Blackmores (BKL.AX / BKL.AU)

**INITIATION**

**China retail: The remedy to reach A$175**

- **Initiating coverage:** A$175 target price. OUTPERFORM rating. Blackmores is a leading Australian supplier of vitamins and dietary supplements (VDS) ideally positioned grow in China – the second largest VDS market in the world. Blackmores’ China sales could double by FY20 fueling 16% EPS CAGR FY16–FY20. China sales could surpass A$580mn accounting for 50% of the group.

- **China on-shore retail may add US$150mn (A$200mn) in sales.** New ‘orange hat’ regulation should enhance market access. Blackmores should soon be able to register a larger product portfolio inside China, thereby expanding distribution and shelf presence in Chinese stores. In China, we observed pent-up demand for Blackmores’ products underpinned by the perception of high quality.

- **Blackmores’ exports to China should continue to grow:** Granted, the widely discussed ‘Positive List’ rule restricts export volume via the cross-border e-commerce channel. But, 70% of Blackmores’ volume travels via the daigou channel – e.g. Australia-based selling agents using China personal post. Channel checks reveal daigou has been less affected.

- **An attractive investment opportunity** with 16% EPS CAGR to FY20 and a 60% ROE – highest among ASX200 and global peers. At 17x FY18E EPS, Blackmores is also trading below China VDS peers. Our DCF based target price implies a re-rating to 19x FY19 PE which is justifiable considering there are 30 ASX200 industrials on a higher PE with less growth and lower returns.

- **Key risk.** Further regulation extending to the daigou channel. A bear case of A$95/shr assumes a 30% cut to Australian indirect China sales (mainly daigou) from the current level, stunted development of China retail, pricing pressure and no EPS growth for four years.

**Financial and valuation metrics**

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<tr>
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<tbody>
<tr>
<td>Revenue (A$ mn)</td>
<td>472</td>
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<td>EBITDA (A$ mn)</td>
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<td>EBIT (A$ mn)</td>
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<td>Net Income (Adj.) (A$ mn)</td>
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<tr>
<td>Change from previous EPS (%)</td>
<td>n.a.</td>
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<tr>
<td>EPS growth (%)</td>
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<td>Consensus EPS (A$)</td>
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<tr>
<td>P/E (x)</td>
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<td>Dividends (A$)</td>
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<td>4.7</td>
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<tr>
<td>Price/Book (x)</td>
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<td>13.2</td>
<td>11.2</td>
<td>9.3</td>
</tr>
<tr>
<td>Net debt/EBITDA (x)</td>
<td>0.1</td>
<td>(0.0)</td>
<td>(0.2)</td>
<td>(0.0)</td>
</tr>
</tbody>
</table>

**Source:** Company data, Thomson Reuters, Credit Suisse estimates

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**DISCLOSURE APPENDIX** AT THE BACK OF THIS REPORT CONTAINS IMPORTANT DISCLOSURES, ANALYST CERTIFICATIONS, LEGAL ENTITY DISCLOSURE AND THE STATUS OF NON-US ANALYSTS. US Disclosure: Credit Suisse does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.
Blackmores (BKL.AX / BKL AU)
Price (12 Jul 2016): A$136.18; Rating: OUTPERFORM [V]; Target Price: A$175; Analyst: Ben Levin

- **Revenue**: 472 706 810 921
- **EBITDA**: 79 153 178 204
- **Depr. & Amort.**: (6) (7) (8) (8)
- **EBIT**: 72 146 171 197
- **Associates**: - - - -
- **Net interest exp.**: (3) (1) (1) (0)
- **Other**: 0 0 0 0
- **Profit before tax**: 69 144 170 196
- **Income tax**: (22) (44) (51) (59)
- **Profit after tax**: 47 100 119 137
- **Minorities**: - - - -
- **Preferred dividends**: 0 0 0 0
- **Associates & Other**: 0 0 0 0
- **Normalised NPAT**: 47 100 119 137
- **Unusual item after tax**: 0 0 0 0
- **Net profit (Reported)**: 47 100 119 137

- **Cash & equivalents**: 37 39 37 35
- **Inventories**: 39 57 62 72
- **Receivables**: 107 125 143 163
- **Other current assets**: 5 5 5 5
- **Current assets**: 188 226 248 275
- **Property, plant & equip.**: 63 87 87 140
- **Intangibles**: 35 35 35 35
- **Other non-current assets**: 7 8 8 8
- **Non-current assets**: 106 130 130 183
- **Total assets**: 293 356 378 458
- **Payables**: 65 86 99 113
- **Interest bearing debt**: 44 35 10 25
- **Other liabilities**: 51 59 61 68
- **Total liabilities**: 160 180 170 206
- **Net assets**: 133 176 208 252
- **Ordinary equity**: 133 176 208 252
- **Minority interests**: 0 0 0 0
- **Preferred capital**: - - - -
- **Total shareholder funds**: 133 176 208 252
- **Net Debt**: 7 (4) (27) (10)

- **EBIT**: 72 146 171 197
- **Net Interest**: (3) (1) (1) (0)
- **Dep & Amort**: 6 7 8 8
- **Tax Paid**: (15) (43) (51) (59)
- **Change in Working capital**: 11 (15) (11) (16)
- **Other cash and non-cash items**: 1 7 12 7
- **Operating cashflow**: 72 100 118 136
- **Capex**: (4) (10) (8) (58)
- **Capex - expansionary**: - - - -
- **Capex - Maintenance**: - - - -
- **Acquisitions & Invest**: 0 (21) 0 (2)
- **Asset sale proceeds**: 0 0 0 0
- **Other**: - - - -

- **Dividends paid**: (23) (57) (88) (94)
- **Equity raised**: 0 0 0 0
- **Net borrowings**: (29) (9) (25) 15
- **Other financing cash inflow**: 0 0 0 0
- **Financing cashflow**: (52) (66) (112) (78)
- **Total cashflow**: 16 2 (2) (2)
- **Adjustments**: 0 0 0 0
- **Movement in cash/equivalents**: 16 2 (2) (2)

### Valuation 6/15A 6/16E 6/17E 6/18E
- **P/E (CS adj.)**: 50.6 23.4 19.6 17.0
- **PEG**: 0.6 0.2 1.0 1.1
- **EV/EBIT (x)**: 32.6 16.1 13.6 11.9
- **EV/EBITDA (x)**: 29.9 15.3 13.0 11.4
- **Dividend Yield (%)**: 1.5 3.2 3.8 4.7
- **FCF Yield (%)**: 2.9 3.8 4.7 3.4
- **Price to book (x)**: 17.5 13.2 11.2 9.3

- **Return on Equity (%)**: 35.0 57.0 57.3 54.5
- **Profit Margin (%)**: 9.9 14.2 14.7 14.9
- **Asset Turnover (x)**: 1.6 2.0 2.1 2.0
- **Equity Multiplier (x)**: 2.2 2.0 1.8 1.8
- **Return on Assets (%)**: 15.9 28.2 31.5 30.0
- **Return on Invested Cap**: 34.9 58.9 66.2 56.9

- **Net Debt to EBITDA (x)**: 0.1 0.1 0.1 0.1
- **Net Debt to Equity (%)**: 5.0 5.0 5.0 5.0

### EBIT Segments
- **Australia**: 64.3 132.9 146.9 154.6
- **BioCeuticals**: 106.8 10.5 10.5 10.5
- **Asia**: 8.7 11.8 19.2 22.9
- **NZ & PAW**: 36.6 61.7 19.3
- **Corporate**: 8.3 11.8 16.2 29.8
- **% chg**: 41.2 38.0 83.6
- **% chg**: 16.4 16.4 16.4
- **% chg**: 14.2 14.2 14.2
- **% chg**: 11.2 11.2 11.2
- **% chg**: 6.4 6.4 6.4
- **% chg**: 3.4 3.4 3.4
- **% chg**: 2.0 2.0 2.0
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### Valuation
- **Price to book (x)**: 17.5 13.2 11.2 9.3
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- **% chg**: 41.2 38.0 83.6
- **% chg**: 16.4 16.4 16.4
- **% chg**: 14.2 14.2 14.2
- **% chg**: 11.2 11.2 11.2
- **% chg**: 6.4 6.4 6.4
- **% chg**: 3.4 3.4 3.4
- **% chg**: 2.0 2.0 2.0
- **% chg**: 2.0 2.0 2.0
- **% chg**: 2.0 2.0 2.0

- **Equiv. FPO (period avg)**: 17 17 17 17
- **EPS (CS adj.) (c)**: 269.1 582.3 695.9 802.1
- **EPS growth (%)**: 80.2 116.4 19.5 15.3
- **DPS (c)**: 203.0 437.0 522.0 642.0
- **Dividend Payout (%)**: 75.4 75.0 75.0 80.0
- **Free CFPS (c)**: 392.6 519.6 644.2 456.5

### Source
- Company data, Credit Suisse Estimates, MSCI ESG Research
Investment Thesis

Blackmores is a leading Australian supplier of vitamins and dietary supplements (VDS) commanding a 20% domestic market share. Surging demand from Chinese consumers has caused company revenue to double in less than two years, with Chinese consumers now accounting for ~40% of group revenue. We envision another leg of growth doubling China revenue to A$580mn by FY20 or 50% of the group.

China retail: this is probably not priced in

We see a new opportunity emerging in what we expect to be a US$10bn China VDS market\(^1\) through the bricks and mortar retail channel by FY20. We believe Blackmores could capture US$150mn (A$200mn), adding 80% to its existing China sales base as new regulations assist Blackmores in tapping this large market.

Specifically, the Chinese Food and Drug Administration (CFDA) is supplementing the existing lengthy and costly VDS registration process with a much faster and simpler procedure for 22 common vitamins and minerals. This new regulation should allow Blackmores to expand its product range in Chinese stores materially, perhaps by three times. With a larger product range we envision greater access to distribution significantly enhancing Blackmores' growth prospects in this channel.

Our estimates equate to a China retail VDS market share of 1.5%:

- Blackmores' has already achieved, by our estimate, about a 4.5%\(^2\) market share of the online VDS market to China. In its largest category, fish oil, Blackmores' share may exceed 15% on cross-border, e-commerce platforms. (See Figure 2.)
- During our recent trip to China, industry participants widely acknowledged Blackmores’ potential to succeed, citing high brand awareness and a perception of high quality.
- Blackmores is adding resources to exploit the China retail market faster than many of its peers. It has established a local, wholly-owned subsidiary, secured a few key distribution relationships, and may double its local headcount from 30 to 60 people.

Regulatory concern: is this the buying opportunity?

We believe concern about new regulation has been overdone. A 33% share price correction since April 8 presents an attractive buying opportunity. On 8 April, 2016 11 government departments of the China State Council jointly announced the 'Positive List' – a list of commodities that can be imported via the cross-border, e-commerce channel.

Although this caused substantial disruption through the cross-border, e-commerce channels, we feel the impact on Blackmores is not as great as the share price move suggests.

- We estimate only 25% of Blackmores' China sales are via cross-border e-commerce.

- Blackmores' daigou channel – Australian based selling agents using China personal post – accounts for 70% of Blackmores' China revenue. We observe through industry contacts that this channel has been far less affected and not explicitly covered by the new China regulatory announcement.

- A peer company with China daigou exposure recently increased guidance: A2 Milk, an Australian dairy company, suggested in mid June that the impact from the regulatory announcement has not been as large as expected.

\(^1\) Estimated wholesale value of the China retail VDS market by FY20

\(^2\) We assume Blackmores has US$180mn in sales to China via cross-border, e-commerce and daigou channels. We estimate the on-line (cross-border and normal e-commerce) and daigou channels currently amount to US$4.0bn (wholesale value)
In late May, the Chinese Government delayed implementation of the 'Positive List' until May 2017. Our channel checks suggest that sales momentum picked up in June through the cross-border, e-commerce channel.

Even with the advent of the 'Positive List', we estimate Blackmores can still sell products that account for 50%–55% of its revenue through cross-border, e-commerce.

Chinese consumer appetite for Western-style VDS products is experiencing secular growth and that should carry the daigou trade. Our base case forecasts 10% annual growth through the daigou channel in each of FY17 and FY18 – more than offsetting a decline in cross-border, e-commerce.

**Attractive investment with solid returns and growth**

Our OUTPERFORM rating is underpinned by 16% EPS CAGR FY16–FY20 and an attractive return profile with Blackmores on track to generate a 60% FY16E ROE putting it at #1 in the ASX 200 and also amongst listed peers.

And yet, Blackmores is trading on 17x FY18E EPS – a rating that is below 30 ASX 200 industrials that have less EPS growth and lower ROE (see Figure 6) Blackmores is also trading below a few China VDS peers such as BioStime and By-Health. Our A$175 DCF based target price translates to a modest re-rating to 19x FY19 EPS.

By our calculation, Blackmores' share price is implying either no further growth in the e-commerce and daigou channels or no material development of the China retail business. However, we believe all channels will remain growth avenues for Blackmores.

**Risks and blue/grey sky scenarios**

China regulatory changes present the largest risk to our investment case. The introduction of the 'Positive List' highlighted that regulatory change can be sudden, unclear and subject to numerous iterations. The most prescient risk is that the 'Positive List' causes cross-border, e-commerce suppliers to divert importation from free trade zones toward use of the China postal service. This may have ramifications for the daigou trade.

Most of the daigou volume is sent through personal post which is not integrated with Chinese customs systems like cross-border e-commerce. Without this integration, examining all goods entering China via personal post is difficult due to the sheer number of parcels. That said, Chinese customs are now requiring detailed information such as product specifications and the identity of the recipient to be disclosed at the time of shipment.

An increase in goods travelling through the postal channel could garner the attention of China regulators as the country seems to be seeking to stem the flow of goods that circumvent taxes and duties and also those that don't conform to Chinese specifications.

To account for China regulatory risk, our WACC used in our DCF incorporates a Beta of 1.15. Blackmores has historically traded with a defensive Beta of 0.6–0.7.

- We derive a bear case or "grey sky" valuation of A$95 share assuming that regulatory changes significantly restrict the daigou trade. This scenario incorporates a 30% reduction in daigou from current levels, a 550bp reduction in Australian EBIT margins instigated by pricing pressure from reduced demand, US$100mn in China retail sales (our base case is US$150mn). NPAT falls to A$92mn for FY18E vs. FY16E A$100mn.

- We also outline a "blue sky" valuation scenario of A$205/share where Blackmores is able to capture an additional 100bps (~2.5%) in the Chinese retail VDS market that we incorporate into our base case forecast (~1.5%). That might equate to about US$100mn in revenue and US$35mn in EBITDA and would likely be margin accretive.
**Key charts**

**Figure 1: China retail or "direct" sales contributes the bulk of future revenue growth**

Source: Company data, Credit Suisse estimates

**Figure 2: Blackmores is commanding a 15% in the Fish Oil category on TaoBao**

Source: Taobao, Credit Suisse estimates

**Figure 3: China may account for 50% of FY20E revenue (from 40% today)...**

Source: Company data, Credit Suisse estimates

**Figure 4: ... leading to 16% NPAT/EPS CAGR forecast**

Source: Company data, Credit Suisse estimates

**Figure 5: Blackmores may generate the highest ROE in ASX 200 at ~60%...**

Source: IBES, Company data, Credit Suisse estimates

**Figure 6: ... yet Blackmores is trading below 30 ASX 200 Industrials that have: 1) less EPS growth; and 2) lower ROE (Black Circles)**

Source: IBES, Company data, Credit Suisse estimates
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China market overview and potential
The numerous selling channels to China

An understanding of Blackmores’ China prospects is best gained through a segmentation of the numerous sales channels into that market (see Figure 7). There are currently two main channels that have facilitated Blackmores’ growth – 1) daigou or local selling agents in Australia who procure Blackmores’ products from Australian retailers, then on-sell or carry the product into China; and 2) online cross-border, e-commerce platforms. We estimate these channels account for over 90% of Blackmores’ existing China revenue (now annualising A$250mn–$300mn). The blue-sky opportunity, however, lies in Blackmores’, small but growing, China retail channel.

