



## 中国：医疗保健：医药

### 坚持选择性择股; 对三家中药企业首次评级; 买入天士力和东阿阿胶(摘要)

#### 医疗改革使 2010 年盈利前景改善

我们维持对该行业的中性看法，因为我们认为投资者可以增持其他行业中估值倍数较低而增长较高的股票。我们预计，受医保范围扩大的推动，未来两到三年中国医疗改革的积极影响可能加速显现，到 2010 年企业盈利前景将有所改善。然而在我们看来，A 股医药板块的估值仍然偏高，因此我们建议投资者坚持选择性择股。

#### 对天士力（买入，位于强力买入名单）、东阿阿胶（买入）及云南白药（中性）进行首次评级

天士力是中国医药行业的领军企业，其主打产品的年销售额突破人民币 10 亿元关口。我们认为市场低估了该公司的长期增长潜力。东阿阿胶在特色药品市场中处于垄断地位，控制着阿胶产品 95% 以上的原材料供应。公司受益于强大的定价能力以及垂直整合带来的进一步增长机会。与我们研究范围内的其他股票相比，其轻资产模式带来了较高的超额现金回报。我们看好云南白药进军增长迅速的消费品市场的经营战略，但给予其中性的首次评级，原因是我们认为公司对消费品市场的愈发侧重使该股的高估值难以持续。此外，我们还将江苏恒瑞医药和山东威高集团的评级由卖出上调至中性，将神威药业的评级由中性上调至买入。我们将先声药业剔除我们的强力买入名单，但维持买入评级。此外，我们还调整了研究范围内各股票的目标价格和每股盈利预测（北京双鹭药业除外）。

#### 估值

今年以来，中国医疗保健股落后大市 34 个百分点。2009 年 4 月以来，国内医疗保健股较 MSCI 中国指数 A 股的估值溢价已经从 97% 大幅收缩至 37%（4 年平均溢价水平为 57%）。鉴于市场状况正常化以及国内医药股强劲的增长前景，我们对研究范围内的股票采用新的 Director's Cut 估值方法来确定评级。该方法根据其行业相对企业价值/总现金投资（资产市值）与投资资本的现金回报率/加权平均资本成本（超额回报）对股票进行评级。目前我们以 2010 年周期中值预期市盈率计算所有股票的目标价格，同时用 Director's Cut 进行交叉验证。

#### 风险

监管风险、中国宏观经济放缓幅度高于预期。

\*全文翻译将随后提供

#### 我们研究范围内的股票一览

Company Name	Ticker	Rating	Pricing	12-m	Potential up/downside	
		New	Old	Currency	TP	
Tianjin Tasly	600535.SS	Buy*		Rmb	18.59	27%
Dong E E-jiao	000423.SZ	Buy		Rmb	20.64	22%
Shineway	2877.HK	Buy	Neutral	HK\$	8.17	15%
Simcere	SCR	Buy	Buy*	US\$	8.71	11%
Mindray	MR	Neutral	Buy	US\$	24.27	-1%
Hengrui	600276.SS	Neutral	Sell	Rmb	34.31	1%
China Pharma	1093.HK	Neutral	Buy	HK\$	4.63	3%
Beijing SL	002038.SZ	Neutral	Neutral	Rmb	32.71	1%
Yunnan Baiyao	000538.SZ	Neutral	Neutral	Rmb	34.75	-1%
Weigao	8199.HK	Neutral	Sell	HK\$	17.62	3%
Guangzhou Pharma	874.HK	Sell	Sell	HK\$	2.70	-20%
Kehua	002022.SZ	Sell	Sell	Rmb	13.79	-19%
NHU	002001.SZ	Sell	Sell	Rmb	22.06	-24%

\*该股位于我们的亚大强力买入名单。请注意我们在 6 月 9 日和 10 日的报告中将迈瑞公司和中国制药的评级由买入下调至中性。

资料来源: Datastream、高华证券研究预测

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## China: Healthcare: Pharmaceuticals

### Stay selective; initiating on three TCM companies; Buy Tasly, E-Jiao

#### Improved earnings prospects in 2010 on healthcare reform

We retain our neutral stance on the sector as we believe investors can gain exposure to higher growth at lower multiples elsewhere. We expect earnings prospects to improve in 2010 as the positive impact of China's healthcare reforms is likely to accelerate in the next two to three years, driven by expanded insurance coverage. However, we think A-share healthcare multiples are still demanding, thus we suggest investors stay selective.

#### Initiate on Tasly (Buy, Conv. List), E-Jiao (Buy), Baiyao (Neutral)

**Tianjin Tasly** is a leading player in China's pharmaceutical industry with sales of its leading product exceeding the Rmb1 bn mark annually. We think the market is underestimating the company's long-term growth potential.

**Dong E E-Jiao** is a niche market player with a monopoly position, controlling over 95% of the raw material supply for E-Jiao products. It enjoys strong pricing power and additional growth opportunities through vertical integration. Its asset-light business model offers higher excess cash returns compared to the other stocks in our coverage group. We like **Yunnan Baiyao's** business strategy of tapping into the fast-growing consumer market, but initiate with a Neutral rating as we think its premium valuation is no longer justified, given its increasingly consumer-oriented focus. We also upgrade Hengrui and Weigao to Neutral from Sell, and Shineway to Buy from Neutral. We remove Simcere from our Conviction Buy List but retain our Buy rating. We also change our target prices and EPS estimates (except for Beijing SL) across the board.

#### Valuation

Chinese healthcare stocks have underperformed the market by 34 pp ytd. The valuation premium of onshore healthcare stocks vs. MSCI China A has shrunk substantially to 37% from 97% (vs. the 4-yr avg. premium of 57%) since April 2009. Given normalizing market conditions and the strong growth profile of domestic pharma stocks, we adopt a new valuation approach for our coverage group to determine our ratings, "the Director's Cut". This approach rates stocks on the basis of their sector relative EV/GCI (market value of assets) vs. CROCI/WACC (excess returns). We now base all our target prices on mid-cycle 2010E P/Es, cross-checked by Director's Cut.

#### Risks

Regulatory risks, worse-than-expected macro slowdown in China.

#### SUMMARY OF OUR COVERAGE UNIVERSE

Company Name	Ticker	Rating New	Rating Old	Pricing Currency	12-m TP	Potential up/downside
Tianjin Tasly	600536.SS	Buy*		Rmb	18.59	27%
Dong E E-Jiao	000423.SZ	Buy		Rmb	20.64	22%
Shineway	2877.HK	Buy	Neutral	HK\$	8.17	15%
Simcere	SCR	Buy	Buy*	US\$	8.71	11%
Mindray	MR	Neutral	Buy	US\$	24.27	-1%
Hengrui	600276.SS	Neutral	Sell	Rmb	34.31	1%
China Pharma	1093.HK	Neutral	Buy	HK\$	4.63	3%
Beijing SL	002038.SZ	Neutral	Neutral	Rmb	32.71	1%
Yunnan Baiyao	000538.SZ	Neutral		Rmb	34.75	-1%
Weigao	8199.HK	Neutral	Sell	HK\$	17.62	3%
Guangzhou Pharma	874.HK	Sell	Sell	HK\$	2.70	-20%
Kehua	002022.SZ	Sell	Sell	Rmb	13.79	-19%
NHU	002001.SZ	Sell	Sell	Rmb	22.06	-24%

\*This stock is on our regional Conviction list. Note that we downgraded both Mindray and China Pharmaceutical from Buy to Neutral in notes published on June 9 and 10, respectively.

Source: Datastream, Gao Hua Securities Research estimates.

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*The prices in the body of this report are based on the market close of June 5, 2009, unless noted otherwise.*

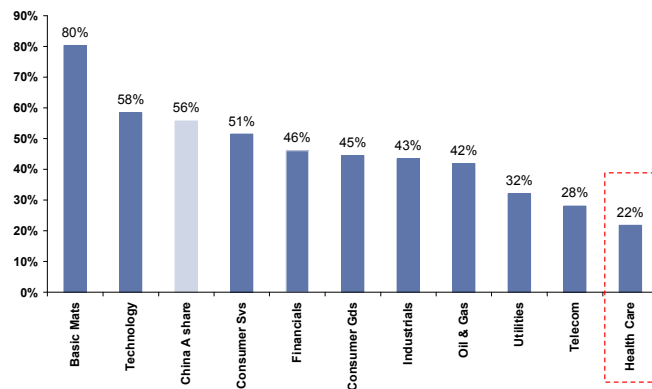
## Sector overview: Fundamentals improving, but stay selective

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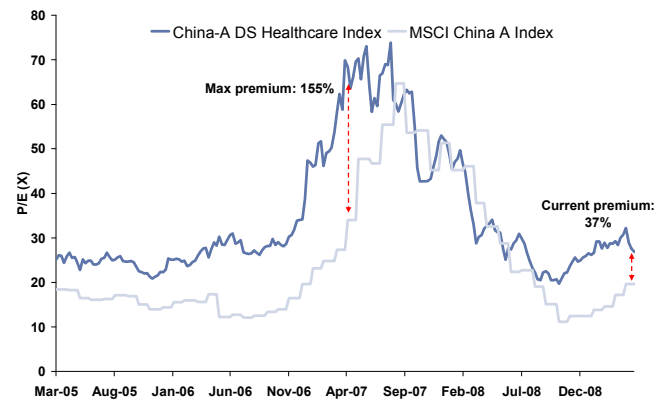
### Despite strong fundamentals, valuations are still demanding

While we remain cautious on the 2009 earnings outlook for the majority of stocks under our coverage, we think earnings prospects are improving as we head into 2010. **We believe the positive impact of China’s healthcare reforms is likely to accelerate in the next two to three years driven by an expansion in insurance coverage.** However, we think A-share healthcare multiples are still demanding. Our neutral sector stance is mainly based on our belief that investors can gain exposure to higher growth at lower multiples than is currently being offered by the Chinese healthcare sector.

Chinese healthcare stocks have underperformed the market 34 pp ytd. The valuation premium of onshore healthcare stocks vs. the MSCI China A has shrunk substantially to 37% from 97%, well below its 4-year average premium of 57%, since early April.

**Exhibit 1: Healthcare has lagged relative to the market**

Source: Datastream, Gao Hua Securities Research.

**Exhibit 2: Onshore healthcare stocks trade at a 37% premium to MSCI China A, below their 4-year avg of 57%**

Source: Datastream, Gao Hua Securities Research.

We suggest investors stay selective and choose underappreciated, quality names—such as Simcere, Tasly and Shineway—in the China healthcare sector. We recommend three key themes for stock picking:

1. Choose companies with a **clear exposure to specific reform measures** and stocks that we believe are **oversold**. **Simcere remains our top pick** in this respect given its valuation, which we consider to be undemanding. We believe Simcere's recent acquisition of Jiangsu Yanshen, the vaccine maker, better positions the company to benefit from ongoing healthcare reforms.
2. Choose companies with **best-in-class products and higher cash returns**. We prefer **Tasly and E-Jiao** on these aspects, given their proprietary formulation technical "know-how" and asset-light business model, respectively.
3. Choose companies **focused on "inexpensive" chronic disease therapeutics**, such as cancer, cardiovascular diseases, diabetes and hepatitis, which in our view offer sustainable growth prospects in the long term. We prefer **Hengrui, Tasly and E-Jiao** in this segment.

## Our TCM stock picks: Buy Tasly (CL) and E-Jiao, Neutral on Baiyao

China's traditional Chinese medicine (TCM) industry (and the pharmaceutical industry overall) is highly fragmented, with the top three companies (namely Yunnan Baiyao, Guangzhou Pharma and Tasly) by sales in 2008 accounting for less than 10% of the total Chinese pharmaceutical market. Therefore, we prefer companies with branded products, proprietary technology and a niche market focus. We think technical know-how offers companies a core strength by which they can differentiate themselves in China's highly fragmented pharmaceutical market. Please refer to our analysis of China's TCM industry beginning on page 14.

**Tianjin Tasly (600535.SS):** Tasly is a leading TCM company in China's pharmaceutical industry. It manufactures Cardiotonic pills—the only traditional Chinese medicine (TCM) product that has exceeded the Rmb1 bn sales mark annually. We value the company's proprietary formulation technology and believe the market has not fully recognized Tasly's long-term growth potential. We expect the company to post earnings CAGR of

25% in 2009E-2011E on the back of revenue CAGR of 21%, driven by stable growth in its distribution business and the increasing market demand of inexpensive products for the treatment of cardiovascular diseases. We believe the sales of its legacy product, the Cardiotonic pill will pick up in 2009 and 2010 due to the deferred impact of price hikes in 2008 and its growing penetration in urban and rural hospitals amid the ongoing healthcare reform. Thus, we initiate on Tasly with a Buy rating (adding it to our Conviction list) and a 12-month target price of Rmb18.59 based on 23X 2010E EPS. Key downside risk: worse-than-expected sales of its legacy products and other non-core products.

**Dong E E-Jiao (000423.SZ):** We like E-Jiao for its niche marketing strategy and monopoly in controlling over 95% of the raw material supply (of donkey skin) for E-Jiao products. Its dominant market position offers strong pricing power on E-Jiao's average selling price as well as provides a cushion for the company which has to pay a premium in securing sufficient raw material supply of donkey skin. Moreover, E-Jiao's strategic move towards the donkey breeding business offers additional opportunities in the food processing industry, which will in turn alleviate its risk of relying on a single product category, and will help in diversifying its business risk. The company also tops our list on higher excess cash return due to its light asset-backed operation in our stock picking framework using our "Director's Cut" methodology (see the Valuation section of this report). Thus, we initiate on E-Jiao with a Buy rating and a 12-month target price of Rmb20.64 based on 25X 2010E EPS. The key risks on the downside are: 1) limited output due to a shortage of raw material (donkey skin) supply which may cap volume growth, and 2) continuous pricing pressure from counterfeit products.

**Yunnan Baiyao (000538.SZ):** We value Baiyao's brand name as well as its business strategy of tapping into the fast growing consumer market in China. Thus, we initiate with a Neutral rating on concerns that its premium valuation may no longer be justified given its increasingly consumer-oriented focus. We assign a 12-month target price of Rmb34.75 based on 24X 2010E EPS. The key risk on the upside is stronger-than-expected growth in the sales of Baiyao paste and other new products; on the downside, the key risk is lower-than-expected growth in the tooth paste sales.

