Universal Health International Group Holding Ltd: An Owner Operator with Best in Class Operations and Capital Allocation Trading on an EBIT/EV Yield of 24.0%

Universal Health International Group
Ticker: 2211:HKG
1 Year Avg. Daily Vol. (USD mn): 6.29

Recommendation: Buy
Closing Price (9/8/2015): HKD2.69
Estimated Annualized Return: 15.8%

FACTOR RATINGS

Factor	Rating	Comment
Financial health	5	Net cash equals 2.41 times ttm operating profit
Business quality	4	The company generates high ROIC and has unique activities that complement each other but the retailing industry is notoriously competitive
Management quality	4	
Operations	5	Management are the best operators in the industry with the highest growth and profitability
Capital allocation	5	Management has acquired companies at cheap valuations and improved operations
Corporate governance	3	There are some insignificant related party transactions and potential areas of concern
Growth prospects	5	The industry is expected to grow at 20% over the next few years with additional growth from acquisition
Valuation	5	The company is trading on a 24% EBIT yield despite the strength of management, growth and financial health

Scale 1 = worst 5 = best

Source: Reperio Capital Research

KEY STATISTICS

Key Statistics	TTM	5Yr Avg
Current price (HKD)	**2.69**	
Price range	2.32-5.58	1.88-5.58
Average daily volume (USD mn)	6.29	4.95
Shares outstanding (mn) basic	2,000	
Shares outstanding (mn) diluted	2,000	
Market cap (HKD mn) diluted	**5,380**	
Net debt (HKD mn)	(2,007)	
Other claims (HKD mn)	141	
Enterprise value (HKD mn)	**3,514**	
EV per share	1.76	
Net Debt/Equity	(0.59)	
Net Debt/EBIT	(2.38)	
Per Share Value	**TTM**	**5Yr Avg**
Net current asset value per share	1.13	0.51
Invested capital per share	0.72	0.44
Tangible book value	1.70	0.77
Net financial assets per share	1.01	0.37
Sales per share	2.97	1.50
EBIT per share	0.42	0.24
NOPAT per share	0.31	0.18
Earnings per share	0.31	0.19
FCF per share	0.09	0.04
Residual income per share	0.28	0.16
Insider ownership	49.2%	
Fiscal year end	December	

Source: Company data, Reperio Capital estimates

Valuation	TTM	5Yr Avg
P/NCAV	2.4	5.3
EV/IC	2.4	4.0
EV/EBIT	4.2	7.4
EV/NOPAT	6.4	11.4
EV/FCF	18.7	43.1
EBIT Yield	24.0%	13.5%
NOPAT Yield	15.7%	8.8%
FCF Yield	5.4%	2.3%
Dividend Yield	1.8%	1.2%
Profitability	**TTM**	**5Yr Avg**
ROIC	43%	44%
FCF ROIC	13%	10%
Gross Margin	29%	27%
Operating Margin	14%	16%
NOPAT Margin	11%	12%
FCF Margin	3%	3%
Working Capital Turnover	17.4	9.3
Fixed Capital Turnover	42.7	114.4
IC Turnover	4.1	3.7
Growth	**TTM**	**5Yr Avg**
Sales Growth	31%	50%
Operating Profit Growth	30%	44%
NOPAT Growth	29%	44%
FCF Growth	2278%	10%
Invested Capital Growth	45%	103%

INVESTMENT THESIS

Universal Health International Holding Group (Universal Health) is a Chinese pharmaceutical distributor and pharmacy operator. The company trades on an EBIT/EV yield of 24.0% despite above industry growth, in an industry growing at 20% per annum, and superior profitability with a four year average ROIC of 43%.

Universal Health is best in class among Chinese pharmaceutical distributors and pharmacy operators in terms of growth, profitability (ROIC), and acquisitions, a key activity in the consolidating pharmaceutical distribution and retail market. The company has a number of unique, complimentary activities strengthening its competitive position ensuring profitability can be sustainable. The company has high quality management with significant share ownership, no significant corporate governance issues, and a net cash position equal to 37% of the company's market cap and 2.41 times trailing twelve month (ttm) operating profit.

The market is pricing in no growth and a reversion from a 2014 ROIC of 39% to the cost of capital within ten years creating little downside but tremendous upside if the company can maintain its profitability and continue to grow at 20% per for the next five years.

KEY METRICS TO WATCH

1. **Number of pharmacies** = economies of scale in purchasing
2. **Number of distribution customers** = economies of scale in distribution
3. **Direct supply model** revenue as a percentage of total revenue = more margin of the value chain capture
4. **Number of high margin products** = greater profitability
5. **Acquisitions** = to gain scale need to increase purchasing power and scale in distribution, to generate growth, and to increase intrinsic value

COMPANY DESCRIPTION

History

Universal Health International Group Holdings Ltd. (Universal Health), formerly Jintian Pharmaceutical Group Limited, is a Chinese pharmaceutical distributor and pharmacy operator listed in Hong Kong (2211:HK).

Universal Health's origins date back to 1998, when Mr. Jin Dongtao, Chairman of the board, and Mr. Jin Dongkun, Vice-Chairman of the board, first started pharmaceutical distribution operations in Jiamusi with their personal savings. The company initially focused its operations in Heilongjiang before gradually expanded its operations to other provinces in China. The company's initial public offering on the Hong Kong Stock Exchange took place in December 2013. The company's shareholder structure is illustrated below.

Shareholder Structure	Pre-IPO		Post-IPO		2014	H1 2014
Asia Health (Jin Dingtao)	902.88	56.43%	902.80	45.14%	45.14%	47.14%
Atlantic Health Century (Hao Ruihua, Jin Guisheng)	61.44	3.84%	61.40	3.07%	3.07%	3.07%
Pacific Health Century (Jin Dongkun, Mr. Chu)	40.96	2.56%	41.00	2.05%	2.05%	2.05%
AMG- CVC Partners (Private Equity)	387.84	24.24%	322.60	16.13%	6.86%	4.86%
DBS Nominees- (Private Equity)	115.04	7.19%	95.60	4.78%	4.78%	4.78%
SEAVI- Advent International Corporation (Private Equity)	91.84	5.74%	76.40	3.82%	3.82%	3.82%
Public shareholders	-	0.00%	500.00	25.00%	34.28%	34.28%
Target Asset Management Pte Ltd					5.09%	5.09%
Total shares outstanding (mn)	**1,600**		**2,000**		**2,000**	**2,000**

Source: Company data, Reperio Capital Research

During the IPO, the company offered 400 million new shares and private equity partners made partial sales, CVC Partners sold 65.24 million shares, DBS sold 19.44 million shares, and Advent International sold 15.44 million shares. All insiders maintained their shares during the IPO. Since the IPO, CVC Partners sold an additional 225.40 million shares. DBS's, Advent International's, and Atlantic Health Century's ownerships are below 5% and none are directors so there is no knowledge of any sales or purchases after the IPO. Mr. Jin Dingtao increased his position on March 31, 2015 by purchasing 2% of the company at HKD2.82 from CVC Partners.

Business Model

Universal Health is an operator of a universal health platform. The company sees its platform with three levels. The upper level is the procurement platform where the company acquires original equipment manufacturers' branded products, domestic branded products, and international branded products. The middle level is the branding and marketing platform including brand promotion, Jintian Institute, and online and offline platforms, and industry alliances. The bottom level is the sales platform including a distribution network covering 29 provinces and cities, a retail network with 953 pharmacies in Northeast China, and an online channel on Tmall.com, JD.com, and mobile based online platform in Hong Kong.

Universal Health operates two segments pharmaceutical distribution and pharmaceutical retail.

Revenue by segment	2010	2011	2012	2013	2014
Retail	386	526	912	1,550	2,008
Distribution	472	948	1,414	1,774	2,348
Revenue	**859**	**1,474**	**2,326**	**3,324**	**4,356**
Gross Profit by Segment	**2010**	**2011**	**2012**	**2013**	**2014**
Retail	148	194	320	605	797
Distribution	92	211	226	331	471
Gross profit	**240**	**405**	**546**	**936**	**1,268**
Gross Margin by Segment	**2010**	**2011**	**2012**	**2013**	**2014**
Retail	38%	37%	35%	39%	40%
Distribution	19%	22%	16%	19%	20%
Gross margin	**28%**	**27%**	**23%**	**28%**	**29%**

Source: Company data

In 2014, retail accounted for 46% of sales and 63% of gross profit. The company primarily generates revenues in Northeast China with 84.5% of revenue coming from the region in 2012 and 80.6% of revenue coming from Northeast China in the first half of 2013. The company did not report revenue from Northeast China after the IPO prospectus.

Universal Health uses its centralized procurement platform to leverage economies of scale and maximize bargaining power with suppliers to lower procurement costs. The company also helps manufacturers with procurement consolidating their procurement needs in order to obtain raw materials needed from upstream suppliers at a favorable wholesale price allowing for economies of scale and cementing the relationship with key manufacturers.

Retail

At the end of 2014, Universal Health had a retail network of 953 self operated pharmacies with 949 pharmacies located in Heilongjiang (688), Liaoning (168), and Jilin (93) in Northeast China making the company the largest pharmacy chain in Northeast China. Four other pharmacies are located in Hong Kong. The Hong Kong pharmacies are used to source high-end international pharmaceutical products for the company's Chinese retail network. All pharmacies use the Jintian Aixin brand. Excluding working capital, the company's expected initial costs per pharmacy is RMB5.0 million in China and RMB9.6 million in Hong Kong.

The company's pharmacies are classified as Class A, Class B, and Class C with the typical store for each classification illustrated below.

	Locations/Pharmacy type	Floor areas (approximately)	Products offered
Class A	Flagship pharmacies located in prime locations in Heilongjiang, Liaoning and Hong Kong	over 200 sq.m.	5,000 types of products on average
Class B	Mid-size pharmacies located in major residential neighbourhoods, prime retail locations and locations close to major hospitals and clinics in Northeast China	100 sq.m. to 200 sq.m.	3,500 types of products on average
Class C	Community pharmacies	less than 100 sq.m.	2,500 types of products on average

Source: IPO prospectus

The company also has 15 supermarkets in Shenyang under the Jintian Aixin brand. These supermarkets operated next to a company owned pharmacy. In Shenyang, pharmacies are prohibited from selling certain non-pharmaceutical products sold in other locations. Universal Health opened supermarkets to sell these non-pharmaceutical products, which are daily necessities like drinking water, toiletries, paper tissues and other products.

Universal Health offers customers a wide range of pharmaceutical products (including prescription and OTC products), healthcare products, medical devices, and other personal and family care products at competitive prices. The company offers many high gross margin products as well as products included in the National and Provincial Medical Insurance Drugs Catalogues and the National List of Essential Drugs, which were under strict price controls until 2015. In the first half of 2013, the last reported date, 22.22% of retail revenues were from high margin products and 6.9% of retail revenues were from drugs with price controls.

At the end of 2014, the company had 1.04 million members enrolled its membership program. Members accounted for 41% of retail sales. Customers apply for membership at a pharmacies or when participating in certain marketing events. Upon joining, the members will receive membership cards, which can be used to accumulate membership points based on their purchases. Membership cards are issued by each retail subsidiaries separately and may only be used in the pharmacies operated by the issuing subsidiaries.

Universal Health also runs the Jintian Institute, which is a training center for employees and important distribution customers. In 2014, the company had 248 training sessions up from 108 in 2010. The company is very acquisitive making the Jintian Institute vital in training existing and acquired employees on the company's culture and processes to ensure a smooth integration of acquisitions.

At the end of 2014, Universal Health had 953 pharmacies up from 187 pharmacies at the end of 2009, representing a compound annual growth rate of 38.5%.

Pharmacy Network	2010	2011	2012	2013	2014	09-14
# of pharmacies at the beg of year	**187**	**185**	**431**	**600**	**794**	**187**
Pharmacies acquired	18	216	148	192	157	731
Pharmacies opened	4	30	21	3	2	60
Pharmacies closed	(24)	-	-	(1)	-	(25)
# of pharmacies at year end	**185**	**431**	**600**	**794**	**953**	**953**

Source: Company data

Of the 766 new pharmacies, 731 were acquired, 60 were opened, and 25 underperforming pharmacies were closed. Acquired pharmacies usually take six to twelve months to reach company standard profitability.

The table below provides all the operating metrics provided by the company for the retail segment.

Retail (RMB mn)	2010	2011	2012	2013	2014	11-14 CAGR
# of pharmacies	**185**	**431**	**600**	**794**	**953**	**51%**
Revenues	**386.4**	**526.1**	**912.2**	**1,549.8**	**2,008.0**	**51%**
Gross Profit	147.8	193.9	319.9	605.2	796.8	52%
EBITDA	**101.0**	**127.6**	**183.7**	**361.6**	**467.5**	**47%**
Depreciation and amortisation	0.8	(2.2)	(9.7)	(23.5)	(27.9)	
EBIT	**100.2**	**125.4**	**174.0**	**338.1**	**439.6**	**45%**
Finance income (loss), net	1.5	0.3	0.5	0.9	(0.4)	+ to -
PBT	**101.7**	**125.8**	**174.5**	**339.0**	**439.2**	**44%**
Income tax	25.4	(29.8)	(40.6)	(83.8)	(109.6)	
PAT	**76.2**	**96.0**	**133.9**	**255.2**	**329.7**	**44%**
Total assets	**116.7**	**301.6**	**751.0**	**979.3**	**1,527.4**	**90%**
Total liabilities	29.1	57.0	165.9	114.2	379.2	90%
Total equity	**87.6**	**244.6**	**585.2**	**865.1**	**1,148.2**	**90%**
Retail	**2010**	**2011**	**2012**	**2013**	**2014**	**11-14 Avg**
Pharmacy growth		133.0%	39.2%	32.3%	20.0%	50.7%
Sales growth		36.1%	73.4%	69.9%	29.6%	51.0%
Gross margin	38.2%	36.9%	35.1%	39.1%	39.7%	37.7%
Opex % sales	12.3%	13.0%	16.0%	17.2%	17.8%	16.0%
Operating margin	25.9%	23.8%	19.1%	21.8%	21.9%	21.7%
Asset turnover	3.3	1.7	1.2	1.6	1.3	1.5
ROA	85.9%	41.6%	23.2%	34.5%	28.8%	32.0%
Equity multiplier	1.3	1.2	1.3	1.1	1.3	1.2
ROE	114.4%	51.3%	29.7%	39.1%	38.3%	39.6%
Revenue per pharmacy	2,088,757	1,220,592	1,520,338	1,951,875	2,107,031	1,777,719
Gross profit per pharmacy	798,659	449,933	533,148	762,211	836,097	676,010
EBIT per pharmacy	541,595	291,014	289,963	425,809	461,298	401,936
Asset per pharmacy	630,784	699,724	1,251,673	1,233,321	1,602,743	1,083,649
Liabilities per pharmacy	157,541	132,148	276,417	143,824	397,931	221,572

Source: Company data, Reperio Capital Research

From 2010 to 2014, Universal Health grew its pharmacies by 50.7% per year and pharmacy revenues by 51% per year. Over the same period, the company maintained fairly consistent margins and asset efficiency with retail gross margin averaging 37.7%, retail operating margin averaging 22.4%, and asset turnover averaging 1.5 times (2011-2014). From 2011 to 2014, retail ROA averaged 33.2%.

On a per store basis, all metrics have fluctuated as Universal Health has acquired pharmacies. In 2011, sales, gross profit and EBIT per store all dropped by over 40% as the company started its acquisition spree by increasing its number of pharmacies by 133%. Since 2011, the company has increased pharmacies at an annual rate of 30.3%. Over the same period on a per store basis, revenue increased by 20% per annum, gross profit increased by 22.9% per annum, operating profit increased by 16.6% per annum, and assets increased by 31.8% per annum.

Distribution

At the end of 2014, Universal Health had a nationwide distribution network with 6,500 customers including 4,300 retailers, hospitals, and clinics and 2,200 other distributors. The company is the largest private pharmaceutical distributor in Northeast China. Since 2010, the company grew its customer base from 760 to the current 6,500, a 71% CAGR. In both distribution and retail, there is no customer concentration.

Universal Health's retail and distribution product portfolio includes over 18,000 products including OTC, prescription and healthcare products. 2,752 products were high margin products where the company has either geographic exclusivity or licensing rights. From 2010 to the first half 2013, high margin products accounted for 29.7% of distribution sales and 57.6% of gross profits. High margin products generated 34.6% gross margin compared to 10.8% gross margin for all other products. The company stopped reporting high margin products contribution to sales and gross profit.