Figure 7: An overview of Blackmores’ selling channels to China – retail the largest opportunity

Daigou and tourists

The largest channel for Blackmores is through daigou and tourists, which we estimate accounts for at least 70% of its China revenue. This entails purchases made through Australian retailers that are ultimately destined for personal consumption in China. (Our estimate attempts to avoid double counting of purchases made through Australia retailers that are eventually sold on Chinese cross-border, e-commerce platforms.)

As mentioned, daigou are individual selling agents that are based in Australia that buy vitamins, infant formula and many other products to send to China. Their end customer can be family members, friends or other associates that are known via word-of-mouth. Many daigou are students or young entrepreneurs looking for some extra cash.

Orders are usually placed via Chinese social media platforms or messaging services such as WeChat. One of Blackmores’ largest competitors, Swisse, (owned by HK listed BioStime) estimates that 100,000 individual daigou in Australia sell its products.

The attractiveness of the daigou channel is that it is built on trust and authenticity. Counterfeiting of foreign products can be a problem through online and offline channels in
China. Daigou are often known to the customer and are therefore well trusted. They provide assurance by shipping the goods directly from Australia and often provide a photograph of the product being purchased in-store to show its authenticity.

This method only incurs a 15% postal tax making it a low-cost sales channel relative to standard import via customs which attracts a total of 32% in taxes and duties (17% VAT + 15% import duties/tariffs)

**Cross-border and e-commerce**

In this report "cross-border" is distinguished from more conventional methods of importation. Our definition of "cross-border" is restricted to goods moved to China using channels that incur low or no customs duty and VAT. This can be through daigou, but also through a number of official e-commerce platforms/websites that also attract low duties and VAT. These channels can also be B2C or C2C whereas the more conventional method of importing through China is B2B.

**Cross-border, e-commerce – about 25% of Blackmores’ China revenue**

We estimate about 25% of Blackmores’ China revenue is derived or exposed to the cross-border, e-commerce channel. This channel has effectively been a pilot program by the Chinese government since 2012 in response to growing Chinese demand for online products, particularly those purchased overseas. It became difficult for the Chinese government to track orders and issues of counterfeiting and tax avoidance began to rise. In response, the government began trialing sales through its own approved platforms that could be tracked and where tax could be collected.

Cross-border, e-commerce utilises eight free trade or bonded zones in China. Goods entering these zones are subject to lower duties and taxes than imports through conventional channels, although there are restrictions on the size of each order. In simple terms, the goods must enter China to be sold directly to consumers.

Today, there are numerous cross-border, e-commerce platforms. Tmall is the largest Chinese B2C e-commerce site (including general e-commerce) and also the largest on cross-border e-commerce with its Tmall global platform. Others include JD.com, VIP.com, and Amazon.

Within cross-border, e-commerce, there are two further divisions in the way Blackmores’ products can be sold.

1. Through a bonded warehouse (B2C) where one of Blackmores’ customers sets up a warehouse in one of eight approved bonded or free-trade zones. Goods are shipped in bulk and stored temporarily at the warehouse, under the supervision of customs, until shipped. The customer places order and goods can usually be shipped within three to five days.

   Blackmores sells directly to 25 re-sellers through this channel and also can sell directly to consumers through its own flagship store. Revenue is captured in Blackmores’ Asia segment. Blackmores has said this channel accounts for about 10%–15% of its China revenue.

2. Through direct purchase (C2C or B2C): An offshore entity sets up an online store on Tmall Global (or other platform) to sell to Chinese consumers. Chinese consumers pay in RMB to the web host (i.e. Tmall) and the offshore entity receives local currency. Goods are shipped from an offshore location (i.e. Australia). Shipping times are longer and customs clearance is slower. Total shipping time can be up to three weeks.

   Blackmores’ exposure to this direct purchase model channel is indirect and may involve: 1) Australian supermarket/pharmacy customers selling through their own cross-border, e-commerce websites; or 2) some daigou selling to Chinese customers.
via C2C websites such as TaoBao. Revenue through this channel is usually captured indirectly in Blackmores’ Australian segment.

Our analysis suggests that the direct shipping method is of similar size to the bonded warehouse channel meaning that it may also account for 10% of its China revenue.

The tax rate for direct purchase is generally 11.9%, although that can vary depending on the size of the order.

**Figure 8: The two main methods of cross-border, e-commerce to China**

<table>
<thead>
<tr>
<th>Method</th>
<th>Direct Shipping</th>
<th>Bonded Zone</th>
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<tbody>
<tr>
<td>Warehouse Location</td>
<td>Offshore</td>
<td>China Free Trade Zone</td>
</tr>
<tr>
<td>Logistics</td>
<td>International logistics provider provided by foreign merchant</td>
<td>Local logistics provider designated by platform</td>
</tr>
<tr>
<td>Customs Clearance Speed</td>
<td>Slower</td>
<td>Faster</td>
</tr>
<tr>
<td>Delivery Time</td>
<td>7-21 days</td>
<td>3-5 days</td>
</tr>
</tbody>
</table>

Source: Tmo Group, Credit Suisse estimates

**China Traditional Retail <5% of Blackmores’ revenue**

Blackmores has a small presence in about 3,200 off-line, retail stores in China selling a limited range of products. This accounts for less than 5% of Blackmores’ China revenue; however, as we had alluded to earlier, it is the channel where we see a large growth opportunity.

Goods accessing this channel are exported from Australia to China, business-to-business via customs, and therefore incur both customs duties (15%) and VAT (17%). Although the total tax on goods for this channel is higher than other channels, the gap should narrow in coming years: The China Australia Free Trade Agreement (CHAFTA) will reduce customs duties on vitamins and supplements to 0% over the next four years.
China: second largest Global VDS Market, 10%+ growth

We estimate China is the second largest VDS market in the world at in excess of US$15bn in terms of retail value. Yet, per-capita VDS consumption is amongst the lowest in the world. Figure 9 shows that per capita VDS consumption of ~US$12/day is well below that of a few SE Asian countries (Thailand, Malaysia) as well as several developed nations. This may also come as a surprise as Chinese consumers are actually the most health conscious in the world according to a study by the Boston Consulting Group³.

One likely reason for low per-capita VDS consumption could be that health expenditure has historically been directed into Traditional Chinese Medicine or TCM – a market worth 515bn RMB (US$80bn) in 2012 according to the Chinese Statistics Bureau. TCM is ingrained in Chinese culture and has roots that extend back for more than 2,500 years.

Chinese consumers are however rapidly adopting Western-Style VDS products, as demonstrated by double-digit market growth over the past few years. In 2015, Euromonitor estimated that market grew 10%, while the China Health Care Association puts the growth rate at closer to 20%. Since 2010, Euromonitor estimates that the Chinese VDS market has grown about 12% CAGR (Figure 10).

Figure 9: China – second largest VDS global market

VDS market, yet low per capita consumption

Bubble size shows size of VDS market

Source: Euromonitor, Company data, Credit Suisse estimates

Figure 10: Chinese VDS Market has grown about 12% CAGR since 2010 according to Euromonitor

Source: Euromonitor

We expect 10%+ CAGR growth will be sustained over the next few years. We see two key growth drivers including: 1) rising incomes and appetite for Western-style VDS products, particularly amongst the 18- to 30-year old demographic; 2) continued penetration of the online channel notwithstanding some of the regulatory changes that have affected that channel.

Growth driver #1: Rising VDS expenditure among 18- to 30-year-olds

We see a core group of nearly 300 million Chinese consumers aged between 18 and 30 as a key growth driver of Chinese VDS demand. Not only are these consumers well educated and technologically savvy, their average income is the highest amongst any age demographic in China. Our China consumer team believes this age group could contribute 35% of total retail consumption by 2020 (from about 15% in 2014).

³ Capturing a Share of China’s Consumer Health Market, Boston Consulting Group, February 2014.
Figure 11: 18- to 29-year olds have the highest income out of any age group in China…

![Monthly Income CNY](image1)

Source: Credit Suisse Emerging Consumer Survey 2014

Figure 12: … unlike developed markets like the US where incomes are higher in older age brackets

![Monthly Income USD](image2)

Source: US Census Bureau

We believe 18- to 30-year olds will be particularly important for growth within the VDS category. We expect that foreign VDS brands will continue to grow in prominence, while online shopping continues to grow in popularity. This particular age group: 1) dominates the Chinese online shopping market (Figure 13); and 2) are perhaps the most familiar with foreign brands given their propensity to travel offshore (Figure 14).

Figure 13: over 50% of the Chinese online shopping population is aged between 20–29

![Normal Online Shopper, Heavy Online Shopper](image3)

Source: CNNIC

Figure 14: 60% of Chinese outbound tourists are aged between 21 and 30

![Normal Online Shopper, Heavy Online Shopper](image4)

Source: Qy.com

**Growth driver #2: Online channel facilitates sales**

Online channels still have bright long-term growth prospects, notwithstanding the introduction of a 'Positive List' from May 2017 through the cross-border, e-commerce channel.

We estimate that the online market in China may amount to US$4bn at a wholesale level, comprising of

1) US$2bn in cross-border, e-commerce/indirect (daigou) sales channels;

We estimate Swisse and Blackmores are annualizing a combined A$500mn (US$375mn) in sales to China across cross-border, e-commerce and through *daigou sales* channels, however we don’t believe their combined market share exceeds 20%. There are also many foreign players including GNC, Nature’s Bounty, Nature Made as well as a few local Chinese companies. On that basis, the total market could be at least A$2.5bn (US$1.9bn) through cross-border, e-commerce and *daigou* sales channels.
2) US$2bn in online wholesale sales within China which is based upon an estimate by Euromonitor of US$3bn in online retail sales into China. Euromonitor did not seem to account for cross-border, e-commerce or indirect sales made by any of the large Australian or American VDS suppliers.

Note: we include the daigou sales channel within the online category given that most of the sales occur through online social media platforms and messaging services.

Cross-border, e-commerce is an economic phenomenon that seems to be far from mature. It only really began in 2012, and grew 40% year over year in 2015 to reach 900bn RMB (~140bn USD). Our China consumer team expects 20%–26% annual growth in the cross-border, e-commerce market from 2016 to 2018 which equates to incremental purchases of about 650bn RMB (100bn USD) over the next three years. The VDS “share” of that could be at least US$1bn, judging by the existing proportion of sales on cross-border, e-commerce.

The sudden increase in VDS demand through online and indirect sales channels has really only occurred over the past 18 months. Figure 16 shows exports of Australian vitamins really only started to occur in late 2014. One element is the growing popularity of online channels/foreign brands, but we also think that greater enforcement by the CFDA of Chinese VDS product registration from late 2013/2014 was also a driver. This enforcement made it more difficult for foreign VDS brands to bring products into the country.

**Price is one factor driving sales.** VDS products purchased via e-commerce only attract a tax of 11.9% or 15%, depending on the method of shipping (Bonded Warehouse or Personal Post) and purchase amount. Goods are also tax free as long as the calculated tax payable does not exceed 50 RMB. That compares with 15% customs duty and 17% VAT through conventional trade imports.

**But more importantly it is the ease of access to trust-worthy foreign goods.** Foreign brands are popular in China across all categories – not merely VDS – due to perceived safety/efficacy and lower risk of counterfeiting. Our 2016 Credit Suisse Emerging Consumer survey showed that only 60% of Chinese consumers trusted local brands. Of the remaining 40%, half doubted both safety and efficacy (the other half doubted one of either safety or efficacy)
**A simpler VDS registration system**

Our positive view on Blackmores’ China retail opportunity is underpinned by recent regulatory change in the VDS registration process thereby improving access to the China retail market. From 1 July 2016, the CFDA will introduce a simpler method of approving common vitamins and minerals under a regime known as the “orange hat”. The new orange hat system should both reduce the time and cost for registration and allow Blackmores to substantially increase its product range in China.

Currently, most VDS products need to undergo a much more stringent registration process with the CFDA, known as the “blue hat”. A single registration can take two to three years to complete and cost in excess of US$100,000 per product. As yet, none of Blackmores’ products and few foreign VDS brands have managed to obtain a blue hat registration.

**Figure 18: Most of China’s blue hat registrations are held by local brands or brands that manufacture locally**

*Number of blue hat registrations by brand*

---

Source: CFDA
Actually, the long lead time and cost to register may only partially explain why few foreign VDS companies have obtained a blue hat registration.

Prior to 2014, a number of products were able to be imported under China's less stringent general food regulation, as long as the products were considered to be derived from food and did not make functional claims (i.e. indicate health benefits or treatment of certain conditions). At that time, the line between what required blue hat registration and what may be imported under general food regulation was still unclear.

However, from late 2013 and early 2014, the CFDA began to impose the requirement of blue hat more broadly and even commenced legal action against a number of foreign VDS manufacturers. It became increasingly difficult to import and sell through the retail channel under general food regulations.

To compensate, many foreign VDS brands may have sought to undergo a blue hat registration in 2014 to continue to sell their products, however we understand that limited CFDA resources and a backlog of applications may have delayed the approval process. Blackmores has been attempting to register its flagship product – fish oil – for at least two years.

Today about 15 Blackmores products are eligible to be sold under the general food regulations in China compared with about 500 it can sell in Australia.

From 1 July 2016, VDS brands will be able to register common simple vitamins and minerals and a simpler regime known as the "orange hat". This forms part of China's new food safety law that was enacted in October 2015. It is also known as a "filing" or "recording" system, and appears similar to registration systems in other developed markets, like Australia.

The blue hat registration will remain in place however, the orange hat system will act as an alternative way to register and sell common vitamins and minerals in China.

Orange hat applications need to submit a detailed report (or dossier) that shows the product conforms to CFDA standards (such as concentration and labelling), and that the product is safe for human consumption. If the CFDA is satisfied with the report, the product may be approved.

This effectively eliminates the need for the CFDA to carry out its own extensive technical evaluation and inspection, and also simplifies the testing requirements for the application.

We believe the total approval time should be less than six months but could even be as little as three months. The registration cost may be US$10,000 to US$30,000 per product, as opposed to US$70,000 to US$200,000 for a blue-hat registration.

Figure 19 outlines the key differences between the orange hat and blue hat registration process.
**Figure 19: The new recording system should greatly speed up registrations in China**

<table>
<thead>
<tr>
<th>Orange hat (new filing system)</th>
<th>Existing Blue Hat Registration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time to approve</td>
<td>&lt;6 months</td>
</tr>
<tr>
<td>Cost per registration</td>
<td>US$10,000 to US$30,000 per product</td>
</tr>
<tr>
<td>Registration Process</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Simpler process, submit a detailed report indicating amongst other things 1) overseas certification 2) safety 3) health function 4) technical requirements 5) production process 6) dosage 7) labels and packaging</td>
</tr>
<tr>
<td></td>
<td>• No need for technical evaluation, R&amp;D Report, onsite inspection, toxicology</td>
</tr>
<tr>
<td></td>
<td>• Speedy approval if application conforms to regulation. If not, the applicant has 3 months to rectify/submit further information</td>
</tr>
</tbody>
</table>

Source: CIRS-REACH, Credit Suisse estimates

The **CFDA has drafted 22 approved common vitamins and minerals** for orange hat registration, most of which are also the basis for some of Blackmores' key products in Australia. Swisse, one of Blackmore's largest competitors, estimates that these new raw materials cover about 20% of its existing products sold in Australia.

**Figure 20: Approved vitamins and minerals for orange hat registration**

<table>
<thead>
<tr>
<th>Draft list of raw materials under orange hat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Folic Acid</td>
</tr>
<tr>
<td>Pantothenic Acid</td>
</tr>
<tr>
<td>Nicotinic Acid</td>
</tr>
<tr>
<td>Biotin</td>
</tr>
<tr>
<td>Selenium</td>
</tr>
<tr>
<td>Vitamin A</td>
</tr>
<tr>
<td>Vitamin B1</td>
</tr>
<tr>
<td>Vitamin B12</td>
</tr>
</tbody>
</table>

Source: CFDA

We understand that the new orange hat system will also allow for mixtures of vitamins and minerals. We engaged a Chinese chemical registration agency who told us that mixtures are allowed as long as the formula only contains the active ingredients from the approved list, and meets the relevant dosages for each active ingredient. Blackmores could, for example, register a similar product to its Calcium + Magnesium + D3 that it sells in Australia.

