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CHINA HEALTHCARE & PHARMACEUTICALS: INITIATION OF COVERAGE

FINDING GAIN IN THE PAIN

PLEASE SEE ANALYST(S) CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 108.

CHINA HEALTHCARE & PHARMACEUTICALS: FINDING GAIN IN THE PAIN

Jason Mann, M.D., Ph.D.
+852 290 34576
jason.mann@barcap.com
Barclays Bank, Hong Kong

The downside will prevail in 2012 for most China healthcare and pharmaceutical stocks, in our view, for two reasons: 1) Policy is the key driver in this space, and policy is broadly negative. The government is now the key buyer, with strong capacity to reduce prices, and in our view, the extent of this earnings headwind will not become apparent until 2012. We provide what we believe to be the first proprietary broker survey of healthcare market participants inside China, which supports our view that market conditions are difficult. We expect further deterioration through the 18th Party Congress in 4Q12, when policy support may unleash the long-term potential of this sector. 2) Valuations remain demanding, trading at a 71% P/E premium to the Hang Seng Index. This is higher than the 3-year average (53%) and 10-year average (28%) premiums. We initiate on 7 stocks in the China Healthcare & Pharmaceuticals sector with a 3-Negative view. Clear exceptions are three well-priced names we see aligned with policy and expect to appreciate: Kanghui, CMED and Shanghai Pharma, all 1-Overweight.

Chinese policy at odds with most listed firms: The government now funds 65% of healthcare and adoption of "lowest price wins" drug tenders accelerated in 2H11. 16 provinces have adopted the Anhui approach, with average price cuts of 49%. Provincial authorities informally compete on price cuts ahead of the key 2012 leadership transition. While sales volumes will continue to rise, policy focus on broad healthcare coverage at minimal prices will compress margins in 2012.

Valuations yet to incorporate negative earnings surprises: The sector remains expensive, even apart from current policy headwinds, and we expect further de-rating in 2012. We forecast negative earnings surprises, which will not start to become widely visible until final 2011 results are announced in March. As a leading indicator, we highlight the 87% y/y earnings loss China Pharma (1093HK) reported for 3Q11. We also expect cash conversion to suffer and anticipate negative operating cash flow for Sinopharm (3-UW) for 2011 and 2012.

Risks: Overall risks to our view include: 1) strong and timely government pricing support; 2) favourable policy developments (eg, elimination of restrictions on antibiotic use); 3) an unexpected recovery in the global macro environment, with higher multiples across markets.

Top picks: Although we have a 3-Negative view on the sector, we see clear exceptions for our 1-OW picks: 1) Kanghui (PT US$19.92) – a domestic premium brand in the protected orthopedic subsector, implying 35% potential upside with moderate risk; 2) CMED (PT US$4.82) – a domestic premium brand in the protected diagnostics subsector, implying 70% potential upside with higher risk; and 3) for those limited to large-cap names, we favour Shanghai Pharma (PT HK$15.83) over better-known Sinopharm (3-UW) as an emerging national champion with stronger cash flow, better margins and less debt. Shanghai Pharma also offers a less demanding valuation (13x earnings vs 26x for Sinopharm) and our PT implies 26% potential upside.

Summary of our Ratings, Price Targets and Earnings Estimates in this Report

Company	Rating		Price	Price Target			EPS FY1 (E)			EPS FY2 (E)		
	Old	New	30-Dec-11	Old	New	%Chg	Old	New	%Chg	Old	New	%Chg
China Health Care & Pharmaceuticals	0-NR	**3-Neg**										
China Kanghui Holdings Inc. (KH)	N/A	**1-OW**	14.74	N/A	**19.92**	-	N/A	**4.73**	-	N/A	**5.66**	-
China Medical Technologies (CMED)	N/A	**1-OW**	2.84	N/A	**4.82**	-	N/A	**5.13**	-	N/A	**6.02**	-
Shanghai Pharmaceuticals Holdings (2607 HK / 2607.HK)	N/A	**1-OW**	12.58	N/A	**15.83**	-	N/A	**0.79**	-	N/A	**0.94**	-
Mindray Medical International (MR)	N/A	**2-EW**	25.64	N/A	**25.78**	-	N/A	**1.43**	-	N/A	**1.43**	-
Shandong Weigao Group Medical Polymer (1066 HK / 1066.HK)	N/A	**2-EW**	6.99	N/A	**6.72**	-	N/A	**0.21**	-	N/A	**0.27**	-
Sinopharm Group Co. Ltd. (1099 HK / 1099.HK)	N/A	**3-UW**	18.66	N/A	**16.15**	-	N/A	**0.59**	-	N/A	**0.67**	-
United Laboratories International (3933 HK / 3933.HK)	N/A	**3-UW**	4.47	N/A	**3.82**	-	N/A	**0.42**	-	N/A	**0.40**	-

Source: Barclays Capital Share prices and target prices are shown in the primary listing currency and EPS estimates are shown in the reporting currency.
FY1(E): Current fiscal year estimates by Barclays Capital. FY2(E): Next fiscal year estimates by Barclays Capital.
Stock Rating: 1-OW: 1-Overweight 2-EW: 2-Equal Weight 3-UW: 3-Underweight RS: RS-Rating Suspended
Sector View: 1-Pos: 1-Positive 2-Neu: 2-Neutral 3-Neg: 3-Negative

Figure 1: China Healthcare & Pharmaceuticals sector

Ticker	Company	BarCap rating	Curr.	Price	Price target	Pot'l upside	Mkt cap US$mn	Vol US$mn	Net margin	Net D/E	BarCap EPS 2010	BarCap EPS 2011E	BarCap EPS 2012E	BarCap EPS CAGR	Consensus EPS 2010	Consensus EPS 2011E	Consensus EPS 2012E	Consensus EPS CAGR	vs consensus 2011E	vs consensus 2012E	P/E 2010	P/E 2011E	P/E 2012E	P/E Min
Pharmaceuticals																								
1099HK	Sinopharm	3-UW	HK$	18.66	16.15	-13%	5,772	8.1	3	14	0.50	0.59	0.67	16%	0.50	0.66	0.83	29%	-0.07	-0.16	43.3	26.3	23.1	19.6
2607HK	Shanghai Pharm.	1-OW	HK$	12.58	15.83	26%	4,620	4.3	5	6	0.69	0.79	0.94	13%	0.69	0.73	0.80	8%	0.06	0.14		13.2	11.1	13.1
460HK	Sihuan Pharm.	NR	HK$	2.75	NR	NR	1,832	3.0	59	(88)	0.13	NR	NR	NR	0.13	0.16	0.21	26%	NR	NR	37.0	13.8	10.8	12.9
1177HK	Sino Biopharm.	NR	HK$	2.31	NR	NR	1,469	2.1	22	(62)	0.12	NR	NR	NR	0.12	0.11	0.15	12%	NR	NR	24.7	21.0	15.7	5.6
2877HK	Shineway	NR	HK$	11.02	NR	NR	1,173	4.1	46	(72)	0.99	NR	NR	NR	0.99	0.96	1.07	4%	NR	NR	19.1	9.3	8.3	2.5
WX	WuXi	NR	US$	11.04	NR	NR	785	3.0	21	(29)	1.31	NR	NR	NR	1.31	1.15	1.27	-1%	NR	NR	17.5	9.6	8.7	3.1
3933HK	United Labs	3-UW	HK$	4.47	3.82	-15%	749	2.4	19	47	0.78	0.42	0.40	-28%	0.78	0.43	0.49	-21%	0.00	-0.09	20.4	10.5	11.1	1.7
1093HK	China Pharma	NR	HK$	1.71	NR	NR	337	1.4	14	15	0.49	NR	NR	NR	0.49	0.26	0.24	-30%	NR	NR	8.9	6.6	7.1	4.9
SCLN	SciClone Pharm.	NR	US$	4.29	NR	NR	251	1.0	26	(65)	0.44	NR	NR	NR	0.44	0.44	0.43	-2%	NR	NR	9.7	9.8	10.1	2.4
								Avg.	24	(26)				0%				2%	0.00	-0.03	22.6	13.3	11.8	7.3
Medical devices																								
1066HK	Weigao	2-EW	HK$	6.99	6.72	-4%	4,028	8.0	27	(5)	0.19	0.21	0.27	20%	0.19	0.21	0.27	21%	-0.01	-0.01	50.5	28.1	21.8	7.0
MR	Mindray	2-EW	US$	25.64	25.78	1%	2,951	10.9	22	(44)	1.32	1.43	1.43	4%	1.32	1.53	1.78	16%	-0.10	-0.35	19.8	18.0	17.9	4.4
853HK	Microport	NR	HK$	3.83	NR	NR	701	0.6	42	(77)	0.20	NR	NR	NR	0.20	0.22	0.25	11%	NR	NR	31.5	13.9	12.6	13.2
KH	Kanghui	1-OW	US$	14.74	19.92	35%	345	0.9	44	(55)	1.60	4.73	5.66	88%	1.60	1.32	5.88	92%	-0.28	-0.22	76.2	19.5	16.3	15.7
CMED	China Med. Tech.	1-OW	US$	2.84	4.82	70%	92	1.7	30	91	3.12	5.13	6.02	39%	3.12	11.09	12.81	103%	-5.96	-6.79	17.0	3.5	2.9	2.7
								Avg.	33	(18)				37%				35%	-1.59	-1.84	39.0	16.6	14.3	8.6
Average									27	(23)				14%				14%			28.5	14.5	12.7	7.8

Note: Stock ratings: 1-OW: 1-Overweight, 2-EW: 2-Equal Weight, 3-UW: 3-Underweight. For full disclosures on each rated company, including details of company-specific valuation methodology and risks, please refer to: http://publicresearch.barcap.com. Estimates for not rated companies are consensus estimates from Bloomberg. Prices as of the market close on 30 Dec 2011.
Source: Bloomberg, Barclays Capital estimates

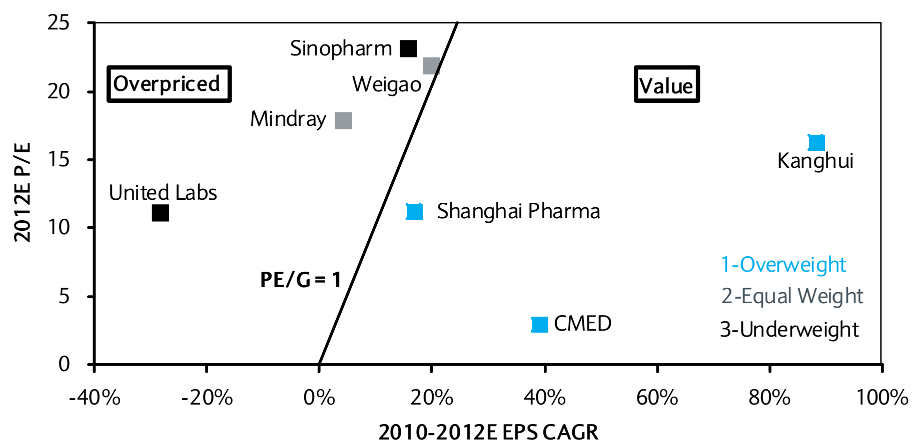
INVESTMENT SUMMARY

In 2012 we expect further downside for most China healthcare names and initiate coverage of the China Healthcare & Pharmaceutical sector with a 3-Negative view. Government policy drives sector performance and remains focused on centralized tendering, antibiotic restrictions and lower prices. While the Chinese economy has grown substantially, less than 5% of GDP is spent on healthcare (below global peers). Moreover, the sector currently trades at a 71% P/E premium to the Hang Seng Index (HSI), well above the 10-year (28%) and 3-year (53%) averages. Our proprietary survey (which we believe is the first broker data on China healthcare sentiment) of Chinese market participants support this bearish view through May 2012 at a minimum. While we see long-term structural potential in the sector, we do not expect significant policy support until after the 18th Party Congress, likely 4Q12. We look for progressive market disappointment on repeated earnings downgrades over the next 12 months. Clear exceptions, however, are well-priced names aligned with government policy: Kanghui, CMED and Shanghai Pharma – all rated 1-OW.

Valuation

We begin our valuation analysis by comparing 2012E P/E (current price divided by 12-month earnings estimates) vs 2010-12E EPS CAGR. Overlaying the chart with a P/E-to-growth (PEG) of 1x provides further insight into those stocks that appear overpriced vs those that may offer value at current levels.

Figure 2: We favour well-priced names aligned with policy trends



Source: Bloomberg, Barclays Capital estimates

Our PT is comprised of a sector discount and a company premium/discount.

Sector discount: For each company, we subtract 1 standard deviation (SD) from the company's 10-year historical mean P/E. We view 1 SD as appropriate, given policy headwinds.

Company discount/premium: We complement the sector discount with a company discount/premium based on a qualitative assessment of forecast growth rates, subsector policy trends, market sentiment, cash flow and management quality.

Figure 3: Valuation framework – given policy headwinds, 1SD below historical multiples was our starting benchmark for the sector. To derive stock-specific target multiples we complemented the sector discount with a qualitative adjustment based on company-specific factors

	Mean P/E	-1SD	Qualitative adjustment	Base case	Current	SD adj.
Kanghui	25.3	21.1	0.9	**22.0**	19.5	-0.75
CMED	11.7	5.1	-0.1	**5.0**	3.5	-1
Sh. Pharma	16.5	14.2	-0.2	**14.0**	13.2	-1
Mindray	25.1	15.6	2.4	**18.0**	18.0	-0.75
Weigao	29.2	21.6	-0.6	**21.0**	28.1	-1
Sinopharm	37.9	30.9	-10.9	**20.0**	26.3	-2.5
United Labs	10.4	5.7	3.8	**9.5**	10.5	-0.2
Average				**15.6**	**17.1**	**-1.0**

Source: Reuters, Barclays Capital estimates

Risks

At current valuations we consider a 3-Negative view appropriate for the sector in 2012. The main risk to this view is robust government intervention in advance of our 4Q12 post-Party Congress expectation. This could take two primary forms:

- **Policy support:** The government may reduce or eliminate barriers to sales, such as antibiotic restrictions that currently limit what has been the largest drug category in China.
- **Pricing support:** With volumes increasing rapidly, the key barrier to the sector is margin pressure. This comes from two main fronts: 1) direct limitations on maximum ex-factory mark-ups; and 2) pervasive adoption of centralized provincial tendering systems that indirectly drive margins down, often to unprofitable levels. If drugs shortages become more frequent, the central government may intervene sooner to provide additional pricing support, with a favourable impact on sector earnings.

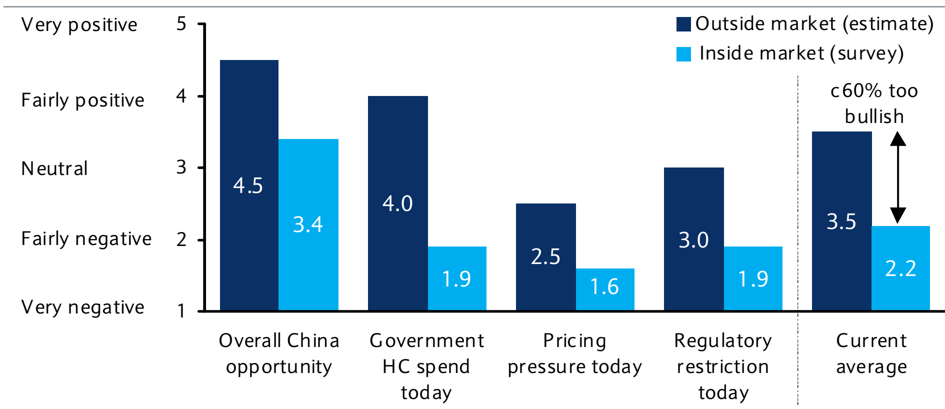
Beyond these direct interventions in the healthcare market, economic conditions in China also present risks to our view. Though infrastructure, local government and defence spending may take priority in a downturn, if Chinese economic growth slows less than expected in 2012 more funding could be made available for healthcare. In addition, unexpected global economic recovery may spur stock investment and lift earnings multiples across equity markets.

Our cautious view is well supported by the first proprietary broker survey measuring Chinese healthcare sentiment among market participants

We surveyed 70 Chinese healthcare executives, sales managers, pharmacists and physicians to gain a real-time estimate of sentiment among market participants in China

We estimate the "outside market view" based on analysis of outside reports and hundreds of discussions with international observers/executives interested in the China healthcare market

Figure 4: Chinese market participants rate current conditions c60% lower than our estimates of the outside perception of the Chinese healthcare market



Source: Barclays Capital, ChinaBio® LLC (see below for further detail and Appendix II for exact survey questions)

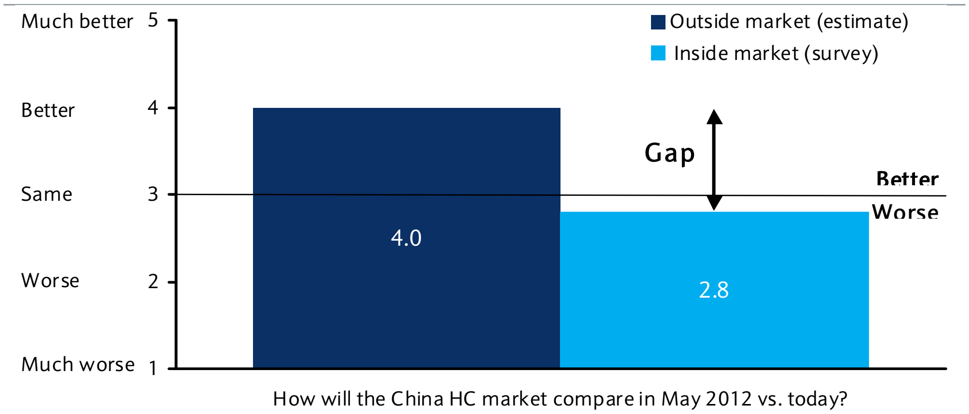
Notably, inside experts remain mildly positive (3.4/5) on the overall healthcare opportunity in China. This supports our long-term confidence in the sector. However, current conditions are rated significantly more negatively (1.8/5), which supports our negative near-term view. Moreover, market participants estimate that market conditions will deteriorate slightly through May 2012.

Environment expected to deteriorate further, at least through 2Q12

Internal sentiment appears negative. We estimate that outside observers rate the current market environment c60% more favourably than direct market participants

Notably, inside experts estimate that China healthcare market conditions will deteriorate further through May 2012, at a minimum

Figure 5: Experts expect a slightly worse environment in May 2012 vs today, a significant gap from our estimates of perceptions outside China



Source: Barclays Capital, ChinaBio® LLC (see below for further detail and Appendix II for exact survey questions)

Top picks

While we remain bearish through the 18th Congress, we utilize a systematic stock selection framework to identify potential outperforming names, as follows:

Figure 6: Key stock selection criteria

		Priority Firm		Attractive	Strong subsector*		Weak subsector**		Significant		
		NC	DP	Valuation	Orthopedics	Diagnostics	Generics	Stents	Opportunity	M&A	Total
1-Overweight	Kanghui		1	2	1				1	1	6
	CMED		1	2		1			1	1	6
	Sh. Pharma	1		2			-1		1		3
2-Equal Weight	Mindray	1	1								2
	Weigao	1	1								2
3-Underweight	Sinopharm	1					-1				0
	United Labs	1					-1				0

NC — National champion: Strong government support, including credit access, beneficiary of consolidation wave
DP — Domestic premium: Quality >90% of multinational company (MNC), Price <70% of MNC, high growth sector
* — High growth area with high multinational company market (MNC) share and less price cuts
** — Low MNC presence and significant pricing pressure

Note: M&A potential estimated by market capitalization and relative ease of organic growth in each subsector
Source: Barclays Capital estimates

- **Kanghui** is a domestic premium brand in the protected orthopaedic subsector, offering 35% potential upside and moderate risk.
- **CMED** is a domestic premium brand in the relatively protected diagnostics subsector, offering 70% potential upside and higher risk.
- **Shanghai Pharma** – for those limited to large-cap names, we favour Shanghai Pharma over better-known Sinopharm (2-EW) as an emerging national champion, with stronger cash flow, better margins, and less debt. Shanghai Pharma (18% potential upside) offers a less demanding valuation, trading at 13x earnings (vs 26x for Sinopharm).

Figure 7: Shanghai Pharma provides several advantages over Sinopharm, at a cheaper valuation

2011E	Sinopharm	Shanghai Pharma
Revenue growth	40%	48%
Gross margin	8%	14%
Operating cash flow	-4%	6%
Income growth	24%	46%
Net margin	1.5%	3.6%
Net debt/equity	4%	-29%
Cash conversion cycle (days)	30	26
China market penetration	~50%	~30%
Valuation	**26x**	**13x**

Source: Company data, Barclays Capital estimates

Stock ratings

1-Overweight rating

A premium domestic player in the attractive orthopaedic space, with 35% potential upside and moderate risk

China Kanghui (1-OW; PT US$19.92; +35%): Kanghui is a premium domestic player in the China orthopaedic space, which many consider the most attractive orthopaedic market globally. Our PT is based on 22.0x 2012E non-GAAP earnings per ADS (EPADS) of Rmb5.66 (currently trading at 16.3x 2011E). The 22.0x P/E is derived by subtracting 1 SD (4.2x) for our negative sector view from the historical mean (25.3x), and adding 0.9x for qualitative factors specific to the firm. 22.0x is roughly 0.75 SD less than the historical average. **Key drivers:** 1) valuation (+35% potential upside); 2) favourable subsector with high M&A potential; 3) strong fundamentals and management. **Key risks:** 1) aggressive government pricing pressure extended to orthopaedic space; 2) increased competition for mid-tier space from premium international brands or low-end domestic players; 3) a hard landing in China, with reduced healthcare spend; and 4) a global recession, with lower earnings multiples across equity markets.

A premium domestic player in the protected China medical diagnostics space, with 70% potential upside and higher risk

China Medical Technologies (1-OW; PT US$4.82; +70%): CMED is one of our top picks as a domestic premium player in the protected China medical diagnostics space. Our PT is based on 5.0x 2012E EPADS of Rmb6.02 (currently trading at 2.9x 2011E). The 5.0x P/E is derived by subtracting 1 SD (6.6x) for our negative sector view from the historical mean (11.7x), and subtracting 0.1x for qualitative factors specific to the firm. 5.0x is roughly 1.0 SD less than the historical average. **Key drivers:** 1) attractive valuation (70% potential upside); and 2) favourable subsector with less pricing pressure. **Key risks**: 1) continued negative sentiment toward small-mid cap China ADRs; 2) accounting irregularities or corporate governance issues; 3) a hard landing in China, with reduced healthcare spend; and 4) a global recession, with lower earnings multiples across equity markets.

A national champion drug distribution firm with diversified businesses in drug manufacturing and retail

Shanghai Pharmaceuticals (1-OW; PT HK$15.83; +26%): Shanghai Pharma is a national champion drug distribution firm with diversified businesses in drug manufacturing and retail. Our PT is based on 14.0x 2012E EPS of Rmb0.94 (currently trading at 11.8x 2011E). The 14.0x P/E is derived by subtracting 1 SD (2.3x) for our negative sector view from the historical mean (16.5x), and subtracting 0.2x for qualitative factors specific to the firm. 14.0x is roughly 1.0 SD less than the historical average. **Key drivers:** We are positive at current levels, based primarily on valuation, and favour Shanghai Pharma in the distribution space. While both Sinopharm and Shanghai Pharma will benefit from consolidation trends, Shanghai Pharma provides better cash flow, margins and debt position with a less demanding valuation (currently 13x vs 26x). **Key risks:** 1) aggressive government limits on distribution margins; 2) difficulty with acquisition integration and value capture across diversified business; 3) a hard landing in China, with reduced healthcare spend; 4) a global recession, with lower earnings multiples across equity markets.

2-Equal Weight rating

A national champion and domestic premium player in the patient monitoring, medical imaging and diagnostics sectors

Mindray Medical (2-EW; PT US$25.78; +1%): Mindray is a national champion and domestic premium player in the patient monitoring, medical imaging, and diagnostics sectors. Our PT is based on 18.0x 2012E EPADS of US$1.43 (currently trading at 17.9x 2011E). The 18.0x P/E is derived by subtracting 1 SD (9.5x) for our negative sector view from the historical mean (25.1x) and adding 2.4x for qualitative factors specific to the firm. 18.0x is roughly 0.75 SD less than the historical average. **Key drivers:** We are neutral at current levels based on valuation, viewing growth opportunities roughly in line with risks. **Key risks:** 1) aggressive government pricing pressure; 2) unexpectedly high growth in China or other key markets; 3) competition in the mid-tier space from both domestic and international players; 4) a hard landing in China, with reduced healthcare spend; 5) a global recession, with lower earnings multiples across equity markets.

A national champion in the single use medical supplies category, with smaller subsidiaries in dialysis and orthopaedics

Shandong Weigao Group (2-EW; PT HK$6.72; -4%): Weigao is a national champion in the single-use medical supplies category, with smaller subsidiaries in dialysis and orthopaedics. Our PT is based on 21.0x 2012E EPS of Rmb0.27 (currently trading at 21.8x 2011E). The 21.0x P/E is derived by subtracting 1 SD (7.6x) for our negative sector view from the historical mean (29.2x) and subtracting 0.6x for qualitative factors specific to the firm. 21.0x is roughly 1.0 SD less than the historical average. **Key drivers:** We are neutral at current levels based on valuation, viewing growth opportunities roughly in line with risks. **Key risks:** 1) aggressive government pricing pressure extended to medical supplies; 2) unexpectedly fast growth within the key Class 2 hospital segment; 3) competition for premium domestic space, either from multinationals or from smaller-scale China players; 4) a hard landing in China, with reduced healthcare spend; 5) a global recession, with lower earnings multiples across equity markets.

3-Underweight rating

A national champion and the largest drug distributor in China. We expect negative operating cash flow in 2012

Sinopharm Group (3-UW; PT HK$16.15; -13%): Sinopharm is a national champion and the largest drug distributor in China. Our PT is based on 20.0x 2012E EPS of Rmb0.67 (currently trading at 23.1x 2011E). The 20.0x P/E is derived by subtracting 1 SD (7.0x) for our negative sector view from the historical mean (37.9x) and subtracting 10.9x for qualitative factors specific to the firm. 20.0x is roughly 2.5 SD less than the historical average. **Key drivers:** 1) a more demanding valuation than Shanghai Pharma; 2) negative operating cash flow; 3) maturation of a previous M&A-driven growth strategy. While both Sinopharm and Shanghai Pharma will benefit from consolidation trends, Shanghai Pharma provides better cash flow, margins and debt position with less demanding valuation (currently 13x vs 26x). **Key risks:** 1) strong government support of distributor margins; 2) unexpected policy and pricing support for generic drugs; 3) significant improvement in credit or payment terms; 4) outperformance of the global economy, with renewed interested in Chinese equities.

A major antibiotic manufacturer, supplying finished drugs to the domestic market and API globally

United Laboratories (3-UW; PT HK$3.82; -15%): United Labs is a major antibiotic manufacturer, supplying finished drugs to the domestic market and API globally. Our PT is based on 9.5x 2012E EPS of HK$0.40 (currently trading at 11.1x 2011E). The 9.5x P/E is derived by subtracting 1 SD (4.7x) for our negative sector view from the historical mean (10.4x) and adding 3.8x for qualitative factors specific to the firm and current trading levels. 9.5x is roughly 0.2 SD less than the historical average. **Key drivers**: 1) valuation, with 15% potential downside; and 2) an unfavourable subsector facing tremendous generic competition and a suite of negative policy headwinds. **Key risks:** 1) swift and supportive government pricing policies; 2) repeal of antibiotic restrictions currently in place; and 3) outperformance of the global economy, with renewed interest in China stocks.

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SECTOR FUNDAMENTALS

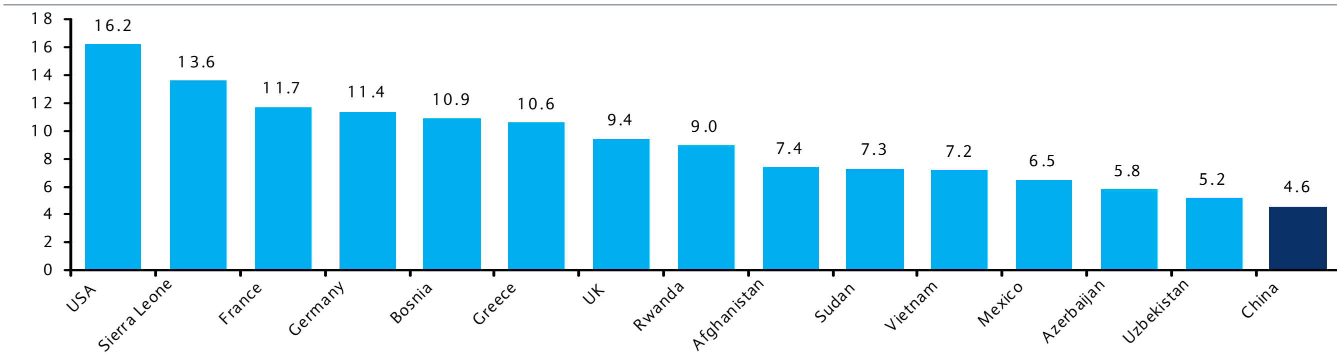
China is the fastest-growing drug and medical device market in the world (2012E Rmb1,854bn) – although growth has slowed since peaking in 3Q09. We forecast 19% overall growth in 2012. However, as profits have declined significantly since the government introduced the Essential Drug List (EDL) in 2009, we expect profit growth for our coverage universe of only 12% in 2011 and 17% in 2012 (vs sales growth of 39% and 19%, respectively). Drug manufacturing and distribution in China remains very fragmented, with significant consolidation expected over the next ten years. Finally, the government's share of healthcare spend has increased substantially, especially since 2009. Patients currently pay 36% out of pocket, vs an average of 60% in 2000.

Second-largest market by 2015, although per capita spend is low

Low percentage of GDP spent on healthcare

Although the China drug and device market has grown rapidly (20-30% pa over 20 years), this is from a low base. The focus on growth of the China market has obscured the fact that China spends only 5% of GDP on healthcare, less than Uzbekistan, Rwanda and Vietnam.

Figure 8: % of GDP spent on healthcare, 2009

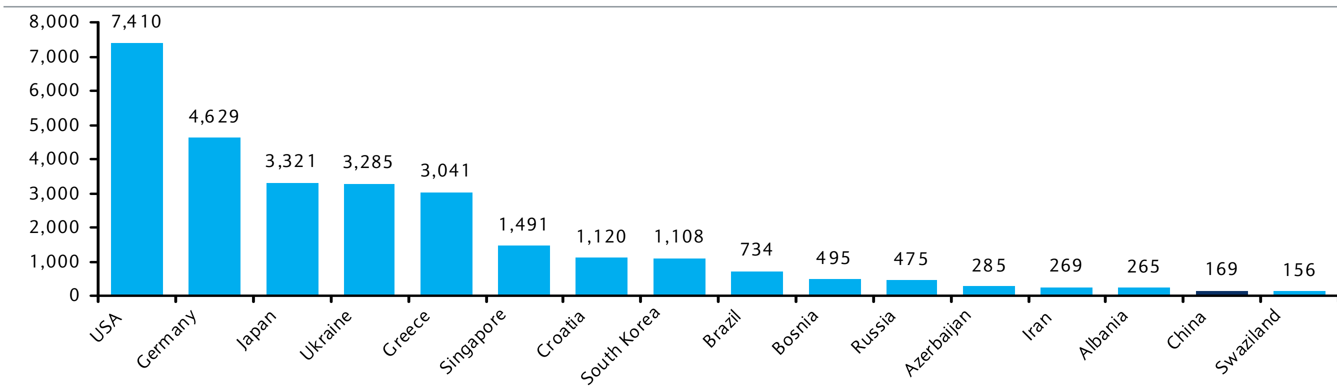


Source: World Health Organization, 2009 (latest), Barclays Capital

Low absolute spend on healthcare

Combining China's modest GDP per capita (US$4,400) with less than 5% dedicated to healthcare yields a low investment in healthcare per capita. Though the market has long-term structural potential, current annual spend per capita is less US$200. This is one-third of Russia, one-fifth of Brazil and barely above Swaziland. While growth rates will remain significant, in our view, the market has missed this fundamental point of scale of the current market.

Figure 9: Healthcare spend per capita

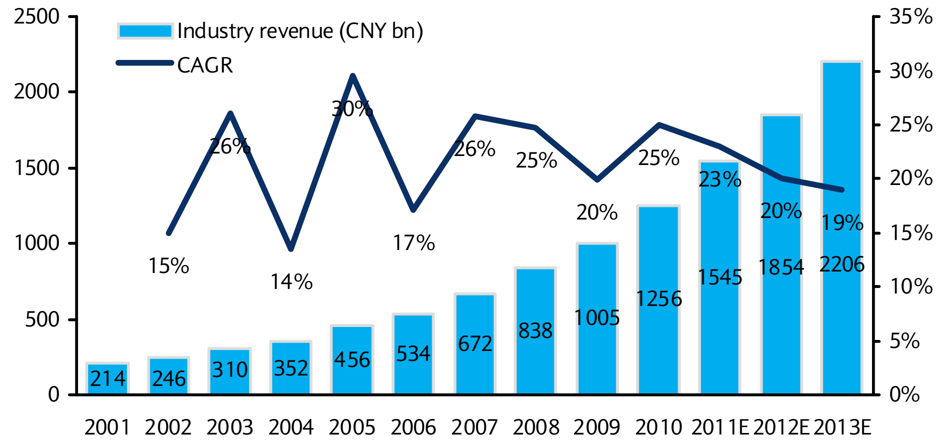


Source: World Health Organization, 2009 (latest), Barclays Capital

Size, segments, and structure

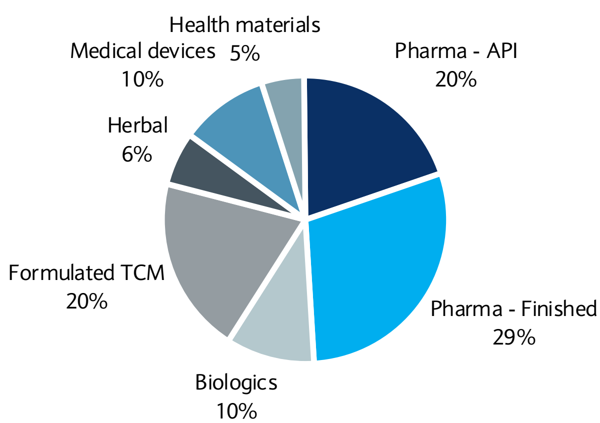
While we highlight limitations of the current Chinese market, given the large scale and growth rate, we believe this market offers opportunity for savvy investors. Drug and device sales reached Rmb1,256bn for drugs and devices in 2010. We forecast this will increase to Rmb1,854bn in 2012.

Figure 10: China drug and device industry



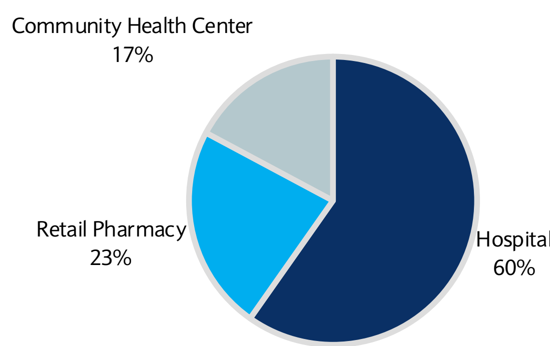
Source: SMEI, NDRC, Barclays Capital estimates

Figure 11: Chemical drugs comprise 50% and TCM 26% of sales



TCM: Traditional Chinese medicine
Biologics: Vaccines, protein-based therapeutics
Pharma: Small molecule chemicals
Source: Southern Medical Economic Institute (2010), Barclays Capital

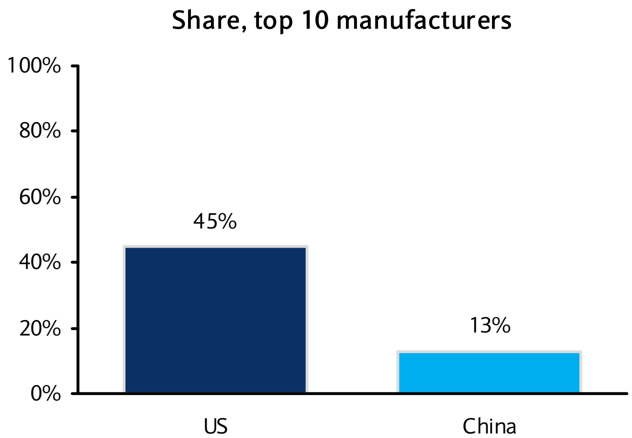
Figure 12: 60% of drug sales occur at hospitals, a much high proportion than most developed economies



Source: Southern Medical Economic Institute (2010), Barclays Capital

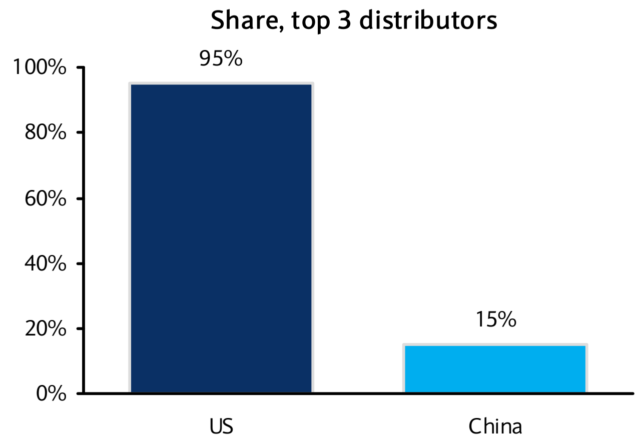
By 2015 we expect further consolidation in the manufacturing and distribution sub-segments.

Figure 13: China manufacturers remain unconsolidated, 2010



Source: SMEI, IMS, Barclays Capital

Figure 14: China distributors remain unconsolidated, 2010



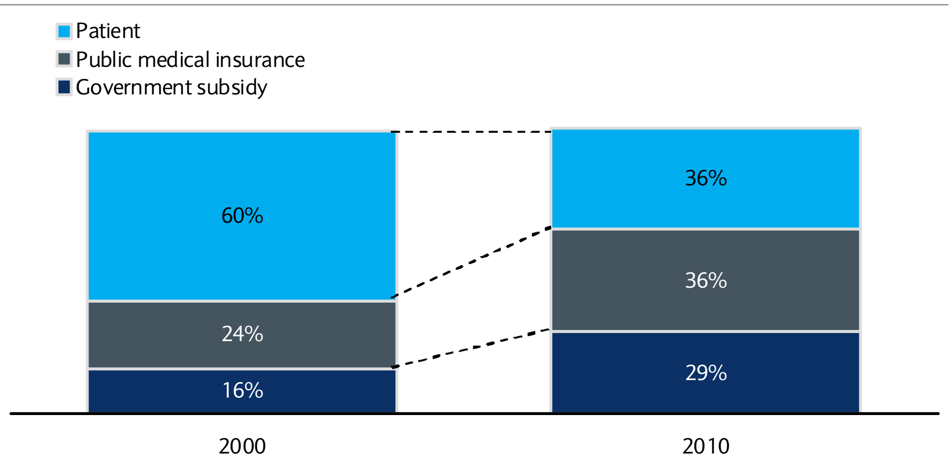
Source: SMEI, IMS, Barclays Capital

Key trends

Reduced out-of-pocket spend

The government has increased direct subsidies and indirect social spending, reducing patient out-of-pocket expenses from 60% in 2000 to 36% in 2010.

Figure 15: Healthcare funding in China

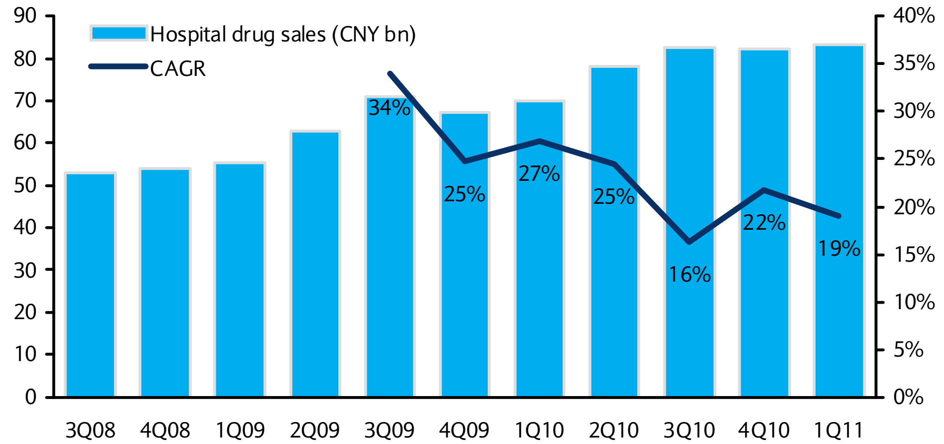


Source: NDRC, Barclays Capital

Declining sales growth

However, growth is slowing. Analysis of IMS hospital drug sales data suggests that sales growth peaked in 3Q09.

Figure 16: 3Q09 represented the peak of hospital sales growth

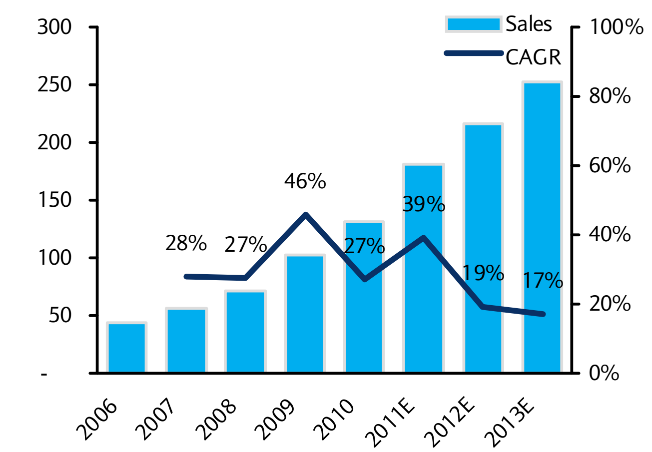


Source: IMS, Barclays Capital

Shrinking margins

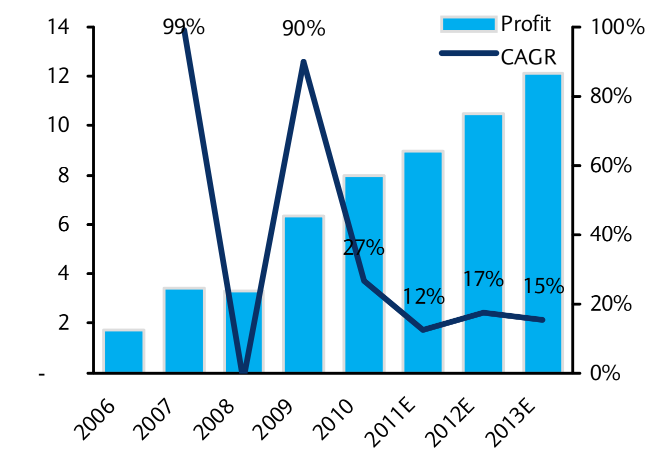
Detailed analysis of our sector universe reveals profit growth outperforming sales growth through 2009. The market grew rapidly in this period prior to introduction of key policies: the Essential Drug List (EDL), National Reimbursed Drug List (NRDL) and Basic Medical Insurance (BMI). With these interventions the government suddenly became the largest buyer of drugs and devices in China. Profit growth fell sharply in 2010 and we predict that net margins will face severe pressure in 2012.

Figure 17: Sales growth remained high in 2011 (Rmb bn)



Source: Company data, Barclays Capital estimates

Figure 18: Profit growth fell sharply in 2010 (Rmb bn)



Source: Company data, Barclays Capital estimates

PROPRIETARY DATA: UNIQUE ON THE STREET, AND SUPPORTING OUR VIEW

Underperformance of this sector is not surprising, in our view, given the gap between outside enthusiasm and negative policy trends on the ground. We support our 3-Negative view on the sector for 2012 with our proprietary quantitative survey of industry sentiment in China – which we believe to be the first of its kind. We surveyed 70 direct market participants in China – healthcare executives, drug sales managers, physicians and pharmacists – regarding current experiences and future expectations for the China healthcare market. Key takeaways include mildly positive views on the long-term potential of the sector, contrasting with negative views on government spending and the current pricing and regulatory environment. Notably, survey participants expect conditions to worsen slightly through May 2012.

First quantitative data of China healthcare sentiment

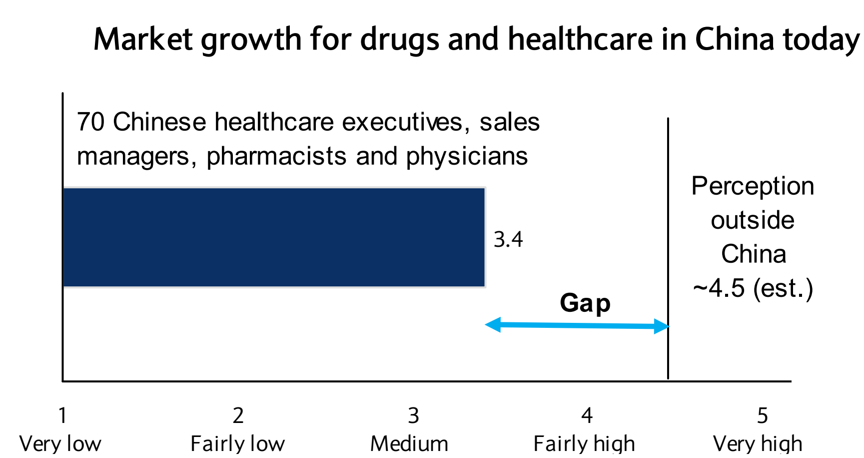
To win in this market, we highlight to investors the importance of understanding market conditions on the ground in China. To put this into practice, we conducted what we believe to be the first broker survey of healthcare sentiment in China. To ensure high-quality data, we collaborated with respected China healthcare consulting firm ChinaBio® LLC, based in Shanghai and led by Greg Scott.

Our survey of 70 Chinese doctors, pharmacists, drug sales managers and industry revealed several striking findings that contrast with our estimates of general perceptions outside China. Respondents were negative on government policy, pricing, and the regulatory environment. Interestingly, industry executives and sales managers were roughly 1.0 more positive, on average, than physicians and pharmacists. We anticipate conducting future surveys to provide quantitative estimates of China healthcare sentiment over time. By extension, we hope to gain a leading indicator of the impact of policy trends, and by extension, corporate performance and share price action.

We surveyed 70 Chinese healthcare executives, sales managers, pharmacists and physicians to gain a real-time estimate of sentiment among market participants in China.

