

China Seven Star: More scaling on the horizon

Recommendation: BUY (unchanged)

China Retail

Price	HK\$0.70	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$1.00 (+43%)	Dec	RMBm	RMB	Δ %	x	x	x	%	%	%
12 mth range	HK\$0.09-0.82	04A	133.6	0.043	n/a	16.4	-	-	-	-	-
Market cap.	US\$454.39m	05A	(16.7)	(0.004)	n/a	n/a	-	-	-	-	-
Daily t/o, 3 mth	US\$4.6m	06F	12.3	0.002	n/a	345.8	-	-	-	-	-
Free float %	48.9%	07F	165.0	0.027	1,240.6	25.8	-	-	-	-	-
Ticker	0245.HK/245 HK	08F	226.4	0.037	37.2	18.8	-	-	-	-	-

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +483.3%, +4.1%, +288.4%

Actual price changes (1 mth, 3 mth, 12 mth): 0.0%, +1.4%, +314.2%

Previous forecasts (06F-07F): RMB16.0m (RMB0.003), RMB165.0m (RMB0.028), RMB226.1m (RMB0.039)

Key points:

- Conducted a top-up placement of 575m new shares (including over allotment) at a placing price of HK\$0.68 per share.
- Raised HK\$378.5m in net proceeds to be used as general working capital to fund expansion of its handset platform and the development of another five to six product-specific platforms.
- Current 2,000 units daily sales on one handset model prove the scalability of TV home shopping platform. Has completed negotiations for another three handset models, with roll out schedule in the next one to two weeks.
- More expansion planned on top of Fuzhou call centre expansion. Shanghai call centre will be doubled from 120 to 240 operators by May 2007.
- Takes in 3-4m registered calls per day, with additional 30-40% dropped calls unaccounted for due to operator shortage. Fuzhou and Shanghai call centres expansion should allow it to capture enlarged market.
- Further upward revision possible as we have yet to factor into our model revenue streams from potential new product platforms.
- Maintain BUY call and target price of HK\$1.00, representing 36.8x FY07F and 26.9x FY08F P/E (post placement) and a proforma 06-08F PEG of 0.6x. The stock is commencing its up cycle and now is a good chance to accumulate. We plan to revisit earnings post CNY after observing the manner Seven Star is able to transform the new funds into revenues.

Top-up placement to raise HK\$378.5m. China Seven Star (Seven Star) announced that the company had conducted a top-up placement to a number of investors on 12 Feb 2007, placing 575m new shares (including over allotment) at a placing price of HK\$0.68 each. The placing price represented a 2.9% discount to the previous closing price of HK\$0.70 and 1.5% discount to the average closing price over the previous 5 trading days. The new shares represent 11.4% of the existing share capital and 10.2% of the enlarged share capital. Net proceeds raised from the placement are estimated at HK\$378.5m

Proceeds to aid expansion of new product-specific TV sales platforms. The proceeds will be used to fund expansion of new product platforms on Seven Star's TV home shopping business model. The company aims to roll out another five to six product-specific platforms, and this will increase working capital demands, especially as we expect the platforms to be volume rich, similar to handsets.

Win-win situation with mutual support between Seven Star and suppliers. The company's aggressive expansion into the sales and distribution of handsets since the beginning of the year has also raised working capital levels. In return for branded handset manufacturers offering better pricing terms to Seven Star, to allow them to maintain a 50%+ gross margins, the company has increased its support to the manufacturers by

temporarily shortening the accounts payable.

Surging handset sales proof of business model scalability. As we have mentioned in our previous report “Budding TV home shopping star” (30 Jan 2007), Seven Star is currently achieving a daily sell-through rate of around 2,000 handset on only one handset model. In our view, the sales volume and pace of the ramp up (handset sales commenced on 8 Jan 2007) prove the scalability of the company’s TV home shopping model, emphasizing the platform’s advantages of faster time-to-market and instant nationwide geographic reach. So much so that the handset manufacturer has seen some production tightness meeting this unexpected demand. In fact, part of the proceeds will be used to aid Seven Star’s supplier to relieve working capital bottlenecks in its handset production.

Three more handset models available. The company has completed negotiations to sell three more models of domestic branded handsets and product roll out is expected in the next one to two weeks. Again, we note the pace with which management has been able to deliver on its strategy. Seven Star is well on its way to fulfill its promise of launching 20 new handset models for at least five brands in 2007, and in the process become the largest shopless handset distributor in China. The company’s aim is to achieve 1m unit sales in the current financial year.

Shanghai call centre expansion. In addition to the scheduled expansion in its Fuzhou call centre (from 120 to 1,120), the company plans to double its call operator workforce at its Shanghai call center from around 120 to 240 by May 2007. Seven Star is taking in 3-4m registered calls per day, and though management estimates that there are an additional 30-40% dropped calls unaccounted for due to the shortage of call operators. The call centre expansion in Shanghai and Fuzhou is aimed at capturing this enlarged addressable market to further raise sales volumes.

