

China Seven Star: Buying opportunity

Recommendation: BUY (unchanged)

China Consumer

Price	HK\$0.65	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$1.20 (+85%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.14-1.41	05A	(16.6)	(0.004)	na	na	na	na	9.0	na	na	na
Market cap.	US\$515.2m	06A	29.6	0.007	na	94.1	11.3	85.0	-	14.4	20.2	Cash
Daily t/o, 3 mth	US\$7.0m	07F	186.1	0.028	308.0	23.1	6.8	8.2	-	42.7	74.2	Cash
Free float %	44.0%	08F	293.7	0.044	57.8	14.6	5.5	5.1	-	37.9	58.8	Cash
Ticker	0245.HK/245 HK	09F	347.8	0.053	18.4	12.3	21.9	3.8	-	33.5	49	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -31.8%, -46.2%, +187.2%

Actual price changes (1 mth, 3 mth, 12 mth): -33.0%, -43.0%, +275.0%

Previous forecasts (07F-08F): HK\$229.0m (\$0.039), HK\$319.8m (\$0.054)

Key points:

- The stock have been subject to sell down pressure since mid Jul. We believe that the stock is substantially oversold despite some emerging competition within the sector and current undemanding valuations represent an opportune time to accumulate.
- New competitions are local players and small in scale. In our view, they will have difficulty to scale up their business from local to nationwide player. Without a full value chain, they would not be able to sustain its success beyond only a couple of products. In this sense, Seven Star has a clear advantage as they possess product “verticals”. Therefore, we project that these smaller players will eventually drop away, leaving Seven Star as a clear winner.
- M&A progress remain on track and we expect an announcement in the near term.
- China’s TV home shopping sector remains a sub-segment with out and out growth within the overall retail industry. This current environment is typical of nascent markets and we expect large sized players to win out after consolidation sets in.
- We re-iterate our BUY call on Seven Star, with a revised target price of HK\$1.20 (from previously HK\$1.80), representing 27.0x FY12/08F P/E on a fully diluted basis. The counter is currently trading at only 14.6x FY12/08F P/E on a fully diluted basis, at a substantial discount to other China retail plays, which are trading at an average of 30.0x next year earnings (based on consensus estimates).

Seven Star is oversold, opportune time to accumulate. The stock of China Seven Star (Seven Star) has been hit hard since mid Jul 2007 on concerns of share dilution of Pei Lian, emerging competition and some negative press emerging from Acorn (ATV US). However, with the stock dropping some 49.6% from its high of HK\$1.41 (24 Apr 2007), current valuations are extremely attractive, even after considering the impacts of some emerging competition. In our view, current levels are an opportune time to accumulate the counter.

Seven Star still in a prime position to beat out would be pretenders. Based on our channel checks, ground level observations and comments from Acorn’s management, it appears as though there are some emerging local players in the TV home shopping sector. Given that Seven Star has more exposure on satellite and provincial channels, the escalated competitive landscape would likely affect the company more, relative to Acorn. However, in our view, Seven Star is still in the prime position to beat out these would be pretenders. As we have mentioned previously, while entry barriers to the industry is not high, the difficulty in setting up the upstream and downstream value chains makes it difficult for these emerging plays to scale up their business from local to nationwide player. Moreover, without a full ecosystem of suppliers, these new players would find it difficult to continually sustain its success beyond only a couple of products. In this sense, Seven Star has a clear advantage as they not only possess more product “verticals” such as consumer electronics, kitchenware, insurance products, fitness equipment etc, but also more suppliers within each category. Therefore, we project that these smaller players will eventually drop away, leaving Seven Star as a clear winner, with increased market

share.

Still the choice for large scale supplier partners. The nationwide distribution platform of Seven Star is one of its greatest assets as large scale suppliers would prefer to partner with them to leverage their business model to distribute their products nationwide. In addition, the network of “below-the-line” POS would further increase the “tail off”, extending the life cycle of each individual product. For new products, which carry with it the highest margins, the supplier partners will first work with Seven Star to capture the time-to-market premium. It is only after the product begins to enter its mature phase, or other second tier products, in which localized players will be able to secure sourcing.

Brand name assumes importance. In the TV home shopping business, consumer confidence in the brand is of extreme importance and consumers see China Seven Star’s nationwide brand as a sign of service and quality guarantee. The brand premium is further elevated as they typically sell products for brand owners that are well known to consumers e.g. Amoi and CECT handsets as well as insurance products for China Pacific Insurance Company (CPIC) (“Jin Yu Man Tang” (金玉满堂)).

M&As remain on track. Management of Seven Star is in constant negotiations with potential M&A targets and we believe that progress remain on track for an announcement in the near future. The company is targeting acquisitions both vertically, to strengthen their product lines as well as horizontally, to further broaden its distribution platform.

