

China Renji: Acquisition of Hefei gamma knife centre

Recommendation: BUY (unchanged)

China Healthcare

| Price | HK\$0.154 | Year to | Net profit | EPS | EPS | P/E | P/B | EV/EBITDA | Yield | ROE | ROCE | N. Gear. |
|------------------|------------------|---------|------------|---------|--------|------|-----|-----------|-------|------|------|----------|
| Target price | HK\$0.45 (+192%) | Dec | HK\$m | HK\$ | Δ % | x | x | x | % | % | % | % |
| 12 mth range | HK\$0.057-0.335 | 05A | (93.6) | (0.022) | na | na | 9.3 | na | - | na | na | Cash |
| Market cap. | US\$223.7m | 06A | (83.0) | (0.018) | (19.3) | na | 8.0 | 353.0 | - | na | na | Cash |
| Daily t/o, 3 mth | US\$12.5m | 07F | (6.6) | (0.001) | 95.4 | na | 2.7 | 35.6 | - | 0.3 | 5.0 | Cash |
| Free float % | 74.6% | 08F | 159.5 | 0.013 | na | 12.0 | 2.0 | 7.6 | - | 21.1 | 14.8 | Cash |
| Ticker | 0648.HK/648 HK | 09F | 198.5 | 0.016 | 24.5 | 9.6 | 1.6 | 6.0 | - | 20.8 | 15.5 | Cash |

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +81.1%, -11.9%, -52.3%

Actual price changes (1 mth, 3 mth, 12 mth): -4.6 %, -42.8 %, +77.2%

Consensus EPS (07F-08F): HK\$0.008, HK\$0.013

Previous forecasts (07F-09F): (HK\$11.6m) (\$0.001), HK\$159.5m (\$0.013), HK\$198.5m (\$0.016)

Key points:

- Acquires the Hefei Gamma Knife Centre – second purchase after the deal with Beijing Er Pao CD&T centre.
- Hefei Hospital is currently the only facility in Anhui province offering gamma knife treatment, ensuring a large catchment area
- Consideration of RMB46.2m, representing 3.9x FY12/08F P/E, was lower than expected signaling that Renji's expanding network is strengthening its bargaining power in M&A negotiations.
- Renji's medical operating network now covers China's Huadong (eastern), Huabei (northern) and Huazhong (central) regions.
- Newly appointed INED, Dr Li Yang, brings substantial experience as a member of the Chinese Academy of Social Sciences (CASS) and Director General of the Institute of Finance and Banking (IFB). He is also previous member of the Monetary Policy Committee of the PBOC.
- The net profit contribution from this acquisition was in line with our expectations and we have left our FY12/08 estimate unchanged. We maintain our BUY call keeping our target price at HK\$0.45, representing 35.0x FY12/08F P/E. In our view, Renji is starting to demonstrate its execution ability and the current stock price offers a good entry level.

Acquisition of Hefei gamma knife centre. Hot on the heels of its Beijing Er Pao deal, China Renji (Renji) announced the acquisition of the Hefei Gamma Knife Centre on 12 October for RMB46.2m in cash. The move involves the 100% acquisition of cancer treatment medical equipment (one set each of head gamma knife, body gamma and MRI). In return, Renji will be entitled to 80% of net profit generated by the equipment, while the remainder will go to the current management of the CD&T centre. Renji preferred this arrangement rather than an 80% stake, as it wanted to wholly own the medical equipment.

Stronger bargaining power. The existing management has guaranteed the net income attributable to Renji at no less than RMB5.0m in 2H FY12/07 and RMB12.0m in FY12/08, in line with our expectations. This represents a valuation of 3.9x FY12/08F P/E, lower than expected and a sign that the company's broadening medical network is strengthening its bargaining power in M&A negotiations. If the net income falls below the guarantee in any of the two periods, Renji will be compensated in cash equal to 6x the difference between the actual net income and guaranteed net income. As of 30 Jun 2007, the net book value of the acquired equipment was RMB31.25m, implying a acquisition P/B valuation of 1.5x.

