

China Medical Science: A New Era

Recommendation: BUY (initiating coverage)

Biotech/ F&B

Price	HK\$0.68	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$1.08 (+58.8%)	Jul	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$0.05-0.95	05A	(63.6)	(0.127)	na	na	-	-	-	-	-	-
Market cap.	US\$109.2m	06A	(5.8)	(0.012)	(91.0)	na	-	-	-	-	-	-
Daily t/o, 3 mth	US\$0.32m	07F	(9.9)	(0.020)	(34.2)	na	-	-	-	-	-	-
Free float	34.93%	08F	73.7	0.054	816.0	12.6	-	-	-	-	-	-
Ticker	8120.HK/8120 HK	09F	141.2	0.104	92.6	6.5	-	-	-	-	-	-

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -9.8%, +516.4%, +353.3%
Actual price changes (1 mth, 3 mth, 12 mth): -13.4%, +528.3%, +468.0%

Key points:

- Placement to fund expansion of its chemical-free bio-feed business.
- Its successful Singapore model to be replicated in new markets and China.
- No further funding exercise expected in the medium term as internal resources are sufficient for production and marketing activities.
- Sakura eggs to be sold by “Fair Price” in Singapore from mid-April and Sakura chicken meat from May.
- Patents in Japan and China provide a platform for future business development and product diversification.
- Leading F&B companies and supermarket chains approach CMSL for business co-operation.
- Designed capacity to increase from 80 tonnes to 2,000 tonnes by the end of 2007 to meet demand.
- Trading at FY07/08F P/E of 12.6x and 6.5x for FY07/09F based on our earnings forecast of HK\$73.7m for FY07/08F and HK\$141.2m for FY07/09F.
- Initiate coverage with a BUY call and a target price of HK\$1.08, representing 20.0x FY07/08F, 10.4x FY07/09F P/E. Potential share price upside of 58.8%.

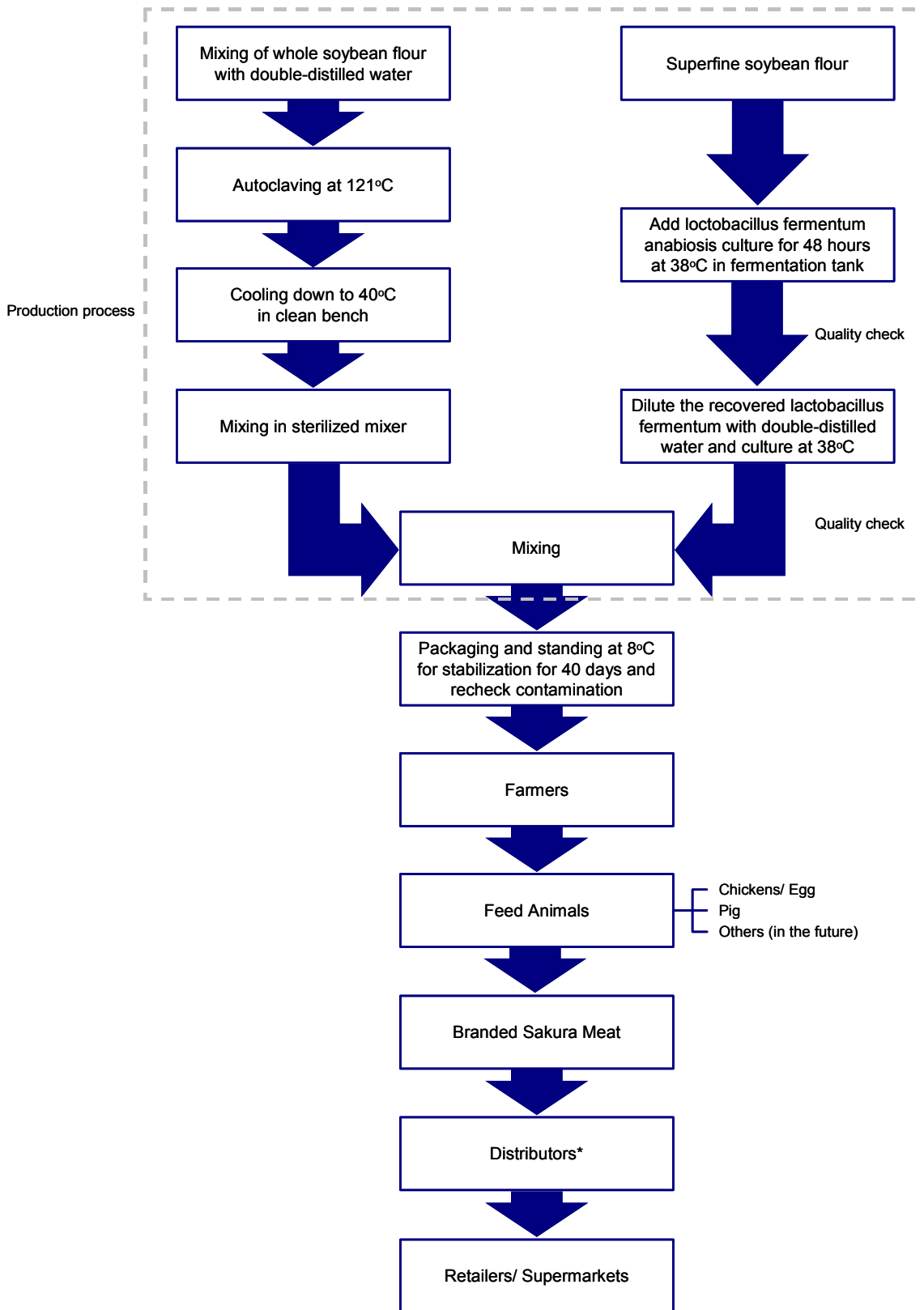
Placement. On 22 March 2007, China Medical Science (CMSL) placed 100m new shares at HK\$0.66 each, or a 7.04% discount to its closing price of HK\$0.71. The new shares represent 7.99% of the company’s existing share capital.

