Corporate Snippet

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Kennedy Tsang
(852) 2533 3713
kennedytsang@sbie2capital.com

One-of-a-kind healthcare acquisition — Hong Kong Conglomerates

SIIS (648 HK, HK$0.180) — Not Rated

Acquiring specialized cancer diagnosis and treatment medical centres. SIIS announced that it has conditionally agreed to acquire China Renji (Renji) for an aggregate consideration of not more than HK$641.0m, subject to valuation adjustments. Renji is an investment holding company, whose sole asset is Anping Medical, a China-based company principally engaged in the management and operation of medical centres, specializing in the diagnosis and treatment of tumour/cancer in cooperation with renowned hospitals.

Table 1: Breakdown of consideration

Item	HK$m
Cash	50.0
2,710m consideration shares at issue price of HK$0.10 each (49.5% discount to last trading price of HK$0.198)	271.0
Balance of HK$320.0m by the issue of bonds (three year maturity with a coupon rate of 3% p.a. payable semi-annually)	320.0
Total	**641.0**

Source: SBI E2-Capital

Additional placing agreement. At the same time, SIIS has entered into an agreement to place 1,500m new placing shares (with an option to place an additional 500m placing shares) to not less than six investors. The placing price of HK$0.125 per share represents a discount of 36.9% to the last trading price of HK$0.198. The net proceeds of about HK$177.5m (placing option not exercised) or HK$237.5m (placing option exercised in full) will be used to expand Renji's medical treatment business including: 1) purchase of medical equipment for diagnosis and treatment of tumour/cancer; 2) setting up new tumour/cancer medical treatment centres and 3) acquisition of hospitals in China.

Renji's management to become largest shareholder. On completion of the acquisition, Renji's management will become the largest shareholder in SIIS with a 22.93% stake, assuming the placing option, all outstanding share options and convertible bonds are exercised in full. Renji will have a right to nominate three executive directors to the board, with one of them nominated as co-chairman.

Table 2: Fully diluted share calculation after completion of acquisition

	At date of announcement		On completion of acquisition	
	No. of shares (m)	%	No. of shares (m)	%
Directors	15.1	0.3	334.8*	2.8
Placees	-	-	2,000.0	17.1
Vendor	-	-	2,710.0	22.9
Public	5,011.5	99.7	6,763.4**	57.1
Total	**5,026.6**	**100.0**	**11,808.2**	**100.0**

** Assumes the full exercise of 319.8m share options held by the directors*

*** Assumes the full exercise of 711.5m share options and the full conversion of convertible notes amounting to 1,080.5m shares*

Source: Company data and SBI E2-Capital

Profit guarantee and acquisition valuation. Renji has provided a net profit guarantee (after tax, extraordinary/exceptional items and MI) of HK$80.0m for FY12/07 and HK$150.0m for FY12/08. This translates to an acquisition valuation of 8.0x FY12/07 P/E and 4.3x FY12/08 P/E. However, we note that the acquisition is not expected to be completed until around end-Jul 2007, implying that only around five months of Renji's FY12/07 net profit will be consolidated into SIIS' FY12/07 P&L.

Investor friendly deal structure, with limited downside risk. In our view, the Renji deal is investor friendly, posing limited downside risk for SIIS listco because: 1) the initial cash outlay of HK$50.0m is not substantial; 2) Renji management becomes the largest shareholder in SIIS on completion of the deal and will nominate new executive directors to the board; 3) Renji management provides profit guarantees for FY12/07 and FY12/08 to provide investors with a valuation benchmark; 4) the deal provides prudent mechanisms for valuation adjustment in case profit guarantee is not reached for both years. In fact, the deal incorporates an exit clause for SIIS in the event that Renji's actual FY12/07 net profit is below HK$40.0m and 5) dilution of listco shares is one off. Bonds issued to Renji are not convertible into shares and the company may redeem them early without any premium/discount.

