

I.T: In quest of China

Recommendation: BUY (initiating coverage)

Hong Kong Retail

| Price | HK\$2.76 | Year to Net profit | EPS | EPS | P/E | P/B | EV/EBITDA | Yield | ROE | ROCE | N. Gear. | |
|------------------|-------------------|--------------------|-------|-------|-------|------|-----------|-------|-----|------|----------|------|
| Target price | HK\$3.50 (+26.4%) | Feb | HK\$m | HK\$ | Δ % | x | x | x | % | % | % | |
| 12 mth range | HK\$1.23-2.85 | 06A | 122.3 | 0.118 | 6.0 | 23.4 | 4.61 | 2.7 | 1.7 | 18.2 | 17.2 | Cash |
| Market cap. | US\$367.9m | 07A | 122.5 | 0.118 | (0.2) | 23.4 | 3.82 | 2.3 | 1.8 | 15.6 | 17.3 | Cash |
| Daily t/o, 3 mth | US\$0.84m | 08F | 162.3 | 0.156 | 32.5 | 17.7 | 4.06 | 1.4 | 2.8 | 21.2 | 23.3 | Cash |
| Free float % | 35.3% | 09F | 203.8 | 0.196 | 25.6 | 14.1 | 3.51 | 1.2 | 3.6 | 26.7 | 30.1 | Cash |
| Ticker | 0999.HK/999 HK | 10F | 237.2 | 0.228 | 16.4 | 12.1 | 3.11 | 0.9 | 4.1 | 27.2 | 30.7 | Cash |

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +40.5%, +17.6%, +28.1%

Actual price changes (1 mth, 3 mth, 12 mth): +38.7%, +60.5%, +95.7%

Consensus EPS (08F-09F): HK\$0.160, HK\$0.199

Key points:

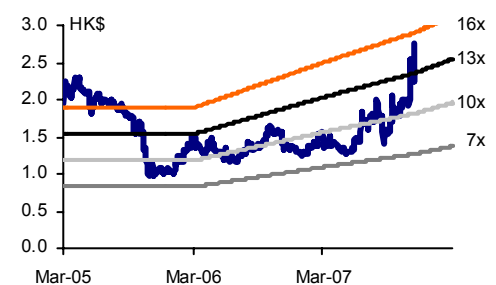
- Acquisition of GSIT to pave way for faster China expansion.
- Self-managed store area to triple to 450,000 sqf in the next three years.
- GSIT breaks even with turnover up 55.3% in six months to 31 August 2007 - expected to contribute positively to I.T in FY02/08F.
- Turnover up 20.0% as in-house brands sales rise 50.9% in 1H FY02/08A and remain top line growth driver.
- Changes in product mix boost gross profit by 21.5% YoY in 1H FY02/08A.
- Initiate coverage with a BUY call and a target price of HK\$3.50, representing 22.4x FY02/08F, 18.0x FY12/09F P/E and a FY02/09F PEG of 0.70x.

GSIT acquisition. In November 2003, the company and Glorious Sun (393 HK) set up a 50:50 JV, GSIT, to wholesale and retail I.T's international, licensed and in-house brands and French Connection in China and in Taiwan. In Sep 2007, I.T agreed to buy Glorious Sun's stake for a total of HK\$263.0m (HK\$80.0m in cash and the issue of 102.8m shares - 9.9% of basic share capital). At the same time, I.T purchased from Glorious Sun its Nanjing and Macao stores for an additional HK\$20.0m cash. As of July 2007, GSIT had 106 self-managed and 61 franchised stores (including French Connection stores) in China and 19 self-managed stores in Taiwan.

GSIT breaks even. Turnover rose 55.3% YoY to HK\$194.7m in six months to 31 August 2007, due to same store sales growth of 36.8%, including China and Taiwan but excluding French Connection revenue. Profit before tax was HK\$0.3m in the period. GSIT's low profit is mainly due to its bottom line loss in Taiwan, which is expected to decrease in 2H FY02/08F. Same store sales are expected to rise 30.0-40.0% in China in FY02/08F. We believe that GSIT will contribute positively to I.T results in FY02/08.

