

A8 Digital Music

Fri, 27 Mar 2009

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China Technology

Domestic consumption underline growth **BUY (unchanged)**

Financial summary

| Year to Dec | 07A | 08A | 09F | 10F | 11F |
|-------------------|-------|-------|-------|-------|---------|
| Turnover (RMBm) | 286.0 | 706.1 | 832.9 | 957.0 | 1,100.5 |
| Net Profit (RMBm) | 55.3 | 80.2 | 95.8 | 116.6 | 140.5 |
| EPS (RMB) | 0.124 | 0.180 | 0.215 | 0.261 | 0.315 |
| EPS Δ% | 38.7 | 45.0 | 19.6 | 21.7 | 20.5 |
| P/E (x) | 8.8 | 6.1 | 5.1 | 4.2 | 3.5 |
| P/B (x) | 2.16 | 1.33 | 0.91 | 0.79 | 0.70 |
| EV/EBITDA (x) | 2.1 | 0.7 | - | - | - |
| Yield (%) | - | - | - | - | - |
| ROE (%) | 36.2 | 29.3 | 21.2 | 20.2 | 21.4 |
| ROCE (%) | 38.6 | 35.1 | 24.6 | 23.5 | 24.9 |
| N. Gear. (%) | Cash | Cash | Cash | Cash | Cash |

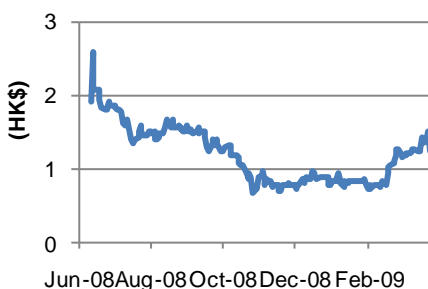
Source: SBI E2-Capital

Price Performance

| | 1 mth | 3 mth | 12 mth |
|--------------------------|-------|-------|--------|
| Relative to HSI (%) | -3.1 | +39.8 | - |
| Actual price changes (%) | -11.5 | +40.1 | - |

| | 09F | 10F | 11F |
|---------------------------|-------|-------|-------|
| Consensus EPS (RMB) | 0.240 | 0.290 | 0.410 |
| Previous forecasts (RMBm) | 829.5 | 968.8 | |
| Previous EPS (RMB) | 96.7 | 117.0 | |

Price Chart



Kennedy Tsang / Helena Qiu

(852) 2533 3713 / 3709

kennedytsang / helenaqiu@sbie2capital.com

| | | | |
|---------|--------------------|-------------------|---------------|
| Ticker: | 800.HK | 12 mth range: | HK\$0.60-2.67 |
| Price: | HK\$1.24 | Market cap: | US\$71.0m |
| Target: | HK\$2.60 (+109.7%) | Daily t/o, 3 mth: | US\$0.09m |
| | | Free float %: | 40.4% |

Key points:

- * FY12/08A in line with expectations, turnover increased 146.9% YoY to RMB706.1m while net profit was up 45.0% YoY to RMB80.2m. Adjusted gross margin stable at 21.4%, down 0.2pcp YoY
- * A8 is well positioned being a domestic consumption oriented company in a growth industry.
- * Several large players such as Tencent and Sina has already indicated that operating environment in the wireless space has improved markedly and China Mobile has also indicated that driving wireless offerings such as mobile music will continue to be a key strategy
- * No advertising revenues a benefit for A8. The company will be shielded from the expected downturn in China's advertising market
- * Healthy top line growth expected for FY12/09F and 10F, though expect some margin compression expected at the gross level. Though overall net margin expected to increase
- * 17.3% drop in stock price yesterday (due to unclear presentation of FY12/07A one-off items) presents a good entry point. Trading at 1.6x ex-cash P/E after yesterday's sell down. A8 is one of the cheapest pure play domestic consumption plays in our view. Maintain BUY call, target price HK\$2.60, 10.7x FY12/09F P/E

FY12/08A results. Turnover increased 146.9% YoY to RMB706.1m while net profit was up 45.0% YoY to RMB80.2m, in line with expectations. Adjusted gross margin (which in our view is a better metric to track the company as it takes into consideration all revenue sharing, selling and marketing related expenses for the company) was steady at 21.4%, down 0.2pcp YoY. Headline gross margin was down 7.3pcp YoY to 37.7%. The relatively weaker bottom line growth was due to several one-off items in FY12/07A (amounting to RMB23.4m), which inflated net profit in that year. Stripping out these items, net profit grew 160.0% YoY and in line with revenues. Music related revenues jumped 150.8% YoY to RMB495.3m, led by ringback tones (up 204.9% YoY) and IVR (up 475.7% YoY) and accounted for 29.9% of turnover while non-music related revenues was up 138.2% YoY to RMB210.8m. At end FY12/08A, the company had RMB315.6m (HK\$0.80 cash/share), representing 64.5% of stock price.

