A8 Digital Music

Fri, 14 Aug 2009

Challenges emerging

SELL (from BUY)

Financial summary

Year to Dec	07A	08A	09F	10F	11F
Turnover (RMBm)	286.0	706.1	667.2	789.4	947.3
Net Profit (RMBm)	55.3	80.2	95.2	115.6	137.7
EPS (RMB)	0.124	0.180	0.213	0.259	0.308
EPS ∆%	38.7	45.0	18.8	21.4	19.1
P/E (x)	29.5	20.3	17.1	14.1	11.8
P/B (x)	7.24	4.47	3.94	3.32	2.59
EV/EBITDA (x)	9.5	5.1	5.2	4.2	3.3
Yield (%)	-	-	-	-	-
ROE (%)	36.2	29.3	24.5	25.6	24.6
ROCE (%)	38.6	35.1	27.0	28.7	28.0
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

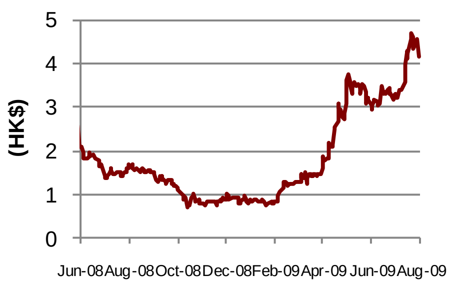
Source: Company data& SBI E2Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+9.8	+7.5	+156.4
Actual price changes (%)	+28.1	+35.6	+150.0

	09F	10F	11F
Consensus EPS (RMB)	0.225	0.258	0.315
Previous forecasts (RMBm)	95.8	116.6	140.5
Previous EPS (RMB)	0.215	0.261	0.315

Price Chart



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Ticker:	**0800.HK**	12 mth range:	HK$0.60-4.83
Price:	**HK$4.15**	Market cap:	US$242.5m
Target:	**HK$3.50 (-16%)**	Daily t/o, 3 mth:	US$2.9m
		Free float %:	53.2%

Key points:

- Net profit up 21.3% YoY to RMB44.9m, but revenue dropped 11.7% YoY on absence of promotional activities with China Mobile in 1H FY12/09A
- Competition appears to be intensifying for music related products. Non-music related revenues helped sustain 1H FY12/09A overall revenue levels
- New partnership with Xinhua solidifies non-music related product offerings, helping to reach broaden demographics and growing addressable customer base
- A8 Box targeting 10m installed base in FY12/09A. Cooperation with Mediatek should help in achieving this goal
- New target price HK$3.50 (previously HK$2.60). However, the counter appears over bought currently, downgrade to SELL

1H net profit up 21.3%, but revenue down 11.7%. 1H FY12/09A revenue was down 11.7% YoY to RMB290.8m, though net profit improved 21.3% YoY to RMB44.9m. Gross margin (on a net revenue basis) was 39.3%, down 2.6pcp YoY. The positive net profit growth was helped by the absence of one-off listing and share option expenses amounting to RMB11.8m in 1H FY12/08A and a lower effective tax rate of 12.6% (1H FY12/08A: 16.9%).

We think competition is intensifying. Music related revenues dropped 21.2% YoY to RMB192.2m. Management explained that 1H FY12/08A music related revenues were boosted by around RMB48.6m due to one-off promotion events with **China Mobile (941 HK, HK$89.1)** during Chinese New Year last year. Stripping this out, music related revenues dropped 1.5% YoY. On a HoH basis, music related revenues dropped 34.4% though the industry is seasonally stronger in 2H. Performance of the music related segment was slightly negative given that many industry players have reported healthy growth in WVAS segment during recent 2Q earnings announcements. **Tencent (700 HK, HK$118.0)** in particular, announced strong voice growth, driven by ringback tones. In our view, A8 is facing increased competition in its music related products was forced to rely back onto non-music related products to sustain revenue levels. Non-music revenues increased 15.2% YoY to RMB98.5m.