Table 3: Prudent deal structure for Renji acquisition

Item	Remarks
Prudent initial cash outlay by listco	❑ Though overall acquisition consideration is HK$641.0m, initial cash outlay is only HK$50.0m
Appropriate Renji representation on SIIS Board	❑ Renji management may nominate three new executive directors to the board, including one as co-chairman
Profit guarantee and valuation adjustment	❑ Renji deal offers profit guarantees, with mechanisms to adjust acquisition consideration if targets are not reached ❑ Exit clause for SIIS if FY12/07 net profit is less than HK$40.0m
Bonds do not further dilute share structure	❑ Bonds are not convertible into shares, ensuring that share dilution from the Renji acquisition is one-off. ❑ SIIS can early redeem bonds without premium/discount

Source: SBI E2-Capital

Table 4: Profit guarantee and valuation adjustment

Condition	Valuation adjustment
FY12/07: actual profit no less than HK$80.0m FY12/08: actual profit no less than HK$150.0m	❑ Profit guarantee achieved, no valuation adjustment
FY12/07: actual profit less than HK$70.0m	❑ Valuation adjustment: 7.0 x (HK$70.0 – actual FY12/07 profit) ❑ Vendor to pay company "valuation adjustment" in the form of: 1) cash payment; 2) forfeiting the amount in Consideration Shares which have been charged in favour of the company; 3) canceling the amount in outstanding Bonds; 4) any combination of items 1) to 3)
FY12/07: actual profit less than HK$40.0m	❑ SIIS has right to dispose of the entire share capital of China Renji ❑ China Renji will forfeit all the Consideration Shares, repay the Cash Consideration (HK$50.0m) and surrender the then outstanding portion of the Bonds to SIIS at nil consideration
FY12/08: actual profit less than HK$150.0m	❑ Valuation adjustment: 3.5 x (HK$150.0 – actual FY12/08 profit) ❑ Vendor to pay company "valuation adjustment" in the form of: 1) cash payment; 2) forfeiting the amount in Consideration Shares which have been charged in favour of the company; 3) canceling the amount in outstanding Bonds; 4) any combination of items 1) to 3)

Source: Company data

Background and expanding network of Renji. Renji operates and manages a network of medical centres focusing on the treatment of tumour/cancer. The company has specialty experience in the use of head/body gamma knife, linear accelerators and PET-CT for diagnosis and treatment. The company had a NAV of RMB150.4m, revenue of RMB22.7m and net profit of RMB12.9m based on unaudited accounts prepared under Chinese accounting standards according to the announcement. However, we understand that this did not represent a full year contribution as Anping Medical was incorporated only in 2H FY12/06. Moreover, it is conservative as the figures included only two medical centres (411 hospital and 455 hospital) in Shanghai that was in operation at the time. According to the management, FY12/06 net profit was HK$43.4m on a pro-forma basis. To date in FY12/07, the company has expanded its medical network by two centres (one in Shanghai, one in Jiangxi). In all, Renji aims to add five new centres in FY12/07. The company currently has around 220 full time employees, with 20+ full time specialists.

Table 5: Current facilities of China Renji

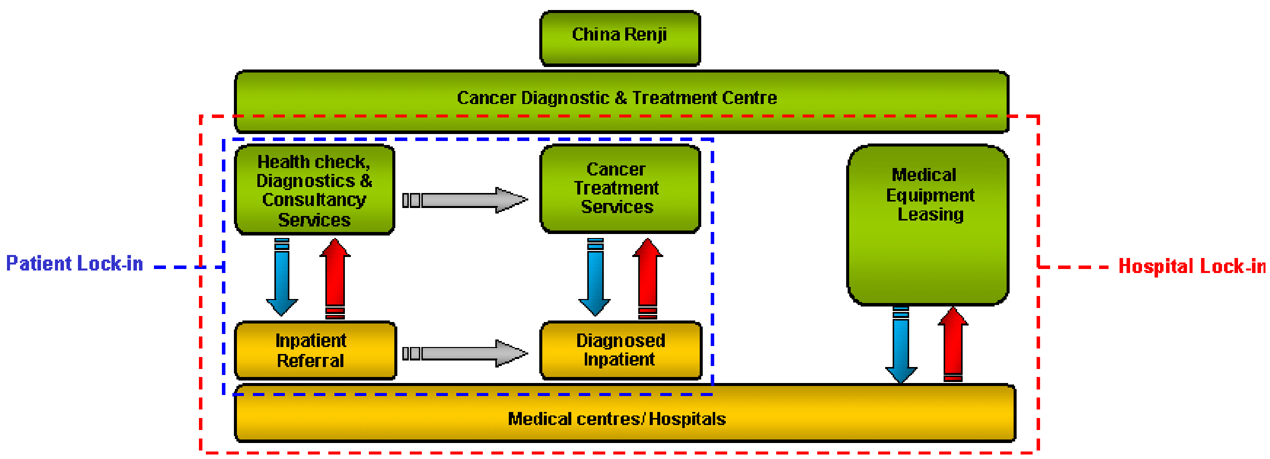
Centre location	Facilities	Operation date	No. of beds at hospital	No. of beds managed by Renji	No. of patients in 2006
411 hospital	1 x head gamma knife	Extg	600	100	1.7m
Puxi (East)	2 x body gamma knife	Extg			
455 hospital	1 x head gamma knife	Extg	750	100	2.9m
Puxi (West)	2 x body gamma knife	Extg			
Shanghai Renji	1 x head gamma knife	May 2007	1,200	150	n/a
(Pudong)	1 x body gamma knife	May 2007			
	1 x linear accelerator	Extg			
	1 x PET-CT Scan	Extg			
	1 x CT Simulator	Extg			