Distribution (RMB mn)	2010	2011	2012	2013	2014	10-14 CAGR
Distribution customers	**760.0**	**3,628.0**	**3,494.0**	**3,800.0**	**6,500.0**	**71%**
Revenues	**473.9**	**947.8**	**1,452.5**	**1,773.7**	**2,347.8**	**49%**
Gross profit	92.0	211.2	225.9	331.2	470.7	50%
EBITDA	**61.8**	**130.8**	**150.1**	**204.7**	**270.5**	**45%**
Depreciation and amortisation	0.9	(2.2)	(4.1)	(4.0)	(8.6)	
EBIT	**61.0**	**128.6**	**146.0**	**200.7**	**261.9**	**44%**
Finance income (loss), net	1.2	2.6	2.9	(0.1)	1.2	0%
PBT	**62.2**	**131.2**	**148.8**	**200.6**	**263.2**	**43%**
Income tax	15.7	(32.6)	(27.6)	(51.3)	(69.2)	
PAT	**46.5**	**98.6**	**121.2**	**149.4**	**194.0**	**43%**
Total assets	**151.5**	**428.9**	**650.1**	**839.8**	**1,466.2**	**76%**
Total liabilities	52.5	97.9	84.0	128.8	405.0	67%
Total equity	**99.0**	**331.0**	**566.2**	**711.0**	**1,061.1**	**81%**
Distribution	**2010**	**2011**	**2012**	**2013**	**2014**	**11-14 Avg**
Distribution customer growth		377%	-4%	9%	71%	71%
Sales growth		100%	53%	22%	32%	49%
Gross margin	19.5%	22.3%	16.0%	18.7%	20.0%	19.2%
Opex % sales	6.6%	8.7%	5.9%	7.4%	8.9%	7.7%
Operating margin	12.9%	13.6%	10.0%	11.3%	11.2%	11.5%
Asset turnover	3.1	2.2	2.2	2.1	1.6	2.0
ROA	40.2%	30.0%	22.5%	23.9%	17.9%	23.6%
Equity multiplier	1.5	1.3	1.1	1.2	1.4	1.3
ROE	61.6%	38.9%	25.8%	28.2%	24.7%	29.4%
Revenue per customers	623,511	261,253	415,720	466,766	361,206	376,236
Gross profit per customers	121,039	58,220	64,665	87,158	72,415	70,615
EBIT per customers	80,217	35,456	41,775	52,818	40,296	42,586
Asset per customers	199,311	118,216	186,073	220,991	225,568	187,712
Liabilities per customers	69,013	26,992	24,037	33,892	62,314	36,809

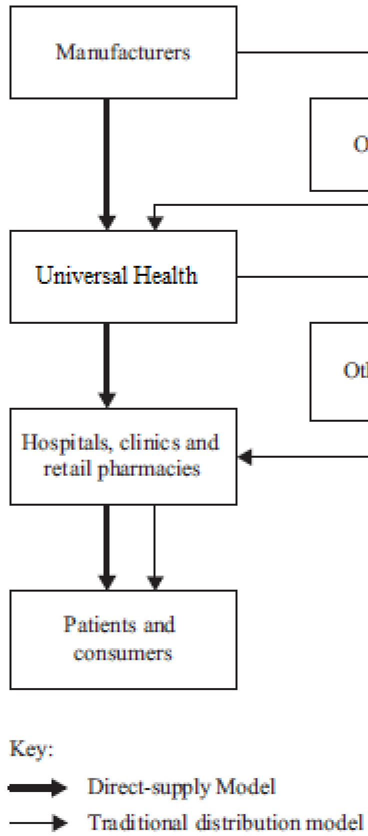
Source: Company data, Reperio Capital Research

From 2010 to 2014, distribution revenue increased by 49% per annum driven by customer growth of 71% per annum over the same period. The distribution operating margin has averaged 11.8%. Since 2011, the distribution business' asset turnover averaged 2.0 and ROA averaged 23.6%. On a per customer basis, unlike the retail segment, the distribution segment has not consistent improved.

Direct Supply Model

In addition to Universal Health's tradition supply model, the company has a direct supply distribution model eliminating many of the steps in the convoluted Chinese pharmaceutical supply chain. Both supply chains are illustrated below.

Distribution Value Chain



Typically, a product may go through multiple distributors before reaching the final retail outlet (hospital, clinic, and retail pharmacies). Universal Health is increasingly streamlining its value chain to provide direct distribution to the final retail outlet. The streamlined value chain allows the company to eliminate a large portion of the manufacturers' promotional costs and distribution costs increasing pricing flexibility allowing the company to generate a higher gross margin.

Universal Health actively markets and sells its products through trade associations for pharmaceutical retailers in China. These trade associations are formed by small to medium-size pharmaceutical retailers that combine to increase their bargaining power. Universal Health is a core member of the China Medical and Resources Association, a national pharmaceutical retailer trade association with sub-associations in 19 provinces in China. It covers more than 460 pharmaceutical retail chains and over 20,000 pharmacies owned by these pharmaceutical retail chains. Mr. Jin, the company's Chairman, serves as a vice president of the China Medical and Resources Association and president of its sub-association in Heilongjiang. These trade associations help the company generate direct supply model revenue. Also, Mr. Jin's leadership positions in trade associations allow him to gain an in-depth understanding of the industry's participants and potential acquisition targets.

Direct Supply Model (RMB mn)	2010	2011	2012	2013	2014	10-14 CAGR
Revenue						
Retail	135	191	253			
Distribution	83	178	296			
Hospitals and clinics	22	87	168			
Pharmaceutical retailers	61	92	128			
Total	**219**	**369**	**549**	**891**	**1,747**	**68%**
Gross profit						
Retail	64	97	126			
Distribution	22	47	60			
Total	**86**	**144**	**186**	**389**	**759**	**72%**
Gross margin						
Retail	48%	51%	50%			
Distribution	26%	26%	20%			
Total	**40%**	**39%**	**34%**	**44%**	**43%**	

Source: Company data, Reperio Capital Research

From 2010 to 2014, the direct supply model grew at a compound annual growth rate of 68%, accounting for 40.1% of revenues in 2014 up from 25.5% in 2010. Over the same period, gross profit grew at a similar pace with gross margin expanding slightly from 40% to 43% but with some volatility.

The table below illustrates the increase in gross margin using the direct supply model relative to the traditional distribution model.

Direct Supply Gross Margin Increase	2010	2011	2012	2013	2014
Retail gross margin	9%	14%	15%		
Distribution gross margin	7%	4%	4%		
Overall gross margin	**12%**	**11%**	**10%**	**15%**	**14%**

Source: Company data, Reperio Capital Research

From 2010 to 2012, the direct supply model's retail gross margin is 10-15% higher than the retail segment's gross margin, while the direct supply model's distribution gross margin is 4-7% higher than traditional distribution's gross margin. The overall direct supply model's gross margin is 10-15% higher than the company's gross margin.

The direct supply business increased Universal Health's gross margin by 9.6% in 2014 up from 4.0% in 2010. The operating expenses and assets required to support the direct supply model are not disclosed.

Overall (RMB mn)	2010	2011	2012	2013	2014
Revenue	859	1,474	2,326	3,324	4,356
Gross profit	240	405	546	936	1,268
Gross margin	27.9%	27.5%	23.5%	28.2%	29.1%
Ex Direct Supply (RMB mn)	**2010**	**2011**	**2012**	**2013**	**2014**
Revenue	640	1,105	1,777	2,433	2,609
Gross profit	153	261	360	548	508
Gross margin	24.0%	23.7%	20.3%	22.5%	19.5%
Gross margin difference	**4.0%**	**3.8%**	**3.2%**	**5.7%**	**9.6%**

Source: Company data, Reperio Capital Research

The direct supply model is not easily replicated as the resources required for the integrated system are much different from the resources required for the traditional value chain. Universal Health has relationships with manufacturers and retail outlets. These relationships take time to build. The company strengthens its relationships with manufacturers by providing value added services such as helping with purchasing, training at its Jintian Institute, and assisting with employee searches among other services. The company also trains its own employees at the Jintian Institute to optimize its direct supply model. The company has exclusivity on many high margin products distributed through the direct supply model.

Wanjia, a distributor and pharmacy operator in Fujian Province saw revenue drop by 27% in 2014 as the distributor customers it supplies had a difficult time with new regulation. The company was unable to alter its value chain to side step the distributors and provide direct supply to retail customers illustrating the difficulty in replicating the direct supply distribution model.

Acquisitions

Acquisitions are a key driver of Universal Health's growth. Since 2011, the company has acquired an estimated RMB1,513 million in annual revenue and RMB158 in annual net income.

Acquisitions (RMB mn)	2011	2012	2013	2014	11-14 Total
Consolidated revenue from acquisitions in the year	352	183	99	240	873
Consolidated net income from acquisitions in the year	21	20	17	19	76
Estimated full year revenue of acquired companies	505	357	165	485	1,513
Estimated full year net income of acquired companies	35	50	29	45	158
Consolidated revenue % of total	24%	8%	3%	6%	8%
Consolidated net income % of total	11%	8%	4%	4%	6%
Consolidated revenue % of incremental	57%	21%	10%	23%	43%
Consolidated net income % of incremental	31%	45%	11%	16%	42%

Source: Company data, Reperio Capital Research

From 2011 to 2014, full year revenue of acquired companies accounted for 43% of growth and 42% of net income. This figure is slightly higher than the individual years as full year income was used for 2011 to 2014 while consolidated income was used for each individual year.

Acquisition Multiples	2011	2012	2013	2014	11-14 Total
Price to sales	0.4	0.9	0.7	0.8	0.7
P/E	5.6	6.5	4.2	8.6	6.5
Price to assets	1.1	0.8	3.9	1.9	1.2
P/B	1.6	1.6	4.0	2.5	2.0
P/TB	1.9	3.0	4.0	20.9	4.0
Net margin	7%	14%	18%	9%	10%
Asset turnover	2.9	0.9	5.3	2.4	1.8
ROA	20%	12%	94%	22%	19%
Equity multiplier	1.4	2.1	1.0	1.3	1.6
ROE	28%	25%	96%	29%	32%

Source: Company data, Reperio Capital Research

The multiples paid for aggregate acquisitions are listed above. On average, the company is acquiring very profitable businesses at low price to earnings multiples. The acquisitions do not look as attractive on a price to book basis. Give the profitability of the businesses acquired, price earnings multiples are probably the appropriate metric to focus on when analyzing acquisitions. The company paid an average of 6.5 times earnings, which is good value when the average return on assets of acquired businesses is 19%.

Pharmacy Buy vs. Build Decision	2011	2012	2013	2014	11-14 Avg
Pharmacies acquired	216	148	192	157	713
Consideration paid for all acquisitions (RMB mn)	193	322	121	386	1,022
Consideration paid per pharmacy acquired (RMB)	891,278	2,175,257	631,021	2,459,503	1,433,032

Source: Company data, Reperio Capital Research

From 2011 to 2014, the company acquired pharmacies at RMB1.433 million per pharmacy and got distribution assets for free. The company expects start up cost excluding working capital of each pharmacy to be approximately RMB5.0 million so the company acquired assets well below their reproduction costs.

The company does not provide updates on the performance of each acquisition post-integration, although the company did provide some metrics on acquisitions in 2011 until it was discontinued in 2014.

Improvements to Acquisitions	2011	2012	2013
Revenue Growth of Acquired Pharmacies			
Acquired in 2011			62.80%
Gross Margin of Acquired Pharmacies			
Acquired in 2011	32.8%	35.4%	40.1%
Revenue Growth of Acquired Distributors			
Acquired in 2011			44.9%
Gross Margin of Acquired Distributors			
Acquired in 2011		9.9%	17.4%

Source: Company data

The company continued to grow both the top line and margins of distributors and pharmacies acquired in 2011.

To provide further evidence of the strength of acquired operations post-integration, key accounts are restated removing cumulative effects of acquisitions.

Restated Accounts W/O Acquisitions (RMB mn)	2010	2011	2012	2013	2014	
Pharmacies w/o acquisitions	185	215	236	238	240	
Revenue w/o cumulative acquisitions	859	1,122	1,638	2,362	3,088	
Net income w/o cumulative acquisitions	123	168	178	284	371	
Assets w/o cumulative acquisitions	269	1,058	1,102	2,713	3,210	
Liabilities w/o cumulative acquisitions	81	817	750	389	764	
Equity w/o cumulative acquisitions	188	241	353	2,325	2,446	
Organic Growth	**2010**	**2011**	**2012**	**2013**	**2014**	**10-14 CAGR**
Pharmacies		16%	10%	1%	1%	7%
Revenue		31%	46%	44%	31%	38%
Net income		37%	6%	59%	31%	32%
Asset		293%	4%	146%	18%	86%
Equity		28%	46%	559%	5%	75%
Profitability w/o acquisitions	**2010**	**2011**	**2012**	**2013**	**2014**	**11-14 Avg**
Net margin	14.3%	15.0%	10.9%	12.0%	12.0%	12.4%
Asset turnover	3.2	1.1	1.5	0.9	1.0	1.1
ROA	45.6%	15.9%	16.2%	10.5%	11.6%	13.5%
Equity Multiplier	1.4	4.4	3.1	1.2	1.3	1.5
ROE	65.3%	69.9%	50.5%	12.2%	15.2%	20.2%

Source: Company data, Reperio Capital Research

After adjusting key accounts by removing all the effects of acquisitions, Universal Health continues to grow revenues at 38% per annum and net income at 32% per annum with a 2011 to 2014 average ROA of 13.5%. Combined with the evidence of 2011 acquisitions, it is highly likely that the organic growth includes growth from existing operations and improvements to acquired assets. The company appears to be doing an excellent job of integrating and improving the profitability of acquisitions.

Universal Health's Jintian Institute is a crucial component in its successful acquisition model. If the company can standardize the vast majority of processes, it can easily transfer from one box to another. The company can easily train employees on the company's processes and procedures to help improve the performance of newly acquired assets. In addition, a central learning location allows for continuous testing and experiment, which is crucial to staying on top of customers' tastes and ahead of the competition.

The company retains staff and managers of acquired businesses who demonstrate a strong aptitude, enthusiasm, and knowledge of the acquired business. The newly acquired employees are incentivized with eligibility to join the company's management. Maintaining newly acquired employees as management is intelligent as it maintains continuity, elevates morale, and increases productivity.

Post-acquisition, Universal Health deploys highly experienced members for three months to monitor the integration process. For three months after the initial three months, the company continues with off-site monitoring, unscheduled inspections, and programs to improve outstanding issues. When possible, Universal Health incorporates the existing systems of acquired companies into its unified management systems.

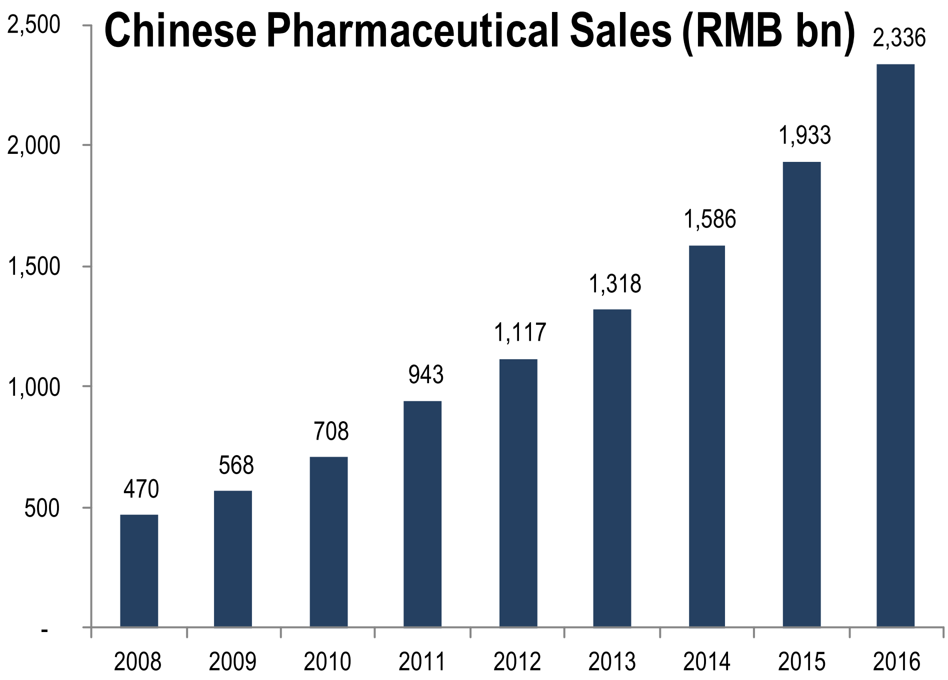
There are obvious concerns associated with acquisitive companies as there have been a number of examples of permanent loss of capital investing in rollups. The main concerns related to rollups are acquisitions need to be bigger and bigger to mask poor underlying fundamentals of the business, the use of debt in acquisitions increases the financial risk of the acquirer, and the rationale for acquisitions do not exist.

After removing all acquisitions, Universal Health is growing revenue and net income rapidly with stable margins alleviating concerns of poor underlying fundamentals. At the end of 2014, the company has net cash position of 2.0 times operating profit. The company has not taken on any debt despite the number of acquisitions. The rationale for acquisitions exists as economies of scale exist in purchasing in retail and economies of scale of distribution in the distribution business. The ability to acquire high margin products offering exclusivity makes strategic sense. Universal Health's ability to improve acquisitions and the relatively cheap acquisition price also provides additional rationale for acquisitions. The company has remained focused on Northeast China for retailing allowing it to have the largest retail network in the region. The company's pharmacy network size positions the company at the front of consumers' minds given acquisitions in the area a strategic rationale in addition to economies of scale of purchasing.

