



MOTLEY FOOL GLOBAL GAINS

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	By Bill Mann Advisor
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BONUS: SSE No. 3: American Oriental Bioengineering

By Bill Mann

When we describe this company’s business, perhaps it’s natural for westerners to picture a rheumy-eyed Chinese guy selling remedies like tiger paw out of a dingy store. After all, “Chinese medicine” hasn’t exactly enjoyed the benefits of positive public relations overseas.

The reality is far, far different. **American Oriental Bioengineering** (NYSE: AOB) is a highly professional pharmacological company that sells plant-based pharmaceuticals into the Chinese medical system, including hospitals. No “eye of newt, horn of rhino” quackery here. In fact, it’s AOB’s professionalism that gives it such a leg up in this explosive market.

A Rapidly Expanding Market With a Hot Ignition

According to industry statistics, China’s pharmaceutical market was the world’s ninth largest in 2007, with total revenue to Chinese drug makers touching about \$10 billion. To put this in perspective, China’s 1.3 billion people spent \$36 billion a year on pharmaceuticals in 2005, while America’s 300 million people spent an estimated \$300 billion.

According to Digital Vector, the Chinese pharmaceutical industry is slated to become the fifth-largest in the world by 2010. This trend is demographic in nature: One of the most closely correlated product demand curves with increased prosperity is health care consumption.

That’s explosive growth. But two more extremely important elements favor AOB: Whereas in most developed countries, the top 10 pharmaceutical companies generally account for more than 50% of all consumption, China’s market is extremely fractured, with the top 10 accounting for less than 20%. Even the largest companies barely exceed \$200 million in revenue, contrasting with **Pfizer’s** (NYSE: PFE) \$47.8 billion in sales in 2007.

China has 3,500 drug companies, many of them mom-and-pop organizations with, at best, questionable quality and safety controls. Since 2004, the Chinese Food and Drug Administration has been closing down companies by the score that do not adhere to sound manufacturing practices.

The second element is the same theme that we've heard from our other companies: There is a great land grab going on, and AOB's management tells us that, if anything, the pace is quickening. The winners in this market will have three things: access to capital, political connections, and smart managers.

AOB passes on all three. It has used its American listing to raise cash, which it has put toward acquiring underperforming Chinese competitors. At the moment, AOB has \$159 million in cash (more than \$2 per share). Its CEO and chairman, Mr. Shujun "Tony" Liu, is a member of the National People's Congress of China, so the company's political connections are incredible. And its management, including CFO Lily Li and co-founder Binsheng Li, have shown an amazing knack for finding underperforming plant-based pharmaceutical companies with valuable assets, buying them and generating spectacular returns on investment.

The prices AOB pays might not seem cheap on acquisition, but once AOB has improved operations, the purchase price for the assets is nearly unbelievably inexpensive. In 2004, it bought Songhuajiang Pharmaceutical Limited for \$7 million, and it is projected to generate \$12 million in pre-tax earnings this year. In 2006, AOB bought Guangxi Lingfeng Pharmaceutical for \$25 million, and this year, it will earn \$22 million.

About Those Drugs

Jun Min, AOB's vice president, noted to us that Chinese medicine works more slowly than Western medicine, and that it doesn't necessarily have the clinical proof that Western drug administrations require. But by the same measure, the Chinese market is not necessarily as hung up on how something works, focusing more on that it works. AOB has multiple drug lines in areas like fighting yeast infections, dandruff, menstrual cramping, and anti-virals. Perhaps the best way to think of AOB is like a Chinese Johnson & Johnson consumer business.

Many of these drugs have strong consumer positioning in China and as such generate high margins, but remember that this is an extremely fractured industry. In 2004, AOB generated \$32 million in revenue; in 2007, it raked in \$160 million. I expect this revenue to keep growing at 30% annually, and its earnings per share to grow at greater than 25%. And yet, shares are trading at less than 10 times this year's earnings when you back out cash on the balance sheet. And unlike U.S.-based pharmaceutical companies, AOB puts a tiny fraction of its earnings back into research and development.

Someday, the Market Will Get It ...

That's blisteringly cheap. I suspect that American investors think all the worst things about AOB. It's a Chinese

company, so it's risky. Its products are snake oil, so they're risky. Pharmaceutical companies have huge research budgets, so it's risky. Its products don't have FDA approval, so they may be superseded, and thus, the company is risky. It acquires aggressively at seemingly high multiples, so it's risky. Its products are not available in the U.S., and it's therefore unknown ... and risky.

All of these objections are at least slightly crazy. AOB has an incredibly talented, highly motivated management team that is using the structure of the Chinese pharmaceutical industry to its advantage. There are lots of mediocre companies and few fantastic ones, so AOB's growing while the growing is good. It doesn't communicate well with Western shareholders, but does that mean we should ignore the stock? Hardly.

One of our tasks on our trip was to check into the company's claim of a wide distribution network, and AOB checks out fine. Eventually, massive growth and incredible financial performance will override fear of this unknown company. I expect AOB to earn at least \$0.76 this year, and as its new Boke and CCXA acquisitions start generating healthy returns, earnings will continue to increase rapidly.

China. Just China

The triple threat of smart management, important connections, and access to capital nearly guarantees that AOB is going to retain its SSE status in China over the next five years as the industry consolidates. When we asked about expanding beyond China, management said they would consider it, but that opportunities domestically are so huge that they don't really need to press outside of China. After all, some experts believe China will be the world's largest pharmaceutical market in 2020. That's an enormous level of growth, and given the state-sanctioned consolidation in the market, this may be a once-in-a-lifetime opportunity to grab a company that the market simply doesn't understand.

Bill Mann and Tim Hanson own shares of American Oriental Bioengineering, a Motley Fool Hidden Gems recommendation. Johnson & Johnson is an Income Investor pick. Pfizer is an Inside Value recommendation.
