Kennedy Tsang
(852) 2533 3713
kennedytsang@softbank.com.hk

TOMO domino effect on the horizon — China Media

TOM Group (2383 HK, HK$1.01) — Not Rated

Organic growth in revenues. TOM Group's (TOM) 1H FY12/06 results came in as expected. Revenues rose 7.5% YoY to HK$1,522.0m through organic growth. Top line gains were mainly driven by the Internet, mainly through the 66.67%-owned TOM Online (8282 HK, HK$1.23, NR) and TV & Entertainment (TV & Ent.) groups, which grew 25.8% and 36.2% YoY to HK$781.9m and HK$44.2m respectively. Outdoor Media (OMG) remained flat at HK$184.7m while Publishing and Sports groups declined 8.7% and 24.5% YoY to HK$467.7m and HK$49.5m respectively. Internet, Publishing, OMG, Sports and TV & Ent. accounted for 51.4%, 30.7%, 12.1%, 3.3% and 2.9% respectively of the revenue pie.

Marked increase in operating profit. Operating profit surged 90.7% YoY to HK$224.7m though previous 1H FY12/05 results were weighed down by one-off provisions in OMG and Sports groups. Excluding these provisions (HK$65.5m), operating profit rose 22.6% YoY.

Proforma net profit down 9.8%. Net profit was HK$91.3m, compared to HK$160.3m a year ago. However, 1H FY12/05 results were boosted by a deemed disposal gain from the Internet group for the issue of consideration shares for its Treasure Base acquisition. This year, the bottom line included a HK$24.6m deemed disposal gain from the introduction of 35%-owned strategic investor Singapore Press Holdings (SPH) in OMG. Stripping out all gains and disposals, net profit fell 10.4% YoY to HK$66.7m primarily on increased finance costs and minority interest payments.

Focus on profitability. The results represent a continuing effort by TOM in consolidating its existing operations and increasing profitability of the group, a process that began in 2H FY12/05. Over the past few years, TOM has expanded through aggressive acquisitions, which came at the expense of operating efficiency. We believe the move to streamline its individual business is a favourable one given that it faces intensifying competition landscape across several of its business segments, and earnings impact at its Internet group as a result of new wireless value added services regulations. Also, emphasis on profitability will place the company on a more solid platform to make further acquisitions going forward.

Publishing showing improved profitability. Magazine and book sales fell 12.0% and 11.9% YoY. Competition in its core Taiwan market (98% of Publishing revenues) has been intensifying, which led to an increase in rebates as well as the discontinuation of non-profitable titles. We believe that circulation and readership numbers are relatively steady however as advertising income only contracted a mild 2.5% YoY, indicating that TOM had enough bargaining power to increase both ad rate card and the number of ad pages slightly. With a more focused portfolio of titles and a slight improvement in revenue mix, segment margins rose 1.1 pcp to 15.1%. TOM's five magazine titles on the Mainland generated HK$3m in revenues, compared to HK$240k a year ago. However, these titles are still loss making as they are still within their three-year investment cycle. Despite having the ability to cross-sell its Taiwan content, the slow ramp up in its China titles suggests that the company is still in the process of building up its distribution and advertising network on the mainland. By contrast, companies with distribution and advertising networks in place, such as SEEC (205 HK, HK$0.275, NR) and One Media Group (426 HK, HK$0.60, NR), have a shorter investment cycle of around 1-1.5 years after title launch. Going forward, we see Publishing group as TOM's cash cow business. Growth in its Taiwan arm is expected to be moderate given the maturity of the operations and market saturation, while growth catalyst will mainly come from its China magazine titles.

OMG continues to restructure. OMG reversed a HK$6.7 loss in 2H FY12/05 to record a HK$12.0m in 1H FY12/06, though segment margin dropped 5.8 pcp YoY to 6.5%. TOM has been reducing its proportion of lower margin media buying assets in favour of self-owned/leased assets. The company increased its total media assets space 17% YoY to over 340,000m^2, with self-owned assets accounted for 83% (cf. 60%). However, as some of the newly added asset space had not yet been rented out, the lower utilization rate of 71% (cf. 79%) and increased competition resulted in lower margins. The World Cup had a limited effect on OMG since billboard and unipole advertising are traditionally targeted for brand building and less driven by event specific marketing/advertising campaigns. While management indicated that ASP rose 9% YoY on average, we believe that the rise was driven more by the increased proportion of self-owned assets in tier one cities, rather than through increase in the advertising rate card. We believe that the business still has a solid upside going forward. Participation by SPH will provide TOM with expertise to improve the quality of its assets by diversifying into other forms of outdoor media advertising such as LED displays. Meanwhile, the business has historically recorded operating margins in the range of mid-teens to low-twenties, suggesting scope to extract further margin gains.

TV & Ent. path towards breakeven intact. Segment loss narrowed to HK$24.9m in 1H FY12/06 from HK$37.1m. The improvement was attributed to aggressive sales and marketing campaigns, a switch to more self-produced programming and a diversification to new revenue streams. Revenues from programming syndication and new media business (e.g. WVAS) surged 189.4% YoY to HK$7.5m and accounted for 17% of overall TV & Ent. revenues. Advertising revenues recorded a 22.9% YoY increase to HK$36.7m, though this growth was curtailed slightly as advertising budgets shifted to competing TV channels with stronger sports content in June during the World Cup. At this stage, we project the segment to break even in 2H FY12/07.

