

China Seven Star: Major earnings upgrade

Recommendation: BUY (unchanged)

China Consumer

Price	HK\$1.24	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$1.80 (+45%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.14-1.35	05A	(16.6)	(0.004)	na	na	na	na	9.0	na	na	na
Market cap.	US\$898.1m	06A	29.6	0.007	na	179.5	21.6	232.1	-	14.4	20.2	Cash
Daily t/o, 3 mth	US\$4.6m	07F	229.0	0.039	844.2	32.1	11.6	14.0	-	52.2	89.4	Cash
Free float %	35.4%	08F	319.8	0.054	39.7	23.0	7.6	10.0	-	40.0	61.1	Cash
Ticker	0245.HK/245 HK	09F	375.3	0.063	17.3	19.6	32.9	8.0	-	34.5	49.9	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +620.4%, +4.9%, +142.6%

Actual price changes (1 mth, 3 mth, 12 mth): +8.1%, +7.2%, +148.1%

Previous forecasts (07F-08F): HK\$165.0m (\$0.027), HK\$226.4m (\$0.037)

Key points:

- Launches first insurance product (with China Pacific Insurance Company) on 15 Apr 2007. Innovative profit sharing model with CPIC, entitling it to both above and below the line commissions.
- New handset models launched in April 2007. Brands carried include Haier, CECT, Amoi and BenQ.
- With a daily sales run-rate of around 2,000-3,000, the company is ahead of schedule to meet its FY12/07F target of 1.0m units.
- Airtime budget for FY12/07F lifted to RMB600.0m (from RMB400.0m) to support new platform and product launches.
- TV home shopping industry gains credibility among consumers after advertising crackdown in 2006. Seven Star has emerged as a stronger player.
- Major earnings revision - net profit forecasts lifted to HK\$229.0m for FY12/07F and HK\$319.8m for FY12/08F.
- Maintain BUY. Target price upgraded to HK\$1.80 (from HK\$1.00), which represents 33.4x FY12/08F and 0.8x FY12/06A-FY12/08F PEG on a pro-forma basis, undemanding given that it is still at a significant discount to other China retail comparables, on a PEG basis.

Maiden results ahead of expectations. China Seven Star (Seven Star) announced its maiden set of financial results since its injection into the former “Landune” in September 2006. Revenue was up 300.3% YoY at HK\$92.4m, while the HK\$29.6m net profit reversed a HK\$16.6m loss a year ago. Though largely meaningless and not reflective of the company’s strong fundamentals, the results beat our HK\$12.3m forecast largely on a HK\$6.2m gain from disposal of a subsidiary and an effective two-month contribution (instead of one-month, as previously assumed) from the TV home shopping operations, after their migration into the listco was completed ahead of schedule in November 2006.

Handset sales well on track to meet 1.0m unit target. Since the beginning of April 2007, Seven Star has aggressively expanded its range of mobile handsets. The company now carries products for renowned homegrown brands such as Haier, Amoi, CECT, Changhong, and BenQ. Daily sales presently stand at 2,000-3,000. The run rate is well ahead of our projections, with around 50% gross margins and the company is well on track to meet its 1.0m unit sales target. As a further testament of the compelling value of its TV advertising platform, Seven Star has entered into agreements with several handset manufacturers to take a small cut of their “below-the-line” distribution sales, in return for advertising their products.

Insurance products finally launched, with innovative sharing model. After much anticipation, Seven Star finally launched its insurance products on 15 Apr 2007. In its first phase, the company will carry the “Jin Yu Man Tang” (金玉滿堂) insurance product line for China Pacific Insurance Company (CPIC) nationwide. Again

demonstrating its business savvy, management has struck an innovative profit sharing deal with CPIC. Seven Star will bear all of the TV airtime advertising costs and in return, will share an undisclosed portion of the signed insurance premiums. The company will be entitled to this profit sharing whether insurance policies are entered into over the phone or at CPIC's local branch touch points. Seven Star has a dedicated team of operators, specifically trained by CPIC's staff, to promote the insurance policies. To further reduce risk, the company is entering into agreements with local/provincial branches offering rebates to the branches once they hit certain sales targets. In our view, this will align the interests of Seven Star and the branch levels of CPIC, ensuring a win-win situation for all. According to our channel checks, the Jin Yu Man Tang product line recorded premiums of around RMB500.0m in 2006.

Expanding insurance products into another over-the-air sales platform. Seven Star will look into developing its insurance product sales into another key over-the-air sales platform. Given its track record, we are confident that this can be achieved promptly. Management is already in talks with other insurance companies to carry their products. This is a good development direction given that sales of insurance products are "inventory light" and require minimal working capital. The move will also offset some of the inventory risk from Seven Star's handset platform.

