

「夏天小語」: 0008

Consumer Staples Sector

Summer Breeze 「夏天小語」

Trading buy opportunity in Biostime (1112 HK)

UP

MP

OP

We identify a trading buy opportunity in Biostime (1112 HK, Neutral, TP raised to HK30.00 from HK\$27.00) despite staying Neutral on the stock. Three reasons for our arguments: (1) Biostime's 2014 results are likely to beat consensus on tighter-than-expected expense control in 2H14. (2) Reduced dairy cost (c30% of Biostime's COGS, in our estimate) coupled with lower shipping cost and weakening euro should lead to visible gross margin expansion (vs. flat in current Street estimates) in 2015E, all else being equal. Note Mead Johnson (MJN US) has already guided to a 1.6-ppt gross margin improvement in 2015E on lower commodity costs. (3) Biostime started to lose sales momentum from 2014 given the fast channel shift to ecommerce, reversing its winner position amid the booming emergence of baby stores nationwide in the past. Such a situation, in our view, should motivate management to close financing deals with strategic investors at Mama100 level asap, following the company announcement in Feb 2015. Despite that we do not think the participation of strategic investor(s) to Mama100 necessarily translate to the success of Biostime's ecommerce venture, this may help change Biostime's investment profile from a pure infant milk formulae (IMF) player into a more integrated and diversified baby FMCG operator (particularly if it can differentiate in products). Given the likely margin-led earnings upgrades and business model enhancement, a trading buy opportunity could emerge from the stock, in our opinion.

- **We raise our 2014-16E core net profit by 9%-12% on margins.** Thanks to (1) favorable dairy cost (with market prices **down c30% YTD** vs 2014 average prices), (2) falling fuel oil prices (**down 45% YTD**) and (3) weakening euro (**down 14% YTD** vs 2014 average levels), we project Biostime's **imported IMF gross margin** to improve by **2-ppt** to 63.5% in 2015E after factoring in the ASP pressure. Combined with the possibility of upbeat management guidance on margins during the analyst meeting (due on 25 Mar), the Street could lift margin assumptions, in our view. On the other hand, we presently remain cautious about Biostime's revenue generation given the "volume" challenge ahead amid competition, and adjust down our revenue forecasts by 1%-7% in 2014-16E. (See our earnings forecast revision on page 3)
- **Why "trading buy" instead of BUY?** The proliferation of online channels and an overall slowing market have put Biostime at a tougher situation given its higher ASP and "generous" profit allocation to offline channels (rather than to end-consumers). Biostime's inflection point is yet to be seen, though we are largely positive on its intention to penetrate ecommerce on baby products via its Mama100.com. The upcoming action may help gradually lift Biostime's investment profile to a more integrated and diversified baby FMCG player (if executed well). However, we have to highlight **two risks** as well: (1) **GMV bottleneck.** E-commerce giants like Jingdong.com (JD US) have cost advantage over specialized Biostime unless Biostime can clearly differentiate, in our view. The participation of strategic investors is also by no means the guarantee of Biostime's success in ecommerce; (2) **Profit concern.** Despite the popularity of baby ecommerce player in the private equity market, few are making money, in our guess. The harvest period is yet to come. Therefore, at this moment, we rate Biostime at Trading Buy/Neutral (before further visibility is identified) with TP raised to HK\$30.00 (from HK\$27.00) on unchanged 20x our revised 2015E EPS.

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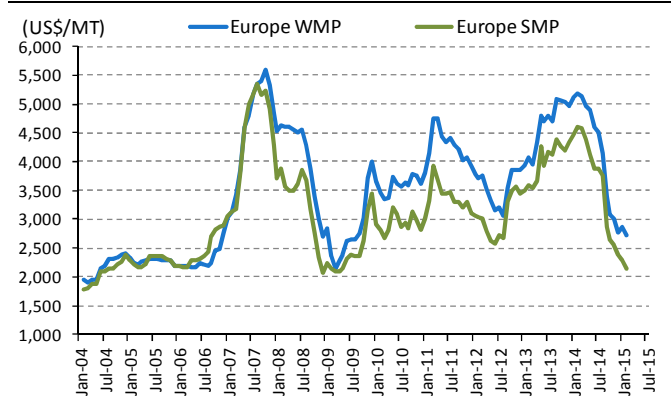
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***Summer Breeze, launched by our consumer analyst Summer Wang, is a unique research product designed to offer investors with actionable ideas in the China Consumer Staples sector.*