### Exhibit 3: Summary of rating and target price changes to our coverage

Company Name	Ticker	Rating			Pricing Currency	Current Price	12-m Target price			Potential up/downside	Implied P/E 10E
		New	Old	Change			New	Old	% chg		
Tianjin Tasly	600535.SS	Buy*			Rmb	14.60	18.59			27%	23
Dong E E-jiao	000423.SZ	Buy			Rmb	16.92	20.64			22%	25
Shineway	2877.HK	Buy	Neutral	↑	HK\$	7.12	8.17	5.10	60%	15%	9
Simcere	SCR	Buy	Buy*	↓	US\$	7.83	8.71	8.90	-2%	11%	9
Hengrui	600276.SS	Neutral	Sell	↑	Rmb	33.97	34.31	26.50	29%	1%	25
Beijing SL	002038.SZ	Neutral	Neutral	↔	Rmb	32.37	32.71	36.49	-10%	1%	23
Yunnan Baiyao	000538.SZ	Neutral			Rmb	35.15	34.75			-1%	24
Weigao	8199.HK	Neutral	Sell	↑	HK\$	17.10	17.62	13.00	36%	3%	22
Guangzhou Pharma	874.HK	Sell	Sell	↔	HK\$	3.39	2.70	2.03	33%	-20%	9
Kehua	002022.SZ	Sell	Sell	↔	Rmb	17.10	13.79	12.15	13%	-19%	23
NHU	002001.SZ	Sell	Sell	↔	Rmb	29.05	22.06	22.50	-2%	-24%	12

\* Indicates the stock is on our Conviction list. For methodology and risks associated with our 12-month target prices mentioned, please refer to analyst's previously published research.

Source: Bloomberg, Gao Hua Securities estimates.

**Exhibit 4: Comparative valuation table reflecting our coverage universe**

Company	Ticker	Stock rating	Market cap (US\$bn)	Pricing Currency	Price 5-Jun-09	EPS (reporting currency)			P/E (X)		EPS CAGR 09E-11E (%)	PEG 09E-11E (X)	P/B 10E (X)	EV/EBITDA 10E (X)	ROE 10E (%)	ROA 10E (%)
<b>HK &amp; US listed Pharmaceuticals</b>																
Guangzhou Pharmaceutical (H)	0874.HK	Sell	0.4	HK\$	3.39	0.24	0.26	0.26	12.4	11.3	4.8	2.6	0.7	26.0	6%	5%
China Pharmaceutical Group	1093.HK	Neutral	0.9	HK\$	4.48	0.68	0.58	0.49	6.5	7.7	-15.6	NM	1.2	3.8	16%	10%
China Shineway Pharmaceutical Group	2877.HK	Buy	0.8	HK\$	7.12	0.69	0.80	0.87	9.1	7.9	12.1	0.7	1.7	3.3	23%	20%
Sincere Pharmaceutical Group	SCR	Buy	0.5	\$	7.83	5.29	6.62	8.46	10.1	8.1	26.5	0.4	1.1	3.3	15%	12%
Average									9.5	8.8	7.0	1.2	1.2	9.1	15%	12%
Median									9.6	8.0	8.5	0.7	1.1	3.5	15%	11%
<b>Medical Devices</b>																
Mindray Medical International	MR	Neutral	2.6	\$	24.43	1.12	1.37	1.77	21.8	17.8	25.7	0.8	3.7	11.0	23%	16%
Shandong Weigao Group	8199.HK	Neutral	2.2	HK\$	17.10	0.56	0.70	0.83	27.0	21.4	22.0	1.2	4.8	21.6	25%	19%
Average									24.4	19.6	23.9	1.0	4.2	16.3	24%	18%
Median									24.4	19.6	23.9	1.0	4.2	16.3	24%	18%
<b>A share Pharmaceuticals</b>																
Shanghai Kehua Bio-Engineering Co	002022.SZ	Sell	0.8	Rmb	17.10	0.49	0.60	0.74	34.9	28.5	23.1	1.5	8.7	23.5	33%	26%
Zhejiang NHU Co	002001.SZ	Sell	1.5	Rmb	29.05	1.17	1.78	1.62	24.7	16.3	17.6	1.4	3.5	10.3	24%	14%
Beijing SL Pharmaceutical	002038.SZ	Neutral	1.2	Rmb	32.37	1.16	1.42	1.73	27.9	22.8	22.1	1.3	6.6	17.5	32%	30%
Jiangsu Hengrui Medicine Co.	600276.SS	Neutral	2.6	Rmb	33.97	1.10	1.37	1.51	30.8	24.7	17.0	1.8	6.3	19.4	29%	25%
Average									29.6	23.1	20.0	1.5	6.3	17.7	29%	24%
Median									29.4	23.8	19.9	1.5	6.5	18.5	30%	26%
<b>TCM</b>																
Tianjin Tasly Pharmaceutical Co.	600535.SS	Buy*	1.1	Rmb	14.60	0.64	0.81	0.99	22.9	18.1	24.7	0.9	3.5	13.0	20%	10%
Yunnan Baiyao Grp Co.	000538.SZ	Neutral	2.5	Rmb	35.15	1.11	1.42	1.74	31.8	24.7	25.4	1.3	4.7	17.4	20%	13%
Shandong Dong-E E-Jiao Co.	000423.SZ	Buy	1.3	Rmb	16.92	0.67	0.83	1.00	25.3	20.5	22.4	1.1	4.7	15.7	24%	18%
Average									26.6	21.1	24.2	1.1	4.3	15.4	21%	14%
Median									25.3	20.5	24.7	1.1	4.7	15.7	20%	13%

Note that we downgraded both Mindray and China Pharmaceutical from Buy to Neutral in notes published on June 9 and 10, respectively.

\*Indicates the stock is on our Conviction list.

Source: Gao Hua Securities Research estimates, Bloomberg.

**Rating changes to our onshore coverage: Upgrade Jiangsu Hengrui**

We remove Jiangsu Hengrui from Sell on valuation grounds as we roll forward our estimates to 2010. The stock has risen 7.4% vs. 25.3% of the Shanghai A-share index since we added it to our Sell list on February 9, 2009; it is up 10.8% over the last 12 months (vs. -16.2% for the Shanghai A-share index). We expect the company to post strong 2Q09 earnings, boosted by valuation gains from its mark-to-market securities amid the recent market rally.

We revise our 2010E/2011E EPS estimates by 1.5%/9.4%, respectively, due to changes in the effective tax rate. We also raise our target price to Rmb34.31 (from Rmb26.50) due to the net effect of upward EPS adjustment and rolling forward to 2010 P/E multiples.

Our revised 12-month target price of Rmb34.31 is based on 25X 2010E P/E, a mid-cycle valuation (from PEG-based valuation methodology previously).

Risks: (1) better-than-expected market penetration of newly-launched products is a key upside risk, and (2) rising R&D costs and a worse-than-expected slowdown in the sale of its legacy products represent downside risks.

**Exhibit 5: Hengrui's share price performance versus peer group**

Prices as of the close of June 9, 2009

Company	Ticker	Primary analyst	Price currency	Price as of 06/09/09	Price performance since 02/09/09	3 month price performance	6 month price performance	12 month price performance
<b>Asia Pacific Pharmaceuticals Peer Group</b>								
Jiangsu Hengrui Medicine Co.	600276.SS	Wei Du, Ph.D	Rmb	34.33	7.4%	3.7%	16.0%	10.8%
Apollo Hospitals	APLH.BO	Balaji V. Prasad	Rs	498.60	24.6%	36.7%	26.8%	2.3%
Biocon	BION.BO	Vikram Sahu	Rs	207.10	101.2%	110.9%	115.1%	-10.0%
Cadila Healthcare	CADI.BO	Vikram Sahu	Rs	330.05	26.7%	38.2%	40.3%	20.5%
China Pharmaceutical Group	1093.HK	Wei Du, Ph.D	HK\$	4.50	67.9%	59.0%	82.9%	23.3%
China Shineway Pharmaceutical Group	2877.HK	Wei Du, Ph.D	HK\$	7.01	58.2%	56.8%	55.8%	13.1%
Cipla	CIPL.BO	Vikram Sahu	Rs	230.80	20.0%	13.5%	24.1%	11.3%
Dr. Reddy's Laboratories	REDY.BO	Vikram Sahu	Rs	686.00	47.8%	77.8%	42.6%	-1.0%
Fortis Healthcare	FOHE.BO	Balaji V. Prasad	Rs	104.95	57.2%	62.5%	66.7%	47.6%
Glenmark Pharmaceuticals	GLEN.BO	Vikram Sahu	Rs	226.95	57.1%	77.0%	-19.4%	-66.2%
Guangzhou Pharmaceutical (H)	0874.HK	Wei Du, Ph.D	HK\$	3.64	34.8%	54.2%	56.9%	-44.4%
Lupin	LUPN.BO	Vikram Sahu	Rs	824.60	35.1%	40.5%	48.0%	27.0%
Piramal Healthcare	PIRA.BO	Vikram Sahu	Rs	264.50	37.4%	43.5%	26.9%	-27.5%
Ranbaxy Laboratories	RANB.BO	Vikram Sahu	Rs	266.20	17.0%	88.4%	24.9%	-47.5%
Shandong Weigao Group	8199.HK	Wei Du, Ph.D	HK\$	16.78	25.2%	37.5%	53.7%	32.1%
Simcere Pharmaceutical Group	SCR	Wei Du, Ph.D	\$	7.79	11.8%	41.9%	18.0%	-48.4%
Sun Pharmaceutical Industries	SUN.BO	Vikram Sahu	Rs	1,334.75	22.4%	30.7%	28.8%	-5.9%
Zhejiang NHU Co	002001.SZ	Wei Du, Ph.D	Rmb	30.00	-5.4%	-4.9%	13.0%	-40.4%
Shanghai Kehua Bio-Engineering Co	002022.SZ	Wei Du, Ph.D	Rmb	16.87	-4.0%	9.2%	2.1%	-8.2%
Beijing SL Pharmaceutical	002038.SZ	Wei Du, Ph.D	Rmb	32.50	-11.8%	-4.6%	-4.9%	8.3%
<b>Shanghai SE A Share Index</b>				<b>2,926</b>	<b>25.3%</b>	<b>31.6%</b>	<b>36.8%</b>	<b>-16.2%</b>

Note: Results presented should not and cannot be viewed as an indicator of future performance.

Source: FactSet, Quantum database.

Our estimates are slightly above consensus for Tasly and E-Jiao, as we believe consensus has not factored in the positive earnings impact of continuing price hikes in the years to come. Our estimates for Hengrui are now in line with consensus.

**Exhibit 6: We are more optimistic about Tasly and E-Jiao than the market/consensus**

Company Nme	Reporting Currency	EPS 2009E			EPS 2010E			EPS 2011E		
		Est	Consensus	% Diff	Est	Consensus	% Diff	Est	Consensus	% Diff
Tianjin Tasly	Rmb	0.64	0.63	1%	0.81	0.76	6%	0.99	0.96	3%
Yunnan Baiyao	Rmb	1.11	1.13	-2%	1.42	1.55	-8%	1.74	1.83	-5%
Dong E E-jiao	Rmb	0.67	0.61	10%	0.83	0.76	9%	1.00	0.91	10%
Hengrui	Rmb	1.10	1.08	2%	1.37	1.33	3%	1.51	1.56	-3%

Source: Wind, Gao Hua Securities estimates.

**Exhibit 7: Our EPS assumption change for the onshore listed company**

Company Nme	Ticker	Rating	Reporting Currency	EPS 2009E			EPS 2010E			EPS 2011E		
				New	Old	% chg	New	Old	% chg	New	Old	% chg
Hengrui	600276.SS	Neutral	Rmb	1.10	0.99	11%	1.37	1.35	2%	1.51	1.38	9%

Source: Gao Hua Securities estimates.



## Rating changes to our offshore coverage: Upgrade Shineway to Buy, Weigao to Neutral

### Exhibit 7: Summary of rating and target price changes to our offshore coverage

Company Name	Ticker	Rating		Pricing Currency	Current Price	12-m TPs		Potential up/downside	Implied P/E 10E
		Old	New			Old	New		
Guangzhou Pharma	874.HK	Sell	Sell	HK\$	3.39	2.03	2.70	-20%	9
China Pharma	1093.HK	Buy	Neutral	HK\$	4.48	4.10	4.63	3%	8
Shineway	2877.HK	Neutral	Buy	HK\$	7.12	5.10	8.17	15%	9
Simcere	SCR	Buy*	Buy	US\$	7.83	8.90	8.71	11%	9
Mindray	MR	Buy	Neutral	US\$	24.43	24.00	24.27	-1%	16
Weigao	8199.HK	Sell	Neutral	HK\$	17.10	13.00	17.62	3%	22

Note: The changes to Mindray's rating/target price/estimates were made in a note published on 9 June; the changes to China Pharmaceutical's rating/target price/estimates were made in a note published on June 10.

\*Indicates the stock is on our Conviction list.

Source: Bloomberg, Gao Hua Securities estimates.

### Upgrade Shineway to Buy on substantial exposure to urban hospital sales

We upgrade Shineway (2877.HK) to Buy from Neutral as we believe that the company will greatly benefit from the expanding insurance coverage due to its strong presence in the rural areas amid the ongoing healthcare reforms. Despite its slower growth in the segment of TCM injections, turnover in the soft-capsule products and granules remain strong, up by 41% and 47% yoy in 1Q09, respectively, helped by its persistent advertising and promotional efforts.

We revise our revenue forecasts for 2009E/2010E/2011E by 7.9%/11.5%/14.2%, respectively, on the back of strong growth momentum of inexpensive generics in the near-medium term. Accordingly, we also revise our EPS estimates by 9.5%/9.5%/11.53% for 2009E/2010E/2011E, respectively. Although sales of TCM injections continue to face challenges, we do not envision the government banning TCM injections, given their cost advantage and popularity in the rural markets.

**Valuation:** We raise our 12-month target price to HK\$8.17 (from HK\$5.10), which is based on 9.0X 2010E P/E (2-year average P/E multiple).

**Risks:** Worse-than-expected slowdown in the sales of TCM injections is a key downside risk.

### Upgrade Weigao on sector-wide multiple expansion

We upgrade Weigao to Neutral from Sell on multiple expansion in the medical consumable sector, driven by stable growth prospects amid all the economic uncertainty. The stock has risen 31.5% since we added it to our Sell list on February 4, 2009, vs. a 45.1% gain in the Hang Seng China Enterprises Index (HSCEI) over the same time frame. The stock is up 32.1% vs. a drop of 22.3% in the HSCEI over the past 12 months. We are positive on Weigao's earnings growth in 2010; however, we believe the current price already reflects the positives.

