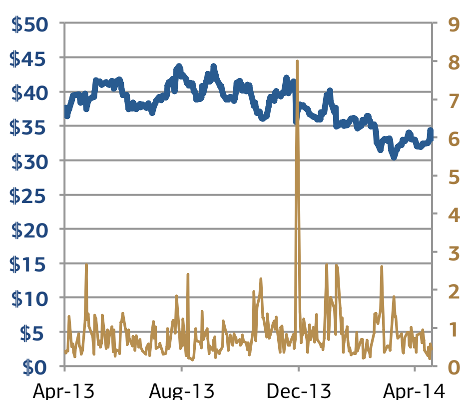
5 May 2014

China | Medical Equipment

Mindray Medical International Ltd. (MR US)

Anne Stevenson-Yang
+86 139 1082 0535
anne@jcapitalresearch.com

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



Source: Bloomberg, May 5, 2014

Mindray Medical Intl. (MR US)

Price	USD 33.17
Rating	**SELL**
Price target	**USD 31.91**
Difference	**3.8%**
Price change since initiation	**-13%**
Market Cap	USD 3.92 bln
Simple Moving Avg.	0.598 mln
P/E	17.09x

Source: Bloomberg, May 5, 2014

Heal thyself

+ Glum

Mindray's 20-F reveals a company whose balance sheet is deteriorating, whose markets show little growth, and whose acquisitions seem not to be contributing to the company.

+ What was that USD 416 mln transfer?

In November last year, Mindray indicated that it would make a dividend payment of about USD 416 mln from Shenzhen to its Hong Kong company, then the company apparently changed its mind. The explanation provided makes no sense to us.

+ PT unchanged; recommendation: SELL

We base our target price on a DCF valuation model with a WACC of 8.77% and a terminal growth rate of 3%.

Anne Stevenson-Yang +86 139 1082 0535 anne@jcapitalresearch.com

Core business performance

There is not too much to like about Mindray's recent 20-F. There was top-line growth of 14.5%, but operating income was up by just under 10%, with USD 37 mln, or 3% of gross revenue, coming from interest income. The company had projected 18% growth at mid-year and did manage to accelerate in the last quarter but is clearly slowing. We expect things will get worse this year.

Growth is slower than projected despite the USD 101 mln acquisition of Zonare in mid-year. The expected growth from Zonare did not materialize, and imaging revenue rose a mere 1%. At acquisition, Zonare already had distribution in China via TCL Medical Systems and has well-established distribution in other parts of the world, so it should be contributing more. We have similarly low expectations for Mindray's acquisition of Shanghai Long Island Biotec, an IVD company, in January. To date, Mindray has declined to provide break-outs on the revenue contribution from its acquisitions, and, on the numbers, there is no clear evidence that the companies have contributed much of anything. In Zonare's case, it seems like the best contribution so far is the tax reduction, since Zonare, like Datascope before it, came with a big tax loss.

In developed markets, Mindray never built out a service offering, so it competes in the "bargain equipment" ghetto.

The core problem is that Mindray just doesn't have a lot to offer. The products were an almost-as-good, much cheaper alternative to imports when smaller hospitals were on an expansion binge. These new buyers did not pay much attention to equipment reliability, because the future application of the equipment was a matter of speculation. But now that hospitals are trying to fund themselves with income rather than only capital investment, they are becoming more mindful of quality issues, and Mindray is not competing well.

In developed markets, meanwhile, Mindray has never had much traction. Independent distributors seeking an entry point to compete with mammoths like GE and Siemens can be found to take on the sale, but Mindray gets none of the lucrative repair and maintenance income and, since quality is lacking, they do not perform well in replacement sales.

Investment-driven sales

In China, the weakening that appears to have begun in early 2012 has taken time to filter through to the company's top line, as distributors bought more than they could sell. Mindray no longer discloses what proportion of its sales is made to distributors, but

Anne Stevenson-Yang +86 139 1082 0535 anne@jcapitalresearch.com

when it did, through 2011, those sales were driving all the Chinese growth. Distributor sales during that period were tracking 18% annually, compared with direct sales growth of 3%. In the meantime, big sales via government tenders, always small for Mindray, have virtually disappeared, with government tenders now down to 1.1% of sales.

In 2012-13, the company re-organized its distribution network. We believe that at least some of this pruning operation occurred at the initiative of distributors that had accumulated too much inventory and/or pre-payments to Mindray in a weakening market and who chose to leave the network. We have interviewed several such distributors in the northern part of China.

Back when Mindray had market power in China, the company set stiff terms for small distributors, requiring pre-payments in the first quarter for up to 100% of the expected annual sales value. This practice, although originally fantastically advantageous to Mindray, led, we believe, to two problems: overstock by distributors and a diversion by Mindray into managing money.

Choking the channels

Mindray's distributors overbought inventory in the fat years, and purchasing should drop more dramatically as a result.

China's market is unusually volatile, and small medical-equipment distributors are poorly equipped to forecast that volatility. The pre-payments forced them into investing, sometimes by taking in outside capital investors, and sinking more capital than the market necessarily merited. When the market started to turn, in early 2012, they found themselves with too much Mindray.

In the recent report, distributors have been trimmed to 1,500, but this is still a huge number. International incumbents say they have between 150-300 distributors in China for bigger businesses. Furthermore, despite claims that nearly all business in China goes through distributors, we have a good deal of trouble finding them. In fact, we find that Mindray's own sales staff has taken over sales in several regions we look at. Since this should be a higher-margin business, why not report it?

