Corporate Flash

Thu, 30 Aug 2007

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China Seven Star: JV brings stability and partnership

Recommendation: BUY (unchanged) — China Consumer

Price	**HK$0.61**
Target price	HK$1.05 (+72%)
12 mth range	HK$0.14-1.41
Market cap.	US$448.9m
Daily t/o, 3 mth	US$7.0m
Free float %	38.2%
Ticker	0245.HK/245 HK

Year to Dec	Net profit HK$m	EPS HK$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
05A	(16.6)	(0.004)	na	na	na	na	9.0	na	na	na
06A	29.6	0.007	na	94.1	11.3	79.5	-	14.4	20.2	Cash
07F	186.1	0.028	273.6	23.6	6.2	7.6	-	42.7	74.2	Cash
08F	278.9	0.039	53.2	15.4	5.8	4.8	-	40.3	61.5	Cash
09F	339.9	0.047	21.8	12.7	22.8	3.5	-	40.5	56.7	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -33.0%, -43.0%, +275.0%
Actual price changes (1 mth, 3 mth, 12 mth): -31.8%, -46.2%, +187.0%
Previous forecasts (07F-08F): HK$186.1m ($0.028), HK$293.7m ($0.044)

Key points:

- Seven Star signed an MOU with two parties, including handset design house Longcheer (LHL SP, S$0.58, NR), to form a JV to market and distribute handsets in China.
- Move is positive as the JV can help Seven Start forge a long-term partnership with a handset manufacturer, secure product supply and enable differentiation against competitors.
- Competitor Acorn emphasized the need to build such long-term relationships at its recent results briefing. Seven Star has a first mover advantage in this regard.
- We maintain our BUY call on Seven Star and revise our target price to HK$1.05 (from HK$1.10), representing 27.0x FY12/08F P/E, after taking into account contributions from the new JV and more prudent margin assumptions. Seven Star remains our top pick as it taps the China consumption story in a growing niche market segment.

JV announcement. Seven Star signed a MOU to form a JV to market and distribute handsets in China. The JV, Shanghai QL Telecommunications Co (QL), is an existing entity 57.0%-owned by Sinolong Technology and 43.0% by Shanghai LS Investment. Sinolong Tech is wholly owned by Singapore-listed Longcheer (LHL SP, S$0.58, NR), a Chinese mobile handset design house. Seven Star will invest RMB28.5m for a 36.3% stake in the RMB78.5m JV. On the deal's completion, Sinolong's and Shanghai LS' stakes will be diluted to 36.3% and 27.4%, respectively. Under the terms of the MOU, Seven Star has a 90-day exclusive period to complete its negotiations with the remaining two parties.

Combining strengths. Sinolong will be responsible for the design and sourcing of the handsets and Shanghai LS for marketing and distribution. Seven Star will add its TV home shopping platform to the mix. In our view, this is a synergistic JV combining each party's particular strengths, which will provide an opportunity for Seven Star to further build on its handset leadership position on the TV home shopping platform.

Flexibility and enhanced partnership. Its participation in the JV does not preclude Seven Star from selling other branded handsets on its TV home shopping platform. We believe that the JV may even create its own brand for distribution. Longcheer already designs handsets for major Chinese brands including ZTE, Konka and TCL. In our view, the JV helps Seven Star to forge a long-term partnership with a leading Chinese handset design house, which is critical given the current competitive landscape. Handset manufacturers are increasingly accepting TV home shopping as a legitimate way to drive sales. Together with emerging local competition, there is relatively little loyalty from handset suppliers and little differentiation among products. Hence, it is imperative for Seven Star to build long-term relationships with handset manufacturers to ensure product supply and a high product refresh rate. More importantly, having its own brand would allow differentiation against other competitors and support margins. Key competitors such as Acorn have cited the need to build long-term partnerships with handset manufacturers during their recent 2Q results conference call.

Read through from Acorn conference call. Other industry read throughs and trends from Acorn's conference call include:

- There is a need to build long-term partnerships with handset manufacturers to secure product supply;
- There has been an escalation in the competitive landscape. Some local players emerged but most don't have the necessary scale to compete in the long term;
- Airtime rates are expected to increase roughly 10% as there has been some slight rate decrease in airtime costs in some non-prime areas;
- There is a big market potential in order fulfilment for insurance products.

Acorn is now guiding for a FY12/07 net profit of US$24.0-26.0m (HK$187-203m), comparable with our net profit estimate for Seven Star, meaning that Seven Star has gained substantial ground on its larger rival.

Maintain BUY, revised target price HK$1.05. We have left our FY12/07F numbers unchanged given that the new JV is unlikely to contribute in this financial year. We estimate that QL will boost Seven Star's bottomline by RMB7.5m in FY12/08F and RMB8.5m in FY12/09F. We have therefore revised our net profit estimates for Seven Star to RMB278.9m for FY12/08F and RMB339.9m for FY12/09F taking into account contributions from the JV and more prudent margin assumptions from a more competitive landscape. We have revised our target price to HK$1.05 (from HK$1.10), representing 27.0x FY12/08F P/E. Seven Star remains our top pick as it taps the China consumption story in a growing niche market segment.

Table 1: P&L

Year to Dec (RMBm)	04A	05A	06A	07F	08F	09F
Turnover	**31.1**	**23.2**	**92.4**	**2,127.3**	**2,734.4**	**3,371.5**
% chg	*220.8*	*(25.5)*	*300.1*	*2201.6*	*28.5*	*23.3*
Cost of sales	(18.5)	(13.9)	(26.0)	(873.6)	(1,139.9)	(1,467.1)
Gross profit	12.6	9.3	66.4	1,253.7	1,594.5	1,904.4
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)	(771.2)	(965.9)
Administration expenses	(7.3)	(14.9)	(17.7)	(259.3)	(303.8)	(306.4)
Other operating expenses	(0.4)	(1.0)	(3.0)	(3.2)	(3.3)	(3.4)
Operating profit	(4.1)	(11.6)	45.1	370.1	524.4	638.9
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**	**524.4**	**637.9**
Taxation	-	(2.0)	(11.9)	(110.8)	(136.1)	(165.9)
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)	(108.5)	(132.2)
Profit attributable to shareholders	**133.6**	**(16.7)**	**29.6**	**186.1**	**278.9**	**339.9**
% chg	*n/a*	*n/a*	*n/a*	*529.6*	*49.9*	*21.9*
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.

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