

BUY (unchanged)

Share price: HKD19.98
Target price: HKD24.40

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Stock Information

Description: Biostime is a leading premium pediatric nutrition and baby care products provider in China.

Ticker:	1112 HK
Shares Issued (m):	602.3
Market Cap (USDm):	1,542.8
3-mth Avg Daily Turnover (USDm):	1.7
HSI:	21,189
Free Float (%):	25.3

Major Shareholders:	%
Biostime Pharmaceuticals	74.7

Key Indicators

ROE – annualised (%)	32.2
Net cash (HKDm):	2,130
NTA/shr (HKD):	4.60
Interest cover (x):	N/A

Historical Chart



Performance:
52-week High/Low HKD22.95/HKD10.35

	1-mth	3-mth	6-mth	1-yr	YTD
Absolute (%)	(4.4)	8.9	(1.3)	63.5	48.0
Relative (%)	(4.6)	4.5	(8.7)	54.9	33.0

Biostime

An Emerging Star

Maintain BUY on encouraging updates. We attended Biostime's 2012 Macau Forum over 12th -13rd November. Overall, we obtained positive updates underpinned by its new product launches, sales network expansion and new business initiatives. We are keeping our 30% net profit CAGR over FY12-14E intact given high recurrent sales from its active members, and growing member numbers. Our TP is unchanged at HKD24.4, which is equivalent to 18/14X FY12/13PER.

New product launches to drive growth. Management indicated it had received a good response to various recently-launched new and upgraded products. Its new probiotics and infant formula products have enhanced taste and functions. In addition, it has co-developed stage four pre-schooler formulas with Isigny Ste Mère to tap into the currently unaddressed market for 3-7-year-olds. It has also introduced a new natural-theme baby skincare series and baby rice cereal products supplied by quality overseas manufacturers.

New developments to maintain competitiveness. The internally-developed Mama100 Android app is already available; the iPhone version will be available shortly. These mobile applications allow customers to locate outlets more easily and offer a way of directly marketing to its customers, which, in our view, would cement brand loyalty and increase the number of active members. Biostime has also partnered with China Citic Bank and Tenpay.com (a wholly-owned subsidiary of Tencent) to expand its POS machines' capabilities to cover payments, a functionality expected to be rolled out on 1 Apr 2013.

Tapping into new markets. Biostime has launched a parenting brand "Parenting Power" and started to offer free and paid parenting courses at selected hospitals. It will develop more research-based parenting classes in future, and is set to publish the first translated version of a very popular parenting book. Meanwhile, it is developing a parent-kids interactive programme with US-based NGO Zero-to-Three, to be tentatively launched in 2014. Overall, we believe the new initiatives can leverage on its sophisticated CRM system while further strengthening its leading position as a one-stop provider of baby solutions.

Biostime – Summary Earnings Table

FYE Dec (CNYm)	2011A	2012F	2013F	2014F
Revenue	2,189	3,072	4,009	5,090
EBITDA	710	920	1,231	1,568
Recurring Net Profit	527	692	908	1,158
Recurring Basic EPS (CNY)	0.88	1.14	1.49	1.89
EPS growth (%)	50.98	30.52	30.66	26.81
DPS (CNY)	0.62	0.46	0.60	0.76
PER	19.17	14.69	11.24	8.87
EV/EBITDA (x)	14.40	11.21	7.95	5.81
Div Yield (%)	3.68	2.72	3.56	4.51
P/BV(x)	5.11	4.38	3.46	2.74
Net Gearing (%)	N/A	N/A	N/A	N/A
ROE (%)	29.00	32.20	34.47	34.58
ROA (%)	24.32	26.05	27.89	28.15
Consensus Net Profit (CNYm)	-	644	824	1,000

Source: Company data, Kim Eng Securities

Biostime 2012 Macau Forum takeaways

Executive summary. We attended Biostime's two-day 2012 Macau Forum of its member stores, and a new product launch meeting, at The Venetian hotel on 12nd-13rd November. The theme for this year was "Efficiency. Sharing. Create Value for Members." Around 4,000 of its VIP baby specialty store owners, which account for almost half of the total, and about 30 representatives from 10 of its suppliers, participated in the event. Around 100 members of different media organizations were also invited. Only around 10 members of the investment community, mostly from the sell side, participated in the event, since Biostime did not open the event to the broader investment community due to limited seating.

