Yestar International (2393 HK)

Target price: **HKD4.00**

Share price (9 Nov): **HKD3.09** | Up/downside: **+29.4%**

5 4 3 2 **1**

Buy
(initiation)

Initiation: a shining star in medical diagnostics

- Stock provides direct exposure to China's fast-growing IVD industry
- EPS forecast to grow at a 32% CAGR to 2017E; more M&A likely
- Initiating with a Buy (1) rating and 12-month target price of HKD4.00

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Investment case: After completing 2 major acquisitions over the past 12 months (Jiangsu Uno and Anbaida), Yestar has transformed into a China medical stock that provides investors with exposure to a rapidly growing niche of the China healthcare sector, the in-vitro diagnostics (IVD) industry. Yestar is already the largest distributor of IVD consumable products for China's leading IVD products supplier, Roche Diagnostics, which has a market share of twice that of its closest competitor. We expect Yestar to ride on the strong growth momentum of Roche Diagnostics in China and register a 38% revenue CAGR for 2014-17E. Over the same period, we look for a 32% EPS CAGR, slightly slower than revenue growth due to dilution from an equity financing exercise in July 2015.

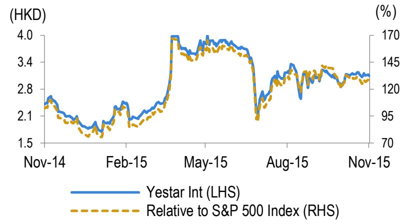
We forecast Yestar's legacy business, as a major processor and distributor of Fujifilm products in China, to register a 7% organic CAGR in 2014-17E, serving as a cash cow to support the growth of its new IVD businesses.

Catalysts: 1) We expect an upward rerating for Yestar stock in tandem with an expansion of the company's medical consumables business, and as it establishes a longer track record as an IVD consumables distributor. Solid 2015E financial results that demonstrate the sustained earnings growth of its 2 recently acquired acquisitions would be a share-price catalyst. 2) Our forecasts do not take into account any future M&A, but we do believe the company will acquire at least 1 more company in 2016. Yestar has so far proven its strong track record in M&A, and any new transaction could be a further boost to earnings growth. We note that even if there are no new acquisitions, it is likely that Yestar will acquire the remaining 30% stakes of Jiangsu Uno and Anbaida in 2017 and 2018, respectively, which is currently not reflected in our forecasts.

Valuation: We initiate coverage of Yestar with a Buy (1) rating and 12-month target price of HKD4.00. We value the company at a 30x PER on our 2016 EPS forecast, which is equivalent to a 50% discount to the average trading multiple of its China-listed IVD peers, but a 50% premium to China medical products suppliers in Hong Kong. We believe our target multiple is undemanding, considering the much stronger earnings growth profile of Yestar compared with its peers. Yestar is trading at an attractive 2015E PEG ratio of 0.8x, which is well below the Hong Kong-listed medical product suppliers' 1.3x and China-listed IVD players' 3.7x.

Risks: The key risk to our call is the inability of Yestar to sustain positive earnings growth for its 2 recently acquired IVD companies.

Share price performance



12-month range	1.76-4.00
Market cap (USDbn)	0.86
3m avg daily turnover (USDm)	1.49
Shares outstanding (m)	2,175
Major shareholder	Hartono Family (61.1%)

Financial summary (CNY)

Year to 31 Dec	15E	16E	17E
Revenue (m)	2,577	3,607	4,052
Operating profit (m)	266	459	533
Net profit (m)	143	237	273
Core EPS (fully-diluted)	0.071	0.109	0.126
EPS change (%)	31.1	53.6	15.5
Daiwa vs Cons. EPS (%)	(20.4)	(16.3)	(18.9)
PER (x)	35.8	23.3	20.2
Dividend yield (%)	1.7	2.6	3.0
DPS	0.043	0.066	0.077
PBR (x)	5.5	5.2	4.2
EV/EBITDA (x)	18.0	10.6	8.9
ROE (%)	21.7	22.9	23.0

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 23

Company

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Buy (initiation)

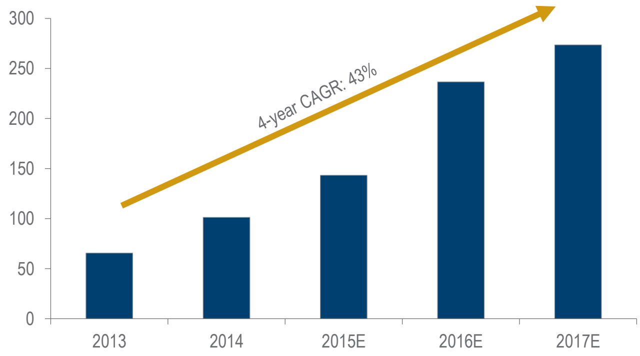
How do we justify our view?

Growth outlook	Valuation	Earnings revisions
✔✔✔✔✔	✔✔✔✔	✔✔

Growth outlook

We forecast net profit attributable to shareholders to rise to CN273m by 2017E, representing a CAGR of 43% since Yestar's IPO in 2013. The robust earnings growth would be driven largely by rising contributions from its newly acquired IVD businesses, which are in an industry whose revenue is growing at 20% per year. While our forecasts do not factor in any additional acquisitions, we do believe the company will complete at least 1 deal in 2016, which suggests upside potential for our forecasts.

Yestar: net profit growth (CNYm)



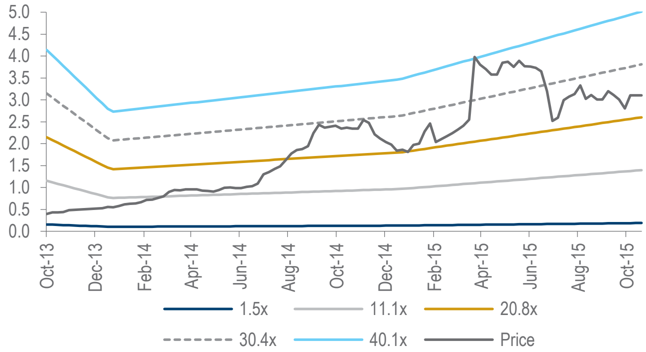
Source: Company, Daiwa forecasts

Valuation

We value Yestar at a 30x PER on our 2016 EPS forecast, which is equivalent to around 1SD above its average 1-year forward PER trading range. Relative to its peers, the 30x PER represents a 50% discount to the average trading multiple of Yestar's China-listed IVD peers, but a 50% premium to China medical products suppliers in Hong Kong.

After taking into account Yestar's much higher earnings growth rate compared to its peers, our target multiple looks undemanding. Our 2015E PEG ratio is 0.8x vs. 1.3x for Hong Kong-listed medical product suppliers and 3.7x for China-listed IVD players.

Yestar: 1-year forward PER band chart



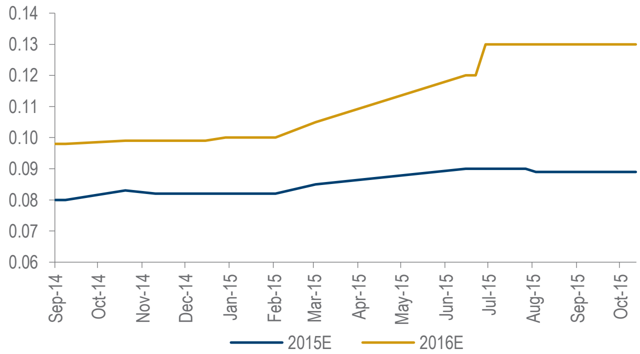
Source: Daiwa forecasts, Bloomberg

Earnings revisions

There are a limited number of analysts covering Yestar.

Our EPS forecasts for 2015-17 are 16-20% below those of the Bloomberg consensus, as we have factored in a higher intangible asset amortisation expense from the recent acquisitions. Our forecasts also do not reflect any additional M&A opportunities.

Yestar: Bloomberg-consensus earnings revisions



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Medical consumable products - revenue growth rate (YoY %)	n.a.	713	(3)	61	52	139	58	16
Colour photographic paper - revenue growth rate (YoY %)	n.a.	39	(7)	(13)	11	5	2	0
Industrial imaging - revenue growth rate (YoY %)	n.a.	n.a.	n.a.	323	32	5	5	2
Jiangsu Uno - Profit after Tax (CNYm)	0	0	0	28	46	58	70	80
Anbaida - Profit after Tax (CNYm)	0	0	58	84	97	160	190	230