**Valuation:** We revise our 12-month target price to HK\$17.62 (from HK\$13.0), based on 22X 2010E P/E (4-year average) from previous market-based sector average P/E. This valuation multiple represents a mid-cycle P/E valuation and it is also in line with implied multiples using our DC methodology.



**Risks:** Better-than-expected sales in the high-end medical consumable segment pose an upside risk, while price erosion in the conventional medical consumable segment is a key downside risk.

### Exhibit 8: Weigao's share price performance versus peer group

Prices as of the close of June 9, 2009

Company	Ticker	Primary analyst	Price currency	Price as of 06/09/09	Price performance since 02/04/09	3 month price performance	6 month price performance	12 month price performance
<b>Asia Pacific Pharmaceuticals Peer Group</b>								
<b>Shandong Weigao Group</b>	<b>8199.HK</b>	<b>Wei Du, Ph.D</b>	<b>HK\$</b>	<b>16.78</b>	<b>31.5%</b>	<b>37.5%</b>	<b>53.7%</b>	<b>32.1%</b>
Apollo Hospitals	APLH.BO	Balaji V. Prasad	Rs	498.60	26.1%	36.7%	26.8%	2.3%
Biocon	BION.BO	Vikram Sahu	Rs	207.10	105.2%	110.9%	115.1%	-10.0%
Cadila Healthcare	CADI.BO	Vikram Sahu	Rs	330.05	26.7%	38.2%	40.3%	20.5%
China Pharmaceutical Group	1093.HK	Wei Du, Ph.D	HK\$	4.50	85.2%	59.0%	82.9%	23.3%
China Shineway Pharmaceutical Group	2877.HK	Wei Du, Ph.D	HK\$	7.01	47.9%	56.8%	55.8%	13.1%
Cipla	CIPL.BO	Vikram Sahu	Rs	230.80	18.3%	13.5%	24.1%	11.3%
Dr. Reddy's Laboratories	REDY.BO	Vikram Sahu	Rs	686.00	57.1%	77.8%	42.6%	-1.0%
Fortis Healthcare	FOHE.BO	Balaji V. Prasad	Rs	104.95	63.6%	62.5%	66.7%	47.6%
Glenmark Pharmaceuticals	GLEN.BO	Vikram Sahu	Rs	226.95	87.3%	77.0%	-19.4%	-66.2%
Guangzhou Pharmaceutical (H)	0874.HK	Wei Du, Ph.D	HK\$	3.64	49.2%	54.2%	56.9%	-44.4%
Lupin	LUPN.BO	Vikram Sahu	Rs	824.60	44.1%	40.5%	48.0%	27.0%
Piramal Healthcare	PIRA.BO	Vikram Sahu	Rs	264.50	26.9%	43.5%	26.9%	-27.5%
Ranbaxy Laboratories	RANB.BO	Vikram Sahu	Rs	266.20	29.1%	88.4%	24.9%	-47.5%
Simcere Pharmaceutical Group	SCR	Wei Du, Ph.D	\$	7.79	11.0%	41.9%	18.0%	-48.4%
Sun Pharmaceutical Industries	SUN.BO	Vikram Sahu	Rs	1,334.75	27.5%	30.7%	28.8%	-5.9%
Zhejiang NHU Co	002001.SZ	Wei Du, Ph.D	Rmb	30.00	-1.3%	-4.9%	13.0%	-40.4%
Shanghai Kehua Bio-Engineering Co	002022.SZ	Wei Du, Ph.D	Rmb	16.87	-0.3%	9.2%	2.1%	-8.2%
Beijing SL Pharmaceutical	002038.SZ	Wei Du, Ph.D	Rmb	32.50	-8.7%	-4.6%	-4.9%	8.3%
Jiangsu Hengrui Medicine Co.	600276.SS	Wei Du, Ph.D	Rmb	34.33	10.9%	3.7%	16.0%	10.8%
<b>Hang Seng China Ent. Index</b>				<b>10,504</b>	<b>45.1%</b>	<b>56.2%</b>	<b>31.3%</b>	<b>-22.3%</b>

Note: Results presented should not and cannot be viewed as an indicator of future performance.

Source: FactSet, Quantum database.

## Simcere: Remove from Conviction List but maintain our Buy rating

We remove Simcere from our regional Conviction Buy list, as the stock trades close to our target price. Simcere's share price has risen 19.8% since we added it to the Conviction Buy list on April 13, 2009 (vs. a 9.7% rise in the S&P 500).

We, however, retain our Buy rating as we are positive on the company's long-term growth prospects. We believe the company continues to be strategically positioned in the Chinese pharmaceutical sector on the back of its strong sales network and product-driven acquisition strategy. We think Simcere's partnership with Shanghai Celgen, a biotech company with expertise in the development of monoclonal antibody and biogeneric products, will substantially broaden Simcere's business scope, offering enormous opportunities in the burgeoning biogeneric market in China.

We think Simcere's recent acquisition of Yanshen was a good move strategically, and view it in the context of the company's apparent attempt to gain access to the vaccine market, which has high barriers of entry and is a relatively less competitive segment. Although we cannot quantify the impact of this acquisition, we think it could potentially offset the stagnant top line growth of Endu.

**Valuation:** We believe much of the risk of a weaker 2009 earnings is already priced in, with the stock trading at 10X 2009 P/E. We trim our revenue estimates by 2.3%/1.3%/1.3% for 2009E/2010E/2011E, respectively to reflect a decline in Endu's sales. Our EPS estimates are marginally down by 1.8%/1%/1% for the same period, as Endu's earnings contribution diminishes.

We revise our 12-month target price to US\$8.71 (from US\$8.9), based on 9X 2010E P/E.

**Risks:** Substantial decline in Endu and Bicun sales; slower sales growth in other products.

**Exhibit 9: Sincere's share price performance versus peer group**

Prices as of the close of June 9, 2009

Company	Ticker	Primary analyst	Price currency	Price as of 06/09/09	Price performance since 04/13/09	3 month price performance	6 month price performance	12 month price performance
<b>Asia Pacific Pharmaceuticals Peer Group</b>								
<b>Sincere Pharmaceutical Group</b>	<b>SCR</b>	<b>Wei Du, Ph.D</b>	<b>\$</b>	<b>7.61</b>	<b>19.8%</b>	<b>39.4%</b>	<b>15.7%</b>	<b>-49.1%</b>
Apollo Hospitals	APLH.BO	Balaji V. Prasad	Rs	516.65	29.6%	40.0%	31.4%	6.2%
Biocon	BION.BO	Vikram Sahu	Rs	216.55	41.6%	118.2%	124.9%	-4.1%
Cadila Healthcare	CADI.BO	Vikram Sahu	Rs	334.70	17.9%	40.2%	42.3%	25.5%
China Pharmaceutical Group	1093.HK	Wei Du, Ph.D	HK\$	4.08	8.8%	43.7%	55.7%	11.8%
China Shineway Pharmaceutical Group	2877.HK	Wei Du, Ph.D	HK\$	7.07	53.7%	58.9%	63.3%	14.0%
Cipla	CIPL.BO	Vikram Sahu	Rs	232.50	2.5%	15.4%	25.0%	12.5%
Dr. Reddy's Laboratories	REDY.BO	Vikram Sahu	Rs	711.40	34.3%	88.5%	47.8%	2.7%
Fortis Healthcare	FOHE.BO	Balaji V. Prasad	Rs	114.15	65.8%	77.9%	81.3%	66.5%
Glenmark Pharmaceuticals	GLEN.BO	Vikram Sahu	Rs	222.40	19.7%	72.1%	-21.1%	-66.4%
Guangzhou Pharmaceutical (H)	0874.HK	Wei Du, Ph.D	HK\$	3.61	22.0%	49.8%	59.0%	-44.9%
Lupin	LUPN.BO	Vikram Sahu	Rs	839.00	25.5%	41.4%	50.6%	19.6%
Mindray Medical International	MR	Wei Du, Ph.D	\$	23.16	-4.0%	21.9%	34.3%	-41.9%
Piramal Healthcare	PIRA.BO	Vikram Sahu	Rs	264.00	17.8%	37.3%	26.7%	-29.7%
Ranbaxy Laboratories	RANB.BO	Vikram Sahu	Rs	283.15	50.5%	109.7%	32.9%	-46.2%
Shandong Weigao Group	8199.HK	Wei Du, Ph.D	HK\$	16.56	16.9%	31.4%	57.7%	30.4%
Sun Pharmaceutical Industries	SUN.BO	Vikram Sahu	Rs	1,335.85	16.5%	36.5%	28.9%	-8.3%
Shanghai Kehua Bio-Engineering Co	002022.SZ	Wei Du, Ph.D	Rmb	17.03	3.7%	8.3%	3.0%	-7.4%
Beijing SL Pharmaceutical	002038.SZ	Wei Du, Ph.D	Rmb	32.48	-3.9%	-1.5%	-4.5%	8.3%
Jiangsu Hengrui Medicine Co.	600276.SS	Wei Du, Ph.D	Rmb	34.50	5.1%	6.3%	16.1%	11.4%
<b>S&amp;P 500</b>				<b>942</b>	<b>9.7%</b>	<b>39.3%</b>	<b>6.0%</b>	<b>-30.8%</b>

Note: Results presented should not and cannot be viewed as an indicator of future performance.

Source: FactSet, Quantum database.

**Exhibit 10: Our EPS assumption changes for the offshore-listed companies**

Company Nme	Ticker	Rating	Reporting Currency	EPS 2009E			EPS 2010E			EPS 2011E		
				New	Old	% chg	New	Old	% chg	New	Old	% chg
Guangzhou Pharma	874.HK	Sell	HK\$	0.24	0.24	0%	0.26	0.26	0%	0.26	0.27	-1%
Shineway	2877.HK	Buy	Rmb	0.69	0.63	10%	0.80	0.73	9%	0.87	0.78	11%
Sincere	SCR	Buy	Rmb	5.29	5.39	-2%	6.62	6.68	-1%	8.46	8.55	-1%
Weigao	8199.HK	Neutral	Rmb	0.56	0.56	0%	0.70	0.70	0%	0.83	0.79	5%

Source: Gao Hua Securities estimates.

**Valuation: EV/GCI vs. CROCI/WACC our new "sanity check" metric**

Given the current economic condition and high-growth profile of our China healthcare universe, we have chosen a new stock rating framework – the Director's Cut (DC) – to pick high-alpha stocks. This framework was first developed and used by our European Tactical Research team. This methodology incorporates cash invested (GCI), cash return trends (CROCI) and the cost of capital into the stock selection and rating process.

Our analysis is based on the relationship between the market valuation premium (EV/GCI, gross cash invested) and the excess value created by healthcare companies (CROCI/WACC). We found that the cash return spreads of the healthcare industry show a better correlation with traditional growth-based metrics (P/E vs. EPS), on average. Back-testing with our coverage universe and its four-year trading history shows a strong correlation.

In our view, this stock-picking framework suits our China healthcare stocks as it emphasizes the rationale for focusing on companies' ability to deliver sustainable returns rather than short-term earnings growth, as returns are the key drivers of valuation and share performance in the long term. We use the "Director's Cut" methodology as our primary stock-screening tool to determine our ratings. For our target prices, we now use P/E (mid-cycle valuation, or sector average) for all stocks in our coverage, but use the Director's Cut methodology as a back-up. Please see Exhibit 10, which details changes to our target prices and the valuation methodology we used to derive them.

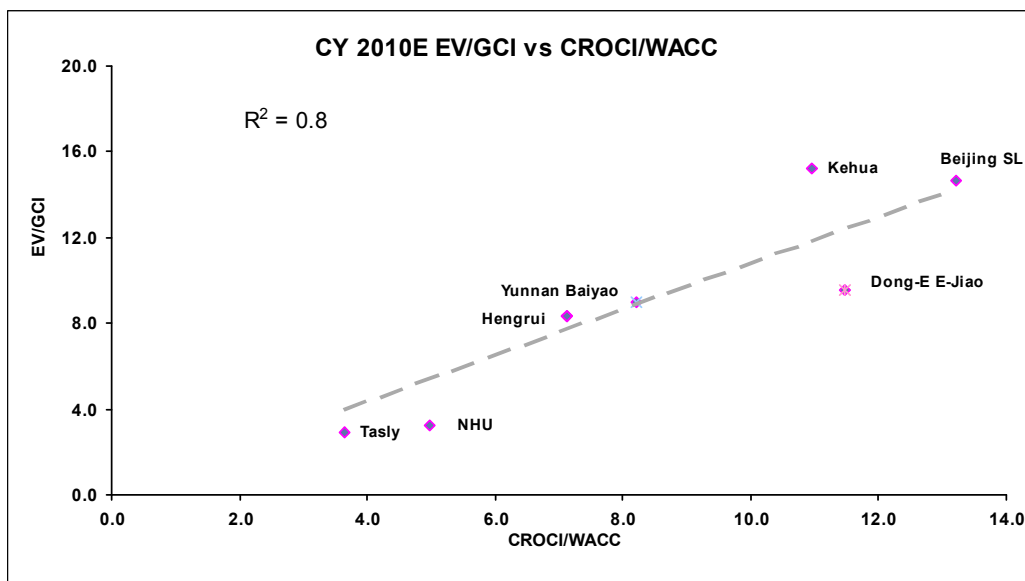
**Exhibit 10: Snapshot of changes in ratings, 12-m target prices and valuation methodology**

Company Name	Ticker	Rating		Pricing Currency	Current Price	12-m TPs		Potential up/ downside	Valuation method	
		Old	New			Old	New		New	Old
<b>Initiate</b>										
Tianjin Tasly	600535.SS		Buy*	Rmb	14.60		18.59	27%	23X 10E P/E	
Yunnan Baiyao	000538.SZ		Neutral	Rmb	35.15		34.75	-1%	24X 10E P/E	
Dong E E-jiao	000423.SZ		Buy	Rmb	16.92		20.64	22%	25X 10E P/E	
Kehua	002022.SZ	Sell	Sell	Rmb	17.10	12.15	13.79	-19%	23X 10E P/E	1.1X 09E PEG
NHU	002001.SZ	Sell	Sell	Rmb	29.05	22.50	22.06	-24%	12X 10E P/E	10.6X 09E P/E
Beijing SL	002038.SZ	Neutral	Neutral	Rmb	32.37	36.49	32.71	1%	23X 11E P/E	1.1X 09E PEG
Hengrui	600276.SS	Sell	Neutral	Rmb	33.97	26.50	34.31	1%	25X 10E P/E	1.1X 09E PEG
Guangzhou Pharma	874.HK	Sell	Sell	HK\$	3.39	2.03	2.70	-20%	9X 10E P/E	7.7X 09E P/E
Shineway	2877.HK	Neutral	Buy	HK\$	7.12	5.10	8.17	15%	9X 10E P/E	7.4X 09E P/E
Simcere	SCR	Buy*	Buy	US\$	7.83	8.90	8.71	11%	9X 10E P/E	9X 10E P/E
Weigao	8199.HK	Sell	Neutral	HK\$	17.10	13.00	17.62	3%	22X 10E P/E	20.5X 09E P/E

\*Indicates the stock is on our Conviction list.

