

Biostime International Holdings Limited
2014 Third Quarter Operating Updates Conference Call Transcript
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INTRODUCTION

Ms. Laetitia Garnier - *International Investment and Cooperation Director:*

Good evening, ladies and gentlemen. Welcome to Biostime's third quarter 2014 operating update conference call. With me today are Mr. Luo Fei, our Chairman and Chief Executive Officer, Mr. Frank Cao, our CFO and Mr. Jason Xu, our Head of Investor Relations.

I will first provide everyone with an update on our Third quarter's operating data. After that, Mr. Luo Fei will make some comments about our current business and strategies. Then we will take questions.

During the third quarter of 2014, our online to offline business has made visible progress and contributed to 12.5% of the Group's total accumulated points, which shows an increase from the average of 9.0% during the first half of the year. As at 30 September 2014, the combined number of Mama100 APP users and Mama100 WeChat followers with registered accounts reached approximately 1.45 million, and during the third quarter this year, we accounted an average of 70,000 daily active users of our Mama100 APP.

As for Mama100 active members, the average number increased by 16.4% from 1,706,458 for the first nine months of last year to 1,985,539 for the first nine months of this year. The number of retail outlets increased by 59.8% from 17,786 as at 30 September of last year to 28,417 as at 30 September 2014. Among these, VIP baby specialty stores increased from 12,014 to 19,916; retail sales organizations increased from 4,477 to 6,104; and VIP pharmacies increased from 1,295 to 2,397.

As these numbers show, our offline distribution network had continued to expand according to our plans. We continue to stick to our criteria for selecting the stores we work with. While we are putting new efforts this year on building the internet sales channel, these 3 offline channels still remain strategic to us. In particular, given that the total number of baby specialty stores in China is growing very fast, it is important for us to accelerate our pace in entering new stores so as to increase our products' visibility and availability. We expect it to take 2 to 3 years for these stores to grow mature.

With that said, I will turn the time to our CEO, Mr. Luo Fei. Fei, please.

Mr. Luo Fei - *Chairman and Chief Executive Officer:*

Okay, thank you Laetitia. Good evening everyone. Thank you for joining this call.

This year, I would say that there are challenges taking place in the infant formula industry in China. As you know, more and more brands are being introduced to the market, and with changes in

consumers' behavior and the change in distribution channels. So these have made 2014 a very challenging year. We consider this competition will continue. Facing this situation, I will talk about our business and strategies.

First of all, we will still invest in our Mama100 platform. This will further increase the value and the potential of our own platform. Also the O2O platform includes Mama100 APP and Mama100 WeChat. This O2O platform is able to attract new customers and also enhance higher consumer loyalty. We believe our self-owned O2O platform is very critical for us to integrate the online and offline resources, so we will maintain its development as our important long-term strategy.

Secondly, we now have established a multi-channel and multi-platform structure. Starting from this August, we have already gradually started to cooperate with China's major B2C platforms, like JD.com, Yihaodian, Amazon China, SF-best. We will also begin to cooperate with Suning.com in the near future. Besides, we have also made certain progress on the C2C internet channel. Now, we have around 400 C2C baby stores that have become online C2C member stores. We are still at the beginning stage of our E-commerce business. It is a very competitive environment. We need to carry on our own approach and invest more resources and time for this online channel to make a material contribution for the Group's future growth.

Lastly, I would like to talk about our new business unit structure. The four business units have been in operation since July. They now have separate budgets and decide their own marketing strategies. We begin to see improved operation efficiency under the new structure. Meanwhile, our people continue to be very dedicated to perform consumer education, as we believe it is the very key to winning the future.

Overall, we hope to get through the transitional year 2014 in a healthy and steady pace. Thank you and I now turn the time to Laetitia.

Ms. Laetitia Garnier - *International Investment and Cooperation Director*:

Thank you very much Fei. Now I would please ask our operator to open the lines for questions.

QUESTIONS AND ANSWERS

Operator:

The first question comes from Jamie Zhou, Macquarie. Please go ahead.

Mr. Jamie Zhou, Macquarie:

Hi, good evening Mr. Luo and Laetitia. Thanks for taking my question. My first question is on whether you can share with us the points-per-store trend you are seeing in the third quarter, and more specifically, trends that pertained to stores that have been opened for more than two years?