Profit and loss (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Medical Consumables Products	37	303	295	474	721	1,726	2,733	3,173
Color Photographic Paper and Other Digital Imaging	486	674	625	545	607	637	650	650
Other Revenue	0	0	36	154	204	214	224	229
Total Revenue	**523**	**977**	**956**	**1,173**	**1,531**	**2,577**	**3,607**	**4,052**
Other income	0	0	0	0	0	0	0	0
COGS	(438)	(814)	(789)	(964)	(1,268)	(2,112)	(2,867)	(3,207)
SG&A	(63)	(97)	(91)	(115)	(116)	(198)	(281)	(312)
Other op.expenses	9	10	10	13	17	40	56	58
Operating profit	**22**	**66**	**77**	**94**	**148**	**266**	**459**	**533**
Net-interest inc./(exp.)	6	7	6	1	5	(2)	(7)	(8)
Assoc/forex/extraord./others	(1)	(4)	(1)	(2)	(6)	(6)	(2)	(2)
Pre-tax profit	**27**	**69**	**82**	**94**	**147**	**258**	**449**	**523**
Tax	(6)	(21)	(24)	(28)	(44)	(77)	(135)	(157)
Min. int./pref. div./others	(2)	(1)	(2)	(0)	(3)	(37)	(78)	(93)
Net profit (reported)	**19**	**47**	**57**	**65**	**101**	**143**	**237**	**273**
Net profit (adjusted)	**19**	**47**	**57**	**65**	**101**	**143**	**237**	**273**
EPS (reported)(CNY)	**n.a.**	**n.a.**	**0.042**	**0.044**	**0.054**	**0.071**	**0.109**	**0.126**
EPS (adjusted)(CNY)	**n.a.**	**n.a.**	**0.042**	**0.044**	**0.054**	**0.071**	**0.109**	**0.126**
EPS (adjusted fully-diluted)(CNY)	**n.a.**	**n.a.**	**0.042**	**0.044**	**0.054**	**0.071**	**0.109**	**0.126**
DPS (CNY)	**0.000**	**0.000**	**0.000**	**0.022**	**0.034**	**0.043**	**0.066**	**0.077**
EBIT	**22**	**66**	**77**	**94**	**148**	**266**	**459**	**533**
EBITDA	**32**	**76**	**86**	**107**	**165**	**306**	**515**	**591**

Cash flow (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	27	69	82	94	147	258	449	523
Depreciation and amortisation	9	10	10	13	18	40	56	58
Tax paid	(2)	(10)	(21)	(43)	(29)	(77)	(135)	(157)
Change in working capital	16	23	(26)	(34)	(26)	(300)	(70)	(69)
Other operational CF items	3	4	0	5	3	7	13	13
Cash flow from operations	**54**	**96**	**45**	**35**	**113**	**(72)**	**314**	**369**
Capex	(18)	(7)	(52)	(22)	(10)	(20)	(20)	(20)
Net (acquisitions)/disposals	(2)	(3)	5	1	(141)	(826)	(182)	0
Other investing CF items	(4)	(22)	25	(6)	2	4	5	8
Cash flow from investing	**(24)**	**(33)**	**(22)**	**(27)**	**(149)**	**(842)**	**(197)**	**(12)**
Change in debt	(5)	10	(2)	72	(11)	179	65	50
Net share issues/(repurchases)	5	0	0	129	0	904	0	0
Dividends paid	0	0	0	(81)	(36)	(50)	(72)	(118)
Other financing CF items	(3)	(4)	(3)	(6)	(6)	(12)	(19)	(23)
Cash flow from financing	**(2)**	**6**	**(4)**	**114**	**(53)**	**1,021**	**(26)**	**(91)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**28**	**70**	**19**	**123**	**(89)**	**106**	**92**	**266**
Free cash flow	36	89	(7)	13	103	(92)	294	349

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (CNYm)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	69	142	160	283	195	301	393	659
Inventory	143	133	178	273	327	463	589	615
Accounts receivable	12	37	101	17	105	353	494	666
Other current assets	54	90	29	33	27	29	40	44
Total current assets	**277**	**401**	**468**	**605**	**654**	**1,146**	**1,516**	**1,985**
Fixed assets	57	53	96	104	104	118	120	121
Goodwill & intangibles	4	3	3	3	337	1,384	1,346	1,309
Other non-current assets	2	19	21	24	23	23	23	23
Total assets	**339**	**476**	**587**	**736**	**1,118**	**2,671**	**3,005**	**3,437**
Short-term debt	20	47	25	117	102	195	200	200
Accounts payable	102	184	244	215	283	434	605	703
Other current liabilities	65	59	139	48	167	102	139	175
Total current liabilities	**187**	**289**	**408**	**380**	**552**	**731**	**944**	**1,078**
Long-term debt	17	0	20	0	5	90	150	200
Other non-current liabilities	2	5	10	13	237	837	837	837
Total liabilities	**206**	**294**	**438**	**394**	**793**	**1,658**	**1,931**	**2,114**
Share capital	0	0	0	37	37	37	37	37
Reserves/R.E./others	111	158	140	296	279	967	1,028	1,276
Shareholders' equity	**111**	**158**	**140**	**333**	**316**	**1,004**	**1,065**	**1,313**
Minority interests	22	23	9	9	9	10	10	10
Total equity & liabilities	**339**	**476**	**587**	**736**	**1,118**	**2,671**	**3,005**	**3,437**
EV	5,507	5,444	5,410	5,360	5,437	5,510	5,483	5,267
Net debt/(cash)	**(32)**	**(95)**	**(115)**	**(166)**	**(89)**	**(16)**	**(43)**	**(259)**
BVPS (CNY)	**n.a.**	**n.a.**	**n.a.**	**0.178**	**0.169**	**0.462**	**0.490**	**0.604**

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	n.a.	86.8	(2.2)	22.8	30.5	68.3	40.0	12.3
EBITDA (YoY)	n.a.	141.3	13.5	24.1	54.2	85.3	68.2	14.7
Operating profit (YoY)	n.a.	198.8	15.7	22.8	57.1	80.0	72.5	16.2
Net profit (YoY)	n.a.	145.2	19.5	15.1	55.1	41.9	65.3	15.5
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	n.a.	6.3	21.4	31.1	53.6	15.5
Gross-profit margin	16.3	16.7	17.5	17.8	17.2	18.0	20.5	20.9
EBITDA margin	6.0	7.8	9.0	9.1	10.8	11.9	14.3	14.6
Operating-profit margin	4.2	6.8	8.0	8.0	9.7	10.3	12.7	13.2
Net profit margin	3.7	4.8	5.9	5.5	6.6	5.6	6.6	6.7
ROAE	n.a.	35.1	37.9	27.5	31.1	21.7	22.9	23.0
ROAA	n.a.	11.6	10.6	9.8	10.9	7.6	8.3	8.5
ROCE	n.a.	33.2	36.3	28.8	33.2	30.7	33.7	33.9
ROIC	n.a.	49.1	90.9	62.5	50.4	30.2	31.6	35.6
Net debt to equity	net cash	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	20.3	30.3	28.9	30.2	29.6	30.0	30.0	30.0
Accounts receivable (days)	n.a.	9.1	26.3	18.3	14.5	32.5	42.9	52.3
Current ratio (x)	1.5	1.4	1.1	1.6	1.2	1.6	1.6	1.8
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	153.2	62.4	71.1
Net dividend payout	n.a.	n.a.	0.0	49.4	62.9	61.0	61.0	61.0
Free cash flow yield	0.7	1.6	n.a.	0.2	1.9	n.a.	5.3	6.3

Source: FactSet, Daiwa forecasts

Company profile

Yestar International is a processor and distributor of Fujifilm imaging products in China. Through the acquisitions of Jiangsu Uno and Anbaida in 2014 and 2015, respectively, the company has become a major distributor of in-vitro diagnostics (IVD) products in China.

Rapid transition to a medical consumables player

Game-changing acquisitions

A long and stable growth history with Fujifilm …

Yestar International (Yestar) was listed on the Hong Kong Stock Exchange in October 2013, primarily as the sole processor and distributor of Fujifilm photographic paper and medical imaging films in China. Back then, the company's business relied heavily on Fujifilm: in 2013, over 99% of Yestar's revenue was derived from products sourced from Fujifilm or associated with the Fujifilm Group. While this proportion has dropped significantly since then, Fujifilm continues to be a major business partner of Yestar, and it has been recognised by Fujifilm Group as its largest authorised distributor of colour photographic paper and Fujifilm colour films in China since 2007.

It is easy to dismiss Yestar's films business as a sunset business, but we would point out that the revenue generated by this business rose organically at over 20% YoY for 2013 and 2014. We still see pockets of growth that should help drive an overall expansion of its films business, such as continued rising demand for medical imaging films, as well as Fujifilm's gains of market share. Hence, we still look for a revenue CAGR of 7% for its legacy films business in 2014-17E and view this business as a cash cow to support the faster growing areas of its business.

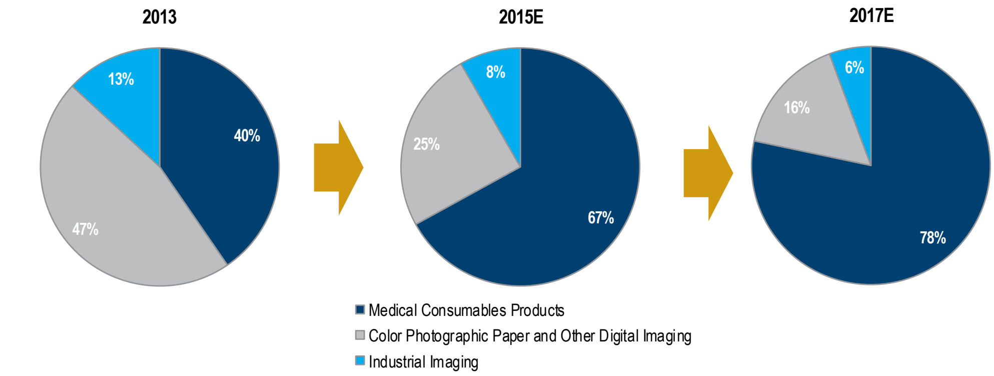
… but 2 recent acquisitions have transformed its business

However, what we find most exciting is Yestar's recent entry into the IVD industry through the acquisitions of Jiangsu Uno and Anbaida in November 2014 and August 2015, effectively transitioning Yestar into a China medical play.

