

Sep 22, 2015
Company Report
Rating: SELL
TP: HK\$ 12.91

Share price (HK\$) 16.46
Est. share price return -21.57%
Est. dividend yield 1.55%
Est. total return -20.02%

Previous Rating SELL
Previous TP 12.91

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Acquisition data

Price (AU\$ mn) 1,386
Equity shares acquired (%) 83

Valuation metrics (x)

Price/Sales 5.33
Price/EBITDA 14.83
Price/Earnings 22.56
Price/Book 81.08

Source(s): The Group, ABCI Securities

Key Data

52Wk H/L(HK\$) 42/11.72
Outstanding shares (mn) 609.40
Market cap (HK\$ mn) 10,031
3-mth avg daily turnover (HK\$ mn) 53.04
Major shareholder(s) (%):
Biostime Pharma China Ltd. 73.84
Franklin Templeton Investments 2.31
Janus Capital Management LLC 1.15
Baring International Inv Ltd 0.9

Source(s): Bloomberg, ABCI Securities

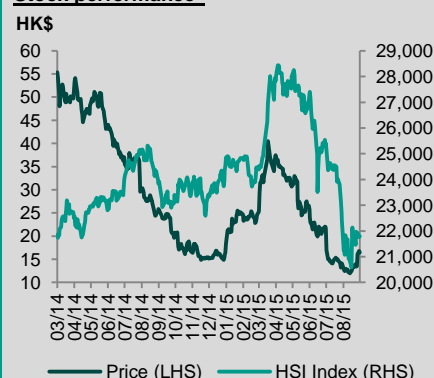
Share price performance (%)

	Absolute	Relative*
1-mth	16.90	(2.74)
3-mth	(38.00)	(19.51)
6-mth	(33.90)	(10.58)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Stock performance



Source(s): Bloomberg, ABCI Securities

Biostime International (1112 HK)

Expensive acquisition brings more challenges; maintain **SELL**

- Biostime announced it would acquire 83% of Swisse Wellness, a family nutrition solution provider in Australia, for AU\$ 1386mn; AU\$ 1336mn will be paid in cash and the remaining AU\$ 50mn in equity.
- We believe the acquisition premium is unjustifiable considering the operating performance of the target remains questionable. We also believe Biostime would encounter short-term pressure post-acquisition. Maintain **SELL**.

Paying more than it should have. The final transaction price represents the firm's valuation at AU\$ 1669.88mn (HK\$ 9236.35mn). We believe such premium is unjustifiable and Biostime may encounter difficulties in attaining its operating targets after the acquisition.

1) A higher valuation than existing players. The transaction price represents a price/sales (P/S) of 5.33x. Blackmores, a competitor of Swisse Wellness competitor listed in AXS, had a P/S of 3.96x. Blackmores' sales reached AU\$ 471.6mn in FY15 (ends on June 30) and has a well-developed operation in China; in contrast, Swisse Wellness does not have any operation in China and its sales was lower at AU\$ 313.06mn for the same period. In our view, Biostime may have paid more than Swisse Wellness deserves.

2) A tough target to swallow. The transaction price represents P/S, P/EBITDA and P/E of 5.33x, 14.83x and 22.91x. However, as of end-Sep 16, Biostime's FY15E P/S, P/EBITDA and P/E were 2.06x, 10.91x, and 16.03x. The company's expensive valuation, as demonstrated by the higher valuation multiples, shows that a high premium is entailed and high growth is expected. Such expectation could be problematic if growth of the new business falls short of target. In addition, the total valuation of HK\$ 9237.35mn for Swisse Wellness is higher than Biostime's market cap of HK\$ 8226.89mn by end-Sep 16. That means Biostime is acquiring a majority stake of a company larger than itself.

Consideration structure provides limited incentive. Swisse Wellness will be paid with a cash consideration of AU\$ 1,336mn and an equity consideration amounting to AU\$ 50mn. As 96% of the payment will be made in cash, we believe the small amount of equity issued would not present a strong incentive for Swisse Wellness's management.

Volatile operating performance is a concern. Swisse Wellness incurred a net loss of AU\$ 5.61mn from its continuing operation in FY14 although the business swung back into a net profit of AU\$ 73.75mn in FY15. According to the announcement, the volatile performance was mainly caused by the discontinued operations. We are unsure if similar events would occur again, as limited financial information of Swisse Wellness has been released at this point.

