

A8 Digital Music



BUY (int. coverage)

Pumping up the volume

Key points:

- Vertically e-record label is one of China's largest provider of original e-music. Its user generated content (UGC) platform has over 60,000 songs by 10,000+ artists
- Mobile music is emerging as a key driver of VAS growth. In 2007, CM's RBT revenues accounted for 39.0% of VAS (ex. SMS & IVR) revenue while VAS (ex. SMS) accounted for 13.9% of CM's service revenues.
- Prime beneficiary of the telecom industry restructuring
- A8 Box, an "iTunes" like music software application for handsets, will further drive consumption of A8.com's UGC music. Service is due for launch on Nokia's models in late 4Q 2008
- Backed by industry strategic investors including IDG, Intel Capital, TDF Capital and JAFCO. Chairman and CEO Alvin Liu, is the co-founder of Tencent (700 HK)
- 3-year net profit CAGR of 28.4%, reaching HK\$117.0m in FY12/10F
- Initiate coverage with BUY call, target price HK\$2.60, representing 12.0x FY12/09F P/E. Counter is currently undemanding at 5.4x FY12/09F P/E

Company background. A8 Digital Music Holdings Ltd (A8.com) is a vertically integrated e-record label for original digital music created by independent artists in China. Through its user-generated content (UGC) website, www.a8.com, the company identifies, packages, promotes digital music and distributes it over the Internet and wireless platforms. Its revenue is mainly derived from sales of: 1) ringback tones (RBT); 2) ringtones; 3) interactive voice response (IVR); 4) full track music. A8.com consistently ranks at the top of China Mobile's (941 HK) central and key provincial platforms for music-related products. A8.com was listed on the Hong Kong Exchange's main board in June 2008.

A new way of delivering music

Streamlined and efficient business model. A8.com's business model is different from that of traditional record labels. The company leverages the advantages of the Internet and mobile platforms to drive inefficiencies out of the traditional chain. It effectively streamlines the process by consolidating content search, promotion, marketing and distribution into one party. This gives it better control of the overall product development process, ensuring a faster time-to-market. The use of the Internet and mobile networks allows it to:

- ❑ Amass musical content from its base of independent artists;
- ❑ Undertake preliminary market testing on its user base;
- ❑ Conduct marketing and promotional activities, own and in alliances, to generate buzz and demand for music content;

China Technology

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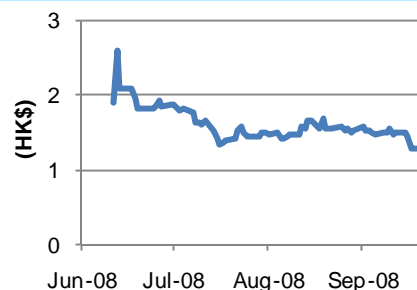
Stock data

Price	HK\$1.29
Target price	HK\$2.60(+102%)
12 mth range	HK\$1.15-2.67
Market cap.	US\$73.9m
Daily t/o, 3 mth	US\$0.2m
Free float %	20.66%
Ticker	0800.HK/800 HK

Financial summary

Year to Dec	06A	07A	08F	09F	10F
Turnover (RMBm)	260.1	278.1	650.5	815.2	952.1
Net profit (RMBm)	39.9	55.3	73.5	96.7	117.0
EPS (RMB)	0.089	0.124	0.165	0.217	0.262
EPS Δ %	(4.7)	38.7	33.0	31.6	21.0
P/E (x)	13.0	9.4	7.1	5.4	4.4
P/B (x)	4.2	2.9	1.1	0.9	0.7
EV/EBITDA (x)	7.8	6.2	1.3	0.4	0.2
Yield (%)	-	-	-	-	-
ROE (%)	38.4	36.2	21.9	17.9	18.0
ROCE (%)	45.7	38.6	27.1	21.4	21.4
N. Gear. (%)	cash	cash	Cash	Cash	Cash

Price Chart

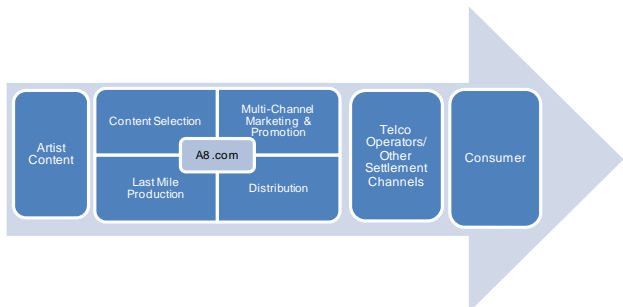


- Distribute and monetise the music content by teaming up with telco operators.

Content screening and selection

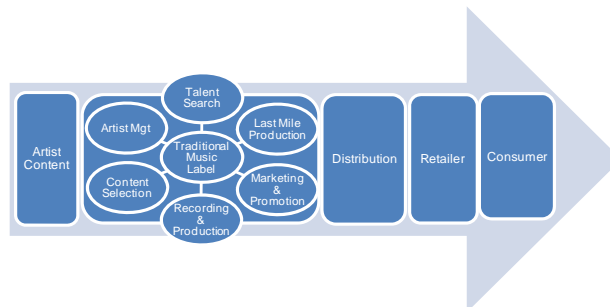
Through its UGC platform www.a8.com, A8.com attracts musical content from its base of independent artists. It currently has about 60,000 songs by some 10,000 artists and we estimate the upload rate at about 1,000 new songs per month. Prior to submitting independent music content to A8.com, artists must agree to terms and conditions relating to the assignment of relevant licensing rights and revenue sharing with A8.com. A standard sharing arrangement is 80/20 in favour of A8.com.

Chart 1: Value chain of A8.com music distribution



Source: SBI E2-Capital

Chart 2: Value chain of traditional music distribution

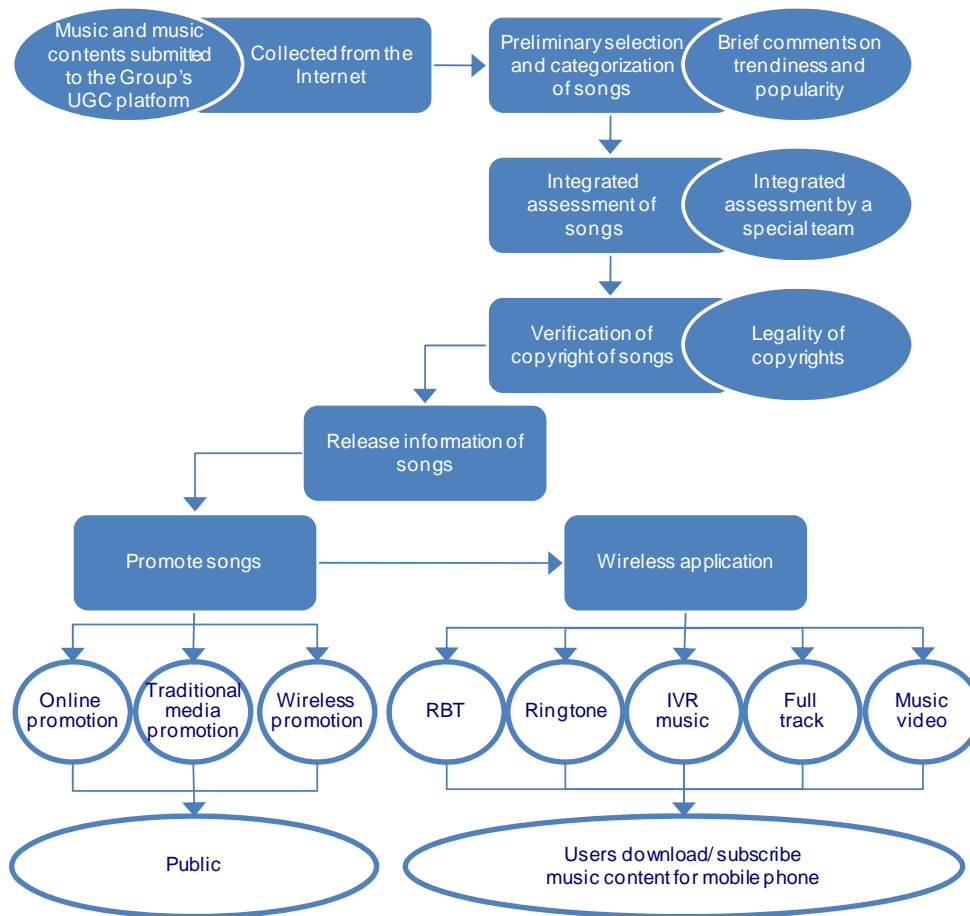


Source: SBI E2-Capital

Two-stage screening to ensure quality. After A8.com’s database receives new music, the company conducts a two-stage screening process to ascertain the song’s “potential”. A8.com’s staff will first evaluate the piece based on current consumer tastes and demand, and ensure that the song has not been plagiarized. Then, the song will be uploaded onto its www.a8.com platform to solicit user feedback. If the feedback is positive, the company will enter into a more formal agreement with the artist and package, promote and market the song. If the screening team feels that the song has significant potential, it may choose to negotiate with the artist to purchase distribution rights to the song outright.

