

Initiating Coverage

Report type

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Tickers

Bloomberg: 802 HK / RCG LN
Reuters: 0802.HK / RCG.LN

Sector

Information Technology

Company website

www.rcg.tv

Major shareholders

Veron International Ltd.	24.00%
Offshore Group Holdings Ltd.	23.22%
Raymond Chu Wai Man	6.85%

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RFID/biometrics leader in China and Asia

RCG an information technology company focusing on the development and implementation of radio frequency identification (RFID), biometrics, wireless and securities solutions for diversified industries ranging from healthcare, logistics/supply chain to entertainment. Established in 1999, the company's key geographic focus is in Greater China, Asia Pacific and Middle East.

- * **Strong industry growth.** Biometrics market in Asia is expected to grow between 60-73% to US\$6,382m by 2012 while the RFID market in Asia is projected to growth at a CAGR of 28.7% over the same period to US\$1,623m (accelerating from CAGR of 19.2% between 2005-2007).
- * **Supportive government policies.** There is strong government support to drive the RFID market in the coming few years, including China's "Internet on Things" ("IoT") policies. RCG, being a leader in Asia and Greater China, stands to be a key beneficiary.
- * **Strength in multi-layer diversity.** One of RCG's key strength is the its' diversity in business segments, industry verticals and geographical segment. Through this, the company has penetrated a number of different verticals, ranging from private enterprise to government. This is a strategic advantage for RCG as it has access to end-user feedback at the various verticals, which would allow them to: 1) cross sell different verticals and 2) gain expertise from feedback and user demands of the different verticals.
- * **Strong M&A track record.** RCG has established a strong track record in the past and after recently completing a new shares placing to raise HK\$189.0m, we expect the company continue to use acquisitions to continue to drive growth.
- * **Strong bottomline growth.** Net profit CAGR of 14.8% between FY12/08A-11F. This solid bottomline growth has yet to include acquisitive M&A contribution, providing further upside to our earnings estimate on RCG.
- * **Undemanding valuation.** One key reason for the company's current undemanding valuation is that due to the overhang with the share registry. This is a risk, but also an opportunity for mid/long term investors to accumulate the counter.

BUY Call. We initiate coverage on RCG Holdings with a BUY Call and target price of HK\$19.80, representing 8.0x FY12/09F and 6.7x FY12/10F. We think that the combination of: 1) sustainable organic growth; 2) M&A potential and 3) removal of share registry uncertainty presents tremendous upside for the counter.

P & L Summary

Year to Dec (HK\$m)	07A	08A	09F	10F	11F
Revenue	1,438.8	2,002.4	2,385.3	2,784.7	3,291.1
Gross profit	719.1	1,058.6	1,250.8	1,430.1	1,661.5
Operating profit	458.4	618.6	695.6	831.0	983.0
Net profit	452.5	622.3	676.1	803.2	942.5

Source: Company data, SBI E2-Capital

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Investment thesis

RFID and biometrics industries are fast growing and sustained

Biometrics

Biometrics is the automated measurement of individual's biological traits for verification and identification purposes. The measured traits are then compared against a database (either online or offline) for the verification or confirmation of the individual's identity.

Emphasis on security and access driving biometrics market

Over the past few years, the application of biometrics solutions has migrated and penetrated from being applied solely in the government sector, to the enterprise and consumer sectors. This broadening adoption of this technology has been driven by:

- ❑ Increased priority being placed on access and data security;
- ❑ One-off incidents such as 911 and other terrorism events;
- ❑ Disadvantages related passwords and personal identification numbers (PINs). (when the individual forgets the passwords/PINs, time is wasted to reset the code and there is no guarantee that it would not be forgotten again);
- ❑ Improvement of accuracy of biometric solutions and lowering of application costs

Table 1: Biometrics Applications

Type	Application
Fingerprinting	Corporate security (physical and logical access) Citizen identification and authorization Home security Inventory control statistics Consumer electronics applications
Facial	Surveillance Consumer electronics applications Recognition for the gaming industry (esp. casinos) Pharmaceutical and laboratory applications
Voice	Telebanking
Iris	Government and healthcare applications

Source: Frost & Sullivan

Table 2: Key industry verticals

Industry	Application
Government	National ID programs e-passports Immigration check-ins Border control programs
Financial	Access and logic security, ATM access Smart card for online/offline transactions
Healthcare	Access to patient data Laboratories access Access control to medical supplies and inventory
Corporate	Physical access control Data access control

Source: Frost & Sullivan

Table 3: Price and accuracy comparison

Type	Price	Accuracy
Voice	Low	Low
Facial	Low	High
Fingerprint	Low	High
Hand geometry	Medium	High
Iris	High	High

Source: Frost & Sullivan

To date, fingerprinting and facial biometric solutions have been most generally adopted. This is due to their lower pricing coupled with high level of identification accuracy.

According to Frost & Sullivan, several of the key biometric trends emerging or currently in progress include:

- ❑ Fingerprinting will continue to be the dominant biometric technology
- ❑ Shift from single modal to multi modal technologies (eg. Fingerprinting and facial for high levels of access)
- ❑ Fingerprint swipe sensor will continue to be ideal for consumer devices, though facial technologies may be used in larger devices such as PCs
- ❑ Voice verification biometrics will gain acceptance in financial applications
- ❑ Contactless biometric technologies will be predominant in hospitals and laboratories settings
- ❑ Integration of biometrics technologies with smart card technologies
- ❑ Increase in portable biometric systems

Table 4: Industry Projections for Biometrics

	Worldwide		North America		Asia		EMEA	
	US\$m	YoY (%)	US\$m	YoY (%)	US\$m	YoY (%)	US\$m	YoY (%)
2008	3,684	59.0	1,419	55.5	846	64.2	1,165	54.8
2009	6,005	63.0	2,229	57.0	1,403	65.9	1,898	62.9
2010	9,788	63.0	3,471	55.7	2,422	72.6	3,110	63.9
2011	15,856	62.0	5,419	56.1	3,999	65.1	5,115	64.5
2012	25,529	61.0	8,574	58.2	6,382	59.6	8,512	66.4

Source: Frost & Sullivan

60-73% growth in Asia market between 2008-2012

The biometrics market worldwide is projected to experience a strong grow trend of between 59.0-63.0% between 2008 to 2012. Asia and EMEA in general is expected to outperform the overall market in terms of growth during this period. Asia is expected to grow between 60-73% while EMEA is expected to grow between 55-66%. Specifically, the Middle East is expected to trend above the growth in EMEA given that Europe is a slightly more mature market.

