

Natural Beauty: New key executives on board

Recommendation: BUY (unchanged)

China Consumer

Price	HK\$1.90	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$2.86 (+50.5%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.93-2.15	05A	81.1	0.041	28.2	46.9	4.7	21.6	1.7	10.1	10.0	Cash
Market cap.	US\$487.2m	06A	123.2	0.062	51.9	30.8	4.2	17.9	2.1	14.3	14.2	Cash
Daily t/o, 3 mth	US\$0.30m	07F	172.1	0.086	39.7	22.1	4.3	13.8	5.9	19.2	19.1	Cash
Free float %	30.0%	08F	228.8	0.114	32.9	16.6	4.1	11.2	7.2	25.2	25.0	Cash
Ticker	0157.HK/157 HK	09F	284.8	0.142	24.5	13.3	4.1	10.4	8.6	30.8	30.6	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +12.9% +7.4%, +37.6%

Actual price changes (1 mth, 3 mth, 12 mth): +1.6%, +25.8%, +102.1%

Consensus EPS (07F-08F): HK\$0.085, HK\$0.105

Previous forecasts (07F-08F): HK\$172.1m (\$0.086), HK\$228.8m (\$0.114), HK\$284.8m (\$0.142)

Key points:

- Double-digit sales growth targeted in China in FY12/07F.
- Single-digit sales growth expected in Taiwan in FY12/07F on strong Fonperi sales, store revamp and product mix enhancement.
- Fonperi to capture 1.0-2.0% of the Taiwan market in the next three years.
- Foray into Vietnam and Indonesia planned.
- Gross margin to widen on the introduction of high-end products.
- Payout ratio of 135.0% supported by net cash of more than HK\$500.0m (HK\$0.25 per share).
- EPS to grow 39.7% in FY12/07F, 32.9% in FY12/08F and 24.5% in FY12/09F.
- Trading at undemanding 16.6x P/E for FY12/08F and ex-cash P/E of 14.9x. Our target price of HK\$2.86, represents 50.5% upside potential.

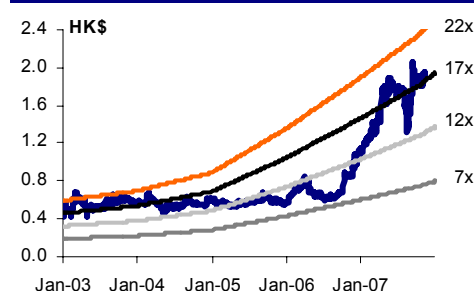
Professional management team. Natural Beauty Bio-Tech (NB) was established by Dr. Tsai Yen Yu in 1984 in Taiwan and in 1992 in Shanghai. Family members hold most of the senior positions within the company. In Sep 2004, Dr. Tsai's daughter, Dr. Sh Hsyu Su became executive director and CEO. After a successful re-branding and store revamping program, the company started to recruit professionals from multinational consumer brands with at least 10 years experience in retailing in China and Taiwan to reduce the family's involvement in management.

New COO for Taiwan and other markets. Prior to joining NB in Oct 2006, Mr. Shaw Wen Chung, COO for Taiwan and other markets, has over 23 years of operational management experience in the consumer goods industry. He was the National Sales Director of Energizer Schick Taiwan Ltd, leading its global sales team in household and personal care products. He also worked for Warner-Lambert in Taiwan as the National Sales Directors and for Unilever Taiwan as Channel Sales Manager.

Turnaround in Taiwan. The company launched Fonperi, a mass-market brand aimed at young consumers (aged 15-25) in Apr 2007. After two years of decreases in turnover, the company started to turnaround in Taiwan in 1H FY12/07A with turnover up 8.8% to HK\$74.3m, mainly on the contributions from Fonperi, which is sold at 1,100 retail outlets (hypermarkets, drugstores and wholesalers). More than 116,000 Fonperi products have been sold for a total of HK\$5.4m (10.7% of Taiwan's turnover) in 1H FY12/07A.