In addition to its base of independent artists, A8.com also sources music from traditional record labels, such as Sony BMG, Universal (Hong Kong), Warner Music (Beijing), Rock Mobile and Shunde Peacock.

Chart 3: A8.com business flow process



Source: Company data

Fast user feedback. The screening process gives A8.com a significant advantage over traditional record labels and other competitors. Communicating with users through its website, A8.com can stay abreast of musical tastes and trends. Using initial product feedback, it can enhance the success rate of its products and minimize wastage of promotion and marketing resources. A8.com’s community user base is broader than record companies’ test groups and more readily mobilized.

Promotion and marketing

Multi-channel distribution platform. A8.com’s main strength is its ability to promote and market music through self-owned and third-party channels, such as new media (Internet, wireless), traditional media (TV, radio) and partnerships with brand owners and event marketers. The company also holds concerts once to twice a year to build brand awareness. Its revenue sharing method with partners ensures a win-win situation.

A8.com is the preferred partner for promoting music by independent artists. In Jun 2008, it completed the “2007 Annual Original Music Competition”. The competition comprised over 4,000 original independent song entries. The award ceremony for the competition was held jointly with the Municipal Government of Shenzhen and broadcasted/reported by over 70 media across the country, including Internet (Sina, QQ, Sohu), TV (Hunan Satellite TV, Shenzhen Satellite TV), newspapers and radio.

In 2006, Pepsi (China) conducted a joint competition with A8.com whereby independent artists submitted their original music onto the company’s UGC website. The winning submission was used in Pepsi Cola (China)’s nationwide advertising campaign as its main musical “jingle”. A8.com was entitled to revenue from the sale of the song over the wireless platform on an exclusive basis.

Table 1: A8.com's promotion and marketing platform

Channel	Format	Details
New media		
UGC platform	Self-owned	Promotion and streaming of music content on www.a8.com to generate interest/demand
Websites	Partnership	Provision of links to partner websites (>1,000 website partners) for streaming or full track downloads of A8.com's content
Wireless	Partnership	Sends promotional material to mobile users over wireless network
	Self-owned	A8 Box, a handset embedded native software solution to access company's music products
Traditional media		
TV	Partnership	Partnership with 7-8 provincial TV channels (eg. Hunan TV Station) with nationwide coverage to promote A8.com's music products
Radio/print	Partnership	Partnerships with radio stations and print media to promote A8.com's music products
Cooperation		
Concerts	Self-owned	A8.com organizes concerts 1-2 times annually to promote its musical contents and independent artists and to position it as the premier e-music label for independent artists
Brand owners	Partnership	Partnerships with Pepsi, artists (e.g. Jacky Cheung), Samsung and China Mobile etc. in competitions and/or promotional campaigns

Source: Company data

Table 2: A8.com's event marketing / promotion track record

Event	Nature of cooperation	Time
2007 Annual Original Music Competition	Promotion of original independent music through a song competition comprising over 4,000 song entries	2007-2008
Jacky Cheung China Tour 2007	Cooperated with Universal Music and China Mobile as sole music content provider over the wireless platform	2007
彩铃激爽赢	Cooperated with Pepsi Cola (Beijing) and China Mobile to promote RBTs	2006
Various shows and concerts	In partnership with Channel [V] to provide music content and services on the wireless network	2006
Production of TV theme songs	Worked with independent production companies for the production of TV theme songs for various series, including: 金色年华, 大旗英雄传, 楚留香 and 裴家大院	2005-06
A8 华语电媒音乐原创榜 "春季颁奖典礼"	Concert held in Beijing in partnership with Hunan TV Station to promote independent artists	2005
Various TV shows and awards shows	Worked with MTV China to provide SMS interactive services	2004-05
百事音乐风云榜	Cooperated with Beijing Pepsi Cola to provide SMS interactive services	2003

Source: Company data

Music requires substantial marketing to be effectively monetized. In contrast to standard wireless value-added services (WVAS) sold by telco operators, such as information (eg. traffic and weather), stories, games, news, wallpapers etc, music-related content requires a significant amount of promotion and marketing across various media platforms. A8.com, through its focused offerings, has accumulated substantial experience in this area. When China Mobile launched its "Wireless Music Club" in 2H 2006, it partnered with licensed music labels/content providers such as EMI, Sony BMG and Rock Mobile. A8.com has also become China Mobile's partner of choice for UGC music content, evident by the number of their joint promotional events held in the past and the recent deal to distribute ringtones and RBTs during the 2008 Beijing Olympics. A key competitive advantage of A8.com is its ability to select "the right song for the right user" and promote the song to a level of popularity such that it can be effectively monetized.

Independent artists' favourite. Independent artists prefer to work with and submit their original music to A8.com because of its: 1) good brand awareness; 2) large user community - wide exposure; 3) strong promotion and marketing resources. Through the fostering and managing of this community, A8.com has developed sufficient bargaining power to rival traditional music labels.

Distribution and sales

Monetization through mobile music. A8.com monetizes its music content primarily through sales of ringtones, RBTs, interactive voice response (IVR), full tracks and music video products over telco operators' networks, delivered via short message services (SMS), multimedia message services (MMS), wireless access protocol (WAP), RBTs and IVR (these two are both products and delivery channels). The company works with China's four major telco operators, China Mobile, China Unicom (762 HK), China Telecom (728 HK) and China Netcom (906 HK), charging either per clip download or monthly. IVR is charged on a "per minute use"

or on a “monthly” basis.

Revenue sharing with the telco operators is depends on delivery channels. Generally, A8.com will share between 50-85% of the revenue generated from sales of its music products.

Table 3: A8.com’s major music-related offerings (1)

Method	Description	Promotional channels	Delivery channels
RBT	Clips of songs which replace the normal ringing heard by the caller while waiting for the receiving party to answer the phone	Internet, wireless, TV, radio, print media, co-promotional activities with brand owners, events	RBT
Ringtones	Truncated clips of songs, which replace the normal ringing of the mobile phone upon receipt of an incoming		SMS, MMS, IVR, WAP
IVR	Through the telco operator’s IVR platform, user can access full track/clips of music content by dialing predetermined numbers		IVR
Full tracks	Entire music tracks, which are downloaded for consumption on the mobile handset		2.75G
Music videos	Entire videos of music tracks, which are downloaded for consumption on the mobile handset		2.75G
Other music related	Wallpapers, pictures of artists		SMS, MMS

Source: Company data

Table 4: A8.com’s major music-related offerings (2)

Method	Per clip price range (RMB)	Monthly price range (RMB)
RBT	0.5 – 3.0	2.0 – 5.0
Ringtones	0.5 – 2.0	6.0 – 20.0
IVR	0.5 – 2.0 (per minute)	3.0 – 10.0
Full tracks	2.0	-
Music videos	2.0	-

Source: Company data

Table 5: Revenue share with telco operators

Delivery channel	A8.com share (%)	Telco operator share (%)
SMS	85	15
RBT	85 (Provincial music platform) 50 (Central music platform)	15 (Provincial music platform) 50 (Central music platform)
WAP	85	15
IVR	70	30
MMS	85	15

Source: Company data, SBI E2-Capital

Nationwide coverage. To ensure that the telco operators effectively distribute its products, A8.com maintains 21 sales offices covering 20 provinces across the country. Their key role is to obtain and maintain data on local consumer tastes and trends to give the company insight into local consumer preferences and help customize marketing efforts and products. The sales teams also establish and maintain working relationships with central and local provincial telco operators.

Music-focused revenue mix. Music-related services have generated revenues of RMB127.8m (54.8% of the total) in FY12/05A, RMB159.3m (59.3%) in FY12/06A and RMB197.4m (69.0%) in FY12/07A. The CAGR of the company’s music-related revenues in FY12/05A-FY12/07A was 24.3%. In 1H FY12/08A, music-related services generated RMB244.0m in revenue, up 256.2% YoY. Although affected by the Ministry of Information Industry’s “clean up” policies introduced in Jul 2006, which included double confirmations and free trial periods etc., A8.com’s music-related revenue rose 23.9% YoY in FY12/07A.

Table 6: Revenue mix (value)

(RMBm)	05A	06A	07A	1H07A	1H08A
Music-related revenue					
Ringtone services	85.8	96.4	72.2	27.2	63.5
RBT services	13.3	42.1	89.5	28.3	167.5
IVR services	15.7	7.2	20.7	6.1	6.3
Others	13.0	13.6	15.0	7.0	6.8
Subtotal	127.8	159.3	197.4	68.5	244.0
Non music-related revenue	105.4	109.2	88.5	40.9	85.4
Total	233.2	268.4	286.0	109.5	329.4

Source: Company data

Table 7: Revenue mix (percentage)

(%)	05A	06A	07A	1H07A	1H08A
Music-related revenue					
Ringtone services	36.8	35.8	25.2	24.8	19.3
RBT services	5.7	15.7	31.3	25.8	50.8
IVR services	6.7	2.7	7.3	5.6	1.9
Others	5.6	5.1	5.2	6.4	2.1
Subtotal	54.8	59.3	69.0	62.6	74.1
Non music-related revenue	45.2	40.7	31.0	37.4	25.9
Total	100.0	100.0	100.0	100.0	100.0

Source: Company data

Music has a “long tail”. One advantage of UGC digital music is that it has a “long tail”, meaning that the songs generate revenue long after their launch. Several of A8.com’s music offerings are recording increased downloads, long after its release. In 1H FY12/08A, the RBT of 寂寞才说爱 was downloaded 17.0m, from 5.9m in FY12/07A, and that of 我不哭 13.7m times, from 1.0m in FY12/07A. This is different from the traditional music industry, where new albums and singles generate around 70-80% of their revenue in the first few weeks of release.

