

Hau Giang Pharmaceutical JSC (DHG VN)

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Q1/2018 results: highlights

- Net sales increased by 3.0% yoy, reaching VND 908 bn. The gross margin decreased by 3 percentage-points to 41.7% due to increased input prices and the higher proportion of the low-margin product distribution channel. Administration expenses as a percentage of net sales fell by 2.2 percentage-points to 6.7%, mainly thanks to lower compensation expenses. Net profit stayed relatively stable at VND 171 bn (-1.7% yoy).
- DHG's financial status remained solid. The D/E ratio was low at 0.24x. Cash and short-term investments accounted for 40.4% of total assets.

Other developments

- On 7 June 2018, DHG has submitted documents to the State Securities Commission (SSC) to ask for the approval to increase the Foreign Ownership Limit (FOL) from 49% to 100%. The FOL lifting process is on schedule and is expected to be completed by 1 July 2018.

Outlook

- The outlook for the Vietnamese pharmaceutical sector is bright with an estimated CAGR of 9% during the next five years.
- As for all 2018, we expect net sales to decline by 6.0% as DHG ended product distribution in early Q2/2018, while net profit should increase by 20.9% thanks to higher sales from high-margin own product sales. As for 2019, we expect the own product sales to keep their growth momentum, leading to net sales growth of 7.7% and net profit growth of 11.9%.

Recommendation

- DHG is Vietnam's leading pharmaceutical company with a strong brand presence and an extensive distribution network. Our current 2018YE valuation target is 16% higher than the current market price. We recommend investors to HOLD DHG shares at current price levels.

Rating	HOLD
2018YE TP	VND 117,223
Upside	+ 16%
2018E Div. Yield	3%

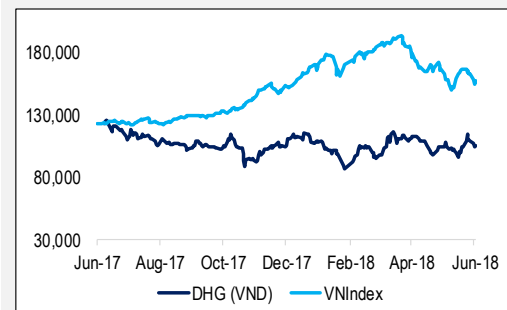
Company description

DHG is the largest domestic pharmaceutical company in Vietnam with net sales of USD 179 mn in 2017.

Stock data

Current Price	VND 101,500
52-week high/low	VND 125,584/86,717
No. of outstanding shares	130,746,071
Market cap	USD 585mn
1Y avg. volume (shs)	262,108
Foreign ownership (%)	47.13%
Foreign limit (%)	49.00%
Free float (%)	24.59%

1-year stock performance



Relative valuation

	2017	2018F	2019F
EPS (VND)	4,332	5,235	6,106
BVPS (VND)	21,013	23,274	25,911
EBITDA (VND Bn)	824,767	998,961	1,158,251
P/E (x)	23.4	19.4	16.6
P/B (x)	4.8	4.4	3.9
EV/EBITDA (x)	14.9	12.3	10.6
Div. yield (%)	3.0	2.9	3.4

Q1/2018 results: highlights

Profit and Loss statement

(All figures are VND million except percentages and where otherwise indicated)	Q1/2017	Q1/2018	Y-o-y (%)
Net revenue	882,367	908,429	3.0
Gross profit	395,703	378,367	(4.4)
Gross margin	44.8%	41.7%	
Selling expenses	142,694	144,007	0.9
Administration expenses	78,863	60,853	(22.8)
SG&A as % of sales	25.1%	22.6%	
Operating profit	174,146	173,507	(0.4)
Operating margin	19.7%	19.1%	
EBITDA	197,092	195,852	(0.6)
EBITDA margin	22.3%	21.6%	
Net financial income	(3,239)	(3,861)	
Net other income	1,585	1,131	(28.6)
Profit before tax	172,492	170,777	(1.0)
Net profit	173,874	170,981	(1.7)
Net margin	19.7%	18.8%	
EPS (VND)			

