SBI E2-Capital

Corporate Visit

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Landune: The only China TV home shopping play

Recommendation: Not Rated | **China Media**

Price	**HK$0.195**	**Yield (12/05A)**	n/a
12 mth range	HK$0.090-0.245	**ROE (12/05A)**	n/a
Market cap.	US$105.8m	**Net gearing (12/05A)**	284.6%
No. shares o/s	4,231.0m	**Net debt/sh. (12/05A)**	HK$0.369 cents
Daily t/o, 3 mth	<US$0.3m	**BV/sh. (12/05A)**	HK$0.004 cents
Free float %	37%	**Consensus EPS**	
Major shareholder	Group First (Chairman Ni Xinguang) – 56.9%	**- 12/06F**	n/a
Ticker	0245.HK/ 245 HK	**- 12/07F**	n/a

Key points:

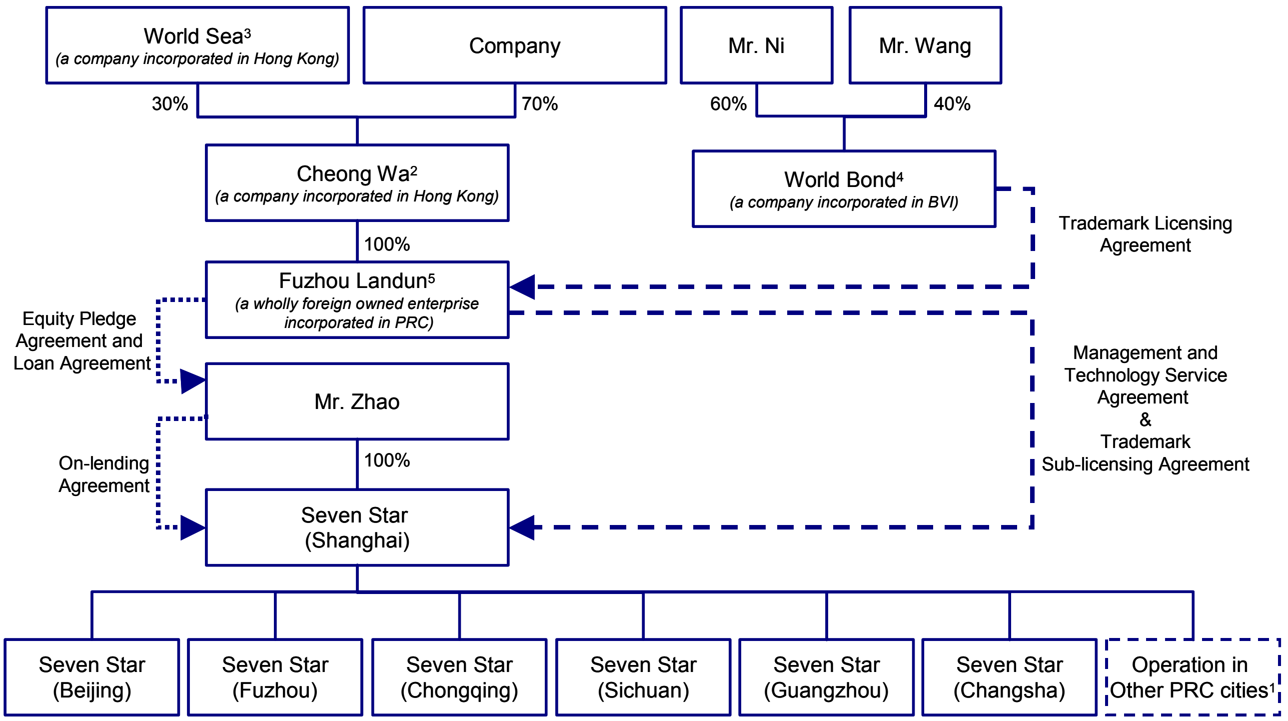
- After acquiring Shanghai Pei Lian in Sep 2005 and entering into structured agreements with Seven Star in Aug 2006, Landune is now in a key position to tap the surging growth of China's direct TV sales market.
- Seven Star has 10 years' industry experience and is China's second largest direct TV sales operator with a market share of 9.1% at the end of 2005. China's direct TV sales market is forecast to increase at a CAGR of 22% between 2003 to 2007.
- Seven Star's strength is in brand management, media strategy development and product distribution over the TV media platform. The use of TV platform provides a test bed for new products and improves product success rate. The company is asset light and sources products from ODM suppliers.
- With full year contribution from Seven Star in FY12/07F, we forecast Landune's bottom line to reach RMB114.4m (RMB2.16 cents fully diluted EPS). The counter trades at 9.4x FY12/07F P/E versus international peers' 14.1x for direct TV sales/media plays and 22.0x for china retail plays respectively.

