River Valley Asset Management

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As we suspected, and mentioned in last month's newsletter, the Fed inevitably postponed its QE tapering. As we mentioned, the factors leading to QE tapering were losing steam. The tapering will happen but it will be slower and smaller than was initially being expected. Hence global liquidity conditions will remain relatively loose for longer.

More importantly the Fed reduced its forward projection on GDP growth for the US. Also, the IMF last week reduced its projection of global GDP growth. All of these reinforce our base scenario of "mediocre growth for the foreseeable future".

In this scenario finding growth is always more difficult and has more risks. But there are always pockets of either cyclical growth (as probably in Europe now) or secular growth (as is true for some of the stocks in our portfolio).

Hence this month, instead of talking once again about macro gyrations, we are looking at one of the growth stocks we have been working on. This is a secular growth story – but with strong cash support and not an extreme valuation. Our portfolio strategy consists of allocating about 10-15% to small growth companies and this company is a typical example of the ones in this basket. The company is called "China Cord Blood Corporation".

China Cord Blood Corporation (CCBC)

What does it do?

The company is a bank to store cord bold (i.e. the blood retrieved from the umbilical cord of a new born baby). The technology to use this blood to find cures for various diseases is well-proven and has been improving and stabilising over the past few decades. Currently over 84 diseases can be alleviated using cord blood and this number is growing. Hence the ability to store this blood for decades and make it available when required is a unique service. The company is like a landlord with its tenant being the cord blood. Hence it is effectively a rent collection business with a very strong forward visibility. More importantly there is strong growth as the penetration of cord blood storage is still low. So, to continue with the "landlord-tenant" analogy, the number of potential tenants is growing very quickly.

What is the opportunity set?

CCBC is the largest cord blood bank in China. China has decided to give one license each in only ten of the nearly thirty provinces in China. Of these ten provinces, licenses have already been given out in seven, with CCBC having four of these. Thus it is a monopoly business with high entry barriers. The license for the remaining three provinces will been given out by 2015. Eventually licenses will be given out in the remaining twenty provinces after 2015. In addition, the penetration even in the existing provinces is very low, at 4-5%. Compare this to a penetration of 19% in Singapore/ Hong Kong. All these factors point to strong growth for the medium term.

How does it fit into our cash + growth framework?

This is a business where cash inflow happens much before revenue recognition. Customers pay an upfront processing fee and then a rental fee. Rental fee can be paid either upfront or on an annual basis. Hence this is a highly cash generative business once the physical infrastructure has been set up (like in a regular landlord-tenant business). Pricing power is high as it is a monopoly business, with the only caveat being that too high a price could slow down demand marginally. At the beginning of the year the company increased processing fees by 17% and storage fees by 58%, and only saw a single digit drop in volume growth.

On the growth front there are three legs – penetration increase, new provinces leading to geographic growth and pricing power. Current expansion plans in Guangdong and the new facility in Zhejiang will sustain growth in the medium term.

Cash generation is strong with increasing support from the recurring cash flow from annual rentals. Gross margins are high at 80%.

The company is cheap at about 15x current year earnings. More importantly it is sitting on USD 163 million of net cash, which is about 58% of market cap. Even after the conversion of an existing convertible bond this net cash number will fall to 50% of market capitalisation. Given that the CBs are at 10% coupon, the conversion would be EPS accretive.

Management and private equity holders

CCBC was formed through the slow integration of multiple players in this business, with the primary shareholder now being Golden Meditech (GM). GM is a Hong Kong listed health care company. The other large shareholder is the private equity firm KKR which came in through a CB issued to it in Q1 2012. The board is controlled by these two entities. The CB conversion price is at a 25% discount to the current price.

What are the risks?

A small independent business comes with its unique set of risks. On the other hand the business is relatively immune to global macro risks. The risks we see are:

- ➡ Regulatory (loss of monopoly, price control, etc.)
- ➡ Operational (quality slippage, contamination, etc.)
- ➡ Slow growth in penetration (this would lead to low utilisation of new facilities and hence negative operating leverage)
- ➡ Overpaying for new licenses. Price will clearly go up but by how much?
- ➡ Disruptive technology. Could new development in blood plasma culturing lead to no requirement to store cord blood? This would make the business model collapse.
- ➡ Small cap stock with low float could lead to high stock price volatility even if the business is stable.

Summary

CCBC is typical example of a growth stock that we like with very strong cash generation. It shows a higher expected return number but with higher volatility and risks vis-a-vis the business. Stocks like these form an important 10-20% of our portfolio and help us create growth optionality in the portfolio.

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