

AK Medical (1789 HK)

High-margin customized and revision products to drive long-term growth

AK Medical reported 2021 revenue/ attribute net profit of RMB761.4mn/ RMB92.6mn, down 26.5%/ 70.5% YoY, primarily affected by the sharp retail price cuts of hip/knee joint products covered by the national VBP. The price cut has led to channel destocking during 2H21, while the actual surgery volume remained stable in 2021. The Company's income from hip and knee implants was RMB636.9mn (-31.9% YoY) in 2021. Excluding the impact of RMB103.8mn sales provision of joint implants affected by the VBP, the actual sales of hip and knee implants decreased by 20.8% YoY in 2021. During national VBP, AK Medical's all four product lines won a total of 20% of the procurement volume, ranking the first among all brands, indicating around 100,000 units procurement volume per year. In addition, winning the VBP tenders will also enable AK Medical to expand its sales channels to the majority of tired hospitals in China.

- **High-margin customized and revision products to drive the growth.** AK Medical has a comprehensive product portfolio with high-margin products safe from VBP risks. Revision products accounted for 15.1% of the total revenue in 2021 while customized products contributed 2.6% during the same period. AK Medical has leading positioning in revision products in China and may benefit from the strong demand growth in revision surgeries in coming years. Revision products generally are sold at much higher prices than primary joint implants, and thus has higher margins. Furthermore, leveraging on its advanced technology in 3D printing, AK Medical is expanding its Innovative Customized Orthopedic Solution (ICOS) services, including preoperative planning, bone model printing, customized vetting guide, 3D-printed customized implants, etc. The Company already has two 3D-printing customized products obtained NMPA Class-III certificates and 28 customized products filings with cooperating hospitals. We expect the Company's ICOS income to grow rapidly from RMB23.3mn in 2021 to c. RMB100mn in 2023E.
- **Increasing investment in innovation.** In 2021, AK Medical's R&D expenses was up 7.7% YoY, indicating 14.8% R&D expense ratio. The Company will continue to invest in R&D of innovative technology and products. The Company aims to obtain approvals from the NMPA for its Hip VTS Navi System and Portable Robotic System in 2022E and approvals for orthopedic surgical robot systems in 2023E. The Company is also actively developing Ortho-biological materials, with three products to be approved in 2022E.
- **Maintain BUY.** We expect the Company to resume solid growth from FY22E thanks to the strong growth in high-margin products. We expect AK Medical's FY22E/23E revenue to grow 37%/ 31% YoY, and attributable net profit to grow 75%/ 47% YoY from the low base in 2021. We revised our TP to HK\$7.69 (WACC: 10.7%, Terminal growth 3.0%).

Earnings Summary

(YE 31 Dec)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue (RMB mn)	1,035	761	1,045	1,367	1,746
YoY growth (%)	11.7	-26.5	37.2	30.9	27.7
Net income (RMB mn)	314	93	162	238	338
EPS (RMB)	0.28	0.08	0.15	0.21	0.30
YoY growth (%)	11.0	-70.8	74.5	46.7	42.0
Consensus EPS (RMB)	N/A	N/A	0.20	0.25	0.29
P/E (x)	12.2	41.9	24.0	16.4	11.5
P/B (x)	1.9	1.9	1.8	1.7	1.5
Yield (%)	1.0	0.6	1.0	1.5	2.2
ROE (%)	15.4	4.6	7.5	10.2	13.1
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price	HK\$7.69
(Previous TP	HK\$11.45)
Up/Downside	+80.94%
Current Price	HK\$4.25

China Healthcare Sector

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Stock Data

Mkt Cap (HK\$ mn)	4,742
Avg 3 mths t/o (HK\$ mn)	24.38
52w High/Low (HK\$)	16.28/ 3.50
Total Issued Shares (mn)	1,116

Source: Bloomberg

Shareholding Structure

Management	57.38%
OrbiMed	7.50%
Hillhouse	7.26%
Free float	27.86%

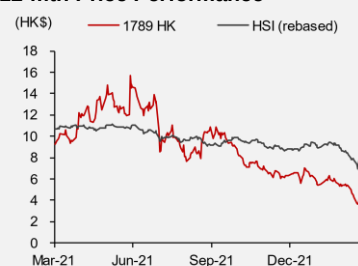
Source: HKEx

Share Performance

	Absolute	Relative
1-mth	-21.9%	-16.9%
3-mth	-33.0%	-27.3%
6-mth	-60.8%	-55.7%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