INDUSTRY

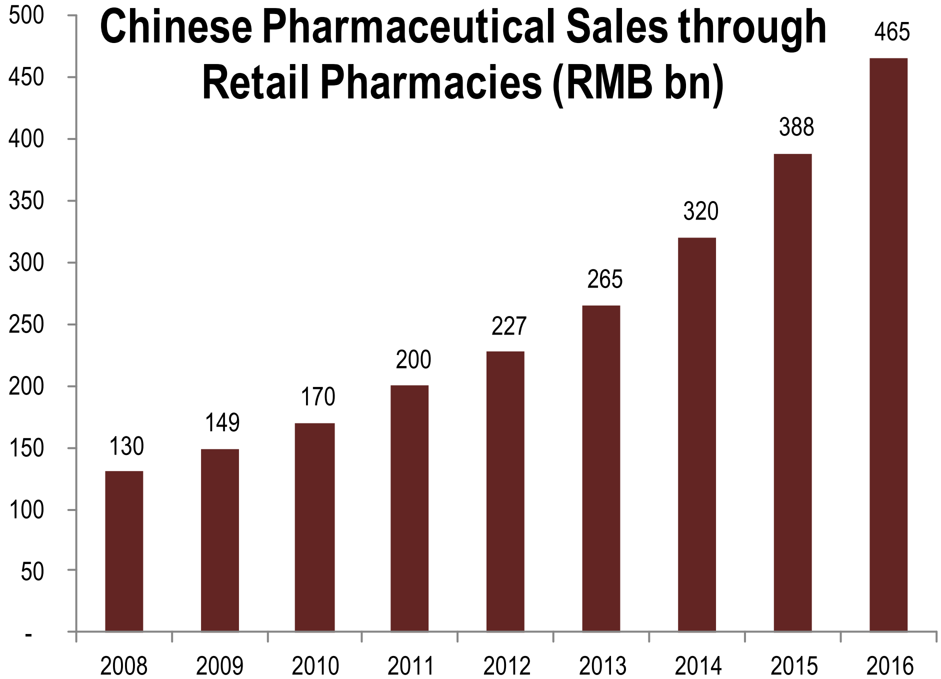
The pharmaceutical industry in China has experienced rapid growth driven by GDP growth, increased healthcare spending per capita, policy reform, ageing population, and urbanization. In 2014, The State Council of China proposed the China health service industry will reach a target size of over RMB8 trillion by 2020 or a quadrupling in six years.

According to NFS, pharmaceutical sales in China increased from RMB470 billion in 2008 to RMB1,117 billion in 2012, representing a CAGR of 24.2%. The industry is expected to maintain a CAGR of 20.2% from 2012 to 2016 reaching RMB2,336 billion in 2016.



Source: NFS

According to NFS, pharmaceuticals sales to consumers through retail pharmacies in China grew from RMB130 billion in 2008 to RMB227 billion in 2012, representing a CAGR of 15.0%. The retail market is expected to reach RMB465 billion sales in 2016, representing a CAGR of 19.6%.



Source: NFS

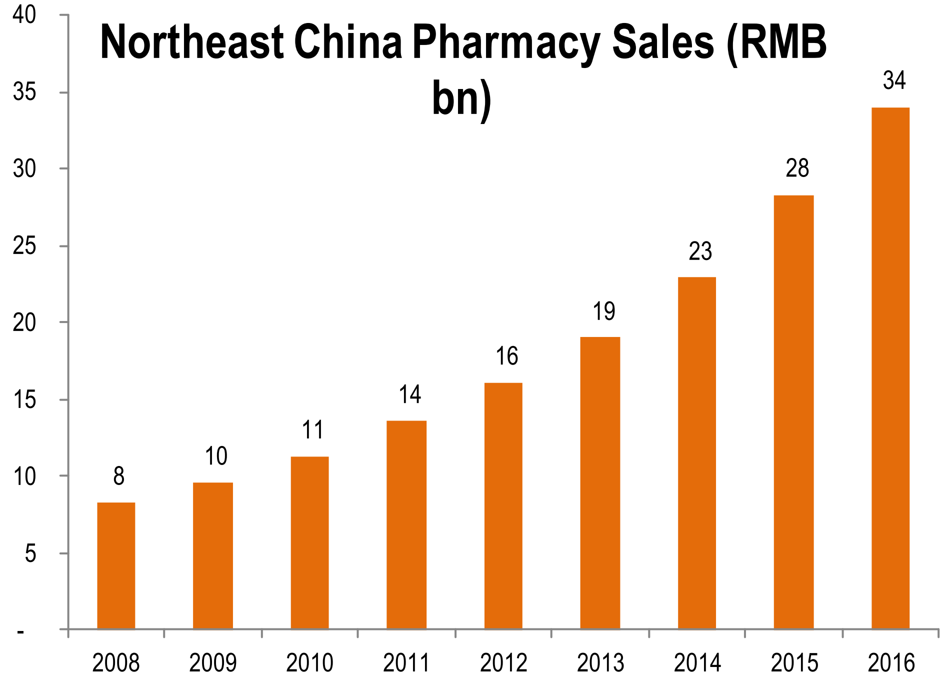
Although prescription medicines are predominantly sold through hospitals, hospitals account for roughly 73% of prescription medicine sales, the product category is still the largest portion of sales for retail pharmacies at 33.5% of total sales, followed by over the counter products (32.8%), food and healthcare products (12.1%), Chinese herbal extract (9.6%), medical devices (6%), and other products (6%).

Pharmaceutical distribution sales in China are growing at a similar pace to retail and the overall industry. According to NFS, distributor sales to hospitals, healthcare centers, clinics, and retail pharmacies in China grew from RMB340 billion in 2008 to RMB891 billion in 2012, representing a CAGR of 27.2%. The pharmaceutical distribution industry is expected to reach RMB1,871 billion in 2016, representing a CAGR of 20.4%.

Source: NFS

Northeast China Pharmaceutical Industry

Northeast China consists of three provinces, Jilin, Heilongjiang, and Liaoning. At the end of 2012, the three provinces had a population of 27.5 million, 38.3 million, and 43.9 million, respectively. The three provinces accounted for 8.1% of Chinese population with a 2008 to 2012 nominal GDP per capita growth rate of 15.4% above the national average of 12.9%. According to NFS, the Northeast China pharmaceutical market grew from RMB37.6 billion in 2008 to RMB76.3 billion in 2012, representing a CAGR of 19.4% in the past five years and is expected to reach RMB154 billion in 2016. Pharmaceutical sales through pharmacies in Northeast China grew from RMB8.3 billion in 2008 to RMB16.1 billion in 2012, representing a CAGR of 18.1%. The market is expected to grow to 34 billion in 2016, as illustrated by the following chart.



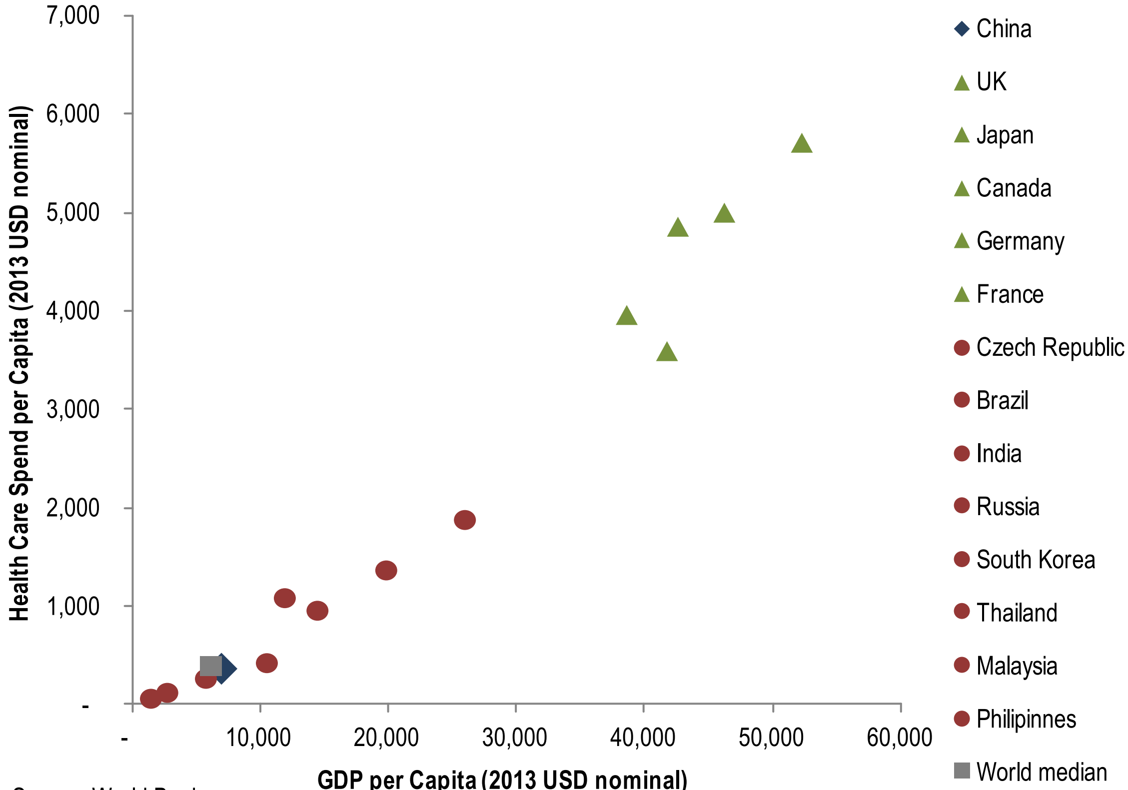
Source: NFS

Key Growth Drivers

The key growth drivers of the pharmaceutical industry's growth in China have been GDP growth, increased healthcare spending per capita, policy reform, ageing population, and urbanization.

China is a has been growing at a rapid pace with GDP per capita in nominal terms growing by 15% per year from 2008 to 2013. There are signs that economic growth is slowing but with the lower range of growth estimates at 3-5% the Chinese economy is still growing at a much faster pace than developed economies.

As illustrated by the chart below health care spend per capita strongly correlates to GDP per capita. Across all countries reporting both variables to the World Bank in 2013, the adjusted R^2 of the two variables was 0.9 in 2010 and 0.89 in 2013, 2005, 2000 and 1995. China with a healthcare spend per capita of USD367 and GDP per capita of USD6,997 can grow for some time without reaching the highest Emerging Market peers of South Korea (1,880, 25,998) and Czech Republic (1,367,19,858).



Source: World Bank

The Chinese government aims to build a nationwide insurance system to provide all of China with affordable medical care services. The system currently consists of three types of essential medical insurances; the Urban Employee Basic Medical Insurance Scheme, a mandatory health insurance program for urban employees and retirees, the Urban Resident Basic Medical Insurance Scheme, a voluntary program for other urban residents, and the New Rural Cooperative Medical Scheme (NRCMS), a voluntary program for all rural residents. According to the 2012 China Health Statistics Yearbook, the two urban insurance schemes covered 536 million urban residents, accounting for 75.3% of the total registered urban population. The NRCMS covered approximately 805 million rural residents, accounting for approximately 98.3% of the total registered rural population. For certain illnesses requiring expensive medical procedures, a supplemental medical reimbursement system provides a minimum of 50% reimbursement on top of the basic medical insurance coverage.

In addition to building a nationwide insurance system, the government is trying to shift drug sales from hospitals to pharmacies to separate medical services and drug sales, in an attempt to lower the high cost of medicines. Hospitals mark-up drugs by 15% to supplement their income. This mark-up is blamed for rising medical costs. Prior to the separation of drug sales from hospitals, hospitals accounted for 73% of drugs sold in China, with the remainder sold through pharmacies. Most people in China seek medical care in hospitals as these facilities are seen as providing the best care. This convergence on hospitals for care leads to overcrowding, which is exaggerated by the expansion of health insurance coverage. Separating drug sales not only decreases costs but helps to decrease overcrowding. As the population gains familiarity with pharmacies and experience the convenience of a pharmacy relative to an overcrowded hospital, the likelihood of returning for additional help increases greatly leading to a continued use of pharmacies for non-major issues.

Pharmaceutical Retail Channels	2005	2010	2015F
Large hospitals	59%	51%	49%
Small hospitals/healthcare clincs	15%	22%	24%
Retail pharmacy	26%	27%	27%

Source: Booz & Company

In 2015, the Chinese government also removed price ceilings on most drugs. Less than 10% of Universal Health's drug sales were from price controlled drugs so it will not be a significant factor in driving the company's top line and profitability.

The Chinese government implemented Good Supply Practices (GSP) in July 2000 with an amendment in June 2013. Each wholesaler or retailer of pharmaceutical products is required to obtain a GSP certificate from the provincial drug administrative authorities. The GSP certificate is valid for five years and may be renewed three months prior to its expiration after a reexamination by the relevant authority. Each enterprise shall be run by a licensed pharmacist, who is responsible for the audit of prescriptions and guidance of the rational use of drugs. All pharmaceutical operators are required to implement strict controls on the operation of pharmaceutical products, including standards regarding staff qualifications, premises, warehouses, inspection equipment and facilities, management, and quality control. Starting from 1 January 2016, pharmaceutical operators who do not meet the requirements of the GSP (2013) are not allowed to continue operations.

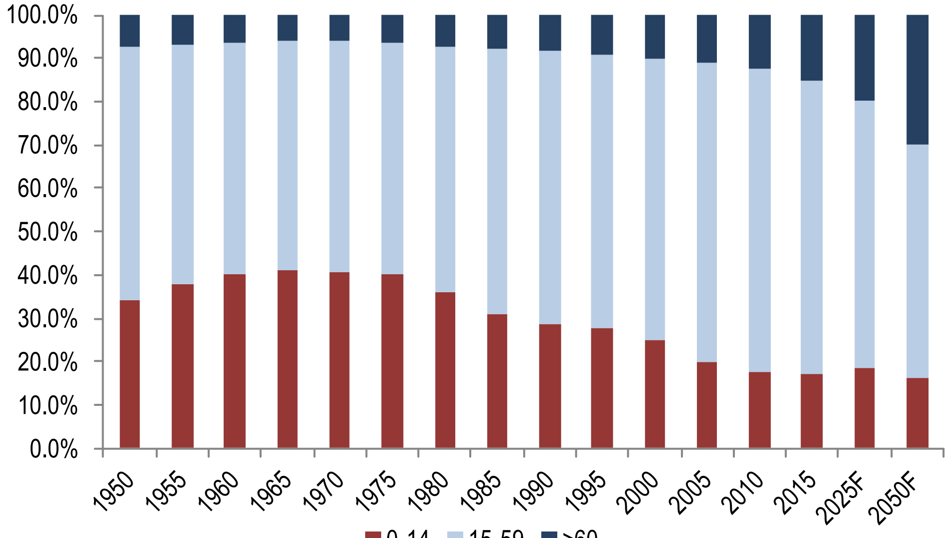
GSP is affecting some players in the industry. Wanjia Group is a pharmaceutical distributor and pharmacy operator in Fujian Province. Wanjia saw a 27.5% decrease in distribution revenues as the distributors it supplies were not GSP compliant and it did not have direct distribution capabilities. The company also stated it was going to slow down new pharmacy openings due to uncertainty surrounding GSP. GSP seems like a difficult regulatory hurdle for some operators.

In 2013 and 2014, Universal Health had some difficulties with GSP compliance due to administrative issues at local authorities, the company was not able to obtain or renew the GSP certificates for four subsidiaries. The company took initiatives to create the software and hardware needed, improve construction of the storage and logistics facilities, and enhance employee training. One of Universal Health's subsidiaries in Changchun already received certificates while the remaining three names in Heilongjiang are expected to apply for certificates in 2015.

Good Supply Practices favor larger pharmacies and distributors as it increases the fixed costs associated with operating a pharmaceutical business. The regulatory burden may speed up consolidation and create incentive for some smaller pharmacies and distributors to exit the market.

In addition, the government implemented a policy of selling infant formula milk powder products in pharmacies. Universal Health reached an agreement with McJayden, a US organic milk based formula powder manufacturer and Betterway, an Australian branded formula milk powder supplier. Infant formula is a high margin product and distributing both Betterway and McJayden points to the ability of the company to source international high margin products.

According to the World Bank, the portion of the Chinese population over 60 increased from 7.5% in 1950 to an estimated 15.2% in 2015. The United Nations believes the portion of the population over 60 will increase to 19.5% in 2025 and 29.9% in 2050 and projects an increase in China's population from 1.376 billion in 2015 to 1.471 billion in 2025 and 1.462 billion in 2050.

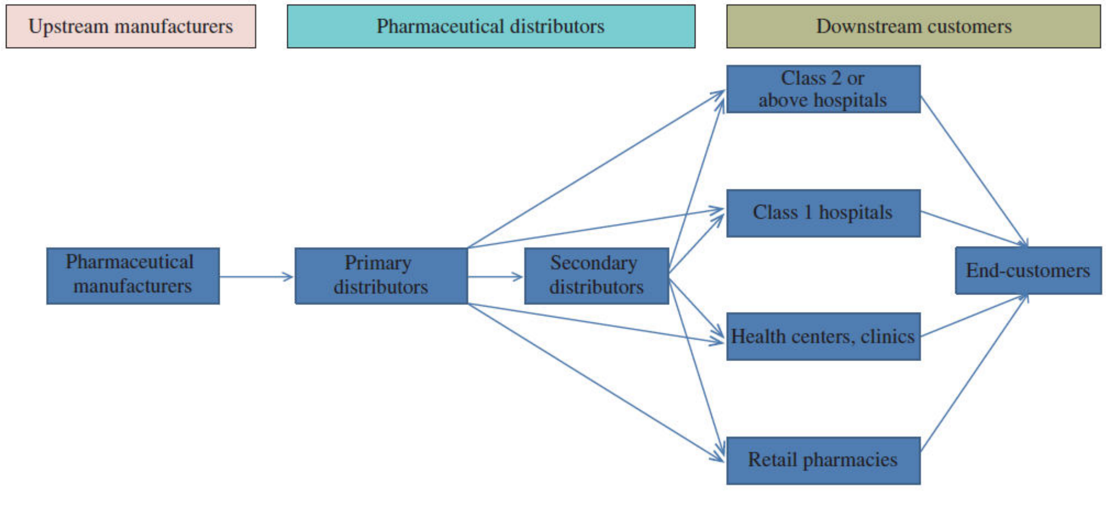


Source: World Bank,United Nations

Overall the population over 60 will increase from 209 million in 2015 to 287 million in 2025 representing a 3.2% CAGR. The population will further increase to 438 million in 2050 representing a 2.1% CAGR from 2015.