Company background. Landune is principally engaged in direct TV and retail sales of consumer products. The company was formed through the restructuring and re-naming of the previous Singapore Hong Kong Properties Investment Ltd., a property investment company. Chairman Ni bought into the company through a share subscription, loan capitalization and restructuring agreement in Dec 2003. Over the next two years, the company proceeded to dispose of various non-core investment properties. In Sep 2005, the company acquired Shanghai Pei Lian, a company focusing on the providing media management, call centre operations and distribution services for sales of consumer products. In Aug 2006, Chairman Ni achieved a back door listing for Seven Star (Shanghai) (Seven Star) through entering into a series of structured contracts with Landune. Seven Star is engaged in the sales of consumer products through retail and direct TV sales channels in the PRC. The structured agreements enable the company to indirectly engage in the business of direct TV sales. Landune adopts the structured contracts mechanism, rather than the traditional M&A process in order to gain first mover advantage in the fast growing direct TV sales market in China.

Deal structure of Seven Star (Shanghai) purchase. The structured contracts consist of 1) the Management and Technology Service Agreement, 2) the Loan Agreement and the On-lending Agreement and 3) the Equity Pledge Agreement. The Management and Technology Service Agreement enables Landune to receive the full economic benefits of Seven Star as payment for the provision of management and technology services. The Loan

Agreement and the On-lending Agreement provide RMB5.6m to Seven Star as working capital and to expand its business in the PRC. Note that Mr Zhao, the 100%-owner of Seven Star[a], is required to act as a middleman for the loan agreement as PRC laws prohibit non-financial institutes to grant any loans to other corporate entities in China, while loans made by non-financial institutes to individuals and vice versa are permitted. Finally, through the Equity Pledge Agreement, Mr Zhao has pledged his entire equity interest in Seven Star as security to Landune for the fulfillment of the Management and Technology Service Agreement and the repayment of the loan. Under these structured contracts, Landune has full control over the business and operations of Seven Star (Shanghai). Such structured contracts are typical in China's media and internet sector. TOM Online (8282 HK, HK$ 1.31, NR) and Tencent (700 HK, HK$18.46, NR) both operate through a similar model. In addition to the structured contracts, the Trademark Licensing Agreement has also been signed to allow Landune to use and sub-license the Seven Star Trademark and associated CNTVS brand name to any of its controlled entities for a term of 3 years commencing 1 Sep 2006 and renewable for another 2 at the discretion of Landune.

Chart 1: Deal structure of Seven Star purchase



1. *Companies or operations to be incorporated or established.*
2. *Cheong Wa is an investment holding company incorporated in Hong Kong and is owned as to 70% by the Company and as to 30% by World Sea Limited ("World Sea")*
3. *World Sea is a company incorporated in Hong Kong and is wholly-owned by Ms. Zhu Zhi Hua, an independent third party and not connected to the Company's shareholders.*
4. *World Bond is an investment holding company incorporated in the BVI and is owned as to 60% by Mr. Ni and as to 40% by Mr. Wang. World Bond is principally engaged in investment holding and is the owner of the Seven Star Trademark."*
5. *Fuzhou Landun is a wholly foreign owned enterprise incorporated in the PRC and is engaged in the manufacture and distribution of health food and cosmetic products.*

Source: Company data, HKEx

Existing sales operations will be migrated into Seven Star (Shanghai). Seven Star is essentially a management company for Chairman Ni's sales operations with negligible earnings (RMB0.3m loss in FY12/05). After signing the structured contracts, the Chairman has begun to migrate the core sales operations from the "old" Seven Star into Seven Star (Shanghai) on an area-by-area basis. The process involves signing new supplier and employee contracts with the new entity. Management expects the migration process to be completed in 2-6 months.

