

# Leader in orthopedics making its foray into medical device

23Jul 2015

## Investment Highlights

- ❖ **Leader in the orthopaedics segment witnessing consistent rapid growth.** Kinetic Medical is primarily engaged in the R&D, manufacturing and sales of minimally-invasive surgery systems. Its products are mainly used in the surgeries for vertebral compression fractures caused by osteoporosis. In addition, the Company has made a string of acquisitions (acquired Jiangsu Ideal Medical Science & Tech to strengthen its core business of orthopaedic devices; also took over Essen Technology as a part of its venture into the cardiovascular area) leveraging on the extensive resources of its management in the medical devices field. Subsequently, Kinetic is gradually becoming leaders of many segments of the medical device industry. On the back of both organic growth and M&As, Kinetic has grown into a leading domestic player in the medical device industry with CAGR for revenue and net profit reaching 42% and 30% respectively since 2010.
- ❖ **Promising outlook for orthopaedic devices on the back of rapid growth of the overall medical device industry.** Thanks to: (i) continual development of healthcare in China; (ii) significant increase in diagnosis and treatment rates; and (iii) localized manufacturing of high-end devices, size of China's medical device market has soared from Rmb17.3bn in 2001 to Rmb255.6bn as of 2014 (CAGR of 23.3%). We estimate the market size will rise further to Rmb1trn by 2020E, implying a CAGR of 22% during the forecasting period. As a results of: (i) increasing injuries from accidents; (ii) fractures caused by osteoporosis due to population aging; (iii) rising prevalence of bone tumours due to environmental factors, size of the orthopaedic device market has already reached Rmb10bn in China. With CAGR of ~20% for the past five years straight, this market segment is expected to maintain its rapid growth going forward.
- ❖ **Rapid growth for the PKP surgery system.** Kinetic's core business, minimally-invasive surgery system (the KMC Kyphoplasty System) have shown signs of accelerating growth on the back of: (i) China's accelerating population aging; (ii) the elderly population continually seeking improved living standards; (iii) rising capacity on medical expenditure; (iv) continual improvement in China's social security system; and (v) increasing recognition of the kyphoplasty. Size of this market in China is forecast to reach Rmb3.3bn by 2020E (CAGR of 22%). After eight years of development, Kinetic has already built up notable advantages in products, pricing, branding and technology in the domestic market. As such, the Company's core business is likely to benefit significantly from rising localized production over the coming three years with CAGR projected to exceed 23%.



## BUY (Initial Coverage)

Current price: Rmb25.29

Target price: Rmb31.30

## CITICS Research

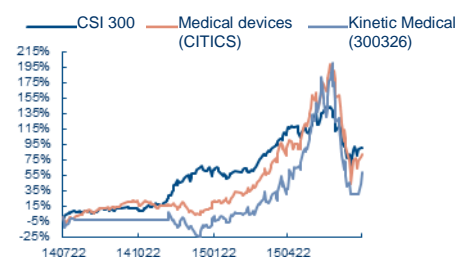
TIAN Jiaqiang

Tel: 021-20262139

Email: tianjiaqiang@citics.com

Practicing license: S1010515070002

## Performance relative to the index



Source: CITICS Quantitative Investment Analysis System

## Main data

CSI 300	4166.01
Total equity/shares o/s (mn)	352.1/274.7
LTM High/low (Rmb)	96.15/20.9
1-month absolute gain	-29.23%
6-month absolute gain	58.31%
YTD Absolute gain	105.46%
LTM Average daily turnover (Rmb mn)	130.83

- ❖ **Leapfrog growth on the back of its buying spree.** Growth underpinned by M&As has already become a key strategy for the Company. Through the acquisition of Essen Technology, Kinetic has forayed into the coronary stent field which has a market size of over Rmb10bn and is forecast to see CAGR of 15% over the next three year. This move will also create notable synergy with Kinetic's existing products, technologies and distribution channels, facilitating rapid earnings growth for Essen's products going forward. Meanwhile, Kinetic also acquired Jiangsu Ideal Medical Science & Tech. The latter is on par with the former in terms of revenue and profitability. This tie-up will enable the two dominant players to collaborate across distribution channels and products, allowing Kinetic to swiftly and comprehensively cover the entire orthopaedic device market (which has a size of tens of billions of RMB). Going forward, the Company will continue to swiftly expand its industry presence and achieve leapfrog growth leveraging on the industry M&A fund established jointly with its major shareholder. In addition, Apart from extensive experience in the medical device industry (over ten years), all of Kinetic's key executives all hold 5%-plus stakes in the Company. Meanwhile, Kinetic also unveiled an incentive scheme for its middle-level management this year, which is conducive for the Company to press ahead with its M&As in the future.
- ❖ **Risks associated with investing in the Company:** (i) income source is highly concentrated; (ii) increasing industry competition; (iii) accountability on products; (iv) management or business consolidation fails to meet expectations.
- ❖ **Earnings forecast, valuation and investment rating.** Given Kinetic's rapid growth and pace of acquisitions, we forecast its 2015-17E net profit to reach Rmb133/203/257mn (CAGR of 60%), implying EPS of Rmb0.38/0.58/0.73. Taking into account (i) the rapid development of the orthopaedics device industry; (ii) its outstanding competitive advantage; (iii) continual progress in its acquisitions; (iv) expectations of leapfrog growth; and (v) valuation of comparables, we initiate coverage with a BUY rating and target price of Rmb31.3 (54x prospective 2016E PER).