Source: Company data

Vertically integrated revenue model, with high margins. Renji sets up its medical centres within renowned hospitals and operates a vertically integrated business model commencing with healthcheck services upstream, through to medical diagnosis, consultancy and treatment services. This unique structure enables Renji to tie-in both patients and the hospitals, allowing it to integrate its cancer diagnosis and treatment services into the hospitals' operation process. Renji's revenue streams are three-fold, comprising: 1) equipment leasing; 2) management/medical consultancy and 3) hospital management fees. Under its profit sharing model, Renji is entitled to 25% as equipment leasing fees and around 20% as management/medical consultancy fees (depending on the mode of treatment) of the treatment fees from each cancer in-patient received by the hospital. Note that the revenue received from the hospital is net of all medical costs such as drugs, medical consumables, bed fees etc. and therefore, this cost structure allows Renji to command very high margins. Based on unaudited accounts, Renji's FY12/06A net margin was 56.8%.

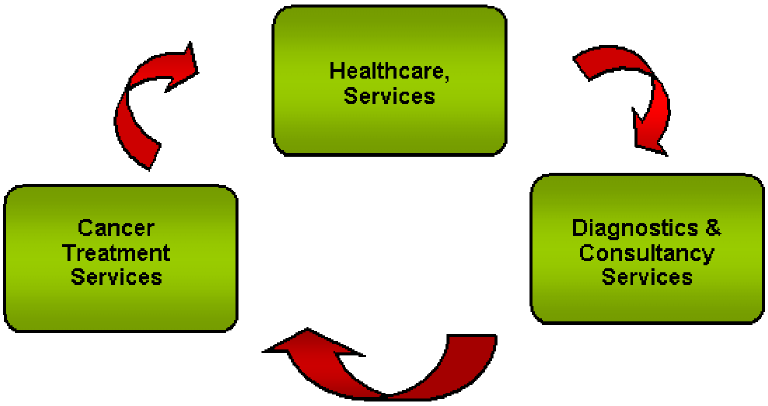
Health check centre will increase lock-in effect. Renji will open a new health check centre in May 2007, as an extension to one of its existing tumour/cancer diagnosis and treatment centres at Shanghai Renji Hospital. We expect healthcheck services to play an integral role in Renji's overall business model going forward. In our view, the healthcheck business is a low-risk, high-margin process which serves two purposes: 1) provides a stream of recurring income for Renji, which is expected to grow every year; 2) front-end services can double up to act as a screening operation and funnel additional cancer patients into Renji's tumour/cancer medical centres.

Chart 1: Vertically integrated business model



Source: Company data

Chart 2: Healthcare business driving lock-in effect



Source: Company data

Gamma knife advantages. The gamma knife, invented by Swedish neurosurgeon Lars Leksell in 1967, is the most widely known stereostactic radiosurgery system. It uses beams of gamma radiation and is most effective at treating tumours less that 30mm in size. The small wavelength of gamma beams and the mode of application allow it to achieve extreme accuracies of greater than 1mm, with minimal effect on surrounding healthy tissue. The gamma knife is often employed for treatment of brain tumours. The mode of treatment maximizes patient comfort, unlike open surgery, which require incisions, or chemotherapy, which tends to have heavy side effects.