We estimate the "outside market view" based on analysis of outside reports and hundreds of discussions with international observers/executives interested in the China healthcare market.

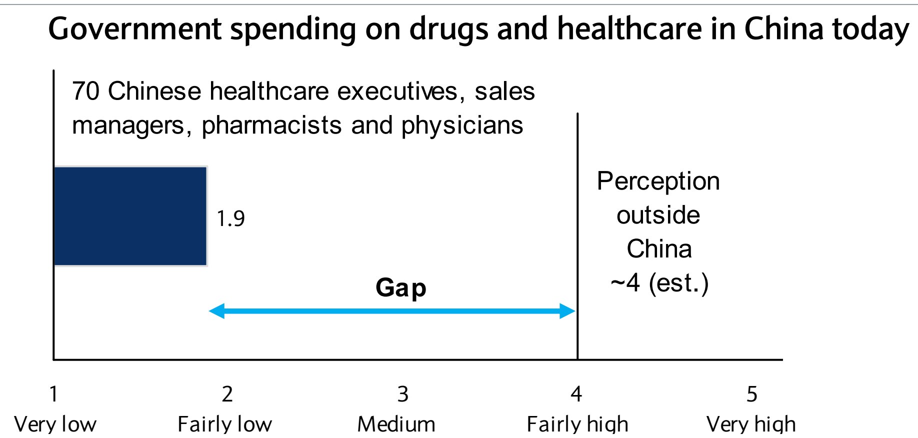
Figure 19: Respondents see medium market growth for drugs and healthcare, a more negative view than our estimates of the view from outside China



Source: ChinaBio® LLC, Barclays Capital

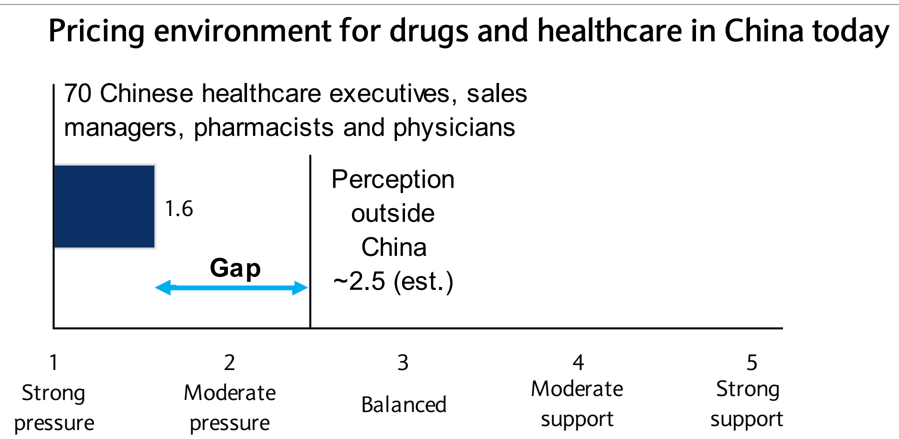
Internal sentiment appears negative. We estimate that outside observers rate the current market environment c60% more favourably than direct market participants.

Figure 20: Respondents see low government spending today on drugs and healthcare, a significant gap from our estimates of the perception outside China



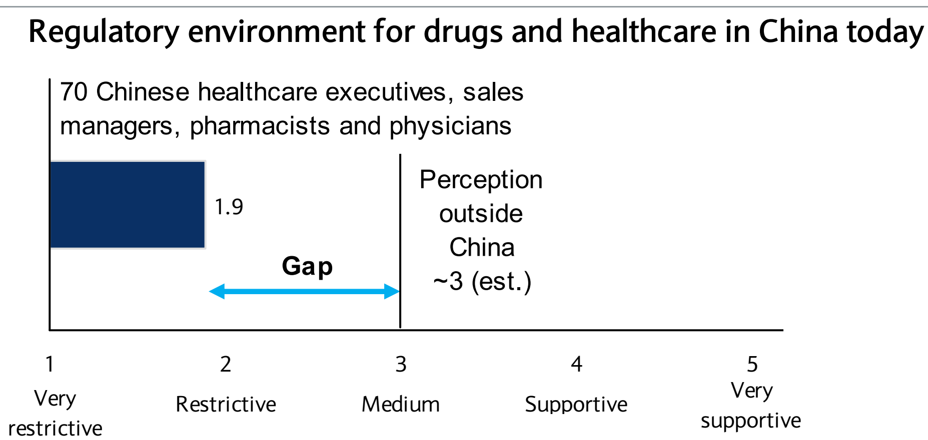
Source: ChinaBio® LLC, Barclays Capital

Figure 21: Respondents see fairly strong pricing pressure on drugs and healthcare



Source: ChinaBio® LLC, Barclays Capital

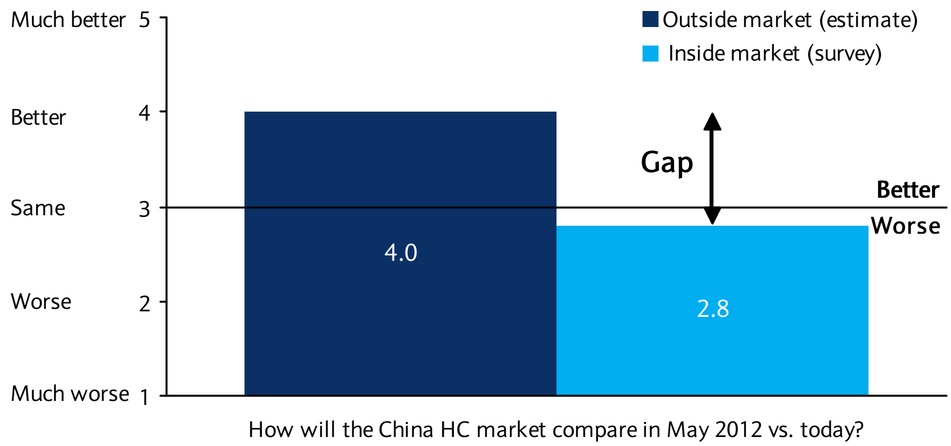
Figure 22: Respondents see a restrictive regulatory environment for drugs and healthcare in China today



Source: ChinaBio® LLC, Barclays Capital

Notably, inside experts estimate that China healthcare market conditions will deteriorate further through May 2012, at a minimum.

Figure 23: Respondents expect worse market conditions through May 2012, a gap with our estimates of the perception outside China



Source: ChinaBio® LLC, Barclays Capital

1) GOVERNMENT POLICY: NOT AS POSITIVE AS YOU MAY THINK

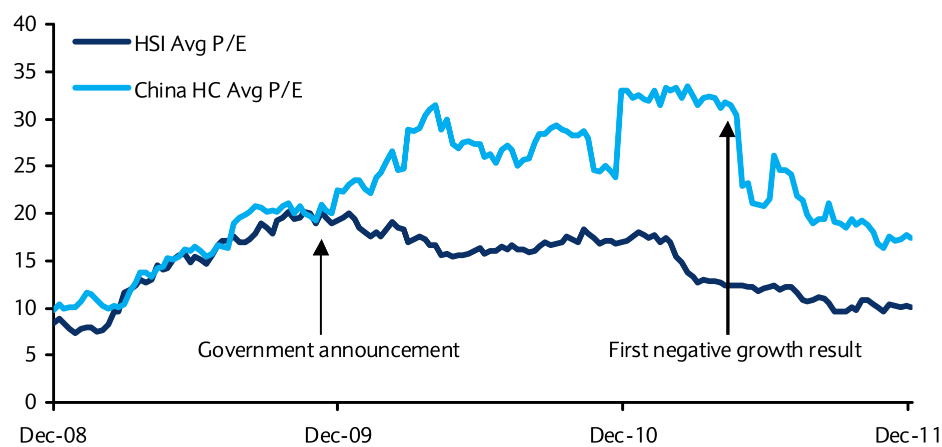
The markets punished this sector in 2011, arguably because of misunderstood policy changes and inflated valuations dating back to 2009. While China healthcare policy is a large subject, we provide one example of how misunderstanding of policy developments cost many investors over the past two years. In section 2 we provide a historical and international context for valuations in the sector, suggesting that these names remain expensive and will likely lead to more disappointment in 2012. In section 3 we describe our stock selection framework and highlight three exceptions to the overall negative policy and valuation themes. To win in this mispriced market, we favour well-priced names aligned with government policy goals.

Government policy misaligned with most listed names

Simply put, the China healthcare market is young. China GDP is US$4,400 per capita, and only 5% is spent on healthcare. With global healthcare executives and investors looking for growth, many seem to overlook the real limitations of the Chinese market today. The fact is that only US$200 is currently spent on healthcare per capita, which does not provide for a tremendous drug and device market. However, with growth rates of 15-20% through 2020, we certainly see long-term structural support for the sector over time.

We argue that policy drives this sector and that policy misunderstanding leads to disappointing investment results. For example, after tracking the HSI average P/E multiple fairly closely, China healthcare multiples rerated dramatically in late 2009 following the announcement of increased government spending on healthcare of US$125bn over three years.

Figure 24: P/E multiples decoupled following misunderstanding of government policy



Source: Reuters, Barclays Capital

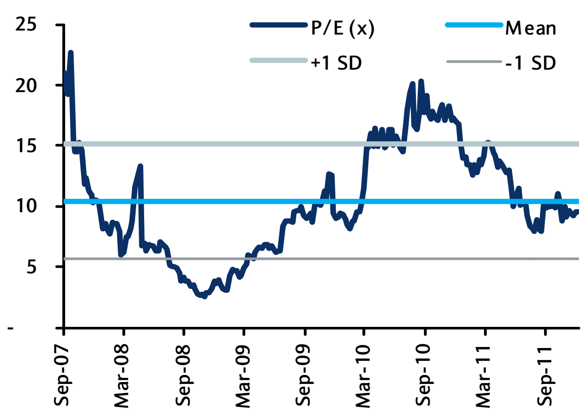
This was a key misunderstanding, in our view, leading to overpriced equities:

- **US$125bn over three years is insignificant to a market the size of China** (roughly US$100 per person), a country starting from a low healthcare base spend. Moreover, the incremental $40bn per year was applied to baseline spend of $300bn, merely an additional 13%. This did not warrant a sudden 50%+ P/E premium to the index, topping out at 156% in May 2011. Multiples have come down 85ppt but remain elevated at 71% above the HSI, well above the 3-year (53%) and 10-year (28%) premiums.

- **The investment was focused on infrastructure investments,** with limited direct benefit to the core businesses of listed companies.
- **Even the broadening basic medical insurance (BMI) coverage from 40% to 90%+ of the population was not that significant**. Reimbursement amounts remain at a very modest level. For example, the average rural resident receives only a maximum of US$30 in guaranteed government support each year, even after this policy.
- **Most importantly, the 13% increase in government spending brought increased government scrutiny of prices** (given that the government is now the largest buyer of medical products). Since then, the government has directly cut drug prices an average of 20-30% (with many more dramatic examples), which directly hit listed companies. In other words, while the $125bn investment was positive for patients, it was, in our view, a net negative for most listed companies.

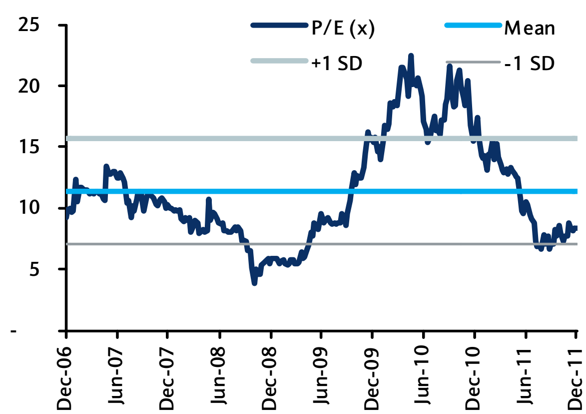
Overall, once the policy misunderstanding began to be apparent, earnings multiples inevitably started falling. In some cases this has been quite dramatic, especially on forward earnings:

Figure 25: United Labs (3933HK), an antibiotics producer



Source: Reuters, Barclays Capital

Figure 26: Shineway (2877HK, not rated), a traditional Chinese medicine producer



Source: Reuters, Barclays Capital

We remain negative on policy support near term, with the balance of corporate vs patient benefit remaining on the side of the patient at least through the key leadership transitions of 2012. However, in 4Q12 we expect additional government policy support and spending in healthcare (eg, increased BMI reimbursement) and greater consumer discretionary spend focused on healthcare. However, it is worth remembering that the market has frequently inflated China and healthcare as two great growth stories of the 21st century. This warrants continued caution, in our view.

2012 outlook

- Broadly, we expect continued policy focus on providing basic healthcare across China at the lowest possible price, at least through 3Q12.
- We forecast drug prices will continue to decline through 3Q12.
- We anticipate more centralized tenders, more cuts and more limits in the drug and stent sectors, at least through 3Q12.

2) VALUATIONS: PROCEED WITH CAUTION

In Section 1 we focused on negative policy headwinds that prioritize lower prices, with negative impacts on earnings and cash flow. In Section 2 we focus on valuations, which remain demanding by historical and international benchmarks. Valuations peaked in 1H11 and declined 17ppt vs the broader index through year end. Share price performance on the year totalled -39%, roughly double the -20% of the HSI. Despite this correction, the sector remains expensive, in our view, trading 71% above the index, vs 3- (53%) and 10-year (28%) averages. While we remain bullish on the sector long term, we do not advocate accumulating positions broadly in the sector before policy improves significantly and forward multiples return to less demanding levels: <50% average forward P/E premium to the index.

China Healthcare & Pharma sector underperformed in 2011

We define the China Healthcare & Pharmaceuticals sector as those stocks that combine: 1) off-shore listing (typically Hong Kong or the US) accessible to international investors; and 2) average daily dollar turnover greater than US$1mn. 14 names generally meet these criteria – although average trading volumes can fluctuate:

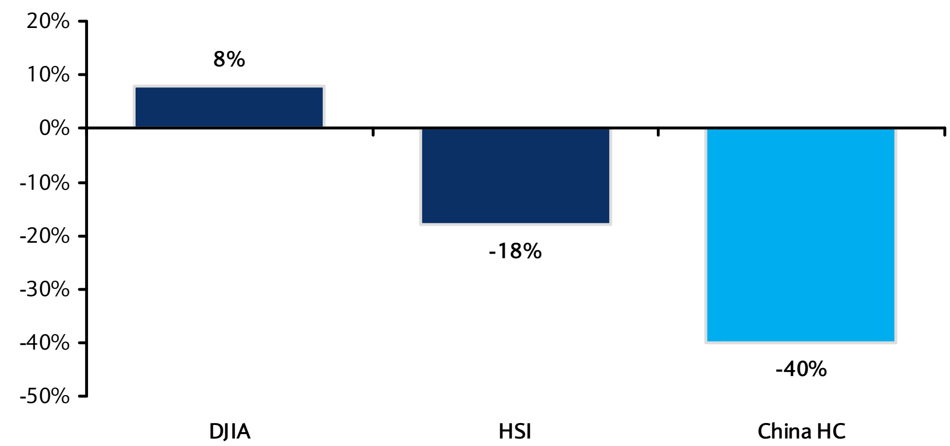
Figure 27: China Healthcare & Pharma universe accessible to most international investors

Ticker	Name	MC (US$mn)	DDT (US$mn)
1099HK	Sinopharm Group	5,772	8.1
2607HK	Shanghai Pharmaceuticals Holdings	4,620	4.3
1066HK	Shandong Weigao Group Medical	4,028	8.0
MR	Mindray Medical International	2,951	10.9
460HK	Sihuan Pharmaceutical Holdings	1,832	3.0
1177HK	Sino Biopharmaceutical	1,469	2.1
2877HK	China Shineway Pharmaceutical	1,173	4.1
WX	WuXi PharmaTech	785	3.0
3933HK	United Laboratories	749	2.4
853HK	Microport Scientific	701	0.6
1093HK	China Pharmaceutical Group	337	1.4
KH	China Kanghui Holdings	345	0.9
SCLN	Sciclone Pharmaceuticals	251	1.0
CMED	China Medical Technologies	92	1.7

MC = market capitalization; DDT = average 3mo daily turnover, US$
Source: Bloomberg, Barclays Capital

In 2011, the total return (capital gains and dividends) of the China healthcare space was -32% vs -11% for the HSI and +6% for the Dow Jones Industrial Average.

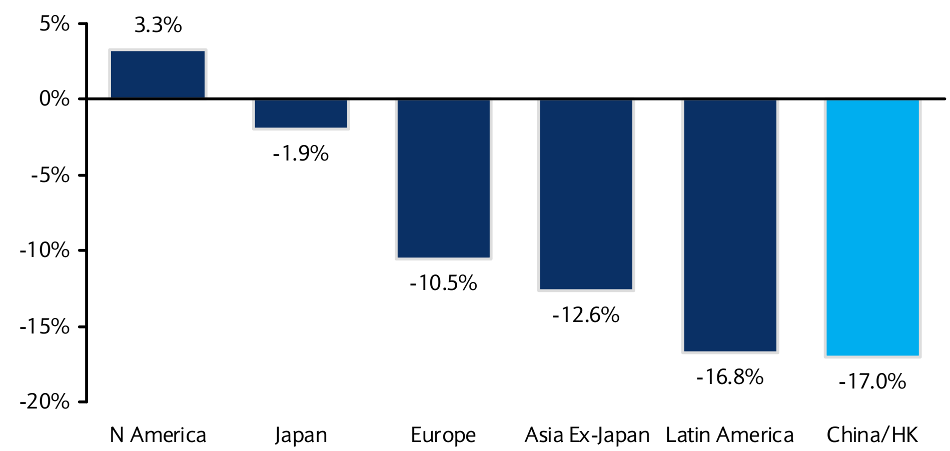
Figure 28: In 2011, China HC substantially underperformed the Dow Jones and HSI in total shareholder return



Source: Bloomberg, Barclays Capital

This is not surprising, as China did not generate favourable returns vs other regions in the past year.

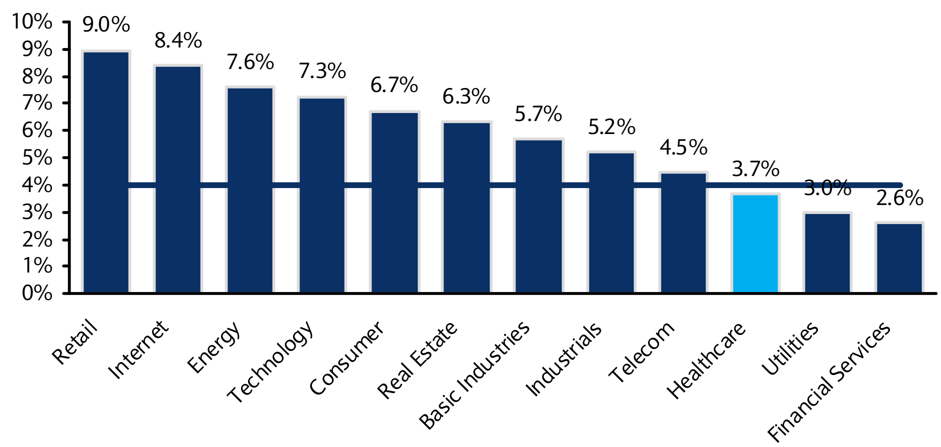
Figure 29: China/HK underperformed other regions in 2011 (total return of 2000 companies under research coverage by Barclays Capital)



Source: Bloomberg, Barclays Capital

Examining global trends, healthcare has also not generated favourable returns over the past three years.

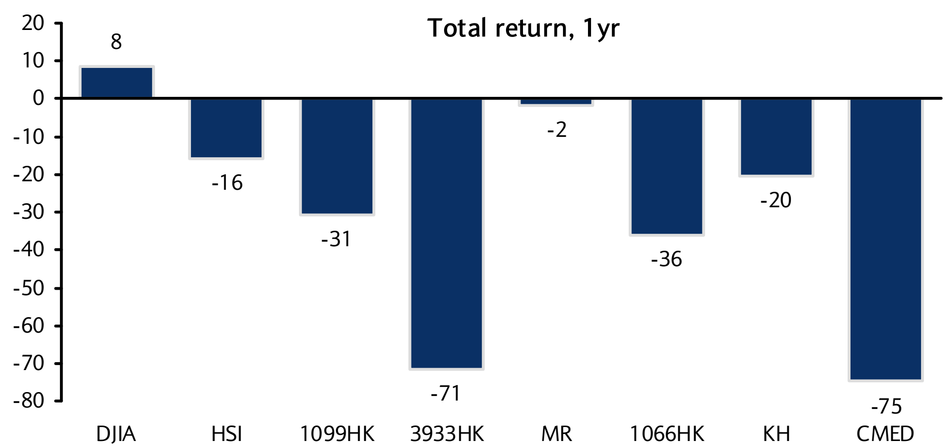
Figure 30: Globally healthcare has underperformed most sectors, and has not kept pace with inflation, estimated at 4% (total return of 2000 companies under research coverage by Barclays Capital)



Source: Bloomberg, Barclays Capital

Healthcare only surpassed utilities and financial services, hardly a stellar showing. Thus, it is not surprising that the combination of China and healthcare did not perform well in 2011.

Figure 31: Sector declined significantly in 2011

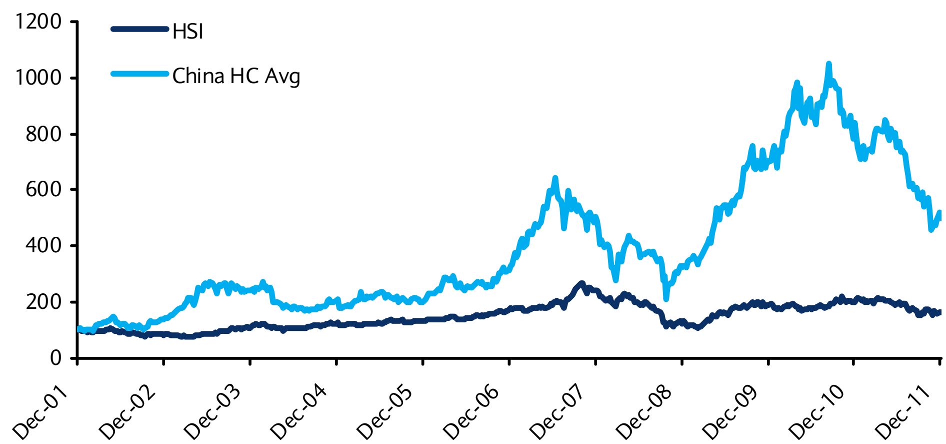


Source: Bloomberg, Barclays Capital

Poor performance not surprising given inflated valuations

On a normalized price basis, the sector entered 2011 roughly 8x the valuation of the broader index. Not surprisingly, the sector fell more than 50% from the peak. However, by this measure the sector remains quite expensive on average vs the broader index.

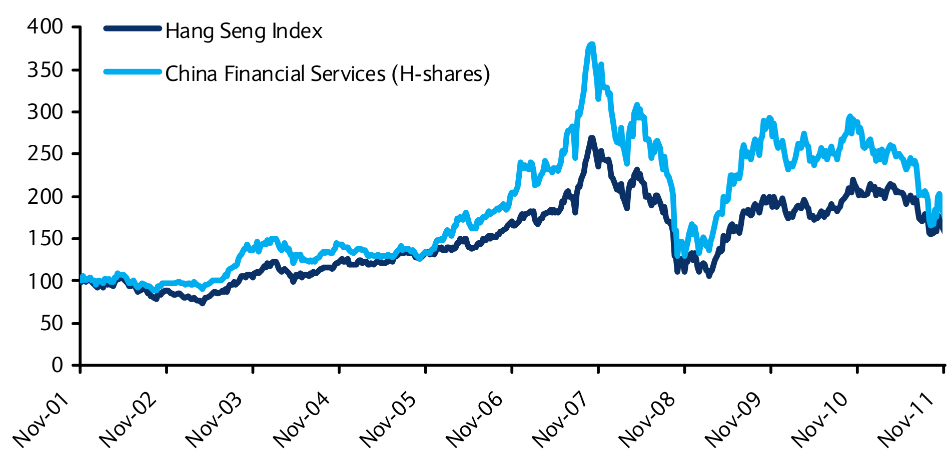
Figure 32: Normalized price, China healthcare vs the HSI over ten years



Source: Reuters, Barclays Capital

Notably, price inflation was not simply driven by China-related enthusiasm

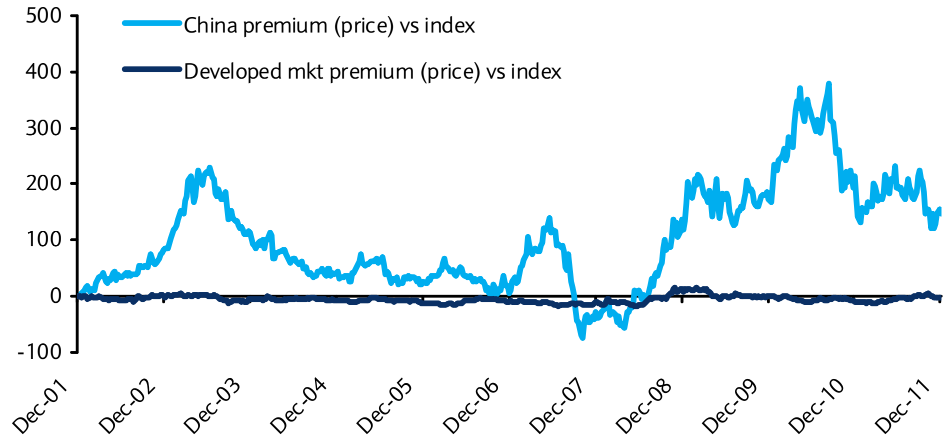
Figure 33: China financial services tracked the HSI much more closely than healthcare



Source: Reuters, Barclays Capital

And the premium is not simply healthcare related, as global healthcare stocks track respective indices much more closely than China healthcare. Figure 36 charts the average price dispersion of global healthcare sectors vs their respective indices. The average normalized dispersion for healthcare stocks in the US, Europe and Japan is -6 points over the last ten years. The China healthcare sector is currently 148 points over the index, 45% over the ten year average of 102.

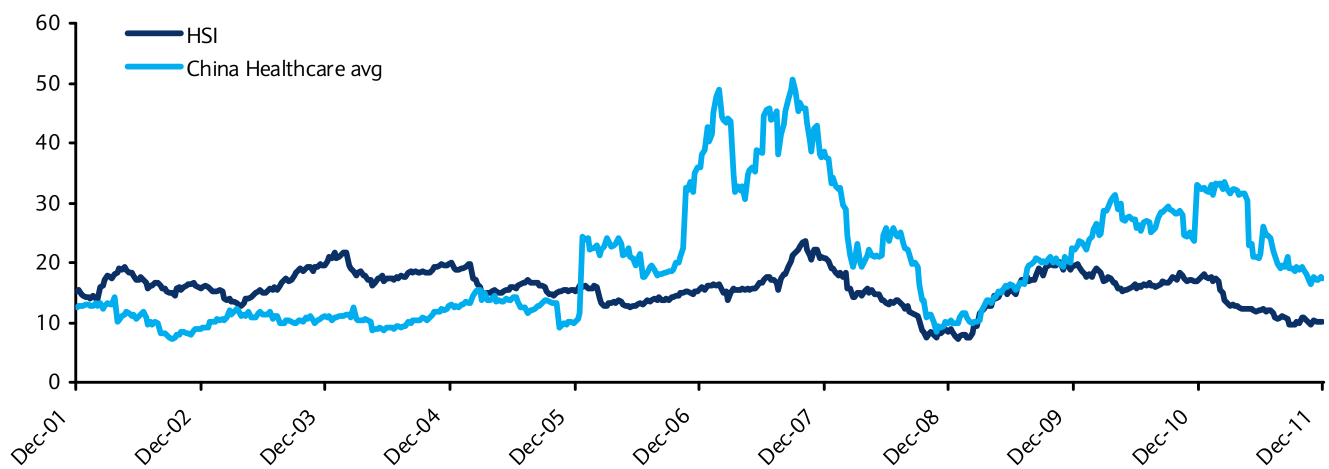
Figure 34: China healthcare stocks normally trade at higher prices than the index (102 points over the last ten years), though the current level is 45% higher than this average. By contrast, US, European and Japanese healthcare firms trade an average of -6 points below their respective indices over the past ten years



Source: Reuters, Barclays Capital

We complement historical price analysis with review of historical P/E averages. By this measure the sector also remains overpriced. Note that average P/E multiples of the sector fell below the HSI through Dec 2005 before inflating in a three-year bubble. Sector multiples re-equated to the index average in Dec 2008 and tracked closely for the following year before decoupling following the policy announcement discussed in Section 1.

Figure 35: Average P/E, China healthcare vs the HSI over ten years



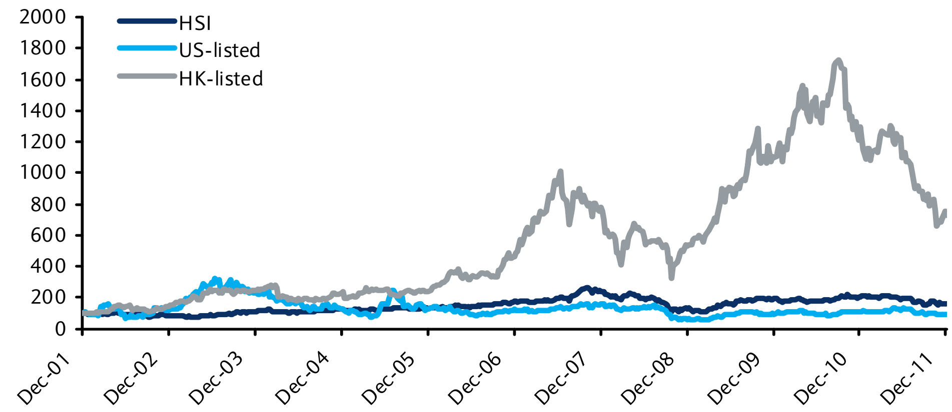
Source: Reuters, Barclays Capital

By this measure, the sector remains overpriced, at 71% premium to the HSI average, vs 3- (51%) and 10-year (28%) averages.

Two sets of firms: HK-listed vs US-listed

We define the investable China healthcare space as the 14 companies that are listed outside the People's Republic of China and trade, on average, more than US$1mn per day. Although these firms compete in the same market, detailed analysis reveals two fundamentally different types of stocks: 1) HK-listed – expensive and correlated; and 2) US-listed – a mixed bag, with more outliers and opportunity for outperformance.

Figure 36: Normalized share prices, China healthcare vs the HSI



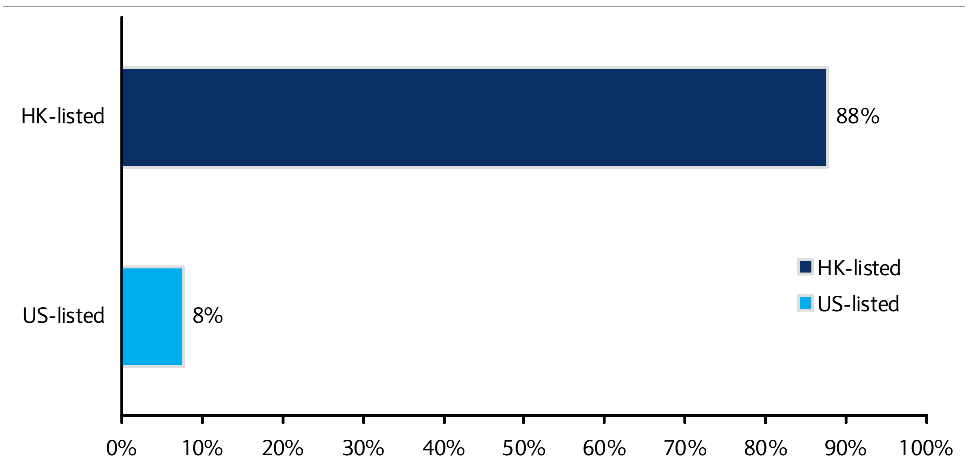
Source: Reuters, Barclays Capital

On average, HK-listed firms appear overpriced and set to continue falling into 2012. US-listed firms appear less expensive. For this reason, we generally see better value on the US-listed side at current valuations.

Correlation with index movements

While HK-listed names vary from the HSI 10x more than their US-listed peers in absolute terms, HK-listed stocks correlate with index movement 10x more closely than US-listed firms. HK-listed stocks also correlate very strongly internally as a group. We expect investor sophistication and hence market differentiation in this space to increase over time, gradually widening the gap between true outperformers and their average peers.

Figure 37: HK-listed names correlate 10x more strongly with each other and the HSI than US-listed stocks



Source: Reuters, Barclays Capital

Figure 38: HK-listed stocks track the HSI much more closely than US-listed peers

Correlation vs HSI	
Shineway	94%
Sihuan	93%
Sino Biopharmaceuticals	92%
Shanghai Pharma	90%
Microport	88%
Shandong Weigao	86%
Sinopharm	84%
China Pharma	82%
United Labs	81%
SciClone	60%
Mindray	32%
Wuxi	25%
Kanghui	-30%
CMED	-47%

Source: Reuters, Barclays Capital

3) EXCEPTIONS: BURIED TREASURE IS WORTH THE HUNT

We support our 3-Negative sector view for 2012 with two main arguments. In Section 1 we highlight negative policy headwinds facing the sector. The balance of historical and international evidence in Section 2 suggests that the sector remains overpriced. After thorough analysis of the 14 investible names in this space, in Section 3 we highlight three exceptions to our negative view, all rated 1-Overweight. These names are aligned with policy goals and remain attractively priced at current levels: Kanghui, CMED and Shanghai Pharma. We forecast valuations will appreciate in 2012, hence our 1-OW ratings.

Winning in a mispriced market

Having discussed the critical role government plays in China healthcare, this sword cuts both ways. Careful scrutiny suggests that a few firms stand to benefit significantly from government policy priorities, which generally fall into two main categories:

1. **Reducing the foreign presence in China healthcare** through cultivation of national champions and domestic premium firms.

2. **Consolidation of subscale companies,** yielding higher quality and economies of scale.

Firms that meet either criterion are set to benefit from government policy. From an investment perspective, those names aligned with policy and trading at favourable valuations represent attractive investments. We anticipate outperformance through earnings growth and multiple expansion for Kanghui (35% potential upside), CMED (70% potential upside), and Shanghai Pharma (18% potential upside) in 2012. Key catalysts include earnings results and government policy announcements.

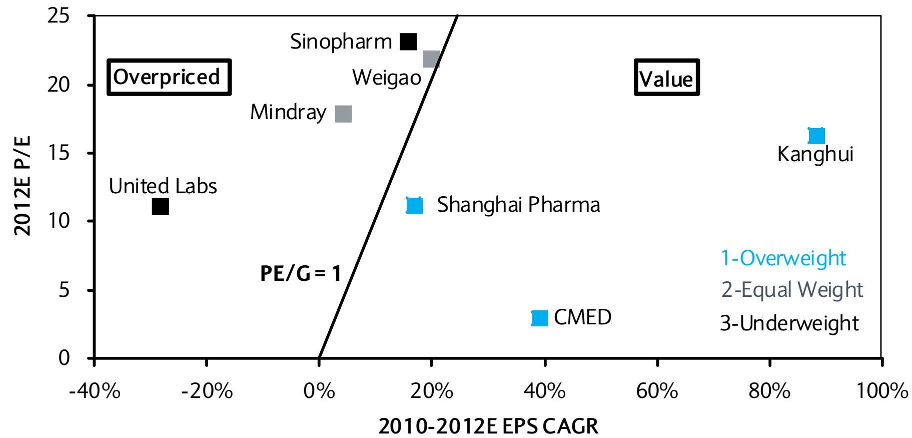
Figure 39: Key stock selection criteria

		Priority Firm		Attractive	Strong subsector*		Weak subsector**		Significant		
		NC	DP	Valuation	Orthopedics	Diagnostics	Generics	Stents	Opportunity	M&A	Total
1-Overweight	Kanghui		1	2	1				1	1	**6**
	CMED		1	2		1			1	1	**6**
	Sh. Pharma	1		2			-1		1		**3**
2-Equal Weight	Mindray	1	1								**2**
	Weigao	1	1								**2**
3-Underweight	Sinopharm	1					-1				**0**
	United Labs	1					-1				**0**

NC	National champion: Strong government support, including credit access, beneficiary of consolidation wave
DP	Domestic premium: Quality >90% of multinational company (MNC), Price <70% of MNC, high growth sector
*	High growth area with high multinational company market (MNC) share and less price cuts
**	Low MNC presence and significant pricing pressure

Note: M&A potential estimated by market capitalization and relative ease of organic growth in each subsector
Source: Barclays Capital estimates

Figure 40: We favour well-priced names aligned with policy trends



Source: Bloomberg, Barclays Capital

Scenario analysis

We remain significantly more bearish than consensus for 2012. However, given macroeconomic uncertainty we complement our base case with our bull and bear scenarios below.

Figure 41: Base-case multiples (P/E)

Ticker		Current price	2012E EPS*	Current P/E	Target P/E	2012 PT	Potential upside
Sinopharm	HK$	18.66	0.81	23.1	20.0	16.15	-13%
Shanghai Pharma	HK$	12.58	1.13	11.1	14.0	15.83	26%
United Labs	HK$	4.47	0.40	11.1	9.5	3.82	-15%
Mindray	US$	25.64	1.43	17.9	18.0	25.78	1%
Weigao	HK$	6.99	0.32	21.9	21.0	6.72	-4%
Kanghui	US$	14.74	0.91	16.3	22.0	19.92	35%
CMED	US$	2.84	0.96	2.9	5.0	4.82	70%
Average				**14.9**	**17.4**		**14%**

* In listing currency
Source: Bloomberg, Barclays Capital estimates

Figure 42: Bull case (+25% 2012E P/E multiples)

Ticker		Current price	2012E EPS*	Current P/E	Target P/E	2012 PT	Potential upside
Sinopharm	HK$	18.66	0.81	23.1	25.0	20.19	8%
Shanghai Pharma	HK$	12.58	1.13	11.1	17.5	19.79	57%
United Labs	HK$	4.47	0.40	11.1	11.9	4.78	7%
Mindray	US$	25.64	1.43	17.9	22.5	32.22	26%
Weigao	HK$	6.99	0.32	21.9	26.3	8.40	20%
Kanghui	US$	14.74	0.91	16.3	27.5	24.90	69%
CMED	US$	2.84	0.96	2.9	6.3	6.02	112%
Average				**14.9**	**19.6**		**43%**

* In listing currency
Source: Bloomberg, Barclays Capital estimates

Figure 43: Bear case (-20% 2012E P/E multiples)

Ticker		Current price	2012E EPS*	Current P/E	Target P/E	2012 PT	Potential upside
Sinopharm	HK$	18.66	0.81	23.1	16.0	12.92	**-31%**
Shanghai Pharma	HK$	12.58	1.13	11.1	11.2	12.66	**1%**
United Labs	HK$	4.47	0.40	11.1	7.6	3.06	**-32%**
Mindray	US$	25.64	1.43	17.9	14.4	20.62	**-20%**
Weigao	HK$	6.99	0.32	21.9	16.8	5.37	**-23%**
Kanghui	US$	14.74	0.91	16.3	17.6	15.94	**8%**
CMED	US$	2.84	0.96	2.9	1.5	1.45	**-49%**
Average				14.9	12.5		-21%

- In listing currency
- CMED scenario involves -70% 2012E P/E multiple de-rating vs base case

Source: Bloomberg, Barclays Capital estimates

CHINA KANGHUI HOLDINGS (1-OW; PT US$19.92; +35%): TOP PICK

We initiate coverage of China Kanghui with a 1-Overweight rating and a 12-month price target of US$19.92, implying 35% potential upside. Kanghui is a premium domestic brand in the China orthopaedic space with a growing mid-market global business. The company is delivering value to shareholders with strong operating cash flow and EPS growth, however, it appears these advantages are not fully priced into current valuations. We forecast more than 20% annual earnings growth through 2015, providing significant upside.

KH

Stock Rating
1-OVERWEIGHT

Sector View
3-NEGATIVE

Price Target
USD 19.92

Price (30-Dec-2011)
USD 14.74

Potential Upside/Downside
+35%

Rating, valuation and risks

Key drivers behind our rating: 1) valuation (+35% potential upside); 2) favourable subsector with high M&A potential; 3) strong fundamentals and management.

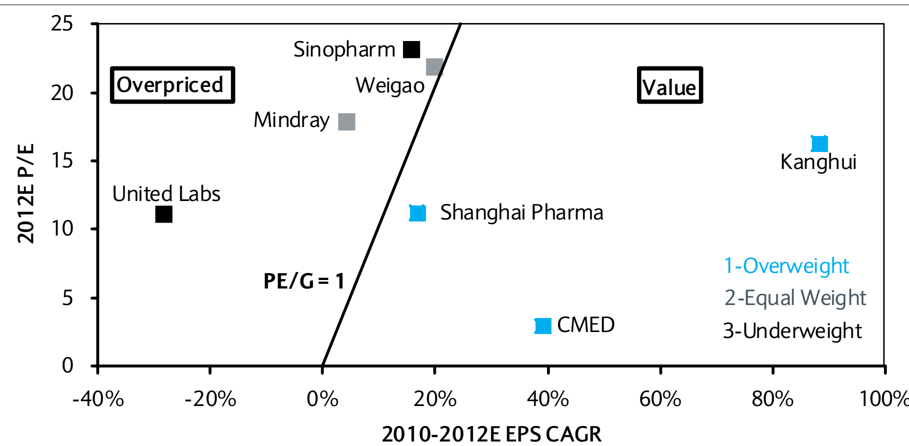
Valuation: Our PT is based on 22.0x 2012E non-GAAP EPADS of Rmb5.66 (currently trading at 16.3x 2011E). The 22.0x P/E is derived by subtracting 1 SD (4.2x) for our negative sector view from the historical mean (25.3x), and adding 0.9x for qualitative factors specific to the firm. 22.0x is roughly 0.75 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) aggressive government pricing pressure extended to the orthopaedic space; 2) increased competition for mid-tier space from premium international brands or low-end domestic players; 3) a hard landing in China, with reduced healthcare spend; and 4) a global recession, with lower earnings multiples across equity markets.

1) Undervalued relative to growth rate

Kanghui currently trades at an attractive valuation relative to a high EPS growth rate, primarily driven by Tier 2 hospital sales within China and emerging market sales globally.

Figure 44: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

China Kanghui Holdings — China Health Care & Pharmaceuticals

Income statement (CNY '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	242,754	317,151	396,909	487,030	26.1%
EBITDA	122,305	149,697	182,062	215,679	20.8%
EBIT	107,969	138,540	169,067	200,285	22.9%
Pre-tax income	106,868	149,411	180,975	214,896	26.2%
Net income	99,707	121,210	146,346	173,777	20.3%
EPS (reported) ($)	1.60	4.73	5.66	6.72	61.4%
Diluted shares (m)	100,347	153,729	155,152	155,152	15.6%
Dividend per share ($)	-	-	-	-	NA

Margin and return data (%)					Average
EBITDA margin	50.4	47.2	45.9	44.3	46.9
EBIT margin	44.5	43.7	42.6	41.1	43.0
Pre-tax margin	44.0	47.1	45.6	44.1	45.2
Net margin	41.1	38.2	36.9	35.7	38.0
ROIC	19.2	16.6	18.4	20.0	18.6
ROA	12.1	10.8	11.5	12.0	11.6
ROE	14.0	11.9	12.7	13.2	13.0

Balance sheet and cash flow (CNY '000)					CAGR
Tangible fixed assets	107,237	129,814	158,508	193,796	21.8%
Intangible fixed assets	201,820	199,802	197,804	195,826	-1.0%
Cash and equivalents	262,476	317,151	395,217	488,699	23.0%
Total assets	1,052,180	1,189,546	1,353,700	1,547,598	13.7%
Short and long-term debt	-	-	-	-	NA
Other long-term liabilities	5,511	5,511	5,511	5,511	0.0%
Total liabilities	94,893	111,049	128,856	148,977	16.2%
Net debt/(funds)	(262,476)	(317,151)	(395,217)	(488,699)	NA
Shareholders' equity	957,287	1,078,497	1,224,844	1,398,621	13.5%
Change in working capital	(1,726)	45,977	41,584	46,986	NA
Operating cash flow	118,972	86,390	117,757	142,185	6.1%
Capital expenditure	320,321	31,715	39,691	48,703	-46.6%
Free cash flow	60,054	54,675	78,066	93,482	15.9%

Valuation and leverage metrics					Average
P/E (x)	76.2	19.5	16.3	13.7	31.4
EV/EBITDA (x)	61.7	11.9	9.4	7.5	22.7
Price/BV (x)	86.2	16.1	13.9	11.9	32.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Total debt/capital (%)	0.0	0.0	0.0	0.0	0.0

Selected operating metrics					
SG&A/sales (%)	23.9	25.1	25.0	25.0	24.7
R&D/sales (%)	2.3	2.9	2.9	2.9	2.7
R&D growth (%)	41.5	66.4	25.1	22.7	38.9
SG&A growth (%)	18.7	37.2	24.7	22.7	25.8

Source: Company data, Barclays Capital

Stock Rating	1-OVERWEIGHT
Sector View	3-NEGATIVE
Price (30-Dec-2011)	US$14.74
Price Target	US$19.92
Ticker	KH

Investment case

Why a 1-OW? We are positive on Kanghui based on: 1) its attractive valuation; 2) a favorable subsector with high M&A potential; 3) strong fundamentals and management. 2010-12E earnings CAGR is 88%. Base case 2012E multiple of 22.0x.

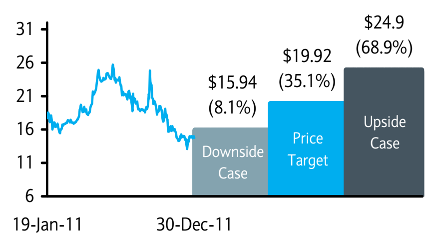
Upside case **$24.90**

In this case multiples rerate 25% vs our base case to 27.5x, providing 69% potential upside. This scenario is more likely if the Chinese economy outperforms and confidence in US-listed ADRs increases. This multiple would remain undemanding vs earnings CAGR.