Figure 1: Snapshots of Biostime's 2012 Macau Forum



Source: Kim Eng Securities

Quick wrap-up: Day 1. The whole-day forum consisted of three key parts: i) speeches given by CEO Mr Luo Fei and Sales Director Mr Charlie Zhao regarding its business outlook and various strategies ahead to improve its sales efficiency; ii) speeches by its key suppliers: Lallemand (probiotics), Laiterie De Montaigu (infant formula), Isigny Ste Mère (infant formula), Kerry Group (baby cereals and nutrition food), Advanced Lipids (condensed beta vegetable oil, key ingredients for its infant formula powders), Elixens (floral water, key ingredients for its newly-launched natural baby skincare product line), Arla Foods (infant formula); and iii) real life cases analyses whereby CEOs from various leading specialty maternity and baby chain stores (eg. Leyou, Aiyingshi, Kidswant, etc.) provided business solutions to four of Biostime’s VIP baby specialty stores owners on their operational difficulties.

Figure 2: Top management of key suppliers attended the forum and delivered speech



Source: Kim Eng Securities

Quick wrap-up: Day 2. The half-day event comprised an investor Q&A session chaired by Biostime’s CEO and an industry discussion with CEOs from three leading specialty baby chain stores. The key focus was largely on the execution of its various new business initiatives, including the parent-child activity programme, joint project with Citic Bank and Tenpay.com as well as the possibility of expanding its business scope to grow with its customers. Also, Mr Luo talked about the target coverage of future retail points. Guest speakers also analysed Biostime’s success with investors and discussed the key challenges it faces going forward. The guests also talked about Biostime’s relationship with leading MNC brands, describing Biostime as a responsible, reliable and innovative business partner.

Figure 3: Guest speakers at the industry forum

Guest speakers	Background
Ms Michelle Hu, Chairman and CEO, Leyou 	Established in 1999, Beijing-based Leyou now runs around 240 directly-owned stores in Beijing, Tianjin, Chongqing, Chengdu, etc. Signed a strategic cooperation agreement with Biostime in March 2012 which allows direct sourcing.
Mr Kevin Shi, President & General Manager, Aiyingshi 	Established in 1997, Shanghai-based Aiyingshi has around 100 directly-owned stores nationwide with eastern China focus. Cooperation since 2003.
Mr Andy Xu, Managing director, Kidswant 	Established in 2009, Nanjing-based Kidswant is the largest child-themed mall with key exposure in eastern China. It runs around 20 self-owned large stores in Shanghai, Nanjing, Hefei, etc. Cooperation since 2010.

Source: Kim Eng Securities

Key topics

New product launches and upgrades. i) Biostime has upgraded its probiotics products by enhancing stability of the bacteria and yeast and improving its taste; ii) has co-developed stage four pre-schooler formula products with Isigny, targeted at children aged 3-7 years, a segment which is not covered by existing product lines; (~CNY220-480/900g, GPM slightly lower than that of existing products, imported with original packaging); iii) Biostime has upgraded its existing infant formula products by using condensed beta vegetable oils for better calcium and fat absorption; iv) it has launched new baby rice cereals products with Kerry Group (retail price: ~CNY70/300g, GPM ~55%, imported with original packaging); v) it has introduced a new baby skincare series featuring natural ingredients and zero burden to babies' skin (using raw materials lavender (France), rose (Bulgaria) and bitter orange (Morocco) from Elixens, with production outsourced to a domestic OEM producer). Of note, Elixens also supplies floral water to Sanoflore(the first organic baby care product of L'Oréal) and Melvita(owned by L'Occitane).