RFID

Radio frequency identification (RFID) is a technology that incorporates the use of electromagnetic or electrostatic coupling in the radio frequency (RF) portion of the electromagnetic spectrum to uniquely identify an object, animal or person. A typical RFID solution would consist of:

Tags (active/passive) – a tiny radio device that consists of an integrated chip (IC) attached to an aerial and is placed in housing. RFID tags can incorporate batteries to enable a longer read range, sensor capabilities, and storage memory;

Readers – sends and receives data to and from the tag through antennas. A reader may have multiple antennas that are responsible for sending and receiving data;

Middleware – data collected by readers are managed by the host computer, which runs RFID middleware software. The basic functions of a middleware is to filter and streamline the data and route those to the respective enterprise or database systems;

RFID market growth accelerating during 2008-2012

System integration – system integration services can be further broken down into several areas, namely RFID implementation, project management, training, and consulting.

The global RFID market looks to accelerate into a sweet period of growth over this current 5-year period according to Frost & Sullivan. Between 2005-2007, global RFID market grew at a CAGR of 18.6%. However, this is expected to accelerate to a CAGR 27.2% from 2008-2012. This trend is mirrored in Asia (incl. China), where growth between 2008-2012 will accelerate to a CAGR of 28.7% (2005-2007: CAGR 19.2%). Within the overall RFID market, typically, around 60%+ consists of RFID tags, 20%+ RFID readers and the remaining 15% RFID middleware and systems integration.

Table 5: Industry Projections for Biometrics

(US\$m)	World	Asia	Nth Am	EMEA
2005	1,459	323	624	474
2006	1,730	384	746	558
2007	2,051	459	894	651
2008F	2,492	560	1,107	771
2009F	3,095	699	1,404	927
2010F	3,970	901	1,846	1,146
2011F	5,160	1,191	2,426	1,448
2012F	6,835	1,623	3,209	1,884
<u>Growth (%)</u>				
05-07 CAGR	18.6	19.2	19.7	17.1
08-12 CAGR	27.2	28.7	29.1	23.7

Source: Frost & Sullivan

The key drivers for the RFID industry going forward include:

- ❑ Compliance to mandates – from government policies (e-passport, e-identification) to corporate initiatives (Wal-Mart, Metro Group);
- ❑ New application areas – penetration of RFID solutions into animal husbandry tagging food industry and healthcare;
- ❑ Government support – funding, programs, policies etc, especially in emerging countries and regions such as China and Asia;
- ❑ Standardisation in global RFID technology standards;
- ❑ Declining costs of tags and readers; and
- ❑ Large scale deployments – many RFID programs are shifting from successful pilot projects and initial deployments to large scale deployments.

China’s “Internet-On-Things” policies would further drive RFID/biometrics demand

RFID market in China has been developing rapidly with potential to be further fueled up

Analysys estimated the entire RFID market in China grew 70.0% in 2008 to RMB7.7b, which further increased 54.7% in 1-3Q 09 to RMB7.8b. Such growth, in our view, is likely to retain in short-term, in view of the country’s resilient economy. In a longer term, we expect the RFID market to be sustained and, probably, even fueled up further by the implementation of “Internet-On-Things” (“IoT”). Prime Minister Wen Jiabao unveiled the country’s passion in Aug 2009, although detailed policies have not come out yet while related technical standards are under drafting, the concept will likely raise huge demand for RFID by tagging and connecting machines.

The concept of IoT is a world where physical objects are seamlessly integrated into the information network, and where the physical objects can become active participants in business processes (Source: SAP). RFID solutions play a major enabling role within this concept.

RCG's portfolio, business segment and geographical diversity allows company to be key player in China and Asia

Vertical/segment/geographic diversity is key strength

Strong outlook in projects segment

Strong M&A track record

Leading RFID/biometrics solutions provider in China and Asia region

RCG is a leading RFID/biometrics solutions provider in the Greater China and Asia Pacific region. While the industry remains fragmented to a certain extent, most of the key RFID/biometric solutions providers such as Cogent, Checkpoint, Intermec and BEA Systems are largely based out of North America and Europe. Meanwhile, solution providers in this region, including Nanjing SampleTech (8287 HK) and/or AutoToll are strong players within a particular country and concentrating within a particular industry, without the portfolio, business segment and geographical diversity of RCG.

RCG's multi-vertical / multi-segment / multi-geographic strategy positions the company to capture growth opportunities

RCG's exposure in the three different business segments has allowed the company to penetrate a number of different verticals, ranging from private enterprise to government. This is a particular strategic advantage for RCG as it has access to end-user feedback at the various verticals, which would allow them to: 1) cross sell different verticals and 2) gain expertise from feedback and user demands of the different verticals.

Consumer – residential/personal security, lifestyle, mobile security, education;

Enterprise – corporates, multi-nationals, manufacturing production facilities; and

Solutions projects – government, healthcare, logistics/infrastructure, entertainment, telecoms, banking and finance.

In addition, the company has a strong presence in multiple geographical emerging markets, including Greater China, SE Asia and Middle East. This allows the company to capture the growth opportunities in these different geographic areas. The portfolio is well rounded too, with SE Asia, Greater China and Middle East accounting for 44.6%, 35.9% and 19.1% respectively of overall revenues in 1H FY12/09A. Though SE Asia is currently RCG's largest geographical segment, we think that it would continue to offer growth opportunities to the company as countries such as Vietnam, Thailand and Indonesia are still largely untapped. This is a particular advantage for RCG given that other North America-based and European-based solutions providers have yet to establish a solid presence in this part of the world.

Projects segment to deliver growth and recurring revenue

RCG's solution projects segment has developed rapidly with a 66.5% YoY growth in 1H FY12/09A. The solutions projects segment has showed to be the key growth driver for RCG. RCG had the contract for providing biometric and RFID solutions for Beijing Science and Technology Museum, Nokia, Guardforce security MTRC Hong Kong and Henderson land development Hong Kong. It also provided solutions for major banks in China, such as Bank of China, China Construction Bank, Industrial and Commercial Bank of China. The company has established its brand name and solid track record in providing solutions for different kind of industries, such as healthcare, entertainment, logistics, infrastructure, and financial industry, in Greater China, Middle East and SE Asia. RCG is also very positive in providing solutions for government sector. It has announced that it won some government contract in China, UAE and Malaysia.