Downside case **$15.94**

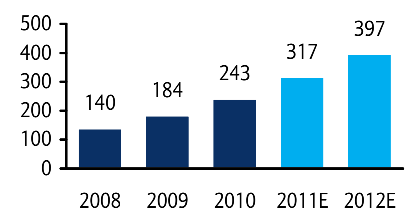
In this case multiples derate 20% vs our base case to 17.6x, providing 8% potential upside. This scenario is more likely if the Chinese economy underperforms and confidence in US-listed ADRs decreases. This scenario still provides upside opportunity vs current levels.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

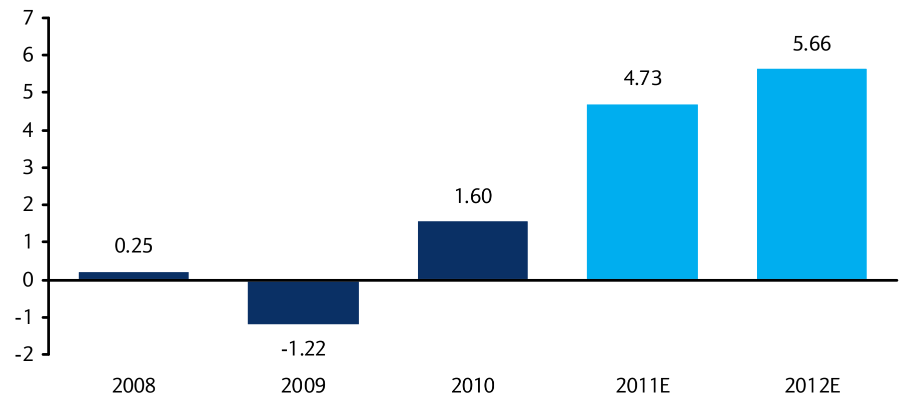
Net revenues, annual (CNY mn)



Note: FY end Dec.

We forecast strong EPADS growth through 2015.

Figure 45: Kanghui is growing EPADS well



Source: Company data, Barclays Capital estimates

2) Favourable subsector with high M&A potential

The China orthopaedic market is large enough to be interesting ...

Figure 46: China expected to be the second-largest orthopaedic market by 2015

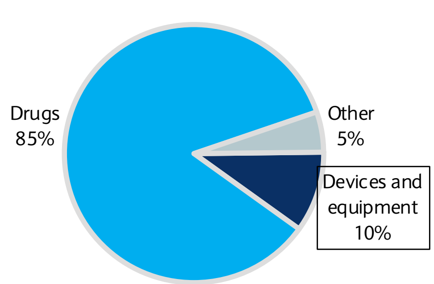
2005	2010	2015
USA	USA	USA
Japan	Japan	**China**
Germany	**China**	Japan
France	Germany	Germany
UK	France	France
Italy	UK	UK
Spain	Italy	Italy
China	Spain	Spain
Canada	Canada	Canada
Brazil	Brazil	Brazil

Source: IMS, Barclays Capital

. . . but small enough to avoid intense government scrutiny

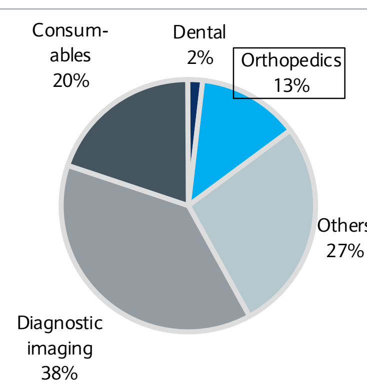
The China medical device market grew 15% to US$15bn in 2010, 5% of the global market. Given the large market potential and high growth rate, many consider this the most attractive device market in the world.

Figure 47: Devices only account for 10% of the China therapeutics market



Source: SMEI, Barclays Capital

Figure 48: Orthopedics only accounts for 13% of the China device market



Source: Espicom estimates, Barclays Capital

Kanghui provides M&A optionality

Multinational orthopaedics players interested in penetrating the large mid-tier China market may be interested in Kanghui. The Class 2 hospital market (100-500 beds) is growing much more quickly than Class 3 (>500 beds), and without the patient affordability challenges of Class 1 (20-100 beds). The Kanghui brand would also provide an attractive mid-market brand for the rapidly growing emerging market segment globally. This would help avoid brand dilution for the MNC high-end brand.

Direct Kanghui competitors in the premium domestic orthopaedics space such as Trauson present more cultural barriers to successful integration. Kanghui senior management led the J&J Depuy China subsidiary before starting Kanghui. Weigao already has a JV with Medtronic.

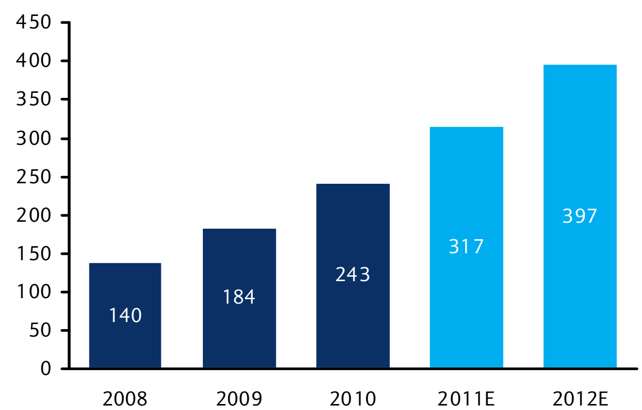
3) Strong fundamentals and management

Management led the J&J Depuy China franchise before establishing Kanghui. The senior team was vetted by experienced China investors Vivo Ventures, and Vivo partner Chen Yu currently leads business development for Kanghui. The level of scrutiny required for the multi-year investment by Vivo underscores the international corporate governance quality of Kanghui.

As detailed below, Kanghui provides strong fundamentals, including revenue growth, steady margins and negative net debt. In our view these positives are not fully priced into the stock, which drives our 1-Overweight rating.

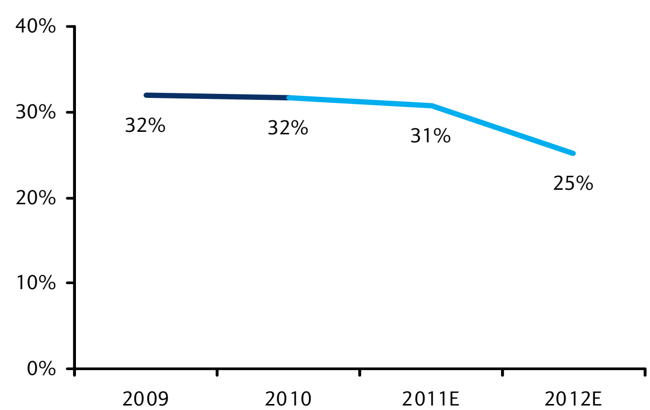
Revenues: Kanghui is growing revenues faster than the market average.

Figure 49: Annual revenues (Rmb mn)



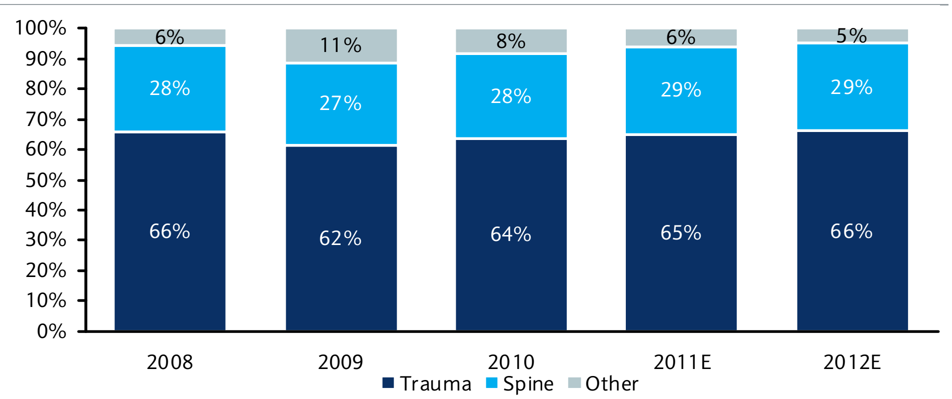
Source: Company data, Barclays Capital estimates

Figure 50: Annual revenues (y/y)



Source: Company data, Barclays Capital estimates

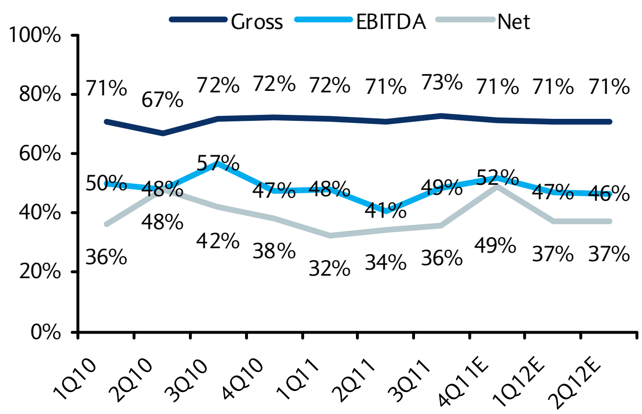
Figure 51: Segment breakdown



Source: Company data, Barclays Capital estimates

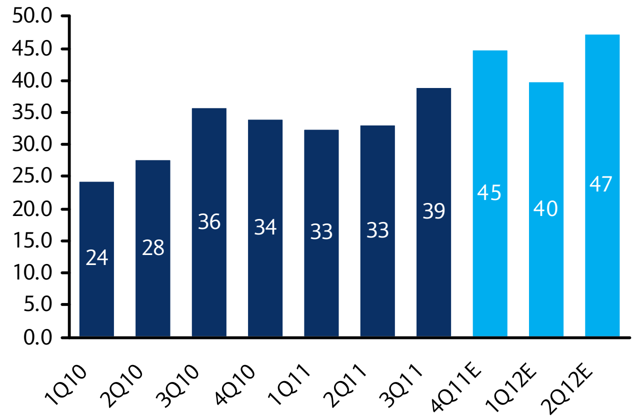
Margins and EBITDA: At the same time, it is maintaining margins and EBITDA.

Figure 52: Quarterly margins



Source: Company data, Barclays Capital estimates

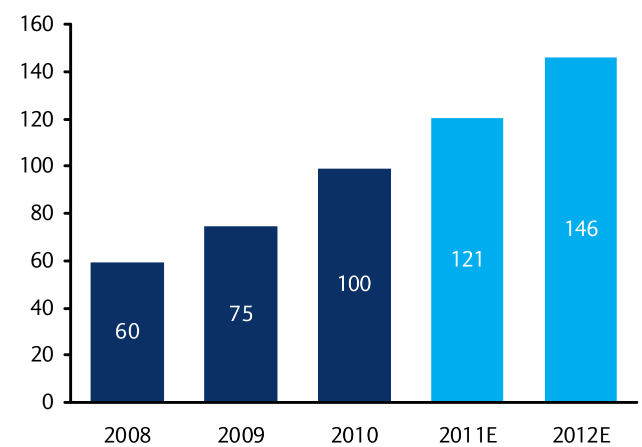
Figure 53: Quarterly EBITDA (Rmb mn)



Source: Company data, Barclays Capital estimates

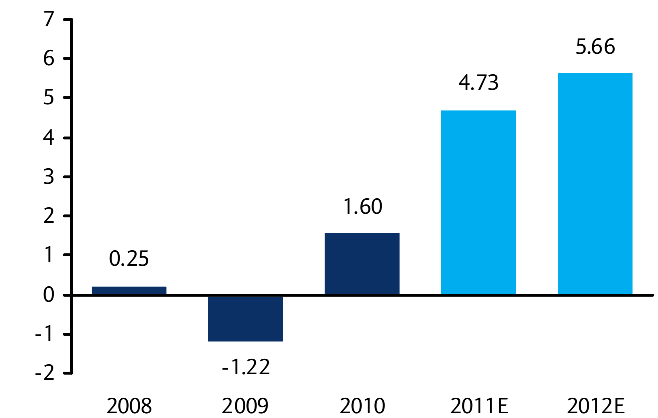
Income: We expect income to rise steadily, particularly earnings attributable to common shareholders. Preferred dividends were paid through 2010.

Figure 54: Annual net income (Rmb mn)



Source: Company data, Barclays Capital estimates

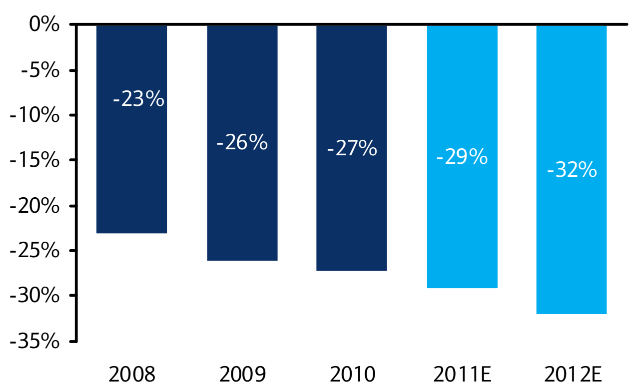
Figure 55: Annual earnings per ADS (Rmb)



Source: Company data, Barclays Capital estimates

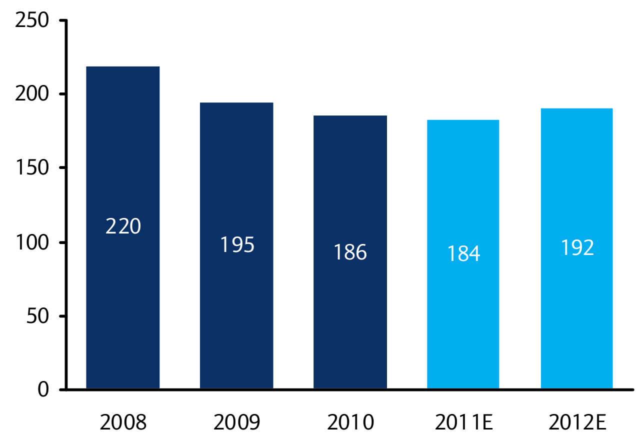
Debt and cash conversion: Net debt is negative, providing flexibility for reinvestment into this growing business. Cash conversion cycles are long in the orthopaedics space, though Kanghui is showing improvement.

Figure 56: Net debt/equity



Source: Company data, Barclays Capital estimates

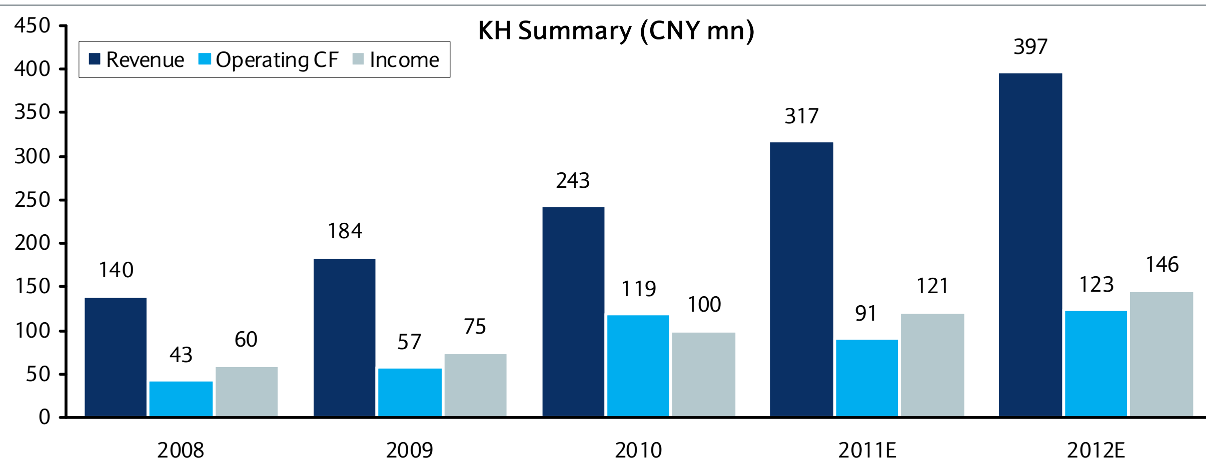
Figure 57: Cash conversion (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 58: Annual revenue, operating cash flow and income

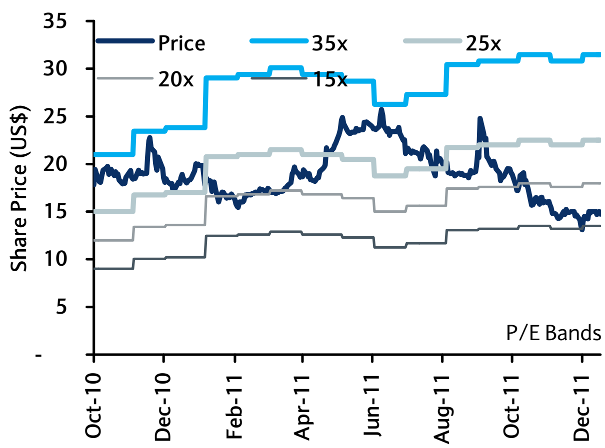


Source: Company data, Barclays Capital estimates

Valuation

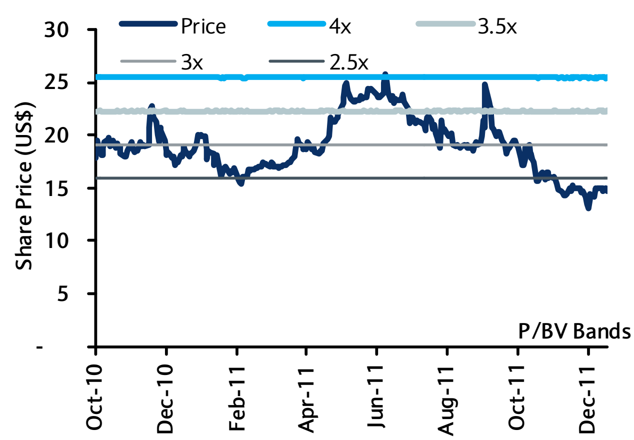
Our PT is based on 22.0x 2012E non-GAAP earnings per ADS (EPADS) of Rmb5.66 (currently trading at 16.3x 2011E). The 22.0x P/E is derived by subtracting 1 SD (4.2x) for our negative sector view from the historical mean (25.3x), and adding 0.9x for qualitative factors specific to the firm. 22.0x is roughly 0.75 SD less than the historical average and below our 2010-12E earnings CAGR forecast of 88%.

Figure 59: P/E bands



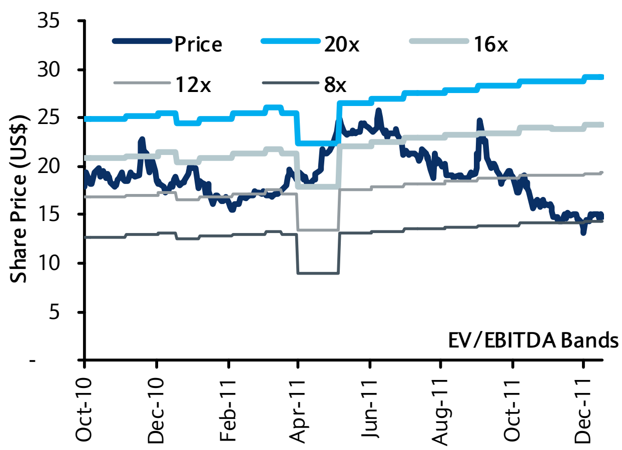
Source: Reuters, Barclays Capital

Figure 60: P/B bands



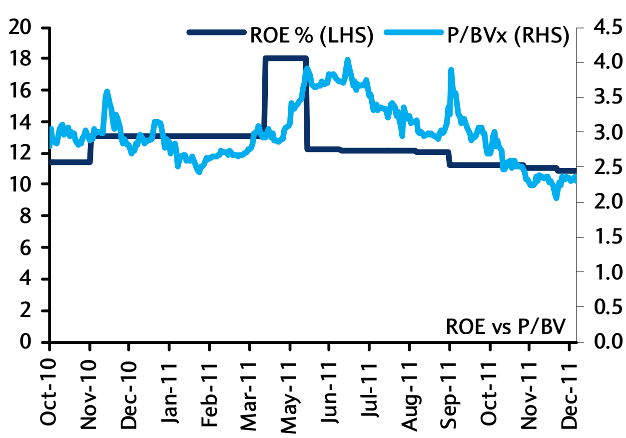
Source: Reuters, Barclays Capital

Figure 61: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 62: ROE vs P/B



Source: Reuters, Barclays Capital

Figure 63: China Kanghui – income statement (Rmb000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net sales	**139,646**	**184,331**	**242,754**	**317,151**	**396,909**	**487,030**
Growth (y/y)		*32%*	*32%*	*31%*	*25%*	*23%*
COGS	49,401	54,719	71,307	89,926	117,199	150,979
% of revenue	*35%*	*30%*	*29%*	*28%*	*30%*	*31%*
Growth (y/y)		*11%*	*30%*	*26%*	*30%*	*29%*
Gross profit	**90,245**	**129,612**	**171,447**	**227,225**	**279,710**	**336,050**
Margin	*65%*	*70%*	*71%*	*72%*	*70%*	*69%*
Growth (y/y)		*44%*	*32%*	*33%*	*23%*	*20%*
Operating expenses	(30,596)	(52,737)	(63,478)	(88,685)	(110,643)	(135,765)
% of revenue	*22%*	*29%*	*26%*	*28%*	*28%*	*28%*
Growth (y/y)		*72%*	*20%*	*40%*	*25%*	*23%*
S&M expenses	(12,962)	(23,246)	(28,230)	(37,410)	(47,629)	(58,444)
% of revenue	*9.3%*	*12.6%*	*11.6%*	*11.8%*	*12.0%*	*12.0%*
Growth (y/y)		*79%*	*21%*	*33%*	*27%*	*23%*
G&A expenses	(14,955)	(25,615)	(29,765)	(42,153)	(51,598)	(63,314)
% of revenue	*10.7%*	*13.9%*	*12.3%*	*13.3%*	*13.0%*	*13.0%*
Growth (y/y)		*71%*	*16%*	*42%*	*22%*	*23%*
R&D expenses	(2,679)	(3,876)	(5,483)	(9,122)	(11,416)	(14,008)
% of revenue	*1.9%*	*2.1%*	*2.3%*	*2.9%*	*2.9%*	*2.9%*
Growth (y/y)		*45%*	*41%*	*66%*	*25%*	*23%*
Operating cash flow (EBITDA)	**69,469**	**89,647**	**122,305**	**149,697**	**182,062**	**215,679**
Depreciation & amortization	(9,820)	(12,772)	(14,336)	(11,156)	(12,995)	(15,394)
Operating income (EBIT)	**59,649**	**76,875**	**107,969**	**138,540**	**169,067**	**200,285**
Growth (y/y)		*29%*	*40%*	*28%*	*22%*	*18%*
Interest expense	0	0	0	0	0	0
% of total debt	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*
Other income (expense)	4,123	10,476	(1,101)	10,871	11,907	14,611
% of revenue	*3.0%*	*5.7%*	*0.5%*	*3%*	*3%*	*3%*
Pretax income	**63,772**	**87,351**	**106,868**	**149,411**	**180,975**	**214,896**
Net income tax	(3,796)	(12,384)	(7,161)	(28,589)	(34,628)	(41,119)
Tax rate	*6%*	*14%*	*7%*	*19%*	*19%*	*19%*
Minority interests	0	0	0	388	0	0
Net income (GAAP)	**59,976**	**74,967**	**99,707**	**121,210**	**146,346**	**173,777**
Margin	*43%*	*41%*	*41%*	*38%*	*37%*	*36%*
Growth (y/y)		*25%*	*33%*	*22%*	*21%*	*19%*
Add back: stock-based comp			0	0	0	0
Net income (non-GAAP)	**59,976**	**74,967**	**99,707**	**121,210**	**146,346**	**173,777**
Preferred dividends	(57,473)	(86,655)	(72,986)	0	0	0
Income attrib. to ADS holders (GAAP)	**2,503**	**(11,688)**	**26,721**	**121,210**	**146,346**	**173,777**
Income attrib. to ADS holders (non-GAAP)	**2,503**	**(11,688)**	**26,721**	**121,210**	**146,346**	**173,777**
Basic weighted avg. shares	57,714	57,714	88,408	139,062	140,358	140,358
Diluted weighted avg. shares	59,937	57,714	100,347	153,729	155,152	155,152
DILUTED EPADS (6 shares/ADS) (non-GAAP)	**0.25**	**(1.22)**	**1.60**	**4.73**	**5.66**	**6.72**

Source: Company data, Barclays Capital estimates

Figure 64: China Kanghui – balance sheet (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	85,679	122,567	262,476	317,151	395,217	488,699
Restricted cash and short-term inv	7,000	27,044	266,673	266,673	266,673	266,673
Accounts receivable, net	44,208	47,868	63,294	86,891	108,742	133,433
Inventories	53,478	75,674	86,266	117,302	146,802	180,134
Prepaid expenses/other current	38,207	38,736	24,471	31,971	40,011	49,095
Total current assets	**228,572**	**311,889**	**703,180**	**819,987**	**957,445**	**1,118,034**
Property, plant, and equipment, net	69,546	72,487	107,237	129,814	158,508	193,796
Intangible assets, net	170,265	183,944	201,820	199,802	197,804	195,826
Other assets	2,933	24,469	39,943	39,943	39,943	39,943
Total assets	**471,316**	**592,789**	**1,052,180**	**1,189,546**	**1,353,700**	**1,547,598**
Liabilities						
Short-term debt	0	0	0	0	0	0
Accounts payable	13,586	10,665	15,086	19,116	23,923	29,355
Accrued expenses	27,386	30,509	39,567	51,693	64,693	79,382
Other current liabilities	49,240	64,774	23,029	23,029	23,029	23,029
Total current liabilities	**90,212**	**105,948**	**77,682**	**93,838**	**111,645**	**131,766**
Long-term debt	0	0	0	0	0	0
Deferred income taxes	12,750	12,225	11,700	11,700	11,700	11,700
Other long-term liabilities	0	7,832	5,511	5,511	5,511	5,511
Total liabilities	**102,962**	**126,005**	**94,893**	**111,049**	**128,856**	**148,977**
Stockholders' equity						
Common stock	462	462	999	999	999	999
Preferred stock	305,541	405,381	0	0	0	0
Additional paid-in capital	17,745	28,053	892,298	892,298	892,298	892,298
Retained earnings	43,179	25,642	49,480	170,690	317,037	490,814
Treasury and other equity	14,933	20,782	31,247	31,247	31,247	31,247
Other comprehensive income	(13,506)	(13,536)	(16,737)	(16,737)	(16,737)	(16,737)
Total shareholders' equity	**368,354**	**466,784**	**957,287**	**1,078,497**	**1,224,844**	**1,398,621**
Total liabilities and equity	**471,316**	**592,789**	**1,052,180**	**1,189,546**	**1,353,700**	**1,547,598**

Source: Company data, Barclays Capital estimates

Figure 65: China Kanghui – cash flow statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net income	**59,976**	**74,967**	**99,707**	**121,210**	**146,346**	**173,777**
Depreciation and amortization	9,820	12,772	14,336	11,156	12,995	15,394
Deferred taxes	(3,636)	(3,800)	(4,069)	0	0	0
Change in working capital	(94,921)	(26,183)	1,726	(45,977)	(41,584)	(46,986)
Others	71,617	(374)	7,272	0	0	0
Cash flow from operations	**42,856**	**57,382**	**118,972**	**86,390**	**117,757**	**142,185**
Capital expenditure	(14,138)	(13,364)	(58,918)	(31,715)	(39,691)	(48,703)
Investments	0	(20,000)	(261,403)	0	0	0
Others	(144,486)	0	(34,203)	0	0	0
Cash flow from investments	**(158,624)**	**(33,364)**	**(354,524)**	**(31,715)**	**(39,691)**	**(48,703)**
Equity issuance, options, and converts	199,339	13,185	386,002	0	0	0
Dividends paid	0	0	0	0	0	0
Debt funding/(repayment)	0	0	0	0	0	0
Others	0	0	0	0	0	0
Cash flow from financing	**199,339**	**13,185**	**386,002**	**0**	**0**	**0**
Fx effects	(13,055)	(315)	(10,541)	0	0	0
Net cash flow	**70,516**	**36,888**	**139,909**	**54,675**	**78,066**	**93,482**
Cash at beginning of period	15,163	85,679	122,567	262,476	317,151	395,217
Cash at end of period	**85,679**	**122,567**	**262,476**	**317,151**	**395,217**	**488,699**

Source: Company data, Barclays Capital estimates

Figure 66: China Kanghui – key metrics (Rmb 000 except per share data)

Return statistics		2008	2009	2010	2011E	2012E	2013E
ROE		33%	18%	14%	12%	13%	13%
ROA		25%	14%	12%	11%	12%	12%
ROIC		42%	24%	19%	17%	18%	20%
Operating statistics		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
DSOs		116	91	84	86	90	91
DIOs		140	128	122	117	121	123
DPOs		36	24	19	20	20	20
Cash conversion cycle		220	195	186	184	192	193
Net debt		(85,679)	(122,567)	(262,476)	(317,151)	(395,217)	(488,699)
Net debt/equity		-23%	-26%	-27%	-29%	-32%	-35%
Net debt/total capital		-30%	-36%	-38%	-42%	-48%	-54%
Net debt/EBITDA		-1.2x	-1.4x	-2.1x	-2.1x	-2.2x	-2.3x
Working capital		176,865	203,452	228,684	306,973	384,172	471,400
Working capital/sales		127%	110%	94%	97%	97%	97%
Current ratio		2.53	2.94	9.05	8.74	8.58	8.48
Interest coverage ratio							
Fixed asset turnover		2.0x	2.6x	2.7x	2.7x	2.8x	2.8x
Total asset turnover		0.6x	0.3x	0.3x	0.3x	0.3x	0.3x
Book value		198,089	282,840	755,467	878,695	1,027,040	1,202,795
BPS		3.30	4.90	7.53	5.72	6.62	7.75
Net sales		139,646	184,331	242,754	317,151	396,909	487,030
COGS		49,401	54,719	71,307	89,926	117,199	150,979
EBITDA		69,469	89,647	122,305	149,697	182,062	215,679
Interest expense		0	0	0	0	0	0
Pretax income		63,772	87,351	106,868	149,411	180,975	214,896
Tax rate		6%	14%	7%	19%	19%	19%
Net income		59,976	74,967	99,707	121,210	146,346	173,777
After-tax interest		0	0	0	0	0	0
Shares outstanding		59,937	57,714	100,347	153,729	155,152	155,152
FTE		638	698	732			
Days		365	365	365	365	365	365
Cash flow		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Operating income (EBIT)		59,649	76,875	107,969	138,540	169,067	200,285
	Per share	1.00	1.33	1.08	0.90	1.09	1.29
	Growth		*34%*	*-19%*	*-16%*	*21%*	*18%*
Operating cash flow (EBITDA)		69,469	89,647	122,305	149,697	182,062	215,679
	Per share	1.16	1.55	1.22	0.97	1.17	1.39
	Growth		*34%*	*-22%*	*-20%*	*21%*	*18%*
Net cash from operations		42,856	57,382	118,972	86,390	117,757	142,185
	Per share	0.72	0.99	1.19	0.56	0.76	0.92
	Growth		*39%*	*19%*	*-53%*	*35%*	*21%*
Capital expenditures		(14,138)	(13,364)	(58,918)	(31,715)	(39,691)	(48,703)
Free cash flow		28,718	44,018	60,054	54,675	78,066	93,482
	Per share	0.48	0.76	0.60	0.36	0.50	0.60
Net external financing needs		28,718	44,018	60,054	54,675	78,066	93,482
	Per share	0.48	0.76	0.60	0.36	0.50	0.60
CF to invest. ratio		**3.03**	**4.29**	**2.02**	**2.72**	**2.97**	**2.92**

Source: Company data, Barclays Capital estimates

CHINA MEDICAL TECHNOLOGIES (1-OW; PT US$4.82; +70%): ONE FOR THE STRONG

We initiate coverage of China Medical Technologies with a 1-Overweight rating and a 12-month price target of US$4.82, implying 70% potential upside. Despite recent valuation declines, CMED is a premium domestic player in the China molecular diagnostics space. The future of medical diagnostics in China will likely involve core technology sold by CMED today. The firm has strong independent directors, including the past Asia-Pacific head of KPMG, and is audited by PWC. However, corporate governance and cash conversion questions have recently dogged this firm. In our view a portion of this is driven by negative sentiment toward US-listed Chinese ADRs generally and will likely rebalance within a year. We favour well-priced names aligned with government policy goals, and at 2.9x forward earnings we view the current risk/reward trade-off favourably. Given secular growth trends in this subsector and near-term price protection, we favour CMED for investors looking for a higher risk/reward profile.

CMED

Stock Rating
1-OVERWEIGHT

Sector View
3-NEGATIVE

Price Target
USD 4.82

Price (30-Dec-2011)
USD 2.84

Potential Upside/Downside
+70%

Rating, valuation and risks

Key drivers of our 1-OW rating: 1) attractive valuation (with 70% potential upside); and 2) a favourable subsector with less pricing pressure.

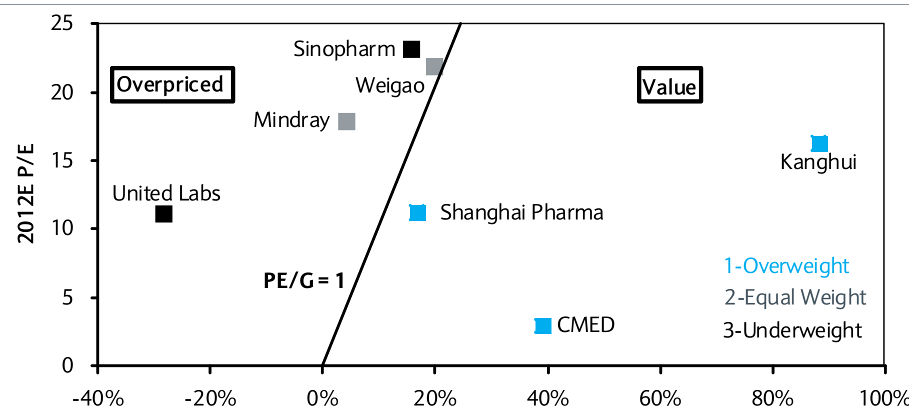
Valuation: Our PT is based on 5.0x 2012E EPADS of Rmb6.02 (currently trading at 2.9x 2011E). The 5.0x P/E is derived by subtracting 1 SD (6.6x) for our negative sector view from the historical mean (11.7x), and subtracting 0.1x for qualitative factors specific to the firm. 5.0x is roughly 1.0 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) continued negative sentiment toward small-mid cap China ADRs; 2) accounting irregularities or corporate governance issues; 3) a hard landing in China, with reduced healthcare spend; and 4) a global recession, with lower earnings multiples across equity markets.

1) Undervalued relative to growth rate

Trading at just 2.9x forward earnings, we believe CMED presents an unusually inexpensive option to play the China Healthcare growth theme for those investors willing to tolerate higher risk.

Figure 67: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

China Medical Technologies Inc — China Health Care & Pharmaceuticals

Income statement (CNY '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	842,366	972,975	1,104,841	1,262,454	14.4%
EBITDA	494,449	628,940	672,036	727,035	13.7%
EBIT	276,466	374,701	425,256	485,922	20.7%
Pre-tax income	176,447	253,851	300,473	361,927	27.1%
Net income	82,619	136,102	159,731	192,400	32.5%
EPS (reported) ($)	3.12	5.13	6.02	7.26	32.5%
Diluted shares (m)	264,969	265,137	265,137	265,137	0.0%
Dividend per share ($)	-	-	-	-	NA

Margin and return data (%)					Average
EBITDA margin	58.7	64.6	60.8	57.6	60.4
EBIT margin	32.8	38.5	38.5	38.5	37.1
Pre-tax margin	20.9	26.1	27.2	28.7	25.7
Net margin	9.8	14.0	14.5	15.2	13.4
ROIC	0.6	2.0	2.8	3.9	2.4
ROA	1.7	2.7	3.1	3.6	2.8
ROE	4.6	7.3	8.0	8.8	7.2

Balance sheet and cash flow (CNY '000)					CAGR
Tangible fixed assets	139,448	162,446	187,495	215,629	15.6%
Intangible fixed assets	2,987,561	2,778,432	2,583,942	2,403,066	-7.0%
Cash and equivalents	1,123,818	1,318,625	1,552,864	1,784,535	16.7%
Total assets	4,948,062	5,082,313	5,247,825	5,447,134	3.3%
Short and long-term debt	2,606,223	2,606,223	2,606,223	2,606,223	0.0%
Other long-term liabilities	415,155	415,155	415,155	415,155	0.0%
Total liabilities	3,157,476	3,155,625	3,161,405	3,168,314	0.1%
Net debt/(funds)	1,053,359	821,688	590,008	355,371	-30.4%
Shareholders' equity	1,790,586	1,926,688	2,086,419	2,278,819	8.4%
Change in working capital	38,631	127,426	94,934	113,470	43.2%
Operating cash flow	224,176	262,916	311,577	320,043	12.6%
Capital expenditure	5,645	68,108	77,339	88,372	150.2%
Free cash flow	218,531	194,807	234,238	231,672	2.0%

Valuation and leverage metrics					Average
P/E (x)	17.0	3.5	2.9	2.4	6.5
EV/EBITDA (x)	9.4	12.6	11.4	10.2	10.9
Price/B (x)	- 2.6	-7.8	- 13.3	- 53.3	- 19.3
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Total debt/capital (%)	59.3	57.5	55.5	53.4	56.4

Selected operating metrics					
SG&A/sales (%)	21.9	20.9	20.9	20.9	21.2
R&D/sales (%)	5.5	4.6	4.6	4.6	4.8
R&D growth (%)	0.0	-3.7	14.1	14.3	6.2
SG&A growth (%)	-11.5	10.0	13.6	14.3	6.6

Source: Company data, Barclays Capital

Stock Rating	**1-OVERWEIGHT**
Sector View	**3-NEGATIVE**
Price (30-Dec-2011)	**$2.84**
Price Target	**$4.82**
Ticker	**CMED**

Investment case

Why a 1-OW? We are positive on CMED based on: 1) a very attractive valuation; 2) a favorable subsector with high M&A potential. 2010-12E earnings CAGR is 39%. Our base case 2012E multiple is 5.0x.

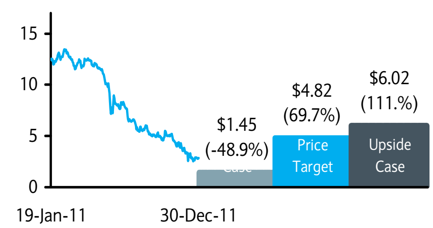
Upside case **$6.02**

In this case multiples rerate 25% vs our base case to 6.3x, providing 112% potential upside. This scenario is more likely if the Chinese economy outperforms and confidence in US-listed ADRs increases. Valuation would remain undemanding vs earnings CAGR.

Downside case **$1.45**

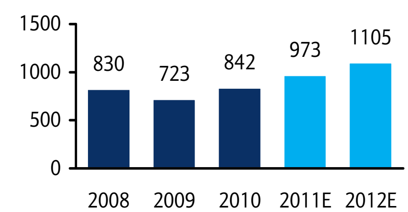
In this case multiples derate 70% vs our base case to 1.5x, providing 49% potential downside. This scenario may transpire if management is unable to address investor concerns or material findings emerge from ongoing shareholder suits.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

Net revenues, annual (CNY mn)



Note: FY end Mar.

Price decline

- The share price peaked at US$50 per share in 2009, steadily declining since then. There has been no single driver of the price decline.
- Broad brush: In our view, CMED has been caught up in general market negativity toward Chinese stocks, especially small-mid cap firms listed in the US.
- Although FY09 was not profitable, CMED has generally met or beat consensus estimates.
- In 2Q FY11 (3Q FY11) CMED beat estimates and raised annual guidance.

Price reversal

Key catalysts will likely be 4Q CY11 and 1Q CY12 results, providing:

- A longer track record to convince investors of the company's ability.
- More time for sentiment toward Chinese ADRs to rebalance across the market.

2) Favourable subsector with low pricing pressure

The molecular diagnostics segment is large enough to be interesting, but small enough to avoid government pricing scrutiny.

Growth of the China diagnostics market is expected to accelerate from 15% in 2011 to 17% in 2013, according to market research firm Frost & Sullivan. The domestic market is quite fragmented, which provides significant M&A opportunity:

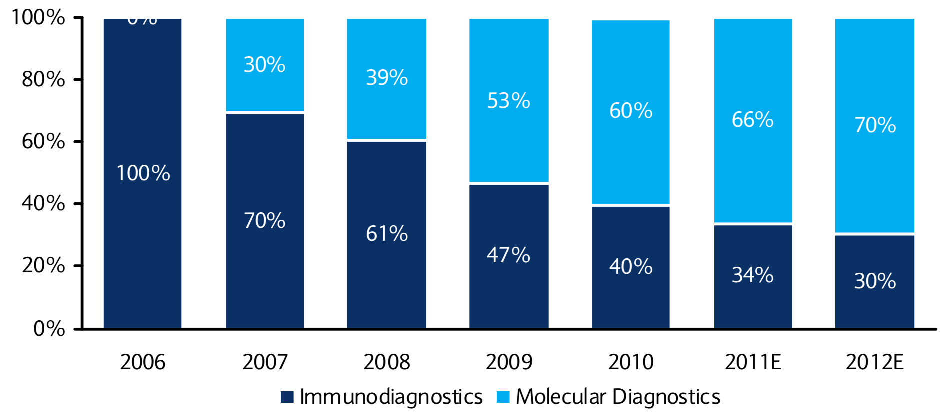
As the largest domestic player, CMED could:

- Acquire multiple smaller players (though cash flow is an issue).
- (More likely) represent an attractive target for international firms interested in a jump-start to this key growth market.

Largest molecular diagnostics firm in China: Rmb800mn in sales through a distribution network of 4,000 Chinese hospitals, gross margin of 60-65% and net margin of 10-15%.

Moving away from lower-margin immunodiagnostics: CMED is transitioning away from the immunodiagnostics business. We view this favourably, as margins and payment terms are less favourable than molecular diagnostics. In addition, CMED leverages a direct sales force with the FISH and SPR (molecular diagnostics) products. We find that in China healthcare firms contracted sales forces generally struggle to deliver strong results under budget, and favour the direct sales approach CMED is using with the higher-end technology. Competition is also lower in the molecular diagnostics business (primarily Abbott, vs 20-30 domestic players in immunodiagnostics).

Figure 68: CMED is expanding the higher-margin molecular diagnostics business



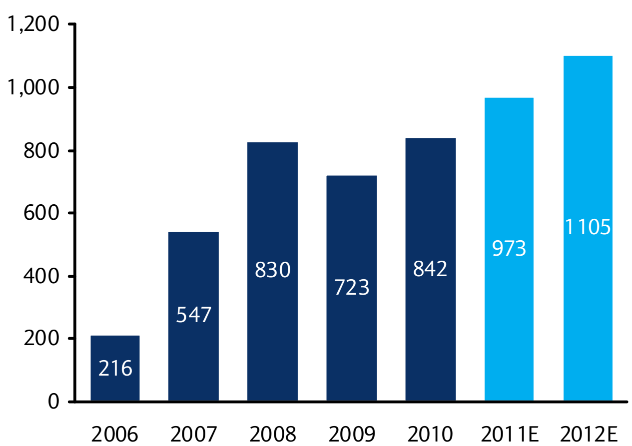
Source: Company data, Barclays Capital estimates

3) Reasonable fundamentals

As detailed below, CMED provides reasonable fundamentals, including revenue growth, steady margins and negative net debt. While corporate governance concerns will need to be addressed, the stock remains significantly undervalued at current levels, in our view.

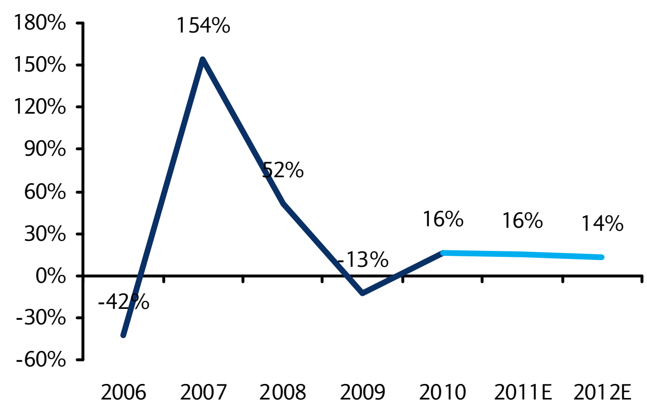
Revenues: CMED revenues declined in FY09, but rebounded in FY10 and 9M11. Outside concerns spurred an investigation in 2009. Management cites the cost and effort involved in clearing the company's name as a key driver of lower revenues in 2009. While the internal investigation did not uncover anything untoward, some investors remain sceptical.

Figure 69: Annual revenues (Rmb mn)



Source: Company data, Barclays Capital estimates

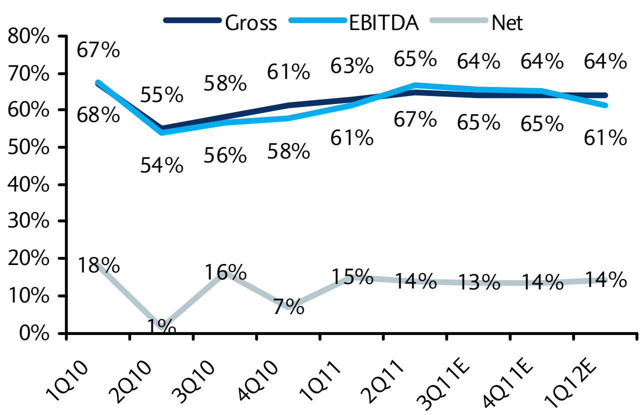
Figure 70: Annual revenue (y/y)



Source: Company data, Barclays Capital estimates

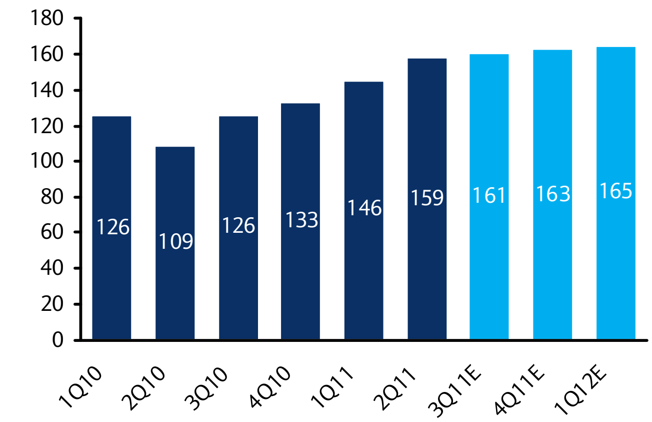
Margins and EBITDA: CMED enjoys gross margins of 65-70% and net margins of 14%. While these figures compare favourably to generic drug manufacturers and distributors, they are not as strong as Kanghui, which provides even stronger performance with 2012E GM of 70% and NM of 37% in the orthopaedics space.