As recently as 2013, some 40% of total revenue was generated from medical consumable products (which back then, constituted only sales of medical and dental films), but we forecast this to rise to 67% in 2015E and further to 78% by the end of 2017E. The new IVD businesses are not only faster growing, but have higher net margins, and hence we expect them to provide a significant boost to the company's earnings growth. Since its IPO, the company had long planned to expand its presence in the medical consumables business in China, as a means of diversifying its revenue streams. At the time, the company allocated 30% or HKD31m of the HKD102m in IPO net proceeds to the "acquisition of a medical device company". In less than 2 years, the company has already positively executed well past this original goal, in our view.

Assuming no additional acquisitions, medical consumable products will contribute over 75% of revenue in 2017E, up from 40% in 2013, on our forecasts

Yestar: change in revenue mix



Source: Company, Daiwa forecasts

In recognition of the change in its revenue mix, the Hang Seng Industry Classification System officially reclassified Yestar from its original "Printing and Packaging" industry to "Medical Device and Services" in August 2015.

According to the US FDA, IVD products are "reagents, instruments, and systems designed for use in diagnosis of disease or other conditions"

What is In-Vitro Diagnostics (IVD)?

IVD is a method of performing a diagnostics test outside a body, or within a laboratory environment (the term "in-vitro" is taken from Latin, meaning "within the glass"). Simply put, IVD tests are used to provide information on a patient's health status and allow medical practitioners or users to make informed decisions on patient care. While IVD tests can be complicated and should only be conducted by trained professionals in a laboratory setting, some IVD test kits are designed for ease of use or home-use. Some everyday examples of IVD tests are home pregnancy tests and blood glucose tests by a diabetic patient.

An IVD test typically requires at least 2 components:

- **Reagents,** which are biological or chemical substances that are designed to react with target substances in samples. These are consumable products that need to be refilled after a certain amount of tests and hence serves as a recurring revenue stream for IVD suppliers. The two recent acquisitions by Yestar primarily distribute reagents in China.
- **Analytical equipment or apparatus,** which are machines that automate the process of conducting the IVD test in a controlled and consistent manner.

IVD tests are important as its results can influence up to 70% of all medical decision making, while it only makes up a fraction (typically up to 5%) of a hospital's budget[1]. Their uses are also becoming increasingly prevalent as tests are done more frequently across all phases of the healthcare pathway: screening, prediction, diagnosis, treatment decisions, and monitoring.

IVD businesses destined for solid growth

Yestar has acquired 2 distributors of IVD consumable products: Jiangsu Uno for CNY245m in November 2014 and Anbaida (a collection of 5 companies) for CNY910m in August 2015. We believe these 2 acquisitions will form the basis of Yestar's accelerated earnings growth in 2015-17E.

Yestar: summary of the acquisitions of Jiangsu Uno and Anbaida

	Jiangsu Uno	Anbaida
Announcement date:	11-Sep-14	9-Apr-15
Completion date:	Nov-14	Aug-15
Target companies:	Jiangsu Uno Technology Development Company	Shanghai Emphasis Investment Shanghai Jianchu Medical Shanghai Chaolian Trading Shanghai Haole Industrial Shanghai Dingpei Industrial
Stake acquired	70%	70%
Consideration	CNY245m in cash	CNY910m in cash
Business scope	- Distribution right of Roche Diagnostics Products in Anhui and Jiangsu province - Distribution right of BD Diagnostics Products in Jiangsu province	- Distribution right of Roche products in Shanghai - Distribution right of Thermo Fisher products in Shanghai
2014 Revenue	Estimate: CNY390m	Actual: CNY635m
2014 Gross margin	Estimate: 20%	Actual: 34%
2014 Net margin	Estimate: 12%	Actual: 15%
Profit guarantee	2014-16 annual net profit not less than CNY45m, CNY54m and CNY64m respectively	2015-17 annual net profit not less than CNY156m, CNY187m and CNY225m respectively
Valuation (based on profit guarantees)	2014 PER of 7.8x 2015 PER of 6.5x 2016 PER of 5.5x	2015 PER of 8.3x 2016 PER of 7.0x 2017 PER of 5.8x
Distribution network (total hospital and clinics):	382	270

Source: Company, Daiwa

A history in partnering with the industry's best

As mentioned, the primary business of both Jiangsu Uno and Anbaida is to distribute IVD consumable products such as reagents, to hospitals and clinics in China. Specifically, Jiangsu Uno has obtained the rights to distribute Roche Diagnostics products in Anhui and Jiangsu provinces, while Anbaida has similar distribution rights for Shanghai. This is

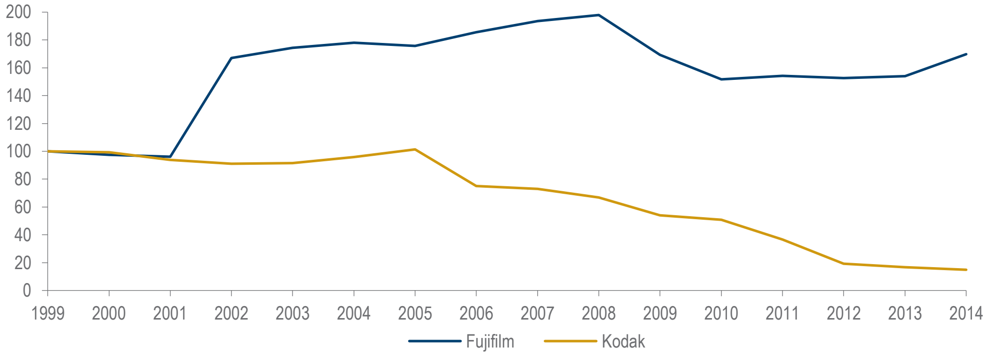
[1] Forsman RW. Why is the laboratory an afterthought for managed care organizations? Clin Chem. 1996;

significant because Roche Diagnostics is the undisputed leader in IVD products globally and in China – and in our opinion, a distributor's long-term success ultimately comes down to the demand for the products it is distributing.

To illustrate the importance of choosing the right partner, we do not need to look further than the diverging fortunes of Yestar's own long-time partner, Fujifilm, and its biggest competitor, Eastman Kodak (not rated). While both companies have been heavily impacted by the structural decline in demand for colour films, Fujifilm has fared much better over the years, as a result of management's ability to diversify revenue streams (in 2001, 54% of Fujifilm's revenue came from imaging solutions, and this has declined to 15% in 2015). In fact, Kodak has continuously lost market share to Fujifilm for most of the past decade, and even filed for bankruptcy in early 2012.

Fujifilm has gradually gained market share in colour photographic films over the years, and this has consequently helped drive revenue growth for Yestar

Revenues of Fujifilm and Kodak (rebased)



Source: Bloomberg

Similarly, we expect Yestar to ride on the strong business growth momentum of Roche Diagnostics in China

According to various industry research sources, Roche Holdings (ROG VX, not rated) (the parent company of Roche Diagnostics) has a market share that is consistently around twice that of the second player, both globally and in China. While Roche itself is a USD220bn market cap healthcare giant headquartered in Switzerland, we believe subsidiary Roche Diagnostics' ability to maintain a consistent and comfortable market share lead globally is impressive, given the highly competitive nature of the industry. Roche Holdings competes primarily with a list of other multi-billion healthcare giants such as Abbott Laboratories (ABT US, not rated), Siemens Healthcare, and Danaher Corporation (DHR US, not rated).

Global and China market share of Roche Diagnostics

Share of global IVD sales in 2013			Share of China IVD market in 2014		
Name	Headquarters	Market share	Name	Headquarters	Market share
Roche	Switzerland	20%	Roche	Switzerland	18%
Abbott	US	11%	Beckman Coulter*	US	9%
Siemens	Germany	10%	Sysmex	Japan	8%
Danaher	US	8%	Abbott Lab	US	7%
Johnson & Johnson	US	7%	Siemens	Germany	5%
bioMérieux	France	3%	Mindray	China	4%
Becton Dickinson	US	3%	Kehua	China	2%
Alere	US	3%	bioMérieux	France	2%
Sysmex	Japan	3%	Becton Dickinson	US	2%
Others	n.a.	32%	Others	n.a.	43%

Source: Roche, Clearstate market research, Daiwa
*Note: *Beckman Coulter is a subsidiary of Danaher Corporation*

Yestar's partnership with a clear IVD market leader bodes well for its 2 acquired subsidiaries, Jiangsu Uno and Anbaida. In fact, with the consolidation of the 2 companies, we believe Yestar is already among the largest distributor for Roche Diagnostics in China, with around an 11-13% share of its revenue in 2014. Yestar's management believes there is still significant room for this relationship to expand, and it aims to ultimately distribute 30% of Roche Diagnostics' IVD products in China.

Since 1971, the controlling shareholders of Yestar have been a major business partner of Fujifilm Group. We believe Yestar is looking to build the same type of lasting relationship with Roche Diagnostics

In partnering with another leading brand like Roche Diagnostics, Yestar is replicating its long period of success with Fujifilm, in our view, which its controlling shareholder has had (Hartono Family) for 44 years. The Hartono family has been doing business with Fujifilm Group since 1971, helping Fujifilm manufacture and distribute its photo imaging products and medical films in Indonesia, Vietnam, India, Cambodia and China. The Hartono family and Yestar remain Fujifilm's most important partners in ASEAN and in China, respectively, and we view the lasting relationship as a testament of management's win-win approach to business partnerships. (More information on Yestar's legacy film business may be found on Page 14.)

