

## Golden Dragon: Risky new business

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**Recommendation: Not Rated**

**China Industrials**

<b>Price</b>	<b>HK\$1.42</b>	<b>Yield (3/06A)</b>	na
<b>12 mth range</b>	HK\$0.46-1.97	<b>ROE (12/06A)</b>	4.0%
<b>Market cap.</b>	US\$199.5m	<b>Net gearing (12/06A)</b>	7.2%
<b>No. shares o/s</b>	700.8m	<b>Net debt/sh. (12/06A)</b>	HK\$0.03
<b>Daily t/o, 3 mth</b>	US\$1.07m	<b>BV/sh. (12/06A)</b>	HK\$0.50
<b>Free float %</b>	22.2%	<b>Consensus EPS</b>	
<b>Major shareholder</b>	AAI and Absolute Target – 77.8%	<b>- 12/07F</b>	na
<b>Ticker</b>	0329.HK/ 329 HK	<b>- 12/08F</b>	na

### Key points:

- First mover advantage in tapping the cigarette substitute market.
- Delivering a safe and effective process for smoke control and abstention.
- Free of any tar and carcinogenic substances, makes Ruyan's product a safe cigarette substitute.
- Growth in China might be limited due to the fear of cannibalizing cigarette tax revenues.
- Mix results in geographical expansion due to different cultural perceptions of Ruyan.
- Ruyan's sales up 111.0% YoY at HK\$286.1m in FY12/06A and net profit up 165.3% at HK\$91.0m.
- Doubling in sales this year is achievable, but visibility beyond FY12/07 is uncertain.

**Company profile.** Listed in May 2001, Golden Dragon is principally engaged in the research and development, production and distribution of pharmaceutical and health care products in China. Early this year, Golden Dragon acquired the entire shareholding of Best Partners ("BP"), which holds the entire issued share capital of SBT, the holding company of three wholly foreign owned enterprises, Beijing SBT, Shenyang SBT and Tianjin SBT. The principal business of Beijing SBT, Shenyang SBT and Tianjin SBT is the research and development, production and sales of atomizing cigarettes. The product is sell under the brand name of Ruyan.

### Table 1: Transaction details

<b>Date</b>	13-Feb-07
<b>Acquisition target</b>	100% stake in Best Partners
<b>Consideration</b>	RMB1.27b (representing 13x FY12/06A earnings)
<b>Payment method</b>	Issue of convertible note <ul style="list-style-type: none"> <li>- Principal amount: RMB1.27b</li> <li>- Interest: 2.5% per annum</li> <li>- Maturity: 3 years</li> <li>- Conversion price: HK\$1.80 per share</li> </ul>

Source: Company data

**Ruyan E-cigarette.** Ruyan (如烟) are electronic atomizing cigarettes functioning as non-combusting tobacco-smoking substitutes. They replicate the behavior and flavor of tobacco smoking and have a unique way of delivering nicotine. Ruyan E-cigarettes use micro-electronic control and supercritical atomizing technologies. Ruyan does not need to ignite and avoids the production of harmful substances such as tar, carbon monoxide.

**Model and cartridge.** Ruyan come in three models – cigarette, cigar and pipe. Ruyan cartridges contain a solution of nicotine, propylene glycol, a small amount of flavoring and antioxidants. They come with different levels of nicotine (zero, low, medium and high) and different flavors such as cool mint, fresh jasmine and tropical orchard.

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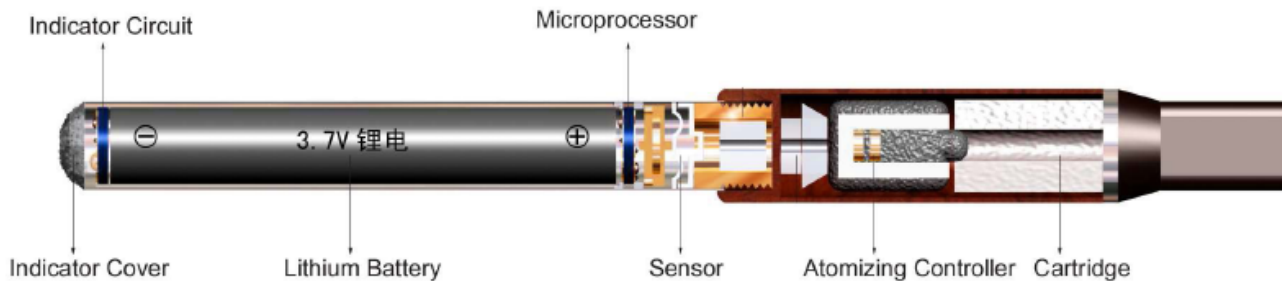
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**Product structure and operating mechanism.** Smoke from Ruyan is a result of liquid atomization in a high-frequency ultrasonic vibration field. The solution of nicotine and flavoring is pumped into an atomizing chamber by a micro-pump, where it is vaporized into micro droplets. An airflow sensor turns on the whole apparatus when the smoker inhales through the mouthpiece.