Image reinforcement. The company expects Fonperi's turnover to reach HK\$15.0m by end-2007 and the brand to capture 1.0 – 2.0% of Taiwan's retail skin-care market in the medium term. The brand is expected to reinforce

Chart 1: P/E bands



Source: SBI E2-Capital

NB's image among Taiwan's young customers and attract them to the company's other products sold in 477 franchises on the island.

Stronger Taiwan momentum in 2H. The number of retail outlets selling Fonperi increased to 2,000 currently, from 1,100, with coverage extended from drug stores (Watson's) to specialized stores such as Sa Sa. In early Oct, NB launched a new series of anti-aging Fonperi products. The company plans to focus on promoting health products in Taiwan and boost their turnover contributions from the current 7.0% to 10.0% in the medium term. NB expects single-digit sales growth in Taiwan in 2H FY12/07F.

New markets. Currently, NB has 50 franchise stores in Malaysia. Malaysia sales are expected to register double-digit growth in the next two years. According to Mr. Shaw, a candidate has been chosen in Ho Chi Minh City in Vietnam and Jakarta in Indonesia for the company's first franchise store scheduled to open next year.

New COO for China and HK. Prior to joining the Group in Jan 2007, Mrs. Yeung Wong Sau Ping (Betty) has accumulated over 27 years of management and operational experience in sales and marketing in Amway (China) Co Ltd. She has spearheaded Amway's sales development in Hong Kong and China and was its general sales manager.

China sales up in 1H. After joining NB, Mrs. Yeung focused on motivating the existing 1,710 franchisee stores in China, setting up direct communication channels with their owners and arranged training for their sales teams. Accounting for 72.0% of the company's total turnover, China sales grew 22.5% in 1H FY12/07A and net profit 32.3% to HK\$70.6m. Its average sales per store reached HK\$82,000.0 in 1H (+13.9% YoY).

Momentum to strengthen in 2H. Turnover in China increased 22.5% to HK\$139.3m in 1H FY12/07A on higher product sales and brand and image revamping. The company expects double-digit sales growth in 2H FY12/07F on the back of stronger-than-expected average sales per store.

Impressive debut in Shanghai. Mrs. Yeung was a guest at our house's Shanghai Conference in early November and impressed fund managers with her extensive China experience and expertise, demonstrating that she is well equipped to improve NB's business model by strengthening its corporate image and customer loyalty.

2H sales boost expected. After a 50.4% net profit growth in 1H FY12/07A, NB expects strong sales growth in 2H thanks to Christmas and New Year peak retail seasons. Its average store sales are expected to see double-digit growth in China and single digit-growth in Taiwan in FY12/07F.

Store revamp continues. The company renovated 1,646 franchised stores, or 83.9% of the total in Taiwan and 76.0% in China, boosting the average sales per store by 13.9% to HK\$82,000.0 in China and 5.7% to HK\$92,000.0 in Taiwan in 1H FY12/07A. The average sales per store reached HK\$84,000.0, up 10.5% YoY, in the period. Same store sales growth reached 14.0% in China and 6.9% in Taiwan. The remainder of the stores will undergo refurbishment soon to comply with the chain's uniform look.