- Net sales increased by 3.0% yoy in Q1/2018, reaching VND 908 bn. The revenue structure changed somewhat with own products, product distribution and other sales accounting for 71%, 27% and 2% respectively. Own product sales fell by 3.8% yoy, and the ratio between the OTC and the ETC sales channels remained relatively unchanged at 90%:10%. Revenue from product distribution surged by 23.1% yoy. The reason for the strong result is that DHG's clients tried to overstock these products as DHG will end this business sales line as part of the FOL lifting process (distribution of MSD and Mega products will be stopped at the end of March and May 2018 respectively). Sales from other services remained negligible in the overall revenue structure. These services include mobile clinics, raw material trading, etc.
- DHG's gross margin has decreased by 3 percentage-points to 41.7%, mainly because of 1) increasing input prices. The API (Active Pharmaceutical Ingredients) price has increased by 4% since beginning of 2018 and 2) the higher proportion of the low-margin product distribution channel (in Q1/2018 this sales line had a gross margin of 9.2%, while the own products sales line reached a gross margin of 53.0%).
- Selling expenses remained stable, while administration expenses (as a percentage of net sales) fell by 2.2 percentage-points to 6.7%. The reduction in administration expenses is mainly due to lower compensation expenses as the own products sales line did not reach its Q1/2018 financial targets. Overall, the decrease of administration expenses has offset the decrease in the gross margin, resulting in a stable operating margin of 19.1% and a largely unchanged operating profit of VND 174 bn (-0.4% yoy).
- The company's net margin remained stable at 18.8%, translating into a net profit of VND 171 bn (-1.7% yoy).
- By the end of Q1/2018, DHG's financial status remained very healthy. The debt to equity ratio was low at 0.24x, and all of the debts were short-term. Cash and short-term investments accounted for 40.4% of total assets.

- In its recent annual report, DHG has laid out the yearly assessment on its strategic goals. With the vision of being the largest generic drugs producer in Vietnam, we think that DHG has been well with its clear strategic goals. Generic drugs, dietary supplements and other products accounted for 83%, 9% and 8% respectively of the company's total sales in 2017. There are 6 brands, which have annual sales of over VND 100 bn. Some of the major brands include: Hapacol (painkiller), Klamentin (antibiotics, used to treat many different infections caused by bacteria, such as sinusitis, pneumonia, ear infections, etc.), Naturenz (dietary supplement, used to enhance the hepatic function).

DHG is the largest domestic pharmaceutical company in Vietnam with a market share of about 5%. It is important to note that domestic enterprises only provide about 50% of the Vietnamese pharmaceutical demand.

In 2017, the company has restructured its sales and distribution channels, with a new sales model and a new warehouse system. DHG stated that the number of customers has increased by approximately 10% in 2017, reaching 25,000. R&D activities have reached several accomplishments: The project to upgrade of the Hapacol production line to the PIC/S standard is on schedule and will be completed by the end of 2018; there are 38 products were declared bio-equivalent to brand name drugs (a product must be proved bio-equivalent to brand name drugs before it can be manufactured and sold to the market).

Other developments

- On 7 June 2018, DHG has submitted the dossiers, in which, the company asks the SSC for the approval to raise the FOL from currently 49% to 100%. This is the final step in the FOL lifting process.

We like to recall that Vietnam's State Capital Investment Corporation (SCIC) has long been planning to divest its 43.31% stake in DHG. DHG's currently largest foreign share holder, Taisho Pharmaceutical Ltd., has expressed its interest to acquire more DHG shares. Indeed, Taisho has bought an additional 650,000 DHG shares on 6 June 2018, increasing its stake from 24.44% to 24.94%. DHG's current foreign ownership is 47.13% and close to the limit (49.00%).

- DHG has received a written confirmation by the tax authorities that the company's tax incentives will not go away after the merger of DHG's two subsidiaries and the parent company. Previously, DHG had terminated the product distribution sales line and merged its two subsidiaries, DHG Printing and Packaging 1 Ltd. as well as DHG Pharmacy Ltd., to the parent company. There were concerns that DHG would not enjoy tax incentives after the merger any more.
- In March 2018, DHG and Vietnam Dairy Products JSC (VNM VN) have signed a cooperation agreement for R&D activities to develop co-branded products. During the recent AGM (Annual General Meeting), Mr. Pham Minh Tien, has been elected as a new member of the BOD (Board of Directors). Mr. Tien is currently the Chief Marketing Officer of VNM. This election is a part of the co-operation plan.

This co-operation is a part of DHG's strategy to expand into the market for drug supplements. There is no update on this topic for the time being.

- DHG expects that it will receive the PIC/S certificate for two of its products (for Hapacol capsules and for Hapacol effervescent tablets, both are painkillers) by the end of December 2018.