Auditor: KPMG

Related Reports

1. Big winner in National VBP – 15 Sep 2021
2. Results of volume-based procurement to come out in mid-September – 26 Aug 2021
3. Channel destocking may continue – 27 Jul 2021

Figure 1: CMBIGM earnings revisions

(RMB mn)	New			Old			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	1,045	1,367	1,746	1,069	1,377	N/A	-2.2%	-0.7%	N/A
Gross profit	627	834	1,082	695	923	N/A	-9.7%	-9.6%	N/A
Operating profit	183	272	389	296	411	N/A	-38.2%	-34.0%	N/A
Net profit	162	238	338	253	350	N/A	-36.0%	-32.0%	N/A
EPS (RMB)	0.15	0.21	0.30	0.23	0.31	N/A	-36.1%	-32.1%	N/A
Gross margin	60.00%	61.00%	62.00%	65.00%	67.00%	N/A	-5.00 ppt	-6.00 ppt	N/A
Operating margin	17.48%	19.87%	22.29%	27.67%	29.86%	N/A	-10.19 ppt	-10.00 ppt	N/A
Net Margin	15.51%	17.38%	19.33%	23.69%	25.38%	N/A	-8.19 ppt	-8.00 ppt	N/A

Source: Company data, CMBIGM estimates

Figure 2: CMBIGM estimates vs consensus

(RMB mn)	New			Consensus			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	1,045	1,367	1,746	1,110	1,365	1,776	-5.9%	0.2%	-1.7%
Gross profit	627	834	1,082	701	865	N/A	-10.6%	-3.6%	N/A
Operating profit	183	272	389	233	332	364	-21.4%	-18.1%	6.9%
Net profit	162	238	338	223	285	318	-27.3%	-16.6%	6.1%
EPS (RMB)	0.15	0.21	0.30	0.20	0.25	0.29	-27.38%	-15.80%	4.32%
Gross margin	60.00%	61.00%	62.00%	63.20%	63.38%	N/A	-3.20 ppt	-2.38 ppt	N/A
Operating margin	17.48%	19.87%	22.29%	20.95%	24.29%	20.50%	-3.47 ppt	-4.42 ppt	+1.79 ppt
Net Margin	15.51%	17.38%	19.33%	20.09%	20.88%	17.91%	-4.58 ppt	-3.50 ppt	+1.43 ppt

Source: Company data, CMBIGM estimates

Valuation

Figure 3: DCF valuation

DCF Valuation (in RMB mn)	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
EBIT	183	272	389	459	537	623	717	817	923
Less: tax	(29)	(42)	(60)	(73)	(86)	(100)	(115)	(131)	(148)
Depreciation and amortization	74	74	74	88	102	119	137	156	176
CAPEX	(80)	(80)	(80)	(94)	(110)	(128)	(147)	(168)	(190)
Change in working capital	282	(11)	(26)	(31)	(36)	(42)	(48)	(54)	(62)
FCF	431	213	298	348	407	473	543	620	700
Terminal value									9,369
Subtotal	431	213	298	348	407	473	543	620	10,069

PV of enterprise (RMB mn)	6,092
Net debt (RMB mn)	(944)
Equity value (RMB mn)	7,036
Equity value (HK\$ mn)	8,580
Number of shares	1,116
Price per share (HK\$)	7.69

Terminal growth rate	3.0%
WACC	10.70%
Cost of equity	13.5%
Cost of debt	5.0%
Equity Beta	1
Risk free rate	3.98%
Market Risk premium	9.50%
Target Debt to Asset ratio	30.0%
Effective Corporate Tax Rate	16.0%

