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Value boost

Hong Kong Properties

Capital Strategic (497 HK, HK\$0.400)

BUY (unchanged)

Target price: HK\$0.560 (+40.0%)

CB issue. Capital Strategic Investment (CSI) has proposed to issue a five-year HK\$390.0m CB to several institutional investors. The initial conversion price of HK\$0.51 represents a premium of about 29.11% to its last closing price of HK\$0.395 before the CB issue on 1 June 2007. The redemption price is at 119.38% of the principal amount and the interest rate is 2% per annum (semi-annual payments). The net proceeds of about HK\$387.0m will be used for property and related investment opportunities in Hong Kong and China.

EPS growth remains high. A total of 764.71m conversion shares will be issued, representing about 15.4% of CSI's existing issued share capital and about 13.3% of its enlarged issued share capital. We believe growth opportunities from acquiring more undervalued properties will offset the EPS dilution of around 13% over a five-year period if the CB is fully converted at HK\$0.51. On a fully diluted basis, the EPS is estimated at HK\$0.048 in FY03/08F and HK\$0.065 in FY03/09F. We expect EPS (fully diluted basis) to grow about 17.0% in FY03/08F and 36.0% in FY04/09F.

Broad institutional shareholder base. Subscribers include the company's major shareholders, Lehman Brothers Commercial Corporation Asia Ltd (stake up to 11.53% from 8.84% based on fully diluted shares of 6,088.93m) and Stark Investments (Hong Kong) Ltd (stake up to 12.16% from 10.32%) and other subscribers such as Citadel Equity Fund Ltd, Perry Principals LLC, Credit Suisse Hong Kong Ltd and Harmony Investment Fund Ltd. The CB issue may pave the way for future strategic alliances with subscribers interested in property investment.

China expansion. Rental income of Fuhai Commercial Centre in Shanghai is estimated at HK\$48.0m in FY03/09F and HK\$69.0m in FY03/10F. Nearby comparable office buildings such as Kairun Golden City (凱潤金城) (1611 Si Chuan Road) are selling at RMB18,922 sq m. We estimate the market value of Fuhai Commercial Centre at RMB900.0m, accounting for around 14.8% of the company's total current NAV.

Valuation. The stock currently trades at FY03/07F P/E of 9.8x and 8.4x for FY03/08F on a fully diluted basis. Amid Hong Kong's strong demand for high quality office space and promising retail property market, we estimate the company's current valuation at HK\$3.74b (NAV per share: HK\$0.61), assuming a 15.0% annual asset value growth rate for FY03/08F and 10.0% for FY03/09F. Its estimated NAV should reach HK\$0.70 per share by FY03/08F and HK\$0.78 by FY03/09F.

Net target price and near-term catalysts. We have revised our target price up to HK\$0.56 based on a 20.0% discount to FY03/08F NAV of HK\$0.70. Near-term share catalysts include: 1) Gloucester Road 88 tender; 2) retail rental hikes and 3) increasing China assets.

Table 1: Financial summary

| Year to | Net profit | EPS | EPS | P/E | P/B | EV/EBITDA | Yield | ROE | ROCE | N. Gearing |
|---------|------------|-------|--------|-----|-----|-----------|-------|------|------|------------|
| Mar | HK\$m | HK\$ | Δ % | x | x | x | % | % | % | % |
| 05A | 181.5 | 0.095 | 492.3 | 4.2 | 0.9 | 9.7 | 1.8 | 23.1 | 13.0 | 22.9 |
| 06A | 140.3 | 0.064 | (32.0) | 6.2 | 1.0 | 14.4 | 1.3 | 13.6 | 9.6 | Cash |
| 07F | 202.4 | 0.041 | (36.7) | 9.8 | 1.0 | 4.5 | 2.5 | 12.9 | 8.2 | 37.0 |
| 08F | 281.6 | 0.057 | 39.1 | 7.1 | 0.9 | 4.8 | 3.5 | 13.7 | 7.8 | 30.0 |
| 09F | 395.0 | 0.080 | 40.3 | 5.0 | 0.7 | 2.3 | 5.0 | 16.7 | 9.4 | 27.0 |

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Table 2: Offices comparable to Fuhai Commercial Centre

| Project | Address | Total GFA (sqm) | GFA sold (sqm) | Average Transaction Price (RMB/sqm) | Remarks |
|--------------------------------|--------------------|--------------------|-------------------|--|--------------------------------------|
| BM Tower (宝矿大厦) | 218 Wusong Road | 76,962 | 12,611 | 24,063 | Bare shell |
| Hitime Times Plaza (海泰时代大厦) | 289 Wujin Road | 27,168 | 15,003 | 23,583 | Loft, decorated |
| Kairun Golden City (凯润金城) | 1611 Si Chuan Road | 9,146 | 6,056 | 18,922 | Small layout 60 –120 sqm per unit |

Source: Company data

New grow driver. After acquiring 60.0% in Commercial Centre in Puxi Shanghai in Feb 2007, CSI is identifying other rental properties in the area and nearby cities to capitalize on the current market consolidation. Fuhai Commercial Centre (600,000 GFA, 29-storey with one-level basement and 20 car parking spaces) is located at the junction of Sichuan North Road and Wujing Road. The new Metro Line 10, which will open by mid 2007, will pass through this area with stations right opposite the property. The site is 10 minutes away from the North Bund reclamation project and the Bund Area.