R&D and product development

Ability to change consumer behavior. The company has an IT/R&D team of 52 and sales and marketing team of 90. In addition to improving the company’s interactive UGC and A8 Box platforms, the R&D team cooperates with the sales team in product development and gauging consumer habits to drive music-related content sales. The company has successfully tackled persistent problems in encouraging users to subscribe to new content by developing “Music Box”. This is a collection of three to five RBTs packaged into one product. The RBTs in the Music Box are recommended by A8.com, based on tunes popular at the time and are played back in a random, jukebox manner. For a monthly fee, consumers can subscribe to one or more Music Boxes and the songs are refreshed on a monthly basis, when the subscription is renewed. The product is innovative as it does not require consumers to waste time on selecting content, while the constant RBT refreshing changes their behaviour by teaching them to “expect” new RBTs on a consistent basis. This type of positive consumer behaviour reinforcement promotes subscription, renewals and increases stickiness of the user base.

Telecom reshuffle initiates opportunities

A8.com to benefit from telco restructuring. Three mobile operators are expected to emerge in China after the sector’s restructuring (to be completed in 4Q 2008): China Mobile, China Telecom and China Netcom. The new operating environment should open up opportunities for the VAS chain, benefitting leaders such as A8.com because of: 1) increase of addressable clients (CT and CN); 2) new mobile licencees’ efforts to improve their services through richer VAS; 3) lower revenue concentration risks and a more balanced competitive landscape and 4) 3G’s boost of VAS appeal to mobile users.

Telcos will focus on VAS.... In our view, telco operators will place an increased emphasis on VAS. Though some price competition is inevitable, we expect it to focus on service improvements and differentiation, with VAS playing a key part. VAS’ proportion of overall services revenues for mobile operators is rising steadily and it is essential in sustaining average revenue per user (ARPU) levels.

Table 8: VAS (ex. SMS) percentage of overall service revenues

(%)	05	06	07
China Mobile	10.5	12.6	13.9
China Unicom (GSM)	6.9	9.7	11.6
China Unicom (CDMA)	8.5	11.1	16.4

Source: Company data, SBI E2-Capital estimates

...and music is the key. Music related services are a key part of VAS revenues. Over the past few years, both CM and CU has been aggressively accumulating mobile music users and ramping up mobile music revenues. The case is best illustrated by ringback tones. The share of RBT in overall VAS (ex SMS & IVR) revenues rose to 39.0% for CM and 23.8% for CU in 2007 from 27.4% and 11.6%, respectively, in 2005. RBT download times have also been increasing at a dramatic rate. In 1H 2008, CM's RBT subscription times surged 100% YoY to 600m. CU's GSM subscribers to RBT surged 20.8% YoY to 42.3m in 1H 2008.

Table 9: RBT percentage of VAS revenues (ex. SMS & IVR)

(%)	05	06	07
China Mobile	27.4	32.6	39.0
China Unicom	11.6	17.7	23.8

Source: Company data, SBI E2-Capital estimates

Management and strategic investors

Founder – usual first mover. The company was founded in 2000 by Liu Xiaosong, Alvin, a former co-founder of Tencent (700 HK) who has more than 15 years of experience in the telecommunications, media and technology industry. He is also a renowned angel investor and is currently vice chairman of Shenzhen Angel Investor Club (深圳天使投资人俱乐部). He was voted one of the “10 most active angel investors” in 2007 by a survey held by Sina.

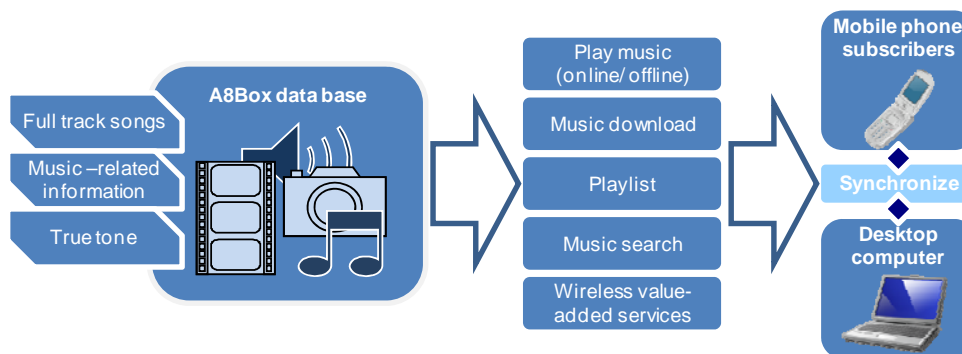
Backing of renowned strategic investors. The company has a number of venture capital heavyweights from the technology sector as its strategic investors. IDG, which held 5.01% immediately prior to the listing and 4.10% immediately after, was its first strategic investor (introduced in Jan 2005). TDF Capital (5.42% before the listing and 4.43% immediately after), Intel Capital (2.71% and 2.21%) and JAFCO (2.71% and 2.21%) were introduced as strategic investors in late 2005.

Expansion plans

Promotion of UGC. A8.com aims to accelerate consumption of its music-related UGC. The music content uploaded by its community, in combination with www.a8.com website and its multi-channel marketing and promotion platform, allows A8.com to produce a current and customised product that can be marketed and monetized in a scalable and fast-time-to-market manner. Furthermore, with its copyright ownership, the company can monetise its content over a long term. It plans to add new features to the web platform, including community building tools (e.g. blogs, user and artists support systems), additional features such as music video uploading and sharing, as well as server capacity. The aim of these enhancements is to drive content accumulation and reinforce A8.com's position as the preferred platform for independent artists and consumers seeking original music content.

A8 Box application for handset. A8 Box, the company's in-house “iTunes”-like music software platform for mobile devices, is embedded into a handset allowing access to music products. It allows users of 2.5G, 2.75G and 3G-enabled handset to get music content from A8 Box's database (UGC products and other licensed content). Through A8 Box, users can search their favourite tracks, create playlists and consume them through: 1) streaming; 2) full track downloads, 3) ringtones and RBTs and 4) music videos.

Chart 4: A8 Box software architecture



Source: Company data

Customized for multiple mobile platform. A8 Box was beta launched in 2006 and is already compatible with many of the commonly used mobile platforms including MTK (MediaTek), Symbian (used by Nokia) and Windows Mobile 6.0. The software has been available for download onto various international/domestic branded handsets such as Nokia and Tianyu (天宇) since the beta launch and towards end-2007, A8.com entered into embedment agreements with Dopod (subsidiary of HTC (2498 TT)) as well as other OEMs for domestic handset brand owners.

Consumption driver. In our view, A8 Box can become a killer application for the company. It is complementary to its interactive UGC platform and allows A8.com to build brand awareness by appearing as an icon on the menu list of mobile phones. With native software embedded in the handset, it is generally more user friendly and faster than WAP-based solutions, which should stimulate mobile usage and increase user stickiness.

The launch of China's 3G standard will allow A8 Box to offer more compelling services, including live streaming and full track downloads. In preparation for this, the company has partnered with Hong Kong's largest telco operator, Hutchison '3', to promote a UGC competition, 原声飞扬, over its 3G platform. This will allow it to gain experience with the 3G standard and customize/debug its products for the 3G platform.

Most importantly, the proliferation of A8 Box in China's mobile community will enable A8.com to reduce its reliance on telco operators, since its native application allows direct access to the company's music content. It will also effectively eradicate competition for deck positions on telco operators' WAP portals and extend A8.com's value chain control downstream towards direct distribution.

Table 10: Strategic advantages of A8 Box

Facilitates acquisition and building of A8.com's UGC user community
Builds and reinforces awareness of the A8.com brand
Native application facilitates access of A8.com's UGC music-related content
Stimulates usage and user stickiness
Reduces dependency on telco operators, extends value chain control to direct distribution
Extend value chain control downstream towards direct distribution

Source: SBI E2-Capital

A8.com has licensed the use of Gracenote's "Gracenote Mobile Music ID" (Gracenote MMID), a "fingerprinting and search" technology solution. For each of its UGC digital music tracks, A8.com uses Gracenote MMID to assign unique identifiers, based on its musical composition and other textual information. Currently, A8.com uses Gracenote MMID mainly to identify, categorize and organize its digital music database and to verify the originality of music uploaded by independent artists. However, we expect A8.com to incorporate Gracenote MMID into A8 Box, which will significantly enhance its compelling value by allowing it to generate customized playlists based on user preferences. A8 Box will then be able to generate these self-recommended playlists to the user, increasing marketing exposure of its UGC offering and stimulating demand/sales of A8.com's products.

