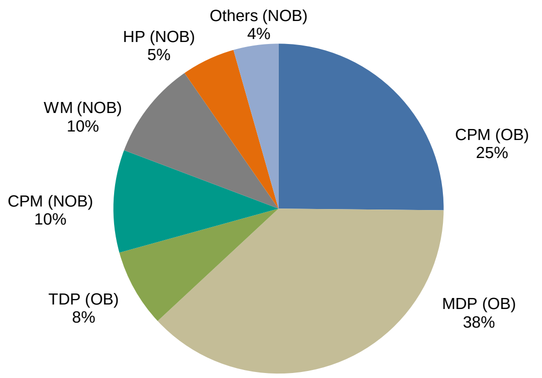
CPM (OB): Own-branded Chinese patent medicines
MDP (OB): Own-branded modern decoction pieces
TDP (OB): Own-branded traditional decoction pieces
CPM (NOB): Non-own-branded Chinese patent medicines
WM (NOB): Non-own-branded western medicines
HP (NOB): Non-own-branded healthcare products
Others (NOB): Non-own-branded personal care products and medical devices
Source(s): The Company

Exhibit 9: Gross profit by segment in FY14 (RMB 320.3 mn)



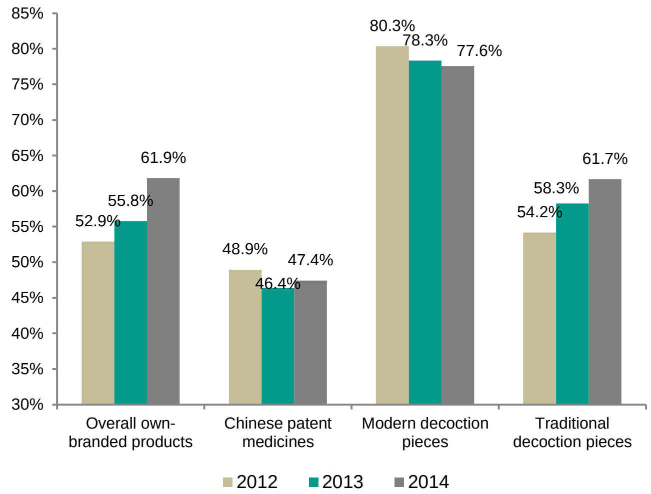
Source(s): The Company

Exhibit 10: Gross profit by product in FY14 (RMB 320.3 mn)



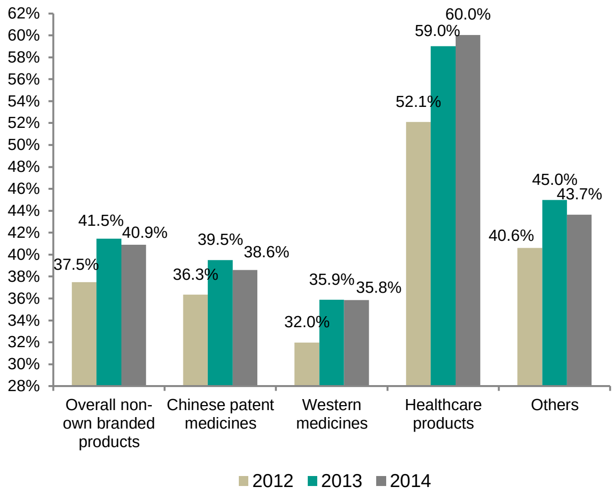
Source(s): The Company

Exhibit 11: Gross profit margin of own-branded products



Source(s): The Company

Exhibit 12: Gross profit margin of non-own-branded products



Source(s): The Company

The Group generally prices its own-branded products and non-own-branded products on a cost-plus basis with reference to the prevailing market conditions, such as demand from customers, pricing and availability of comparable products in the market. From 2012-2014, over 800 of its non-own-branded products and 18 of its own-branded products were included in the National Medical Insurance Drugs Catalogue or Provincial Medical Insurance Drugs Catalogue, and/or National List of Essential Drugs and were subject to PRC government's price control policies. Pursuant to the Drug Pricing Reform Notice, price control on all pharmaceutical products except for anesthetics and some types of psychiatric drugs will be removed with effect from June 1, 2015. After that, all own-branded and non-own-branded products will not be subject to government price control.

In FY14, the Group's sold its own-branded products via 523 contractual distributors, 588 non-contractual distributors, 381 independent chain pharmacies, and its self-operated pharmacies. The Group sold its modern decoction pieces mainly to independent chain pharmacies or via its self-operated pharmacies. Direct sales to independent chain pharmacies surged at 122% CAGR from 2012-2014, contributing to 50% of total pharmaceutical manufacturing revenue in 2014.

Exhibit 13: Revenue mix of pharmaceutical manufacturing business by channel or region

	FY2014 (RMB mn)	% of pharma mfg revenue	2012-14 CAGR
Pharma mfg revenue breakdown by sales channels **Sales to:**			
Contractual distributors	90.2	30.6%	5.3%
Non-contractual distributors	57.2	19.4%	-3.2%
Total sales to distributors	147.4	50.0%	1.7%
Independent chain pharmacies	147.5	50.0%	122.4%
Total revenue from pharma mfg	**294.8**	**100.0%**	**30.8%**
Avg. revenue/average number of contractual distributor	0.1648		
Avg. revenue/average number of non-contractual distributor	0.0936		
Direct sales per independent pharmacy	0.3870		
Pharma mfg revenue breakdown by regions **Sales to:**			
Southern China	106.4	36.1%	27.5%
Eastern China	59.0	20.0%	20.7%
Southwest China	47.6	16.2%	82.1%
Central China	41.2	14.0%	27.5%
Northern China	17.3	5.9%	-3.7%
Northeast China	15.8	5.3%	87.4%
Northwest China	7.5	2.5%	47.9%
Total revenue from pharma mfg	**294.8**	**100.0%**	**30.8%**

Source(s): The Company, ABCI Securities

In Mar 2015, the Group had 201 pharmacies located in all districts of Zhongshan under the "Zeus (中智)" brand. Since the number of self-operated pharmacies remained stable for the last three years, revenue growth of pharmacy operation has relied mainly on the sales growth of products. Sales of own-branded products and non-own-branded products accounted for 23.5% and 76.5% of total revenue of pharmacy operation in FY14.

Exhibit 14: Pharmacy operation

Number of self-operated pharmacy	**2012**	**2013**	**2014**	
Beginning of period	150	198	195	
Closure	(1)	(4)	(6)	
Add	49	1	9	
End of period	**198**	**195**	**198**	
FY ended Dec 31	**2012**	**2013**	**2014**	**2012-14 CAGR**
Pharmacy operation revenue by product (RMB mn)	**237.8**	**275.5**	**300.7**	**12.5%**
Own-branded products sales (RMB mn)	54.3	66.1	71.3	14.6%
Non-own-branded product sales(RMB mn)	183.5	209.5	229.5	11.8%
Pharmacies revenue/Avg. no. of pharmacy (RMB mn/pharmacy)	**1.367**	**1.402**	**1.530**	**5.8%**
Chg (YoY)	-	*2.6%*	*9.1%*	
Own-branded product sales/Avg. no. of pharmacies (RMB mn/pharmacy)	0.312	0.336	0.363	7.8%
Chg (YoY)	-	*7.8%*	*7.8%*	
Non-own-branded product sales/Avg. no. of pharmacies (RMB mn/pharmacy)	1.055	1.066	1.168	5.2%
Chg (YoY)	-	*1.1%*	*9.6%*	

Remarks: In Mar 2015, the number of self-operated pharmacy increased to 201
Source(s): The Company, ABCI Securities

According to Ipsos, the pharmaceutical retail market in Zhongshan was fragmented with ~687 chain pharmacies and 2,218 individual pharmacies in 2013. The Group had the largest self-operated pharmaceutical chain in Zhongshan in terms of the number of pharmacies and revenue in 2012-2014. In 2013, the Group captured 16.3% of market share in terms of retail sales value in Zhongshan.