Willingness to grow via M&As

RCG has a solid M&A track record to boost the company's growth profile. Since 2006, the company has made acquisitions to help the company: 1) improve IP base; 2) complement existing portfolio / business functions and 3) enter into new segment / geographical markets. Examples are the acquisition of UCH in Apr/Dec 2006 to gain access to a strong distribution network to help drive sales of RCG's products and solution. The company also acquired Vast Base and Chance Best to help the company strengthen its presence in China and at the same time, break into the anti-counterfeit solutions market. We expect that the company would continue to be

aggressive on the M&A front going forward.

Table 6: M&A record

Acquisition	Date	Description	Amt (HK\$m)	Remarks
Skycomp Technology	Jan 06	IT services/hardware distributor	35.0	Access to sales and distribution network
Huge Wealth	Mar 06	Software solutions for gaming industry	13.8	
UCH	Apr 06/ Dec 06	IT hardware/software assembler and distributor	105.0	Access to Malaysia strong sales distribution network
ECTAsia	Apr 06/ Dec 06	IT services and systems integrator	See UCH	Strengthen IT project management and systems integration capabilities
Neulex	Dec 06	Manufacture/sale of IT/PC products	5.0	
Towards Soft	Dec 06	Software R&D	43.0	
Virtual Storage	Dec 06	Online security software R&D	15.0	
Chance Best	Nov 07/ Nov 08	Systems integrator for ticketing management systems	203.0	Gain foothold into ticketing solutions market in China
Vast Base	Dec 07/ Dec 08	Systems integrator for healthcare management systems	735.0	Gain foothold into healthcare management solutions in China
A-1	Apr 09	IT services and related business	135.0	

Source: Company data

Attractive valuation

Undemanding position at 4.2x
FY12/09F P/E

Backed by a net profit CAGR of 14.8% between FY12/08A to FY12/11F, the counter is extremely undemanding trading at 4.2x FY12/09F P/E. Similar counters listed in the US are currently trading at an industry average of 35.0x FY12/09F P/E. After the recent new shares placement by the company (Oct 09), we estimate that the company would have net cash of around HK\$525.0m by the end of the year.

Table 7: US listed Peers

Company name	Ticker	Mkt cap (US\$m)	Currency	Last Price (Local)	Cur Est P/E (x)	Nxt Est P/E (x)	Est ROE (x)
Cogent Systems	COGT US	858.8	USD	9.58	22.4	18.2	8.8
L-1 identity solutions	ID US	531.4	USD	5.87	63.8	37.4	-
Checkpoint systems	CKP US	652.3	USD	13.89	18.8	14.2	-
Intermec	IN US	764.5	USD	12.31	-	28.6	7.4
Total average					35.0	24.6	

Source: Bloomberg and SBI E2-Capital

Share registry overhang is risk, but also opportunity

Shareholder lawsuit is also
good opportunity

One key reason for the company's current undemanding valuation is that due to the overhang with the share registry. Second largest shareholder (23.22%), Tony Chan (via Offshore Group Holdings) is contesting the estate of the late Nina Wang and largest shareholder (24.00% via Veron International). There is also rumour that Tony Chan himself maybe interested in selling down his stake. We are of the view that both parties would eventually exit RCG (though we acknowledge that timing is uncertain), and the removal of this share overhang would lead to a sustained re-rating in the company's stock. We think that the current share overhang offers long investors to accumulate a position in RCG at cheap valuations.

Business analysis

Company overview and background

Overview RCG is an information technology company focusing on the development and implementation of radio frequency identification (RFID), biometrics, wireless, and securities solutions for diversified industries ranging from healthcare, logistics/supply chain to entertainment. Established in 1999, the company's key geographic focus is in Greater China, Asia Pacific and Middle East. RCG's listed on London's AIM Board in 2004, and was also later admitted to the PLUS Board. The company listed on Hong Kong's HKEx Main Board by way of introduction in Feb 2009.

Product overview

RFID Radio frequency identification (RFID) is a technology that incorporates the use of electromagnetic or electrostatic coupling in the radio frequency (RF) portion of the electromagnetic spectrum to uniquely identify an object, animal or person.

RFID solutions can be used in various forms including item tagging, product identification, personnel tracking, asset tracking and anti-counterfeit systems and has been increasingly gaining adoption in a variety of industry verticals including logistics/supply chain, healthcare and entertainment industries.

A typical RFID solution would include both hardware (RFID tags, readers, backend servers/PCs) and software (firmware, middleware and software). RCG's RFID productions are mainly concentrated on project solutions.

Biometrics Biometrics is the digital identification of unique physical characteristics that distinguish an individual such as fingerprint, face, voice and hand geometry. Biometrics solutions are generally used for access control in residential and/or commercial settings ranging from access control for residential/commercial buildings to logical access for PCs or confidential information.

RCG's biometric solutions focus mainly on fingerprint authentication access control devices and facial recognition software solutions in its biometric segment.

Multi business segments

Enterprise and projects segment has been growing faster than consumer segment

RCG's conducts its business and sells its solutions in three key business segments, namely: 1) consumer; 2) enterprise and 3) projects solutions. In particular for the enterprise and projects solutions segment, RCG has the ability to combine both biometric, RFID and wireless elements to enhance the overall value proposition of its solutions. As at 1H FY12/09A, the consumer segment is the largest accounting for 41.5% of overall revenues, though the enterprise (1H FY12/09A: 37.9%) and solutions projects (1H FY12/09A: 20.6%) segments have been growing faster.

Table 8: Segment breakdown

	06A		07A		08A		1H 09A	
	HK\$m	%	HK\$m	%	HK\$m	%	HK\$m	%
Consumer	464.0	52.4	783.5	54.4	835.6	41.7	536.5	41.5
Enterprise	267.7	30.3	533.3	37.1	824.1	41.2	490.0	37.9
Solutions projects	153.1	17.3	121.9	8.5	342.7	17.1	267.2	20.6
Total	884.8	100.0	1,438.8	100.0	2,002.4	100.0	1,293.7	100.0

Source: Company data

Consumer

RCG's consumer segment products are mainly off-the-shelf biometric solutions. This principally include FxGuard Windows Logon, a biometric facial recognition software for PCs as well as others such as FxSecure (lightweight PC notebook), BioMirage Coffe (biometric fingerprint storage box) and iTrain (e-learning device adopting infra-red and RFID technologies).

