# MANAGEMENT SERIES REPORT

HEALTHCARE SPECIAL SITUATIONS

WATER TOWER RESEARCH

## 111, Inc.

A Start-Up That Is Delivering Revenue and Profit

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## KEY POINTS

- **We hosted CEO and Co-Founder Junling Liu for a fireside chat on July 18, 2024.** The discussion included an overview of 111's business model, its strategic priorities, and target milestones in the short and longer term. Liu also described the competitive landscape, explaining how the company differentiates itself from the competition, and the market opportunity that presents itself to 111. This report contains a transcript of the conversation, which can be accessed on demand.
- **Management credentials.** Liu began by presenting his experience and that of 111's co-founder Dr. Gang Yu, which included management roles at Dell and Amazon. 111's innovative technology leadership and supply chain expertise have been integral to the success of the company to date.
- **Strategic priorities.** In the short term, the company's focus is to remain profitable, a feat it achieved at the GAAP operating level for the first time in 1Q24. Longer term, 111 wants to strengthen its competitive capabilities, continue to invest in technology, and realize its vision of reshaping the value chain of this industry.
- **Competitive advantages.** Liu explained that 111's digital capabilities are a major differentiator from the traditional players, whose main market is the in-hospital pharmacies. Meanwhile, 111's competitive edge over the online B2B competition is its operating efficiency. 111 has been adept at leveraging technology to emerge as the industry's best-in-class operator, an important advantage in the low-margin B2B business.
- **Tailwinds.** At the macro level, the most important tailwind is the Chinese government's commitment to reduce the overselling of drugs to the hospitals, which is increasing the public financing burden directed to the country's Medicare system amid its aging population. The outflow of prescription business from hospitals to retail pharmacies is expected to continue, presenting an attractive long-term prospect for 111's business model.
- **Financials.** Considering 111's current scale and the expected market opportunity, Liu still considers 111 a start-up, albeit one that is already delivering ~$2 billion of revenue and is profitable.

## KEY STATISTICS

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|---|---|
| **Ticker:Exchange** | YI:NASDAQ |
| **Current Price** | $1.08 |
| **52-Week Range** | $0.97-$3.36 |
| **Average Volume (30-Day)** | 56,628 |
| **Enterprise Value ($MM)** | $40.6 |
| **Shares Outstanding (MM)** | 85.5 |
| **Market Cap ($MM)** | $92.4 |
| **Fiscal Year-End** | December |

## PRICE PERFORMANCE

## ABOUT THE EXECUTIVE

**Junling Liu**
CEO

Mr. Junling Liu is 111's co-founder and has served as its chairman and chief executive officer since 2015. Mr. Liu co-founded and served as chief executive officer of YHD.com from 2008 to 2015. Prior to founding YHD.com, Mr. Liu served as the global vice president and president for mainland China and Hong Kong at Dell Inc. from 2006 to 2007. He also held numerous executive positions at internationally renowned technology companies such as Avaya China, Openwave Systems and Lucent Technologies Asia. Since January 2015, he has been an independent director of Autohome Inc. (NYSE: ATHM), the leading online destination for automobile consumers. Mr. Liu received his bachelor's degree in education from Flinders University in Australia in 1991 and master's degree in international business administration from Flinders University in 1998.

## EXECUTIVE DISCUSSION

**Robert Sassoon:** I'm Robert Sassoon, Senior Analyst at Water Tower Research, and I'm thrilled to be joined by Junling Liu, CEO and Co-Founder of 111, Inc., for this fireside chat. 111 currently trades on the NASDAQ as it has done since 2018 under the ticker YI.

For those who are less familiar with the company, let me just give a quick description. 111 has developed and operates one of China's leading tech-enabled healthcare platforms committed to efficiently manage the pharmaceutical supply chain by digitally connecting the key stakeholders in that chain from drug manufacturers through to distributors and pharmacies, and ultimately consumers.

I would like to also add that for 111's safe harbor statements, please refer to the company's filings with the SEC.

Without further ado, let me welcome Junling to this fireside chat. Thank you for joining us today.

**Junling Liu:** Hi, Robert.

**Robert Sassoon:** Before we delve into the company, it will be helpful if you give us some background about yourself.

**Junling Liu:** Thanks for having me here. I used to be an executive for multinational companies that operate in China, and I have held different positions in different capacities for various companies like Lucent Technologies, Avaya, and the last job I had with the corporate world is Dell. I was the President for Dell China and Hong Kong.