Use of net proceeds. Out of total net proceeds of about HK\$63.0m, about HK\$40.0m will be used as general working capital, HK\$21m for the feed supplement business and the rest for existing businesses.

Proposed new name to reflect its business model. The company plans to change its name to China Medical and Bio Science Limited after completing its asset injection and change of its board membership in Dec 2006 to better reflect its new business focus – chemical-free bio-feed additives. Its technology was developed in Japan, tested in its eight experimental farms in Guangdong province and is now used at its production facilities in Zhongshan, China. Its current annual production capacity of bio-feed additives will increase from 80 tonnes to 2,000 tonnes by end-2007.

Chemical-free feed additives. The company uses lactobacillus fermentum which can stay in the body longer than ordinary bacteria because of its high acid toleration. Its feed supplements are developed mainly from lactobacillus fermentum, which is one of the most commonly used pro-biotics (friendly bacteria). Pro-biotics inhabit intestines of humans and animals and prevent the entrance and proliferation of organisms which cause disease. As its lactobacillus can accelerate the growth rate and increase immunity of pigs and other animals.

Chart 1: Production and distribution process



*Singapore Example:

1. Singapore Food Industries acts as a distributor and sells JBC Sakura Meat to restaurants
2. National Trade Union Congress sells JBC Sakura Meat in its supermarket (Fair Price)

Source: Company data and SBI E2-Capital

Proven track record. The company’s licensed “YY Sakura Meat” series is now sold in Singapore’s supermarkets, after two-year commercial-scale trials in China. It has further penetrated the Malaysian market after introducing its feed additives to a pig and chicken farm. The company has also got approval from the

Australian government to export bio additives to the country and will begin its first stage trial in one farm this March. We expect CMSL to adopt its business model that proved successful in Singapore and Malaysia to penetrate new markets, including China.