Exhibit 15: Top five retailers of Chinese medicines and healthcare products (by revenue) in Zhongshan in 2013

Rank	Company name	Headquarters location	Number of pharmacies in Zhongshan	Revenue in 2013 (RMB mn)	Mkt Share	Avg. revenue per pharmacy (RMB mn)	Avg. mkt share per pharmacy
1	**The Group**	**Zhongshan**	**195**	**275.7**	**16.3%**	**1.41**	**0.084%**
2	Zhongshan Da Sen Lin Chain Drugstore Co., Ltd (中山市大参林连锁药业有限公司)	Guangzhou	56	75.7	4.5%	1.35	0.080%
3	Zhongshan Zhongshantang Pharmaceutical Chain Co., Ltd (中山市中山堂药业连锁有限公司)	Zhongshan	36	34.1	2.0%	0.95	0.056%
4	Zhongshan Furentang Pharmaceutical Chain Co., Ltd. (中山市福仁堂药房连锁有限公司)	Zhongshan	32	28.8	1.7%	0.90	0.053%
5	China Nepstar Chain Drugstore Ltd. (深圳市海王星辰健康药房连锁有限公司)	Shenzhen	39	25.0	1.5%	0.64	0.038%
	Total of number 2 to 5				**9.7%**		
	Total of top 5				**26.0%**		

Source(s): Ipsos, ABCI Securities

Exhibit 16: Top five customers of the Group in FY14

	Major products sold to customer	Business relationship since	Business nature of customer	% of total revenue	Sales (RMB mn)
Yunnan Hongxiang Yixintang Pharmaceutical Co., Ltd. 云南鸿翔一心堂药业(集团)股份有限公司	Modern decoction pieces	2014	Operation of chain pharmacies	4.6	27.4
Customer B	Chinese patent medicines	2004	Distribution of pharma products	2.8	16.7
Guangdong Dongguan Guoyao Group Co., Ltd. 广东省东莞国药集团有限公司	Chinese patent medicines	2005	Distribution of pharma products	2.8	16.7
Jointown Pharmaceutical Group Co., Ltd. 九州通医药集团股份有限公司	Chinese patent medicines	2003	Distribution of pharma products	2.2	13.1
Customer C	Chinese patent medicines	2003	Distribution of pharma products	1.3	7.7
			Total	13.7	81.6

Source(s): The Company

Exhibit 17: Top five suppliers of the Group in FY14

	Major products procured from supplier	Business relationship since	Business nature of supplier	% of total purchases	Purchases (RMB mn)
Customer B	Pharma products	2004	Distribution of pharma products	12.6	27.9
Customer C	Pharma products	2003	Distribution of pharma products	10.7	23.7
Jointown Pharmaceutical Group Co., Ltd. 九州通医药集团股份有限公司	Pharma products	2003	Distribution of pharma products	8.9	19.7
Supplier A	Chinese herbs	2010	Distribution of Chinese herbs	4.4	9.8
Shandong Dong-E E-jiao Co., Ltd 山东东阿阿胶股份有限公司	Healthcare products	2002	Mfg & trading of healthcare products	3.4	7.5
			Total	40.0	88.7

Remarks: The top three suppliers were also three of the Group's top five customers in 2014
Source(s): The Company

Exhibit 18: Working capital cycle

FY	2012	2013	2014
Avg. inventories/Revenue (days)	65.0	71.9	60.5
Avg. trade payables/ Revenue (days)	43.0	39.2	32.8
Avg. trade & notes receivables/Pharmaceutical manufacturing revenue (days)	50.6	49.0	39.8

Source(s): The Company

At end-2014, the Group had 198 self-operated pharmacies and non-own-branded finished goods in the inventories amounting to RMB 47.45mn. Assuming the Group kept ~RMB 0.24 mn of non-own-branded finished goods for each pharmacy, the amount of non-own-branded finished goods in the inventories at end-2014 accounted for 53.6% of the Group's total inventories, or 20.7% of total sales of non-own-branded products in FY14. We estimate the turnover days for non-own-branded finished goods (i.e. non-own-branded finished goods/revenue of non-own-branded products x 365 days) to be 62.9 days and 66.6 days in FY13 and FY14, respectively.

Exhibit 19: Major cost items

% to total revenue	FY12	FY13	FY14
Total cost of inventories sold	54.0%	50.4%	46.2%
Total staff cost	20.4%	23.9%	20.3%
Total operating leases expenses	3.6%	3.6%	3.1%
Total D&A	3.0%	2.4%	2.1%
R&D	2.6%	2.9%	1.9%
Finance cost	1.0%	0.3%	0.2%
% to total revenue	**FY12**	**FY13**	**FY14**
Selling & distribution costs	29.7%	29.5%	25.0%
Admin expenses	8.6%	8.1%	8.4%

Source(s): The Company, ABCI Securities

The cost of inventories sold and staff are the two major cost items of the Group, accounting for 46.2% and 20.3% of total revenue in FY14. Any adverse changes in raw material prices (such as Chinese herbs, non-own-branded products) or staff cost will significantly affect the profitability of the Group. Based on the revenue and cost structure with other things being equal, a 10% increase/decrease in cost of inventories will reduce/enhance gross profit margin by ~4.6ppt; a 10% increase/decrease in staff cost will reduce/enhance pre-tax profit margin by ~2.0ppt.

Our analysis indicates the Group is adopting an asset-light business model for its pharmacy chain operation. In Mar 2015, the Group had 201 self-operated pharmacies, of which 200 were operated in leased properties. The burden of rental expense were manageable - total operating leases expenses accounted for only 3.6%, 3.6% and 3.1% of total revenue in FY12-FY14, respectively.

Exhibit 20: Profitability ratios and asset efficiency

	FY12	FY13	FY14
Gross profit margin	6.8%	10.0%	19.4%
Operating profit margin	5.7%	9.7%	19.3%
Pre-tax profit margin	4.2%	7.8%	14.6%
Net profit margin	-	14.0%	29.1%
ROAA	-	33.8%	69.0%
ROAE	-	179.3%	199.6%
Sales to avg. assets	6.8%	10.0%	19.4%

Source(s): The Company, ABCI Securities

As discussed, the significant rise in profit margin during FY12-14 can be attributed to the increased sales proportion of high-margin products, including the modern decoction pieces. The high ROAA in FY14 was a result of improved profitability and the asset-light business model adopted in the chain pharmacy operation. ROAE also jumped to 199.6% in FY14 due to higher profitability and increased financial leverage after the Group had distributed a dividend of RMB 96.0 mn in FY14, which in turn suppressed equity growth.

Product Analysis

Total revenue of the Group is consisted of the sales of own-branded products (core brands: “Zeus (中智)”, “Liumian (六棉牌)” and “Caojinghua” (草晶华)) and non-own-branded products. The own-branded products are manufactured and sold by the Group through its self-operated pharmacies, contractual or non-contractual distributors, and independent chain pharmacies; the self-operated pharmacies sell both its own-branded products and over 4,000 types of other pharmaceutical products, healthcare products and medical devices sourced from independent suppliers.

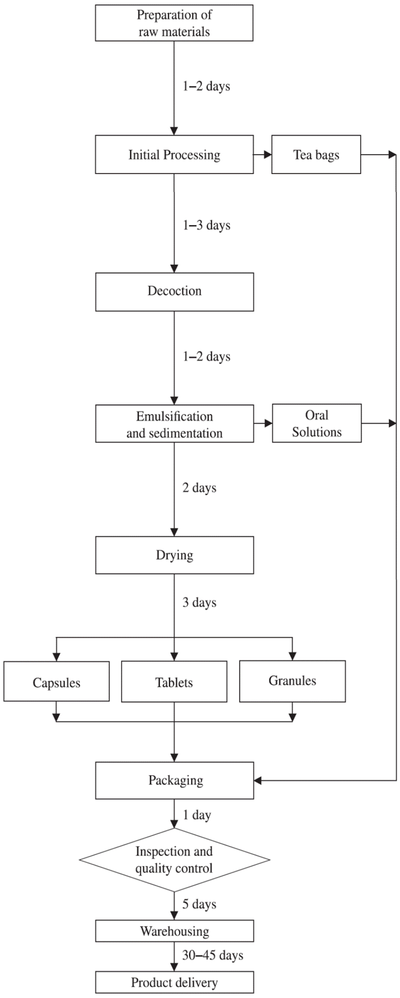
In FY14, sales of own-branded products and non-own-branded products accounted for 61.5% and 38.5% of total revenue. From 2012-2014, sales of own-branded products and non-own-branded products grew at 27.1% and 11.8 CAGRs.

The own-branded products manufactured by the Group can be classified into two categories – the Chinese patent medicines and decoction pieces. Decoction pieces can be sub-classified into traditional decoction pieces and modern decoction pieces.