China's rapid economic growth increased the percentage of population living in urban areas as cities offer better employment prospects and educational opportunities. Urban areas offer better healthcare services and have higher healthcare spending per capita. The urbanization level in Northeast China is relatively higher than other regions in China. In 2012, the proportion of urban residents is 59.6% of whole population in Northeast China, 7% higher than the average level in China. The high urbanization rate in Northeast China directly results in a higher per capita healthcare spending for residents of Northeast China.

Industry Structure



Source: NFS

The industry value chain is divided into three segments: upstream pharmaceutical manufacturers, pharmaceutical distributors, and downstream retail outlets. Universal Health operates in the distribution and downstream segments. The distribution segment contains multiple layers of distributors while the downstream segment includes different types of retail outlets including multiple classes of hospitals, health centers and clinics, and pharmacies.

Within the industry, there are three types of distribution business models, distribution oriented, professional agency, and value chain integrated. Universal Health is both distribution oriented and value chain integrator.

The distribution oriented business model involves a distributor distributing pharmaceutical products for a pharmaceutical manufacturer. The pharmaceutical manufacturer promotes the product or engages third parties to promote the product while the distributor provides logistic distribution services. The distributor oriented model generates a small gross margin. The separation of activities allows the distributor to take advantage of economies of scale and scope.

Under the professional agency business model, a pharmaceutical manufacturer assigns an exclusive distributor. The distributor is responsible for all distribution, promotion, and marketing of the pharmaceutical manufacturer's product.

Under the value chain integrated business model, a pharmaceutical distributor acquires upstream products through contracts with licensed product manufacturers to secure attractive and cost competitive products. The distributor also integrates parts of downstream retail outlets to vertically integrate the pharmaceutical value chain. Under the value chain integrated model, promotion, and marketing of the licensed products is typically done by distributors, rather than manufacturers as distributors have direct access to the downstream customers.

Market Structure

The pharmaceutical retail segment in China is fragmented. According to the China Food and Drug Administration, in November 2013, there were 433,873 chain and individual drug stores in China, 10,150 more stores than 2012. There are 3,376 enterprises with multiple locations in China. Enterprises with multiple locations are more likely to manage the business for profitability and close down unprofitable stores. All though the market is fragmented, market consolidation is underway with Universal Health and Sinopharm leading the way. Retail competition comes in the form of target customer bases, business models, and product portfolios.

At the time of its IPO, Universal Health was the largest pharmaceutical retailer in Northeast China with 794 self operated outlets. There is not sufficient information to get a sense of the efficiency of each store as competitors with higher revenue per store maybe a function of bigger stores, but it seems Universal Health's may not be as efficient as competitors. This poor efficiency may be due to acquiring less efficient stores and improving operations. The pharmacy market in Northeast China has low level of concentration with a 2012 five firm concentration ratio of 44.2%. This only tells part of the story as there could be a large number of smaller independent stores. Universal Health has increased its estimated market share in Northeast China retail from 5.7% in 2012 to an estimated 8.8% in 2014.

Northeast China Pharmaceutical Retail	Ownership	# of Self-Operated	Revenue (RMB bn)	Revenue per Store	2012 Market Share
Universal Health	Private	794	0.91	1,148,870	5.7%
Liaoning CDFY Pharmacy Chain Co Ltd	State	678	2.90	4,277,286	18.0%
Jilin Pharmacy	State	481	0.80	1,663,202	5.0%
Jilin Yihe Pharmacy Co Ltd	Private	467	NA	NA	NA
Harbin Renmin Tongtai Pharmacy Chain Stores	State	338	1.80	5,325,444	11.2%
Sinopharm Pharm Group Co Ltd	State	NA	0.70	NA	4.3%
Top 5		2,758	7.1	3,103,700	44.2%
Total Industry Revenues			16.1		

Source: China Drugstore Magazine, 21 Century Drugstore Magazine, NFS, IPO Prospectus, Reperio Capital Research

The largest distributors in Northeast China at the time of the IPO are listed below. Universal Health is the largest private pharmaceutical distributor in Northeast China.

Northeast China Pharmaceutical Distribution	Ownership	2012 Sales (RMB bn)	2010-2012 CAGR
Harbin Pharmaceutical Group Holding Co Ltd	State	6.10	0.9%
Northeast Pharmaceutical Group Distribution Co Ltd	State	3.70	-0.2%
Harbin Pharmaceutical Group Sanjing Pharmaceutical Trading Co Ltd	State	2.40	14.4%
Liaoning Pharmaceutical Foreign Trade Corporation	State	1.80	23.2%
Universal Health	Private	1.70	73.1%

Source: Ministry of Commerce, NFS

The largest retail pharmacy chains in China are listed below. In 2012, the largest pharmacy operator had a 2.1% market share. The 2012 five firm concentration ratio was 9.4%, while the ten firm concentration ratio was 16.0% indicating a very fragmented market. At the end of 2012, Universal Health's China retail market share was 40bps.

Chinese Pharmaceutical Retail	2012 Sales (RMB bn)	2012 Market Share
Sinopharm Holding Guoda Drug Store Co Ltd	4.8	2.1%
Beijing Tong Ren Tong Group Co	4.4	1.9%
Chongqing Tongjunge Pharmacy Chain Store Ltc	4.4	1.9%
China Nepstar Chain Drugstore Ltd	4.0	1.7%
Guangdong Da Shen Lin Chain Drug Store Ltd	3.9	1.7%
Chongqing Peace Drug Store Ltd	3.6	1.6%
Yunnan Hongxiang Yixintang Pharmacy Ltd	3.3	1.4%
Hubei Tongjitang Pharmacy Co Ltd	3.0	1.3%
Liaoning Chengda Fangyuan Pharmacy Chain Lt	2.8	1.2%
Zhejiang Zhenyuen Corporation Ltd	2.3	1.0%
Top 5	21.4	9.4%
Top 10	36.3	16.0%
Total Industry Revenues	227.0	

Source: CAPC, NFS

The Chinese pharmaceutical distribution market is less fragmented than the retail market but still exhibits low concentration with the leading player accounting for 16.8% of the overall market. The five firm concentration ratio is 36.5% and the ten firm concentration ratio is 44.9%. Universal Health garnered 16 bps of the total Chinese pharmaceutical distribution market.

Chinese Pharmaceutical Distribution	2012 Sales (RMB bn)	2012 Market Share
China National Pharmaceutical Group Corporatior	149.7	16.8%
China Resources Pharmaceutical Commercial Gr	63.8	7.2%
Shanghai Pharmaceutical Co Ltd	61.7	6.9%
Jointown Group Co Ltd	29.4	3.3%
Guangzhou Pharmaceutical Corporation	20.9	2.4%
Chongqing Medicines Group Co Ltd	18.8	2.1%
Nanjing Pharmaceutical Co Ltd	18.0	2.0%
Huadong Medicine Co Ltd	14.5	1.6%
Sichuan Kelun Medicine & Trade Co Ltd	13.0	1.5%
Zhejiang International Medicine Co Ltd	10.6	1.2%
Top 5	325.5	36.5%
Top 10	400.5	44.9%
Total Industry Revenues	891.0	100.0%

Source: CAPC, NFS

While each individual country has its own idiosyncrasies leading to different development paths, the market structure of more developed markets may give a roadmap for developing countries.

US Pharmacy Market Structure	2014 Prescription Revenues	2014 Market Share	Store Type
CVS Health Corporation	72.5	23.7%	Chain drugstore & mail pharmacy
Walgreen Company	49.4	16.2%	Chain drugstore
Express Scripts, Inc	38.1	12.5%	Mail pharmacy
Walmart Stores, Inc	18.8	6.1%	Mass merchant with drugstore
Rite Aid Corporation	18.1	5.9%	Chain drugstore
UnitedHealth	8.9	2.9%	Mail pharmacy
The Kroger Company	8.6	2.8%	Supermarket w/ drugstore
Safeway/Albertsons	4.6	1.5%	Supermarket w/ drugstore
Catamaran	4.0	1.3%	Mail pharmacy
Target Corporation	3.2	1.0%	Mass merchant with drugstore
Top 5	196.9	64.4%	
Top 10	226.2	74.0%	
Total Industry Revenues	305.8		

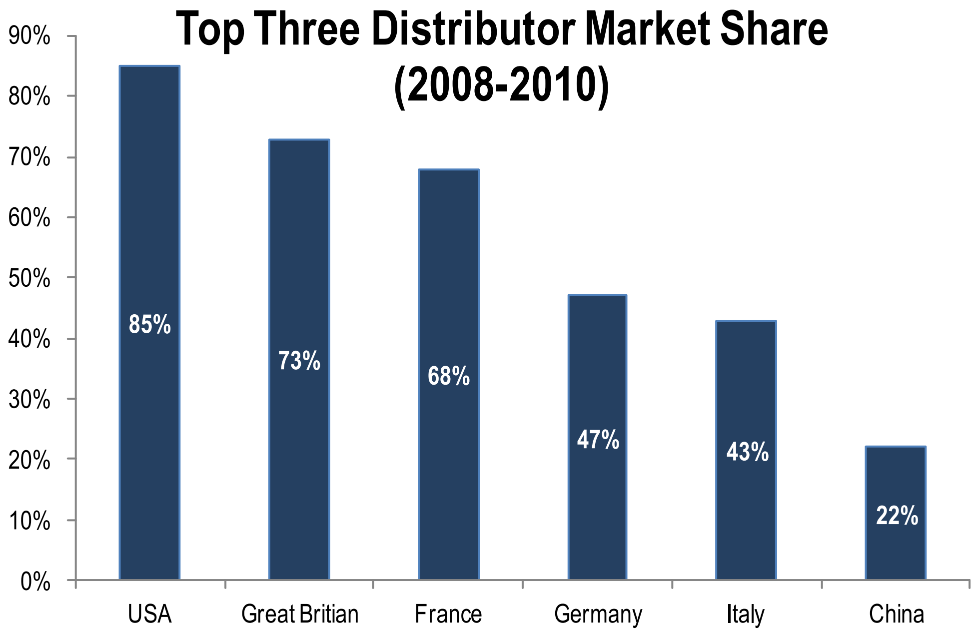
Source: Fein, Adam J., 2014-15 Economic Report on Retail, Mailm and Specialty Pharmacies, Drug Channels Institute, January 2015

The US pharmacy market shows moderate levels of concentration with a five firm concentration ratio of 64.4%. There is some fragmentation but there are a significant number of small players still operating in the market.

According to Canada's Office of Consumer Affairs, the Canadian pharmacy market has a 2012 four firm concentration ratio of 68.6%. The largest company is Shoppers Drug Mart with a 31.8% market share followed by Katz Group with a 16.7% market share, Jean Coutu with a 12.2% market share, and McKesson with a 7.9% market share.

According to the Pharmaceutical Journal, in the UK, there are 14,361 pharmacies with 4,201 independent owners, owning up to five pharmacies, operating 5,590 pharmacies and 174 multiple owners, owning six or more pharmacies, operating 8,771 pharmacies. Large owners and supermarkets account for 52% of the overall market.

The US's, Canada's, and UK's pharmacy market structures point to a much more consolidated market than the Chinese market but not the oligopolistic market structure you would expect if there was a significant benefit from economies of scales. There seems to be economies of scale in purchasing but only to a point. Another reason for the fragmentation and large number of small independent operators may be that independent operators do the job for something other than profit maximization. Just like optometrists or dentists, the ability to be your own boss and make a decent living trumps the desire to sell to a larger chain or exit when faced with a competitive disadvantage.



Source: Booz & Company

Pharmaceutical distribution markets are far more concentrated in developed countries than China with a three firm concentration ratio ranging from 43% to 85%. Developed pharmaceutical distributors, economies of scale manifest themselves in high capital efficiency as operating margins often struggle to reach 2%. The high fixed costs associated with upfront investments and low marginal cost for selling an additional unit leads to very high competitive rivalry among distributors and the need to utilize fixed costs as much as possible leading to greater profitability.

MANAGEMENT

Operational Execution

The key value drivers for Universal Health, Chinese peers, and developed peers are illustrated below.

Company	Ticker	Sales growth		Gross margin		Operating margin		Invested capital turnover		ROIC	
		Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg
Universal Health	**2211:HKG**	**31%**	**44%**	**29%**	**27%**	**16%**	**15%**	**3.1**	**3.2**	**49%**	**49%**
China Nepstar	NPD:US	9%	6%	42%	44%	1%	1%	4.1	3.7	4%	3%
China Jo Jo Drugstore	CJJD:US	17%	-6%	16%	14%	3%	-14%	2.7	2.4	7%	-33%
Shanghai No 1 Pharmacy	600833:SHG	5%	4%	16%	17%	3%	3%	5.3	4.6	18%	16%
Zhongzhi Pharma	3737:HKG	23%		54%	50%	21%	14%	3.8	3.4	78%	47%
Wanjia	401:HKG	-25%	-3%	10%	9%	-48%	-14%	2.2	1.9	-106%	-31%
Sinopharm	1099:HKG	20%	25%	8%	8%	4%	4%	3.7	3.7	15%	14%
Shanghai Pharma	601607:SHG	18%	19%	12%	13%	4%	4%	3.0	3.1	11%	12%
Jointown Pharma	600998:SHG	23%	18%	7%	7%	2%	2%	2.5	3.0	4%	5%
Rite Aid	RAD:US	4%	1%	29%	29%	3%	3%	7.3	6.0	23%	17%
CVS Health Corp	CVS:US	10%	9%	18%	18%	6%	6%	8.2	7.7	50%	48%
Walgreens Boots Alliance	WBA:US	6%	2%	27%	29%	5%	5%	6.4	4.6	33%	24%
McKesson	MCK:US	30%	13%	6%	6%	2%	2%	21.9	20.0	38%	35%
Cardinal Health	CAH:US	13%	-2%	6%	5%	2%	2%	28.3	23.9	60%	42%
AmerisourceBergen	ABG:US	36%	14%	3%	3%	0%	1%	112.9	47.2	7%	48%
China pharmaceutical peers average		12%	9%	18%	17%	-2%	0%	3.3	3.2	4%	4%
Developed pharmacy average		7%	4%	24%	25%	5%	5%	7.3	6.1	35%	30%
Developed distributors average		26%	9%	5%	5%	1%	2%	54.4	30.4	35%	42%
Universal Health rank among Chinese peers		**1**	**1**	**3**	**3**	**2**	**1**	**5**	**5**	**2**	**1**
Universal Health rank among all peers		**2**	**1**	**3**	**5**	**2**	**1**	**11**	**11**	**4**	**1**

Source: Company data, Morningstar, Reperio Capital Research

As illustrated by the last two rows, Universal Health ranks highly among publicly listed peers across most metrics. Among the nine Chinese pharmaceutical distributors and pharmacy peers, Universal Health is in the top three in all categories with the exception of invested capital turnover. The company comes in first in sales growth, three year average operating margin, and three year average ROIC.

The company is third among Chinese pharmaceutical peers in gross margin. Zhonghzi is able to generate a higher margin from both retail operations and sale of its pharmaceutical products. China Nepstar is able to generate a much better gross margin than Universal Health in its pharmacy operations as it is much larger and able to take advantage of its size to obtain purchasing discounts. Universal Health's gross margin is still well above the peer group average.

Relative to peers, Universal Health's weakest area is capital efficiency, where the company is exactly middle of the pack ranking fifth. The company scores highly against Chinese peers in working capital turnover and fixed capital turnover ranking second. The intangible assets resulting from the company's acquisitions drag the company's capital efficiency performance down. It is worst among Chinese peers in intangible asset turnover. Given the consolidation occurring in the industry, intangible assets are an investment in place of building fixed assets. A combination of fixed assets and intangible assets presents a more accurate picture of long term asset efficiency. Universal Health's ranking does not change when fixed assets and intangible assets are combined. It still ranks at the bottom of Chinese peers in efficiency.

The inclusion of developed peers only drops Universal Health significantly in capital efficiency as developed peers do a really good job utilizing invested capital. Working capital is a function of industry maturity leading to consolidation, and a more streamlined value chain, both increase supply chain visibility allowing for more efficient use inventory levels and receivable levels. Fixed capital is also a function of industry maturity as developed players have more mature operations, which companies have been able to consolidate, improve operations, and generate higher sales per fixed capital.