Strong presence in Singapore. We estimate that Singapore will generate about 15.4% of the company’s turnover in FY07/08F. Singapore Food Industries (SFI SP, S\$0.89, NR), one of its key clients, sells Sakura meat to restaurants, hotels and other catering companies in Singapore. Fair Price, the largest supermarket chain owned by National Trade Union Congress, sells Sakura pork to Singapore retail customers. Sakura chicken meat and eggs are expected to be available for sale in “Fair Price” in the next few months

Chart 2: Sakura Pork : \$6.9/100g in “Fair Price”



Source: Company data

Chart 3: Other brands: \$8.4/100g in “Fair Price”



Source: Company data

Malaysia. Prompted by the government’s move to close down unhygienic pig farms, which fail to reach the National Environmental Standard by 31 Dec 2006, pork producers are turning to high-quality chemical-free feed additives. With the official recognition from the Ministry of Agriculture, the company has started to sell bio-feed additives in Malaysia.

Huge growth potential in China. China is the world’s largest producer and consumer of pork. According to a report issued by Agriculture and Agri-Food Canada in March 2006, China was expected to account for 53.4% of the world’s pork production of 97.2m tons in 2006. By 2010, a 0.1% annual increase in the use of bio-feed supplements will boost demand for pro-biotic bacteria feed supplements by 200,000 tons, from 1,000 tons in 2000, according to China’s National Development and Reform Commission. Currently, around 30% of the company’s turnover is from the Southeast Asian countries and 20.0% from Japan and Australia. Turnover from China is expected to reach around 40.0% by 2009 from the current 33.0%.

Government focus on agriculture. According to an official work report, the Chinese government plans to spend RMB391.7b on agriculture, farming villages and farmers in 2007. It also earmarked funds for the reform of the country’s veterinary medicine management system, development of the animal disease prevention and control system and structural adjustments to promote the development of the livestock and poultry industry.

China strategy. CMSL has started to tap the Chinese market by focusing on major cities such as Beijing, Shanghai and Guangzhou. The company plans to replicate its business model adopted in Singapore in China, which is expected to generate about 31.9% of turnover in FY07/08F.

Table 1: Turnover breakdown (%)

Year to Jul	08F	09F
Singapore	15.4	14.9
Malaysia	15.2	15.8
Japan	15.1	17.3
PRC	31.9	31.8
Hong Kong	7.9	8.0
Australia	3.7	3.1
Russia	10.8	9.1
Total	100.0	100.0

Source: Company data

Overall market strategy. The initial focus is on affluent Asian countries such as Singapore and Australia, with high standards of poultry breeding and strong demand for quality bio-feed additives. The next step is further penetration into China and Russia by replicating the business model tried and tested in Singapore.

Capacity expansion to drive growth. The company has increased its annual designed production capacity to 2,000 tonnes with production facilities located in Japan and China (Zhongshan, Guangdong province, and Qiqihar, Heilongjiang province).

Worldwide preference for antibiotic substitutes. Concerns about food safety and the quality of animal feeds are on the rise. Sweden banned the use of antibiotics as animal growth promoters in 1986, Denmark in 1999 and the European Union in 2006. Demand for high quality chemical and antibiotics free bio-feed additives is on the rise. So far this year, China Medical's strong book orders prove that the global trend is well established.

Strong research professionals. Out of the company's 15 research and technical staff, around 1/3 got doctorate degrees in bioscience, medicine, animal science and genetics-related disciplines. Its key executives in charge of product development are professors at well-know universities in Japan, the US and China. Moreover, the estimated research costs only accounts for around 3 – 5% of its total turnover as the company has already going into the commercialization,

Key management of CMSL. Ms. Liu Yang, chairman of CMSL, holds a master degree in law, Institute of Law, Chinese Academy of Social Sciences. Other senior executives include:

Dr. Tang Min - Director of Product Development, professor of the medical school of Zhongshan University. Holds a doctoral degree from the Zhongshan School of Medicine, Sun Yat-sun University, China. Studied at Kobe University in Japan and Singapore National University.

Mr. Fang Ming - Director of Sales and Marketing, holds a bachelor's degree from the Foreign Economic Trade University, master's degree in international economic law from Beijing University and MBA from South Australia University. Previously he worked for COFCO in Singapore.

