

# China Seven Star



**SELL (from HOLD)**

## Correction year ahead

### Key points:

- HK\$385.3m loss wider than expected due to fierce competition and handset market saturation.
- Plans to shift some ad budget to “brick and mortar” products in China’s second and third tier cities.
- Turnaround expected in FY12/09F.
- Downgrade to SELL with target price revised to HK\$0.160.

**Wider-than-expected loss.** China Seven Star’s (CSS) FY12/07A net loss reached HK\$385.3m or HK\$137.6m after excluding its goodwill impairment loss of HK\$247.7m. Considering that the company recorded a net profit of HK\$43.3m in 1H FY12/07A, net loss in 2H FY12/07A was HK\$180.9m. Turnover was HK\$680.2m, with TV home shopping sales at HK\$659.0m, representing 96.9% of the total. Below-the-line commissions and rental income were HK\$20.3m and HK\$0.9m, accounting for 3.0% and 0.1%, respectively. The sales-adspend ratio was 2.1, compared with 4.1 in 1H FY12/07A.

**Continued reliance on handset sales.** CSS had a difficult time diversifying away from its core cash cow of handset sales. Handset sales accounted for 84.0%, or HK\$553.6m of TV home shopping sales and 50.0%, or HK\$10.2m of commission sales in FY12/07. Though during its 1H result announcement the company said it planned to sell jewelry, watches and insurance, these products failed to develop out into a scalable platform.

**Fierce competition.** With many well funded players entering the market and incumbent operators aggressively scaling up, CSS faced intense competition. After seeing CSS’ and, to a lesser extent, Acorn’s (ATV US) success with handsets, they decided to replicate the model which 1) saturated the home shopping arena with handset products with little differentiating features and 2) drove rate cards for air time, by as much as 30% in 2H FY12/07A, according to CSS. Some domestic handset brand owners even “went direct” and placed infomercial on TV channels to sell their own branded handsets.

**Other one-offs exacerbated losses.** CSS’s losses were exacerbated by several one-off items such as a HK\$7.6m inventory allowance (mainly for handsets) and HK\$20.8m allowance for trade receivables. This provision was due to the fact that one of the company’s cookware wholesalers went into receivership in 2H FY12/07A and CSS may not be able to recover the advances previously made to it. To guard its own interest, CSS has already taken over the cookware’s brand name and business relationships.

**Two tier strategy.** CSS indicated plans to pursue a two tier strategy of placing infomercials on satellite TV stations to sell higher ticket items and to shift around 50-70% of its adspend budget to local TV stations in China’s second and third tier cities. Advertising

### China Retail

Tue, 06 May 2008

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### Stock data

Price	HK\$0.184
Target price	HK\$0.160 (-13%)
12 mth range	HK\$0.13-1.31
Market cap.	US\$172.8m
Daily t/o, 3 mth	US\$1.2m
Free float %	38.7%
Ticker	0245.HK/245 HK

### Financial summary

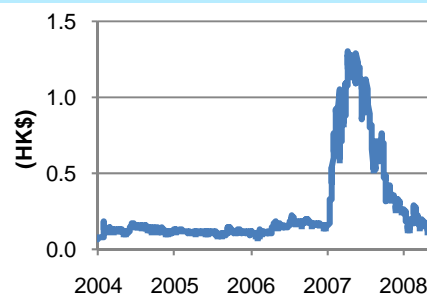
Year to Dec	06A	07A	08F	09F	10F
Turnover (HK\$m)	92.4	680.2	777.21	2,021.51	2,277.0
Net Profit (HK\$m)	29.6(385.3)	(28.8)	24.5	54.6	
EPS (HK\$m)	0.007(0.062)	(0.004)	0.003	0.007	
EPS Δ %	n/a	n/a	n/a	n/a	122.9
P/E (x)	26.6	n/a	n/a	54.9	24.7
P/B (x)	3.2	2.5	3.0	2.3	2.1
EV/EBITDA (x)	29.2	n/a	n/a	41.5	14.9
Yield (%)	-	-	-	-	-
ROE (%)	24.2	n/a	n/a	4.7	9.0
ROCE (%)	28.7	n/a	n/a	4.1	9.8
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

### Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-10.7	-14.1	-88.2
Actual price changes (%)	-3.7	-4.2	-85.2

	08F	09F	10F
Consensus EPS (HK\$)	0.03	0.04	
Previous forecasts (HK\$m)	44.8	48.9	
Previous EPS (HK\$)	0.006	0.007	

### Price Chart



rate cards on local TV stations are significantly lower, ranging from HK\$100-HK\$1,000/min. CSS plans to place a large number of infomercials on these channels to sell lower ticket items in high volumes. The company conducted trials in late 2007 and officially launched its new platform in Jan 2008. This new strategy, currently applied in Henan and Zhejiang, will be extended nationwide but the company has yet to provide a time frame. CSS will source products locally within each province and aim to carry zero inventories to reduce its product delivery and cash conversion time from 15 to 3 days.

**New strategy will take time.** This new strategy will require some time to scale up. We believe it will result in CSS having a higher overall volume of ad time minutes on channels, hence its guidance that the ad budget for FY12/08F is roughly the same as for FY12/07A. Key risks include increased pressure on CSS' management of air time, product development and inventory management in each province. We also believe that zero inventories will be hard to achieve. We understand that the company is currently implementing an ERP system but we do not expect it to be operational until 3Q FY12/08, at the earliest. This should significantly lift its sales-adspend ratio, though gross margins will be compromised. In our view, this strategy does not specifically force out existing competition and may need significant sales volumes to turn a profit.

**Limited effect from staff cuts.** CSS has also indicated plans to cut its workforce by about 25% to save costs. However, we believe that the scope is limited as its sales strategy in second and third tier cities will require extra staff.

**Downgrade to SELL, revised target price of HK\$0.160.** FY12/08F looks to be another correction year for CSS as it shifts towards its new strategy of selling "brick and mortar" products in second and third tier cities. We now expect the company's turnaround to come in FY12/09F. After adjusting our model, we project net loss to narrow to HK\$28.8m in FY12/08F, followed by net profit of HK\$24.5m in FY12/09F and HK\$54.6m in FY12/10F. A DCF valuation model (WACC of 10.0%, terminal growth rate 2.0%) implies a fair value of HK\$0.160.

**Table 1: P&L**

Year to Dec (HK\$m)	06A	07A	08F	09F	10F
Turnover	92.4	680.2	777.2	1,021.5	1,277.0
Cost of sales	(26.0)	(369.3)	(460.6)	(574.7)	(709.7)
Gross profit	66.4	310.9	316.6	446.7	567.3
Other income and gains	10.5	16.3	10.7	12.8	14.9
Selling and distribution costs	(11.2)	(379.9)	(293.7)	(357.6)	(429.3)
Administrative expenses	(17.7)	(51.7)	(53.2)	(59.2)	(70.0)
Other operating expenses	(3.0)	(29.2)	(7.8)	(8.2)	(8.3)
Impairment of goodwill and others	-	(247.2)	-	-	-
Operating profit	45.1	(380.3)	(27.3)	34.5	74.6
Finance costs, net	(0.9)	(0.3)	(0.5)	(0.8)	(0.8)
Share of profits of an associate	-	(1.3)	(1.0)	(1.0)	(1.0)
Profit before taxation	44.1	(381.9)	(28.8)	32.7	72.8
Taxation	(11.9)	(12.6)	-	(8.2)	(18.2)
Profit after tax	32.2	(394.5)	(28.8)	24.5	54.6
Minority interests	(2.6)	9.3	-	-	-
Profit attributable to shareholders	29.6	(385.3)	(28.8)	24.5	54.6
%chg	-94.8	n/a	n/a	n/a	122.9
Dividends	-	-	-	-	-

Source: Company data, SBI E2-Capital

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

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

**SELL** : absolute downside of >10% over the next six months

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