Mr. Luo Fei - Chairman and Chief Executive Officer:

For our main competitors in baby stores, their average distribution penetration is very high, up to 80% to 90%. For Biostime, especially in baby stores, our penetration rate is only half, close to 50%. During the last 2 to 3 years in China, more and more baby stores opened. The growth rate is around 25% every year. So we want to keep increasing our penetration compared to our competitors. Our target for the second half of 2014 and early next year will be to open more and more baby stores to catch this trend. That is why you can see, compared to last year, the growth of our baby stores is going up by 59%. I think we know when we open a new store, it does need time to grow the business. We expect these newly opened stores to start contributing significantly to our sales next year.

Mr. Jamie Zhou, Macquarie:

Okay thanks. Maybe I can ask the question in a different way. We notice in your interim results, you point out that your stores that have been open since 2011 or before saw a same store points decline of 9.7% for the first half. Could you give us any color on the trend heading into the third quarter?

Mr. Luo Fei - Chairman and Chief Executive Officer:

For this quarter, there is no comment now, but for the first half of this year, we can see some old store points decreasing, that is because of the intensified competition between the brands in the stores and the stores between them, with more new stores opening in the same area (where our old stores are located). Actually, for the whole industry, the average sales of brands per baby store decreased, not only for Biostime's products.

Mr. Jamie Zhou, Macquarie:

Okay thank you. My second question and a quick one is on your percentage of your sales that are now coming from B2C and C2C.

Mr. Luo Fei - Chairman and Chief Executive Officer:

For B2C, we are still at the very beginning stage. You know we just entered JD.COM in Early August. We are now building our own e-commerce team. We have decided to separate a dedicated team to take care of the e-commerce sales. But I would like to say that for Biostime, we will need to learn how to run the e-commerce business. There will be new change with the new dedicated team. So in the future, I guess this will increase, but for the time being, it is still challenging.

Mr. Jamie Zhou, Macquarie:

Thank you and my last question is on new product launches. Can you give us an update on both BMcare as well as the new Adimil? Is that still on target to be launched by the end of this year?

Mr. Luo Fei - Chairman and Chief Executive Officer:

Yes, the good news is that, last week, our new factory in Changsha has started to produce products. We have finished the whole testing and analysis and the results are good. Since last week, we have already been producing the new Adimil series. In the coming month, we will be distributing these products in tier 4 and 5 cities.

And for BMcare products, we are also very happy to know that our new products have started being produced in our Hangzhou JV factory.

Mr. Jamie Zhou, Macquarie:

Okay, thank you very much Mr. Luo.

Mr. Luo Fei - Chairman and Chief Executive Officer:

Thank you.

Operator:

The next question comes from Alice Chan, HSBC. Please go ahead.

Mr. Chris Leung, HSBC:

Hi Mr. Luo, this is Chris. Why did the number of active Mama100 members for the third quarter decline slightly compared with the second quarter? Recently we found many new brands emerging in the online channel. Did you find any changes in the industry trends and landscapes in August and September? As I recall, the company gave a top-line guidance of about 6-7% growth for the full year in August. Do you think if you can still achieve this at this point of time?

Mr. Luo Fei - Chairman and Chief Executive Officer:

The number of active Mama100 members was around 1.9 million for the first quarter, 2.0 million for the second quarter and 1.9 million for the third quarter. This number remained quite flat and at similar level with the average number in the first half. Indeed, the competition this year is more intense than our expectation. However, similar to what we did in the first half, we need to keep on spending on marketing in order to maintain our market shares. Looking at the current situation, the number of active members has not increased much, and we are hoping to increase our market share. At this standpoint, we expect the fourth quarter to be very challenging. For example, 11/11 now is not only an e-commerce event exclusively, but in fact it is moving offline. We will participate in this event in the online channel and will also work with our offline stores to launch some activities. We think such events can contribute some growth in sales, but as you can see, the growth in the number of active members has been flat, we expect sales for 2014 to be flat as well. We tell our team that it should be a satisfying result for maintaining our sales while getting through this challenging

situation.

Mr. Chris Leung, HSBC:

Yes, I agree as well. Thank you very much, Mr. Luo.

Mr. Luo Fei - Chairman and Chief Executive Officer:

Thank you.