Figure 71: Quarterly margins



Source: Company data, Barclays Capital estimates

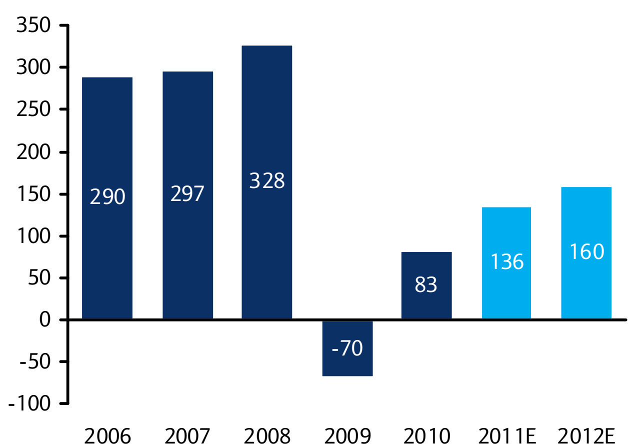
Figure 72: Quarterly EBITDA



Source: Company data, Barclays Capital estimates

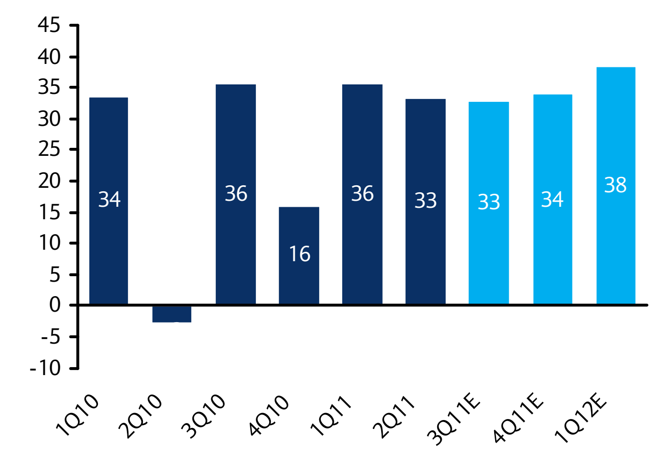
Income and EPS: After the loss in FY09, CMED has maintained income and EPS reasonably well in 2010-11. We expect this to be maintained going forward given sector growth and lower pricing pressure in this space.

Figure 73: Annual net income



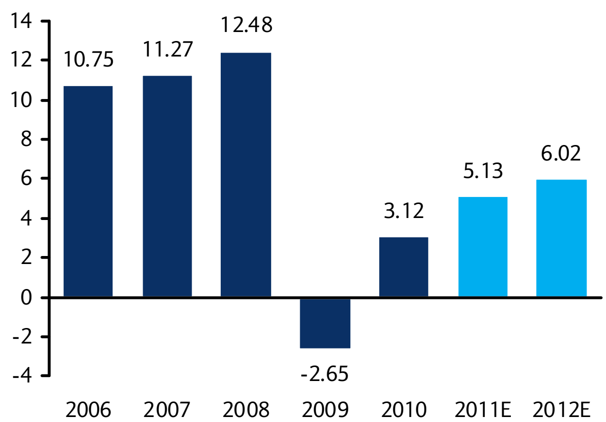
Source: Company data, Barclays Capital estimates

Figure 74: Quarterly net income



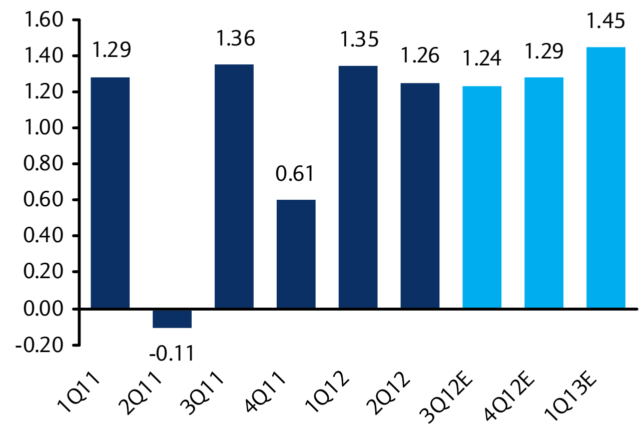
Source: Company data, Barclays Capital estimates

Figure 75: Annual diluted earnings per ADS, adj. (Rmb)



Source: Company data, Barclays Capital estimates

Figure 76: Quarterly diluted earnings per ADS, adj. (Rmb)



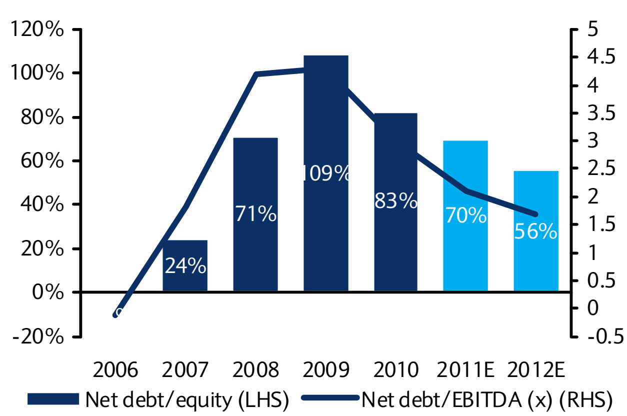
Source: Company data, Barclays Capital estimates

Debt and cash conversion: CMED issued convertible bonds (CBs) to finance the purchase of the FISH and SPR business lines. Net debt to equity was 83% in 2010, among the highest in our coverage universe. However, management successfully refinanced the first CB at reasonable rates without any dilutive conversion to equity.

Cash conversion is another area to watch carefully. Although conversion cycles in China are longer for device companies than drug firms, CMED remains long and is growing longer. In comparison with other Chinese device names, Weigao had a shorter cycle in 2010 (101 days) but Kanghui had a longer cycle than CMED at 186 days.

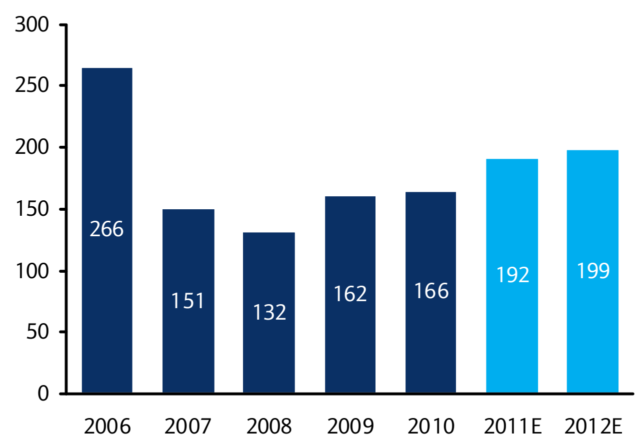
In our view current valuations reflects investor concern about CMED corporate governance, debt and cash conversion cycle levels. However, we also see broad-brush concern applied to all US-listed Chinese firms and look for sentiment to improve in 2012.

Figure 77: Net debt/equity



Source: Company data, Barclays Capital estimates

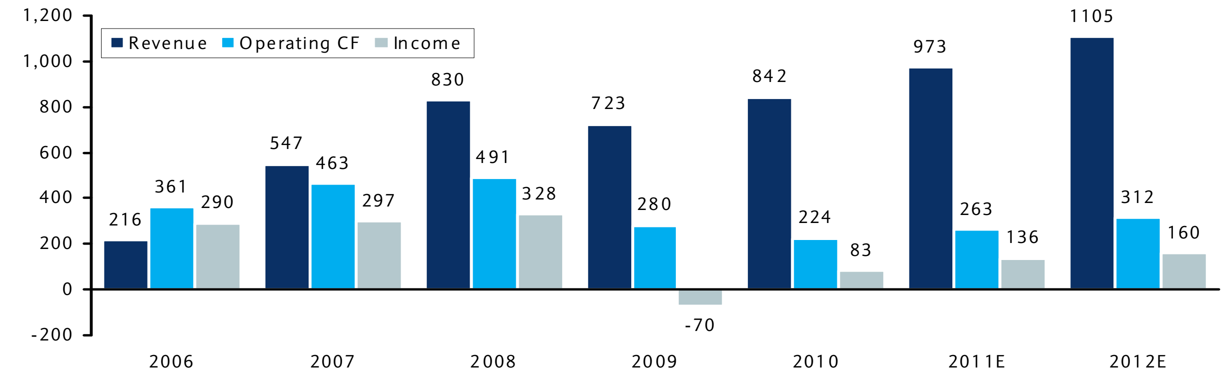
Figure 78: Cash conversion cycle (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 79: Annual revenue, operating cash flow and income

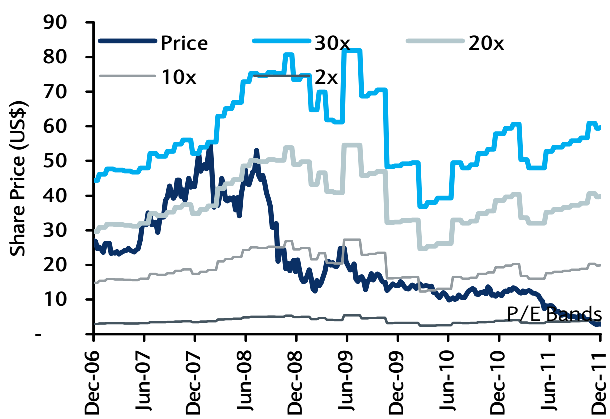


Source: Company data, Barclays Capital estimates

Valuation

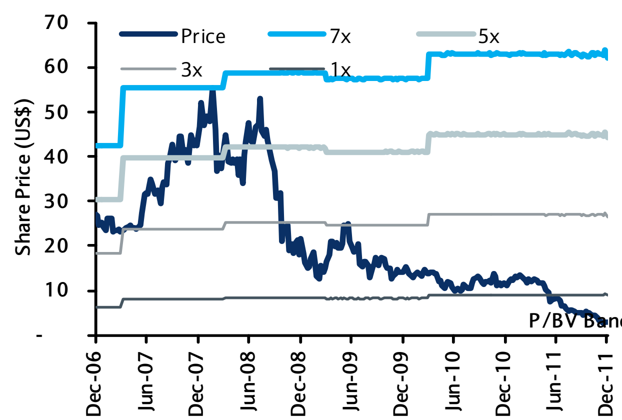
Our PT is based on 5.0x 2012E EPADS of Rmb6.02 (currently trading at 2.9x 2011E). The 5.0x P/E is derived by subtracting 1 SD (6.6x) for our negative sector view from the historical mean (11.7x), and subtracting 0.1x for qualitative factors specific to the firm. 5.0x is roughly 1.0 SD less than the historical average and well below our 2010-12E earnings CAGR forecast of 39%.

Figure 80: P/E bands



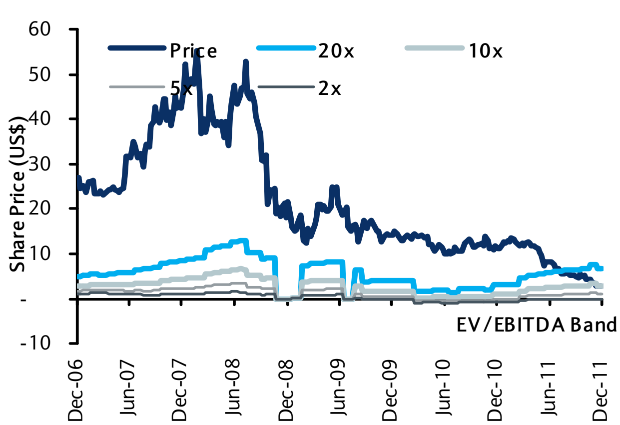
Source: Reuters, Barclays Capital

Figure 81: P/B bands



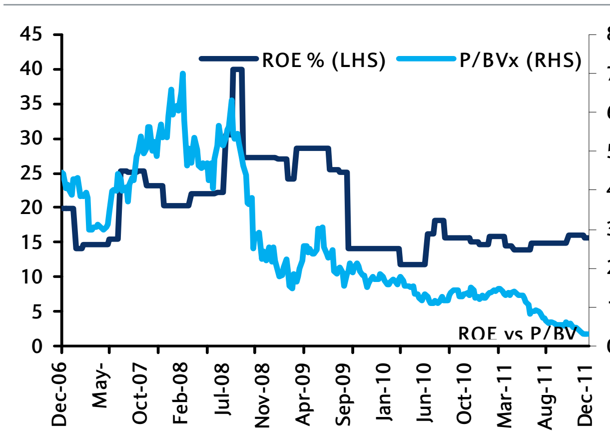
Source: Reuters, Barclays Capital

Figure 82: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 83: ROE vs P/B



Source: Reuters, Barclays Capital

Figure 84: CMED – income statement (Rmb 000 except per share data)

Year-end 31 Mar	2008	2009	2010	2011E	2012E	2013E
Net sales	**829,950**	**723,071**	**842,366**	**972,975**	**1,104,841**	**1,262,454**
Growth (y/y)	*52%*	*-13%*	*16%*	*16%*	*14%*	*14%*
COGS	232,571	237,550	334,682	350,271	397,743	454,483
% of revenue	*28%*	*33%*	*40%*	*36%*	*36%*	*36%*
Growth (y/y)	*-5%*	*2%*	*41%*	*5%*	*14%*	*14%*
Gross profit	**597,379**	**485,521**	**507,684**	**622,704**	**707,098**	**807,970**
Margin	*72%*	*67%*	*60%*	*64%*	*64%*	*64%*
Growth (y/y)	*98%*	*-19%*	*5%*	*23%*	*14%*	*14%*
Operating expenses	(416,640)	(251,019)	(231,218)	(248,003)	(281,842)	(322,049)
% of revenue	*50%*	*35%*	*27%*	*25%*	*26%*	*26%*
Growth (y/y)	*266%*	*-40%*	*-8%*	*7%*	*14%*	*14%*
S&M expenses	(42,722)	(64,055)	(88,182)	(113,136)	(128,469)	(146,796)
% of revenue	*5.1%*	*8.9%*	*10.5%*	*11.6%*	*11.6%*	*11.6%*
Growth (y/y)	*94%*	*50%*	*38%*	*28%*	*14%*	*14%*
G&A expenses	(97,596)	(144,671)	(96,567)	(90,126)	(102,341)	(116,940)
% of revenue	*11.8%*	*20.0%*	*11.5%*	*9.3%*	*9.3%*	*9.3%*
Growth (y/y)	*38%*	*48%*	*-33%*	*-7%*	*14%*	*14%*
R&D expenses	(276,322)	(42,293)	(46,469)	(44,742)	(51,033)	(58,313)
% of revenue	*33.3%*	*5.8%*	*5.5%*	*4.6%*	*4.6%*	*4.6%*
Growth (y/y)		*-85%*		*-4%*	*14%*	*14%*
Operating cash flow (EBITDA)	**327,477**	**455,754**	**494,449**	**628,940**	**672,036**	**727,035**
Depreciation & amortization	(146,738)	(221,252)	(217,983)	(254,240)	(246,780)	(241,113)
Operating income (EBIT)	**180,739**	**234,502**	**276,466**	**374,701**	**425,256**	**485,922**
Growth (y/y)	*-4%*	*30%*	*18%*	*36%*	*13%*	*14%*
Interest expense	(122,992)	(152,035)	(131,918)	(130,311)	(130,311)	(130,311)
% of total debt	*-4%*	*-5%*	*-5%*	*-5%*	*-5%*	*-5%*
Other income (expense)	343,197	(88,493)	31,899	9,462	5,528	6,316
% of revenue	*41%*	*-12%*	*4%*	*1%*	*1%*	*1%*
Pretax income	**400,944**	**(6,026)**	**176,447**	**253,851**	**300,473**	**361,927**
Net income tax	(73,042)	(63,556)	(93,828)	(117,749)	(140,741)	(169,527)
Tax rate	*18%*	*-1055%*	*53%*	*46%*	*47%*	*47%*
Minority interests	0	0	0	0	0	0
Net income (GAAP)	**327,902**	**(69,582)**	**82,619**	**136,102**	**159,731**	**192,400**
Margin	*40%*	*10%*	*10%*	*14%*	*14%*	*15%*
Growth (y/y)	*10%*	*-121%*	*219%*	*65%*	*17%*	*20%*
Add back: Stock-based comp	0	0	0	0	0	0
Net income (non-GAAP)	**327,902**	**(69,582)**	**82,619**	**136,102**	**159,731**	**192,400**
Preferred dividends	0	0	0	0	0	0
Income attrib. to ADS holders (GAAP)	**327,902**	**(69,582)**	**82,619**	**136,102**	**159,731**	**192,400**
Income attrib. to ADS holders (non-GAAP)	**327,902**	**(69,582)**	**82,619**	**136,102**	**159,731**	**192,400**
Basic weighted avg. shares	262,776	262,546	261,841	264,953	264,953	264,953
Diluted weighted avg. shares	262,776	262,546	264,969	265,137	265,137	265,137
DILUTED EPADS (10 shares/ADR) (non-GAAP)	**12.48**	**(2.65)**	**3.12**	**5.13**	**6.02**	**7.26**

Source: Company data, Barclays Capital estimates

Figure 85: CMED – balance sheet (Rmb 000 except per share data)

Year-end 31 Mar	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	1,456,410	815,453	1,123,818	1,318,625	1,552,864	1,784,535
Restricted cash and short-term inv	0	0	0	0	0	0
Accounts receivable, net	343,037	303,368	481,096	573,122	650,797	743,637
Inventories	16,932	24,889	19,273	34,654	39,351	44,964
Prepaid expenses/other current	225,412	226,282	117,177	135,345	153,689	175,613
Total current assets	**2,041,791**	**1,369,992**	**1,741,364**	**2,061,747**	**2,396,699**	**2,748,750**
Property, plant, and equipment, net	169,422	155,825	139,448	162,446	187,495	215,629
Intangible assets, net	3,502,000	3,299,528	2,987,561	2,778,432	2,583,942	2,403,066
Other assets	67,183	83,724	79,689	79,689	79,689	79,689
Total assets	**5,780,396**	**4,909,069**	**4,948,062**	**5,082,313**	**5,247,825**	**5,447,134**
Liabilities and equity						
Short-term debt	0	0	0	0	0	0
Accounts payable	27,863	20,126	44,502	42,651	48,431	55,340
Accrued expenses	0	0	0	0	0	0
Other current liabilities	970,017	241,027	415,155	415,155	415,155	415,155
Total current liabilities	**997,880**	**261,153**	**459,657**	**457,806**	**463,586**	**470,495**
Long-term debt	2,826,348	2,777,086	2,606,223	2,606,223	2,606,223	2,606,223
Deferred income taxes	29,898	67,134	91,596	91,596	91,596	91,596
Other long-term liabilities	0	0	0	0	0	0
Total liabilities	**3,854,126**	**3,105,373**	**3,157,476**	**3,155,625**	**3,161,405**	**3,168,314**
Stockholders' equity						
Common stock	967,687	1,067,061	1,134,288	1,134,288	1,134,288	1,134,288
Preferred stock	0	0	0	0	0	0
Additional paid-in capital	0	0	0	0	0	0
Retained earnings	1,028,540	852,334	934,953	1,071,055	1,230,786	1,423,186
Treasury and other equity	0	(45,143)	(201,362)	(201,362)	(201,362)	(201,362)
Other comprehensive income	(69,957)	(70,556)	(77,293)	(77,293)	(77,293)	(77,293)
Total shareholders' equity	**1,926,270**	**1,803,696**	**1,790,586**	**1,926,688**	**2,086,419**	**2,278,819**
Total liabilities and equity	**5,780,396**	**4,909,069**	**4,948,062**	**5,082,313**	**5,247,825**	**5,447,134**

Source: Company data, Barclays Capital estimates

Figure 86: CMED – cash flow statement (Rmb 000 except per share data)

Year-end 31 Mar	2008	2009	2010	2011E	2012E	2013E
Net income	**327,902**	**(69,582)**	**82,619**	**136,102**	**159,731**	**192,400**
Depreciation and amortization	167,152	249,756	243,913	254,240	246,780	241,113
Deferred taxes	28,774	37,236	24,462	0	0	0
Change in working capital	(260,128)	23,105	(38,631)	(127,426)	(94,934)	(113,470)
Others	227,058	39,362	(88,187)	0	0	0
Cash flow from operations	**490,758**	**279,877**	**224,176**	**262,916**	**311,577**	**320,043**
Capital expenditure	(25,972)	(8,616)	(5,645)	(68,108)	(77,339)	(88,372)
Investments	0	0	0	0	0	0
Others	(1,441,223)	(706,906)	99,814	0	0	0
Cash flow from investments	**(1,467,195)**	**(715,522)**	**94,169**	**(68,108)**	**(77,339)**	**(88,372)**
Equity issuance, options, and converts	1,837,871	2,249	962,230	0	0	0
Dividends paid	(86,574)	(99,724)	0	0	0	0
Debt funding/(repayment)	0	0	0	0	0	0
Others	0	(107,586)	(965,230)	0	0	0
Cash flow from financing	**1,751,297**	**(205,061)**	**(3,000)**	**0**	**0**	**0**
Fx effects	(1,129)	(251)	(6,980)	0	0	0
Net cash flow	**773,731**	**(640,957)**	**308,365**	**194,807**	**234,238**	**231,672**
Cash at beginning of period	682,679	1,456,410	815,453	1,123,818	1,318,625	1,552,864
Cash at end of period	**1,456,410**	**815,453**	**1,123,818**	**1,318,625**	**1,552,864**	**1,784,535**

Source: Company data, Barclays Capital estimates

Figure 87: CMED – key metrics (Rmb 000 except per share data)

Return statistics		2008	2009	2010	2011E	2012E	2013E
ROE		19%	-4%	5%	7%	8%	9%
ROA		8%	-1%	2%	3%	3%	4%
ROIC		9%	-52%	1%	2%	3%	4%
Operating statistics		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
DSOs		139	163	170	198	202	202
DIOs		10	11	10	10	12	12
DPOs		17	12	14	16	15	15
Cash conversion cycle		132	162	166	192	199	199
Net debt		1,369,938	1,961,633	1,482,405	1,287,598	1,053,359	821,688
Net debt/equity		71%	109%	83%	67%	50%	36%
Net debt/total cap		42%	52%	45%	40%	34%	27%
Net debt/EBITDA		4.2x	4.3x	3.0x	2.0x	1.6x	1.1x
Working capital		613,244	574,665	662,048	785,772	892,267	1,019,555
Working capital/sales		74%	79%	79%	81%	81%	81%
Current ratio		2.05	5.25	3.79	4.50	5.17	5.84
Interest coverage ratio		3x	3x	4x	5x	5x	6x
Fixed asset turnover		5.0x	4.4x	5.7x	6.4x	6.3x	6.3x
Total asset turnover		0.2x	0.1x	0.2x	0.2x	0.2x	0.2x
Book value		(1,575,730)	(1,495,832)	(1,196,975)	(851,744)	(497,522)	(124,246)
BV/share		(6.00)	(5.70)	(4.52)	(3.21)	(1.88)	(0.47)
Net sales		829,950	723,071	842,366	972,975	1,104,841	1,262,454
COGS		232,571	237,550	334,682	350,271	397,743	454,483
EBITDA		327,477	455,754	494,449	628,940	672,036	727,035
Interest expense		(122,992)	(152,035)	(131,918)	(130,311)	(130,311)	(130,311)
Pretax income		400,944	(6,026)	176,447	253,851	300,473	361,927
Tax rate		18%	-1055%	53%	46%	47%	47%
Net income		327,902	(69,582)	82,619	136,102	159,731	192,400
After-tax interest		(100,586)	(1,755,543)	(61,769)	(69,866)	(69,273)	(69,273)
Shares outstanding		262,776	262,546	264,969	265,137	265,137	265,137
FTE		733	879	971			
Days		365	365	365	365	365	365
Cash flow		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Operating income (EBIT)		180,739	234,502	276,466	374,701	425,256	485,922
	Per share	0.69	0.89	1.04	1.41	1.60	1.83
	Growth	*-4%*	*30%*	*17%*	*35%*	*13%*	*14%*
Operating cash flow (EBITDA)		327,477	455,754	494,449	628,940	672,036	727,035
	Per share	1.25	1.74	1.87	2.37	2.53	2.74
	Growth	*61%*	*39%*	*7%*	*27%*	*7%*	*8%*
Net cash from operations		490,758	279,877	224,176	262,916	311,577	320,043
	Per share	1.87	1.07	0.85	0.99	1.18	1.21
	Growth	*6%*	*-43%*	*-21%*	*17%*	*19%*	*3%*
Capital expenditures		(25,972)	(8,616)	(5,645)	(68,108)	(77,339)	(88,372)
"Free cash flow"		464,786	271,261	218,531	194,807	234,238	231,672
	Per share	1.77	1.03	0.82	0.73	0.88	0.87
Net external financing needs		464,786	271,261	218,531	194,807	234,238	231,672
	Per share	1.77	1.03	0.82	0.73	0.88	0.87
CF to invest. ratio		**19**	**32**	**40**	**4**	**4**	**4**

Source: Company data, Barclays Capital estimates

SHANGHAI PHARMACEUTICALS (1-OW; PT HK$15.83; +26%): UNDERVALUED NATIONAL CHAMPION

We initiate coverage of Shanghai Pharmaceuticals, the second-largest drug distributor in China, with a 1-Overweight rating and 12-month price target of HK$15.83, implying 26% potential upside. At current levels we favour Shanghai Pharma in the distribution space. While both Sinopharm and Shanghai Pharma are expected to benefit from consolidation trends, Shanghai Pharma has a more diversified business in drug manufacturing and retail. In our view, compared with Sinopharm, Shanghai Pharma provides better cash flow, margins and debt levels with a less demanding valuation (currently 13x vs 26x). Shanghai Pharma is our top pick for those limited to large-cap names.

2607 HK / 2607.HK

Stock Rating
1-OVERWEIGHT

Sector View
3-NEGATIVE

Price Target
HKD 15.83

Price (30-Dec-2011)
HKD 12.58

Potential Upside/Downside
+26%

Rating, valuation and risks

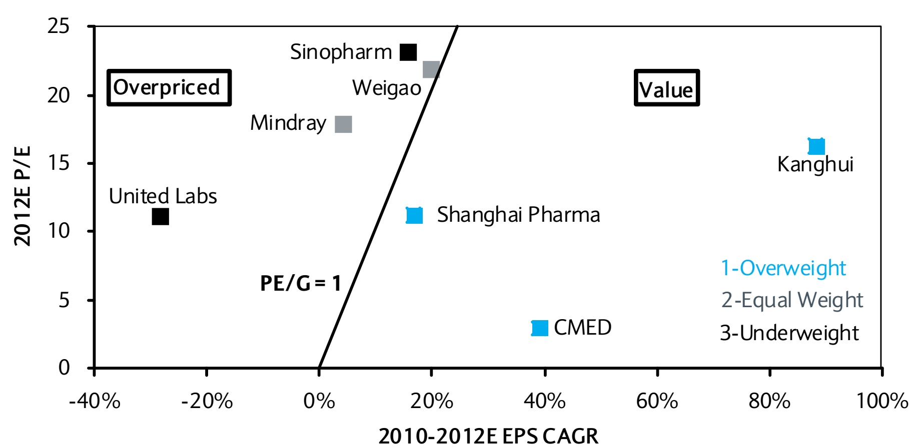
Key drivers of rating: 1) valuation (13x vs 26x for Sinopharm); and 2) positive operating cash, stronger margins and negative net debt. Shanghai Pharma also offers greater growth opportunity in 2012, given a smaller starting base.

Valuation: Our PT is based on 14.0x 2012E EPS of Rmb0.94 (currently trading at 11.8x 2011E). The 14.0x P/E is derived by subtracting 1 SD (2.3x) for our negative sector view from the historical mean (16.5x), and subtracting 0.2x for qualitative factors specific to the firm. 14.0x is roughly 1.0 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) aggressive government limits on distribution margins; 2) difficulty with acquisition integration and value capture across diversified business; 3) a hard landing in China, with reduced healthcare spend; 4) a global recession, with lower earnings multiples across equity markets.

1) Favourable valuation

Figure 88: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

Shanghai Pharmaceuticals Holding Co Ltd — China Health Care & Pharmaceuticals

Income statement (CNY '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	37,411,066	55,497,696	69,372,120	83,246,544	30.6%
EBITDA	1,702,146	2,733,257	3,075,322	3,220,904	23.7%
EBIT	2,084,890	2,409,316	2,774,885	2,913,629	11.8%
Pre-tax income	2,172,538	2,901,813	3,166,752	3,544,858	17.7%
Net income	1,368,254	1,995,825	2,533,401	2,835,887	27.5%
EPS (reported) ($)	0.69	0.79	0.94	1.05	15.4%
Diluted shares (m)	1,992,643	2,514,844	2,688,911	2,688,911	10.5%
Dividend per share ($)	0.36	0.32	0.38	0.26	-9.8%

Margin and return data (%)					Average
EBITDA margin	4.5	4.9	4.4	3.9	4.4
EBIT margin	5.6	4.3	4.0	3.5	4.4
Pre-tax margin	5.8	5.2	4.6	4.3	5.0
Net margin	3.7	3.6	3.7	3.4	3.6
ROIC	17.0	22.2	28.0	26.4	23.4
ROA	5.5	6.9	7.9	7.7	7.0
ROE	15.7	20.8	22.9	21.5	20.2

Balance sheet and cash flow (CNY '000)					CAGR
Tangible fixed assets	3,979,180	4,236,190	5,230,349	5,780,486	13.3%
Intangible fixed assets	1,298,706	1,272,732	1,247,277	1,222,331	-2.0%
Cash and equivalents	6,338,337	5,506,737	5,417,107	5,802,443	-2.9%
Total assets	28,169,020	29,474,725	34,421,095	39,398,919	11.8%
Short and long-term debt	4,884,474	2,555,474	2,555,474	2,555,474	-19.4%
Other long-term liabilities	3,007,298	3,007,298	3,007,298	3,007,298	0.0%
Total liabilities	19,034,461	19,441,435	22,292,344	25,143,253	9.7%
Net debt/(funds)	(1,453,863)	(2,951,264)	(2,861,633)	(3,246,970)	NA
Shareholders' equity	9,134,559	10,033,290	12,128,752	14,255,667	16.0%
Change in working capital	1,685,742	(829,706)	1,216,388	1,216,388	-10.3%
Operating cash flow	1,686,088	3,149,472	1,617,451	1,926,773	4.5%
Capital expenditure	1,885,271	554,977	693,721	832,465	-23.9%
Free cash flow	1,135,787	2,594,495	923,730	1,094,308	-1.2%

Valuation and leverage metrics					Average
P/E (x)	-	13.2	11.1	9.9	8.6
EV/EBITDA (x)	-	3.9	3.6	3.4	2.7
Price/BV (x)	-	2.0	1.7	1.5	1.3
Dividend yield (%)	-	4.5	5.3	3.7	3.4
Total debt/capital (%)	34.8	20.3	17.4	15.2	21.9

Selected operating metrics					
SG&A/sales (%)	12.8	9.8	10.0	10.0	10.7
R&D/sales (%)	0.0	0.0	0.0	0.0	0.0
R&D growth (%)	0.0	0.0	0.0	0.0	0.0
SG&A growth (%)	12.4	13.6	27.1	20.0	18.3

Source: Company data, Barclays Capital

Stock Rating	**1-OVERWEIGHT**
Sector View	**3-NEGATIVE**
Price (30-Dec-2011)	**HK$12.58**
Price Target	**HK$15.83**
Ticker	**2607 HK**

Investment case

Why a 1-OW? We are positive on 2607HK based on: 1) more attractive valuation than Sinopharm; 2) greater growth opportunity in 2012 vs. Sinopharm. 2010-2012E earnings CAGR is 17%. Base case 2012E multiple of 14.0x.

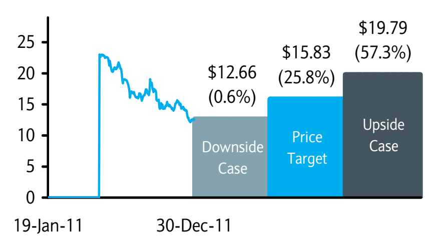
Upside case — HK$19.79

This case assumes multiples will rerate 25% vs our base case to 17.5x, providing 57% potentila upside. This scenario is more likely if the Chinese economy outperforms and government healthcare spend increases faster than expected.

Downside case — HK$12.66

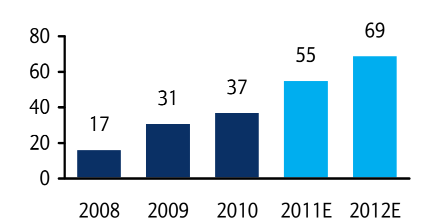
This case assumes multiples will derate 20% vs our base case to 11.2x, providing 1% potential upside. This scenario is more likely if the Chinese economy underperforms and government pricing pressure increases faster than expected.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

Net revenue, annual (CNY bn)



Note: FY end Dec.

Figure 89: Shanghai Pharma provides several advantages over Sinopharm, at a cheaper valuation

2011E	Sinopharm	Shanghai Pharma
Revenue growth	40%	48%
Gross margin	8%	14%
Operating cash flow	-4%	6%
Income growth	24%	46%
Net margin	1.5%	3.6%
Net debt/equity	4%	-29%
Cash conversion cycle (days)	30	26
China market penetration	~50%	~30%
Valuation	**26x**	**13x**

Source: Company data, Barclays Capital estimates

2) Opportunities outweigh risks

- **Opportunities for Shanghai Pharma:** Beneficiary of government support (national champion) and credit access, beneficiary of consolidation trend. The firm is relatively well-insulated from direct pricing pressure via the EDL and provincial tendering systems. China still does not have a truly national distribution network for drugs, and the government views Shanghai Pharma as a key participant in the growth plan for this industry.

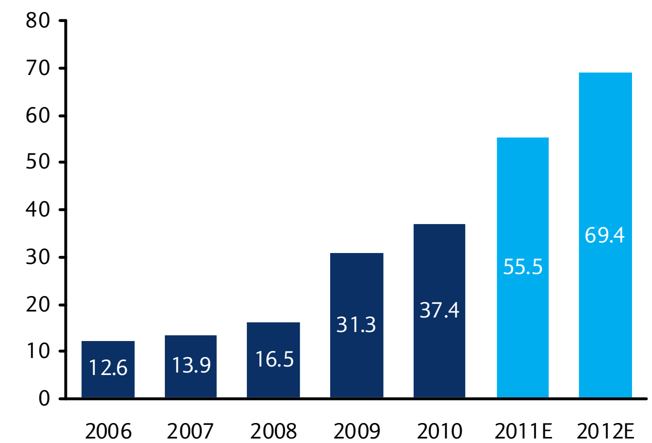
- **Risks for Sinopharm:** Because Sinopharm is already the largest and most well-known player in this space, upside is reduced and dependent on M&A. M&A is becoming more difficult and expensive, especially to maintain the 30%+ growth rates of the recent past. Shanghai Pharma will also be a key player but provides more growth opportunity due to its smaller size (only currently accessing ~30% of the market vs ~50% for Sinopharm) and a more diversified approach combining distribution with retail and manufacturing subsidiaries. Finally, Sinopharm trades at a premium to Shanghai Pharma, which provides a less demanding valuation for Shanghai Pharma and greater potential upside.

- **Catalysts:** We anticipate 2012 earnings announcements will provide catalysts for the market to understand the advantages of Shanghai Pharma vs Sinopharm. In addition, as the government seeks to build three key distributors in the China healthcare space we expect Shanghai Pharma to benefit from positive policy support, likely to be announced in 3Q-4Q12, following the NPC and 18th Party Congress.

3) Reasonable fundamentals

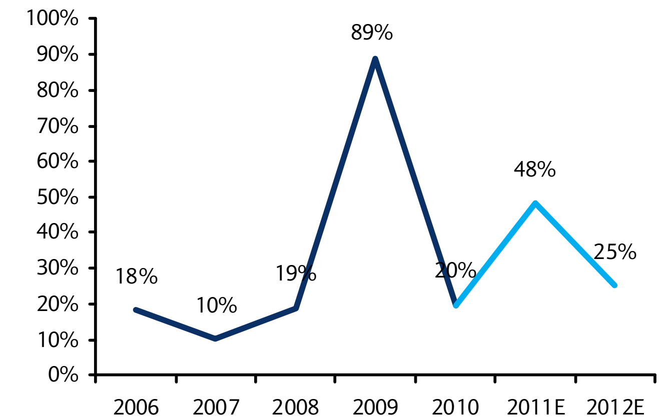
Revenues: Shanghai Pharma is growing revenues at >20% annually while maintaining stronger margins, operating cash flow and income than Sinopharm.

Figure 90: Annual revenues (Rmb bn)



Source: Company data, Barclays Capital estimates

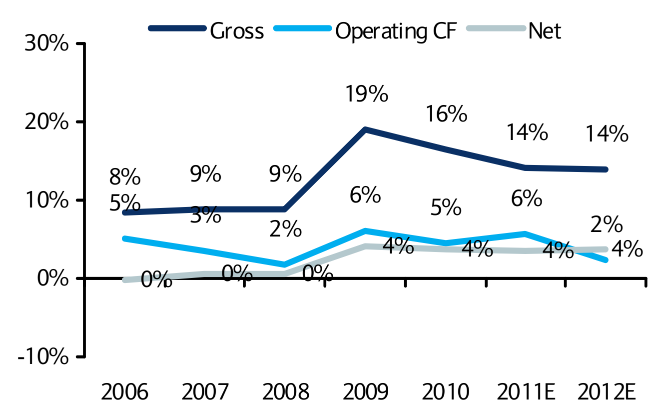
Figure 91: Annual revenues (y/y)



Source: Company data, Barclays Capital estimates

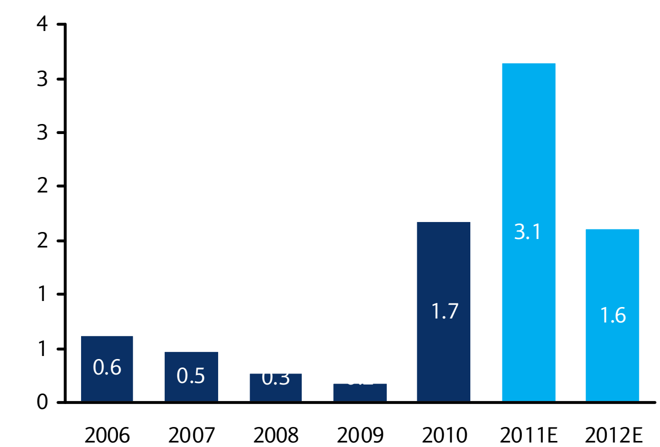
Margins and cash flow: Operating cash flow is especially critical for Chinese distributors, as payment terms are long and growing longer. We anticipate Sinopharm generating negative operating cash flow for 2011 and 2012, while Shanghai Pharma will likely maintain positive operating cash flow.

Figure 92: Annual margins



Source: Company data, Barclays Capital estimates

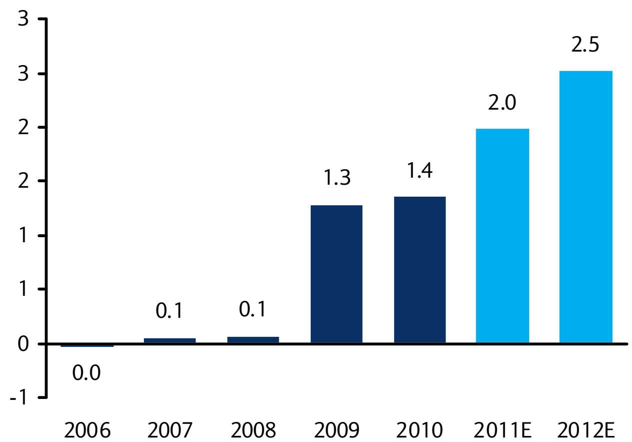
Figure 93: Annual operating cash flow (Rmb bn)



Source: Company data, Barclays Capital estimates

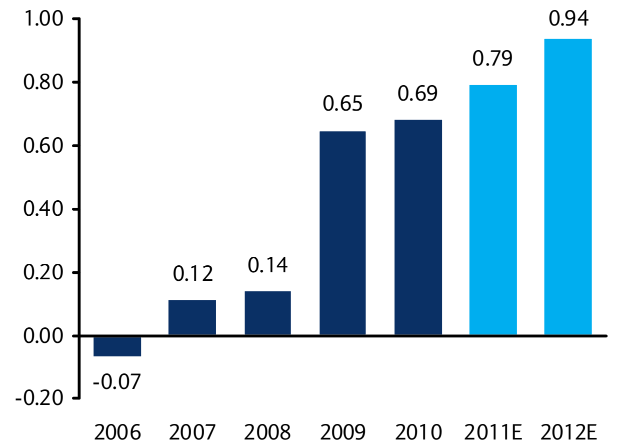
Net income and EPS: Shanghai Pharma provides attractive income and EPS growth at a reasonable valuation, in our view. Bearish commentators argue most of this growth is inorganic, and that the firm will have to slow soon as M&A opportunities dry up or become too expensive. We generally agree, although the less demanding valuation and greater smaller base vs Sinopharm lead us to prefer this name in the large-cap space.

Figure 94: Annual net income (Rmb bn)



Source: Company data, Barclays Capital estimates

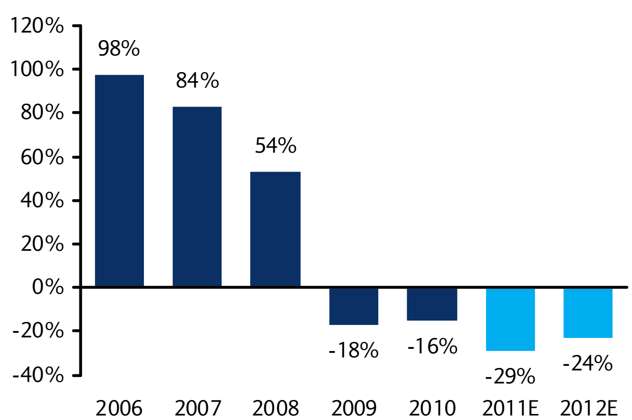
Figure 95: Annual diluted EPS, adj. (Rmb)



Source: Company data, Barclays Capital estimates

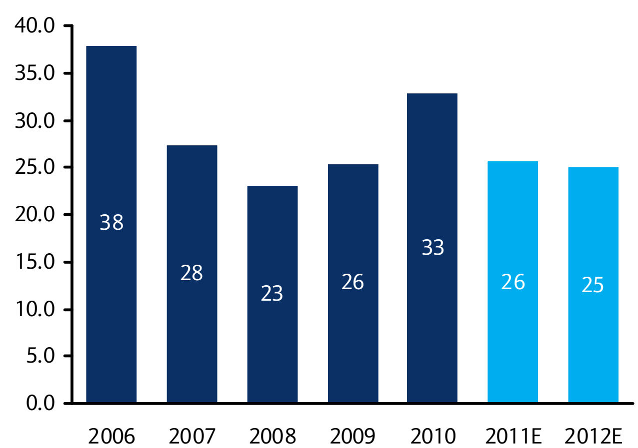
Debt and cash conversion: Shanghai Pharma carries negative net debt. This provides reserves for further M&A activity and also increases resilience in the event of a downturn. Moreover, cash conversion is robust, which facilitates the positive operating cash flow critical to this business.

Figure 96: Net debt/equity



Source: Company data, Barclays Capital estimates

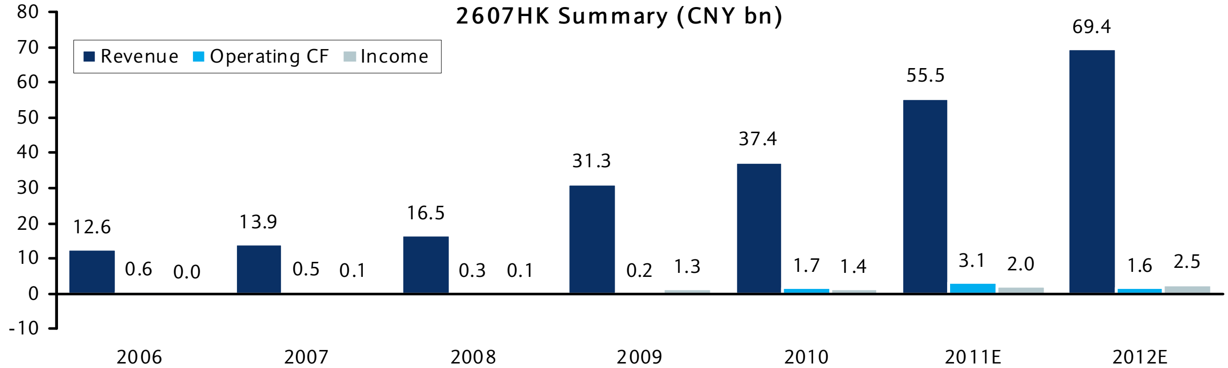
Figure 97: Cash conversion (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 98: Annual revenue, operating cash flow and income

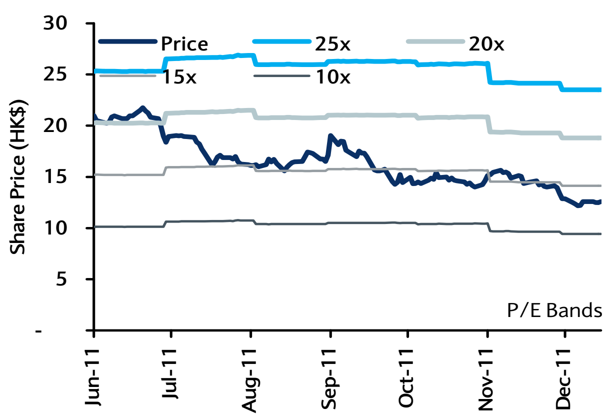


Source: Company data, Barclays Capital estimates

Valuation

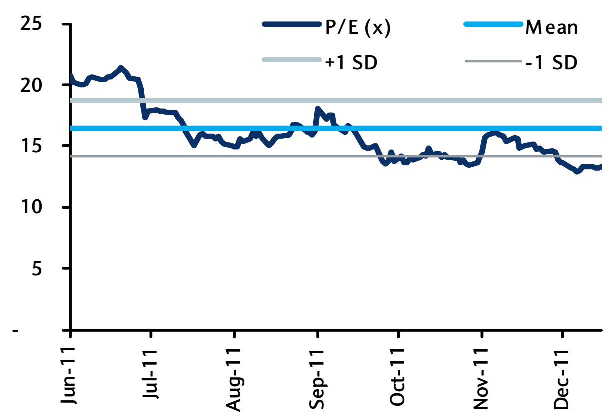
Our PT is based on 14.0x 2012E EPS of Rmb0.94 (currently trading at 11.8x 2011E). The 14.0x P/E is derived by subtracting 1 SD (2.3x) for our negative sector view from the historical mean (16.5x), and subtracting 0.2x for qualitative factors specific to the firm. 14.0x is roughly 1.0 SD less than the historical average.