Table 1: Distribution channels as at 30 June 2007

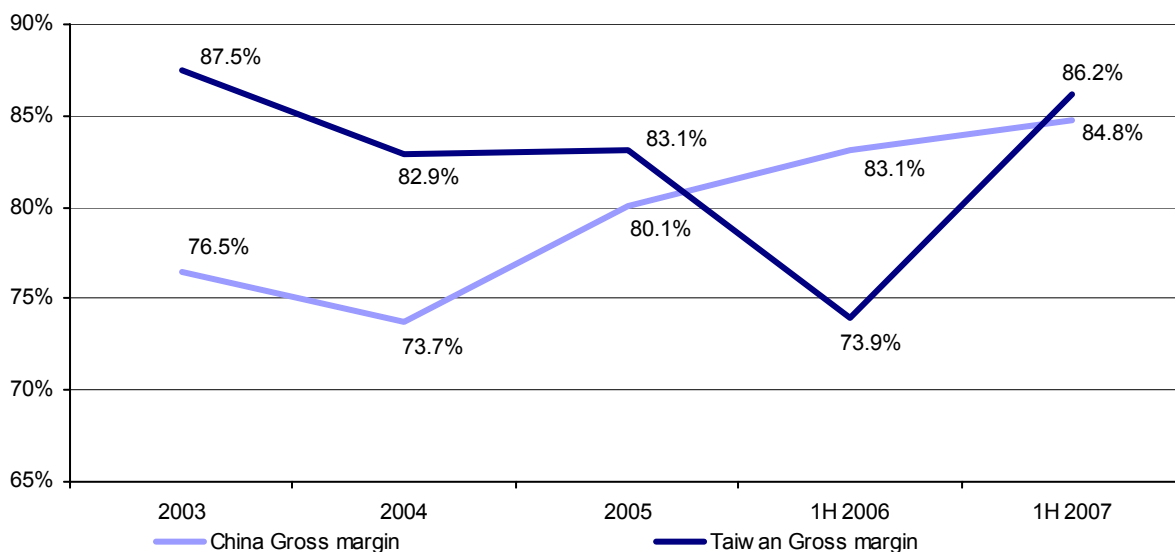
Six months to Jun	Franchisee owned spas	Entrusted		Self owned		Group Total	Retail channel	Grand Total
		Spas	Counters	Spas	Counters			
PRC	1,613	21	19	5	52	1,710	-	1,710
Taiwan	468	-	-	9	-	477	*1,100	1,577
Others	51	-	-	1	-	52	-	52
Total	2,132	21	19	15	52	2,239	1,100	3,339

Source: Company data

* increased to 2,000 in Oct 2007

Gross margin enhancement. NB has further improved its gross margins through 1) introduction of new high-margin products with higher ASPs and 2) cost savings from repackaging, which usually accounts of 30.0% of its cost of goods sold. Currently around 40.0% of all products have been repackaged. The company reduced the number of its package forms from over 200 to 24 for 314 products (204 China products and 110 Taiwan products). The exercise reduced its cost of packaging and improved the gross margin. The operating margin widened 4.3pcp to 88.7% and the gross margin should stay at about 83.8% in FY12/07F.

