THE SMALL COMPANY
SHAREWATCH

July 2010

MARKET COMMENT

Last month we suggested you shouldn't be lulled into a false sense of security and after a high of around 5400 in early May we are now toying with 4800 on the FTSE-100 index. After such a sharp fall we would ordinarily be looking out for signs of support developing and a bounce. But if anything, the economic news is getting worse.

China's slowdown has gathered pace, though that was at least their intention. Not so in the US where, despite extraordinary stimulus the manufacturing data was atrocious, export orders fell sharply (Eurozone woes are now at play in the US), the unemployment report confirmed gathering gloom, their housing market is turning down again and consumer confidence is going south. There is an eerie calm in European credit markets (the Jaws theme tune getting louder) and short-dated Treasury yields are now lower than when everyone ran for cover post-Lehmans.

Add all of this gloom to the fact that some surveys of investor sentiment have fallen to extremes and that oversold indicators are very oversold and a picture is building that would normally encourage contrarians like us to be ready to pile in. Sadly, once a renewed market downturn gets underway the sharpest falls occur from a point when the indices already appear to be very oversold. Sorry.

What's the good news? Well, at the moment the UK economy is almost a pillar of stability but it isn't clear that this can last as the US economy rolls over. And the idea that a weak euro (normally good for exports) will save the eurozone is daft. Greece exports mostly to the rest of the eurozone. Will the US and China be importing more or less from the EU?

The technical picture is the same for most major stockmarket indices around the globe. For the FTSE 100 there is a clear downtrend in place and the most optimistic analysis we can come up with is support around 4400. For those of you trawling the market each day for signs of hope, we want to see lower volume on declining days, higher volume on up days (it is currently the reverse), plus the index must stop tumbling lower into the daily close. Until then, expect the downtrend to persist.

It would be a game changer in the short-term if new stimulus packages were announced, particularly if co-ordinated globally. In fact, we should expect this. But it just isn't clear that this would do much other than push markets higher for a while, as happened in March '09, which is fine if you are fleet of foot.

HUTCHISON CHINA MEDITECH (HCM)

FT Sector :	Pharmaceuticals & Biotechnology
Latest Price :	304p
High/Low	332.5p - 66p
Market Cap. :	£157.2m
Shares in issue:	51.7m
end12/2009 EPS/PER est	* - -
end12/2010EPS/PER est	* - -
end12/2011 EPS/PER est	* - -
Telephone	+852 2128 1188
Registrars	0870 702 0003
CALENDAR	
Int/Fins/AGM	Jul/Mar/Apr
* See text	

There is a strong argument for saying that Hutchison China Meditech (HCM), a supplier of medicines in China, is the most exciting Chinese company to be listed on AIM. In 2005, when Hutchison's present chief executive, Christian Hogg (an ex Procter & Gamble executive in China) arrived, sales were only US$37.2m but by last year they had grown to US$119m. That might sound no great shakes for a business operating in China but because two of the three businesses which make up its medicines division are partly owned joint ventures (and therefore proportionally accounted for) actual sales have in fact grown to US$300m. But ignoring that, in the last four years, attributable turnover and profit has more than doubled and grown twenty-one fold, respectively.

The story touches on the big theme of the explosive emergence of China, which houses 1.3 billion or 20% of the world's population and rising wealth as it transforms from an agrarian economy. There should be plenty of continued growth for HCM as spending per head on healthcare is only 2% of the US levels but healthcare reforms are making medical care available to those in remote rural areas - for example, the Chinese intend to open 30,000 clinics in rural areas and have just launched a list of 307 medicines that are mandatory for state healthcare bodies to stock and HCM has 17 of these.

Three exciting legs

HCM's core business presently is the manufacture and sale of prescription and over-the-counter (OTC) drugs (those you can buy without a prescription) in China.

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Most of these are based on Traditional Chinese Medicines (herbal remedies) rather than western medicines and form an integral part of the health service in China. When we briefly touched on the company last month at 245p, we thought this division was basically the growth driver. Not so; having now spoken to the company, we note that HCM also has two other equally exciting legs.

