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China Seven Star: Operating metrics better than Acorn

Recommendation: BUY (unchanged) — **China Consumer**

Price	**HK$0.59**
Target price	HK$0.71 (+20%)
12 mth range	HK$0.14-1.41
Market cap.	US$515.29m
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	85.4	10.3	76.8	-	14.4	20.2	Cash
07F	137.6	0.019	176.2	37.2	5.0	13.5	-	27.9	36.8	Cash
08F	205.5	0.028	49.4	24.9	5.4	8.5	-	27.0	38.4	Cash
09F	246.7	0.034	20.0	17.3	99.3	6.3	-	26.9	37.3	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:

- Earnings risk materialises as expected. 1H FY12/07A net profit of HK$43.3m was due to: 1) higher than expected effective tax rate; 2) lesser contribution from handsets due to competition and supplier issues and 3) insurance products taking longer to ramp up.
- Handset supply issues further highlights the value of potential JV with leading Chinese handset design house Longcheer (LHL SP, S$0.635, NR). The long term partnership will assist in the securing handset supply and allowing CSS to differentiate itself more from competitors such as Acorn (ATV US, US$17.67, NR).
- Effective tax rate 39.7% due to a prudent accounting treatment in 1H. We expect year end tax expense to be substantially lower.
- Our sensitivity analysis shows that adjusted net profit for 1H FY12/07 would have been substantially higher and in line with our original estimate even if a 28.0% effective tax rate was maintained as per our original estimate our P&L model.
- Expect CSS to announce further strategic alliances / JVs with other product suppliers to broaded their product lines going forward. In 3Q FY12/07, the company has already commenced distributing new products such as watches and jewelry on its TV home shopping platform. Meanwhile, the company is also expecting to enter into distribution of high value products such as automobile and housing.
- Despite an indifferent set of 1H FY12/07A results, and some near term uncertainty, long term prospects remain intact, We have revised down our target price for CSS to HK$0.71 (from HK$1.05), representing 25.0x FY12/08F P/E. We expect the stock price to experience some weakness in the near term, which may present accumulating opportunities.

Earnings risk materialises as expected. China Seven Star (CSS) reported an interim net profit of HK$43.3m on a turnover of HK$414.0m reflecting its maiden set of results with a full six months contribution from the TV home shopping business. Though we had previously anticipated some earnings risk to our estimates given the current competitive landscape of the industry, the bottom line result was still slightly below our expectations. The main reasons for the underperformance of the results was due to: 1) higher than expected effective tax rate; 2) lesser contribution from handsets due to competition and supplier issues and 3) insurance products taking longer to ramp up.

Table 1: 1H FY12/07A results

Six months to Jun	Turnover (HK$m)	Gross profit (HK$m)	Gross margin (%)	Pre-tax profit (HK$m)	Tax rate (%)	Net profit (HK$m)	EPS (HK$)	DPS (HK$)
1H FY06	18.0	14.0	77.4	12.4	19.2	10.0	0.26	-
1H FY07	414.1	216.8	52.4	74.4	39.7	43.3	0.79	-
YoY (%)	*2,196.6*	*1,453.2*		*1,035.1*		*332.0*	*203.8*	

Source: Company data

Direct TV sales accounting for the bulk of the revenue. Above-the-line sales accounted for HK$391.9m, or 94.7% of overall turnover, while below-the-line sales accounted for HK$21.6m (5.2%). The remaining 0.1% of turnover was derived from rental income. CSS' air time expenses for the first six months of FY12/07A amounted to HK$100.2m, implying that the company had maintained a sales-to-adspend ratio of 4.13, which was largely in line with expectations.

Table 2: 1H FY12/07A turnover breakdown

Turnover	HK$m	% of turnover
Manufacture, retail and distribution of consumer products (above-the-line)	391.9	94.7
Handsets	290.1	70.1
Others	101.8	24.6
Media management service fees (below-the-line)	21.6	5.2
Handsets	11.8	2.9
Insurance	2.0	0.5
Others	7.9	1.9
Rental income	0.4	0.1
Total	**414.0**	**100.0**

Source: Company data

Table 3: Key expense analysis

Turnover	HK$m	% of turnover
Advertising costs	100.2	24.2
Staff costs (ex-share option expenses)	9.9	2.4
Share option expenses	6.7	1.6
Provision / write-off for bad and doubtful debts	7.8	1.9
Reversal of provision for doubtful debts	(1.2)	-0.3
Overprovision for taxation	(8.9)	-2.2

