

August 21, 2018
Company Update

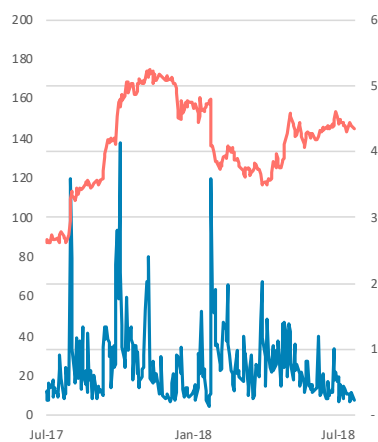
Tim Murray
Tim@jcapitalresearch.com

+61 411 046 476

Blackmores (BKL ASX) One Year Price Chart and Volume

Price	AUD 145.59
Market Cap (AUD)	2.492 bln
Target Price	AUD 106
Downside	27%
P/E	38.53
Volume (AUD)	5.8 mln
Recommendation	SELL

Blackmores Limited (BKL ASX) last share price in AUD (left, pink) and volume in 100k shares (right, blue)



Source: Bloomberg August 21, 2018

Blackmores Limited (BKL ASX) The End of the China Story

- ▶ **We prefer honesty:**
Despite Blackmores' "preferred" data series showing growth in China sales in Q3 we believe total China sales declined 4%.
- ▶ **Q4 China Sales Down 20%:**
Based on our capturing of sales on Alibaba we believe sales have fallen sharply in Q4 yoy.
- ▶ **China is over:**
We believe the China growth story that sustained Blackmores growth since 2015 has ended, and Blackmores has gone ex-growth.
- ▶ **SELL:**
We recommend selling Blackmores stock and have a target price of AUS\$106 We expect that annual results announcement on the 28 August 2018 will be the catalyst for a 27% decline. We would expect the decline to come over a six- to 12-month period, as results gradually disappoint.

China Sales Decline Q4: What will drive growth next year?

Table 1. Blackmores 4Q FY2018 Revenue Estimates (Gross)

Revenue by Segment	Q4 2018	QoQ Growth	FY 2018	Growth
Australia and New Zealand	102	-6%	367	-1%
China (in Country + Export Division)	32	-16%	144	11%
BioCeuticals	28	6%	112	9%
Other Asia	26	16%	100	18%
Revenue Total	189	-3%	726	5%

Source: J Capital

Earnings growth to stagnate in FY 2019.

Our revenue estimate for Q4 is only a few percentage points lower than consensus. It is the sharp decline in China sales in Q4 that leads us to the disappointing conclusion that Blackmores China growth story is over. Our revenue projection in subsequent years are around 10% lower than consensus but our earnings estimates are 20% lower than consensus. We expect the company will experience declining margins as price competition and marketing costs rise in China, and as the revenue share of lower margin products/regions like BioCeuticals and Other Asia.

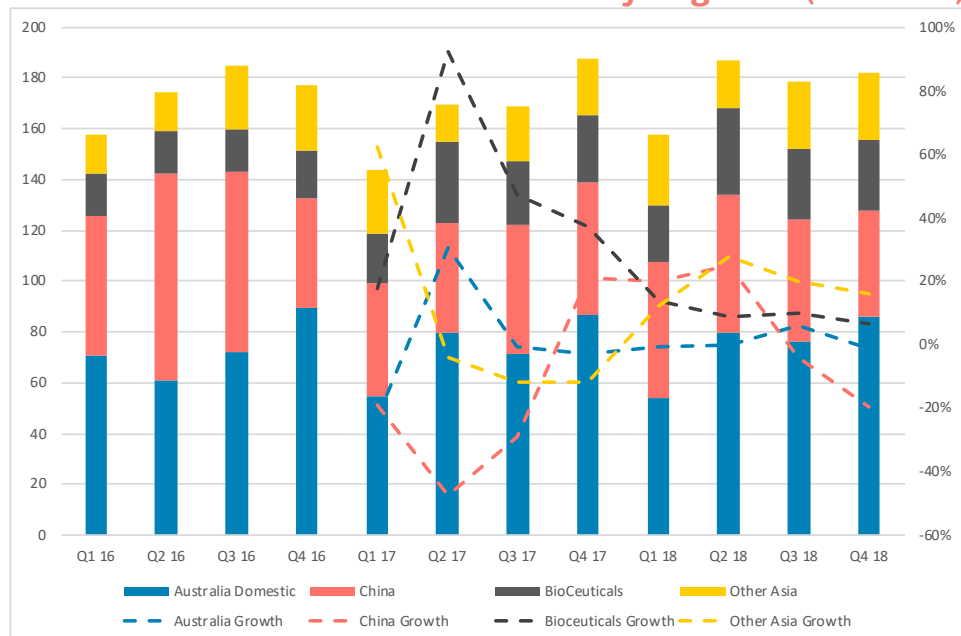
Blackmores has lost market share to competitors in China and is being out marketed by competitors. China provided Blackmores with high margin growth. Now it is low growth and diminishing margins.

