Corporate Flash

Thu, 25 Oct 2007

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China Seven Star: Oversold

Recommendation: BUY (unchanged) China Consumer

Price	HK$0.375
Target price	HK$0.66 (+76%)
12 mth range	HK$0.14-1.41
Market cap.	US$376.4m
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	54.3	6.5	47.7	-	24.2	28.7	Cash
07F	126.2	0.018	153.3	21.4	3.2	8.6	-	25.7	33.9	Cash
08F	189.0	0.026	50.5	14.2	3.5	4.9	-	25.1	35.7	Cash
09F	235.6	0.033	24.1	11.5	67.1	2.9	-	25.3	35.2	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$137.6m ($0.019), HK$205.5m ($0.028)

Key points:

- High effective tax rate was mainly due to double taxation effect in 1H, the result of conservative tax accounting policies by the auditor.
- CSS' top line appears significantly lower than Acorn's, in part due to a commission based revenue model for its below-the-line distribution of handsets.
- Acorn's 1H earnings were boosted by investment income and government subsidies. Stripping out one-off items from both companies, CSS' adjusted net profit compares well with its competitor.
- New JVs with a handset designer and a handset component sourcing company to better control its value chain will improve execution (by securing supply and improving product refresh rate). However, the component sourcing deal may increase CSS' exposure to China's handset industry.
- To avoid inventory and working capital risks, management for a commission-based revenue model for its new platforms of automobiles and property.
- We believe CSS has been oversold due to negative press coverage and previous unfair comparison against Acorn. Its 1H performance fares well against Acorn on an adjusted basis. Trading at an undemanding 14.2x FY12/08F P/E, we believe the currents level is a good entry point compared with Acorn's 20.9x FY12/08F P/E, whose market cap of US$610.1m is almost twice the size of CSS' US$376.4m.

Facts vs rumours. There have been a lot of reports on China Seven Star (CSS) recently in the press. We try to place the facts against issues raised in these reports and elaborate on our previous reports on the company. Specifically, we will touch on the issues of: 1) earnings gap between CSS and Acorn; 2) tax expenses; 3) account receivables in its interim results and 4) monetisation of its customers.

CSS below the line revenue model different from Acorn. CSS' HK$21.6m distribution revenue is significantly lower than Acorn's HK$262.9m, partly due their different business models. Acorn sells its products directly to distributors (has to carry inventory), while CSS only collects a commission on products (advertised by CSS) sold by its distributor partners. According to CSS, its commission is around 5-10% of the handset selling price. In 1H FY12/07A, CSS's commission revenue from handsets was HK$11.8m. Assuming the mid-point commission rate of 7.5%, CSS' effective below-the-line revenue was around HK$157.6m. Taking into account that the company lost potential commission revenues of around RMB100m in unbooked handset sales from its distribution partners, the resulting below-the-line revenue is similar for both companies.

CSS and Acorn book direct TV revenues in a similar manner. Both companies have a similar method of recognizing revenue from their direct TV sales, booking it upon delivery of the products to customers. Cash collection depends on the time it takes for the distributors to remit the money back to the companies. For EMS, which is both CSS and Acorn's main distributor, this takes around 60 days.

High effective tax rate the result of double taxation. CSS recorded a tax expense of HK$29.5m in 1H

FY12/07A, representing an effective tax rate of 39.7%. However, this included a HK$8.9m over provision from the previous fiscal year. Excluding the write back, the tax expense would have been HK$38.4m (51.6% effective tax rate). The unusually high tax expense was the result of the auditor's over prudent interpretation of tax expenses from Shanghai Pei Lian. Typically, the subsidiary is subject to preferential enterprise income tax of only 3.3% on its turnover. However, as the auditor conservatively considered that this locally determined tax rate may be inconsistent with national tax laws, it made an additional tax provision of 33.0% on the subsidiary's taxable income. In the interim report, the auditor stated that the additional HK$23.5m tax liability would be subject to reassessment at the year-end audit and we expect a significant portion to be written back. Management indicated that they would obtain all of the clearance paperwork from local tax authorities prior to the year-end audit. Therefore, the higher-than-expected effective tax rate for 1H FY12/07A was due to double booking of tax expenses for the period.