These products are mainly sold through third party wholesalers, distributors or directly into hypermarkets in South East Asia and/or bundled in with hardware vendors. At the end-FY12/07A and beginning-FY12/08A, RCG signed agreements

with both Acer and NEC to bundle the software into their respective notebooks.

Enterprise

The company’s enterprise solutions comprise the sale of access control devices and related control/data tracking management software. Similar to the consumer solutions, the products are sold through third party distributors and system integrators. The company produces a series of biometric solutions (I-series, S-series, M-series, K-series) which differ in terms of: 1) form (slim line, industrial etc); 2) function (bundled time attendance, visitor management, security applications) and 3) level of security (both facial and fingerprint biometric functions). The company originally focused on the sales of hardware access control devices, but over time increased the depth of its offerings by building in more software features and also the offering of total solutions.

Solutions Projects

This segment of RCG’s business focuses of the development and implementation of customized of security, enterprise management and RFID solutions for corporate and government customers. For these solutions, RCG performs the integrated role of solution designer, software developer and systems integrator. In producing these solutions, the company would use both in-house and third party hardware and software. Management indicates that the ratio of in-house/third party products that comprise their solutions typically averages around 60% / 40% in terms of the cost of solution.

The company sources these solutions contracts both directly and working as a vendor partner to third party hardware and solutions providers such as Motorola and HP. In these contracts, RCG would bundle their hardware and software into the overall solution. RCG is currently a Premier Business Partner of Motorola (under its Partner Select VAR Program) and Vendor Partner to HP and its specialty in RFID and biometrics solutions plugs a technology gap in these IT powerhouses. The IT MNCs typically select RCG as their vendor partner on a combination of: 1) skill set (in this case, RCG’s focus on biometrics/RFID); 2) track record and 3) pricing.

The company’s solutions are deployed in a wide range of verticals including: government, healthcare, logistics/infrastructure, entertainment, telecoms, banking and finance.

Table 9: Project solutions samples

Solution Description	Client	Sector
Document tracking solutions	Malaysian Government, UAE Government	Government
Container tracking	Johor Port	Logistics and infrastructure
Document tracking solutions	MTRC	
Surveillance security passenger info system	Wuhan Metro	
Ticketing anti-counterfeit and management solution	LA Galaxy Tour, Eason Chan Concert, Aaron Kwok Concert	Entertainment
Theme park access and value storage solutions	Sunway Lagoon	Entertainment
Healthcare tagging solutions	Tianjing Dagang Hospital, Sri Kota Specialist Medical Centre	Healthcare
Asset tracking solutions	China Mobile, Nokia	Telecoms
Server tagging solutions	ICBC, CCB, Bank of China	Banking

Source: Company data

Diversified geographic exposure

Greater China is the fastest growing region

RCG has strong presence in Greater China, Asia Pacific as well as the Middle East, with 7 of its 8 offices in these regions. Southeast Asia is the largest, accounting for 44.6% as at 1H FY12/09A. Greater China segment is the fastest growing however, from 3.4% in FY12/06A to 35.9% in 1H FY12/09A.

Table 10: Regional sales breakdown

	06A		07A		08A		1H 09A	
	HK\$m	%	HK\$m	%	HK\$m	%	HK\$m	%
Southeast Asia	733.9	83.0	947.3	65.8	1,111.6	55.5	577.1	44.6
Greater China	30.5	3.4	205.5	14.3	432.0	21.6	464.4	35.9
Middle East	120.3	13.6	247.0	17.2	429.6	21.5	247.3	19.1
Others	-	-	39.1	2.7	29.2	1.4	4.9	0.4
Total	884.8	100.0	1,438.8	100.0	2,002.4	100.0	1,293.7	100.0

Source: Company data

Expansion strategies

RCG has been developed quickly in the past through acquisition and organic growth. The company plans to continue its growth strategy and to keep expansion for new opportunity. Its expansion strategy include:

- Expansion by M&A;
- Venture into government sector;
- Strengthen R&D capability; and
- Geographic expansion.

Further expanded by M&A

RCG has been expanded quickly by M&A. With sufficient financial support, M&A would still be one of the expansion strategies for RCG. It would consider companies which could broaden its suite of solutions and products to help it to better satisfied the requirement of clients or strengthen its market position and help it to further expand.

Taking opportunity in government sector

RCG has been very active in venturing into government sector. During the past months, RCG has announced several government contracts including provision of biometrics and RFID solutions to Department of Education, National Registration Department and Department of Environment in Malaysia, China Science and Technology Museum in PRC, the Ministry of Foreign trade and industry in UAE, the Ministry of Interior in UAE and the Royal Court of Oman Palace. We think that these are the good sign for RCG to further take opportunity in government sector with these track records in government projects.

Strengthen R&D to create more value

Given that there are big potential market towards the concept of "Internet of Things"(IoT), RCG plans to put more R&D effort in developing solutions based on IoT concept. It will utilize its expertise in RFID-related development, system and technology integration and solutions projects provision to provide industry solutions which automate business processes and improve efficiency, especially in the vertical industries where RCG has established its brand name such as healthcare, entertainment, logistics, infrastructure, and financial industries.

Geographic expansion, particularly in China

RCG has been geographically focused on the PRC, Southeast Asia and the Middle East. Its revenue growth in China has been jumped at a CAGR of 276.3% from FY12/06A to FY12/08A. The revenue in China kept increase of 153.2% YoY to HK\$464.4m for 1H FY12/09A. Most of the revenue has been from Northern China. With established reputation in Northern China, the company is now seeing the demand and expansion opportunity in Southern China. RCG plans to alliance with regional government for catching the market of Southern China. Going forward, we think that although the company could still generate good revenue from Southeast Asia and Middle East, China would be the key growth driver.

