

Aug 21, 2015
Company Report
Reinitiate: SELL
TP: HK\$ 12.91

Share price (HK\$)	14.08
Est. share price return	-8.30%
Est. dividend yield	1.81%
Est. total return	-6.49%

Previous Rating BUY

Analyst: Paul Pan
Tel: (852) 2147 8829
Email: paulpan@abci.com.hk

Key Data

52Wk H/L(HK\$)	42/13.04
Outstanding shares (mn)	609.38
Market cap (HK\$ mn)	8,580
3-mth avg daily turnover (HK\$ mn)	60.53
Major shareholder(s) (%):	
Biostime Pharma China Ltd.	73.85
Franklin Templeton Investments	2.2
Janus Capital Management LLC	1.15
Baring International Inv Ltd	0.9

Source(s): Bloomberg, ABCI Securities

Revenue contribution of business

segments

(%)	1H15	FY14
Infant formula	86.50	84.15
Probiotic supplements	8.82	8.98
Dried bay food & nutrition supplements	2.20	3.20
Baby care products	2.49	3.67

Source(s): Company, ABCI Securities

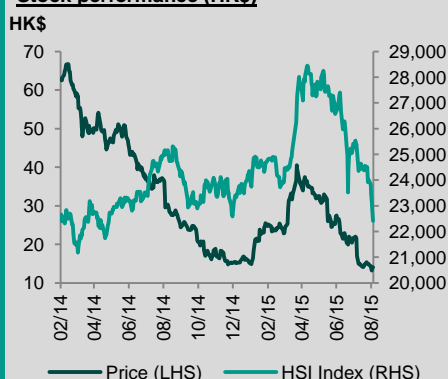
Share price performance (%)

	Absolute	Relative*
1-mth	(36.15)	(23.90)
3-mth	(55.09)	(36.51)
6-mth	(44.68)	(34.92)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Stock performance (HK\$)



Source(s): Bloomberg, ABCI Securities

Biostime International (1112 HK)

Performance worsens with no major turnaround in sight ; downgrade to SELL

- Biostime's 1H15 revenue, gross profit, operating profit and net profit unexpectedly declined by 10.33% YoY, 15.06% YoY, 30.73% YoY, and 34.36% YoY, respectively. Performance worsened further in May and June when revenue and net profit decreased by 20.03% YoY and 80.26% YoY, mainly attributable to the unfavorable industry environment and inventory clearance by the Group prior to new product launch in July.
- Industry condition would be unfavorable in the medium term. In addition, it remains uncertain whether the Group can implement its growth strategies successfully. Therefore, we downgrade the Group's rating to **SELL** with a revised TP of HK\$ 12.91.

Decline in revenue and profitability on unfavorable industry condition and promotional efforts. Biostime's revenue in 1H15 declined by 10.33% YoY. GPM, OPM, and NPM all dropped to 58.23%, 16.72%, and 10.44% from 61.47%, 21.64% and 14.26% in 1H14. Heightened competition and the Group's efforts to clear inventory were the major causes of the deteriorated performance and the higher SG&A/Sales ratio at 42.10% in 1H15 (FY14: 37.26%).

Intensified industry competition in 1H15. Discounts offered on e-commerce sites and the price decline of foreign IMF products via Haitao (online purchase agents) are forcing offline channels to cut prices. In addition, the decline in int'l milk powder prices and the depreciation of Euro enable IMF manufacturers to compete with lower prices. Moreover, the new labeling requirement that took effect on July 1 drove many IMF brands to clear inventories in 1H15. Due to these reasons, competition in the IMF product market has been exceptionally high in 1H15.

Competition to worsen going forward. The price gap between foreign and domestic brands widened to RMB 47.43 in the week of Aug 14, extending the increase since June. We believe the declining prices of domestic IMF products reflect the overcapacity problem and the unhealthy competition among the domestic players. Given that there would be no major changes in the market fundamentals and the population relaxation policy is yet to translate into significant population growth, the competition would only worsen as existing players fight for market share.

Decreased efficiency of sales network. The Group's expanded sales network is another major concern. Despite the larger sales network, sales per store have been declining in new stores and some old stores in the baby specialty and supermarket channels. The Group's strategy of shifting the expansion to lower-tier cities may not translate into higher growth, which was the case for some of the Group's peers.

Higher pricing pressure. The Group may face higher pricing pressure in the future on changing consumers' preference, which is reflected by the revenue contribution of Biostime's high-tier products that has been increasing over the past two years. Promotional activities on the ecommerce platform and easy access of foreign products would also affect the Group's pricing ability.

Results and Valuation

FY ended Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (RMB mn)	4,561	4,732	3,991	4,227	4,731
Chg (% YoY)	34.87	3.73	(15.64)	5.89	11.95
Net Income (RMB mn)	821	807	513	595	745
Chg (% YoY)	10.44	(1.70)	(36.40)	15.90	25.21
Basic EPS (RMB cent)	1.37	1.34	0.84	0.98	1.22
P/E (x)	21.55	19.17	13.37	11.54	9.15
BVPS (RMB)	4.20	4.85	5.33	6.09	7.06
P/B (x)	2.62	2.33	2.11	1.85	1.58
DPS (RMB)	1.21	0.67	0.59	0.68	0.85
Yield (%)	1.90	4.23	4.17	4.83	6.05
ROAA (%)	20.08	14.31	7.92	8.52	9.79
ROAE (%)	33.93	29.70	16.65	17.10	18.59