We believe modern decoction pieces will be one of major growth drivers in coming years due to the following reasons:

1. Patented production technique differentiates the Group’s modern decoction pieces from its competitors’ products or other traditional decoction pieces
2. A relatively high profit margin
3. Product life cycle in high-growth phase

Exhibit 21: Production flow chart of the Group’s Chinese patent medicines



Source(s): The Company

Chinese patent medicines

In Mar 2015, the Group obtained approvals from relevant government authorities for the production of a total of 60 Chinese patent medicines. The Group has launched 33 types of own-branded Chinese patent medicines (of which 27 are OTC medicines) in the market. One type of Chinese patent medicine is currently undergoing clinical trial. Its Chinese patent medicines are intended to treat different illnesses such as cough, throat inflammation, indigestion and common cold. Its Chinese patent medicines are produced by the Group’s wholly-owned subsidiary, Honeson Pharmaceutical (GMP license number: GD20130135, valid from Oct 28, 2013 till Oct 27, 2018) in Zhongshan. All of its Chinese patent medicines are manufactured in accordance with the formula set out in the monographs in the Chinese Pharmacopoeia or the Drug Standards.

Decoction pieces

In the Chinese community, decoction pieces have long been used as supplements for health improvement and maintenance. In Mar 2015, the Group obtained approvals from relevant government authorities for the production of 196 types of traditional decoction pieces and 62 types of modern decoction pieces. The Group has been selling 158 types of decoction pieces, of which 136 are traditional decoction pieces and 22 are modern decoction pieces. In Mar 2015, 18 types of modern decoction pieces were awaiting approvals from the Guangdong Food and Drug Administration of the PRC (GFDA).

The Group’s decoction pieces follow the standards set forth by the Chinese Pharmacopoeia, the Drug Standards, or those prescribed and filed in the system of CFDA. The decoction pieces are produced by Zhongzhi Herbs Pieces (GMP license number: GD20140307; valid from Dec 23, 2014 till Dec 22, 2019), which is a consolidated affiliate of the Group.

Traditional decoction pieces
Traditional decoction pieces are usually used for the production of Chinese patent medicines by pharmaceutical manufacturers and for diet therapy as used in soups or cooking.

Modern decoction pieces
Pharmaceutical manufacturers have developed techniques such as ultrafine pulverization, additive-free granulation, extraction and concentration to provide various modern forms such as concentrated traditional Chinese medicines granules (中药配方颗粒), syrup, and paste of concentrated decoction pieces for ready consumption,.

Plant products such as Chinese herbs can be pulverized by three methods commonly used in the pharmaceutical and healthcare products industry. These methods are:

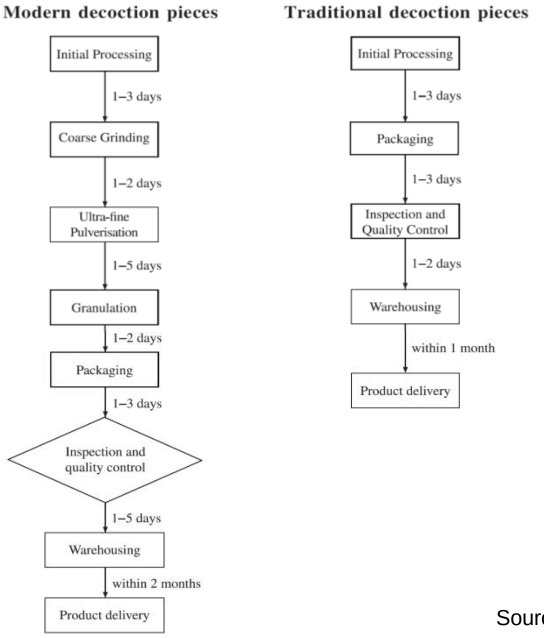
(i) jet stream ultrafine pulverization
(ii) vibration grinding
(iii) mechanic ultrafine pulverization

The Group uses the jet stream ultra-fine pulverization in the production of its modern decoction pieces because of the following reasons.

(i) It provides a low temperature processing environment suitable for Chinese herbs that are sensitive to heat
(ii) It produces fine particles
(iii) It would not contaminate the pulverized herbs

The particles are combined to form granules after being finely pulverized. The Group developed and patented the additive-free granulation techniques (Patent number: ZL200610122171.7), which mainly utilize the adhesiveness of cell-broken Chinese herbs to form granules. Owing to the patented additive-free granulation technique, surface areas of the granules are reduced and the finished products are more resistant to moisture, mold, and bacteria; therefore, no preservatives are required.

Exhibit 22: Production flow chart of modern decoction pieces and traditional decoction pieces



Source(s): The Company

Business Strategies

The Group aims to become a leading pharmaceutical company in the PRC. To achieve this, the following principal strategies will be implemented in coming years:

1. Expand chain pharmacies in the Guangdong province
2. Expand the breadth and depth of distribution network
3. Expand production capacity
4. Further strengthen R&D capabilities and expand product range
5. Further strengthen brand recognition and awareness by enhancing marketing and promotional activities

Exhibit 23: Summary of business strategies

Item	Strategies	Summary of details	Our analysis
1	Expand chain pharmacies in the Guangdong province	The Group plans to establish 200 self-operated pharmacies outside Zhongshan but in Guangdong province from 2016E- 2018E. The Group will add 60, 80 and 60 pharmacies in 2016E-2018E, respectively, outside Zhongshan. The Group had 201 self-operated pharmacies in Zhongshan in Mar 2015.	By our estimates, its chain pharmacies operation contributed to 50.5% and 46.0% of total revenue and gross profit in 2014, and its pharmacy operation registered a gross profit growth of 20.2% CAGR in 2012 - 2014. The success of its pharmacy business was based on its chain pharmacies in Zhongshan. The Group can replicate its pharmacy operation know-how in neighboring areas of Zhongshan.
2	Expand the breadth and depth of distribution network	The Group plans to expand its distribution network by increasing both the number of distributors and independent chain pharmacies operators, thereby enabling it to further penetrate into its existing markets, especially in eastern and southern China. The Group plans to strengthen its sales and marketing team by recruiting more sales staff to support the expansion of its distribution network and also to further enhance the management and efficiency of its distribution network.	In 2014, wholesale business (i.e. pharmaceutical manufacturing business segment) accounted for 49.5% of total revenue. Sales to distributors and independent chain pharmacies accounted for 49.96% and 50.04% of total wholesale revenue in FY14. Southern China and eastern China were the two major markets of the Group, contributing to 36.10% and 20.0% of total wholesale business revenue in FY14.
3	Expand production capacity	To capture growth momentum of own-branded products and enhance overall profitability, the Group plans to purchase additional machineries and equipment for the manufacturing of the Chinese patent medicines and decoction pieces. The Group plans to acquire 5 jet stream ultra-fine pulverization machines and 5 granulating machines in 2016E to expand production capacity of decoction pieces.	By our estimates, its own-branded products grew at a CAGR of 27.1%, compared to a CAGR of 11.8% for sales of non-own-branded products in 2012-2014. In 2014, the gross profit margin of own-branded products was 61.9%, or 21ppt higher than its non-own-branded products.
4	Further strengthen R&D capabilities and product range	The Group intends to hire an addition of 50-60 experienced personnel with sound and relevant academic background for its R&D team. It will continue to collaborate with research institutions and universities in the PRC to develop the techniques and knowledge in the development and manufacturing of new pharmaceutical products, and refine its existing ones in terms of production process, effectiveness and forms.	R&D costs accounted for 2.6%, 2.9% and 1.9% of total revenue for 2012, 2013 and 2014, respectively.
5	Further strengthen brand recognition and awareness by enhancing marketing and promotional activities	The Group plans to increase its budget for various advertising channels such as television, newspapers, medical journals, and sponsor pharmaceutical conferences to promote (i) its core brands including "Zeus (中智)", "Liumian* (六棉牌)" and "Caojinghua* (草晶华)"; (ii) its own-branded products; and (iii) its chain pharmacies.	Advertising and promoting costs accounted for 8.1%, 5.7% and 3.9% of total revenue for 2012, 2013 and 2014, respectively.

Source(s): The Company, ABCI Securities

Business Challenges and Risks

We have identified the challenges that the Group will face in coming years upon implementing its business strategies.