Limited dilution from new share issues. The dilution of new shares issues is expected to be limited mainly because we had previously been too conservative in our estimates for the shares earn out from Shanghai Pei Lian (Pei Lian). Due to the restructuring of Pei Lian as it integrates its operations with Seven Star, we now expect a more moderate contribution of RMB14.1m from the subsidiary (previously RMB21.4m). Therefore, we now estimate shares on a fully diluted basis, incorporating the new share issue, at 6,048.0m.

Maintain BUY call and target price at HK\$1.00 with earnings revision after CNY. We have scaled back our FY06F net profit to RMB12.3m (previously RMB16.0m) on reduced contribution from Pei Lian, but have otherwise kept our FY07F and FY08F numbers. We believe that there is further upward revision potential in our earnings as we have yet to factor into our model revenue streams from potential new product platforms. We maintain our BUY call and target price of HK\$1.00 on Seven Star, representing 36.8x FY12/07F and 26.9x FY12/08F P/E (post placement) and a proforma 06F-08F PEG of 0.6x. In our view, the stock is commencing its up cycle and now is a good chance to accumulate. We will revisit our earnings projections post CNY after observing the manner in which the company has utilized the raised funds to generate new funds.

Table 1: P&L

Year to Dec (RMBm)	03A	04A	05A	06F	07F	08F
Turnover	9.7	31.1	23.2	108.0	1,453.2	1,999.3
% chg	-	220.8	(25.5)	365.5	1245.6	37.6
Cost of sales	(13.3)	(18.5)	(13.9)	(39.3)	(591.8)	(824.3)
Gross profit	(3.6)	12.6	9.3	68.7	861.4	1,175.0
Other revenue	-	-	-	0.3	1.4	3.0
Selling and distribution expenses	-	(9.0)	(5.0)	(33.4)	(377.5)	(541.3)
Administration expenses	(6.9)	(7.3)	(14.9)	(9.2)	(196.2)	(229.9)
Other operating expenses	(14.5)	(0.4)	(1.0)	(5.8)	(6.5)	(8.0)
Operating profit	(25.0)	(4.1)	(11.6)	20.6	282.8	398.8
Finance costs	(28.6)	(3.4)	(0.5)	(0.5)	-	-
Exceptionals	16.7	111.3	(3.4)	-	-	-
Share of profits/(losses) of an associate	-	-	-	-	-	-
Share of profits/(losses) of JCE	-	-	-	-	-	-
Profit before taxation	(36.9)	134.5	(15.4)	20.1	282.9	387.4
Taxation	0.6	-	(2.0)	(4.6)	(49.5)	(77.8)
Profit after taxation	(36.3)	133.7	(17.4)	19.8	233.4	321.1
Minority interests	-	(0.9)	0.8	(3.2)	(68.4)	(94.7)
Profit attributable to shareholders	(36.3)	133.6	(16.7)	12.3	165.0	226.4
% chg	-	n/a	n/a	n/a	1240.6	37.2
Dividend	-	-	-	-	-	-

Source: SBI E2-Capital

Table 2: Valuation comparisons – TV home shopping

Company Name	Ticker	Country	Mkt Cap (US\$m)	Price	His. Turnover (US\$m)	His. Net Profit (US\$m)	Nxt Yr P/E (x)
Media Related Retail							
GS Home Shopping	028150 KS	Korea	621.7	KW76,200	691.7	76.5	9.8
CJ Home Shopping	035760 KS	Korea	958.1	KW70,100	745.9	81.3	14.5
Ideal Shopping Direct	IDS LN	UK	108.5	GBp196.5	148.5	9.7	11.9
Valuevision Media	VVTV US	US	478.8	US\$12.80	691.9	(15.8)	n/a
InterActiveCorp	IACI US	US	11,670.9	US\$39.74	6,277.6	442.5	22.5
Gems TV	GEMS SP	Sing	1,566.1	SGD1.52	137.6	28.8	29.9
Focus Media	FMCN US	China	4,553.6	US\$81.66	68.2	23.6	45.5
Qin Jia Yuan	2366 HK	HK	136.0	HK\$2.08	16.0	10.7	9.5
<i>Average</i>							20.5
China Retail							
Hongxing Sports	CHHS SP	China	735.5	SGD2.91	38.4	5.8	20.5
Li Ning	2331 HK	China	1,995.6	HK\$15.08	311.1	23.7	42.2
Parkson	3368 HK	China	3,304.9	HK\$46.70	143.7	31.5	42.3
Suning Appliance	002024 CH	China	5,988.0	RMB65.45	2,019.9	44.5	54.0
GOME	493 HK	China	3,321.6	HK\$8.51	2,279.7	63.3	21.8
Golden Eagle	3308 HK	China	1,467.5	HK\$6.30	93.9	16.9	30.5
<i>Average</i>							35.2

Source: Bloomberg, SBI E2-Capital

Disclosure of interests: SBI E2-Capital acted as the sole bookrunner and joint placing agent for the China Seven Star top-up placement of 832.2m new shares at HK\$0.188 per share on 28 September 2006 and as the sole bookrunner and placing agent for the China Seven Star top-up placement of 500m new shares with over-allotment option of 75m shares at HK\$0.68 per share on 12 February 2007.

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