2018 – 2019 Outlook

(All figures are VND million except percentages and where otherwise indicated)	2018F	Y-o-y (%)	2019F	Y-o-y (%)	2017 (USD mln)	2018F (USD mln)	2019F (USD mln)
Net revenue	3,819,994	(6.0)	4,115,575	7.7	179.0	168.3	181.3
Gross profit	1,884,063	5.6	2,109,089	11.9	78.6	83.0	92.9
Gross margin	49.3%		51.2%				
Selling expenses	689,005	(6.0)	742,318	7.7	32.3	30.4	32.7
Administration expenses	299,306	(6.0)	322,466	7.7	14.0	13.2	14.2
SG&A as % of sales	25.9%		25.9%				
Operating profit	895,752	22.2	1,044,306	16.6	32.3	39.5	46.0
Operating margin	23.4%		25.4%				
EBITDA	998,961	21.1	1,158,251	15.9	36.3	44.0	51.0
EBITDA margin	26.2%		28.1%				
Net financial income	1,366		6,186		(0.4)	0.1	0.3
Net other income	-		-		(0.1)	-	-
Profit before tax	897,118	24.5	1,050,492	17.1	31.7	39.5	46.3
Net profit	778,000	20.9	907,362	16.6	28.4	34.3	40.0
Net margin	20.4%		22.0%				
EPS (VND)	5,235	20.9	6,106	16.6			

Note: USD/VND 22,700

- There is a huge potential of Vietnam's pharmaceutical sector thanks to the expansion of the middle-class population and the Vietnamese people's increasing average age. IQVIA (IQV NYSE, formerly IMS Health and Quintiles) estimates that the medicine consumption per capita in Vietnam will grow by a CAGR of 9% during the period of 2017 – 2021.
- As for the whole 2018, we expect DHG's net sales and net profit to reach VND 3,820 bn (-6.0% yoy) and VND 778 bn (+20.9% yoy) respectively. The reason for the revenue decline is simply the termination of DHG's product distribution line, which took place in early Q2/2018 as a requirement for the FOL lifting process. With regard to the main sales line, own products, we think that DHG will grow at a higher rate than the industry average of 12%. DHG will benefit from its proven product quality and its extensive distribution network. It is important to note that DHG has already completed 1) to build its new central warehouse system, 2) the restructuring of its sales channel and sales strategy and 3) the upgrading of the Hapacol production line. These activities have resulted in some slowdown of DHG's sales in 2017. In addition, the co-operation between DHG and VNM offers a huge potential as the market for supplement drugs in Vietnam is expected to grow by 9%-10% annually (estimated by Vietnam Functional Food Association). We do not expect significant changes in the other services business line.

As we mentioned in earlier notes, DHG seems to be less affected than other domestic pharmaceutical companies by increasing API prices as it has higher bargaining power than most of its competitors. In fact, the company said that it had purchased input material at much more favorable prices than its domestic competitors in Q1. It is worth noting that the price gap between DHG's products and those of foreign pharmaceutical companies is considerable. We keep our conservative forecast of a somewhat lower gross margin of 54.8% for DHG's own products line in 2018. Overall, thanks to the higher proportion of the high-margin own products (expected to account for nearly 90% of total revenue), DHG's gross margin is expected to improve to 49.3%.

As DHG has received written confirmation from the tax authorities that it will still enjoy the tax incentives as it did before the merger of its two subsidiaries into the parent company. We estimate that the company's

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effective tax rate for 2018 will be 11.4%, leading to a net margin of 20.8%.

- As for 2019, net sales and net profit growth are expected to reach 7.7% yoy and 16.6% yoy respectively. We strongly believe that the own product sales line will maintain its growth momentum (12.5% yoy). There will be no sales from product distribution, and sales from other services are expected to remain stable. The ratio of own products to other sales lines should then be 93.5%:6.5%, which is likely to translate into a gross margin of 51.3%. The company's net margin is expected to improve accordingly to 22.0%.
- The company has currently no major investment plans.