We would not rule out further inclusions over and above the initial 22 common vitamins and minerals announced for orange hat registration. There are a few key other products that were not included such as Fish Oil and Co-Enzyme Q10 – products which have been sold in developed markets for many years. The CFDA is actually considering public comments on the orange hat registration process after taking submissions in early June. One industry body, the US China Health Products Association, indicated during a March 2016 interview that it has been actively discussing potential inclusions under orange hat and that so far, these discussions have been constructive.

There are still a few areas of the orange hat regulation that need clarification, and we include our latest intelligence after consulting with a Chinese chemical registration agency.

1) Owner of health food filing/registration: The CFDA’s draft stipulates that “the recording owner of domestic health food should be the health food manufacturer.”
Our understanding is that Blackmores can qualify as the health food manufacturer despite outsourcing its tablet production to contract manufacturers.

2) Requirement that goods be sold overseas for a year. This may be an issue if a new formula needs to be produced for the Chinese market.

Our feedback indicates that a comprehensive safety report could suffice, in the absence of being able to show a one-year sales record. This is alluded to in the CFDA draft which mentions a "safety report of overseas sales and consumer's feedback" could be used.

Recent regulatory changes; the 'Positive List'

Recently, there have been numerous regulatory changes affecting e-commerce and cross-border in China that have caught investors by surprise. While the implications are not entirely clear, our assessment is that the daigou channel (70% of Blackmores’ existing China revenue) has been far less affected and should continue to be a viable sales channel. Growth in the daigou channel should also offset any decline in smaller cross-border, e-commerce channel (25% of Blackmores China revenue).

Cross-border, e-commerce has been an attractive sales channel for foreign VDS products as the paperwork to access the Chinese consumer is less stringent. Cross-border sellers only needed to show country of origin, manufacture date and that the goods were safe to use (among other details). For some products, B2C and C2C cross-border access enabled sellers to circumvent the very lengthy and costly blue hat registration process through the CFDA. In effect, B2C and C2C sellers were free to sell most of Blackmores’ Australian product range (which numbers 500 products).

On 8 April 2016, 11 ministries under the State Council (across finance, trade, customs, food safety and tax) jointly announced a 'Positive List' of 1,142 approved items for importation via cross-border, e-commerce in an attempt to bring imported goods in line with Chinese food and drug regulations. The declaration of the 'Positive List' was unexpected and led to quite a bit of confusion.

As background, in China, the central State Council and its ministries generally draft legislation in accordance with broad directives from the Central Party Committee and National Peoples’ Congress. Legislation is sometimes written to allow flexibility and change. It is not uncommon to observe regulation announced and revised. Moreover, China’s 33 provincial governments may implement quite pronounced local variations of laws and national regulations.

The implications of the 'Positive List' were initially unclear. Some VDS categories were included on the list, however it was also stipulated that Chinese registration should be obtained by 1 July 2016. There were several VDS products such as Co-Enzyme Q10 and Fish Oil that were simply not included on the list and it was unclear whether these products could still be sold via cross-border, e-commerce. The only other importation channel would be via general trade – business-to-business, through customs. That avenue incurs higher taxes and charges and most products require a blue hat registration.

The uncertainty caused substantial disruption through the cross-border, e-commerce channel. On our recent trip to China, we heard that some cross-border, e-commerce sellers also had not shipped any product until prior to April 8 2016 and were running down existing inventories. Chinese media (finance.sina) reported that imports through the Zhengzhou, Shenzhen and Ningbo trade zones showed a decline of 70%, 61% and 62%, respectively in the week after the 'Positive List' was implemented.
Like many regulations in China, there have since been a few major changes,

1) On 15 April 2016, a second 'Positive List' was published and included an additional 150 items. Among these inclusions were Fish Oil and Co Q10.

2) On 25 May 2016, the government further announced
   ii. Extension of the policy to include the “direct shipping” model of cross-border, e-commerce. Previously the 'Positive List' only applied to the “bonded warehouse” model.

The cross-border, e-commerce channel should therefore continue to operate as it did prior to the 'Positive List' until 11 May 2017.

Implications for cross-border, e-commerce post 11 May 2017

It seems clear that VDS products will need to comply with Chinese standards from 11 May 2017 if they are to be sold through the cross-border, e-commerce channel.

We believe Blackmores can continue to sell products accounting for ~40% of its revenue in the cross-border, e-commerce channel. Two of Blackmores’ largest products, Fish Oil and Lecithin, are already currently sold through the off-line channel in China under “general food” regulations, albeit with Chinese labels and no mention of functional claims. Another large Blackmores' seller, Vitamin E Skin cream, could be registered under China's cosmetics regulations – a much easier process compared to VDS and typically less than six months.

We believe orange hat registration could cover a further 10%–15% of Blackmores’ existing product range. Comments by Swisse suggest that the orange hat system may cover about 20% of its existing SKUs. That may be a reasonable benchmark for the number of products that Blackmores can sell although it may require some alterations to dosage/formulas. Here we assume that 20% of Blackmores’ product range might equate to 10%–15% of its revenue given that a few other products (Fish Oil, Glucosamine, Co Q10, etc.) account for a large amount of Blackmores’ revenue.

There may be 45%–50% of Blackmores cross-border, e-commerce revenue where the ability to register and sell post May 2017 is uncertain. It is perhaps too early to draw the conclusion that these products simply cannot be sold without a CFDA blue-hat registration.

Some of Blackmores’ products are herbal based and may also be able to be registered under food regulations (without making health claims). The initial list of 22 common vitamins and minerals for filing may be expanded. Blackmores may be also able to counteract lost revenue on these products by incremental gains on other products.

Cross-border, e-commerce tax increases – immaterial effect in our view

Recent cross-border, e-commerce tax increases will have an immaterial effect in our view. Perceived quality and safety seems to be more of a driving factor than price alone in our view. Actually, it is plausible that higher prices may reinforce the notion that vitamins and dietary supplements are premium products.

In any case an increase in the cross-border, e-commerce tax (from 8 April 2016) is not substantial. The largest incremental tax increase occurs via the direct-purchase model and even then, the tax rate has only increased 10% to 15%. VDS products purchased via cross-border, e-commerce will still remain far cheaper than that of retail within mainland China.

In some circumstances, the tax changes actually bring about a more favourable tax regime within the bonded warehouse model. Previously, goods shipped between a value of 1000 and 2000 RMB (US$155–$310) were subject to full trade duties of ~37%. This has since moved to a 0% customs duty and 11.9% VAT.
These tax rates do apply up to a yearly purchase value of 20,000 RMB (~3,000 USD) per customer across all cross-border, e-commerce platforms. Any purchase beyond that is subject to full trade duties. We do not believe this will have a material impact on cross-border spending given that, on average, Chinese consumers make three to five purchases a year, spending about 700RMB per purchase according to Nielsen.

**Figure 21: Summary of taxes and fees on cross-border, e-commerce**

<table>
<thead>
<tr>
<th>Purchase Amount</th>
<th>Bonded Warehouse</th>
<th>Direct Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;1000RMB (&lt;US$155)</td>
<td>11.9% consisting of</td>
<td>15% Personal Postal Tax (Food and Beverage)</td>
</tr>
<tr>
<td></td>
<td>- 0% customs duty</td>
<td>Tax is waived if total tax payable &lt;50RMB</td>
</tr>
<tr>
<td></td>
<td>- 11.9% Import VAT</td>
<td>i.e. if item value &lt;50 RMB/15% = 333RMB (US$51.50)</td>
</tr>
<tr>
<td>1000-2000RMB (US$155-310)</td>
<td>Normal trade tariffs (~37%) consisting of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>17% Import VAT</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20% customs duty</td>
<td></td>
</tr>
<tr>
<td>&gt;2000RMB (&gt;US$310)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: CIRS Reach, Company data, Credit Suisse estimates

**Daigou – a viable sales channel but cognisant of risks**

We acknowledge the risk of further regulation affecting the *daigou* trade; however, we currently consider it a viable sales channel. At this stage the 'Positive List' will only apply to the cross-border, e-commerce channel – including both bonded warehouse and the direct shipping methods of importation. The *daigou* method of shipment is mainly via personal post which is not covered by the new regulatory pronouncement.

Implementing the positive list via cross-border e-commerce may not be difficult as cross-border e-commerce sellers are integrated into the systems of Chinese customs. Sellers must provide details about individual products and the identity of the consumer. Customs clearance is assisted by the integration of systems.

We believe the biggest risk to *daigou* is not the Chinese government targeting *daigou* themselves but rather cross-border, e-commerce suppliers potentially using post as a means to send goods. Practically, sellers may seek to set up warehouses offshore (such as HK), bypassing official platforms connected with Chinese customs and send goods to consumers through personal post. An increase in postal volume might draw the attention of customs which may cause delays in customs clearance, or create some uncertainty for *daigou* post.

Personal post sent by *daigou* is not integrated into the customs system, although recently China customs has taken measures to increase oversight of this channel. Shipments now require details of the recipient and specific details of the goods being sent, such as product type, brand and quantity.

To highlight, Figure 22 is a web extract from a logistics company that ships from Australia to China. To send orders to China, sellers must enter the Chinese contact detailers of their receiver, including an upload of the receiving party's photo ID. This information is forwarded onto Chinese customs.

**Figure 22: Chinese customs requires identity information of receiving party in China**

<table>
<thead>
<tr>
<th>身份证姓名</th>
<th>身份证号码</th>
<th>身份证手机号</th>
<th>身份证上传图片</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese Name</td>
<td>Chinese ID CARD Number</td>
<td>Chinese Mobile</td>
<td>ID Photo Upload</td>
</tr>
</tbody>
</table>

Source: Polar Express
Figure 23 shows that senders also need to specify the goods they wish to send. In this case, A2 Stage 3 infant formula.

**Figure 23: Chinese customs requires details of the goods (in this case A2 Infant Formula)**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>品牌</td>
<td>A2婴儿奶粉3段 A2</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Polar Express

We believe the ‘Positive List’ is really an attempt by the Chinese government to make cross-border, e-commerce suppliers, which are effectively retailers and businesses, subject to the same rules/regulations as those operating in China. Not only has this included higher tax (recently announced) but also complying with the same regulations as Chinese bricks and mortar retailers.

Sentiment amongst industry contacts was that regulation was unlikely to extend to the daigou channel because of the difficulty in tracking small parcels. That said it does not guarantee that the Chinese Government will not further restrict the movement of goods via the post. In the absence of regulatory restrictions, we still see daigou as a channel that should continue to grow, benefiting from Chinese demand for Australian/Western Style VDS.

**Are Daigou likely to be superseded? Unlikely in the near term**

There is one obvious question as to whether the market may eventually evolve to supersede or diminish the role of daigou. Again we believe the risk here is low, at least in the near term. Daigou provide access to hundreds of thousands, perhaps even millions of Chinese consumers, particularly those who seem to place a heavy emphasis on trust and word-of-mouth (over price).

It also seems clear that Blackmores sees daigou as an integral part of its China distribution and it is becoming increasingly sophisticated in communicating to these customers. Blackmores has built a special loyalty program (see Figure 24) where daigou are notified of special events and retail promotions through Wechat. Indeed, we attended the inaugural daigou conference in April 2016 and found Blackmores, in conjunction with a pharmacy partner, offering trade specials on infant formula. Swisse, by comparison, directed us to purchase through Chemist Warehouse.

**Figure 24: Blackmores has initiated a daigou sales agent program**

![Blackmores Sales Agent VIP Program](image)

Source: Company data
China industry structure supports solid returns

Favorable industry structure in the Chinese VDS market should also support high margins and attractive returns in our view. The customer base in China is fragmented and there are few competitors with substantial market share. That may provide the clue as to why two large publicly listed Chinese VDS companies – By Health and Nanjing SinoLife – generate some of the highest EBITDA margins out of publicly listed VDS peers.

Figure 25: Two Chinese listed VDS companies generate some of the highest EBITDA margins out of our pure-play VDS comp set

CY2015 EBITDA Margin. Blackmores CS FY16E

Source: IBES *Note BioStime and Conba excluded due to their infant formula and pharmaceutical businesses respectively.

A diverse and fragmented customer base

Comparing the Australian and Chinese VDS markets shows that the customer base in China is far more fragmented. In the Chinese retail channel, there are around 450,000 pharmacies and a further 5,000 health/beauty foods for which to retail VDS products. The largest chain of pharmacies, Nepstar Drug Store is no more than 2,000 stores. Pharmacy wholesalers do exist, however the reach of the second largest – Shanghai Pharma – is only to about 35,000 pharmacies.

In Australia, we estimate that at least 60% of industry volume is passed through three large retailers. This has partially been driven by the rise of high-volume discount pharmacies which have captured substantial market share from smaller pharmacies.

Growth in the online channel is also further diversifying the customer base with dozens of VDS sellers on any single cross-border, e-commerce platform. Blackmores is currently selling directly to 25 separate cross-border, e-commerce buyers, and indirectly to possibly tens of thousands of daigou.

Cross-border, e-commerce has also provided Blackmores with the ability to sell directly to consumers through its online flagship stores. We understand that Swisse’s flagship store, launched in March 2016 has now become one of its largest cross-border, e-commerce channels in only a few months. Swisse even sells its products at a higher price than other retailers, demonstrating that trust and authenticity may be more important than lower prices.

No single entity >11% of the market

We also observe that no single VDS entity in China has built scale – at least from a market share perspective. Even the largest, Amway, only holds an 11% market share. The top 10 players account for less than 50% of the market according to Euromonitor.
Lack of scale could be explained by the high-cost and lengthy approval time of the blue hat registration process which has probably constrained the number of products any entity can register and sell. No single entity has more than about 150 blue hat registrations while in Australia, Swisse/Blackmores each sell in excess of 250 products.

Offline channels also differ slightly. About 50% of the market in China is through multi-level marketing or direct selling brands. Here, companies employ a large salesforce or membership base. Members sell to friends/family and associates. These companies would not really compete for shelf space in pharmacies or health food stores, although they may share the same customer.

On our recent trip to China we raised the question to market participants as to whether the new Orange Hat registration method could significantly lower the barriers to entry and lead to a flurry of new entrants in the market. The concern being that the VDS sector may go the way of the infant formula market in China. That market has become fiercely competitive as any infant formula brand can be sold in China as long as it was manufactured at an approved dairy factory. Small dairy factories are often producing 20–30 different branded infant formulas and most often with the same recipe. The number of infant formula brands in China has proliferated to about 2,000 today (the Chinese government has recently taken steps to significantly consolidate this industry).

It is true that there seems to be greater industrial interest in China and perhaps expansion in VDS competition. However, another characteristic of this sector is that there is significant differentiation. Variations on VDS supplements are as many as can be imagined.

Notwithstanding that the Orange Hat registration will be easier than Blue Hat, it is still more onerous than the clearance needed for infant formula. For Orange Hat approval, VDS brand owners must demonstrate to the CFDA that their products are safe for use by providing information about where the product is produced, overseas certifications, research testing, and/or a sales history in another market.

Finally, reputation and track record raise the barrier to entry. Retailers in China are seeking out overseas brands with established reputations. Industry participants also stressed the cautious nature of Chinese consumers following numerous food safety scares over the past few years. Quality, more than price, seems to be the main driver of purchase decisions in the VDS category.

**Table: Market Share of VDS Brands in China**

<table>
<thead>
<tr>
<th>Brand</th>
<th>Company</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nutrilite</td>
<td>Amway (China)</td>
<td>10.7%</td>
</tr>
<tr>
<td>Infinitus</td>
<td>Infinitus (China)</td>
<td>10.2%</td>
</tr>
<tr>
<td>Tiens</td>
<td>Tianjin Tianshi Biological Developments</td>
<td>5.1%</td>
</tr>
<tr>
<td>By-Health</td>
<td>Guangzhou By-Health Biological Engineering</td>
<td>4.3%</td>
</tr>
<tr>
<td>Perfect</td>
<td>Perfect (China)</td>
<td>4.2%</td>
</tr>
<tr>
<td>Dong-E E-Jiao</td>
<td>Shandong Dong-E E-Jiao</td>
<td>3.6%</td>
</tr>
<tr>
<td>Guozhen</td>
<td>New Era Health Industry Group</td>
<td>5.1%</td>
</tr>
<tr>
<td>Real Nutri</td>
<td>Wuxin Ruinian Industry &amp; Commerce Co</td>
<td>2.3%</td>
</tr>
<tr>
<td>Caltrate</td>
<td>Wyeth Pharmaceutical Co Ltd</td>
<td>2.1%</td>
</tr>
<tr>
<td>Herbalife</td>
<td>Herbalife (China)</td>
<td>1.1%</td>
</tr>
<tr>
<td>Total Top 10</td>
<td></td>
<td>48.7%</td>
</tr>
</tbody>
</table>

Source: Euromonitor
Blackmores China – well positioned

Blackmores’ strong brand is built upon its high quality; its differentiated approach to marketing and its established China platform give us confidence that its foray into the Chinese retail VDS market will most likely be successful. The main constraint has been its very limited product range – which makes it difficult to access distribution and to justify sales, marketing and headcount. However, we believe the new orange hat VDS registration system should dramatically reduce this constraint such that Blackmores could increase its product range from 15 products to perhaps 40–50. Overall we see potential for Blackmores’ China retail business to reach US$150mn (A$200mn) in revenue by FY20.