Apart from Roche Diagnostics, Jiangsu Uno also has distribution rights for Becton Dickinson (BD) diagnostics products in Jiangsu Province (another top-10 IVD player by sales globally and in China), while Anbaida has distribution rights for Thermo Fisher products in Shanghai. However, we note that Roche Diagnostics is by far the most important supplier for both companies, as at the time of acquisition, almost 100% and around 90% of Jiangsu Uno and Anbaida's purchases were generated from Roche's products respectively. In 2015-17E, we expect less than 10% of IVD-related sales to come from BD and Thermo Fisher, given the much larger opportunity with Roche Diagnostics and Yestar's focus in servicing this supplier.

Roche Diagnostics' market leadership in China is likely here to stay

Given the increasing importance of Roche Diagnostics to Yestar, we visited the company's China headquarters in Shanghai to better understand its business prospects and competitive advantage. Since 2005, the Roche Diagnostics division has consistently contributed 20-23% of Roche Holding's group annual revenue, the rest being contributed by its pharmaceuticals unit. While the smaller of its 2 main operating units, Roche Diagnostics holds key strategic value for Roche Holdings, in our view, as the revenue from this division is comparatively less volatile than that from its other businesses, and the division is the clear market-share leader in most countries worldwide.

China has become Roche Diagnostics' second-largest revenue contributor, behind only the US

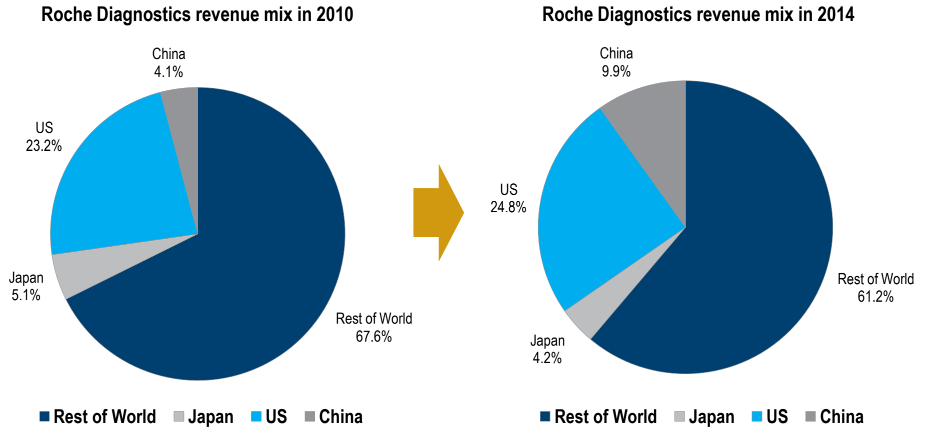
China has become a major focus for Roche Holdings' top management, as the revenue growth in the country has far outpaced its other markets. For example, there was virtually no growth in Roche Holdings' global revenue from 2010 to 2014, while its China business revenue rose at a CAGR of 22% over the same period. More specifically, revenue for its diagnostics division increased at a 4-year CAGR of 26%, outpacing that of its pharmaceuticals unit of 20%. In 2014, the diagnostics division contributed over 40% of Roche Holdings' China revenue. Within Roche Diagnostics, China was just shy of contributing 10% of its total revenue, but has recently become the second largest country, behind only the US. According to Roche Diagnostics, it aims to make China its largest revenue source for Roche Diagnostics by 2020, surpassing that of the US.

Roche Holdings' increasing investments in China signal its bullish view on the country's business prospects

In November 2014, Roche Holdings announced that it would be investing CHF450m to build a diagnostics manufacturing facility in Suzhou, its first in the Asia-Pacific region and its eighth worldwide. The facility will focus on products for immunoassay and clinical chemistry tests, and aims to commence initial packaging activities at the end of 2016. By 2018, the plant is designed to produce about 180 different reagents, calibrators and controls for clinical chemistry and immunodiagnostics. We view this major project as a clear sign of Roche Holdings' commitment to China and the bullish view of its business prospects.

For Roche Diagnostics, the proportion of revenue derived from China has more than doubled in 4 years

Roche Diagnostics: changes to geographic revenue mix



Source: Roche, Bloomberg

After visiting Roche Diagnostics' campus in Shanghai, we believe the company will continue to experience strong revenue growth for the foreseeable future. We believe the company's business practices are aligned with those of its major distributors and hence, Jiangsu Uno and Anbaida should be able to piggyback off the company's continued growth in China. Our takeaways are as follows:

- **International IVD brands favoured over local brands.** Roche Diagnostics' reputation as a pioneer in diagnostics globally has greatly helped the company's expansion in China. Despite the increasingly competitive local IVD reagent suppliers, such as Shenzhen-based Mindray Medical International (MR US, not rated) and Shanghai-based Kehua Bio-Engineering (002022 CH, not rated), we understand that most hospitals still favour international brands due to their better diagnostics accuracy, technologies, ease of use and after-sales support. In addition, we believe hospitals are generally more inclined to use imported equipment as its costs are typically higher, and hence the mark-up for the hospital is likely higher too. On the other hand, we believe most patients in China also prefer to use internationally branded equipment if given the choice due to the perception of higher quality.

With 26,000 hospitals in China, we believe a distributor model is the only viable way for Roche Diagnostics to expand quickly in the country

- **A distributor-only model.** Roche Diagnostics in China has so far only used third-party distributors to distribute its IVD products in the country and has not engaged in direct-sales to hospitals or clinics. According to a Roche Diagnostics accounts manager with whom we have spoken, it is highly unlikely that Roche Diagnostics China would transition to a direct sales model (ie, cutting out the distributors) due to:

    1) China remains primarily a relationship-driven economy. It is much more efficient to leverage the existing relationships and trusts formed by the distributors with hospitals than for Roche to build relationships from scratch.
    2) A direct sales model would require sizeable investments in logistics, warehousing and sales personnel. Any cost savings would likely be offset by the investment costs.
    3) According to the National Health and Family Planning Commission, China had over 26,000 hospitals across the country as of the end of May 2015. By comparison, the total number of all US registered hospitals in 2013 was less than 5,700. China is simply too large for any IVD supplier to cost-effectively engage in direct sales with hospitals.

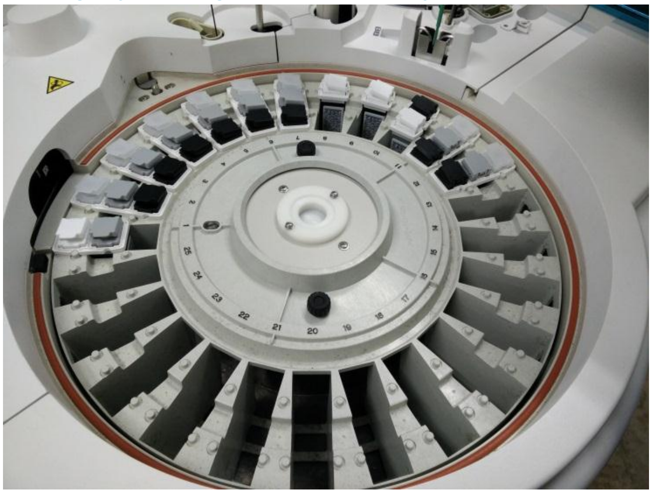
- **Leading R&D and customer service.** Roche Diagnostics is growing at roughly twice the rate of other major IVD brands in China (4-year revenue CAGR of 26% vs. c.13%). We attribute the brand's outperformance to 2 major factors:

1) Unlike other multinational healthcare companies, Roche Diagnostics is approaching its China expansion around innovation and differentiated products, instead of pursuing branded generic products. Roche Diagnostics is one of the largest investors in R&D in the world, and hence has a constant and innovative pipeline of new products. In 2014, Roche Group invested almost CHF9bn, or 19% of total sales in R&D, which is among the highest of any company in the world (Fortune Magazine even listed Roche Holdings as the 5th biggest spender of R&D globally, behind Volkswagen, Samsung, Intel and Microsoft in 2013). For diagnostics specifically, the company invested over CHF1bn, or almost 10% of total sales. As such, Roche Diagnostics is able to offer over 100 different tests in immunochemistry alone, which we believe is the broadest range selection of any single diagnostics company globally.
.
2) The company also puts a significant focus on customer service, which helps ensure a swift turnaround time whenever any problem arises with its diagnostics machines. For example, the largest department of Roche Diagnostics in Shanghai is after-sales service, and almost all of the maintenance and repair work for its IVD products are done in-house.

Roche Diagnostics: cobas 702 and 502 analyser modules

Source: Daiwa

Loading bays for reagents on Roche analytical equipment



Source: Daiwa

Supplier and customer stickiness

One of the major advantages to Yestar of partnering with Roche Diagnostics, in our opinion, is that an overwhelming portion of its revenue is derived from sales of reagents or consumable products, and hence is recurring by nature. The company adopts a razor-and-blade business model (or more simply understood, a “printer and ink” model, where the inks are the reagents) – analytical equipment is leased very cheaply to hospitals and most of the profits are generated subsequently by their continued purchase of reagents. According to Roche Diagnostics China, 90% of its revenue is generated from consumables. By comparison, Sysmex and Beckman generate 80% and 50%, respectively, of their revenue from consumables.

Almost all of Jiangsu Uno’s and Anbaida’s revenues are recurring by nature

Importantly, note that Roche Diagnostics’ reagents and other consumables can only be used in Roche Diagnostics’ analytical equipment. Hence, every machine installed is a source of future recurring revenue stream for Roche Diagnostics and its distributors. As a result, over 90% of Jiangsu Uno’s and Anbaida’s revenues are recurring revenue. In order to entice the use of Roche Diagnostics’ IVD products, Roche Diagnostics supplies the analytical equipment at a minimal cost to Jiangsu Uno and Anbaida for leasing out to end-users. For most cases however, the equipment rental fees are waived when the customer reaches a certain level of purchase amount for IVD consumables.