Item/Year	2013	2014	2015E	2016E	2017E
Turnover (Rmb mn)	126.7	222.4	472.9	596.8	719.0
Growth rate (YoY, %)	24.6	75.5	112.7	26.2	20.5
Net profit (Rmb mn)	64.1	62.2	133.1	202.5	257.2
Growth rate (YoY, %)	15.4	-2.8	113.9	52.1	27.0
EPS (Basic, Rmb)	0.18	0.18	0.38	0.58	0.73
Gross margin (%)	74.5	62.3	72.4	72.1	73.0
ROE (%)	12.6	5.6	11.1	15.2	17.0
BVPS (Rmb)	1.4	3.1	3.4	3.8	4.3
PER (x)	139	143	67	44	35
P/B(x)	17.5	8.0	7.4	6.7	5.9

Source: CITICS Quantitative Investment Analysis System

Note: Closing price as of 21 Jul 2015

## Income Statement (Rmb mn)

Indicator	2013	2014	2015E	2016E	2017E
Turnover	127	222	473	597	719
Operating cost	32	84	130	167	194
Gross margin	74.50%	62.33%	72.44%	72.09%	72.96%
Business tax & surcharge	1	2	4	5	6
Selling expense	20	34	79	83	92
Selling expense ratio	15.83%	15.31%	16.80%	13.94%	12.86%
Administrative expense	24	38	84	107	126
Administrative expense ratio	18.67%	17.20%	17.67%	17.85%	17.57%
Financial expense	-9	4	-7	5	6
Financial expense ratio	-6.76%	1.95%	-1.57%	0.91%	0.78%
Investment revenue	7	11	0	0	0
Operating profit	64	74	185	229	293
Operating profit margin	50.78%	33.37%	39.08%	38.35%	40.79%
Non-operating income	9	4	7	7	6
Non-operating expenditure	0	0	0	0	0
Total profit	74	78	192	236	299
Income tax	10	11	27	33	42
Income tax rate	12.98%	13.81%	14.00%	14.00%	14.00%
Minority interests	0	5	32	0	0
Net profit attributable to shareholders	64	62	133	203	257
Net margin	50.56%	27.99%	28.15%	33.94%	35.78%
EPS (Rmb, diluted)	0.18	0.18	0.38	0.58	0.73

## Cash Flow Statement (Rmb mn)

Indicator	2013	2014	2015E	2016E	2017E
Net profit	64	62	133	203	257
Minority interests	0	5	32	0	0
Depreciation & amortization	5	6	18	19	19
Change in working capital	42	-66	37	-65	-47
Others	-78	64	-9	7	7
Operating cash flow	33	71	211	163	236
CAPEX	-38	-64	-104	-165	-10
Investment revenue	1	2	0	0	0
Disposal of assets	-45	35	2	0	0
Others	-140	-155	18	0	0
Investing cash flow	-222	-183	-83	-165	-10
Stock issuance	-26	396	0	0	0
Change in liabilities	73	90	-66	126	-85
Dividend paid	-20	-20	-43	-65	-83
Others	43	-282	7	-5	-6
Financing cash flow	70	184	-101	55	-174
Net increase in cash and equivalent	-119	73	27	53	52