Downward pressure on operating performance. Assuming the 1H15 revenue of Swisse Wellness was half of what was reported in the announcement (HKD 1731.62mn), the revenue contribution from the company in 1H15 would be ~30.16%, meaning that Biostime's revenue would have risen by 29.22% YoY instead of declining by 10.33% YoY in 1H15. According to the Sydney Morning Herald, however, Swisse Wellness's annual marketing spending once reached AU\$ 50mn due to its marketing campaign featuring international celebrities. In addition, Blackmores had a SG&A/sales ratio of 47% in FY15. Therefore, we believe Biostime's SG&A/Sales would increase substantially in the coming years.

Immense pressure on Biostime's cash situation. Biostime entered into a bridge loan agreement that will provide a maximum amount of HK\$ 3,487.55mn (US\$ 450mn) to finance the purchase. The remaining HK\$ 3902.46mn would be covered by Biostime's cash amounting to HK\$ 3998.20mn on the balance sheet as of June 30, 2015. After the completion of the transaction, the Group would have ~HK\$ 95.74mn of liquid cash on hand. Moreover, if the Group's listing committee rejects the equity payment, Biostime would have to obtain HK\$ 277mn in cash to finance the purchase.



Capital structure to change further. We believe that Biostime's debt/equity ratio to reach ~161% right after the transaction and before the incorporation of Swiss Wellness. Given the acquisition would tighten Biostime's cash flow, we believe the Group would need to boost its capital through equity or debt financing. The Group may have to issue new shares and refinance its debt with new debts to stabilize its capital structure shares in the next few years.

Business outlook is uncertain. Swiss Wellness currently does not have any operations in China. Its impressive sales growth has been mainly driven by tourists in Australia and the online purchase agents (Daigou) in China. One serious risk is that tourists may shift to other brands or destinations. In addition, the Chinese authorities may tighten rules on the online purchase agents due to the present legal ambiguity in the realm of e-commerce. Biostime would have to introduce the Swiss Wellness brand into China through proper channels, such as opening official online stores and setting up physical stores across the country, in an accelerated pace.

Acquisition may mean a shift in business focus. The milk formula industry has been undergoing major changes in recent years. Danone sold the China operation of Dumex to Yashili back in July 2015; Mengniu also announced it would sell its Oushi Mengniu brand to Yashili in Sep 2015. Given the deteriorating condition of the milk formula industry, we believe Biostime is also diversifying away from the business to weather the storm.

Switching from milk formula stocks to downstream counters. The milk formula industry, especially the infant milk formula business, is confronted by increased competition and sluggish growth. Biostime's stock price has underperformed by 19.51% relative to the HSI for the past three months compared to Mengniu's 16.77%. Therefore, we believe continuous rotation within the dairy sector from milk powder counters to the downstream players would persist. Due to the lack of financial and operating information, we are unable to provide post-acquisition projections. Based on our current analysis of the transaction and Biostime's stand-alone projection, we reiterate **SELL** and maintain our TP at HK\$12.91.

Appendix: Financial Statements of the Group

* The following tables are for Biostime alone due to the lack of financial information of Swisse Wellness.

Consolidated income statement (2013A-2017E)

As of Dec 31 (RMB mn, except per share data)	2013A	2014A	2015E	2016E	2017E	1H14	1H15
Revenue	4,561.30	4,731.56	3,991.36	4,226.51	4,731.42	2,189	1,963
- Infant formula	3,752.12	3,981.58	3,429.88	3,662.14	4,122.01	1,859	1,698
- Probiotic supplements	458.16	425.09	331.22	311.29	310.77	186	173
- Dried baby food and nutrition supplements	198.78	151.42	112.49	117.27	132.10	71	43
- Baby care products	152.24	173.47	117.76	135.81	166.54	73	49
COGS	(1,586.18)	(1,804.63)	(1,692.36)	(1,702.43)	(1,882.00)	(843)	(820)
Gross profit	2,975.12	2,926.93	2,299.00	2,524.08	2,849.41	1,346	1,143
Other income and gains	23.47	23.03	22.86	26.94	33.61	54	69
SG&A	(1,690.36)	(1,763.03)	(1,574.47)	(1,672.68)	(1,783.31)	(886)	(826)
Other expenses	(55.57)	(87.55)	(48.83)	(54.94)	(63.72)	(39)	(57)
Operating profit	1,252.65	1,099.38	698.57	823.41	1,036.00	474	328
Net interest income/(expense)	72.34	18.36	63.86	64.47	34.32	5	10
Fine on violation of anti-monopoly law	(162.90)	0.00	0.00	0.00	0.00	0	0
Share of profit of an associate	0.00	0.59	0.71	0.85	1.02	(0)	(0)
Profit before tax	1,162.10	1,118.34	699.28	824.26	1,037.02	433	280
Tax	(341.38)	(311.55)	(186.15)	(229.56)	(292.38)	(121)	(75)
Net profits	820.72	806.79	513.13	594.70	744.64	312	205
Dividend	577.42	321.26	155.47	180.19	225.62	125	0
EPS (RMB)							
- Basic	1.37	1.34	0.84	0.98	1.22	0.52	0.34
- Dilute	1.34	1.31	0.79	0.91	1.15	0.51	0.33
DPS (RMB)	1.21	0.67	0.59	0.68	0.85	0.26	0