In our opinion, this razor-and-blade business model enhances the customer stickiness of using Roche Diagnostics' IVD products, as customers are incentivised to meet a certain level of reagent commitment in order to waive their equipment fees – which in turn, increases the revenue visibility of Jiangsu Uno and Anbaida. Compared with buying the machines outright, a razor-and-blade model also relieves hospitals from a major upfront investment, which can often be a decision factor for lower-tier hospitals in China.

In addition to customer loyalty, we believe the supplier-distributor relationship between Jiangsu Uno/Anbaida and Roche to also be quite secure. We note that even though Jiangsu Uno and Anbaida's distributor contract is typically signed for 1 year and renewed on a yearly basis, unless the companies miss their annual targets significantly, we believe it is highly unlikely that Roche Diagnostics would change its distributors. This is because for all the reagent business that hospitals commit to, the contracts are signed with the distributors (Anbaida or Jiangsu Uno), and are usually on a multi-year basis. Hence, if Roche Diagnostics decides to change its distributor, it would have to forego or disrupt the supply agreements with the all the hospitals in the distributor's network.

Profit guarantees ensure strong net profit growth

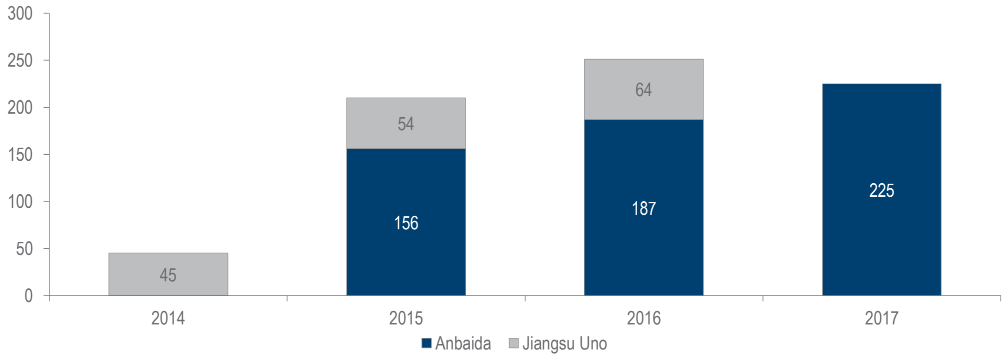
For each of the acquisitions, management negotiated a profit guarantee from the sellers, to ensure a certain level of net-profit growth for 3 years, from the year of purchase. If the profit levels do not meet the guaranteed level that was pre-determined, the sellers have agreed to compensate Yestar double the difference. The profit guarantees alone, make up 58-74% of our net-profit forecasts for 2015-17E (although we expect an increase in amortisation expenses on the acquired intangibles to weigh on group-level net profit growth).

Profit guarantees embedded in both transactions ensure solid earnings growth through 2017E

For both Jiangsu Uno and Anbaida, their first year of profit guarantees (2014 and 2015, respectively) implies a substantial 60-62% YoY growth rate. We note that this jump in net profit is due to different reasons. For Jiangsu Uno, the implied 62% increase in net profit is largely due to the consolidation of businesses from Nanjing Uno, another company of the sellers that held some of the IVD business contracts. Yestar would not be acquiring Nanjing Uno directly, but instead has required the seller to transfer all of Nanjing Uno's business to Jiangsu Uno, and dissolve the company within 1 year. For Anbaida, the 62% growth rate is largely a result of a sizeable increase in machine installs in 2014 and 1H15.

For the 2 years following the first, the level of profit guarantee is benchmarked to the approximate rate of growth of the IVD industry in China, which is around 20%. According to Renub Research, the IVD industry in China would grow from USD2.6n in 2013 to USD6.3bn in 2018, implying a CAGR of 19.2%.

Yestar: profit guarantees from the Jiangsu Uno and Anbaida acquisitions (CNYm)



Source: Company

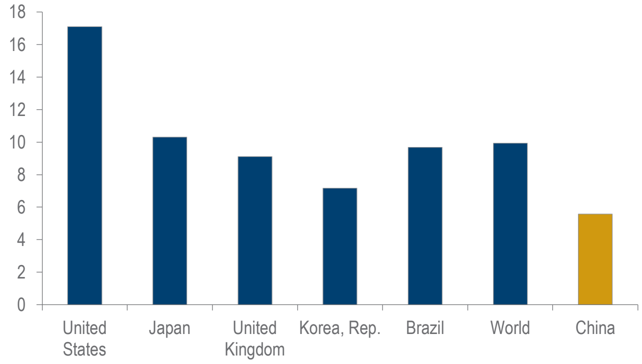
If all the profit guarantees are met, Yestar will acquire the remaining 30% stakes of both companies at a 10x PER on their third year of earnings

For each of the acquisitions, if the profit guarantees are met for all 3 years, it is stipulated in the sales and purchase agreement that Yestar will acquire the remaining 30% at a price equivalent to a PER of 10x on the third year's profit guarantee. For Anbaida, the acquisition cost is fixed at CNY675m, while for Jiangsu Uno, the actual purchase price would depend on the actual net profit of 2016 (still based on a 10x PER), up to a maximum of CNY250m.

Strong industry tailwinds

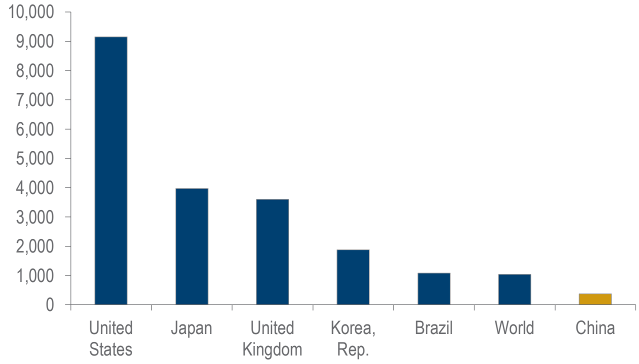
With the rapid rise in GDP, household incomes, and standards of living in China, the health care sector is one of the fastest growing industries in China. Deloitte estimates that health care expenditure in China will grow at an average rate of 11.8% from 2014-18, reaching USD0.9tn by 2018, while McKinsey & Co forecasts health care spending to reach USD1.0tn by 2020 from USD0.36tn for 2011, implying a CAGR of 12.1%. Nonetheless, both as a percentage of GDP and on a per-capita basis, China's health expenditure still lags that of many of the major countries, and we believe there is still a long way to go in terms of health care investments.

Health expenditure as % of GDP (2013)



Source: World Bank

Health expenditure per capita (USD) (2013)



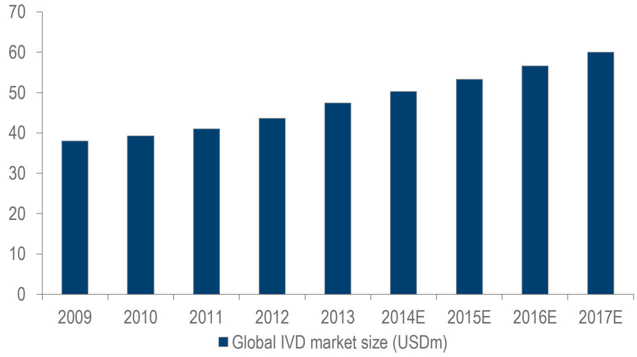
Source: World Bank

China's aggressive spending on healthcare is due to a mix of catch-up spending (the World Health Organization ranked China bottom fourth worldwide in government expenditure on health in 2006), an ambitious plan to provide affordable health care and universal basic health insurance, and to prepare for exponentially rising demand for health services resulting from rising standards of living and a looming aging population crisis. In 2009, the Chinese Government unveiled a CNY850bn plan to revamp its health-care system, and has subsequently rolled out a number of health-care reform targets. In March 2015, the government unveiled a new 5-year plan (2015-20), which among its many goals include encouraging investment in private hospitals in China and drastically increasing the number of hospitals beds in China (increase public hospital beds by 30% to almost triple the number of private hospitals beds).

China's aging population should drive incremental demand for immunochemistry diagnostics services, a field in which Roche Diagnostics excels

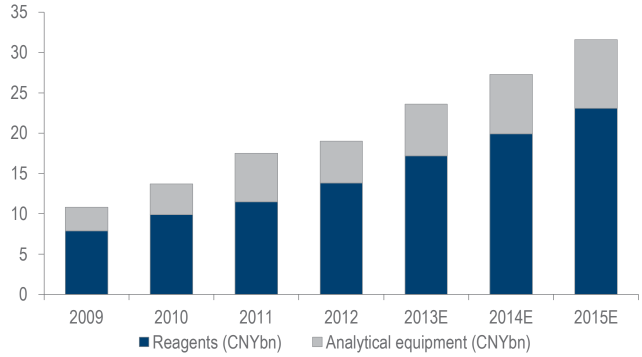
We believe the recent abandoning of the one-child-policy of over 30 years has highlighted the inherent challenges China is facing regarding its aging population and consequently, will drive ever-growing demand for diagnostics services. The shift to a two-child-policy was announced after the conclusion of the Fifth Plenum, and follows a third straight year of decline in China's working population in 2014. The United Nations forecasts China's elderly population (over 65 years old) to rise by 93% to 243m, between 2014 to 2030. It implies that the elderly proportion in China will increase from 9% to 17% of the entire population, over the same period. Many market observers, including Kevin Lai, Daiwa's in-house Chief Economist of Asia ex-Japan, believes the policy change has come too late, and will have a limited near-term impact on population growth. We believe a growing elderly population will primarily increase demand for immunochemistry diagnostics services (ie, testing for cancer and infectious diseases) – the segment in which Roche Diagnostics specializes.