Visible gross margin expansion on imported IMF in 2015E

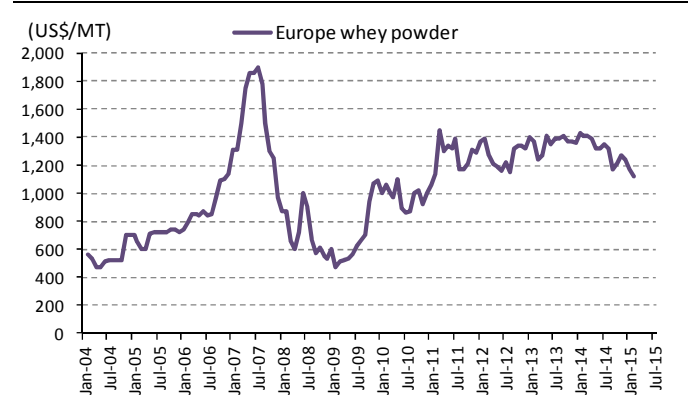
(on lower dairy prices, shipping cost and weakening euro, all else being equal)

Figure 1: Europe skim and whole milk powder prices 2004-YTD (down c30% YTD vs 2014 average)



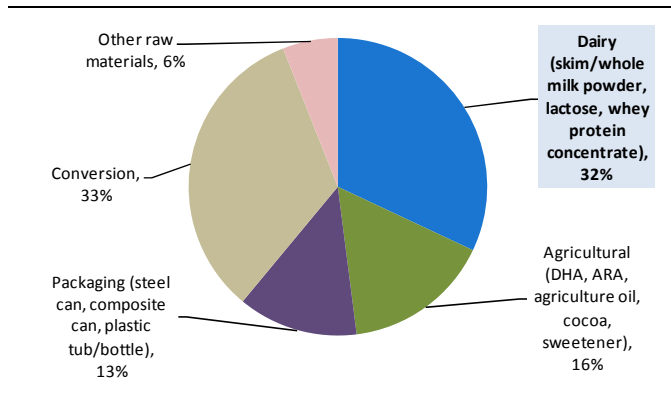
Source: Bloomberg

Figure 2: Europe whey powder prices 2004-YTD (down 15% YTD vs 2014 average)



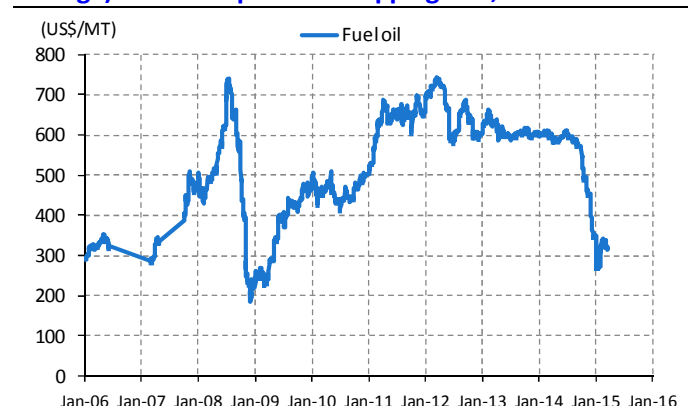
Source: Bloomberg

Figure 3: Mead Johnson's COGS breakdown 2014; we think Biostime's COGS mix should be similar.