Figure 4: New product launches



Source: Company, Kim Eng Securities

Figure 5: Advertisement for its upgraded products



Source: Company, Kim Eng Securities

New development plans in the pipeline. i) Biostime's Mama100 membership Android app is now available (the iPhone app is to be launched shortly), which allows members to easily locate shops, download coupons and receive updates on promotional activities as well as checking and redeeming their membership points; iii) the company has sponsored a TV programme called "Super Q Baby" which is to be broadcast on the Xingkong TV channel (known as "Star TV"). The show mainly invites celebrity couples and parents to talk about their nursery experience and participate in some interactive parenting and nursery knowledge quizzes; however, our chats with management suggest there is no material hike to its A&P budget from its sponsorship of this show; iv) another breakthrough development plan is to improve the compatibility of its POS machines by cooperating with China Citic Bank and Tenpay.com (a wholly-owned subsidiary of Tencent) to extend the functions of the current POS machines from purely accumulation of membership points to payment, QQ resource sharing, etc. Management targets to have a trial run on 1 Jan 2013, and launch the service nationwide by 1 Apr 2013. Management see limited technical difficulties for executing the plan; the key challenge would be mainly to persuade its VIP specialty stores to choose Citic Bank as a key cooperation and settlement bank. Hence, it is trying to negotiate more favourable transaction fee rates with Citic for its VIP stores; iii) it is going to build a new R&D center in Guangzhou with an estimated budget of CNY200m to be spent in over next two years.

Figure 6: Mama100 Android app is available now



Source: mama100.com, Kim Eng Securities

Figure 7: New business partners



Source: Company, Kim Eng Securities

Tapping into new markets. Biostime is launching a new brand “Parenting Power” to tap into the early education and parenting publication markets. It has offered free and paid nursery courses to parents at hospitals covering basic nutritional and nursery knowledge. Management highlighted that it is working with US-based NGO Zero-to-Three to develop parent-child activity programmes targeting children aged 0-3 years, which is tentatively slated for launch in 2014. Also, it is going to publish a translated version of “What Every Parent Needs To Know” in December, a popular parenting book in many countries. Its author Dr. Margot Sunderland is an English child psychologist and psychotherapist who has published over twenty books in the field of child mental health. Going forward, Biostime will incorporate Dr. Sunderland’s theories into its free and paid parenting courses. Dr. Sunderland expressed her appreciation of Biostime’s efforts to improve parenting in China in a pre-recorded video during the event. Management plans to cooperate with some of its VIP specialty stores to conduct some of the parenting classes at the stores and set up one to two flagship education centers at prime locations to increase its brand recognition. Meanwhile, Mr Luo believes the parents and child-related publication market(with GPM of 70-80%) may be another growth area to look at in future.

Figure 8: New publication products under “Parenting Power”