Production capacity constraint

Although the Group expanded production capacity of modern decoction pieces from 53 tonnes in 2012 to 212 tonnes in 2014, the rapid sales growth of modern decoction pieces still drove up the capacity utilization rate from 57% in FY12 to 78% in FY14. The Group produced 165 tonnes of modern decoction pieces in FY14 (maximum designed capacity was 212 tonnes). If the Group is able to ramp up the utilization rate of its modern decoction piece production line to 100% this year based on existing production facilities, the output volume will grow by 28%.

Currently, the Group has 5 jet stream ultrafine pulverization machines and 3 granulating machines for the production of modern decoction pieces. We believe the bottleneck will mainly arise from the granulating process which entails techniques patented by the Group. In order to meet the increasing demand for the modern decoction pieces, the Group plans to acquire 5 jet stream ultrafine pulverization machines and 5 granulating machines in FY16E. Until new production machines are installed, production capacity of modern decoction pieces will be constrained in FY15E-16E.

Aside from the modern decoction pieces, output of traditional decoction piece and oral solution is also constrained. From 2012-2014, the designed production capacity of its Chinese patent medicines and traditional decoction pieces remained unchanged. The utilization rate of traditional decoction pieces production line reached 99% while that of the oral solution reached 107% in 2014, suggesting that the Group had increased the number of work shifts to increase output. Hence, growth momentum of these two product lines may be stifled in coming years.

Exhibit 24: Production capacity in 2014

	Unit	Designed Capacity	Capacity chg (YoY)	Output	Output chg (YoY)	Utilization rate	Utilization rate chg (ppt)
Chinese patent medicines							
Granule	Mn bags	270.0	0.0%	191.8	-10.5%	71%	(8)
Capsule	Mn capsules	140.0	0.0%	126.1	-6.5%	90%	(6)
Tablet	Mn tablets	1,280.0	0.0%	993.6	-7.5%	78%	(6)
Oral solution	Mn bottles	15.0	0.0%	16.0	46.2%	107%	34
Tea bags	Mn bags	5.3	0.0%	3.5	3.5%	66%	2
	Unit	**Designed capacity**	**Capacity chg (YoY)**	**Output**	**Output chg (YoY)**	**Utilization rate**	**Utilization rate chg (ppt)**
Decoction pieces							
Traditional decoction pieces	tonnes	2,561	0.0%	2,540	7.9%	99%	7
Modern decoction pieces	tonnes	212	33.3%	165	120.0%	78%	31

Remarks: Designed capacity is computed based on 252 effective production days per year and a 7-hour shift per day.
Source(s): The Company, ABCI Securities

Exhibit 25: Production capacity in 2013

	Unit	Designed Capacity	Capacity chg (YoY)	Output	Output chg (YoY)	Utilization rate	Utilization rate chg (ppt)
Chinese patent medicines							
Granule	Mn bags	270.0	0.0%	214.2	-8.5%	79%	(7)
Capsule	Mn capsules	140.0	0.0%	134.9	19.3%	96%	16
Tablet	Mn tablets	1,280.0	0.0%	1,074.7	2.7%	84%	2
Oral solution	Mn bottles	15.0	0.0%	11.0	13.7%	73%	9
Tea bags	Mn bags	5.3	0.0%	3.4	-29.5%	64%	(27)
	Unit	**Designed Capacity**	**Capacity chg (YoY)**	**Output**	**Output chg (YoY)**	**Utilization rate**	**Utilization rate chg (ppt)**
Decoction pieces							
Traditional decoction pieces	tonnes	2,561	0.0%	2,353	3.9%	92%	3
Modern decoction pieces	tonnes	159	200.0%	75	150.0%	47%	(9)

Source(s): The Company, ABCI Securities

Supply constraint of quality Chinese herbs

To meet expected sales volume of modern decoction pieces, the Group plans to increase the number of ultrafine pulverization machines from 5 in 2015E to 10 in 2016E, and the number of granulating machines from 3 in 2015 to 8 in 2016. We estimate the designed capacity of modern decoction pieces will increase from 212 tonnes in 2014 to 565 tonnes in 2016E, up 167%. It is equally crucial for the Group to ensure sufficient supply of quality Chinese herbs as major raw materials to cope with the major expansion in production capacity.

New market development challenge

The Group is the largest pharmacy chain operator by the number of pharmacies and revenue in Zhongshan and has 201 self-operated pharmacies in the city. The Group plans to establish 200 self-operated pharmacies outside Zhongshan by end-2018E. The Group will diversify its geographical coverage by establishing new pharmacies in other major areas within the Guangdong province. Lacking the experience of operating pharmacies outside Zhongshan, the Group may encounter new business risks arising from the location of new outlets, logistics support, personnel management, and brand promotion in the new regions. Besides, the business scale of the outlets in new areas may not be large enough to create synergistic effects that the Group enjoys in Zhongshan.

Exhibit 26: Expansion of pharmacies outside Zhongshan in 2016E-18E

Number of self-operated pharmacies outside Zhongshan	2016E	2017E	2018E	Total
Jiangmen	30			30
Zhuhai	30			30
Foshan		40		40
Dongguan		40		40
Other cities in Guangdong province			60	60
Total				200

Remarks: Jiangmen, Zhuhai, Foshan and Dongguan are in Guangdong province
Source(s): The Company

Compliance to new GSP standard

According to the new GSP standard promulgated by the CFDA on June 1, 2013, each pharmacy is required to have a licensed pharmacist on site by end-2015. Subsequently, staff cost of pharmacy operators will increase. We expect a large number of small pharmacies would be eliminated in coming years due to the inability to train, recruit or retain qualified pharmacists. This regulatory change nonetheless will provide room for financially sound pharmacy chain operators, including the Group, to expand their market shares. However, the Group's market expansion plan can be constrained by the availability of qualified pharmacists. In coming years, the Group plans to establish 200 new self-operated pharmacies. We believe the Group's expansion pace will be determined by its ability to employ and retain the large number of qualified pharmacists.

Undesirable side effects of higher business transparency
The Group enjoys a high gross profit margin from its pharmaceutical manufacturing and chain pharmacy operation. If its upstream suppliers, downstream customers or competitors are informed of the Group's profitability, its bargaining power could be adversely affected. The lucrative profit margin of its modern decoction pieces may attract new competitors to enter the market.

Validity of contractual arrangements
Under the current PRC laws and regulations, foreign ownership of PRC entity engaged in the production of decoction pieces business is prohibited. Zhongzhi Pharmaceutical Holdings Ltd, a foreign company incorporated in the Cayman Island, is the holding company of the Group. The Group conducts its production of decoction pieces in the PRC through the Contractual Arrangements. The Group entered into the Contractual Arrangements to manage the business of Zhongzhi Herb Pieces (whose principal activities are the manufacture and sale of Chinese decoction pieces; for details please refer to Appendix 1) with all economic benefits derived from the business, financial and operating activities of Zhongzhi Herb Pieces transferred to Zhongzhi Pharmaceutical by means of service fees payable by Zhongzhi Herb Pieces to Zhongzhi Pharmaceutical.

On Jan 19, 2015, MOFCOM released the Draft Foreign Investment Law and the Explanatory Notes for public consultation. The Draft Foreign Investment Law introduced the concept of ''actual control'' on a PRC domestic enterprise whereby a domestic enterprise, if controlled by a ''foreign investor'' through contractual arrangements, shall be regarded as a ''foreign-invested enterprise'' and such foreign-invested enterprise is restricted or prohibited from investment in certain industries listed on the ''Negative List'' unless permission from the competent authority in the PRC is obtained.

If the Draft Foreign Investment Law is to be interpreted in the most stringent way to the effect that Zhongzhi Herb Pieces is not regarded as a domestic enterprise; and the production of decoction pieces falls into the scope of foreign prohibited business on the Negative List, the Contractual Arrangements will be regarded as invalid and illegal. As a result, the Group would not be able to manufacture decoction pieces through the Contractual Arrangements with Zhongzhi Herb Pieces.

If the validity of the contractual arrangements is challenged by relevant authorities in China in the future and the Group is subsequently forced to terminate the contractual arrangements and to cease its decoction pieces business, its profitability will be adversely affected.

In our financial forecasts and valuation of the Group, we assume the contractual arrangements will remain valid in our business and financial projections. The actual outcome in the future may deviate from our assumptions and hence our profit forecasts and valuation for the Group will be inapplicable.