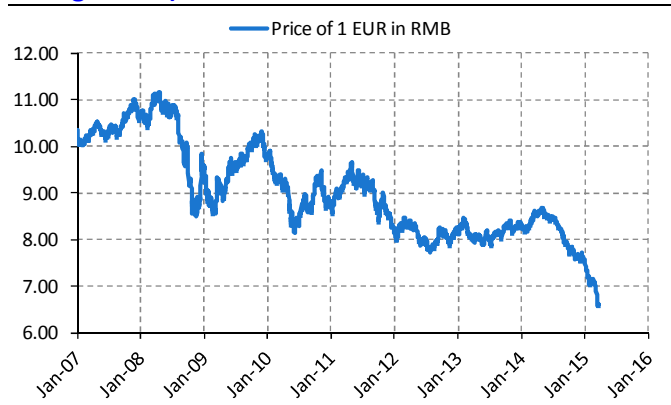
Source: Company data

Figure 4: Lower fuel prices (down 45% YTD vs 2014 average) should help reduce shipping cost, in our view.



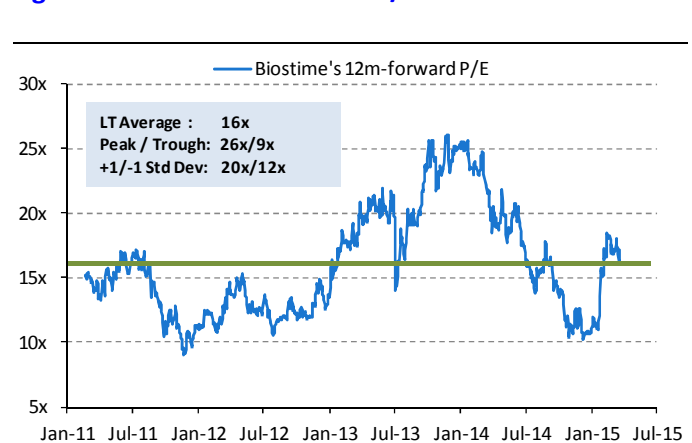
Source: Bloomberg

Figure 5: RMB/Euro exchange rate (down 14% YTD vs 2014 average levels)



Source: Bloomberg

Figure 6: Biostime's 12-forward P/E 2011-YTD



Source: Bloomberg, BOCOM Int'l

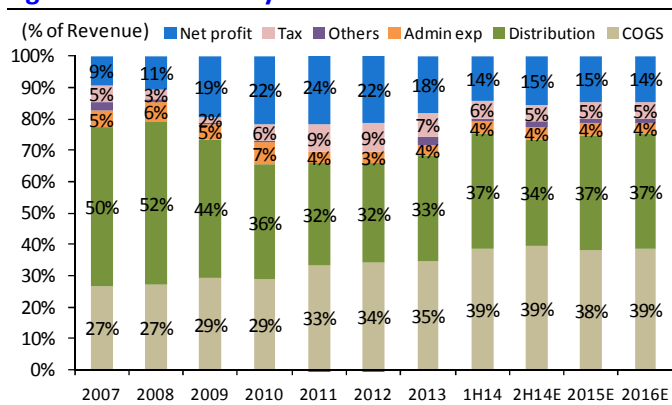
Raise 2014-16E core net profit by 9%-12% on margins