Table 1: Income tax expense summary

Item	HK$m	Eff tax rate (%)
China tax		
Current	38.4	51.6
Over provision for prior year	(8.9)	
Hong Kong tax	-	
Total	29.5	39.7

Source: Company data

Acorn earnings exaggerated by investment income. Acorn's 1H net profit of HK$104.7m appears much higher than CSS' HK$43.3m but Acorn's 1H earnings were magnified by: 1) investment income of HK$32.0m and 2) government subsidies of HK$7.8m. CSS' investment income in the period was only HK$4.5m. On an adjusted basis excluding all one-off items, CSS' recurrent earnings of HK$48.6m compare well with Acorn's HK$65.0m.

Table 2: Adjusted net profit comparison

6 months to Jun (HK$m)	Acorn	CSS
Revenue		
Direct sales	761.2	391.9
Distribution sales	262.9	21.6
Others	-	0.4
	1,024.2	**414.0**
COGS	(472.6)	(197.2)
Gross profit	551.5	216.8
Other operating income, net	17.0	(0.7)
Advertising expense	(278.9)	(100.2)
Other SG&A	(215.4)	(41.2)
Operating profit	74.3	74.7
Interest expenses	(0.0)	(0.2)
Other income, net	48.1	(0.1)
Profit before tax	**122.4**	**74.4**
Tax	(6.4)	(29.5)
Profit after tax	**116.0**	**44.9**
Minority interest	(11.2)	(1.6)
Net profit	**104.7**	**43.3**
Adjustment items		
Overprovision of tax in previous year	-	8.9
Double taxation effect	-	(20.0)*
Interest income	32.0	4.5
Reversal of allowance for bad/doubtful debts	-	1.2
Government subsidies	7.8	-
Adjusted net profit	65.0	48.6

**Management estimates that around HK$20.0m of the HK$23.5m additional tax liability can be written back.*

Source: Company data

Accounts receivable. CSS saw its accounts receivable surge from HK$66.7m at end-FY12/06A to HK$236.6m at end-1H FY12/07A, mainly due to the ramp up in handset sales on the TV platform since 1Q. Acorn saw a similar trend in the period, with receivable up from US$11.7m at US$29.9m (HK$91.4m to HK$232.8m). As CSS' below-the-line revenue is largely from cash rebates, we prefer to compare the companies using CSS' direct TV sales revenues only. Though CSS' A/R turnover days are significantly higher than those of Acorn, we estimate that its accounts receivable that were over 181 days old were largely carried over from the company's sales of cosmetics products from the previous year. Furthermore, CSS has better cash conversion cycle days than Acorn, which means that while CSS has a longer receivables period, the company is able to partially offset this by extending its payables period. Despite A/R being high in absolute terms, A/R turnover days of around 60 days is still within our expectations. Nevertheless, it will be a metric that we will closely monitor going forward.

Table 3: Working capital analysis (based on TV direct sales)

Item	CSS	CSS**	Acorn
Turnover (HK$m)	391.9*	391.9*	1,024.2
Accounts receivables (HK$m)	236.6	214.2	232.8
% of A/R of direct sales turnover	60.4	54.6	22.7
A/R turnover days	71	65	29
Inventory turnover days	14	14	31
A/P turnover days	36	36	7
Cash conversion cycle days	49	43	53

Source: Company data, SBI E2-Capital

* Direct TV sales revenues only

** Accounts receivables for 0-180 days only

Table 4: A/R aging analysis

Period	HK$m	%	Remarks
Trade receivables			
0-90 days	175.6	74.2	Mainly from distributor EMS
91-180 days	38.6	16.3	
181-365 days	21.2	9.0	Mainly from sales of cosmetic products in 2006, as well as some distribution revenue
Over 365 days	-	-	
Sub-Total	235.5	99.5	
Bills receivables	1.1	0.5	
Total	**236.6**	**100.0**	

Source: Company data, SBI E2-Capital

Non-effective monetization crimped earnings in 1H FY12/07A. As we detailed in our report on 25 Sep, CSS had difficulties monetising its customer base in 1H FY12/07A mainly due to: 1) handset inventory shortages – meaning inability to meet customer demands and 2) sales of products not distributed by CSS to referred insurance clients. These issues crimped CSS' earnings in 1H FY12/07 and showed the company's limited control over its value chain during the period.