Blackmores' BioCeutical division has experienced strong growth but is now stalled, and the margins are not great. Other Asia is growing fast but due to high overheads only breaks even. The company does not expect Other Asia to make a significant contribution anytime soon.

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China Sales Fell in Q3 FY2018

Chart 1. Blackmores Gross Revenue by Segment (AUD mln)



Source: Company Reports, J Capital

Table 2. Blackmores Gross Revenue AUD mlns

	Q1 17	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
Australia	54	80	72	87	54	80	76	86
China via <i>Daigou</i> Australia	14	10	22	14	14	12	17	10
China via Australian Export Division	17	13	15	25	21	19	16	16
China In Country Sales	14	20	13	13	19	23	15	16
(China in Country + Export Division)	31	33	28	38	40	42	31	32
Total China Sales	45	43	50	52	54	54	48	42
BioCeuticals	20	31	25	26	22	34	27	28
Other Asia	25	15	22	22	28	19	26	26
New Zealand	3	3	6	7	3	3	6	6
Rest of the World	1	0	1	1	1	-1	2	1

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	Q1 17	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
Revenue Total	147	173	176	195	162	190	186	189
Australia	-23%	31%	0%	-3%	-1%	0%	6%	-1%
China via <i>Daigou</i> Australia	-69%	-83%	-54%	-30%	3%	20%	-22%	-29%
China via Australian Export Division	1600%	1200%	50%	47%	24%	46%	7%	-36%
China In Country Sales	40%	0%	8%	117%	32%	13%	15%	23%
(China in Country + Export Division)	182%	57%	27%	65%	28%	26%	10%	-16%
Total China Sales	-19%	-47%	-29%	21%	20%	25%	-4%	-20%
BioCeuticals	18%	92%	47%	37%	14%	9%	10%	6%
Other Asia	62%	-4%	-12%	-12%	12%	28%	20%	16%
New Zealand	-25%	-25%	0%	17%	0%	0%	0%	-14%
Revenue Total	-9%	-3%	-9%	6%	10%	10%	6%	-3%

Source: Company reports, J Capital

A Q4 decline in China is the end of the hope of a China growth recovery.

Blackmores reported 22% YTD growth through the third quarter of FY2018 (July 2017 to June 2018) but that masks the real story: we calculate that total China sales (direct and indirect) fell 4% in the quarter. China sales represent about 29% of total sales for Blackmores but has been the engine of growth. A Q4 decline in China is the end of the hope of a China growth recovery.

Blackmores claimed 7% QoQ growth in Q3 for its “preferred data series” on China. That sounds much better than a decline, doesn’t it?

Blackmores stopped reporting total China sales in Q3 FY16, when sales fell off a cliff and never recovered. Since then, the company has reported “China in-country sales,” which is sales from its own operations in China, and “Australian export division sales to China.” The fuzzy bit, that is no longer reported, is the sales made in Australia, and included in the “Australian sales” that end up in China. apparently via the *daigou* channel. This fuzzy bit, which encompasses products carried in by travellers and sold through special import channels online, was 80% of China sales in FY 2016 and 53% of sales in FY 2017 and has slowed considerably. Blackmores continues to make specific comments on the Australian domestic sales but refuses to reveal estimates of *daigou* sales, saying they are too hard to work out.

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Other Asian markets make no money and BioCeuticals growth has slowed.