Figure 99: P/E bands



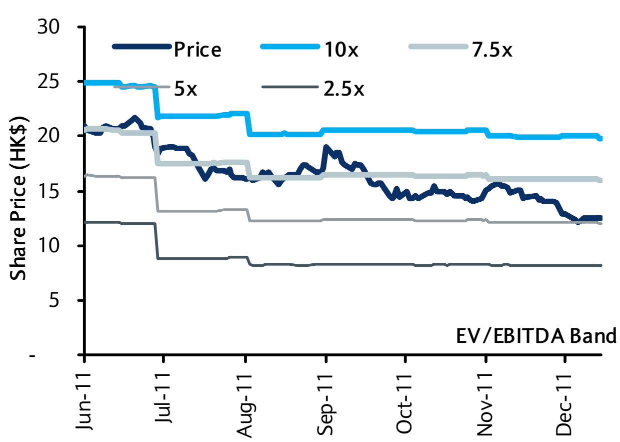
Source: Reuters, Barclays Capital

Figure 100: P/E bands



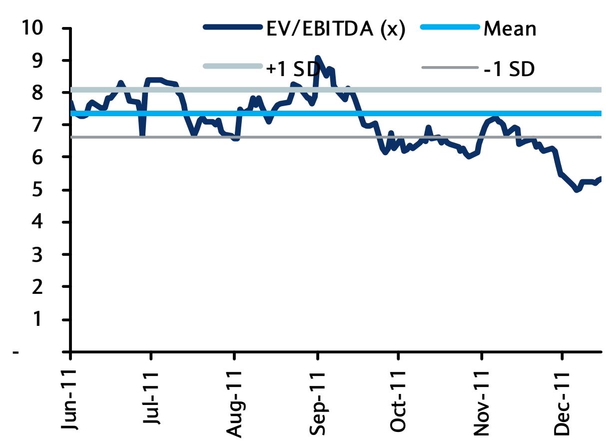
Source: Reuters, Barclays Capital

Figure 101: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 102: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 103: Shanghai Pharma – income statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net sales	**16,547,825**	**31,260,881**	**37,411,066**	**55,497,696**	**69,372,120**	**83,246,544**
Growth (y/y)	*19%*	*89%*	*20%*	*48%*	*25%*	*20%*
COGS	15,101,389	25,331,940	31,285,630	47,629,076	59,660,023	72,008,260
% of revenue	*91.3%*	*81.0%*	*83.6%*	*85.8%*	*86.0%*	*86.5%*
Growth (y/y)	*19%*	*68%*	*24%*	*52%*	*25%*	*21%*
Gross profit	**1,446,436**	**5,928,941**	**6,125,436**	**7,868,620**	**9,712,097**	**11,238,283**
Margin	*9%*	*19%*	*16%*	*14%*	*14%*	*14%*
Growth (y/y)	*18%*	*310%*	*3%*	*28%*	*23%*	*16%*
Operating expenses	(1,072,093)	(4,275,469)	(4,806,034)	(5,459,304)	(6,937,212)	(8,324,654)
% of revenue	*6%*	*14%*	*13%*	*10%*	*10%*	*10%*
Growth (y/y)	*15%*	*299%*	*12%*	*14%*	*27%*	*20%*
S&M expenses	(719,807)	(2,625,374)	(3,006,095)	(3,274,626)	(4,162,327)	(4,994,793)
% of revenue	*4.3%*	*8.4%*	*8.0%*	*5.9%*	*6.0%*	*6.0%*
Growth (y/y)	*15%*	*265%*	*15%*	*9%*	*27%*	*20%*
G&A expenses	(352,286)	(1,650,095)	(1,799,939)	(2,184,678)	(2,774,885)	(3,329,862)
% of revenue	*2.1%*	*5.3%*	*4.8%*	*3.9%*	*4.0%*	*4.0%*
Growth (y/y)	*14%*	*368%*	*9%*	*21%*	*27%*	*20%*
R&D expenses	0	0	0	0	0	0
% of revenue	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*
Growth (y/y)						
Operating cash flow (EBITDA)	468,556	2,044,867	1,702,146	2,733,257	3,075,322	3,220,904
Depreciation & amortization	(94,213)	(391,395)	(382,744)	(323,941)	(300,438)	(307,275)
Operating income (EBIT)	**374,343**	**1,653,472**	**2,084,890**	**2,409,316**	**2,774,885**	**2,913,629**
Growth (y/y)	*31%*	*342%*	*26%*	*16%*	*15%*	*5%*
Interest Expense	(156,526)	(198,287)	(166,231)	(440,030)	(301,854)	(201,236)
% of Debt	*8%*	*6%*	*3%*	*6%*	*6%*	*4%*
Other income (expense)	(31,108)	674,860	253,878	932,527	693,721	832,465
% of revenue	*0%*	*2%*	*1%*	*2%*	*1%*	*1%*
Pretax income	**186,709**	**2,130,045**	**2,172,538**	**2,901,813**	**3,166,752**	**3,544,858**
Net income tax	(57,273)	(464,855)	(393,552)	(534,447)	(633,350)	(708,972)
Tax rate	*31%*	*22%*	*18%*	*18%*	*20%*	*20%*
Minority interests	(47,451)	(368,401)	(410,732)	(371,541)	0	0
Net income (GAAP)	**81,985**	**1,296,789**	**1,368,254**	**1,995,825**	**2,533,401**	**2,835,887**
Margin	*0.5%*	*4.1%*	*3.7%*	*3.6%*	*3.7%*	*3.4%*
Growth (y/y)	*24%*	*1482%*	*6%*	*46%*	*27%*	*12%*
Add back: Stock-based comp	0	0	0	0	0	0
Net income (non-GAAP)	**81,985**	**1,296,789**	**1,368,254**	**1,995,825**	**2,533,401**	**2,835,887**
Dividends		0	0	0	0	0
Income attrib. to ADS holders (GAAP)	**81,985**	**1,296,789**	**1,368,254**	**1,995,825**	**2,533,401**	**2,835,887**
Income attrib. to ADS holders (non-GAAP)	**81,985**	**1,296,789**	**1,368,254**	**1,995,825**	**2,533,401**	**2,835,887**
Basic weighted avg. shares	569,173	1,992,643	1,992,643	2,514,844	2,688,911	2,688,911
Diluted weighted avg. shares	569,173	1,992,643	1,992,643	2,514,844	2,688,911	2,688,911
DILUTED EPS (non-GAAP)	**0.14**	**0.65**	**0.69**	**0.79**	**0.94**	**1.05**

Source: Company data, Barclays Capital estimates

Figure 104: Shanghai Pharma – balance sheet (Rmb 000 except per share data)

Year-end 3	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	1,037,249	4,887,220	6,338,337	5,506,737	5,417,107	5,802,443
Restricted cash and short-term inv	9,157	10,445	5,970	5,970	5,970	5,970
Accounts receivable, net	2,657,387	5,218,180	7,215,828	9,122,909	11,403,636	13,684,363
Inventories	1,622,831	3,700,720	5,040,729	6,538,085	8,172,606	9,807,127
Prepaid expenses/other current	195,951	820,360	2,106,362	608,194	760,242	912,291
Total current assets	**5,522,575**	**14,636,925**	**20,707,226**	**21,781,895**	**25,759,561**	**30,212,194**
Property, plant, and equipment, net	913,512	3,955,349	3,979,180	4,236,190	5,230,349	5,780,486
Intangible assets, net	446,634	939,407	1,298,706	1,272,732	1,247,277	1,222,331
Other assets	872,794	2,342,882	2,183,908	2,183,908	2,183,908	2,183,908
Total assets	**7,755,515**	**21,874,563**	**28,169,020**	**29,474,725**	**34,421,095**	**39,398,919**
Liabilities and equity						
Short-term debt	1,919,520	3,331,950	4,818,377	2,515,452	2,515,452	2,515,452
Accounts payable	3,096,032	5,729,745	8,667,661	11,403,636	14,254,545	17,105,454
Accrued expenses				0	0	0
Other current liabilities	566,059	1,982,225	2,431,508	2,431,508	2,431,508	2,431,508
Total current liabilities	**5,581,611**	**11,043,919**	**15,917,546**	**16,350,596**	**19,201,505**	**22,052,414**
Long-term debt	25,103	84,297	66,098	40,022	40,022	40,022
Deferred income taxes	620	33,407	43,520	43,520	43,520	43,520
Other long-term liabilities	459,128	2,430,933	3,007,298	3,007,298	3,007,298	3,007,298
Total liabilities	**6,066,462**	**13,592,557**	**19,034,461**	**19,441,435**	**22,292,344**	**25,143,253**
Stockholders' equity						
Common stock	569,173	569,173	1,992,643	1,992,643	1,992,643	1,992,643
Preferred stock				0	0	0
Additional paid-in capital	578,180	4,953,849	3,432,762	3,432,762	3,432,762	3,432,762
Retained earnings	304,065	2,185,046	3,117,023	4,015,754	6,111,215	8,238,130
Treasury and other equity	237,637	573,939	592,131	592,131	592,131	592,131
Other comprehensive income				0	0	0
Total shareholders' equity	**1,689,055**	**8,282,007**	**9,134,559**	**10,033,290**	**12,128,752**	**14,255,667**
Total liabilities and equity	**7,755,517**	**21,874,563**	**28,169,020**	**29,474,725**	**34,421,096**	**39,398,920**

Source: Company data, Barclays Capital estimates

Figure 105: Shanghai Pharma – cash flow statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net income	**81,985**	**1,296,789**	**1,368,254**	**1,995,825**	**2,533,401**	**2,835,887**
Depreciation and amortization	94,213	391,395	382,744	323,941	300,438	307,275
Deferred taxes	0	0	0	0	0	0
Change in working capital	45,630	(2,629,379)	(1,685,742)	829,706	(1,216,388)	(1,216,388)
Others	63,850	2,851,987	1,620,832	0	0	0
Cash flow from operations	**285,678**	**1,910,793**	**1,686,088**	**3,149,472**	**1,617,451**	**1,926,773**
Capital expenditure	(90,503)	(765,029)	(550,301)	(554,977)	(693,721)	(832,465)
Investments	(23,163)	(75,027)	(1,334,970)	0	0	0
Others	463,512	1,127,086	(857,702)	0	0	0
Cash flow from investments	**349,846**	**287,031**	**(2,742,973)**	**(554,977)**	**(693,721)**	**(832,465)**
Equity issuance, options, and converts	(35,679)	(456,072)	1,042,903	0	0	0
Dividends paid	(211,305)	(537,242)	(716,412)	(798,330)	(1,013,361)	(708,972)
Debt funding/(repayment)				(2,329,001)	0	0
Others	(25,100)	386,213	1,998,954	0	0	0
Cash flow from financing	**(272,084)**	**(607,101)**	**2,325,445**	**(3,127,331)**	**(1,013,361)**	**(708,972)**
Fx effects	1,423	411	(5,490)	0	0	0
Net cash flow	**364,863**	**1,591,133**	**1,263,070**	**(532,836)**	**(89,630)**	**385,336**
Cash at beginning of period	604,664	3,185,370	4,776,503	6,039,573	5,506,737	5,417,107
Cash at end of period	**969,527**	**4,776,503**	**6,039,573**	**5,506,737**	**5,417,107**	**5,802,443**

Source: Company data, Barclays Capital estimates

Figure 106: Shanghai Pharma – key metrics (Rmb 000 except per share data)

Return statistics	2008	2009	2010	2011E	2012E	2013E
ROE	5%	26%	16%	21%	23%	21%
ROA	1%	9%	5%	7%	8%	8%
ROIC	-1%	24%	17%	22%	28%	26%

Operating statistics	2008	2009	2010	2011E	2012E	2013E
DSOs	54	46	61	54	54	55
DIOs	33	31	43	38	39	39
DPOs	64	52	70	66	68	69
Cash conversion cycle	23	26	33	26	25	26
Net debt	907,374	(1,470,973)	(1,453,863)	(2,951,264)	(2,861,633)	(3,246,970)
Net debt/equity	54%	-18%	-16%	-29%	-24%	-23%
Net debt/total cap	35%	-22%	-19%	-42%	-31%	-29%
Net debt/EBITDA	1.9x	-0.7x	-0.9x	-1.1x	-0.9x	-1.0x
Working capital	7,572,201	15,469,005	23,030,580	27,672,824	34,591,030	41,509,235
Working capital/sales	46%	49%	62%	50%	50%	50%
Current ratio	0.99	1.33	1.30	1.33	1.34	1.37
Interest coverage ratio	3x	10x	10x	6x	10x	16x
Fixed asset turnover	16.2x	12.8x	9.4x	13.5x	14.7x	15.1x
Total asset turnover	2.2x	2.1x	1.5x	1.9x	2.2x	2.3x
Book value	1,242,419	7,342,600	7,835,854	8,760,558	10,881,475	13,033,335
BV/share	2.18	3.68	3.93	3.48	4.05	4.85
Net sales	16,547,825	31,260,881	37,411,066	55,497,696	69,372,120	83,246,544
COGS	15,101,389	25,331,940	31,285,630	47,629,076	59,660,023	72,008,260
EBITDA	468,556	2,044,867	1,702,146	2,733,257	3,075,322	3,220,904
Interest expense	(156,526)	(198,287)	(166,231)	(440,030)	(301,854)	(201,236)
Pretax income	186,709	2,130,045	2,172,538	2,901,813	3,166,752	3,544,858
Tax rate	31%	22%	18%	18%	20%	20%
Net income	81,985	1,296,789	1,368,254	1,995,825	2,533,401	2,835,887
After-tax interest	(108,512)	(155,013)	(136,118)	(358,986)	(241,483)	(160,989)
Shares outstanding	569,173	1,992,643	1,992,643	2,514,844	2,688,911	2,688,911
FTE	2,411		31,493			
Days	365	365	365	365	365	365

Cash flow		2008	2009	2010	2011E	2012E	2013E
Operating income (EBIT)		374,343	1,653,472	2,084,890	2,409,316	2,774,885	2,913,629
	Per share	0.66	0.83	1.05	0.96	1.03	1.08
	Growth	*31%*	*26%*	*26%*	*-8%*	*8%*	*5%*
Operating cash flow (EBITDA)		468,556	2,044,867	1,702,146	2,733,257	3,075,322	3,220,904
	Per share	0.82	1.03	0.85	1.09	1.14	1.20
	Growth	*22%*	*25%*	*-17%*	*27%*	*5%*	*5%*
Net cash from operations		285,678	1,910,793	1,686,088	3,149,472	1,617,451	1,926,773
	Per share	0.50	0.96	0.85	1.25	0.60	0.72
	Growth	*-41%*	*91%*	*-12%*	*48%*	*-52%*	*19%*
Capital expenditures		(90,503)	(765,029)	(550,301)	(554,977)	(693,721)	(832,465)
"Free cash flow"		195,175	1,145,764	1,135,787	2,594,495	923,730	1,094,308
	Per share	0.34	0.57	0.57	1.03	0.34	0.41
Net external financing needs		195,175	1,145,764	1,135,787	2,594,495	923,730	1,094,308
	Per share	0.34	0.57	0.57	1.03	0.34	0.41
CF to invest. ratio		**3.16**	**2.50**	**3.06**	**5.67**	**2.33**	**2.31**

Source: Company data, Barclays Capital estimates

MINDRAY MEDICAL (2-EW; PT US$25.78; +1%): GROWTH PRICED IN

We initiate coverage of Mindray Medical with a 2-Equal Weight rating and a 12-month price target of US$25.78, implying 1% potential upside. Mindray is a strong firm, a national champion and domestic premium player in the patient monitoring, medical imaging and diagnostics subsectors. Although we expect the firm to continue expanding into emerging markets, rural China and the mid-range developed market niche, the stock's current valuation, in our view, does not provide meaningful upside. Revenues continue to grow, while operating cash flow and income are flat. Hence, we rate the stock 2-EW.

MR

Stock Rating
2-EQUAL WEIGHT

Sector View
3-NEGATIVE

Price Target
USD 25.78

Price (30-Dec-2011)
USD 25.64

Potential Upside/Downside
+1%

Rating, valuation and risks

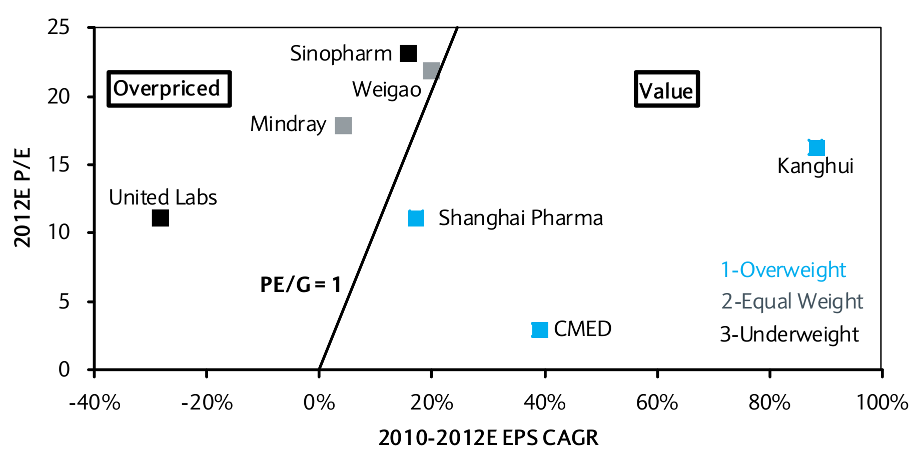
Key factors driving our rating: We rate the stock 2-Equal Weight at current levels based on valuation, viewing growth opportunities roughly in line with risks.

Valuation: Our PT is based on 18.0x 2012E EPADS of US$1.43 (currently trading at 17.9x 2011E). The 18.0x P/E is derived by subtracting 1 SD (9.5x) for our negative sector view from the historical mean (25.1x) and adding 2.4x for qualitative factors specific to the firm. 18.0x is roughly 0.75 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) aggressive government pricing pressure; 2) unexpectedly high growth in China or other key markets; 3) competition in the mid-tier space from both domestic and international players; 4) a hard landing in China, with reduced healthcare spend; 5) a global recession, with lower earnings multiples across equity markets

1) Current valuation in line

Figure 107: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

MindRay Medical International China Health Care & Pharmaceuticals

Income statement (US$ '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	704,308	865,272	1,026,026	1,121,659	16.8%
EBITDA	182,730	195,660	202,057	218,324	6.1%
EBIT	156,505	164,754	168,994	182,698	5.3%
Pre-tax income	173,096	190,712	194,645	210,739	6.8%
Net income	155,465	170,732	171,287	179,128	4.8%
EPS (reported) ($)	1.32	1.43	1.43	1.50	4.4%
Diluted shares (m)	117,958	119,602	119,602	119,602	0.5%
Dividend per share ($)	0.20	0.22	0.22	0.22	3.3%

Margin and return data (%)					Average
EBITDA margin	25.9	22.6	19.7	19.5	21.9
EBIT margin	22.2	19.0	16.5	16.3	18.5
Pre-tax margin	24.6	22.0	19.0	18.8	21.1
Net margin	22.1	19.7	16.7	16.0	18.6
ROIC	21.3	19.6	18.2	18.0	19.3
ROA	14.7	13.8	12.2	11.4	13.0
ROE	19.3	16.4	14.5	13.4	15.9

Balance sheet and cash flow (US$ '000)					CAGR
Tangible fixed assets	207,636	227,973	253,912	281,799	10.7%
Intangible fixed assets	227,998	220,018	212,317	204,886	-3.5%
Cash and equivalents	137,502	199,311	286,049	394,898	42.1%
Total assets	1,150,561	1,316,853	1,487,452	1,655,796	12.9%
Short and long-term debt	-	-	-	-	NA
Other long-term liabilities	1,135	1,135	1,135	1,135	0.0%
Total liabilities	183,960	205,130	230,051	244,877	10.0%
Net debt/(funds)	(137,502)	(199,311)	(286,049)	(394,898)	NA
Shareholders' equity	966,601	1,111,723	1,257,401	1,410,919	13.4%
Change in working capital	32,185	70,956	40,701	24,213	-9.1%
Operating cash flow	147,696	130,683	163,649	190,541	8.9%
Capital expenditure	230,954	43,264	51,301	56,083	-37.6%
Free cash flow	111,802	87,419	112,348	134,459	6.3%

Valuation and leverage metrics					Average
P/E (x)	19.8	18.0	17.9	17.1	18.2
EV/EBITDA (x)	17.9	9.0	8.3	7.2	10.6
Price/BV (x)	5.0	2.6	2.2	1.9	2.9
Dividend yield (%)	0.6	1.1	1.1	1.1	1.0
Total debt/capital (%)	0.0	0.0	0.0	0.0	0.0

Selected operating metrics					
SG&A/sales (%)	26.1	27.4	30.0	30.0	28.4
R&D/sales (%)	8.6	9.1	9.0	9.0	8.9
R&D growth (%)	3.3	30.1	17.7	9.3	15.1
SG&A growth (%)	19.8	28.6	29.9	9.3	21.9

Source: Company data, Barclays Capital

Stock Rating	2-EQUAL WEIGHT
Sector View	3-NEGATIVE
Price (30-Dec-2011)	US$25.64
Price Target	US$25.78
Ticker	MR

Investment case

Why a 2-EW? MR is a strong firm. We are neutral at current levels based primarily on valuation. In our view, risks roughly balance opportunities in the medium term. 2010-12E earnings CAGR is 4%. Base case 2012E multiple of 18.0x.

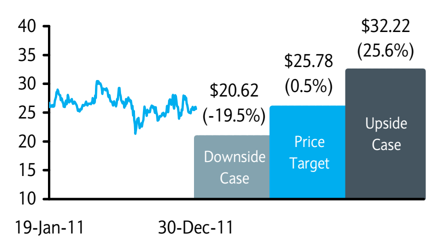
Upside case **US$32.22**

This case assumes multiples will rerate 25% vs our base case to 22.5x, providing 18% potential upside. This scenario is more likely if the Chinese economy outperforms and government healthcare spend increases faster than expected.

Downside case **US$20.62**

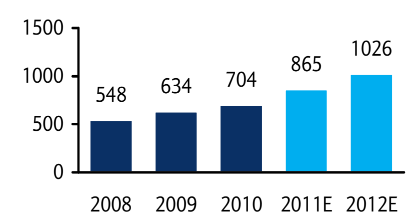
This case assumes multiples will derate 20% vs our base case to 14.4x, providing 25% potential downside. This scenario is more likely if the Chinese economy underperforms and government healthcare spend decreases faster than expected.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

Net revenue, annual (USD mn)



Note: FY end Dec.

2) Challenging subsector

Mindray competes in the mid-tier space, which faces significant competition from up-market and down-market firms. While smaller domestic premium firms such as Kanghui and CMED provide M&A optionality to investors, at US$3bn+ market capitalization Mindray presents a more difficult acquisition.

In our view opportunities and challenges are roughly balanced, which along with valuation, leads us to initiate with a 2-EW rating.

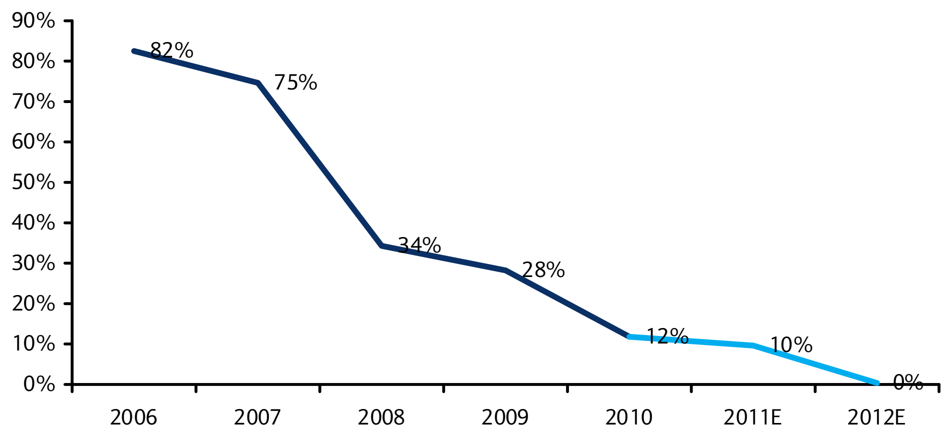
Key opportunities

- Growth market: The medical device space is a bright spot in the current medical reform landscape of China. With the government focus on cutting prices in the much larger generic drug space, the medical device segment is large enough to be interesting, but not so large that it attracts government scrutiny. Mindray also benefits from growing acceptance in the US and other developed markets. Technology replacement cycles increasingly favour domestic premium products such as those Mindray produces, which provide greater value for money at roughly 90-100% of the multinational quality at 70% of the cost.
- Established firm: Mindray was founded in 1991 and represents the first Chinese healthcare company to expand to international markets. Sales are generated from Turkey to the US and almost everywhere in between, with a seasoned management team that is both familiar with the sector and professional.

Key risks

- Intensified competition from above: GE, Phillips and Siemens face saturated developed markets. These firms are eager to diversify into second-tier products for emerging markets. This strategy threatens Mindray directly.
- Intensified competition from below: Smaller Chinese firms with less fixed costs and more aggressive practices have poached Mindray talent in recent years. In addition, as these firms mature they naturally encroach on Mindray, which has intensified competition in the key mid-tier China hospital markets. While Mindray enjoys the incumbent position and a deep distribution network, growth is not easy. In fact, annual net income growth has steadily declined for several years (82% in 2006 to 12% in 2010).

Figure 108: Net income (y/y) has declined steadily



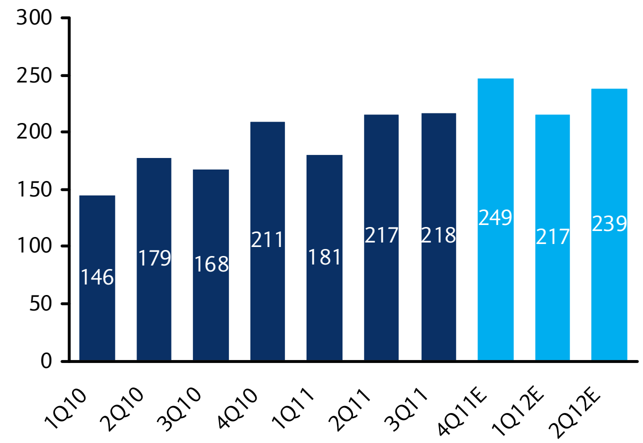
Source: Company reports and Barclays Capital estimates

3) Reasonable fundamentals

Despite challenges, Mindray remains a well-managed firm with reasonable fundamentals.

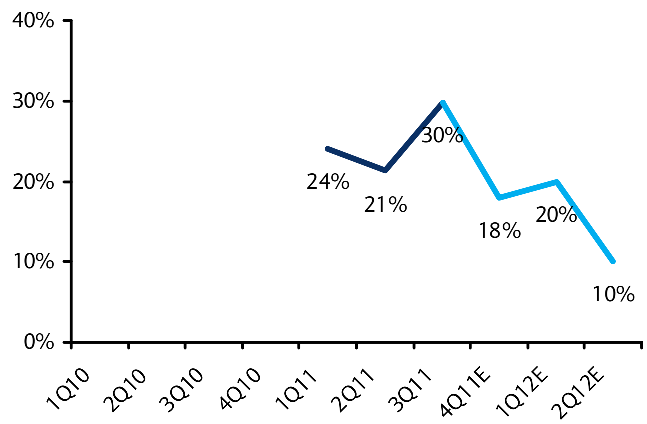
Revenues: Mindray revenues are strong, but growth rates are declining.

Figure 109: Interim revenues



Source: Company data, Barclays Capital estimates

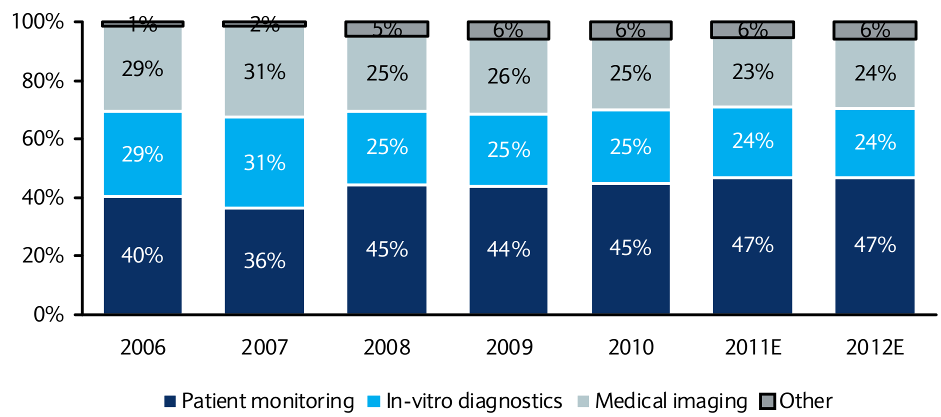
Figure 110: Interim revenue (y/y)



Source: Company data, Barclays Capital estimates

Product segments: Patient monitoring continues to expand as a share of revenue vs in-vitro diagnostics and medical imaging.

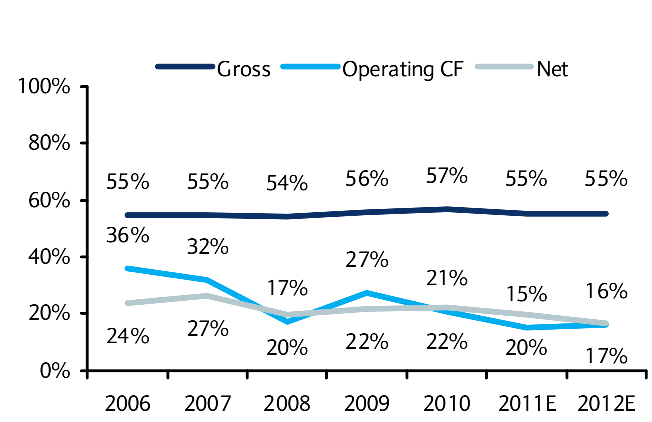
Figure 111: Segment breakdown



Source: Company data, Barclays Capital estimates

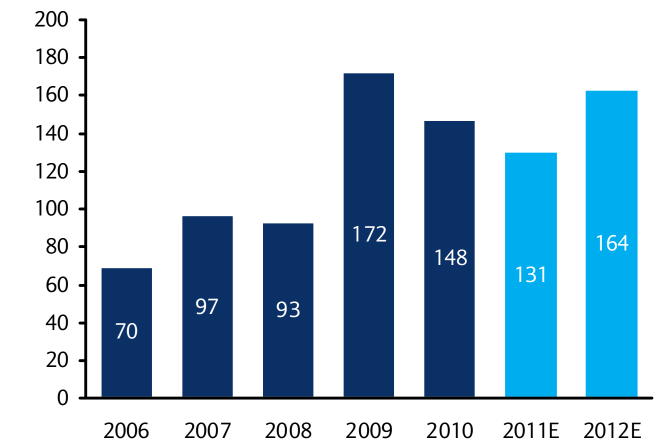
Margins and cash flow: Gross margin and net margin have stayed steady at c56% and c21%, while operating cash flow has declined from 27% in 2009 to 15% in 2011E

Figure 112: Annual margins



Source: Source: Company data, Barclays Capital estimates

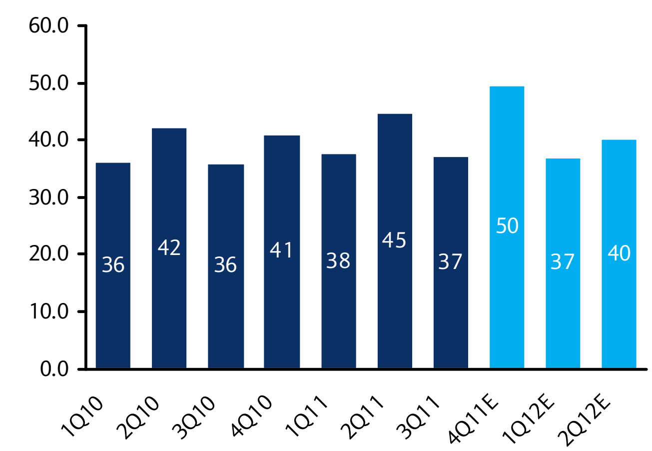
Figure 113: Annual operating cash flow (US$ mn)



Source: Source: Company data, Barclays Capital estimates

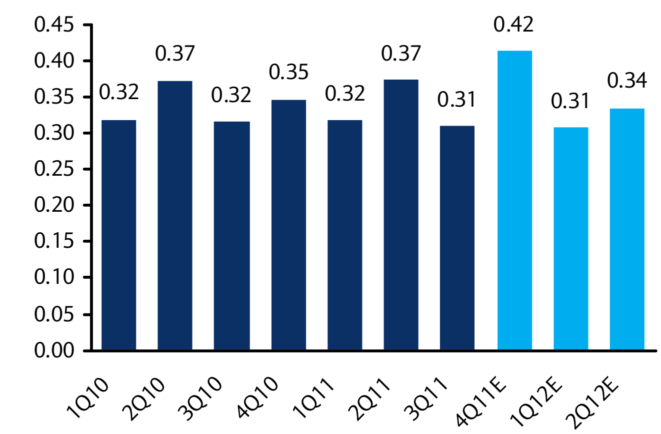
Net income: Net income and EPS have stagnated over the past several quarters.

Figure 114: Interim net income (US$ mn)



Source: Company data, Barclays Capital estimates

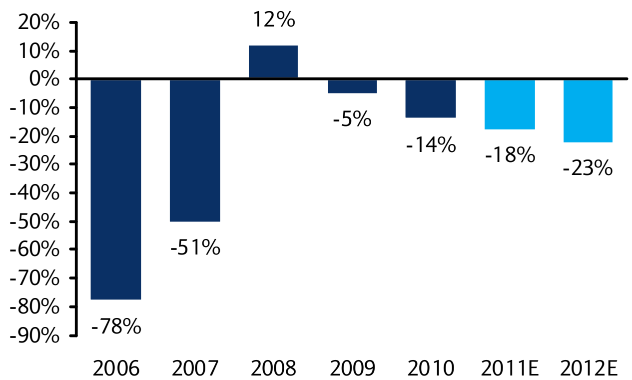
Figure 115: Interim EPS, adj. (US$)



Source: Company data, Barclays Capital estimates

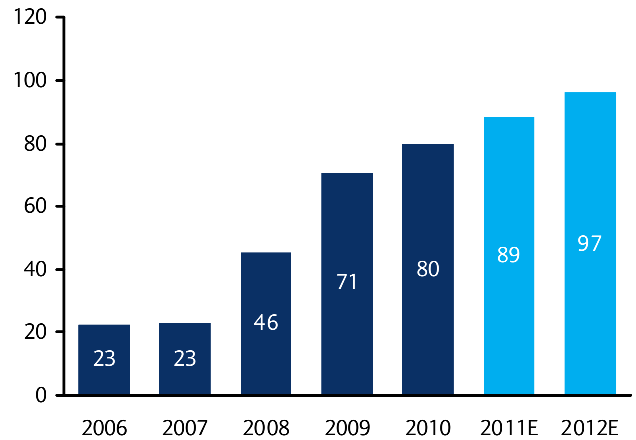
Debt and cash conversion: Net debt is negative bush cash conversion cycles have lengthened significantly since 2007.

Figure 116: Net debt/equity



Source: Company data, Barclays Capital estimates

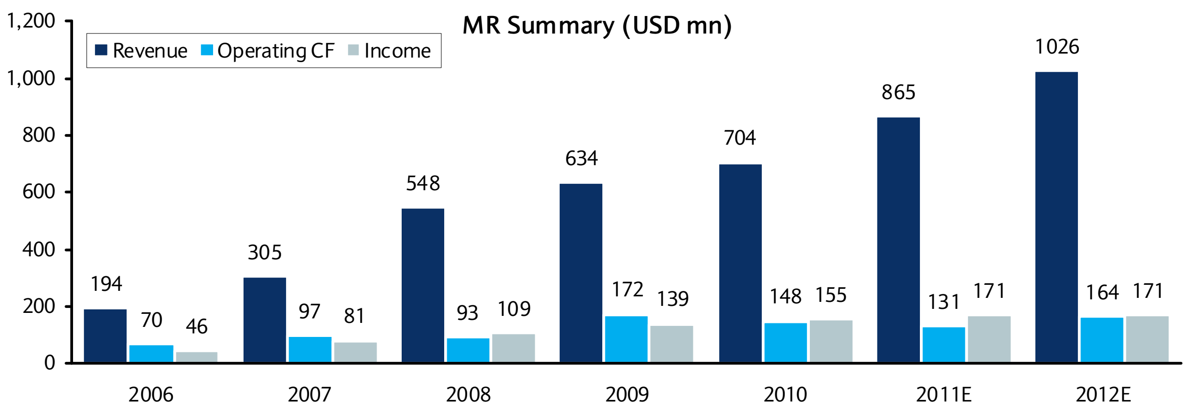
Figure 117: Cash conversion (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 118: Annual revenue, operating cash flow and income

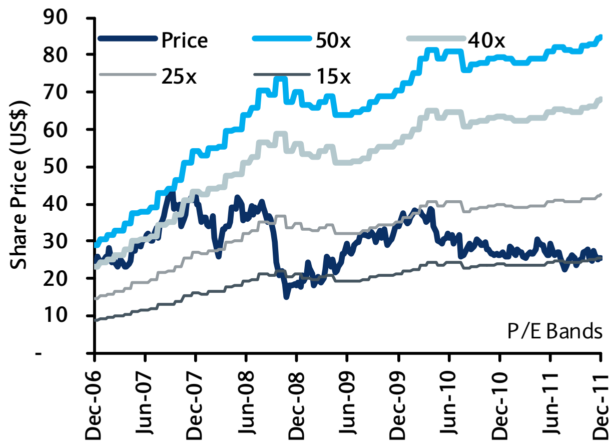


Source: Company data, Barclays Capital estimates

Valuation

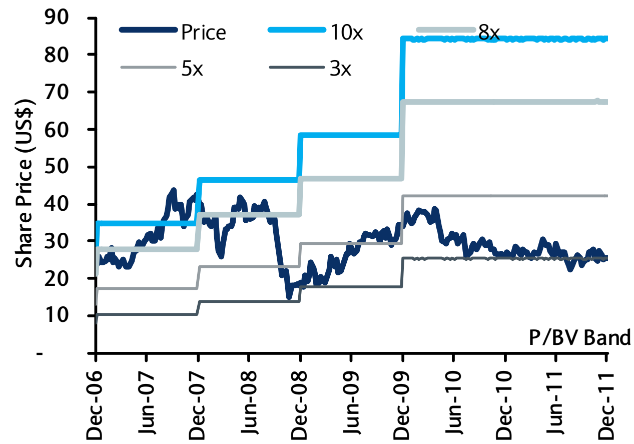
Our PT is based on 18.0x 2012E EPADS of US$1.43 (currently trading at 17.9x 2011E). The 18.0x fair-value forward multiple is derived by subtracting 1 SD (9.5x) for general sector conditions from the historical mean (25.1x) and adding 2.4x for qualitative factors specific to the firm. 18.0x is roughly 0.75 SD less than the historical average.

Figure 119: P/E bands



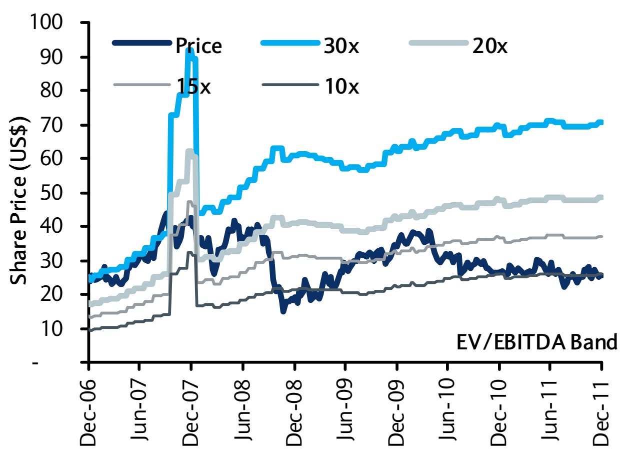
Source: Reuters, Barclays Capital

Figure 120: P/B bands



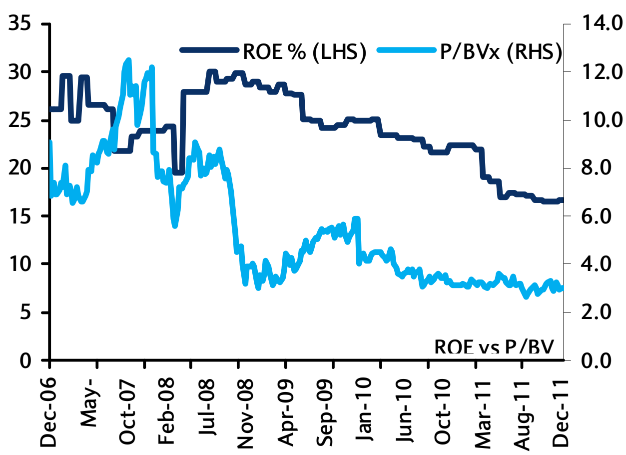
Source: Reuters, Barclays Capital

Figure 121: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 122: ROE vs P/B



Source: Reuters, Barclays Capital

Figure 123: Mindray – income statement (US$ 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net sales	**547,527**	**634,183**	**704,308**	**865,272**	**1,026,026**	**1,121,659**
Growth (y/y)	*79%*		*11%*	*23%*	*19%*	*9%*
COGS	250,573	280,319	303,334	385,186	456,881	501,514
% of revenue	*46%*	*44%*	*43%*	*45%*	*45%*	*45%*
Growth (y/y)	*82%*		*8%*	*27%*	*19%*	*10%*
Gross profit	**296,954**	**353,864**	**400,974**	**480,086**	**569,144**	**620,145**
Margin	*54%*	*56%*	*57%*	*55%*	*55%*	*55%*
Growth (y/y)	*77%*	*19%*	*13%*	*20%*	*19%*	*9%*
Operating expenses	(178,536)	(212,037)	(244,469)	(315,332)	(400,150)	(437,447)
% of revenue	*33%*	*33%*	*35%*	*36%*	*39%*	*39%*
Growth (y/y)	*111%*		*15%*	*29%*	*27%*	*9%*
S&M expenses	(80,088)	(106,142)	(122,960)	(161,857)	(205,205)	(224,332)
% of revenue	*15%*	*17%*	*17%*	*19%*	*20%*	*20%*
Growth (y/y)	*88%*		*16%*	*32%*	*27%*	*9%*
G&A expenses	(39,903)	(47,512)	(61,193)	(75,020)	(102,603)	(112,166)
% of revenue	*7%*	*7%*	*9%*	*9%*	*10%*	*10%*
Growth (y/y)	*220%*		*29%*	*23%*	*37%*	*9%*
R&D expenses	(58,545)	(58,383)	(60,316)	(78,455)	(92,342)	(100,949)
% of revenue	*11%*	*9%*	*9%*	*9%*	*9%*	*9%*
Growth (y/y)			*3%*	*30%*	*18%*	*9%*
Operating cash flow (EBITDA)	**140,257**	**168,673**	**182,730**	**195,660**	**202,057**	**218,324**
Depreciation & amortization	(21,839)	(26,846)	(26,225)	(30,907)	(33,063)	(35,626)
Operating income (EBIT)	**118,418**	**141,827**	**156,505**	**164,754**	**168,994**	**182,698**
Growth (y/y)	*43%*	*20%*	*10%*	*5%*	*3%*	*8%*
Interest expense	(5,163)	(4,759)	(2,900)	0	0	0
% of Total Debt	*3%*	*3%*	*nm*	*2%*	*2%*	*2%*
Other income (expense)	12,380	30,884	19,491	25,958	25,651	28,041
% of revenue	*2%*	*4%*	*3%*	*3%*	*3%*	*3%*
Pretax income	**125,635**	**167,952**	**173,096**	**190,712**	**194,645**	**210,739**
Net income tax	(16,948)	(28,764)	(17,631)	(19,980)	(23,357)	(31,611)
Tax rate	*13%*	*17%*	*10%*	*10%*	*12%*	*15%*
Minority interests	0	0	0	0	0	0
Net income (GAAP)	**108,687**	**139,188**	**155,465**	**170,732**	**171,287**	**179,128**
Margin	*20%*	*22%*	*22%*	*20%*	*17%*	*16%*
Growth (y/y)	*34%*	*28%*	*12%*	*10%*	*0%*	*5%*
Add back: Stock-based comp	0	0	0	0	0	0
Net income (non-GAAP)	**108,687**	**139,188**	**155,465**	**170,732**	**171,287**	**179,128**
Preferred dividends	0	0	0	0	0	0
Income attrib. to ADS holders (GAAP)	**108,687**	**139,188**	**155,465**	**170,732**	**171,287**	**179,128**
Income attrib. to ADS holders (non-GAAP)	**108,687**	**139,188**	**155,465**	**170,732**	**171,287**	**179,128**
Basic weighted avg. shares	107,366	108,567	114,627	116,771	116,771	116,771
Diluted weighted avg. shares	113,365	113,026	117,958	119,602	119,602	119,602
DILUTED EPS (non-GAAP)	**0.96**	**1.23**	**1.32**	**1.43**	**1.43**	**1.50**

Source: Company data, Barclays Capital estimates

Figure 124: Mindray – balance sheet (US$ 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	96,370	204,228	137,502	199,311	286,049	394,898
Restricted cash and short-term inv	156,491	102,257	296,003	296,003	296,003	296,003
Accounts receivable, net	89,735	113,340	143,318	201,502	238,937	261,208
Inventories	57,466	64,518	79,185	104,307	123,685	135,214
Prepaid expenses/other current	27,352	27,322	38,592	47,412	56,220	61,460
Total current assets	**427,414**	**511,665**	**694,600**	**848,535**	**1,000,895**	**1,148,783**
Property, plant, and equipment, net	126,399	153,726	207,636	227,973	253,912	281,799
Intangible assets, net	183,959	204,894	227,998	220,018	212,317	204,886
Other assets	47,999	95,980	20,327	20,327	20,327	20,327
Total assets	**785,771**	**966,265**	**1,150,561**	**1,316,853**	**1,487,452**	**1,655,796**
Liabilities and equity						
Short-term debt	157,007	103,128	0	0	0	0
Accounts payable	36,458	41,399	50,095	56,895	67,465	73,753
Accrued expenses	40,791	47,843	62,877	77,247	91,598	100,136
Other current liabilities	45,565	62,268	61,585	61,585	61,585	61,585
Total current liabilities	**279,821**	**254,638**	**174,557**	**195,727**	**220,648**	**235,474**
Long-term debt	0	66,000	0	0	0	0
Deferred income taxes	736	3,734	8,268	8,268	8,268	8,268
Other long-term liabilities	7,122	1,344	1,135	1,135	1,135	1,135
Total liabilities	**287,679**	**325,716**	**183,960**	**205,130**	**230,051**	**244,877**
Stockholders' equity						
Common stock	14	14	15	15	15	15
Preferred stock	0	0	0	0	0	0
Additional paid-in capital	274,993	298,408	466,613	466,613	466,613	466,613
Retained earnings	183,886	301,476	434,143	579,265	724,943	878,461
Treasury and other equity	0	0	0	0	0	0
Other comprehensive income	39,199	40,651	65,830	65,830	65,830	65,830
Total shareholders' equity	**498,092**	**640,549**	**966,601**	**1,111,723**	**1,257,401**	**1,410,919**
Total liabilities and equity	**785,771**	**966,265**	**1,150,561**	**1,316,853**	**1,487,452**	**1,655,796**

Source: Company data, Barclays Capital estimates

Figure 125: Mindray – cash flow statement (US$ 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net income	**108,687**	**139,188**	**155,465**	**170,732**	**171,287**	**179,128**
Depreciation and amortization	22,399	27,899	27,662	30,907	33,063	35,626
Deferred taxes	0	0	0	0	0	0
Change in working capital	(69,371)	(18,634)	(32,185)	(70,956)	(40,701)	(24,213)
Others	31,201	23,797	(3,246)	0	0	0
Cash flow from operations	**92,916**	**172,250**	**147,696**	**130,683**	**163,649**	**190,541**
Capital expenditure	(44,440)	(40,553)	(35,894)	(43,264)	(51,301)	(56,083)
Investments	58,542	(54,702)	(195,060)	0	0	0
Others	(349,122)	27,119	43,582	0	0	0
Cash flow from investments	**(335,020)**	**(68,136)**	**(187,372)**	**(43,264)**	**(51,301)**	**(56,083)**
Equity issuance, options, and converts	6,166	13,177	160,821	0	0	0
Dividends paid	(19,267)	(21,598)	(22,799)	(25,610)	(25,610)	(25,610)
Debt funding/(repayment)	155,304	12,072	(169,066)	0	0	0
Others	0	0	0	0	0	0
Cash flow from financing	**142,203**	**3,651**	**(31,044)**	**(25,610)**	**(25,610)**	**(25,610)**
Fx effects	7,226	93	3,994	0	0	0
Net cash flow	**(92,675)**	**107,858**	**(66,726)**	**61,809**	**86,738**	**108,849**
Cash at beginning of period	189,045	96,370	204,228	137,502	199,311	286,049
Cash at end of period	**96,370**	**204,228**	**137,502**	**199,311**	**286,049**	**394,898**

Source: Company data, Barclays Capital estimates

Figure 126: Mindray – key metrics (US$ 000 except per share data)

Return statistics		2008	2009	2010	2011E	2012E	2013E
ROE		25%	24%	19%	16%	14%	13%
ROA		18%	16%	15%	14%	12%	11%
ROIC		28%	23%	21%	20%	18%	18%
Operating statistics		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
DSOs		39	58	67	73	78	81
DIOs		27	35	37	39	41	42
DPOs		21	22	24	23	22	23
Cash conversion cycle		46	71	80	89	97	101
Net debt		60,637	(35,100)	(137,502)	(199,311)	(286,049)	(394,898)
Net debt/equity		12%	-5%	-14%	-18%	-23%	-28%
Net debt/total cap		11%	-6%	-17%	-22%	-29%	-39%
Net debt/EBITDA		0.4x	-0.2x	-0.8x	-1.0x	-1.4x	-1.8x
Working capital		251,802	294,422	374,067	487,362	577,906	631,771
Working capital/sales		46%	46%	53%	56%	56%	56%
Current ratio		1.53	2.01	3.98	4.34	4.54	4.88
Interest coverage ratio		27x	35x	63x			
Fixed asset turnover		6.3x	4.5x	3.9x	4.0x	4.3x	4.2x
Total asset turnover		0.9x	0.7x	0.7x	0.7x	0.7x	0.7x
Book value		314,133	435,655	738,603	891,705	1,045,083	1,206,033
BV/share		2.77	3.85	6.26	7.46	8.74	10.08
Net sales		547,527	634,183	704,308	865,272	1,026,026	1,121,659
COGS		250,573	280,319	303,334	385,186	456,881	501,514
EBITDA		140,257	168,673	182,730	195,660	202,057	218,324
Interest expense		(5,163)	(4,759)	(2,900)	0	0	0
Pretax income		125,635	167,952	173,096	190,712	194,645	210,739
Tax rate		13%	17%	10%	10%	12%	15%
Net income		108,687	139,188	155,465	170,732	171,287	179,128
After-tax interest		(4,467)	(3,944)	(2,605)	0	0	0
Shares outstanding		113,365	113,026	117,958	119,602	119,602	119,602
FTE		5,500	5,800	6,400			
Days		365	365	365	365	365	365
Cash flow		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Operating income (EBIT)		118,418	141,827	156,505	164,754	168,994	182,698
	Per share	1.04	1.25	1.33	1.38	1.41	1.53
	Growth	*42%*	*20%*	*6%*	*4%*	*3%*	*8%*
Operating cash flow (EBITDA)		140,257	168,673	182,730	195,660	202,057	218,324
	Per share	1.24	1.49	1.55	1.64	1.69	1.83
	Growth	*47%*	*21%*	*4%*	*6%*	*3%*	*8%*
Net cash from operations		92,916	172,250	147,696	130,683	163,649	190,541
	Per share	0.82	1.52	1.25	1.09	1.37	1.59
	Growth	*-5%*	*86%*	*-18%*	*-13%*	*25%*	*16%*
Capital expenditures		(44,440)	(40,553)	(35,894)	(43,264)	(51,301)	(56,083)
"Free cash flow"		48,476	131,697	111,802	87,419	112,348	134,459
	Per share	0.43	1.17	0.95	0.73	0.94	1.12
Net external financing needs		48,476	131,697	111,802	87,419	112,348	134,459
	Per share	0.43	1.17	0.95	0.73	0.94	1.12
CF to invest. ratio		**2.09**	**4.25**	**4.11**	**3.02**	**3.19**	**3.40**

Source: Company data, Barclays Capital estimates

SHANDONG WEIGAO GROUP (2-EW; PT HK$6.72; -4%): STRONG AND FAIRLY PRICED

We initiate coverage of Shandong Weigao Group with a 2-Equal Weight rating and a 12-month price target of HK$6.72, implying 4% potential downside. Weigao is a strong firm, a national champion in the single-use medical supplies space with smaller subsidiaries in orthopaedics and dialysis. Operating cash flow and earnings growth are steady and already priced into current valuations, in our view. We are neutral at current levels based on valuation, viewing growth opportunities roughly in line with risks.