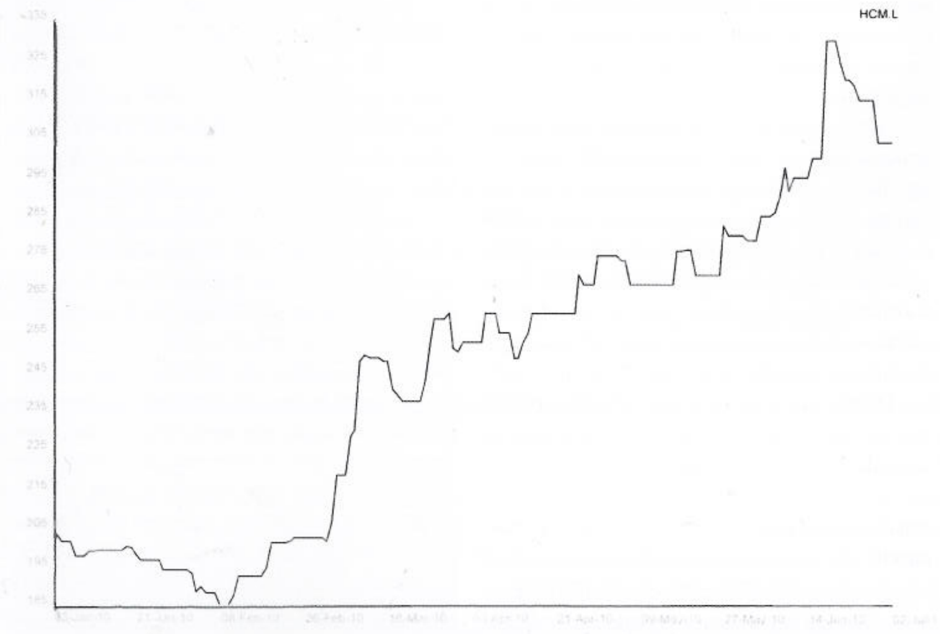
As we describe, one division is developing drug candidates for several western pharmas and the value is very likely to be crystallised by floating it on NASDAQ (probably sometime after clinical trials on a lead drug complete in 2011). The other business is still only at startup stage, having concluded a deal last year which has seen it set itself up to import a range of 40 natural and organic food items and personal care items from the US into China. This includes everything from tea bags, chips, chicken broth and pasta but it should also grow explosively fast.

Strange bedfellows

Some subscribers might be thinking that medicines and organic foodstuffs are strange bedfellows. But as Christian Hogg points out, HCM is being transformed and is enjoying dramatic growth in sales.

Hogg says that selling OTC medicines and food is all about the same skills - marketing - and his company has this in spades. In particular, he says the fact that Fortune-500 conglomerate, Hutchison Whampoa of Hong Kong (whose interests span ports, telecoms and retail) owns 70% of the shares, is enabling HCM to punch above its weight. Not only is that relationship opening doors that would otherwise not be open to it but it is also enabling it to attract the best employees.

It is also easy to see Hogg's logic to wanting a food import business under his wing, given that before he joined HCM in 2005, he ran Procter & Gamble's consumer products business in China. In fact, when P&G wanted a local partner to market its goods, Hutchison Whampoa was the obvious choice as it owned various chains of grocers. Now with quirky genius, Hogg will use these same retailers, including initially 440 Watsons and ParknShop stores to stock his newly imported items.



Medicines - 29% compound sales growth

We wouldn't want to overplay the consumer side because HCM's core business supplying medicines is still the main reason to buy the shares and is the largest part of the business - accounting for US$102m of the US$111m sales in the year to 31 December 2009.

You shouldn't under any circumstances underestimate the scale of this business. HCM already has over 4,500 employees, including over 2,600 sales and distribution people. It also operates two state of the art manufacturing facilities producing some 3.6 billion doses of medicine a year; a 75,000 sq ft one at Shanghai and 40,000 sq ft at Guangzhou. Unsurprisingly, Hogg says this muscle means that it dominates the subsectors in which it operates, such as OTC cough-cold remedies (no.1) and also prescription medicine in the cardiovascular area (no.2).

HCM's medicines division is made up of three operating companies, OTC (Hutchison Baiyushan; 37.5% owned), prescription (Shanghai Hutchison Pharmaceuticals; 50%) and health supplements (Hutchison Healthcare; 100%). In the last four years, these have gone from recording a combined attributable profit of US$0.6m on sales of US$37.2m in 2005, to last year making an operating profit of US$13.1m on sales of US$102m - all organic. The larger size has enabled operating margin to grow from 4.6% to a very respectable 12.8%.

Key brands

HCM's OTC business is focussed on generic (off-patent) products. The key brand is *Ban Lan Gen*, a granule formulation that is mixed with a drink and taken as a treatment or prophylatic for colds and flu. This contributed sales of US$30m last year (+42%) when it overtook sales from *Fu Fu Dan Shen* (angina tablets), which had sales of US$21.6m (+3%). Other key brands are *Kou Yan Qing* (periodontitis), *CXL* (inflammation) and *Xiao Yan Li Dan* (liver health).

On the prescription side, the main drug is *She Xiang Bao Xin* (SXBX) pills for the long-term treatment of coronary artery and heart disease (FY09 sales +41%).

Alongside medicines, HCM also does a line in branded infant nutrition products. It supplies a range of products for pregnant women under the *Zhi Ling Tong* brand launched six years ago but under wraps are plans to move into supplying infant formula (milk powder), which should do well given China's "one child" measures and this encourages parents to provide the best nutrition for their only child.

