

**Proprietary offerings across all segments****China Medical Devices****Golden Meditech (8180 HK, HK\$3.30)****Not Rated**

**Business model.** Golden Meditech (Meditech) operates in three major businesses focusing on 1) research, development, manufacture and sale of medical devices and personal healthcare products; 2) storage and application of blood stem cell and 3) research, development and manufacture of Chinese herbal medicines. Medical devices sales and associated sales of disposable chambers are the company's largest revenue source, accounting for 78.1% of revenues for 1-3Q FY3/07, cord blood bank services accounted for 19.2% with Chinese herbal medicine accounting for the remaining 2.7%. The company products are predominantly sold in China.

**Proprietary ABRS has 80% market share in China.** Autologous blood recovery system (ABRS), for blood recovery and purification, is Meditech's flagship medical device and the first China-manufactured device of its kind to receive the State Food and Drug Administration's (SFDA) approval (2000). It is particularly suitable for the China market as blood donation and storage is not popular in the Chinese culture, resulting in a general shortage of replacement blood. ABRS are mainly sold to "rated" hospitals. Meditech's ABRS is currently being used in some 2,200 rated hospitals in China, and management estimates that it has an 80% market share. Management aims to have a total coverage target of more than 6,000 rated hospitals over the next five years.

**Meditech's ABRS derives recurring revenue from disposable chambers.** Though sales of ABRS are generally one-off, with follow up sales through upgrades, re-placement cycles and maintenance, the segment is able to derive important recurring revenues in sales of disposable chambers. The chambers are a consumable part of the ABRS and are proprietary to the device, with no SFDA approved/licensed substitutes. In our view, this segment may be an overlooked growth driver for the company. As penetration of ABRS grows within China's hospitals, we expect disposable chamber sales to grow at an increasing rate.

**Cord blood bank is the sleeping giant.** To further tap China's general replacement blood shortage, Meditech has been engaged in the separation, processing, and storage of umbilical cord blood stem cells from newborns. The company operates this business through its non-wholly owned privately held subsidiary China Stem Cells Holding (CSC). This business is essentially an oligopoly, with only one licensed operator permitted in each region. At present, cord blood bank business is only licensed in Beijing, Tianjin, Shanghai and Guangdong, and Meditech is the only company to possess licenses in more than one place (Beijing and Guangdong). The revenue model comprises a one-off examination/extraction fee of RMB5,000 and then a recurring annual storage fee of RMB580 for 18 years. Around 20% of the customers select to pay the extraction and total storage fee on a one-off lump sum basis. Though the initial take-up rate has been moderate, the recent sign-up rate has been encouraging, suggesting that the service is on the verge of accelerating growth.

**CSC new share issue to fund Guangdong centre.** Meditech's new Guangdong cord blood bank centre is scheduled to open in 2H FY3/07. In our view, the Guangdong branch may be a significant revenue driver for the segment and company after the initial ramp up phase. Reports estimate that the annual birth rate in Guangdong is around 1m compared to around 100k in Beijing. To fund the expansion, CSC entered into subscription agreements with eight private investors to issue a total of 242,000 new shares at US\$82.65 each in Nov 2006. The new share issue represents 16.7% of CSC's enlarged share capital and yielded proceeds of US\$20.0m. As part of the deal, CSC is required to achieve a listing on a recognized stock exchange with a market cap  $\geq$ US\$240.0m, within two years of the completion of the deal. Should this fail to occur, the subscribers have the right to require CSC to repurchase the respective shares at the issue price, plus an 8% gross yield. Around US\$10.0m will be used for the establishment of the Guangdong cord blood bank facility. Meditech's stake in CSC has been diluted to 56.5% from 67.8% as a result of the new share issue.

**AIDS-treating Chinese herbal medicine solidifies long-term growth prospects.** Meditech's main product in the Chinese herbal medicine segment is TangHerb, used to boost the immune system of HIV carriers and alleviate common symptoms of AIDS without side effects. Government reports that there are 650,000 HIV carriers in China, though we believe that this is a conservative estimate. In 2004, TangHerb became the first, and thus far the only, proprietary Chinese medicine of its kind to be granted a New Medicine Certificate by China's SFDA. The drug is mainly supplied to the government controlled "China Centre for Disease Control", which subsequently distributes it free to HIV patients via doctor's prescriptions. After its launch in 4Q FY3/06, the product is still recording losses, mainly due to annual amortization costs of around RMB25m. The group has already started researching an improved version of TangHerb, which will be even more effective in reducing the HIV viral load.