Financials

Track record financials

Growing quickly through acquisition and organic growth

RCG has developed quickly through acquisition and organic growth. The revenue increased at a 3-year CAGR of 113.4% to HK\$2,002.4m in FY12/08A while the net profit increased at a 3-year CAGR of 114.5% to HK\$622.3m. The cost of sale mainly include raw material, in-house assembly costs, contracting costs and installation cost, which has been increased with the growth of top line. The cost of sales accounted for 51.2%, 50.0% and 47.1% of total sales for FY12/06A, FY12/07A and FY12/08A respectively. The SG&A expenses has been increased steadily, accounting for 17.7%, 20.2% and 22.9% of total sales for FY12/06A, FY12/07A and FY12/08A respectively. Benefiting from some tax exemptions, the effective tax rate of the company has been low, which was 1.1%, 0.8% and 0.4% for FY12/06A, FY12/07A and FY12/08A respectively. The net margin of the company was relatively stable at 31.0%, 31.5% and 31.1% for FY12/06A, FY12/07A and FY12/08A respectively.

Table 11: P & L

Year to Dec (HK\$m)	06A	07A	08A	1H08A	1H09A
Revenue	884.8	1,438.8	2,002.4	984.4	1,293.7
Cost of sales	(453.2)	(719.7)	(943.7)	(489.9)	(631.0)
Gross profit	431.5	719.1	1,058.6	494.5	662.7
Other income	7.8	29.1	19.3	12.9	1.0
Distribution expenses	(49.1)	(113.4)	(96.9)	(34.2)	(58.1)
Administrative expenses	(107.5)	(176.4)	(362.5)	(149.6)	(223.1)
Operating porfit	282.8	458.4	618.6	323.6	382.6
Finance costs	(1.7)	(2.2)	(5.2)	(1.1)	(2.0)
Profit before tax	281.1	456.2	613.4	322.5	380.5
Income tax expense	(3.0)	(3.5)	(2.3)	(0.9)	(4.2)
Profit after tax	278.1	452.7	611.1	321.6	376.3
Minority interests	(4.1)	(0.1)	11.1	5.2	(2.3)
Net profit	274.0	452.5	622.3	326.8	373.9

Source: Company data

Solutions project segment and Greater China region was the key growth driver for 1H FY12/09A

For 1H FY12/09A, RCG's sales increased 31.4% YoY to HK\$1,293.7m, which was mainly driven by 66.5% YoY growth in solutions project segment. The sales in Greater China region increased 153.2% YoY, South Eastern Asia decreased 1.8% YoY and Middle East increased 23.7% YoY. The gross margin improved slightly of 1.0 pcp YoY to 51.2%. The SG&A expenses increased 53.0% YoY to HK\$281.2m due to the HK-listing expenses and increasing promotion activities. The net profit increased 14.4% YoY to HK\$373.9m.

Forecasts and valuation

Earnings estimates

Solutions projects has good growth potential

We estimate that the revenue would increase 19.1% YoY to HK\$2,385.3m for FY12/09F, 16.7% YoY to HK\$2,784.7m for FY12/10F, and 18.2% YoY to HK\$3,291.1m for FY12/11F. We project that the sales of solutions project segment would be the main growth driver with increase of 68.4% YoY for FY12/09F, 32.7% YoY for FY12/10F and 30.0% YoY for FY12/11F; the sales of enterprise segment would increase of 20.5% YoY for FY12/09F, 18.0% YoY for FY12/10F, and 20.0% YoY for FY12/11F; and the sales of consumer segment would be slow with a drop of 2.4% YoY for FY12/09F and increase of 3.9% YoY FY12/10F and 5.0% YoY for FY12/11F.

Net margin would be relatively stable

We estimate that the gross margin would be slightly move downwards from 52.4% for FY12/09F to 50.5% for FY12/11F, which mainly affected by the some margin decrease in solutions projects segment. However, we expect that The SG&A expenses would increased in a lower paces mainly due to the slow growth in administration expenses. We estimate that SG&A expenses would account for 24.1%, 23.0%, and 22.5% of total revenue for FY12/09F, FY12/10F, and FY12/11F respectively.

The effective tax rate would move upward from 1.1% in FY12/09F to 3.0% in FY12/11F. Overall, the net margin would be between 28.3% and 28.6% from FY12/09F to FY12/11F, maintaining relatively stable. The net profit would increase 8.6% YoY to HK\$676.1m for FY12/09F, 18.8% YoY to HK\$803.2m for FY12/10F, and 17.3% YoY to HK\$942.5m for FY12/11F.

Table 12: Segment breakdown

	09F		10F		11F	
	HK\$m	%	HK\$m	%	HK\$m	%
Consumer	815.3	(2.4)	847.4	3.9	889.8	5.0
Enterprise	993.2	20.5	1,171.9	18.0	1,406.3	20.0
Solutions projects	576.9	68.4	765.4	32.7	995.0	30.0
Total	2,385.3	19.1	2,784.7	16.7	3,291.1	18.2

Source: Company data

Table 13: P & L forecast

Year to Dec (HK\$m)	07A	08A	09F	10F	11F
Revenue	1,438.8	2,002.4	2,385.3	2,784.7	3,291.1
Cost of sales	(719.7)	(943.7)	(1,134.5)	(1,354.6)	(1,629.6)
Gross profit	719.1	1,058.6	1,250.8	1,430.1	1,661.5
Other income	29.1	19.3	20.7	41.4	62.1
Distribution expenses	(113.4)	(96.9)	(134.5)	(167.1)	(213.9)
Administrative expenses	(176.4)	(362.5)	(441.4)	(473.4)	(526.6)
Operating profit	458.4	618.6	695.6	831.0	983.0
Finance costs	(2.2)	(5.2)	(6.3)	(3.0)	(1.2)
Profit before tax	456.2	613.4	689.3	828.1	981.8
Income tax expense	(3.5)	(2.3)	(7.6)	(16.6)	(29.5)
Profit after tax	452.7	611.1	681.7	811.5	952.4
Minority interests	(0.1)	11.2	(5.6)	(8.4)	(9.9)
Net profit	452.5	622.3	676.1	803.2	942.5

Source: Company data, SBI E2-Capital

Valuation and target price

Initiate coverage with BUY call, Target price HK\$19.80

Our DCF derived fair value for RCG is HK\$19.80, based on WACC 19.0% and terminal growth of 1.0%. We give a high risk premium for RCG concerning the risk from lawsuit involved with its major shareholders. We initiate coverage on RCG with BUY call. The target price is HK\$19.80, representing 8.0x FY12/09F and 6.7x FY12/10F. We think that the combination of: 1) sustainable organic growth; 2) M&A potential and 3) removal of share registry uncertainty presents tremendous upside for the counter.