Financial Forecasts

We have considered the following factors in our financial forecasts for the Group:

1. Output of the Group's pharmaceutical manufacturing business will be constrained by its existing capacity until new production machineries are installed. In particular, the utilization rates of oral solution and traditional decoction pieces productions were running at an almost-full capacity in 2014, while utilization rate of the modern decoction pieces was 78% in 2014.
2. The Group expects to increase the output of modern decoction pieces by 20% each year in 2015 and 2016.
3. The Group plans to acquire 5 jet stream ultrafine pulverization machines and 5 granulating machines, in addition to completing 4 fully automated production lines in 2016 to meet the increased demand for modern decoction pieces.
4. The Group plans to upgrade its existing production facilities.
5. The future market and product development strategies of the Group
6. The Group plans to establish 60, 80 and 60 pharmacies in 2016, 2017 and 2018 in Guangdong province outside Zhongshan.
7. We assume the Group will be able to secure sufficient funding sources, human resources and raw material resources internally or externally to implement its production and market expansion plans in a timely manner.
8. The Group raised a net proceed of HK$452.9mn from the IPO in Jul 2015.
9. Authorities will not withdraw licenses granted to the Group. Moreover, the Group is able to obtain relevant licenses for the expansion of pharmacy chain and production facilities.
10. We expect the contractual arrangements in decoction pieces business will remain valid.

Financial Statements Projection

Exhibit 27: Assumptions on chain pharmacy operation

FY Ended Dec 31	2012A	2013A	2014A	2015F	2016E	2017E
Number of self-operated pharmacies (period end)	198	195	198	208	263	338
Pharmacies revenue/avg. no. of pharmacies (RMB mn/pharmacy)	1.367	1.402	1.530	1.702	1.880	2.068
Own-branded products sales/avg. no. of pharmacies (RMB mn/pharmacy)	0.312	0.336	0.363	0.417	0.467	0.514
Non-own-branded products sales/avg. no. of pharmacies (RMB mn/pharmacy)	1.055	1.066	1.168	1.284	1.413	1.554

Source(s): The Company, ABCI Securities estimates

Consolidated income statement (2012A-2017F)

FY Ended Dec 31 (RMB mn)	2012A	2013A	2014A	2015E	2016E	2017E
Revenue breakdown by product category:						
Own-branded products	226.5	273.4	366.1	443.3	503.6	746.7
Chinese patent medicines	166.8	167.4	170.0	195.4	205.2	215.5
Modern decoction pieces	22.4	65.5	156.5	207.4	257.2	489.2
Traditional decoction pieces	37.4	40.5	39.6	40.4	41.2	42.1
Non-own-branded products	183.5	209.5	229.5	260.8	332.7	467.0
Total revenue	**410.1**	**482.8**	**595.6**	**704.0**	**836.4**	**1,213.8**
Gross profit breakdown by product category:						
Own-branded products	119.9	152.5	226.4	288.5	332.9	517.5
Chinese patent medicines	81.6	77.7	80.6	101.6	106.7	109.9
Decoction pieces	38.3	74.9	145.9	186.8	226.2	407.6
Traditional decoction pieces	20.2	23.6	24.4	25.1	25.6	26.1
Modern decoction pieces	18.0	51.3	121.4	161.8	200.6	381.6
Non-own-branded products	68.8	86.8	93.8	106.9	136.4	191.5
Total gross profit	**188.7**	**239.4**	**320.3**	**395.4**	**469.3**	**709.0**
Revenue breakdown by segment:						
Pharma mfg	172.2	207.3	294.8	358.6	393.6	592.3
Operation of chain pharmacies	237.8	275.5	300.7	345.4	442.8	621.5
Total revenue	**410.1**	**482.8**	**595.6**	**704.0**	**836.4**	**1,213.8**
Chg (%YoY)	-	*17.7*	*23.4*	*18.2*	*18.8*	*45.1*
Gross profit breakdown by segment:						
Pharma mfg	86.7	108.9	172.9	225.0	250.4	401.7
Operation of chain pharmacies	102.0	130.4	147.4	170.4	218.9	307.3
Total gross profit	**188.7**	**239.4**	**320.3**	**395.4**	**469.3**	**709.0**
Chg (%YoY)	-	*26.9*	*33.8*	*23.4*	*18.7*	*51.1*
Other income & gains	7.4	5.4	6.5	12.5	17.5	15.5
S&D expenses	(121.9)	(142.3)	(148.7)	(169.0)	(200.7)	(291.3)
Admin expenses	(35.3)	(38.9)	(50.2)	(64.8)	(71.1)	(103.2)
Other expenses	(11.2)	(15.4)	(12.0)	(15.3)	(25.6)	(36.9)
Operating profit	27.7	48.2	115.8	158.9	189.4	293.1
Finance costs	(4.3)	(1.4)	(1.0)	0.0	0.0	0.0
Pre-tax profit	**23.4**	**46.8**	**114.8**	**158.9**	**189.4**	**293.1**
Tax	(6.2)	(9.2)	(28.1)	(30.2)	(37.2)	(56.7)
Net profit	**17.3**	**37.6**	**86.7**	**128.7**	**152.1**	**236.5**
Chg (%YoY)	-	*118.1*	*130.3*	*48.4*	*18.2*	*55.4*
Dividends declared and paid (pre-listing)	-	-	96.0	30.0	-	-
Dividends forecast (post-listing)	-	-	-	38.6	45.6	70.9
EBITDA	39.7	59.3	128.2	167.5	208.1	313.8

Remarks: The Group declared and paid dividends of RMB96 mn and RMB30 mn in 2014 and Apr 2015 respectively.
Source(s): The Company, ABCI Securities estimates

Major financial ratios (2012A-2017F)

FY Ended Dec 31	2012A	2013A	2014A	2015E	2016E	2017E
Overall gross profit margin	46.0%	49.6%	53.8%	56.2%	56.1%	58.4%
Gross profit margin of :						
Pharmaceutical manufacturing	50.3%	52.6%	58.6%	62.7%	63.6%	67.8%
Chain pharmacies	42.9%	47.3%	49.0%	49.1%	49.0%	49.0%
Gross profit margin of :						
Own-branded products	52.9%	55.8%	61.9%	65.1%	66.1%	69.3%
Chinese patent medicines	48.9%	46.4%	47.4%	52.0%	52.0%	51.0%
Decoction pieces	64.0%	70.7%	74.4%	75.4%	75.8%	76.7%
Traditional decoction pieces	*54.2%*	*58.3%*	*61.7%*	62.0%	62.0%	62.0%
Modern decoction pieces	*80.3%*	*78.3%*	*77.6%*	78.0%	78.0%	78.0%
Non-own branded products	37.5%	41.5%	40.9%	41.0%	41.0%	41.0%
Operating profit margin	6.8%	10.0%	19.4%	22.6%	22.6%	24.2%
Pre-tax profit margin	5.7%	9.7%	19.3%	22.6%	22.6%	24.2%
Net profit margin	4.2%	7.8%	14.6%	18.3%	18.2%	19.5%
ROAA	-	14.0%	29.1%	24.4%	18.0%	22.7%
ROAE	-	33.8%	69.0%	36.6%	24.3%	32.6%
Sales to avg. assets	-	179.3%	199.6%	133.5%	99.2%	116.4%
R&D costs/revenue	2.6%	2.9%	1.9%	2.1%	3.0%	3.0%

S&D expenses/revenue	29.7%	29.5%	25.0%	24.0%	24.0%	24.0%
Admin expenses/revenue	8.6%	8.1%	8.4%	9.2%	8.5%	8.5%
Effective tax rate	26.4%	19.6%	24.5%	19%	20%	19%
Avg. inventories/revenue (days)	65.0	71.9	60.5	57.0	57.1	54.1
Avg. trade payables/revenue (days)	43.0	39.2	32.8	30.7	30.7	29.1
Avg.trade & notes receivables/pharmaceutical manufacturing revenue (days)	50.6	49.0	39.8	40.0	40.0	40.0
Total equity/total assets	38.6%	43.6%	40.6%	76.9%	72.2%	67.4%
Net cash/ (debt) (RMB mn)	0.0	13.1	43.0	411.9	480.7	475.7

Source(s): The Company, ABCI Securities estimates

Major financial ratios (2012A-2017F)