1066 HK / 1066.HK

Stock Rating
2-EQUAL WEIGHT

Sector View
3-NEGATIVE

Price Target
HKD 6.72

Price (30-Dec-2011)
HKD 6.99

Potential Upside/Downside
-4%

Rating, valuation and risks

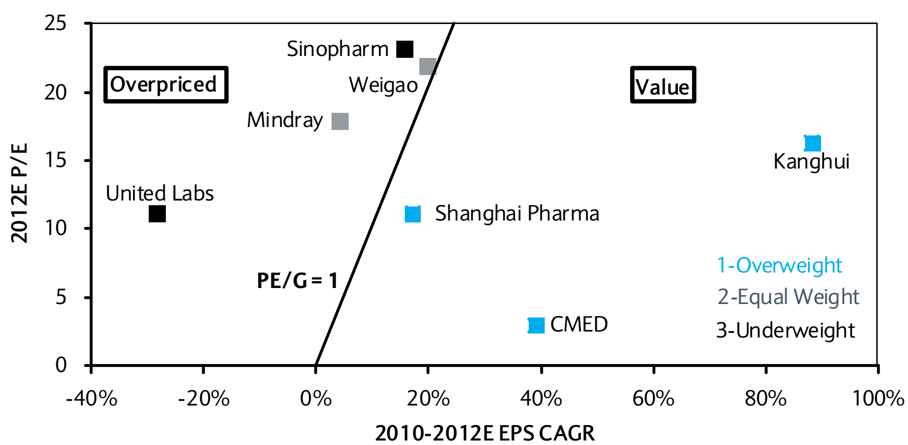
Key drivers of our 2-Equal Weight rating: 1) valuation; and 2) balanced opportunities and risks.

Valuation: Our PT is based on 21.0x 2012E EPS of Rmb0.27 (currently trading at 21.8x 2011E). The 21.0x P/E is derived by subtracting 1 SD (7.6x) for our negative sector view from the historical mean (29.2x) and subtracting 0.6x for qualitative factors specific to the firm. 21.0x is roughly 1.0 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) aggressive government pricing pressure extended to medical supplies; 2) unexpectedly fast growth within the key Class 2 hospital segment; 3) competition for premium domestic space, either from multinationals or from smaller-scale China players; 4) a hard landing in China, with reduced healthcare spend; 5) a global recession, with lower earnings multiples across equity markets.

1) Valuation in-line

Figure 127: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

Shandong Weigao Group Medical Polymer Co Ltd — China Health Care & Pharmaceuticals

Income statement (CNY '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	2,462,557	3,162,290	4,015,473	5,099,371	27.5%
EBITDA	689,664	904,680	1,167,814	1,530,996	30.5%
EBIT	596,187	804,683	1,044,023	1,376,830	32.2%
Pre-tax income	887,884	1,029,969	1,320,792	1,729,472	24.9%
Net income	799,072	913,038	1,172,789	1,521,935	24.0%
EPS (reported) ($)	0.19	0.21	0.27	0.35	23.1%
Diluted shares (m)	4,305,124	4396785	4,396,785	4,396,785	0.7%
Dividend per share ($)	0.03	0.04	0.05	0.06	33.0%

Margin and return data (%)					Average
EBITDA margin	28.0	28.6	29.1	30.0	28.9
EBIT margin	24.2	25.4	26.0	27.0	25.7
Pre-tax margin	36.1	32.6	32.9	33.9	33.9
Net margin	32.4	28.9	29.2	29.8	30.1
ROIC	28.8	26.5	28.4	30.7	28.6
ROA	18.6	17.8	18.9	20.0	18.8
ROE	24.3	22.8	24.1	25.5	24.2

Balance sheet and cash flow (CNY '000)					CAGR
Tangible fixed assets	1,411,384	1,749,517	2,181,437	2,732,366	24.6%
Intangible fixed assets	223,749	221,512	219,296	217,103	-1.0%
Cash and equivalents	628,223	718,186	960,198	1,291,122	27.1%
Total assets	4,649,364	5,593,644	6,828,837	8,424,347	21.9%
Short and long-term debt	114,721	97,074	97,074	97,074	-5.4%
Other long-term liabilities	88,303	75,502	75,502	75,502	-5.1%
Total liabilities	1,022,954	1,216,979	1,488,477	1,833,394	21.5%
Net debt/(funds)	(513,502)	(621,112)	(863,124)	(1,194,048)	NA
Shareholders' equity	3,626,410	4,376,665	5,340,360	6,590,953	22.0%
Change in working capital	170,833	306,749	291,978	370,933	29.5%
Operating cash flow	523,511	706,286	1,004,602	1,305,168	35.6%
Capital expenditure	339,441	435,893	553,496	702,902	27.5%
Free cash flow	184,070	270,394	451,105	602,266	48.5%

Valuation and leverage metrics					Average
P/E (x)	50.5	28.1	21.8	16.8	29.3
EV/EBITDA (x)	179.1	16.2	12.3	9.2	54.2
Price/BV (x)	36.5	3.8	3.0	2.4	11.4
Dividend yield (%)	0.1	1.0	1.3	1.7	1.1
Total debt/capital (%)	3.1	2.2	1.8	1.5	2.1

Selected operating metrics					
SG&A/sales (%)	31.0	29.2	29.0	28.0	29.3
R&D/sales (%)	0.0	0.0	0.0	0.0	0.0
R&D growth (%)	0.0	0.0	0.0	0.0	0.0
SG&A growth (%)	53.0	21.1	25.9	22.6	30.7

Source: Company data, Barclays Capital

Stock Rating	**2-EQUAL WEIGHT**
Sector View	**3-NEGATIVE**
Price (30-Dec-2011)	**HK$6.99**
Price Target	**HK$6.72**
Ticker	**1066 HK**

Investment case

Why a 2-EW? Weigao is a strong firm. We are neutral on at current levels based primarily on valuation. In our view, risks roughly balance opportunities in the medium term. 2010-12E earnings CAGR is 20%. Base case 2012E multiple is 21.0x.

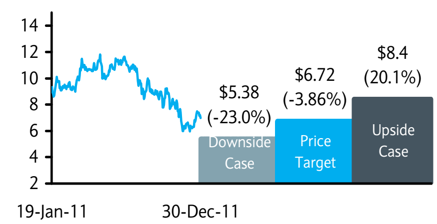
Upside case — HK$8.40

In this case multiples rerate 25% vs our base case to 26.3x, providing 20% potential upside. This scenario is more likely if the Chinese economy outperforms and government healthcare spend increases faster than expected.

Downside case — HK$5.38

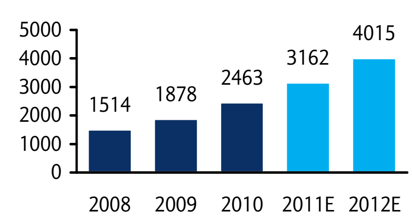
In this case multiples derate 20% vs our base case to 16.8x, providing 23% potential downside. This scenario is more likely if the Chinese economy underperforms and government healthcare spend decreases faster than expected.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

Net revenues, annual (CNY mn)



Note: FY end Dec.

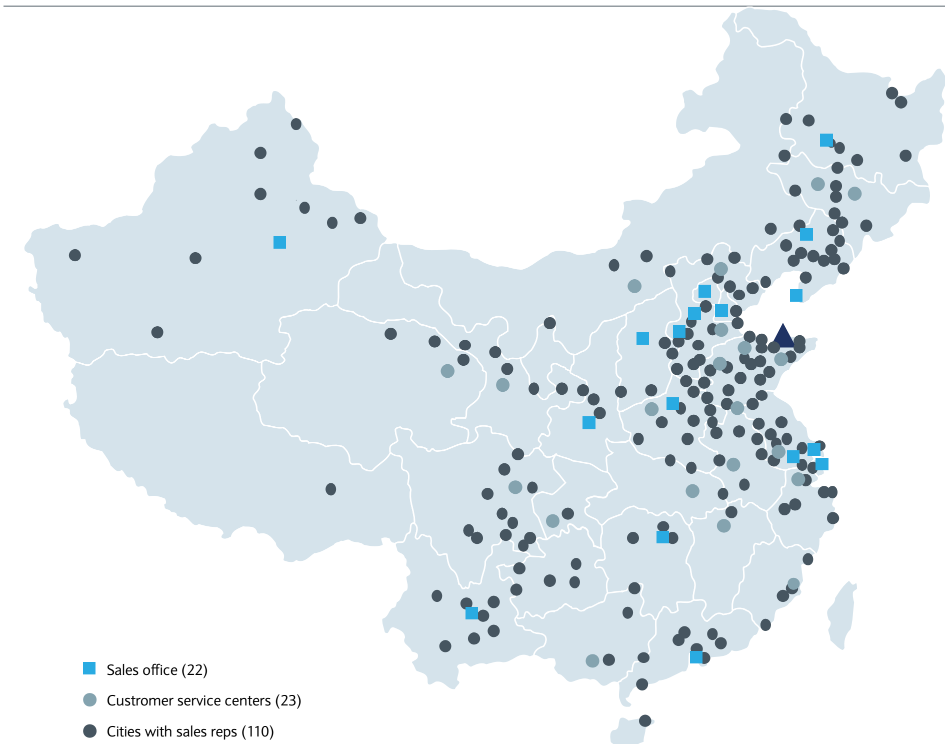
2) Subsector in-line

Weigao produces low- to mid-grade medical supplies (eg, blood bags and IV kits), with more recent forays into orthopaedics (with Medtronic) and dialysis clinics. Notably, Medtronic has optionality to purchase the orthopaedics JV outright in 2013, limiting potential upside for Weigao. While Weigao received the first dialysis clinic registration in China, its first-mover advantage is unlikely to benefit shareholders significantly due to profit-limitation agreements with the government.

In line with our 2-Equal Weight rating, we see current valuation as fair, with relatively few significant risks or opportunities.

- **Balanced market:** Medical supplies provide 20-35% net margin and shelter from most government price cuts. The government is focused on cutting prices in the much larger generic drug space.
- **National champion:** Weigao is a classic national champion, providing China an alternative to foreign suppliers and increasing government control. As an example of this dual profit/service role, the company has agreed to launch a chain of dialysis clinics, albeit at no profit for the first few years. With Chinese dialysis treatment rates much lower than most developed markets, the government identified a need (rising levels of end-stage renal disease, partly stemming from diabetes rates) and Weigao accepted the role. This illustrates the downside of becoming a national champion serving the domestic healthcare market. In our view, the government generally supports growth and margins to a certain point while requiring clear service obligations as well.
- **Little competition to core business:** The production and distribution scale required for profitable operations also provide meaningful barriers to entry. Moreover, as a national champion, Weigao receives implicit government support.

Figure 128: Weigao has built a nationwide sales and service network



Source: Company data, Barclays Capital

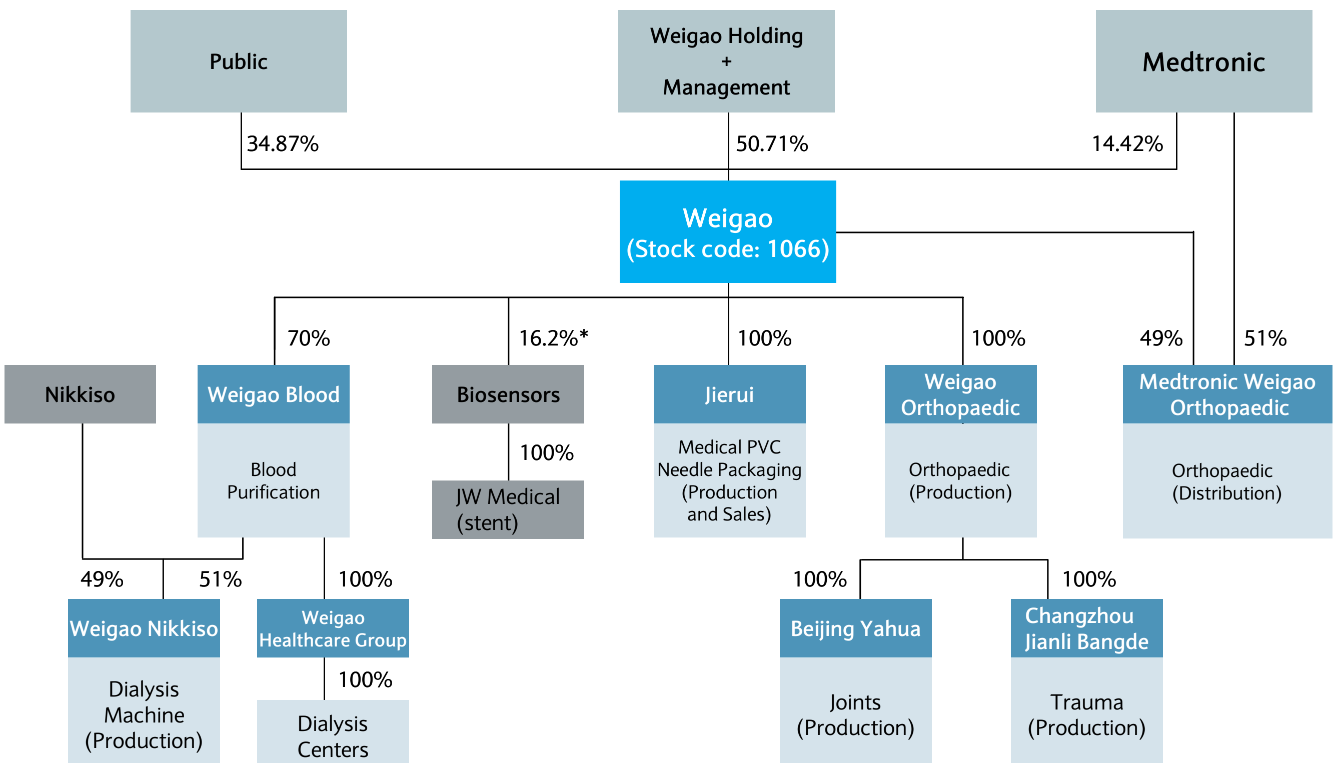
- **Primary growth in mid-tier hospitals and dialysis:** Weigao currently covers 81% of the Class 3 hospital market, dominating categories formerly served by multinational brands like Becton-Dickinson. Class 2 hospitals and dialysis will provide key growth markets through 2015. The production and distribution scale required for profitable operations provide meaningful barriers to entry.

Figure 129: Weigao has nearly saturated the major Class 3 hospital market

Hospital class	Total	Penetration
Class 3 (500+ beds)	1,186	81%
Class 2 (100-500 beds)	6,608	25%
Class 1 (20-100 beds)	4,687	6%

Source: Company reports

Figure 130: Weigao management is the primary owner, with 50.7%



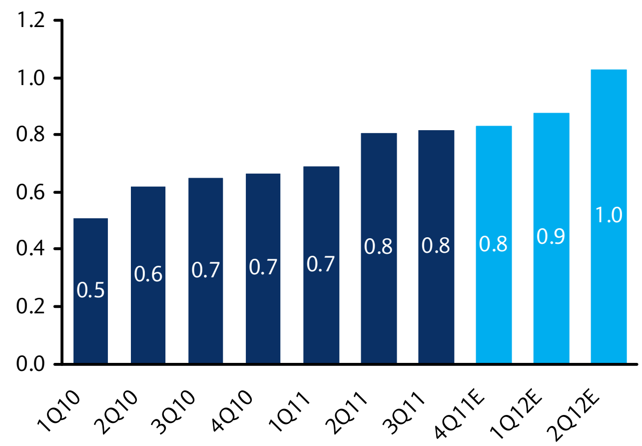
Source: Company data, Barclays Capital

3) Fundamentals

Strong fundamentals, with little outperformance: As detailed below, Weigao provides strong fundamentals, including revenue growth, steady margins, negative net debt. However, these advantages are priced into current valuations, in our view.

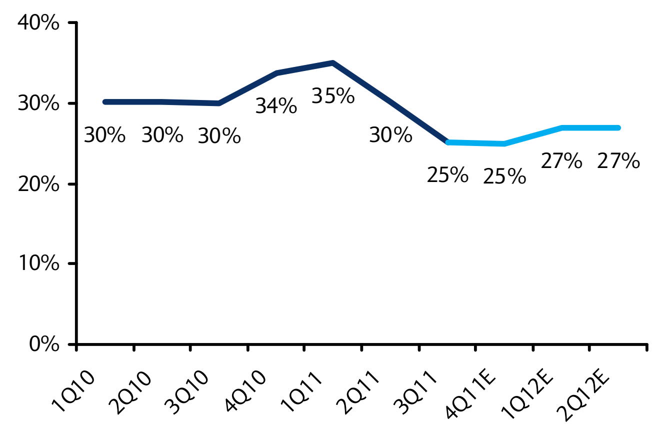
Revenues: Weigao continues to generate double-digit revenue growth, though growth rates have fallen slightly.

Figure 131: Quarterly revenues (Rmb bn)



Source: Company data, Barclays Capital estimates

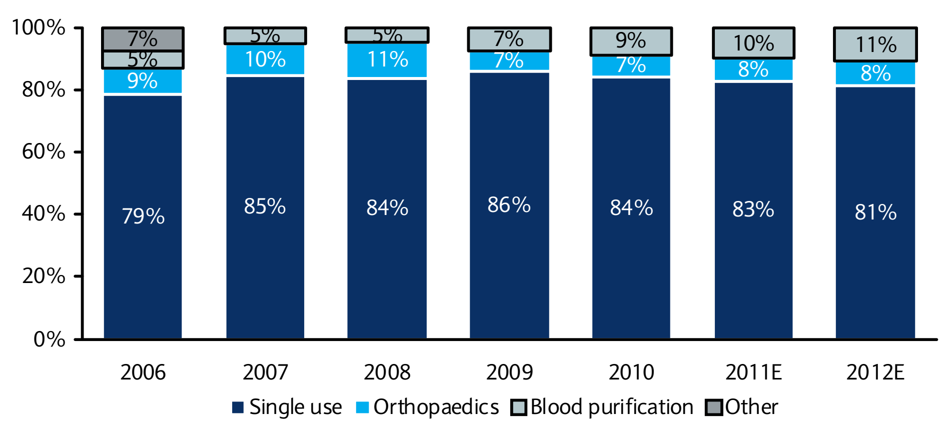
Figure 132: Quarterly revenue (y/y)



Source: Company data, Barclays Capital estimates

Product segments: Weigao generates 83% of revenues from low- to mid-market medical supplies. Quality has remained consistently strong, which provides a competitive advantage in the Chinese market. Blood purification (dialysis) provides a growing portion of revenues (11% by 2012 on our forecast).

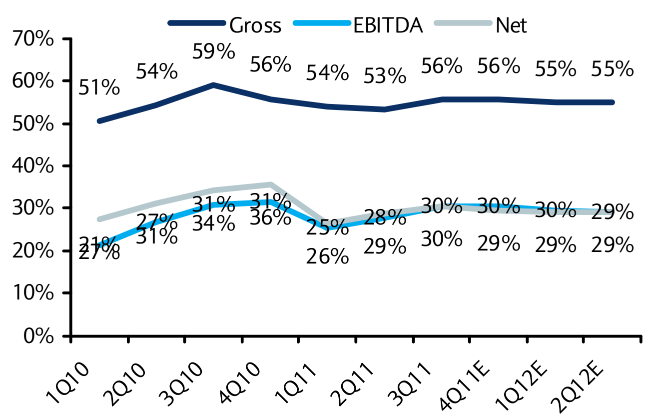
Figure 133: Segment breakdown



Source: Company data, Barclays Capital estimates

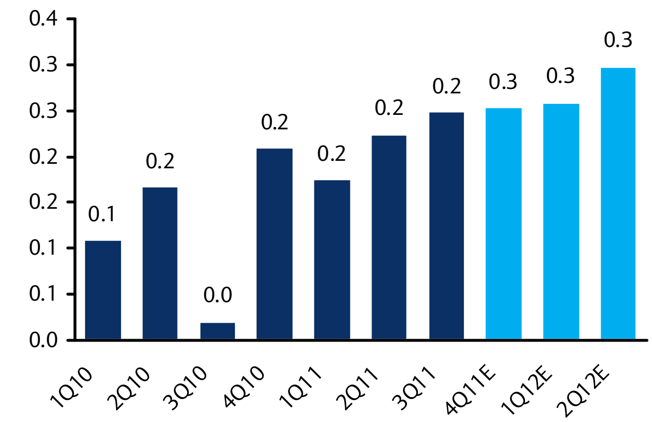
Margins and cash flow: Since 2010, generic pharmaceutical and distributor margins have been repeatedly compressed. By contrast, device players such as Weigao have maintained firmer margins, with 4Q11 estimates of 55% gross margin and 29% net margin.

Figure 134: Quarterly margins



Source: Company data, Barclays Capital estimates

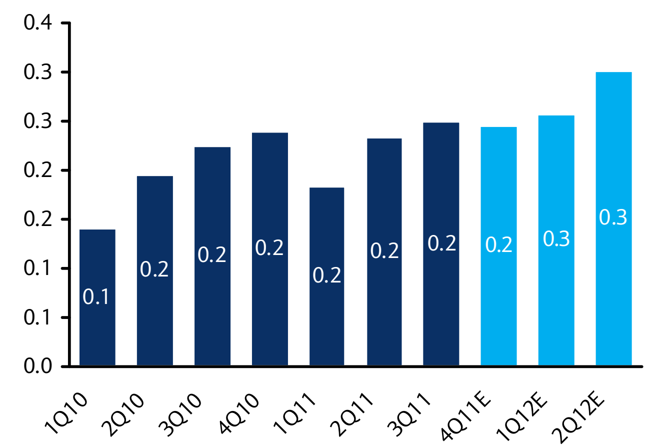
Figure 135: Quarterly EBITDA (Rmb bn)



Source: Company data, Barclays Capital estimates

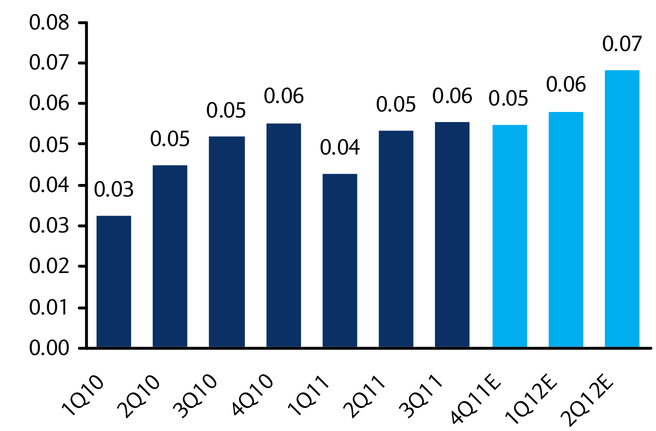
Income: Net income and EPS growth declined from 57% in 2008 to an estimated 14% in 2011E. We expect 28% earnings growth in 2012.

Figure 136: Quarterly net income (Rmb bn)



Source: Company data, Barclays Capital estimates

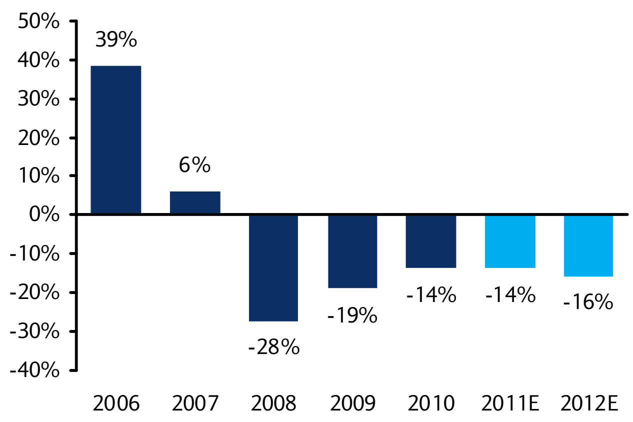
Figure 137: Quarterly diluted EPS, adj. (Rmb)



Source: Company data, Barclays Capital estimates

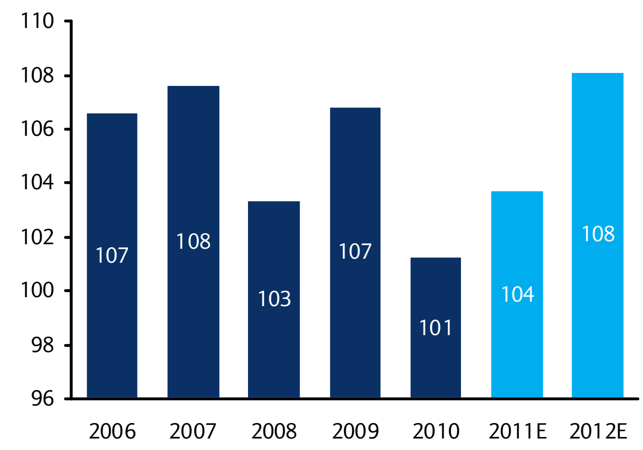
Debt and cash conversion: Net debt levels remain negative. With 29% net margins, Weigao has avoided taking on net debt while maintaining a dividend payout ratio of 38-40% until 2010 (18%).

Figure 138: Net debt/equity



Source: Company data, Barclays Capital estimates

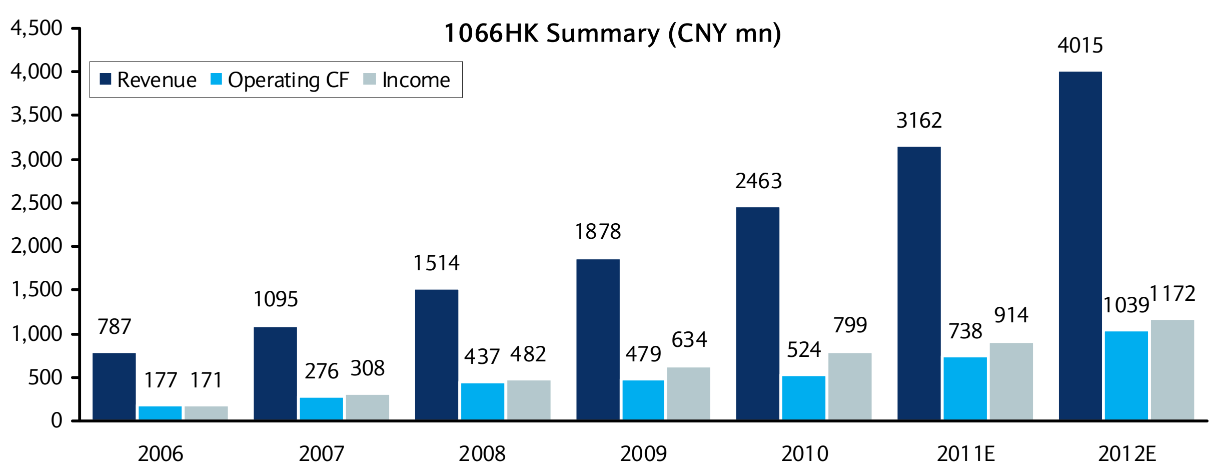
Figure 139: Cash conversion (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 140: Annual revenue, operating cash flow and income

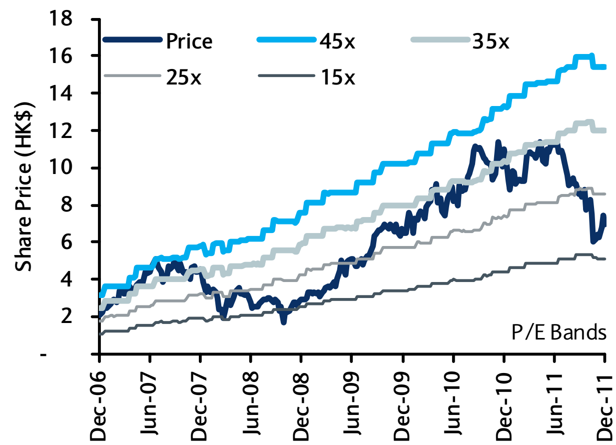


Source: Company data, Barclays Capital estimates

Valuation

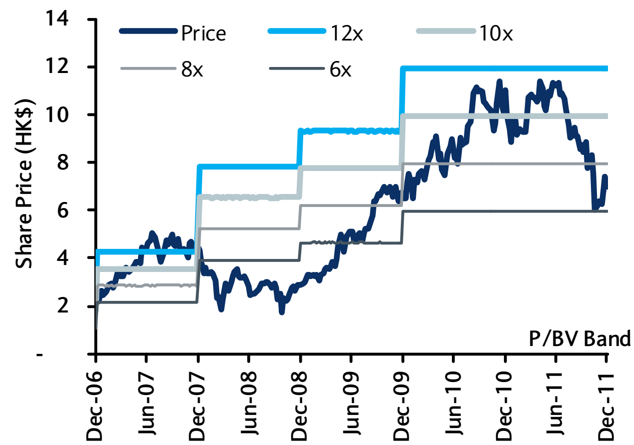
Our PT is based on 21.0x 2012E EPS of Rmb0.27 (currently trading at 21.8x 2011E). The 21.0x P/E is derived by subtracting 1 SD (7.6x) for our negative sector view from the historical mean (29.2x) and subtracting 0.6x for qualitative factors specific to the firm. 21.0x is roughly 1.0 SD less than the historical average.

Figure 141: P/E bands



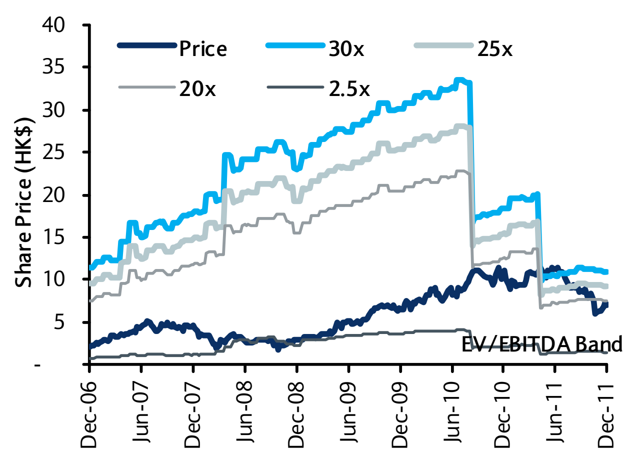
Source: Reuters, Barclays Capital

Figure 142: P/B bands



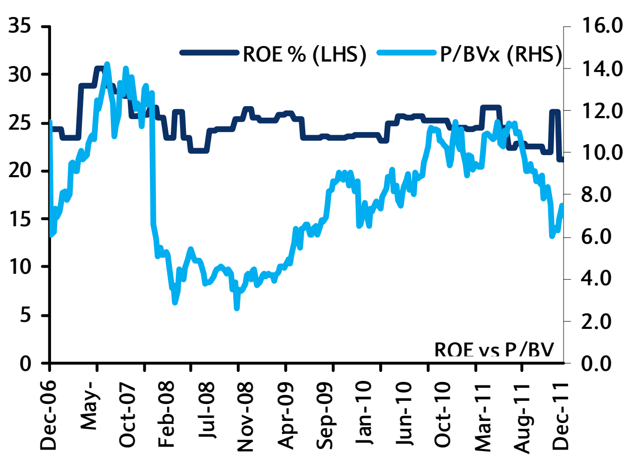
Source: Reuters, Barclays Capital

Figure 143: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 144: ROE vs P/B



Source: Reuters, Barclays Capital

Figure 145: Shandong Weigao – income statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net sales	**1,514,367**	**1,878,495**	**2,462,557**	**3,162,290**	**4,015,473**	**5,099,371**
Growth (y/y)	*38%*	*24%*	*31%*	*28%*	*27%*	*27%*
COGS	756,134	877,236	1,102,858	1,432,641	1,806,963	2,294,717
% of revenue	*50%*	*47%*	*45%*	*45%*	*45%*	*45%*
Growth (y/y)	*27%*	*16%*	*26%*	*30%*	*26%*	*27%*
Gross profit	**758,233**	**1,001,259**	**1,359,699**	**1,729,649**	**2,208,510**	**2,804,654**
Margin	*50%*	*53%*	*55%*	*55%*	*55%*	*55%*
Growth (y/y)	*52%*	*32%*	*36%*	*27%*	*28%*	*27%*
Operating expenses	(342,884)	(499,146)	(763,512)	(924,966)	(1,164,487)	(1,427,824)
% of revenue	*23%*	*27%*	*31%*	*29%*	*29%*	*28%*
Growth (y/y)	*43%*	*46%*	*53%*	*21%*	*26%*	*23%*
S&M expenses	(208,747)	(321,319)	(501,324)	(300,088)	(361,393)	(458,943)
% of revenue	*14%*	*17%*	*20%*	*9%*	*9%*	*9%*
Growth (y/y)	*37%*	*54%*	*56%*	*-40%*	*20%*	*27%*
G&A expenses	(134,137)	(177,827)	(262,188)	(624,878)	(803,095)	(968,881)
% of revenue	*9%*	*9%*	*11%*	*20%*	*20%*	*19%*
Growth (y/y)	*54%*	*33%*	*47%*	*138%*	*29%*	*21%*
R&D expenses	0	0	0	0	0	0
% of revenue	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*
Growth (y/y)						
Operating cash flow (EBITDA)	**475,600**	**576,872**	**689,664**	**904,680**	**1,167,814**	**1,530,996**
Depreciation & amortization	(60,251)	(74,759)	(93,477)	(99,997)	(123,791)	(154,166)
Operating income (EBIT)	**415,349**	**502,113**	**596,187**	**804,683**	**1,044,023**	**1,376,830**
Growth (y/y)	*59%*	*21%*	*19%*	*35%*	*30%*	*32%*
Interest expense	(30,656)	(4,003)	(9,658)	(4,799)	(4,314)	(4,314)
% of Debt	*22%*	*3%*	*8%*	*10%*	*10%*	*10%*
Other income (expense)	139,389	206,850	301,355	230,085	281,083	356,956
% of revenue	*9%*	*11%*	*12%*	*7%*	*7%*	*7%*
Pretax income	**524,082**	**704,960**	**887,884**	**1,029,969**	**1,320,792**	**1,729,472**
Net income tax	(38,977)	(71,782)	(85,532)	(113,799)	(148,003)	(207,537)
Tax rate	*7%*	*10%*	*10%*	*11%*	*11%*	*12%*
Minority interests	(2,711)	686	(3,280)	(3,132)	0	0
Net income (GAAP)	**482,394**	**633,864**	**799,072**	**913,038**	**1,172,789**	**1,521,935**
Margin	*32%*	*34%*	*32%*	*29%*	*29%*	*30%*
Growth (y/y)	*57%*	*31%*	*26%*	*14%*	*28%*	*30%*
Add back: Stock-based comp	0	0	0	0	0	0
Net income (non-GAAP)	**482,394**	**633,864**	**799,072**	**913,038**	**1,172,789**	**1,521,935**
Preferred Dividends						
Income attrib. to ADS holders (GAAP)	**482,394**	**633,864**	**799,072**	**913,038**	**1,172,789**	**1,521,935**
Income attrib. to ADS holders (non-GAAP)	**482,394**	**633,864**	**799,072**	**913,038**	**1,172,789**	**1,521,935**
Basic weighted avg. shares	3,993,740	4,305,124	4,305,124	4,396,785	4,396,785	4,396,785
Diluted weighted avg. shares	3,993,740	4,305,124	4,305,124	4,396,785	4,396,785	4,396,785
DILUTED EPS (non-GAAP)	**0.12**	**0.15**	**0.19**	**0.21**	**0.27**	**0.35**

Source: Company data, Barclays Capital estimates

Figure 146: Shandong Weigao – balance sheet (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	830,419	723,167	628,223	718,186	960,198	1,291,122
Restricted cash and short-term inv	0	0	0	0	0	0
Accounts receivable, net	604,307	780,603	960,062	1,256,252	1,595,188	2,025,778
Inventories	292,118	319,002	380,222	537,156	682,080	866,195
Prepaid expenses/other current	161,479	171,847	229,798	295,095	374,711	475,857
Total current assets	**1,888,323**	**1,994,619**	**2,198,305**	**2,806,689**	**3,612,178**	**4,658,952**
Property, plant, and equipment, net	922,475	1,166,751	1,411,384	1,749,517	2,181,437	2,732,366
Intangible assets, net	229,977	226,863	223,749	221,512	219,296	217,103
Other assets	299,891	563,562	815,926	815,926	815,926	815,926
Total assets	**3,340,666**	**3,951,795**	**4,649,364**	**5,593,644**	**6,828,837**	**8,424,347**
Liabilities and equity						
Short-term debt	1,716	37,415	26,418	21,572	21,572	21,572
Accounts payable	413,968	482,058	591,215	745,087	946,111	1,201,496
Accrued expenses	152,397	184,772	203,412	261,211	331,686	421,218
Other current liabilities	112,244	161,098	85,779	85,779	85,779	85,779
Total current liabilities	**680,325**	**865,343**	**906,824**	**1,113,650**	**1,385,148**	**1,730,065**
Long-term debt	136,692	113,803	88,303	75,502	75,502	75,502
Deferred income taxes	0	0	0	0	0	0
Other long-term liabilities	46,917	32,966	27,827	27,827	27,827	27,827
Total liabilities	**863,934**	**1,012,112**	**1,022,954**	**1,216,979**	**1,488,477**	**1,833,394**
Stockholders' equity						
Common stock	107,628	107,628	215,256	215,256	215,256	215,256
Preferred stock	0	0	0	0	0	0
Additional paid-in capital	0	0	0	0	0	0
Retained earnings	865,570	1,328,305	1,961,711	2,711,966	3,675,661	4,926,254
Treasury and other equity	1,503,534	1,503,750	1,449,443	1,449,443	1,449,443	1,449,443
Other comprehensive income	0	0	0	0	0	0
Total shareholders' equity	**2,476,732**	**2,939,683**	**3,626,410**	**4,376,665**	**5,340,360**	**6,590,953**
Total liabilities and equity	**3,340,666**	**3,951,795**	**4,649,364**	**5,593,644**	**6,828,837**	**8,424,347**

Source: Company data, Barclays Capital estimates

Figure 147: Shandong Weigao – cash flow statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net income	**482,394**	**633,864**	**799,072**	**913,038**	**1,172,789**	**1,521,935**
Depreciation and amortization	60,251	74,759	93,477	99,997	123,791	154,166
Deferred taxes	0	0	0	0	0	0
Change in working capital	(78,344)	(113,083)	(170,833)	(306,749)	(291,978)	(370,933)
Others	(26,819)	(116,466)	(198,205)	0	0	0
Cash flow from operations	**437,482**	**479,074**	**523,511**	**706,286**	**1,004,602**	**1,305,168**
Capital expenditure	(202,413)	(318,396)	(339,441)	(435,893)	(553,496)	(702,902)
Investments	0	0	0	0	0	0
Others	(91,648)	(94,703)	(61,601)	0	0	0
Cash flow from investments	**(294,061)**	**(413,099)**	**(401,042)**	**(435,893)**	**(553,496)**	**(702,902)**
Equity issuance, options, and converts	782,670	0	0	0	0	0
Dividends paid	(115,485)	(171,129)	(113,010)	(162,783)	(209,093)	(271,342)
Debt funding/(repayment)	(200,019)	12,810	(36,497)	(17,647)	0	0
Others	(35,131)	(15,124)	(68,571)	0	0	0
Cash flow from financing	**432,035**	**(173,443)**	**(218,078)**	**(180,430)**	**(209,093)**	**(271,342)**
Fx effects	(609)	216	665	0	0	0
Net cash flow	**574,847**	**(107,252)**	**(94,944)**	**89,963**	**242,012**	**330,924**
Cash at beginning of period	255,572	830,419	723,167	628,223	718,186	960,198
Cash at end of period	**830,419**	**723,167**	**628,223**	**718,186**	**960,198**	**1,291,122**

Source: Company data, Barclays Capital estimates

Figure 148: Shandong Weigao – key metrics (Rmb 000 except per share data)

Return statistics		2008	2009	2010	2011E	2012E	2013E
ROE		25%	23%	24%	23%	24%	26%
ROA		18%	17%	19%	18%	19%	20%
ROIC		28%	30%	29%	26%	28%	31%
Operating statistics		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
DSOs		121	135	129	128	130	130
DIOs		65	59	52	53	55	55
DPOs		83	87	80	77	77	77
Cash conversion cycle		103	107	101	104	108	108
Net debt		(692,011)	(571,949)	(513,502)	(621,112)	(863,124)	(1,194,048)
Net debt/equity		-28%	-19%	-14%	-14.2%	-16.2%	-18.1%
Net debt/total cap		-39%	-24%	-16%	-16.5%	-19.3%	-22.1%
Net debt/EBITDA		-1.5x	-1.0x	-0.7x	-0.7x	-0.7x	-0.8x
Working capital		1,624,269	1,938,282	2,364,709	3,094,802	3,929,777	4,990,543
Working capital/sales		107%	103%	96%	98%	98%	98%
Current ratio		2.78	2.31	2.42	2.52	2.61	2.69
Interest coverage ratio		16x	144x	71x	189x	271x	355x
Fixed asset turnover		1.7x	1.8x	1.9x	2.0x	2.0x	2.1x
Total asset turnover		0.6x	0.5x	0.6x	0.6x	0.6x	0.7x
Book value		2,246,755	2,712,820	3,402,661	4,155,153	5,121,064	6,373,850
BV/share		0.56	0.63	0.79	0.95	1.16	1.45
Net sales		1,514,367	1,878,495	2,462,557	3,162,290	4,015,473	5,099,371
COGS		756,134	877,236	1,102,858	1,432,641	1,806,963	2,294,717
EBITDA		475,600	576,872	689,664	904,680	1,167,814	1,530,996
Interest expense		(30,656)	(4,003)	(9,658)	(4,799)	(4,314)	(4,314)
Pretax income		524,082	704,960	887,884	1,029,969	1,320,792	1,729,472
Tax rate		7%	10%	10%	11%	11%	12%
Net income		482,394	633,864	799,072	913,038	1,172,789	1,521,935
After-tax interest		(28,376)	(3,595)	(8,728)	(4,269)	(3,831)	(3,797)
Shares outstanding		3,993,740	4,305,124	4,305,124	4,396,785	4,396,785	4,396,785
FTE		6,723	6,862	7,233			
Days		365	365	365	365	365	365
Cash flow		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Operating income (EBIT)		415,349	502,113	596,187	804,683	1,044,023	1,376,830
	Per share	0.10	0.12	0.14	0.18	0.24	0.31
	Growth	*58%*	*12%*	*19%*	*32%*	*30%*	*32%*
Operating cash flow (EBITDA)		475,600	576,872	689,664	904,680	1,167,814	1,530,996
	Per share	0.12	0.13	0.16	0.21	0.27	0.35
	Growth	*52%*	*13%*	*20%*	*28%*	*29%*	*31%*
Net cash from operations		437,482	479,074	523,511	706,286	1,004,602	1,305,168
	Per share	0.11	0.11	0.12	0.16	0.23	0.30
	Growth	*56%*	*2%*	*9%*	*32%*	*42%*	*30%*
Capital expenditures		(202,413)	(318,396)	(339,441)	(435,893)	(553,496)	(702,902)
"Free cash flow"		235,069	160,678	184,070	270,394	451,105	602,266
	Per share	0.06	0.04	0.04	0.06	0.10	0.14
Net external financing needs		235,069	160,678	184,070	270,394	451,105	602,266
	Per share	0.06	0.04	0.04	0.06	0.10	0.14
CF to invest. ratio		**2.16**	**1.50**	**1.54**	**1.62**	**1.82**	**1.86**

Source: Company data, Barclays Capital estimates

SINOPHARM GROUP (3-UW; PT HK$16.15; -13%): CASHLESS EARNINGS

We initiate coverage of Sinopharm Group with a 3-Underweight rating and 12-month price target of HK$16.15, implying 13% potential downside. Sinopharm is a national champion and the largest drug distributor in China. At current levels, we favour Shanghai Pharma in the distribution space. While both firms are expected to benefit from consolidation trends, Shanghai Pharma has a more diversified business in drug manufacturing and retail. Compared with Sinopharm, we believe Shanghai Pharma provides better cash flow, margins and debt levels with a less demanding valuation (currently 13x vs 26x for Sinopharm).