Source: Bloomberg, Gao Hua Securities estimates.

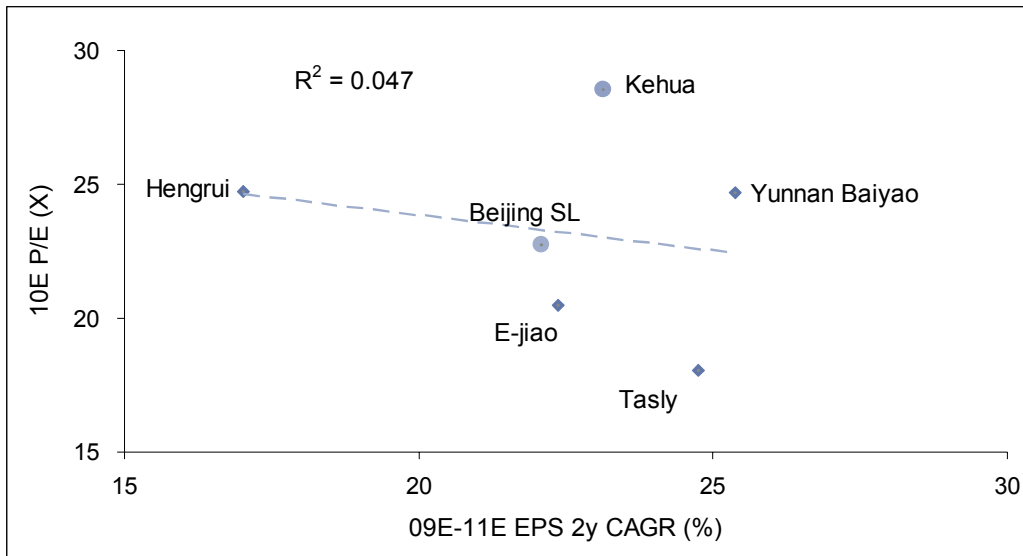
**Exhibit 11: E-Jiao and Tasly appear to be underappreciated using our DC framework**  
EV/GCI 2010E vs. CROCI/WACC 2010E



Source: Gao Hua Securities Research estimates.

**Exhibit 12: Correlation between P/E and EPS CAGR appears to be weak using growth-based valuation metric**

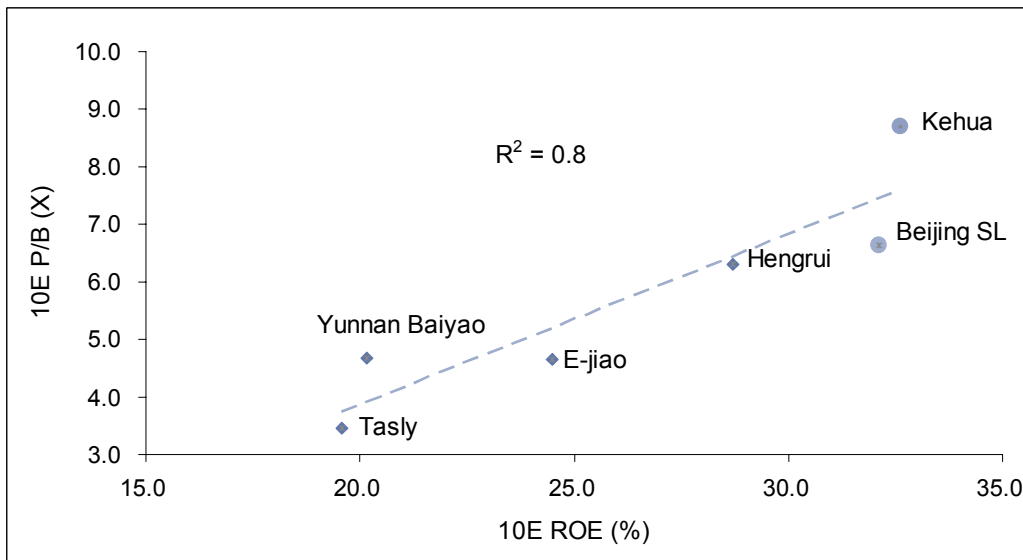
P/E 2010E vs. EPS 2009E-2011E CAGR relative valuation



Source: Bloomberg, Gao Hua Securities Research estimates.

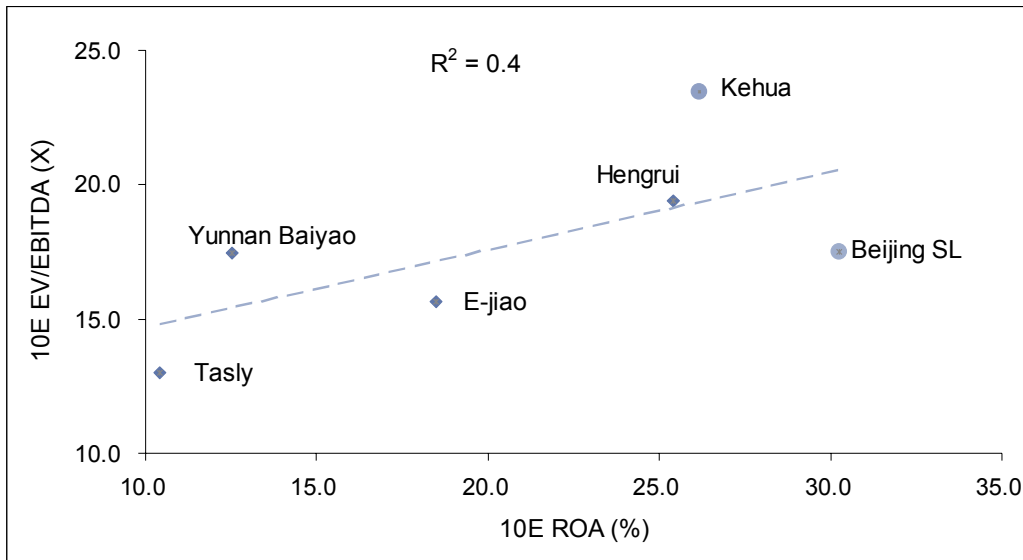
**Exhibit 13: Tasly and E-Jiao are trading at lower P/E's relative to their ROEs...**

P/B 2010E vs. ROE 2010E relative valuation



Source: Bloomberg, Gao Hua Securities Research estimates.

**Exhibit 14: ... and at a lower EV/EBITDA relative to their ROAs**  
 EV/EBITDA 2010E vs. ROA 2010E relative valuation



Source: Bloomberg, Wind, Gao Hua Securities Research estimates.

**Exhibit 15: Tasly is now trading at the lower range of its one-year forward P/E...**  
 One-year forward P/E band, December 2000-current



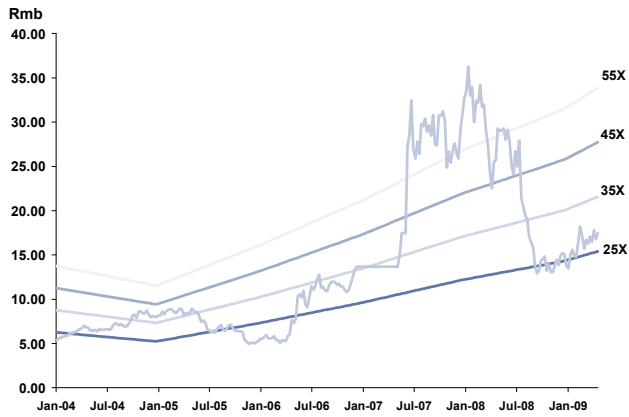
Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 16: ...and in the middle range of its one-year forward P/B**  
 One-year forward P/E band, December 2000-current



Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 17: Dong E E-Jiao is trading at the trough of its one-year forward P/E...**  
 One-year forward P/E band, 2004-current



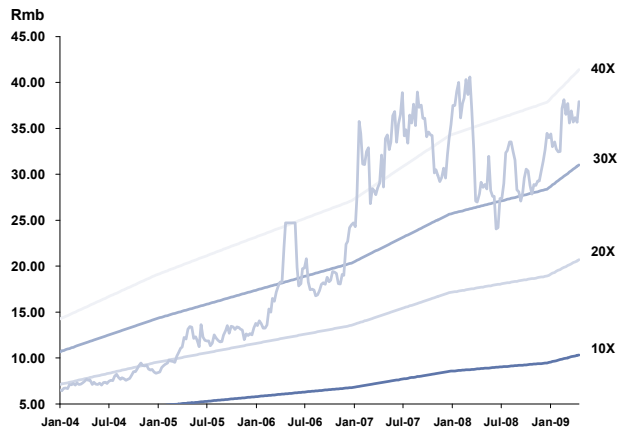
Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 18: ...and in the middle of its P/B range**  
 One-year forward P/B band, 2004-current



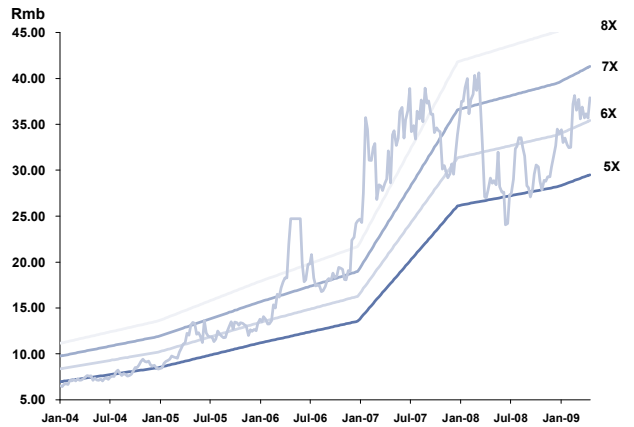
Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 19: Yunnan Baiyao is now trading at the higher end of its one-year forward P/E...**  
 July 2004-current



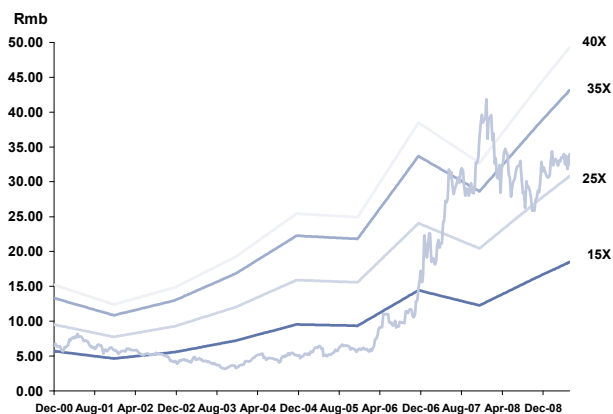
Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 20: ...and at the upper range of one-year forward P/B**  
 July 2004-current



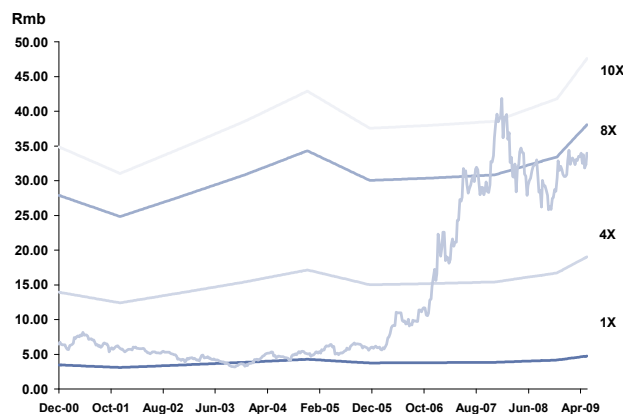
Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 21: Hengrui is now trading at the higher end of its one-year forward P/E...**  
December 2000-current



Source: Datastream, Company data, Gao Hua Securities Research estimates.

**Exhibit 22: ... and in the upper range of its one-year forward P/B**  
December 2000-current



Source: Datastream, Company data, Gao Hua Securities Research estimates.

## Prominent position of TCM in the basic medicine catalogue

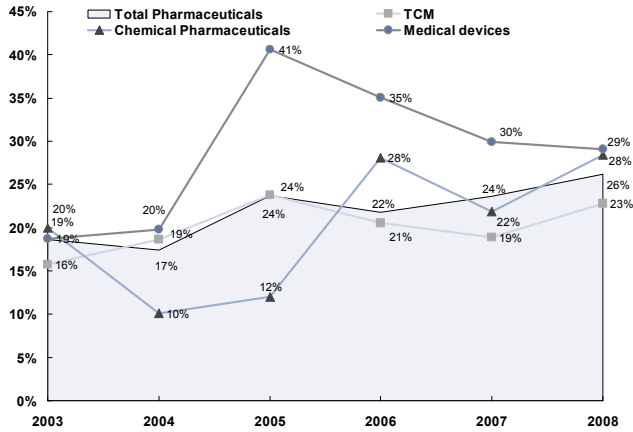
Traditional Chinese medicines (TCM) continue to play a prominent role in China's medical system due to their: (1) proven efficacy and lesser side effects than Western medicine, (2) cost advantage, and (3) popularity in treatment of chronic diseases. The TCM industry, with total sales of Rmb175 bn in 2008 (accounted for around 26% of China's total pharmaceutical industry in 2008), has been growing at an 18% CAGR in the past five years. We expect this trend to continue as TCM occupies a major position as a complementary and alternative form of medicine. Thus, TCMs extend the scope of healthcare services to both rural and urban residents in China.