New China expansion strategy. The GSIT acquisition will allow I.T to step up its China expansion. The company plans to triple the area of self-managed stores to 450,000 sqf in the next three years (footage is expected to increase 40.0% a year). Store opening costs are estimated at HK\$100.0m in total, including inventory and decoration costs. In 1H FY02/08A, 99% of its stores in China were located in Shanghai and Beijing. Management plans to increase the number of stores in these cities and expand to other first-tier and second-tier cities, such as Hangzhou, Suzhou and Chongqing. In 1H FY02/08A, 10% of overall stores were in department stores, 70-80% in malls and the rest were ground floor outlets. The company plans to associate with a department store in its expansion in China and to increase the number of department store outlets, which cost

Chart 1: P/E bands



Source: SBI E2-Capital

50% less than ground-floor stores. More efforts will be put into advertising & marketing in China in FY02/09F.

Table 1 : Distribution network

| Year to Feb | FY02/07A | 1H FY02/08A | Change |
|--|-------------|-------------|-------------|
| Self-managed stores in China | 104 | 93* | -11 |
| Total floor area of self-managed stores in China | 189,800 sqf | 173,922 sqf | -15,878 sqf |
| French connection stores in China | 14 | 13 | -1 |
| Franchised stores in China | 51 | 63 | 12 |
| Self managed stores in Taiwan | 25 | 19 | -6 |

Source: Company data

* Decrease in number of stores in China due to renovation

China retail sector. China's retail sales rose 15.9% YoY to RMB6.4t in the first nine months of FY12/07A despite the soaring consumer price index, due to increasing incomes, the National Bureau of Statistics said. Urban disposable incomes rose 13.2% YoY in the period, while rural cash incomes were up 14.8%. Retail sales in urban areas climbed 16.3% to RMB4.3t and 14.9% to RMB886.0b in rural areas. Second- and third-tier cities and inland regions are becoming the next big market for retailers. China's middle class is expected to double by 2020 boosting demand for higher-end goods.

Fashion trendsetter. Set up in 1988, I.T is a fashion leader with a knack for spotting new fashion trends. The company is principally engaged in the wholesale and retail sales of international, licensed and in-house brands in Hong Kong and through its GSIT JV, in China. International brands include Tsumori Chisato, Yves Saint Laurent, Stella McCartney, Chloe and A Bathing Ape. Licensed brands comprise Baby Jane, Underground and in-house brands are <http://www.izzue.com>, b+ab, 5cm, fingercroxx, Chocoolate and Venilla Suite. The company also operates French Connection stores in Hong Kong through a 50:50 JV with French Connection since Nov 2003 and in China through a 50:50 JV between GSIT and French Connection.

Multi-branding & multi-segment power. I.T's portfolio of international brands has grown close to 400 currently with over 10 in-house & licensed brands. The advantage of multi-branding rests mainly on a low brand concentration, which means that it is easy for I.T to replace any non-performing brand without significantly affecting its business. I.T outlets offer several international brands target shoppers looking for new designs and fashion trends who are less price-sensitive than those in the mass-market. While i.t outlets sell lower-priced in-house brands aimed at young customers. This multi-segment strategy enables I.T to enlarge its market share.

Products mix change. In-house brands sales grew 50.9% and accounted for 39.7% of total sales in 1H FY02/08A, excluding licensed brands. International brands increased 4.6% and reached 44.6% of total turnover from 55.1% in 1H FY02/07A. In-house brands performed well thanks to Chocoolate and Venilla Suite, which contributed 6.0% of total retail sales. Licensed brands represented 9.1% of total turnover in 1H FY02/08A and their share is expected to decrease, as Arnold Palmer and i.t loves Mickey will not be renewed next year.

Improving gross margins. The retail gross margin widened 0.5pcp to 60.8% in 1H FY02/08A, as a result of growing in-house brand sales, which command higher margins (65.0-70.0%) than international brands (50.0-55.0%). Same store sales grew 16.7% in Hong Kong in 1H FY02/08A, 24.0% for in-house brands and 14.0% for international brands. In September and October, same store sales in Hong Kong represented 23.0% and 20.0% of sales, respectively, and are expected to reach 15% in FY02/08F.

Table 2 : Sales breakdown

| | 1H FY02/07A % of total | 1H FY02/08A % of total | Change (%) |
|-------------------------------|---------------------------|---------------------------|-------------|
| In-house brands | 31.6 | 39.7 | 50.9 |
| Licensed brands | 10.5 | 9.1 | 3.5 |
| International brands | 51.1 | 44.6 | 4.8 |
| Others (including wholesales) | 6.8 | 6.6 | - |
| Total (HK\$m) | 673.3 | 808.0 | 20.0 |

Source: Company data

Store image revamping. In August 2007, the company had 150 stores with a total floor area of 294,500 sqf. It has started renovating existing stores (at a total cost of HK\$50.0-60.0m) and focusing on opening larger stores. Store and brand revamping is expected to enhance same store sales growth in FY02/08F.