Xinhua partnership increases addressable customer base. A8 announced that it would be the exclusive mobile partner for Xinhua News Agency (Xinhua) to launch its Xinhua Mobile Media platform. The service will distribute Xinhua multimedia contents covering finance, entertainment, sports, learning, living, health, mobile games. The content will also be distributed via the company's proprietary A8 Box mobile software. We think that this partnership (and slight shift in strategy) is positive to A8 as the Xinhua content would allow them to broaden its demographic exposure and increase its addressable customer base to cross sell its music content/products. Going forward, we expect the company increase its non-music related revenues to increase, relative to overall revenues.

A8 Box rollout on track, critical to company success. A8 has customized the A8 Box on the Mediatek platform and has closed a cooperation agreement to embed A8 Box onto MTK's chipset. This is a major milestone for the company as it would allow A8 to significantly accelerate seeding of its A8 Box into China's mobile community. Management now expects installed base of up to 10m by the end of 2009, targeting a 20% activation rate. At present, we estimate that A8 Box's current installed base is over 200,000, mostly on Nokia's Symbian OS. Current activation rate is around 50%. In our view, with competition intensifying, impending launch of CM's application store, A8 Box gaining a large install base is becoming critical to A8 for building out a sticky community base and sustaining it's future growth momentum.

Other industry developments. Both China Telecom (728 HK, HK$4.1) and China Unicom (762 HK, HK$11.3) still in the process of ramping up their WVAS product offerings and we do not expect material contribution this year. However, management noted that CT has been particularly aggressive in building out its central WVAS service platform. As for the upcoming launch of CM's application store, we see this as slightly negative for A8 as: 1) may need to allocate more revenue share to CM for music products purchased on its application store; and 2) lowers entry barriers for potential A8 Box competing products.

Revised estimates. We have left our FY12/09F net profit relatively unchanged at RMB95.2m but have revised down our revenue estimates to RMB667.2m (from RMB832.9m) to take into consideration heightened competition in the music related segment. For FY12/10F and FY12/11F, we estimate the revenue of RMB789.4m (from RMB957.0m) and RMB947.3m (from RMB1, 100.5m) and net profit of RMB115.6m (RMB116.6) and RMB137.7m (from RMB140.5m) respectively.

Raising target price to HK$3.50, downgrade to SELL on over bought. The counter has risen 234.7% since our last report on 27 Mar 2009. We have revised up our DCF-based target price to HK$3.50, WACC 11.0%, terminal growth 4.5%), to reflect improved risk appetite and market sentiment. That said, at 17.1x FY12/09F, we think the stock has overshot its fair value. We downgrade the counter to SELL (previously BUY).

Table 1: DCF valuation reference table

	Terminal Growth				
WACC	2.5%	3.5%	4.5%	5.5%	6.5%
10.0%	3.6	4.1	4.6	5.4	6.7
11.0%	2.9	3.1	3.5	4.0	4.7
12.0%	2.5	2.7	2.9	3.3	3.7
13.0%	2.2	2.3	2.5	2.8	3.1

Source: SBI E2-Capital

Table 2: P&L

Year to Dec (RMBm)	07A	08A	09F	10F	11F
Revenue					
Music-related	197.5	495.3	428.7	515.4	659.6
Non music related	88.5	210.8	238.5	274.0	287.7
	286.0	706.1	667.2	789.4	947.3
Business tax	(7.9)	(14.2)	(9.8)	(11.1)	(16.1)
Net revenue	278.1	691.9	657.4	778.3	931.2
Cost of services	(149.4)	(425.8)	(403.6)	(484.0)	(583.7)
Gross profit	128.7	266.1	253.8	294.3	347.5
Other income/gains, net	20.2	7.6	10.6	13.5	8.6
Gain from disposal of JCE	5.7	-	-	-	-
Selling & marketing expenses	(67.1)	(115.3)	(98.8)	(109.9)	(123.8)
Administration expenses	(21.7)	(44.2)	(55.3)	(60.3)	(66.1)
Other expenses	(0.1)	(17.3)	(0.2)	(2.0)	(2.8)
Finance costs	(4.9)	(2.0)	-	-	-
Profit/loss from JV	(0.3)	-	-	-	-
Tax	(5.2)	(14.2)	(14.7)	(19.7)	(25.3)
Profit after tax	55.2	80.8	95.5	115.9	138.0
Minority interest	0.0	(0.6)	(0.3)	(0.3)	(0.3)
Net profit	55.3	80.2	95.2	115.6	137.7

Source: Company data& SBI E2Capital