### TCM growth to stabilize at a 17% CAGR for the next three years

Traditional medicines will continue to form a large segment of China's pharmaceutical industry. Although the industry has experienced rapid development in the last decade, the **growth rate is slower than Western pharmaceuticals due to limited pricing flexibility and lack of proprietary products**. We expect the TCM industry to grow at a 17% CAGR in the next three years helped by the healthcare reform, and we believe it will continue to benefit from its cost advantage and a proxy to consumer play.

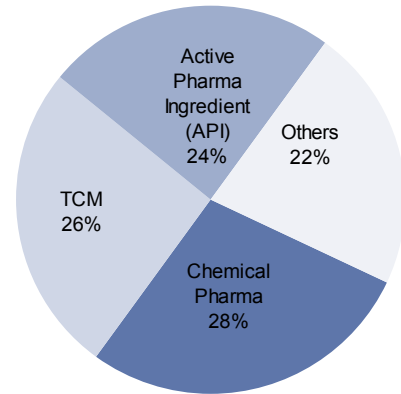


**Exhibit 23: TCM industry growth is slower than the Western pharmaceuticals**



Source: CEIC, Gao Hua Securities Research.

**Exhibit 24: Sales of TCM accounted for about 26% of China’s pharmaceutical output in 2008**



Source: CEIC, Gao Hua Securities Research.

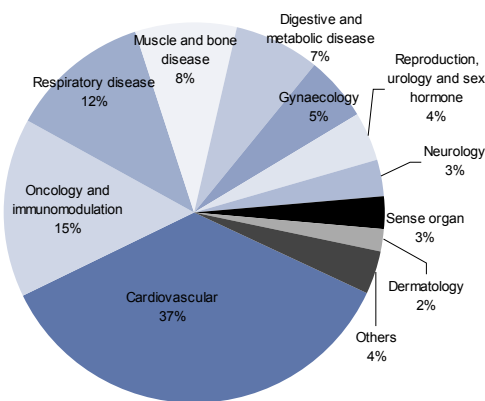
### Opportunities amid China’s healthcare reforms

**Further expansion and enhancement of medical insurance coverage in China remains a key growth driver for the TCM industry.** Although it is still unclear whether the number of TCMs in the new basic medicine catalogue remains the same as previously proposed, 326 items (43% of total) last year, we continue to believe in its prominent role in China’s pharmaceutical market. We believe companies with innovative products and proprietary technology, such as Tasly are likely to gain market share and continue to benefit from the sweeping healthcare reform.

**Cost advantage secures TCM’s market position in chronic disease treatment.** TCM plays a unique role in the treatment of chronic diseases, such as cardiovascular diseases, cancer and infectious diseases. Treatment using traditional Chinese medicines not only reduces symptoms of a patient but also improves the overall quality of life. In 2008, hospital sales of TCM for the treatment of cardiovascular diseases are estimated to be around Rmb7 bn, accounting for 37% of the total TCM market share. We think its solid market position is largely attributable to the fact that herbal medicines are safer and more affordable for long-term usage. We have also seen TCM experience strong sales growth in other therapeutic areas such as infectious diseases (e.g., SARS, avian flu, and AIDS) as the efficacy of TCM treatment in these therapeutic areas has been clearly demonstrated.

**Exhibit 25: TCM in cardiovascular treatment accounts for 37% of the total TCM sales in hospitals**

Breakdown in hospital sales of TCM 1H2008



Source: <http://www.yyjib.com.cn>.

**Exhibit 26: Strong sales growth of TCM is also seen in the treatment of chronic diseases**

Sales growth of different therapeutic classes in 1H2008

Therapeutic category	Yoy growth (%)
Muscle and bone disease	29.4
Oncology	28.9
Gynaecology	27.5
Cardiovascular disease	25.6
Urology	21.1
Neurology	20.2
Dermatology	19.4
Respiratory disease	18.4
Anaemia	16.3
Paediatric	11.8

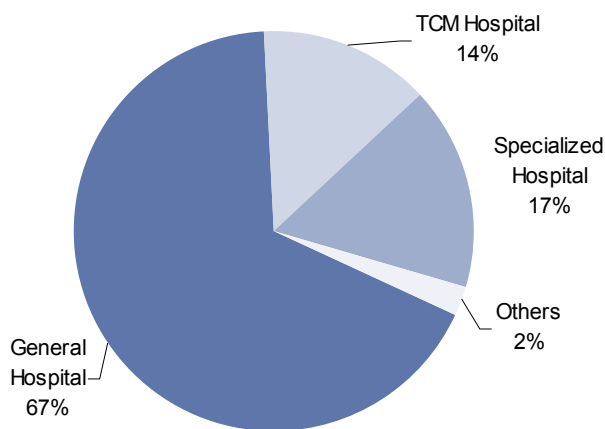
Source: <http://www.yyjib.com.cn>.

**Expansion in the fast growing consumer market fuels growth.** TCM plays a significant role in China’s consumer market. According to the China Chamber of Commerce for Import & Export of Medicines and Health Products (CCCMHPIE), sales of TCM accounts for 44% of health supplements, which amounted to Rmb148 bn in 2007. We believe the fast growing Chinese consumer market driven by China’s booming middle-class segment provides significant growth opportunities for TCM in the long term.

**Government’s protection policies and initiatives of establishing more TCM hospitals and clinical research centers** fuel long term growth. By end-2007, there were 2,720 TCM hospitals in the country, which accounted for 14% of total healthcare institutions.

**Exhibit 27: TCM hospitals accounted for 14% of total healthcare institutions in China in 2007**

Hospital breakdown by category in China



Source: MOH.

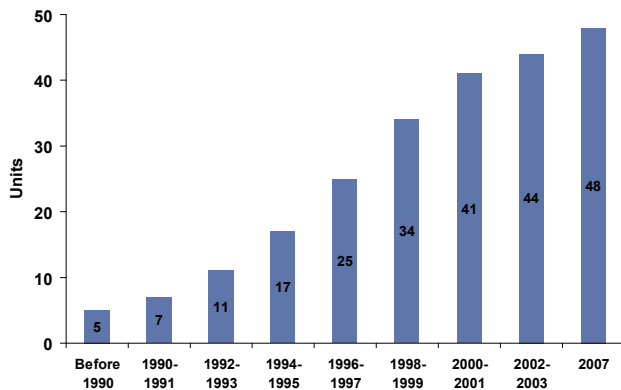
In May 2009, the State Council released a circular to boost the TCM industry, indicating that the government will put in greater effort and inject more capital in order to enhance TCM and TCM hospitals' position in the health services network. Traditional medicines will be included in the State's basic medicine catalogue and traditional medicine hospitals will be included in the list of designated hospitals under the country's basic health insurance programs for both rural and urban residents.

Although the circular provides a favorable direction for the development of TCM in China in the long term, we see limited near-term impact due to lack of clear measures on how and when the TCM should be applied for clinical use. Recent unfortunate incidents related to TCM injection products can prove to be negative for the near-term growth prospects of the TCM industry, in our view. The TCM injection market has been growing at nearly 30% CAGR during 1999-2006. According to China Pharmaceutical Economics news, the sales of TCM injections reached Rmb17 bn in 2007. Today, there are approximately 110 registered TCM injection products in China and the new basic medicine catalogue (draft version) includes 14 TCM injection products.

**Growing presence in the West.** We have noticed an increasing consumption of TCM as a health supplement by Asians as well as Westerners. According to CCCMHPIE, TCM exports grew 11.2% in 11M2008 to US\$1.2 bn, with Asia and Europe being the major import and export markets. The trade volume with Asia was US\$1.13 bn, up 11.8% yoy, with an average price growth of 31.9%, accounting for 64.4% of the total trade in 2008, while trade volume with Europe was US\$0.27 bn, up 21%, accounting for 15.4% of the total trade in 2008.

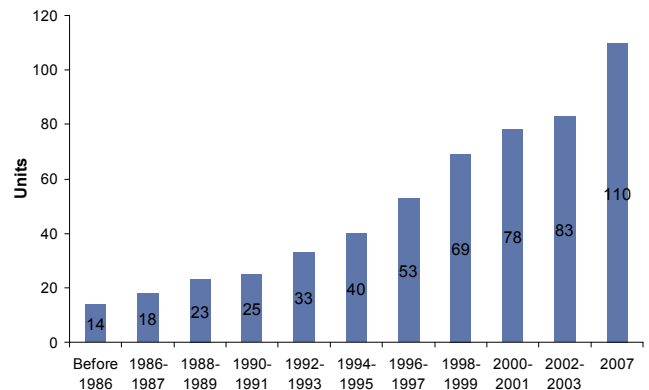
As EU countries are gradually becoming the top export destinations for China's TCM products, regulatory agencies have urged for a formal standard of TCM products to ensure the accountability of the Chinese herbal products and herbal practitioners. In June 2004, US Food and Drug Administration (FDA) released the final version of 'Guidance for Industry' for botanical drug products with detailed procedures and requirements for botanical preparations to enter clinical studies. These measures set out a framework for the development and marketing of TCMs in the US and provided significant impetus for TCM to enter the international market.

**Exhibit 28: Number of WHO member countries with national policy on traditional medicine/complementary and alternative medicine is on the rise**



Source: WHO.

**Exhibit 29: Number of WHO member countries with herbal medicine laws or regulation is also on the rise**



Source: WHO.

## Bumpy road ahead

### **TCM injection scams trigger tighter regulatory control in the domestic market.**

Uncertainties around the regulatory measures regarding proper use of TCM injections remain an overhang for the TCM industry. We see two possible dynamics: (1) adverse near-term impact on earnings due to nationwide fears of prescribing TCM injections, (2) tighter regulatory framework may weed out disreputable firms, thus providing a better competitive environment for the surviving companies in the medium term. However, we withhold our concerns over the long term prospects of TCM injections, as these injections are largely used in less-regulated rural hospitals.

**Several issues acting as major obstacles for TCM going mainstream: (1)** Safety and quality concerns, **(2)** lack of proven principle/mechanism of action, **(3)** drug-drug interaction as the result of a mixture. The effects of natural drugs are widely respected, but the lack of industry standards for quality and safety regulation will continue to be the major hurdles hindering the sector's growth potential, in our view.

The application of TCM theory to clinical usage has demonstrated its uniqueness as a practical tool, being time tested for thousands of years. However, the theory faces challenges in the modern era as the spectrum of diseases continues to change dramatically over time. We think the TCM industry should be innovative by adopting modern science and new-age technologies to identify herbal species, which would in turn help sustain its competitive edge in the long term.

## **Key to success: Innovation, quality and safety**

Although China maybe rich in natural resources and may have well-developed technology for TCM production, it still lags behind Japan and Korea in the sale of herbal medicines. It only obtained a 3% market share of the international sales of around US\$20 bn (excluding domestic sales) in 2007. As China continues its efforts in modernizing the TCM industry, we believe one thing is clear – **the need for tighter standards**. In our view, the major focus area of the TCM industry over the next few years should be the establishment of good agricultural practices (GAPs) during the process of herbal plantation, including quality of seeds, cultivation, plantation, harvesting, processing, manufacturing, formulation of high-quality standards and storage. We believe the modernization and globalization of the TCM industry will not only benefit the healthcare system in China, but will also create a significant opportunity for the global pharmaceutical industry.

## Tianjin Tasly (600535.SS, Buy, CL): Strong proprietary technology

### Investment thesis

We initiate coverage of Tasly with a Buy rating (add to our Conviction List) and a 12-month target price of Rmb18.59 (27% potential upside). Tasly remains a leading company in China's pharmaceutical sector. Tasly's constant efforts in promoting innovation and modernization of TCM have set the company apart from its peers, in our view. Its leading product, the Cardiotonic pill, is the only TCM product that exceeds the Rmb1 bn sales mark annually in China due to its proprietary technology in product formulation. We believe Tasly's efforts in promoting innovation in TCM formulation and new product launches are the company's core competitiveness for its long-term growth.

### Core growth drivers

- We expect Tasly to post earnings CAGR of 25% in 2009E-2011E, on the back of revenue CAGR of 21%, driven by strong market demand in the treatment of cardiovascular diseases and potential volume growth in Cardiotonic pills as a result of its growing penetration in rural hospitals. We estimate 13% and 10% sales growth for Cardiotonic pills in 2009E and 2010E, respectively.
- Increasing contribution from its distribution business will drive margin expansion. We forecast a CAGR of 24% in Tasly's pharmaceutical distribution business during 2009E-2010E, which offers a stable margin driven by market expansion in rural and suburban areas amid the ongoing healthcare reform.
- New product launches serve as a long-term growth driver. We expect two biological products, pro-UK (Human Urinary Kallikrein), an anti-stroke medication, and a potential influenza vaccine to be launched by Tasly in 2010. Although near-term earnings contribution is limited, it offers a great opportunity for product diversification.

### Catalyst

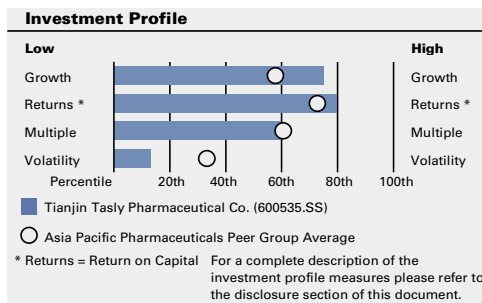
We expect 10% upward price adjustment to come into effect in 2009, as inventory prior to the price adjustment gradually runs through the system. Tasly's consistent efforts in negotiating new contract prices with individual hospitals should also help fuel its growth. We also expect upstream integration of GAP in herbal plantations will pave the way for rising export opportunities in the long term.

### Valuation

Our 12-month target price of Rmb18.59 is based on 23X 2010E P/E, a mid-cycle valuation, which is in line with the 2010E P/E implied by our Director's Cut approach.

### Risks

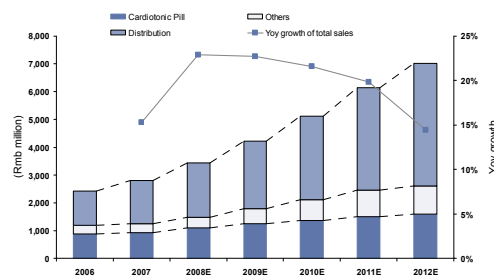
Worse-than-expected sales of its legacy products and other non-core products pose a downside risk to our target price.



