STANDARD &POOR'S

Pharmaniaga

Recommendation: **HOLD**

Stock Code: 7081 | Bloomberg: PHRM MK | Price: MYR3.40 | 12-Month Target Price: MYR4.05 | Date: June 26, 2008

Board: Main

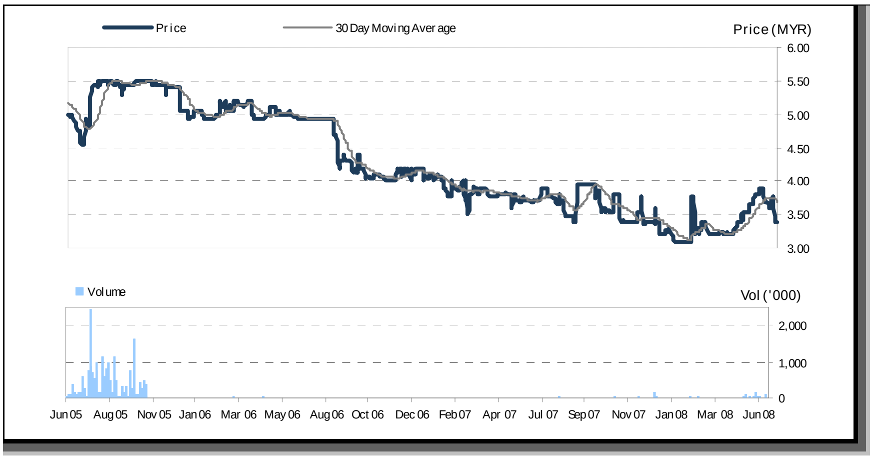
Sector: Trading/Services

GICS: Health Care/Pharmaceuticals

Market Value - Total: MYR363.7 mln

Summary: Pharmaniaga holds the sole concession for the supply of pharmaceuticals to government hospitals, which expires in October 2009. The group also manufactures generic pharmaceuticals and supplies medical products and equipment in Malaysia and Indonesia.

Analyst: Siti Rudziah Salikin



Highlights

- By virtue of its concession, Pharmaniaga stands out as the largest pharmaceutical distributor in Malaysia, controlling 25% of the market. Backed by its own manufacturing arm, as well as a growing distribution operation in Indonesia, demand prospects are favorable, in our opinion, in view of rising healthcare spending and the expected rise in generic substitutes.

- We forecast an 8.1% YoY increase in Pharmaniaga's revenue for 2008, led stronger concession sales as well as better performance in Indonesia. Higher prices and a more favorable product mix for concession sales are expected to improve operating margin. Together with a lower tax rate, we project a 23.8% YoY increase in net profit for the year to MYR62 mln.

- Despite the strong earnings growth expected in the near term, revenue beyond 2009 is less secure as its concession agreement, which contributes to the bulk of Pharmaniaga's earnings, expires in October 2009. While we believe that Pharmaniaga's extensive coverage and network nationwide places it in a strong bargaining position, we cannot entirely rule out the possibility of less favorable variations to the concession terms.

Investment Risks

- Risks to our recommendation and target price include: (i) Pharmaniaga not successfully renewing its concession or renewing it on less favorable terms; and (ii) lower-than-expected demand for pharmaceuticals due to among others, an economic slowdown.

Recommendation

- We initiate coverage on Pharmaniaga with a Hold call and a 12-month target price of MYR4.05.

- We attach a 12-month target price of MYR4.05 to Pharmaniaga, valuing the stock at 7x PER on projected earnings for 2008. The assigned multiple is at about a 20% discount to present valuations for its domestic peers in the pharmaceutical industry, which we believe is fair, given present uncertainty surrounding the renewal of the concession, which contributes significantly to Pharmaniaga's earnings.

- We believe that interest towards the stock is likely to be subdued until such time when there is further clarity on the renewal of the concession agreement, the outcome of which is expected to be known by October 2008.

- Dividend payout is likely to remain at 18 sen per share in 2008, yielding a decent 5.3% at the current share price.