Table 14: DCF valuation reference table

WACC	Terminal Growth				
	0.5%	1.0%	1.5%	2.0%	2.5%
15.0%	27.44	27.97	28.53	29.14	29.80
17.0%	22.96	23.32	23.69	24.09	24.52
19.0%	19.55	19.80	20.06	20.33	20.62
21.0%	16.89	17.06	17.25	17.44	17.64

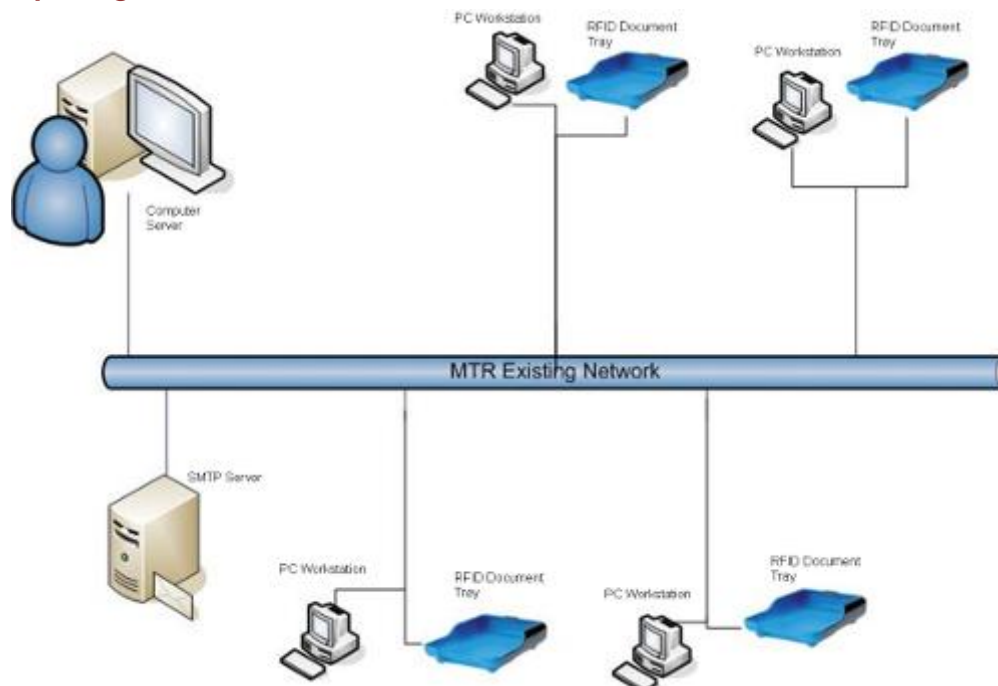
Source: SBI E2-Capital

Risks

- *Share registry* – The current 24.00% stake of the late Nina Wang's estate (via Veron International) is being contested. Rumours that Mr Tony Chan, with 23.22% stake (via Offshore Group Holdings) is in financial difficulty and looking to sell down his stake.
- *M&A integration risk* – RCG typically undertakes a lot of M&As. A particular risk would be whether the company can successfully integrate the acquired entity into the overall group post M&A.
- *Competition* – Both the RFID and biometrics market are still relatively fragmented. Competition can significantly intensify. However, given the strong growth projections in each of these markets over the medium term, we expect competition to remain healthy.

Appendix I: Internet on things (IoT) concept

Chart 1: Concept Diagram



Source: Company data

Stage 1: Object **self recognition**

- Tag important documents / reports with RFID
- Embed information related to the document in RFID chip (e.g. scheduling, reviewer, actions required etc)
- Placed in tray which equipped with RFID readers

Stage 2: Data **communication** or calculation through Internet or mobile network

- A software application will consolidate the activities of the document
- Send to the centralised server via Internet

Stage 3: **Remote control or manage** the workflow of the recognized objects via mobile devices or computer

- Inform end user on the status of the document via email
- Users remotely control the action via a web page

Stage 4: Enabling **business process automation** and decision making

- Management review of document flow and scheduling
- Report generation

Appendix II: Company profile

Business background

Established in 1999, RCG is focused on the sourcing, development and implementation of radio frequency identification (RFID), biometrics and securities solutions for diversified industries. The company's key geographic focus is in Greater China, Asia Pacific and Middle East. RCG's stock is traded on London's AIM Board, PLUS Board as well as Hong Kong's HKEx Main Board.

Shareholding structure

	(%)
Veron International Ltd.	24.00
Offshore Group Holdings Ltd.	23.22
Raymond Chu Wai Man	6.85
Public	45.93
Total	100.00

Management team

Mr. Raymond Chu, Founder, Chairman and CEO. He is responsible for overall business strategy and development and management of the company. Over 11 years experience in the IT industry and over 10 years experience in law and corporate finance.

Ms. Anita Chau, Founder, Deputy Chairman and COO. Responsible for the business development and operational execution of the RCG. She has over 12 years experience in business management and marketing.

Dato' Lee Boon Han, Deputy CEO. Over 20 years experience in the IT and security solutions industry. Lee was the founder of UCH and joined the management of RCG when RCG acquired UCH in 2006.

Dr. Sri Hartati Kurniawan, CTO. Extensive experience in technology investment and management for commercialisation and government sponsored projects. She holds a Master of Science degree and a Doctor of Philosophy degree in Industrial Engineering and Engineering Management from the HKUST

Corporate milestones

- 1999: Founders establish RCG Holdings Ltd. as an internet and software business.
- 2001: Entered the biometrics and RFID solutions business. Opened first office in PRC to address the China market.
- 2004: Listed on London's AIM Board. Opened first office in Malaysia to address the Asia Pacific market.
- 2005: Acquisition of Skycomp Technology. Gained access to Southeast Asia hyperstores network
- 2006: Acquired UCH to gain access to distribution network, and virtual storage solutions technology. Opened first office in Middle East.
- 2007: Admitted to the PLUS Board in London. Acquired interests in Vast Base and Chance Best to further develop the China market.
- 2008: Increased interests in Vast Base and Chance Best.
- 2009: Listing on HKEx Main Board by way of introduction.