Table 6: Gamma knife advantages

Advantages
❑ Treats cancerous tumours at an earlier stage, leading to higher chance of success
❑ No incision, no scars, no risk of haemorrhage or infection
❑ Treatment is painless and in most casts, requires no general anaesthetics
❑ Fast treatment time, high patient turnaround
❑ High accuracy, target rays reach only the tumor, not surrounding healthy tissue
❑ Can be used for inoperable tumours, vascular malformations, treatment of facial pain, focal epilepsy and Parkinson's disease

Source: Company data and SBI E2-Capital

Gamma knife ideal for cancer treatment in China. Another advantage of the gamma knife is its relatively fast treatment time of 15-30mins. Head gamma treatment typically requires only up to two courses while body gamma treatment requires six to eight courses. With China's scarce medical facilities (especially specialized ones) and a high incidence of cancer, a treatment method was needed to allow quick turnaround of patients with a high success rate. Gamma knife fitted the demand perfectly. The machine is robust, which is advantageous, given the limited government funding to hospitals. The first gamma knife machine in China was set up in the late 1960s and is still operational today. The machine costs around RMB12.0m to buy and install.

Cancer is no. 1 cause of death in China. According to China Health Statistical Yearbook of 2006, cancer was the top cause of death in China with a rate of 126.4 per 100,000 people, accounting for 24% of deaths in 2004. Meanwhile, medical healthcare expenditure per capita in the country was RMB582.2 in 2004 and RMB600.9 in 2005, up 13.8% YoY. During the same period, medical healthcare expenditure per capita as a percentage of overall expenditure per capita increased from 7.4% to 7.6%. This situation is likely to be further exacerbated by its rapidly aging population. Reports have suggested that people aged over 65 are expected to represent around 8.2% of China's population by 2010 (c.f. 7.5% in 2004). With an aging population, the incidence of potentially terminal illnesses, such as cancer, is expected to increase substantially.

Growing proliferation of health insurance. We expect demand for healthcare services, be it preventative, such as healthchecks, or reactive, such as cancer treatment, to grow significantly over the next few years, driven in part by the proliferation of health insurance in China. Chinese are naturally health conscious and traditionally willing to spend money on health. This appetite will rise with rising disposable incomes, growing healthcare preventative awareness, and more insurance products on the market. The government is encouraging individuals to cover healthcare costs through private insurance plans and as they become more affordable, demand for medical services will increase. According to the China Insurance Regulatory Commission, the nations' personal health insurance premiums grew at a three-year CAGR of 15.9% from 2004 to 2006. The government introduced initiatives in its 11th Five-Year Plan to improve healthcare facilities, especially in rural areas, which will provide a further boost to the industry as a whole.

Three-tiered expansion plan. The company has a three-tiered expansion schedule comprising: 1) new equipment purchases; 2) new tumour/cancer diagnosis and treatment centres and 3) acquisitions of hospitals. In its acquisition of hospitals, Renji deploys an innovative investment method. Rather than a straight up cash consideration, the company invests an agreed amount through setting up cancer diagnosis and treatment centres in return for a stake in the hospital. The company said it typically looks to acquire around 70% in target hospitals. It aims to set up five new tumour/cancer diagnosis and treatment centres in FY12/07, and is currently finalizing discussions to undertake the management of a chain of around 20 medical centres across China. We estimate that Renji's 2007 capex requirements will be about RMB206.0m. However, we note that the management is likely to revise this figure up once new funds become available.

Table 7: Renji's tentative capex requirements in FY12/07

Item	HK$m
Purchase of new equipment at existing centres	
411 and 455 hospitals in Shanghai	20.0
Establishment of new tumour/cancer diagnosis and treatment centres	
Jiangxi Renji	70.0
2 x Beijing centres	66.0
Zhenzhou Renji	20.0
Acquisition of hospitals	30.0
Total	**206.0**

Source: Company data and SBI E2-Capital

Renji is a more solid acquisition among comparables. Recently, a number of listed companies have acquired or diversified into healthcare operations. We believe SIIS' acquisition of Renji is the most prudent in comparison and offers: 1) most prudent acquisition valuation; 2) multi-year profit guarantees and exit clauses; 3) most extensive network; 4) more scalable business model; 5) most specialized healthcare service offerings and 6) most attractive current valuations. In terms of other comparables, Hua Xia's acquisition also of the St Edward Hospital in Chongqing is higher in terms of valuation, while HK Healthcheck's series of health centres in Hong Kong is unlikely to break even in fiscal year 2007. Meanwhile, details of Chun Wo's acquisition of Chengdu Friendship Hospital have yet to be released. Note that while SIIS' FY12/07F P/E valuation appears high, it only assumes a five-month contribution from Renji (assuming the deal is closed in July 2007). Moreover, it is underestimated in that it has not taken into account SIIS' existing business, which we expect to show a strong earnings rebound in FY12/07F. Based on our initial estimates, the FY12/07F P/E will narrow down to around 28.3x if results of SIIS' current businesses are taken into consideration.