Seeding period for A8 Box begins. Since its IPO, A8 has made further developments to its A8 Box, including: 1) playlist auto update and 2) porting onto the Symbian S60 V3 and Spectrum Mocor (3G) operating system platforms. The company is ready to have a full scale launch and expects around 3-5m handsets to be shipped with A8 Box by the end of FY12/08. We expect the offering to gradually gain traction with users and materially drive sales of ringtones and RBTs towards the end of FY12/09. A8.com will continue to develop and add features to A8 Box. Management has plans to incorporate "humming" services,

music video and music related news, as well as porting onto more OS platforms (e.g. Symbian's touch screen OS). In 1Q FY12/09, A8.com plans to launch personalized recommended playlist services, converged music search services and music-oriented casual games on its A8 Box platform.

Increase brand awareness. The company plans online and offline marketing to boost its brand awareness and enhance A8.com's value along each part of the value chain: upstream – generating increased submissions of original music by independent artists; midstream – becoming a more attractive partner for handset manufacturers; downstream - improving leverage to build its user base community.

M&As. We expect A8.com to use some IPO proceeds for M&As. In our view, A8.com could acquire upstream content providers and companies offering similar services/products.

Table 11: Use of IPO proceeds

Use	HK\$m	%
Upgrading interactive UGC platform	12.5	9.5
Promotion and marketing of UGC platform	11.1	8.4
Promoting original independently produced music content	11.1	8.4
Further development of A8 Box	27.4	20.8
Integration of business with the 3G technology platform	20.7	15.7
Mergers and acquisition	48.2	36.6
Working capital	0.9	0.6
Total	131.9	100.0

Source: Company data

Financial results

Track record period. From FY12/05A to FY12/07A, revenues grew at a CAGR of 24.3%, from RMB127.8m to RMB197.5m. Overall revenue during the period was RMB233.2m, RMB268.4m and RMB286.0m, representing a CAGR of 10.7%. The relatively lower overall revenue growth was due to the declining non-music related revenue as the company increased its focus on music and UGC offerings. Non-music related revenue fell from RMB105.4m in FY12/05A to RMB88.5m in FY12/07A, representing a two-year compounded annual decline of 8.4%. RBTs exhibited the strongest growth, up from RMB13.3m to RMB89.5m between FY12/05A to FY12/07A, representing a two-year CAGR of 159.8%. IVR revenue dipped 54.4% in FY12/06A, as A8.com suspended its IVR platform for upgrading. It rebounded 189.8% YoY in FY12/07A to RMB20.7m. Ringtone revenue increased 12.4% YoY to RMB96.4m in FY12/06A but declined 25.1% in FY12/07A to RMB72.2m as a result of the enforcement of MIIT regulations.

Gross margin shrinks due to product and channel shift. A8.com's cost structure consists of mainly of: 1) operator costs; 2) partner alliances costs; 3) licensing/copyright costs and 4) direct costs. In FY12/07A, these items accounted for 45.5%, 43.1%, 6.3% and 5.1% respectively of overall cost of services. A8.com's gross margin contracted between FY12/05A and FY12/07A from 55.1% to 46.3% because of the impact of MII's "clean up" policies and product mix changes in favour of lower-margin RBT and IVR. In addition, A8.com has increased its cooperation with channel partners such as TV stations, brand owners and wireless operators, which increased costs of services due to the revenue sharing model adopted with these parties. Costs arising from business alliances rose 5.0pcp YoY to 43.1% of total cost of services in FY12/07A.

Healthy rebound in FY12/07A. A8.com's net profit contracted 4.7% YoY to RMB39.9m in FY12/06A, in part due to MII regulations, and rebounded 38.7% to RMB55.3m in FY12/07A on improving industry conditions and one-off items. Excluding one-off items of RMB9.0m (securities gains and fair value gain on derivative financial instruments), FY12/07A net profit grew 16.1% to RMB46.3m, on a proforma basis.

1H FY12/08A results

Beating expectations. A8 Digital Music (800 HK) announced its maiden interim results since its listing on the HKEx on 12 June. Revenue was up 200.9% YoY at HK\$329.4m and net profit at HK\$37.0m (which included a HK\$9.0m listing expense), up 73.3% YoY. Excluding other incomes and gains from both years, A8's 1H net profit of HK\$35.3m surged 259.8% YoY. Despite its profit "alert" on 11 August, the results handily beat our expectations.

Music - key driver. Revenue growth was driven primarily by: 1) increased consumption of music products by the mobile community, 2) increased number of mobile subscribers and 3) overall recovery in the mobile VAS industry. RBT revenue surged 492.9% YoY to HK\$167.5m, accounting for 50.8% of the total (1H FY12/07A: 25.8%). Ringtone services jumped 133.8% YoY to HK\$63.5m. Music related revenue accounted for 74.1% of the total (1H FY12/07A: 62.6%). According to the management, music from A8's user generated content (UGC) platform accounted for around 35% of music related revenues.

Margins. In line with our expectations, the gross margins narrowed 3.6pcp YoY to 41.4% due to: 1) product mix changes (RBT have a lower margin) and 2) revenue sharing with Internet website partners. The net margin (ex other income and gains for both years) expanded 1.7pcp to 10.7%, benefitting from improved economies of scale.

Consolidation benefits. As the industry consolidates after restructuring, A8 appears to be taking much of the vacated market share. Its RBT growth of 492.9% YoY exceeds that of others such as Linktone (up 81% YoY) and Kongzhong (up 73% YoY). We believe its product differentiation (offering UGC music) is one of the keys to its outperformance.

Introducing our estimates. We expect revenue to increase 131.5% to RMB661.9m in FY12/08F, 25.3% to RMB829.5m in FY12/09F and 16.8% to RMB968.8m in FY12/10F driven by high broad-based growth in music consumption. The three-year CAGR of net profit is estimated at 28.4% (RMB55.3m in FY12/07F to RMB117.0m in FY12/10F). The gross margin should shrink and stabilize at around 37.5% in FY12/10F due to product mix changes and revenue sharing with business partners who promote its products. The gross margin compression should be offset by operating scale improvements. The net margin should improve to 12.3% in FY12/10F, from 11.3% in FY12/08F.

Table 12: Summary P&L

Year to Dec (RMBm)	06A	07A	08F	09F	10F
Revenue					
Music-related	159.3	197.5	496.5	649.5	780.8
Non music related	109.2	88.5	165.4	180.0	188.0
	268.4	286.0	661.9	829.5	968.8
Business tax	(8.3)	(7.9)	(11.4)	(14.3)	(16.7)
Net revenue	260.1	278.1	650.5	815.2	952.1
Cost of services	(127.8)	(149.4)	(388.1)	(496.8)	(595.4)
Gross profit	132.3	128.7	262.4	318.4	356.6
Other income/gains, net	9.7	20.2	4.6	4.9	5.5
Gain from disposal of JCE	-	5.7	-	-	-
Selling & marketing expenses	(67.8)	(67.1)	(120.0)	(149.1)	(165.4)
Administration expenses	(22.4)	(21.7)	(31.2)	(37.2)	(41.3)
Other expenses	(2.8)	(0.1)	(21.5)	(16.5)	(10.6)
Finance costs	(5.0)	(4.9)	(3.8)	(2.0)	(2.0)
Profit/loss from JV	0.6	(0.3)	-	-	-
Tax	(5.3)	(5.2)	(15.1)	(20.1)	(24.3)
Profit after tax	39.3	55.2	75.4	98.4	118.5
Minority interest	0.6	0	(1.9)	(1.7)	(1.5)
Net profit	39.9	55.3	73.5	96.7	117.0

Source: Company data

Initiating coverage with BUY call, target price HK\$2.60. We initial coverage A8.com with a target price HK\$2.60, based on 15.8x FY12/08F P/E and 12.0x FY12/09F P/E. There are no pure listed e-record label companies on the HKEx. Vertically integrated media companies with content ownership and distribution platforms are presently trading at an average of 10.4x current-year forward and 14.0x 1-year forward P/E. UGC-based Internet companies trades at an average of 28.4x current-year forward and 21.5x 1-year forward P/E, with premium valuations going to Alibaba (1688 HK) and Tencent (700 HK), reflecting their large user communities and promising growth prospects. Pure diversified overseas-listed WWAS companies are trading at an average of 36.5x current-year forward and 25.9x 1-year forward P/E.