Benefiting from improved operating environment. The company was able to record such strong growth in FY12/08A due to a combination of: 1) rebound from effects of industry restructuring in 2007 and 2) increased proliferation of mobile music, especially user generated content. The company's growth in ringback tones exceeded the overall colour ringback tone growth of China Mobile in 2008 (up 21.9% YoY), suggesting that they were able to take market share from peers. Management indicated that they are consistently ranked no. 1 in several key provinces in terms of ringback tone revenues. In addition, several players in the mobile space such as Tencent (700 HK) and Sina (SINA US) have reaffirmed that operating environment for mobile SPs have improved markedly, though competition has also increased. We therefore expect A8 should be able to maintain a relatively high rate of top line growth for FY12/09 (though moderating from the triple digit level seen in FY12/08A). Upside should come from any successful take up of A8's mobile music offerings through their proprietary developed A8

Box. The company expects to embed around 10m units of A8 Box on mobile handsets in 2009 (2008: ~6m)

Macro factors favourable for A8. We think one key theme of A8 going into FY12/09F and FY12/10F is that this is a domestic consumption focus company in a high growth industry. Industry dynamics are extremely favourable to A8. China Mobile has already indicated that a key strategy to sustain growth in 2009 and 2010 will be to further promote use of MVAS offerings and begin to drive adoption of these products in rural areas, and in the process, stealing a head start on rivals China Telecom and China Unicom as they work to ramp up their services. Thus, we think that China Mobile will work more closely with and be less restrictive in regulating service and content partners. This will open up more opportunities for A8, who has already developed a good working relationship with both China Mobile central and provincial units and has a track record of helping China Mobile to drive MVAS revenues. China Mobile accounted for ~90% of A8 revenues according to the management.

More contribution from CT and CU in 2010. Management indicated that they are currently discussing and working with China Telecom (728 HK) and China Unicom (762 HK) to develop mobile music offerings. In FY12/09F as it would take time for the two telcos to ramp up subscriber base and music offerings. We think that material contribution from CT and CU would come in FY12/10F at the earliest and that these two new channel partners will become A8's new growth drivers going into end-FY12/08F and into FY12/11F onwards.

No advertising revenues a benefit. One additional benefit of A8 is that the company does not derive any revenue from advertising. Unlike other Internet and wireless peers such as Kongzhong (KONG US), Sina (SINA US) etc, A8's revenues are solely derived from music and non-music related wireless offerings. Therefore, they are somewhat shielded from the expected downturn in China's advertising sector, which would negatively impact their P&Ls and depressed their stock valuations.

Any M&As may be small in scale. Management is continuing to explore M&A opportunities but we think it may be difficult to find good M&A targets with high level of synergy at reasonable valuation. We do not expect any M&A announcements in the near term and any M&As announced to be small in terms of scale

Minor revision on estimates. We still expect a good growth rate in FY12/09F and FY12/10F for A8 given that the three telecom operators seek to sustain growth through promoting consumption of MVAS offerings, although the intensified competition is a concern. We expect unadjusted gross margin to compress, but still expect margin expansion at the operating and net margin levels. We slight revised our net profit forecast for A8 to RMB95.8m for FY12/09F and RMB116.6m for FY12/10F (previously: RMB96.7m for FY12/09F and RMB117.0m for FY12/10) and also introduce our FY12/11F estimates.