Key data	Current
Price (Rmb)	14.60
12 month price target (Rmb)	18.59
Market cap (Rmb mn / US\$ mn)	7,184.6 / 1,051.5
Foreign ownership (%)	--

	12/08	12/09E	12/10E	12/11E
EPS (Rmb)	0.52	0.64	0.81	0.99
EPS growth (%)	40.5	22.5	26.8	22.7
EPS (diluted) (Rmb)	0.52	0.64	0.81	0.99
EPS (basic pre-ex) (Rmb)	0.52	0.64	0.81	0.99
P/E (X)	28.1	22.9	18.1	14.7
P/B (X)	3.8	3.6	3.5	3.3
EV/EBITDA (X)	19.4	16.2	13.0	10.5
Dividend yield (%)	2.7	3.4	4.3	5.2
ROE (%)	13.7	16.1	19.6	22.9

### Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(0.4)	21.7	(0.5)
Rel. to Shanghai SE A Share Index	(19.7)	(10.8)	21.1

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 6/05/2009 close.

**Exhibit 30: Tianjin Tasly — Summary financials**

Profit model (Rmb mn)	12/08	12/09E	12/10E	12/11E	Balance sheet (Rmb mn)	12/08	12/09E	12/10E	12/11E
<b>Total revenue</b>	<b>3,434.2</b>	<b>4,214.3</b>	<b>5,124.4</b>	<b>6,141.4</b>	Cash & equivalents	331.3	327.7	361.0	406.8
Cost of goods sold	(2,295.7)	(2,825.1)	(3,475.1)	(4,209.7)	Accounts receivable	663.6	814.4	990.2	1,186.7
SG&A	(749.1)	(919.3)	(1,066.6)	(1,216.8)	Inventory	313.3	385.6	474.3	574.6
R&D	--	--	--	--	Other current assets	202.9	202.9	202.9	202.9
Other operating profit/(expense)	(1.7)	(2.1)	(2.6)	(3.1)	<b>Total current assets</b>	<b>1,511.2</b>	<b>1,730.5</b>	<b>2,028.3</b>	<b>2,371.0</b>
<b>EBITDA</b>	<b>387.6</b>	<b>467.8</b>	<b>580.2</b>	<b>711.8</b>	Net PP&E	1,344.7	1,367.1	1,375.2	1,380.6
Depreciation & amortization	(115.2)	(121.6)	(122.3)	(122.7)	Net intangibles	195.3	177.7	160.2	142.6
<b>EBIT</b>	<b>272.5</b>	<b>346.2</b>	<b>457.9</b>	<b>589.1</b>	Total investments	172.5	172.5	172.5	172.5
Interest income	0.0	0.0	0.0	0.0	Other long-term assets	224.5	224.5	224.5	224.5
Interest expense	(70.8)	(72.1)	(72.1)	(72.1)	<b>Total assets</b>	<b>3,448.1</b>	<b>3,672.3</b>	<b>3,960.6</b>	<b>4,291.1</b>
Income/(loss) from uncons. subs.	0.2	0.0	0.0	0.0	Accounts payable	495.1	609.3	749.5	907.9
Others	112.7	119.2	119.8	120.2	Short-term debt	620.6	620.6	620.6	620.6
<b>Pretax profits</b>	<b>314.6</b>	<b>393.3</b>	<b>505.7</b>	<b>637.3</b>	Other current liabilities	120.6	165.0	229.6	299.1
Income tax	(64.2)	(86.5)	(116.3)	(159.3)	<b>Total current liabilities</b>	<b>1,236.3</b>	<b>1,394.8</b>	<b>1,599.7</b>	<b>1,827.6</b>
Minorities	5.5	6.8	8.3	10.0	Long-term debt	100.0	100.0	100.0	100.0
<b>Net income pre-preferred dividends</b>	<b>255.9</b>	<b>313.6</b>	<b>397.6</b>	<b>487.9</b>	Other long-term liabilities	18.9	18.9	18.9	18.9
Preferred dividends	0.0	0.0	0.0	0.0	Total long-term liabilities	118.9	118.9	118.9	118.9
<b>Net income (pre-exceptionals)</b>	<b>255.9</b>	<b>313.6</b>	<b>397.6</b>	<b>487.9</b>	<b>Total liabilities</b>	<b>1,355.2</b>	<b>1,513.8</b>	<b>1,718.6</b>	<b>1,946.5</b>
Post-tax exceptionals	0.0	0.0	0.0	0.0	<b>Preferred shares</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Net income</b>	<b>255.9</b>	<b>313.6</b>	<b>397.6</b>	<b>487.9</b>	<b>Total common equity</b>	<b>1,911.9</b>	<b>1,984.2</b>	<b>2,076.0</b>	<b>2,188.6</b>
EPS (basic, pre-except) (Rmb)	0.52	0.64	0.81	0.99	Minority interest	181.0	174.3	166.0	156.0
EPS (basic, post-except) (Rmb)	0.52	0.64	0.81	0.99	<b>Total liabilities &amp; equity</b>	<b>3,448.1</b>	<b>3,672.3</b>	<b>3,960.6</b>	<b>4,291.1</b>
EPS (diluted, post-except) (Rmb)	0.52	0.64	0.81	0.99	<b>BVPS (Rmb)</b>	<b>3.89</b>	<b>4.03</b>	<b>4.22</b>	<b>4.45</b>
DPS (Rmb)	0.40	0.49	0.62	0.76					
Dividend payout ratio (%)	76.9	76.9	76.9	76.9					
Free cash flow yield (%)	2.0	2.7	3.8	4.9					
<b>Growth &amp; margins (%)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Ratios</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
Sales growth	22.9	22.7	21.6	19.8	ROE (%)	13.7	16.1	19.6	22.9
EBITDA growth	53.1	20.7	24.0	22.7	ROA (%)	7.8	8.8	10.4	11.8
EBIT growth	69.1	27.1	32.3	28.6	ROACE (%)	12.8	14.4	17.3	20.2
Net income growth	44.0	22.5	26.8	22.7	Inventory days	44.1	45.2	45.2	45.5
EPS growth	40.5	22.5	26.8	22.7	Receivables days	68.8	64.0	64.3	64.7
Gross margin	33.2	33.0	32.2	31.5	Payable days	67.2	71.3	71.4	71.9
EBITDA margin	11.3	11.1	11.3	11.6	Net debt/equity (%)	18.6	18.2	16.0	13.4
EBIT margin	7.9	8.2	8.9	9.6	Interest cover - EBIT (X)	3.8	4.8	6.4	8.2
<b>Cash flow statement (Rmb mn)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Valuation</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
Net income pre-preferred dividends	255.9	313.6	397.6	487.9	P/E (analyst) (X)	28.1	22.9	18.1	14.7
D&A add-back	115.2	121.6	122.3	122.7	P/B (X)	3.8	3.6	3.5	3.3
Minorities interests add-back	(5.5)	(6.8)	(8.3)	(10.0)	EV/EBITDA (X)	19.4	16.2	13.0	10.5
Net (inc)/dec working capital	(154.6)	(108.8)	(124.4)	(138.3)	Dividend yield (%)	2.7	3.4	4.3	5.2
Other operating cash flow	49.3	0.0	0.0	0.0					
<b>Cash flow from operations</b>	<b>260.2</b>	<b>319.6</b>	<b>387.2</b>	<b>462.3</b>					
Capital expenditures	(114.5)	(126.4)	(112.7)	(110.5)					
Acquisitions	(4.9)	0.0	0.0	0.0					
Divestitures	0.0	0.0	0.0	0.0					
Others	(60.1)	0.0	0.0	0.0					
<b>Cash flow from investments</b>	<b>(179.5)</b>	<b>(126.4)</b>	<b>(112.7)</b>	<b>(110.5)</b>					
Dividends paid (common & pref)	(146.4)	(196.8)	(241.2)	(305.9)					
Inc/(dec) in debt	71.9	0.0	0.0	0.0					
Common stock issuance (repurchase)	5.9	0.0	0.0	0.0					
Other financing cash flows	73.7	0.0	0.0	0.0					
<b>Cash flow from financing</b>	<b>5.1</b>	<b>(196.8)</b>	<b>(241.2)</b>	<b>(305.9)</b>					
<b>Total cash flow</b>	<b>85.8</b>	<b>(3.7)</b>	<b>33.3</b>	<b>45.9</b>					

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

# Dong E E-Jiao (000423.SZ, Buy): Moving up the value chain

## Investment thesis

We initiate coverage of Dong E E-Jiao (EJ) with a Buy rating and a 12-month target price of Rmb20.64 (22% potential upside). EJ is chiefly engaged in manufacturing herbal medicines and health supplements. It is the largest producer of donkey-skin gelatin in China (E-Jiao), serving 90% of the domestic market. Its legacy product, the E-Jiao series is the main revenue contributor, accounting for 62% of total sales and 81% of total gross profits in 2008.

## Core growth drivers:

**1) Rising market demand for health supplements in China.** We expect E-Jiao to continue to register strong volume growth in 2009E-2011E with a CAGR of 22%. We attribute this potential growth to its pricing power and rising market demand for health supplements driven by the steady growth of China's affluent class.

**2) Dominant player controlling upstream raw material supply.** We expect an upward trend in E-Jiao's selling price, despite the strong competition. The company currently holds a monopoly in upstream raw material supply of donkey skin. Its significant market share and manufacturing capacity offers a cushion for the company that has to pay a relatively higher price in securing over 95% of the donkey skin supply.

**3) Moving up the value chain.** EJ's strategic move towards the donkey breeding business solidifies its dominant market position in the long term. In our view, it also offers additional business opportunities in the food processing industry. Increasing demand for donkey meat vs. decline in donkey livestock creates a perfect opportunity to diversify its business risk.

## Catalysts

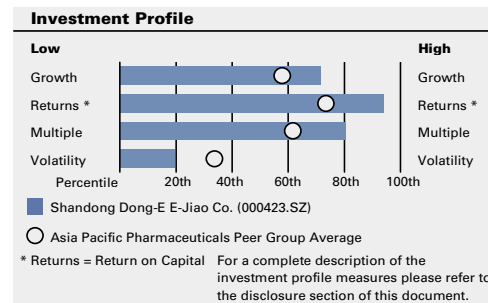
Upward price adjustments due to E-Jiao's monopoly in the raw material supply of donkey skin and its trusted brand name will continue to improve its overall margin, in our view. Rapid expansion of retail channels in the major cities in China offers additional opportunities for the development of new products.

## Valuation

Our 12-month target price of Rmb20.64 is based on 25X 2010E P/E, a mid-cycle valuation, which is in line with the 2010E P/E implied by our Director's Cut approach.

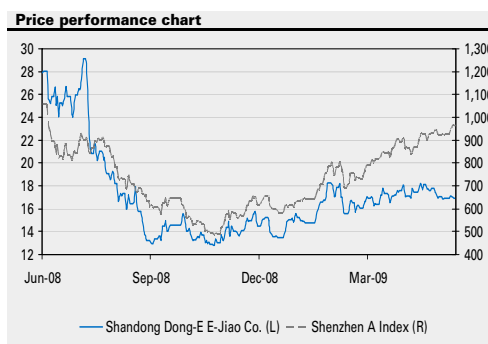
## Risk

The key risks on the downside are: 1) limited output due to a shortage of raw material (donkey skin) supply which may cap volume growth, and 2) continuous pricing pressure from counterfeit products.



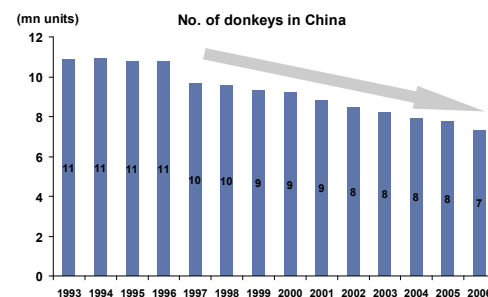
Key data	Current
Price (Rmb)	16.92
12 month price target (Rmb)	20.64
Market cap (Rmb mn / US\$ mn)	8,862.1 / 1,297.0
Foreign ownership (%)	--

	12/08	12/09E	12/10E	12/11E
EPS (Rmb)	0.55	0.67	0.83	1.00
EPS growth (%)	39.5	22.3	23.2	21.5
EPS (diluted) (Rmb)	0.55	0.67	0.83	1.00
EPS (basic pre-ex) (Rmb)	0.55	0.67	0.83	1.00
P/E (X)	30.9	25.3	20.5	16.9
P/B (X)	6.3	5.4	4.7	4.0
EV/EBITDA (X)	33.5	19.4	15.7	12.5
Dividend yield (%)	1.2	1.4	1.8	2.2
ROE (%)	21.8	23.1	24.5	25.4



Share price performance (%)	3 month	6 month	12 month
Absolute	1.4	13.0	(39.4)
Rel. to Shenzhen A Index	(20.3)	(25.9)	(33.2)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 6/05/2009 close.