At developed pharmaceutical distributors, economies of scale manifest themselves in high capital efficiency as operating margins struggle to average 2%. Chinese pharmaceutical distributors generate roughly double the operating margin of developed pharmaceutical distributors but their capital efficiency is extremely weak.

Within the retail segment, at the end of 2014, Sinopharm had the largest pharmacy network with 2,360 pharmacies. China Nepstar and Shanghai Pharmaceuticals are close behind with 1,980 and 1,895 pharmacies, respectively.

	Universal Health 2211:HKG	China Nepstar NPD:US	China Jo Jo Drugstore CJJD:US	Zhongzhi Pharma 468:HKG	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
# of pharmacies	953	1,980	59	198	119	2,360	1,895
Retail revenue, 2014 RMB mn	2,008	2,953	407	301	177	5,902	3,309
Per Store (4 yr ave, RMB)							
Revenue	1,699,959	1,258,552	6,241,287	1,377,642	-	2,257,763	1,526,224
Cost of sales	(1,054,612)	(698,094)	(4,813,776)	(734,839)	-	-	-
Gross profit	645,347	560,458	1,427,511	642,802	-	-	-
Opex	(278,326)	(548,510)	(2,014,902)	-	-	-	-
Operating profit	367,021	11,949	(587,392)	-	-	75,478	16,042
Total operating expenses	(1,332,938)	(1,246,603)	(6,828,679)	-	-	(2,182,285)	(1,510,182)
Total assets	1,196,865	832,694	-	-	-	1,081,402	507,358
Total liabilities	237,580	340,187	-	-	-	663,688	312,205
Total equity	959,285	492,507	-	-	-	417,713	195,153

Source: Company data, Reperio Capital Research

On a per store basis, China Jo Jo Drugstore is able to generate the highest revenue per store followed by Sinopharm followed by Universal Health. On a gross profit basis, China Jo Jo comes top followed by Universal Health and Zhongzhi Pharma. Universal Health outperforms peers on operating profit per store by a factor of ten as Universal Health generates RMB367,021 per store compared to a peer group average of RMB34,490 per store. Universal Health's high operating profit per store comes with the highest assets per store.

Key Value Drivers Pharmacy Segment	Universal Health 2211:HKG	China Nepstar NPD:US	China Jo Jo Drugstore CJJD:US	Zhongzhi Pharma 3737:HKG	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
Sales growth (4 yr CAGR)	51.0%	5.8%	-2.3%	12.5%	8.8%	36.2%	17.7%
Gross profit growth (4 yr CAGR)	52.4%	1.4%	-13.9%	20.2%	-22.1%		
Operating profit growth (4 yr CAGR)	44.7%	+ to -	+ to -			51.6%	19.8%
Gross margin (4 yr ave)	37.7%	44.8%	23.2%	46.4%	9.5%		
Opex % sales (4 yr ave)	16.0%	43.8%	33.4%				
Operating margin (4 yr ave)	21.7%	1.0%	-10.2%			3.3%	1.0%
Asset turnover (4 yr ave)	1.5	1.5			2.0	2.2	3.0
ROA (4 yr ave)	32.0%	1.4%				7.2%	3.2%
Equity multiplier (4 yr ave)	1.2	1.7			1.6	2.9	2.6
ROE (4 yr ave)	39.6%	2.3%				20.9%	8.4%

Source: Company data, Reperio Capital Research

Universal Health is the best performing pharmacy operator across pretty much all metric except asset turnover. The only peer growing its retail business at a comparable rate is Sinopharm. Other firms have better gross margins but Universal Health operating efficiency is far superior to peers as retail operating margin is above 20% while no peer could reach 5%. The company has the weakest asset turnover but the company's strong operating efficiency leads to a return on assets of 32%. The closest peer could only reach a return on assets of 7.2% and the peer group average ROA is 3.9%.

The strength of the company's operating margin and weakness of asset turnover has a few potential explanations. First, the company could be selling high margin differentiated products that do not turnover to the extent that lower price products do. This is not the case as Universal Health is one of the most efficient with its working capital. Second, its use of less efficient assets such as Jintian Institute allows for value added products but weakens fixed asset turnover. This does not seem to be the case either as Universal Health is efficient with fixed asset turnover. The source of asset turnover weakness is intangible asset turnover pointing to either over paying for acquisitions, which will be demonstrated not to be the case later, buying asset light businesses, buying businesses that are underperforming that may eventually improve, or just a large number of acquisitions.

Sinopharm is the largest distributor with 176,437 distribution customers dwarfing all of its publicly listed peers.

	Universal Health 2211:HKG	China Jo Jo Drugstore CJJD:US	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
Distribution customers	6,500			176,437	15,188
Distribution revenue, 2014 RMB mn	2,348	85	1,678	190,133	79,226
Per Distribution Customer (4 yr ave, RMB)					
Revenue	376,236	-	-	924,603	6,311,814
EBIT	42,586	-	-	32,797	160,806
Total assets	187,712	-	-	580,409	3,325,412
Total liabilities	36,809	-	-	294,165	2,320,556
Total equity	150,903	-	-	286,244	1,004,856

Source: Company data, Reperio Capital Research

Shanghai Pharmaceutical has the most efficient distribution operations in terms revenue and operating profit per customer. Universal Health's distribution business is very efficient with its assets per customer. Its assets required to serve distribution customers is 32% of Sinopharm's assets per customer and 5% of Shanghai Pharmaceutical's assets per customer.

Key Value Drivers, Distribution	Universal Health 2211:HKG	China Jo Jo Drugstore CJJD:US	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
Sales growth (4 yr CAGR)	49.2%	-22.4%	2.9%	30.9%	28.8%
Gross profit growth (4 yr CAGR)	50.4%	-47.9%	+ to -		
Operating profit growth (4 yr CAGR)	44.0%	+ to -		35.5%	31.2%
Gross margin (4 yr ave)	19.1%	5.3%	-11.2%		
Operating margin (4 yr ave)	11.5%	-12.5%		3.5%	2.6%
Asset turnover (4 yr ave)	2.0		3.3	1.6	1.8
ROA (4 yr ave)	23.6%			5.8%	4.9%
Equity multiplier (4 yr ave)	1.3		3.0	2.0	3.2
ROE (4 yr ave)	29.4%			11.8%	15.7%

Source: Company data, Reperio Capital Research

Just like pharmaceutical retail, Universal Health is the fastest growing distributor followed by Sinopharm and Shanghai Pharmaceutical. Also like pharmaceutical retailing, Universal Health is far more profitable on an operating margin and return on asset basis. The company's asset turnover is poor relative to Wanjia but just better than other peers, which is counterintuitive as developed market distribution peers economies of scale come in the form of capital efficiency. Larger distribution peers are not generating the efficiency of developed peers. This weaker capital efficiency may be due to the immaturity of the market with multiple layers of distributors. It may also be that larger distributors are building a nationwide network that is not efficient.

Universal Health is clearly the best operator in both the retail and distribution segments. It has been able to grow the fastest while maintaining the highest profitability.

Given the industry is fragmented and economies of scale are assumed to exist, consolidation should continue making acquisitions and acquisition performance a key driver of success within the industry. The importance of acquisitions for each company from 2011 to 2014 is illustrated below.

2011-2014	Universal Health	Sinopharm	Shanghai Pharma	Wanjia
Consolidated revenue % of total	7.6%	4.1%	1.9%	1.3%
Consolidated net income % of total	5.8%	4.3%	0.8%	0.1%
Consolidated revenue % of incremental revenue	43.3%	20.9%	11.6%	53.9%
Consolidated net income % of incremental net income	41.5%	24.5%	8.6%	0.1%

Source: Company data, Reperio Capital Research

Universal Health is the most acquisitive of publicly listed competitors, from 2011-2014, consolidated revenue from acquisition accounted for 7.6% of total revenues and 43.3% of incremental revenue. Sinopharm was also very acquisitive with 4.1% of total revenue and 20.9% of incremental revenue coming from acquisitions.

The table below shows the performance of Universal Health and peers after removing the cumulative effects of acquisitions. Given the importance of acquisitions, the ability to integrate acquisitions and improve the performance one integrated is crucial to profitability and growth. Companies do not report the performance of companies after acquisition. To determine the strength of a company's integration abilities, a company's operations is analyzed after eliminating any consolidated revenue, net income in the year of the acquisition and estimated full year revenue and net income in the following years.

Organic Growth 11-14 CAGR	Universal Health	Sinopharm	Shanghai Pharma	Wanjia
Revenue	37.7%	22.9%	17.3%	1.4%
Net income	31.9%	17.7%	9.0%	+ to -
Asset	85.9%	30.6%	13.1%	-13.3%
Equity	75.1%	23.5%	17.6%	46.4%
Profitability w/o Acquisitions 11-14 Average				
Net margin	12.4%	2.2%	3.8%	-7.1%
Asset turnover	1.1	1.4	1.4	1.4
ROA	13.5%	3.1%	5.4%	-10.2%
Equity Multiplier	1.5	3.4	1.9	3.8
ROE	20.2%	10.6%	10.1%	-38.7%

Source: Company data, Reperio Capital Research

As illustrated above, Universal Health has the highest growth after eliminating revenues of acquired companies. Assuming growth of existing revenues was roughly 20% in-line with the industry growth rate, Universal Health was able to double its revenue growth rate by improving the operating performance of acquired companies. The growth of Universal Health's assets and equity above revenue and net income is due to its recent IPO and the cash build on the balance sheet. The company's acquisition process and its Jintian Institute drive the integration performance.

Using the same assumption of growth, Sinopharm was able to barely improve the operations of acquired companies. Shanghai Pharmaceutical and Wanjia Group were not very acquisitive but underperformed industry growth rates.

The multiples for acquisitions and the profitability of businesses acquired from 2011 to 2014 are below.

Acquisition Multiples 11-14	Universal Health	Sinopharm	Shanghai Pharma	Wanjia
Price to sales	0.7	0.1	0.7	0.1
P/E	6.5	5.0	45.3	(18.2)
Price to assets	1.2	2.5	5.4	(0.0)
P/B	2.0	1.3	2.7	0.7
P/TB	4.0	2.4	4.2	0.7
Net margin	10%	2%	2%	-1%
Asset turnover	1.8	2.8	1.1	2.4
ROA	19%	7%	2%	-2%
Equity multiplier	1.6	3.8	3.8	2.6
ROE	32%	26%	6%	-4%

Source: Company data, Reperio Capital Research

Given the profitability of Universal Health's acquisitions, the most appropriate valuation metric is PE. Universal Health and Sinopharm were not only the most acquisitive but bought companies at the cheapest prices on a PE basis. After accounting for improvements above industry growth the PE of Universal Health's acquisitions drop from 6.5 times to 3.3 times.

Overall, Universal Health is buying the best businesses at the cheapest prices and improving them the most. Due to its strong acquisition process and Jintian Institute, the company is the best acquirer in the industry.

In addition to its strong performance of operations and acquisitions, Universal Health' management is innovative with its direct supply model, Jintian Institute, and customer acquisition strategy of using trade associations. In addition, it was the first of its peers to open online shops on Tmall and JD, to cooperate with e-commerce Alibaba "Ali-health", to partner with KUH, the largest mobile internet community in China, to build mobile terminal marketing system, and to source products overseas.

Capital Allocation

Universal Health has generated RMB1.536 billion in operating cash flow over the past five years.

Capital Allocation	2010	2011	2012	2013	2014	Σ 10-14	% of Total
Cash flow from operations	**126**	**198**	**248**	**426**	**538**	**1,536**	**100%**
Working capital investment	(18)	(76)	(87)	(39)	54	(166)	-11%
Fixed capital investment	(1)	(12)	(15)	(43)	(68)	(138)	-9%
Acquisitions	-	(177)	(228)	(122)	(369)	(897)	-58%
Free cash flow	**106**	**(67)**	**(81)**	**222**	**154**	**335**	**22%**
Other investing	37	2	(131)	112	(358)	(338)	-22%
Cash from/(to) debtholders	-	673	41	5	71	790	51%
Cash from/(to) shareholders	(106)	(1)	(5)	770	(84)	575	37%
Total change in cash	**37**	**607**	**(176)**	**1,109**	**(216)**	**1,361**	**89%**

Source: Company data, Reperio Capital Research

11% of cash flow generated from operations has been allocated to working capital, 9% to fixed capital, and 58% to acquisitions. Returns in both retail and distribution are well above the cost of capital with retail returns on assets above 30% and distribution return on assets above 20% so investments to working capital, fixed capital, and acquisitions to fuel growth will create a lot of value for Universal Health's owners.

As mentioned earlier, the company expects start up cost excluding working capital of each pharmacy to be approximately RMB5.0 million. The table below illustrates consideration paid for all acquisition (pharmacy and distribution).

Pharmacy Buy vs. Build Decision	2011	2012	2013	2014	11-14 Avg
Pharmacies acquired	216	148	192	157	713
Consideration paid for all acquisitions (RMB mn)	193	322	121	386	1,022
Consideration paid per pharmacy acquired (RMB)	891,278	2,175,257	631,021	2,459,503	1,433,032

The company is buying pharmacies and distribution companies below the reproduction costs. From 2011 to 2014, the company was able to acquire pharmacies at RMB1.433 million per pharmacy and get distribution assets for free.

As illustrated in the previous section, Universal Health acquisitions are very good use of capital. Over the past four years, the company has buying assets in an industry that conservatively expected to grow at a double digit rate per year at a 15.5% an earnings yield. In addition, the company is a strong integrator and evidence points to doubling growth rates through operational improvements.

Other than operations and acquisitions, management built a large net cash position equal to 46% of assets and 2.41 times ttm operating profit. The net cash position allows the company to withstand any industry downturn or financial market stress. It also allows the company to take advantage any acquisition targets as they arise. Given cheap prices and the ability to integrate acquisitions, holding cash is very valuable.

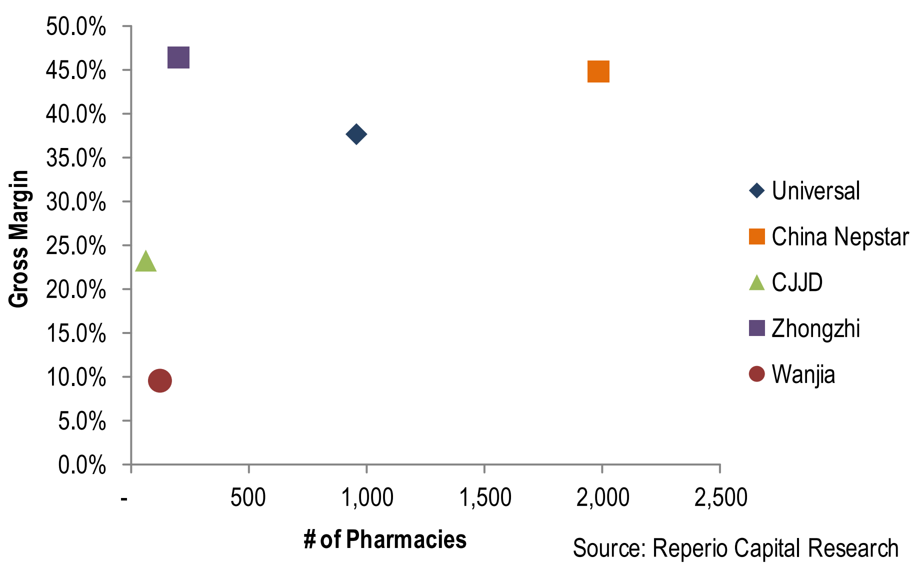
The company pays a very small dividend, but the profitability, growth, and consolidation opportunities in the industry, capital would be better used if put to growth opportunities.

Strategy

As illustrated earlier, the pharmaceutical retail and pharmaceutical distribution industries are fragmented. To determine why these industries are fragmented, the four primary reasons of fragmentation are analyzed, which will allow for a potential future roadmap for the industry.

1. Low entry barriers and/or high exit barriers
2. Lack of power advantages with buyers and/or suppliers
3. Regional issues
4. Regulatory issues

The Chinese pharmaceutical retail market is characterized by low but increasing entry barriers. Fragmentation and low barriers to entry are almost synonymous. If high barriers to entry were present, the market would not be fragmented. Management teams in pharmaceutical retail state there are economies of scale in purchasing. If economies of scale in purchasing were present gross margin would be higher for larger players. The graph below charts the peer group by number of pharmacies and gross margin to see if there is a relationship.



Source: Reperio Capital Research

Although the sample size is very, very small, with the exception of Zhongzhi, there seems to be a relationship between the number of pharmacies a company owns and gross margin hinting at possible economies of scale in purchasing. Zhongzhi Pharmaceutical researches, develops, manufactures, and sells Chinese patent medicines and decoction pieces. Zhongzhi sells its products through its retail channel creating its gross margin anomaly. Zhongzhi's gross margin on other products sold through its pharmacies is 40%, which is still high relative to its size.

Economies of scale in marketing does not seem to exist as China Nepstar's 44.8% gross margin turns into a 1.0% operating margin, while Universal's 37.7% retail gross margin turns into an operating margin of 16.7%. Other large players, Sinopharm, 2,360 pharmacies, and Shanghai Pharmaceutical, 1,895 pharmacies have operating margins of 3.3% and 1.0%, respectively. Sinopharm and Shanghai Pharmaceutical do not report their pharmaceutical retail gross margin but assuming economies of scale in purchasing exists should be between 45-50% for both players meaning significant outlays on operating expenses. The lack of correlation between size and operating expense points to no economies of scale in marketing in fact the higher operating expense point to diseconomies of scale. Universal Health could perform well in retail due to its geographical focus making administration much easier.