Presence, product portfolio and customer base. Seven Star operates its direct TV sales platform in China under the brand name of CNTVS. The subsidiary has a nationwide presence, including Shanghai, Changsha, Beijing, Xian, Guangzhou, Fuzhou, Chongqing and Sichuan. Products sold and distributed by Seven Star are primarily aimed at the demographic group of housewives, elderly and young females. The products are generally divided into kitchenware, learning products, cosmetic and slimming products, health food, fitness equipment, home

[a] Chairman Ni transferred his 80% equity interest in the registered capital of Seven Star to Mr. Zhao on 30 Aug 2006

appliance and digital electronic products. At the end of 2005, Seven Star had a customer base of 1m. Management aims to expand this base by 10 fold to 10m in 3 years' time. Average value per transaction per customer was RMB783 in FY12/05.

Table 1: Product category sales breakdown

Product category	% of 2005 turnover
Kitchenware products	16
Learning products	7
Cosmetic/slimming products	29
Health foods	9
Fitness equipment	14
Digital electronics products	24
Others	1

Source: Company data

Table 2: Main forms of TV shopping

TV sales format	Characteristics
DRTV infomercials	❑ Fast paced, hard-selling infomercials ❑ Elicit a direct response from viewers ❑ Purchase the product being demonstrated on TV
24/7 home shopping	❑ TV equivalent of "mail crawling" ❑ Slow browse products on dedicated channels
Next generation	❑ Interactive shopping channels on digital TV and IPTV platforms ❑ Compelling and entertaining format ❑ Facilitate the purchasing decision with technology advances

Source: Company data

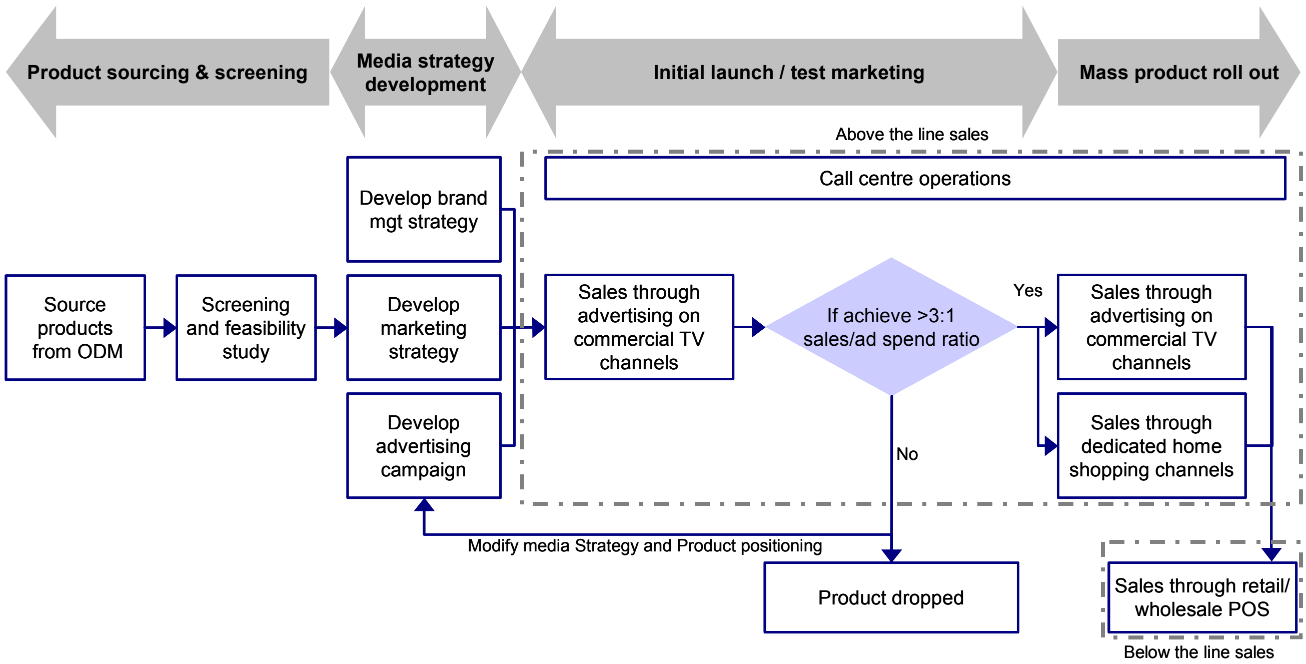
Strength in distribution strategy/brand/marketing management. Seven Star does not own manufacturing facilities and sources products from ODM suppliers. When potential products are sourced, the subsidiary conducts a screening and feasibility study to select products for onward market testing. In this respect, Seven Star has a clear advantage. The subsidiary has been established in the industry for 10 years and has been profitable in each year of operation. Furthermore, Chairman Ni has over 10 years experience in the retail, product procurement/development/packaging in the television shopping industry. Over this period, Seven Star has built up a rich database of customer information and has developed an in-depth appreciation of consumer spending habits and trends across China. This allows the subsidiary to adopt either a regional or nationwide distribution strategy for its products. Once the products for market testing are identified, the company again draws on its customer base knowledge to develop a media strategy, which includes brand promotion and management, as well as advertising strategy. The company will then proceed to produce a made-for-TV infomercial, typically of 5-10 minutes duration. Shanghai Pei Lian, acquired by Landune in Sep 2005, will bring synergies to this area with its expertise in retail and media management.