Source: Ministry of Agriculture



**Exhibit 31: Dong E E-Jiao — Summary financials**

<b>Profit model (Rmb mn)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Balance sheet (Rmb mn)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
<b>Total revenue</b>	<b>1,686.0</b>	<b>1,993.7</b>	<b>2,330.1</b>	<b>2,738.5</b>	Cash & equivalents	689.5	878.8	954.9	1,186.2
Cost of goods sold	(849.4)	(1,009.1)	(1,189.7)	(1,417.2)	Accounts receivable	201.2	237.9	278.0	326.7
SG&A	(503.5)	(557.8)	(617.0)	(684.0)	Inventory	190.9	226.8	267.4	318.5
R&D	--	--	--	--	Other current assets	79.7	79.7	79.7	79.7
Other operating profit/(expense)	0.0	(15.6)	(18.3)	(21.5)	<b>Total current assets</b>	<b>1,161.3</b>	<b>1,423.2</b>	<b>1,580.0</b>	<b>1,911.2</b>
<b>EBITDA</b>	<b>333.1</b>	<b>411.1</b>	<b>505.2</b>	<b>615.7</b>	Net PP&E	344.0	363.9	551.5	636.0
Depreciation & amortization	(34.3)	(35.4)	(50.9)	(57.8)	Net intangibles	0.0	0.0	0.0	0.0
<b>EBIT</b>	<b>298.8</b>	<b>375.7</b>	<b>454.3</b>	<b>557.9</b>	Total investments	115.9	115.9	115.9	115.9
Interest income	12.5	15.1	19.2	20.9	Other long-term assets	272.0	266.6	261.1	255.6
Interest expense	(1.3)	(0.5)	(0.5)	(0.5)	<b>Total assets</b>	<b>1,893.2</b>	<b>2,169.5</b>	<b>2,508.5</b>	<b>2,918.8</b>
Income/(loss) from uncons. subs.	0.0	0.0	0.0	0.0	Accounts payable	102.4	121.6	143.4	170.8
Others	31.4	35.4	50.9	57.8	Short-term debt	1.0	1.0	1.0	1.0
<b>Pretax profits</b>	<b>341.3</b>	<b>425.7</b>	<b>523.9</b>	<b>636.1</b>	Other current liabilities	331.3	354.6	384.3	418.3
Income tax	(45.2)	(63.9)	(78.6)	(95.4)	<b>Total current liabilities</b>	<b>434.6</b>	<b>477.2</b>	<b>528.7</b>	<b>590.1</b>
Minorities	(9.1)	(10.9)	(12.9)	(15.2)	Long-term debt	0.0	0.0	0.0	0.0
<b>Net income pre-preferred dividends</b>	<b>287.0</b>	<b>351.0</b>	<b>432.4</b>	<b>525.5</b>	Other long-term liabilities	8.7	8.7	8.7	8.7
Preferred dividends	0.0	0.0	0.0	0.0	Total long-term liabilities	8.7	8.7	8.7	8.7
<b>Net income (pre-exceptionals)</b>	<b>287.0</b>	<b>351.0</b>	<b>432.4</b>	<b>525.5</b>	<b>Total liabilities</b>	<b>443.3</b>	<b>485.9</b>	<b>537.4</b>	<b>598.8</b>
Post-tax exceptionals	0.0	0.0	0.0	0.0	<b>Preferred shares</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Net income</b>	<b>287.0</b>	<b>351.0</b>	<b>432.4</b>	<b>525.5</b>	<b>Total common equity</b>	<b>1,405.3</b>	<b>1,628.1</b>	<b>1,902.8</b>	<b>2,236.5</b>
EPS (basic, pre-except) (Rmb)	0.55	0.67	0.83	1.00	Minority interest	44.6	55.4	68.3	83.5
EPS (basic, post-except) (Rmb)	0.55	0.67	0.83	1.00	<b>Total liabilities &amp; equity</b>	<b>1,893.2</b>	<b>2,169.5</b>	<b>2,508.5</b>	<b>2,918.8</b>
EPS (diluted, post-except) (Rmb)	0.55	0.67	0.83	1.00	<b>BVPS (Rmb)</b>	<b>2.68</b>	<b>3.11</b>	<b>3.63</b>	<b>4.27</b>
DPS (Rmb)	0.20	0.24	0.30	0.37					
Dividend payout ratio (%)	36.5	36.5	36.5	36.5					
Free cash flow yield (%)	2.1	3.3	2.3	4.4					
<b>Growth &amp; margins (%)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Ratios</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
Sales growth	22.1	18.3	16.9	17.5	ROE (%)	21.8	23.1	24.5	25.4
EBITDA growth	14.6	23.4	22.9	21.9	ROA (%)	16.4	17.3	18.5	19.4
EBIT growth	16.0	25.7	20.9	22.8	ROACE (%)	39.3	44.6	47.1	48.6
Net income growth	39.5	22.3	23.2	21.5	Inventory days	73.3	75.5	75.8	75.5
EPS growth	39.5	22.3	23.2	21.5	Receivables days	52.7	40.2	40.4	40.3
Gross margin	49.6	49.4	48.9	48.2	Payable days	39.9	40.5	40.7	40.5
EBITDA margin	19.8	20.6	21.7	22.5	Net debt/equity (%)	(47.5)	(52.1)	(48.4)	(51.1)
EBIT margin	17.7	18.8	19.5	20.4	Interest cover - EBIT (X)	NM	NM	NM	NM
<b>Cash flow statement (Rmb mn)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Valuation</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
Net income pre-preferred dividends	287.0	351.0	432.4	525.5	P/E (analyst) (X)	30.9	25.3	20.5	16.9
D&A add-back	34.3	35.4	50.9	57.8	P/B (X)	6.3	5.4	4.7	4.0
Minorities interests add-back	9.1	10.9	12.9	15.2	EV/EBITDA (X)	33.5	19.4	15.7	12.5
Net (inc)/dec working capital	(27.2)	(53.4)	(59.0)	(72.5)	Dividend yield (%)	1.2	1.4	1.8	2.2
Other operating cash flow	(6.3)	0.0	0.0	0.0					
<b>Cash flow from operations</b>	<b>296.8</b>	<b>343.9</b>	<b>437.2</b>	<b>526.1</b>					
Capital expenditures	(51.4)	(49.8)	(233.0)	(136.9)					
Acquisitions	0.0	0.0	0.0	0.0					
Divestitures	0.9	0.0	0.0	0.0					
Others	(16.4)	0.0	0.0	0.0					
<b>Cash flow from investments</b>	<b>(66.9)</b>	<b>(49.8)</b>	<b>(233.0)</b>	<b>(136.9)</b>					
Dividends paid (common & pref)	(104.8)	(104.8)	(128.1)	(157.8)					
Inc/(dec) in debt	(4.0)	0.0	0.0	0.0					
Common stock issuance (repurchase)	2.9	0.0	0.0	0.0					
Other financing cash flows	(3.8)	0.0	0.0	0.0					
<b>Cash flow from financing</b>	<b>(109.6)</b>	<b>(104.8)</b>	<b>(128.1)</b>	<b>(157.8)</b>					
<b>Total cash flow</b>	<b>120.3</b>	<b>189.3</b>	<b>76.1</b>	<b>231.3</b>					

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

# Yunnan Baiyao (000538.SZ, Neutral): Premium valuation reflects strong growth

## Investment thesis

We initiate coverage of Yunnan Baiyao (YBY) with a Neutral rating and a 12-month target price of Rmb34.75 (1% potential downside). YBY is a leading company in China's TCM industry. YBY has experienced sales growth of 28% CAGR during 2000-2008, driven by rising market demand and the continuous roll-out of new products. The company's strong performance is attributable to its nimble business strategy in tapping China's fast growing consumer market and strong marketing power helped by its brand name. The key components of YBY's products are strictly guarded by the Chinese government, leading to minimal competition.

## Core growth drivers

We forecast YBY to post earnings CAGR of 25% during 2009E-2011E on the back of revenue growth of 25%, driven by:

- Baiyao paste enjoys strong pricing power due to limited competition.** Although the price mark-up of Baiyao paste may impede near-term volume growth, the magnitude of price increase will offset volume decline leading to a higher growth margin in the medium term. We expect 50% growth in the sale of Baiyao paste in 2009, accounting for 7% of the total manufacturing revenue.
- New products enjoying broader market penetration due to consumer-driven growth strategy.** We expect YBY's customized first-aid packs and herbal beauty products to contribute 0.3% of the total revenue in 2009, helped by its brand name. We continue to see Baiyao posting strong sales growth in the over-the-counter (OTC) segment.
- Vertical integration likely to lead to margin expansion in the long term.** YBY's new herbal plantation project offers sufficient raw material supply as well as a stable pricing trend in the long term. We expect margins to stabilize or improve as a result of stable raw material prices.

## Concerns

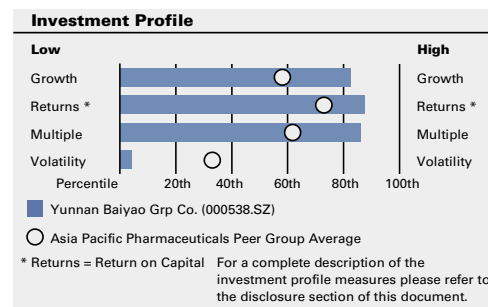
- Centralized SOE (state-owned enterprise) structure hinders execution.
- Premium valuation is no longer justified given its more consumer-oriented focus, in our view.

## Valuation

Our 12-month target price of Rmb34.75 is based on 24X 2010E P/E, a mid-cycle valuation, which is in line with the 2010E P/E implied by our Director's Cut approach.

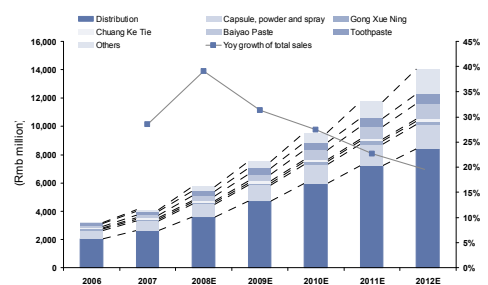
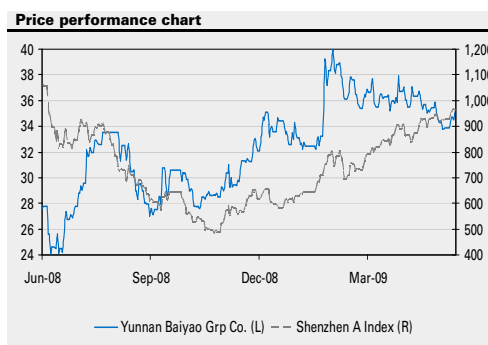
## Risks

The key risk on the upside is stronger-than-expected growth in sales of Baiyao paste and other new products; on the downside, the key risk is lower than expected growth in tooth paste sales.



Key data	Current
Price (Rmb)	35.15
12 month price target (Rmb)	34.75
Market cap (Rmb mn / US\$ mn)	17,014.4 / 2,490.0
Foreign ownership (%)	--

	12/08	12/09E	12/10E	12/11E
EPS (Rmb)	0.96	1.11	1.42	1.74
EPS growth (%)	38.2	15.1	28.7	22.1
EPS (diluted) (Rmb)	0.96	1.11	1.42	1.74
EPS (basic pre-ex) (Rmb)	0.96	1.11	1.42	1.74
P/E (X)	36.6	31.8	24.7	20.2
P/B (X)	6.0	5.3	4.7	4.1
EV/EBITDA (X)	24.4	23.4	17.4	13.2
Dividend yield (%)	0.9	1.1	1.4	1.7
ROE (%)	20.8	17.7	20.2	21.5



Share price performance (%)	3 month	6 month	12 month
Absolute	(6.8)	12.5	27.3
Rel. to Shenzhen A Index	(26.8)	(26.2)	40.2

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 6/05/2009 close.

**Exhibit 32: Yunnan Baiyao – Summary financials**

Profit model (Rmb mn)	12/08	12/09E	12/10E	12/11E	Balance sheet (Rmb mn)	12/08	12/09E	12/10E	12/11E
<b>Total revenue</b>	<b>5,723.2</b>	<b>7,518.7</b>	<b>9,577.5</b>	<b>11,747.8</b>	Cash & equivalents	2,335.3	2,465.9	2,627.1	2,916.7
Cost of goods sold	(3,958.0)	(5,192.0)	(6,574.7)	(8,002.7)	Accounts receivable	377.9	496.5	632.5	775.8
SG&A	(1,202.1)	(1,579.3)	(2,011.7)	(2,467.6)	Inventory	1,301.6	1,707.5	2,162.2	2,631.8
R&D	--	--	--	--	Other current assets	473.5	473.5	473.5	473.5
Other operating profit/(expense)	(38.1)	(50.1)	(63.8)	(78.3)	<b>Total current assets</b>	<b>4,488.4</b>	<b>5,143.4</b>	<b>5,895.3</b>	<b>6,797.8</b>
<b>EBITDA</b>	<b>524.9</b>	<b>697.4</b>	<b>927.3</b>	<b>1,199.3</b>	Net PP&E	283.7	338.4	454.6	539.4
Depreciation & amortization	(36.8)	(29.2)	(36.3)	(41.4)	Net intangibles	64.9	56.1	47.4	38.6
<b>EBIT</b>	<b>488.2</b>	<b>668.1</b>	<b>891.0</b>	<b>1,157.9</b>	Total investments	39.3	39.3	39.3	39.3
Interest income	12.8	39.8	42.0	44.8	Other long-term assets	60.8	60.8	60.8	60.8
Interest expense	(14.5)	(10.5)	(10.5)	(10.5)	<b>Total assets</b>	<b>4,937.2</b>	<b>5,638.0</b>	<b>6,497.3</b>	<b>7,476.0</b>
Income/(loss) from uncons. subs.	0.0	0.0	0.0	0.0	Accounts payable	873.9	1,146.4	1,451.7	1,767.0
Others	68.7	29.2	36.3	41.4	Short-term debt	21.4	21.4	21.4	21.4
<b>Pretax profits</b>	<b>555.2</b>	<b>726.7</b>	<b>958.8</b>	<b>1,233.6</b>	Other current liabilities	833.2	876.5	934.8	992.8
Income tax	(91.7)	(138.1)	(201.4)	(308.4)	<b>Total current liabilities</b>	<b>1,728.5</b>	<b>2,044.3</b>	<b>2,407.9</b>	<b>2,781.2</b>
Minorities	1.9	2.5	3.2	3.9	Long-term debt	6.7	6.7	6.7	6.7
<b>Net income pre-preferred dividends</b>	<b>465.4</b>	<b>591.1</b>	<b>760.6</b>	<b>929.1</b>	Other long-term liabilities	15.3	15.3	15.3	15.3
Preferred dividends	0.0	0.0	0.0	0.0	Total long-term liabilities	22.0	22.0	22.0	22.0
<b>Net income (pre-exceptionals)</b>	<b>465.4</b>	<b>591.1</b>	<b>760.6</b>	<b>929.1</b>	<b>Total liabilities</b>	<b>1,750.5</b>	<b>2,066.3</b>	<b>2,429.9</b>	<b>2,803.2</b>
Post-tax exceptionals	0.0	0.0	0.0	0.0	<b>Preferred shares</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Net income</b>	<b>465.4</b>	<b>591.1</b>	<b>760.6</b>	<b>929.1</b>	<b>Total common equity</b>	<b>3,137.2</b>	<b>3,524.9</b>	<b>4,023.7</b>	<b>4,632.9</b>
EPS (basic, pre-except) (Rmb)	0.96	1.11	1.42	1.74	Minority interest	49.4	46.9	43.7	39.8
EPS (basic, post-except) (Rmb)	0.96	1.11	1.42	1.74	<b>Total liabilities &amp; equity</b>	<b>4,937.2</b>	<b>5,638.0</b>	<b>6,497.3</b>	<b>7,476.0</b>
EPS (diluted, post-except) (Rmb)	0.96	1.11	1.42	1.74	<b>BVPS (Rmb)</b>	<b>5.87</b>	<b>6.60</b>	<b>7.53</b>	<b>8.68</b>
DPS (Rmb)	0.33	0.38	0.49	0.60					
Dividend payout ratio (%)	34.4	34.4	34.4	34.4					
Free cash flow yield (%)	3.2	1.5	1.9	2.9					
<b>Growth &amp; margins (%)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Ratios</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
Sales growth	39.1	31.4	27.4	22.7	ROE (%)	20.8	17.7	20.2	21.5
EBITDA growth	35.8	32.8	33.0	29.3	ROA (%)	11.9	11.2	12.5	13.3
EBIT growth	36.1	36.9	33.4	29.9	ROACE (%)	55.4	56.1	56.3	55.3
Net income growth	38.2	27.0	28.7	22.1	Inventory days	106.7	105.8	107.4	109.3
EPS growth	38.2	15.1	28.7	22.1	Receivables days	32.3	21.2	21.5	21.9
Gross margin	30.8	30.9	31.4	31.9	Payable days	74.1	71.0	72.1	73.4
EBITDA margin	9.2	9.3	9.7	10.2	Net debt/equity (%)	(72.4)	(68.3)	(63.9)	(61.8)
EBIT margin	8.5	8.9	9.3	9.9	Interest cover - EBIT (X)	291.2	NM	NM	NM
<b>Cash flow statement (Rmb mn)</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>	<b>Valuation</b>	<b>12/08</b>	<b>12/09E</b>	<b>12/10E</b>	<b>12/11E</b>
Net income pre-preferred dividends	465.4	591.1	760.6	929.1	P/E (analyst) (X)	36.6	31.8	24.7	20.2
D&A add-back	36.8	29.2	36.3	41.4	P/B (X)	6.0	5.3	4.7	4.1
Minorities interests add-back	(1.9)	(2.5)	(3.2)	(3.9)	EV/EBITDA (X)	24.4	23.4	17.4	13.2
Net (inc)/dec working capital	283.3	(251.9)	(285.4)	(297.6)	Dividend yield (%)	0.9	1.1	1.4	1.7
Other operating cash flow	23.3	0.0	0.0	0.0					
<b>Cash flow from operations</b>	<b>806.9</b>	<b>365.9</b>	<b>508.4</b>	<b>668.9</b>					
Capital expenditures	(317.8)	(75.2)	(143.7)	(117.5)					
Acquisitions	0.0	0.0	0.0	0.0					
Divestitures	0.6	0.0	0.0	0.0					
Others	(70.5)	0.0	0.0	0.0					
<b>Cash flow from investments</b>	<b>(387.7)</b>	<b>(75.2)</b>	<b>(143.7)</b>	<b>(117.5)</b>					
Dividends paid (common & pref)	(48.4)	(160.2)	(203.5)	(261.8)					
Inc/(dec) in debt	(55.3)	0.0	0.0	0.0					
Common stock issuance (repurchase)	1,366.1	0.0	0.0	0.0					
Other financing cash flows	(20.9)	0.0	0.0	0.0					
<b>Cash flow from financing</b>	<b>1,241.5</b>	<b>(160.2)</b>	<b>(203.5)</b>	<b>(261.8)</b>					
<b>Total cash flow</b>	<b>1,660.7</b>	<b>130.5</b>	<b>161.2</b>	<b>289.6</b>					