Source: Company data

Handset sales contributed 74.0% of above-the-line sales, but supplier constraints hamper ability to meet demand. In terms of percentage, handset sales accounted for around 74.0% of the above-the-line sales in 1H FY12/07A, which was within our expectations. However, in unit terms, we had expected the company to ship more than 250K units of handsets. The main issue was one of supply by their handset manufacturing partners. While CSS saw high demand response at their call centres for their handset products, the company at times was unable to meet this demand as their manufacturing partners were not able to guarantee sufficient supply. Therefore, CSS found themselves in a position where they had to turn away some customers. Management estimates that loss revenue as a result of supplier constraints was upwards of HK$100.0m.

Handset supplier constraints further highlights the value of JV. CSS' issues with handset suppliers further highlights the value of potential JV with leading Chinese handset design house Longcheer (LHL SP, S$0.635, NR). The long term partnership will assist in securing handset supply, which is critical to maximising revenue capture of call responses. It will also allow CSS to differentiate itself more from competitors such as Acorn (ATV US, US$17.67, NR), as it can maintain a higher product refresh rate and launch its own brand under the JV. We are presently estimating the JV to ship around 1.0-1.2m handset units in its first year of operations. We expect around two thirds will be distributed through CSS platform, with the remaining one third distributed through traditional distribution channels.

Company sensible in placing airtime. Seeing that they were unable to meet a portion of the handset demand, CSS wisely cut back on their air time expenditure. The HK$100.2m recorded in 1H FY12/07A was around one-sixth of the originally budgeted HK$600.0m for FY12/07. Based on the current rate, we do not expect CSS for spend the entire allocated air time budget for FY12/07.

Exploring more effective methods for monetisation of potential insurance clients. CSS saw strong response for its insurance products after its launch in Apr 2007. However, the company found that after referral of the client to China Pacific Insurance Company (CPIC), other different products were often sold to the potential client. Therefore, CSS was not able to effectively monetise the strong demand for such products. To further develop the market, the company is at present exploring the possibility of setting up an agency in-house for distribution of insurance products. This way, CSS can monetise call responses to its insurance products in-house, without the need to onward refer them to CPIC. This would lead to more effective revenue capture. Details are not yet available, but we speculate that it may involve CSS setting up a subsidiary to work as a partner to an insurance company, which would allow them to operate under the insurance company's license.

Effective tax rate 39.7%, but HK$23.5m tax subject to reassessment at the end of the financial year. The company also booked a tax expense of HK$29.5m, implying an effective tax rate of 39.7%. The abnormally high tax rate was primarily due to a temporary conservative accounting treatment. Pei Lian is currently subject to an enterprise income tax calculated at the rate determined by the local tax authority at an effectve tax rate of 3.3% on the turnover in FY12/07. However, such locally determined tax rate may in certain areas be inconsistent with the national tax laws. Therefore as the interim results are unaudited, the auditor, on prudent measure, temporarily applied an income tax rate of 33% on the whole business for enterprise income tax in accordance with provisional regulations of the PRC until the final year audit. Taking into consideration that a couple of the investment holding subsidiaries under CSS was loss making during the half (as they are only holding company vehicles), the effective tax rate came in at 39.7%. The auditor has clearly stated in the interim announcement that the current tax liabilities amounting to HK$23.5m will be reassessed during the final year audit. We are confident that a large proportion of the tax liabilities will be written back during the year-end audit and also note that Acorn reported an effective tax rate of only 7.5% in their interim results.

Results in line if more reasonable effective tax rate was used. We have conducted a sensitivity analysis and note that adjusted net profit for 1H FY12/07 would have been substantially higher. In fact, even if a 28.0% effective tax rate was maintained as per our original estimate our P&L model, the adjusted 1H FY12/07 net profit of HK$52.0m would have been in line with our HK$55.0m interim net profit estimate.