Table 13: Valuation comparison

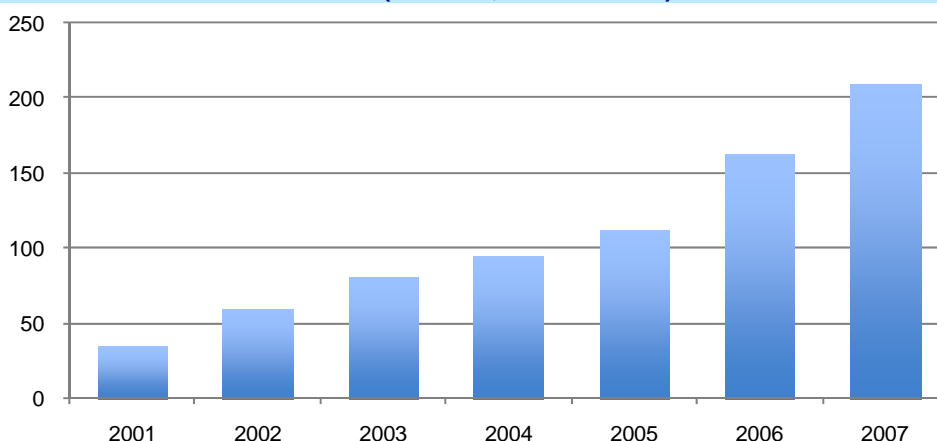
Company name	Ticker	Country	Mkt Cap (US\$m)	Price (HK\$/US\$)	Cur Yr PE (x)	Nxt Yr PE (x)	ROE (%)
Media content companies							
TOM Group	2383 HK	China	202.6	0.4	n/a	15.6	n/a
Phoenix TV	8002 HK	China	522.1	0.8	12.8	11.7	21.9
Qin Jia Yuan	2366 HK	China	223.7	2.7	8.0	5.8	19.5
<i>Average</i>					<i>10.4</i>	<i>14.0</i>	
UGC based companies							
Alibaba	1688 HK	China	5,239.3	7.0	28.2	22.2	51.5
Tencent	700 HK	China	13,701.7	57.0	38.7	28.0	35.2
Global Sources	GSOL US	China	545.4	10.7	18.4	14.3	16.1
<i>Average</i>					<i>28.4</i>	<i>21.5</i>	
Diversified WVAS companies							
Hurray!	HRAY US	China	57.9	2.6	n/a		n/a
Linktone	LTON US	China	36.0	1.5	n/a	n/a	n/a
Kongzhong	KONG US	China	133.8	3.6	36.5	25.9	1.7
<i>Average</i>					<i>36.5</i>	<i>25.9</i>	<i>1.7</i>

Source: Bloomberg (14/04/08)

Industry overview

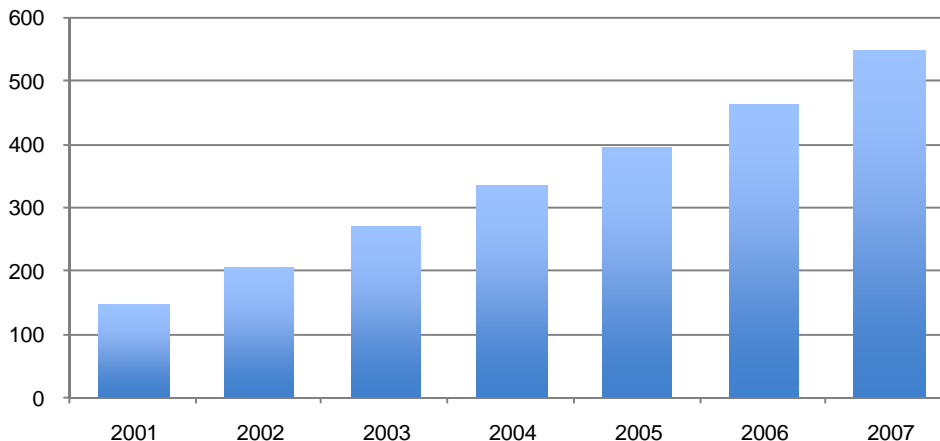
One of the world's largest internet and mobile populations. China has one of the largest Internet and mobile populations in the world. Over the past few years, infrastructure availability, declining subscription rates, network effects and rising disposable income levels have boosted uptake and growth rates. China's mobile community, at 547.3m at end-2007 according to MII, registered a CAGR of 17.8% in 2005-2007. Internet growth has been similarly explosive. According to CNNIC (China Internet Network Information Center), broadband subscribers at end-2007 totaled 210.0m, up 29.6% YoY, rising at a three-year CAGR of 30.7%. Despite this explosive growth, the country's Internet and mobile phone penetration, at 16.0% and 41.7%, respectively, in 2007, remains much lower than that in developed countries.

Chart 5: Number of Internet users in China (millions, 2001 to 2007)



Source: CNNIC

Chart 6: Number of mobile subscribers in the PRC (millions, 2001 to 2007)

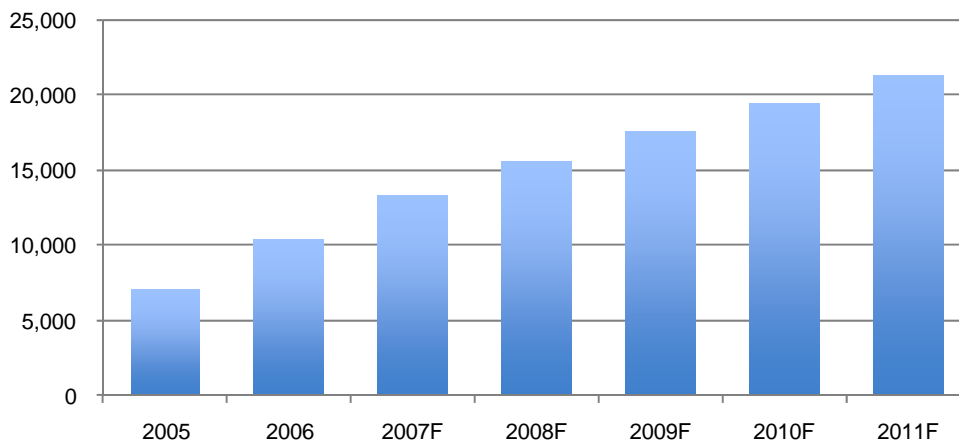


Source: MII

Mobile music accounts for around 90% of the digital music industry. According to BDA (China), China’s digital music market, which includes music delivered over the Internet and mobile platforms, was worth RMB13.4b in 2007, with mobile music accounting for around 90%. The emergence of the mobile platform, popularity of mobile-related music products such as ringtones and RBTs and the relatively closed/secured platform of the mobile network have facilitated the distribution of legitimate music and hence, the industry’s growth.

For many Chinese, mobile phones are the only device to access the Internet and obtain digital information and entertainment. There is an increasing trend among young Chinese consumers (18-30 years) to highlight their own individuality through personalized products, such as ringtones and RBTs, on their mobile handsets. Other key market drivers include: 1) better quality music features available on low-to-mid end handsets and 2) increasing shipments of music enabled handsets.

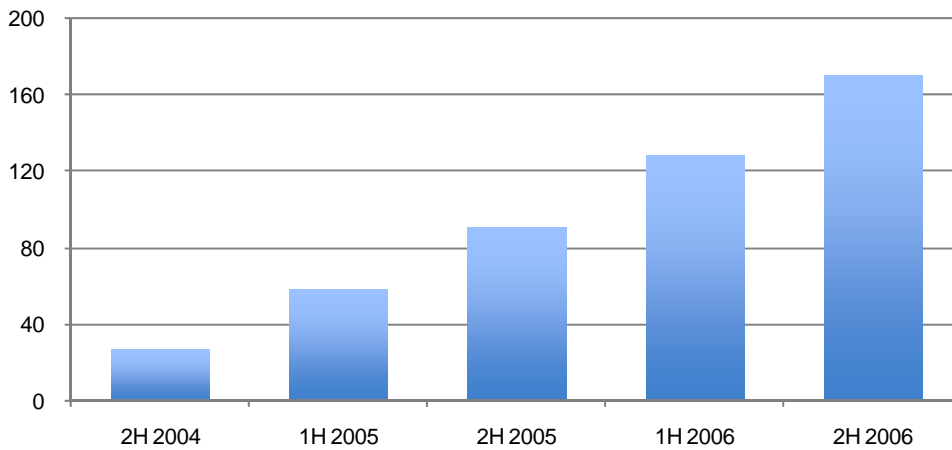
Chart 7: China’s digital music industry size (RMB, millions)



Source: BDA (China)

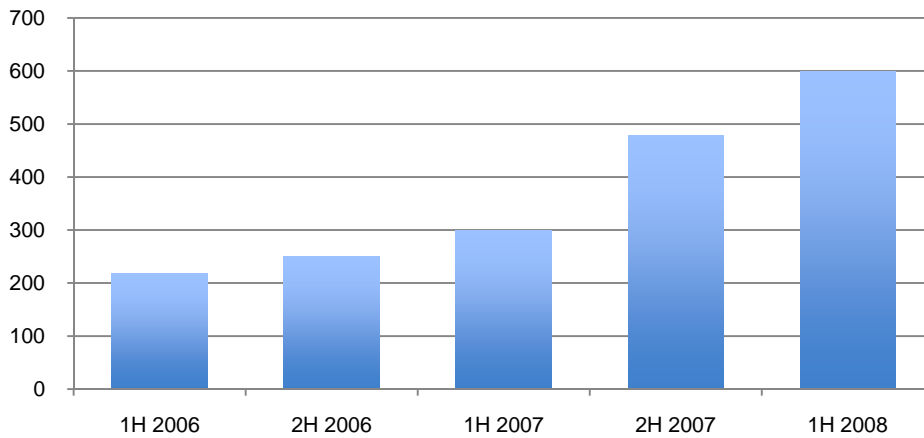
Music handsets drive mobile music consumption. Mobile music services are key growth drivers of telco operators’ wireless value-added service revenue and helped arrest declining ARPU over the past few years. At end-2006, China Mobile had 170.4m RBT users, up from 27.2m in 2004. In 2007 the company recorded 779.0m RBT downloads, up 65.7% YoY and in 1H 2008, 600.0m RBT downloads, up 100.0% YoY. Launched in 2H 2006, its “Wireless Music Club” had 66.9m subscribers by end-2007. According to In-Stat, shipments of music handsets in China totaled 86.0m in 2007, up 47.1% YoY and are expected to reach 161.6m by 2010, representing a CAGR of 23.4%.