Once all the channels for China sales are taken into account, Blackmores shows growth on a low base in total China sales between Q4 2017 and Q2 2018. But in Q3 2018, China sales are falling again. Our research is showing this decline will continue in Q4.

The company has obfuscated this poor performance further over the last 18 months by restating some *daigou* sales as Australian export sales to China, shifting New Zealand sales into the Australian segment, and changing segment reporting form gross to net.

Blackmores's growth problem

We believe Blackmores has gone ex-growth. Blackmores was a low-growth company with high margins, before China sales exploded at even higher margins. Poor sales growth and extreme competition in China are driving Blackmores' margins down, as the company turns to discounting to bolster sales. With the Blackmores' acquisition of a manufacturing company, we can expect margins to fall further. Investors have remained optimistic that Blackmores can recover high growth in China following the 2016 year-end market implosion. It will not.

True, Blackmores has some growth in other Asian markets and in BioCeuticals, but the Asian markets make no money, and BioCeuticals margins are 3% points lower than those of Australia sales and 10% lower than China sales. Besides, growth is slowing fast.

Table 3. Operating Margins by Segment (Gross unless in Green then Net)

	2H FY 16	FY 16	1H FY 17	FY 17	1H FY 18
Revenue (Gross)	375.8	717.2	322.1	692.8	351.9
Australia	244.4	482.0	123.0	372.0	120.6
China	77.8	77.3	58.1	132.1	73.9
BioCeuticals	39.0	72.3	48.0	102.3	53.1
Other Asia	20.4	81.4	33.4	84.4	39.4
Operating Income	76.1	145.2	41.9	86.2	49.3
Australia	53.4	117.0	21.7	62.9	25.8
China	25.8	25.8	20.0	27.9	20.8
BioCeuticals	5.0	10.0	7.7	14.3	7.9

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	2H FY 16	FY 16	1H FY 17	FY 17	1H FY 18
Other Asia	-3.5	2.3	-0.2	0.9	1.2
Operating Margin	20%	20%	13%	12%	14%
Australia	22%	24%	18%	17%	21%
China	33%	33%	34%	21%	28%
BioCeuticals	13%	14%	16%	14%	15%
Other Asia	-17%	3%	-1%	1%	3%

Source: Company Reports, J Capital

Rising China rebates

When Blackmores restated its H1 FY2017 results from gross to net in the H1 FY2018 report, it provided insight into the level of rebate by segment. The Australian market has the highest rebates. China rebates at that time were moderate. But, as Blackmores faces intense competition and marketing pressure in China, it is increasingly using discounts to drive sales. We believe that is why rebates went back up in Q3 2017. We are not expecting rebates to return to the lower levels of H2 2017.

Table 4. Rebates by Segment

Revenue by Segment	Net H1 2017	Gross H1 2017	Rebate by Segment
Australia	123	165	25.3%
China (in Country + Export Division)	58	64	9.1%
BioCeuticals	48	51	5.9%
Other Asia	33	40	16.4%
Revenue Total	263	322	18.3%

Source: Company Reports, J Capital

Production Acquisition: Management Distraction

Blackmores announced the acquisition of 100% of Catalent Australia, one of its key manufacturing suppliers, for AUD \$43.2 million in April 2018. Catalent currently supplies 15% of Blackmores needs and this will expand to 50% post acquisition.

Management claims this acquisition supports growth and provides greater control over production to respond faster to market conditions. There is

Intense competition in China will keep rebates high.

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Blackmores Fish Oil on sale 50% off on July 4, 2018 in Woolworths, Sydney Australia. Chasing Q4 sales with large discounts to the largest retailer. | Source: J Capital

Net contribution margin of 2% from the acquisition.

the weak claim that it “future proofs” the Asia-ex China business as product registrations in countries like Thailand are linked to the production facility. Blackmores claims it will be positive for EPS from FY 2020 when the acquisition is completed. The company argues they will capture the margin Catalent currently makes. In previous years the company

has avoided vertical integration as they believed they could save more from competitive tendering for supply. We estimate Catalent net margin is 3-4%, so after the interest cost of the debt funded acquisition we expect net contribution margin of around 2% from the new business. We believe this lower margin business will see the the market re-rate Blackmores as a hybrid consumer and manufacturing company. We believe this acquisition distracts management focus from the core problem of the companys’ failure in marketing. Acquisition seldom achieve synergies planned but always distract management

Losing its Core Focus on Marketing

Blackmores was a successful brand manager that tolled out manufacturing. It is no longer a strong marketing company. It is transforming itself into a discounter and a low-margin manufacturer.