Operator:

The next question comes from Tina, Merrill Lynch. Please go ahead.

Ms. Tina Long, BAML:

Hi, Mr. Luo, Frank, Jason and Laetitia. I think you've just mentioned that you expect the topline for the second half of 2014 to be flat, which is revised from the previous guidance. Am I correct?

Mr. Luo Fei - Chairman and Chief Executive Officer:

In August, I said the growth for the second half would be around 5-6%. However, in fact the second half of 2013 set a very high comparison base for us. Now we estimate 2014 topline to be flat year on year.

Ms. Tina Long, BAML:

Thank you. My second question is – we understand that B2C and C2C just started two or three months ago. Can you give us some color on what percentage of B2C, C2C together with O2O have contributed to sales?

Mr. Luo Fei - Chairman and Chief Executive Officer:

You mean the contribution of B2C and C2C?

Ms. Tina Long, BAML:

Yes, and also including O2O, or not including is also fine. What is the contribution to our sales? Or what percentage do you expect it to contribute to sales by the end of this year?

Mr. Luo Fei - Chairman and Chief Executive Officer:

For O2O, it was around 12.5%. As for B2C and C2C, since we have just started, sales are still low. As I mentioned earlier, we wanted to let our existing team to handle the e-commerce part. However,

since August, we've found that e-commerce requires a very different approach, so we decided to build a separate team for this channel. Therefore, for the second half of this year, we do not expect a huge sales growth contributed by B2C and C2C.

Ms. Tina Long, BAML:

If there will be a new team, instead of contribution to sales, will there be an obvious increase in selling expense in terms of absolute amount?

Mr. Luo Fei - Chairman and Chief Executive Officer:

The new team building will not lead to many new headcounts because the e-commerce team is not similar to the offline teams which need a lot of people. We expect the B2C team will consist of around 30 people. It is not similar to offline, for which we would need to look for many people.

Ms. Tina Long, BAML:

Can you share the latest market share data with us?

Mr. Luo Fei - Chairman and Chief Executive Officer:

Actually we have not gotten the latest market share data. The market share should be similar to before. As we know, the top ten players' market shares have decreased from 75% to around 72%, which means consolidation is decreasing. In such situation, though the October figures have not been released yet, we expect to maintain our market shares.

Ms. Tina Long, BAML:

So that should be around 6%. Did you get your data from AC Nielsen, then that should be around 7%? Or above?

Mr. Luo Fei - Chairman and Chief Executive Officer:

I still have not gotten the data yet.

Ms. Tina Long, BAML:

Okay. Last question, how much of the expansion of retail network is related to Adimil? As the retail network is expanding quite fast.

Mr. Luo Fei - Chairman and Chief Executive Officer:

I should say they are very much related. With the presence of Biostime branded products in the existing areas, we hope to penetrate into more areas with Adimil. For Adimil, we have the existing

imported series, and the new series produced domestically which will be distributed in the coming month. Therefore, we expect the network to expand even more in the second half of 2014, and the expansion is mainly due to Adimil.

Ms. Tina Long, BAML:

Okay, thank you Mr. Luo.

Mr. Luo Fei - *Chairman and Chief Executive Officer*:

Thank you.

Operator:

The next question comes from Alicia, GIC. Please go ahead.

Ms. Alicia Chu, GIC:

Yes. Hi, thank you for taking my questions. I just have two questions. First of all, if you can just comment briefly about M&A talks by the company? And then secondly, in terms of the existing market share, the latest market share data, can you comment? What is Biostime's market share in total infant milk formula market? And what is your recent average selling price trend?

Mr. Luo Fei - *Chairman and Chief Executive Officer*:

For M&A, we are still in discussion with target companies. But for the time being, I don't have any detailed information to give to you.

Second question about the market share. I just said as we can see from some information from AC Nielsen, for the whole industry, the top ten players' market shares are going down. That means more and more players in this industry will dilute the market shares. And I believe Biostime can still keep almost the same market share. For the updated data, we don't have the updated data now.

And for the last question?

Ms. Alicia Chu, GIC:

Yes, my last question was about, I guess your selling price in the...