FY Ended Dec 31	2012A	2013A	2014A	2015E	2016E	2017E
Revenue composition:						
Total revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Pharmaceutical manufacturing	42.0%	42.9%	49.5%	50.9%	47.1%	48.8%
Operation of chain pharmacies	58.0%	57.1%	50.5%	49.1%	52.9%	51.2%
Total revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Own-branded products	55.2%	56.6%	61.5%	63.0%	60.2%	61.5%
Chinese patent medicines	40.7%	34.7%	28.5%	27.8%	24.5%	17.8%
Modern decoction pieces	5.5%	13.6%	26.3%	29.5%	30.7%	40.3%
Traditional decoction pieces	9.1%	8.4%	6.7%	5.7%	4.9%	3.5%
Non-own branded products	44.8%	43.4%	38.5%	37.0%	39.8%	38.5%
Revenue growth:						
Pharmaceutical manufacturing	-	20.3%	42.3%	21.6%	9.8%	50.5%
Operation of chain pharmacies	-	15.9%	9.1%	14.9%	28.2%	40.4%
Total revenue	-	17.7%	23.4%	18.2%	18.8%	45.1%
Own-branded products	-	20.7%	33.9%	21.1%	13.6%	48.3%
Chinese patent medicines	-	0.4%	1.5%	15.0%	5.0%	5.0%
Modern decoction pieces	-	192.1%	139.1%	32.5%	24.0%	90.2%
Traditional decoction pieces	-	8.3%	-2.1%	2.0%	2.0%	2.0%
Non-own branded products		14.1%	9.6%	13.6%	27.6%	40.4%
Gross profit composition:						
Total gross profit	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Pharmaceutical manufacturing	45.9%	45.5%	54.0%	56.9%	53.3%	56.7%
Operation of chain pharmacies	54.1%	54.5%	46.0%	43.1%	46.7%	43.3%
Total gross profit	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Own-branded products	63.5%	63.7%	70.7%	73.0%	70.9%	73.0%
Chinese patent medicines	43.3%	32.4%	25.2%	25.7%	22.7%	15.5%
Decoction pieces	20.3%	31.3%	45.5%	47.3%	48.2%	57.5%
Traditional decoction pieces	*10.7%*	*9.9%*	*7.6%*	6.3%	5.4%	3.7%
Modern decoction pieces	*9.5%*	*21.4%*	*37.9%*	40.9%	42.7%	53.8%
Non-own branded products	36.5%	36.3%	29.3%	27.0%	29.1%	27.0%
Gross profit growth (YoY):						
Total gross profit	-	26.9%	33.8%	23.4%	18.7%	51.1%
Pharmaceutical Manufacturing	-	25.7%	58.7%	30.1%	11.3%	60.5%
Operation of chain pharmacies	-	27.8%	13.0%	15.6%	28.5%	40.4%
Total gross profit	-	26.9%	33.8%	23.4%	18.7%	51.1%
Own-branded products	-	27.2%	48.5%	27.4%	15.4%	55.5%
Chinese patent medicines	-	-4.8%	3.7%	26.1%	5.0%	3.0%
Decoction pieces	-	95.7%	94.9%	28.1%	21.0%	80.2%
Traditional decoction pieces	-	*16.5%*	*3.6%*	*2.5%*	*2.0%*	*2.0%*
Modern decoction pieces	-	*184.8%*	*136.8%*	*33.2%*	*24.0%*	*90.2%*
Non-own branded products	-	26.2%	8.1%	13.9%	27.6%	40.4%

Source(s): The Company, ABCI Securities estimates

Consolidated balance sheet (2012A-2017F)

As of Dec 31 (RMB mn)	2012A	2013A	2014A	30/6/2015*	2015E	2016E	2017E
PPE	63.8	71.4	79.4	88.6	114.4	214.4	234.4
Prepayment for PPE	1.9	0.9	2.1	3.3	1.0	1.0	2.0
Prepaid land lease	15.8	15.3	14.8	14.6	16.9	16.4	15.9
Goodwill	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Other intangible	1.4	1.6	1.4	1.3	1.3	1.2	1.1
AFS investment	0.5	0.0	0.0	1.0	0.0	0.0	0.0
Deferred tax	4.0	5.5	5.0	4.4	5.5	5.5	5.5
Rental deposits	2.5	2.5	3.3	3.5	3.7	4.7	6.1
Total non-current assets	**91.4**	**98.8**	**107.5**	**118.3**	**144.4**	**244.8**	**266.6**
Prepaid land lease	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Inventories	81.2	108.9	88.5	97.2	131.4	130.1	229.5
Trade & notes receivables	26.8	28.8	35.5	75.1	61.7	48.7	114.9
Prepayment, deposits & other rec	4.6	7.7	7.9	16.1	6.9	8.2	11.8
AFS investments	10.0	25.0	0.0	0.0	0.0	0.0	0.0
Cash	25.0	29.1	58.0	36.8	411.9	497.8	531.8
Total current assets	**148.2**	**200.0**	**190.4**	**225.7**	**612.3**	**685.3**	**888.5**
Total assets	**239.6**	**298.9**	**297.9**	**344.0**	**756.7**	**930.1**	**1,155.1**
Trade payables	49.5	54.2	52.8	66.4	65.6	75.2	118.4
Other payables & accruals	57.8	75.9	60.8	63.8	74.9	102.7	113.2
Due to shareholder	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Due to related parties	0.0	0.0	8.8	8.8	0.0	0.0	0.0
Loans	25.0	16.0	15.0	20.0	0.0	17.1	56.1
Deferred income	2.5	1.9	6.0	4.0	5.0	5.0	5.0
Tax payable	4.8	9.7	20.2	14.7	21.7	43.9	66.8
Total current liabilities	**139.5**	**157.8**	**163.6**	**177.7**	**167.2**	**243.9**	**359.5**
Deferred income	6.1	9.5	9.0	9.0	5.7	9.0	9.0
Deferred tax	1.4	1.4	4.3	4.3	1.9	5.3	8.1
Total non-current liabilities	**7.5**	**10.9**	**13.4**	**13.4**	**7.6**	**14.3**	**17.1**
Total liabilities	**147.1**	**168.7**	**177.0**	**191.0**	**174.8**	**258.2**	**376.6**
Total equity	**92.6**	**130.2**	**120.9**	**153.0**	**581.9**	**672.0**	**778.5**
Total equity & liabilities	239.6	298.9	297.9	344.0	756.7	930.1	1,155.1
Net cash (debt)	0.0	13.1	43.0	16.8	411.9	480.7	475.7
Issued shares (mn)	600.0	600.0	600.0	600.0	800.0	800.0	800.0
NBV (RMB/share)	0.154	0.217	0.201	0.255	0.727	0.840	0.973

Note*: Data at end-Jun 2015 is un-audited data
Remark: The Company issued 200 mn new shares in Jul 2015 at HK$2.46/share
Source(s): The Company, ABCI Securities estimates

Consolidated cash flow statement (2012A-2017F)

FY ended Dec 31 (RMB mn)	2012A	2013A	2014A	2015E	2016E	2017E
Pre-tax profit	23.4	46.8	114.8	158.9	189.4	293.1
Total adjustments	15.8	9.2	9.0	4.7	14.7	16.7
Pre-tax profit after adjustments	**39.3**	**56.0**	**123.8**	**163.5**	**204.1**	**309.8**
Total change in WC	17.4	(5.2)	11.9	(50.4)	49.3	(116.8)
Cash generated from operations	56.7	50.8	135.7	113.2	253.4	193.0
Income tax paid	(1.2)	(5.8)	(14.1)	(22.6)	(27.9)	(42.5)
Net cash flows from operating activities	**55.5**	**45.0**	**121.6**	**90.5**	**225.5**	**150.5**
Net cash flows from investing activities	**(5.5)**	**(30.6)**	**5.3**	**(43.0)**	**(118.0)**	**(40.0)**
Net cash flows from financing activities	**(44.0)**	**(10.4)**	**(98.0)**	**444.0**	**8.5**	**(6.6)**
Net change in cash	**6.0**	**4.0**	**28.9**	**491.5**	**116.0**	**103.9**
Cash, open balance	19.0	25.0	30.1	58.0	549.5	665.5
Forex effect	0.0	1.0	(1.0)	0.0	0.0	0.0
Cash, end balance	25.0	30.1	58.0	549.5	665.5	769.4

Source(s): The Company, ABCI Securities estimates

Valuation

The Group has two major business segments – pharmaceutical manufacturing and operation of chain pharmacy.