**TangHerb – from "prescription" to "over-the-counter".** Management wants to move this product from "prescription drug" to "over-the-counter drug", to be distributed through pharmacies, directly to HIV carriers. If successful, this will significantly expand the addressable market size to about a few million patient dosages per year and significantly increase sales. However, we believe this is unlikely to occur in the short-to-medium term given the Chinese government's stance and the sensitive nature of the disease.

**1H FY3/07 results affected by industry regulations.** FY3/07F figures to be a correction year for Meditech, as it absorbs the impact of the Chinese government's anti corruption measures and regulatory policy changes in the pharmaceutical and medical devices industry. For 1H FY3/07A, turnover rose 18.5% YoY to HK\$156.0m and net profit was up 15.3% YoY to HK\$91.2m after stripping out the HK\$116.6m one-off disposal gain for a stake reduction in China Medical Devices (CMED US). However, we note that the 1H FY3/06A bottom line was significantly boosted by HK\$15.0m in interest income. Excluding interest income from both years, net profit actually fell 2.9% YoY. As hospitals reduced orders, sales of ABRS machines rose only 0.6% YoY to HK\$97.8m. Perhaps an encouraging sign, Meditech sold around the same amount of ABRS machines as the previous year, suggesting that there were no significant pressure on prices. Cord blood bank services continued its ramp up and recorded a 131.2% YoY increase to HK\$30.0m and in the process replaced sales of disposable chambers as the company's second largest contributor. Chinese herbal medicines recorded HK\$4.3m sales compared with nil a year ago. Devices segment margins narrowed 3.0 pcp YoY to 69.1% as lower margin sales of disposable chambers accounted for a larger part of the segment. Cord blood bank services benefited from increasing scale and raised its segment margins from 29.2% to 43.1%. For the first half, the Chinese herbal medicine segment lost HK\$15.9m. Overall, the company weathered the negative impact of regulatory restructuring well, giving further proof that companies with proprietary technologies and strong R&D will benefit from a tighter operating environment over the long term.

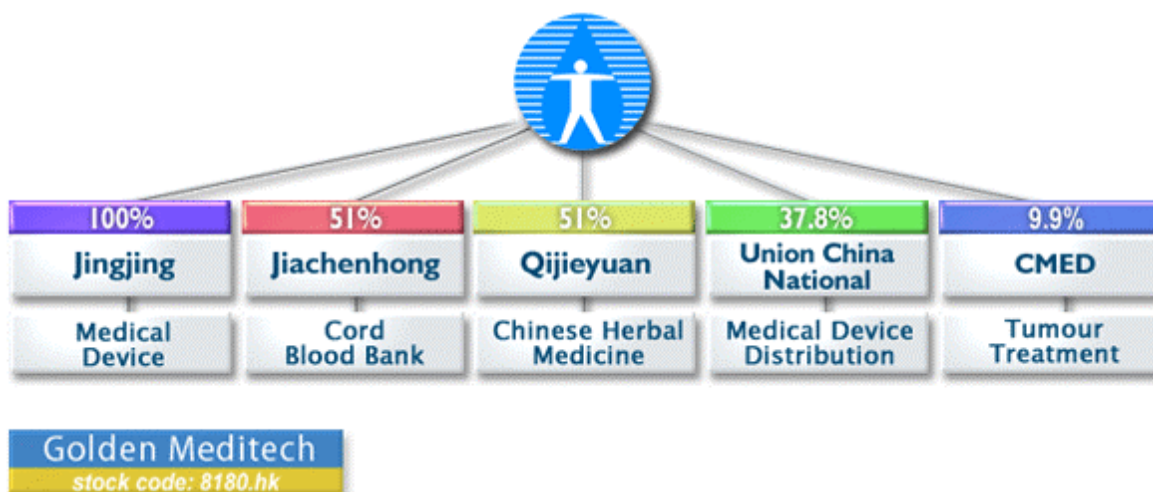
**Remain soft in 2H FY3/07F, possible rebound in FY3/08F.** We estimate Meditech's earnings are likely to remain soft in 2H FY3/07, before a rebound in FY3/08F. Catalysts for rebound will be: 1) moderating operating conditions; 2) rebounding sales in ABRS machines after hospitals delayed investments in FY3/06; 3) favourable government policies to improve healthcare services in rural areas; 4) continuing ramp up in the cord blood bank services and 5) narrowing losses in Chinese herbal medicine. However, the extent of the rebound will depend on the progress of the company's business restructuring, aimed at improving its corporate governance. After the restructuring, we expect annual administrative expenses to increase by around HK\$15.0m. We project ABRS sales to rise around 20% in FY3/08F on increased penetration of its devices and recovering investment spending by hospitals. In addition, Meditech aims to launch a series of personal healthcare products, such as heart monitors, in 2H FY3/07.