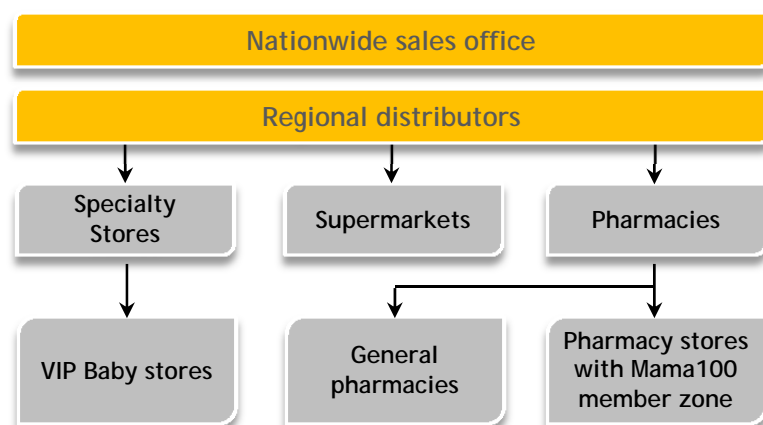


Source: Company, Kim Eng Securities

To grow with its partners. As highlighted in our previous research notes, Biostime differentiates itself against its peers on the solid channel control and management front. Of note, its sales team directly services its end-clients; distributors only serve as a logistics point. Industry statistics suggest that there are around 45,000 specialty maternity and baby stores nationwide while only limited numbers of leading players currently own around 100-200 stores, highlighting the fragmented nature of the industry. Hence, Biostime offers various initiatives to support these small shops (~accounts for 90% of its sales from the specialty store channel) in terms of end-point promotional activities and human resource development. For example, Biostime’s Mama100 Education Center regularly hosts courses on shop management, professional nursery knowledge, etc.. On a separate note, the company has just launched a “Mutual Help Consulting Group” project by inviting a number of leading players to offer business solutions to its VIP specialty store members. The courses and consulting sessions can be redeemed with shops’ membership points. Overall, our chats with some of its VIP specialty store members revealed that a reasonable and clear profit-sharing mechanism, in addition to value-added offerings, are the key reasons behind their solid and growing relationship.

Sales network expansion targets. i) As of 9M12, Biostime’s POS covered around 14,000 stores, comprising 9000/4,000/640 VIP baby specialty stores/supermarkets/pharmacies, according to earlier announcements, ahead of its previous FY12E target of 8,500/4,000/1,000 outlets. Our chats with management suggest updated targets of 9,500/4,000/800 respectively. As of 1H12, sales contribution from the three channels are 70%/23%/7%, respectively. Looking ahead, CEO Mr Luo expects supermarket channels to account for 50% of its sales in the long run given an anticipated higher growth rate for this market. His goal is to reach a store target of around 15,000/6,000/1,000-2000 for the three respective channels over medium term. Overall, Mr Luo sees huge potential for Biostime to grow, as it only covers 20-25% of the specialty stores across China.

Figure 9: Multi-channel distribution model



Source: Company data, Kim Eng Securities

SWOT analysis

We have summarized the key focus of the two day-forum using a SWOT matrix.

Competitive strength. CEOs from three leading specialty stores attributed Biostime's great success to its ability to cut into a niche segment, which was neglected by MNCs, at the right time, as Biostime offered premium infant formula products (imported with original packaging) after the melamine incident through the specialty stores channel. Its pioneering move in establishing a sophisticated customer relationship management system has also contributed to its fast pace of growth over the last several years. Also, its more equitable and stable profit-sharing mechanism along the distribution layer, has successfully aligned distributors and retailers' interests. We are told by many retailers that they are selling MNC products at marginally breakeven or loss-making prices. Biostime's better understanding of local consumer behavior and more innovative marketing ideas are key competitive strengths, in our view.

Weakness. Despite of offering richer margins to distributors and retailers (double-digits vs. the single-digit margins of MNCs), industry players indicated that the top four brands (Mead Johnson, Dumex, Wyeth, Abbott) will continue to lead Biostime due to their long-established brand names and competitive advantage in first-tier cities with their intensive and comprehensive marketing campaigns. Hence, retailers will still put MNC products at favourable locations within stores to drive customer traffic. Secondly, the guest speakers believed the pricing of Biostime's diapers was not competitive, and it may not be able to replicate its success with infant formula in the diaper segment, given the high sensitivity of diaper consumption to prices. P&G's Pampers was highlighted as a very strong player with good value-for-money items. Yet, customers' brand loyalty is observed to be low and purchasing decisions can be triggered by promotional discounts.

Opportunities. Mead Johnson's market share loss in China in the last couple of months, as shown in its disappointing 3Q results, partly exposed its channel management weakness, in our view. Industry players revealed the confused pricing and unstable profitability along the channel could explain MJ's weak sales. Most believed Mead Johnson was losing its growth steam while Dumex and Wyeth performed relatively better among MNCs. The guest speakers thought the top four players in fact had some company-specific problems and due to their large size, the problems cannot be easily rectified. We also share their view that the unreasonably low profitability for carrying MNC products is not sustainable over the long term. We believe Biostime may likely take some market share from its bigger rivals with its sophisticated channel management. On a separate note, we see two new growth areas for Biostime: i) a first-mover advantage and high growth potential for the scientific-based parenting and early education industry; ii) potential of extending the life cycle of its active members and improving sales efficiency by tapping into the children's market and introducing more products to its existing sales platform.