Figure 7: Biostime's earnings forecast revision 2014-16E

(RMBm, Year ending 31 Dec)	2007	2008	2009	2010	2011	2012	2013	New		Revision					
								1H14	2H14E	2014E	2015E	2016E	2014E	2015E	2016E
Total Revenue	188	326	559	1,234	2,189	3,382	4,561	2,189	2,364	4,553	5,081	5,523	-1%	-4%	-7%
Infant formulas (imported)	0	41	238	794	1,685	2,715	3,752	1,859	1,969	3,828	3,962	4,160	-1%	-3%	-5%
Infant formulas (China manufactured)	0	0	0	0	0	0	0	0	31	31	373	560	0%	-23%	-25%
Probiotic supplements	172	254	266	304	332	379	458	186	189	376	398	422	0%	0%	0%
Dried baby food and nutrition supplements	16	31	55	98	125	181	199	71	73	143	146	153	0%	0%	0%
Baby care products	0	0	0	38	48	106	152	73	102	175	201	228	0%	0%	0%
YoY growth															
Total Revenue	NA	73%	72%	121%	77%	54%	35%	6%	-5%	0%	12%	9%			
Infant formulas (imported)	NA	NA	483%	233%	112%	61%	38%	11%	-5%	2%	3%	5%			
Infant formulas (China manufactured)	NA	NA	NA	NA	NA	NA	NA	NA	NM	NM	1100%	50%			
Probiotic supplements	NA	47%	5%	14%	9%	14%	21%	-18%	-18%	-18%	6%	6%			
Dried baby food and nutrition supplements	NA	91%	78%	78%	27%	46%	10%	-19%	-35%	-28%	2%	5%			
Baby care products	NA	NA	NA	NA	24%	122%	44%	15%	15%	15%	15%	13%			
Gross profit	138	237	396	877	1,456	2,229	2,975	1,346	1,435	2,781	3,138	3,390	-1%	0%	-3%
YoY growth	NA	72%	67%	122%	66%	53%	33%	-2%	-11%	-7%	13%	8%			
Blended gross margin	73.2%	72.8%	70.8%	71.1%	66.5%	65.9%	65.2%	61.5%	60.7%	61.1%	61.8%	61.4%		↑	↑
Infant formulas (imported)	NA	64.0%	67.3%	68.4%	65.5%	65.1%	64.5%	61.7%	61.4%	61.5%	63.5%	63.5%		↑	↑
Infant formulas (China manufactured)	NA	NA	NA	NA	NA	NA	NA	NA	50.0%	50.0%	51.0%	51.0%			
Probiotic supplements	73.5%	74.9%	76.5%	81.9%	77.8%	77.7%	78.6%	71.6%	71.0%	71.3%	71.0%	72.0%			
Dried baby food and nutrition supplements	70.3%	67.2%	58.9%	65.9%	60.2%	59.1%	55.6%	46.0%	44.0%	45.0%	44.0%	43.0%			
Baby care products	NA	NA	NA	55.6%	40.2%	54.9%	54.2%	46.0%	44.3%	45.0%	42.0%	41.0%			
EBIT	27	44	117	332	697	1,008	1,248	425	501	925	1,011	1,082	9%	11%	8%
YoY growth	NA	62.7%	167.7%	182.7%	109.9%	44.7%	23.8%	-31.0%	-20.8%	-25.8%	9.3%	7.0%			
EBIT margin	14.3%	13.5%	21.0%	26.9%	31.8%	29.8%	27.4%	19.4%	21.2%	20.3%	19.9%	19.6%			
% of Revenue															
Operating expenses	59.0%	59.3%	50.2%	44.4%	37.2%	36.5%	38.3%	42.3%	39.3%	40.8%	41.9%	41.8%		↓	↓
Distribution costs	50.5%	51.9%	44.4%	36.4%	32.4%	31.9%	33.2%	36.6%	34.3%	35.4%	36.6%	36.5%			
Admin expenses	5.3%	6.2%	4.7%	7.1%	3.7%	3.5%	3.9%	3.9%	3.6%	3.8%	3.8%	3.8%			
Other operating expenses	3.2%	1.2%	1.1%	0.8%	1.1%	1.1%	1.2%	1.8%	1.4%	1.6%	1.5%	1.5%			
Fine on the violation of Anti-monopoly law	0	0	0	0	0	0	-163	0	0	0	0	0			
Finance costs	0	0	0	0	0	-2	-11	-40	-51	-91	-103	-105			
Effective tax rate	36.2%	21.2%	8.3%	20.5%	26.1%	29.3%	29.4%	27.9%	26.2%	27.0%	27.0%	27.0%			
Reported net profit	17	35	108	266	527	743	821	312	366	678	745	800	9%	12%	9%
YoY growth	NA	101%	209%	145%	98%	41%	10%	5%	-30%	-17%	10%	7%			
Core net profit	17	35	108	266	527	743	984	312	366	678	745	800	9%	12%	9%
YoY growth	NA	101%	208%	145%	98%	41%	32%	-32%	-30%	-31%	10%	7%			
Core net margin	9.3%	10.8%	19.4%	21.5%	24.1%	22.0%	21.6%	14.3%	15.5%	14.9%	14.7%	14.5%			
Change in pts	NA	1.5%	8.6%	2.2%	2.6%	-2.1%	-0.4%	-8.1%	-5.4%	-6.7%	-0.2%	-0.2%			
Reported diluted EPS (RMB)	0.04	0.08	0.24	0.58	0.86	1.22	1.34	0.51	0.59	1.10	1.20	1.29	8%	11%	8%
YoY growth	NA	101%	209%	141%	49%	41%	10%	5%	-30%	-18%	9%	7%			
Core diluted EPS (RMB)	0.04	0.08	0.24	0.58	0.86	1.22	1.60	0.51	0.59	1.10	1.20	1.29	8%	11%	8%
YoY growth	NA	101%	208%	141%	49%	41%	32%	-32%	-30%	-31%	9%	7%			