Use of TV platform as test bed increases success rate. Seven Star initiates the market test process by placing the product infomercial on advertising airtime of commercial TV stations (predominantly on provincial satellite networks) in various cities according to the distribution strategy previously defined over a 3 month period. Due to the length of the infomercials, they are typically shown during non-peak hours of 9:00am-6:00pm and 11:00pm-2:00am. The non-peak time slots are suitable as the products' target audience typically spend a significant amount of time at home. For the product to be considered "successful", the product will need to generate a sales/ad spend ratio of 3:1. Products that don't meet this milestone are either sent back to the product development department to have its media strategy and product positioning modified for re-testing, or dropped from the portfolio altogether. The key benefit of using the TV platform to gauge market acceptance is that it minimizes product and marketing risks. The subsidiary typically launches around 20 new products per year, with around half considered to be suitable for market launch on average.

Cost sharing further reduces Seven Star's risk. Seven Star is able to further reduce its product development risk through a cost sharing arrangement with the ODMs during the market test process. All ad spend are split on a 20% (Seven Star) / 80% (ODM) basis. Advertising airtime varies widely, ranging from RMB85/min to RMB1,000/min depending on whether the infomercial is placed on local TV stations or national/provincial satellite TV stations.

Dual strategy for mass market distribution. The subsidiary adopts a dual mode distribution strategy to sell its products, which is differentiated by "above-the-line" and "below-the-line" sales. Above-the-line sales are essentially Seven Star's direct TV sales channels comprising both commercial TV stations and dedicated 24/7 home shopping channel stations. The subsidiary has a nationwide access to around 15 provincial TV stations and 100 city TV stations. In FY12/05, the Seven Star logged around 160 minutes/day airtime on provincial stations and 1,800 minutes/day on local TV stations respectively. Below-the-line sales consist of the subsidiary's wholesale and retail operations. Seven Star also distributes its products through a retail network of 300 directly owned outlets and 3,000 point of sales (POS) in total, which is sizeable when compared to the distribution network of other retail plays. According to the management, the subsidiary's 180 staff strong call center typically receives around 5,000 calls per day, with a 20% conversion rate. For FY12/05, above-the-line sales accounted for 46.4% of turnover while below-the-line sales accounted for the remaining 53.6%. Gross margin for above/below-the-line sales were in the region of 70% and 50% respectively. We estimate that blended gross margin for Seven Star was 57.8% in FY12/05. In our view, the dual channel distribution strategy is positive. Historically, above-the-line sales tend to be more volatile as it is strongly correlated with advertising airtime invested. The complementary below-the-line sales offer Seven Star a more stable earnings avenue, as the downstream operation tends to benefit from the previous TV product marketing campaigns. The company's net profit amounted to RMB47.0m in FY12/04 and RMB62.0m in FY12/05. Meanwhile, 1H FY12/06 net profit reached RMB48.1m.

Chart 2: Business model of Seven Star



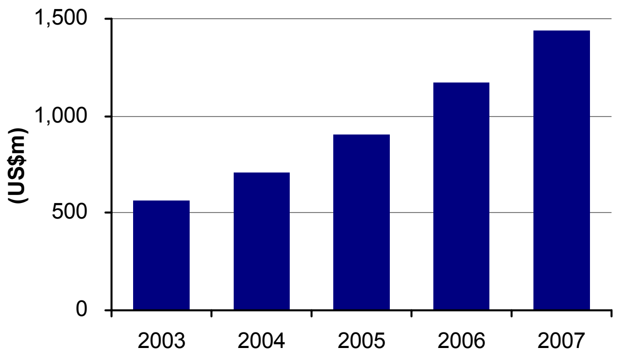
Source: Company data, SBI E2-Capital

Entry barriers and competitive advantages. Though barriers to enter the direct TV retail industry are not high, there are significant costs for upstarts to achieve a leading position such as that occupied by Seven Star. These barriers include: 1) operating scale, 2) broad geographical distribution network and 4) rich database of market and client data. Together, the barriers allow Seven Star to derive its competitive advantages of lower cost structure (through lower product sourcing costs and bulk purchase of ad time), distribution reach and nationwide brand presence.