Chart 8: China Mobile's RBT subscribers (millions, 2004 to 2006)



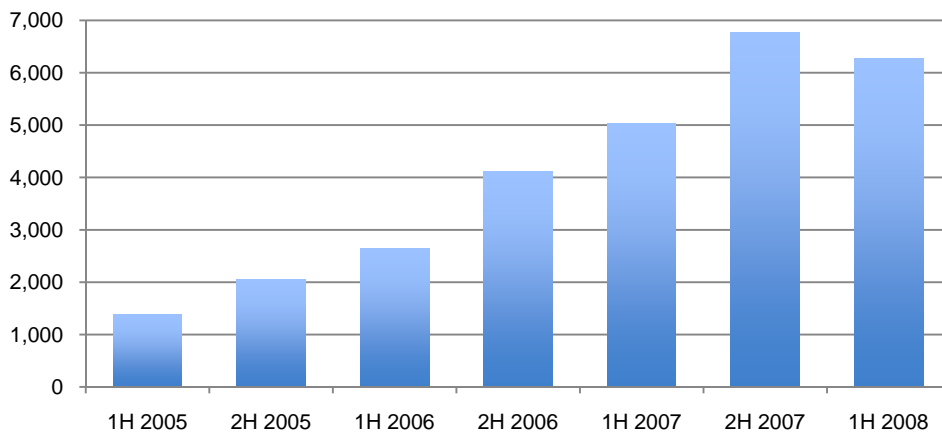
Source: CNNIC, MII

Chart 9: China Mobile's RBT subscription times (millions, 2006 to 1H 2008)

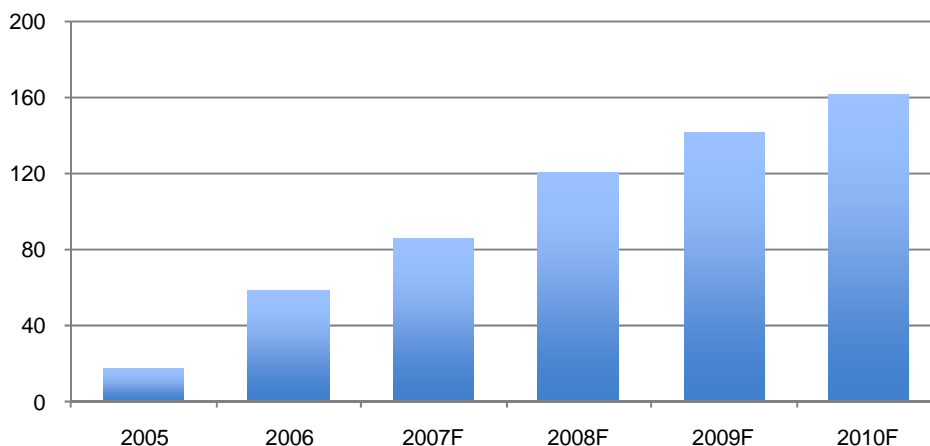


Source: China Mobile

Chart 10: China Mobile's RBT revenue (RMB, millions, 2005 to 1H 2008)

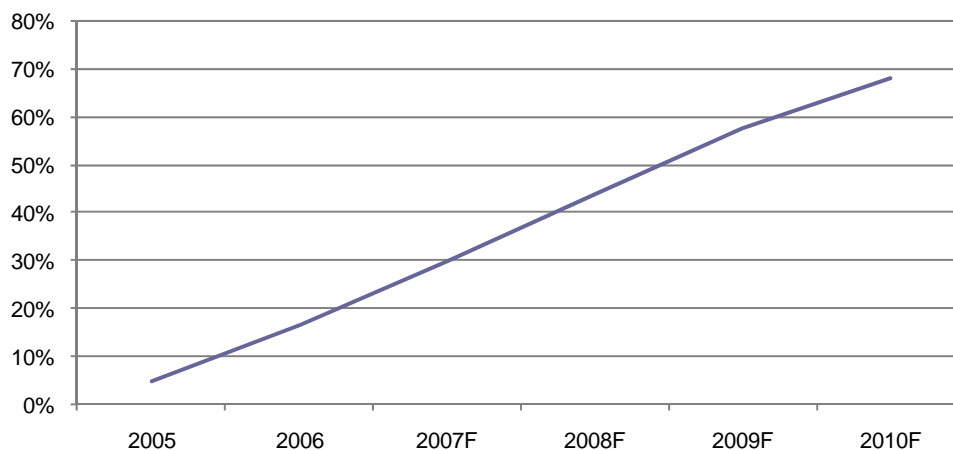


Source: China Mobile

Chart 11: Music handset shipments in China (millions)

Source: In-Stat

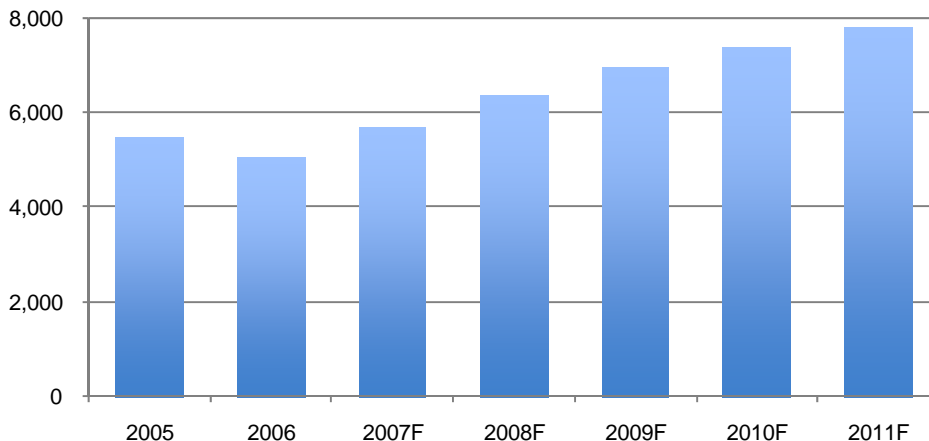
With music capabilities becoming a standard handset feature, In-Stat estimates that the penetration rate of music phone owners will increase from 30.2% at end-2007 and to 68.3% by end-2010. This growing user base should further drive demand for music-related products over the mobile platform.

Chart 12: Music handset penetration in China (pct of overall mobile subs)

Source: In-Stat

This will fuel revenue growth for content providers (CPs) and SPs in the mobile music industry. The industry rebounded to RMB5,680.6m in 2007, up 12.5% YoY after a correction year in 2006, according to In-Stat. We estimate that SPs and CPs accounted for 42.5% of China's overall digital music industry, with the remainder shared by telco operators and digital music distributed over the Internet. In 2006, the sector shrank 8.1% YoY to RMB5,050.7m as a result of MII's "clean up" measures but it is expected to rebound to RMB7,393.7m by 2009, representing a three-year CAGR of 11.1%. In this period, the industry is expected to be driven mainly by RBT growth (CAGR of 11.2%) and full track downloads (CAGR of 54.9%). We believe there is further upside in full track downloads. In-Stat cites the combination of relatively high prices of full track downloads (compared to ringtones and RBTs) and "side loading" of music onto the handset as a main factor inhibiting widespread adoption. We believe that as in the past, mobile music industry participants will develop innovative packages and revenue schemes to increase the affordability of music products and drive demand. A good example is A8.com's full track and music video downloads at only RMB2.0 per piece. This is similar to RBT pricing and we believe that at this affordable price point full tracks (and music videos) should experience healthy demand and revenue growth, in excess of those previously estimated by In-Stat.

