

**Time to rock the house****Hong Kong Industrials****Playmates (635 HK, HK\$0.99)****Not rated****Company background**

Founded in 1966 and headquartered in California, Playmates has successfully transformed into a pure hard toy marketing company from an OEM toy manufacturer after the complete disposal of all manufacturing facilities in 1990. Playmates outsources all production to five to six OEM suppliers based in China and itself focusing on product creation, design, selling, distribution and marketing under its proprietary and licensed product brands. With an expertise in action figures, vehicles and dolls, its major proprietary brands include “Amazing” dolls, “Waterbabies” dolls, Battle Dice and R.E.V.s, while licensed products and entertainment brands include “Teenage Mutant Ninja Turtles” (TMNT), “Viva Piñata”, “Kiba”, “The Land Before Time”, “Disney Princess”, “Disney Fairies”, “Strawberry Shortcakes” and “Popples”. US remains as its major market accounting for 76.5% of total sales in 1H FY12/06A. Walmart, Toy R’us and Target are Playmates’ major customers, contributing 70-80% of its total sales in FY12/05A. The Group also engaged in property investment and has increased its exposure by acquiring residential properties in Hong Kong’s Mid-Levels area in January 2006. The group has 138 employees in Hong Kong, China and the US as of 31 Dec 2005, with the major marketing and product creation team based in the US and engineering team stations in Hong Kong.

**Toys business**

- ❑ **First computer generated (CG) TMNT movie, premiering in March 2007.** The CG movie, collaborated by “Warner Bros. Studios”, “The Weinstein Company” and “Imagi Films”, will feature a brand new CG and three-dimensional TMNT. Playmates will launch fresh lines of toys with a brand new CG look with the movie in 2007. The new lines will include a new six-inch action figures featuring new Turtles, villains and monsters. In the past, the release of mega movies lead to surges in TMNT toy sales. Shortly after the first TMNT cartoon series was launched in 1978, Playmates acquired the master toy license for TMNT toys and the first TMNT toys were introduced to the market in 1988, generating around US\$50m sales. When the first TMNT movie was released in 1990, Playmates’ toy sales surged to US\$500m.
- ❑ **Microsoft’s Xbox 360 “Viva Piñata” game.** The game will bring traditional toys from the physical to digital world. The game targets the 6-11 age group and is Microsoft’s first step into the children’s entertainment business with an aim to broaden the appeal and demographics of its Xbox 360 games. Playmates has acquired the master toy license for Viva Piñata and to produce Viva Piñata smart figures to play along with the Xbox 360. Unlike traditional games, Viva Piñata is an interactive game through the use of 1) smart figures; 2) hand-held device; 3) Xbox 360 video game; 4) T.V. show; 5) retail scanner and 6) customized website. It can be played alone or plugged into a handheld device with a bar-code recorder. A digital DNA is embedded in each smart figure with the use of “J-Sync” technology. The digital DNA can record the points these smart figures gained from each game. Players can also exchange their accessories in the Viva Piñata community through the Internet and download additional “power” or attributes by scanning the bar codes of various retail items from retail stores. The first animated Viva Piñata series was premiered in September 2006 on “4Kids TV” with 52 episodes, followed by Microsoft’s Xbox 360 “Viva Piñata” game which was launched in November 2006. Playmates plans to launch 60 basic and deluxe smart figures. The first batch of 24 smart figures is scheduled to launch in 3Q FY12/07F.
- ❑ **“Disney Fairies” from Tinkerbell.** Playmates acquired the master toy license for Disney Fairies, which extended its partnership with Disney Consumer Products and targets the older girls market, complementing the Disney Princess product line. Playmates’ new lines of small dolls and playsets were launched in fall 2006. The first Disney Fairies full-length animation film was originally planned to premier in 2007 but it might be

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delayed to 2008. Nonetheless, Playmates will gain as the film will expand the Fairies story and introduce new characters.

- **Tapping the pre-school market.** According to the survey by NDP Group, a global market research firm, the pre-school segment captured the largest toy retail sales in the US by sales value. The pre-school segment captured 14.7% of total US toy retail sales in 2005, followed by dolls with 12.5% and arts & crafts with 11.4%. As a result, Playmates targets to increase its resources in developing the pre-school market. Universal Studios' "The Land Before Time" is one of the best selling children's home video series of all time. A new animated television series is being produced and is scheduled to premier on Cartoon Network in spring 2007. Playmates will create a line of pre-school figures, playsets and plush toys, which will be launched in 3Q FY12/07F.

### Property investment

**Increasing exposure.** Playmates completed the acquisition of residential suites in MacDonnell Road, Mid-levels in Jan 2006, with a total consideration of HK\$218.4m (c.HK\$6,400/sq.ft.). There are 34 units in that site and Playmates has already acquired 60% of them, which means that if it is able to acquire another 20% of the site, it can apply for redevelopment. The selling price for a redeveloped site is as high as HK\$11,000-16,000/sq.ft., based on a nearby site, "No.11 MacDonnell Road", co-developed by New World Development Group and Henderson Land. Playmates currently receives rental income from these properties with an average yield of 5-6%.

**Remodeling its portfolio to maximize income.** Playmates began to remodel its principal commercial property, "The Toy House" in Tsim Sha Tsui since 2005. It has modified its tenant mix to include upscale restaurants and retailers, such as sushi bars and spa centers. It has remodeled four floors into restaurants, which lead to a 1.35x increase in operating profit for the property segment in 1H FY12/06A. The Group plans to remodel an addition of three to four floors in FY12/07F. The exercise can boost its rental income by no less than HK\$10/sq. ft.

### Valuations

**1H FY12/06A results review.** In 1H FY12/06A, overall sales declined 26.7% YoY to HK\$338.8m but net profit rose 31.9% YoY to HK\$125.1m fuelled by a revaluation surplus on investment properties. Excluding the revaluation gains, the group recorded an operating loss of HK\$32.3m as a result of the decline in the sales volume, lower gross margin and increase spending on the marketing of new brands in its toys segment. The sales decline in 1H FY12/06A was mainly caused by lower TMNT sales and the discontinuation of the "Speedez". Although 1H sales usually accounts for only 25-30% of total FY sales, we do not expect much upside in its core business in FY12/06F since the contribution from King Kong will not figure prominently in 2H FY12/06F and the Disney Fairies was just launched in fall 2006.

**Potential turnaround.** With the new CG TMNT movie in 2007 and accelerating growth with Viva Piñata, we believe Playmates will stage a significant turnaround in FY12/07F. The property segment will act as a steady income stream and mitigate the fluctuations in its toy business. Playmates is in a net cash of HK\$387m (HK\$0.21 per share), well-positioned to acquire the remaining units of MacDonnell Road for redevelopment. It is trading at an 8.3x consensus P/E on a fully-diluted basis for FY12/07F, compared with an average of 15.3x for Bandai (7967 JP), Mattel (MAT US), Hasbro (HAS US), RC2 (RCRC US), Marvel (MVL US), Leapfrog (LF US) and Jakks Pacific (JAKK US). It is also trading at a deep discount of c.49.5% to its estimated NAV per share of HK\$1.48 (including HK\$0.21 net cash per share). It targets to payout about 30-50% of its net profit in FY12/06F.

**Risk factors.** 1) High exposure to the US economy; 2) sales relies heavily on whether the licensed product will become a blockbuster or not; 3) low sales visibility as the lead-time is only 7-10 days from its clients and 4) losses from property revaluations.