Its pharmaceutical manufacturing business is engaged in the production of Chinese patent medicines and decoction pieces. Hence, comparable stocks for this business segment should be pharmaceutical manufacturers focusing on the production of Chinese medicines, especially decoction pieces or granules. Among the HK-listed pharmaceutical manufacturers, we have identified China Traditional Chinese Medicine (570 HK) and PuraPharm Corp as the Group's comparable peers. The peer group is trading at 17.5x/ 12.3x estimated FY15E/FY16E P/E and 2.37x/2.15x estimated FY15/FY16 P/B. The average ROAE of this peer group is expected to be 21.01%/18.4% for FY15E/FY16E.

The Group is a leading pharmacy chain operator in Zhongshan. Hence, we have identified the following HK-listed pharmaceutical stocks that are leading pharmacy chain operators as comparable peers. They include Sinopharm (1099 HK), Fosun Pharma (2196 HK), Shanghai Pharma (2607 HK), Baiyunshan Pharma (874 HK), Beijing Tong Ren Tang Chinese Medicine (8138), Universal Health (2211 HK). The peer group is trading at 14.2x/11.9x estimated FY15E/FY16E P/E and 2.12x/1.85x estimated FY15E/FY16E P/B. The average ROAE of this peer group is expected to be 17.9%/16.7% for FY15E/FY16E.

Decoction pieces are the major product lines of the Group. Kangmei Pharma (600518) is also engaged in the production of decoction pieces, while Yixintang (002727) and Jointown Pharma (600998) also had business relationships with the Group.

In view of the forward P/E rating of peer group, we value the Group's pharmaceutical manufacturing business segment and chain pharmacy operation segment at 13.0x and 12.0x of their corresponding profit projection for FY16E. We set our 12-mth TP at HK$ 2.88/share, which represents 14.8x/12.5x FY15E/FY16E P/E or 3.28x/2.84x FY15E/FY16E P/B.

Exhibit 28: Equity valuation of the Group (sum-of-parts)

Valuation of business segment	**FY16 P/E**	**RMB mn**	**HK$ mn**
1. Pharma manufacturing	13.0	1,055	1,276
2. Pharmacy operation	12.0	852	1,030
Appraised equity value		**1,907**	**2,305**
Issued shares (mn)		800	800
Appraised equity value per share		**RMB2.38/share**	**HK$2.88/share**
Forex: RMB0.82717/HK$			

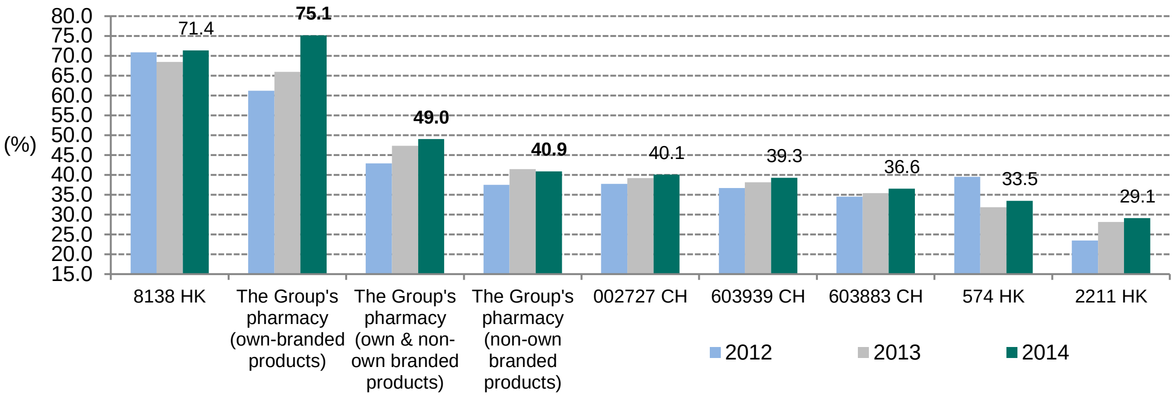
Source(s): ABCI Securities estimates

Exhibit 29: Sector Valuation

Code	Aug 25, 2015	Price (local)	Trailing P/E (x)	12/2014 P/B (x)	12/2014 ROAE (%)	12/15E P/E (x)	12/15E P/B (x)	12/15E ROAE (%)	12/16E P/E (x)	12/16E P/B (x)	12/16E ROAE (%)
	Pharmacy operators										
1099	SINOPHARM-H	26.60	19.82	2.15	13.25	16.64	1.94	12.27	13.91	1.71	13.06
2196	FOSUN PHARMA-H	19.66	17.67	2.15	13.49	18.01	2.01	11.54	14.13	1.81	13.48
2607	SHANGHAI PHARM-H	15.72	13.54	1.26	9.64	12.04	1.15	9.96	10.65	1.07	10.37
874	BAIYUNSHAN PH-H	18.28	16.38	2.40	16.87	14.28	1.91	14.91	12.49	1.70	14.40
8138	TONGRENTANGCM	7.77	22.20	4.34	20.81	17.94	3.68	22.20	14.86	3.11	22.71
2211	UNIVERSAL HEALTH	2.69	9.36	1.71	19.09	7.86	1.43	19.80	7.11	1.21	18.41
3737	**ZHONGZHI PHARMA**	**2.40**	**13.74**	**9.85**	**69.04**	**12.34**	**2.73**	**34.64**	**10.44**	**2.36**	**24.27**
		Average	**16.10**	**3.41**	**23.17**	**14.16**	**2.12**	**17.90**	**11.94**	**1.85**	**16.67**
	Chinese medicine granule producers										
570	TRAD CHI MED	4.72	23.95	3.11	13.90	18.95	1.92	12.51	13.01	1.75	14.06
1498	PURAPHARM CORP	4.15	23.31	5.88	33.02	21.28	2.41	16.08	13.39	2.09	16.71
3737	**ZHONGZHI PHARMA**	**2.40**	**13.74**	**9.85**	**69.04**	**12.34**	**2.73**	**34.64**	**10.44**	**2.36**	**24.27**
		Average	**20.33**	**6.28**	**38.66**	**17.52**	**2.35**	**21.07**	**12.28**	**2.07**	**18.35**
	A-share comparable										
600518	KANGMEI PHARMA-A	14.63	28.13	4.41	18.48	18.57	2.56	17.45	14.67	2.18	16.06
600085	BEIJING TONGRE-A	21.89	38.95	4.47	13.26	33.17	4.77	13.90	28.06	4.37	16.24
000028	CHINA NATIONAL AD-A	57.70	30.37	4.22	14.66	25.96	3.52	14.79	20.91	3.04	15.60
600511	CHINA NATIONAL-A	29.30	29.07	5.16	20.17		4.69			3.88	
600332	GUANGZHOU BAIY-A	25.64	27.78	4.07	16.87	23.02	3.21	15.59	19.19	2.82	15.65
603883	LAOBAIXING PHA-A	50.45	49.95	10.42	22.77	52.94			42.04		
603939	YIFENG PHARMA-A	53.00	45.30	10.77	25.83	47.53	6.69	17.37	37.99	5.64	16.10
002727	YUNNAN HONGXIA-A	43.37	33.23	5.37	15.48	29.71	4.58	16.66	23.66	3.84	17.67
600998	JOINTOWN PHARM-A	16.52	45.89	3.34	7.85	42.04	3.26	7.84	35.91	3.05	8.77
000999	CHINA RESOURCE-A	22.60	21.32	3.12	15.39	18.23	2.87	16.40	16.34	2.52	16.41
002462	CACHET PHARMAC-A	39.70	41.79	7.40	18.44	53.07	6.55	13.10	38.25	5.71	15.96
		Average	**35.62**	**5.70**	**17.20**	**34.42**	**4.27**	**14.79**	**27.70**	**3.70**	**15.38**