## Balance Sheet (Rmb mn)

Indicator	2013	2014	2015E	2016E	2017E
Cash and cash equivalent	248	176	203	256	309
Inventory	16	61	78	101	125
Accounts receivable	36	233	171	205	236
Other current assets	73	47	67	95	111
Current assets	373	517	520	656	781
Fixed assets	40	155	337	330	322
Long-term equity investment	146	11	11	11	11
Intangible assets	16	78	77	76	75
Other long-term assets	35	751	636	636	637
Non-current assets	238	995	1,061	1,053	1,045
Total assets	611	1,511	1,581	1,709	1,826
Short-term borrowing	0	32	67	138	119
Accounts payable	4	19	20	28	35
Other current liabilities	24	55	62	69	82
Current liabilities	28	106	149	235	237
Long-term liabilities	70	155	57	115	51
Other long-term liabilities	4	21	22	24	29
Non-current liabilities	74	176	79	140	80
Total liabilities	102	281	228	375	317
Share capital	77	176	352	352	352
Capital reserve	290	685	509	509	509
Owner's equity	509	1,107	1,197	1,334	1,509
Minority interests	0	123	155	0	0
Liabilities & owner's equity	611	1,511	1,581	1,709	1,826

## Major financial indicators

Indicator	2013	2014	2015E	2016E	2017E
Growth rate (%)					
Turnover	24.6	75.5	112.7	26.2	20.5
Operating profit	25.6	15.3	149.1	23.8	28.2
Net profit	15.4	-2.8	113.9	52.1	27.0
Margin (%)					
Gross margin	74.5	62.3	72.4	72.1	73.0
EBIT Margin	39.2	29.0	37.2	39.5	41.7
EBITDA Margin	43.4	31.7	41.0	42.7	44.4
Net margin	50.6	28.0	28.2	33.9	35.8
Return (%)					
ROE	12.6	5.6	11.1	15.2	17.0
ROA	10.5	6.2	9.5	12.9	14.6
Others (%)					
Liability/asset ratio	16.7	18.6	14.4	21.9	17.4
Income tax rate	13.0	13.8	14.0	14.0	14.0
Dividend payout ratio	31.2	32.1	32.1	32.1	32.1

Source: CITICS Quantitative Investment Analysis System

**Analyst Certification:** The analysts primarily responsible for the preparation of all or part of the research report contained herein hereby certify that: (i) the views expressed in this research report accurately reflect the personal views of each such analyst about the subject securities and issuers; and (ii) no part of the analyst's compensation was, is, or will be directly or indirectly, related to the specific recommendations or views expressed in this research report.

## Investment rating system

Rating standard for Investment Recommendations		Rating	Description
Investment ratings are divided into stock rating and sector rating (unless stated otherwise). Rating standard is based on the relative performance with market in 6 to 12 months from the report issuance date, i.e. Performance of company stock price (or sector index) over the 6-to-12-month period from report issuance day is benchmarked against the change in market representative index in the same period. CSI 300 Index will be the benchmark index for A-share market; MSCI-China Index will be the benchmark index for Hong Kong market; NASDAQ Composite Index or Standard & Poor's 500 Index will be the benchmark indices for U.S. market.	Stock ratings	BUY	Increase relative to market representative index over 20%
		OVERWEIGHT	Increase relative to market representative index between 5% and 20%
		HOLD	Increase relative to market representative index between -10% and 5%
		SELL	Decrease relative to market representative index over 10%
	Industry ratings	OUTPERFORM	Increase relative to market representative index over 10%
		NEUTRAL	Increase relative to market representative index between -10% and 10%
		UNDERPERFORM	Decrease relative to market representative index over 10%

## Other Disclosures

This research report has been prepared by CITIC Securities Company Limited ("CS") or an affiliate thereof. CS, its subsidiaries, branches and affiliates (excluding CLSA group of companies for the purpose of this research report disclaimer) are referred to herein as "CITIC Securities".

## Legal Entities Disclosures

**China:** This material is issued and distributed in the People's Republic of China (excluding Hong Kong, Macau and Taiwan) through CS (Securities Business License Number Z20374000) which is regulated by the China Securities and Regulatory Commission.

**Singapore:** This material is distributed in Singapore through CLSA Singapore Pte Limited ("CLSA Singapore") and may only be provided to Institutional Investors, Accredited Investors and Expert Investors, as defined in s.4A(1) of the Securities and Futures Act. Any such investor wishing to discuss this material or effect transactions in any security discussed herein should do so with or through MAS licensed representatives of CLSA Singapore. If you are an accredited investor or expert investor, please be informed that in CLSA Singapore's dealings with you, it is relying on certain exemptions to the Financial Advisers Act ("FAA") - (1) the exemption in Regulation 33 of the Financial Advisers Regulations ("FAR"), which exempts it from complying with Section 25 of the FAA on disclosure of product information to clients; (2) the exemption set out in Regulation 34 of the FAR, which exempts it from complying with Section 27 of the FAA on recommendations; and (3) the exemption set out in Regulation 35 of the FAA, which exempts it from complying with Section 36 of the FAA on disclosure of certain interests in securities.

## Jurisdiction Specific Disclosures

**China:** Businesses scope of CS includes securities investment advisory service, according to the securities business license issued by the China Securities Regulatory Commission.

