SBI China Capital

Equity Research Report
18 June 2014

Company Flash

Town Health International Medical Group 3886 HK

Expanding at full speed via M&A

- *We met with Town Health to obtain more updated information on the company and the hospital industry in China.*
- *The 51.0% acquisition of Renji Group, which is engaged in hospital and clinical services in China, is expected to accelerate the growth of its business in the area.*
- *The 94.3% acquisition of Dr. Vio & Partners, a primary and specialist healthcare services provider in HK, is expected to reinforce its medical business within the region.*
- *The company's strategic investment in Convoy is expected to boost its investment income and secure more insured clients from China.*

Research Team
(852) 2533 3700
research@sbichinacapital.com

Stock Data (3886 HK)

Rating	Not Rated
Price (HK$)	1.62
Target Price (HK$)	n.a.
12m Price Range (HK$)	0.091-1.81
Market cap. (HK$m)	7,427.2
Daily t/o (HK$m)	25.5
Free float (%)	69.0

Source: Bloomberg

What's new. Earlier this month, we met with the management of Town Health International Medical Group ("Town Health"), a healthcare-related services provider in HK, to obtain more updated information regarding their recent business operations, future plans and prospects of the healthcare industry in HK and China. Town Health announced that it had signed 2 agreements in June regarding the acquisition of Renji Group and Dr. Vio & Partners.

Our view. We are positive as to the acquisition of Renji because: i) The valuation of the transaction is attractive with only 10.0x P/E for FY12/15, while Phoenix Healthcare Group (0151 HK, HKD10.48) is trading at a prospective P/E of 29.0x for FY12/15. ii) The company can use Renji as a platform to acquire some small- to medium-sized public hospitals in Zhejiang, and to turn them around from loss-making to making a profit by way of reform. iii) Renji is expected to have synergy effects with its medical centers in HK, as its medical technologies in HK can be shared with hospitals in China, and professionals in HK can provide training and supervision to the medical staff at hospitals in China.

We also believe the acquisition of Dr. Vio & Partners can reinforce its business in HK, because i) Referral clients of Dr. Vio & Partners will now be referred to the medical centers of the company, and thereby raise the overall profitability of the group. ii) The company can expand its medical network in HK through acquisition, which allows the company to provide more integrated care and services to its clients.

Figure 1: Financials and valuation

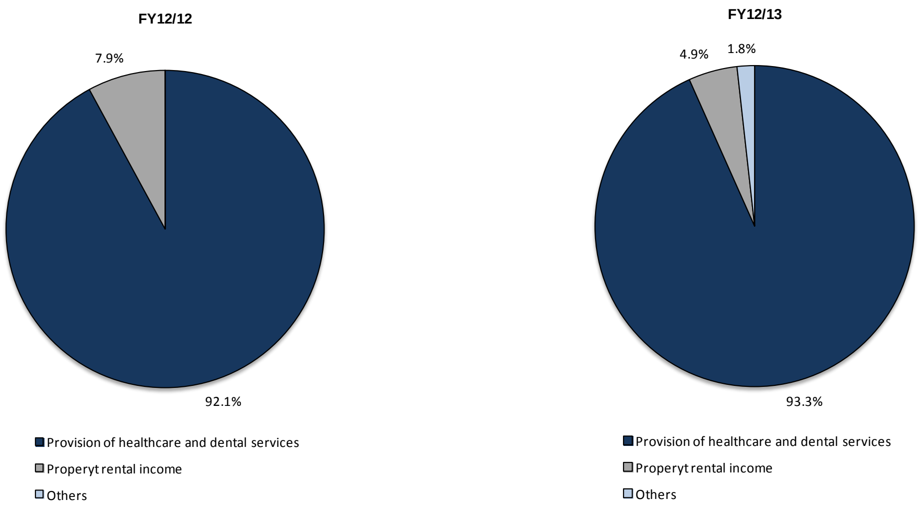
	FY12/11	FY12/12	FY12/13
Total revenue (HKD m)	**339.3**	**341.8**	**354.6**
Revenue growth (YoY)	*10.4%*	*0.7%*	*3.7%*
PBT (HKD m)	**115.3**	**(427.6)**	**83.0**
PBT growth (YoY)	*-33.2%*	*n.a.*	*n.a.*
Net profit (HKD m)	**66.0**	**(430.7)**	**79.3**
Net profit growth (YoY)	*-36.8%*	*n.a.*	*n.a.*
EPS (HKD cents)	**7.0**	**(48.0)**	**5.0**
DPS (HKD cents)	5.0	0.0	5.5
P/E (x)	115.7	n.a.	162.0
Dividend yield	3.1%	0.0%	3.4%