Costs under control. In 1H FY02/08A, total rental expenses increased 19.1% to HK\$181.6, including management fees, rates and government rent, and accounted for 22.5% of total turnover, down 0.2pcp YoY.

The company should continue to control costs efficiently in FY02/08F. Staff costs rose 24.3% to HK\$154.2m and represented 19.1% of total turnover, up 0.7pcp YoY, as a result of the launch of two new in-house brands in November 2006. Staff costs are expected to be stable in 2H FY02/08F.

Potential expansion plan. In August 2007, I.T had five stores in Saudi Arabia, four in Macau and eight in Thailand. It plans to export Chocoolate and open more stores in Saudi Arabia as well as expanding franchised operations in Singapore, Korea, Canada and Australia.

Strong financials. The company is in a net cash position of HK\$333.6m, down 8.6% from 1H FY02/07A. Capex increased 64.4% to HK\$29.6m in 1H FY02/08A.

Interim results recap. Net profit rose 41.4% YoY to HK\$44.1m, while turnover increased 20.0% to HK\$808.0m, due to same store sales growth, up 16.7% in 1H FY02/08A.

Table 3 : Interim results

| Six months to Aug | Turnover (HK\$m) | Gross profit (HK\$m) | Gross margin (%) | Pre-tax profit (HK\$m) | Tax rate (%) | Net profit (HK\$m) | EPS (HK\$) | DPS (HK\$) |
|-------------------|------------------|----------------------|------------------|------------------------|--------------|--------------------|------------|------------|
| 1H FY08 | 808.0 | 467.1 | 57.8 | 53.2 | 17.1 | 44.1 | 0.042 | 0.021 |
| 1H FY07 | 673.3 | 384.4 | 57.1 | 37.3 | 16.4 | 31.2 | 0.030 | - |
| YoY (%) | 20.0 | 21.5 | | 42.6 | | 41.3 | 40.0 | - |

Source: SBI E2-Capital

Corporate governance. Mr. Sham Kar Wai - executive director, chairman and chief executive officer founded the company in November 1988 with his brother, Sham Kin Wai, and is responsible for its overall management and strategic development. He has nearly 20 years of experience in the fashion retail industry and has established an extensive network of contacts at international design houses.

Dr. Lo Wing Yan, William - J.P., executive director, vice chairman, managing director and chief financial officer since May 2006. He holds a master's degree in molecular pharmacology and a doctorate in genetic engineering from the University of Cambridge in England. Before his appointment as executive director, he was an executive director of China Unicom Ltd. for four years.

Miss Lam Tak Yee, Lysanda - strategic and corporate development director, joined in October 2006. She holds a bachelor's degree of business administration (finance) from The Hong Kong University of Science and Technology. She has nearly 10 years corporate finance experience, specializing in mergers and acquisitions as well as investment and restructuring.

Dividend policy. The company was incorporated in October 2004 and therefore no dividend was paid or declared from 2002 to 2004. The dividend payout ratio reached 210.6% in FY02/05A, 40.8% in FY02/06A and 42.4% in FY02/07A. An interim dividend of HK\$0.021 and a dividend payout ratio of 50.0% were declared for the first time in 1H FY12/08A.

Capital history. The company was listed on the Hong Kong Stock Exchange in October 2004 and appointed Pricewaterhouse Coopers as its auditor. Its major shareholder Mr. Sham Kin Wai, Mr. Sham Kar Wai and Ms. Yau Shuk Ching, Chingmy hold 64.7%. Glorious Sun owns 9.9% and Arisaig Partners Ltd 9.3%. Public shareholders account for 16.1%.

Risks. 1) Execution risks in China expansion; 2) Major economic slowdown in Hong Kong; and 3) Cost control risks in China as rental costs are increasing there.