JVs to better control value chain. To better control its value chain, the company has signed MOUs to form JVs with Longcheer, an independent handset design house in China and Uniscope (Sinolong), a handset sourcing company currently serving many of China's branded manufacturers. CSS also intends to form a new subsidiary to obtain a licence to market and distribute insurance products. In our view, the handset JVs will be positive as it will enable the company to secure handset supplies and improve its product refresh rate. However, the Uniscope JV does bear some risk given that it exposes CSS to China's handset industry beyond its TV sales platform. As for the insurance JV, we are still awaiting details as the company is in the process of securing its licence, which we expect by the end of the year. In terms of new products, CSS has already begun to sell jewellery/watches and management indicates that it will likely partner with a designer/supplier as it scales up this new product line. In addition, the company plans to launch new platforms to sell automobiles and property by end-FY12/07 or 1Q FY12/08. While exact partnership details and revenue models have yet to be revealed, the move to distribute higher end products should provide a further boost to CSS' product offering. Management suggests that to avoid carrying inventory and minimizing working capital risks, the revenue model of these new product lines are likely to be on commission basis.

Buying opportunity – oversold on negative news. Our FY12/07F and FY12/08F net profit estimates now stand at HK$126.2m and HK$189.9m, respectively. The counter is trading at 21.4x FY12/07F and 14.2x FY12/08F P/E respectively, way below Acorn's equivalent valuations of 22.9x and 20.9x. Acorn's market cap (at US$610.1m) is now almost twice the size of CSS' US$376.4m. Though CSS interim results have indicated that the company faces some execution challenges, we think the counter has been oversold on its negative press coverage and unfair comparisons with Acorn. In our view, CSS' 1H performance compares well against Acorn's, on an adjusted basis and current share price levels present a buying opportunity. We maintain our BUY call with a revised down target price of HK$0.66, representing 25.0x FY12/08F P/E.

Table 5: P&L

Year to Dec (HK$m)	05A	06A	07F	08F	09F
Turnover	**23.2**	**92.4**	**951.0**	**1,575.2**	**2,026.3**
% chg	*(25.5)*	*300.1*	*928.9*	*65.6*	*28.6*
Cost of sales	(13.9)	(26.0)	(457.2)	(749.6)	(980.3)
Gross profit	9.3	66.4	493.8	825.6	1,046.0
Other revenue	-	4.2	13.7	8.1	10.2
Gain on disposals	-	6.3	-	-	-
Selling and distribution expenses	(5.0)	(11.2)	(273.6)	(457.4)	(592.3)
Administration expenses	(14.9)	(17.7)	(49.6)	(67.1)	(81.5)
Other operating expenses	(1.0)	(3.0)	(16.0)	(17.3)	(20.3)
Operating profit	(11.6)	45.1	168.4	291.9	362.1
Finance costs	(0.5)	(0.9)	(0.4)	(0.4)	(0.4)
Exceptionals	(3.4)	-	-	-	-
Share of profits/(losses) of an associate	-	-	(0.2)	-	-
Share of profits/(losses) of JCE	-	-	-	-	-
Profit before taxation	**(15.4)**	**44.1**	**167.8**	**291.6**	**361.8**
Taxation	(2.0)	(11.9)	(37.0)	(75.8)	(94.1)
Profit after taxation	**(17.4)**	**32.2**	**130.8**	**215.8**	**267.7**
Minority interests	0.8	(2.6)	(4.6)	(25.9)	(32.1)
Profit attributable to shareholders	**(16.6)**	**29.6**	**126.2**	**189.9**	**235.6**
% chg	*n/a*	*n/a*	*327.0*	*50.5*	*24.2*
Dividend	-	-	-	-	-

Source: SBI E2-Capital

Table 6: Valuation comparisons

Company Name	Stock Code	Country	Mkt Cap (US$m)	Price	07F Net Profit (US$m)	08F Net Profit (US$m)	07F P/E (x)	08F P/E (x)
China Seven Star	ATV US	China	376.4	HK$0.365	16.2	24.3	21.4	14.2
Acorn	245 HK	China	610.1	US$20.41	24.1	29.4	22.9	20.9

Source: Bloomberg & SBI E2-Capital

Disclosure of interests: SBI E2-Capital Securities Limited acted 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.