Mr. Luo Fei - *Chairman and Chief Executive Officer*:

Selling price, yes, selling price will be going down, you know, we have the Adimil new branded products. As these Adimil products increase, the average selling price will be slightly going down.

Ms. Alicia Chu, GIC:

And if I may just ask, in terms of the average selling price, if we take away the new products, which are new Adimil products which are sold at a lower price, if we take that away, what has been the trend on your existing products' average selling price? If you may just comment briefly.

Mr. Luo Fei - Chairman and Chief Executive Officer:

For Biostime products, it almost keeps the same. Biostime golden care and premium series still take the majority. There is not a big change for Biostime.

Ms. Alicia Chu, GIC:

Sure. Okay. Thank you.

Mr. Luo Fei - Chairman and Chief Executive Officer:

Thank you.

Operator:

The next question comes from Tiffany, BOCI. Please go ahead.

Ms. Tiffany Feng, BOCI:

Hello Mr. Luo, Laetitia, and other management. My first question is about the O2O contribution, Mr. Luo you mentioned just now that O2O currently contributed to 12.5% of total sales, is it declining? As I remembered it was 15% at the beginning of the year?

Mr. Luo Fei - Chairman and Chief Executive Officer:

It was 9% for the first half.

Ms. Tiffany Feng, BOCI:

Okay, understand. I would also like to ask – as we see the company is now giving more points reward in order to encourage consumers using the new O2O platforms, I would like to ask what are the views of the baby specialty stores on this approach? As they need to deliver and this does not increase cross selling in their own stores, are they really willing to do this?

Mr. Luo Fei - Chairman and Chief Executive Officer:

Around 14,000 to 15,000 stores in total have participated in our O2O business now. With the increase in sales from the O2O platform, stores are paying more attention to it. Currently, our

self-owned O2O platform receives approximately 5,000 orders on a daily basis and this number has been increasing. Of course, as we mentioned in the past, some stores are not really willing to participate in the O2O business and some are willing. In this case, we have selected 3,000 stores to become our flagship stores. These stores shall be cooperative and be able to sell our full portfolio of products. According to our data analysis, the average order value of customers who buy products in a store and then share information and educate other consumers on our APP afterwards is indeed higher than that of an ordinary member. Also, such customer retention rate is higher than the ordinary offline members. Therefore, we believe the development of our own platform for customer communication is very important. You know, we were not able to conduct such communication and education with our members without our APP and WeChat in the past. Now with our APP and WeChat, we are able to do many similar activities. If you ever notice our APP, you may find many customer-based or brand-based communication and education activities.

Ms. Tiffany Feng, BOCI:

Understand. Now we have 5,000 orders per day. Then how many orders per day were there at the begging, in the first half?

Mr. Luo Fei - Chairman and Chief Executive Officer:

This number should be higher than before, I cannot remember the exact number for the past, but it is definitely higher than before.

Ms. Tiffany Feng, BOCI:

I have another question – recently I see in the channel that some of our products have been left on shelves for a long time. We can see that some competitors launch large-scale promotion or use other means to collectively deal with aged inventory. What's our thought on this?

Mr. Luo Fei - Chairman and Chief Executive Officer:

The situation with each store can be different. For some stores, maybe a certain product is not selling well. However, we would not conduct any nationwide measures to deal with it because it is indeed difficult. Because it may be a different product at a different store that is not selling well or been left on shelves for a long time. It is up to our sales offices and the stores themselves to work out a plan to deal with this.

Ms. Tiffany Feng, BOCI:

Do you mean individual promotion, case by case?

Mr. Luo Fei - Chairman and Chief Executive Officer:

Yes.

Ms. Tiffany Feng, BOCI:

Understand. Thank you. I have no further questions.

Operator:

The next question comes from Jasmine, Citi Bank. Please go ahead.

Ms. Jasmine Bai, Citi Bank:

Hi, Mr. Luo and the management. As you mentioned in August, it seems that now we are selling the same products and brands for both online and offline. However, some other companies mentioned that it is difficult to do online business, so they need to launch a new product exclusively for this channel. We are wondering if you think it is still a long-term strategy to use the same products after several months of internet operation? Have we encountered any difficulties in the past two to three months and what are they?