- In its 2007 annual report, we note Pharmaniaga's commitment to the Corporate Social Responsibility. Its social contributions included a mobile clinic program, which provides health screening and awareness of a healthy lifestyle. Pharmaniaga also supported the Ministry of Health's campaigns nationwide such as "Kempen Kenali Ubat Anda" and "Karnival Sihat Sepanjang Hayat".

Key Stock Statistics

FY Dec.	2007	2008E
Reported EPS (sen)	46.8	58.0
PER (x)	7.3	5.9
Dividend/Share (sen)	18.0	18.0
NTA/Share (MYR)	2.93	3.34
Book Value/Share (MYR)	3.27	3.67
No. of Outstanding Shares (mln)	107.0	
52-week Share Price Range (MYR)	3.10 - 3.96	
Major Shareholders:	%	
UEM World Bhd	72.5	
Employees Provident Fund Board	9.1	

* Stock deemed Shariah compliant by the Securities Commission.

Per Share Data

FY Dec.	2005	2006	2007	2008E
Book Value (MYR)	2.94	2.96	3.27	3.67
Cash Flow (sen)	45.0	32.5	62.6	75.0
Reported Earnings (sen)	26.0	11.7	46.8	58.0
Dividend (sen)	15.0	15.0	18.0	18.0
Payout Ratio (%)	59.6	60.1	38.4	31.0
PER (x)	13.1	29.1	7.3	5.9
P/Cash Flow (x)	7.5	10.5	5.4	4.5
P/Book Value (x)	1.2	1.1	1.0	0.9
Dividend Yield (%)	4.4	4.4	5.3	5.3
ROE (%)	9.0	8.5	15.0	16.7
Net Gearing (%)	46.3	60.4	49.2	46.9

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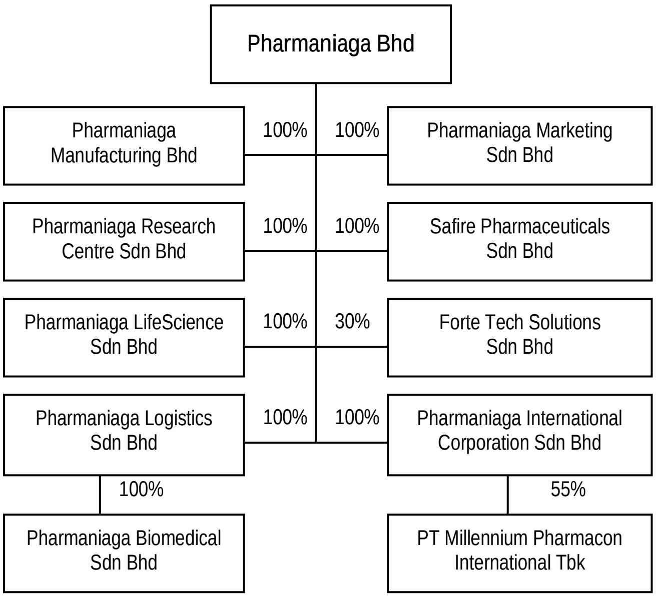
Background

The jewel in Pharmaniaga's crown is its concession agreement, which gives it the exclusive right to purchase, store and distribute pharmaceuticals and medical products to medical institutions and hospitals under the jurisdiction of Malaysia's Ministry of Health (MoH). The concession to privatize the Government Medical Store was initially awarded to United Engineers (M) in May 1994 and was subsequently novated to the latter's subsidiary Remedi Pharmaceuticals (M) [formerly known as Southern Task (M)]. Remedi Pharmaceuticals then became a subsidiary of Pharmaniaga via a pre-listing restructuring exercise in September 1999.

Pharmaniaga was listed on the Second Board of Bursa Malaysia in November 1999 and migrated to the Main Board in March 2003. UEM World (UEM MK, MYR2.99, Not Ranked) is Pharmaniaga's largest shareholder, with a 72.5% stake in the company. Dato' Mohamed Azman bin Yahya is the Chairman of Pharmaniaga and Mohamad bin Abdullah acts as the Managing Director.