Initiating coverage with BUY call, target price HK\$3.49. Given its strong sales growth in Hong Kong, promising Greater China market and multi-branding business model, we expect I.T's net profit to grow at a CAGR of over 23.5% in 2008-2010. We estimate net profit will increase 32.5% to HK\$162.3m in FY02/08F, 25.6% to HK\$203.8m in FY02/09F and 16.4% to HK\$237.2m in FY02/10F. The counter is currently trading at 17.7x P/E and ex-cash P/E of 15.6x, based on our net profit estimate for FY02/08F. I.T's retail listed peers' average valuation reached 22.8x P/E FY02/09F. We initiate coverage on this counter with a target price of HK\$3.50, representing 18.0x P/E for FY02/09F and 0.70x PEG. Our target valuation is based on a 20% discount on the mid point of the Hong Kong and China listed retail peers to take into consideration execution risk in China.

Table 4 : Peer valuation

| Name | Ticker | Price (HK\$) | Market Cap. (US\$m) | 07/E (x) 1-yr fwd | 08/E (x) 2-yr fwd | ROE (%) | PEG 1yr Fwd (%) | Yield (%) |
|------------------------|---------|-----------------|------------------------|----------------------|-----------------------|-------------|--------------------|-------------|
| HK retailers | | | | | | | | |
| Dickson Concept | 113 HK | 6.62 | 316.0 | 10.8 | 8.6 | 13.7 | 1.08 | 4.6 |
| Esprit | 330 HK | 116.90 | 18,463.2 | 22.8 | 19.1 | 48.9 | 0.90 | 1.7 |
| YGM | 375 HK | 5.08 | 100.2 | 6.2 | 25.4 | 16.8 | n.a. | 7.7 |
| Glorious Sun | 393 HK | 4.62 | 627.5 | 15.9 | 14.7 | 16.0 | 1.26 | 4.2 |
| Bauhaus | 483 HK | 1.72 | 79.3 | 8.4 | 7.2 | 18.4 | 0.40 | 2.9 |
| Bossini | 592 HK | 0.38 | 76.2 | 9.9 | n.a. | 3.4 | n.a. | 0 |
| Giordano | 709 HK | 4.03 | 770.6 | 19.3 | 16.9 | 10.0 | 1.35 | 117.9 |
| Average | | 19.9 | 2,919.0 | 13.3 | 15.3 | 18.2 | 1.0 | 19.9 |
| PRC retailers | | | | | | | | |
| Ports | 589 HK | 28.30 | 2,025.8 | 43.5 | 33.4 | 30.4 | 1.29 | 1.6 |
| Prime Success | 210 HK | 6.30 | 1,322.9 | 27.0 | 21.1 | 33.8 | 0.93 | 0.6 |
| Belle | 1880 HK | 11.42 | 12,359.0 | 48.2 | 37.6 | 56.4 | 1.42 | n.a. |
| Li Ning | 2331 HK | 27.50 | 3,655.1 | 62.8 | 43.9 | 23.0 | 1.62 | 0.7 |
| Average | | 18.4 | 4,840.7 | 45.4 | 34.0 | 35.9 | 1.3 | 1.0 |
| Overall average | | 19.4 | 3,617.8 | 25.0 | 22.8 | 24.6 | 1.1 | 14.2 |