Mr. Luo Fei - Chairman and Chief Executive Officer:

Yes, what you said is right. For e-commerce, we had no experience in online business before. We started cooperating with JD.COM, and then Yihaodian in August and now we find that the operation online is very different from offline. For example, some activities such as the Mother & Baby Festival require brands to give out 20% or 15% discount in order to take part in the festival. If we are not able to do this we cannot take part in it. You just mentioned whether we are going to use a new brand for the online channel which we are still exploring. Also we are considering taking some series out of the existing products to increase exposure of the brand and sales volume online. However, we should limit the quantity. For example, only 5,000 cans are available for a certain online event. As mentioned, we are still looking into this. In addition, we have three series under Adimil, including Adimmun, Adigest and Adismart. We are considering if we should use one series to compete online. We will promote this in the fourth quarter. As mentioned, we are now going to set up a dedicated e-commerce team. This is our current thought.

Ms. Jasmine Bai, Citi Bank:

Understand. If the products will be different for online and offline, how will be the online products be positioned?

Mr. Luo Fei - Chairman and Chief Executive Officer:

It will be positioned at around RMB200. As we can see from JD.COM, customers online are inclined to buy products that are priced at around RMB200. There are certainly sales of products that are priced over RMB400 but the sales are relatively low. Therefore, we think our product online will be priced at around RMB200.

Ms. Jasmine Bai, Citi Bank:

Understand. The next question is – given our O2O business accounted for over 12% of sales now, has the company been able to identify how many of the customers are incremental, and how many have actually just switched from offline?

Mr. Luo Fei - Chairman and Chief Executive Officer:

The concept of switching from offline to online is like this – the customers can buy online and at the same time switch back to offline and vice versa, and this is why our self-owned platform is very important. Online customers may still purchase offline, while offline customers can purchase online. It is very hard to identify whether a customer is actually from online or offline. However, we define that customers directed from B2C platforms and other electronic markets are new customers. These new customers accounted for 20-30% in the O2O platform.

Ms. Jasmine Bai, Citi Bank:

These new customers accounted for 20-30% in the O2O platform?

Mr. Luo Fei - Chairman and Chief Executive Officer:

That means, new customers directed from B2C platforms and other e-channels accounted for 20-30% of the new customers on the O2O platform.

Ms. Jasmine Bai, Citi Bank:

Understand. Lastly I would like to ask a question on profit margin. It now seems that in terms of product line, Adimil is growing faster. Then in terms of online channel, it seems that we will promote the mid-end product and there will also be expense in the e-commerce channel. What is your view on the profit margin in the next two years?

Mr. Luo Fei - Chairman and Chief Executive Officer:

It was around 62% in the first half. Were you asking about gross margin or net profit margin?

Ms. Jasmine Bai, Citi Bank:

I meant operating profit margin.

Mr. Luo Fei - Chairman and Chief Executive Officer:

We think the net profit margin will be around 15% in the long term.

Ms. Jasmine Bai, Citi Bank:

Understand. Okay. I have no further questions.

Mr. Luo Fei - Chairman and Chief Executive Officer:

Okay. Thank you.

Operator:

The next question comes from Dustin, Morgan Stanley. Please go ahead.

Mr. Dustin Wei, Morgan Stanley:

Hello, Mr. Luo and the management. I have a few questions. The first question is – Mr. Luo just mentioned that we have split the business units, could you share with us what changes have we seen in terms of expense control and profitability? As you mentioned improved operation efficiency.

My second question is about the industry. What is the sales volume growth and value growth for the industry in the third quarter? Thank you.

Mr. Luo Fei - Chairman and Chief Executive Officer:

We had only one team for both Biostime and Adimil before we split the business unit. Then we split the Adimil business unit from Biostime, because Admil was positioned differently from Biostime and Adimil's current series, especially the new domestically manufactured series, its distribution channels and penetration are also different from that of Biostime. Based on these, we separate them into two teams for Biostime and Adimil respectively. At this moment, we see some positive impact. The Biostime team is now more focused on brand building, customer education, etc., while the Adimil team is now focused on achieving better distribution. In the short term, the split will bring some pressure to our cost. However, they both have their own budgets and are running in the right direction now.