**Singapore:** Regulations or exchange rules prescribe certain disclosures to be made for certain actual, potential or perceived conflicts of interests relating to research reports. Details of the disc losable interest can be found in certain reports as required by the relevant rules and regulation and the full details are available at <https://www.clsa.com/disclosures/>. Disclosures therein include the position of CLSA group, CLSA Americas and CA Taiwan only and do not reflect those of CITIC Securities, Credit Agricola Corporate & Investment Bank and/or their respective affiliates. If investors have any difficulty accessing this website or require disclosure information on previous dates, please contact [compliance\\_hk@clsa.com](mailto:compliance_hk@clsa.com).

**United States:** This research report has been produced in its entirety by CITIC Securities. This research report is distributed into the United States by CITIC Securities (excluding CITIC Securities International USA, LLC ("CSI-USA")) and CLSA group of companies (excluding CLSA Americas, LLC ("CLSA Americas")) solely to persons who qualify as "major U.S. institutional investors" as defined in Rule 15a-6 under the Securities and Exchange Act of 1934 and who deal with CSI-USA and CLSA Americas respectively. However, the delivery of this research report to any person in the United States shall not be deemed a recommendation to effect any transactions in the securities discussed herein or an endorsement of any opinion expressed herein. Any recipient of this research report from CITIC Securities and CLSA group of companies in the United States wishing to effect a transaction in any security mentioned herein should do so by contacting CSI-USA and CLSA Americas respectively.

**United Kingdom:** The disclosures contained in this part of "United Kingdom" shall be governed by and interpreted in accordance with British law. This research is a marketing communication. It has not been prepared in accordance with the legal requirements designed to promote the independence of investment research as defined in the Financial Conduct Authority Handbook, and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The research is disseminated in the EU by CLSA (UK), which is authorized and regulated by the Financial Conduct Authority. This document is directed at persons having professional experience in matters relating to investments as defined in Article 19 of the FSMA 2000 (Financial Promotion) Order 2005. Any investment activity to which it relates is only available to such persons. If you do not have professional experience in matters relating to investments you should not rely on this document.

## General

This research report is strictly confidential to the recipient and provided only for the use of the recipient and it is not intended for persons in places where the distribution or publication of this research report is not permitted under the applicable laws or regulations of such places. This research report is for information purposes only and should not be construed as an offer to buy or sell or the solicitation of an offer to buy or sell any securities or financial instruments in any jurisdiction. CITIC Securities will not deem the recipient as its clients by reason of their receiving this report. The opinions and recommendations herein do not take into account individual client circumstances, objectives or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients. The recipient of this report must make his own independent decisions regarding any securities or financial instruments mentioned herein.

Information has been obtained from sources believed to be reliable but CITIC Securities do not warrant its accuracy or completeness. CITIC Securities assumes no liability whatsoever for any direct or consequential loss arising from any use of material contained in this research report or otherwise arising in connection therewith. Any securities referred to herein may involve significant risk, may be illiquid and may not be suitable for all investors. The prices, values and income of the securities or financial instruments referred to herein may fluctuate and be affected by changes in exchange rates. Past performance is not indicative of future results.

Information, opinions and estimates contained herein reflect the judgment of analyst(s) of CITIC Securities at the date of its original publication and are subject to changes without notification. They also may be different from or contrary to the opinions presented by other business departments, units or affiliates of CITIC Securities, as different assumptions, standards, views and analytical methods may be adopted in the preparation of such other materials, and CITIC Securities has no obligation to bring such other materials to the attention of any recipient of this report. CITIC Securities relies on information barriers to control the flow of information contained in one or more areas within CITIC Securities, into other areas, units, groups or affiliates of CITIC Securities. The compensation of analysts who prepared this research report is determined solely by the management of Research Department and senior management of CITIC Securities. Analysts' compensation is not decided based on revenue of CITIC Securities' investment banking business but may be linked with overall revenue of its investment banking business as a whole, of which investment banking, sales and trading are a part.

If this research report is distributed by a financial institution other than CITIC Securities, that financial institution is solely responsible for its distribution. Clients of that institution should contact that institution to effect a transaction in the securities mentioned in this research report or if they require further information. This research report does not constitute investment advice by CITIC Securities to the clients of the distributing financial institution, and neither CITIC Securities nor its respective officers, directors and employees will accept any liability whatsoever for any direct or consequential loss arising from their use of this research report or its content.

**This research report may not be reproduced, distributed or sold by any person for any purpose without the prior written consent of CITIC Securities.**

**Copyright 2015.CITIC Securities. All rights reserved.**