Strong brand, high quality

On our recent trip to China, we gathered from numerous industry participants that Blackmores’ has an exceptionally strong brand, built upon a perception of quality. Indeed, Blackmores is among one of the better known VDS brands in China, despite having an insignificant retail footprint. A survey by the US China Health Products Association in early 2015 found that 17% of Chinese consumers were familiar with the Blackmores brand placing it fifth out of 15 large international brands. Given the rise in prominence of Blackmores since early 2015, we would expect that measured brand awareness has grown significantly.

Figure 27: 17% of those surveyed were familiar with the Blackmores brand

<table>
<thead>
<tr>
<th>Which international brands are you familiar with?</th>
<th>Which domestic brands are you familiar with?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pfizer Centrum</td>
<td>Amway (China)</td>
</tr>
<tr>
<td>NBTY</td>
<td>By-Health</td>
</tr>
<tr>
<td>GNC</td>
<td>Yang Sheng Tang</td>
</tr>
<tr>
<td>Schiff</td>
<td>Tong Ren Tang</td>
</tr>
<tr>
<td>Blackmores</td>
<td>21Vita</td>
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<tr>
<td>Nature Made</td>
<td>Juizhitang</td>
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<tr>
<td>Nature’s Way</td>
<td>Taitai Jingxin</td>
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<tr>
<td>Puritan’s Pride</td>
<td>Life No.1</td>
</tr>
<tr>
<td>Jamieson</td>
<td>Conba</td>
</tr>
<tr>
<td>Others</td>
<td>Herbalife (China)</td>
</tr>
<tr>
<td>Nordic Naturals</td>
<td>Perfect (China)</td>
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<tr>
<td>Swanson</td>
<td>Infinitus</td>
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<td>Swisse</td>
<td>Tiens</td>
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<td>Jarrow Formulas</td>
<td>Nu Skin (China)</td>
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<tr>
<td>Now Foods</td>
<td>Or Herbs</td>
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<tr>
<td>Nature Made</td>
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<td>21Vita</td>
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<tr>
<td>Jamieson</td>
<td>21Vita</td>
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</tbody>
</table>

Source: US China Health Products Association. Survey size 1,100.

Further demonstrating the potential of the Blackmores brand inside China are Figure 28 to Figure 31 which show Blackmores has managed to capture a sizeable market share in several product segments in the cross-border, e-commerce channel. (We have used monthly sales volume and pricing data provided by these platforms to calculate Blackmores’ market share in each category.)
Blackmores’ brand strength is really built upon a perception of high quality, and its 80-year history as a VDS company. It frequently rates as the most “trusted” vitamin brand in Australia. In the eyes of the Chinese consumer, quality, safety and authenticity are carefully considered when making VDS purchases. The 2016 Credit Suisse Emerging Consumer Survey showed that 40% of Chinese consumers do not trust the safety or efficacy of local brands.

Blackmores' quality stems from its control procedures in Australia which include,

- A team of 45 people in its quality department (up from 25 in 2012) that undertake final product testing, auditing of manufacturers and suppliers, and formulation of new products amongst other functions. We understand this is the largest quality team in Australia, and possibly one of the largest among global VDS brands.

- Deliberately packing its goods in Australia as a final quality control procedure. Blackmores also packs most of its products in glass packaging which it believes allows for better stability.

- Wherever possible using naturally sourced active ingredients.

- New suppliers undergo an extensive evaluation process. Blackmores recently contracted tablet manufacturing offshore in both Europe and Germany to meet rising demand. The audit process took around six months to complete.

An incident affecting the quality or perceived quality of the Blackmores brands poses a substantial risk to the company. The implications are well demonstrated by the Pan
Pharmaceuticals case in 2003. The Australian Therapeutic Goods Administration (TGA) ordered the recall of over 1,700 products manufactured by contract manufacturer Pan Pharmaceuticals following concerns over "systematic and deliberate manipulation of quality control data". Fortunately, Blackmores was not using Pan Pharmaceuticals as a supplier and actually gained market share from competitors that were. Two competitor brands Nature's Own and Cenovis had to write off around A$20mn worth of inventory. 

Quality is reinforced through market education.

Blackmores’ China marketing strategy will not be too dissimilar to that of Australia – that being to educate consumers in the use of Western style dietary supplements. Over the next 12 months Blackmores is looking to double its China headcount to 60 people, from 30 today. Many of the new hires are likely to be focused on marketing and selling in-store.

In Australia, Blackmores has focused its resources on an education and advisory program. Blackmores employs a team of 50 in-store naturopaths and 80 sales reps in Australia to educate pharmacy staff, sales assistants and health food advisors, as well as the general public. The strategy is to educate the consumer in the correct product use and to build a culture of awareness and loyalty. Many of the incremental hires in China are likely to adopt a similar role.

Blackmores’ marketing approach differs considerably from its Australian-based competitors which have typically relied upon trade spend and above-the-line marketing, particularly TV advertising. For example, Swisse has historically spent 40%–50% of its revenue on advertising; marketing and trade spend, while employee expenses accounted for 7%–10% of its revenue. Blackmore's marketing/trade spend has usually been ~25% of its revenue, while employee expenses have equated to about 20% of its revenue.

Blackmores also leverages its Australian "Blackmores Institute" – a unique research, development and educational platform. Here Blackmores provides seminars and courses to employees in the industry such as pharmacy staff and healthcare professionals. It also undertakes numerous research and development projects in conjunction with universities. In FY15 the institute educated over 25,000 healthcare practitioners.

The company is looking to increasingly use this platform to educate the Chinese VDS industry participants. In 2015, the company held its inaugural Blackmores Institute "symposium" – an event attended by over 200 people including CFDA staff, regulatory experts, pharmaceutical industry representatives and a few key customers. Two further symposiums are being planned for 2016.

China platform – an established presence

Blackmores seems to have the right infrastructure in place to exploit its Chinese retail opportunity. Blackmores’ established local presence was cited as a key competitive advantage by industry participants on our recent trip to China.

Blackmores’ China platform is enhanced by its ownership structure being a Wholly Foreign Owned Enterprise (WFOE). Not only is it a 100% subsidiary of Blackmores Ltd, it gives Blackmores similar legal status to that of a local Chinese company. But perhaps the most important reason for setting up a WFOE is one of perception. In a country where deep business relationships are an integral part of success, a WFOE may demonstrate Blackmores’ commitment to the Chinese market among Chinese regulators, distribution partners and even competitors.

Blackmores did have a few other options available for it to sell into China including appointing a local Chinese distributor, and perhaps engaging in a joint-venture with a Chinese VDS company. There are several benefits to these two business models – local knowledge, access to an existing platform, distribution and other business relationships etc.

A WFOE removes the risk of misalignment amongst parties and gives Blackmores full control over its strategic direction in China. It also protects its intellectual property – mostly
being its formulas and recipes. These factors may outweigh the benefits of a joint venture or a local distribution partner.

It is worthwhile noting that one of Blackmore’s large competitors, NBTY (US based) has opted for a JV structure having signed a 40-60 JV with By-Health earlier in 2016. However, the circumstances driving NBTY’s decision seem somewhat unique to the company in our view. NBTY has had its own Chinese subsidiary since 2005, however sales have languished under stricter enforcement by the CFDA over the past few years. NBTY may have opted for a JV partner to overcome regulatory constraints or take advantage of the new filing system. NBTY is still of reasonable size generating about 1bn RMB (US$150mn) in sales through offline channels in China.

**Key distribution relationships in place**

Blackmores has secured a few key distribution partnerships. Two of China’s largest distributors into the retail pharmacy channel, SinoPharm and Shanghai Pharma are customers of Blackmores in cross-border, e-commerce. Although SinoPharm and Shanghai Pharma have yet to embark on an offline distribution push for Blackmores, we think this is likely to eventuate as Blackmores rounds out its product portfolio in China. Blackmores is also currently selling to Watsons, one of the largest health and beauty chains in China with about 2,500 stores.

**Headcount expansion**

Blackmores is also facilitating a large expansion in headcount and sales presence. At its investor day in May, Blackmores indicated that it will look to open sales offices in the south of China (Guangzhou) and also in the west of China (Chengdu). Over the next 12 months it is planning to double its headcount from 30 to 60. We believe this could grow to over 100 in coming years as Blackmores continues to build its presence through the offline channel.

**Local team well regarded**

Blackmores’ local China team seems to be well regarded. Industry participants acknowledged that Blackmores’ local presence, local hires and understanding of the market should give it a distinct advantage. They pointed to pricing harmonisation across distribution channels as one area that Blackmores’ management has kept under control – at least to a greater extent than its competitors. The challenge for VDS brands has been to ensure consistent pricing across the dozens of direct and thousands of indirect sellers across cross-border, e-commerce distribution channels.

The Chinese business is run by Blackmores’ Head of Asia Peter Osborne, formerly from Austrade and Blackmores’ Head of China, Jason Zhang a Chinese local with extensive experience working with multinational FMCG brands in China.
Investment opportunity: China retail

We believe Blackmores might be able to turn its China retail business into an operation generating US$150mn revenue, selling 40–50 products across 10,000 distribution channels and staffed by 100 people.

We recently had the opportunity to travel to China, meet with a few industry contacts and visit local pharmacies. We found that Blackmores' retail presence, while established, is virtually invisible in the context of a potential US$10bn offline market.

Blackmores' China retail channel business today:

- Sales: A$10mn or less than 5% of Blackmores’ China revenue.
- Product range: About five products in any given pharmacy. In total, Blackmores has managed to register about 15 products in the country under general food regulations; however this is only a fraction of the 500 products it sells in Australia.
- Distribution: 3,200 stores in China – relative to 450,000 pharmacies, 5,000 health/beauty stores, 50–100,000 supermarkets/hypermarkets, 200,000 mother/baby stores exist in the country. Even in Shanghai, we found it difficult to find Blackmores products.
- Blackmores Staff: 30.
- Offices: Shanghai and Beijing.

Blackmores has actually been operating in China since 2012 however we believe that over the past four years growth has been constrained by a very small product portfolio. Like many other foreign VDS brands, Blackmores is yet to obtain a blue hat VDS registration, instead importing a small portfolio under general food regulations.

We believe that Blackmores' narrow product range does not yet justify a significant sales and marketing investment in China to broaden distribution. In Australia, Blackmores supports its range of about 500 products with 7,500 points of distribution, 50 in-store naturopaths and 80 sales reps.

We also imagine that a limited product range could restrict Blackmores' ability to gain shelf space, particularly high frequency areas of the store, or front of aisle promotional displays. Figure 32 and Figure 33 show visually the contrast Blackmores’ range in a Chinese pharmacy to that of one in Australia.

Figure 32: Small amount of shelf space dedicated to Blackmores in a China pharmacy

Figure 33: Blackmores encompasses almost an entire aisle in an Australian pharmacy
The importance of wide-spread distribution and access to shelf space can be highlighted by the success of By-Health, the #4 player in the Chinese VDS market. By-Health has managed to build a US$400mn revenue business in China by growing its distribution footprint to over 40,000 points.

Today Blackmores sells about 15 products under general food regulations, however we believe the orange hat system could see the number of products double or triple. Not only can Blackmores potentially register 22 individual vitamins and minerals but also numerous mixtures. As we highlighted earlier, we would not rule out the CFDA including other products under the new orange hat system. Blackmores has recently launched a new probiotics range and may soon launch a protein supplements range, which may supplement a larger orange hat registered vitamins/minerals range.

We believe that one of Blackmores’ best seller’s – Vitamin E skin cream – could also be launched into the China retail channel. This skin treatment product is among its most popular products both online and in Australia. We estimate it accounts for 25% of the sales on Blackmores’ Tmall flagship store. Demand has grown to ~1 million units per month, relative to <3,000 per month only a few years ago. Humorously, growth ramped when the popular Chinese actress Fan BingBing dropped a tub of Blackmores’ Vitamin E cream out of her bag.

Vitamin E cream falls under China’s cosmetics regulation which has a much simpler and shorter approval process than VDS. Registrations can usually be complete in less than six months.

Currently, supply constraints mean that Blackmores can only service the China market through Australia and the online channels. Blackmores outsources the full production of Vitamin E cream. However, assuming additional supply can be made available, the product could be a key growth driver.

**Case study NBTY – a benchmark for Blackmores’ US$150mn China retail opportunity**

Our estimate of the potential size of Blackmores’ retail business is based on NBTY, a US competitor in the China retail market. NBTY is one of the largest VDS companies globally having generated US$3.3bn in sales in 2015, across Europe, North America and Asia. It has been operating in China since 2005. Over the past ten years, NBTY has managed to build a US$150mn Chinese retail business without a single blue-hat registration. Instead it has sold its brands under general food regulations.

We are confident that Blackmores has the potential to meet NBTY’s US$150mn sales benchmark for a few reasons;

1. The regulatory reform (orange hat registration) should enable Blackmores to register a wide range of products and not solely be confined to those products legal under the food regulations.

2. Our analysis of cross-border, e-commerce data suggests that Blackmores and NBTY are generating a similar level of sales through the platform – despite Blackmores being a far smaller company without a Chinese retail presence.

3. Blackmores also seems to be garnering more interest from Chinese consumers. Figure 34 shows that Blackmores’ is now attracting far more online web searches than NBTY as measured by the Baidu Index – a proxy for search traffic on China’s largest search engine. Here we compare Blackmores and NBTY (using NBTY’s more popular Chinese name 自然之宝).
Figure 34: Blackmores is generating a far higher search index on China's largest search engine Baidu

Source: Baidu Index

Blackmores China offline business potential by FY20

- Sales: US$150mn (A$200mn)
- Distribution: potentially 10,000+ stores
- Product Range: 40–50 Products
- Staff: 100+
- Offices: Shanghai, Beijing, Guangzhou (South), Chengdu (West)
Quantifying A$580mn in China sales by FY20

Our base case assumption is that Blackmores' China business may grow to about A$580mn (US$420mn) by FY20 from a current run rate of A$250mn–$300mn (>90% of which is through cross-border, e-commerce and daigou). This translates to a total market share of about 2.5% in a market that we estimate could be worth ~US$16bn wholesale by FY20.

A 2.5% market share would be consistent with what Blackmores has achieved in some of its other Asian markets. Blackmores currently sells VDS products in about 15 countries throughout Asia with the four largest being Malaysia, Thailand, Hong Kong and Singapore. Figure 35 shows that Blackmores has a 2%–3% market share in three out of four of these countries according to data from Euromonitor.

Figure 35: Blackmores has gained a 2%–3% market share in some SE Asian markets

Source: Euromonitor

Our US$16bn market estimate is based upon near 10% growth continuing in the Chinese VDS market over the next few years. As discussed previously, the Chinese VDS market remains underpenetrated however Chinese consumers are rapidly adopting Western-style dietary supplements – particularly the younger, high income age groups.

We also disaggregated our forecasts by channel:

1) Retail – US$9.5bn by FY20 (from about US$7.5bn today). We assume that Blackmores can develop a US$150mn retail business by capturing ~1.5% market share.