Source(s): The Group, ABCI Securities estimates

Consolidated balance sheet (2013A-2017E)

As of Dec 31 (RMB mn)	2013A	2014A	2015E	2016E	2017E	1H14	1H15
Cash and cash equivalents	1,662.84	3,347.16	3,124.06	3,579.93	3,541.49	2,748	3,998
Restricted bank deposit	70.00	0.00	0.00	0.00	0.00	0	0
Trade and bills receivable	15.18	12.04	11.23	11.76	12.10	17	22
Inventories	971.89	797.03	715.52	716.94	649.71	1,113	626
Others	145.96	179.49	76.45	183.51	79.88	210	197
Current assets	2,865.87	4,335.72	3,927.25	4,492.14	4,283.18	4,089	4,844
PP&E	326.19	478.03	614.94	820.27	1,092.40	379	519
Prepaid land lease payments	64.72	63.24	62.47	60.23	58.12	64	63
Goodwill	76.00	76.00	76.00	76.00	76.00	76	76
Intangible assets	109.89	104.11	105.23	105.22	113.74	106	101
Bonds and loans receivable	183.59	183.83	231.47	191.80	241.63	168	181
Others	1,014.76	1,390.22	1,315.06	1,884.52	1,722.61	1,551	830
Non-current assets	1,775.15	2,295.44	2,405.18	3,138.03	3,304.50	2,344	1,770
Total assets	4,641.02	6,631.16	6,332.42	7,630.17	7,587.69	6,433	6,614
Trade and bills payables	361.63	294.54	265.55	335.79	265.53	265	193
Other payables and accruals	719.84	737.49	325.44	832.67	481.41	608	711
Short-term debt	750.61	0.00	0.00	0.00	0.00	540	135
Others	212.73	235.59	0.79	241.35	40.93	58	123
Current liabilities	2,044.81	1,267.62	591.78	1,409.82	787.87	1,469	1,161
Deferred tax liabilities	80.62	35.92	51.29	63.03	52.93	44	39
Convertible bonds	0.00	2,410.53	2,444.35	2,445.52	2,446.00	2,380	2,456
Non-current liabilities	80.62	2,446.45	2,495.63	2,508.55	2,498.93	2,424	2,495
Equity	2,515.59	2,917.09	3,245.02	3,711.79	4,300.89	2,540	2,958
Total liabilities and Equity	4,641.02	6,631.16	6,332.42	7,630.17	7,587.69	6,433	6,614

Source(s): The Group, ABCI Securities estimates

Consolidated cash flow statement (2013A-2017E)