Potential threats. Key concerns largely focused on whether the MNCs' move into the supreme-tier segment, and potentially fighting back in the specialty store channel with their deep pockets, would take away Biostime's market share. One player also indicated that MNCs have started to realise their existing problems and try to offer slightly better margins. Overall, while industry players admitted the unreasonable price of infant formula products in China, they believe the high-tier and supreme tier market are still growing given the unique demographics led by the one-child policy and low confidence in domestic brands. Hence, even if each of the top four brands tap into the high and supreme-tier markets, this is not necessarily a zero sum game for the players. In 1H12, market statistics

suggested sales rose 15% YoY with a slight drop in volume; the growth came mainly from sales mix upgrades. Looking ahead, we expect the market to grow at mid-to-high-teen CAGR owing to limited increases in the birth rate and per capita consumption; growth will be solely driven by consumer upgrade patterns. We also believe it would take time for the MNCs to fully rectify their channel problems and build relationships with end-point retailers given their historical focus on the modern KA channels and reliance on distributors. In short, we believe Biostime's niche strength in the specialty channel will safeguard its competitiveness over time.

Figure 10: Our sales estimates assumptions

	FY10	FY11	FY12E	FY13E	FY14E
Sales (CNY'000)					
Probiotic supplements	303,749	331,962	355,199	380,063	406,668
Infant formula	793,565	1,684,655	2,476,443	3,343,198	4,346,157
Dried baby food	97,779	97,126	106,839	122,864	141,294
Baby care	38,467	47,845	64,591	83,968	104,960
Nutritional supplements		27,446	68,615	78,907	90,743
Total	1,233,560	2,189,034	3,071,687	4,009,001	5,089,822
Growth rate (%)					
Probiotic supplements	14.24	9.29	7.00	7.00	7.00
Infant formula	233.28	112.29	47.00	35.00	30.00
Dried baby food	77.86	(0.67)	10.00	15.00	15.00
Baby care	N/A	24.38	35.00	30.00	25.00
Nutritional supplements		N/A	150.00	15.00	15.00
Total	120.68	77.46	40.32	30.51	26.96
Sales mix (%)					
Probiotic supplements	24.62	15.16	11.56	9.48	7.99
Infant formula	64.33	76.96	80.62	83.39	85.39
Dried baby food	7.93	4.44	3.48	3.06	2.78
Baby care	3.12	2.19	2.10	2.09	2.06
Nutritional supplements	N/A	1.25	2.23	1.97	1.78

Source: Company data, Kim Eng Securities estimates

Figure 11: Number of Point-of-Sales (POS) and active member numbers

Number of stores	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12E
VIP Baby Specialty Stores	4,005	4,399	5,129	6,727	7,659	8,321	9,343	9,500
Supermarkets	2,069	2,126	2,465	2,968	3,079	3,336	3,849	4,000
Pharmacies with Mama100 Member Zone	365	389	461	545	605	601	640	800
Total	6,439	6,914	8,055	10,240	11,343	12,258	13,832	13,500
Active Mama 100 members	632,973	685,458	769,610	825,230	1,044,828	1,179,732	1,345,289	-

Source: Company data, Kim Eng Securities

Figure 12: Our gross margin assumptions for different segments

Gross margin (%)	FY10	FY11	FY12F	FY13F	FY14F
Probiotic supplements	81.90	76.50	77.00	78.00	78.00
Infant formula	68.40	67.30	65.30	65.30	65.50
Dried baby food	66.00	65.90	58.00	58.30	58.50
Baby care	55.60	55.60	45.00	45.00	45.00
Nutritional supplements	-	-	65.00	65.00	65.00
Total	71.11	66.52	65.97	65.86	65.87