Source: Bloomberg, SBI E2-Capital

| P & L (HK\$m) | 06A | 07A | 08F | 09F | 10F |
|--|----------------|----------------|----------------|-----------------------|----------------|
| Year to Feb | | | | | |
| Turnover | 1,314.4 | 1,530.8 | 1,945.2 | 2,368.7 | 2,670.4 |
| % chg | 26.3 | 16.5 | 27.1 | 21.8 | 12.7 |
| Gross profit | 774.2 | 890.3 | 1,151.6 | 1,414.1 | 1,602.3 |
| EBITDA | 183.1 | 192.0 | 244.7 | 269.5 | 332.0 |
| Depre./amort. | (51.7) | (55.9) | (65.7) | (39.7) | (65.0) |
| EBIT | 131.4 | 136.1 | 179.0 | 229.8 | 267.0 |
| Net int. income/(exp.) | 15.0 | 16.0 | 17.1 | 18.3 | 19.6 |
| Exceptionals | - | - | - | - | - |
| Associates | 4.2 | (3.9) | (0.3) | (2.2) | (0.6) |
| Jointly-controlled entit. | - | - | - | - | - |
| Pre-tax profit | 150.6 | 148.2 | 195.8 | 245.9 | 286.1 |
| Tax | (28.3) | (25.7) | (33.5) | (42.0) | (48.9) |
| Minority interests | - | - | - | - | - |
| Net profit | 122.3 | 122.5 | 162.3 | 203.8 | 237.2 |
| % chg | 9.8 | 0.2 | 32.5 | 25.6 | 16.4 |
| Dividends | 49.9 | 52.0 | 81.1 | 101.9 | 118.6 |
| Retained earnings | 72.4 | 70.5 | 243.4 | 305.7 | 355.7 |
| EPS - Basic | 0.118 | 0.118 | 0.156 | 0.196 | 0.228 |
| EPS - F.D. | 0.118 | 0.118 | 0.156 | 0.196 | 0.228 |
| DPS | 0.048 | 0.050 | 0.078 | 0.098 | 0.114 |
| No. sh.s o/s (m) - W.A. | 1,035.5 | 1,039.3 | 1,039.3 | 1,039.3 | 1,039.3 |
| No. sh.s o/s (m) - Y.E. | 1,035.5 | 1,039.3 | 1,039.3 | 1,039.3 | 1,039.3 |
| No. sh.s o/s (m) - F.D. | 1,035.5 | 1,039.3 | 1,039.3 | 1,039.3 | 1,039.3 |
| Margins (%) | | | | | |
| Gross | 58.9 | 58.2 | 59.2 | 59.7 | 60.0 |
| EBITDA | 13.9 | 12.5 | 12.6 | 11.4 | 12.4 |
| EBIT | 10.0 | 8.9 | 9.2 | 9.7 | 10.0 |
| Pre-tax | 11.5 | 9.7 | 10.1 | 10.4 | 10.7 |
| Net | 9.3 | 8.0 | 8.3 | 8.6 | 8.9 |
| Balance Sheet (HK\$m) | | | | | |
| Year to Feb | | | | | |
| Fixed assets | 97.2 | 93.2 | 111.8 | 171.8 | 225.0 |
| Intangible assets | 19.2 | 14.8 | 16.3 | 17.9 | 19.7 |
| Other LT assets | 96.8 | 147.7 | 117.1 | 142.2 | 172.4 |
| Cash | 424.9 | 364.8 | 262.3 | 248.2 | 242.3 |
| Accounts receivable | 6.6 | 9.3 | 11.8 | 14.4 | 16.2 |
| Other receivables | 45.7 | 82.0 | 104.2 | 126.9 | 143.0 |
| Inventories | 147.4 | 196.3 | 249.4 | 303.8 | 342.4 |
| Due from related co.s | 44.6 | 82.4 | 31.9 | 31.9 | 31.9 |
| Other current assets | 0.8 | 2.6 | 2.6 | 2.6 | 2.6 |
| Total assets | 883.2 | 993.1 | 907.4 | 1,059.5 | 1,195.6 |
| Accounts payable | (48.2) | (66.8) | (82.8) | (99.6) | (111.4) |
| Other payable | (62.7) | (71.7) | (88.8) | (106.9) | (119.6) |
| Tax payable | (9.9) | (19.4) | (27.9) | (35.1) | (40.8) |
| Due to related co.s | - | - | - | - | - |
| ST debts | - | - | - | - | - |
| Other current liab. | (2.4) | (0.4) | - | - | - |
| LT debts | - | - | - | - | - |
| Other LT liabilities | (12.6) | (8.1) | (0.5) | (0.5) | (0.5) |
| Total liabilities | (135.8) | (166.4) | (200.0) | (242.0) | (272.3) |
| Share capital | 103.9 | 103.9 | 103.9 | 103.9 | 103.9 |
| Reserves | 643.5 | 722.8 | 684.6 | 815.6 | 938.0 |
| Shareholders' funds | 747.4 | 826.7 | 707.3 | 817.6 | 923.3 |
| Minority interest | - | - | - | - | - |
| Total | 747.4 | 826.7 | 707.3 | 817.6 | 923.3 |
| Capital employed | 747.4 | 826.7 | 707.3 | 817.6 | 923.3 |