Three key 'props'

There are three key props supporting the medicines business. The first is geographic expansion, which is taking place outside the core territories. The OTC business has traditionally been strong in south central China, whilst the prescription side is strong in eastern cities. HCM has been rapidly rolling out across the mainland and Hogg says it has representation in every city with a population of over 1 million and to achieve this it is still recruiting between 200 or 300 people into its field force each month. Competition is intense and Hogg says that, for example, business for Ban Lan Gen must be retendered in each province but the broad network means it is keeping its market shares.

The company is also reaping the benefit of a growing Chinese healthcare market. In China, the scheme for basic medical insurance presently only covers 24% of the 1.3bn population- mostly in the urban areas - but under a set of reforms there are plans to expand coverage to 90% of the population by building thousands of clinics in rural areas.

17 on 'Essential Medicines List'

As part of these reforms, what has electrified prospects has been the creation of the Essential Medicines List in late 2009. This list contains 307 drugs that are reasonably priced and have high efficacy and safety profiles and which will become mandatory for all state-owned healthcare facilities to stock. The deadline for implementation is phased: 30% of facilities had to comply by the end of 2009 and 100% by 2020.

Hogg says that HCM has 17 medicines on this list. Of these, sixteen are generics and the seventeenth drug is SXBX, for which HCM is the only supplier.

The point is that, whilst a generic OTC medicine can generate gross margins of 55% or so, the margin on a prescription drug is almost 80% because there is no competition. Patent expiry might have been one worry but last year the Chinese government said SXBX was so important that it is to be protected as a "state secret", which has extended its patent protection for six more years to 2016. Given that SXBX is currently distributed in 6,700 hospitals but set to rise to 19,700 by 2020, in addition to 39,000 community health centres and 173,000 clinics - it is easy to see why Hogg is excited.

MedPharma

HCM has also built a powerful biotech business, which now employs 210 scientists involved in drug discovery and development - the biggest business of this kind in China. It has three collaborative partnerships with Johnson & Johnson, Eli Lily and Merck Serono. These are IP co-development and co-ownership agreements in the areas of oncology and autoimmune diseases and it uses technology platforms from its partners to screen large numbers of botanicals or small molecules for drug candidates.

These partners outsource the pre-clinical work to HCM for a fee and milestone payments as it takes a drug through the development process. But unlike a normal contract-research-set-up, Hogg says that HCM owns 50% of any drug that is discovered and it will receive royalties on sales. It has already developed a number of product candidates and anticipates three proprietary drugs will enter phase one clinical trials this year although he is coy about giving too much away just yet.

That said, last year, fees / milestones amounted to US$4.8m but generated a loss of US$9.9m. The loss last year was largely because HCM is progressing development of one proprietary drug off its own back. This is *HMPL-004* for the treatment of Crohn's disease and ulcerative colitis, both moderate-to-large size markets. HMPL-004 moves into phase 3 clinical trials in the US this year and this will take twelve months to complete. At best, the drug should make an appearance on the market by around 2014 but well before that you should expect news of a partner to take the drug into the trials, with Hogg saying negotiations are underway with several parties.

Consumer products division

Lastly, Hogg also expects exciting progress in the consumer products business. This reported a loss of US$2.5m on sales of US$4.2m last year. Until now it has been operating the chain of Sen retail outlets selling herbal remedies and Chinese skincare treatments in fashionable parts of London. That was going nowhere fast but then in October, Hogg changed strategy after he formed a 50:50 joint venture deal with Hain Celestial.

Hain Celestial is a leading North American supplier of natural and organic food and personal care products and the joint venture will distribute a shortlist of 40 of these into the Asian market. The curious mix of free range chicken broth or organic teabags might appear strange but Chinese consumers are embracing these premium priced products rather than buying locally produced ones, which might be packed full of monosodium glutomate and other nasties.

Hogg says that by cutting out middlemen he will also reduce prices. He has even created an exciting working capital gap so that he pays Hain [redacted] but will get paid by Hutchison after 45 days. That means as this business gets bigger and R&D losses recede, the group should be sitting on a colossal pile of cash (adding to the cash that stood at US$21.8m last year).

In the short run, the R&D business is continuing to be a drag on profits but the group is battling to the point where overall, Charles Stanley expect it will report a profit of US$1.3m on sales of US$146m this year. When value in the R&D side is finally crystallised (eg NASDAQ float) profits will come through very strongly. A great company; *buy*.

UPDATES

Scott Wilson (SWG) 290p bid

FT : Support Services

A fantastic month for the shares, which tripled after bid approaches from two separate US consulting firms. First came an 210p a share offer from URS Corporation. This was followed by rival CH2M Hill carrying out a dawn raid to acquire a 13.1% stake in the market before offering 245p a share. URS responded a couple of days later with a knockout 290p cash offer which values Scott Wilson at £223m.