1099 HK / 1099.HK

Stock Rating
3-UNDERWEIGHT

Sector View
3-NEGATIVE

Price Target
HKD 16.15

Price (30-Dec-2011)
HKD 18.66

Potential Upside/Downside
-13%

Rating, valuation and risks

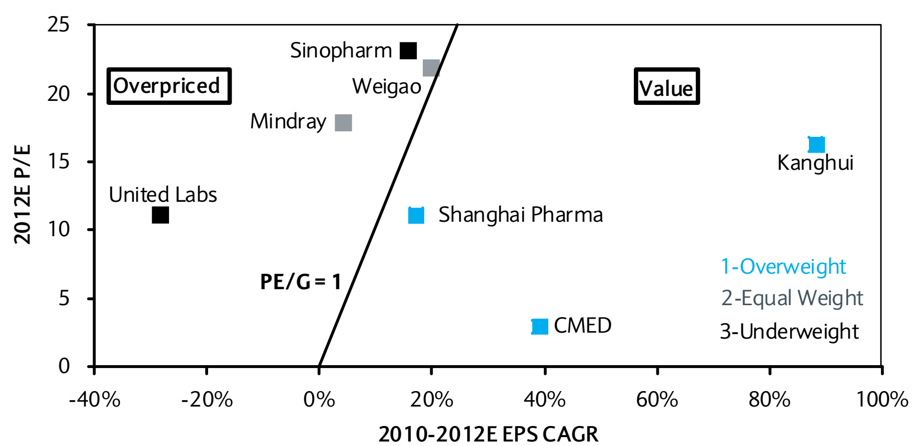
Key drivers of our 3-Underweight rating: 1) demanding valuation (26x vs 13x for Shanghai Pharma); 2) negative operating cash flow; 3) maturation of previous M&A-driven growth strategy; 4) less attractive margins and cash flow than Shanghai Pharma, which also provides greater growth opportunity in 2012 given a smaller starting base.

Valuation: Our PT is based on 20.0x 2012E EPS of Rmb0.67 (currently trading at 23.1x 2011E). The 20.0x P/E is derived by subtracting 1 SD (7.0x) for our negative sector view from the historical mean (37.9x) and subtracting 10.9x for qualitative factors specific to the firm. 20.0x is roughly 2.5 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) strong government support of distributor margins; 2) unexpected policy and pricing support for generic drugs; 3) significant improvement in credit or payment terms; 4) outperformance of the global economy, with renewed interested in Chinese equities.

1) Demanding valuation given negative operating cash flow

Figure 149: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

Sinopharm Group — China Health Care & Pharmaceuticals

Income statement (CNY '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	69,233,669	97,219,215	112,552,015	130,398,227	23.5%
EBITDA	2,562,244	3,650,299	4,017,992	4,653,867	22.0%
EBIT	2,266,709	3,387,258	3,714,216	4,303,142	23.8%
Pre-tax income	2,344,391	2,986,640	3,418,935	3,889,977	18.4%
Net income	1,140,897	1,419,308	1,745,963	2,101,895	22.6%
EPS (reported) ($)	0.50	0.59	0.67	0.81	17.2%
Diluted shares (m)	2,264,568	2,402,625	2,594,835	2,594,835	4.6%
Dividend per share ($)	0.06	0.06	0.07	0.08	13.7%

Margin and return data (%)					Average
EBITDA margin	3.7	3.8	3.6	3.6	3.6
EBIT margin	3.3	3.5	3.3	3.3	3.3
Pre-tax margin	3.4	3.1	3.0	3.0	3.1
Net margin	1.6	1.5	1.6	1.6	1.6
ROIC	12.8	7.4	7.1	6.7	8.5
ROA	3.1	2.9	3.0	3.1	3.0
ROE	9.7	11.5	12.7	13.6	11.9

Balance sheet and cash flow (CNY '000)					CAGR
Tangible fixed assets	3,330,750	4,112,100	5,003,877	6,025,066	21.8%
Intangible fixed assets	2,406,632	2,334,433	2,264,400	2,196,468	-3.0%
Cash and equivalents	7,474,698	6,614,367	5,249,869	5,898,845	-7.6%
Total assets	42,014,480	54,722,327	62,994,774	72,377,099	19.9%
Short and long-term debt	3,435,082	7,131,725	9,131,725	11,131,725	48.0%
Other long-term liabilities	4,192,715	4,192,715	4,192,715	4,192,715	0.0%
Total liabilities	30,303,342	41,747,025	48,464,360	55,954,979	22.7%
Net debt/(funds)	(4,039,616)	517,357	3,881,856	5,232,880	NA
Shareholders' equity	11,711,138	12,975,302	14,530,415	16,422,120	11.9%
Change in working capital	(2,375,299)	5,111,294	4,096,895	2,288,347	NA
Operating cash flow	1,202,537	(3,428,945)	(2,047,156)	164,274	-48.5%
Capital expenditure	1,908,608	972,884	1,126,492	1,305,108	-11.9%
Free cash flow	(226,795)	(4,401,137)	(3,172,676)	(1,139,709)	NA

Valuation and leverage metrics					Average
P/E (x)	43.3	26.3	23.1	19.2	28.0
EV/EBITDA (x)	25.5	12.1	11.8	10.5	15.0
Price/BV (x)	7.5	4.4	4.1	3.6	4.9
Dividend yield (%)	0.2	0.3	0.4	0.4	0.5
Total debt/capital (%)	22.7	35.5	38.6	40.4	34.3

Selected operating metrics					
SG&A/sales (%)	5.2	4.6	4.7	4.7	4.8
R&D/sales (%)	0.0	0.0	0.0	0.0	0.0
R&D growth (%)	0.0	0.0	0.0	0.0	0.0
SG&A growth (%)	38.9	25.2	18.3	15.9	24.6

Source: Company data, Barclays Capital

Stock Rating	3-UNDERWEIGHT
Sector View	3-NEGATIVE
Price (30-Dec-2011)	HKD 18.66
Price Target	HKD 16.15
Ticker	1099 HK

Investment case

Why a 3-UW? 1099HK is a national champion but faces growth challenges and negative operating cash flow. We are negative at current levels based on valuation and negative policy headwinds. 2010-2012E earnings CAGR is 16%. Base case 2012E multiple of 20.0x.

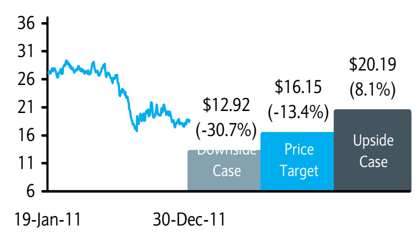
Upside case — HKD 20.19

This case assumes multiples will rerate 25% vs our base case to 25.0x, providing 8% potential upside. This scenario is more likely if the Chinese economy outperforms and government healthcare spend increases faster than expected.

Downside case — HKD 12.92

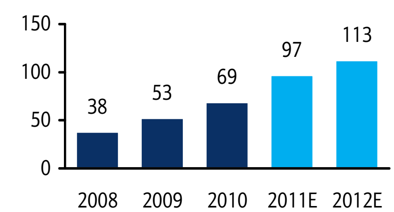
This case assumes multiples will derate 20% vs our base case to 16.0x, providing 31% potential downside.This scenario is more likely if the Chinese economy underperforms and government healthcare spend decreases faster than expected.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

Net revenue, annual (CNY bn)



Note: FY end Dec.

More demanding valuation than Shanghai Pharma, despite similar businesses

Figure 150: Shanghai Pharma provides several advantages over Sinopharm, at a cheaper valuation

2011E	Sinopharm	Shanghai Pharma
Revenue growth	40%	48%
Gross margin	8%	14%
Operating cash flow	-4%	6%
Income growth	24%	46%
Net margin	1.5%	3.6%
Net debt/equity	4%	-29%
Cash conversion cycle (days)	30	26
China market penetration	~50%	~30%
Valuation	**26x**	**13x**

Source: Company data, Barclays Capital estimates

2) Opportunities and risks roughly in-line

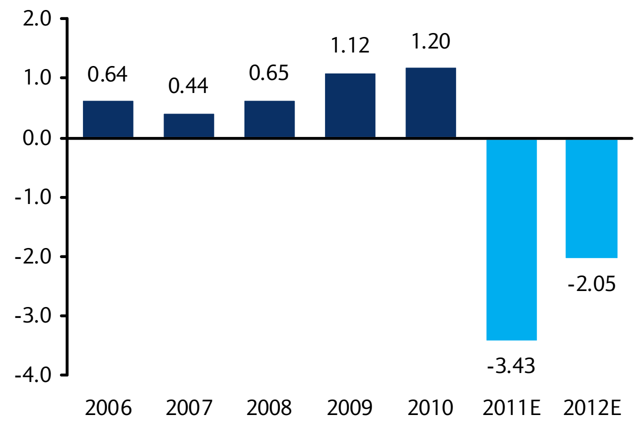
Sinopharm is the largest China healthcare name by market cap. In our view, challenges outweigh opportunities at current levels:

- **Opportunities: As a national champion Sinopharm benefits from government support, credit access and the general consolidation trend.** The firm has less exposure to direct pricing pressures related to the Essential Drug List and provincial tendering systems. However, Sinopharm generates revenue as a percentage of end-sales price, which will come under further pressure this year and hit margins further.

- **Risks: Sinopharm will continue to be hit by negative policy headwinds in 2012. With limited upside and more invested in the previous system it may be difficult to adapt quickly to the evolving landscape.** Because it is already the largest and most well-known player in this space, upside is reduced and more dependent on M&A. M&A is becoming more difficult and expensive, especially to maintain the 30%+ growth rates of the recent past. Shanghai Pharma will also be a key player but provides more growth opportunity due to smaller size (only currently accessing 30% of the market vs 50% for Sinopharm) and a more diversified approach combining distribution with retail and manufacturing subsidiaries.

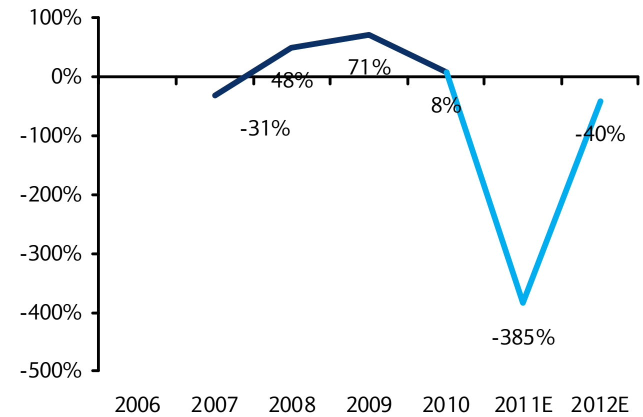
- **The largest risk is cash flow:** We forecast cash flow to turn negative in 2011 and remain negative through 2015. As a national champion Sinopharm enjoys favourable credit access, so this operating cash flow shortfall is unlikely to threaten business viability long term. For investors, however, we forecast a negative shock to share prices as the magnitude of cash flow issues becomes apparent in 2Q12.

Figure 151: Operating cash flow (Rmb bn)



Source: Company reports and Barclays Capital estimates

Figure 152: Operating cash flow (y/y)

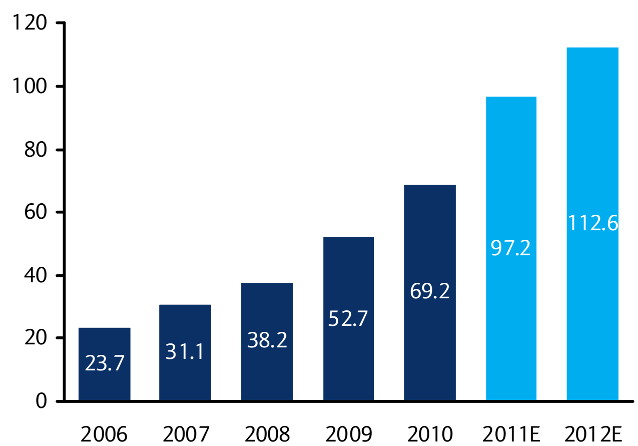


Source: Company reports and Barclays Capital estimates

3) Challenging near-term fundamentals

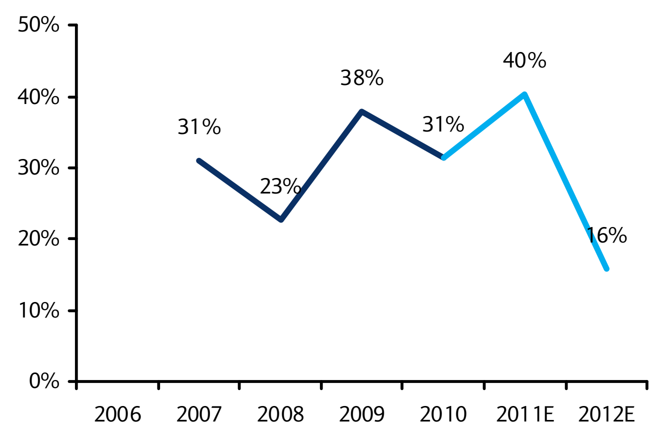
Revenues: Sinopharm has grown revenues strongly via M&A, which is becoming more difficult and expensive. We expect a significant decline in revenue growth in 2012, to 16%.

Figure 153: Annual revenues



Source: Company data, Barclays Capital estimates

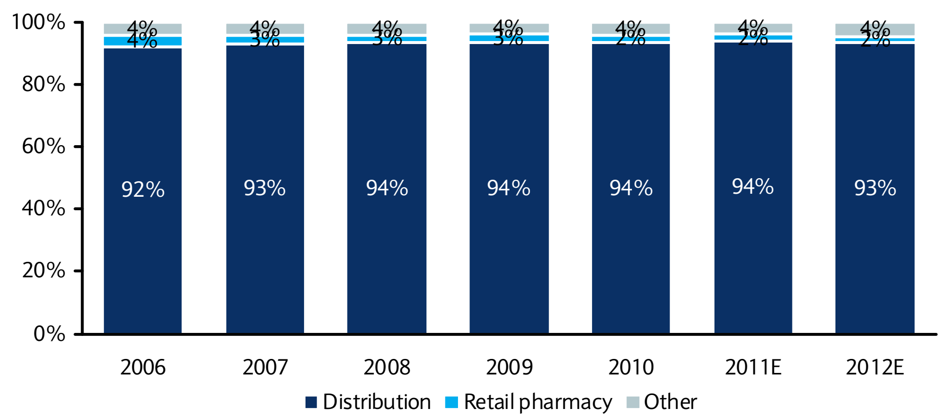
Figure 154: Annual revenues (y/y)



Source: Company data, Barclays Capital estimates

Product segments: Although Sinopharm has a small retail pharmacy business, the vast majority of revenues flow from drug distribution.

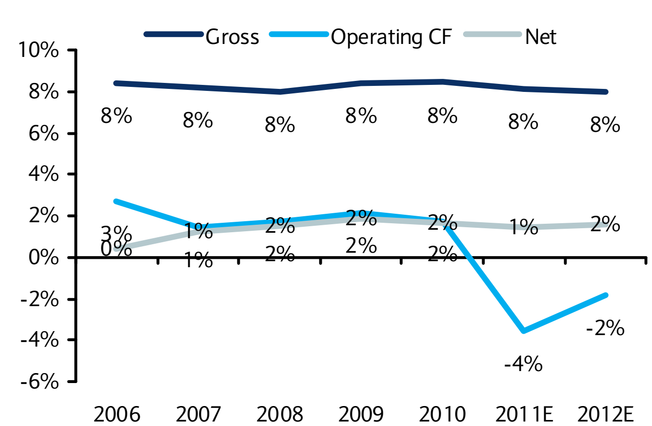
Figure 155: 94% of Sinopharm revenues are from the distribution business



Source: Company data, Barclays Capital estimates

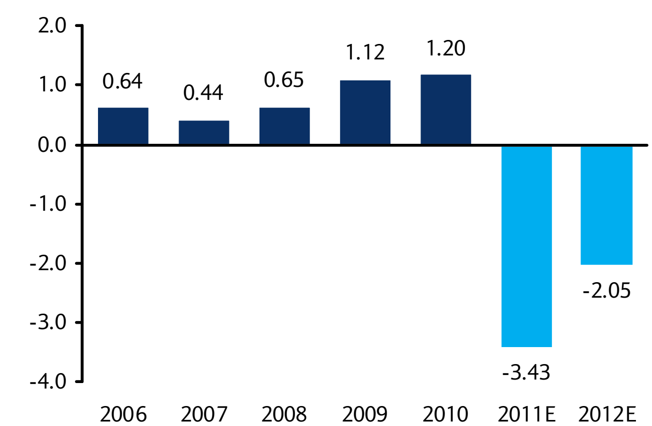
Margins and cash flow: Though gross margin and net margin have remained steady at 8% and 1-2% respectively, this is cash-less growth. Due to increases in operating capital we expect progressive strain on the balance sheet.

Figure 156: Annual margins



Source: Company data, Barclays Capital estimates

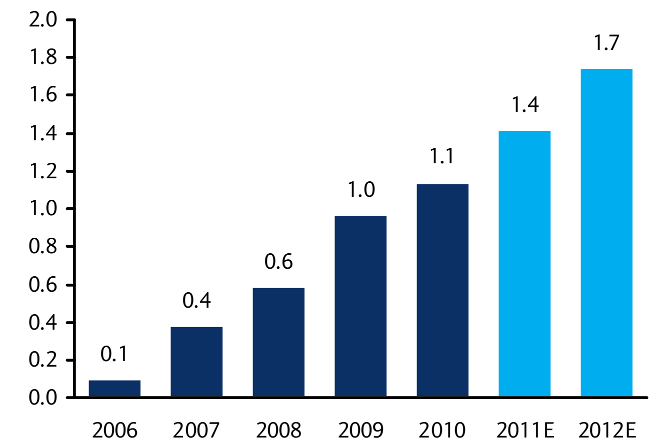
Figure 157: Annual operating cash flow



Source: Company data, Barclays Capital estimates

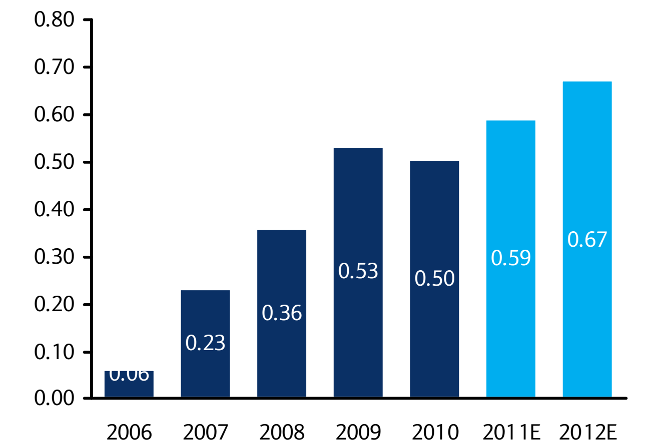
Net income and EPS: Net income remains reasonable, although growth rates have slowed significantly over the 2007-09 CAGR.

Figure 158: Annual net income (Rmb bn)



Source: Company data, Barclays Capital estimates

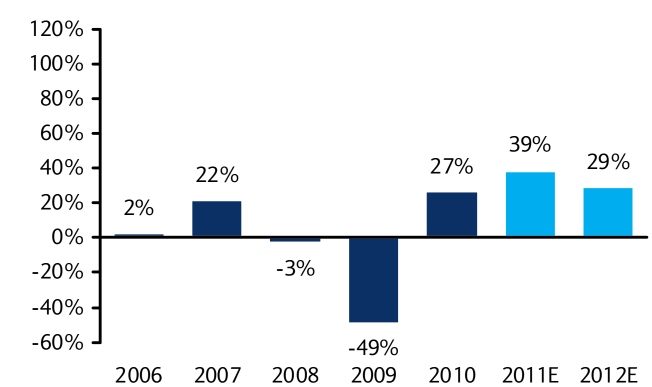
Figure 159: Diluted annual EPS, adj. (Rmb)



Source: Company data, Barclays Capital estimates

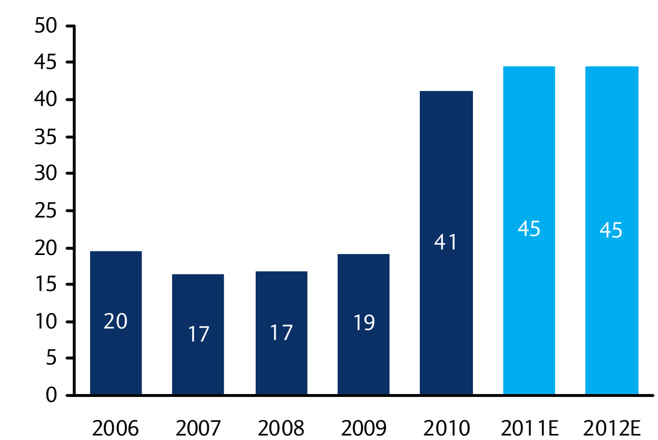
Debt and cash conversion cycle: We expect net debt to increase for full-year 2011, largely due to reduced cash flow following a much longer cash conversion cycle.

Figure 160: Net debt/equity



Source: Company data, Barclays Capital estimates

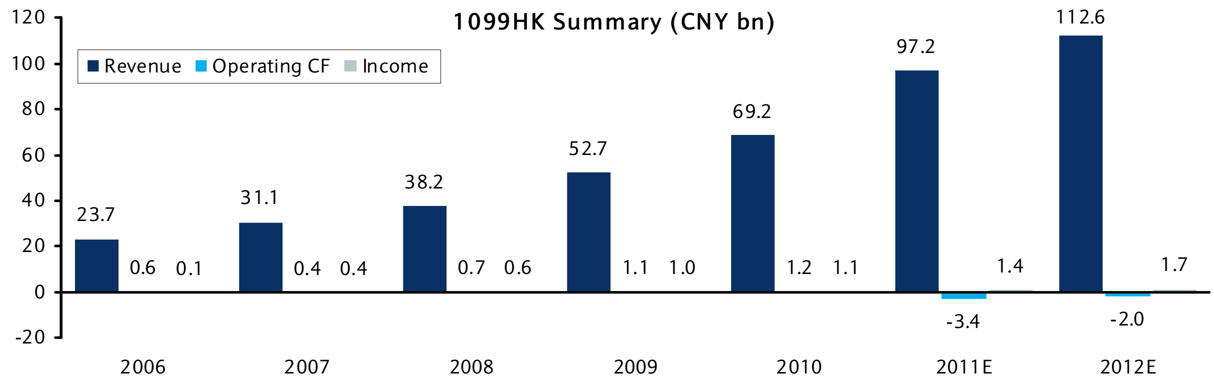
Figure 161: Cash conversion cycle (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 162: Annual revenue, operating cash flow and income

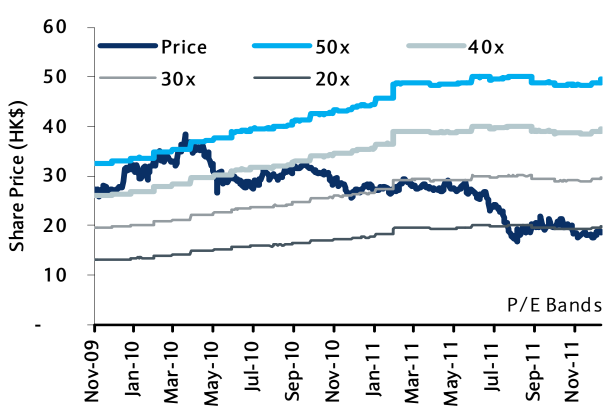


Source: Company data, Barclays Capital estimates

Valuation

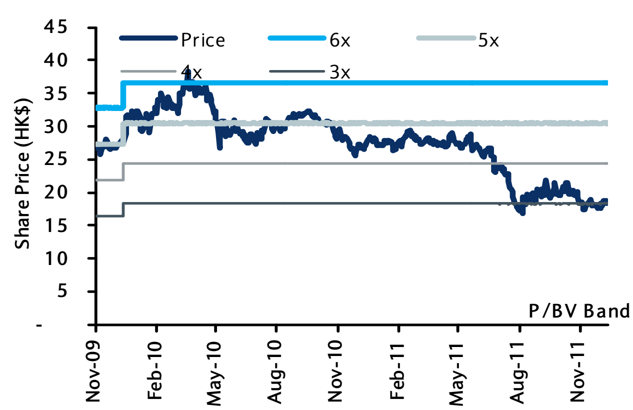
Our PT is based on 20.0x 2012E EPS of Rmb0.67 (currently trading at 23.1x 2011E). The 20.0x P/E is derived by subtracting 1 SD (7.0x) for our negative sector view from the historical mean (37.9x) and subtracting 10.9x for qualitative factors specific to the firm. 20.0x is roughly 2.5 SD less than the historical average.

Figure 163: P/E bands



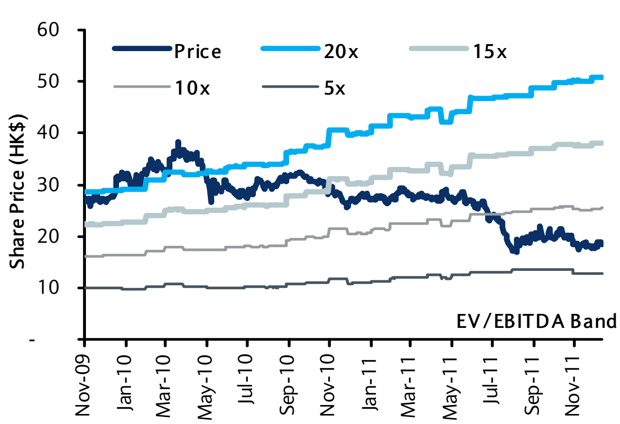
Source: Reuters, Barclays Capital

Figure 164: P/B bands



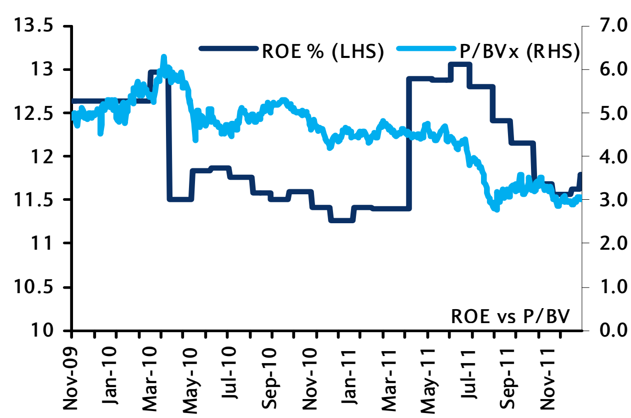
Source: Reuters, Barclays Capital

Figure 165: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 166: ROE vs P/B



Source: Reuters, Barclays Capital

Figure 167: Sinopharm – income statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net sales	**38,191,909**	**52,668,164**	**69,233,669**	**97,219,215**	**112,552,015**	**130,398,227**
Growth (y/y)	*23%*	*38%*	*31%*	*40%*	*16%*	*16%*
COGS	35,152,762	48,260,824	63,397,799	89,361,862	103,547,854	119,966,369
% of revenue	*92%*	*92%*	*92%*	*92%*	*92%*	*92%*
Growth (y/y)	*23%*	*37%*	*31%*	*41%*	*16%*	*16%*
Gross profit	**3,039,147**	**4,407,340**	**5,835,870**	**7,857,353**	**9,004,161**	**10,431,858**
Margin	*8.0%*	*8.4%*	*8.4%*	*8.1%*	*8.0%*	*8.0%*
Growth (y/y)	*19%*	*45%*	*32%*	*35%*	*15%*	*16%*
Operating expenses	(1,935,560)	(2,569,858)	(3,569,161)	(4,470,095)	(5,289,945)	(6,128,717)
% of revenue	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*
Growth (y/y)	*8%*	*33%*	*39%*	*25%*	*18%*	*16%*
S&M expenses	(966,020)	(1,404,129)	(2,024,342)	(2,695,540)	(3,151,456)	(3,651,150)
% of revenue	*2.5%*	*2.7%*	*2.9%*	*2.8%*	*2.8%*	*2.8%*
Growth (y/y)	*2%*	*45%*	*44%*	*33%*	*17%*	*16%*
G&A expenses	(969,540)	(1,165,729)	(1,544,819)	(1,774,555)	(2,138,488)	(2,477,566)
% of revenue	*2.5%*	*2.2%*	*2.2%*	*1.8%*	*1.9%*	*1.9%*
Growth (y/y)	*15%*	*20%*	*33%*	*15%*	*21%*	*16%*
R&D expenses	0	0	0	0	0	0
% of revenue	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*
Growth (y/y)						
Operating cash flow (EBITDA)	**1,277,557**	**2,086,365**	**2,562,244**	**3,650,299**	**4,017,992**	**4,653,867**
Depreciation & amortization	(173,970)	(248,883)	(295,535)	(263,041)	(303,776)	(350,725)
Operating income (EBIT)	**1,103,587**	**1,837,482**	**2,266,709**	**3,387,258**	**3,714,216**	**4,303,142**
Growth (y/y)	*44%*	*67%*	*23%*	*49%*	*10%*	*16%*
Interest Expense	(265,996)	(256,548)	(352,568)	(847,958)	(813,172)	(1,013,172)
% of Debt	*16.3%*	*14.9%*	*10.3%*	*15.0%*	*12.0%*	*8.0%*
Other income (expense)	241,738	328,472	430,250	447,339	517,891	600,008
% of revenue	*0.6%*	*0.6%*	*0.6%*	*0.5%*	*0.5%*	*0.5%*
Pretax income	**1,079,329**	**1,909,406**	**2,344,391**	**2,986,640**	**3,418,935**	**3,889,977**
Net income tax	(259,286)	(465,314)	(573,379)	(729,849)	(835,490)	(950,599)
Tax rate	*24%*	*24%*	*24%*	*24%*	*24%*	*24%*
Minority interests	(232,430)	(476,927)	(630,115)	(837,482)	(837,482)	(837,482)
Net income (GAAP)	**587,613**	**967,165**	**1,140,897**	**1,419,308**	**1,745,963**	**2,101,895**
Margin	*1.5%*	*1.8%*	*1.6%*	*1.5%*	*1.6%*	*1.6%*
Growth (y/y)	*54%*	*65%*	*18%*	*24%*	*23%*	*20%*
Add back: Stock-based comp	0	0	0	0	0	0
Net income (non-GAAP)	**587,613**	**967,165**	**1,140,897**	**1,419,308**	**1,745,963**	**2,101,895**
Preferred dividends	0	0	0	0	0	0
Income attrib. to ADS holders (GAAP)	**587,613**	**967,165**	**1,140,897**	**1,419,308**	**1,745,963**	**2,101,895**
Income attrib. to ADS holders (non-GAAP)	**587,613**	**967,165**	**1,140,897**	**1,419,308**	**1,745,963**	**2,101,895**
Basic weighted avg. shares	1,637,037	1,808,964	2,264,568	2,402,625	2,594,835	2,594,835
Diluted weighted avg. shares	1,637,037	1,808,964	2,264,568	2,402,625	2,594,835	2,594,835
DILUTED EPS (non-GAAP)	**0.36**	**0.53**	**0.50**	**0.59**	**0.67**	**0.81**

Source: Company reports and Barclays Capital estimates

Figure 168: Sinopharm – balance sheet (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	1,712,119	7,567,839	7,474,698	6,614,367	5,249,869	5,898,845
Restricted cash and short-term inv	15	548	990	1,682	2,655	3,780
Accounts receivable, net	7,913,583	11,979,788	17,751,877	26,102,693	32,069,615	37,154,563
Inventories	3,154,820	5,301,152	7,530,376	11,186,869	13,567,914	15,719,238
Prepaid expenses/other current	883,275	4,257,481	2,105,359	2,956,385	3,422,647	3,965,341
Total current assets	**13,663,812**	**29,106,808**	**34,863,300**	**46,861,996**	**54,312,699**	**62,741,767**
Property, plant, and equipment, net	1,333,777	1,958,053	3,330,750	4,112,100	5,003,877	6,025,066
Intangible assets, net	620,088	1,006,750	2,406,632	2,334,433	2,264,400	2,196,468
Other assets	507,658	574,956	1,413,798	1,413,798	1,413,798	1,413,798
Total assets	**16,125,335**	**32,646,567**	**42,014,480**	**54,722,327**	**62,994,774**	**72,377,099**
Liabilities and equity						
Short-term debt	1,504,170	1,667,765	3,344,182	2,949,772	2,949,772	2,949,772
Accounts payable	9,053,074	13,703,430	19,831,205	26,635,401	30,836,169	35,725,542
Accrued expenses	212,194	235,794	2,332,509	3,275,353	3,791,921	4,393,167
Other current liabilities	1,111,896	1,811,055	246,180	246,180	246,180	246,180
Total current liabilities	**11,881,334**	**17,418,044**	**25,754,076**	**33,106,706**	**37,824,041**	**43,314,660**
Long-term debt	130,000	50,977	90,900	4,181,953	6,181,953	8,181,953
Deferred income taxes	68,041	110,090	265,651	265,651	265,651	265,651
Other long-term liabilities	1,778,914	3,200,577	4,192,715	4,192,715	4,192,715	4,192,715
Total liabilities	**13,858,289**	**20,779,688**	**30,303,342**	**41,747,025**	**48,464,360**	**55,954,979**
Stockholders' equity						
Common stock	1,893,126	10,395,670	2,264,568	2,264,568	2,264,568	2,264,568
Preferred stock	0	0	0	0	0	0
Additional paid-in capital	0	0	0	0	0	0
Retained earnings	363,424	362,724	1,380,248	2,644,412	4,199,525	6,091,230
Treasury and other equity	10,496	1,108,485	8,066,322	8,066,322	8,066,322	8,066,322
Other comprehensive income	0	0	0	0	0	0
Total shareholders' equity	**2,267,046**	**11,866,879**	**11,711,138**	**12,975,302**	**14,530,415**	**16,422,120**
Total liabilities and equity	**16,125,335**	**32,646,567**	**42,014,480**	**54,722,327**	**62,994,774**	**72,377,099**

Source: Company data, Barclays Capital estimates

Figure 169: Sinopharm – cash flow statement (Rmb 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net income	**587,613**	**967,165**	**1,140,897**	**1,419,308**	**1,745,963**	**2,101,895**
Depreciation and amortization	173,970	248,883	300,515	263,041	303,776	350,725
Deferred taxes	0	0	0	0	0	0
Change in working capital	(124,559)	(4,912,787)	2,375,299	(5,111,294)	(4,096,895)	(2,288,347)
Others	16,825	4,814,497	(2,614,174)	0	0	0
Cash flow from operations	**653,849**	**1,117,758**	**1,202,537**	**(3,428,945)**	**(2,047,156)**	**164,274**
Capital expenditure	(269,345)	(534,458)	(1,429,332)	(972,192)	(1,125,520)	(1,303,982)
Investments	(57,689)	(3,040,612)	(479,276)	(692)	(972)	(1,126)
Others	179,081	262,824	77,129	0	0	0
Cash flow from investments	**(147,953)**	**(3,312,246)**	**(1,831,479)**	**(972,884)**	**(1,126,492)**	**(1,305,108)**
Equity issuance, options, and converts	0	8,528,205	(25,661)	0	0	0
Dividends paid	(158,266)	(1,207,419)	(124,711)	(155,144)	(190,851)	(210,190)
Debt funding/(repayment)	(356,641)	(318,264)	759,542	3,696,643	2,000,000	2,000,000
Others	(234,466)	696,076	(73,369)	0	0	0
Cash flow from financing	**(749,373)**	**7,698,598**	**535,801**	**3,541,498**	**1,809,149**	**1,789,810**
Fx effects				0	0	0
Net cash flow	**(243,477)**	**5,504,110**	**(93,141)**	**(860,331)**	**(1,364,499)**	**648,976**
Cash at beginning of period	1,955,596	2,063,729	7,567,839	7,474,698	6,614,367	5,249,869
Cash at end of period	**1,712,119**	**7,567,839**	**7,474,698**	**6,614,367**	**5,249,869**	**5,898,845**

Source: Company data, Barclays Capital estimates

Figure 170: Sinopharm – key metrics (Rmb 000 except per share data)

Return statistics		2008	2009	2010	2011E	2012E	2013E
ROE		30%	14%	10%	11%	13%	14%
ROA		4%	4%	3%	3%	3%	3%
ROIC		18%	19%	13%	7%	7%	7%

Operating statistics		2008	2009	2010	2011E	2012E	2013E
DSOs		67	69	78	82	94	97
DIOs		28	29	34	35	40	41
DPOs		78	79	88	87	93	93
Cash conversion cycle		17	19	24	30	41	45
Net debt		(77,949)	(5,849,097)	(4,039,616)	517,357	3,881,856	5,232,880
Net debt/equity		-3%	-49%	-34%	4%	27%	32%
Net debt/total cap		-4%	-97%	-53%	4%	21%	24%
Net debt/EBITDA		-0.1x	-2.8x	-1.6x	0.1x	1.0x	1.1x
Working capital		1,782,478	11,688,764	9,109,224	13,755,290	16,488,658	19,427,107
Working capital/sales		5%	22%	13%	14%	15%	15%
Current ratio		1.15	1.67	1.35	1.42	1.44	1.45
Interest coverage ratio		5x	8x	7x	4x	5x	5x
Fixed asset turnover		29.3x	32.0x	26.2x	26.1x	24.7x	23.6x
Total asset turnover		2.5x	2.2x	1.9x	2.0x	1.9x	1.9x
Book value		1,646,958	10,860,129	9,304,506	10,640,869	12,266,014	14,225,652
BV/share		1.01	6.00	4.11	4.43	4.73	5.48
Net sales		38,191,909	52,668,164	69,233,669	97,219,215	112,552,015	130,398,227
COGS		35,152,762	48,260,824	63,397,799	89,361,862	103,547,854	119,966,369
EBITDA		1,277,557	2,086,365	2,562,244	3,650,299	4,017,992	4,653,867
Interest expense		(265,996)	(256,548)	(352,568)	(847,958)	(813,172)	(1,013,172)
Pretax income		1,079,329	1,909,406	2,344,391	2,986,640	3,418,935	3,889,977
Tax rate		24%	24%	24%	24%	24%	24%
Net income		587,613	967,165	1,140,897	1,419,308	1,745,963	2,101,895
After-tax interest		(202,096)	(194,028)	(266,339)	(640,741)	(614,456)	(765,582)
Shares outstanding		1,637,037	1,808,964	2,264,568	2,402,625	2,594,835	2,594,835
FTE		12,259	15,110	24,117			
Days		365	365	365	365	365	365

Cash flow		2008	2009	2010	2011E	2012E	2013E
Operating income (EBIT)		1,103,587	1,837,482	2,266,709	3,387,258	3,714,216	4,303,142
	Per share	0.67	1.02	1.00	1.41	1.43	1.66
	Growth	*44%*	*51%*	*-1%*	*41%*	*2%*	*16%*
Operating cash flow (EBITDA)		1,277,557	2,086,365	2,562,244	3,650,299	4,017,992	4,653,867
	Per share	0.78	1.15	1.13	1.52	1.55	1.79
	Growth	*42%*	*48%*	*-2%*	*34%*	*2%*	*16%*
Net cash from operations		653,849	1,117,758	1,202,537	(3,428,945)	(2,047,156)	164,274
	Per share	0.40	0.62	0.53	(1.43)	(0.79)	0.06
	Growth	*48%*	*55%*	*-14%*	*-369%*	*-45%*	*-108%*
Capital expenditures		(269,345)	(534,458)	(1,429,332)	(972,192)	(1,125,520)	(1,303,982)
"Free cash flow"		384,504	583,300	(226,795)	(4,401,137)	(3,172,676)	(1,139,709)
	Per share	0.23	0.32	(0.10)	(1.83)	(1.22)	(0.44)
Net external financing needs		384,504	583,300	(226,795)	(4,401,137)	(3,172,676)	(1,139,709)
	Per share	0.23	0.32	(0.10)	(1.83)	(1.22)	(0.44)
CF to invest. ratio		**2.43**	**2.09**	**0.84**	**(3.53)**	**(1.82)**	**0.13**

Source: Company data, Barclays Capital estimates

UNITED LABORATORIES (3-UW; PT HK$3.82; -15%): WRONG PLACE, WRONG TIME

We initiate coverage of United Laboratories with a 3-Underweight rating and 12-month price target of HK$3.82, implying 15% potential downside. United Labs is a national champion antibiotic manufacturer, supplying finished drugs to the Chinese market and precursor API chemicals to drug firms globally. The firm is also building a China-focused insulin business. Given that generic antibiotics are under significant policy and pricing pressure, we view a 3-UW rating as most appropriate for 2012. Longer term, we see positive growth as: 1) policy rebalances to support drug manufacturers; and 2) the company enjoys accretive earnings from a more diversified antibiotic/insulin product portfolio.

3933 HK / 3933.HK

Stock Rating
3-UNDERWEIGHT

Sector View
3-NEGATIVE

Price Target
HKD 3.82

Price (30-Dec-2011)
HKD 4.47

Potential Upside/Downside
-15%

Rating, valuation and risks

Key drivers of our 3-Underweight rating: 1) valuation, with 15% potential downside; and 2) unfavourable subsector facing tremendous generic competition and a suite of negative policy headwinds.

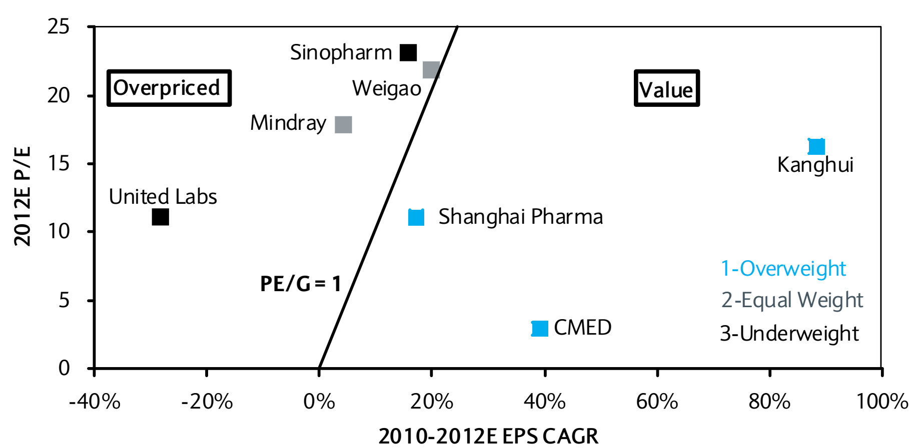
Valuation: Our PT is based on 9.5x 2012E EPS of HK$0.40 (currently trading at 11.1x 2011E). The 9.5x P/E is derived by subtracting 1 SD (4.7x) for our negative sector view from the historical mean (10.4x) and adding 3.8x for qualitative factors specific to the firm and current trading levels. 9.5x is roughly 0.2 SD less than the historical average.