| Net (debt)/cash | 424.9 | 364.8 | 262.3 | 248.2 | 242.3 |
| Cash Flow (HK\$m) | | | | | |
| Year to Feb | | | | | |
| EBIT | 131.4 | 136.1 | 179.0 | 229.8 | 267.0 |
| Depre./amort. | (51.7) | (55.9) | (65.7) | (39.7) | (65.0) |
| Net int. paid | 15.0 | 16.0 | 17.1 | 18.3 | 19.6 |
| Tax paid | (24.4) | (23.1) | (33.5) | (42.0) | (48.9) |
| Dividends received | 14.1 | 12.8 | 11.7 | 12.3 | - |
| Gross cashflow | 84.3 | 85.9 | 108.6 | 178.6 | 172.8 |
| Chgs. in working cap. | (35.2) | (80.3) | (56.9) | (60.1) | (28.7) |
| Operating cashflow | 49.1 | 5.6 | 51.7 | 118.5 | 144.1 |
| Capex | (110.7) | (42.4) | (75.0) | (75.0) | (108.0) |
| Free cashflow | (61.5) | (36.8) | (23.3) | 43.5 | 36.1 |
| Dividends paid | (44.6) | (49.9) | (81.1) | (101.9) | (118.6) |
| Net distribution to MI | - | - | - | - | - |
| Investments | (106.7) | (46.4) | (175.0) | (75.0) | (108.0) |
| Disposals | - | 0.7 | - | - | - |
| New shares | 73.3 | 0.1 | - | - | - |
| Others | 2.5 | 72.3 | 176.9 | 119.4 | 184.6 |
| Net cashflow | (137.1) | (60.1) | (102.5) | (14.1) | (5.9) |
| Net (debt)/cash - Beg. | 562.0 | 424.9 | 364.8 | 262.3 | 248.2 |
| Net (debt)/cash - End. | 424.9 | 364.8 | 262.3 | 248.2 | 242.3 |
| Interim Results (HK\$m) | | | | | |
| Six months to Aug | | | | | |
| Turnover | 568.1 | 673.3 | 808.0 | | |
| % chg | 37.4 | 18.5 | 20.0 | | |
| Profit from operations | 41.4 | 45.9 | 54.2 | | |
| Interest expenses | (1.0) | (0.3) | (0.1) | | |
| Associates | - | - | - | | |
| Jointly-controlled entit. | (1.9) | (8.3) | (0.9) | | |
| Pre-tax profit | 38.5 | 37.3 | 53.2 | | |
| Tax | (8.3) | (6.1) | (9.1) | | |
| Minority interests | - | - | - | | |
| Net profit | 30.2 | 31.2 | 44.1 | | |
| % chg | (8.3) | 3.4 | 41.3 | | |
| EPS (HK\$) - W.A. | 0.029 | 0.030 | 0.042 | | |
| DPS (HK\$) | - | - | 0.021 | | |
| Shareholding Structure | | | | | |
| | | | | Shares o/s (m) | % |
| Sham Kar Wai & Family | | | | 672.1 | 64.7 |
| Glorious Sun Hlgs BVI Ltd | | | | 102.8 | 9.9 |
| Arisaig Partners Ltd | | | | 96.1 | 9.3 |
| Public | | | | 168.3 | 16.1 |
| Total | | | | 1,039.3 | 100.0 |
| Background | | | | | |
| Established in 1988, I.T is well-established as a trend setter in the fashion apparel retail market in Hong Kong. The Group is principally engaged in the retail sales of international brands such as Tsumori Chisato, licensed brands including Arnold and Palmer, i.t loves mickey and in-house brands, like b+ab and http://www.izzue.com. The Group operates FCUK stores in Hong Kong in a JV with French Connection since Nov 2003. Through GSIT, a JV with Glorious Sun, the Group operates the same business in the PRC. | | | | | |
| Key Ratios | | | | | |
| Net gearing | Cash | Cash | Cash | Cash | Cash |
| NET ROE | 18.2 | 15.6 | 21.2 | 26.7 | 27.2 |
| EBIT ROCE | 17.2 | 17.3 | 23.3 | 30.1 | 30.7 |
| Dividend payout ratio | (40.8) | (42.4) | (50.0) | (50.0) | (50.0) |
| Effective tax rate | 18.8 | 17.3 | 17.1 | 17.1 | 17.1 |
| Net interest cover. (x) | (8.8) | (8.5) | - | - | - |
| A/R days | 2.3 | 1.9 | 2.0 | 2.0 | 2.1 |
| A/P days | 102.4 | 13.7 | 14.0 | 14.0 | 14.4 |
| Inventory days | 84.0 | 97.9 | 102.5 | 105.8 | 110.4 |

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