2) Online – including e-commerce and daigou. This market may grow to US$6.5bn by FY20 (from ~US$4bn today) implying Blackmores’ market share is ~4.2%. Slower growth in cross-border, e-commerce may see Blackmores naturally cede share in a fast growing online market.
Figure 36: CS China VDS market forecast and implied Blackmores share

<table>
<thead>
<tr>
<th>US$mn</th>
<th>FY16E</th>
<th>FY20E</th>
<th>% Growth</th>
<th>Comment</th>
</tr>
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<tbody>
<tr>
<td>CS Est. Retail Market Size (Wholesale Value)</td>
<td>7,500</td>
<td>9,500</td>
<td>26.7%</td>
<td>Growth in Retail channel albeit slower than online</td>
</tr>
<tr>
<td>CS Est. Online Market Size (Wholesale Value)</td>
<td>4,000</td>
<td>6,500</td>
<td>62.5%</td>
<td>13% CAGR in online channel</td>
</tr>
<tr>
<td>Total Market</td>
<td>11,500</td>
<td>16,000</td>
<td>39.1%</td>
<td>Near 10% market growth annually</td>
</tr>
</tbody>
</table>

- **Blackmores China Retail Sales**
  - % Share: 0.1% → 1.6%
  - Development of US$150mn retail business

- **Blackmores Online Sales (mainly CBEC and Daigou)**
  - % Share: 4.8% → 4.2%
  - 9% CAGR - driven by Daigou, cede some online share due to cross-border, e-commerce impact

- **Total Blackmores China Revenue US$mn**
  - % Share: 1.7% → 2.6%
  - Near 10% market growth annually

Source: Company data, Credit Suisse estimates

We have also produced a more concise "bottom up" analysis, based on the market share that Blackmores could capture in its largest product segments. We have used data from Euromonitor and adjusted for our estimate of the size of the cross-border, e-commerce/daigou channels to reflect the size of the Chinese VDS market measured by consumer purchases or retail value. We then adjust for retailer margin at ~40% (that of one of China's largest pharmacy chains – Nepstar Drugstore) to get a wholesale estimate.

There are a few categories where Blackmores has a negligible presence such as probiotics, protein supplements and nutritional drinks. Our estimates imply a 2%-3% market share in a few major categories with a higher 11% market share in Blackmores' market leading category – fish oil.

**Vitamins and Minerals** – Blackmores should be able to sell under the new orange hat regime supplementing existing daigou and cross-border, e-commerce volume.

**Herbal/Traditional dietary supplements** – some of these may be able to be sold under general food, supplementing existing daigou volume.

**Fish Oil** – currently sold under general food – albeit with functional claims removed. Supplemented by daigou and cross-border, e-commerce sales.

**Paediatric vitamins and supplements**: many products can be registered as foods/confectionary as well as under orange hat registration.

**Other non-herbal/traditional supplements**: mostly through daigou.

Figure 37: "Bottom up" analysis of Blackmores' China business

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**Paediatric vitamins and supplements**: many products can be registered as foods/confectionary as well as under orange hat registration.

**Other non-herbal/traditional supplements**: mostly through daigou.
We also believe our forecasts are broadly consistent with Blackmore's internal growth ambitions. Although Blackmores has not explicitly stated a China target it has provided a few clues as to how large it expects the business to grow.

Blackmores recently doubled its production capacity to about 70 million bottles per annum in order to meet its future demand. In FY15, Blackmores derived about A$470mn on production of 35 million bottles, equating to about A$13.40 per bottle. On that basis, a doubling of production capacity provides Blackmores with scope to generate a further A$470mn in revenue – most of it from growth in China.

Blackmores' Chairman, Marcus Blackmore also indicated in a press interview (the Australian) that he expects that China could contribute up to two-thirds of the company's revenue over the next five to ten years. That could imply a long-term revenue target of about A$700mn generated from China.
Blackmores' Australia business is now showing improving margins, commands a leading position, and supports exceptional return on capital. It holds c20% retail market share in the A$1.85bn Australian VDS market (retail). It is the #1 player in many of the largest categories including fish oil, non-herbal products, glucosamine and vitamin C. Blackmores has the largest portfolio of VDS products in Australia with 500 items registered.

Australia – Blackmores leads an A$1.85bn (retail) growing market

The Australian VDS market grew 30% in 2015 reaching about A$1.85bn measured as retail sales to consumers. Since 2012, the market has grown 13% CAGR, largely reflecting demand from Chinese consumers – through daigou and also tourists. We believe demand from Australian consumers has grown not more than 3%-4% annually over this time frame which implies that Chinese demand has driven about 80% of the growth. Chinese demand may now account for 25%-30% of the Australian VDS sales.

Australia VDS retail sales could surpass A$2bn in CY16. Blackmores and Swisse started the year well with AUD revenue growth of 59% and 53%, respectively. We suspect there has been a temporary slowdown in the June quarter 2016 arising from cross-border, e-commerce regulatory changes and possible caution on behalf of consumers and daigou. Nevertheless, 1H performance pretty much pushes the Australia VDS market over A$2bn.
**The Australia VDS market is partially consolidated.** The top 5 brands Swisse (owned by BioStime HK), Blackmores, Healthy Care (owned by Nature's Care), Nature's Way (owned by Pharmacare) and Nature's Own (own by Sanofi) account for 56% of the market. The top 5 company market share would be more concentrated — about 60% — given that Sanofi, Pharmacare and Nature's Care also own a few smaller brands. The remaining 40% of the market is split between about 40–50 small brands on our estimates.

Swisse is Blackmore's largest competitor, although the two companies do maintain a reasonable difference in product portfolios. While Blackmores is the leader in several large VDS categories including fish oil, vitamin C, glucosamine, magnesium and Co Q10, Swisse leads the categories of multi-vitamins, krill oil and hair-skin-nail products.

Private label penetration is low accounting for less than 5% of the Australian market, although there are a few quasi private label brands that may be exclusive to a particular retail chain or supplier.

Pharmacy accounts for about 80% of Blackmores' sales in Australia and this channel has historically been the main focus for the company. Blackmores employs ~80 sales reps to service its pharmacy network in Australia, supplemented by ~50 in-store naturopaths. As a consequence Blackmores' share is about 25% in the community pharmacies – higher than its 20% share across all distribution channels.

![Figure 42: About 60% of Australian Non-Prescription health spend is though pharmacy...](source: ASMI)

![Figure 43: ...yet BKL sells about 80% of its products through the pharmacy channel](source: Company data, Credit Suisse estimates)

**Fundamentals in Australia improving**

A few years ago, Blackmores entered a phase when its margins suffered due to the simultaneous emergence of a strong customer (Chemist Warehouse) and a strong competitor (Swisse Wellness). Now, these players are well established and no longer seem to be causing a further drag on Blackmores' margins. Over the past 12 months, Blackmores has managed to increase its EBITDA margins by ~500bps. Trade expenditure has diminished as a percentage of sales; and also channel shift was positive due to strong growth in higher-margin community pharmacy customers.

Between FY10 and 1H15 Blackmores experienced about 10 percentage point of margin erosion. Promotions, rebates and marketing costs grew from nearly 20% of sales in 1H10 to 40% by 1H15. Blackmores' gross contribution margin (sales less COGS less marketing expenditure divided by sales) fell by almost 15pp from 1H10 to 2H13. Trade expenditure and gross contribution margin are shown in Figure 44 and Figure 45.
This margin pressure coincided with two developments in the Australian VDS market

1) **The Rise of High-Volume Discount Pharmacies Exerting Margin Pressure**

One particular pharmacy group, Chemist Warehouse, grew to become Blackmores' largest customer by a wide margin. From only about 15% of Blackmores' Australian sales in 1H10, Chemist Warehouse surpassed 40% in 1H15. Co-incidentally, Blackmores' trade expenditure began to rise and its margins began to fall with Chemist Warehouse's business model built upon a large format and low prices.

And that business model has allowed Chemist Warehouse to gain considerable market share. Since launch in 2005, it has grown to over 300 stores, A$2.7bn revenue equating to about a 20% share of pharmacy sales. In the past four years, it has increased its total revenue by more than 50%.

Chemist Warehouse seems to have done exceptionally well in the VDS category – its share of Blackmores' revenue at ~40% is much higher than its total share of pharmacy revenue (~20%).

2) **The Growth of Swisse Wellness**

FY10 to 1H15 was also characterised by an expansion phase for Swisse Wellness, much of it through its strong partnership with Chemist Warehouse. In FY08, Swisse was a sub A$50mn business and less than one-third the size of Blackmores, however by FY15 Swisse had grown to A$390mn, and its size rivalled that of Blackmores. Swisse's growth was also propelled by its heavy investment in trade spend and above-the-line marketing which equated to 50%–60% of its revenue (compared to Blackmores at 30%).
More recently it seems that both pharmacy price pressure and competitive tension are diminishing, as demonstrated by


2) Blackmores has been generating broader based growth across its customers, particularly its higher margin community pharmacies. The proportion of sales made to Chemist Warehouse (vs. other customers) has fallen about 500bps (from 41% to 36% of BKL’s Australian revenue). Absolute dollar sales to Chemist Warehouse have grown, however sales to other customers appear to have grown at a faster pace.

3) BKL’s trade and promotional spend has also fallen by about 100bps as a percentage of revenue over the past 12 months.

4) Swisse seems to have taken a more disciplined view of its above-the-line marketing expenditure following a restructure during 2014. Advertising and marketing expenses (excluding trade spend) fell from A$45mn in FY13 to A$27mn in FY15 according to filings with ASIC.
Australia – high returns seem sustainable

Industry returns are high and sustainable, in our view. Even during the rise of Swisse and Chemist Warehouse, both Blackmores and Pharmacare (owner of the Nature's Way brand) seem to have maintained relatively high returns over the past few years. With the competitive environment more benign and less pressure from customers we see high-returns being sustained.

Admittedly, Blackmores' ROE fell from about 40% in 2008 to 25% in 2014 – at the peak of customer/competitive pressure. Yet a 25% ROE is excellent – striking well within the top quartile of the ASX 200. With growth in China and margin expansion, Blackmores grew its ROE to nearly 40% in FY15. Blackmores is now on track to generate ~60% ROE in FY16 putting it at the highest of the ASX 200.

Even Swisse managed to generate high returns during its aggressive pursuit of market share. Between FY10 and FY12 Swisse's return on invested capital exceeded 50%. Swisse did incur a small, A$6mn operating loss in FY13 with high marketing spend.

Figure 49: ROE’s have generally been above 20% amongst Australian VDS companies– even during Swisse expansion/rise of Chemist Warehouse

Source: Company data, ASIC filings Credit Suisse estimates

Brand equity is where the value is captured. This is no better demonstrated than BioStime's A$1.67bn purchase of Swisse: out of cash consideration of 6.49bn RMB, 4.5bn RMB was recorded as Goodwill and 2.6bn RMB as intangible assets. Swisse had virtually no PPE or other tangible assets. Actually, the acquisition accounting recorded a negative tangible asset base!

Swisse, like Blackmores and several other competitors are capital light marketing companies with some R&D and product development. Production of tablets is usually outsourced to one of several contract manufacturers in Australia such as Catalent or Lipa Pharmaceuticals.
Option growth: infant formula, Indonesia

While China represents the bulk of our future growth forecast, Blackmores has two other joint ventures that should modestly augment EPS growth – infant formula and Indonesia. Cumulatively these could equate to revenue of ~A$60mn over the next few years, however we have excluded the Indonesian Joint venture from our forecast with limited detail at this point.

Infant formula joint venture with Bega – A$5/sh potential

We see a modest A$5/share opportunity through Blackmores 50-50 Infant Formula JV with Bega Cheese. Formed in October 2015, Bega and Blackmores have partnered together through an arrangement where the infant formula would be manufactured by Bega’s subsidiary Tatura, sold into the JV, and marketed under the Blackmores brand.

The Australian and Chinese infant formula markets are nearly A$27bn combined at a retail level. Figure 50 shows that Chinese demand drove a 70% increase in the Australian infant formula market during FY15 (June y/e) to reach nearly A$600mn. The Chinese infant formula market is nearly 45x the size at A$26bn.

The JV will produce three infant formulas, Blackmores Newborn Formula, Follow-On Formula and Toddler Milk Drink. Products are positioned at the middle price-point level. Blackmores, at A$25–$28/can, is priced on the shelf above Aptamil and S-26 but below that of A2 Platinum, Aptamil Pro.

The infant formula is currently selling in Australian supermarkets and pharmacies with a launch into China slated for late CY16/early CY17. Blackmores has signed a distribution agreement with Leyou Baby Stores which operates about 500 stores throughout mainland China. Blackmores is currently awaiting clearance from Chinese Quarantine and Inspection (CIQ) to sell through the offline channel.

We are cautiously optimistic about the potential success of this joint venture. The joint venture will utilise the Blackmores brand synonymous for its high-quality and deep Australian history. It will also be 100% manufactured in Australia – which is particularly important as from 1 July 2016, food labels in Australia will need to show the percentage of ingredients and manufacturing process that occurs in Australia. Some other brands sold in Australia either import organic milk powder or are actually manufactured in NZ. Blackmores also has the infrastructure in place with which to sell into China including a local subsidiary, headcount and sales presence.

Reviews on Tmall suggest Chinese consumers like the product. The consensus amongst Chinese consumer reviews on Tmall indicates the infant formula is: 1) affordable;
2) flavorsome; 3) high quality; and 4) authentic. It may just be a matter of time before word-of-mouth begins to build and the brand gains traction.

Figure 52: Tmall review comments from Blackmores' Newborn Formula generally positive (translated from Mandarin)

<table>
<thead>
<tr>
<th>Date</th>
<th>Review Comments (Translated from Mandarin)</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/06/16</td>
<td>Baby eats and does not get angry. Yes, next time purchase.</td>
</tr>
<tr>
<td>6/06/16</td>
<td>Like in the store before selling, but here the price is cheap, direct mail is still assured. Mainly baby liked to drink</td>
</tr>
<tr>
<td>6/06/16</td>
<td>Milk received is a genuine original, buy the same as before with the baby also like to eat, cost-effective, next time purchase</td>
</tr>
<tr>
<td>5/06/16</td>
<td>Baby received a very good taste, but baby does not get angry, very good milk powder, value!!</td>
</tr>
<tr>
<td>29/05/16</td>
<td>Milk is genuine, net imports, cannot wait to get the goods to the children to drink, the children liked the taste, satisfaction</td>
</tr>
<tr>
<td>29/05/16</td>
<td>Taste fresh taste good quality no problem is genuine child likes to drink price promotions really not expensive than the store</td>
</tr>
<tr>
<td>28/05/16</td>
<td>Baby liked it, and cheap, store service is very good very satisfied, the next will come satisfied</td>
</tr>
<tr>
<td>24/05/16</td>
<td>Products received great! Rushed to the baby bottle taste is very mellow baby likes to drink! Will come back.</td>
</tr>
<tr>
<td>19/05/16</td>
<td>Satisfied with the final answer is, absolutely genuine, will drink again</td>
</tr>
</tbody>
</table>

Source: Tmall

There are a few challenges ahead. Since a January launch in Australia momentum is yet to accelerate. Blackmores' infant formula captured just 0.1% market share in early May according to industry figures quoted in the Australian Financial Review.

While the market in Australia is large, it is nonetheless competitive and mostly dominated by large multinationals including Danone and Nestle. The two smaller companies that have managed to capture significant share, A2 and Bellamy's seem to have a differentiated infant formula, and also seem to spend heavily in marketing and advertising. Bellamy's markets its product as one of the organic formulations, while A2 claims benefits from the use of the A2 beta casein protein.

Blackmores' infant formula doesn't seem to have any particularly strong differentiation from a purely product point of view (branding and access to market are another matter). It is not the least expensive product on the shelf either.

Blackmores is also not alone in launching its own infant formula range during 2016. Recently we have seen new infant formulas from Devondale (owned by Murray Goulburn) and Kids Smart/Nature's Way (owned by Blackmores' VDS competitor Pharmacare).

The Chinese market is in some respects, more competitive than Australia. It has both large multinationals (Nestle, Danone, Abbott Laboratories, Mead Johnson Nutrition) and large local players (Beingmate, Mengniu, Daqing). While the market is large (A$26bn), margins are low, and even capturing a 0.5% market may not be an easy task.