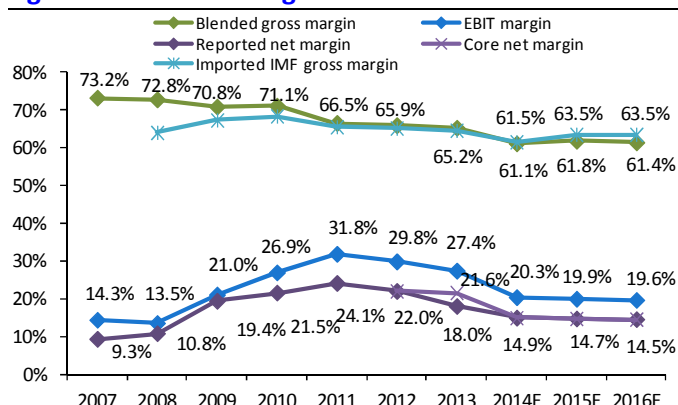
Source: Company data, BOCOM Int'l estimates

Figure 8: Biostime's key cost ratio breakdown 2007-16E



Source: Company data, BOCOM Int'l estimates

Figure 9: Biostime's margins 2007-16E



Source: Company data, BOCOM Int'l estimates

Financial Statements

Figure 10: Biostime - Financial summary 2008-16E

(RMBm, Year ending 31 Dec)	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
P&L									
Total Revenue	326	559	1,234	2,189	3,382	4,561	4,553	5,081	5,523
Infant formulas (imported)	41	238	794	1,685	2,715	3,752	3,828	3,962	4,160
Infant formulas (China manufactured)	0	0	0	0	0	0	31	373	560
Other baby products	285	321	440	504	667	809	694	746	803
Gross profit	237	396	877	1,456	2,229	2,975	2,781	3,138	3,390
EBIT	44	117	332	697	1,008	1,248	925	1,011	1,082
Reported PBT	45	118	334	714	1,051	1,162	929	1,021	1,096
Effective tax rate	21.2%	8.3%	20.5%	26.1%	29.3%	29.4%	27.0%	27.0%	27.0%
Reported net profit	35	108	266	527	743	821	678	745	800
Core net profit	35	108	266	527	743	984	678	745	800
Reported diluted EPS (RMB)	0.08	0.24	0.58	0.86	1.22	1.34	1.10	1.20	1.29
Core diluted EPS (RMB)	0.08	0.24	0.58	0.86	1.22	1.60	1.10	1.20	1.29
DPS (RMB)	NA	NA	0.200	0.618	0.879	0.963	0.786	0.860	0.923
Dividend payout	0.0%	0.0%	38.2%	70.6%	70.9%	70.4%	70.0%	70.0%	70.0%
Cash flow									
Net operating cash flow	23	110	381	516	947	660	-100	1,573	99
Capex	-11	-6	-18	-39	-39	-138	-300	-127	-110
Acquisitions	0	0	0	0	0	-280	0	0	0
Change in loans and bond receivable	0	0	0	0	-122	-89	-8	-16	-13
Change in time deposits	-1	-5	6	-484	-1,727	388	0	0	0
Change in deposits	-1	-5	6	-21	-3	0	0	0	0
Interest received	1	1	2	14	29	60	95	112	119
Other investing cash	-2	-10	12	-21	8	-21	0	0	0
Net investing cash flow	-14	-20	3	-529	-1,850	-81	-213	-30	-5
Net proceeds from share issuance	0	0	1,372	12	-57	-64	0	0	0