Large catchment area. Hefei Hospital is a standalone hospital that specializes in the use of gamma knives to treat cancer/tumours. It is the only hospital in Anhui offering such services. It covers Hefei municipality and adjacent Bangpu and Chaohu cities, as well as the northern and western regions of Anhui Province. This catchment area has an estimated population of over 30m. Its management team is led by Mr. Pan Mianshun, one of China's seven prominent gamma knife treatment experts.

Nationwide network. The acquisition will broaden Renji's medical network into a nationwide platform. With its operating base in Shanghai, the company's Er Pao CD&T centre covers Huabei (northern) region, while its newly acquired Hefei CD&T centre covers Huadong (eastern) region. Meanwhile, a minority stake in a CD&T centre in Nanchang gives the company access to Huazhong (central) region.

Table 1: Renji acquisition summary (since completion of Anping Medical acquisition)

| Project | Date | Acquired stake (%) | Consideration | Attributable profit guarantee | Acquisition valuation |
|-----------------------------|----------|--------------------|----------------------------------|---|-----------------------|
| Er Pao Hospital CD&T centre | Sep 2007 | 51.0 | RMB74.12m (cash + new shares) | RMB10.2m (FY12/08) | 7.3x FY12/08F P/E |
| Hefei Hospital | Oct 2007 | 100.0 | RMB46.2m (cash) | RMB5.0m (FY12/07) RMB12.0m (FY12/08) | 3.9x FY12/08F P/E |

Source: Company data, SBI E2-Capital

Improved screening ability in Anhui will boost patient numbers. According to the announcement, Hefei Hospital's net profit was RMB7.6m in FY12/05A and RMB8.3m in FY12/06A. Its gamma knife equipment was used to treat 680 patients in FY12/06A and 485 in the first seven months of FY12/07A. They attributed the comparative growth in these two years to the addition of an MRI machine at the end of 2005. The MRI allowed the hospital to increase its screening capability, allowing them to capture more cancer/tumour patients. We expect this patient growth trend to continue as Anhui Provincial Hospital has also recently added a Pet-CT machine to its facilities. Renji's Hefei Gamma Knife Centre should benefit, as patients identified by Anhui Provincial Hospital will be referred to Hefei Hospital for treatment. We expect sustained demand since gamma knife treatment is covered by the social insurance scheme of Hefei city.

New INED with substantial experience and reference. Renji has announced the appointment of an Independent Non-Executive Director with substantial background in China's medical and finance industries. Dr Li Yang (aged 56), currently serves as a member of the Chinese Academy of Social Sciences (CASS) and Director General of the Institute of Finance and Banking (IFB). Dr Li's other references include:

- ❑ Pluralistic Professor of Beijing University, Tsinghua University, Renmin University of China, Fudan University, Nanjing University and University of Science and Technology of China;
- ❑ Deputy President of the China Society of Finance & Banking;
- ❑ Deputy President of the China Society of Public Finance; and
- ❑ Previous member of the Monetary Policy Committee of the People's Bank of China.

Dr. Li replaces Raja Shahrudin on the Board. We believe this Renji's another step towards building corporate governance and credibility within the investment community after the completion of the Anping Medical acquisition in July this year.

More non-core asset disposals. Renji has completed arrangements for the disposal of China Gloria, its investment in China's lottery, for about HK\$15.0m. The company will realize a gain of around HK\$5.0m on the P&L. This is not a discloseable transaction and therefore no announcement will be made on HKEx.