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

**Exhibit 33: Global pharmaceuticals stocks under Goldman Sachs/Gao Hua Securities Research coverage**

Company	Ticker	Stock rating	Market cap (US\$bn)	Pricing Currency	Price 5-Jun-09	EPS (reporting currency)			P/E (X)		EPS CAGR 09E-11E (%)	P/B 10E (X)	EV/EBITDA 10E (X)	ROE 10E (%)	ROA 10E (%)
<b>China Pharmaceuticals</b>															
Guangzhou Pharmaceutical (H)	0874.HK	Sell	0.4	HK\$	3.4	0.24	0.26	0.26	12.4	11.3	4.8	0.7	26.0	6%	5%
China Pharmaceutical Group	1093.HK	Neutral	0.9	HK\$	4.5	0.68	0.58	0.49	6.5	7.7	-15.6	1.2	3.8	16%	10%
China Shineway Pharmaceutical Group	2877.HK	Buy	0.8	HK\$	7.1	0.69	0.80	0.87	9.1	7.9	12.1	1.7	3.3	23%	20%
Simcere Pharmaceutical Group	SCR	Buy	0.5	\$	7.8	5.29	6.62	8.46	10.1	8.1	26.5	1.1	3.3	15%	12%
Shanghai Kehua Bio-Engineering Co	002022.SZ	Sell	0.8	Rmb	17.1	0.49	0.60	0.74	34.9	28.5	23.1	8.7	23.5	33%	26%
Zhejiang NHU Co	002001.SZ	Sell	1.5	Rmb	29.1	1.17	1.78	1.62	24.7	16.3	17.6	3.5	10.3	24%	14%
Beijing SL Pharmaceutical	002038.SZ	Neutral	1.2	Rmb	32.4	1.16	1.42	1.73	27.9	22.8	22.1	6.6	17.5	32%	30%
Jiangsu Hengrui Medicine Co.	600276.SS	Neutral	2.6	Rmb	34.0	1.10	1.37	1.51	30.8	24.7	17.0	6.3	19.4	29%	25%
Average									19.6	15.9	13.5	3.7	13.4	22%	18%
Median									18.6	13.8	17.3	2.6	13.9	24%	17%
<b>Indian Pharmaceuticals</b>															
Apollo Hospitals	APLH.BO	Neutral	0.6	Rs	501.7	16.66	16.35	18.97	30.1	30.7	6.7	2.1	14.1	7%	4%
Biocin	BION.BO	Neutral	0.9	Rs	208.9	7.17	8.40	10.63	29.1	24.9	21.7	2.5	12.2	9%	5%
Cadila Healthcare	CADI.BO	Neutral	1.0	Rs	345.8	24.69	27.27	31.04	14.0	12.7	12.1	3.0	8.5	23%	11%
Cipla	CIPL.BO	Sell	3.9	Rs	233.5	10.58	12.12	13.54	22.1	19.3	13.1	3.7	16.0	18%	12%
Dr. Reddy's Laboratories	REDY.BO	Buy*	2.4	Rs	684.4	52.87	64.74	77.39	12.9	10.6	21.0	2.4	8.2	21%	11%
Fortis Healthcare	FOHE.BO	Buy	0.5	Rs	113.8	3.00	4.12	5.64	37.9	27.6	37.0	1.7	21.9	5%	3%
Glenmark Pharmaceuticals	GLEN.BO	Neutral	1.3	Rs	252.8	21.81	27.67	30.58	11.6	9.1	18.4	2.4	7.2	27%	15%
Lupin	LUPN.BO	Neutral	1.5	Rs	847.2	74.65	94.01	114.88	11.3	9.0	24.0	3.1	8.5	33%	15%
Piramal Healthcare	PIRA.BO	Neutral	1.2	Rs	272.8	15.82	18.54	21.51	17.2	14.7	16.6	3.8	10.3	24%	10%
Ranbaxy Laboratories	RANB.BO	Sell	2.3	Rs	284.6	7.88	25.77		36.1	11.0		2.9	16.0	9%	4%
Sun Pharmaceutical Industries	SUN.BO	Neutral	5.4	Rs	1,341.9	72.00	78.41	87.00	18.6	17.1	9.9	3.7	14.9	24%	20%
Average									21.9	17.0	18.1	2.9	12.5	18%	10%
Median									18.6	14.7	17.5	2.9	12.2	21%	11%
<b>European Pharmaceuticals</b>															
Almirall	ALM.MC	Buy	1.9	€	8.3	1.07	1.07	1.00	7.8	7.8	(3.3)	1.6	4.9	21%	13%
AstraZeneca	AZN.L	Neutral	60.4	£	2,523.0	5.50	5.56	5.47	7.3	7.3	-0.3	2.7	4.8	35%	17%
GlaxoSmithKline	GSK.L	Sell*	91.3	£	1,032.0	119.61	108.11	115.93	8.6	9.5	-1.6	4.0	6.1	46%	13%
Grifols	GRLS.MC	Buy*	3.6	€	12.1	0.83	1.08	1.38	14.5	11.3	28.8	3.3	7.7	33%	16%
Ipsen	IPN.PA	Not Rated	3.6	€	30.8	2.34	3.02	3.73	13.2	10.2	26.2	2.0	5.1	22%	15%
Lundbeck	LUN.CO	Not Rated	4.7	Dkr	120.0	11.13	11.48	11.73	10.8	10.5	2.7	2.0	4.8	21%	14%
Meda AB	MEDAA.ST	Neutral	2.2	Skr	55.8	7.16	7.33	7.48	7.8	7.6	2.2	1.1	6.8	9%	6%
Merck KGaA	MRCG.DE	Neutral	20.9	€	68.8	4.86	6.45	7.45	14.2	10.7	23.8	1.5	6.5	9%	8%
Novartis	NOVN.VX	Buy*	91.5	SFr	42.8	3.64	3.99	4.62	10.9	9.9	12.7	1.4	6.2	15%	10%
Novo Nordisk	NOVOB.CO	Neutral	33.8	Dkr	279.5	16.64	18.87	21.81	16.8	14.8	14.5	4.4	8.6	31%	21%
Orion OYJ	ORNBV.HE	Neutral	2.2	€	11.3	1.08	1.24	1.36	10.5	9.1	11.9	3.4	5.5	39%	24%
Pharmstandard	PHSTQ.L	Neutral	2.3	\$	15.5	33.52	42.79	58.15	14.3	11.2	31.7	3.0	7.3	31%	25%
Recordati	RECI.MI	Sell	1.3	€	4.7	0.53	0.48	0.49	8.8	9.8	-3.6	1.7	5.3	18%	11%
Roche	ROG.VX	Not Rated	114.8	SFr	142.1	11.76	12.95	14.34	12.1	11.0	10.4	2.2	4.9	20%	13%
sanofi-aventis	SASY.PA	Neutral	87.0	€	46.1	6.14	6.36	6.30	7.5	7.3	1.3	1.3	4.6	18%	12%
Shire	SHP.L	Buy	7.7	£	877.0	1.04	1.01	1.49	13.5	13.9	19.6	3.7	9.5	24%	13%
UCB	UCB.BR	Sell	5.9	€	23.0	0.95	0.94	1.65	24.3	24.6	31.9	1.1	9.7	4%	2%
Veropharm	VRPH.RTS	Buy	0.2	\$	24.5	2.89	3.60	4.65	8.5	6.8	26.9	1.2	4.0	20%	16%
Average									11.7	10.7	13.1	2.3	6.3	23%	14%
Median									10.8	10.0	12.3	2.0	5.8	21%	13%
<b>US Pharmaceuticals</b>															
Bristol-Myers Squibb Company	BMJ	Neutral	39.5	\$	19.9	1.92	2.03	2.23	10.4	9.8	7.8	2.5	4.6	27%	12%
Eli Lilly & Company	LLY	Neutral	38.1	\$	34.8	4.25	4.63	4.74	8.2	7.5	5.6	3.1	5.1	47%	16%
Merck & Co., Inc.	MRK	Not Rated	54.9	\$	26.1	3.19	3.24	3.56	8.2	8.1	5.5	2.3	6.3	31%	15%
Pfizer Inc.	PFE	Buy*	96.7	\$	14.5	1.93	2.24	2.36	7.5	6.5	10.6	1.4	4.7	22%	8%
Schering-Plough Corporation	SGP	Not Rated	38.7	\$	23.8	1.74	1.88	2.05	13.7	12.6	8.5	2.8	7.1	25%	9%
Wyeth	WYE	Not Rated	58.6	\$	44.1	3.49	3.30	3.23	12.6	13.4	-3.8	2.7	7.0	19%	9%
Average									10.1	9.6	5.7	2.5	5.8	29%	12%
Median									9.3	8.9	6.7	2.6	5.7	26%	11%
<b>US Generics</b>															
Mylan Inc.	MYL	Buy	4.2	\$	13.7	1.11	1.60	1.81	12.4	8.6	28.1	1.6	6.0	21%	7%
Par Pharmaceutical Cos., Inc.	PRX	Sell	0.5	\$	14.8	1.26	1.00	1.13	11.7	14.8	-5.5	1.1	4.5	8%	5%
Perrigo Co.	PRGO	Neutral	2.5	\$	26.4	1.83	1.93	2.08	14.4	13.7	6.4	2.4	8.6	19%	7%
Watson Pharmaceuticals, Inc.	WPI	Sell*	3.1	\$	30.4	2.41	2.30	2.41	12.7	13.2	0.0	1.4	4.9	11%	7%
Average									12.8	12.6	7.3	1.6	6.0	14%	7%
Median									12.5	13.4	3.2	1.5	5.4	15%	7%

\*This stock is on our regional Conviction list. For important disclosures, please go to <http://www.gs.com/research/hedge.html>.

Source: Datastream, Gao Hua Securities Research estimates, Goldman Sachs Research estimates.

## Reg AC

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I, Wei Du, Ph.D, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

## Investment profile

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The Investment Profile provides investment context for a security by comparing key attributes of that security to its peer group and market. The four key attributes depicted are: growth, returns, multiple and volatility. Growth, returns and multiple are indexed based on composites of several methodologies to determine the stocks percentile ranking within the region's coverage universe.

The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

**Growth** is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

## Quantum

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Quantum is Goldman Sachs' proprietary database providing access to detailed financial statement histories, forecasts and ratios. It can be used for in-depth analysis of a single company, or to make comparisons between companies in different sectors and markets.

## Disclosures

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### Coverage group(s) of stocks by primary analyst(s)

Wei Du, Ph.D: China Healthcare.

China Healthcare: Beijing SL Pharmaceutical, China Pharmaceutical Group, China Shineway Pharmaceutical Group, Guangzhou Pharmaceutical (H), Jiangsu Hengrui Medicine Co., Mindray Medical International, Shandong Dong-E E-Jiao Co., Shandong Weigao Group, Shanghai Kehua Bio-Engineering Co., Simcere Pharmaceutical Group, Tianjin Tasly Pharmaceutical Co., Yunnan Baiyao Grp Co., Zhejiang NHU Co.

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### Definitions

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