**Chart 1: Product structure**

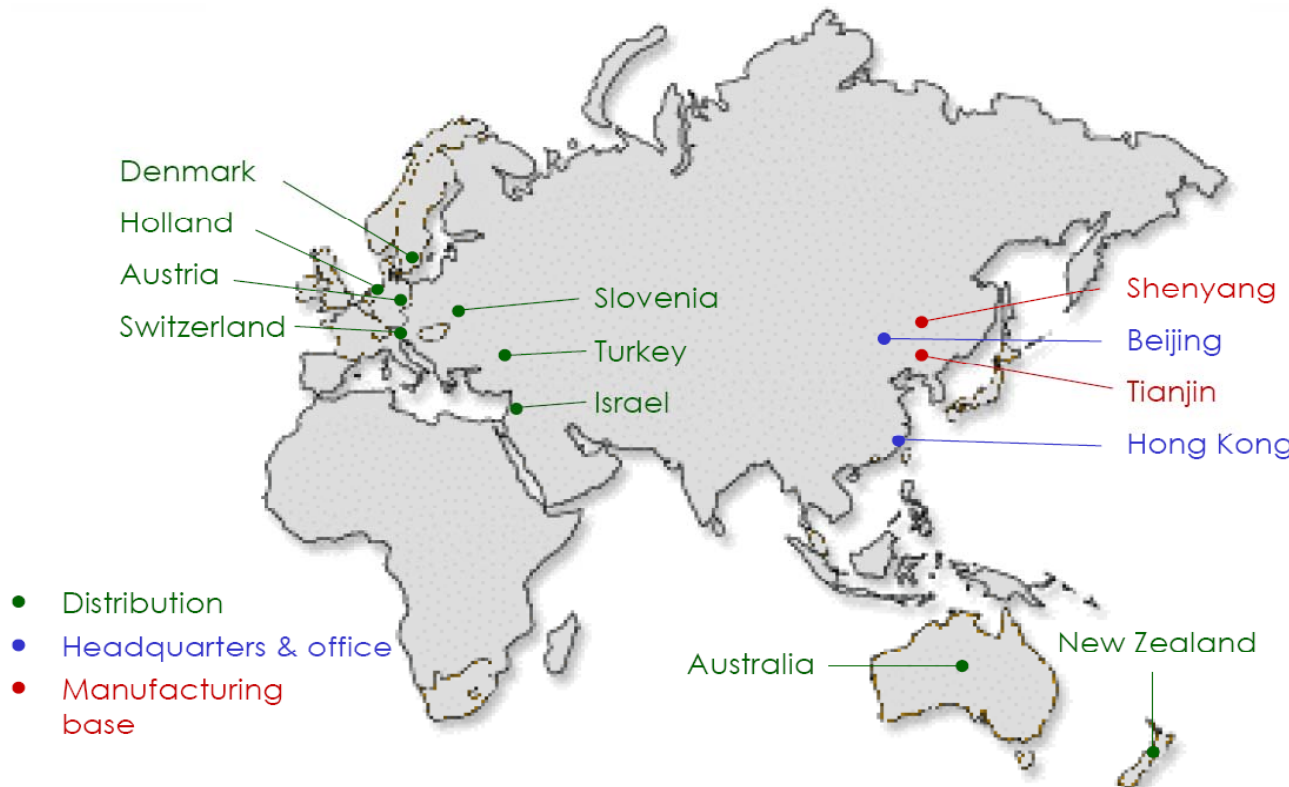


Source: Company data

**Benefits.** The real danger of smoking comes from substances such as tar (major carcinogen) and carbon monoxide. Ruyan do not contain tar or any other harmful substances and they do not need to ignite, thus eliminating the danger of fire. They do not produce many hazardous chemical substances or “second-hand” smoke and can be used in public places where smoking is prohibited.