Source: Company data

Company Background

Town Health, being the first HK-based healthcare company listed on the main board of HKEx, was established in 1989 and is mainly engaged in 3 areas of business, namely, provision of healthcare and dental services, leasing of properties, and other miscellaneous services. Healthcare and dental services is the company's major source of revenue, contributing approximately 92.1% and 93.3% of its total revenue in FY12/12 and FY12/13 respectively. Leasing of properties and other miscellaneous services, on the other hand, are only auxiliary businesses and accounted for a small proportion of its total income in the same period (See Figure 2).

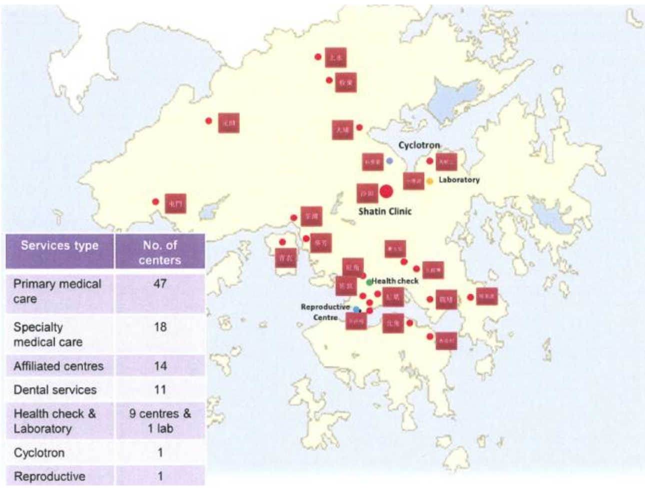
Figure 2. Revenue breakdown by segment in FY12/12 & FY12/13



Source: Company data

Healthcare Business in HK. For the healthcare business, the company offers a variety of healthcare services to its clients, including primary and specialty medical care services, health check, dental services, reproductive and hair care services, cosmetic surgery, etc. As of September 2013, the company had a total of 102 medical centers in HK, comprised of 79 medical care centers (including 47 primary medical care centers, 18 specialty medical care centers, and 14 affiliated centers), 11 dental services centers, 10 health check and laboratory centers, 1 cyclotron center, and 1 reproductive center (See Figure 3).

Figure 3. Location of the company's healthcare center in HK



Source: Company data

The company has 3 types of clients, including walk-in clients, medical cardholders, and hospital referrals. While walk-in clients are those without medical insurance coverage and other contracted corporate plans, cardholders are just the opposite. Hospital referrals are clients referred from public hospitals or organizations for follow-up treatments.

Walk-in clients are the largest revenue contributor of the company, representing 81.0% of its total revenue in the healthcare segment, while medical cardholders and referrals accounted for 13.0% and 5.0% of the revenue in the segment in the same year respectively.