Key risks: The key risks that could keep our price target from being achieved, in our view, include the following: 1) swift and supportive government pricing policies; 2) repeal of antibiotic restrictions currently in place; and 3) outperformance of the global economy, with renewed interest in China stocks

1) Overvalued firm relative to growth rate

In 2011, United Labs was one of the worst performing stocks in the sector. Limited growth prospects suggest it will remain overpriced for 2012.

Figure 171: We favour well-priced names aligned with policy trends



Source: Barclays Capital estimates

COMPANY SNAPSHOT

The United Laboratories — China Health Care & Pharmaceuticals

Income statement (HK$ '000)	2010A	2011E	2012E	2013E	CAGR
Revenue	6,502,817	6,519,921	7,041,515	7,393,591	4.4%
EBITDA	1,681,397	1,052,496	1,081,241	1,198,654	-10.7%
EBIT	1,262,271	676,291	711,193	968,560	-8.5%
Pre-tax income	1,163,280	664,010	629,197	886,564	-8.7%
Net income	974,157	552,357	523,397	737,488	-8.9%
EPS (reported) ($)	0.78	0.42	0.40	0.57	-10.2%
Diluted shares (m)	1,246,144	1,301,500	1,301,500	1,301,500	1.5%
Dividend per share ($)	0.31	0.17	0.16	0.23	-10.0%
Margin and return data (%)					**Average**
EBITDA margin	25.9	16.1	15.4	16.2	18.4
EBIT margin	19.4	10.4	10.1	13.1	13.2
Pre-tax margin	17.9	10.2	8.9	12.0	12.2
Net margin	15.0	8.5	7.4	10.0	10.2
ROIC	14.8	6.8	6.5	9.2	9.3
ROA	11.4	5.5	5.0	6.7	7.1
ROE	23.5	10.5	9.3	12.3	13.9
Balance sheet and cash flow (HK$ '000)					**CAGR**
Tangible fixed assets	4,651,121	4,605,027	4,588,701	4,728,945	0.6%
Intangible fixed assets	6,858	2,743	1,097	439	-60.0%
Cash and equivalents	464,055	1,222,937	1,375,797	1,557,778	49.7%
Total assets	9,607,894	10,327,620	10,799,548	11,348,616	5.7%
Short and long-term debt	2,350,074	2,733,209	2,733,209	2,733,209	5.2%
Other long-term liabilities	-	-	-	-	NA
Total liabilities	4,497,952	4,886,264	5,044,153	5,150,729	4.6%
Net debt/(funds)	1,886,019	1,510,271	1,357,411	1,175,431	-14.6%
Shareholders' equity	5,109,942	5,441,356	5,755,394	6,197,887	6.6%
Change in working capital	1,129,972	5,875	179,150	120,926	-52.5%
Operating cash flow	668,208	922,686	714,295	846,655	8.2%
Capital expenditure	1,088,203	325,996	352,076	369,680	-30.2%
Free cash flow	(419,995)	596,690	362,219	476,975	NA
Valuation and leverage metrics					**Average**
P/E (x)	20.4	10.5	11.1	7.9	12.5
EV/EBITDA (x)	13.0	8.6	8.2	7.3	9.3
Price/BV (x)	3.9	1.4	1.4	1.3	2.0
Dividend yield (%)	1.9	2.8	2.7	3.7	2.8
Total debt/capital (%)	31.5	33.4	32.2	30.6	31.9
Selected operating metrics					
SG&A/sales (%)	20.0	23.2	23.5	20.5	21.8
R&D/sales (%)	0.1	0.7	0.3	0.3	0.4
R&D growth (%)	0.0	580.2	-54.2	5.0	132.8
SG&A growth (%)	28.7	16.7	9.2	-8.4	11.5

Source: Company data, Barclays Capital

Stock Rating	3-UNDERWEIGHT
Sector View	3-NEGATIVE
Price (30-Dec-2011)	HK$4.47
Price Target	HK$3.82
Ticker	3933 HK

Investment case

Why a 3-UW? We are negative on United Labs at current levels based on pricing pressure to key products and ongoing antibiotic restrictions in China. Risks outweigh opportunities in the medium term, in our view. 2010-12E earnings CAGR is -28%. Base case 2012E multiple of 9.5x.

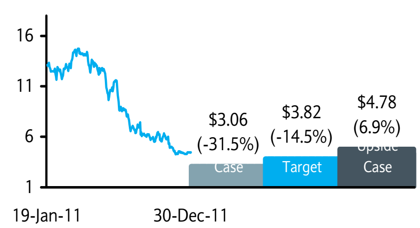
Upside case **HK$4.78**

In this case multiples rerate 25% vs our base case to 11.9x, providing 7% upside. This scenario is more likely if the Chinese economy outperforms, government healthcare spend increases quickly and government restrictions on antibiotic use are lifted.

Downside case **HK$3.06**

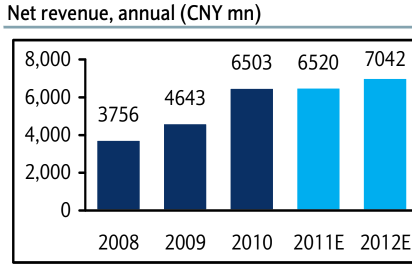
In this case multiples derate 20% vs our base case to 7.6x, providing -32% downside. This scenario is more likely if the Chinese economy underperforms and government healthcare spend decreases faster than expected.

Upside/downside scenarios



Source: Reuters, Barclays Capital estimates

Net revenue, annual (CNY mn)



Note: FY end Dec.

2) Unfavourable subsector

United Labs produces generic antibiotics, perhaps the most hard-hit subsector of China healthcare at this time. While the firm has launched insulin products for the diabetes market, fierce competition in that space will limit upside in the medium term.

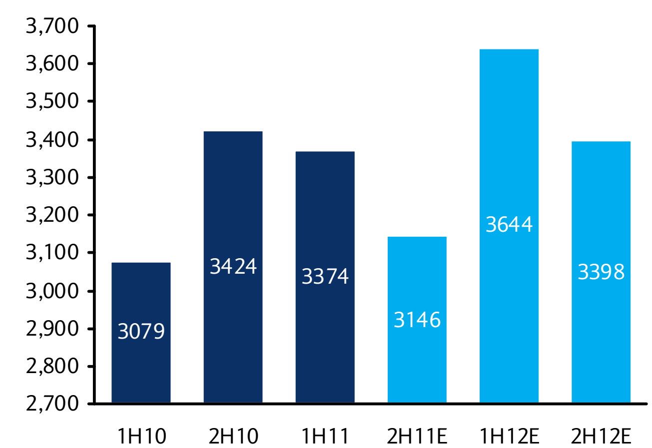
In line with our 3-UW rating, we believe the company remains slightly overpriced and that risks currently outweigh opportunities.

- **Generics market:** From 2009-11, the government increased insurance coverage from 40-90% of the Chinese population. To accomplish this affordably, the government has implemented more than two dozen price cuts. These cuts focus on generic drugs, especially antibiotics, the most prescribed drug class in China.
- **Antibiotics market:** The government has concluded that many hospitals and physicians overprescribe antibiotics in order to increase revenues. Significant restrictions on antibiotic use were implemented in 2011 to combat the added expense and reduce the spread of antibiotic-resistant bacteria. While United Labs benefited significantly as a key manufacturer during the mid-2000s, it now faces declining revenue and profit. In fact, United Labs was the first firm within our coverage universe to record negative sales growth due to government policy and pricing pressure.
- **Insulin market:** The move into insulin will likely soften the fall for United Labs, however the long timelines in manufacturing and regulatory hurdles will not allow quick revenue gains to offset declining antibiotic sales. Moreover, the insulin market is quite crowded in China, with multinationals and domestic firms competing fiercely. In our view, United Labs will face challenges breaking into this market, though we expect modest share over time given management experience.

3) Poor fundamentals, including negative growth and debt

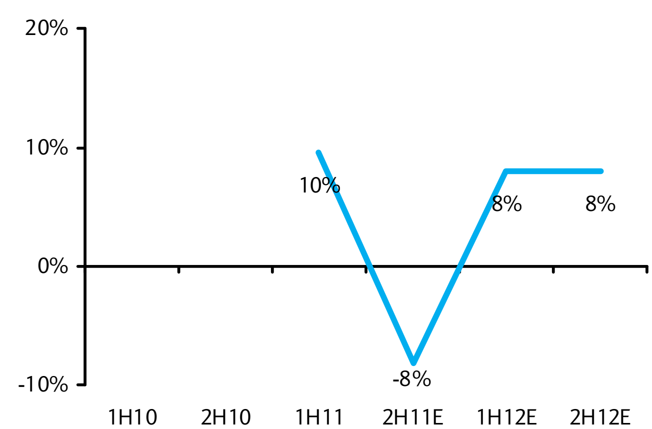
Revenues: United Labs revenues declined in 1H11 and we expect further decline in 2H11. The company faces two negative policies, including: 1) negative pricing trends on core generic antibiotic products; and 2) clinical restrictions on antibiotic use. In this way, we see United Labs as a leading indicator for the sector as a whole, with more negative growth stories expected in 2012.

Figure 172: Interim revenues (Rmb mn)



Source: Company data, Barclays Capital estimates

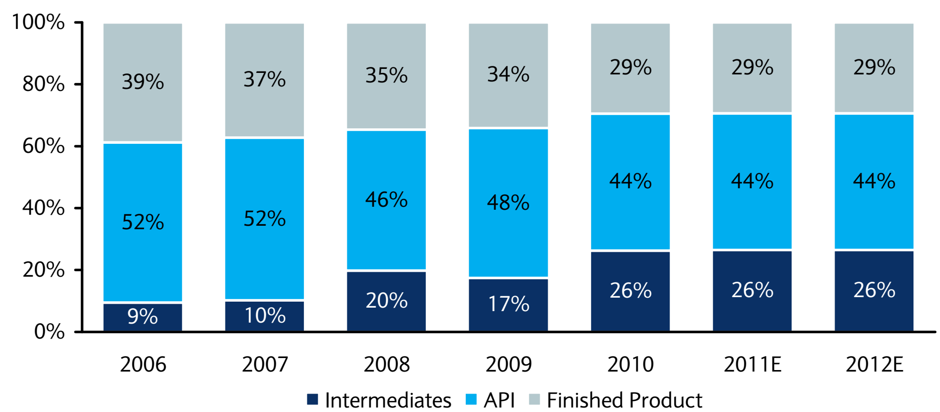
Figure 173: Interim revenue (y/y)



Source: Company data, Barclays Capital estimates

Product segments: Product mix more skewed toward intermediates, the least finished drug category.

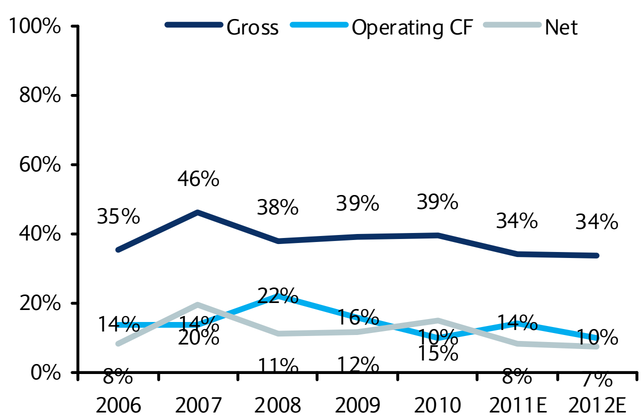
Figure 174: Segment breakdown



Source: Company data, Barclays Capital estimates

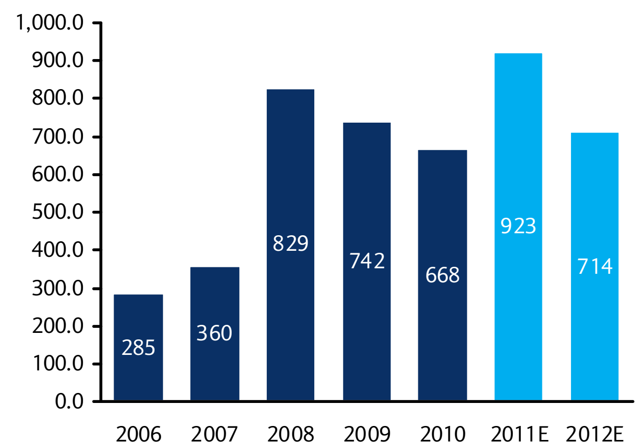
Margins and cash flow: Operating cash flow declined during 2008-10 as operating cash flow margin declined from 22% in 2008 to 14% in 2011E. Gross margins also declined from 38% in 2008 to 34% in 2011E, while net margins fell from 11% to 8%.

Figure 175: Annual margins



Source: Company data, Barclays Capital estimates

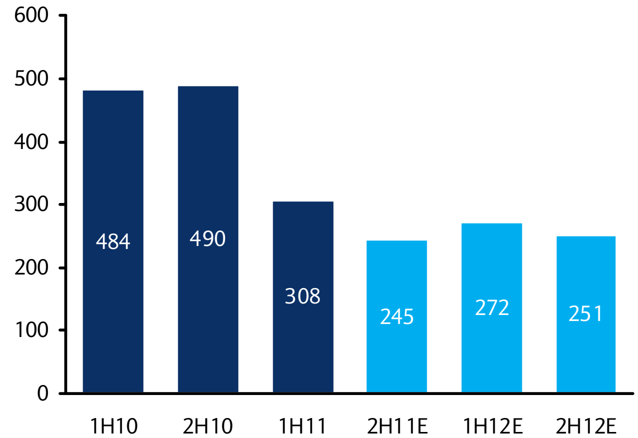
Figure 176: Annual operating cash flow (HK$ mn)



Source: Company data, Barclays Capital estimates

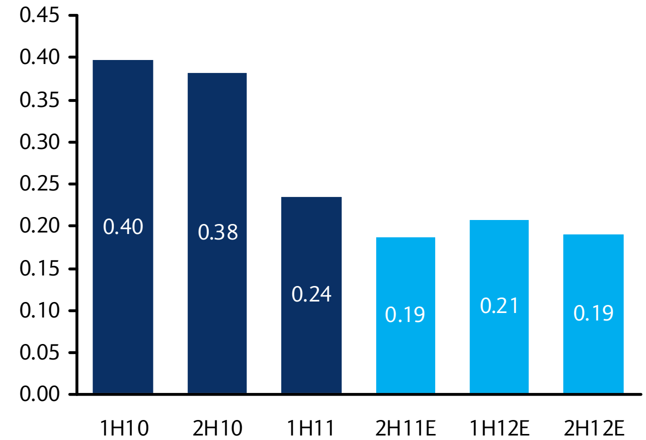
Net income and EPS: Income and EPS fell significantly from 2H10 to 1H11due to pricing pressure and antibiotic restrictions. We expect trends to remain fairly weak for 2012.

Figure 177: Interim net income (HK$ mn)



Source: Company data, Barclays Capital estimates

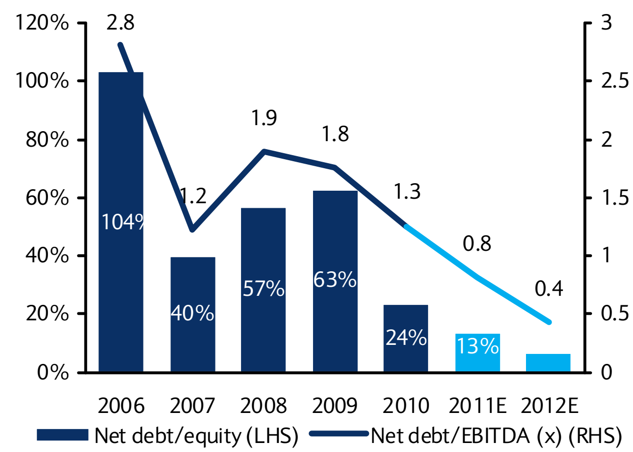
Figure 178: Interim diluted income, adj. (HK$)



Source: Company data, Barclays Capital estimates

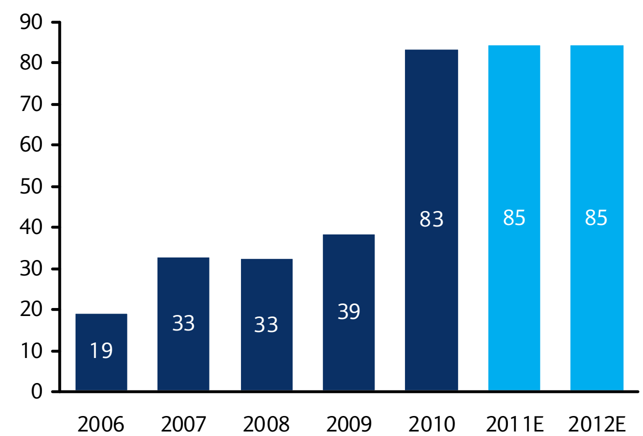
Debt and cash conversion: In a bright spot for the firm, net debt has declined significantly since 2006. However, cash conversion increased dramatically in 2010 and we do not expect near-term improvement.

Figure 179: Net debt/equity



Source: Company data, Barclays Capital estimates

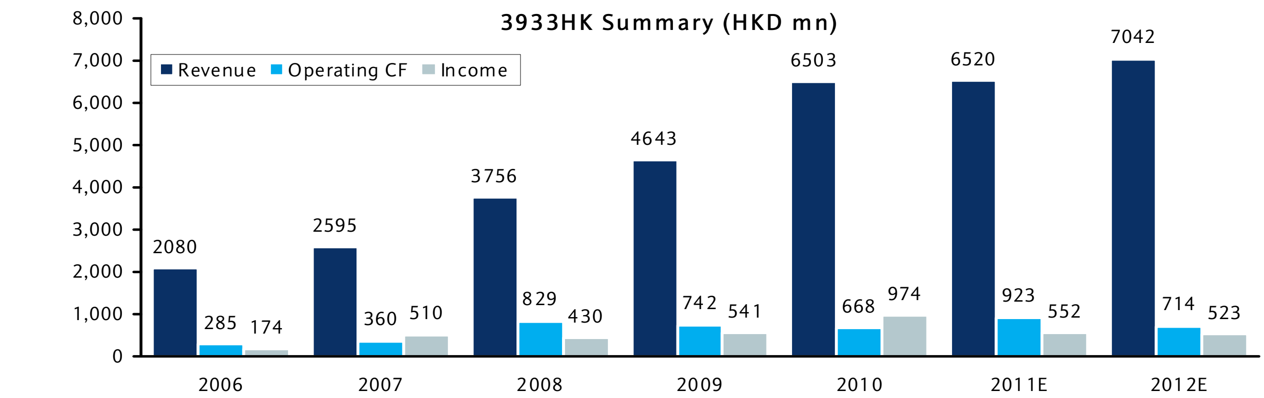
Figure 180: Cash conversion (days)



Source: Company data, Barclays Capital estimates

Summary

Figure 181: Annual revenue, operating cash flow and income

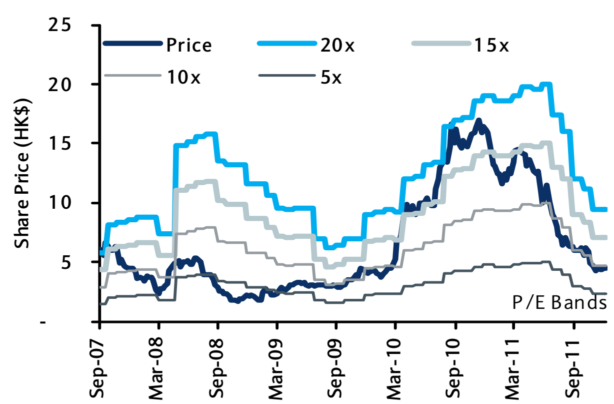


Source: Company data, Barclays Capital estimates

Valuation

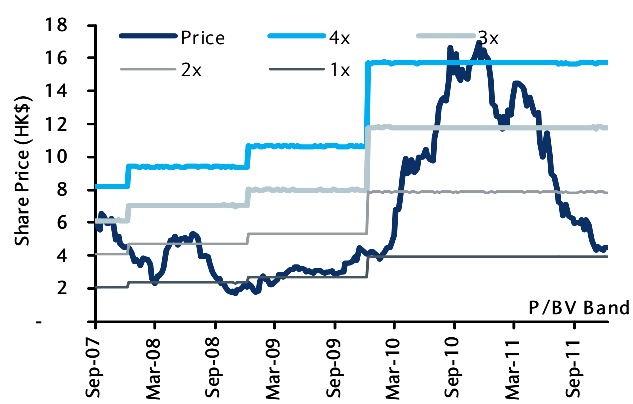
Our PT is based on 9.5x 2012E EPS of HK$0.40 (currently trading at 11.1x 2011E). The 9.5x P/E is derived by subtracting 1 SD (4.7x) for our negative sector view from the historical mean (10.4x) and adding 3.8x for qualitative factors specific to the firm and current trading levels. 9.5x is roughly 0.2 SD less than the historical average.

Figure 182: P/E bands



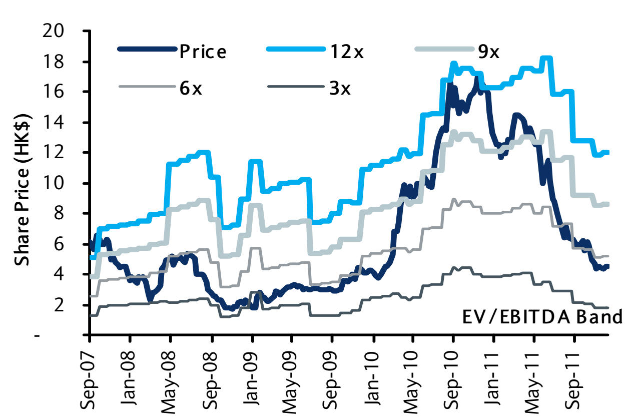
Source: Reuters, Barclays Capital

Figure 183: P/B bands



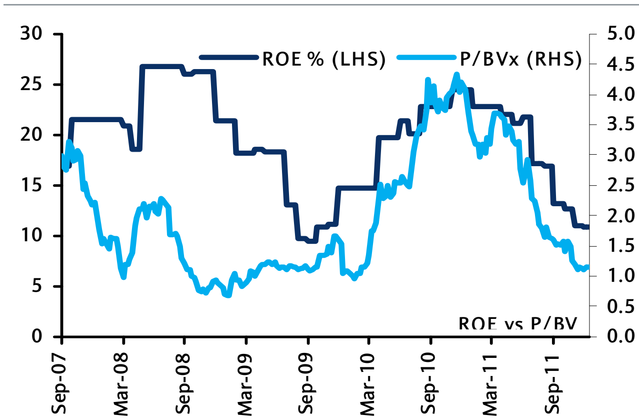
Source: Reuters, Barclays Capital

Figure 184: EV/EBITDA bands



Source: Reuters, Barclays Capital

Figure 185: ROE vs P/B



Source: Reuters, Barclays Capital

Figure 186: United Labs –income statement (HK$ 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net sales	**3,755,856**	**4,643,177**	**6,502,817**	**6,519,921**	**7,041,515**	**7,393,591**
Growth (y/y)	*45%*	*24%*	*40%*	*0%*	*8%*	*5%*
COGS	2,326,256	2,829,159	3,934,763	4,282,232	4,654,441	4,887,163
% of revenue	*62%*	*61%*	*61%*	*66%*	*66%*	*66%*
Growth (y/y)	*67%*	*22%*	*39%*	*9%*	*9%*	*5%*
Gross profit	**1,429,600**	**1,814,018**	**2,568,054**	**2,237,689**	**2,387,074**	**2,506,427**
Margin	*38%*	*39%*	*39%*	*34%*	*34%*	*34%*
Growth (y/y)	*19%*	*27%*	*42%*	*-13%*	*7%*	*5%*
Operating expenses	(834,303)	(1,009,604)	(1,305,783)	(1,561,398)	(1,675,881)	(1,537,867)
% of revenue	*22%*	*22%*	*20%*	*24%*	*24%*	*21%*
Growth (y/y)	*42%*	*21%*	*29%*	*20%*	*7%*	*-8%*
S&M expenses	(554,479)	(718,022)	(939,082)	(1,073,437)	(1,197,058)	(1,109,039)
% of revenue	*14.8%*	*15.5%*	*14.4%*	*16.5%*	*17.0%*	*15.0%*
Growth (y/y)	*45%*	*29%*	*31%*	*14%*	*12%*	*-7%*
G&A expenses	(264,388)	(291,582)	(359,927)	(441,883)	(457,698)	(406,647)
% of revenue	*7.0%*	*6.3%*	*5.5%*	*6.8%*	*6.5%*	*5.5%*
Growth (y/y)	*39%*	*10%*	*23%*	*23%*	*4%*	*-11%*
R&D expenses	(15,436)	0	(6,774)	(46,077)	(21,125)	(22,181)
% of revenue	*0.4%*	*0.0%*	*0.1%*	*0.7%*	*0.3%*	*0.3%*
Growth (y/y)	*6%*	*-100%*		*580%*	*-54%*	*5%*
Operating cash flow (EBITDA)	**845,389**	**1,142,932**	**1,681,397**	**1,052,496**	**1,081,241**	**1,198,654**
Depreciation & amortization	(250,092)	(338,518)	(419,126)	(376,204)	(370,048)	(230,093)
Operating income (EBIT)	**595,297**	**804,414**	**1,262,271**	**676,291**	**711,193**	**968,560**
Growth (y/y)	*4%*	*35%*	*57%*	*46%*	*5%*	*36%*
Interest expense	(117,181)	(88,490)	(86,055)	(92,051)	(81,996)	(81,996)
% of Debt	*6.6%*	*4.0%*	*3.7%*	*6.7%*	*6.0%*	*6.0%*
Other income (expense)	54,414	(22,554)	(12,936)	79,769	0	0
% of revenue	*1.4%*	*-0.5%*	*-0.2%*	*1.2%*	*0.0%*	*0.0%*
Pretax income	**532,530**	**693,370**	**1,163,280**	**664,010**	**629,197**	**886,564**
Net income tax	(102,361)	(151,927)	(189,123)	(111,654)	(105,800)	(149,076)
Tax rate	*19%*	*22%*	*16%*	*17%*	*17%*	*17%*
Minority interests	0	0	0	0	0	0
Net income (GAAP)	**430,169**	**541,443**	**974,157**	**552,357**	**523,397**	**737,488**
Margin	*11%*	*12%*	*15%*	*8%*	*7%*	*10%*
Growth (y/y)	*-16%*	*26%*	*80%*	*-43%*	*-5%*	*41%*
Add back: Stock-based comp	0	0	0	0	0	0
Net income (non-GAAP)	**430,169**	**541,443**	**974,157**	**552,357**	**523,397**	**737,488**
Preferred dividends	0	0	0	0	0	0
Income attrib. to ADS holders (GAAP)	**430,169**	**541,443**	**974,157**	**552,357**	**523,397**	**737,488**
Income attrib. to ADS holders (non-GAAP)	**430,169**	**541,443**	**974,157**	**552,357**	**523,397**	**737,488**
Basic weighted avg. shares	1,200,000	1,200,000	1,246,144	1,301,500	1,301,500	1,301,500
Diluted weighted avg. shares	1,200,000	1,200,000	1,246,144	1,301,500	1,301,500	1,301,500
DILUTED EPS (non-GAAP)	**0.36**	**0.45**	**0.78**	**0.42**	**0.40**	**0.57**

Source: Company data, Barclays Capital estimates

Figure 187: United Labs – balance sheet (HK$ 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Assets						
Cash and cash equivalents	165,474	192,489	464,055	1,222,937	1,375,797	1,557,778
Restricted cash and short-term inv	0	0	0	0	0	0
Accounts receivable, net	1,091,192	1,668,783	2,262,525	2,268,476	2,449,954	2,572,452
Inventories	773,991	884,723	1,248,199	1,251,482	1,351,601	1,419,181
Prepaid expenses/other current	399,356	474,129	691,218	693,036	748,479	785,903
Total current assets	**2,430,013**	**3,220,124**	**4,665,997**	**5,435,931**	**5,925,831**	**6,335,313**
Property, plant, and equipment, net	3,466,393	4,009,768	4,651,121	4,605,027	4,588,701	4,728,945
Intangible assets, net	7,363	8,887	6,858	2,743	1,097	439
Other assets	266,489	221,217	283,918	283,918	283,918	283,918
Total assets	**6,170,258**	**7,459,996**	**9,607,894**	**10,327,620**	**10,799,548**	**11,348,616**
Liabilities and equity						
Short-term debt	1,347,888	2,205,284	2,350,074	2,733,209	2,733,209	2,733,209
Accounts payable	1,509,928	1,924,104	1,968,439	1,973,617	2,131,506	2,238,081
Accrued expenses	0	0	0	0	0	0
Other current liabilities	35,798	68,697	83,704	83,704	83,704	83,704
Total current liabilities	**2,893,614**	**4,198,085**	**4,402,217**	**4,790,529**	**4,948,418**	**5,054,994**
Long-term debt	424,692	0	0	0	0	0
Deferred income taxes	35,457	68,884	95,735	95,735	95,735	95,735
Other long-term liabilities	0	0	0	0	0	0
Total liabilities	**3,353,763**	**4,266,969**	**4,497,952**	**4,886,264**	**5,044,153**	**5,150,729**
Stockholders' equity						
Common stock	12,000	12,000	13,015	13,015	13,015	13,015
Preferred stock	0	0	0	0	0	0
Additional paid-in capital	0	0	0	0	0	0
Retained earnings	1,153,530	1,514,973	2,004,463	2,335,877	2,649,915	3,092,408
Treasury and other equity	1,650,965	1,666,054	3,092,464	3,092,464	3,092,464	3,092,464
Other comprehensive income	0	0	0	0	0	0
Total shareholders' equity	**2,816,495**	**3,193,027**	**5,109,942**	**5,441,356**	**5,755,394**	**6,197,887**
Total liabilities and equity	**6,170,258**	**7,459,996**	**9,607,894**	**10,327,620**	**10,799,548**	**11,348,616**

Source: Company data, Barclays Capital estimates

Figure 188: United Labs – cash flow statement (HK$ 000 except per share data)

Year-end 31 Dec	2008	2009	2010	2011E	2012E	2013E
Net income	**430,169**	**541,443**	**974,157**	**552,357**	**523,397**	**737,488**
Depreciation and amortization	253,165	338,518	419,126	376,204	370,048	230,093
Deferred taxes	(58,168)	(95,046)	(166,286)	0	0	0
Change in working capital	166,653	(348,920)	(1,129,972)	(5,875)	(179,150)	(120,926)
Others	36,811	305,825	571,183	0	0	0
Cash flow from operations	**828,630**	**741,820**	**668,208**	**922,686**	**714,295**	**846,655**
Capital expenditure	(1,125,523)	(850,284)	(1,088,203)	(325,996)	(352,076)	(369,680)
Investments	0	0	0	0	0	0
Others	64,355	(2,249)	(67,142)	0	0	0
Cash flow from investments	**(1,061,168)**	**(852,533)**	**(1,155,345)**	**(325,996)**	**(352,076)**	**(369,680)**
Equity issuance, options, and converts	0	0	1,191,175	0	0	0
Dividends paid	(204,000)	(180,000)	(387,500)	(220,943)	(209,359)	(294,995)
Debt funding/(repayment)	313,932	425,301	63,163	383,135	0	0
Others	(117,181)	(105,770)	(114,818)	0	0	0
Cash flow from financing	**(7,249)**	**139,531**	**752,020**	**162,192**	**(209,359)**	**(294,995)**
Fx effects	1,088	1,159	6,683	0	0	0
Net cash flow	**(238,699)**	**29,977**	**271,566**	**758,882**	**152,860**	**181,980**
Cash at beginning of period	401,262	165,474	192,489	464,055	1,222,937	1,375,797
Cash at end of period	165,474	192,489	464,055	**1,222,937**	**1,375,797**	**1,557,778**

Source: Company data, Barclays Capital estimates

Figure 189: United Labs – key metrics (HK$ 000 except per share data)

Return statistics		2008	2009	2010	2011E	2012E	2013E
ROE		16%	18%	23%	10%	9%	12%
ROA		8%	8%	11%	6%	5%	7%
ROIC		9%	10%	15%	7%	6%	9%
Operating statistics		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
DSOs		75	108	110	127	122	124
DIOs		52	65	60	70	67	68
DPOs		94	135	109	110	106	108
Cash conversion cycle		33	39	61	86	83	85
Net debt		1,607,106	2,012,795	1,886,019	1,510,271	1,357,411	1,175,431
Net debt/equity		57%	63%	37%	28%	24%	19%
Net debt/total cap		36%	39%	27%	22%	19%	16%
Net debt/EBITDA		1.9x	1.8x	1.1x	1.4x	1.3x	1.0x
Working capital		3,774,467	4,951,739	6,170,381	6,186,611	6,681,540	7,015,617
Working capital/sales		81%	107%	95%	95%	95%	95%
Current ratio		0.84	0.77	1.06	1.13	1.20	1.25
Interest coverage ratio		7x	13x	20x	11x	13x	15x
Fixed asset turnover		1.6x	1.2x	1.5x	1.4x	1.5x	1.6x
Total asset turnover		0.9x	0.7x	0.8x	0.7x	0.7x	0.7x
Book value		2,809,132	3,184,140	5,103,084	5,438,613	5,754,297	6,197,448
BV/share		2.34	2.65	4.10	4.18	4.42	4.76
Net sales		4,643,177	4,643,177	6,502,817	6,519,921	7,041,515	7,393,591
COGS		2,326,256	2,829,159	3,934,763	4,282,232	4,654,441	4,887,163
EBITDA		845,389	1,142,932	1,681,397	1,052,496	1,081,241	1,198,654
Interest expense		(117,181)	(88,490)	(86,055)	(92,051)	(81,996)	(81,996)
Pretax income		532,530	693,370	1,163,280	664,010	629,197	886,564
Tax rate		19%	22%	16%	17%	17%	17%
Net income		430,169	541,443	974,157	552,357	523,397	737,488
After-tax interest		(94,657)	(69,101)	(72,064)	(76,572)	(68,209)	(68,209)
Shares outstanding		1,200,000	1,200,000	1,246,144	1,301,500	1,301,500	1,301,500
FTE		7,300	9,100	11,000			
Days		365	365	365	365	365	365
Cash flow		**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Operating income (EBIT)		595,297	804,414	1,262,271	676,291	711,193	968,560
	Per share	0.50	0.67	1.01	0.52	0.55	0.74
	Growth	*-15%*	*35%*	*51%*	*-49%*	*5%*	*36%*
Operating cash flow (EBITDA)		845,389	1,142,932	1,681,397	1,052,496	1,081,241	1,198,654
	Per share	0.70	0.95	1.35	0.81	0.83	0.92
	Growth	*-7%*	*35%*	*42%*	*-40%*	*3%*	*11%*
Net cash from operations		828,630	741,820	668,208	922,686	714,295	846,655
	Per share	0.69	0.62	0.54	0.71	0.55	0.65
	Growth	*104%*	*-10%*	*-13%*	*32%*	*-23%*	*19%*
Capital expenditures		(1,125,523)	(850,284)	(1,088,203)	(325,996)	(352,076)	(369,680)
"Free cash flow"		(296,893)	(108,464)	(419,995)	596,690	362,219	476,975
	Per share	(0.25)	(0.09)	(0.34)	0.46	0.28	0.37
Net external financing needs		(296,893)	(108,464)	(419,995)	596,690	362,219	476,975
	Per share	(0.25)	(0.09)	(0.34)	0.46	0.28	0.37
CF to invest. ratio		**0.74**	**0.87**	**0.61**	**2.83**	**2.03**	**2.29**

Source: Company data, Barclays Capital estimates

APPENDIX I: BRIEF INTRODUCTION TO KEY PLAYERS

Central government: Focused on rebalancing the economy away from infrastructure and exports to include more consumption. Key factor is reducing patient uncertainty around out-of-pocket healthcare costs by providing much broader insurance coverage. Basic Medical Insurance (BMI) now covers 90% of the Chinese population (1.2bn people), albeit at a modest level.

Insurance companies: The commercial health insurance market is very small in China, but growing rapidly. This piece is critical for a mature market to provide full coverage for patients. The private insurance market will likely function as a supplement to BMI for more expensive therapies.

Patients: Typically seek care in large hospitals, even for routine care. Concern about out-of-pocket costs, which is a key driver of the high savings/consumption ratio in China. Best insurance coverage for urban workers, with out-of-pocket often limited to 30%, with balance paid by employer (20%), and government (50%). Patients remain concerned about quality and will usually buy imported drugs if they can afford them.

Doctors: Formally employed by the government. Salaries remain relatively low at roughly US$6K on average, which increases incentive to supplement income through high prescription volumes. Clinical knowledge varies widely between three tiers of hospitals, from large Class 3 hospitals with some world class clinicians to more rudimentary training at Class 1 hospitals. In fact, for procedural specialties like surgery and interventional cardiology, Class 3 hospital physicians are among the best in the world due to very high patient volumes (typically 5x that of developed markets).

Hospitals: Formally owned by government. Patient fees are low, volume is very high, service relatively poor by international standards. Previously ~50% of revenues came from drug fees, which are being eliminated by the central government. In response the government has pledged to increase treatment-related reimbursement, potentially in a DRG (diagnosis related group) system. Policy restrictions have preceded reimbursement gains, causing the majority of hospitals to run budget deficits.

Provincial governments: Two aspects: can modify Essential Drug List / Reimbursed Drug List and influence drug pricing. Much activity currently focused in this area as different provinces experiment with a range of organization and payment structures. Informal competition has developed between provinces as to who can lower drug pricing the most. This is viewed favourably by the central government (less payment required to the provinces for healthcare) and by patients (lower out of pocket costs). Drug companies and physicians are negatively impacted.

Ministry of Health (MOH): Responsible for setting broad clinical policy and licensing hospitals.

State Food and Drug Administration (SFDA): Responsible for approving drugs and devices for marketing and import to China.

National Development and Reform Commission (NDRC): Responsible for setting national level pricing for drugs.

Essential Drug List (EDL): The (generic) core medicines that must be available at low cost across China.

National Reimbursed Drug List (NRDL): The list of medicines (including the EDL) that are partially reimbursable along with pricing limits and percentage of reimbursement. Each province has a variation with minor adjustments.

APPENDIX II – CHINA HEALTHCARE SENTIMENT SURVEY

China Healthcare Sentiment Survey provided by Barclays Capital and ChinaBio® LLC

1) On a scale from 1-5, please rate your view of market growth for drugs and healthcare in China today:

1 – very low, 2 – fairly low, 3 – medium, 4 – fairly high, 5 – very high

2) On a scale from 1-5, please rate your view of government spending on drugs and healthcare today:

1 – very low, 2 – fairly low, 3 – medium, 4 – fairly high, 5 – very high

3) On a scale from 1-5, please rate your view of the pricing environment for drugs and healthcare today:

1 – strong pricing pressure, 2 – moderate pricing pressure, 3 – balanced, 4 – moderate pricing support, 5 – strong pricing support

4) On a scale from 1-5, please rate your view of the regulatory environment for drugs and healthcare today:

1 – very restrictive, 2 – restrictive, 3 – medium, 4 – supportive, 5 – very supportive

5) On a scale from 1-5, please rate your view of how the China healthcare environment will change over the next 6 months:

1 – much worse, 2 – moderately worse, 3 – similar, 4 – moderately better, 5 – much better

Valuation Methodology and Risks

China Health Care & Pharmaceuticals

China Kanghui Holdings Inc. (KH)

Valuation Methodology: Our US$19.92 PT for Kanghui is based on 22.0x 2012E non-GAAP earnings per ADS (EPADS) of Rmb5.66 (currently trading at 16.3x 2011E). The 22.0x P/E is derived by subtracting 1 SD (4.2x) for our negative sector view from the historical mean (25.3x), which we view as appropriate, given policy headwinds, and adding 0.9x for qualitative factors specific to the firm. 22.0x is roughly 0.75 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Downside risks to our US$19.92 PT for Kanghui are: 1) aggressive government pricing pressure extended to orthopaedic space; 2) increased competition for mid-tier space from premium international brands or low-end domestic players; 3) a hard landing in China, with reduced healthcare spend; and 4) a global recession, with lower earnings multiples across equity markets.

China Medical Technologies (CMED)

Valuation Methodology: Our US$4.82 PT for CMED is based on 5.0x 2012E EPADS of Rmb6.02 (currently trading at 2.9x 2011E). The 5.0x P/E is derived by subtracting 1 SD (6.6x) for our negative sector view from the historical mean (11.7x), which we view as appropriate, given policy headwinds, and subtracting 0.1x for qualitative factors specific to the firm. 5.0x is roughly 1.0 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Downside risks to our US$4.82 PT for CMED are: 1) continued negative sentiment toward small-mid cap China ADRs; 2) accounting irregularities or corporate governance issues; 3) a hard landing in China, with reduced healthcare spend; and 4) a global recession, with lower earnings multiples across equity markets.

Mindray Medical International (MR)

Valuation Methodology: Our US$25.78 PT for Mindray is based on 18.0x 2012E EPADS of US$1.43 (currently trading at 17.9x 2011E). The 18.0x P/E is derived by subtracting 1 SD (9.5x) for our negative sector view from the historical mean (25.1x), which we view as appropriate, given policy headwinds, and adding 2.4x for qualitative factors specific to the firm. 18.0x is roughly 0.75 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Risks to our US$25.78 PT for Mindray are: 1) aggressive government pricing pressure; 2) unexpectedly high growth in China or other key markets; 3) competition in the mid-tier space from both domestic and international players; 4) a hard landing in China, with reduced healthcare spend; 5) a global recession, with lower earnings multiples across equity markets.

Shandong Weigao Group Medical Polymer (1066 HK / 1066.HK)

Valuation Methodology: Our HK$6.60 PT for Weigao is based on 21.0x 2012E EPS of Rmb0.27 (currently trading at 21.8x 2011E). The 21.0x P/E is derived by subtracting 1 SD (7.6x) for our negative sector view from the historical mean (29.2x) , which we view as appropriate, given policy headwinds, and subtracting 0.6x for qualitative factors specific to the firm. 21.0x is roughly 1.0 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Risks to our HK$6.60 PT for Weigao are: 1) aggressive government pricing pressure extended to medical supplies; 2) unexpectedly fast growth within the key Class 2 hospital segment; 3) competition for premium domestic space, either from multinationals or from smaller-scale China players; 4) a hard landing in China, with reduced healthcare spend; 5) a global recession, with lower earnings multiples across equity markets.

Shanghai Pharmaceuticals Holdings (2607 HK / 2607.HK)

Valuation Methodology: Our HK$15.83 PTfor Shanghai Pharma is based on 14.0x 2012E EPS of Rmb0.94 (currently trading at 11.8x 2011E). The 14.0x P/E is derived by subtracting 1 SD (2.3x) for our negative sector view from the historical mean (16.5x), which we view as appropriate, given policy headwinds, and subtracting 0.2x for qualitative factors specific to the firm. 14.0x is roughly 1.0 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Risks to our HK$15.83 PTfor Shanghai Pharma are: 1) aggressive government limits on distribution margins; 2) difficulty with acquisition integration and value capture across diversified business; 3) a hard landing in China, with reduced healthcare spend; 4) a global recession, with lower earnings multiples across equity markets.

Sinopharm Group Co. Ltd. (1099 HK / 1099.HK)

Valuation Methodology: Our HK$16.15 PT for Sinopharm is based on 20.0x 2012E EPS of Rmb0.67 (currently trading at 23.1x 2011E). The 20.0x P/E is derived by subtracting 1 SD (7.0x) for our negative sector view from the historical mean (37.9x) , which we view as appropriate, given policy headwinds, and subtracting 10.9x for qualitative factors specific to the firm. 20.0x is roughly 2.5 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Risks to our HK$16.15 PT for Sinopharm are: 1) strong government support of distributor margins; 2) unexpected policy and pricing support for generic drugs; 3) significant improvement in credit or payment terms; 4) outperformance of the global economy, with renewed interested in Chinese equities.

United Laboratories International (3933 HK / 3933.HK)

Valuation Methodology: Our HK$4.02 PT for United Labs is based on 9.5x 2012E EPS of HK$0.40 (currently trading at 11.1x 2011E). The 9.5x P/E is derived by subtracting 1 SD (4.7x) for our negative sector view from the historical mean (10.4x), which we view as appropriate, given policy headwinds, and adding 3.8x for qualitative factors specific to the firm and current trading levels. 9.5x is roughly 0.2 SD less than the historical average.

Risks which May Impede the Achievement of the Price Target: Risks to our HK$4.02 PT for United Labs are: 1) swift and supportive government pricing policies; 2) repeal of antibiotic restrictions currently in place; and 3) outperformance of the global economy, with renewed interest in China stocks.

Source: Barclays Capital

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Primary Stocks (Ticker, Date, Price)

China Kanghui Holdings Inc. (KH, 30-Dec-2011, USD 14.74), 1-Overweight/3-Negative

China Medical Technologies (CMED, 30-Dec-2011, USD 2.84), 1-Overweight/3-Negative

Mindray Medical International (MR, 30-Dec-2011, USD 25.64), 2-Equal Weight/3-Negative

Shandong Weigao Group Medical Polymer (1066.HK, 30-Dec-2011, HKD 6.99), 2-Equal Weight/3-Negative

Shanghai Pharmaceuticals Holdings (2607.HK, 30-Dec-2011, HKD 12.58), 1-Overweight/3-Negative

Sinopharm Group Co. Ltd. (1099.HK, 30-Dec-2011, HKD 18.66), 3-Underweight/3-Negative

United Laboratories International (3933.HK, 30-Dec-2011, HKD 4.47), 3-Underweight/3-Negative

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1-Overweight - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

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3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

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3-Negative - sector coverage universe fundamentals/valuations are deteriorating.

Below is the list of companies that constitute the "sector coverage universe":

IMPORTANT DISCLOSURES CONTINUED

China Health Care & Pharmaceuticals

China Kanghui Holdings Inc. (KH)	China Medical Technologies (CMED)	Mindray Medical International (MR)
Shandong Weigao Group Medical Polymer (1066.HK)	Shanghai Pharmaceuticals Holdings (2607.HK)	Sinopharm Group Co. Ltd. (1099.HK)
United Laboratories International (3933.HK)		

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