Since the failure of the China strategy in 2016, the CEO has departed, but the COO was promoted, and key staff, such as the MD for Asia, remain in place. They recently added a new board member whose strength is logistics. What they need is leadership in marketing.

Until there is management and strategic change we can expect Blackmores to retreat further from high margin growth.

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China Revenue Q4 FY 2018: Down 20% QoQ

Table 5. China Revenue Estimate Q4 FY 2018

	Q4 2018	QoQ Growth	FY 2018	Growth
China (in Country + Export Division)	32	-16%	54	-11%
China via Daigou	10	-29%	144	11%
Total China	42	-20%	198	4%

Source: J Capital

Table 6. Blackmores China Q4 Sales (mln)

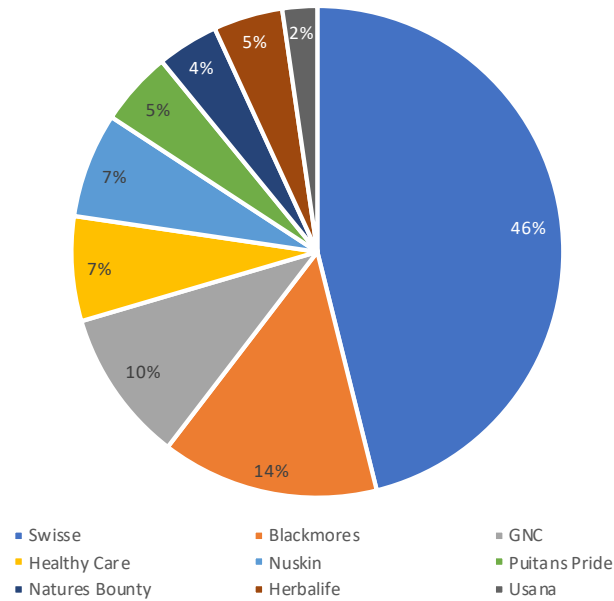
Tmall Retail Revenue RMB	75
Taobao Retail Revenue RMB	24
Estimated Retail Margin	30%
Wholesale Revenue RMB	53
Tmall and Taobao share of sales	25%
Estimated Total Revenue RMB	210
AUD/RMB	5.04
Estimated Total Revenue AUD	41.7

Source: J Capital

for Q4.

Based on our own data collection, we estimate the total China revenue of Blackmores at AUD \$42 mln for Q4 FY 2018 (Apr-Jun 2018) a decline of 20% QoQ. Total China sales for FY 2018 would be AUD \$197 mln or 4% growth. The China in-country and Australian export sales to China we estimate to be \$32 mln for Q4 FY 2018, 3% growth on the previous quarter, Q3 FY18, and a 16% decline QoQ and total sales for FY18 of AUD \$144 million an increase of 11%. This will disappoint the market as the company has guided improved China sales

Chart 2. China Imported VDS Market Share July 2018



Source: J Capital

Data Description

J Capital has built a web scraping software to monitor sales in the VDS category on the key ecommerce websites of Tmall and Taobao. We now measure Blackmores’ and competitor brands by channel, shop, product, price and volume on a weekly basis. We conducted a survey of international and domestic VDS brands to determine the size of the Tmall and Taobao channel for different brands. Survey respondents stated that retail margins are between 30% and 50%, but typically 30%. We use 30% retail margins to estimate wholesale sales and market size and share.

We caution that our current data collection only began in April 2018. We have no historical data to test our data against reported sales for brands. We therefore cannot be certain our estimates of market share and our data collection methods are accurate and able to predict Blackmores China sales.

We believe Tmall is around 20% and Taobao 5% of Blackmores sales. Blackmores sales on JD and Koala are about equal to its sales on Tmall. A respondent to our survey told us that Blackmores sales on JD and Koala are now falling, because Blackmores signed an exclusive strategic marketing agreement with Tmall in June 2018. Signing the agreement has led to more support from Tmall for Blackmores and the expectation is for Tmall sales to double.

