Fitch Affirms Yestar's 'BB-' Ratings; Outlook Stable

Fitch Ratings has affirmed Yestar International Holdings Company Limited's (Yestar) Foreign Currency Long-Term Issuer Default Rating (IDR) of 'BB-' and senior unsecured ratings of 'BB-'. The Outlook on the IDR is Stable. The ratings reflect high exposure to China's rapidly growing in-vitro diagnostics (IVD) market, an established partnership with IVD industry leader Roche Diagnostics, and a strong foothold in IVD distribution across important markets in northern, eastern and southern China.

Yestar's leverage has risen over the past year but Fitch expects it to stay below our downgrade triggers as we expect the acquisition of the remaining 30% stake in its 70%-owned subsidiary Anbaida not to take place in 2018. However, the rating headroom at current leverage level is very limited.

KEY RATING DRIVERS

Growing IVD Business: Yestar entered the IVD market in 2014 and since then has acquired six IVD distributors that had established partnerships with Roche Diagnostics. As one of the largest IVD distributors for Roche in China, Yestar benefits from the robust growth of China's IVD market. Fitch expects IVD business will grow at mid-teen percentage and contribute around 70% of Yestar's revenue in 2018, up from 49% in 2016, and this proportion will continue to rise.

Heightened Regulatory Risks: The 'two-invoice' system was introduced in 2017 and has so far focused on the drug distribution industry. The implementation of 'two-invoice' system in medical devices distribution industry is still in the early stage and the progress varies among provinces. We note that the progress has been relatively slow so there is limited impact in the short term. Fitch views regulatory change a medium term risk to Yestar as the company may lose some of its revenue from lower-tier distributors. This could be partially offset by increasing direct sales to hospitals as lower-tier distributors exit the market. Currently, revenue from hospitals and lower-tier distributors accounted for 70% and 30% of its total revenue.

Acquisition Pace to Slow: Yestar acquired four IVD distributors in 2017, and is due to pay for the remaining 30% stake in IVD distributor Anbaida upon the completion of the three years guarantee period. Yestar's readily available cash on hand of CNY368 million at end-June 2018 is not sufficient to pay for Anbaida's acquisition cost for the remaining stake of CNY675 million. According to management, the company is in discussion with the seller and this acquisition is likely to be delayed to 2019. Fitch also expects Yestar to slow down its M&A activities and focus on consolidating its current business in the coming year as it has covered important markets in northern, eastern and southern China.

Increasing Working Capital Needs: Cash conversion cycle has lengthened since 2017 with increase in inventory and account receivables turnover days, which weighed on Yestar's operating cash flow. Inventory and account receivables turnover days rose to 109 days and 102 days at end-June 2018 from 74 days and 79 days at end-2016, respectively. Fitch expects increasing working capital needs along with the expansion of its IVD business as payment terms with hospitals are longer than that with imaging customers.

DERIVATION SUMMARY

Yestar's ratings are supported by its exposure to China's rapidly growing IVD market, an established partnership with IVD-industry leader Roche Diagnostics, and strong FCF generation, but constrained by the company's small operating scale, limited track record in the IVD business, and M&A risk. Its financial profile is better than peers of similar scale in the diversified services and diversified manufacturing sectors, such as eHi Car Services (B+/Stable) and Hilong Holdling Limited (B+/Stable). Compared to 361 Degrees International (BB/Stable), Yestar has slightly smaller operating scale and a weaker financial profile.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- Mid-to-high teen revenue growth for IVD business and 19% EBITDA margin in 2018-2019
- Revenue for the traditional imaging business to decline -3% in 2018-2019
- Company to acquire remaining 30% interest in IVD distributor Anbaida in 2019
- No further M&A assumed

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Significant increase in operating scale, brand partners and geographic diversification while keeping FFO adjusted net leverage below 2.5x on a sustained basis (2017: 2.2x)

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 2.5x on a sustained basis
- EBITDA margin below 15% on a sustained basis (2017: 20.1%)
- Adverse regulatory environment changes that lead to subdued growth
- Weakening in liquidity as a result of fast-than-expected payment for acquisitions

LIQUIDITY

Sufficient Liquidity: As of end-June 2018, Yestar had CNY368 million of cash and cash equivalents and around CNY28 million in undrawn banking facilities, which was more than enough to cover its short-term debt of CNY286 million.

FULL LIST OF RATING ACTIONS

Yestar International Holdings Company Limited
- Long-Term Foreign-Currency Issuer Default Rating affirmed at 'BB-';
- Foreign-currency senior unsecured rating affirmed at 'BB-'.

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Summary of Financial Statement Adjustments - A multiple of 8 times was used to calculate lease-equivalent debt as the company is based in China. (2017: CNY24 million)

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.