Sports segment again the soft spot. TOM's greatest near term challenge remains to be the future of its Sports group. Segment loss totaled HK$14.3m for the first half. The business segment has proved to be management intensive and difficult to maintain profitability in the absence of significant scale. We believe that domestic sporting leagues are difficult to operate given that its geographic reach stretches management resources, while limited attendance numbers makes them difficult to attract potential advertisers. TOM's operating right of China Tennis Open remains the only sporting event with significant marketing and advertising potential. Management has perhaps acknowledged this and has put in place a plan to reposition the business segment as an integrated marketing communication specialist. However, the company will need to absorb losses in this segment going forward as it undergoes the transformation.

Internet group faces regulation challenges. TOM Online (TOMO) accounted for 98% of Internet revenues. Though segment profit surged 18.2% YoY to HK$207.2m, the segment's outlook is clouded, due to regulatory transition in the WVAS industry. For details, refer to our report on TOMO titled – "Industry transition begins" issued on 14 Aug 2006.

Challenging 12 months ahead. Though 1H FY12/06 results were sound, with top line growth and improving profitability, we argue that TOM will face a challenging 12 months ahead. TOMO's weaker earnings ability over the next 6-9 months will have a domino effect on TOM given that it is the company's largest contributor at the operating line and also the most profitable. The company relies on contribution from its Internet group to offset losses in Sports and TV & Ent. segments as well as other unallocated corporate expenses. The company's tax expenses is mainly incurred on its OMG and Publishing groups and a deterioration in operating income (due to a lesser contribution Internet group) will dramatically raise the effective tax rate. We expect effecting tax rate to surge to 25.5% in 2H FY12/06 (cf. 11.2% in 1H FY12/06). Furthermore, TOM is historically burdened by heavy financing costs with interest payments on loans and CBs totaling HK$2,987m.

Preliminary forecasts. We expect TOM's operating and net profit in 2H FY12/06 to contract 37.5% HoH and 75.6% HoH (proforma) to HK$140.3m and HK$16.3m respectively, primarily due to a 54.3% HoH decline in Internet segment profits. This will translate to a full year FY12/06 profit of HK$107.5m (EPS: HK$2.76 cents). We project that the Internet group will struggle to match its contribution in FY12/07 given the exceptionally strong 1H FY12/06. Consequently, we forecast TOM's FY12/07 earnings to edge up 4.4% YoY (proforma) to HK$86.6m (EPS: HK$2.22 cents). We expect TOM's financials over the next two years to be driven by efficiency gains in OMG, ramp up in its Mainland magazine publishing and narrowing losses in TV & Ent. Potential upside to our estimates will come from less than expected earnings decline from TOMO.

Valuation. 66.67%-owned TOMO presently accounts for 88.8% of TOM's market capitalization (HK$3,932.2m), implying that the company's other media assets are not fully reflected. TOM currently trades at 1.3x P/B compared with an average of 2.6x for other international media conglomerates such as SPH (3.9x), News Corp (2.1x), Time Warner (1.1x) and Meredith (3.3x). However, given the soft earnings outlook for the company, we see sizeable acquisitions as the only near term catalyst for the stock's re-rating.

Table 1: Interim results

Six months to June	Turnover (HK$m)	Gross profit (HK$m)	Gross margin (%)	Operating profit (HK$m)	Tax rate (%)	Net profit (HK$m)	Basic EPS (HK$)
1H06	1,522.0	606.0	39.8	224.7	11.2	91.3	0.234
1H05	1,415.7	541.4	38.2	117.8	10.1	169.3	0.435
YoY (%)	*7.5*	*11.9*	*1.6*	*90.7*	*1.1*	*(46.1)*	*(46.2)*

Source: Company data

Table 2: P&L

Year to Dec (HK$m)	2003A	2004A	2005A
Turnover			
Internet	592.4	989.0	1,370.7
Outdoor Media	298.0	369.3	412.3
Publishing	771.4	909.7	1,034.9
Sports	251.5	295.3	208.5
TV & Entertainment	175.8	32.0	79.0
	2,089.2	**2,595.2**	**3,105.3**
% chg	*28.6*	*24.2*	*19.7*
Cost of sales	(1,202.7)	(1,509.1)	(1,919.3)
Gross profit	886.5	1,086.2	1,186.0
Interest income	14.1	83.2	88.1
Selling and marketing expenses	(191.4)	(268.3)	(332.2)
General and administrative expenses	(216.6)	(259.2)	(272.9)
Other operating expenses	(400.3)	(410.7)	(347.7)
Provisions/impairment	-	(261.7)	(7.3)
Share of results from JCEs	(6.4)	(0.4)	(0.1)
Share of results from associates	1.8	11.0	21.2
Operating profit before gains/(losses)	**(87.8)**	**(20.0)**	**335.1**
Gains on deemed disposal of subsidiary	-	979.5	160.3
Operating profit	**(87.8)**	**959.5**	**495.4**
Finance costs	(19.9)	(65.8)	(104.0)
Profit before taxation	**67.9**	**893.7**	**391.5**
Tax	(12.4)	(28.5)	(40.2)
Profit after taxation	**55.5**	**865.2**	**351.3**
Minority interests	(42.9)	(91.7)	(91.8)
Profit attributable to shareholders	**12.6**	**773.4**	**259.5**
% chg	*n/a*	*29.8*	*(66.4)*
Dividend	-	-	-

Source: Company data