Airtime budget up at RMB600.0m. With its firm growth momentum, Seven Star has lifted its airtime budget to RMB600.0m from RMB400.0m. While significant, we believe this ramp in adspend is necessary to support the company's roll-out of new sales platforms and products, which when launched, need to be promoted aggressively to capture the "first-to-market" advantage and reinforce their brand association with Seven Star. Management indicated that currently, the company is running around 1,500min/day advertising. We project that Seven Star can maintain its around 4:1 sales/adspend ratio.

Call centre expansion on track for May targets. Management reaffirmed that their call centre expansion plans are also on track. The company plans to double the number of "seats" in Shanghai to 200-220 and increase the number to 500 from 180 in Fuzhou. At present, Seven Star is running on average 2.5 operators per seat, while each seat can run up sales as high as RMB50,000 per day. We expect the increased capacity to allow to capture more dropped calls and increase the company's capacity for "outbound" push marketing calls to past customers. Seven Star has a rich client database with purchasing behaviour details, which, with more manpower, can be used to further drive sales.

TV home shopping industry gains credibility with Chinese consumers. Quietly, the TV home shopping mode of sales has re-emerged after China's crackdown on healthcare and beauty advertising in 2006. We note from experience that industries (e.g. mobile value-added services and pharmaceutical) tend to rebound stronger after a regulatory-initiated correction, as weaker players are forced out, leaving dominant incumbents in an even stronger position. The trend is repeating itself in the TV home shopping space, which appears to have gained legitimacy in the eyes of the Chinese consumer after the government's action last year. Seven Star has benefited from this change of mindset. Given that the penetration rate of TV home shopping in China is still well below 1%, we believe this newfound credibility will place the industry on a solid track to sustainable growth.

Major upgrade in earnings estimates, introducing FY12/09F numbers. In light of handset sales tracking ahead of schedule, roll-out of new product platforms, and increased transparency in the company's operating metrics, we have undertaken a major upgrade in our earnings estimates. We have lifted our FY12/07F net profit forecast by 38.8% to HK\$229.0m off a turnover of HK\$2,338.3m and FY12/08F net profit forecast by 41.3% to HK\$319.8m. In our earnings model, we have also introduced FY12/09F numbers for the first time.

Maintain BUY call, upgrading target price to HK\$1.80. On the back of Seven Star's strong top and bottom line growth momentum and emerging China retail format, we have upgraded our target price to HK\$1.80 (from HK\$1.00), which represents 33.4x FY12/08F and 0.6x FY12/06A-FY12/08F PEG on a pro-forma basis. The valuation is not aggressive as it is still at a discount (on a two-year forward and PEG basis) to other China retail comparables, despite the company's ability to deliver more growth over the same period and its "asset light" platform, which should arguably warrant a premium over conventional retail plays. We note that similar plays such as Amazon and Ebay are regularly trading at higher valuations to their conventional peers.

Table 1: P&L

Year to Dec (RMBm)	04A	05A	06A	07F	08F	09F
Turnover	31.1	23.2	92.4	2,338.3	2,982.2	3,639.2
% chg	220.8	(25.5)	300.1	2429.9	27.5	22.0
Cost of sales	(18.5)	(13.9)	(26.0)	(968.6)	(1,242.2)	(1,584.4)
Gross profit	12.6	9.3	66.4	1,369.7	1,739.9	2,054.8
Other revenue	-	-	4.2	5.1	8.1	10.2
Gain on disposals	-	-	6.3	-	-	-
Selling and distribution expenses	(9.0)	(5.0)	(11.2)	(631.5)	(812.2)	(1,025.6)
Administration expenses	(7.3)	(14.9)	(17.7)	(144.3)	(167.0)	(166.8)
Other operating expenses	(0.4)	(1.0)	(3.0)	(3.5)	(3.6)	(3.0)
Operating profit	(4.1)	(11.6)	45.1	455.3	601.2	705.3
Finance costs	(3.4)	(0.5)	(0.9)	(0.9)	(0.9)	(0.9)
Exceptionals	111.3	(3.4)	-	-	-	-
Share of profits/(losses) of an associate	-	-	-	-	-	-
Share of profits/(losses) of JCE	-	-	-	-	-	-
Profit before taxation	134.5	(15.4)	44.1	454.3	600.2	704.3
Taxation	-	(2.0)	(11.9)	(136.3)	(156.1)	(183.1)
Profit after taxation	133.7	(17.4)	32.2	318.0	444.2	521.2
Minority interests	(0.9)	0.8	(2.6)	(89.0)	(124.4)	(145.9)
Profit attributable to shareholders	133.6	(16.7)	29.6	229.0	319.8	375.3
% chg	n/a	n/a	n/a	1158.6	39.7	17.4
Dividend	-	-	-	-	-	-