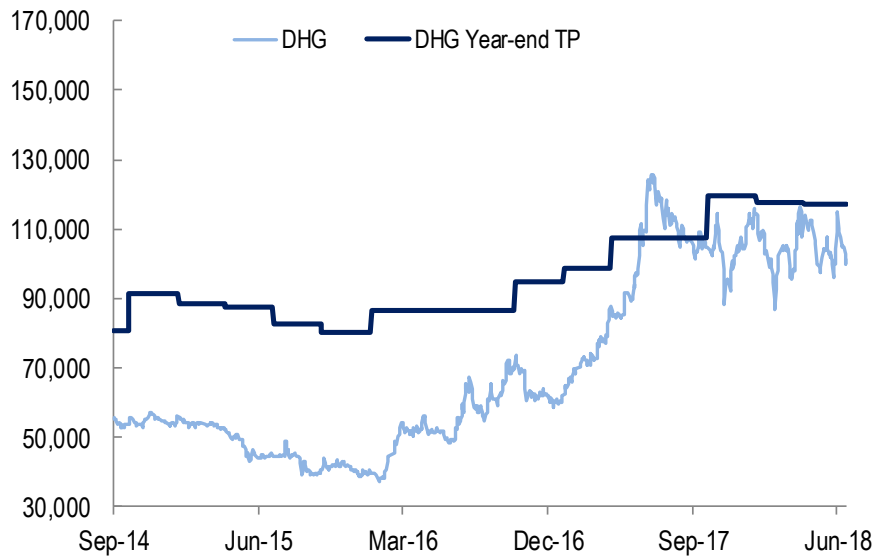
Recommendation

- DHG shares closed at VND 101,500/share on 20 June 2018 and are trading at a 2018F P/E and at a P/B ratio of 19.4x and of 4.4x respectively. This is lower than the regional level (the Asia Pacific ex Japan healthcare sector is trading at a forward P/E of 29.6x and at a trailing P/B of 5.9x, source: Credit Suisse).
- DHG is the largest domestic pharmaceutical company in Vietnam in terms of revenue. The company has a strong brand presence, an extensive distribution network and strong support from its currently largest foreign shareholder, Taisho Pharmaceutical Ltd., one of the leading OTC drug companies in Japan. Moreover, the prospects of Vietnam's pharmaceutical sector are very bright as discussed above.
- Our 2018YE valuation target is VND 117,223/share, which is 16% higher than the current share price. We recommend investors to HOLD DHG shares at the current price level.

Appendix 1: Balance Sheet and Ratio

Balance Sheet (Figures in VND Mil)	2015	2016	2017	2018F	2019F
Cash	594,908	603,189	543,652	616,355	886,322
Short-term Financial Investment	333,193	703,731	930,559	1,023,615	1,125,977
Account Receivable	645,119	692,281	807,659	759,259	818,009
Inventory	634,925	732,861	634,012	519,109	517,963
Other Current Assets	9,572	14,011	25,428	23,905	25,754
Current Asset	2,217,717	2,746,073	2,941,310	2,942,243	3,374,024
Tangible Fixed Assets	809,654	841,469	785,209	873,705	865,157
Intangible Fixed Assets	256,418	261,965	241,790	236,893	231,996
Work-in-progress	16,991	17,161	36,308	-	-
Long-term Financial Investment	15,932	15,744	14,538	15,991	17,591
Other Non-current Assets	43,135	57,831	66,940	73,634	80,998
Non-current Asset	1,142,130	1,194,170	1,144,785	1,200,224	1,195,742
Total Assets	3,359,847	3,940,242	4,086,095	4,142,467	4,569,766
Account Payable	242,911	321,663	314,126	223,254	231,390
Expenses Payable	122,683	170,799	170,969	154,353	166,296
Short-term Loans	270,711	354,765	469,800	441,647	475,820
Short-term Liabilities	774,562	1,017,959	1,266,925	1,024,056	1,106,451
Long-term Loans	-	-	-	-	-
Other Long-term Payables	62,330	57,600	63,449	63,449	63,449
Long-term Liabilities	62,330	57,600	63,449	63,449	63,449
Total Liabilities	836,892	1,075,559	1,330,374	1,087,505	1,169,900
Common Shares	871,643	871,643	1,307,461	1,307,461	1,307,461
Capital Surplus (Share Premium)	-	6,779	6,779	6,779	6,779
Retained Earnings	607,632	736,639	337,999	633,583	978,315
Funds (Dev. & Investment, Others)	1,039,479	1,220,562	1,095,181	1,095,181	1,095,181
Total Equity	2,502,633	2,835,623	2,747,419	3,043,003	3,387,736
Minority Interest	20,323	34,160	11,812	11,959	12,130
Total Equity and Liabilities	3,359,848	3,945,342	4,089,605	4,142,467	4,569,766
	2015	2016	2017	2018F	2019F
Gross Margin (%)	39.2%	45.3%	43.9%	49.3%	51.2%
Operating Margin (%)	19.3%	20.7%	18.0%	23.4%	25.4%
Net Margin (%)	16.5%	18.2%	15.8%	20.4%	22.0%
ROA (Average) (%)	17.5%	19.1%	16.6%	19.5%	21.4%
ROE (Average) (%)	24.8%	25.8%	23.1%	26.9%	28.2%
Current Ratio	2.9	2.7	2.3	2.9	3.0
Quick Ratio	2.0	2.0	1.8	2.4	2.6
Debt/Total Assets (%)	0.1	0.1	0.1	0.1	0.1
Turnover Growth (%)	-7.8%	4.8%	7.4%	-6.0%	7.7%
Net Profit Growth (%)	12.1%	15.9%	-6.5%	20.9%	16.6%

Appendix 2: Historical Target Price (year-end target for any given year), in VND



Note:

- Year-end target prices are those we communicated through our quarterly notes, adjusted for share bonus and share dividend
- When our report note is issued within Q4 of each year, we communicate already the target price at year-end of the next year

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