Back in 2007, I approached my colleague Gang Yu to start our first company called Yihaodian. Dr. Gang Yu also was an executive. He was the Vice President for Dell's global procurement in Asia Pacific. Prior to that, he was the Vice President for Amazon's global supply chain. Before then, he also was an entrepreneur, and he built a successful business and sold it to Accenture.

I figured that he would be the ideal partner for us to start our Yihaodian business, which was an e-commerce company focused on online grocery retail. The motivation came from the idea of instead of customers physically going to supermarkets, we deliver supermarkets to consumers' homes. It became one of the fastest growing companies in China. In a short few years' time, we had over 100 million online users and generated more than RMB30 billion in revenue annually. In 2015, Walmart acquired the company, and we moved down to our current startup, 111. Although we have sales of US$2 billion, in our heart, it is still a startup.

**Robert Sassoon:** Well, thank you for that. You've got very impressive credentials. Moving on to the company, 111, can you please give us an overview of the business model you have there?

**Junling Liu:** It's just like our first business. We saw a tremendous opportunity to leverage digital technology to create a more efficient business for the industry. As you know, the healthcare sector in China is very traditional and inefficient. Our technology can enable us to reshape the value chain of the industry. We have built a 100% digital operating system internally. All of our orders are online and digital. Frankly speaking, we don't even have the capability to produce any offline orders. With a small mobile terminal, we know exactly how the business is functioning in real time. We then use some of the modules of our digital suite to enable both the upstream and downstream partners to make them more efficient.

There are two parts to our business. The first part is direct-to-consumer. We call it B2C. The second part is to service the fragmented pharmacies across the country, which is our B2B business. There are about 600,000 pharmacies in China. The majority of them are either small to medium chains or standalone stores. The market is extremely fragmented. When we talk about the first 10 biggest chains, they still add up to less than one-third of the market compared with the United States where you have Walgreens and CVS. That's pretty much 80% of the market.

Typically, at such a small scale, they lack the resources and skills to modernize their business. That's where we come in with a suite of services, ranging from inventory management, assortment management and online prescription, chronic patient management, and so on. Today, out of the 600,000 pharmacies, we are already serving 470,000, which is roughly 80% of the market.

**Robert Sassoon:** Well, pretty good. You also have a number of drug suppliers too. How many do you have?

**Junling Liu:** We have direct purchase partners from the upstream, which is already over 500. Of course, we also have thousands of other commercial companies that we partner with to really create the richest selection for our customers in the country. Obviously, our business model hinges on providing the best selection and also the best prices for our customers.

**Robert Sassoon:** Right, interesting. What do you see as the principal growth drivers for the company and ultimately, what is the market opportunity? How do you see that?

**Junling Liu:** At a macro level, the government has strong motivations to limit hospitals from overselling drugs to patients. Everybody understands why because the expenditure from government on Medicare is getting higher and higher with the country aging rapidly. Lots of policies have been put in place to encourage drug distribution to retail channels. That is precisely our addressable market. When we talk about the size of the market you mentioned, we have different sources and so on. One of the major sources in China, the research firms, suggested that the market is over RMB2 trillion.

When we started our business, the majority of the drug sales were through the hospitals and the mix between retail pharmacy and the hospital was about 20-80. Today, the prescription market is seeing more than 30% of the sales coming from the retail side, with the hospital accounting for a little over 60%. Industry projections suggest that by 2027, the market size is going to be, for the retail pharmacy alone, over RMB1 trillion, with the [out-of-hospital/in-hospital] mix going to almost half and half. It's about 47 to 53. That is one of the key drivers at a macro level.

Of course, the other key driver of our business is really our core competitive edge, which is our operational efficiency. Even on a relatively small scale, we are more efficient than some of the giants in the industry. Mind you, most of the state-owned enterprises have revenues of hundreds of billion yuan, and each order they deliver to the hospitals is a few hundred thousand [RMB], whereas we are only making RMB15 billion in revenue, and some of our orders are as small as RMB300, and we have to deliver that to customers' premises. Even with that comparison, our operational expenditure is already superior compared with those giants. I spoke about the country's aging population and there'll be more demand for medication. The long-term prospect is very attractive.

**Robert Sassoon:** Right. In the context of that very positive tailwind you've just described to us, can you discuss 111's strategic priorities and target milestones you hope to achieve both in the short and longer term?

**Junling Liu:** Short term, we have a laser focus to be profitable. As you understand, as a startup, you have to invest so heavily in the infrastructure, onto getting customers on board, and being profitable is a major milestone. From the very beginning, we have had a three-step strategy, which is, firstly, to build infrastructure, both digital and physical, when I refer to digital, I refer to the dozens and dozens of systems that we built in-house, which is essential for us to operate. The physical infrastructure is like the fulfilment centers, of which we have 11 already in full operation across the country, and more are coming.