Chart 2 : Gross margin analysis

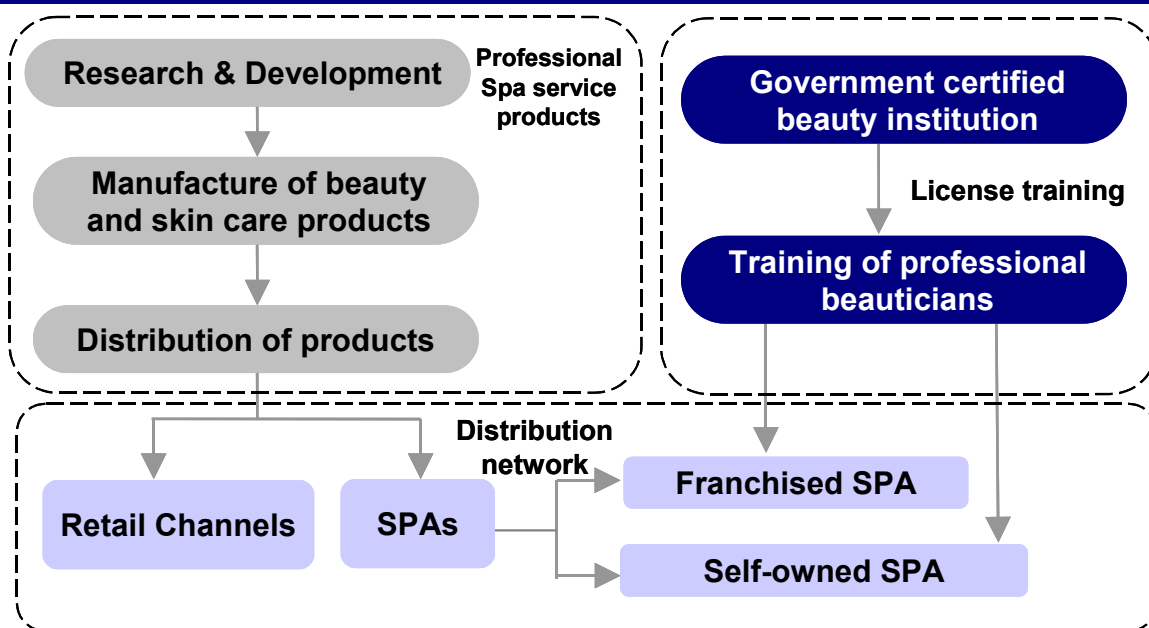


Source: Company data

Effective cost control. Although staff costs are increasing, other operational costs are under control. Advertising and promotional expenses accounted for 12.6% of total turnover in 1H FY12/07A, down from 14.1% in 1H FY12/06A and should be capped at below 20.0% in the full-year. Distribution costs accounted for 30.0% of total turnover in 1H FY12/07A and should stay at the current level of not more than 35.0% in the whole year.

Quality boost from vertical integration. NB’s operations are fully integrated and range from research and development and in-house production. The company is currently running at 70% of its operating capacity. It has taken over the operation of its warehouse, inventory and logistics management from China Post, which it used to collaborate with since 2005. NB also runs training and examination centers in China together with the Ministry of Labour. Franchisees and beauticians are required to attend beauty and management courses for 1,200 hours. Frequent visits are paid to franchise stores to ensure their compliance with NB’s standards.

Chart 3 : Business Model



Source: Company data

Higher margins expected. Operating profit in Taiwan reached HK\$17.7m, up 48.3%, in 1H FY12/07A. NB may introduce Fonperi to China in the near future. The operating margin of Fonperi products is expected to exceed the current 40.0% when the company achieves economies of scale.

High payout supported by strong financials. The group is in a net cash position of HK\$501.4m, up 40.7%

from 1H FY12/06A. The dividend payout is expected to exceed 100.0% in the next few years. We expect its future dividend payout ratio at 130.0% in FY12/07F, 120.0% in FY12/08F and 115.0% in FY12/09F.

Strong brand recognition. According to a 2005 Annual Report on Beauty Economy in China, the consumer recognition rate for NB's stores was 49.7%, ahead of other market leaders such as Decleor (17.4%) and Beauty Farm (9.4%). NB was among the top leading cosmetics brands recommended by the China International Beauty Net (www.prcen.com.cn), a leading website on China's beauty industry, together with Shiseido, Mentholatum, Helena Rubinstein, AVON, OLAY, Amway, Revlon and DHC.

Skin care products – high growth segment. According to Euromonitor (19 June 2007 report), the sales value of cosmetics and toiletries grew 11.0% YoY in 2006 in China (skin care products up 15%). Skin care products are the fastest growing segment in the country with a 10-year CAGR (1997-2007) of 11.2%, compared with 7.7% globally.

Table 4: Sales of Cosmetics and toiletries by sector

% current value growth	2005/06	2001/06 CAGR	2001/06 Total
Colour cosmetics	10.8	11.8	74.6
Fragrances	20.1	17.6	124.7
Skin care	15.4	18.6	134.4
Cosmetic and toiletries	10.8	11.3	71.0

Source: Company data

Foreign brands dominate in China. The report says that the sales of cosmetics and toiletries are led by multinationals, with Procter & Gamble, L'Oreal, Unilever, Amway and Colgate making up the top five in major retail networks (e.g. supermarkets/hypermarkets, convenience stores, drug stores, specialized shops and department stores).

Valuation. We expect NB's net profit to grow at a CAGR of over 29.0% in FY12/07F-FY12/09F. The counter is expected to trade at 16.6x FY12/08F P/E and ex-cash P/E of 14.9x based on our net profit estimate of HK\$228.8m. Our target price is HK\$2.86, based on 25.0x P/E for FY12/08F and 0.76x PEG.

Risks: 1) Execution risks in getting and keeping franchisees; 2) Major economic slowdown in China and Taiwan; and 3) unexpected disasters like SARS in Hong Kong in 2003.