Corporate governance issues

The company publishes half year results with effect to enhance transparency.

Company management is diligent to undertake institutional investor and media roadshows to enhance transparency

Audit committee (to review and supervise the financial reporting process and internal control system), executive committee (to implement group strategy and run day-to-day operation) and human resources committee (to oversee and implement the general human resource strategy) are set up.

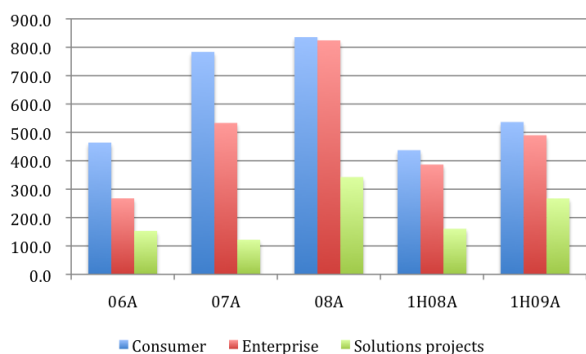
Staff Count

As at end-Jan 2009, a total of 263 staffs in different locations, of which:

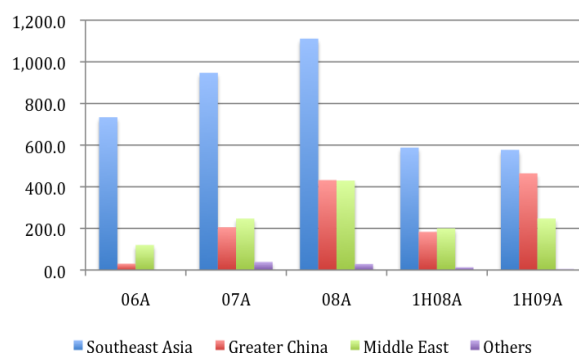
Management	10
Administration	58
Sales and Marketing	65
IT, R&D, Engineering	77
Production and Logistics	24
Finance and Accounting	23
Security	6
Total	263

