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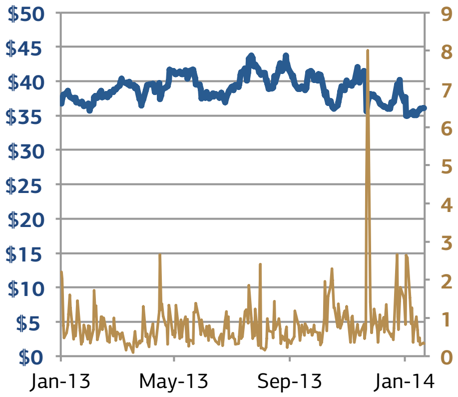
Mindray Medical International Ltd. (MR US) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg, February 12, 2014

Mindray Medical Intl. (MR US)

Price	USD 36.06
Rating	**SELL**
Price target	**USD 31.91**
Difference	**12%**
Price change since initiation	**-12.5%**
Market Cap	USD 4.26 bln
Simple Moving Avg.	0.95 mln
P/E	21x

Source: Bloomberg, February 12, 2014

China | Medical Equipment

Mindray Medical International Ltd. (MR US)

Etherized upon a table

+ CEO shorting his shares?

On February 10, Mindray filed a disclosure revealing that CEO Li Xiting had entered into a prepaid forward contract with UBS to sell 16.6 mln shares, representing 13.9% of the company. Under the contract, the seller receives about 75% of the share value and delivers shares at a later date, so it has the effect of short selling the shares. The sale should yield almost exactly the sum that Mindray requires to pay its promised dividend. Given that we believe Mindray does not have the cash it reports, this could be a significant coincidence.

+ Leasing equipment in China

Mindray management said on a recent call that it had begun to lease equipment to hospitals rather than selling it outright, and the company blamed weak access to financing for the small hospitals rated Grade 1. Additionally, anti-corruption measures apply to contracts over about RMB 200,000. If the same equipment is sold on a lease string, its purchase might avoid the anti-corruption rules and processes. Although this strategy might be adaptive for Mindray, it also means that the company is taking on much more balance sheet risk, and it does not presage well for 2014 China sales.

+ PT unchanged; recommendation: SELL

Our USD 31.91 PT is unchanged and is based on a DCF valuation of the company's cash flows, given an 8.77 WACC and 3% terminal growth.

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Bearish on China outlook

Since mid-year 2013, Mindray has guided down results and has blamed anti-corruption campaigns in China for slowing sales. Our checks with medical distributors, however, suggest that the anti-corruption campaigns are simply adding new paperwork (and sometimes a new kickback) to sales but not obstructing them. Instead, distributors say that elite hospitals buy only imported equipment and small hospitals have run short of money for new purchases. We believe that Mindray is losing share in a market experiencing a more sluggish growth than a year ago.

If insiders are selling, why would outsiders buy?

Furthermore, we wonder whether Mindray CEO Li Xiting agrees. Li appears to be selling most of his shares but doing so via a forward contract that benefits him if the share price falls. The disclosure reads:

> In connection with a variable prepaid forward contract entered into between (i) Quiet Well and Mr. Xiting and (ii) UBS Securities LLC, 1,720,097 of the American Depositary Shares are held by UBS AG for the benefit of Quiet Well. Each of Quiet Well and Mr. Li Xiting retains voting power over such American Depositary Shares until the settlement date under such contract.

Quiet Well is owned by Li Xiting.

Where's the cash?

Mindray is a company that claims around USD 800 mln in cash on its balance sheet and, yet, it never seems to have cash when needed. The company borrowed money to buy Zonare last summer. It borrowed to make its dividend payments. Now, it seems at least questionable why the CEO would need to raise about USD 50 mln in the same month that the company is scheduled to pay out roughly USD 53 mln in a dividend. Mindray withheld USD 20 mln in order to remit USD 400 mln out of China in the form of dividends from the China company in December.

Although Mindray has announced a USD 200 mln repurchase plan, we have not identified any large repurchases yet, and the company's record of completing earlier announced repurchases is weak. Mindray says it converts all sales revenue to Renminbi and does not hold hard currency in its overseas subsidiaries to support their operating capital requirements. Given continuing appreciation

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of the Renminbi, this is not an intelligent strategy.

Whatever the wisdom associated with Mindray's cash management strategies, there is no evident need for USD 400 mln offshore now. Mindray needs to explain the transaction to its investors.

Results in 2013 are relatively weak once the effect of acquisitions is stripped away. Ex the Zonare acquisition, Mindray reported growth of roughly 9% in 2013, against original projections of 17%. Given that Mindray has reported negative profitability in the United States to SEC authorities, and claims that profit in Western Europe is lower than in China, the company needs significant new sales in China to support its current valuation.

We believe Mindray's growth of 9% in 2013 is overstated.

Not only that, but we believe that even this 9% growth is overstated, and that Mindray overstates its capital expenditure to work the resulting phantom cash off its balance sheet. Explaining capex in 2013, the company has said that it spent USD 100 mln on its new factory in Shenzhen, on completing its Beijing R&D center, and on maintenance capex. Management said they reduced capex plans by USD 30 mln in the year because they failed to gain government approval for a project, but they did not specify which project. Our primary research has found that Mindray is very unlikely to have spent as much as it claims on the R&D centers, which are mostly simple concrete shells or empty plots of land. Given the annual capex for a dozen R&D centers around the world plus roughly 10% of gross revenue spent on R&D, Mindray has very little to show in terms of new inventions. The balance sheet does not display capitalized R&D.

Outlook for 2014

Mindray's 2014 outlook: "relatively dangerous."

The company gave preliminary guidance of 15% top-line sales growth for 2014. But on a Chinese-language conference call conducted in November 2013 with Chinese brokerage Guotai Jun'an, company Investor Director Li Wenmei called the outlook for 2014 "relatively dangerous" and said that equipment leasing would be Mindray's "principal strategy." In the call, Li disclosed that Mindray is now leasing equipment to some hospitals rather than selling it outright, and that it hopes to increase this type of transaction. Li said that smaller hospitals lack the cash for equipment purchases. He did not say whether Mindray would finance the sales directly or use a third-party financial-leasing company.

On that call, the company also told investors that their U.S. and

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Mindray's highest levels of growth were in developed markets, which are not as profitable as developing countries.

Western European operations show the highest levels of growth but are not very profitable compared with developing countries and with China, though management would not describe the break-out, saying that the calculations are very complicated. Asked why there is a difference, management did not answer directly but said that the company relies mostly on direct sales in developed countries and distributors in developing markets.

Mindray explained that its sales team now is split into two divisions: the channel management team, numbering about 1,000 people, and the key customers team, with about 300 employees. Distributors within China now number 700-800. They said that about one-third of volume is sold to Tier 3, the top tier hospitals, and 40% to Tier 2. Of China's 1,600 Tier 1 hospitals, the management team estimated that Mindray has penetrated 1,000.

Risks

- Major stimulus spending by the Chinese government to build out county-level hospitals
- Significant new low-interest lending to hospitals or to Mindray directly by the China Development Bank or China Exim Bank
- A major acquisition of an attractive new company or segment

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