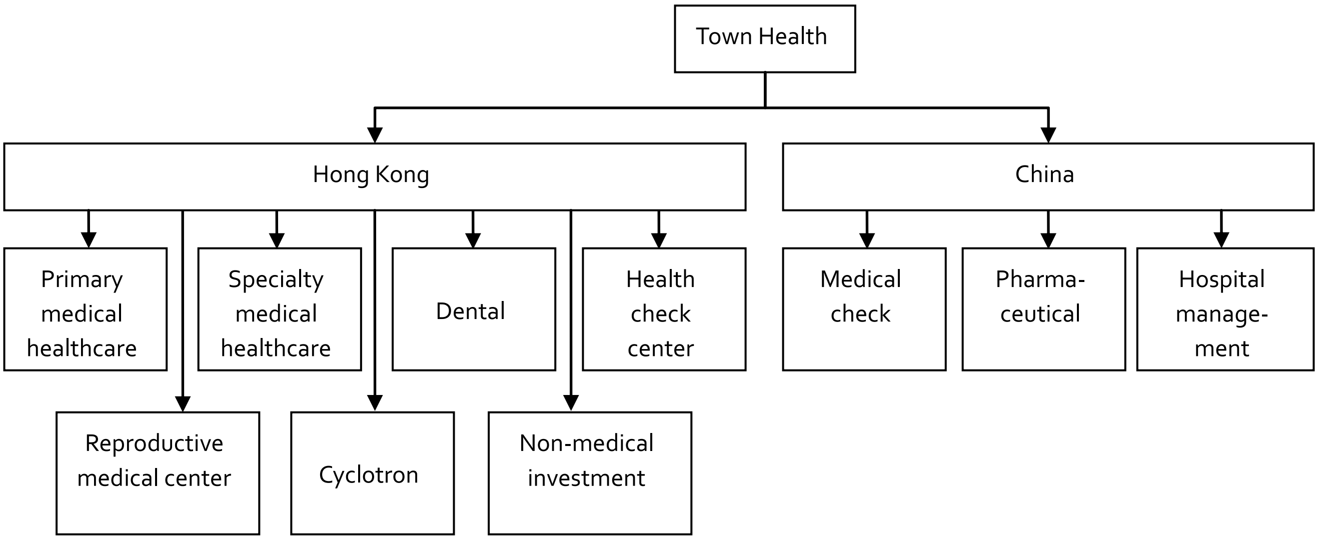
Healthcare Business in the PRC. Town Health mainly provides 3 types of services to its clients in China, including health check, pharmaceutical distribution, and hospital management.

The company mainly provides its health check services to clients in its Medical Diagnostic Center of the 6th Affiliated Hospital of Sun Yat-Sen University, which is managed and consulted by You Clinics, a medical management organization in Guangzhou jointly owned by the company (80.0%) and Sun Yat-Sen University (20.0%). The medical diagnostic center is a centralized laboratory which provides health check services, one-stop body check services, and diagnostic imaging to its clients.

The company's pharmaceutical business is conducted by one of its non-wholly owned subsidiaries, New Ray Medicine (8180 HK, HKD0.52), which is a company engaged in pharmaceutical distribution business in China with a focus in Hangzhou and Zhejiang provinces. Town Health originally held a 48.0% equity interest in New Ray Medicine, but its stake in the company was reduced to 35.0% after the company was listed on the HKEx in 2013.

The hospital management business is a new business of the company, and will be initiated when the acquisition of Renji Group is completed (See more detail in the following section).

Figure 4. The company's major businesses in HK and China



Source: Company data

Our view

The acquisition of Renji Group will accelerate the growth of its China business: Although currently revenue from the PRC accounts for only a small proportion of the company's total revenue, the company is actually eyeing the China market with plans to expand its footage in the market by M&A.

In fact, the company has signed a framework agreement in early June regarding the acquisition of a 51.0% equity interest in Renji Group in China, with a total consideration of RMB153.0m. Renji Group mainly conducts its business in 2 subsidiaries, namely, Hangzhou Shengkang and Hangzhou Shuke. While the former operates a 500-bed rehabilitation-oriented hospital in Hangzhou and provides services relating to rehabilitation care, traditional Chinese orthopedics, and Western medical orthopedics, the latter operates 3 outpatient medical clinics in Hangzhou and provides traditional Chinese medical care, Western internal medicine healthcare, and quality dental care services.

The profit of the group is guaranteed to be not less than RMB30.0m, RMB36.0m, and RMB42.0m in FY12/15, FY12/16 and FY12/17 respectively. Therefore, a 51.0% acquisition with a total consideration of RMB153.0m represents a prospective P/E of 10.0x for FY12/15, and Renji Group will start contributing revenue to the company, if the transaction is materialized, starting next year.

We believe this is an accretive acquisition and is in line with the long-run interests of shareholders, because: i) The valuation of the transaction is attractive with only 10.0x P/E for FY12/15, while Phoenix Healthcare Group, a company providing hospital services and hospital management services in China, is trading at a prospective P/E of 29.0x for FY12/15. ii) The company can use Renji as a platform to acquire some small- to medium-sized public hospitals in Zhejiang, and to turn them around from loss-making to making a profit by the way of reform, and iii) Renji is expected to have synergy effects with its medical centers in HK, as its medical technologies in HK can be shared with hospitals in China, and professionals in HK can provide training and supervision to the staff at said hospitals in China. Profitability is expected to improve without a significant increase in costs.