Reiterate BUY call, maintain target price HK\$2.60. The stock is currently trading at 5.1x P/E and 1.6x ex-cash P/E on FY12/09F earnings based on our current estimate. The counter dropped 17.3% yesterday on, in our view, a slightly unclear presentation of its FY12/07A one-off items during the analyst meeting. We think that the valuation of the counter is very attractive given that A8 is one of the few quality companies with pure play exposure the wireless sector, a domestic consumption oriented sector which is expected to display solid industry growth in 2009. We maintain our BUY call on the counter with a target price HK\$2.60, representing 10.7x and 8.5x ex-cash FY12/09F P/E. The counter is one of the cheapest pure play domestic consumption plays in our view.

Table 1: Adjusted net profit (ex. one-off items)

| Year to Dec (RMBm) | 07A | 08A | YoY (%) |
|--|-------------|-------------|--------------|
| Net profit attributable to shareholders | 55.3 | 80.2 | 45.0 |
| Add/(less) | | | |
| Gain arising from disposal of JCE | (5.7) | - | |
| Gain on disposal of investments @ FV | (3.1) | (0.1) | |
| Render of VAS mobile phone cards | (7.0) | - | |
| FV gain on derivative financial instrument | (3.1) | - | |
| FV gain on investments | (2.9) | - | |
| Realisation of gain from asset transfer | (1.5) | - | |
| Management fee income | (0.9) | - | |
| Dvd income from investments @ FV | (0.2) | - | |
| Gain on disposal of subsidiaries | (0.2) | - | |
| Subtotal | (24.4) | (0.1) | |
| Adjusted net profit | 30.8 | 80.1 | 160.0 |

Source: Company data, SBI E2-Capital

Table 2: Turnover by source

| Year to Dec (RMBm) | 07A | % of total | 08A | % of total | YoY (%) |
|---------------------------|--------------|--------------|--------------|--------------|--------------|
| Music related revenue | | | | | |
| Ringtone services | 72.2 | 25.2 | 86.9 | 12.3 | 20.3 |
| RBT services | 89.5 | 31.3 | 272.9 | 38.7 | 204.9 |
| IVR services | 20.7 | 7.3 | 119.5 | 16.9 | 475.7 |
| Others | 15.0 | 5.2 | 16.0 | 2.3 | 6.7 |
| Subtotal | 197.4 | 69.0 | 495.3 | 70.2 | 150.8 |
| Non music related revenue | 88.5 | 31.0 | 210.8 | 29.8 | 138.2 |
| Total | 286.0 | 100.0 | 706.1 | 100.0 | 146.9 |

Source: Company data

Table 3: P&L

| Year to Dec (RMBm) | 07A | 08A | 09F | 10F | 11F |
|------------------------------|---------|---------|---------|---------|---------|
| Revenue | | | | | |
| Music-related | 197.5 | 495.3 | 652.9 | 769.0 | 903.1 |
| Non music related | 88.5 | 210.8 | 180.0 | 188.0 | 197.4 |
| | 286.0 | 706.1 | 832.9 | 957.0 | 1100.5 |
| Business tax | (7.9) | (14.2) | (14.4) | (16.5) | (18.7) |
| Net revenue | 278.1 | 691.9 | 818.5 | 940.4 | 1081.8 |
| Cost of services | (149.4) | (425.8) | (509.8) | (595.2) | (693.3) |
| Gross profit | 128.7 | 266.1 | 308.6 | 345.2 | 388.5 |
| Other income/gains, net | 20.2 | 7.6 | 4.9 | 5.5 | 6.1 |
| Gain from disposal of JCE | 5.7 | - | - | - | - |
| Selling & marketing expenses | (67.1) | (115.3) | (132.6) | (146.1) | (157.4) |
| Administration expenses | (21.7) | (44.2) | (48.3) | (52.8) | (55.0) |
| Other expenses | (0.1) | (17.3) | (16.5) | (10.6) | (12.1) |
| Finance costs | (4.9) | (2.0) | - | - | - |
| Profit/loss from JV | (0.3) | - | - | - | - |
| Tax | (5.2) | (14.2) | (19.7) | (24.0) | (28.9) |
| Profit after tax | 55.2 | 80.8 | 96.4 | 117.2 | 141.1 |
| Minority interest | - | (0.6) | (0.1) | (0.6) | (0.7) |
| Net profit | 55.3 | 80.2 | 96.3 | 116.6 | 140.5 |

Source: Company data & SBI E2Capital

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the Sole Bookrunner, lead manager and underwriter for the A8 Digital Music Holdings Limited in June 2008.

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