Dr. Liu Donghui - Financial controller with extensive international entrepreneur experience. Responsible for CMSL's finance and investment projects. Holds a doctoral degree in management science from Zhongshan University.

Mr. Feng Dingyuan - Head of the animal feed and feedstuff technology consultant team is a professor and the faculty head of South China Agricultural University-College of Animal Science. He is the vice-committee member of China Feedstuff Economic Committee. Holds a doctoral degree from the South China Agricultural University.

Dr. Zhang Shouquan - Doctor of Agricultural Studies, professor of the South China Agricultural University, Deputy Head of the College of Animal Sciences – Department of Animal Genetics, Breeding and Reproduction Science. He is also one of the key persons in charge of the development of JBC's feedstuff additives in the trial-run period.

Wide range of applications. The company's products can be used in poultry raising, fishery product cultivation and preservation of fresh fruit and vegetables. After encouraging results in piglets, the feed supplements were used in two poultry farms and one aquatic farm in late 2005. They improved the quality of chicken and shrimp, completely replacing the use of antibiotics and other chemical growth promoters, resulting in safer food and preventing infectious diseases. In the longer term, the company aims to extent its medical research to humans, focusing on diabetes, cancer, respiratory infections and contagious diseases.

Professional verification. The company has developed a series of bio products for livestock and poultry using lactobacillus fermentum. Its lactobacillus additives are used in the production of pork known as "Sakura" pork. On 6 November 2003, Southern China Agricultural University issued a certificate strongly endorsing the company's products for livestock feeding. In an experiment conducted by the university, the weight growth rate of pigs fed with the company's products was 17.25% higher than that in the control group, and the feedstuff yield growth rate in the test group was 14.57% higher than in the control group. The products are chemical-free. No side effects were noted. China's Ministry of Agriculture evaluated and certified "Sakura" pork and special cultivation techniques in 10 April 2004.

Patented technology. The company's patented technology in Japan and China provide a platform for future business development and product diversification. In China, the company patented its feed supplements manufacturing methods under the name of "*Methods of manufacture domestic animal feeds*" on 28 December 2005 for 20 years (from 8 March 2004), with the patent is held by the guarantor (Ms. Liu Yang). The registration of the assignment of the PRC patent was completed by February 2007. The company's proprietary intellectual property rights to its lactobacillus and fermentation methodology have enhanced its competitiveness in the biological industry.

Chart 4: Cert. fr The Japanese Patent Office



Source: Company data

Chart 5: Cert. fr The Chinese Trademark Office



Source: Company data

Entry barriers. The unique and patented technology keeps out new entrants. Also, once a client uses bio-feed additives supplied by CMSL, it is difficult for them to shift back to antibiotics. The company’s most important asset is its research professionals and patented technology, its lead-time is usually around 3 – 4 years patent/ trial period, which form an entry barrier to newcomers.

Earnings forecast. Our initial net profit forecast for FY07/08F is HK\$73.7m on a turnover of HK\$333.6m. We expect the company to deliver superior growth with from FY07/08F onwards with strong order books received in Asian countries. This growth rate is higher than that of other mainstream China consumer plays. The above-market growth rate is a sign of the company’s advanced technology and strong demand for chemical-free additives.