Table 5: Peer comparison

Name	Ticker	Year End	Price	Market cap (US\$m)	P/E (x) 1 yr fwd	P/E (x) 2 yr fwd	ROA (%)	ROE (%)	EBIT Margin (%)
Natural Beauty	157 HK	Dec	HK\$1.90	487.2	22.1	16.6	12.7	14.3	39.3
Shiseido	4911 JP	Mar	JPY2,805	9,709.7	32.2	29.3	3.6	6.6	7.2
Mandom	4917 JP	Mar	JPY3,220	616.2	21.6	20.5	4.8	6.1	10.1
Fancl	4921 JP	Mar	JPY1,936	826.6	19.2	17.0	3.0	3.6	8.3
Kose	4922 JP	Mar	JPY3,700	1,509.6	20.6	18.9	4.0	7.1	7.8
Avon	4915 JP		JPY180	92.7	n.a.	n.a.	-5.7	-10.2	-0.2
Estee Lauder	EL US		US\$42.35	8,173.5	17.5	15.8	11.4	31.8	10.7
Revlon	REV US		US\$1.00	510.5	n.a.	n.a.	-25.4	n.a.	-2.3
Procter & Gamble	PG US		US\$73.13	227,115.4	21.0	18.7	7.4	16.1	20.2
Unilever	UL US		US\$36.48	110,347.8	19.3	17.3	n.a.	n.a.	n.a.
Colgate	CL US		US\$79.15	40,347.7	23.6	21.0	15.0	116.0	17.7
<i>Average</i>					<i>21.9</i>	<i>19.6</i>	<i>3.1</i>	<i>21.3</i>	<i>11.9</i>

Source: SBI E2-Capital, Bloomberg

Renowned brand

2007 Honor and 2006 Silver Winner of the World's Best Annual Report by International ARC Awards, New York

2007 Best Asia Brand Innovation award

2007 Best Asia Brand Innovation Figure award

2006 and 2005 Outstanding Enterprise in Hong Kong

2006 Bronz Winner of Asia Marketing and Promotion Award

2006 Bronz Winner of Best Asia B2B Events Award

2006 Best Asia Interactive Media Application Award

2005 Top 10 most influential beauty brands in China

2005 Top 10 most influential beauty franchised salons in China

2005 Golin Awards in Corporate Branding/Reputation Management

2005 Best Franchisee Network in China (with the highest consumer recognition rate of 49.7% by 2005 - China Beauty Economy Annual Report)

2005 London International Advertising Award

2005 New York Global Longshi Advertising Award

1H FY12/07 results recap. Turnover grew 18.1% YoY to HK\$193.2m, pre-tax profit 31.1% (due to savings in other operating expenses) and net profit 50.4% to HK\$74.3m. An interim dividend of three HK\$0.03 and HK\$0.02 special dividend were declared and payout ratio reached 135.0% of EPS. Turnover from China increased 22.5% to HK\$139.3m on higher product sales and brand and image revamping. Net profit in China was HK\$70.6m, up 32.3%. Turnover in Taiwan rose 8.8% YoY to HK\$50.6m, with Fonperi generating HK\$5.4m. Net profit grew 64.3% YoY.

Margin improvement. The gross margin widened 5.1pcp to 83.6% in 1H FY12/07A and operating margin 5pcp to 49.6% as a result of better operating & marketing efficiency. The net margin improved 8.2pcp to 38.4% due to a 9.6% decrease in taxation expenses.

Table 6: Interim results

Six months to Jun	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS Basic (HK\$)
1H FY12/07A	193.2	161.9	83.8	95.5	22.2	74.3	0.037
1H FY12/06A	163.6	128.8	78.7	72.8	32.2	49.4	0.025
YoY (%)	18.1	25.7		31.2	(31.1)	50.4	50.0

Source: Company data

Table 7: Geographical turnover breakdown

Year to Dec (HK\$m)	1H 2006	% of sales	1H 2007	% of sales	Change (%)
PRC	113.7	69.5	139.3	72.1	22.5
Taiwan	46.5	28.4	50.6	26.2	8.8
Others	3.4	2.1	3.3	1.7	(2.9)
Total	163.6		193.2		18.1

Source: Company data

Table 8: Turnover breakdown by activity

Year to Dec (HK\$m)	1H 2006	% of sales	1H 2007	% of sales	Change (%)
Product sales	153.0	93.5	182.0	94.2	19.0
Service income	8.3	5.1	9.1	4.7	9.6
Entrustment fee income	2.3	1.4	2.1	1.1	(8.7)
Total	163.6		193.2		18.1