Global IVD market size



Source: GlobalData: In Vitro Diagnostics Markets; EvaluateMedTech

China IVD market size



Source: Kalorama Information, McEvoy & Farmer, Huidian Research

Globally, we estimate that the diagnostics industry makes up only around 1-2% of total health care expenditure; but this proportion is likely to gradually increase, driven primarily by growing investment in IVD in emerging markets, which are still at a relatively early stage of adopting various IVD technologies. In fact, most of the diagnostics sales growth of multinational companies in 2015 is already being driven by emerging markets. For the 9 months ending September 2015, Roche Diagnostics' recorded sales growth of 13% YoY in Latin America and 15% YoY in Asia Pacific, whereas its revenue growth in North America, EMEA and Japan ranged from -5% to 4%.

China's public hospital reform should increase medical services

Given China's ambitious healthcare reform plans, we expect the country to remain one of the fastest growing countries for IVD in the foreseeable future. In the 4 years leading up to 2015, China's IVD industry revenue growth had already far outpaced that of the global IVD industry, rising at a CAGR of 16% vs. 6%. According to Renub Research, the revenue generated by the IVD industry in China will rise at a CAGR of 19.2% through 2018.

Starting on 6 May 2015, the Guiding Opinions on Pilot Comprehensive Reform of Urban Public Hospitals (guiding opinion) published by the State Council took effect. The guiding opinion made clear that one of its objectives is to overhaul the profit-driven model of public hospitals and reduce patients' medical expenditures. Public hospital revenue is derived primarily from three sources: income from drug mark-ups, government financial subsidies and medical service fees. The guiding opinion now requires the drug mark-ups be removed, in order to dis-incentivise prescribing more (and sometimes unnecessary) medicine just for increasing income.

After the public hospital reform in China, hospitals will be increasingly reliant on medical services, such as diagnostics tests, for income

In effect, public hospitals in China will likely see a significant decline in revenue over the next few years. Previously, hospitals were allowed to mark up drugs by up to 15%, with drug sales accounting for about 40% of total revenue. The guiding opinion aims to reduce this proportion to 30% by 2017 and hence, we believe public hospitals will have to resort to their 2 other revenue sources to make up for the lost revenue. However, in October 2015, the Ministry of Finance announced that it had allocated only CNY11.1bn to finance the public hospital reform, an amount that is deemed insufficient by a number of experts. To make up for the lost revenue, this leaves adjusting medical service fees, or increasing the volume of services, as the only option. Logically, we believe increasing diagnostics services and health checks would be an easy choice for public hospitals to supplement their lost revenue.

Traditional films business is a cash cow

Prior to its entry into IVD, Yestar's legacy business largely revolved around processing and distributing 3 main types of Fujifilm products: colour photographic papers, medical imaging products, and industrial imaging products. We view this business as Fujifilm's outsourced arm in China, providing a turnkey solution to Fujifilm's processing, distribution and marketing needs in the country. We estimate that 96% of 2014 revenue was derived from its legacy business (the 4% is Jiangsu Uno's 2-month consolidation), but we forecast this portion to fall to 62% in 2015E and 44% by the end of 2017E, as its IVD business picks up.

For all 3 product categories, Yestar's business model generally consists of:
1) Procuring master rolls of photographic paper and medical films directly from Fujifilm.
2) Converting the master rolls into sheets of customised ready-to-use sizes through slitting and cutting.
3) Packaging the products under Fujifilm or Yestar's own brand, Yes!Star.
4) Distributing and marketing the products to wholesalers, retailers, directly to end-users or in the case of its medical films, selling directly back to Fujifilm.

We believe the entry barriers for Yestar's legacy business are moderately high, largely due to the Hartono Family's lasting relationship with Fujifilm. With the Hartono's having done business with Fujifilm since 1971, we believe Fujifilm values the trust built over the years with both the Hartono Family and Yestar. Hence, we think it unlikely that Yestar will have a diminished role in Fujifilm's film operations in China. Another barrier is the technological knowhow in dealing with delicate film products, such as processing and storing film products under precisely controlled illumination levels, temperatures, humidity and dust levels. Other major brands such as Kodak and Lucky (a local brand) process their own films in China, as they are considered a trade secret.

Its legacy films business has historically generated CNY36-113m in cash flow from operations

From 2010-14 when almost all of its segments were derived from its films business, operating cash flow before working capital increased steadily from CNY40m to CNY168m, while net cash flow from operations ranged from CNY36m to CNY113m. Going forward, we expect the strong cash-generating ability of Yestar's legacy business to be maintained, which would help fund the expansion of its IVD business.

Exclusive distributor of Fujifilm's colour photographic paper in China

Yestar's colour photographic paper segment is the most mature, and contributed 40% of the company's revenue in 2014. Since June 2009, almost all of the processing and distribution of Fujifilm's colour photographic paper in China has been done by Yestar. Four years later, the company was officially appointed the sole and exclusive distributor of Fujifilm colour photographic paper in China.

Colour photographic paper is dominated by 3 players in China, the largest being Fujifilm which we estimate to have a c.45% market share in 2014, followed by local-brand Lucky with c.30% market share and Kodak with c.20%. Yestar's management is targeting to bring the company's market share up to around 60% by 2017, by lowering prices, but this would likely be at the expense of its gross margin (which we forecast to decline from 21.6% in 2014 to 15.7% in 2015E). We expect largely muted growth from its colour photographic paper segment in 2015-17E, given the structural decline in demand for films.

The organic growth of its legacy films business should be driven by its medical film products

For its legacy films business, the bright spot is Yestar's medical films products, which are used in diagnostics imaging such as x-rays, and the revenue from this business is now consolidated under medical consumable products. We estimate that medical films contributed 43% of total revenue in 2014 and forecast 10-15% YoY revenue growth for 2015-17E, driven by the increase in diagnostics services in China.

Expect more M&A to come

Judging by the willingness of Yestar's management to pursue M&A to bolster top and bottom line growth, we expect Yestar to conclude more M&A deals over the next few years. Note that we have not factored any M&A into our forecasts, but do expect at least 1 M&A deal to be done in 2016. In our opinion, any M&A announcements would be a positive share-price catalyst for the stock.

From a deal-sourcing standpoint, we believe Yestar has a strong track record so far. The acquisitions of Jiangsu Uno and Anbaida were both earnings-accretive and transacted at reasonable next-year PERs of 6.5x and 7.0x, respectively (based on Jiangsu Uno's 2015 and Anbaida's 2016 profit guarantees). We note that the acquisition multiples were in line with a precedent transaction conducted by an A-share listed peer in 2012. Humanwell Healthcare (Group) Co Ltd (600079 CH, not rated) acquired an 80% equity stake in Beijing Baron Medical Equipment (Beijing Baron) for CNY776m. At the time of the acquisition, Beijing Baron was Roche Diagnostics' largest distributor in China and the acquisition also included a 3-year profit guarantee. Its next-year acquisition PER (based on its 2013 profit guarantee) was 6.9x.

Given the significant growth prospects of Yestar's IVD business, we expect the next acquisition to again be a distributor of IVD consumable products. We believe the industry is ripe for consolidation, given the high fragmentation (we estimate that there are over 300 IVD supply distributors in China). Our discussions with management have led us to believe that Anbaida's deal size is likely the upper limit in the near term, and we would expect the size of the next acquisition to be closer to Jiangsu Uno's (CNY200-400m). We believe the next acquisition will be restricted by the amount of debt financing the company can raise. As the company already completed a private placement in July 2015 to fund the 2 acquisitions (net proceeds of CNY904m), we do not expect it would do any more equity financing over the near term. Alternatively, we see plenty of room to raise debt considering its low net debt-to-equity ratio, particularly as a result of its now enlarged equity base.

We believe Yestar has plenty of room to raise debt to fund future acquisitions

As of the end of 1H15, the company had net debt of CNY148m. When we take into account the net proceeds of CNY904m through the private placement in July 2015 and all the expected cash flows in 2H15, we forecast Yestar to return to a net cash position of CNY16m by the end of 2015. On the other hand, we expect total equity to triple from the end of 2014 to CNY1.0bn by the end of 2015, implying lots of room to raise its net debt-to-equity ratio. However, we would point out that the actual equity figure in 2015 is subject to 2 swing factors: 1) the outcome of the purchase price allocation of Anbaida by its auditors, which would determine the amount of intangible assets and goodwill of the acquisition, and 2) the fair value of the right to dispose of the 30% remaining equity interest in Jiangsu Uno and Anbaida held by the sellers. Given that this is a future cash outflow obligation for Yestar, its accountants have considered this as a financial liability, and its change in fair value is charged to equity.

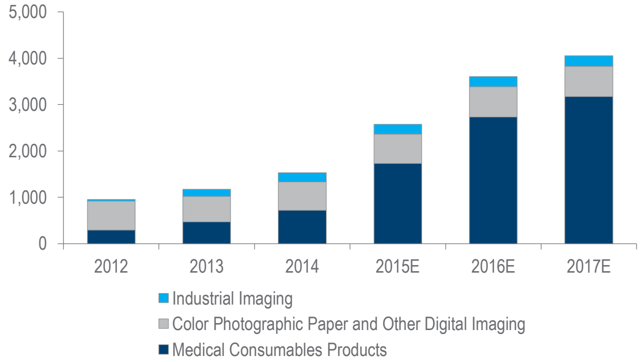
Note that even in the unlikely event that there are no additional acquisitions, Yestar's obligated purchase for the 30% stakes of Jiangsu Uno and Anbaida (assuming the profit guarantees are met) would provide another boost to net profit growth. Our 2017 forecasts do not yet factor in the acquisition of the remaining stake of Jiangsu Uno, but will do so as its results prove that it is likely the profit guarantees will be met.