Table 2: P&L

Year to Jul (HK\$m)	05A	06A	07F	08F	09F
Turnover	121.1	54.1	82.0	333.6	592.6
% chg	na	(55.3)	51.6	306.8	77.6
Cost of sales	(88.8)	(38.0)	(30.8)	(110.1)	(195.6)
Gross profit	32.3	16.1	51.2	223.5	397.1
Other revenue	3.5	13.0	-	-	-
Selling and distribution expenses	(15.5)	(9.2)	(22.6)	(71.7)	(130.4)
Administration expenses	(18.9)	(10.7)	(19.6)	(50.0)	(88.9)
Other operating expenses	(9.7)	(2.7)	(12.3)	(9.8)	(10.0)
Loss on sale of subsidiary	(25.5)	1.4	-	-	-
Bad Debt	-	(10.9)	-	-	-
Operating profit	(34.0)	(3.0)	(3.3)	92.0	167.8
Finance costs	(10.3)	(4.7)	(6.6)	(7.0)	(7.4)
Share of profit on sub.	1.3	-	-	-	-
Depreciation	(25.2)	-	-	-	-
Profit before tax	(68.3)	(7.8)	(9.9)	85.0	160.4
Taxation	(0.7)	(0.2)	(0.2)	(11.3)	(19.3)
Profit after taxation	(68.9)	(8.0)	(10.1)	73.7	141.2
Minority interests	5.4	2.2	-	-	-
Profit attributable to shareholders	(63.6)	(5.8)	(10.1)	73.7	141.2
% chg	na	(90.9)	(74.1)	829.7	91.6
Dividend	-	-	-	-	-

Source: SBI E2-Capital

Initiating coverage with BUY call, target price HK\$1.08. We initiate coverage on the company with a BUY call and a target price of HK\$1.08. The share price is underpinned by the company's superior growth performance prospects over the next three years and uniqueness, as there is no direct comparable listed in Hong Kong. The most relevant peer is Japan's Yakult Honsha Co (2267 JP, JPY 3,490, NR), which is currently trading at FY03/06A P/E of 84.4x, 36.5x P/E for FY03/07F and 32.0x P/E for FY03/08F. Our price target represents 20.0x FY07/08F and 10.4x FY07/09F P/E.

Company background. China Medical Bio-science principally engaged in production and sales of chemical-free bio-feed additives. China Medical came to be listed through the asset injection into China Medical Science (8120 HK, HK\$0.68, BUY), a listed company in the General Growth Enterprises Board and subsequent business operations migration. Its revenue is mainly from selling bio-feed additives to farmers in the Asian countries.

Corporate history. The former China Medical Science formed China Medical Bio-science through the acquisition and business injection by Ms. Liu Yang, Chairman, bought into the company by a major transaction for China Medical Science. After that the Chairlady injected 70% of JBC assets into the listed China Medical and proposed to change name into company migrated the core operations from the privately owned JBC Group into the listed China Medical Bio-science company. The process was completed at the end of Jan 07 and proposed change name later.

New major shareholder JBC Bio-Tech currently owns 35.49% of CMSL, is the largest major shareholder. CMSL, through JBC Bio-Tech, will focus on the development, production, sales and distribution of feed supplements developed from lactobacillus fermentum.

Table 3: Post top-up placement shareholder structure

	No. of shares	%
JBC Bio-Tech	480,000,000	35.49
CPT* and its associates	400,000,000	29.58
Public shareholders		
-Placee	100,000,000	7.39
-Public	372,400,000	27.54
Total	1,352,400,000	100.00

* Concord Pharmaceutical Technology (CPT) used to be the largest single shareholder.

Source: Company data

JBC Bio-Tech. JBC Bio-Tech acquired 70.0% in JBCBP for a consideration of 480m new shares in December 2006. Currently, JBC Bio-Tech it is 90.00% owned by Ms. Liu Yang. Incorporated in November 2002 and based

in Zhongshan, Guangdong, JBC Group comprises JBCBP, which wholly owns JBC China. JBC China wholly owns Zhongshan JBC Bio-Technology, which was set up in November 2003 and is principally engaged in the development and manufacture of animal feed supplements developed mainly from *lactobacillus fermentum*.

Corporate governance: 1) Dividend policy. The company has not committed to a target dividend payout ratio. However, given its high growth potential and cash required to start operations, we believe any excess cash will be reinvested into the business and do not expect dividends in the short term; 2) Auditor - PKF Accountants & Business Advisors

Risks. 1) execution risk in commercialization; 2) regulatory risk in terms of government policy changes and 3) new product substitutes

Disclosure of Interest: SBI E2-Capital Securities Ltd. acted as the sole book runner and placing agent for the China Medical Science's top up placement on 16 January 2007 and 21 March 2007.

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