Table 8: Local peer comparison

	SIIS	Hua Xia	HK Healthcheck	Chun Wo
Ticker	648 HK	8143 HK	397 HK	711 HK
Last Price	HK$0.180	HK$0.58	HK$0.405	HK$1.00
Description of service	Provision of healthcheck, cancer diagnosis and treatment services	Operation and management of hospital	Provision of healthcheck services in Hong Kong	Operation and management of hospital
Current extent of network	4 (Shanghai, Jiangxi)	1 (Chongqing)	1 (not including satellite centres)	1 (Chengdu)
Addressable market	China	China	Hong Kong	China
Acquired stake	100%	55%	Not through acquisition	100%
Acquisition consideration (HK$m)	641.0	157.3	n/a	49.1
Profit guarantee from acquisition	HK$80.0m (FY12/07F) HK$150.0m (FY12/08F)	HK$12.0m (FY3/08F) Nil (FY3/09F)	n/a	n/a
Acquisition valuation	9.2x (FY12/07) 4.3x (FY12/08)	13.1x (FY3/08)	n/a	n/a
Net profit	HK$30.0m* (FY12/07F) HK$150.0m (FY12/08F)	HK$21.99m (FY3/08F) HK$34.53m (FY3/09F)	n/a	n/a
Fully diluted EPS	HK$0.003* (FY12/07F) HK$0.013 (FY12/08F)	HK$0.014 (FY3/08F) HK$0.022 (FY3/09F)	n/a	n/a
Estimated Fwd P/E	70.9x (FY12/07F) 14.2x (FY12/08F)	41.1x (FY3/08F) 26.4x (FY3/09F)	n/a	n/a

* *HK$30.0m is based on a 5 month contribution of Renji into SIIS assuming the deal is closed in Jul 2007 and conservatively assuming no contribution from SIIS existing business*

Source: Company data, Bloomberg and SBI E2-Capital

SIIS to gradually dispose of current business segments. At a recent analyst meeting, SIIS has indicated that once the Renji acquisition is completed, the company will dispose of its current business segments, though no timetable was given. These include property holdings, garment manufacturing and financial services. Once this is completed, SIIS will be in a position to fully reflect its valuation as a pure China healthcare services play. Management has indicated that the proceeds from any disposals will be re-injected into the Renji business.

SIIS current businesses likely to surprise in FY12/07F. Our back-of-pad estimate of HK$30.0m for SIIS in FY12/07F is extremely conservative given that it does not consider any contribution from SIIS' existing business. However, we believe that this is likely to surprise on the upside. The company has already made provisions on its investment holdings, which clear the way for a "cleaner" P&L for FY12/07F. Our preliminary conservative estimate is that SIIS is in a position to record a net profit of HK$45.0m in FY12/07F.

Valuation and peer comparison. Based on the last trading price of HK$0.180, a HK$30.0m proportionate contribution from Renji in FY12/07F and the guaranteed HK$150m in FY12/08F, the counter is trading at 70.9x FY12/07F P/E and 15.6x FY12/08 P/E on a fully diluted basis assuming 11,808.2m shares. Note that the P/E valuation does not consider the current holdings of SIIS. If the preliminary FY12/07F net profit estimate of HK$45.0m is taken into consideration, the FY12/07F P/E valuation will drop to 28.3x. Other China-related hospital plays are trading at 40x+ estimate next year P/E and comparables from other emerging markets such as India are trading at 30x+ based on consensus estimates.

Execution - the largest risk factor. We see execution as the major risk. With aggressive expansion plans comprising several acquisitions and business structure changes, effective execution is paramount, both to solidify its first mover advantage and to meet predefined profit targets. Other risks include: 1) closure of the acquisition deal; 2) regulatory risk in the healthcare industry; 3) ability to secure employees with the necessary skills; 4) insurance liabilities; 5) significant escalation in market competition and 6) non-effective use of capital resources.