Pei Lian overhang will soon be over. Management is at present finalizing the auditing of Pei Lian to determine its earned out consideration (as part of the acquisition terms). We expect an announcement regarding the number of shares issued in around mid Aug 2007, which will remove a significant overhang on the stock. As a recap, the number of consideration shares to be issued will be equivalent to 3.0x the audited consolidated net profit of Pei Lian for the first full financial year after completion of the acquisition, at an issue price of HK\$0.1025. In our diluted shares calculation, we currently assume 878.0m consideration shares.

China’s TV home shopping space is a sector with out and out growth. China’s TV home shopping sector remains a sub-segment with out and out growth within the overall retail industry. The company accounted for only 0.11% of China’s retail market in 2005 and market reports suggests that this could grow to around 1~2% by 2010, representing a CAGR of some 60%. In our view, this current environment is typical of nascent markets with many emerging plays within a fragmented market. However, we expect the industry to consolidate over time as the industry grows and as smaller competitors with less scale and sourcing scale are gradually weeded out.

Revised net profit. We have revised down our net profit forecasts for China Seven Star taking into consideration of these emerging local plays. We now estimate its FY12/07F net profit to come in at HK\$186.1m (c.f. HK\$229.0m previously). For FY12/08F, we now project net profit to reach HK\$293.7m (c.f. HK\$319.8m previously). We expect the company’s FY12/07F earnings to be heavily skewed towards the second half of the financial year. Seven Star spent around RMB60m in 1Q FY12/07 on advertising expenses and we estimate 1H FY12/07F advertising expenses to be RMB245m, or approximately 40% of the RMB580.0m full year advertising budget for the company. This would translate to a 1H FY12/07F net profit of HK75.4m.

Re-iterate BUY call, new target price HK\$1.20. We re-iterate our BUY call on Seven Star, with a revised target price of HK\$1.20 (from previously HK\$1.80). Despite being subject to more short term competition, we maintain our view that Seven Star will emerge as a clear winner in the TV home shopping space. The current sell down therefore, represents an opportune time to accumulate the stock. China’s TV home shopping space remains a growth sub-segment within the China’s overall retail space. The counter is currently trading at only 14.6x FY12/08F P/E on a fully diluted basis, at a substantial discount to other China retail plays, which are trading at an average of 30.0x next year earnings (based on consensus estimates). Our revised target price represents 27.0x FY12/08F P/E on a fully diluted basis and takes into consideration: 1) lower earnings estimate and 2) the issue of consideration shares for the acquisition of Pei Lian.

Table 1: P&L

Year to Dec (RMBm)	04A	05A	06A	07F	08F	09F
Turnover	31.1	23.2	92.4	2,127.3	2,661.0	3,251.8
% chg	220.8	(25.5)	300.1	2201.6	25.1	22.2
Cost of sales	(18.5)	(13.9)	(26.0)	(873.6)	(1094.5)	(1,394.5)
Gross profit	12.6	9.3	66.4	1,253.7	1,566.5	1857.3
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)	(626.2)	(723.6)	(914.8)
Administration expenses	(7.3)	(14.9)	(17.7)	(259.3)	(295.7)	(295.7)
Other operating expenses	(0.4)	(1.0)	(3.0)	(3.2)	(3.2)	(3.3)
Operating profit	(4.1)	(11.6)	45.1	370.1	552.1	653.7
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	369.2	551.2	652.8
Taxation	-	(2.0)	(11.9)	(110.8)	(143.3)	(169.7)
Profit after taxation	133.7	(17.4)	32.2	258.4	407.9	483.1
Minority interests	(0.9)	0.8	(2.6)	(72.3)	(114.2)	(135.3)
Profit attributable to shareholders	133.6	(16.7)	29.6	186.1	293.7	347.8
% chg	n/a	n/a	n/a	529.6	57.8	18.4
Dividend	-	-	-	-	-	-