Source: Company data

Table 9: Product sales revenue breakdown by region

Year to Dec (HK\$m)	1H 2006	1H 2007	Change (% YoY)
PRC	108.6	133.0	22.5
Taiwan	41.7	46.2	10.8
Others	2.7	2.8	3.7
Total	153.0	182.0	19.0

Source: Company data

Table 10: Average sales per store

Year to Dec	2003	2004	2005	2006	1H 2006	1H 2007	1H YoY (%)
China	122,000	133,000	139,000	148,000	72,000	82,000	13.9
Taiwan	175,000	237,000	259,000	220,000**	87,000	92,000	5.7
Total*	138,000	161,000	169,000	166,000	76,000	84,000	10.5

Source: Company data

*Does not include Hong Kong and Malaysia turnover

**Excluded 161 new retail outlets.

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the bookrunner for Natural Beauty on November 28, 2007 for vendor share placement at HK\$1.91 per share for 94.47m shares.

P & L (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	357.9	363.7	456.6	594.8	749.9
% chg	(0.1)	1.6	25.5	30.3	26.1
Gross profit	284.6	295.0	380.4	498.4	629.2
EBITDA	142.1	191.0	227.3	294.1	364.0
Depre./amort.	(25.6)	(20.8)	(18.3)	(15.9)	(16.9)
EBIT	116.5	170.1	209.0	278.2	347.1
Net int. income/(exp.)	3.3	4.3	5.2	7.3	7.6
Exceptionals	-	-	-	-	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	119.8	174.5	214.2	285.5	354.7
Tax	(38.8)	(51.6)	(42.4)	(57.1)	(70.2)
Minority interests	0.1	0.4	0.4	0.4	0.4
Net profit	81.1	123.2	172.1	228.8	284.8
% chg	28.2	51.9	39.7	32.9	24.5
Dividends	(61.0)	(80.0)	(223.8)	(274.5)	(327.5)
Retained earnings	20.1	43.2	(51.6)	(45.8)	(42.7)
EPS (HK\$) - Basic	0.041	0.062	0.086	0.114	0.142
EPS (HK\$) - F.D.	-	-	-	-	-
DPS (HK\$)	0.033	0.040	0.112	0.137	0.164
No. sh.s o/s (m) - W.A.	2,000.0	2,000.0	2,000.0	2,000.0	2,000.0
No. sh.s o/s (m) - Y.E.	2,000.0	2,000.0	2,000.0	2,000.0	2,000.0
No. sh.s o/s (m) - F.D.	-	-	-	-	-
Margins (%)					
Gross	79.5	81.1	83.3	83.8	83.9
EBITDA	39.7	52.5	49.8	49.4	48.5
EBIT	32.6	46.8	45.8	46.8	46.3
Pre-tax	33.5	48.0	46.9	48.0	47.3
Net	22.7	33.9	37.7	38.5	38.0

Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	116.5	170.1	209.0	278.2	347.1
Depre./amort.	25.6	20.8	18.3	15.9	16.9
Net int. paid	3.3	4.3	5.2	7.3	7.6
Tax paid	(39.2)	(44.2)	(62.3)	(39.5)	(64.4)
Dividends received	-	-	-	-	-
Gross cashflow	106.2	151.1	170.1	262.0	307.2
Chgs. In working cap.	1.2	(42.7)	42.4	(51.9)	(43.4)
Operating cashflow	107.4	108.4	212.5	210.0	263.8
Capex	(24.9)	(25.8)	132.7	(25.0)	(20.0)
Free cashflow	82.5	82.6	345.2	185.0	243.8
Dividends paid	(61.3)	(80.3)	(134.0)	(245.1)	(296.8)
Net distribution to MI	-	-	-	-	-
Investments	-	(0.4)	0.3	(0.6)	-
Disposals	2.1	0.1	-	-	-
New shares	-	-	-	-	-
Others	11.7	16.8	63.1	(79.2)	-
Net cashflow	34.9	18.7	274.7	(139.9)	(53.0)
Net (debt)/cash - Beg.	330.3	365.2	384.0	658.7	518.8
Net (debt)/cash - End.	365.2	384.0	658.7	518.8	465.8