Previous fund raising activities. SIIS has previously conducted a series of fund raising activities, the latest of which was a HK$89.5m CB issued on 3 March 2007. The company currently has a total of three CBs outstanding, amounting to HK$108.5m. Of this, HK$5.0m is due to expire on 28 August 2008 (conversion price HK$0.11), HK$14.0m on 2 February 2009 (conversion price HK$0.10) and the remaining HK$89.5m on 3 March 2009 (conversion price HK$0.10).

Table 9: Valuation comparison

Company name	Ticker	Country	Mkt Cap (US$m)	Last price (local)	Est Curr Yr P/E (x)	Est Nxt Yr P/E (x)	P/B (X)
Pacific Healthcare	PACH SP	Singapore	72	SGD0.40	14.1	11.6	2.3
Thomson Medical	THOM SP	Singapore	128	SGD0.67	22.2	18.5	2.5
Raffles Medical	RFMD SP	Singapore	397	SGD1.42	28.0	22.0	5.2
Average					*21.4*	*17.4*	*3.3*
HK Healthcheck	397 HK	HK/China	138	HK$0.41	n/a	n/a	253.8
Quality Healthcare	593 HK	HK/China	110	HK$3.60	10.9	n/a	4.7
China Healthcare	673 HK	HK/China	55	HK$1.88	n/a.	n/a	13.7
Hua Xia Healthcare	8143 HK	HK/China	79	HK$0.58	90.8	41.5	8.6
Average					*50.8*	*41.5*	*70.2*
Apollo Hospitals	APHS IN	India	630	INR501.50	36.5	30.8	4.1
Average					*36.5*	*30.8*	*4.1*
Sonic Healthcare	SHL AU	Australia	2,747	AUD14.54	21.9	19.4	3.3
Ramsay Health	RHC AU	Australia	2,662	AUD11.29	20.6	17.2	3.2
Primary Health	PRY AU	Australia	1,154	AUD12.22	27.3	23.5	3.8
Average					*23.2*	*20.1*	*3.5*
Community Health	CYH US	US	3,309	USD35.18	15.1	13.5	1.9
Universal Healthcare-B	UHS US	US	3,207	USD59.71	19.5	17.3	2.3
United Surgical	USPI US	US	1,390	USD31.05	23.9	22.1	2.3
Average					*19.5*	*17.6*	*2.2*
Generale de Sant	GDS FP	Europe	2,382	EUR32.00	24.8	22.8	n/a.
Rhoen-Klinikum	RHK GR	Europe	3,188	EUR45.10	24.0	20.2	3.6
Average					*24.4*	*21.5*	*3.6*
Sector average					27.1	21.6	21.3

Source: Bloomberg

Table 10: P&L

Year to Dec (HK$m)	04A	05A	06A
Turnover	**109.1**	**112.4**	**140.2**
Cost of sales	(65.3)	(62.9)	(74.8)
Gross profit	**43.7**	**49.8**	**65.5**
Other revenues	3.6	2.6	15.2
Distribution costs	-	-	-
Administrative expenses	(61.1)	(73.4)	(84.3)
Other operating income/(expenses)	(3.3)	9.1	1.5
Exceptionals	30.4	(42.4)	(18.2)
Operating profit	13.3	(54.6)	(20.3)
Finance costs	(3.8)	(4.2)	(6.3)
Share of results from associates	(1.4)	(33.6)	(54.7)
Profit before taxation	**8.2**	**(92.4)**	**(81.3)**
Taxation	(1.1)	(0.8)	(2.1)
Profit after tax	**7.1**	**(93.2)**	**(83.4)**
Minority interests	(0.8)	(0.4)	0.4
Profit attributable to shareholders	**6.3**	**(93.6)**	**(83.0)**
% chg	*n/a*	*n/a*	*11.3*
Dividends	-	-	-

Source: Company data

Disclosure of interests: SBI E2-Capital acted as the sole bookrunner and joint placing agent for the SIIS placement of 1,500m new shares (including an option for an additional placement of 200m new shares which was exercised in full) at HK$0.125 per share on 25 April 2007.
An Executive Director of SBI E2-Capital Securities Ltd. is also an Executive Director of SIIS. SBI E2-Capital is a joint venture between SIIS and E2-Capital (Holdings) Ltd. (378 HK).