Table 2: Non-core business disposal summary

| Item | HKEx announcement | Net proceeds (HK\$m) | Valuation | P&L impact |
|---|-------------------|----------------------|--------------------|--------------------|
| Disposal of 49% interest in SBI E2-Capital Securities | Y | 76.8 | ~1.0x P/B | nil |
| Disposal of 5.67% interest in E2-Capital (378 HK) | Y | 23.2 | ~7.6x FY12/06A P/E | HK\$3.9m gain |
| Disposal of ~80-90% of property portfolio | N | ~50.0 | na | ~HK\$2.0-5.0m gain |
| Disposal of garment business | Y | ~20.0 | ~1.0x P/B | HK\$0.82m gain |
| Disposal of China Gloria | N | ~15.0 | ~1.5x P/B | ~HK\$5.0m gain |

Source: Company data, SBI E2-Capital

Starting to demonstrate execution ability. With two new acquisitions after completing the Anping Medical deal and associated name change in Jul 2007, the company is beginning to demonstrate its execution ability and we expect further acquisitions by year-end.

Maintaining estimates and BUY call. The net profit contribution from Hefei Hospital is in line with our projections. We have revised our FY12/07F estimate to a net loss of HK\$6.6m to take into consideration the gain on disposal of China Gloria, but left our FY12/08F estimate unchanged at HK\$159.5m. We maintain our BUY call on Renji, with a target price at HK\$0.45, representing 35x FY12/08F P/E.

Chart 1: Hefei Hospital (1)



Source: Company data

Chart 2: Hefei Hospital (2)



Source: Company data

Chart 3: Hefei Hospital (3)



Source: Company data

Chart 4: Hefei Hospital (4)



Source: Company data

Table 2: P&L

| Year to Dec (HK\$m) | 05A | 06A | 07F | 08F | 09F |
|--|---------------|---------------|--------------|--------------|--------------|
| Turnover | | | | | |
| Investment holding | 2.5 | 6.4 | 9.0 | - | - |
| Financial services | 29.1 | 59.2 | 71.8 | - | - |
| Media, consulting, technology | 20.1 | 2.8 | 0.1 | - | - |
| Garment manufacturing | 53.7 | 64.2 | 67.4 | - | - |
| Property holding & others | 7.1 | 7.9 | 8.3 | - | - |
| Medical services | - | - | 85.5 | 332.8 | 389.6 |
| | 112.4 | 140.2 | 242.2 | 332.8 | 389.6 |
| Cost of sales | (62.9) | (74.8) | (102.7) | (133.1) | (153.4) |
| Gross profit | 49.8 | 65.5 | 139.6 | 199.7 | 236.2 |
| Other revenues | 2.6 | 15.2 | 21.2 | 22.6 | 69.8 |
| Distribution costs | - | - | - | - | (0.1) |
| Administrative expenses | (73.4) | (84.3) | (115.3) | (27.8) | (54.8) |
| Other operating income/(expenses) | 9.1 | 1.5 | (9.6) | (12.5) | (25.1) |
| Exceptionals | (42.4) | (18.2) | (27.1) | 1.9 | 1.0 |
| Operating profit | (54.6) | (20.3) | 8.8 | 183.9 | 227.0 |
| Finance costs | (4.2) | (6.3) | (8.9) | (6.7) | (6.4) |
| Share of results from associates | (33.6) | (54.7) | (1.0) | - | - |
| Profit before taxation | (92.4) | (81.3) | (1.1) | 177.2 | 220.6 |
| Taxation | (0.8) | (2.1) | (4.2) | (17.2) | (21.6) |
| Profit after tax | (93.2) | (83.4) | (5.4) | 160.0 | 199.0 |
| Minority interests | (0.4) | 0.4 | (1.2) | (0.5) | (0.5) |
| Profit attributable to shareholders | (93.6) | (83.0) | (6.6) | 159.5 | 198.5 |
| % chg | na | na | na | na | 24.5 |
| Dividends | - | - | - | - | - |

Source: Company data, SBI E2-Capital

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the sole bookrunner and placing agent for the China Renji Medical Group Ltd (formerly known as Softbank Investment International (Strategic) Ltd) placement of 1,500m new shares (including an option for an additional placement of 500m 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 China Renji Medical Group Ltd.

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months

BUY : absolute upside of >10% over the next six months

HOLD : absolute return of -10% to +10% over the next six months

SELL : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Securities Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Securities Limited 2007. All rights reserved.