FY ends at Dec 31 (RMB mn)	2013A	2014E	2015E	2016E	2017E	1H14	1H15
Profit before tax	1,162.10	1,118.34	699.28	824.26	1,037.02	433.33	280.12
Depreciation and amortization	26.56	50.67	41.50	60.28	86.68	24.76	30.11
Finance costs	10.59	86.67	73.82	73.82	73.82	40.35	47.55
Income tax paid	(347.47)	(338.38)	(159.61)	(193.43)	(256.26)	(294.87)	(213.50)
Change in working capital	(166.52)	150.98	(594.48)	643.23	(549.62)	(352.09)	43.20
Others	(24.79)	(96.10)	(140.36)	(142.58)	(113.66)	(44.47)	(40.08)
Cash flow from operating activities	660.47	972.17	(79.86)	1,265.58	277.98	(192.98)	147.40
Change in PP&E	(135.58)	(132.92)	(169.04)	(244.10)	(325.32)	(56.03)	(63.30)
Change in intangible assets	(2.23)	(13.82)	(8.81)	(9.46)	(19.99)	0.00	0.00
Others	57.06	(313.65)	166.47	1,022.44	(234.66)	(526.75)	5.10
Cash flow from investing activities	(80.75)	(460.39)	(11.38)	768.88	(579.97)	(582.79)	(58.20)
Change in bank loans	480.09	(750.61)	0.00	0.00	0.00	(211.10)	134.60
Net proceeds from convertible bonds	0.00	2,414.37	0.00	0.00	0.00	2,414.37	0.00
Dividends paid	(621.91)	(492.70)	(393.44)	(168.83)	(195.73)	(368.39)	(196.10)
Others	-73	1	-74	-74	-74	1.86	11.00
Cash flow from financing activities	(214.67)	1,171.85	(467.25)	(242.65)	(269.55)	1,836.74	(50.50)
Net change in Cash	365.05	1,683.63	(558.50)	1,791.82	(571.53)	1,060.97	38.70
Cash and equivalent at beg	400.62	764.84	2,447.16	2,134.06	2,490.93	764.84	2,447.16
Forex effect	(0.83)	(1.30)	245.40	(1,434.94)	424.20	2.37	1,033.45
Cash and equivalent at end	764.84	2,447.16	2,134.06	2,490.93	2,343.59	1,828.17	3,519.30

Source(s): The Group, ABCI Securities estimates

Key operating and financial ratios (2012A-2016E)

FY ended Dec 31	2013A	2014A	2015E	2016E	2017E	1H14	1H15
Revenue composition (%)							
- Infant formula	82.26	84.15	85.93	86.65	87.12	84.92	86.50
- Probiotic supplements	10.04	8.98	8.30	7.37	6.57	8.51	8.82
- Dried baby food and nutrition supplements	4.36	3.20	2.82	2.77	2.79	3.23	2.20
- Baby care products	3.34	3.67	2.95	3.21	3.52	3.34	2.49
Profitability ratios (%)							
Gross margin	65.23	61.86	57.60	59.72	60.22	61.47	58.23
- Infant formula	64.55	61.96	57.11	59.19	60.01	61.70	58.60
- Probiotic supplements	78.61	71.44	73.69	82.75	86.22	71.60	63.80
- Dried baby food and nutrition supplements	55.60	49.10	49.88	52.87	41.72	46.00	44.50
- Baby care products	54.16	47.25	34.02	27.04	31.73	46.00	36.80
EBIT margin	27.46	23.24	17.50	19.48	21.90	21.64	16.72
EBITDA margin	28.05	24.31	18.89	21.60	24.43	22.77	18.25
Pre-tax margin	25.48	23.64	17.52	19.50	21.92	19.80	14.27
Total net margin	17.99	17.05	12.86	14.07	15.74	14.26	10.44
Return ratios (%)							
ROAA	20.08	14.31	7.92	8.52	9.79	5.64	3.09
ROAE	33.93	29.70	16.65	17.10	18.59	12.35	6.98
ROIC	36.21	17.76	23.54	27.33	29.42	10.96	7.56
Liquidity ratio (%)							
Current ratio	1.40	3.42	6.64	3.19	5.44	2.78	4.17
Quick ratio	0.93	2.79	5.43	2.68	4.61	2.03	3.63
Cash ratio	0.85	2.64	5.28	2.54	4.50	1.87	3.44
Cash conversion cycle (days)							
Days of outstanding receivable	0.6	1.1	1.1	1.0	0.9	1.3	1.6
Days of inventory on hand	172.0	178.9	163.1	153.6	132.5	225.6	158.4
Days of outstanding payable	56.0	73.5	63.5	64.4	60.5	51.1	64.3
CCC	116.6	106.5	100.7	90.1	73.0	175.8	95.7
Leverage ratios (%)							
Total debt/Equity	29.84	82.63	75.33	65.89	56.87	114.93	87.57
Total debt/Total assets	16.17	36.35	38.60	32.05	32.24	45.38	39.16

Source(s): The Group, ABCI Securities estimates

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Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return $- 6\% \leq$ Stock return $<$ Market return rate
Sell	Stock return $<$ Market return $- 6\%$

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate from 2010-2014

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility $<$ 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility $<$ 1.5
Low	180 day volatility/180 day benchmark index volatility $<$ 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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