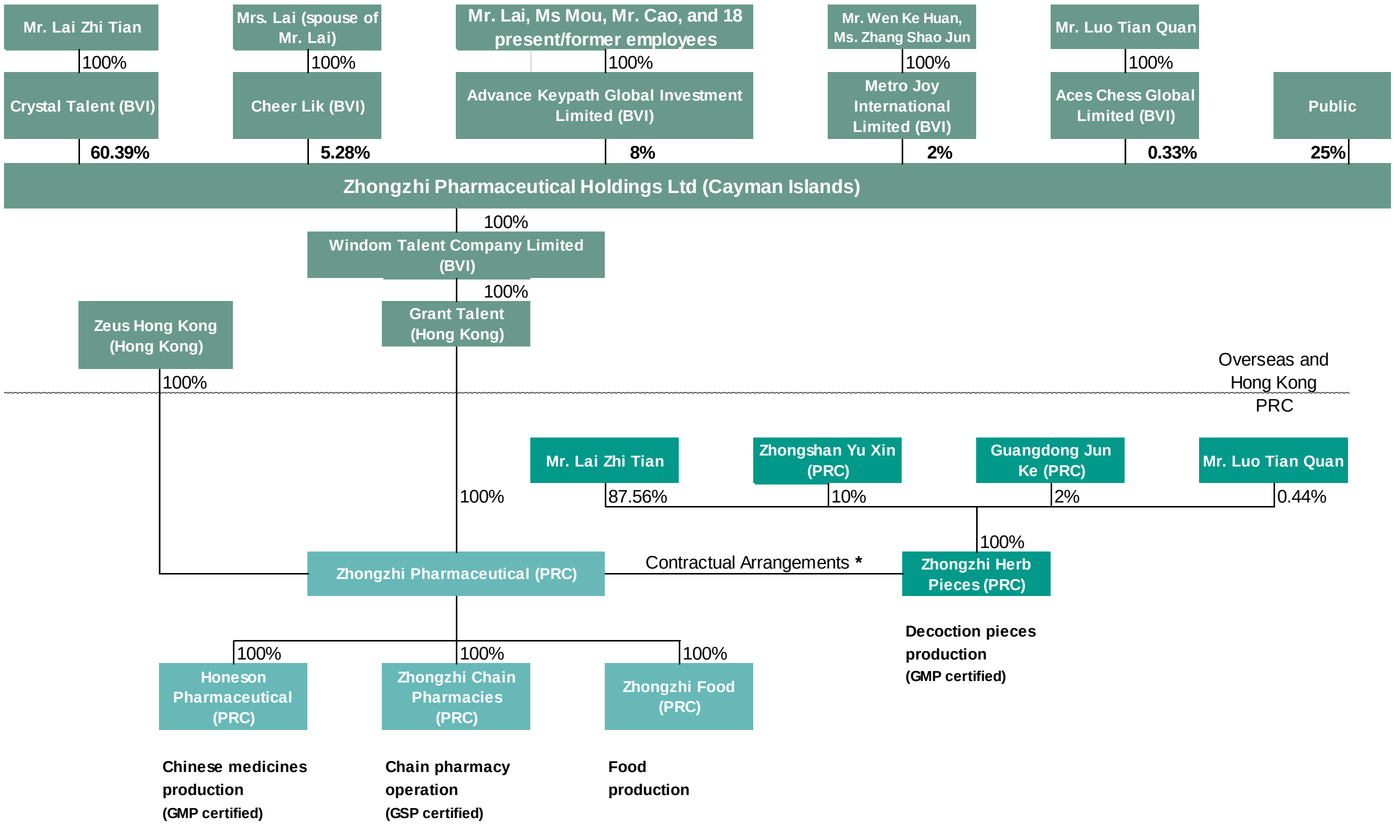
Source(s): Bloomberg, ABCI Securities estimates

Exhibit 30: Gross profit margin of selected HK or China-listed major pharmacy chain operators



8138 HK: HK-listed Beijing Tong Ren Tang Chinese Medicine
603883 CH: Shanghai-listed Laobaixing Pharmacy Chain
603939 CH: Shanghai-listed Yifeng Pharmacy Chain
002727 CH: Shenzhen-listed Yixintang Pharmaceutical
574 HK: HK-listed Pashun Pharma's pharmacy business
2211 HK: HK-listed Jintian Pharmaceutical
Source(s): The Company, Annual reports of companies, ABCI Securities

Appendix 1: Shareholding Structure and Organization Structure



Remarks: The diagram indicates the shareholding structure immediate after IPO in July 2015
* Under the current PRC laws and regulations, foreign ownership of PRC entity engaged in the production of decoction pieces business is prohibited. The Group conducts its production of decoction pieces in the PRC through the Contractual Arrangements. The Group entered into the Contractual Arrangements in order for the Group to manage the business of Zhongzhi Herb Pieces with all economic benefits derived from the business, financial and operating activities of Zhongzhi Herb Pieces transferred to Zhongzhi Pharmaceutical by means of service fees payable by Zhongzhi Herb Pieces to Zhongzhi Pharmaceutical. According to the accountants' report of the Group audited by Ernst & Young CPA, as a result of the Contract Arrangements, Zhongzhi Herbal Pieces was ultimately controlled by Zhongzhi Pharmaceutical (PRC), which is a wholly-owned subsidiary of the Company.
Source(s): The Company

Appendix 2: Summary of Corporate Milestones

1993: Zhongzhi Pharmaceutical was established with Mr. Lai Zhi Tian as the manager.

1999: Zhongzhi Pharmaceutical was transformed to a limited company. Mr. Lai contributed capital and became a major shareholder and founder of the company.

2001: Zhongzhi Chain Pharmacies was incorporated. First pharmacy in Zhongshan called "Zeus Chain Pharmacy" was established. Zhongzhi Herb Pieces was incorporated.

2003: Zhongzhi Herb Pieces was accredited as a High and New Technology Enterprise (高新技术企业) by the Guangdong Provincial Bureau for Science and Technology (广东省科学技术厅).

2007: Zhongzhi Pharmaceutical acquired Chinese medicine manufacturer Honeson Pharmaceutical.

2008: Honeson Pharmaceutical was accredited as a High and New Technology Enterprise* (高新技術企業) by the Guangdong Provincial Bureau for Science and Technology.

2010: Honeson Pharmaceutical became a wholly-owned subsidiary of Zhongzhi Pharmaceutical.

2011: Modern decoction pieces were launched in the PRC market.

2014: The Group was approved by the State Administration of Traditional Chinese Medicine of the PRC (国家医药管理局) to set up the State-level laboratory in the PRC for the development of modern decoction pieces techniques and applications.
A total of 32 self-operated chain pharmacies of the Group were accredited as official preferential price pharmacies* (药品平价商店) by the Price Control Administration of Guangdong Province (广东省物价局), offering a wide range of pharmaceutical products to customers at preferential price.
A total of 85 self-operated chain pharmacies of the Group were designated as medical insurance designated pharmacies* (中山医保指定药店) allowing customers to purchase drugs listed in Zhongshan Outpatient Essential Medical Insurance Drugs Catalogue* (中山市门诊基本医疗保险药品目录) by using their medical insurance cards.
Zhongzhi Food was incorporated.

Mar 2015: Number of self-operated pharmacies increased to 201.
The Group had obtained the business license for the production and distribution of food products and relevant food production licenses for the manufacturing of three kinds of food products.
All of its self-operated chain pharmacies had obtained the relevant food circulation permit (食品流通许可).

Source(s): The Company, ABCI Securities

Appendix 3: Board of Directors

Name	Age	Date of joining the Group	Date of appointment as Director/senior management	Position	Roles and responsibilities	Relationship with the other Directors
Mr. Lai Zhi Tian (赖智填)	47	27-Sep-99	30-Jan-15	Executive Director, Chairman of the Board and General Manager of the Group	Formulating the corporate strategies and planning the business development of the Group	The spouse of Ms. Jiang Li Xia
Ms. Jiang Li Xia (江丽霞)	50	24-Feb-09	12-Sep-14	Executive Director	Supervising business administration	The spouse of Mr. Lai Zhi Tian
Ms. Mou Li (牟莉)	52	1-Mar-02	30-Jan-15	Executive Director and chief financial officer	Supervising financial management and control	N/A
Mr. Cao Xiao Jun (曹晓俊)	47	8-Mar-10	30-Jan-15	Executive Director and deputy general manager	Supervising business development and overseeing sales and marketing activities	N/A
Mr. Ng Kwun Wan (吴冠云)	51	--	--	Independent nonexecutive Director	Providing independent advice to the Board	N/A
Mr. Wong Kam Wah (黄锦华)	46	--	--	Independent nonexecutive Director	Providing independent advice to the Board	N/A
Mr. Zhou Dai Han (周岱翰)	73	--	--	Independent nonexecutive Director	Providing independent advice to the Board	N/A

Source(s): The Company

Disclosures

Analyst Certification

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