Net proceeds from bank borrowings	0	1	-1	0	271	480	-150	0	0
Convertible bond	0	0	0	0	0	0	2,480	0	0
Interest paid	0	0	0	0	-1	-9	-91	-103	-105
Dividends paid	-13	-27	-146	-180	-404	-622	-476	-486	-531
Other financing cash	13	1	6	0	0	0	0	0	0
Net financing cash flow	0	-26	1,231	-169	-192	-215	1,763	-588	-635
Net change in cash and cash equivalents	9	64	1,615	-182	-1,095	365	1,451	954	-541
Balance sheet									
Cash and bank balances	60	134	1,728	1,814	1,669	1,663	3,113	4,068	3,527
Inventory	44	81	106	297	523	972	1,703	1,083	1,814
Trade and bills receivables	6	4	5	10	0	15	10	7	11
Prepayments, deposits and other receivables	14	21	23	29	86	111	109	122	127
Other current assets	23	14	0	0	13	105	105	103	106
Total current assets	147	254	1,862	2,150	2,291	2,866	5,041	5,383	5,585
Net PPE	22	22	31	59	77	326	550	596	622
Prepaid land lease payment	0	0	0	0	20	65	83	101	119
Intangible assets	1	1	1	1	1	110	111	114	116
Goodwill	0	0	0	0	0	76	76	76	76
Bonds receivable	0	0	0	0	0	98	100	112	120
Loans receivable	0	0	0	0	110	85	91	97	99
Time deposits	0	0	0	160	942	855	855	855	855
Other non-current assets	5	7	7	67	91	160	160	160	160
Total non-current assets	28	30	40	288	1,242	1,775	2,026	2,109	2,167
Total assets	175	283	1,902	2,438	3,533	4,641	7,067	7,492	7,752
Trade and bill payables	18	40	66	67	263	362	338	429	412
Other payables and accruals	44	64	142	265	444	720	637	711	718
Dividend payable	0	0	0	0	0	0	0	0	0
Interest-bearing bank loans	0	1	0	0	271	751	601	601	601
Tax payable	7	9	28	83	156	213	213	213	213
Other current liabilities	17	0	0	0	0	0	0	0	0
Total current liabilities	87	113	236	415	1,133	2,045	1,788	1,954	1,944
Deferred tax liabilities	0	0	6	45	77	81	81	81	81
Total liabilities	87	113	242	461	1,211	2,125	4,349	4,514	4,504
Total equity	89	171	1,660	1,978	2,323	2,516	2,718	2,978	3,248
Total liabilities and equity	175	283	1,902	2,438	3,533	4,641	7,067	7,492	7,752

