GATOR CAPITAL MANAGEMENT

China Cord Blood (NASAQ: CO)

Company Background:

China Cord Blood (CO) provides cord blood banking services (including umbilical cord blood stem cell collection, matching, testing, processing, and storage) to consumers in China. CO presently owns three cord blood banks in China with exclusive operating rights in Beijing municipality, Guangdong province, and Zhejiang province. CO also owns stakes in several other cord blood banking firms, including 24.0% of Qilu (operates in Shandong province), 14.1% of CBB (operates in India, Indonesia, and the Philippines), and 10.1% of Cordlife Singapore (operates in Singapore and Hong Kong).

Investment Merits:

1. Dominant industry leader: CO is the first cord blood banking operator in China with the longest operating track record. CO is also the largest cord blood banking operator in China based on its regional and newborn coverage. Furthermore, CO is the only Chinese cord blood banking operator with multiple regional licenses. CO has received three of only seven regional licenses in China awarded to date, and CO's licenses cover nearly half the newborn population across all licensed regions.

2. High barriers to entry: CO benefits from a "wide competitive moat" as 1) only one cord blood banking operator is permitted to operate in each licensed region; 2) The cord blood banking license application process is complex, expensive, and lengthy 3) Initial cord blood banking and testing facility construction costs are high (although incremental maintenance, storage, and testing costs are low); 4) CO has a large direct sales team with direct access to expectant parents through exclusive marketing partnerships with hundreds of hospitals in its licensed regions.

3. Significant growth potential: CO benefits from 1) a large addressable market as China has ~16M newborns per year (second highest globally after India) with ~2M born annually in CO's licensed regions; 2) low market penetration as cord blood banking is still relatively new in China, with a penetration rate of only ~1% of the overall newborn population and only ~3% in CO's licensed regions. Penetration should rise with increased consumer education, rising public awareness, and new stem cell therapies; 3) growth in Chinese disposable income and rising healthcare spend. Global consulting firm Deloitte estimated in 2013 that Chinese private incremental cord blood storage units (subscriptions) will grow at a ~23% compounded annual growth rate (CAGR) between 2011 and 2015.

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4. Substantial revenue visibility: CO's business model is subscription-based and hence generates a steady stream of long-term recurring revenue. A typical customer contract runs for at least 18 years and includes a one-time upfront processing fee and an annual storage fee. This business model also generates sizable and predictable cash flows. In fact, operating cash flow typically exceeds operating income as ~40% of new subscribers fully prepay the 18 years of storage for a ~20% discount.

5. Sizable pricing power: CO's de-facto monopoly status in its licensed regions provides it with the ability to raise prices judiciously to boost sales and profit growth. For example, in April 2013 CO raised its one-time upfront processing fee by 17% and its storage fee by 72%. The motive was to offset a slowdown in subscriber growth volume due to tough comparisons with the baby boom experienced in FY13 (March) that coincided with China's "Year of the Dragon".

6. Robust margin profile: Due to its economies of scale and pricing power, CO has been consistently profitable over the years. It has a strong margin profile with recent gross margins of ~80% (>75% since its initial public offering in 2009), operating margins of ~40% (>35% since 2009), net margins of ~20% (>20% since 2009), and FCF margins above 50%.

7. Seasoned management with sizable ownership: CO's Chairman has 20+ years of experience in China's healthcare industry and owns ~10.8% of CO. He is also the founder and CEO of Golden Meditech, a leading Chinese integrated healthcare firm that owns a ~53% stake in CO. CO's CEO owns ~1.5% of the firm. She has over 10 years of experience in corporate strategy in China's healthcare industry and has been involved in establishing cord blood banking operations since 2003. Other CO directors and executive officers own ~2.1% of CO.

8. Attractive valuation: CO is attractively priced based on multiple valuation metrics. CO's net cash balance is equal to ~50% of its equity market capitalization, and CO's stock also trades at only 1.4x book value. Excluding the net cash on its balance sheet, CO's stock currently trades at only ~8x earnings and ~5x free cash flow, on FY14 estimates. CO's net cash position and ownership stakes in cord banking operators Qilu, CBB, and Cordlife Singapore have an estimated worth per share greater than its own recent stock price.

CO'S NET CASH POSITION AND OWNERSHIP STAKES IN CORD BANKING OPERATORS QILU, CBB AND CORDLIFE SINGAPORE HAVE AN ESTIMATED WORTH PER SHARE GREATER THAN ITS OWN RECENT STOCK PRICE.

Investment Catalysts:

1. New license awards: Of 31 regions in China, only seven have been authorized to provide cord blood banking services to date. The Chinese government plans to issue three more licenses before 2015. As the industry leader in China, CO is well-positioned to win future license awards in other regions.

2. Facility expansion: CO is expanding the capacity of its cord blood banking facility in Guangdong (to be completed near end of FY14) and constructing its first cord blood banking facility in Zhejiang (to be completed by early FY15).

3. New product introductions: CO is seeking to increase sales by expanding its product offerings to customers. One example is a recent partnership with Cordlife Singapore to provide cord tissue storage in addition to its current cord blood stem cell storage services.

4. New acquisitions and partnerships: CO management is consistently evaluating opportunities to partner with and/or invest in cord banking operators and related service providers in other regions in China or Southeast Asia.

5. Increased investor awareness: CO is not widely followed by Wall Street, nor is it well-known to investors given its small size ($300M equity market capitalization) and China focus. CO is followed by only ~630 users on Seeking Alpha (the largest crowd-sourced investing platform with ~3 million registered users) and is covered by only 3 sell-side research analysts, all from small financial boutiques. Most of these sell-side analysts primarily cover the US healthcare industry and pay less attention to the Chinese healthcare market. Should CO continue to execute well and grow along its current trajectory, Gator Capital Management would expect more investors to become familiar with and interested in the stock.

Investment Risks:

1. China regulatory changes: Future Chinese regulations may adversely impact cord blood banking products and/or pricing. However, this is unlikely as the stem cell industry is listed as a key development area of China's 12th Five-Year-Plan. Moreover, in the unlikely event of a worst case scenario, such as the Chinese government deciding to abolish the one-license per region rule, it would take several years and substantial investments for potential entrants to complete the application process to be eligible to operate a cord blood bank.

2. China's relaxation of its one-child policy: One-child families are more likely to utilize cord blood banking since finding matching stem cells is more difficult without siblings. They are also more willing to invest large portions of their disposable income in their child's healthcare. While China is moving to relax its one-child policy, it is doing so very gradually. Moreover, the high cost of living in CO's licensed regions often deters even high income families from having more than one child. Furthermore, cord blood banking penetration is higher in culturally comparable economies with no one-child policies (e.g., Singapore, Taiwan) as cord blood banking penetration rises with education and wealth.

3. China fraud risk: Many Chinese firms have been tainted with investor fraud concerns in recent years. However, CO is unlikely to be engaging in deceptive practices as no concerns have been raised to date and 1) CO's equity has been publicly traded on a US stock exchange since 2009; 2) a respected "Big 4" accounting firm (KPMG) has been CO's auditor since its initial public offering; 3) a leading private equity firm (KKR) is a large long-term investor in CO; 4) CO's business is highly regulated by the Chinese government.