**“Safe” substitute and smoking cessation treatment.** Ruyan is targeted at habitual smokers and smoke quitters. For habitual smokers, Ruyan provide physiological and psychological satisfaction by giving them regular means of accessing nicotine, while avoiding harmful substances. In other words they are a safe substitute for conventional smoking. For quitters, Ruyan provide a more satisfying alternative compared with nicotine patches and pills. They are able to deliver nicotine to the lung in a manner similar to cigarette smoking and in a dose sufficient to reduce cravings and withdrawal symptoms.

**Chart 2: Geographical presence**



Source: Company data

**Balancing local and overseas contribution.** The Ruyan are now sold in the China, Turkey, Australia and certain countries in Europe. In FY12/06, China was its major market (95% of total sales) and Turkey its major overseas market. The company plans to expand further in Europe as well as in the US and Japan. By the end of this year, it expects contributions from local and overseas businesses to be balanced.

**Explosive growth may be difficult in China.** With 1.9t sticks of cigarettes consumed every year (or c.1/3 of the global total), China is the world's largest tobacco market and is expected to grow 3-5% a year. Currently, tax payments from the tobacco industry exceed RMB300.0b annually. Given their importance to the country's tax revenue, all cigarette manufactures are owned and controlled by the Chinese government and thus are well protected. This poses a challenge for cigarette substitute manufacturers such as Golden Dragon. In our view, we believe that while the government will support initiatives such as Ruyan to honor its anti-smoking mandate commitments to the WHO, they would not allow it to grow significantly, for fear of cannibalizing its cigarette tax revenues. Furthermore, existing cigarette companies may act against Ruyan. We understand that there were several smear campaigns targeting Ruyan late last year and early this year. Also, Chinese consumers are not familiar with nicotine replacement treatments (NRT) and cigarettes are often seen as suitable gifts for relatives/friends. These factors may hamper the company's expansion in the country.

**Mix results in overseas expansion.** We believe the company will achieve indifferent results in its overseas expansion due to different cultural perceptions of Ruyan.

- *US and Australia.* In the US and Australia people are more health conscious and familiar with NRT, but due to the form factor issues, Ruyan may not be that well received there. We believe that Golden Dragon needs to do more research and development on the product to make it look and feel more like a real cigarette, to gain traction in these markets. Also, obtaining FDA approval in the US is a long process, which may cause delays in Ruyan's launch. Management indicates that they are currently in talks with US officers to waive the FDA approval requirements.
- *Japan.* Known as trendsetters and always looking for ways to be unique and different, Japanese consumers are very attracted to "high-tech" products. We believe Ruyan's product has a change to become a "FAD" in the country, receive good market exposure and build a strong brand image.
- *Turkey.* Nargile (Turkish water pipe) has been very popular in Turkey since ancient times. From function to effect, we see Ruyan is a substitute for nargile. Ruyan is portable in contrast to nargile, which consists of a heavy glass bottle with a metal pipe device. Currently, Turkey is the company's major overseas market and we believe it will be the key growth driver for its overseas business.

**Medical application.** The Ruyan series of products will also be developed for medical use. Able to deliver content directly to the lung, Ruyan technology and devices will be adapted for treatment of upper respiratory tract diseases such as asthma, bird flu and SARS.

**Limited earning visibility.** We believe the company should be able to achieve its target of doubling its sales this year, thanks to its overseas expansion. However, the company's future is clouded beyond FY12/07 in our view. With uncertainties in its stronghold market of China and potentially mixed results in overseas expansion, earnings visibility appears to be limited.

**Table 2: P&L**

Year end Dec (HK\$m)	2004	2005	2006
Turnover	173.1	176.8	219.5
Cost of goods sold	(72.3)	(79.2)	(118.9)
Gross profit	100.8	97.6	100.5
Other income	0.6	0.4	1.6
Distribution costs	(62.7)	(63.6)	(64.2)
Administration expenses	(19.6)	(19.4)	(27.0)
Finance costs	(6.0)	(3.3)	(3.6)
Before tax profit	13.0	11.7	7.4
Income tax expense	(3.5)	(2.8)	(2.0)
Profit for the year	9.5	9.0	5.4
Minority interest	(1.2)	0.0	0.0
Net profit	8.3	9.0	5.4
EPS- Basic (HK\$)	0.014	0.015	0.009

Source: Company data