Source: SBI E2-Capital

Table 2: Valuation comparisons – TV home shopping

Company Name	Ticker	Country	Mkt Cap (US\$m)	Price	P/E His yr	Fwd P/E Curr -yr	Fwd P/E 1-yr	His - 1yr fwd CAGR (%)	PEG
Media Retail									
CJ Home Shopping	035760 KS	Korea	800.3	KW68,000	8.4	11.2	10.8	-12.0	-1.1
GS Home Shopping	028150 KS	Korea	567.5	KW80,000	9.7	10.0	8.8	4.8	0.5
Amazon.com	IDS LN	UK	2,536.8	US\$44.75	96.3	59.9	50.5	56.3	0.9
eBay	VVTV US	US	46,056.8	US\$33.76	33.8	26.4	22.0	38.7	1.5
InterActiveCorp	IACI US	US	10,969.1	US\$37.43	34.3	22.2	19.1	78.6	3.5
Gems TV	GEMS SP	Sing	1,504.2	S\$1.47	27.6	26.2	12.7	47.4	1.8
<i>Average</i>					35.0	26.0	20.7	23.9	1.2
China Retail									
Hongxing Sports	CHHS SP	China	978.1	S\$3.68	35.2	29.1	17.3	41.2	.7
Li Ning	2331 HK	China	10,906.1	HK\$16.2	55.1	41.3	29.9	36.6	1.1
Parkson	3368 HK	China	3,949.7	HK\$53.00	66.6	48.1	35.7	37.4	1.3
Suning Appliance	002024 CH	China	6,894.5	RMB36.07	73.1	49.9	37.0	40.9	1.2
GOME	493 HK	China	4,903.2	HK\$12.50	32.2	31.2	27.9	35.9	0.9
Golden Eagle	3308 HK	China	1,189.6	HK\$5.10	39.0	25.9	19.0	44.1	0.6
<i>Average</i>					50.2	37.6	27.8	39.3	1.0
Seven Star	245 HK	China	898.1	HK\$1.24	51.2	32.1	23.0	61.6	0.5

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.