Sales on JD and Koala are falling.

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Blackmores had three shops on JD--its self-operated flagship store and two authorized stores run by partner Shuangxingxian. At the end of last year, Blackmores had a dispute, and these shops were closed. This had a negative impact on Blackmores' sales on the JD platform. In general, market participants say that Blackmores' advertising and discounts on JD are not attractive enough to generate high sales.

Survey Results

Table 7. VDS Brand Sales and Growth by Channel

	Blackmores	GNC	By Health (largest domestic brand)	Growth Rates
Tmall	21%	33%	54%	35%
Taobao	4%	17%	11%	25%
JD	18%	12.5%	25%	30%
Xiaohongshu	8%	4%	4%	25%
Netease Koala	19%	12.5%	1%	30%
Miya	4%	2.5%	3%	25%
Others	26%	18%	1%	20%

Source: J Capital

We surveyed five ecommerce service providers and online shop operators familiar with the sales of VDS brands in China. Top-line results of the survey:

- ▶ Blackmores Tmall sales are 21% of sales
- ▶ Blackmores Taobao sales are 4% of sales
- ▶ Blackmores sales on JD are declining
- ▶ Growth is best on Tmall, JD and Koala
- ▶ Retail margins are between 30 and 50%

Respondents all said brand awareness and marketing are critical to sales success online.

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Blackmores' product offering is aging, management is unstable, and as sales are falling.

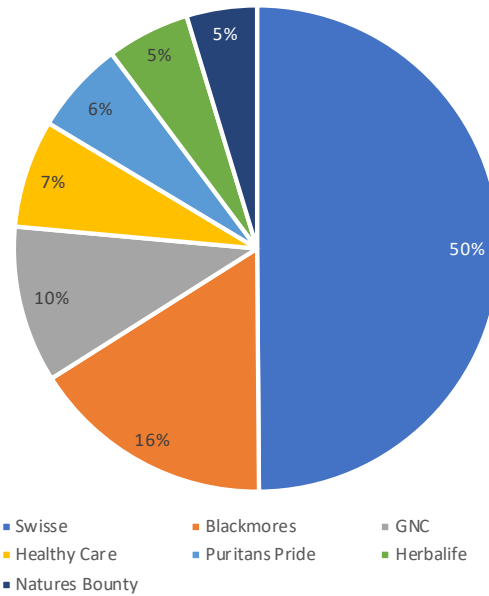
Respondents said Swisse is spending heavily on online advertising to promote its flagship store on Tmall in addition to traditional advertising. Blackmores, by contrast, is perceived to do little advertising and relies on word of mouth. When asked to compare Blackmores with Swisse, respondents said:

- ▶ “Blackmores has a fairly simple annual marketing plan. The marketing department is weak. Blackmores’s brand awareness in China is lower than Swisse’s.”
- ▶ “Swisse and Blackmores are on two very different levels when it comes to sales. There is no comparison. Blackmores was ranked seventh in China last year.”
- ▶ “Blackmores’ product offering is aging, management is unstable, and as sales are falling. Marketing expenditure is also being cut.”
- ▶ “New competitors are taking market share from Blackmores”
- ▶ “Swisse sales are 5x Blackmores’.”
- ▶ “Swisse is better at everything.”

Marketing staff from the leading domestic VDS brand, By Health, said “Blackmores sales are falling a lot, and it is because their products are getting old. In 2017, Blackmores’ growth was 2% lower than the market growth.” Respondents said brands need to be constantly developing new products, but Blackmores mainly sells its Australian product line to the Chinese consumer. Competitors develop products specifically for Chinese consumers.

Tmall: Blackmores Distant No 2

Chart 3. Imported VDS Tmall Market Share July 2018



Source: J Capital

Table 8. Tmall Sales Analysis Sales Leading Australian Brands July 2018

	Swisse	Blackmores	Healthy Care
Tmall Store	25,003,720	13,063,554	3,516,406
Brand Flagship Store	23,683,117	7,001,802	2,828,471
Chemist warehouse	14,403,313	2,303,530	5,798,221
Saint Cos	5,120,901	3,499,331	943,481
Care Plus	3,625,514	3,274,876	435,100
Alihealth	2,901,407	1,505,536	155,251
Total Top Six	74,737,972	30,648,629	13,676,930
Share of Total Sales	89%	94%	98%

Source: J Capital

Tmall is the single most important channel for sale of VDS in China. We estimate 40% of all online VDS sales are made in this channel. For Australian brands, the sellers are very concentrated, the top six stores sell at least

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Top six stores
on Tmall make
at least 90%
of sales.