Direct TV sales poised for strong growth. With a penetration rate of 0.23% at the end of 2005, China's direct TV sales industry is still in its nascent stage. This compares to a penetration rate of 8% in the US and 10% in Korea and Japan. Moreover, unlike other emerging industries in China, the infrastructure for direct TV sales is already in place. Number of TV households reached 331m in 2005, with a penetration rate of 95.3%. While we do not expect the direct TV sales penetration rate to reach that of mature countries, there is still significant potential in the industry. The industry's growth and increasing penetration will be driven by a number of macro factors. Firstly, as the China economy continues to grow, disposable income levels are also on the rise. China's rising middle class consumers are increasingly shifting their spending towards discretionary consumption. Secondly, China consumers are growing increasingly comfortable with alternative payment methods e.g. credit. According to McKinsey, consumer credit is expected to increase at a CAGR of 25% between 2006 and 2013. Finally, the emergence of next generation media platforms such as digital TV and IPTV are expected to further drive adoption of direct TV sales. The new media will increase the level of interaction with consumers and enhance the overall TV shopping experience. China has shown it can achieve fast adoption rates of new technology platforms as previously demonstrated through mobile communication and Internet. According to Euromonitor, China's direct

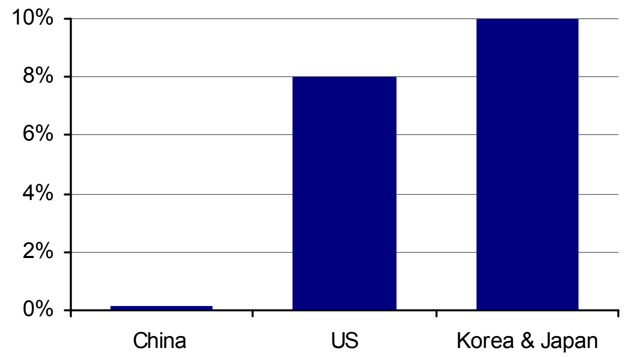
TV sales market is expected to increase at a CAGR of 22% for 2003 to 2007, compared to a historical average growth rate of around 12% p.a. for the retail industry as a whole.

Chart 3: Growth of China direct TV sales market



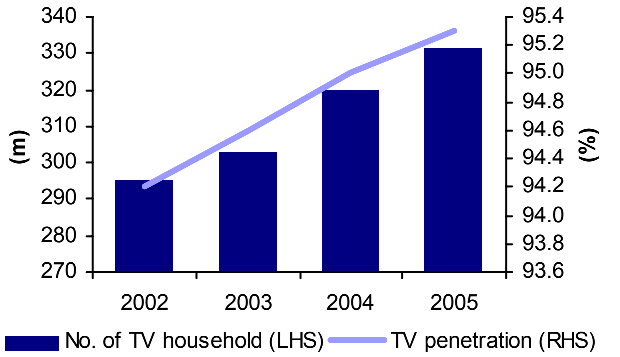
Source: Euromonitor

Chart 4: % home shopping/retail spending in 2005



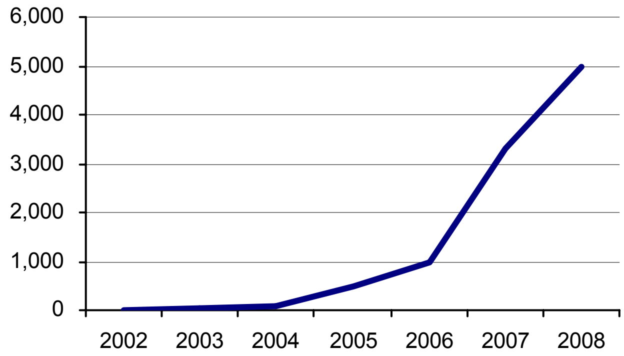
Source: China TVShopping, Euromonitor

Chart 5: TV penetration in China 2005



Source: China Statistical Yearbook (2004, 2005), Asia Pacific Cable and Satellite Market Report 2005

Chart 6: Digital TV subscribers in China



Source: SARFT

Competitive landscape. China's TV home shopping market is dominated by 5 players, which collectively accounted for 44.5% market share in 2005. Seven Star, with a 9.1% market share is ranked second behind industry leader Acorn International. The main markets for TV home shopping include Beijing, Shanghai, Guangdong and Jiangsu. From a geographical perspective, Eastern, Northern and North Eastern China accounted for 64% of the market in 2005. Acorn International is reported to be seeking an IPO listing on the Nasdaq to raise up to US$200m.