Source: 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
Year to Dec					
Turnover	23.1	92.4	2,127.3	2,661.1	3,251.8
% chg	(25.5)	300.3	2,201.6	25.1	22.2
Gross profit	9.2	66.4	1,253.7	1,566.5	1,857.3
EBITDA	(11.4)	41.7	366.1	545.5	645.7
Depre./amort.	(0.2)	(0.8)	(1.1)	(1.5)	(2.1)
EBIT	(11.6)	40.9	365.0	544.0	643.5
Net int. income/(exp.)	(0.4)	3.2	4.2	7.2	9.3
Exceptionals	(3.4)	-	-	-	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	(15.4)	44.1	369.2	551.2	652.8
Tax	(2.0)	(11.9)	(110.8)	(143.3)	(169.7)
Minority interests	0.8	(2.6)	(72.4)	(114.2)	(135.3)
Net profit	(16.6)	29.6	186.1	293.7	347.8
% chg	(112.5)	(278.3)	529.6	57.8	18.4
Dividends	-	-	-	-	-
Retained earnings	(16.6)	29.6	186.1	293.7	347.8
EPS (HK\$) - Basic	(0.004)	0.007	0.028	0.044	0.053
EPS (HK\$) - F.D.	(0.004)	0.007	0.028	0.044	0.053
DPS (HK\$)	-	-	-	-	-
No. sh.s o/s (m) - W.A.	3,722.8	4,252.3	6,603.7	6,603.7	6,603.7
No. sh.s o/s (m) - Y.E.	3,722.8	5,063.2	6,603.7	6,603.7	6,603.7
No. sh.s o/s (m) - F.D.	3,722.8	4,279.4	6,603.7	6,603.7	6,603.7
Margins (%)					
Gross	40.0	71.9	58.9	58.9	57.1
EBITDA	(49.3)	45.1	17.2	20.5	19.9
EBIT	(50.1)	44.2	17.2	20.4	19.8
Pre-tax	(66.5)	47.7	17.4	20.7	20.1
Net	(71.8)	32.0	8.7	11.0	10.7
Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	4.6	2.8	13.7	26.2	42.1
Intangible assets	28.4	28.4	27.9	27.3	26.8
Other LT assets	-	0.2	0.2	0.2	0.3
Cash	4.0	141.4	661.7	901.8	1,204.5
Accounts receivable	18.3	124.6	66.9	125.0	142.4
Other receivables	-	-	-	-	-
Inventories	2.2	2.2	45.7	44.3	70.3
Due from related co.s	-	-	-	-	-
Other current assets	9.7	9.8	11.3	13.0	14.9
Total assets	67.3	309.4	827.3	1,137.8	1,501.3
Accounts payable	(40.6)	(29.0)	(87.6)	(131.2)	(189.6)
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)	(117.6)	(164.6)	(226.9)
Share capital	372.3	506.3	660.4	660.4	660.4
Reserves	(372.1)	(262.7)	(32.8)	116.5	282.4
Shareholders' funds	0.2	243.6	627.6	776.9	942.8
Minority interest	1.6	9.8	82.1	196.3	331.6
Total	1.8	253.4	709.7	973.2	1,274.4
Capital employed	21.4	263.6	720.5	984.5	1,286.2
Net (debt)/cash	(15.6)	131.2	672.5	913.1	1,216.4
Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	(11.6)	40.9	365.0	544.0	643.5
Depre./amort.	0.2	0.8	1.1	1.5	2.1
Net int. paid	(0.4)	3.2	4.2	7.2	9.3
Tax paid	(0.2)	(11.9)	(110.8)	(143.3)	(169.7)
Dividends received	-	-	-	-	-
Gross cashflow	(12.1)	33.0	259.5	409.4	485.2
Chgs. in working cap.	7.7	(23.7)	(44.3)	(100.4)	(101.8)
Operating cashflow	(4.3)	9.3	215.2	309.0	383.4
Capex	(1.0)	(5.0)	(12.0)	(14.0)	(18.0)
Free cashflow	(5.3)	4.3	203.2	295.0	365.4
Dividends paid	-	-	-	-	-
Net distribution to MI	-	(2.6)	(72.4)	(114.2)	(135.3)
Investments	-	-	-	-	-
Disposals	-	-	-	-	-
New shares	-	200.0	378.5	-	-
Others	(4.2)	16.6	31.9	59.9	73.1
Net cashflow	(9.5)	146.8	541.3	240.7	303.3
Net (debt)/cash - Beg.	(6.1)	(15.6)	131.2	672.5	913.1
Net (debt)/cash - End.	(15.6)	131.2	672.5	913.1	1,216.4
Interim Results (HK\$m)	05A	06A			
Six months to Jun					
Turnover	9.9	18.0			
% chg	-	81.9			
Profit from operations	(8.3)	12.8			
Interest expenses	(0.0)	(0.4)			
Associates	-	-			
Jointly-controlled entit.	-	-			
Pre-tax profit	(8.3)	12.4			
Tax	-	(2.4)			
Minority interests	0.4	0.0			
Net profit	(8.3)	10.0			
% chg					
EPS (HK\$) - Basic	(0.002)	0.003			
DPS (HK\$)	-	-			
Shareholding Structure					
		Shares o/s (m)	%		
Michael Ni, Chairman		2,004.7	35.5		
Keywise Capital		373.5	6.6		
Other substantial shareholders		1,117.6	19.8		
Public		2,153.4	38.1		
Total		5,649.2	100.0		
Background					
China Seven Star (Seven Star) is principally engaged in direct TV sales and retail sales of consumer products in China.					
Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	(209.1)	Cash	Cash	Cash	Cash
Net ROE (%)	(302.4)	24.2	42.7	41.8	40.4
EBIT ROCE (%)	(50.7)	28.7	74.2	63.8	56.7
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	32.0	35.0
A/P turnover (days)	411.1	137.5	10.0	15.0	18.0
Stock turnover (days)	41.2	31.1	10.0	15.0	15.0

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

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

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Securities Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Securities Limited 2007. All rights reserved.