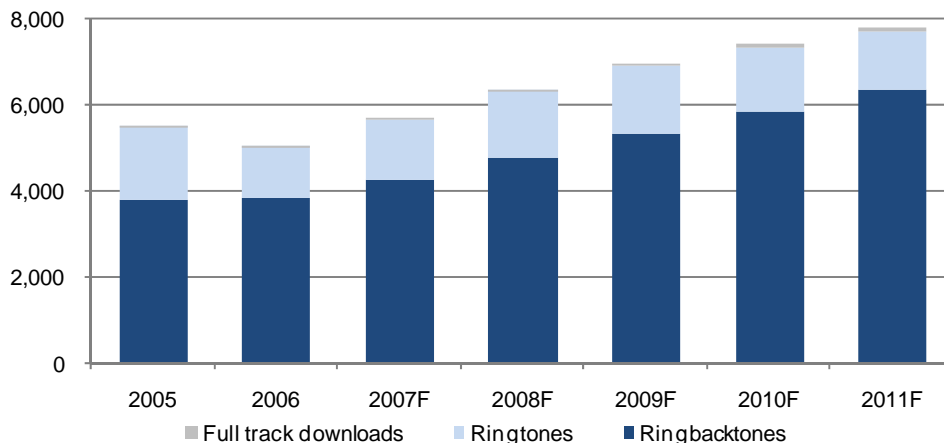
Chart 13: China's mobile music market revenue (RMB, millions, 2005 to 2011F)



Note: Market size for service providers and content providers

Source: In-Stat

Chart 14: Breakdown of China's mobile music market revenue (Rmb, millions, 2005 to 2011F)

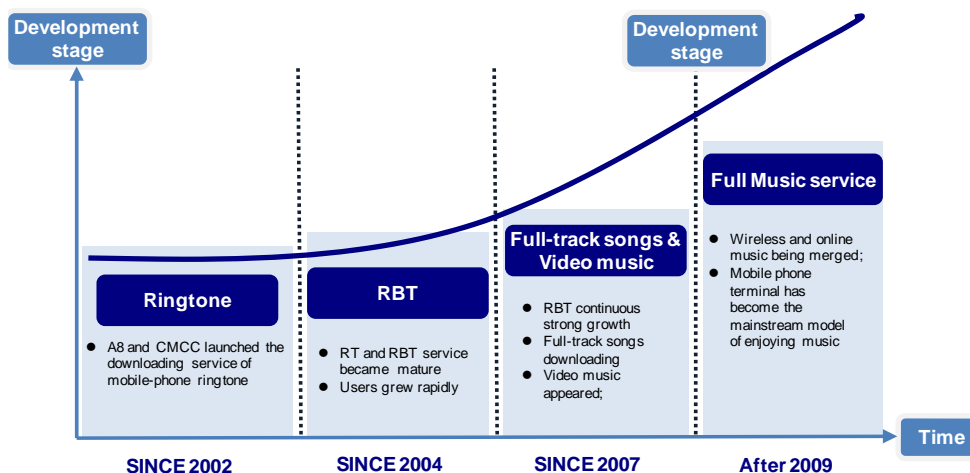


Note: Market size for service providers and content providers

Source: In-Stat

Mobile music on fast development track. China's mobile music industry is expected to benefit from the improved operating environment after the restructuring and we expect healthy product and demand growth. In our view, the continuing innovation of new music-related products will shift the technology curve towards the next stage of growth drivers. This, coupled with the large addressable mobile user community, suggests a new fast-growth stage of development and sustainable growth prospects.

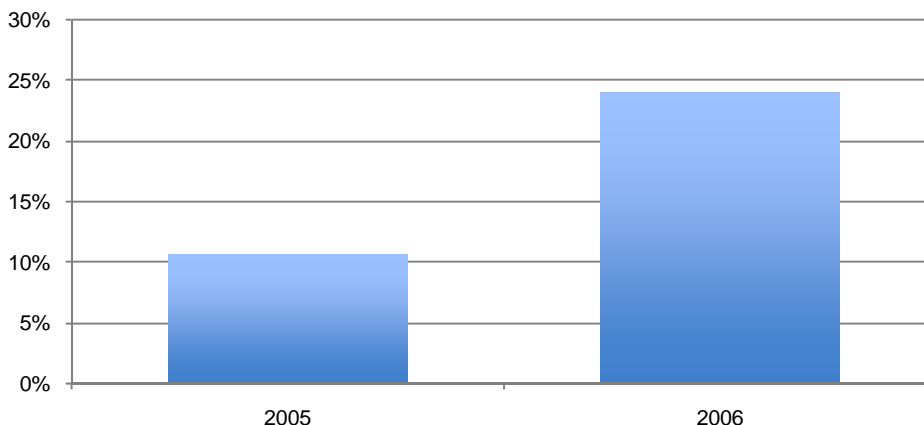
Chart 15: Development track for mobile music



Source: SBI E2-Capital

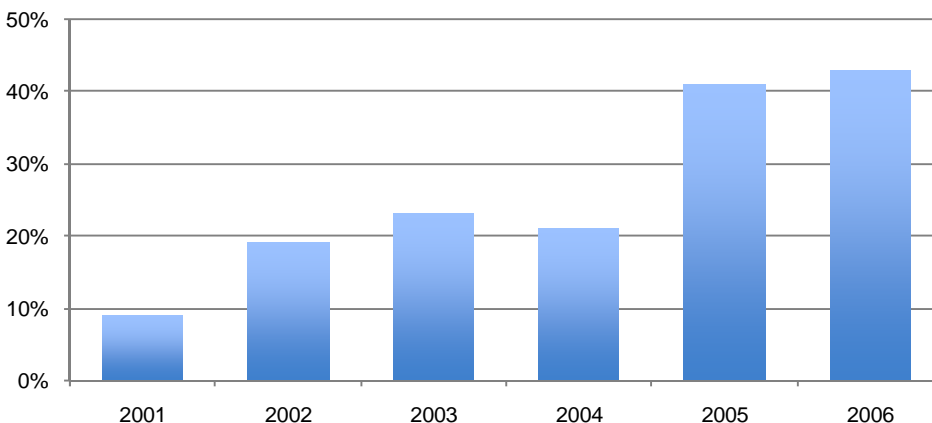
Large appetite for user-generated content. According to CNNIC, 52.9% of China's Internet users are aged 18-30. This favourable demographic base has created a vibrant and active community for UGC. Based on a 2006 survey, CNNIC estimated that China had around 29.2m bloggers (about 24.0% of the Internet's population at the time), and some 53.1m (about 43.0%) regular visitors of bulletin board systems (BBS). Four out of the top 10 most trafficked websites in China, such as qq.com (owned by Tencent), taobao.com and Sina are UGC related. Furthermore, due to the inefficiencies of China's mainstream media and news flow restrictions, many users rely on these forums for timely and up-to-date information. Hence, UGC sites often have a significant amount of influence on mainstream culture and are in high demand.

Chart 16: Percentage of regular blog users in China



Source: CNNIC, CIC Data

Chart 17: Percentage of regular BBS users online in China



Source: CNNIC, CIC Data

Competitive landscape. A8.com, with its e-record label business model, has no direct competitors. However, there is a number of diversified SPs who sell music content in the form of ringtones and RBTs, in a similar manner to A8.com, such as TOM Online, Kongzhong, Linktone and Hurray!. A8.com is different from them in terms of its upstream integration of content ownership, selection, packaging, promotion and marketing services, and focus on music-related products and UGC music. Also, A8.com is different from iTunes and MySpace.cn. iTunes is essentially an enabler to drive sales of hardware and it is not available in China (it is unlikely to be available any time soon as Apple is concerned about piracy issues). MySpace.cn's revenue comes from advertising. Although MySpace has a channel to accumulate UGC music, it is not user-friendly for consumers seeking music as the platform architecture focuses on the individual rather than music. Also, it does not have downstream distribution and/or marketing.

Table 14: competitors landscape

Company	Business Model	Remark
A8.com (800 HK)	Revolutionise the traditional music distribution model by consolidating content accumulation, screening, promotion and marketing and distribution into one party and promoting and marketing music through self-owned and third-party channels	The music produced is more aligned with consumer's taste as UGC music is developed by the end users how ultimately consumes the music product; feedback is both faster and more accurate as it is from its internet channels; and A8.com's UGC platform is more scalable as it is open to mass users.
iTunes (APPL US)	Sales of hardware music devices and digital music. Music is licensed from traditional record labels.	Mainly rely on sales of hardware, with sales digital music and software applications as complementary, intended to drive hardware sales.
MySpace.cn	Advertising revenues, some sales of digital music.	Platform architecture (and core intention) is to focus on the individual rather than the music. Therefore, portal is not efficient for searching UGC music
Warner Music, EMI, Universal, Song BMG	Main revenue from physical media (such as CD) and small portion of revenue from digital music.	Traditional music distribution model is not efficient in China. Slow time to market opens the opportunity for piracy. Artist management inherently has more risk as artist is not guaranteed to produce a next hit song/album.
Kongzhong (KONG US)	Offer free WAP services to all mobile phone users and derive revenues from advertising and mobile gaming	Shift of business focus from traditional diversified SP to focus on mobile advertisement.
Linktone (LTON US)	Move back to a WVAS service provider as it failed to cooperate with TV stations.	Shift of business focus back to traditional diversified SP from a media advertising agent.
Hurray! (HRAY US)	Traditionally a WVAS service provider and acquired several traditional record labels in China through M&As.	Experienced difficulties in: 1) integration into its business model and 2) turnaround the newly acquired entities.
TOM Online	A traditional diversified WVAS service provider. Company has acquired eBay in China.	A distribution platform, does not have own content. Seeking to diversified to C2C business.