Corporate Structure

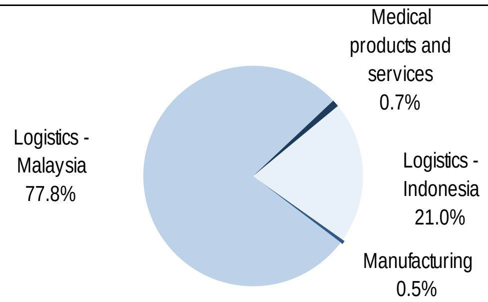


Source: Company data

Business

Pharmaniaga's business can be divided into three main segments: (i) logistics and distribution of pharmaceuticals and medical products in Malaysia and Indonesia, (ii) manufacturing of pharmaceuticals and (iii) supply of medical products and equipment. The logistics and distribution business, under which the concession contribution is recognized, is the mainstay of Pharmaniaga's earnings, contributing the bulk or 77.8% of 2007 revenue. Its Indonesian operations accounted for 21% of 2007 revenue. The balance came from the manufacturing and medical products divisions.

2007 Revenue Breakdown



Source: Company data

Logistics and distribution – Malaysia

Pharmaniaga owns the exclusive rights to supply and distribute pharmaceuticals and medical products to government hospitals and medical institutions in the country. This 15-year concession agreement supplies about 50% of the pharmaceuticals required by the country's estimated 140 government hospitals and medical institutions. With government hospitals and medical institutions accounting for about half of the country's pharmaceutical expenditure, as the sole concessionaire for Government Medical Stores, Pharmaniaga thus stands out as the largest pharmaceutical distributor in Malaysia.

Under the terms of the concession, an approved products price list is decided upon every three years, and the government then evaluates the relevant supply tenders. Although both volume and pricing for the approved products price list is fixed, there is however room for some variation during the three year period. Pharmaniaga earns a cost plus margin fee from volume stipulated under the approved products price list. At the start of the current three-year period i.e. October 2007, prices for products under concession sales were revised upwards by an average of 1%, helping boost margins upwards. There is also the possibility of increasing product range. In 2007, for instance, Pharmaniaga secured the rights for the distribution of the influenza vaccines for Ranbaxy (M), which helped boost annual revenues by some MYR13 mln.

The MoH's remaining 50% pharmaceutical requirement is sourced via tenders from the open market. Pharmaniaga also participates in the open tender, competing with pharmaceutical distributors such as Zuellig Pharma and CCM Duopharma Biotech (CCMD MK, MYR2.52, Not Ranked). Revenue from the MoH segment makes up the bulk 63.7% of revenue from the Malaysian logistics division. Pharmaniaga also supplies pharmaceuticals to other government related institutions, private hospitals as well as to the over-the-counter (OTC) segment. In total, the non- MoH segment contributes to a smaller 36.3% of revenue from the Malaysian logistics division.

The 15-year concession agreement will expire in October 2009 and Pharmaniaga is hopeful that the concession will be renewed without any major changes to the terms. Of significant interest here is whether competition will be introduced or whether Pharmaniaga will continue to enjoy its currently exclusive distribution rights for the Government Medical Stores. A renewal proposal for the concession has been submitted to the government and a decision is expected to be known in October 2008.

Currently, Pharmaniaga's inventory for the concession supply is managed through four warehouses, with the largest located in Bukit Raja. As a strategic part of the business involves inventory management, we believe it is likely that Pharmaniaga's proposal to renew its concession will see some success given that Pharmaniaga already has an existing network of warehouses spread across the country. However, there is also a possibility of other competing concessions may also be introduced.

Warehouse capacity

Location	Size (sq ft)	Capacity (pallets)	Utilization (%)
Bukti Raja, Selangor	95,000	10,000	85%
Juru, Penang	13,000	300	100%
Kuching, Sarawak	23,774	1,368	98%
Kota Kinabalu, Sabah	24,000	936	87%

Source: Company data

Logistics and distribution – Indonesia
Pharmaniaga is also involved in the distribution of pharmaceutical and diagnostic products in Indonesia via 55%-owned PT Millennium Pharmacon International Tbk (MPI) (SDPC ID, IDR115.0, Not Ranked). MPI has a total of 25 branches in Indonesia, covering Jawa, Sumatera, Kalimantan, Sulawesi and Bali and products distributed by MPI come from a total of 17 principals.