The bid activity overshadowed the results for the full year to 2 May, which showed pretax profits of £18m on sales of £340m.

Pity none of the two US bidders could see the attractions at 45p in April '09, when Sharewatch made them its main buy recommendation.

Accept the offer. Gain in 15 months : 544%.

Ideal Shopping Direct (IDS) 149p

FT : AIM, Retailers

The shares shot ahead to a new high after Ideal said that sales for the first 21 weeks of the first half have increased by 17.9%. That consists of 10.5% like-for-like growth from the core business and 7.4% from the Lead the Good Life acquisition.

In addition, gross margins have also trended higher and as a result, Ideal said it expects to report a "substantial profit for the first half." Broker, Singer expects a profit of £1.5m for H1 10, versus the £0.9m loss in H109. For the full year to 31 December, the broker now forecasts £5.2m pretax and eps of 13p. Next year's target is £7.7m pretax and eps of 15.9p but this could be erring on the low side.

Despite the share price rise, net cash is still 25% of the market capitalisation. On a cash adjusted basis, the PE is less than 10 times. *Very strong hold.*

SuperGroup (SGP) 720p

FT : Retailers

As expected, the latest FTSE-250 reshuffle saw SuperGroup promoted into the index with effect from 18 July, one week after last month's issue landed.

The company has also since appointed a franchise partner for the Middle East, which will enable it to expand in the region without a commitment to capital. The agreement with Al Khayyat is to open 13 Superdry stores across the UAE in the next three years, with the first to open in July. The next step for SuperGroup will be to look for opportunities in the Far East, in particular in Indonesia, China and Taiwan. Expansion in Japan is a bit of a thorny issue as the *Superdry* brand is owned by Ashai Breweries, which produces *Ashai Super Dry* beer. It owns the trademarks for not just beer but for workwear, which includes clothing - but it isn't unsurmountable and SuperGroup expects a deal there soon.

During the month we also had a fruitful meeting with finance director, Chas Howes. There was only a couple of tidbits not covered in our main write up last month. The first is embellishment of the group's expansion plans. In the UK it is opening stores directly and is expected to open 20 this year against a base of 40 at the time of the float. The expectation is to ultimately have 130-150 owned stores, as well as franchised ones overseas. Howes says there is no reason not to have at least 100 franchised stores in each of Germany, France and Spain and slightly fewer in Benelux. Add the latest Middle East and the US franchisees into the melt and it's easy to see franchise store numbers growing by 20 per annum.

Clearly with the group expanding at such a frenetic rate, the supply chain is one element of risk. Howes points out that around 40% of its clothes are sourced from dedicated factories in Turkey, 30% in China and 10% each from India and Peru and the rest of the world. In total, there are 33 dedicated factories, against 12 three years ago and items can be restocked in as little as eight weeks. All supplies are paid in sterling with the exception of China, where supplies are paid in dollars and this reduces currency and margin risk. *Buy.*

Entertainment One (ETO) 77p

FT : Not listed in FT

Entertainment One's transfer to the Full List goes ahead on 15 July. The company has also appointed a new head for its kids division to help develop its focus, rather than just being part of its film division.

Based on a forecast from Singer of £30.1m pretax and eps of 12.9p, the shares look very cheap. Next year's target is £34.4m and eps of 14.7p. *Buy.*

James Fisher (FSJ) 422p

FT : Industrial Transportation

The shares bounced sharply after Fisher sold *mt Supremity*, a 4,426 dwt clean petroleum product tanker, for US$10.9m - this is not at any old distressed

price because the sale is a profit over book value of £0.3m - and now means contract capacity for the Tankships division is more in line with current levels of demand. Separately, Fisher also sold-and-leased-back a Norwegian property for £17.8m, around book value and equating to a 7% yield. The money will reduce bank debt. Both excellent developments. *Strong hold.*

Caretech (CTH) 333p

FT : AIM, Health Care Equip & Services

Latest interims showed Caretech got within spitting distance of 1,500 beds at the H1 stage, although it has since passed that short-term objective.

As at 31 March there were 1,480 beds, with the 50 added being organic additions, most of which were in the residential services sector. With utilisation remaining high and unchanged at 93%, Caretech reported a 5% increase in sales to £41.4m. Pretax profit was, however, up 32% to £7.6m as were eps to 13p. Net debt was £80.8m.

Caretech's market is the provision of care for those with learning disabilities. Finance director, David Pugh told *Sharewatch* that the period saw 78% of the turnover coming from residential care, 17% from supported living, with the remainder split between children and mental health.

Caretech is one of the few operators to provide such a pathway of care, which enables service users to step down from a residential care home to supported living as their needs change and this is enabling it to win market share. Just post the period end, it further enhanced its capability and also entered one new area by making three acquisitions for a combined £11m. This represents an exit