We expect China assets to account for around 14.8% of its total current NAV and the ratio should rise to 50% in the next few years. Given its successful track record in enhancing rental and capital values of its properties, we expect CSI to successfully duplicate its winning Hong Kong model in China.

88 Gloucester Road. CSI has appointed one of Hong Kong's leading property agencies to hold a tender on 28 June 2007 for its 100.0% owned 88 Gloucester Road Commercial Building in Wan Chai. It acquired the building for HK\$196.0m (about HK\$1,905.0 per sq.ft.) in June 2003 after SARS. Its current expected market value is HK\$800.0-830.0m. Other assets (Tai Tam Road) are estimated at around HK\$150.0m each (our estimate HK\$90.0m – 120.0m each). In 1Q 2007, the number of individual arrivals who tend to spend more on luxury goods rose 17.1% YoY to 2.65m according to the Hong Kong Tourism Board. CSI will benefit from the trend, as its portfolio is mostly located with prime areas of Wan Chai, Tsim Sha Tsui and Causeway Bay.

Table 3: Commercial vacancy rates in Hong Kong (by major district)

| Rental growth (%) | December 06 | March 07 | Variance |
|-----------------------|-------------|----------|----------|
| Central | 4.2 | 3.9 | (0.3) |
| Wan Chai/Causeway Bay | 4.1 | 3.9 | (0.2) |
| Hong Kong East | 2.8 | 3.8 | 1.0 |
| Tsim Sha Tsui | 5.3 | 5.2 | (0.1) |
| Overall | 5.4 | 4.9 | (0.4) |

Source: Jones Lang LaSalle

Firm retail rents. According to Jones Lang LaSalle, retail rents rose 30.7% YoY in Central in 1Q 2007 and 10.8% in Wan Chai and Causeway Bay. According to Collier International, the successful launch of H&M in Hong Kong attracted attention of international brands to the local retail market. In 1Q 2007, the number of individual arrivals who tend to spend more on luxury goods rose 17.1% YoY to 2.65m according to the Hong Kong Tourism Board. CSI will benefit from the trend, as its portfolio is mostly located with prime areas of Wan Chai, Tsim Sha Tsui and Causeway Bay.

Table 4: Estimated adjusted net asset valuation as at 31 Mar 2007

| | Net asset value (HK\$m) | No. of issued shares | Adjusted NAV per share |
|--|----------------------------|-------------------------|---------------------------|
| Audited consolidated net assets value per interim report as at 30 September 2006 | 1,808.21 | | |
| Adjustments: | | | |
| Net proceed from share placement dated 30 January 2007 | 130.00 | | |
| Revaluation surplus from properties | 1,279.41# | | |
| Repurchase of shares since 1 Oct 2006 | (5.21) | | |
| Gain on disposal of 50% of Hau Fook House dated 8 Nov., 2006 | 19.50 | | |
| Exercise of share option | 5.38 | | |
| Adjusted NAV before conversion of CB | 3,237.29 | 4,966.69 | HK\$0.65 |
| Liability portion of CB to be converted | 114.60 | 357.53 | |
| Adjusted NAV after conversion of CB | 3,351.89 | 5,324.22 | HK\$0.63 |
| Conversion of New CB | 387.00 | 764.71 | |
| Adjusted NAV after conversion of CB | 3,738.89 | 6,088.93 | HK\$0.61 |

Source: Company data

Revaluation surplus

Table 5: Revaluation surplus

| | Market value (HK\$m) | Book value (HK\$m) | % holding | Attributable surplus (HK\$m) |
|---|-------------------------|-----------------------|-----------|---------------------------------|
| Investment properties | | | | |
| G88 | 800.0 | 580.0 | 100 | 220.0 |
| | 800.0 | 580.0 | | |
| Properties held for sale | | | | |
| Jervois Street (51%) | 350.0 | 269.4 | 51 | 41.1 |
| AXA | 950.0 | 780.0 | 100 | 170.0 |
| Ashley Road 23 & 25, 27 | 500.0 | 343.6 | 100 | 156.4 |
| Tai Tam Road | 440.0 | 285.0 | 100 | 155.0 |
| Hankow Road | 700.0 | 575.0 | 100 | 125.0 |
| Fuhai Commercial Centre (60%) | 900.0 | 431.0 | 60 | 281.4 |
| | 3,840.0 | 2,684.0 | | |
| Properties held through associates | | | | |
| Hoi Ping Road (25%) | 400.0 | 312.0 | 25 | 22.0 |
| Paul Y Centre (25%) | 1,150.0 | 780.0 | 25 | 92.5 |
| Hau Fook House (50%) | 220.0 | 188.0 | 50 | 16.0 |
| | 1,770.0 | 1,280.0 | | |
| | 6,410.0 | 4,544.0 | | 1,279.41 |

Source: Company data

Risks: 1) any slowdown in demand for retail and commercial space due to natural disasters or diseases affecting Hong Kong's economic development and 2) oversupply leading to lower capital values.

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the placement agent for Capital Strategic Investment Limited on 30 January 2007. A director of SBI E2-Capital Securities Limited serves as an independent non-executive director of Capital Strategic Investment Limited.