The acquisition of Dr. Vio & Partners will reinforce its medical business in HK: The company also announced last week that it has signed a sale and purchase agreement regarding an acquisition of 94.3% equity interest in Dr. Vio & Partners, which is principally engaged in the provision of primary and specialist healthcare services including hospital admission, insurance-based or employer-sponsored health scheme expenditure management, logistics, and related services. The total consideration of the transaction was HKD409.3m, which will be fully settled by cash. As Dr. Vio & Partners recorded operating profit of HKD36.2m for FY12/13, and the transaction represents a 12.0x price/operating profit for FY12/13.

We believe the acquisition is positive for the company and can reinforce its business in HK, because: i) Referral clients of Dr. Vio & Partners, who used to be referred to other third-parties before the acquisition, will now be referred to the medical centers of the company, and thereby raise the overall profitability of the group. And ii) The company can expand its medical network in HK through the acquisition, which allows the company to provide a more integrated care and services to its clients.

Strategic investment in Convoy can help increase investment income and secure more insured clients: Town Health is currently a strategic investor and the second largest shareholder of Convoy (1019 HK, HKD1.27), holding 25.7% of equity interest in the company as at 5 Jun 2014. Convoy, as one of the largest independent insurance and MPF scheme brokerage firms in HK, saw a substantial growth in its Independent Financial Advisory (IFA) business over the past few years, with a revenue CAGR of 19.9% during the 3-year period between FY12/10 to FY12/13. Its stake in Convoy is expected to bring further investment income to the company.

In addition, Convoy is also expanding its coverage of its insurance business in China, with its proportion of revenue from China increasing from 2.5% in FY12/12 to 9.5% in FY12/13. This will benefit Town Health's medical business in China by increasing the revenue contributed from insured clients. This will also benefit the company's medical business in HK when Convoy launches its medical travel insurance arm in China, which covers medical expenses for insured travellers who seek medical advice in the company's medical centers when traveling in HK.

Valuation

The company is currently trading at a 162.0x historical P/E for 2013, while its peers on average are trading at 57.0x. We believe the premium that the company is trading at relative to its peers is mainly attributable to the potential M&As mentioned above, which could potentially boost the company's earnings from FY12/15, if they can close the deal this year. The possibility to acquire another hospital in China, which the management expressed to be likely this year, also helped to raise the valuation.

Figure 5. Peer comparison

Company	Ticker	Mkt Cap (HKD m)	3M avg turnover (HKD m)	2013 P/E (x)	2014E P/E (x)	2015E P/E (x)	P/book (x)
Town Health	**3886 HK**	7,427.2	25.5	162.0	n.a.	n.a.	n.a.
Phoenix Health Group	1515 HK	8,921.3	16.4	53.7	36.9	29.1	4.4
Aier Eye Hospital	300015 CH	19,379.0	91.2	64.0	50.9	37.7	8.9
Topchoice Medical Investment	600763 CH	8,163.4	55.8	63.5	53.1	41.2	12.0
Jinling Pharmaceutical	000919 CH	7,966.9	131.4	38.4	33.4	27.2	2.9
Hengkang Medical	002219 CH	15,703.1	219.2	65.2	40.9	28.0	15.1
	Average*	**12,026.7**	**102.8**	**57.0**	**43.0**	**32.6**	**8.7**

Source: Company data

**Town Health is not include in the average figures.*

Figure 6. Per share items

	FY12/11	FY12/12	FY12/13
EPS (HK cents)			
- Basic & diluted	7.0	-48.0	5.0
DPS (HKD cents)	5.0	0.0	5.5
BVPS (HKD)	0.3	0.3	0.3

Source: Company data

Figure 7. Ratio analysis

	FY12/11	FY12/12	FY12/13
Growth (YoY)			
Revenue	10.4%	0.7%	3.7%
Profit before tax	-33.2%	-	-
Net profit	-36.8%	-	-
Margins			
EBIT margin	34.0%	-125.1%	23.4%
Net profit margin	19.5%	-126.0%	22.4%
Other ratios			
Return on average assets	3.7%	-24.8%	4.3%
Return on average equity	4.2%	-29.8%	5.6%
Dividend payout ratio	71.4%	0%	110.0%
Valuation measures			
P/E (x)	115.7	-	162.0
P/B (x)	4.8	5.6	5.0
Dividend yield	3.1%	0%	3.4%