Another topic, you asked about the competition in the industry. For the third quarter, I should say that competition was even more intense than we have expected. You may also know that just one or two days ago, some companies which are in the sports and real estate sector, have also entered this market. Besides, some foreign companies might be overly optimistic about China's infant formula market. According to the data we can see, there is not much growth in volume in the industry. We are also seeing the modern channel is declining in both volume and value. In some large chained supermarkets, the sales volume of infant formulas has declined over 10%. In baby specialty store channel, there is no volume growth, while the sales value is growing at single digit growth. At the same time, there are more and more baby specialty stores opened. The number increased from 40,000-50,000 two years ago to over 60,000 now. This explains why we have entered more stores this year, especially in the third quarter, and in the coming fourth quarter as well as early next year.

We will continue to enter more stores in order to increase our penetration with the Adimil brand. Meanwhile, the online channel is growing faster than the two offline channels, so it is necessary for us to put more efforts online. That is why we need to set up a dedicated e-commerce team.

Mr. Dustin Wei, Morgan Stanley:

Thank you. I have a follow up question. Mr. Luo, do you agree that it is contradictory to see in this market - when the demand is turning weak in other fast moving consumer product segments, more market players will exit the market and let the leading players consolidate their market share, but we see an opposite trend for the infant formula market. Do you think it is a short term phenomenon or what is the cause behind it?

Mr. Luo Fei - Chairman and Chief Executive Officer:

This is mainly due to the positive messages of the industry in the previous one to two years, so everyone thought the China market would be great, and that there would be huge increases in coming two to three years. Some companies did their planning one year ago to enter this market, and now after they entered the market, it is not doing as good as they have expected. They have seen the intense market competitions including aggressive promotions. We also know these aggressive promotions would harm the brands. That is why we have built our APP and organized face-to-face small group activities, to do customer education, we have invested resources in these area. At the same time, we have followed up with the aggressive promotion in the first half. As for the second half, since the level of promotion in the market would not decrease, we will maintain a certain level of promotion. If not, we might lose market share. In such a situation, as I mentioned at the beginning of the call, it is not easy even to maintain a steady pace. We have done a lot of work to prepare for the future, including building our own O2O platform. Our own platform is very important for us in the competition. That is why we place such importance on the O2O platforms.

Mr. Dustin Wei, Morgan Stanley:

My last question is – based on the industry growth, is it possible to project the growth trend of the high-tier, supreme-tier product infant formula segments and also products which are priced at about RMB200?

Mr. Luo Fei - Chairman and Chief Executive Officer:

As we said just now, volume growth is insignificant. The growth of the industry mainly came from the launch of supreme-tier products by some brands, which have led to consumption upgrades by some consumers. Therefore for the industry as a whole, supreme-tier products have a positive contribution to the overall growth. It is difficult to tell how long the trend can last. At the same time, we saw price competition intensified among supreme-tier products. The industry situation is a bit strange now as sales volume growth is limited and sales growth was mainly driven by supreme-tier products, but at the same time the price is trending down due to competition. This means consumer communications and education are very important.

Mr. Dustin Wei, Morgan Stanley:

Thank you. I don't have further questions.

Operator:

The next question comes from Hing, Nomura. Please go ahead.

Mr. Hing Chan, Nomura:

Hello, Mr. Luo and the management. Regarding your comment on promotion efforts, did you mention that the marketing effort is steady in the third quarter as compared with the first half of the year? As such, do you maintain your guidance on gross profit margin, which you said will be slightly higher in the second half than the first half of the year? Thank you.

Mr. Luo Fei - Chairman and Chief Executive Officer:

As I said, we need to follow up on that but we will maintain our marketing efforts at more or less the level of the first half as we won't be too aggressive in marketing. So, more or less that level.

Mr. Hing Chan, Nomura:

Understand. On gross margin, due to the exchange rate and also the lower costs of milk source, do you see any help on gross margin?

Mr. Luo Fei - Chairman and Chief Executive Officer:

Gross margin for the second half of the year will be similar to the first half. It is because, as I said, our marketing efforts will not be too aggressive, but the impact of the exchange rate and cost of milk supply, as you mentioned, will be more likely reflected in the next year.

Mr. Hing Chan, Nomura:

Understand. Thank you. I have no further questions.

Operator:

This is to conclude the conference call today. Thank you.

Ms. Laetitia Garnier - International Investment and Cooperation Director:

Thank you everyone.