Source: Company data, CMBIGM estimates

Financial Summary

Income statement						Cash flow summary					
YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E	YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue	1,035	761	1,045	1,367	1,746	EBIT	369	99	183	272	389
Knee replacement implants	258	167	218	287	373	D&A	61	74	74	74	74
Hip replacement implants	677	469	657	841	1,052	Change in working capital	(186)	11	282	(11)	(26)
3D-printed products	6	23	58	105	157	Income tax paid	(45)	(16)	(29)	(42)	(60)
Third party orthopedic products	69	79	83	92	101	Others	7	(0)	-	-	-
Other	25	22	28	42	63	Net cash from operating	205	169	511	293	378
Cost of sales	(321)	(262)	(418)	(533)	(663)	Capex	(351)	(106)	(80)	(80)	(80)
Gross profit	715	499	627	834	1,082	Other	(6)	9	8	8	8
Other income and gains	5	6	5	5	5	Net cash from investing	(356)	(97)	(72)	(72)	(72)
Distribution expenses	(154)	(187)	(240)	(301)	(367)	Net proceeds equity financing	701	-	-	-	-
Administrative expenses	(83)	(105)	(104)	(130)	(157)	Dividend paid	(75)	(23)	(41)	(59)	(84)
R&D expenses	(105)	(113)	(104)	(137)	(175)	Others	(14)	-	-	-	-
Operating profit	369	99	183	272	389	Net cash from financing	612	(23)	(41)	(59)	(84)
Net finance income / (expenses)	8	9	8	8	8	Net change in cash	461	49	398	161	221
Exceptional	-	-	-	-	-	Cash at the beginning year	277	713	476	874	1,035
Pre-tax profit	377	109	191	280	397	Exchange difference	(24)	-	-	-	-
Profits tax	(63)	(16)	(29)	(42)	(60)	Cash at the end	713	476	874	1,035	1,256
Minority interest	-	-	-	-	-						
Net profit	314	93	162	238	338						

Balance sheet						Key ratios					
YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E	YE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Non-current assets	624	671	677	683	688	Sales mix (%)					
PP&E	364	382	401	419	437	Knee replacement implants	24.9	22.0	20.8	21.0	21.4
Intangible assets	76	80	67	55	42	Hip replacement implants	65.4	61.7	62.9	61.5	60.2
Deferred tax assets	51	76	76	76	76	3D-printed products	0.6	3.1	5.6	7.7	9.0
Other non-current asset	-	-	-	-	-	Third party orthopedic products	6.7	10.4	8.0	6.7	5.8
						Other	2.5	2.9	2.7	3.1	3.6
Current assets	1,903	1,934	2,363	2,712	3,167	Total	100.0	100.0	100.0	100.0	100.0
Inventories	361	423	412	467	545	Profit & loss ratios (%)					
Trade receivables	552	530	572	704	860	Gross margin	69.0	65.6	60.0	61.0	62.0
Prepayments & other receivables	34	28	28	28	28	Net margin	30.3	12.2	15.5	17.4	19.3
Available-for-sale financial assets	188	366	366	366	366	Effective tax rate	16.6	14.7	357.4	15.0	15.0
Cash and cash equivalents	713	476	874	1,035	1,256	Balance sheet ratios					
Current liabilities	418	489	802	979	1,187	Current ratio (x)	4.6	4.0	2.9	2.8	2.7
Payables	318	260	573	749	957	Trade receivables turnover days	126	183	150	150	150
Current tax	42	52	52	52	52	Trade payables turnover days	143	204	200	200	200
Contract liabilities	46	167	167	167	167	Inventory turnover days	320	498	360	320	300
Provision	-	-	-	-	-	Net debt to total equity ratio (%)	Net cash	Net cash	Net cash	Net cash	Net cash
Non-current liabilities	66	84	84	84	84	Returns (%)					
Deferred revenue	12	12	12	12	12	ROE	15.4	4.6	7.5	10.2	13.1
Deferred tax liabilities	39	41	41	41	41	ROA	12.4	3.6	5.3	7.0	8.8
Total net assets	2,043	2,032	2,153	2,331	2,584	Per share data					
Minority interest	-	-	-	-	-	EPS (RMB)	0.28	0.08	0.15	0.21	0.30
Shareholders' equity	2,043	2,032	2,153	2,331	2,584	DPS (RMB)	0.03	0.02	0.04	0.05	0.08
						BVPS (RMB)	1.9	1.8	1.9	2.1	2.3

Source: Company data, CMBIGM estimates

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