**Valuation.** The company trades at 25.6x FY3/07F and 18.3x FY3/08F P/E based on consensus estimates, compared with a sector average of 18.3x and 13.9x, though we note that **Sunray (SRAY SP, S\$0.26, SELL)** is trading at a significantly lower valuation relative to its peers. On an ex-cash basis, Meditech trades at 24.6x FY3/07F and 16.7x FY3/08F P/E, taking the HK\$116.0m CB as debt.

**Corporate governance.** Mr. Kam Yuen, the founder and current chairman of the company is the largest shareholder with a 32.7% stake. Individual investor Kent C. McCarthy is the next largest shareholder at 19.0%. Meditech has an outstanding CB with a principal amount of HK\$116.0m, with a coupon interest rate of 1% p.a. expiring in Sept 2007. The CB is convertible to shares at a conversion price of HK\$1.90 at any time prior to maturity. The company has recently repurchased shares over block periods. The first, totaling 12,667,900 shares at a HK\$1.89-2.07 each, between 16 Aug 2006 to 1 Sept 2006 and the second, totaling 2,564,000 shares at HK\$2.30-2.55, between 22 Nov 2006 to 14 Dec 2006.

**Company's background.** Golden Meditech is a leading hi-tech integrated medical group in China. Its story has its origin in the early 1990s when the group's founder and chairman, Mr. Kam Yuen, began investing in

research and development of the autologous blood recovery system. The company was established in 2000 and listed on Hong Kong's GEM (Growth Enterprise Market) Board in 2001. More recently, China's high-tech medical sector has strongly expanded in parallel with the country's phenomenal economic growth. Today, the company has interests in a number of subsidiaries and associate companies, which collectively conduct the company's businesses in: 1) sales of medical devices; 2) cord blood bank services and 3) development and manufacturing of Chinese herbal medicines.

**Chart 1: Company structure**

Source: Company data

**Table 1: P&L**

Year to Mar (HK\$m)	03A*	04A	05A	1-3Q05A	1-3Q06A
Medical device sales	133.5	170.8	224.2	118.7	121.7
Cord blood bank service	0	3.7	14.5	12.9	29.9
Chinese herbal medicine sales	-	-	-	-	4.2
Turnover	133.5	174.6	238.9	131.6	156.0
Cost of sales	-36.5	-55.2	-68.7	-36.8	-56.9
Gross profit	97.0	119.3	170.3	94.8	99.0
Other revenue	12.9	12.8	18.1	8.6	23.4
Selling expenses	-5.1	-4.8	-7.8	-5.7	-8.9
Administrative expenses	-28.2	-30.6	-48.8	-23.6	-29.2
Operating profit	76.5	96.7	131.7	74.0	84.3
Finance costs	-0.2	-0.7	-6.8	-6.1	-5.5
Gain on deemed disposal of an associate	0	0	29.7	116.5	0
Share of profits of an associated	0	14.8	0	16.1	0.2
Share of profits and losses of jointly controlled entities	0	0	0	0	23.5
Profit before taxation	76.5	110.8	154.6	200.7	102.575
Taxation	0	-3.3	-13.5	-5.6	-6.2
Profit after tax	76.5		-0.4	195.0	96.3
Minority interests	0	0.5	-2.5	-0.6	5.1
Profit attributable to shareholders	76.5	107.9	140.7	195.6	91.1
% chg					
Dividends	14.5	21.4	26.5	0	0

Source: Company data

**Table 2: Valuation comparisons**

Company Name	Ticker	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Nxt Yr P/E (x)	Est Yield (%)	ROE (%)
China Medical-ADR	CMED US	715.7	US\$26.16	n/a	n/a	n/a	60.8
Golden Meditech	8180 HK	641.5	HK\$3.30	25.6	18.3	n/a	37.4
Medical China	8186 HK	15.2	US\$0.14	n/a	n/a	n/a	-1.8
Mindray Medial-ADR	MR US	2,733.1	US\$25.85	n/a	n/a	n/a	n/a
Mingyuan Medical	233 HK	268.8	HK\$0.78	21.1	15.0	1.9	16
Sunray Holdings	SRAY SP	54.6	SGD0.26	8.1	8.3	n/a	21.2
Average				18.3	13.9	1.9	26.7

Source: Bloomberg and SBI E2-Capital