Table 3: China's direct TV sales leaders

Company	2005 market share (%)
Acorn International	22.5
Seven Star	9.1
Dongfang CJ	5.5
TVSN	4.0
BTV Shopping	3.4

Source: Company data

Seven Star as key earnings driver. Going forward, Seven Star will become the key earnings driver to Landune. The subsidiary's top and bottom line is expected to be driven by a combination of industry growth and market share gains. The direct TV sales will be a key platform to realizing this growth being the test bed and first mover distribution channel for its products. However, with a comparatively larger carrying product portfolio for below-the-line operations, we expect sales growth in this segment to out pace above-the-line sales. We project the above/below-the-line sales will shift from 46.4%/53.6% in FY12/05 to around 35%/65% in FY12/07F. The blended gross margin for the subsidiary is expected to contract from 57.8% in FY12/05 to 55.7% in FY12/07F as a result of the change in sales mix.

Preliminary forecasts. FY12/07F will be the first year in which Seven Star will have a full 12-month contribution to Landune's financials. We forecast Landune's FY12/07F net profit to reach RMB114.4m (fully diluted EPS: RMB2.16 cents) with Seven Star accounting for RMB74.5m (after minority interest).

Valuation. Landune trades at 9.4x FY12/07F P/E. International peers are presently trading at 14.1x for direct TV sales/media plays and 22.0x for china retail plays respectively next year P/E based on consensus estimates.

Table 4: Valuation comparisons

Company Name	Ticker	Country	Mkt Cap (US$m)	Price	His. Turnover (US$m)	His. Net Profit (US$m)	Nxt Yr P/E (x)
Direct TV Sales/Media							
GS Home Shopping	028150 KS	Korea	633.1	KW76,000	691.7	76.5	8.3
CJ Home Shopping	035760 KS	Korea	1,146.1	KW82,000	745.9	81.3	12.8
Ideal Shopping Direct	IDS LN	UK	141.2	GBp259.50	148.5	9.7	11.7
Valuevision Media	VVTV US	US	444.1	US$11.75	691.9	(15.8)	55.2
InterActiveCorp	IACI US	US	8,456.5	US$28.35	5,753.7	876.2	16.3
Focus Media	FMCN US	China	3,135.6	US$59.98	68.23	23.6	24.6
Qin Jia Yuan	2366 HK	HK	154.2	HK$2.37	13.6	8.5	10.8
Average							**14.1***
China Retail							
Hongxing Sports	CHHS SP	China	422.1	SGD1.60	38.4	5.8	11.4
Hongguo	HGUO SP	China	170.5	SGD0.66	53.9	9.0	12.0
Li Ning	2331 HK	China	1,241.6	HK$9.38	311.1	23.7	27.8
Parkson	3368 HK	China	2,045.2	HK$28.10	143.7	31.5	27.5
Lianhua	980 HK	China	709.7	HK$8.56	1,816.8	30.4	17.0
Wumart	8277 HK	China	946.6	HK$24.20	497.4	20.9	21.9
Suning Appliance	002024 CH	China	4,417.1	RMB47.9	2,019.9	44.5	25.6
China Paradise	503 HK	China	628.6	HK$2.03	1,554.5	36.7	39.6
GOME	493 HK	China	1,822.5	HK$6.11	2,279.7	63.3	14.8
Average							**22.0**
Landune	245 HK	HK	103.1	HK$0.190	3.0	(2.1)	9.4

* *Excludes Valuevision Media*

Source: Bloomberg, SBI E2-Capital

Risks. 1) no significant entry barriers, 2) a slow down in China domestic consumption, 3) rising rental and TV airtime costs, 4) rising rebates for Seven Star's wholesale operations, 5) regulatory risk in terms of both direct TV sales industry and product categories, 6) structured contracts arrangement between Landune and Seven Star and 7) failure to fully migrate the sales operations from the "old" Seven Star to Seven Star.