Projections for China

Our recent checks on the market in China—very partial, given the fragmentation of the market—indicate that hospitals are delaying budgetary allocations while they wait for clearer signals on credit policy and likely medical spending. We believe the uncertainty itself is negative for the market, especially since four months of the year have already passed and no fog is clearing. Given that credit has

Anne Stevenson-Yang +86 139 1082 0535 anne@jcapitalresearch.com

slowed, that Mindray does not seem to be making inroads at the top hospitals, and that small hospitals have thus far failed to gain the revenue to justify their 2009-11 spending spree, we do not see much hope for sales growth in China beyond GDP growth.

Telltale signs

Signs of increasing strain in the company filter through the financials. In the 20-F, accounts payable rose by 76% and advances from customers by 61%, salaries payable by 30%. Overall, current liabilities rose by 63%.

It remains a mystery why, with so much cash on the balance sheet, Mindray keeps borrowing, taking longer to pay suppliers, and taking bigger advances from customers.

Long-term liabilities rose even more, nearly 250%. The principal reason was bank loans. Short-term bank loans rose by USD 135 mln, and total borrowings outstanding at the end of the year were USD 475.7 mln. Net debt to equity has gone from negative 10% to positive 6%. Working capital was kept under control, but only through sharp increases in payables. Total liabilities more than doubled, from USD 480 mln to USD 986 mln.

This ever-growing borrowing remains one of the most peculiar things about Mindray. Minus the borrowings, the company reports cash and short-term investments of more than USD 750 mln. That is equivalent to 159% of total operating expenses for the year or three full quarters of all the company's expenses, including raw materials and sales commissions. The company's yield on its cash and short-term investments comes to 3%, and its average interest on debt is 5%. It clearly does not need to hold all that cash, especially given that the company still receives significant pre-payments. Would it kill Mindray to pay for something in cash?

The disappearing dividend

In November, Mindray statements showed an odd withholding: USD 20.8 mln in taxes withheld on a dividend payment from Chinese subsidiaries to the Hong Kong holding company. Mindray disclosed very little about this but did affirm during a Chinese-language call in November that the withholding represented 5% of the payment, making the presumed payment USD 416 mln.

Given that Mindray discloses that "We generally have substantial cash in accounts located outside of China," why would it need this cash? The company said the dividend was required, "given concerns that borrowing rates would increase." This seems to suggest that the company was considering paying down debt, because it is hard to imagine why any new borrowing might be under consideration.

Anne Stevenson-Yang +86 139 1082 0535 anne@jcapitalresearch.com

Average interest expenses for the year, however, were declining.

The 20-F then discloses that Mindray changed its mind and reversed the withholding in the same quarter.

> "...[W]e reversed the $20.8 million withholding tax charge when we elected to unwind the proposed intra-group dividend from the distribution of earnings from 2008 and thereafter. We did so based on changed near-term expectations for offshore borrowing rates and to provide us additional opportunities to explore other tax-efficient means to transfer funds within our corporate group (including possible cross-border Renminbi loans from Shenzhen Mindray directly to our Hong Kong subsidiaries)."

Presumably this means that 1) US rates looked like they'd rise in November but didn't, so Mindray is fine with keeping its money in China and 2) It's okay to create a liability in Hong Kong for the extra cash presumably being held by Chinese subsidiaries, because they may need funding in the future and anyway, maybe inter-company debts don't really have to be paid.

Did Mindray rent out its balance sheet to transfer USD 400 mln overseas? Or did the company change its mind about the transfer over a couple of weeks? Whatever happened, Mindray should disclose the details.

None of this sounds remotely plausible to us. We observe that Mindray got into the habit of managing large cash pre-payments from distributors long ago. The company has an investment division and has been making equity investments in China, buying land for its multiple R&D centers, and making investments in various types of money market instruments in China. Given that about 55% of the business is offshore, Mindray has easy access to currency trades. We find the company's disclosures on its cash management highly unsatisfactory, unclear, and incomplete, and we wonder what the underlying reality might be. What this means for investors is that the USD 847 mln in short-term investments may not be quite as readily available as it looks.

Valuation

We apply a DCF valuation with a terminal growth rate of 3% and WACC of 8.77% for a target price of USD 31.91.

Risks

- The Renminbi has depreciated by more than 4% since mid-January, and we believe there is a good chance of depreciation to 7:1 this year. Since all of Mindray's products are manufactured in China and shipped overseas, the

Anne Stevenson-Yang +86 139 1082 0535 anne@jcapitalresearch.com

depreciation gives the company significant margin upside.

- Zonare has a good reputation in the market. If the imaging systems begin selling, they could raise the margins for this portion of the business.
- Chinese stimulus spending could increase hospital procurement.

Anne Stevenson-Yang +86 139 1082 0535 anne@jcapitalresearch.com

Disclaimer

This publication is issued by J Capital Research ("J Capital"). This publication has been prepared for the general use of the clients of J Capital and unauthorized copying or distribution is prohibited. Nothing in this document shall be construed as a solicitation to buy or sell any security or product. In preparing this document, J Capital did not take into account the investment objectives, financial situation and particular needs of the reader. Before making an investment decision, the reader needs to consider, with or without the assistance of an adviser, whether the advice is appropriate in light of their particular investment needs, objectives and financial circumstances. J Capital accepts no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this publication and/or further communication in relation to this document.