Interim Results (HK\$m)	05A	06A	07A
Six months to Jun			
Turnover	163.1	163.6	193.2
% chg	8.1	0.3	18.1
Profit from operations	49.7	72.8	95.5
Interest expenses	-	-	-
Associates	(0.1)	0.0	0.0
Jointly-controlled entit.	-	-	-
Pre-tax profit	49.6	72.8	95.5
Tax	(17.2)	(23.4)	(21.2)
Minority interests	0.4	0.2	0.0
Net profit	32.8	49.4	74.3
% chg	5.0	50.7	50.4
EPS (HK\$) - Basic	0.016	0.025	0.037
DPS (HK\$)	0.013	0.020	0.050

Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	338.4	335.7	180.4	193.8	196.8
Intangible assets	0.9	-	0.7	0.7	0.7
Other LT assets	35.0	49.3	45.8	34.9	34.9
Cash and cash equiv.	365.2	384.0	658.7	518.8	465.8
Accounts receivable	77.9	86.0	67.8	95.2	120.0
Other receivables	63.6	79.2	58.3	108.8	137.2
Inventories	56.5	63.6	67.6	61.7	77.3
Due from related co.s	-	-	-	-	-
Other current assets	-	-	-	(0.0)	-
Total assets	739.5	768.9	1,079.2	1,013.8	1,032.7
Accounts payable	(16.6)	(16.6)	(13.0)	(14.3)	(18.0)
Other payable	(65.4)	(53.6)	(64.3)	(83.1)	(104.8)
Tax payable	(15.8)	(27.6)	(7.7)	(25.3)	(31.1)
Due to related co.s	-	-	-	-	-
ST debts	-	-	-	-	-
Other current liab.	(8.5)	(9.3)	(93.8)	(8.8)	(8.8)
LT debts	-	-	-	-	-
Other LT liabilities	(10.9)	(11.3)	(11.6)	(11.6)	(11.6)
Total liabilities	(117.2)	(118.5)	(190.3)	(143.1)	(174.3)
Share capital	200.0	200.0	200.0	200.0	200.0
Reserves	613.5	710.3	682.7	732.1	720.1
Shareholders' funds	813.5	910.3	882.7	932.1	920.1
Minority interest	6.8	6.4	6.0	5.7	5.3
Total	820.3	916.7	888.7	937.8	925.5
Capital employed	820.3	916.7	888.7	937.8	925.5
Net (debt)/cash	365.2	384.0	658.7	518.8	465.8

Shareholding Structure	Shares o/s (m)	%
Dr. Tsai Yen Yu	933.0	46.7
Dr. Su Chien Cheng	233.5	11.7
Dr. Su Sh Hsyu	233.5	11.7
Martin Currie	180.0	9.0
Keywise Capital Management	120.0	6.0
Public shareholders	300.0	15.0
Total	2,000.0	100.0

Background
Founded by Dr. Tsai Yen Yu in 1984, Natural Beauty is principally engaged in the manufacture and sale of skin, care, beauty and aroma therapeutic products and provision of skin treatments, beauty and spa services and skin care consulting and beauty training. Currently, the company operates 2,239 stores. According to 2005 China Beauty Economy Annual Report, Natural Beauty is one of the top 10 most influential cosmetics brands in China with the highest consumer recognition rate of 49.7%. It was listed in Hong Kong in Mar 02.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Net ROE (%)	10.1	14.3	19.2	25.2	30.8
EBIT ROCE (%)	14.8	20.1	23.7	31.3	38.1
Dividend payout (%)	81.4	64.9	130.0	120.0	115.0
Effective tax rate (%)	32.4	29.6	19.8	20.0	19.8
Net interest coverage (x)	na	na	na	na	Na
A/R turnover (days)	79.4	86.3	54.2	58.4	58.4
A/P turnover (days)	82.6	88.2	62.3	54.1	54.4
Stock turnover (days)	281.2	337.6	323.5	233.6	233.6

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months

BUY : absolute upside of >10% over the next six months

HOLD : absolute return of -10% to +10% over the next six months

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