

Top vertically-integrated portal in China (Updated) China Internet

Pacific Online (543 HK) Not Rated

Background. Founded in 1993 and launched in 1997, Pacific Online Limited (PConline) provides information on IT-related products, automobiles, PC games, women lifestyles and parenting in China. The listco has monetized its Internet platform by online advertising.

Table 1: Offer statistics

No. of shares offered	285.0m*
Funds raised	HK\$623.2m
Price range	HK\$2.98-3.58
Offer P/E (FY12/07F F.D.)	31.4-37.7x
FY12/06A EPS – F.D.	HK\$0.071
FY12/07F EPS – F.D. (Based on profit guarantee of HK\$90.0m)	HK\$0.095
Market cap.	US\$109.0m-131.0m
IPO open	5-Dec
IPO close	10-Dec
Listing	18-Dec

Source: Company data

*Including 190.0m new shares and 95.0m old shares

Top position. The page view of the company's pconline.com.cn website for IT-related products launched in 1999 reached 586m in 1H FY12/07A. In 2002, PConline launched pauto.com.cn, a website for automobile products, which recorded page views of 207m in 1H FY12/07A. Its pcgames.com.cn (PC games) was launched in 2003, pclady.com.cn (women life-style-related products) in 2004 and pckids.com.cn (parenting-related products) in 2007. According to Iresearch, in 2006, PConline ranked the third, after Sina (SINA US) and Sohu (SOHU US) in advertising revenue for IT-related products and the ninth in car products. Pauto.com.cn was named the best in automobile-related coverage by the China Internet Survey in 2007.

In-house content. In contrast to other general portals, PConline generates a significant amount of content in-house. It focuses on product specific articles, draft product test reports, monitoring of price trends, reviewing and editing contributions from third party writers and drafting new product reviews.

Solid margins. PConline have traditionally maintained a gross margin in excess of 70%. This is higher than both Sina and Sohu, whose margins are around the 60% range. This is expected as Sina/Sohu operates many other different platforms e.g. blogs, videos etc, which has higher operating and bandwidth costs. In addition, the large amount of in-house content (as oppose to sourcing third party content) allows PConline to better control costs. While we expect gross margins to trend down going forward, as the company's operations expand, we still expect it to be maintained at a healthy level.

Growth in China's Internet advertising. China's Internet advertising sector is developing rapidly. According to ZenithOptimedia, Internet advertising revenue reached US\$759.6m in 2006 and is expected to top US\$2,241.4m by 2009, with a three-year (2006-2009) CAGR of 43.4%. According to iResearch, IT-related product and automobile makers were the two largest client groups of China's Internet advertising in 2006. IT-related products accounted for 20.5% of total Internet advertising revenue and automobiles for 16.5%. China's Internet advertising segment is growing significantly faster than the overall advertising sector. Between 2003 to 2006, Internet advertising's share of the overall pie increased from 1.9% to 6.1%. At the same time, vertically-integrated portals is taking market share from general portals with a trend that market share of general portals had decreased from 76.5% to 58.3% while vertically-integrated portals had increased from 20.4% to

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27.7%.

New monetizing platform. The company is trying to develop e-commerce to capitalize on its brand name and traffic volume. It started to sell LCD TVs online in March 2007 and makes profit from the difference between the online price and purchase price offered by manufacturers. The business is still at its initial stage.

Financial performance. The company's revenue rose 31.1% YoY to RMB94.2m in 1H FY12/07A and gross profit 29.5% YoY. From 2004 to 2006, revenue grew at a CAGR of 45.0% and net profit at 44.2%

Table 2: Use of net proceeds

	HK\$m	%
Expanding and upgrading its Internet portal	130.0	22.7
Acquisitions	225.4	39.4
Working capital	57.3	10.0
Purchase of new facilities	50.0	8.7
Marketing	40.0	7.0
Research and development	40.0	7.0
Developing E-commerce platform	30.0	5.2
Total	572.7	100

Source: Company data

Table 3: Financial highlights

Year to Dec (RMBm)	04A	05A	06A	1H06	1H07
Turnover	81.3	114.3	171.0	71.9	94.2
Gross profit	65.8	86.3	124.8	53.3	67.3
Profit before tax	36.3	52.3	82.0	38.0	48.0
Net profit	32.3	46.0	67.2	30.8	40.0

Source: Company data

Table 4: Turnover breakdown

Year to Dec (RMBm)	04A	05A	06A	1H06	1H07
Pconline.com.cn	72.1	96.6	131.3	58.4	62.6
Pcauto.com.cn	5.5	12.9	33.5	10.5	28.1
Other portals	1.1	2.2	4.8	1.6	3.5
Network service income	2.6	2.6	1.3	1.3	0
Total	81.3	114.3	171.0	71.9	94.2

Source: Company data

Table 5: Margins

Year to Dec (%)	04A	05A	06A	1H06	1H07
Gross	80.9	75.5	73.0	74.1	71.5
Before taxes	44.6	45.8	48.0	52.9	51.0
Net	39.7	40.2	39.3	42.8	42.5

Source: Company data

Table 6: Key ratios

Year to Dec	04A	05A	06A	Pro Forma 06A
Inventory days	-	-	-	-
Receivable days	55	47	59	59
Payables days	216	143	143	143
Current ratio (x)	2.4	2.2	2.5	11.7
Gearing (%)	Cash	Cash	Cash	Cash
ROE (%)	81.2	51.3	42.2	9.8
Debt/equity (%)	-	-	-	-
Interest coverage (x)	-	-	-	-

Source: Company data, SBI E2-Capital

Investment highlights

- ❑ The only pure Chinese Internet advertising company to be listed on the HKEx. Other near comparables such as Sina and Sohu are listed overseas. PConline is a market leader in the vertically-integrated portals category.
- ❑ Vertically-integrated portals such as those run by PConline are taking market share away from general portal operators such as Sina and Sohu.
- ❑ Consumer electronics segment only accounts for 5.3% of the Internet advertising pie in China. However, this, together with the automobile sector are fast growing segments in terms of advertising budgets. PConline is in a prime position to tap this growth.
- ❑ Generates a significant amount of content in-house.
- ❑ Great growth potential – China’s Internet advertising revenue reached US\$759.6m in 2006 and should top US\$2,241.4m by 2009, registering a three-year (2006-2009) CAGR of 43.4%. Internet advertising is growing at a faster rate than the overall advertising industry.
- ❑ From 2004 to 2006, revenue grew at a CAGR of 45.0% and net profit at 44.2%

Valuation.

PConline’s offer price of HK\$2.98-3.58 represents a FY12/07F P/E of 31.4-37.7x on a fully diluted basis (based on profit guarantee of HK\$90.0m), which we believe is reasonable given that its US peers, including Sina (SINA US) and Sohu (SOHU US), are trading at an average 56.0x FY12/07F P/E and 38.4 FY12/08F P/E and HK peers, Tencent (700 HK), is trading at 67.5x FY12/07F P/E and 47.8x FY12/08F P/E, based on market estimates.