Pharmacies account for roughly 25% of pharmaceutical retail sales. Hospitals account for the remainder. Hospitals are more important distribution outlet decreasing the bargaining power of pharmacies. As illustrated above, larger pharmacies have bargaining power over suppliers as they obtain purchasing discounts. The government's desire to separate pharmaceutical sales from hospitals will increase the bargaining power of pharmacies relative to both suppliers and buyers. The pharmacy market is more fragmented than the distributor market also pointing to moderately strong bargaining power of suppliers. Pharmacies bargaining power of buyers are moderate as buyers can go to overcrowded hospitals to face waits or a competitor. Buyers are very fragmented and lack experience and sophistication when consuming at pharmacies as the tradition form of pharmaceutical sales is hospitals.

There are no major regional issues other than at the national level where the pharmaceutical industry is highly regulated including what can be sold in a pharmacy and amount of foreign ownership. The business is about selling standardized products at high volume. The only customization is prescription size. This activity is not significant enough to alter the market structure. There are not fragmented tastes, high transportation costs, or high inventory costs that would create regional markets. The only issue that will create fragmentation and regional markets is the number of independent pharmacy operators in China and the developed world may point to owning small pharmacies for the lifestyle rather than profit maximization. These companies would only be able to exist if the economies of scale from purchasing were not a significant enough to put them at a competitive disadvantage.

Regulatory issues are not preventing consolidation in the industry. A centrally managed economy and society is more likely to desire larger consolidated pharmacies as it is easier to control the industry through regulation and dictating to companies the acceptable activities and policies.

It seems pharmaceutical retail fragmentation comes from newness of the industry as the industry is building the skill set, including expertise and capital, needed to consolidate the industry. Given the presence of economies of scale in purchasing consolidation should continue.

Entry barriers are higher in distribution due to the need for scale. The upfront investment costs in facilities and trucks are very high, while the marginal cost of distributing one additional unit is very low leading to intense competitive rivalry as competitors attempt to fill capacity. This competitive rivalry leads to a very low gross margin and the need to use capital as efficiently as possible. Distributor gross margins at most are 9-10%. Universal Health is able to have higher gross margins due to its direct supply business model eliminating steps in the supply chain. The company is also focused on high margin products. Developed market pharmaceutical distributors better illustrate the need for efficient capital turnover. Develop world distributor operating margins are under 2% to get to 10% ROIC you need a 500% invested capital turnover. All developed world distributor have invested capital turnover over 20 times, while Chinese distributors struggle to hit 4 times. As the Chinese market consolidates and the supply chain streamlines, margins will decrease leading to an increase need for capital efficiency.

Company	Ticker	Gross margin		Operating margin		Working capital turnover		Fixed capital turnover		Intangible capital turnover		Invested capital turnover		ROIC	
		Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg	Curr	3 yr avg
Universal Health	**2211:HKG**	**29%**	**27%**	**16%**	**15%**	**9.4**	**7.9**	**34.9**	**42.8**	**5.4**	**6.1**	**3.1**	**3.2**	**49%**	**49%**
Sinopharm	1099:HKG	8%	8%	4%	4%	5.0	5.1	31.0	29.5	28.2	28.0	3.7	3.7	15%	14%
Shanghai Pharma	601607:SHG	12%	13%	4%	4%	4.6	4.8	20.3	17.8	15.3	15.6	3.0	3.1	11%	12%
Jointown Pharma	600998:SHG	7%	7%	2%	2%	3.2	4.0	15.7	16.3	58.7	56.5	2.5	3.0	4%	5%
McKesson	MCK:US	6%	6%	2%	2%	29.0	26.2	89.4	86.1	14.0	12.9	21.9	20.0	38%	35%
Cardinal Health	CAH:US	6%	5%	2%	2%	46.3	37.1	73.0	68.6	18.3	17.4	28.3	23.9	60%	42%
AmerisourceBergen	ABG:US	3%	3%	0%	1%	402.2	77.2	157.0	121.8	24.6	29.6	112.9	47.2	7%	48%

Source: Company data, Morningstar, Reperio Capital Research

The bargaining power of pharmaceutical distributors increases with the size of the organization. A pharmaceutical manufacturer will want to distribute its product to the most retail outlets and pharmaceutical retailers will want access to the best selling products and may want to decrease the number of distributors to decrease purchasing costs and complexity of management of distributor relationships. Similar to retailing, the largest distributors will have the highest bargaining power.

There are no regional or regulatory issues preventing consolidation in the pharmaceutical distribution market.

The market structure of more developed countries, no strong reason for fragmentation, high fixed costs leading to high competitive rivalry among distributors, and the multiple layers of the pharmaceutical distribution segment point to consolidation to achieve bargaining power and efficient distribution networks.

There is little standing in the way of consolidation of both pharmaceutical retail and pharmaceutical distribution other than the lack of expertise and the newness of the markets. Given the presence of economies of scale, strategic logic states consolidation will continue until economies of scale are exhausted as consolidation lowers costs. The most likely outcome is probably a continuation of consolidation in both retail and distribution as firms gain the expertise and capital needed to consolidate the industry. Distribution should consolidate more than retail as the benefits and importance of scale are far greater in distribution than in retail.

The appropriate strategy in industries with economies of scale is to reach critical mass, particularly in fragmented industries where you can gain an advantage over competitors. Universal Health is one of the most acquisitive companies in the industry, buying the highest quality companies at the cheapest multiples. There acquisition strategy is perfect for the current market environment and is allowing the company to outperform on growth and profitability.

Universal Health other unique activities include Jintian Institute, direct supply model, focus on high margin products, acquiring distribution customers and acquisition targets through trade associations, and value add to smaller customers.

The Jintian Institute is unique among the publicly listed peers. It is a training facility that allows Universal Health to quickly bring personnel of an acquired target up to speed on the standards, processes, and culture of Universal Health. The institute is crucial given the number of acquisitions the company makes and the importance of acquisitions to this stage of the industry's development. Its effectiveness is seen in the estimated performance of acquisitions after integration.

The company also has a unique direct supply model. The model eliminates the multiple layers of distributors typically seen in pharmaceutical value chain. It allows the company to capture the gross margin from those segments without significant higher operating expenses or investment requirements. As the industry matures and consolidation continues, the industry distribution segment will consolidate and streamline making the direct supply model more common but it is still currently unique. Wanjia Group saw a 27.5% decline in distribution revenues in 2014 due to the implementation of GSP in Fujian Province preventing some of its distributor customers from operating. The company does not have direct supply capabilities so it was unable to alter its value chain and sell direct to pharmaceutical retailers illustrating the uniqueness of the direct supply model. In 2014, the direct supply model accounted for 40.1% of Universal Health's revenue and 59.9% of the company's gross profit up from 25.5% of revenue and 36.1% of gross profit in 2010.

Universal Health focuses on identifying high margin products including international products such as McJayden and Betterway and pushing these products through its distribution channel and pharmacies. To be high margin products, these products must be unique otherwise the product's margin would be similar to commodity product margins and therefore not be a high margin product. The company has not reported high margin products as a percentage of revenues since 2012 but in that year, high margin products accounted for 38% of revenues and 52% of overall gross profit.

Universal Health actively markets and sells its products through trade associations for pharmaceutical retailers in China. These trade associations are formed by small to medium-size pharmaceutical retailers that combine to increase their bargaining power. Universal Health is a core member of the China Medical and Resources Association, a national pharmaceutical retailer trade association with sub-associations in 19 provinces in China. It covers more than 460 pharmaceutical retail chains and over 20,000 pharmacies owned by these pharmaceutical retail chains. Mr. Jin, the company's Chairman, serves as a vice president of the China Medical and Resources Association and president of its sub-association in Heilongjiang. Mr. Jin's leadership positions in trade associations in China allow him to gain an in-depth understanding of the industry's participants.

The company strengthens its relationships with manufacturers and customers by providing value added services such as training at its Jintian Institute, helping with purchasing, and assisting with employee searches among other services.

Universal Health's unique activities complement each other making it harder for competitors to replicate. Jintian Institute complements smaller customer acquisition through associations and offering value added services. Direct supply complements high margin products and acquiring smaller customers through associations. The value added services complements the acquisition of smaller customers through associations. The company has a number of unique activities that complement each other making it even more difficult for competitors to replicate.

Universal Health will continue to focus on organic and acquisitive expansion in Northeast China and Greater China Region. The company will continue to grow the direct supply model by strengthening relationships with peer companies and international companies to bring products to China. In addition, the company will strengthen its online presence and introduce more healthcare products to improve the product portfolio.

Corporate Governance

Corporate governance is not a significant issue but the company does have a history of related party transactions.

On 1 July 2013, Jintian Century, a Chinese company incorporated on 17 April 2013, held by Mr. Jin Dongtao (89%), Ms. Hao Ruihua (3%), Mr. Jin Guisheng (3%), Mr. Jin Dongkun (3%) and Ms. Chen Xiaoyan (2%) acquired 4.99% equity interest in Jintian Aixin Co., a subsidiary. Jintian Century never received any dividends or fees. Universal Health maintained complete control over the 4.99% interest through a power of attorney and an exclusive option to purchase the interest. The 4.99% was acquired by Universal Health on August 25, 2014 for RMB67.5 million equal to book value of the investment. Jintian Century acquired the 4.99% stake for RMB23 million through a capital injection. This transaction is a bit concerning but given the acquisition it will not be an issue. Hopefully, now that the company is public, it will not participate in future arrangements that may give the hint of value extraction at the expense of minority shareholders.

On January 1 2012, and in supplemental agreements dated 1/10/2012, 6/30/2013, and 11/25/2013, Universal Health entered into a trademark agreement with Chengde Yushi. Chengde Yushi granted Universal Health with non-exclusive rights from 1/1/2012 to 6/29/2013 and exclusive rights from 6/30/2013 to 6/30/2016 to distribute its pharmaceutical products throughout China. Universal Health is paying RMB7.8 million in three installments for the exclusive agreement. Chengde Yushi was 95% owned by Mr. Geng Liyuan, uncle of Mr. Jin, and 5% owned by Mr. Geng Changsheng, cousin of Mr. Jin. The annual caps for purchasing pharmaceutical products from Chengde Yushi for the three years ending 31 December 2013, 2014 and 2015 were RMB110.0 million, RMB150.0 million and RMB190.0 million respectively. On May 14, 2014, Mr. Geng Liyuan and Mr. Geng Changsheng transferred their interest in Chengde Yushi to an independent third party therefore Chengde Yushi is no longer a connected person.

From 1 January to 14 May 2014, the aggregate value of purchase of pharmaceutical products from Chengde Yushi was RMB72.5 million. The annual revenue target for Chengde Yushi products is RMB80 million, which will increase by 40% annually thereafter. There is no obligation to reach the annual targets.

On January 1 2012, Universal Health entered into a trademark agreement with Heilongjiang Baitai. Heilongjiang Baitai granted Universal Health with non-exclusive rights from 1/1/2012 to 6/29/2013 and exclusive rights from 6/30/2013 to 6/30/2016 to distribute its pharmaceutical products throughout China. Universal Health paid RMB8.75 million to Heilongjiang Baitai for exclusivity. Heilongjiang Baitai is wholly-owned by Ms. Liu Shuxia, cousin-in-law of Mr. Jin. The annual cap for the purchases of pharmaceutical products from Heilongjiang Baitai is RMB84.0 million in 2014 up from RMB60.0 million in 2013. In 2014 Universal Health purchased RMB83.8 million from Heilongjiang Baitai. The annual revenue target for Heilongjiang Baitai pharmaceutical products in 2013 is RMB85 million, which will increase by 35% annually thereafter.

Heilongjiang Baitai shall not transfer the Kangyisheng trademark to any third party without prior consent from Universal Health. At expiry of the agreement or in the event that Heilongjiang Baitai intends to sell its trademark, Universal Health has the right of first refusal. If the Kangyisheng trademark is transferred to a third party, Heilongjiang Baitai needs to get the third party to agree to the existing licensing agreements.

On February 21, 2013, Mintai and Universal Health entered into a sales agreement where Mintai authorized Universal Health to distribute, on an exclusive basis, some of its pharmaceutical products throughout China from 25 February 2013 and 24 February 2016. Mintai is jointly-owned with 49% owned by Ms. Li Shuyu and her husband, Mr. Xin Youjiang, and 51% owned by an independent third party. Jifeng is 40% owned by Mr. Xin Youjiang and 60% owned by an independent third party. Ms. Li Shuyu owned 36% equity interest in Universal Health's subsidiary, Weikang. As such, each of Mintai and Jifeng were connected persons. The annual caps for purchases of pharmaceutical products from Mintai for the three years ending 31 December 2013, 2014 and 2015 were RMB70.0 million, RMB88.0 million, and RMB105.0 million, respectively.

During the year ended 31 December 2014, the aggregate value of purchase of pharmaceutical products from Heilongjiang Baitai was RMB83.8 million.

On August 27, 2014, Universal Health purchased Ms. Li Shuyu 36% equity interest in Weikang for RMB250 million. Universal Health purchased the initial 64% of Weikang for RMB225 million when Ms. Li Shuyu did not want to sell. From 1 January to 27 August 2014, the aggregate value of purchase of pharmaceutical products from Mintai and Jifeng was RMB73.9 million.

In 2015, the only connected transaction would be with Heilongjiang Baitai. All transactions post-IPO seem to be on a commercial basis.

Accounting

A company's accounting policies speaks volumes about the company's management. Conservative accounting is preferred as it illustrates the company is not trying to mask flaws in the business. Additionally, if the company prepares its financial statements in a conservative nature, the internal budgeting will probably be just as conservative leading to a built in margin of safety in budgets. Accounting assumptions are compared to industry peers to determine how conservative the company's accounting is. The table below shows the accounting assumptions used by publicly listed Chinese pharmaceutical peers.

Accounting Assumptions	Universal Health 2211:HKG	Zhongzhi Pharma 3737:HKG	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
Trademarks and brand loyalty	8-20			5-15	Useful life
Contractual supplier relationships	10				
Computer software	5-7	10		3-10	3-5
Building	20	20		20-40	5-50
Motor vehicles	4-8	4-5	5	5-8	4-14
Furniture and office equipment	3-5	3-5	5	3-8	3-14
Plant and machinery		3-10		8-15	4-20
Lease improvements	Lease term	3-10	Lease term		
Land rights use	50				Lease term
Sales network				9-20	Useful life
Product development costs				5	
Exclusive distribution rights				10	
Know how					5-10
Research and development					Useful life
Inventory valuation	Weighted avg	Weighted avg	FIFO	Weighted avg	Weighted avg
Depreciation method	Straight line	Straight line	Straight line	Straight line	Straight line

Source: Company data, Reperio Capital Research

Universal Health's accounting is overall in line with peers. A few worrying items are amortizing trademarks and brand loyalty over 8-20 years when few other peers amortized trademarks. Being in the distribution and retail business, customer show very little brand loyalty meaning trademarks and brand loyalty has little or no value. Contractual supplier relationships are amortized over 10 years when no other peer accounts for this. While there may be value in contractual supplier relationships, it is minimal and conservatism states do not include in intangibles. Other than these two items everything looks in line.

Some peers also report their value in use calculations used in calculating goodwill from acquisitions.

Value-in-Use Calculation Assumptions	Universal Health 2211:HKG	Zhongzhi Pharma 3737:HKG	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
Retail					
Gross margin	39.1%			26.7-39.2%	
Growth rate	3.0%	3.0%	8.0%	3.0%	
Discount rate	17.5%	5.0%	12.0%	14.7%	
Distribution					
Gross margin	20.0%			2.6-12.5%	6.0-7.0%
Growth rate	3.0%		8.0%	3.0%	3.0%
Discount rate	18.5%		12.0%	14.6%	16.0-19.0%

Source: Company data, Reperio Capital Research

Universal Health's retail gross margin is at the high end of peers in both retail and distribution. These margins are just about equal to 2014 gross margins for both segments. Essentially, the company is assuming no cyclicality, no future competitive pressures, or continued improvement in gross margins. Regardless, there is not significant conservatism or extreme optimism in the gross margin assumptions. Other than gross margin, the company assumes the lowest growth rate and the highest discount rate so there is a level of conservatism in these assumptions.

Salary/Incentives

Management's salaries are not excessive. Over the past three years, the company's five highest paid employees earned an average of 0.46% of operating profit. The 2014 figure was 0.72%, an increase over previous years.

Top 5 Salaries (3 yr avg)	Universal Health 2211:HKG	Zhongzhi Pharma 3737:HKG	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG
Top 5 salaries % operating income	0.46%	4.01%	2.19%	0.19%	0.48%
Employees	5,428	1,967	1,077	45,417	39,297
Employee benefit expense (RMB mn)	164	107	77	3,591	3,376
Top 5 salaries % employee benefit expense	1.43%	1.74%	2.40%	0.32%	0.44%
Employee benefit expense per employee (RMB)	30,190	54,272	71,427	79,074	85,906

Source: Company data, Reperio Capital Research

The top five salaries at Universal Health are below all peers with the exception of Sinopharm. Given the company's growth and profitability, management is good value for money.