Source: Company data, BOCOM Int'l estimates

Figure 11: Biostime - Key ratios 2008-16E

Year ending 31 Dec	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
YoY growth									
Total revenue	73%	72%	121%	77%	54%	35%	0%	12%	9%
Infant formulas (imported)	NA	483%	233%	112%	61%	38%	2%	3%	5%
Infant formulas (China manufactured)	NA	NA	NA	NA	NA	NA	NM	1100%	50%
Other baby products	NA	13%	37%	15%	32%	21%	-14%	7%	8%
Gross profit	72%	67%	122%	66%	53%	33%	-7%	13%	8%
EBIT	63%	168%	183%	110%	45%	24%	-26%	9%	7%
EBITDA	65%	163%	177%	109%	45%	24%	-23%	9%	7%
Reported PBT	63%	165%	183%	114%	47%	11%	-20%	10%	7%
Reported net profit	101%	209%	145%	98%	41%	10%	-17%	10%	7%
Core net profit	101%	208%	145%	98%	41%	32%	-31%	10%	7%
Reported diluted EPS	101%	209%	141%	49%	41%	10%	-18%	9%	7%
Core diluted EPS	101%	208%	141%	49%	41%	32%	-31%	9%	7%
Margins									
Blended gross margin	72.8%	70.8%	71.1%	66.5%	65.9%	65.2%	61.1%	61.8%	61.4%
EBIT margin	13.5%	21.0%	26.9%	31.8%	29.8%	27.4%	20.3%	19.9%	19.6%
EBITDA margin	14.3%	21.9%	27.5%	32.4%	30.5%	27.9%	21.6%	21.1%	20.7%
Reported PBT margin	13.7%	21.1%	27.1%	32.6%	31.1%	25.5%	20.4%	20.1%	19.8%
Reported net margin	10.8%	19.4%	21.5%	24.1%	22.0%	18.0%	14.9%	14.7%	14.5%
Core net margin	10.8%	19.4%	21.5%	24.1%	22.0%	21.6%	14.9%	14.7%	14.5%
Returns									
ROE (average)	54.4%	83.6%	29.0%	29.0%	34.6%	33.9%	25.9%	26.2%	25.7%
ROA (average)	25.1%	47.2%	24.3%	24.3%	24.9%	20.1%	11.6%	10.2%	10.5%
ROIC	39.0%	62.9%	15.8%	25.4%	26.7%	26.3%	11.5%	12.0%	12.3%
Working capital									
Average inventory days	118	140	96	100	130	172	200	190	180
Average AR days	8	3	1	1	1	1	1	1	1
Average AP days	45	65	54	33	52	72	72	72	72
Cash conversion days	80	78	43	69	78	101	129	119	109
Leverage									
Current ratio	5.3x	8.5x	46.7x	7.5x	1.8x	1.6x	2.5x	2.6x	2.6x
Assets / Equity	1.7x	1.5x	1.1x	1.1x	1.0x	1.1x	1.9x	1.8x	1.7x
Gross gearing	0%	0%	0%	0%	12%	30%	113%	103%	95%
Net cash / Equity	67%	78%	104%	92%	60%	36%	1%	33%	14%
Dupont analysis									
Net profit / EBIT	80.0%	92.3%	80.1%	75.7%	73.7%	65.8%	73.3%	73.7%	74.0%
EBIT / EBITDA	94.5%	96.1%	97.9%	98.2%	97.8%	97.9%	94.2%	94.3%	94.4%
EBITDA margin	14.3%	21.9%	27.5%	32.4%	30.5%	27.9%	21.6%	21.1%	20.7%
Asset turnover	1.9x	2.0x	0.6x	0.9x	1.0x	1.0x	0.6x	0.7x	0.7x
Financial leverage	1.7x	1.5x	1.1x	1.1x	1.0x	1.1x	1.9x	1.8x	1.7x
ROE (year end)	33.3%	56.8%	15.7%	23.5%	20.7%	20.1%	17.8%	18.0%	17.7%
Valuation (on current price)									
P/E					11.6x	10.5x	12.8x	11.7x	10.9x
P/B					3.7x	3.4x	3.2x	2.9x	2.7x
P/S					2.5x	1.9x	1.9x	1.7x	1.6x
EV/Sales					3.4x	2.5x	2.5x	2.2x	2.1x
EV/EBITDA					11.1x	9.0x	11.6x	10.6x	10.0x
Dividend yield					6%	7%	6%	6%	7%
FCF yield					11%	6%	-5%	17%	0%

Source: Company data, BOCOM Int'l estimates, valuation based on HK\$24.90 as of market close on 20 Mar, 2015.

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Rating System
Company Rating

Buy: Expect more than 20% upside in 12 months
 LT Buy: Expect more than 20% upside but longer than 12 months
 Neutral: Expect low volatility
 Sell: Expect more than 20% downside in 12 months

Sector Rating

Outperform ("OP"): Expect more than 10% upside in 12 months
 Market perform ("MP"): Expect low volatility
 Underperform ("UP"): Expect more than 10% downside in 12 months

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