New regulation should however assist Blackmores' entrance into the China infant formula market. The CFDA has released new measures for the registration of infant formula from 1 October, 2016 with a three-year grace period until 1 January 2018. Under the new regulations, infant formula manufacturers, both domestic and offshore will only be able to produce a total of nine infant formulations. This effectively means that each infant formula manufacturer can only produce for three customers, as each brand usually holds three formulations for each stage of infant nutrition (0–6 months, 6–12 months, 1–3 years).

Currently there are about 2,000 infant formula brands in China, amongst about 100 domestic manufacturers and 66 overseas manufacturers. These new regulations may only provide for a maximum of ~500 (166 manufacturers x 3 customers/brands) infant formula brands in the Chinese market. That would imply that ~75% of the brands on the market could be removed.
It may also mean that domestic and offshore infant formula manufacturers may need to consolidate its customer base into its three largest/most profitable. Fortunately for Blackmores, its joint venture with Bega should insulate it from these regulatory changes. It is fair to assume that the JV will remain one of Bega's three infant formula customers. Small 'virtual' brand owners may find it difficult sourcing infant formula. Investment in proprietary infant formula manufacturing capacity seems an unlikely option for many small entities as the minimum investment would be at least A$100mn.

Our base case assumption is that the JV can sell 3.2 million cans of infant formula by FY20, equivalent to A$60mn in revenue and ~A$12mn in EBITDA (Blackmores may consolidate 50%). While that may appear substantial, we would note our estimates might only equate to:

1) 3% Australian market share and less than 0.2% share in China – assuming that each market continues to grow at a double-digit rate.

2) The JV grows to less than one-sixth the size of A2 milk and Bellamy's infant formula business by FY20 based on consensus estimates for each company.

Our DCF values the venture at A$5 per Blackmores share. At the 100% level, we value the venture at about A$155mn, or 13x FY20 EBITDA which is broadly consistent with the one- to two-year forward trading multiple across comparable infant formula companies (A2, Bellamy's, MJN, Danone and Nestle.)

Indonesia: An A$1.4bn VDS market not factored in

Blackmores is looking to expand its presence in the A$1.4bn Indonesian market through a distribution joint venture with Kalbe-Farma, Indonesia's largest pharmacy distributor. Overall, the JV might be able to generate A$30mn–$40mn in revenue annually over the next few years, in our view. However, we have not yet built this revenue into our forecasts given the limited detail at this point.

Today the Indonesian VDS market is dominated by several of the large US VDS brands including Nature's Plus, GNC and Nature's Bounty. There are also a few local suppliers with reasonable scale.

Initially, Kalbe Farma will distribute Blackmores existing products in the country. There are also plans to create a joint venture and launch about 23 new products in the country. Indonesian press (Jakarta Globe) indicated that the joint venture is targeting about 100bn IDR of sales (A$10mn) in the first year. That seems achievable, albeit requiring a decent sales push by Kalbe Farma.

Other elements of the Blackmores–Kalbe Farma relations remain unclear at this point. The same Indonesian press quoted Kalbe Farma's management as contemplating an US$8mn–$10mn vitamins production plant in Jakarta to be built by 2018. Blackmores, however is yet to disclose details of such a plant and it would be somewhat at odds with its strategy of restricting production to Australia to ensure quality control.

It may be that Kalbe is contemplating its own VDS production, subsequent to its distribution/JV agreement with Blackmores. Kalbe's is quite large in other areas of consumer health such as OTC drug, nutrient beverages and also has its own range of health food products.

Blackmores had a presence in Indonesia previously. Blackmores engaged PT Indocare Citra Pacific in 1994. From what we can tell, Indocare was, and still is, a multi-level marketing brand or direct seller, which differs considerably to Blackmores' traditional wholesaler and retailer selling model. Growth was initially strong however business was affected by the Asian Financial Crisis in 1997 and didn't really recover until 2000. We don’t believe that Indonesia has ever grown to surpass A$10mn in revenue – not a meaningful part of Blackmores' sales.
Valuation and forecast suggest good value at current price

We regard Blackmores as inexpensive, given the share price is only implying 8% EPS CAGR FY16–FY20. Our A$175/share DCF based target price assumes that Blackmores’ EBITDA can eventually grow to about A$268mn by FY20 (from A$155mn in FY16) mostly due to growth in China. With minimal debt, and D&A, EPS could grow 16% CAGR to FY20

To derive a valuation of A$136/share (Blackmores current share price), would require

1) No growth in the Chinese "indirect" demand through Australia (mainly daigou).
2) 450bps reduction in Australia segment EBIT margin, assuming that either a higher marketing budget is required to support growth or that in a slower growth environment pricing comes under pressure.

Pages 15-18 detail why we believe China "indirect demand" through daigou should continue to grow as new regulations i.e. the 'Positive List' may only affect the cross-border, e-commerce channel which accounts for 25% of Blackmores' China revenue.

We anticipate that Australian segment EBIT margins should continue to expand given a reasonable degree of operating leverage in the business and improving industry structure, albeit at a slower pace than prior years. Blackmores grew its Australian EBIT margin from about 15% in 1H14 to 27% in 1H16 on a doubling of revenue which equated to an incremental EBIT margin of ~40%. Our estimates incorporate about 150bps of EBIT margin in the Australian segment assuming that Blackmores can generate 6%–7% CAGR revenue growth FY16–FY19.

Pages 21-30 detail why we believe China "direct revenue" should continue to grow. We indicated scope to generate US$150mn (A$200mn) in revenue through the Chinese offline channel as Blackmores launches new products, expands its distribution presence and builds its headcount.

Our A$175/share DCF based target price translates to 19x FY19 EPS, implying a modest re-rating from Blackmores' current multiple of 17x FY18 EPS. However we feel a modest re-rating is justified by:

- Untapped US$150mn (A$200mn) potential in the Chinese offline VDS market and confidence in the sustainability and growth of existing A$250mn–$300mn in revenue generated through daigou and cross-border, e-commerce channel.
- High returns and growth, yet low P/E relative to ASX comps: Figure 53 shows that Blackmores has consistently generated amongst the highest ROE in the industry and it is also on track to generate the highest ROE in the ASX 200 in FY16 at ~60% (Figure 54). Yet Figure 55 shows 30 other ASX 200 industrials that are trading on a higher P/E, with both lower returns and lower forecast EPS growth.
- Blackmores is trading at a discount to fellow China exposures; BioStime, Conba and By-Health seem to be in the range of 18.5–21x FY18 EPS – as compared with Blackmores at 17x FY18 EPS. More specifically, BioStime could be implying a multiple of close to 19–20x for Swisse, given that growth prospects and margins seem higher in that business relative to its staple – infant formula.
Figure 53: Blackmores has consistently generated amongst the highest ROE in the industry…

Figure 54: … and it is on track to generate the highest ROE in the ASX200

Figure 55: … yet 30 other ASX industrials are trading on a higher P/E with lower EPS growth and Lower ROE (Black Circles)
We value Blackmore’s China business at ~A$1.85bn or ~60% of its enterprise value. While discounted cashflow is our primary valuation technique, it is somewhat difficult to disaggregate segment wise cashflow and earnings given the interconnectedness with the Australian business. Our sum-of-the-parts in Figure 57 attempts to capture the value of each of Blackmore’s major revenue streams using peer or historical based EV/EBITDA multiple approach.

Figure 57: Blackmores sum-of-parts valuation – China ~60% of the enterprise value

<table>
<thead>
<tr>
<th>Segment</th>
<th>FY18 Revenue</th>
<th>FY18 EBITDA</th>
<th>EBITDA Value</th>
<th>$/Share</th>
<th>% EV before corporate</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia base-business</td>
<td>274.7</td>
<td>66.6</td>
<td>11.0x</td>
<td>735.1</td>
<td>$43.0</td>
<td>23.9%</td>
</tr>
<tr>
<td>China - direct and indirect</td>
<td>368</td>
<td>116</td>
<td>16.0x</td>
<td>1,861.4</td>
<td>$108.8</td>
<td>60.4%</td>
</tr>
<tr>
<td>BioCeuticals</td>
<td>112.8</td>
<td>23.1</td>
<td>11.5x</td>
<td>266.4</td>
<td>$15.6</td>
<td>8.6%</td>
</tr>
<tr>
<td>Asia ex China</td>
<td>92.9</td>
<td>11.2</td>
<td>12.5x</td>
<td>139.4</td>
<td>$8.1</td>
<td>4.5%</td>
</tr>
<tr>
<td>NZ &amp; Paw</td>
<td>24.9</td>
<td>1.5</td>
<td>12.0x</td>
<td>17.6</td>
<td>$1.0</td>
<td>0.6%</td>
</tr>
<tr>
<td>Infant Formula (50% share - FY19)</td>
<td>27.0</td>
<td>4.6</td>
<td>13.5x</td>
<td>62.3</td>
<td>$3.6</td>
<td>2.0%</td>
</tr>
<tr>
<td>Corporate</td>
<td>N/A</td>
<td>(-13.9)</td>
<td>11.0x</td>
<td>(-152.6)</td>
<td>$(-8.9)</td>
<td>N/A</td>
</tr>
<tr>
<td>Total</td>
<td>930.5</td>
<td>204.5</td>
<td>14.3x</td>
<td>2,929.6</td>
<td>$171.2</td>
<td></td>
</tr>
</tbody>
</table>

Less net debt (cash) FY17: $(-27.2) ($1.6)

Equity value: $2956.9 $172.8

Shares outstanding: 17.1

Source: Credit Suisse estimates
Base case assumptions A$175/share valuation

Our base case A$175/share valuation incorporates the following:

- **BKL’s Chinese business growing to A$580mn in revenue** – consistent with previous discussion.
- **2%–3% growth in underlying Australian volumes** consistent with a mature VDS market that already has one of the highest, per-capital VDS consumption rates in the world.
- **5%–7% FY16–FY18 growth in BioCeuticals** benefiting from some Chinese demand, but also new product launches. This excludes the acquisition of Global Therapeutics which should add about A$21mn to BioCeuticals group revenue in FY17 with growth.
- **7%–10% local currency growth in Thailand and Malaysia**, BKL’s largest Asian markets apart from China. We take the view that Blackmores is likely to grow at an industry growth rate given that it has been operating in both countries since the 90s.

**Figure 58: China drives most of our future expected revenue growth.**

Margins should continue to expand as BKL grows volume and a direct presence in China. Although Blackmores is investing in its China business and adding headcount across the group, we believe that revenue growth will be somewhat ahead of growth in Blackmores’ cost base. Overall our estimates capture about 200bps of group margin expansion between FY16 and FY19.

Blackmores has three large cost centres – COGS/Raw materials, marketing/trade spend and headcount.

- **COGS**: We expect that VDS gross margins should hold steady at ~69% with the efficiency of volume growth offset by: 1) higher raw material costs from a lower AUDUSD (Blackmores’ contracts typically have a one-year lag in pass through); and 2) some potential margin dilution from the global therapeutics acquisition (EBIT margins of 15% versus group average 21%).

Growth in the infant formula business may cause about 100bps in gross margin dilution. Infant formula gross margins are typically ~30%–40%.

- **Marketing and trade spend** – assumed to be held at a similar % of sales to 1H16, ~24%–25% with improvement in the Australian operating environment.
Headcount: our model incorporates a significant increase in headcount over the next four years, particularly in Blackmores Asian business. We assume 250 new hires by FY20 – mostly in sales/marketing within Asia.

Our estimates incorporate 16% CAGR EPS growth FY16–FY20, most of the growth in EBITDA should filter through to the bottom line. D&A should not grow substantially with minimal capex required to support Blackmores' growth ambitions. Interest costs are likely to reduce, and may perhaps turn into a source of income given that Blackmores should end FY16 with A$30mn net cash. Blackmores’ effective tax rate is assumed to remain near 30%.

Figure 59: Blackmores P+L

<table>
<thead>
<tr>
<th>A$mn</th>
<th>FY14A</th>
<th>FY15A</th>
<th>FY16F</th>
<th>FY17F</th>
<th>FY18F</th>
<th>FY19F</th>
<th>FY20F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>346.8</td>
<td>471.6</td>
<td>706.2</td>
<td>810.5</td>
<td>920.9</td>
<td>1,036.5</td>
<td>1,161</td>
</tr>
<tr>
<td>Australia</td>
<td>221.5</td>
<td>317.4</td>
<td>488.5</td>
<td>525.7</td>
<td>553.4</td>
<td>591.1</td>
<td>625.2</td>
</tr>
<tr>
<td>BioCeuticals</td>
<td>47.2</td>
<td>55.5</td>
<td>69.6</td>
<td>102.9</td>
<td>112.8</td>
<td>120.8</td>
<td>123.2</td>
</tr>
<tr>
<td>Asia</td>
<td>66.6</td>
<td>84.0</td>
<td>125.0</td>
<td>150.3</td>
<td>212.4</td>
<td>273.4</td>
<td>356.2</td>
</tr>
<tr>
<td>NZ &amp; Paw</td>
<td>13.1</td>
<td>15.5</td>
<td>22.3</td>
<td>23.7</td>
<td>24.9</td>
<td>25.9</td>
<td>26.7</td>
</tr>
<tr>
<td>Infant Formula</td>
<td>0.0</td>
<td>0.0</td>
<td>1.8</td>
<td>9.3</td>
<td>18.9</td>
<td>27.0</td>
<td>31.4</td>
</tr>
<tr>
<td></td>
<td>(-1.6)</td>
<td>(-0.8)</td>
<td>(-1.0)</td>
<td>(-1.4)</td>
<td>(-1.6)</td>
<td>(-1.7)</td>
<td>(-1.7)</td>
</tr>
<tr>
<td>EBITDA</td>
<td>46.1</td>
<td>78.7</td>
<td>152.7</td>
<td>178.3</td>
<td>204.5</td>
<td>235.0</td>
<td>268.4</td>
</tr>
<tr>
<td>Depreciation and Amortisation</td>
<td>(-6.3)</td>
<td>(-6.4)</td>
<td>(-7.0)</td>
<td>(-7.5)</td>
<td>(-7.9)</td>
<td>(-9.6)</td>
<td>(-10.1)</td>
</tr>
<tr>
<td>EBIT</td>
<td>39.8</td>
<td>72.3</td>
<td>145.6</td>
<td>170.8</td>
<td>196.6</td>
<td>225.4</td>
<td>258.3</td>
</tr>
<tr>
<td>Australia</td>
<td>34.1</td>
<td>64.3</td>
<td>132.9</td>
<td>146.9</td>
<td>154.6</td>
<td>166.5</td>
<td>177.6</td>
</tr>
<tr>
<td>BioCeuticals</td>
<td>6.8</td>
<td>8.7</td>
<td>11.8</td>
<td>19.2</td>
<td>22.9</td>
<td>25.6</td>
<td>26.1</td>
</tr>
<tr>
<td>Asia</td>
<td>4.6</td>
<td>8.3</td>
<td>11.8</td>
<td>16.2</td>
<td>29.8</td>
<td>42.0</td>
<td>62.5</td>
</tr>
<tr>
<td>NZ &amp; Paw</td>
<td>(-1.3)</td>
<td>(-0.3)</td>
<td>1.1</td>
<td>1.4</td>
<td>1.4</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Infant Formula</td>
<td>0.0</td>
<td>0.0</td>
<td>(-0.7)</td>
<td>0.3</td>
<td>1.8</td>
<td>4.6</td>
<td>6.1</td>
</tr>
<tr>
<td>Corporate</td>
<td>(-4.4)</td>
<td>(-8.7)</td>
<td>(-11.3)</td>
<td>(-13.2)</td>
<td>(-13.9)</td>
<td>(-14.6)</td>
<td>(-15.4)</td>
</tr>
<tr>
<td>Net Interest</td>
<td>(-4.8)</td>
<td>(-3.4)</td>
<td>(-1.2)</td>
<td>(-0.6)</td>
<td>(-0.4)</td>
<td>(-0.6)</td>
<td>0.0</td>
</tr>
<tr>
<td>Profit before Tax</td>
<td>35.0</td>
<td>68.8</td>
<td>144.4</td>
<td>170.2</td>
<td>196.1</td>
<td>224.8</td>
<td>258.3</td>
</tr>
<tr>
<td>Tax Expense</td>
<td>(-9.5)</td>
<td>(-22.3)</td>
<td>(-44.1)</td>
<td>(-51.0)</td>
<td>(-58.8)</td>
<td>(-67.5)</td>
<td>(-77.5)</td>
</tr>
<tr>
<td>Minorities/associates</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>NPAT</td>
<td>25.4</td>
<td>46.6</td>
<td>100.4</td>
<td>119.1</td>
<td>137.3</td>
<td>157.4</td>
<td>180.8</td>
</tr>
<tr>
<td>EPS c</td>
<td>149.2</td>
<td>269.1</td>
<td>582.3</td>
<td>695.9</td>
<td>802.1</td>
<td>919.3</td>
<td>1,055.9</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse estimates

Blue sky and grey sky scenarios

The main risk to our target price stems from how Blackmores’ future China growth may eventuate.