Source(s): The Group, Bloomberg, ABCI Securities estimates

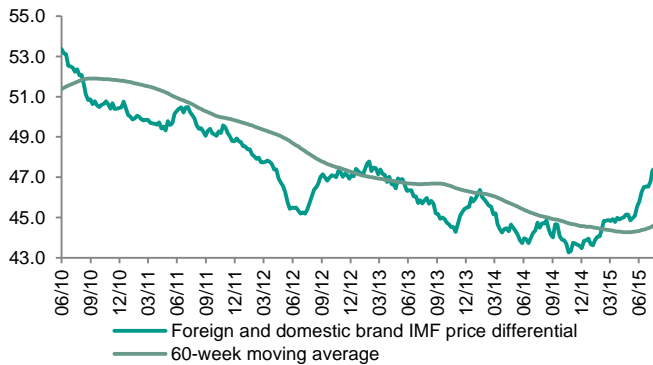
Working capital condition may not reveal the full picture. According to the Group, its working capital management has generally improved. But, distributors' inventory slightly increased from 31 days in FY14 to 38 days in 1H15. However, our major concern is that the improvement may not genuinely reflect the condition in the consumers' end. We believe that consumers may have purchased more products than needed in 1H15 because of the intensified promotional effort in the market. Hence, demand in 2H15 may decrease as consumers' inventory increases while consumption rate remains stable. This could lead to a slower pace of recovery for Biostime.

Financial projections. We expect the Group's sales would decline by 15.64% YoY in FY15E and grow mildly by 5.89% YoY in FY16E. Due to intensified promotional campaign, we project that the Group's FY15E GPM, OPM, and NPM to be 57.6%, 17.5%, and 12.86%, respectively. Hence, the Group's ROAA and ROAE would fall to 7.92% and 16.65% for the same period.

Downgrade to SELL; TP at HK\$12.91. After the Group issued a profit warning on July 23, its share price has been on a declining streak. On Aug 21, 2015, the Group's price closed at HK\$ 14.08, which represents 11.54x 2016E P/E and 1.85x 2016E P/B, and a 34.81% drop from July 23. In light of the changing industry condition and the Group's operating performance, we downgrade the Group's rating to SELL with a TP of HK\$ 12.91, which represents 10.58x 2016E P/E and 1.70x 2016E P/B.

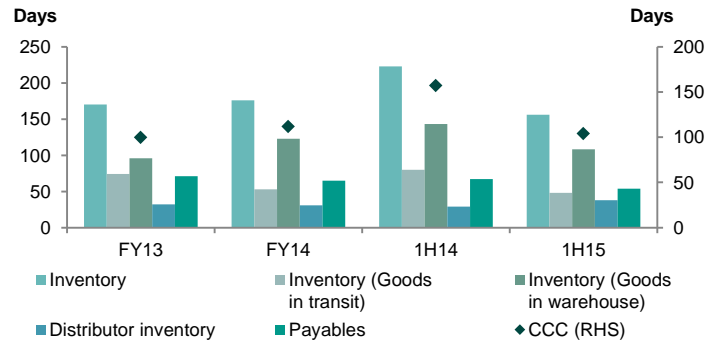
Risk factors: 1) Supplier concentration risk; 2) Corporate governance risk, 3) Regulatory risk; 4) Product quality and food safety risk; 5) Domestic economic growth risk; 6) Population growth risk.

Exhibit 1: Price gap between foreign and domestic brands



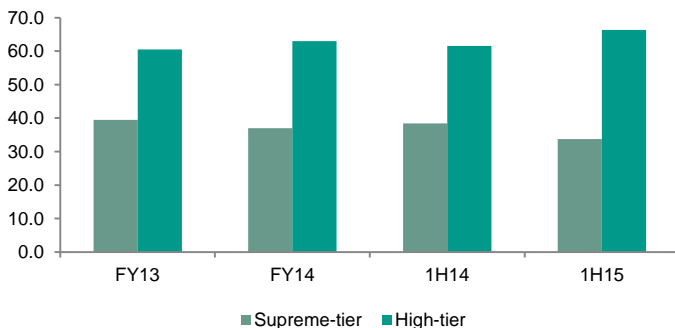
Source(s): Wind, ABCI Securities

Exhibit 2: Working capital condition



Source(s): The Group, ABCI Securities

Exhibit 3: Supreme-tier & High-tier sales contribution



Source(s): The Group, ABCI Securities

Exhibit 4: Sales per store – by year of opening



Source(s): The Group, ABCI Securities calculations

Appendix: Financial Statements of the Group

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	17.50	19.48	21.90	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

Disclosures

Analyst Certification

I, Hongxing (Paul) PAN, being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view 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. I and/or my associates have no financial interests in relation to the listed company (ies) covered in this report, and I and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

Disclosures of Interests

ABCI Securities Company Limited and/or its affiliates may pursue financial interests to the companies mentioned in the report.

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.

Disclaimers

This report is for our clients only and is for distribution only under such circumstances as may be permitted by applicable law. It has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. No representation or warranty, either expresses or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein. This report should not be regarded by recipients as a substitute for the exercise of their own judgment. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas as a result of using different assumptions and criteria. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. ABCI Securities Company Limited is under no obligation to update or keep current the information contained herein. ABCI Securities Company Limited relies on information barriers to control the flow of information contained in one or more areas within ABCI Securities Company Limited, into other areas, units, groups or affiliates of ABCI Securities Company Limited. The compensation of the analyst who prepared this report is



determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of ABCI Securities Company Limited as a whole, of which investment banking, sales and trading are a part. The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. The price and value of the investments referred to in this research and the income from them may fluctuate. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither ABCI Securities Company Limited nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Additional information will be made available upon request.

Copyright 2015 ABCI Securities Company Limited

No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of ABCI Securities Company Limited.

**Office address: ABCI Securities Company Limited, 13/F Fairmont House,
8 Cotton Tree Drive, Central, Hong Kong.**

Tel: (852) 2868 2183