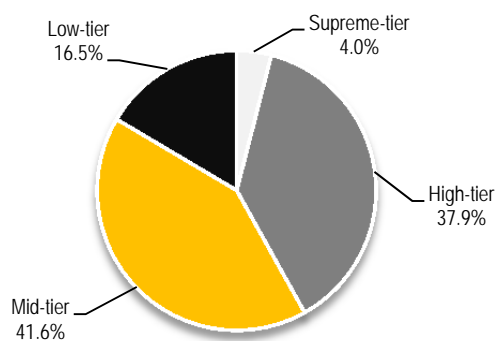
Source: Company data, Kim Eng Securities estimates

Figure 13: Our active member numbers and POS coverage assumptions

	FY10	FY11	FY12F	FY13F	FY14F
VIP Baby Specialty Stores	3,687	6,727	8,500	10,455	12,546
Supermarkets	1,716	2,968	4,000	5,000	6,250
Pharmacies with Mama100 Member Zone	301	545	800	840	882
Total	5,704	10,240	13,300	16,295	19,678
Active Mama 100 members	465,536	825,230	1,500,000	2,018,268	2,641,639

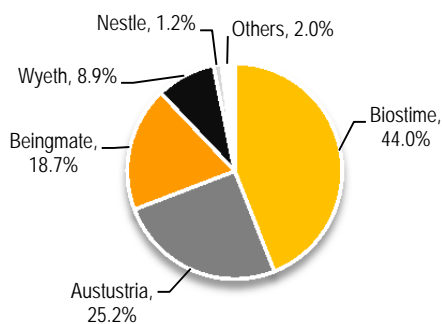
Source: Company data, Kim Eng Securities estimates

Figure 14: Breakdown of China infant formula market value size (2009)



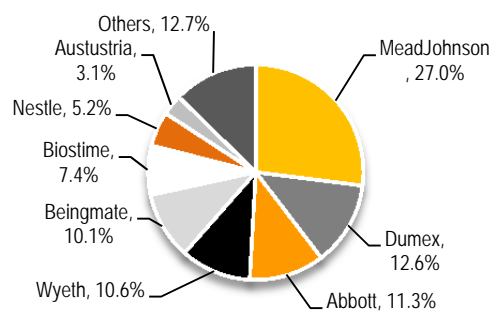
Source: Euromonitor, Kim Eng Securities

Figure 15: PRC supreme-tier infant formula market shares(2011)



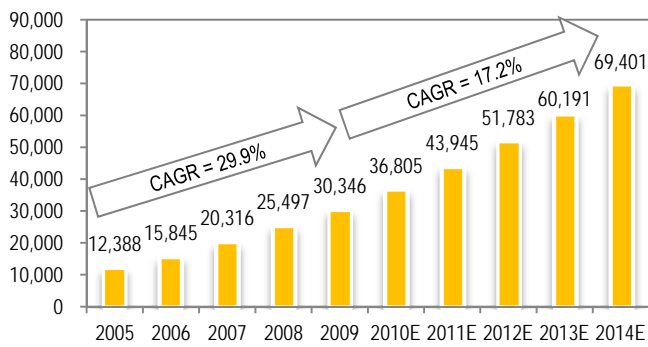
Source: Euromonitor, Kim Eng Securities

Figure 16: PRC high-tier infant formula market shares(2011)



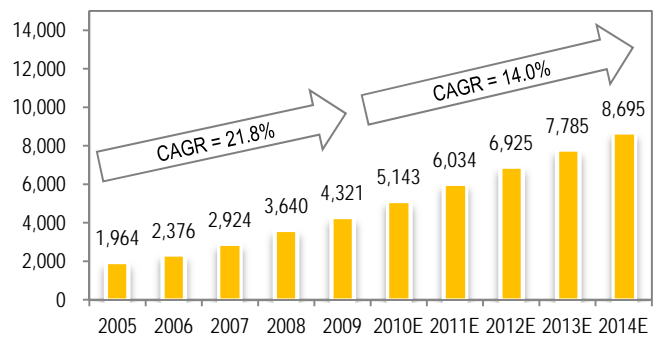
Source: Euromonitor, Kim Eng Securities

Figure 17: Market size- infant formula products(CNYm)