Grey sky – A$95/share

Regulatory risk in the daigou trade represents one of the greatest risks to our target price. We derive a bear case A$95/share valuation with the following assumptions:

- A 30% reduction in Australian indirect sales (mainly daigou) in FY17 and FY18 from current levels.
- Australian segment EBIT margins fall 500bps to 23% assuming lower pricing is required to clear inventory or pricing pressure from retail customers.
- US$100mn in China retail sales vs. our base case of US$150mn.
- Group NPAT falls to A$92mn in FY18 from A$100mn in FY16, before growing low single-digits into perpetuity.
- Return on invested capital (ROIC) falls from 60% in FY16 to 42% by FY20.

**Blue sky scenario – A$205/share**

A blue sky scenario whereby Blackmores is able to gain an additional 100bps of market share in the US$10bn Chinese retail VDS market could yield a valuation of A$205/share. This would be equivalent to about US$100mn (A$130mn) in revenue, and perhaps US$35mn (A$47mn) in EBITDA.

Our current assumption implies that Blackmores’ only captures 1.5% China retail market share by FY20, however it is plausible that market share gains exceed our forecast given that Blackmores is already transacting a higher market share in online channels within China.

**Key Valuation Parameters**

- **WACC of 8% consisting of**
  - 3% risk free rate (current Australian 10 year government bond is lower at 2%)
  - 5.5% market risk premium
  - Beta of 1.15 – higher than Blackmores’ historical Beta of 0.6–0.7. We feel that growing exposure to China also inherently carries greater risk and hence we assign a higher Beta.
  - **Long-term growth** of 2% – consistent with a mature vitamins market growing at roughly the rate of population growth in both Australia and China.
  - 5.5% pre-tax cost of debt.

**Key Sensitivities**

**FX – natural hedge**

One of Blackmores’ strategies is to create a natural hedge from its USD raw materials. With our current projected growth for China, Blackmores should largely be able to achieve that target.

About one-third of Blackmores’ COGS relate to raw materials, the majority of which is sourced in USD. By our calculations, Blackmores’ exposure to USD raw materials might be about US$75mn by FY19 based on our current projections. In addition, Blackmores may have a local China cost base of CNY400mn (US$60mn) consisting of 100 staff, sales and marketing cost and other overheads. In essence, Blackmores’ total USD exposure is about US$135mn.

By FY19, we assume Blackmores’ can achieve on-shore revenue in China of CNY820mn or US$120mn (A$170mn).

Therefore, by FY19, USD revenues will be very similar to USD costs for the Blackmores Group.
Other key sensitivities

Figure 60: Blackmores key sensitivities

<table>
<thead>
<tr>
<th>Sensitivity</th>
<th>FY18–FY19 EPS Impact</th>
<th>Valuation Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>100 bps change in EBIT margin from FY18</td>
<td>4.5%</td>
<td>4%</td>
</tr>
<tr>
<td>100 bps movement in FY17–FY19 revenue growth (maintaining cost base assumptions)</td>
<td>3-5%</td>
<td>6%</td>
</tr>
<tr>
<td>100 bps change in FY20+ earnings growth</td>
<td>N/A</td>
<td>6%</td>
</tr>
<tr>
<td>100 bps change in WACC</td>
<td>N/A</td>
<td>13%</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse estimates

Cash flow/balance sheet: solid shape

Strong cash flow generation has provided Blackmores with an excellent balance sheet. The company is net cash and has ample room to fund either a capital return (more likely a special dividend) or perhaps add a few bolt-on acquisitions.

Even with A$50mn in capex assumed in FY18, Blackmores could support an A$200mn special dividend (A$11/share) and still maintain its leverage below 1x net debt to EBITDA, although it may not have enough surplus franking credits to fully frank a special dividend. In our view a buyback is unlikely given Blackmores' high P/E. Even an A$100mn buyback at A$140/share would not be EPS accretive.

Further acquisitions are possible however it is only likely to be small, i.e. <A$50mn. Blackmores has usually acquired into areas where it has only a negligible or small presence such that an acquisition can boost its product range. That has was the case with BioCeuticals (A$40mn acquisition) and more recently Global Therapeutics (A$23mn acquisition).

Figure 61: Blackmores should be net cash by FY16 year end

Source: Company data, Credit Suisse estimates

Cash flow

Blackmores is a highly cash generative company and our forecasts currently capture a future cash flow conversion ratio of about 95%. We define this as operating cash flow before interest and tax divided by EBITDA.

Historically this ratio has varied between about 80%–115%; although cash flow conversion above 100% is unlikely to be sustained. During FY14/FY15, strong demand and a shortage in supply allowed for the release of working capital. Blackmores also negotiated far better payment terms as it renewed supplier contracts during FY15. From FY14 to FY15, days payable increased from 80 to 97.
Blackmores now seems to be largely on top of issues in supply and future supply renegotiations are unlikely to be as favourable. Working capital movements may therefore be a slight cash drain during 2H16.

**Figure 63: Blackmores cash flow statement**

<table>
<thead>
<tr>
<th></th>
<th>FY14A</th>
<th>FY15A</th>
<th>FY16F</th>
<th>FY17F</th>
<th>FY18F</th>
<th>FY19F</th>
<th>FY20F</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>39.8</td>
<td>72.3</td>
<td>145.6</td>
<td>170.8</td>
<td>196.6</td>
<td>225.4</td>
<td>258.3</td>
</tr>
<tr>
<td>Depreciation and Amortisation</td>
<td>6.3</td>
<td>6.4</td>
<td>7.0</td>
<td>7.5</td>
<td>7.9</td>
<td>9.6</td>
<td>10.1</td>
</tr>
<tr>
<td>Net Interest</td>
<td>(-4.8)</td>
<td>(-3.4)</td>
<td>(-1.2)</td>
<td>(-0.6)</td>
<td>(-0.4)</td>
<td>(-0.6)</td>
<td>0.0</td>
</tr>
<tr>
<td>Tax Paid</td>
<td>(-6.9)</td>
<td>(-14.8)</td>
<td>(-43.3)</td>
<td>(-51.0)</td>
<td>(-58.8)</td>
<td>(-67.5)</td>
<td>(-77.5)</td>
</tr>
<tr>
<td>Working Capital</td>
<td>2.9</td>
<td>10.6</td>
<td>(-15.5)</td>
<td>(-10.8)</td>
<td>(-15.8)</td>
<td>(-16.8)</td>
<td>(-18.4)</td>
</tr>
<tr>
<td>Other</td>
<td>0.5</td>
<td>0.5</td>
<td>6.8</td>
<td>2.3</td>
<td>7.1</td>
<td>7.5</td>
<td>8.0</td>
</tr>
<tr>
<td>Operating Cash Flow</td>
<td>37.8</td>
<td>71.6</td>
<td>99.6</td>
<td>118.1</td>
<td>136.4</td>
<td>157.6</td>
<td>180.5</td>
</tr>
<tr>
<td>Capex</td>
<td>(-4.7)</td>
<td>(-3.6)</td>
<td>(-10.0)</td>
<td>(-7.9)</td>
<td>(-58.3)</td>
<td>(-8.9)</td>
<td>(-9.4)</td>
</tr>
<tr>
<td>Acquisitions</td>
<td>0.0</td>
<td>0.0</td>
<td>(-21.0)</td>
<td>0.0</td>
<td>(-2.0)</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other investing cash flow</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Free cash flow</td>
<td>33.2</td>
<td>67.9</td>
<td>66.6</td>
<td>110.3</td>
<td>76.1</td>
<td>148.7</td>
<td>171.1</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse estimates

**Capex and investment**

Blackmores underlying maintenance capex appears to be in the vicinity of A$4mn–$5mn per annum – a relatively small amount in the context of about ~A$120mn in operating cash flow forecast for FY17. Blackmores' "growth" capex requirement is also not substantial – a doubling of capacity at Blackmores' Warriewood production facility only incurred about an A$8mn investment.

Based on our current forecasts Blackmores may fill its existing capacity by FY18, which equates to a doubling of volume from a base in FY15. While we see Blackmores' exceptional returns as being sustainable, we are cognisant that the incremental return on future capital spend may not be as generous as it has been in FY16. Blackmores has invested about A$10mn on new equipment that effectively allows it to double its EBIT.

Therefore we have assumed that the next round of capacity expansion might entail a larger spend of ~A$50mn. Blackmores may, at some stage contemplate a make versus buy decision in the context of production of tablets which is currently outsourced to about five contract manufacturers. Outsourcing limits Blackmores' maintenance capex to about A$3mn per annum.

Blackmores also seems to be rapidly outgrowing its Warriewood facility in Sydney Australia. Over the past 12 months it has hired an additional 100 people in Australia and it has reportedly run out of office space (SMH).

A dedicated Greenfields production plant including internal tablet manufacturing may cost on the order of US$80mn–$100mn (A$112mn–$140mn) judging by a recent plant built by Amway in the US.
Manufacturing, raw materials, distribution

Blackmores should be predominantly viewed as a brand and marketing company, with its manufacturing really limited to packing, labeling and distribution. The bulk of the production process – gel and tablet manufacturing – is outsourced to a number of third-party contract pharmaceutical manufacturers such as Lipa Pharmaceuticals, Catalent and Alpha Laboratories (NZ). This effectively frees up capital/capex requirements as BKL only really needs to maintain packaging, warehousing and distribution infrastructure. Blackmores' maintenance capex is only about A$3mn per annum. Capacity has been tight amongst Australian contract manufacturers from the recent spike in Australian vitamin and nutritional supplement demand.

Two of Blackmores' Australian competitors, Vitaco and Nature's Care, operate their own internal manufacturing, although we understand that Vitaco still outsources about 40% of its production (mainly soft-gel capsules). Both Vitaco and Nature's Care claim that internalised manufacturing/vertical integration assists quality control, flexibility and speed to market, although we are less certain that these benefits completely outweigh the addition of a large fixed cost base. Vitaco for example undertakes third-party manufacturing in order to better utilise plant capacity.

Tight local manufacturing capacity is unlikely to restrict Blackmores tablet supply. More recently, Blackmores has begun to source manufactured tablets from suppliers in Germany and Canada. Globally, there is surplus capacity in tablet manufacturing and tight capacity seems largely confined to Australia. In December 2015, Catalent disclosed that its global soft-gel capacity utilisation was below 50%. Vitaco, which also provides some third-party contract manufacturing, indicated its tablet and hard shell capacity utilisation was 50% and 60%, respectively. Globally, contract pharmaceutical manufacturers tend to operate with spare capacity to maintain sufficient short-term flexibility in responding to demand fluctuations.

Blackmores has recently doubled packing, warehousing and distribution capacity. Prior to this expansion, packing capacity was constrained however press reports (SMH) indicate that Blackmores' Warriewood facility will now be able to fill about 4.2 million bottles per month, up from about 2.7 million in FY15 (+60%). Blackmores has said that its total operational capacity across all areas of its supply chain will have roughly doubled by the end of FY16.

We estimate Blackmores will spend total capex of ~A$10mn on the following capacity expansion initiatives during FY16:

1) Upgrade from single head tablet filling to double, triple or quadruple head fillers.
2) Automation of packing machinery.
3) Relocation of some distribution to Blackmores' warehouse in Western Sydney to free up distribution capacity at Warriewood.

From June 2015, Blackmores also moved to a 24x5 packing operation as well as one additional shift on a Saturday from June 2015.

We also believe that Blackmores may at some stage contemplate shifting some production equipment to its Western Sydney Distribution centre given that it is fast outgrowing the size of its Warriewood facility.

We estimate Blackmores has enough packing/warehouse capacity until FY18, based upon our current growth forecasts. Beyond that, we have factored in about A$50mn in capex assuming that Blackmores may also in-source some of its tablet manufacturing given that it now uses five separate suppliers.
Blackmores packs about 90% of its goods internally. Of the remaining 10%, a reasonably large portion is its Vitamin E skin cream, which it fully outsources to several suppliers.

Blackmores' cost of goods sold is equally split between:
- Raw materials and ingredients, of which about half are sourced in USD.
- Outsourced production/tablet manufacturing costs.
- Internal production costs including packing and warehousing.

About 95% of Blackmores' active ingredients are sourced offshore. Blackmores has a diverse range of raw materials and active ingredients used in its products and we understand that its exposure to any single raw material is not substantial – i.e. > 10% of its cost of goods.

Key risks

- **A change in Chinese regulation**: As discussed previously, we see the largest risk to our investment case as any change in Chinese regulation that affects the daigou channel which accounts for 70% of Blackmores' China volume. The introduction of the "Positive List" in Blackmores' smaller cross-border, e-commerce channel highlights that regulatory changes in China can often be sudden, vague and adversely impact earnings. At this stage, we do not see this regulation significantly impacting daigou although further regulatory changes do remain a risk.

- **Deterioration (or improvement) in Australian industry structure**: While we see the Australian operating environment improving, this does not rule out risk to Blackmores' Australian segment earnings, particularly if Chinese demand slows. Some competitors have invested significantly in capacity expansion to meet growing demand. Blackmores' largest Australian customer still accounts for 36% of its Australian revenue.

- **Raw material shortages** – the surge in Chinese demand over the past 18 months caused some supply issues in some of Blackmores' key products such as Evening Primrose Oil. Sustained supply shortages could cause loyal customers to seek out alternative brands, although Blackmores has recently looked to address raw material shortages and diversify its supplier base.

- **Quality** – Blackmores' brand is built upon a reputation of high quality and it frequently ranks as the most trusted brand in Australia. The Pan Pharmaceuticals case highlighted the risks to a VDS brand if quality was compromised with those brands implicated losing market share and having to write off inventory (Blackmores was not implicated). Contamination, product recalls or other issues in quality do pose a risk.

Environmental, Social and Governance

**Summary of ESG issues**

- We only see regulatory risk and supply shortages as major ESG concerns.

- Regulatory risks mainly stems from China which accounts for ~60% of our Blackmores valuation. We do not incur any ESG related target price risks with limited visibility on future regulatory changes, however our grey sky scenario valuation of A$95/share assumes that regulatory changes in China significantly impacts the daigou channel and also assumes less favourable development of Blackmores' China retail sales.

- We believe that Blackmores' remuneration structure could be enhanced with additional STI and LTI measures such as cashflow, working capital, total shareholder and return on invested capital. The vast majority of STI and LTI are awarded on the basis of NPAT growth which can be subject to changing accounting treatment of items such as...
depreciation and capitalised interest. NPAT also does not take into account the dilution effect of capital raisings.

- Marcus Blackmore, as the majority shareholder (25.2% shares on issue), and Executive Chairman, has the potential to exert substantial influence over the company. We do however accept Mr. Blackmore’s value to the company being part of the founding family and his long board tenure and experience in running Blackmores.

Environmental issues

- Supply shortages of products: Many of Blackmores’ key raw materials range are either grown or harvested and therefore raw materials can often be in short supply, particularly with the recent surge in Chinese demand. One product in short supply has been Evening Primrose Oil where Blackmores estimates that it buys 50% of the world’s supply annually and it is an ingredient that is harvested once a year. While product shortages are always a risk, we note that Blackmores has a diverse range of 500 products that should provide some diversity to raw material shortages in individual cases. Blackmores has also looked to address the issue of product shortages by seeking out alternative sources of supply.

- Sustainably sourced Fish Oil: Fish Oil is amongst Blackmores’ largest sellers in a segment where it holds 30% market share in Australia. In recent years, global demand for omega 3 fish oil – both for vitamins and dietary supplements (VDS) and also aquaculture – has outstripped supply, which may raise the question as to whether it may be exacerbating the issue of overfishing. To address this issue Blackmores partnered with the World Wildlife Fund (WWF) to meet its highest standard of sustainability in its Fish Oil.