Solid top and bottom-line growth outlook

38% revenue CAGR from 2014-17E

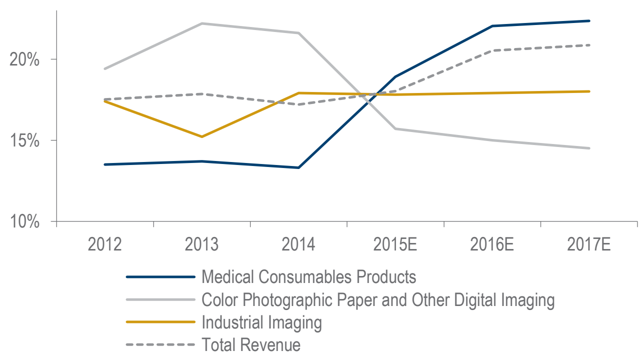
We forecast a 68% YoY jump in Yestar's revenue for 2015 due to a full year contribution from Jiangsu Uno and an approximate 5-month contribution by Anbaida. For 2016E and 2017E, we look for 40% and 12% YoY growth, respectively. Revenue growth for both companies should be driven primarily by rising demand for Roche Diagnostics' products in China (Roche Diagnostics' expects its China revenue to continue growing at 20%+ in the near term), an expanding scope of IVD products and categories, and an increased hospital network penetration within each of their respective distribution regions.

Yestar: revenue forecast (CNYm)



Source: Daiwa forecasts, company

Yestar: gross margin trend



Source: Daiwa forecasts, company

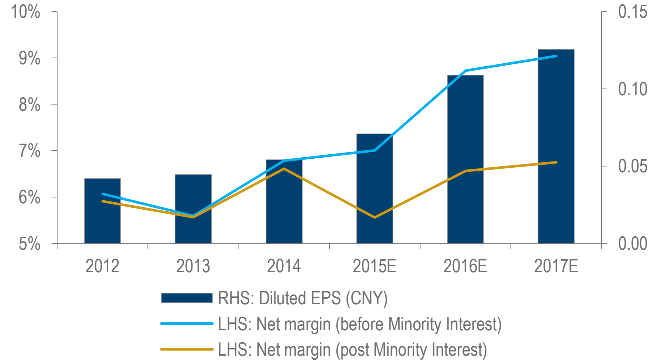
We believe Jiangsu Uno and Anbaida still have plenty of leeway to expand their hospital networks. Both companies operate in regions that are favourable in terms of hospital count: as of May 2015, Jiangsu and Anhui provinces had respectively the 3rd (with 1,535 hospitals) and 13th (985 hospitals) most hospitals in the country, while Shanghai had 336 hospitals (of which there are relatively more top-tier hospitals). So far, both companies have concentrated on penetrating Class III (top tier) and to a lesser extent, Class II, hospitals, where the demand for high-end IVD devices is the strongest, but we note that Class III and Class II hospitals combined typically only account for around one-third of the total number of hospitals. We believe Class I hospitals alone make up another 30% of hospitals, and we expect these hospitals to see an increasing number of patients to conduct non-complex or non-life-threatening procedures, such as IVD tests. This is in line with the government's public hospital reform to free up resources and hospital beds at top-tier hospitals.

We note that Anhui Province appears to have the biggest room for growth, as Jiangsu Uno only has coverage of around 64 hospitals and clinics, while we estimate that there are over 200 Class III and Class II hospitals in the province. Management is aiming to add at least 30 hospitals in Anhui and Jiangsu, as well as 12 more sub-distributors in 2016, which implies at least a 16% YoY increase in its hospital and clinic network distribution.

By our estimates, Anbaida and Jiangsu Uno combined distributed about 11-13% of Roche Diagnostics' products in China in 2014 (derived from our estimates of Anbaida and Jiangsu Uno's cost of goods sold vs. Roche Diagnostics' diagnostics revenue in China), which Yestar's management believes already represents Roche Diagnostics' largest distributor in the country. Yestar believes it can raise this up to 30% of Roche Diagnostics' revenue in China. Note that while expanding its business with Roche Diagnostics is Yestar's focus in the near term, the company will concurrently be ramping up its distribution of Becton Dickinson products for Jiangsu Uno and Thermo Fisher for Anbaida, which should supplement its revenue growth. Further, neither Jiangsu Uno nor Anbaida have exclusivity with any of the brands they distribute for, and hence in the long term, can leverage its sales network to distribute products for other major brands.

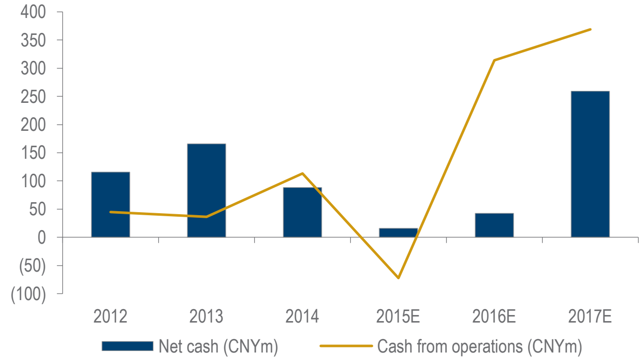
Organically, we expect its combined legacy businesses (medical films, colour photographic paper and industrial imaging) to grow by 9% YoY, supported primarily by its medical films business. However, we look for revenue growth to slow to 6% YoY and 5% YoY for 2016E and 2017E, respectively, given the structural decline in demand for colour photographic paper and weaker demand growth of industrial imaging products.

Yestar: net profit trend



Source: Daiwa forecasts, company

Yestar: net cash and cash flow from operations



Source: Daiwa forecasts, company

We forecast the company's blended gross margin to rise from 17.2% in 2014 to 20.9% in 2017E, driven primarily by the increasing contribution from Yestar's new IVD businesses, as both Jiangsu Uno and Anbaida have substantially higher gross margins than Yestar's legacy business. Anbaida appears to be most profitable with a gross margin of 34% in 2014, which is roughly double the gross margin for its legacy business. This is also greater than Jiangsu Uno's gross margin of around 20%, which we attribute to Anbaida's more comprehensive coverage of top-tier hospitals and more higher-end products sourced.

39% earnings CAGR from 2014-17E

Depending on the amount of intangible assets that will be arising from the Anbaida acquisition, it could be a swing factor to our earnings estimates, given the increase in amortisation expense

Similarly, Yestar's consolidated net margins should also expand as the bottom-line profitability of the new IVD businesses is much higher than that for the legacy businesses (we estimate an 11-15% net margin for Jiangsu Uno and Anbaida vs. 6-7% for its legacy business). We look for a net margin of 7.0% for Yestar in 2015, up only slightly from 6.8% in 2014, but subsequently rising to 9.0% by 2017E. We expect the net margin improvement in 2015 to be mild because of a sizeable increase in amortisation costs from the acquired intangible assets of Anbaida that would hit the P&L at the group level. In reality, we believe this could be a swing factor for our net-profit forecasts, as Yestar's auditors have yet to conduct a purchase price allocation to determine the amount of intangible assets to be recognized. In our model, we assume CNY700m of additional acquired intangibles in 2015E.

After netting out the non-controlling interest, we expect the net margin attributable to shareholders to temporarily dip to 5.6% in 2015E (from 6.6% in 2014) before trending back up to 6.7% in 2017E. This equates to net-profit growth of 39% CAGR from 2014-17E and implies that the net profit guarantees alone from the acquisitions would contribute 58-74% of our net earnings over the same period.

Our forecasts currently assume flat net margins for Jiangsu Uno and Anbaida throughout 2015-17E (11% and 15%, respectively), but judging by the profitability of some IVD peers, there may be upside to our forecasts. At the time of Beijing Baron's acquisition by Humanwell Healthcare in 2012, Beijing Baron had net margins of over 20%. We also reference the average net margins of our China-listed IVD peer group, which is 19%.

Due to the Anbaida acquisition, we expect cash flow from operating activities to temporarily dip to negative territory in 2015, before resuming positive operating cash inflow in 2016-17E. We forecast a significant net working capital drawdown of CNY330m in 2015E, due to a substantial increase in trade receivables and inventories. We note that in general, the IVD businesses have a longer cash conversion cycle, primarily caused by lengthier credit terms (90 days vs. 2-3 weeks for the legacy business).

Valuation

Taking into account Yestar's above-market earnings growth rate, our 30x target PER looks undemanding

We initiate coverage with a Buy (1) call and 12-month target price of HKD4.00. We value Yestar at a PER of 30x on our 2016 EPS forecast, equivalent to about a 50% discount to the average trading PER of China-listed IVD peers, but a 50% premium to Hong Kong-listed medical device suppliers. When considering the earnings growth potential of Yestar and its peers, we believe our target multiple is undemanding. We forecast 31% YoY and 54% YoY EPS growth for 2015E and 2016E, respectively, which is far higher than the corresponding average EPS growth rates of the 2 peer groups. When averaging the EPS growth rates of 2015 and 2016, we obtain a 2015 PEG ratio of 0.8x, which is substantially lower than the 1.3x of Hong Kong-listed medical device suppliers and 3.7x of China-listed IVD players.