90% of all sales in this channel:

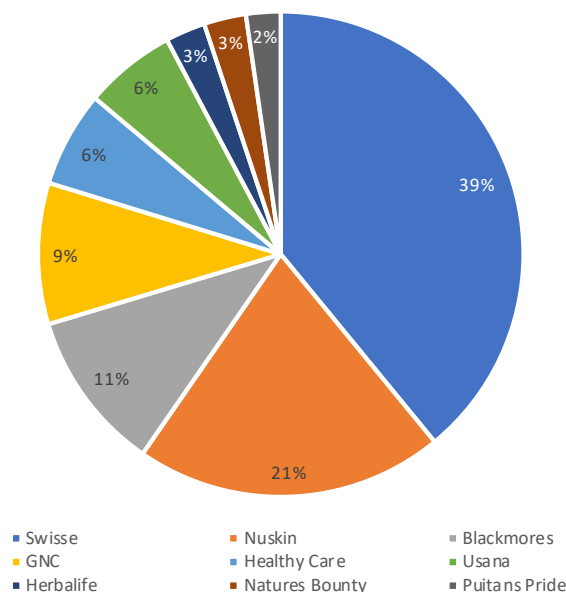
- ▶ Tmall's own direct sales shop has the highest VDS sales. It markets best selling products of major brands. Blackmores top 2 products, sold at 15% discount make up 50% of sales.
- ▶ A Brand's flagship stores is key to sales and Blackmores sales have tanked since they brought the operations of its flagship store inhouse late last year.
- ▶ ChemistWarehouse led the way in Blackmores export sales to China in 2015 and 2016. Since then the relationship has soured as Blackmores has tried to sieze back more control of its market. Blackmores does not feature in the top 10 VDS products in the channel. Healthy Choice, the number 3 Australian brand has double the sales of Blackmores in this channel, despite Blackmores best selling products being sold at a 40% discount.
- ▶ CarePlus is an online retailer, established in 2011, focusing on Australian products with prominent stores on Tmall, JD and Suning. Two Blackmores products, Vitamin E and Celery account for 71% of Care Plus Blackmores sales. The Vitamin E cream sells at 40% discount to the price on the Blackmores store and Celery at 20% discount.

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Blackmores sales falling on Taobao.

Taobao: Blackmores Slipped to Number 3

Chart 4. Imported VDS Taobao Market Share July 2018



Source: J Capital

Table 9. Taobao Sales Analysis for July 2018 for leading Australian Brands

Taobao Shop	Suisse	Blackmores	Healthy Choice	Notes
Cow Mummy 乳牛妈咪	1,881,475	786,823	277,941	Swisse 15% cheaper, Healthy Choice 20% cheaper than Blackmores,
Mila 米拉诺米	1,594,105	705,444	155,438	Blackmore price 30% lower than Suisse fish oil
Little Koala 小考拉国际直邮店	1,816,988	596,613	243,397	Swisse 80% of top 10 products
Lohas 乐活 澳洲直邮店	449,447	477,416	132,464	Swisse leads with calcium and vitamin D
Little Fruit 小果澳洲代购直邮店	1,886,246	334,103	219,846	Swisse honey facial mask 1/3 of all sales, Healthy Choice Grapeseed 20% cheaper

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Taobao Shop	Suisse	Blackmores	Healthy Choice	Notes
Kanshop 姗姗的袋鼠小铺	532,313	321,158	87,835	Swisse products female focused, Blackmores elderly focused
Top 6	8,160,574	3,221,557	1,116,921	
Top 6 as % of total	32%	37%	24%	
Top 10	11,034,750	3,756,117	1,406,966	
Top 10 as % of total	43%	43%	31%	
Total number of Vendors (selling)	882	1,715	772	
Average Sale per vendor	29,160	5,141	5,962	
Vendors sold 3 or less items	13%	50%	42%	