Source: Company data

Risks

A8.com has less risk exposure to telco operators. Reliance on telco operators is typically seen as a key risk for any company which engages in sales over the wireless network. However, we believe that A8.com's exposure is low given that its music-related products require a substantial amount of marketing prior to monetization and that the company is able to promote, market and distribute its products using self-owned and partnership channels, independent of telco operators such as China Mobile.

Entry barriers. Despite the industry clean up, entry barriers are still relatively low and the sector fragmented. However, we believe that entry barriers in China are not as low as they appear, because local telco operators are all relationship driven. Moreover, China Mobile's current points and penalty system favours incumbent leaders and makes it difficult for new entrants to survive.

A8.com's extensive marketing and distribution team, solid relationships with leading telecom operators at central and provincial levels and strong execution record should continue to keep it ahead of the pack. While the market may be concerned about the industry's future restructuring, we believe that A8.com is well positioned to benefit because such moves have always favour large incumbent players.

Other risks factors include: 1) need to continue building its UGC music database, 2) reliance on telco operator's settlement platform, 3) failure to spot emerging music trends and tastes, 4) increasing competition and 5) slowing GDP growth in China.

P & L (RMBm)						Cash Flow (RMBm)					
	06A	07A	08F	09F	10F		06A	07A	08F	09F	10F
Year to Dec						Year to Dec					
Net Revenue	260.09	278.1	650.5	815.2	952.1	EBIT	47.6	58.9	90.8	115.6	139.3
% chg	14.6%	6.9%	133.9%	25.3%	16.8%	Depre./amort.	3.3	3.6	6.0	11.5	17.5
Gross profit	132.3	128.7	262.4	318.4	356.6	Net int. paid	(0.0)	-	-	-	-
EBITDA	50.9	62.5	96.7	127.1	156.8	Tax paid	(3.1)	(9.4)	(12.1)	(16.1)	(19.4)
Depre./amort.	(3.3)	(3.6)	(6.0)	(11.5)	(17.5)	Others	0.1	(10.8)	-	-	-
EBIT	47.6	58.9	90.8	115.6	139.3	Gross cashflow	47.9	42.3	84.7	111.0	137.4
Net int. income/(exp.)	(3.6)	(3.8)	(0.3)	2.9	3.5	Chgs. in working cap.	(1.6)	(25.1)	38.4	(2.6)	(27.2)
Exceptionals	-	5.7	-	-	-	Operating cashflow	46.3	17.2	123.0	108.4	110.2
Associates	-	-	-	-	-	Capex	(2.0)	(0.9)	(28.7)	(36.2)	(33.7)
Jointly-controlled entit.	0.6	(0.3)	-	-	-	Free cashflow	44.3	16.3	94.3	72.2	76.5
Pre-tax profit	44.6	60.5	90.5	118.5	142.8	Dividends paid	-	-	-	-	-
Tax	(5.3)	(5.2)	(15.1)	(20.1)	(24.3)	Net distribution to MI	0.6	0.0	(1.9)	(1.7)	(1.5)
Minority interests	0.6	0.0	(1.9)	(1.7)	(1.5)	Investments	(1.4)	(4.7)	-	-	-
Net profit	39.9	55.3	73.5	96.7	117.0	Disposals	-	-	162.9	-	-
% chg	-4.7%	38.7%	33.0%	31.6%	21.0%	New shares	-	-	-	-	-
Dividends	-	-	-	-	-	Others	(14.0)	(3.7)	5.3	6.6	7.0
Retained earnings	39.9	55.3	73.5	96.7	117.0	Net cashflow	29.5	8.0	260.7	77.1	82.0
EPS (RMB) - Basic	0.111	0.154	0.179	0.217	0.262	Net (debt)/cash - Beg.	93.9	123.4	131.3	392.0	469.0
EPS (RMB) - F.D.	0.089	0.124	0.165	0.217	0.262	Net (debt)/cash - End.	123.4	131.3	392.0	469.0	551.1
DPS (RMB)						Interim Results (RMBm)					
No. sh.s o/s (m) - W.A.	360.0	360.0	410.3	446.3	446.3		07A	08A			
No. sh.s o/s (m) - Y.E.	360.0	360.0	410.3	446.3	446.3	Six months to Jun					
No. sh.s o/s (m) - F.D.	446.3	446.3	446.2	446.3	446.3	Net Revenue	106.3	323.7			
Margins (%)						% chg	n/a	204.6%			
Gross	50.9	46.3	40.3	39.1	37.5	Profit from operations	26.2	47.6			
EBITDA	19.6	22.5	14.9	15.6	16.5	Interest expenses	(2.6)	(1.9)			
EBIT	18.3	21.2	14.0	14.2	14.6	Associates	-	-			
Pre-tax	17.1	21.7	13.9	14.5	15.0	Jointly-controlled entit.	0.2	-			
Net	15.3	19.9	11.3	11.9	12.3	Pre-tax profit	23.8	45.7			
						Tax	(2.5)	(7.7)			
						Minority interests	0.1	(0.9)			
						Net profit	21.4	37.0			
						% chg	n/a	73.3%			
						EPS (RMB) - Basic	n/a	0.110			
						DPS (RMB)	-	-			
Balance Sheet (RMBm)						Shareholding Structure					
Year to Dec						Shareholding Structure					
Fixed assets	9.6	6.8	16.7	26.8	33.4				Shareso/s (m)	%	
Intangible assets	0.5	0.4	13.5	28.3	39.0	Controlling shareholder			238.4	53.4	
Other LT assets	19.5	-	6.1	6.1	6.1	Top Results			48.6	10.9	
Cash	123.4	131.3	392.0	469.0	551.1	Pre-IPO investors			62.0	13.9	
Accounts receivable	37.6	64.8	117.0	124.2	152.2	Public			97.3	21.8	
Other receivables	17.1	21.6	42.6	51.2	63.6	Total			446.3	100.0	
Inventories	-	-	-	-	-	Background					
Due from related co.s	22.9	59.7	-	-	-	A8 Digital Music Holdings Ltd (A8.com) is a vertically integrated e-record label for original digital music created by independent artists in China. Through its user-generated content (UGC) website, www.a8.com , the company identifies, packages, promotes digital music and distributes it over the Internet and wireless platforms. Its revenue is mainly derived from: 1) sale of ringback tones (RBT); 2) sale of ringtones; 3) sale of interactive voice response (IVR); 4) sale of full track music. A8.com consistently ranks at the top of China Mobile's (941 HK) central and key provincial platforms for music-related products. A8.com was listed on the Hong Kong Exchange's main board in June 2008.					
Other current assets	-	6.6	-	-	-						
Total assets	230.5	291.2	587.9	705.7	845.4						
Accounts payable	(12.4)	(18.0)	(43.6)	(46.2)	(50.0)						
Other payable	(17.4)	(18.8)	(45.0)	(55.7)	(65.0)						
Tax payable	(3.3)	-	(6.2)	(9.4)	(13.4)						
Due to related co.s	(0.3)	-	-	-	-						
ST debts	-	-	-	-	-						
Other current liab.	(3.1)	(3.6)	(3.0)	(3.0)	(3.0)						
LT debts	-	-	-	-	-						
Other LT liabilities	(70.4)	(69.3)	(0.8)	(0.8)	(0.8)						
Total liabilities	(106.8)	(109.7)	(98.6)	(115.1)	(132.3)						
Share capital	-	-	3.9	3.9	3.9						
Reserves	123.6	181.5	485.4	586.7	709.2						
Shareholders' funds	123.6	181.5	489.3	590.6	713.1						
Minority interest	0.1	0.0	-	-	-						
Total	123.7	181.5	489.3	590.6	713.1						
Capital employed	123.7	181.5	489.3	590.6	713.1						
Net (debt)/cash	123.4	131.3	392.0	469.0	551.1						
						Key Ratios					
						06A	07A	08F	09F	10F	
						Net gearing (%)	Cash	Cash	Cash	Cash	Cash
						Net ROE (%)	38.4	36.2	21.9	17.9	18.0
						EBIT ROCE (%)	45.7	38.6	27.1	21.4	21.4
						Dividend payout (%)	-	-	-	-	-
						Effective tax rate (%)	11.9	8.7	16.7	17.0	17.0
						Net interest coverage (x)	13.4	15.6	306.6	na	na
						A/R turnover (days)\	56.4	67.2	51.0	54.0	53.0
						A/P turnover (days)	31.4	37.2	29.0	33.0	29.5
						Stock turnover (days)	-	-	-	-	-

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

A fellow subsidiary of SBI E2-Capital Securities Limited was acted as the sponsor for the A8 Digital Music Holdings Limited in June 2008.

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