P & L (HK\$m)	05A	06A	07F	08F	09F	Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Dec						Year to Dec					
Turnover	23.1	92.4	2,338.3	2,982.2	3,639.2	EBIT	(11.6)	40.9	450.1	593.1	695.1
% chg	(25.5)	300.3	2,429.9	27.5	22.0	Depre./amort.	0.2	0.8	1.1	1.5	2.1
Gross profit	9.2	66.4	1,369.7	1,739.9	2,054.8	Net int. paid	(0.4)	3.2	4.2	7.2	9.3
EBITDA	(11.4)	41.7	451.2	594.6	697.2	Tax paid	(0.2)	(11.9)	(136.3)	(156.1)	(183.1)
Depre./amort.	(0.2)	(0.8)	(1.1)	(1.5)	(2.1)	Dividends received	-	-	-	-	-
EBIT	(11.6)	40.9	450.1	593.1	695.1	Gross cashflow	(12.1)	33.0	319.1	445.7	523.3
Net int. income/(exp.)	(0.4)	3.2	4.2	7.2	9.3	Chgs. in working cap.	7.7	(23.7)	(81.9)	19.3	(96.0)
Exceptionals	(3.4)	-	-	-	-	Operating cashflow	(4.3)	9.3	237.3	465.0	427.3
Associates	-	-	-	-	-	Capex	(1.0)	(5.0)	(12.0)	(14.0)	(18.0)
Jointly-controlled entit.	-	-	-	-	-	Free cashflow	(5.3)	4.3	225.3	451.0	409.3
Pre-tax profit	(15.4)	44.1	454.3	600.2	704.3	Dividends paid	-	-	-	-	-
Tax	(2.0)	(11.9)	(136.3)	(156.1)	(183.1)	Net distribution to MI	-	(2.6)	(89.0)	(124.4)	(145.9)
Minority interests	0.8	(2.6)	(89.0)	(124.4)	(145.9)	Investments	-	-	-	-	-
Net profit	(16.6)	29.6	229.0	319.8	375.3	Disposals	-	-	-	-	-
% chg	(112.5)	(278.3)	674.7	39.7	17.3	New shares	-	200.0	378.5	-	-
Dividends	-	-	-	-	-	Others	(4.2)	16.6	35.1	67.1	81.9
Retained earnings	(16.6)	29.6	229.0	319.8	375.3	Net cashflow	(9.5)	146.8	549.8	393.7	345.3
EPS (HK\$) - Basic	(0.004)	0.007	0.039	0.054	0.063	Net (debt)/cash - Beg.	(6.1)	(15.6)	131.2	681.0	1,074.6
EPS (HK\$) - F.D.	(0.004)	0.007	0.039	0.054	0.063	Net (debt)/cash - End.	(15.6)	131.2	681.0	1,074.6	1,419.9
DPS (HK\$)	-	-	-	-	-	Interim Results (HK\$m)	05A	06A			
No. sh.s o/s (m) - W.A.	3,722.8	4,252.3	5,928.4	5,928.4	5,928.4	Six months to Jun					
No. sh.s o/s (m) - Y.E.	3,722.8	5,063.2	5,928.4	5,928.4	5,928.4	Turnover	9.9	18.0			
No. sh.s o/s (m) - F.D.	3,722.8	4,279.4	5,928.4	5,928.4	5,928.4	% chg	-	81.9			
Margins (%)						Profit from operations	(8.3)	12.8			
Gross	40.0	71.9	58.6	58.3	56.5	Interest expenses	(0.0)	(0.4)			
EBITDA	(49.3)	45.1	19.3	19.9	19.2	Associates	-	-			
EBIT	(50.1)	44.2	19.3	19.9	19.1	Jointly-controlled entit.	-	-			
Pre-tax	(66.5)	47.7	19.4	20.1	19.4	Pre-tax profit	(8.3)	12.4			
Net	(71.8)	32.0	9.8	10.7	10.3	Tax	-	(2.4)			
Balance Sheet (HK\$m)	05A	06A	07F	08F	09F	Minority interests	0.4	0.0			
Year to Dec						Net profit	(8.3)	10.0			
Fixed assets	4.6	2.8	13.7	26.2	42.1	% chg					
Intangible assets	28.4	28.4	27.9	27.3	26.8	EPS (HK\$) - Basic	(0.002)	0.003			
Other LT assets	-	0.2	0.2	0.2	0.3	DPS (HK\$)	-	-			
Cash	4.0	141.4	670.2	1,063.3	1,408.0	Shareholding Structure					
Accounts receivable	18.3	124.6	87.7	102.9	140.2						
Other receivables	-	-	-	-	-						
Inventories	2.2	2.2	50.9	51.2	79.0						
Due from related co.s	-	-	-	-	-						
Other current assets	9.7	9.8	11.3	13.0	14.9						
Total assets	67.3	309.4	861.8	1,284.2	1,711.2						
Accounts payable	(40.6)	(29.0)	(99.1)	(64.3)	(95.2)						
Other payable	-	-	-	-	-						
Tax payable	(5.3)	(16.8)	(19.3)	(22.2)	(25.5)						
Due to related co.s	-	-	-	-	-						
ST debts	(10.5)	(10.2)	(10.7)	(11.3)	(11.8)						
Other current liab.	-	-	-	-	-						
LT debts	(9.1)	-	-	-	-						
Other LT liabilities	-	-	-	-	-						
Total liabilities	(65.5)	(56.0)	(129.1)	(97.7)	(132.6)						
Share capital	372.3	506.3	592.8	592.8	592.8						
Reserves	(372.1)	(262.7)	41.0	370.4	616.7						
Shareholders' funds	0.2	243.6	633.8	963.2	1,209.5						
Minority interest	1.6	9.8	98.8	223.2	369.1						
Total	1.8	253.4	732.7	1,186.4	1,578.6						
Capital employed	21.4	263.6	743.4	1,197.7	1,590.5						
Net (debt)/cash	(15.6)	131.2	681.0	1,074.6	1,419.9						
						Key Ratios	05A	06A	07F	08F	09F
						Net gearing (%)	(209.1)	Cash	Cash	Cash	Cash
						Net ROE (%)	(302.4)	24.2	52.2	40.0	34.5
						EBIT ROCE (%)	(50.7)	28.7	89.4	61.1	49.9
						Dividend payout (%)	-	-	-	-	-
						Effective tax rate (%)	(12.8)	27.0	30.0	26.0	26.0
						Net interest coverage (x)	na	na	na	na	na
						A/R turnover (days)	189.4	282.2	40.0	28.0	28.0
						A/P turnover (days)	411.1	137.5	10.0	10.0	8.0
						Stock turnover (days)	41.2	31.1	10.0	15.0	15.0

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