MPI's revenue grew at a CAGR of 23% for the past five years and revenue from this segment has been the fastest growing within Pharmaniaga's businesses since it was acquired in 2005. However, as MPI operates as a pure distributor and competes head-on with international pharmaceutical firms, margins are razor thin. Net margin came in at or below 1.5% for the past five years.

MPI is the sixth largest player in Indonesia, which is a highly competitive market with the top three players controlling the bulk of the market. Growth going forward will be dependent on Pharmaniaga's ability to secure more principals and increasing its distribution reach. Pharmaniaga intends to introduce its own generic pharmaceutical products into Indonesia via MPI, particularly the disposable products range and some are in the process of being registered. Pharmaniaga is also looking at expanding its presence in the Indonesian market through mergers or acquisitions.

Manufacturing
Pharmaniaga's manufacturing operations focus on off-patent generic products and traditional herbal medicine. Production is currently being carried out at its two facilities located in Bangi and Ipoh. Pharmaniaga has rationalised its manufacturing facilities over the last couple of years and transferred the production of all galenicals, liquid and cream products to the Bangi facility, which also produces the tablets, capsules as well as Cephalosporin range of products. The Bangi facility is currently running at a 70% utilization rate.

Following the plant rationalisation exercise, the much smaller facility in Ipoh now focuses only on penicillin production and is currently running at a low 30.0% utilization rate. Pharmaniaga is looking to dispose of the plant and is aiming to do so by end 2008. Plans are also afoot to open a third plant, dedicated for Small Volume Injectables (SVI) production. Located in Puchong, final renovation and preparation of the plant is currently ongoing and the plant is expected to be operational by end of 2008.

Pharmaniaga's product development work focuses on developing off-patent generic products, SVI and transforming local research into enhanced products. Therefore, R&D expenditure incurred by Pharmaniaga is not high and is estimated at under MYR5 mln in 2007 (or 3.3% of manufacturing revenue). Pharmaniaga's products distributed domestically cover most of the drug classification categories such as anti-diabetic, cardiovascular drugs, anti-infective, analgesics and dosage forms, such as tablet, capsule, oral liquid, cream, ointment, injectables and others. Pharmaniaga is also actively developing Bio-Equivalent (BE) products, which are expected to be a key growth area in the future. Pharmaniaga has to-date obtained 30 BE products, approvals for two of which were received in 2007.

The bulk of Pharmaniaga's manufacturing output is used for supply in its concession sales, and external sales make up less than 4.1% of 2007's revenue from this division. Efforts are being made to increase its share of the non-government segment in Malaysia while marketing efforts are also being made abroad. Aside from its presence in Indonesia (via MPI), Pharmaniaga is also involved in distributing its own generic pharmaceutical products to several other markets regionally such as Vietnam, Papua New Guinea and Sri Lanka. However, contribution from overseas sales is still insignificant given the long gestation period taken for product registration in each market. To-date, Pharmaniaga has registered a total of 165 products in its export markets and plans going forward include penetrating the Middle East as well as Eastern Europe.

Medical Products and Services
Under this segment, Pharmaniaga offers medical equipment planning, hospital equipping and equipment supply. The main revenue contributor for this division over the past two years comes from an equipment supply contract for six East Malaysian hospitals, which is now nearing completion. Contract in hand are currently much smaller and include a contract for coordinating the renovation of the National Heart Institute as well as some small equipment supply subcontracts for government related medical institutions such as the military hospital.

Going forward, Pharmaniaga hopes to secure a portion of the hospital refurbishment contracts slated to be awarded under the Ninth Malaysia Plan (9MP), whereby a total of MYR2 bln is expected to be spent on refurbishing government hospitals. Assuming 30% of the spending is allocated to medical equipment, the potential contract size for this division is MYR600 mln.

Earnings Outlook

The Malaysian pharmaceutical industry is estimated to have expanded by 12% in 2007, while the generic market registered a stronger 16% growth. Going forward, growth is expected to be sustained at healthy levels, with the generic market expected to see stronger growth given the large number of patents expiring worldwide.

Given that locally manufactured pharmaceuticals account for only an estimated 20% to 30% of the market, there is good potential ahead for local players to increase their market share. Pharmaniaga's concession and subsequent control of at least 25% of pharmaceutical distribution in the country puts it in a favourable position to benefit from the growth expected in the market over the next two years from distributing both third party products as well as their own products.