Source: J Capital

Taobao is a much more fragmented market place than Tmall. The top six retailers only sell about 30% of products and the top 10 around 40%. The other 60% is sold by around 1000 vendors. This is the home of the *daigou*. Blackmores has made the strategic decisions to cut off the *daigou* and take control of online sales through large customers on Tmall, JD and Koala. As a result Blackmores has lost market share on Taobao. 50% of Blackmores vendors sold 3 items or less of Blackmore products in Q4. This is just vendors selling off old stock. Swisse is the clear leader with much more active vendors selling on average RMB29,160 each month. This channel is a race to the bottom. Whoever discounts the most will get the sale.

Competitors Acquired by Chinese Companies

Blackmores has a go-it-alone strategy in China, which we believe condemns the company to slower growth. It has no Chinese partner and operates its own stores on key platforms. Blackmores major competitors Swisse and GNC have been acquired or formed joint ventures with Chinese companies. Swisse surged ahead in sales and market share in China after being acquired. GNC sales will soon overtake Blackmores in China.

Australia's number three VDS company, Natures Care, which has the brand Healthy Choice, was taken over by the "China A Team" of investors. JIC

Natures Care
acquired by
China's "A
Team" of
investors.

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and Tamar took a majority in the company on a valuation of \$800 mln. JIC investments is ultimately owned by the China sovereign wealth fund China Investment Corporation. Tamar is a joint venture between Citic (One of the key SOE's in China) and Dah Chong Hong, a Hong Kong company that owns a chain of supermarkets and convenience stores in China. This is important, as these state-backed companies can get products regulated and have access to distribution and retail chains. Healthy Choice has cleverly targeted Blackmores key online retailers, discounting products that compete with Blackmores best sellers. Healthy Choice sales are catching Blackmores fast. With a distribution and regulatory advantage, we expect stronger competition.

Nutrition Care a distant number 4 brand in Australia is now owned by Hong Kong-listed Ausnutria Dairy). With only \$30 mln in revenue it is not a significant challenger to Blackmores. It competes more with Blackmore brand BioCeuticals in Australia.

Blackmores board met in China in June and discussing partnerships, but not equity partnerships, was a key issue. They realise this threat but are yet to take action.

Valuation: Target Price \$106 Downside of 27%

We have a target price of \$106 for Blackmores based on DCF model with a WACC of 6.27% and a terminal growth rate of 1%.

The risk to our model is using untested data for our key estimate of China revenue.

Table 10. Blackmores Ltd (BKL AU) thousands

Segment revenue:	2018	2019	2020	2021
Australia	296,000	298,960	300,455	303,459
China via Daigou Australia	53,454	42,764	38,487	38,487
China via Australian Export Division	72,000	75,600	79,380	83,349
China In Country Sales	72,000	82,800	95,220	104,742
(China in Country + Export Division)	144,000	158,400	174,600	188,091
Total China Sales	197,454	201,164	213,087	226,578
BioCeuticals	111,920	120,874	129,335	137,095

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Segment revenue:	2018	2019	2020	2021
Other Asia	99,552	114,485	131,657	144,823
New Zealand	18,000	18,180	18,362	18,545
Rest of the World	3,000	3,300	3,630	3,993
Gross Revenue	725,926	756,962	796,526	834,494
Rebate	145,185	151,392	159,305	166,899
Rebate %	20%	20%	20%	20%
Net Revenue	580,741	605,569	637,221	667,595
EBIT	101,780	101,111	106,384	111,427
Net Income	69,479	69,561	73,734	77,655

Segment revenue:	2018	2019	2020	2021
Australia	1%	1%	1%	1%
China via <i>Daigou</i> Australia	-11%	-20%	-10%	0%
China via Australian Export Division	3%	5%	5%	5%
China In Country Sales	20%	15%	15%	10%
(China in Country + Export Division)	11%	10%	10%	8%
Total China Sales	4%	2%	6%	6%
BioCeuticals	9%	8%	7%	6%
Other Asia	18%	15%	15%	10%
New Zealand	-5%	1%	1%	1%
Rest of the World	47%	10%	10%	10%
Total	5%	4%	5%	5%

Source: TMall, J Capital

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