Smart owner-operators with a passion for the business are ideal management teams as they have skin in the game and incentives are aligned with minority shareholders. On the other side of the spectrum are management teams with little or no ownership stake simply trying to forward their career or worse extract as much value as possible leading to a huge contrast in incentives between minority shareholders and management. The founders are brothers and Chairman and Vice-Chairman of the company. The Chairman owns 47.14%, including a 2015 share purchase that increased his ownership by 2%. The Vice-Chairman owns 2.05%. The share ownership of the Chairman aligns his interests with minority shareholders. Management clearly fit the smart owner operator mold.

VALUATION

Asset Valuation

With the company's profitability, unique activities, and growth, liquidation value and reproduction value are less appropriate valuations but illustrate potential downside should industry fundamentals or profitability deteriorate.

Universal Health International Group Holding Ltd (2211:HKG)						
Per Share Values	2010	2011	2012	2013	2014	H1 2015
Current Price	1.99	1.99	1.99	2.57	2.62	2.69
NCAV	0.13	0.18	0.10	1.17	1.03	1.16
NNWC w/ PP&E	0.30	0.56	0.65	1.75	1.76	1.89
Asset Reproduction Value	0.48	1.05	1.35	2.52	2.58	2.68

Source: Reperio Capital Research

Universal Health liquidation value is determine using net current asset value (NCAV) and net net working capital plus property, plant, and equipment (NNWC + PP&E) valuation methods. Asset reproduction value takes into account the cost of reproducing the company's assets.

At the end of the first half of 2015, Universal Health's NCAV was HKD1.16 per share representing 57% downside. NNWC + PP&E is HKD1.89 representing 30% downside. NCAV's conservatism comes from not taking into account any long term assets such as distribution assets or pharmacies. NNWC + PP&E gives cash a value equal to 100% of the balance sheet value, accounts receivable 75% of the balance sheet value, inventory 50% of the balance sheet value, each pharmacy is given RMB1.5 million valuation, and distribution assets are given no value. Liquidation values are most appropriate when an industry is not viable or the company's position within the industry is not viable leading to the inevitable liquidation of assets. The importance of the pharmaceutical industry along with the industry's growth, relative immaturity, and profitability eliminate liquidation value as anything useful.

Universal Health's reproduction value is equal to HKD2.68 representing 0% upside. Current assets are valued at balance sheet values. Each pharmacy is given RMB1.5 million valuation and distribution assets are given no valuation, roughly equivalent to all the cost of all acquired pharmacies, but well below the cost of opening a new pharmacy, which the company estimates at RMB5 million. Reproduction value is meant to be the cheapest way to reproduce the company, which is currently through acquisition. Reproduction value is appropriate in an industry with perfect competition where profitability will revert to the cost of capital.

Earnings Valuation

Earnings valuation is the average of three valuations (earnings power valuation, residual income and discounted cash flow). Residual income and discounted cash flow valuations are three staged. The first stage is the first five year, the second stage is the next four years where assumptions fade from the first five years assumptions to the terminal assumptions, and the third stage is the terminal assumptions. The key assumptions for all earnings valuations are listed below.

Key Assumptions	First 5 Years	Year 10	Current	Average	Peak	Trough	St Dev
Discount rate	10.0%	10.0%					
Tax rate	-25.0%	-25.0%	-26.2%	-25.5%	-24.8%	-26.2%	0.6%
Working capital turnover	11.5	9.3	11.5	9.3	11.6	6.5	2.2
Fixed asset turnover	34.9	114.4	34.9	114.4	365.5	34.9	141.3
Intangible asset turnover	5.4	8.9	5.4	8.9	16.2	5.4	4.9

Source: Reperio Capital Research

A 10% discount rate is used for all valuations. A constant discount rate eliminates subjectivity. Given beta is a measure of volatility rather than risk, CAPM is not valuable in determining a discount rate. A discount rate equivalent to opportunity cost is used. The S&P 500 has roughly returned 10% since 1928. MSCI Emerging Markets returned roughly 10% since inception. The assumed 25% tax rate is equivalent to the regulatory tax rate in China. Working capital turnover, fixed asset turnover, and intangible asset turnover are assumed to be equal to the current figure for the next five years until fading to the average over the past five years. Given the importance of acquisitions, the second largest asset, behind cash, on the company's balance sheet is intangible assets. The intangible assets represent a capital outlay to acquire companies and therefore needs to be included to accurately assess the true profitability of the business.

To determine the value of Universal Health, revenue growth and operating margin are altered to arrive at different scenarios of the world. Different scenarios are important as the future is uncertain and random.

Key Assumptions	Current	Average	Peak	Trough	St Dev
Revenue growth	31.1%	50.1%	71.7%	31.1%	17.7%
Operating margin	15.8%	15.8%	18.7%	13.8%	1.8%

Source: Reperio Capital Research

From 2010 to 2014, revenue growth averaged 50.1% with a peak of 71.7% and with a trough growth rate of 31.1%. Acquisitions and improvements to acquired companies fueled much of the growth. The market is still fragmented so acquisitions can continue for some time. The problem is as the market consolidates returns on acquisitions fall as competition increases and existing acquisition targets ask for higher valuations. For the first five years, the industry is expected to continue to grow at 20%, which is the peak scenario growth rate. The trough growth rate is 0% as a very conservative case for any company with growth. Also, if you can acquirer a growing rapidly growing company at below its no growth price a margin of safety is built in. 10% or the mid-point of both scenarios is the base case. Terminal growth rates are 0%, 2.5%, and 5%. 0% is used for conservatism as the market is expected to grow for sometime, 2.5% is just below management's assumption of 3% growth, and 5% is used as peak terminal growth as it is roughly long term World GDP.

Revenue Growth Scenarios	First 5 Years	Terminal Value
Peak	20.0%	5.0%
Base case	10.0%	2.5%
Trough	0.0%	0.0%

Source: Reperio Capital Research

Operating margin has been fairly consistent with a peak of 18.7%, a trough of 13.8%, and average of 15.8%. The company has unique activities, a top management team, a growing market, and is investing heavily in companies with weaker operating performance than Universal Health, which is dragging down current profitability but increasing future value of the company. These factors lead us to believe in the next five years operating margin can remain stable leading to peak operating margin in the next five years of 17.5%, a base operating margin in the next five years of 15.0%, and a trough operating margin in the next five years of 12.5%. In year ten and beyond operating margins are assumed to compress due to competitive pressures with peak margins at 15.0%, base operating margins at 10%, and trough margins at 5.0% .

Operating Margin Scenarios	First 5 Years	Terminal Value
Peak	17.5%	15.0%
Base	15.0%	10.0%
Trough	12.5%	5.0%

Source: Reperio Capital Research

ROIC under various scenarios is illustrated below.

ROIC Scenarios	First 5 Years	Terminal Value
Peak	59.1%	70.6%
Base case	44.4%	36.8%
Trough	31.3%	12.5%

Source: Reperio Capital Research

Historical ROIC is below.

ROIC	2010	2011	2012	2013	2014
NOPAT	120	185	239	392	508
Invested capital	77	339	689	898	1,304
ROIC	157.4%	54.6%	34.7%	43.6%	38.9%
Incremental NOPAT		64	54	152	116
Incremental invested capital		262	350	210	405
Incremental ROIC		24.6%	15.5%	72.8%	28.6%

Source: Reperio Capital Research

ROIC is calculated with NOPAT divided by invested capital. Invested capital equals working capital plus fixed assets plus intangible assets. From 2011 to 2014, the company averaged an ROIC of 43%. Incremental ROIC continues to be well above the cost of capital but below current ROIC meaning new projects add value but not as much value as previous projects. As long as the incremental ROIC is above the cost of capital the company should continue to invest heavily as the projects add value.

Given the assumptions of each scenario what would have to happen for each scenario to take place. The assumptions of the peak scenario are below.

Peak	First 5 Years	Terminal Value
Revenue growth	20.0%	5.0%
Operating margin	17.5%	15.0%
ROIC	59.1%	70.6%

Source: Reperio Capital Research

To reach the peak scenario growth rate, Universal Health would have to continue to grow at the same rate as the market is expected to grow over the next five years then fade to the World GDP growth rate. The 20% growth rate is well below the 2010 to 2014 trough growth rate of 31% and the 2010 to 2014 average growth rate of 51%. Growth rates will inevitably come down as the company grows in size so this assumes strong continued execution with a few acquisitions but not to the extent the company was acquiring companies in the past. This slowing in acquisitions for the peak scenario comes despite the benefits of economies of scale in purchasing in retailing and economies of scale in distribution assets in distribution.

Under the peak scenario, the company's operating margin would need to continue to improve over the next five years before competitive pressures decrease the company's operating margin. As the market is growing at 20% competitive pressures are low. Additionally, Universal Health performs a number of unique activities that are not easily replicated by its peers allowing it to sustain economic profitability. The company is competing against much weaker competition in the form of smaller pharmacies and state run pharmacies that do not have the profit incentives that private companies have. Universal Health also has a history of operational improvements.

The peak scenario is achievable given historical growth rates and operational improvements but conservatism and a desire for a margin of safety states it is the peak scenario. 2015 fair value under the peak scenario is HKD14.17 per share while 2020 fair value is HKD21.64 per share representing 427% and 705%, respectively.

Base case	First 5 Years	Terminal Value
Revenue growth	10.0%	2.5%
Operating margin	15.0%	10.0%
ROIC	44.4%	36.8%

Source: Reperio Capital Research

Under the base case scenario, revenue growth is half the expected industry growth rate, a third of the trough growth, and a fifth of the average growth of the company over the past four years. Using half the expected industry growth rate and assuming no acquisitions adds a significant margin of safety in case the industry is affected by macroeconomic concerns in China. Growth fades to a terminal rate of 2.5% just below managements' budget estimates of 3% growth.

Operating margin under the base case scenario is 15% over the next five years before declining to 10% in the terminal value as competitive pressure intensify as the market slows. The current operating margin is 15.8% and the company continues to improve its margin despite investing heavily in assets with weaker economics than the existing business creating a drag on the company's performance. Given the current margin, continued operating improvements, and heavy investments dragging down operating margin, there is conservatism built into the base case operating margin. Under the base case, Universal Health's 2015 Fair Value is HKD5.62 and 2020 Fair Value is HKD6.75 representing 109% and 151% upside, respectively.

Trough	First 5 Years	Terminal Value
Revenue growth	0.0%	0.0%
Operating margin	12.5%	5.0%
ROIC	31.3%	12.5%

Source: Reperio Capital Research

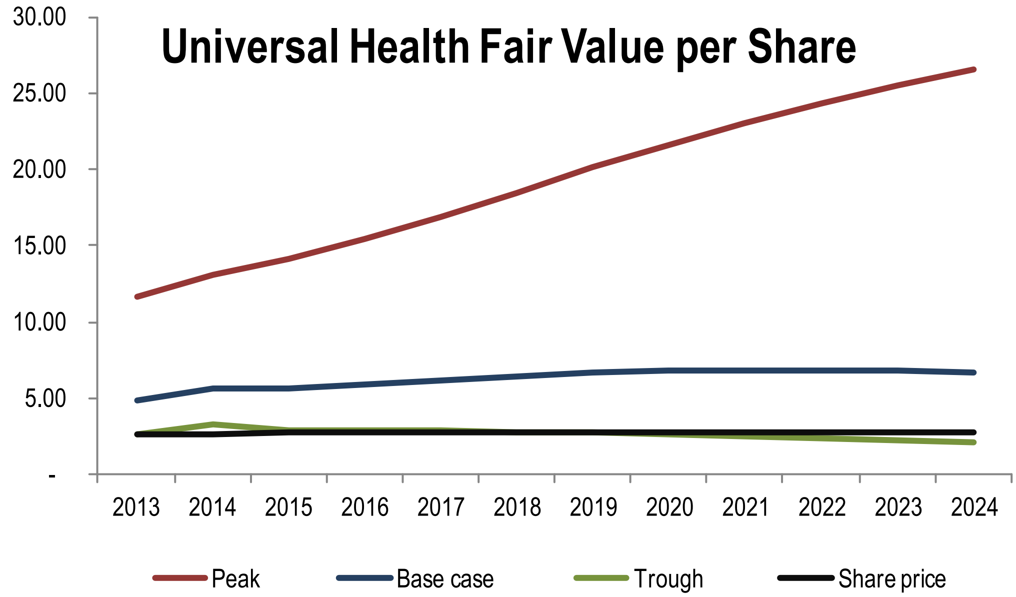
The trough scenario is a worst case scenario where the company seizes to grow and operating margins shrink. Essentially, this is a scenario where Universal Health is able to withstand competitive pressures in the short term as competitors build similar capabilities leading to Universal Health's profitability reverting towards its cost of capital. The growth rate and near term operating margins under this scenario are highly unlikely but long term margin pressures are not. There has yet to be a downturn in the industry so the ability of Universal Health to withstand a downturn without deteriorating profitability has not been validated. The company's multiple and complimentary unique activities insulates it against competition better than one unique activity but competition is constant. Also, the world is complex and highly uncertain so the potential for an industry's trajectory to change is not zero as seen recently in many retail segments in China. Under the trough scenario, the 2015 Fair Value is HKD2.88 and 2020 Fair Value is HKD2.60 or 7% upside and 3% downside, respectively.

The table below shows the percentage of total value from the terminal value under each scenario.

Terminal Value	% of Total Value
Peak	62.4%
Base case	36.0%
Trough	9.6%

Source: Reperio Capital Research

The chart below illustrates the progression of Universal Health's Fair Value per Share under each scenario.



Source: Reperio Capital Research

2015 and 2020 Fair Values per share and related upsides under a combination of growth and margin scenarios are in the table below.

Valuation Assumption	2015 Target Price (HKD)	Upside	2020 Target Price (HKD)	Upside
NCAV	1.16	-57%	1.16	-57%
NNWC + PP&E	1.89	-30%	1.89	-30%
Reproduction Value	2.68	0%	2.68	0%
Earnings Based Valuations (DCF/EVA/EPV)	**2015 Target Price (HKD)**	**Upside**	**2020 Target Price (HKD)**	**Upside**
Trough growth, trough margins	2.88	7%	2.60	-3%
Trough growth, base case margins	3.61	34%	3.50	30%
Trough growth, peak margins	4.33	61%	4.40	64%
Base case growth, trough margins	4.11	53%	4.51	68%
Base case growth, base case margins	5.62	109%	6.75	151%
Base case growth, peak margins	7.13	165%	8.99	234%
Peak growth, trough margins	6.89	156%	9.65	259%
Peak growth, base case margins	10.53	291%	15.64	482%
Peak growth, peak margins	14.17	427%	21.64	705%
Average Earnings Valuations Upside	**5.64**	**110%**	**7.01**	**160%**

Source: Reperio Capital Research estimates

Expected Annualized Return

Rather than forecasting, an estimated return can be determined by adding dividend yield to the value of retained earnings (retained earnings x franchise factor) plus organic growth.

Expected Annualized Return				
NOPAT yield	**15.7%**	**15.7%**	**15.7%**	**15.7%**
- Dividend yield	2.7%	2.7%	2.7%	2.7%
= Reinvestment earnings yield	13.0%	13.0%	13.0%	13.0%
Return on reinvestment	**10.0%**	**20.0%**	**30.0%**	**40.0%**
= Value of reinvested earnings yield	13.0%	26.0%	38.9%	51.9%
Dividend yield	**2.7%**	**2.7%**	**2.7%**	**2.7%**
+ Value of reinvested earnings yield	**13.0%**	**26.0%**	**38.9%**	**51.9%**
+ Organic growth	**0%**	**0%**	**0%**	**0%**
= Expected Return	**15.7%**	**28.7%**	**41.6%**	**54.6%**

Source: Reperio Capital Research estimates

Assuming the company's current earnings are sustainable, its current NOPAT/EV yield is 15.9%. The company paid a dividend equivalent to 2.7% of its enterprise value and the company reinvested 13.1% of its earnings. The return the company generates on its reinvested cash flows and the organic growth the company can generate determine the remainder of its expected return. Organic growth is assumed to be 0% for conservatism. To get an annualized return of 15.9% the company needs to generate returns on reinvested earnings equal to its cost of capital. The company ROIC is 38.9% with a four year average of 43.0% so the 10% return on reinvested earnings seems conservative. Assuming the company's ROIC halves leading to a 20% return on reinvested earnings, the company expected annual return is 28.9%.

ROIC	2010	2011	2012	2013	2014
NOPAT	120	185	239	392	508
Invested capital	77	339	689	898	1,304
ROIC	157.4%	54.6%	34.7%	43.6%	38.9%
Incremental NOPAT		64	54	152	116
Incremental invested capital		262	350	210	405
Incremental ROIC		24.6%	15.5%	72.8%	28.6%

Source: Reperio Capital Research

The table below gives expected returns assuming different returns on reinvested earnings and organic growth rates.