The second step is to grow in scale, not only scaling customers and the suppliers, but also scaling the revenue. Of course, the third phase of the development in our three-step strategy is to grow in profit. Our team was really proud to deliver the first profitable quarter in 1Q this year. We will be building on that to make the business a sustainable one.

Long term, we want to strengthen our competitive capabilities and invest in technology and realize our vision of reshaping the value chain of this industry.

**Robert Sassoon:** Right, that's really interesting. A lot of investors will be interested in understanding what the competitive landscape is in which 111 operates and what would you say are the main differentiators that set you apart from the competition?

**Junling Liu:** Fair question. We have two types of competitions: the traditional established players and the new online players. Our main differentiation is our digital capabilities against the traditional players. As for the online players, our operational efficiency is going to be our edge to compete long term. With the current economic climate in China, the entry barrier is never higher. We feel extremely lucky to be where we are today.

**Robert Sassoon:** Right. Thank you. Let's finally turn to the company financials, you alluded to them a little earlier. What do they look like?

**Junling Liu:** We want to be recognized as a major player in the industry, so one of the financial milestones is to continue to be more efficient operationally. Right now, [our opex] is above 5% of revenue, and our next goal is to reduce opex to under 5% at RMB20 billion revenue. That is a key financial metric we relentlessly pursue. Of course, in this year's first quarter, we achieved profitability and also [became] cash flow positive. This will remain our continued focus. With a long-term vision for the industry, we have successfully validated our business model. While we may be small in scale still, compared with the traditional giants, we are very eager and enthusiastic about advancing to the next phase of development.

**Robert Sassoon:** Well, thank you for that information. We'll wrap it up here. If you have any more questions for Junling, please send them to me and I'll be sure to pass them on. For our analysis of the company, please refer to our open access website, that's www.watertowerresearch.com. Once again, I'd like to thank Junling for joining us in this fireside chat.

I'd like to finish with the views expressed in this fireside chat may not necessarily reflect the views of Water Tower Research LLC and are provided for information purposes only.

There were two questions from a fireside chat registrant that were sent through to Junling Liu.

**Q1:** Do you have products that have fairly inelastic demand that you could raise prices on?

**Junling Liu:** We have more than 100 proprietary brand products, some of which generate inelastic demand in certain seasons, allowing us to adjust prices. For example, during the flu season, we will increase the prices of cough medicines.

**Q2:** What about AI consultations directly with patients online? Also, where else do you see AI helping, and at what stage are you at with introducing AI?

**Junling Liu:** We utilize AI to efficiently assist doctors in collecting essential and critical information from patients to form prescriptions. Based on the collected information and our system's knowledge base, we proactively determine if there are potential risks and alert the doctors accordingly.

The company is bold in trying out different AI initiatives. By utilizing AI large language models to optimize low-price strategies and traffic allocation mechanisms, our order conversion rate has seen encouraging improvements. These results highlight the success of our technology team's efforts in AI application development. One major challenge we faced was data cleaning, due to the lack of common standards in the industry and the multiple names a single drug can have across different companies and regions. AI proved to be invaluable in automating this labor-intensive task, enabling us to contribute industry data to the Shanghai Data Exchange. We are also impressed by the impact of 111 Help, our AI-powered tool developed by our tech team. It effectively addresses both internal and external customer issues, reducing the need for additional staff and therefore cutting expenses. Although it is still early days, we anticipate further AI applications will continue to streamline our operations and drive innovation.

## ABOUT THE ANALYST

**Robert Sassoon**
Senior Research Analyst

Robert Sassoon has been an equity analyst for more than three decades, focusing primarily on global special situations. During his career, Robert has worked for several sell-side institutions in London, Hong Kong, and New York, including Credit Suisse, NatWest Capital Markets, and Societe Generale. In 2017, Robert founded AlphaSituations, an independent idea-generating event driven/special situations investment research service, which produced comprehensive research on early stage/emerging publicly traded and privately owned companies with the goal of telling an underappreciated or unknown story to relevant investors.

Robert has developed a uniquely broad and deep knowledge base in multiple industries from a global perspective and has achieved top five rankings in various analyst surveys, including the Extel and Greenwich surveys. Robert holds an MSc in Economics from the London School of Economics and Political Science, and has held FINRA licenses Series 7, 63, 86, 87, and 24.

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