Appendix III: Financial analysis

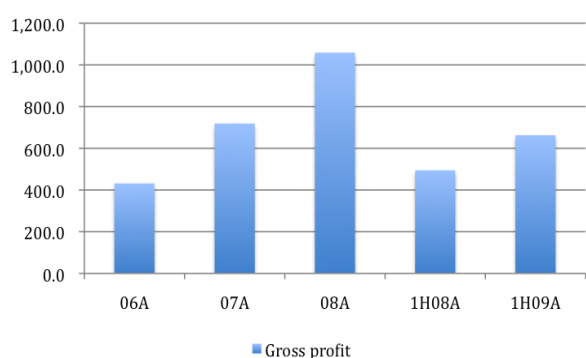
Turnover breakdown



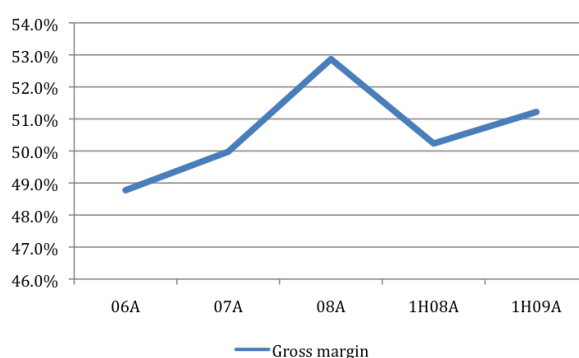
Geographical breakdown



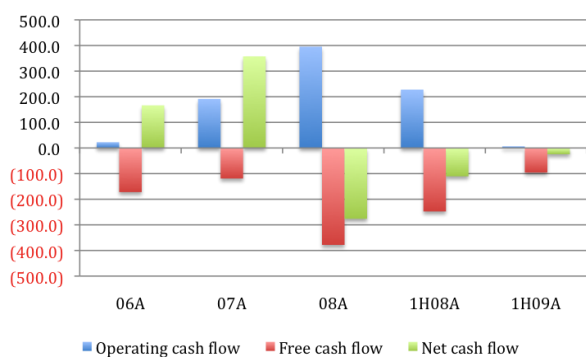
Gross profit breakdown



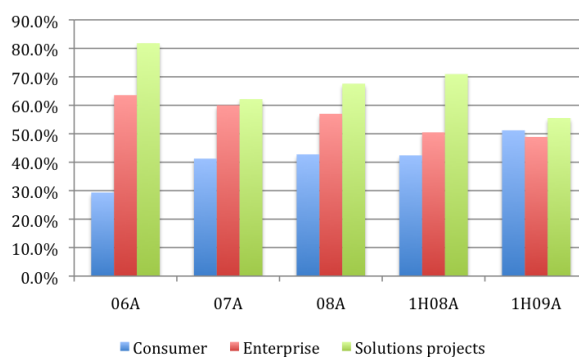
Gross margin by segment



Cashflow generating ability



Margin trends



Appendix IV: Infopage

P & L (HK\$m)	07A	08A	09F	10F	11F	Cash Flow (HK\$m)	07A	08A	09F	10F	11F
Year to Dec						Year to Dec					
Turnover	1,438.8	2,002.4	2,385.3	2,784.7	3,291.1	EBIT	432.2	599.8	674.9	789.7	921.0
% chg	62.6	39.2	19.1	16.7	18.2	Depre./amort.	24.9	123.4	205.3	219.6	249.1
Gross profit	719.1	1,058.6	1,250.8	1,430.1	1,661.5	Net int. paid	24.0	13.6	14.4	38.4	60.9
						Tax paid	(4.8)	(4.3)	(6.1)	(13.2)	(23.6)
EBITDA	457.2	723.2	880.3	1,009.3	1,170.0	Dividends received	-	-	-	-	-
Depre./amort.	(24.9)	(123.4)	(205.3)	(219.6)	(249.1)	Gross cashflow	476.3	732.5	888.5	1,034.5	1,207.3
EBIT	432.2	599.8	674.9	789.7	921.0	Chgs. in working cap.	(328.7)	(350.9)	(380.9)	(310.1)	(207.8)
Net int. income/(exp.)	24.0	13.6	14.4	38.4	60.9	Operating cashflow	147.6	381.6	507.6	724.3	999.5
Exceptionals	-	-	-	-	-	Capex	(329.1)	(801.4)	(300.0)	(300.0)	(300.0)
Associates	-	-	-	-	-	Free cashflow	(181.5)	(419.8)	207.6	424.3	699.5
Jointly-controlled entit.	-	-	-	-	-	Dividends paid	(21.9)	(19.2)	(33.8)	(40.2)	(47.1)
Pre-tax profit	456.2	613.4	689.3	828.1	981.8	Net distribution to MI	-	-	-	-	-
Tax	(3.5)	(2.3)	(7.6)	(16.6)	(29.5)	Investments	-	-	-	-	-
Minority interests	(0.1)	11.2	(5.6)	(8.4)	(9.9)	Disposals	0.6	-	-	-	-
Net profit	452.5	622.3	676.1	803.2	942.5	New shares	675.9	0.0	189.0	0.0	0.0
% chg	65.2	37.5	8.6	18.8	17.3	Others	(119.7)	108.0	(76.4)	(139.6)	(62.1)
Dividends	(18.1)	(19.2)	(33.8)	(40.2)	(47.1)	Net cashflow	353.4	(331.0)	286.4	244.6	590.4
Retained earnings	434.4	603.1	642.3	763.0	895.4	Net (debt)/cash - Beg.	297.9	651.3	338.6	625.0	869.6
						Net (debt)/cash - End.	651.3	320.3	625.0	869.6	1,459.9
EPS (HK\$) - Basic	2.032	2.685	2.471	2.936	3.445	Interim Results (HK\$m)	08A	09A			
EPS (HK\$) - F.D.	2.020	2.675	2.471	2.936	3.445	Six months to June					
DPS (HK\$)	0.081	0.083	0.124	0.147	0.172	Turnover	984.4	1,293.7			
No. sh.s o/s (m) - W.A.	222.7	231.8	273.6	273.6	273.6	% chg	65.4	31.4			
No. sh.s o/s (m) - Y.E.	222.7	231.8	273.6	273.6	273.6	Profit from operations	323.6	382.6			
No. sh.s o/s (m) - F.D.	224.0	232.6	273.6	273.6	273.6	Interest expenses	(1.1)	(2.0)			
						Associates	-	-			
Margins (%)						Jointly-controlled entit.	-	-			
Gross	50.0	52.9	52.4	51.4	50.5	Pre-tax profit	322.5	380.5			
EBITDA	31.8	36.1	36.9	36.2	35.6	Tax	(0.9)	(4.2)			
EBIT	30.0	30.0	28.3	28.4	28.0	Minority interests	5.2	(2.3)			
Pre-tax	31.7	30.6	28.9	29.7	29.8	Net profit	326.8	373.9			
Net	31.5	31.1	28.3	28.8	28.6	% chg	76.5	14.4			
						EPS (HK\$) - Basic	1.409	1.553			
						EPS (HK\$) - F.D.	1.403	1.547			
Balance Sheet (HK\$m)	07A	08A	09F	10F	11F	Shareholding Structure					
Year to Dec											%
Fixed assets	162.6	187.7	356.3	487.0	551.8	Veron International Ltd.					24.0
Intangible assets	256.5	1,275.7	1,261.8	1,260.0	1,246.1	Offshore Group Holdings Ltd.					23.2
Other LT assets	317.7	191.4	309.0	293.4	279.3	Raymond Chu Wai Man					6.9
Cash	651.3	320.3	625.0	869.6	1,459.9	Public					45.9
Accounts receivable	395.3	500.3	937.5	1,122.5	1,221.9	Total					100.0
Other receivables	-	-	-	-	-						
Inventories	144.9	294.0	389.8	500.9	570.6	Background					
Due from related co.s	-	-	-	-	-	RCG an information technology company focusing on the development and implementation of radio frequency identification (RFID), biometrics, wireless and securities solutions for diversified industries ranging from healthcare, logistics/supply chain to entertainment. Established in 1999, the company's key geographic focus is in Greater China, Asia Pacific and Middle East.					
Other current assets	236.9	407.5	339.3	398.0	465.9						
Total assets	2,165.3	3,176.9	4,218.6	4,931.2	5,795.5						
Accounts payable	(18.8)	(73.5)	(81.9)	(103.6)	(110.7)	Key Ratios	07A	08A	09F	10F	11F
Other payable	(11.0)	(24.5)	(99.9)	(122.8)	(145.1)	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Tax payable	(3.2)	(0.6)	(1.5)	(3.3)	(5.9)	Net ROE (%)	40.9	26.2	25.2	22.5	19.4
Due to related co.s	-	-	-	-	-	EBIT ROCE (%)	37.5	23.1	22.2	20.5	18.0
ST debts	(32.3)	(191.0)	(100.0)	-	-	Dividend payout (%)	4.0	3.1	5.0	5.0	5.0
Other current liab.	(0.5)	(0.6)	-	-	-	Effective tax rate (%)	0.8	0.4	1.1	2.0	3.0
LT debts	-	-	-	-	-	Net interest coverage (x)	-	-	-	-	-
Other LT liabilities	(5.2)	(5.5)	(4.5)	(8.3)	(14.7)	A/R turnover (days)	84	82	110	135	130
Total liabilities	(71.1)	(295.8)	(287.8)	(238.0)	(276.4)	A/P turnover (days)	16	18	25	25	24
Share capital	2.3	2.3	2.6	2.6	2.6	Stock turnover (days)	62	85	110	120	120
Reserves	2,060.2	2,679.0	3,708.5	4,448.9	5,250.7						
Shareholders' funds	2,062.5	2,681.3	3,711.1	4,451.4	5,253.2						
Minority interest	31.6	199.8	219.7	241.7	265.9						
Total	2,094.2	2,881.1	3,930.8	4,693.1	5,519.1						
Capital employed	2,126.5	3,072.1	3,001.3	4,693.1	5,519.1						
Net (debt)/cash	619.0	129.3	525.0	869.6	1,459.9						



Disclosure of interests: SBI E2-Capital Securities Limited acted as sole placing agent for the RCG Holdings Limited (stock code: 802) at September 2009.

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