Table 4: Effective tax rate sensitivity analysis

Scenario	Effective tax rate (%)	Adjusted 1H net profit (HK$m)
Actual	39.7	43.3
Scenario 1 – Original P&L model	28.0	52.0
Scenario 2 – 15% effective tax rate	15.0	61.6
Scenario 3 – Acorn's effective tax rate	7.5	67.2

Source: SBI E2-Capital

Key operating metrics still stronger than Acorn. Despite the moderate financial results, we note that CSS' key operating metrics are still ahead of that of Acorn's. For the first half of 2007, CSS outperformed Acorn in the areas of: 1) handsets sold; 2) sales-to-adspend ratio and 3) pre-tax margin. Acorn's gross margin is slightly higher than CSS, mainly due to the comparatively slightly higher ASPs for the sales of handsets.

Table 5: Operating metric comparison

Operating metric	CSS	Acorn
Handsets sold (direct over the air)	~250K units	~190K units
Handset ASPs	HK$1,200	HK$1,400
Sales-adspend ratio	4.13	3.67
Gross margin	52.4	53.9
Operating margin	17.9	11.9

Source: Company data, SBI E2-Capital

Expect CSS to enter into more JVs and more new product launches. CSS has noted that the key to a rebound in company financials is to secure product supply and maintain product refresh rate. As such, we expect CSS to announce further strategic alliances / JVs with other product suppliers to secure their product lines going forward. In 3Q FY12/07, the company has already commenced distributing new products such as watches and jewelry on its TV home shopping platform. Meanwhile, the company is also expecting to enter into distribution of high value products such as automobile and housing. We expect the sales of the high value products will be on a cost-plus or commission basis, which will not lead to significant increase in inventory costs. We are expecting the company to commence distribution of these products at the end of FY12/07 or early FY12/08.

Revised FY12/07F net profit at HK$137.6m. We have revised down our FY12/07F net profit estimate to HK$137.6m (from HK$186.1m). We now expect air time expenses for FY12/07F to come in at <HK$300.0m. In terms of effective tax rate, we have prudently assumed that the CSS will be able achieve an effective tax rate of 29% for the whole year. For FY12/08F, we have revised our net profit to HK$205.5m (previously HK$278.9m). Our estimates have yet to reflect any contribution from sales of automobile and housing. These will be incorporated into our model once the details of the revenue model becomes clear.

Fundamental BUY call, revised target price HK$0.71. Despite an indifferent set of 1H FY12/07A results and some near term uncertainty, CSS' long term prospects remain intact, as evident by the strong growth of the industry and strong call response to its products. We have revised down our target price for CSS to HK$0.71 (from HK$1.05), representing 25.0x FY12/08F P/E. We expect the stock price to experience some weakness in the near term, which may present accumulating opportunities.

Table 6: P&L

Year to Dec (HK$m)	04A	05A	06A	07F	08F	09F
Turnover	**31.1**	**23.2**	**92.4**	**1,126.2**	**1,865.0**	**2,401.5**
% chg	*220.8*	*(25.5)*	*300.1*	*1,118.4*	*65.6*	*28.8*
Cost of sales	(18.5)	(13.9)	(26.0)	(539.1)	(916.6)	(1,210.8)
Gross profit	12.6	9.3	66.4	587.1	948.4	1,190.7
Other revenue	-	-	4.2	13.7	8.1	10.2
Gain on disposals	-	-	6.3	-	-	-
Selling and distribution expenses	(9.0)	(5.0)	(11.2)	(324.6)	(542.1)	(702.6)
Administration expenses	(7.3)	(14.9)	(17.7)	(56.3)	(77.9)	(95.2)
Other operating expenses	(0.4)	(1.0)	(3.0)	(16.5)	(20.5)	(24.0)
Operating profit	(4.1)	(11.6)	45.1	203.5	316.0	379.1
Finance costs	(3.4)	(0.5)	(0.9)	(0.4)	(0.4)	(0.4)
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**	**203.0**	**315.6**	**378.8**
Taxation	-	(2.0)	(11.9)	(60.4)	(82.1)	(98.5)
Profit after taxation	**133.7**	**(17.4)**	**32.2**	**142.6**	**233.6**	**280.3**
Minority interests	(0.9)	0.8	(2.6)	(5.1)	(28.0)	(33.6)
Profit attributable to shareholders	**133.6**	**(16.7)**	**29.6**	**137.6**	**205.5**	**246.7**
% chg	*n/a*	*n/a*	*n/a*	*365.5*	*49.4*	*20.0*
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.

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