Source: Company data

Figure 8. Income statement (HKD m)

	FY12/11	FY12/12	FY12/13
Revenue	**339.3**	**341.8**	**354.6**
COGS	(225.2)	(223.2)	(234.3)
Administrative expenses	(192.0)	(184.0)	(200.4)
Share of results of associates	17.5	(9.5)	159.9
Increase in fair value of investment properties	22.4	78.6	54.7
Financial expenses	(1.7)	(3.9)	(9.3)
Other gains and losses	154.3	(430.7)	(65.8)
Other	0.8	3.4	23.7
Profit before tax	**115.3**	**(427.6)**	**83.0**
Income tax	(49.3)	(3.1)	(3.7)
Net profit	**66.0**	**(430.7)**	**79.3**
Net profit attributable to shareholders	64.2	(435.0)	49.6
Minority interest	1.8	4.3	29.7
Total profit	**66.0**	**(430.7)**	**79.3**
EPS (HK cents)	7.0	-48.0	5.0

Source: Company data

Figure 9. Balance sheet (HKD m)

	FY12/11	FY12/12	FY12/13
Non-current assets			
Investment properties	284.4	573.0	448.4
Property, plant and equipment	183.1	163.3	171.9
Interests in associates	216.5	224.7	116.7
Other	71.2	70.6	113.0
Total non-current Assets	**755.1**	**1,031.7**	**849.9**
Current assets			
Inventories	12.0	9.8	11.6
Trade and other receivables	44.6	41.2	45.4
Held for trading investments	903.4	314.1	660.9
Other	35.8	99.5	243.5
Bank balances and cash	46.3	176.3	201.2
Total current assets	**1,042.1**	**640.9**	**1,162.6**
Total assets	**1,797.2**	**1,672.5**	**2,012.5**
Current liabilities			
Bank borrowing	(113.0)	(210.6)	(363.8)
Trade and other payables	(29.0)	(33.9)	(57.8)
Tax payable	(85.4)	(84.2)	(82.0)
Other	(16.1)	(4.9)	(12.4)
Total current liabilities	**(243.5)**	**(333.6)**	**(516.0)**
Non-current liabilities	(1.0)	(1.6)	(3.1)
Net assets	**1,552.8**	**1,337.3**	**1,493.5**
Equity			
Equity attributable to owners of the Company	1,546.8	1,127.6	1,209.2
Non-controlling interests	6.0	209.7	284.3
Total Equity	**1,552.8**	**1,337.3**	**1,493.5**

Source: Company data

Figure 10. Cash flow statement (HKD m)

	FY12/11	FY12/12	FY12/13
Operating activities			
Profit before taxation	115.3	(427.6)	83.0
Adjustment for non cash items	(103.5)	287.4	(271.3)
Change in working capital	(293.2)	317.6	(187.0)
Tax paid	(6.0)	(4.1)	(6.2)
Net cash generated from operating activities	(287.4)	173.4	(381.5)
Investing activities			
Purchase of PP&E	(26.3)	(4.0)	(8.7)
Proceeds from disposal of investment properties	0.0	0.0	265.7
Dividend received from associates	6.9	7.3	209.2
Repayment of loans receivable	35.4	2.8	180.7
Advances of loans receivable	(9.6)	(13.7)	(318.7)
Purchase of investment properties	(53.5)	(12.9)	(163.6)
Acquisition of subsidiaries	(0.4)	(0.1)	(100.5)
Other	39.9	(113.8)	177.7
Nelt cash flow from investing activities	(7.5)	(134.4)	241.9
Financing activities			
New bank borrowing raised	388.0	442.6	1347.6
Repayment of bank borrowing	(370.0)	(345.0)	(1194.4)
Other	(46.4)	(6.6)	10.7
Net cash flow from financing activities	(28.4)	91.0	163.8
Net increase in cash and cash equivalent	(323.2)	130.1	24.3
Cash and cash equivalents at the beginning of the year	369.5	46.3	176.3
Exchange rate effect	0.0	0.0	0.7
Cash and cash equalents at the end of the year	**46.3**	**176.3**	**201.2**

Source: Company data

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