Pharmaniaga

Recommendation: HOLD

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Pharmaniaga's revenue grew 11.9% YoY in 2007 driven by higher concession sales (aided by an increase in volume and a more favorable product mix) and stronger contribution from its Indonesian operations. There was also a price hike for the new approved price products list from October 2007, helping to drive margins up. Together with a lower tax rate, net profit grew 4x YoY (based on recurring net profit for 2006 after stripping off a MYR21.5 mln write-off and MYR7.3 mln disposal gain). The Indonesian subsidiary, MPI recorded a 14% YoY growth in net profit driven by an increase in its distribution network as well as the number of principals. Revenue from the manufacturing division was flat YoY while revenue from the medical products division declined 6.3% YoY due to completion of the contracts in hand and in the absence of new sizeable contracts.

We forecast an 8.1% YoY increase in Pharmaniaga's revenue for 2008, led by stronger concession sales and better performance from Indonesia. Despite rising cost pressures, we expect operating margins to improve to 7.9% from 7.4% due to the price hike and a more favorable product mix for concession sales. Helped by a lower tax rate, net profit is expected to grow 24% YoY 2008 net profit to MYR62 mln. Based on its KPI, Pharmaniaga is targeting a higher revenue growth of 20% YoY for 2008 as it already assumes contribution from new contracts for medical products supply under the 9MP and from possible acquisitions in Indonesia, which are not factored into our forecast.

Forecast risk beyond October 2009 is high given the uncertainty of the concession renewal, particularly as concession earnings make up a significant portion Pharmaniaga's bottomline. We are estimating a 7.1% YoY rise in total revenue for 2009 and a 9.3% YoY growth in net profit to MYR67.8 mln. Our 2009 forecast assumes that Pharmaniaga will successfully renew its concession agreement without any changes in the terms.

Valuation

We attach a 12-month target price of MYR4.05 to Pharmaniaga, valuing the stock at 7x PER on projected earnings for 2008. The assigned multiple is at about a 20% discount to present valuations for its domestic peers in the pharmaceutical industry, which we believe is fair, given present uncertainty surrounding the renewal of the concession, which contributes significantly to Pharmaniaga's earnings. While we believe that Pharmaniaga's extensive coverage and network nationwide places it in a strong bargaining position, we cannot entirely rule out the possibility of less favorable variations to the concession terms

Recent Developments

February 2008: Pharmaniaga entered into an MOU with Visor Holding of the Kazakhstan to collaborate and jointly participate in the Republic of Kazakhstan's healthcare industry.

Profit & Loss

FY Dec. / MYR mln	2006	2007	2008E	2009E
Reported Revenue	1,057.9	1,184.0	1,279.6	1,370.7
Reported Operating Profit	37.2	87.4	100.8	109.6
Depreciation & Amortization	-23.0	-17.6	-19.0	-20.3
Net Interest Income / (Expense)	-9.7	-9.0	-9.3	-9.7
Reported Pre-tax Profit	27.2	77.9	91.1	99.4
Effective Tax Rate (%)	48.2	33.6	30.0	30.0
Reported Net Profit	12.5	50.1	62.0	67.8
Reported Operating Margin (%)	3.5	7.4	7.9	8.0
Reported Pre-tax Margin (%)	2.6	6.6	7.1	7.3
Reported Net Margin (%)	1.2	4.2	4.8	4.9

Source: Company data, S&P Equity Research

Balance Sheet

FY Dec. / MYR mln	2005	2006	2007
Total Assets	797.9	827.8	884.8
Fixed Assets	251.5	252.6	241.0
Current Assets	510.1	508.8	545.7
Other LT Assets	36.2	66.5	98.1
Current Liabilities	383.4	405.7	460.1
LT Liabilities	99.9	105.9	75.0
Share Capital	107.0	107.0	107.0
Shareholders' Funds	314.6	316.2	349.7

Source: Company data, S&P Equity Research

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Glossary

Strong Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.
Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.
Hold: Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.
Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.
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STANDARD & POOR'S

Recommendation and Target Price History

Date	Recommendation	Target Price
New	Hold	4.05