- Lack of environmental and social disclosure: Despite Blackmores having strong sustainability credentials (e.g. sustainable sourcing, environmental sponsorships, etc.) we found it difficult to locate key sustainability data such as energy/water use, greenhouse gas intensity and safety. Blackmores has said that will implement an environmental management system and publish its first sustainability report during FY16.

- Blackmores manufactures in Australia providing it with better visibility and quality control over its manufacturing process. We also consider Blackmores’ Australian manufacturing as a key strength with its perceived quality sought out by Chinese consumers.

Social issues

- Regulatory risk is large for Blackmores particularly in China where regulatory changes can often be immediately averse. The recent changes to cross-border, e-commerce significantly reduced VDS demand through this channel virtually overnight. Equally however, there has been legislation in China that should dramatically improve Blackmores’ prospects in the US$10bn offline retail channel. A new method of registering products should allow Blackmores to substantially increase its product range through this channel. The cumulative effect of regulatory changes so far do not detract from our long-term view of Blackmores’ prospects in China, although we are cognisant that sudden regulatory changes could dramatically alter the investment case.

- Blackmores’ brand is built on quality and a contamination or product recall could harm that perception in the eyes of the consumer. One notable example was the Pan Pharmaceuticals case in 2003, where an Australian contract tablet manufacturer was found to have manipulated quality control data by the TGA and a large product recall was initiated. Blackmores actually saw its sales increase 20% in 2004 as it was not involved in this incident. Blackmores has built one of the largest quality control teams in Australia, if not one of the largest in the world for a VDS supplier.
Blackmores adheres to manufacturing in a TGA approved facility according to the International Pharmaceutical Inspection Convention and Co-operation schemes standards of Good Manufacturing Practice (GMP)

- **Corruption/unethical dealing could be a risk** with Blackmores’ growing exposure to China. Transparantly International Ranked China at 83 out of 168 countries in its 2015 Corruption Perceptions Index. In Blackmores’ case, this risk is reduced through its 100% owned Chinese subsidiary which sells directly to Chinese wholesalers and retailers.

**Governance issues**

- **STI and LTI hurdles seem narrow focused based on NPAT and EPS CAGR.** We would prefer to see STI and LTI also focused on other potential value creation measures such as operating cashflow, working capital, Total Shareholder Return (TSR) and Return on Invested Capital. NPAT and EPS are both earnings based measures that can be subject to changing accounting treatment of items such as depreciation and capitalised interest an does not take into account capital raisings. We would like to see the addition of a cashflow, returns or share price based measure.

---

**Figure 64: Summary of Blackmores remuneration structure**

<table>
<thead>
<tr>
<th>% of Base Remuneration</th>
<th>Delivery</th>
<th>Measurement</th>
<th>NPAT Growth</th>
<th>For CEO and Senior Exec 70-80% NPAT and Divisional NPAT growth against budget/pcp 20-30% Financial (e.g. revenue growth, new products) and Non-Financial (safety, employee engagement)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Profit Share</td>
<td>Cash</td>
<td>Short Term Incentive</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>For CEO - 0-65% of base remuneration</td>
<td>5% Mgmt 0-78% of base remuneration</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>7.5% of NPAT is allocated each year</td>
<td>2.5% allocation on achievement of NPAT growth over prior year</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse research

- **Profit share structure largely aimed at all employees:** While the STI and Profit Share seem duplicative for senior executives, Blackmores applies its profit share across all eligible permanent staff. We would prefer a greater variable component to the profit share as only one-quarter of the profit share is determined by NPAT growth – the rest being a fixed % of NPAT.

- **CEO total comp A$1.54mn in FY15** – consisting of base salary of A$637,000 (41%), STI and Profit Share A$529,000 (34%), LTI A$289,000 (19%) and other benefits A$85,000 (6%).

- **Executive Chairman and substantial holder acceptable:** We accept that Marcus Blackmores’ value to the company – being part of the founding family and having been on the board for 43 years – outweigh concerns over undue influence that he may exert.

- **Board generally well rounded with:** 1) majority independent directors; 2) directors from a range of backgrounds and areas of expertise. We would however prefer to see one additional board member with legal expertise as we do not find any indication that any member has been part of a legal practice. We also believe board depth could be enhanced with members with experience operating in Asia given that the region now accounts for 50% of Blackmores’ revenue.

- **Gender diversity not yet at ASX target of 30% by 2018,** with two female directors out of seven on the board. It is unusual that the board does not have greater female representation as over 80% of Blackmores’ 1000 employees are female.
Figure 65: Blackmores board composition

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Tenure (years)</th>
<th>Financial</th>
<th>Legal</th>
<th>Health/FMCG</th>
<th>Asia Experience</th>
<th>Former CEO</th>
<th>ASX 200 Board experience</th>
<th>Independent</th>
<th>Fees/pay ($k) FY15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marcus Blackmore</td>
<td>Executive Chairman</td>
<td>43</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>No</td>
<td>761</td>
</tr>
<tr>
<td>Christine Holgate</td>
<td>CEO</td>
<td>7.5</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td>No</td>
<td>1,539</td>
</tr>
<tr>
<td>Stephen Chapman</td>
<td>Non exec director</td>
<td>23</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Yes*</td>
<td>117</td>
</tr>
<tr>
<td>David Ansell</td>
<td>Non exec director</td>
<td>3</td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td>Yes</td>
<td>93</td>
</tr>
<tr>
<td>Helen Nash</td>
<td>Non exec director</td>
<td>3</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>Yes*</td>
<td>97</td>
</tr>
<tr>
<td>Brent Wallace</td>
<td>Non exec director</td>
<td>11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Yes*</td>
<td>103</td>
</tr>
<tr>
<td>John Armstrong</td>
<td>Non exec director</td>
<td>1.5</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td>Yes*</td>
<td>15</td>
</tr>
<tr>
<td><strong>Median Tenure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7.5</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse estimates *Note CS Australia ESG assume that directors serving longer than 10 years are not independent – the issue being perceived lack of independence, possibility a director is “entrenched” in the company, new skills being required for a changing board.

- **Average tenure may appear high**: We feel that Blackmores’ board has a good mix between long serving (10+ years) and new directors (<5 years), although the median board tenure could appear high at 7.5 years. The Chairman has been on the board for 43 years, and two other directors for 23 years and 11 years, respectively. We prefer shorter average board tenure to prevent directors becoming “entrenched” in the company and to ensure a continuous update of fresh skills to the board as well as to avoid sudden loss of a corporate member when several very long standing directors leave.

Peers

Figure 66: PEERS relationship matrix

Source: Credit Suisse PEERS
HOLT® valuation A$190/share

Link to CS analyst estimates based scenario: https://holtlens.credit-suisse.com/dal/THp1UYIDqvgg3s9

Applying key Credit Suisse Research analyst estimates through our HOLT® framework results in a A$190.43 valuation. This valuation initially uses five years of key analyst estimates to drive CFROI® forecasts, before proprietary algorithms determine the “rate of fade” towards the long-run average CFROI (6%). Owing to the forecast persistence of these economic returns, a modestly slower-than-average (7.5%) final fade rate has been employed.

Figure 67: CS Holt® Blackmores valuation

Source: HOLT®
Shareholder structure

Figure 68: Blackmores shareholder split

Source: Bloomberg

Select key management personnel

Christine Holgate CEO

Christine has more than 30 years of diverse international leadership experience in highly regulated industries, including healthcare, media, telecommunications and finance. Christine was appointed to her current role as Blackmores Chief Executive Officer in November 2008. In 2015, Christine named CEO of the Year by CEO Magazine/CEO Institute (she was the first female to win this award).

Aaron Canning CFO

Aaron has a wealth of experience gained from working in a variety of general management and financial leadership positions in ASX-listed and multinational organisations in Asia, Australia and New Zealand, the UK and US.

Prior to joining Blackmores in December 2014, Aaron worked at Goodman Fielder, Westfield and Diageo Plc. At Goodman Felder he held several senior roles including MD Grocery Category, MD APAC, and Finance Director APAC.

Peter Osborne – Managing Director Asia

A former Australian trade diplomat with more than 25 years of experience living and working in Asia, Peter has extensive expertise in business development, sales and marketing, trade development, and export and investment facilitation and promotion.

David Fenlon – Managing Director Australia and NZ

David brings more than 25 years of retail experience to Blackmores including an in-depth understanding of grocery and retail channel strategies. With an emphasis on driving business transformation and showcasing leadership, David combines his commercial acumen with an adept ability to recruit superior talent and motivate teams.

Nathan Cheong Managing Director, BioCeuticals

With more than 15 years’ experience in the complementary medicine industry, Nathan first joined BioCeuticals in September 2012 as the Director of Sales & Marketing, moving into the Managing Director role in 2014. Prior to this, Nathan was the General Manager of Herbs of Gold, a subsidiary of Vita Life Science.

Source: Company
Reference Appendix

Our new “Total return forecast in perspective” chart helps visualize Credit Suisse and consensus views of a company’s 12-month return within the context of forecasting risks and its historical trading pattern:

**12mth Volatility** is calculated as the annualised standard deviation of weekly total return series over the past 12 months. It illustrates variability of stock returns; in other words, risk. The way to think about it is that one would rather take 10% forecast return from a stock that has 20% volatility, than from the stock that has 40% volatility. The shaded area shows the one standard deviation range based on past 12 months volatility. In statistical terms, once you make a number of brave assumptions, there is a 68% probability that the share price will end up inside that range in 12 months’ time.

**52wk Hi-Lo** is maximum and minimum daily closing price over the past 52 weeks. It is often handy to know the price momentum especially when the stock is trading close to its highs and lows: Is the stock trading close to its peak? Is the momentum against the stock?

*Consensus is IBES consensus supplied by Thomson Reuters. IBES is a survey of sell side research analysts, collecting a few dozen data points such as EPS, DPS, Sales, Target Price, ROE and so on. *Mean is the average of target returns, while the shaded area around the mean represents the range of estimates from the lowest to the highest estimate. This aids visualisation of a number of important factors such as: the range of analyst estimates; where Credit Suisse’s estimates on this stock sit relative to consensus; and where the share price is relative to consensus mean and consensus range target.

**Target return** is calculated as capital gain plus forecast dividend yield (net) over the next 12 months. For ”CS tgt“ we have used Credit Suisse’s target price and Credit Suisse forecast for 12-month forward dividend, grossed up for franking. For the consensus mean and range, we have used consensus target price and consensus dividend forecasts for 12 month forward.
Companies Mentioned  [Price as of 12-Jul-2016]

Abbott Laboratories (ABT.N, $42.12)
Alibaba Group Holding Limited (BABA.N, $81.46)
Amazon.com Inc. (AMZN.OQ, $753.78)
Amway Malaysia (AMWA.KL, RM88.22)
Austfarm Pharmaceutical Ind (APLAX, A$1.7)
Baidu Inc (BIDU.OQ, $167.03)
Bega Cheese (BGA.AX, A$55.2)
Beimgate (002570.SZ, Rmb14.56)
Bellamy's (BALAX, A$11.13)
BioStime (1112.HK, HK$27.7)
Blackmores Ltd (BKL.AX, A$135.9, OUTPERFORM[V], TP A$175.0)
By-health (800146.SZ, Rmb14.5)
CXLLife Sciences (0775.HK, HK$0.7)
CONBA (600572.SS, Rmb6.7)
Caplano Honey (CZZ.AX, A$20.72)
Catalent (CTLT.N, $23.54)
China Mengniu Dairy (2319.HK, HK$13.36)
Danone (DANO.PA, €84.36)
Daqing Dairy (1007.HK, HK$1.68)
Fonterra Shareholders' Fund (FSF.NZ, NZ$5.42)
Freedom Foods (FNP.AX, A$4.5)
General Nutrition Centers, Inc. (GNC.N, $25.75)
Herbalife (HLF.N, $60.98)
JD.com, Inc. (JD.OQ, $21.76)
Kalbe Farma (KLBF.JK, Rp1,605)
MG Unit Tr (MGC.AX, A$1.23)
Mead Johnson Nutrition Co. (MJN.N, $89.77)
Mega Lifescience (MEGA.BK, Bt16.8)
Nestle (NESP.SF, SF78.0)
Pfizer (PFE.N, $36.15)
Reckitt Benckiser (RB.L, 7692.0p)
Sanofi (SAN.PA, €74.8)
Shanghai Pharmaceuticals Holding Co., Ltd. (6007.HK, HK$17.68)
Sigma Pharma (SHPHY.PK, $17.88)
SinoLife United (3332.HK, HK$2.48)
Sinopharm Group Co (1099.HK, HK$38.05)
Synlait Milk Limited (SML.NZ, NZ$3.24)
Tencent Holdings (0700.HK, HK$180.0)
The a2 Milk Company Limited (ATM.NZ, NZ$1.86)
Treasuries (TWE.AX, A$9.34)
Usana Hlth Sci (USNA.N, $113.66)
Vitaco Hldgs (VIT.AX, A$1.58)
Wesfarmers (WES.AX, A$40.87)
Woolworths (WOA.AX, A$21.2)

* FNZC Coverage

Disclosure Appendix

Important Global Disclosures

Ben Levin and Larry Gandler each certify, with respect to the companies or securities that the individual analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

The analyst(s) responsible for preparing this research report received Compensation that is based upon various factors including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.

As of December 10, 2012 Analysts' stock rating are defined as follows:

Outperform (O) : The stock's total return is expected to outperform the relevant benchmark* over the next 12 months.
Neutral (N) : The stock's total return is expected to be in line with the relevant benchmark* over the next 12 months.
Underperform (U) : The stock's total return is expected to underperform the relevant benchmark* over the next 12 months.

*Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperformers representing the most attractive, Neutrals the less attractive, and Underperformers the least attractive investment opportunities. Japanese and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperformers representing the most attractive, Neutrals the less attractive, and Underperformers the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%: Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between -5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 18 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.

Restricted (R) : In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.

Not Rated : Credit Suisse Equity Research does not have an investment rating or view on the stock or any other securities related to the company at this time.
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<th>Rating</th>
<th>Versus universe (%)</th>
<th>Of which banking clients (%)</th>
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<tr>
<td>Outperform/Buy*</td>
<td>51%</td>
<td>(41% banking clients)</td>
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<tr>
<td>Neutral/Hold*</td>
<td>36%</td>
<td>(17% banking clients)</td>
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*For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor’s decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.

Target Price and Rating
Valuation Methodology and Risks: (12 months) for Blackmores Ltd (BKL.AX)

Method: Our A$175 target price is set using a DCF methodology. We incorporate an 8.0% WACC, consisting of a 3% risk free rate and an asset beta of 1.15 reflecting higher risk as Blackmores diversifies into China (Blackmores’ historical Beta is 0.6-0.7). Our DCF incorporates a 25 year competitive advantage period between 2030 and 2043 where long-term growth falls from 2.0% to 0.0%, and return on invested capital diminishes from 60% to Blackmores’ WACC at 8%. Our OUTPERFORM rating is based on Blackmores’ growth prospects in the Chinese market for vitamins and supplements which does not seem to be factored into the current share price.

Risk: The key risks to our OUTPERFORM rating and A$175 target price include 1) any new regulation in China that may limit or restrict Blackmores’ ability to access the market 2) concentration of customers in Australia who have historically exerted pricing pressure 3) shortages in raw materials which sometimes have inelastic supply 4) issues in quality control that may affect the strength of the Blackmores brand.

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See the Companies Mentioned section for full company names
The subject company (PFE.N, ATM.NZ, MJN.N, NESN.S, FSF.NZ, WOW.AX, WES.AX, BABA.N, 1099.HK, DANO.PA) currently is, or was during the 12-month period preceding the date of distribution of this report, a client of Credit Suisse.
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Credit Suisse expects to receive or intends to seek investment banking related compensation from the subject company (PFE.N, ATM.NZ, MJN.N, NESN.S, FSF.NZ, SML.NZ, TWE.AX, WOW.AX, WES.AX, BABA.N, JD.OQ, 2607.HK, 1099.HK, DANO.PA) within the next 3 months.
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Ben Levin ; Larry Gandler

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