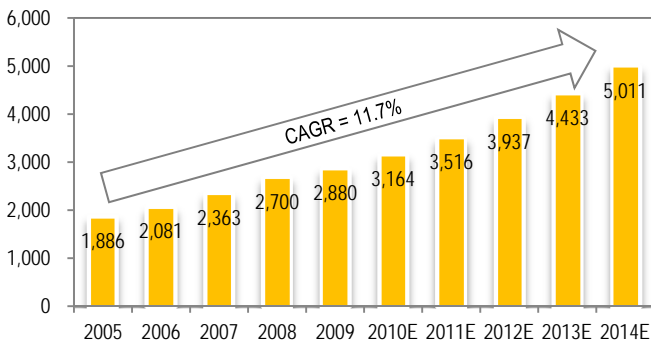
Source: Euromonitor, Kim Eng Securities

Figure 18: Market size-other baby food(CNYm)



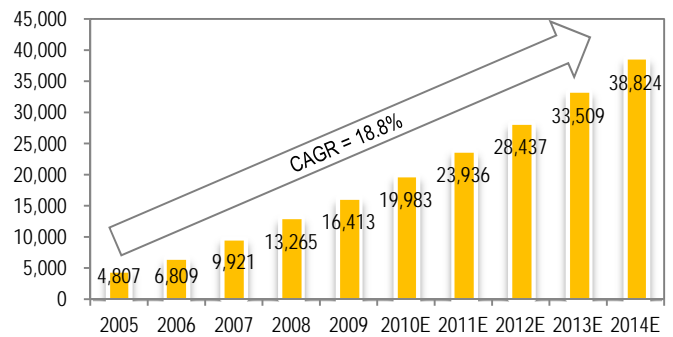
Source: Euromonitor, Kim Eng Securities

Figure 19: Market size- Baby skin and hair care products (CNYm)



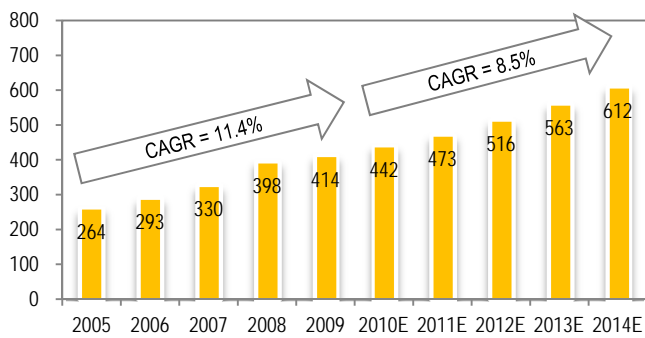
Source: Euromonitor, Kim Eng Securities

Figure 20: Market size-disposable diapers/nappies (CNYm)



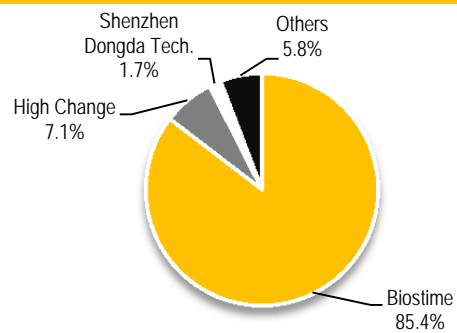
Source: Euromonitor, Kim Eng Securities

Figure 21: Market sales of children's probiotic supplements (CNYm)



Source: Euromonitor, Kim Eng Securities

Figure 22: Market shares-children's probiotic supplements(2009)