Yestar: valuation comparisons

	Company Name	Ticker	Last Price	Market Cap (US$m)	P/E Ratio LTM	P/E Ratio FY1	P/E Ratio FY2	EV/EBITDA LTM	EV/EBITDA FY1	EV/EBITDA FY2	Div. Yield (%) FY1	ROE (%) FY1	Average EPS growth of FY1/FY2	PEG Ratio FY1
Hong Kong-listed Medical Product Suppliers														
1	SHANDONG WEIGAO GP MEDICAL-H	1066 HK	5.66	3,269	18.9	17.3	14.9	n.a.	11.4	9.9	1.5	11.5	18.1	1.0
2	LIFETECH SCIENTIFIC CORP	1302 HK	1.63	841	n.a.	70.2	46.8	46.0	57.5	28.6	n.a.	41.3	50.0	1.4
3	SSY GROUP LTD	2005 HK	1.97	716	13.5	11.2	9.1	8.7	7.6	6.6	4.2	17.5	5.0	2.2
4	MICROPORT SCIENTIFIC CORP	853 HK	3.33	612	n.a.	142.8	25.2	25.5	17.9	11.2	-	(1.6)	107.1	1.3
5	PW MEDTECH GROUP LTD	1358 HK	1.73	373	11.9	10.8	9.2	6.9	6.8	6.0	1.0	11.1	23.0	0.5
				Average:	**14.8**	**50.4**	**21.0**	**21.7**	**20.2**	**12.5**	**1.7**	**16.0**	**40.6**	**1.3**
				Median:	**13.5**	**17.3**	**14.9**	**17.1**	**11.4**	**9.9**	**1.3**	**11.5**	**23.0**	**1.3**
China-listed IVD Players														
1	DA AN GENE CO LTD SUN YAT-A	002030 CH	47.19	4,889	225.5	152.2	126.3	n.a.	159.4	112.8	n.a.	16.5	26.1	5.8
2	ZHEJIANG DIAN DIAGNOSTICS-A	300244 CH	85.54	3,628	183.3	115.6	93.0	126.8	94.6	72.2	n.a.	20.0	41.4	2.8
3	SICHUAN MAKER BIOTECHNOLOG-A	300463 CH	112.28	3,283	73.0	70.9	56.7	n.a.	51.4	41.7	n.a.	27.7	23.6	3.0
4	NINGBO MEDICAL SYSTEM BIOT-A	300439 CH	44.40	2,373	49.5	90.6	73.3	74.0	63.6	51.7	n.a.	27.5	26.5	3.4
5	SHANGHAI KEHUA BIO-ENGINEE-A	002022 CH	29.21	2,354	62.3	46.9	38.8	n.a.	33.7	27.6	0.8	20.3	13.4	3.5
6	BEIJING STRONG BIOTECHNOLO-A	300406 CH	44.02	1,729	48.1	n.a.	n.a.	40.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7	XILONG CHEMICAL CO LTD-A	002584 CH	42.89	1,578	110.7	80.2	54.5	81.5	59.3	42.7	0.5	8.4	42.6	1.9
8	BEIJING LEADMAN BIOCHEMIST-A	300289 CH	19.80	1,324	58.5	54.2	46.8	39.7	32.8	29.3	0.3	14.7	11.8	4.6
9	DIRUI INDUSTRIAL CO LTD-A	300396 CH	51.03	1,230	69.3	59.3	49.0	73.0	n.a.	n.a.	0.5	11.8	13.4	4.4
				Average:	**97.8**	**83.8**	**67.3**	**72.5**	**70.7**	**54.0**	**0.5**	**18.4**	**24.9**	**3.7**
				Median:	**69.3**	**75.5**	**55.6**	**73.5**	**59.3**	**42.7**	**0.5**	**18.3**	**24.9**	**3.5**
Hong Kong-listed Pharma/Medical														
1	SINOPHARM GROUP CO-H	1099 HK	32.90	11,744	21.7	19.8	16.8	10.6	9.9	8.5	1.4	12.9	19.5	1.0
2	SHANGHAI PHARMACEUTICALS-H	2607 HK	18.66	7,986	14.2	14.3	12.6	n.a.	12.4	11.3	1.9	9.6	11.5	1.2
3	SINO BIOPHARMACEUTICAL	1177 HK	10.10	6,439	27.3	26.9	22.7	18.3	15.0	12.5	0.8	24.9	20.1	1.3
4	SIHUAN PHARMACEUTICAL HLDGS	460 HK	4.39	5,874	16.3	18.0	14.9	14.3	11.3	10.6	1.4	22.4	22.6	0.8
5	GUANGZHOU BAIYUNSHAN PHARM-H	874 HK	20.50	5,608	16.9	16.4	14.6	20.8	20.7	18.3	1.3	14.8	12.0	1.4
6	CSPC PHARMACEUTICAL GROUP LT	1093 HK	7.03	5,361	26.7	24.2	19.4	16.4	14.6	12.2	1.6	19.4	28.7	0.8
7	CHINA MEDICAL SYSTEM HOLDING	867 HK	11.16	3,581	18.8	20.6	16.7	17.7	18.6	15.1	1.7	22.1	23.1	0.9
8	TONG REN TANG TECHNOLOGIES-H	1666 HK	12.40	2,049	25.0	23.7	20.6	13.1	13.2	11.7	1.6	14.1	16.3	1.5
9	CHINA SHINEWAY PHARMACEUTICA	2877 HK	10.32	1,101	10.0	10.1	9.8	5.6	4.5	4.4	5.2	13.5	n.a.	n.a.
10	THE UNITED LABORATORIES INTE	3933 HK	4.36	915	27.6	11.3	9.9	8.0	8.2	7.7	-	7.5	11.0	1.0
				Average:	**20.4**	**18.5**	**15.8**	**13.9**	**12.8**	**11.2**	**1.7**	**16.1**	**18.3**	**1.1**
				Median:	**20.2**	**18.9**	**15.8**	**14.3**	**12.8**	**11.5**	**1.5**	**14.5**	**19.5**	**1.0**
	YESTAR INTERNATIONAL HOLDING*	2393 HK	3.09	867	**39.2**	**35.8**	**23.3**	**26.1**	**18.0**	**10.6**	**1.7**	**21.7**	**42.5**	**0.8**

*Source: Bloomberg, *Daiwa forecasts*
Note: As of 9 November 2015

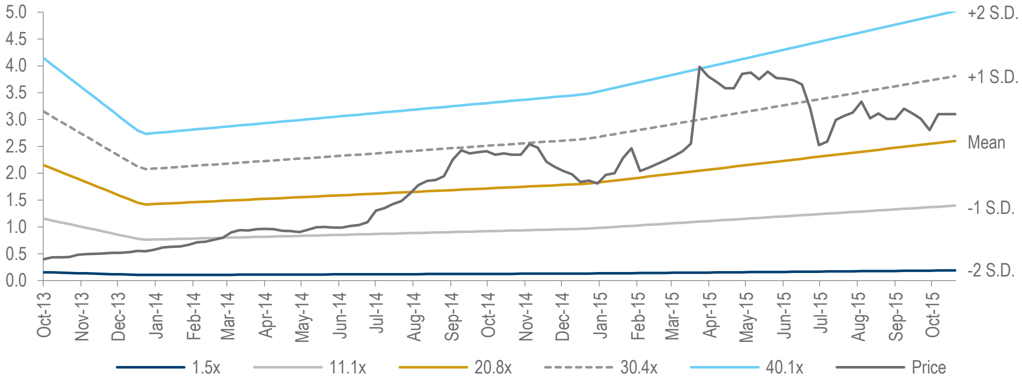
Additionally, we believe Yestar deserves to trade at a premium to the Hong Kong-listed health care plays because of:

1) **Its scarcity premium.** There are no other direct peers listed in Hong Kong that provide direct exposure to China's IVD industry, which is growing substantially faster than the overall health care sector (19% revenue growth rate vs. 12% for the industry).
2) **High ROE.** We forecast Yestar's ROE in 2015 is significantly higher than the average of Hong Kong medical product suppliers (22% vs. 16%). This is particularly impressive considering the private placement during the year.
3) **Tuck-in acquisitions to boost earnings growth.** Our forecasts do not take into account the possibility of more roll-up acquisitions, which we do believe is very likely given the company's track record.

Since its IPO, Yestar has gone through a significant multiples expansion as it transitioned into a high-growth China medical stock

Our 30x PER is 1SD above its 1-year forward trading average since its IPO

1-year forward PER Band Chart



Source: Daiwa forecasts, Bloomberg

Risks

The primary risks to our Buy (1) call are the inability for Yestar to sustain positive earnings growth for the 2 IVD companies recently acquired, and a faster-than-expected structural decline in the use of film products in China.

Secondary risks include:

- **Dilution from private placements.** If Yestar were to pursue more deals that were of roughly the same size as Anbaida, the company could be required to seek alternative sources of financing other than debt, such as another round of equity financing, which could dilute earnings.
- **Heavy dependence on 2 parties for revenue.** At present, almost 100% of the revenue of Yestar is linked to Fujifilm Group and Roche Holdings; hence any disruption to their business relationship may impact future revenue growth.
- **Concentrated shareholdings.** On 11 February 2015, the company was required by the Securities and Futures Commission to warn investors of a high concentration of shareholding by a small number of shareholders. While the private placement in July 2015 has since changed the shareholding ratios, other than the Hartono Family and a group of 16 shareholders, only about 8% of shares were held by “other shareholders” (ie, public, minority shareholders) as at February 2015. The concentrated shareholdings could be a source of unwanted volatility.

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