Expected Return Sensitivity

Organic Growth	Return on Reinvested Earnings: 10%	20%	30%	40%	50%
0%	15.7%	28.7%	41.6%	54.6%	67.6%
1%	16.7%	29.7%	42.6%	55.6%	68.6%
2%	17.7%	30.7%	43.6%	56.6%	69.6%
3%	18.7%	31.7%	44.6%	57.6%	70.6%
4%	19.7%	32.7%	45.6%	58.6%	71.6%
5%	20.7%	33.7%	46.6%	59.6%	72.6%

Source: Reperio Capital Research

Relative Valuation

Valuations	Universal Health 2211:HKG	China Nepstar NPD:US	China Jo Jo Drugstore CJJD:US	Shanghai No 1 Pharmacy 600833:SHG	Zhongzhi Pharma 3737:HKG	Wanjia 401:HKG	Sinopharm 1099:HKG	Shanghai Pharma 601607:SHG	Jointown Pharma 600998:SHG
EV/EBIT									
Current	4.3	41.1	18.7	59.3	15.2	NM	9.4	15.3	59.2
3 yr avg	4.8	304.8	NM	61.0	26.1	NM	9.7	17.1	73.9
EV/IC									
Current	2.1	1.4	1.3	10.4	11.9	0.7	1.4	1.6	2.4
3 yr avg	2.4	9.1	1.1	9.5	12.7	0.5	1.3	2.0	3.5

Source: Reperio Capital Research

Despite, Universal Health's superior operating performance it is one of the cheapest peers on an EV/EBIT basis.

WHY IS IT CHEAP

Macro fundamentals concerns in China are trumping company fundamentals.

RISKS

Macroeconomic risks in China could affect industry fundamentals leading to lower demand and high competitive rivalry. There has been sudden weakness in other sectors, such as sportswear and children's apparel. An investor in Universal Health is well compensated for macroeconomic risk. The company's has an EBIT/EV yield of 24.0% and an expected return assuming a 10% return on reinvested earnings and 0% organic growth is 15.7%.

Industry consolidation could slow decreasing Universal Health's growth and increasing investment costs. A key driver of the company's growth has been acquisitions. The company acquired pharmacies at a price well below its estimated cost of building equivalent pharmacies. The slowdown in the industry consolidation would likely bring higher competition for acquisitions as there are fewer available acquisitions with the same number of buyers. Again, investors are compensated for the risk associated with the investment.

There is regulatory risk. The industry is highly regulated and the Chinese government may impose regulation that could hurt the industry. This is a difficult risk to assess as it is anybody's guess what policies any government will make. Many regulations have favored pharmacies with milk powder being sold through pharmacies and the potential separation of drug sales from hospitals. The government should be in favor continued consolidation as it leads to easier monitoring and control of an industry. The government should also favor well run companies and Universal Health clearly is one of the best in the industry.

Universal Health may not be able to acquire high margin products with some form of exclusivity. In 2012, high margin products accounted for 52% of overall gross profit. If the company was to lose exclusivity on these product and gross margins were to fall to the gross margin of other products gross margin, 2012 gross profit would have fallen by 43%.

Universal Health's direct supply model is unique in a pharmaceutical industry with multiple layers of distributors. As the market matures and consolidates, layers from the distribution segment of the value chain should be eliminated decreasing the uniqueness of Universal Health's direct supply model. With decreased uniqueness comes increased competition and lower profitability.

In Northeast China, Universal Health's largest competitors are state owned enterprises. If these companies are privatized, incentivizes in the organization could change leading to potentially greater competition.

The founder is the largest shareholder with 47.14% and driver of the company's strategy and performance. If the founder did not continue to lead the company, the operating performance, capital allocation, and financial health of the company could deteriorate.

Financial risk is limited given the company's net cash position.

Valuation risk is not a concern given the company's EBIT yield of 24.2% with revenue and operating profit growth rates above 20%.

FINANCIAL STATEMENTS

FINANCIAL SUMMARY (RMB mn)	2010	2011	2012	2013	2014
Total Revenue	**859**	**1,474**	**2,326**	**3,323**	**4,356**
Cost of sales	(619)	(1,096)	(1,781)	(2,387)	(3,088)
Gross Profit	**240**	**378**	**546**	**936**	**1,267**
Selling and Distribution Expense	(67)	(103)	(189)	(333)	(502)
Adminstrative Expenses	(12)	(29)	(37)	(75)	(77)
Operating Profit	**161**	**246**	**320**	**529**	**688**
Other Income	0	(0)	(12)	(9)	(12)
Financial Income (expense)	3	6	3	0	6
Profit before Tax	**164**	**251**	**311**	**520**	**682**
Income Tax	(41)	(62)	(79)	(135)	(179)
Profit after Tax	**123**	**189**	**232**	**385**	**503**

FINANCIAL SUMMARY (RMB mn)	2010	2011	2012	2013	2014
Cash	107	713	575	1,573	1,732
Accounts Receivables	66	141	179	194	266
Inventory	81	178	249	272	363
Other Current Assets	9	68	94	167	108
PP&E	2	19	47	76	125
Intangibles	-	91	355	446	802
Other Non-Current Assets	4	22	15	16	18
Total Assets	**269**	**1,233**	**1,515**	**2,744**	**3,414**
Accounts Payable	52	87	99	85	188
Other NIBCLs	29	72	136	172	172
ST Debt	-	668	626	9	378
LT Debt	-	-	-	-	-
Other Liabilities	-	43	104	124	78
Total Liabilities	**82**	**870**	**966**	**389**	**816**
Equity	188	363	549	2,355	2,598
Shares Outstanding, basic end	1,600	1,600	1,600	2,000	2,000
Shares Outstanding, diluted end	1,600	1,600	1,600	2,000	2,000

FINANCIAL SUMMARY (RMB mn)	2010	2011	2012	2013	2014
Cash Flow from Operations	**126**	**198**	**248**	**426**	**538**
Working Capital Investment	(18)	(76)	(87)	(39)	54
Fixed Capital Investment	(1)	(12)	(15)	(43)	(68)
Acquisitions	-	(177)	(228)	(122)	(369)
Free Cash Flow	**106**	**(67)**	**(81)**	**222**	**154**
Other Investing	37	2	(131)	112	(358)
Cash from/(to) Debtholders	-	673	41	5	71
Cash from/(to) Shareholders	(106)	(1)	(5)	770	(84)

MANAGEMENT BIOS

Executive Directors

Mr. JIN Dongtao, aged 46, was appointed as the Chairman of the Board and an executive Director on 12 March 2012. Mr. Jin is one of the co-founders of Universal Health serving as the chairman since its inception in June 1998. He has substantial experience in the pharmaceutical retail and distribution sector and is responsible for setting the strategic vision, direction and goals. Mr. Jin has over 20 years of experience in the pharmaceutical distribution industry and in marketing. Other experience:

- 1991 – 1995: business manager of Jiamusi City Morning Star Pharmaceutical Company
- 1995 – 1998: general manager of Jiamusi City Morning Star Pharmaceutical Store
- 2010 – September 2014: chairman of the Heilongjiang Alliance of Pharmaceutical Retailers
- 2012 – present: vice chairman of the China Medical Pharmaceutical Material Association

Education:

- July 1991: graduated from Jiamusi United Workers University
- December 2010: obtained a Master's degree in Business Administration in a program run by United Business Institutes

Mr. Jin received the National Enterprise Management Specialist Award by the China National Management Specialist Centre in 2006. He is qualified as a practicing pharmacist in China.

Mr. JIN Dongkun, aged 41, was appointed as the Vice Chairman and an executive Director on 12 March 2012. He is one of the co-founders of Universal Health serving as business manager, general manager and vice president June 1998. He is responsible for overseeing external affairs and relationships. Mr. Jin Dongkun has over 15 years of experience in the pharmaceutical distribution industry and in marketing.

Other experience:

- 1995 – 1998: business manager of Jiamusi City Morning Star Pharmaceutical Store
- 2010 – September 2014: vice chairman of the Heilongjiang Alliance of Pharmaceutical Retailers
- November 2014 – present: vice chairman of the China Medical Pharmaceutical Material Association

Education:

- December 1994: graduated from Harbin Engineering University with a major in Electric Technology
- July 2013: obtained a Master's degree in Business Management in a program run by the Scandinavian Art and Business Institute.

Mr. Jin Dongkun is qualified as a practicing pharmacist in China. Mr. Jin Dongkun is Mr. Jin Dongtao's brother.

Mr. CHU Chuanfu, aged 44, was appointed as the Chief Executive Officer of Universal Health in January 2011 and an executive Director on 12 March 2012. He is responsible for the operations. He has experience in the expansion and management of chain stores and the promotion of pharmaceutical products. Mr. Chu has over 15 years of experience within Universal Health. He previously worked as assistant to the general manager from 1999 to 2001 and deputy chief general manager from 2001 to 2011.

Other experience:

- 2008 – present: vice president of the Municipal Association for Private Enterprises in Jiamusi
- 2010 – present: honorable chairman of the Municipal Pharmaceutical Association in Jiamusi
- September 2014 – present: chairman of the Heilongjiang Alliance of Pharmaceutical Retailers

Education:
- July 1993: graduated from Harbin University of Civil Engineering and Architecture (now School of Architecture of Harbin Institute of Technology) with a major in coal chemical engineering
- January 2013 – present: enrolled in a Master's degree program run by the Scandinavian Art and
- Business Institute

Mr. Chu is qualified as a nutritionist in China.

Mr. YANG Jiacheng, aged 44, was appointed as the Chief Operating Officer of Universal Health in January 2014 and was appointed as an executive Director on 25 August 2014. He joined the company in January 2013 and is responsible for operations. He is a qualified senior lecturer (associate professor) in China.

Other experience:
- 2006 – 2011: marketing director and general manager of company strategy and public strategy; special assistant to the chief executive officer at American Oriental Bioengineering Inc.
- 2011 – 2012: chief operating officer of Renji Shanghai Hospital Group

Current positions:
- standing director of the Chinese Medical Association Health Industry Committee
- chartered researcher at the China International Medical Exchange Foundation

Education:
- 1998: obtained a Master's degree in Political Economics Studies from Northeast Normal University
- 2010: graduated from a doctoral program in management from Beijing Normal University

Independent non-executive Directors

Mr. CHENG Sheung Hing, aged 67, was appointed as an independent non-executive Director of the company on 18 November 2013. Mr. Cheng is a senior economist of PBOC with many years of experience in foreign exchange management and management of pharmaceutical companies and listed companies.

Other experience:
- 1982 – 1985: in charge of the foreign affairs and organization department of Beijing Pharmaceutical Co., Ltd. and stores for new drugs and specific drugs
- 1986 – 1995: deputy administrative officer of Non-trade Department and Inspection Department of the State Administration of Foreign Exchange

Directorships:

- 1995 − 2002: assistant to the general manager and assistant to board chairman of Wing On Travel Limited, a company listed the Hong Kong Stock Exchange (stock code: 01189). It was acquired by CTrip.com International (NASDAQ:CTRP) for RMB435 million in 2010.
- 2003 − 2005: assistant to board chairman of Heng Fai Enterprises Limited, a company listed on the Hong Kong Stock Exchange (stock code: 00185)
- 2005 – 2013: independent director of National United Resources Holdings Limited (formerly known as China Outdoor Media Group Limited), a company listed on the Hong Kong Stock Exchange (stock code: 00254)

Education:

- 1982: graduated from the School of Trade and Economy of Beijing Economics College (now Capital University of Economics and Business) with a major in Trading Economics Directors and Senior Management

Ms. CHIANG Su Hui Susie, aged 68, was appointed as an independent non-executive Director on 18 November 2013. Ms. Chiang has over 22 years of experience in governmental affairs, treasury and cross-straits relations.

Other experience:

- 1991 – 1994: the representative of Government Information Office of the Executive Yuan of Taiwan
- 1994 – 2004: in charge of the Taiwanese Kwang-hwa Information and Culture Centre
- 2002: established the C S Forum and the C S Corp. Consultancy Limited in Hong Kong with a goal of promoting cross-straits economic and trade communications

Current positions:

- member of the Hong Kong-Taiwan Cultural Co-operation Committee of the Hong Kong Special Administrative Region
- chairwoman of the C S Culture Foundation
- chairwoman of the C S Corp. Consultancy Limited
- chairwoman of the C S Finance & Investment Company Limited
- honorary chairwoman of the Taiwan Business Association (Hong Kong) Limited
- consultant to the International Affairs Committee of Taichung City Government
- visiting professor at the Taiwan Research Academy of Beijing Union University

Education:

- July 1969: graduated from the Taiwan National Chung Hsing University with a major in laws

Mr. CHEN Xiao, aged 51, was appointed as an independent non-executive Director on 18 November 2013. Mr. Chen is a professor in the Department of Accounting at the School of Economics and Management of Tsinghua University. For the past 16 years, he has been teaching and conducting academic research in the fields of accounting and taxation at Tsinghua University. Mr. Chen has extensive experience in accounting and has published a number of articles in both domestic and international academic accounting journals on topics such as financial accounting, corporate governance and taxation.

Other experience:

- 2000 – 2013: department chair of the Department of Accounting at the School of Economics and Management of Tsinghua University
- 2006 – 2012: independent director of Hanwang Technology Co. Ltd., a company listed on the Shenzhen Stock Exchange (stock code: 002362)

- 2003 – 2009: independent director of Invengo Information Technology Co. Ltd., a company listed on the Shenzhen Stock Exchange (stock code: 002161)
- 2006 – 2009: independent director of Chenzhou Mining Group Co. Ltd., a company listed on the Shenzhen Stock Exchange (stock code: 002155)
- 2003 – 2009: independent director of Norinco International Co. Ltd., a company listed on the Shenzhen Stock Exchange (stock code: 000065)
- 2002 – 2005: independent director of Henan Huanghe Whirlwind Co. Ltd., a company listed on the Shanghai Stock Exchange (stock code: 600172)
- 2007 – 2014: independent director and chairman of the audit committee of Noah Education Holdings Ltd., a company listed on the New York Stock Exchange (stock code: NED)

Directorships:
- 2014 – present: independent director of the Beijing Chineseall Digital Publishing Co., Ltd., a company listed on the Shenzhen Stock Exchange (stock code: 300364)
- June 2011 – present: independent director and chairman of the audit committee of China First Chemical Holdings Ltd., a company listed on the Hong Kong Stock Exchange (stock code: 02121)

Directors and Senior Management
- 2012 – present: independent director of Changyou.com Ltd., a company listed on NASDAQ (stock code: CYOU)

Education:
- 1983: graduated from Wuhan Institute of Technology with a major in chemical engineering
- 1989: obtained a Master's degree in management from University of Science and Technology of China
- 1996: obtained a Doctorate degree in Economics from Tulane University in the United States

Senior Management

Mr. GE Junming, aged 46, was appointed company secretary on 18 November 2013 and is currently one of Universal Health's joint company secretaries. He joined the company in 1998. Mr. Ge has worked in various other capacities in the company, including as an accountant, head of the planning department, chief secretary to the Chairman, head of the legal department, general secretary and director in various members in Universal Health.

Other experience:
- 1988 – 1994: a materials accountant, costs accountant and head accountant of Jiamusi CNC Machine Tools Factory
- 1994 – 1995: head accountant of Jiamusi Import and Export Wood Products Company
- 1995 – 1996: chief of finance at Jiamusi Forging Equipment Factory
- 1996 – 1998: financial inspector at Jiamusi Marketing Limited Company of the Sanzu Group

Education:
- July 1988: obtained a Secondary Professional Degree in Financial Accounting from Heilongjiang School of Machinery Manufacturing
- July 1993: graduated from the School of Economics at Peking University with a major in Financial Accounting, by way of distance learning

Mr. Ge is also a qualified senior accountant, senior planner, pharmacist and nutritionist in China.

Mr. Ge received the National Enterprise Management Specialist Award by the China National Management Specialist Centre in 2005. He has not held any directorships in any publicly listed company over the past three years.

Mr. ZHAO Zehua, aged 46, was appointed as the general manager of finance in October 2011. He joined the company in January 2005 as financial controller and was promoted to his current position in October 2011. He is responsible for financial control and management. He has over 25 years of experience in financial management, with particular expertise in financial accounting, treasury and internal control.

Other experience:
- 1989 – 2001: head of finance at Hebei Chengde Tianyuan Pharmaceutical Co., Ltd.
- 2001 – 2004: manager of finance and deputy general manager of Hebei Chengde Tianyuan Pharmaceutical Co., Ltd.
- 2003 – 2004: manager of finance and deputy general manager of Chengde Pharmaceutical Group Liuhe Pharmaceutical Co., Ltd.

Education:
- July 1992: graduated from Hebei Radio and Television University with a major in Finance and Accounting

Mr. Zhao is a qualified accountant in China.

Mr. TAM Tsang Ngai, aged 40, was appointed financial controller in November 2014. He is responsible for the financial management outside China.

Other experience:
- 1997 – 2000: semi-senior accountant, audit of Deloitte Touche Tohmatsu
- 2001 – 2007: finance manager of China Resources Petrochems Co., Ltd. and China Resources Gas Holdings Ltd
- 2008 – 2010: finance manager of Ming Hing Waterworks Holdings Ltd., a company listed on the Hong Kong Stock Exchange (stock code: 00402)
- 2010 – 2012: chief financial officer and company secretary of CNC Holdings Ltd., a company listed on the Hong Kong Stock Exchange (stock code: 08356)
- 2012 – 2014: director of Voyage Consulting Ltd.

Education:
- 1997: graduated from the Chinese University of Hong Kong with a major in Professional Accountancy

Mr. Tam is a member of the Hong Kong Institute of Certified Public Accountants and a fellow of the Association of Chartered Certified Accountants.

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