Source: Euromonitor, Kim Eng Securities

INCOME STATEMENT

FYE Dec (CNYm)	2011A	2012F	2013F	2014F
Revenue	2,189	3,072	4,009	5,090
EBITDA	710	920	1,231	1,568
Depreciation & Amortisation	13	0	0	0
Operating Profit (EBIT)	697	886	1,176	1,496
Interest (Exp)/Inc	17	36	36	47
Associates	0	0	0	0
One-offs	0	0	0	0
Pre-Tax Profit	714	922	1,211	1,543
Tax	(187)	(231)	(303)	(386)
Minority Interest	0	0	0	0
Net Profit	527	692	908	1,158
Revenue Growth %	77.46	40.32	30.51	26.96
EBITDA Growth (%)	109.38	29.68	33.75	27.42
EBIT Growth (%)	109.93	27.19	32.68	27.26
Net Profit Growth (%)	98.49	31.17	31.31	27.44
Tax Rate %	26.13	25.00	25.00	25.00

BALANCE SHEET

FYE Dec (CNYm)	2011A	2012F	2013F	2014F
Fixed Assets	59	156	251	328
Other LT Assets	228	420	403	371
Cash/ST Investments	1,814	1,775	2,368	3,100
Other Current Assets	337	525	618	786
Total Assets	2,438	2,876	3,640	4,585
ST Debt	0	0	0	0
Other Current Liabilities	415	512	644	795
LT Debt	0	0	0	0
Other LT Liabilities	45	45	45	45
Minority Interest	0	0	0	0
Shareholders' interest	1,978	2,319	2,951	3,745
Total Liabilities & Capital	2,438	2,876	3,640	4,585
Share Capital (m, no. of shares))	602	605	608	611
Gross Debt/(Cash)	0	0	0	0
Net Debt/(Cash)	(1,814)	(1,775)	(2,368)	(3,100)
Working capital	1,735	1,789	2,343	3,091

CASH FLOW

FYE Dec (CNYm)	2011A	2012F	2013F	2014F
Profit before taxation	714	922	1,211	1,543
Depreciation	13	34	55	72
Net interest receipts/(payments)	(17)	(36)	(36)	(47)
Working capital change	(24)	(93)	39	(16)
Cash tax paid	(119)	(152)	(200)	(254)
Others	0	0	0	0
Cash flow from operations	567	675	1,070	1,298
Capex	(42)	(150)	(150)	(150)
Disposal/(purchase)	0	0	0	0
Others	17	36	36	47
Cash flow from investing	(24)	(114)	(114)	(103)
Debt raised/(repaid)	0	0	0	0
Equity raised/(repaid)	0	0	0	0
Dividends (paid)	(372)	(277)	(363)	(463)
Interest payments	0	0	0	0
Others	0	0	0	0
Cash flow from financing	(372)	(277)	(363)	(463)
Change in cash	170	285	592	733

RATES & RATIOS

FYE Dec	2011F	2012F	2013F	2014F
EBITDA Margin %	32.42	29.96	30.70	30.81
Op. Profit Margin %	31.82	28.84	29.32	29.39
Net Profit Margin %	24.09	22.52	22.66	22.74
ROE %	29.00	32.20	34.47	34.58
ROA %	24.32	26.05	27.89	28.15
Dividend Cover (x)	1.87	3.20	3.24	3.23
Interest Cover (x)	N/A	N/A	N/A	N/A
Asset Turnover (x)	0.90	1.07	1.10	1.11
Asset/Debt (x)	N/A	N/A	N/A	N/A
Debtors Turn (days)	1	1	1	1
Creditors Turn (days)	33	21	16	16
Inventory Turn (days)	100	134	136	131
Net Gearing %	N/A	N/A	N/A	N/A
Debt/ EBITDA (x)	N/A	N/A	N/A	N/A
Debt/ Market Cap (x)	N/A	N/A	N/A	N/A

PER SHARE DATA

FYE Dec (CNY)	2011F	2012F	2013F	2014F
EPS	0.88	1.14	1.49	1.89
CFPS	0.94	1.12	1.76	2.12
BVPS	3.28	3.83	4.85	6.13
SPS	3.63	5.08	6.59	8.33
EBITDA/share	1.18	1.52	2.02	2.57
DPS	0.62	0.46	0.60	0.76

Source: Company data, Kim Eng Securities

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