

## Wasion

### Margin pressure from centralized procurement, but over-sold

to summarize...

- Wasion won orders for 329,725 single-phase smart metres (12.5% of total) in SGCC's first round of centralized procurement but nil for three-phase ones due to conservative pricing strategy.
- Downside risk on market occupancy is limited, but trial-and-error price adjustment might cause temporary market share loss. Long-term outlook, however, remains positive backed by the company's leading position in both branding and technology.
- Margin squeeze is anticipated. We believe gross margin of three-phase products will drop ~15pcps while single-phase 5pcps, with reference of past experience from telecom industry.
- Some demand was on hold in 2H 09 due to pending release of smart metre standard and will likely be realized in 2010.
- Earnings forecasts were revised by -9.7%, +6.3% and -19.3%, respectively, for FY12/09F-12/11F.
- Target price was cut from HK\$8.14 to HK\$5.75 to reflect mainly the expected margin squeeze industry wise.
- The stock was heavily sold recently, which brings buy-in opportunity.
- Risk is at both upside and downside, mainly associated with future margin trend.

**First round bidding results are somewhat disappointing.** Sate Grid Corporation of China (SGCC) released bidding results for its first round centralized procurement of smart power metres on 21 Dec. Wasion won orders for 329,725 single-phase metres out of total 2.6m (12.5%), which is encouraging considering the company's short history in this specific area and relatively small market occupancy (~5%). Disappointment came from three-phase side, however. The company failed, obtaining nil purchase order, and we attribute this failure to its conservative pricing strategy. Wasion continued using old pricing model during the tender with intention to protect margin while some other firms cut prices aggressively. Although exact bidding price of each party is yet to be known, we estimate, based on public press reports, the final winning price for three-phase metre is within RMB450-800 range, which is considerably lower than Wasion's ASP (FY12/08A : RMB845.2, 1H FY12/09A: RMB927.1).

**However, market share should not become a concern.** Wasion realized the problem and is reviewing the pricing model. According to our discussion with the management, it will adjust its price in future tendering but possibly step by step subject to bidding results so that gross margin will not be over-sacrificed. We do not very agree with this trial-and-error strategy and think it will cost Wasion market share in short term. Nevertheless, we believe, even so, the company should be able to recover its market occupancy gradually and capture more in long run, given its proven strength in R&D, production as well as branding. A potential risk is that SGCC will implicitly limit a certain supplier's exposure to balance the overall supply mix and, therefore, maximize its own bargaining power. Therefore, we lowered our assumption on Wasion's long-term market share for three-phase metre from previous 25% to 20%.

Ticker	3393 HK
Rating	BUY
Price (HK\$)	5.09
Target Price (HK\$)	5.75 (+13%)
12m Price Range (HK\$)	1.82-8.65
Market cap. (US\$m)	607.7
Daily t/o (US\$m)	5.6
Free float (%)	45.1

#### Financial summary

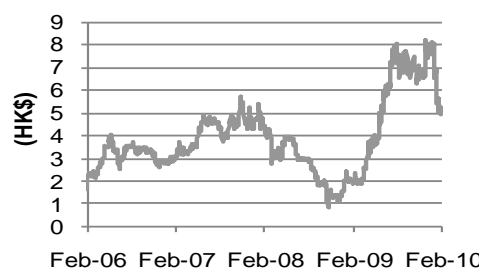
Year to Dec	07A	08A	09F	10F	11F
Turnover (RMBm)	804.0	1,059.4	1,117.8	1,739.4	2,299.4
Net Profit (RMBm)	212.9	261.5	259.2	343.8	409.8
EPS (RMB)	0.290	0.320	0.302	0.369	0.437
P/E (x)	15.4	13.9	14.8	12.1	10.2
P/B (x)	2.98	2.62	1.92	1.71	1.51
EV/EBITDA (x)	15.5	11.7	11.5	8.9	7.5
Yield (%)	1.9	2.2	1.9	2.5	2.9
ROE (%)	16.3	14.8	11.3	13.2	13.8
ROCE (%)	14.7	14.4	12.1	14.3	15.2
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Source: SBI E2-Capital

	09F	10F	11F
Consensus EPS (RMB)	0.328	0.373	0.495
Previous earnings (RMBm)	286.9	323.3	508.0
Previous EPS (RMB)	0.329	0.348	0.547

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	-28.6	-21.6	+76.7
Actual price changes (%)	-37.0	-28.2	+163.7



Source: Bloomberg

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**Table 1. Market share assumption (%)**

Year end Dec	10F	11F	12F	13F	14F	15F
<b>New – blended</b>	7.6	9.6	11.6	13.5	15.4	16.2
Three-phase metre	13.2	14.5	15.8	17.2	18.6	20.0
Centralized procurement	10.0	12.0	14.0	16.0	18.0	20.0
Others	15.0	16.0	17.0	18.0	19.0	20.0
Single-phase metre	6.7	8.8	10.8	12.8	14.4	15.0
Centralized procurement	8.0	10.0	12.0	14.0	15.0	15.0
Others	6.0	8.0	10.0	12.0	14.0	15.0
<b>Old – blended</b>	10.7	12.2	13.6	15.1	16.5	18.0
Three-phase metre						25.0
Single-phase metre						15.0

Source: SBI E2-Capital

**Industry gross margin is anticipated to step down.** An important indication of the first round bidding, in our view, is that margin squeeze seems unavoidable going forward under SGCC's centralized procurement policy, especially for those three-phase metre manufacturers, who used to enjoy juicy gross margin. The final RMB450-800 price range three-phase metre contains 10-40% gross margin, in our estimates, which is well below Wasion's 54% in FY12/08A and 50% in 1H FY12/09A. Meanwhile, experiences from telecom industry also support this margin squeeze view. Taking Comba (2342 HK, HK\$8.00) as an example, the wireless coverage solution provider lost 11.1pcp gross margin in FY12/05A (from 51.6% to 40.5%) immediately after China Mobile (941 HK, HK\$XXX) initiated centralized procurement programme that year. Comba's gross margin dipped slightly further thereafter and stabilized at 37.5% in FY12/08A (i.e. total 14.1pcps loss on gross margin in three years). Accordingly, we predict the centralized procurement will:

- Three-phase metre / data collection terminal – push the gross margin substantially from present ~50% to ~35%.
- Single-phase metre – narrow the gross margin moderately from ~35% to ~30%. Margin pressure is less severe on single-phase metre. Orders Wasion won in the bidding carry ~35% gross margin, which is comparable to its existing business.

**Wasion may find margin support from non-centralized procurement business.** Centralized procurement can account for ~50% of SGCC's total purchase, implying it will represent ~30% of Wasion's entire sales. Remaining balance will come from China Southern Power Grid (CSG), corporate and retail clients as well as overseas market. Gross margin of these non-centralized procurement sales stayed relatively solid, according to the management, underpinning the company's overall gross margin, though we do expect it to diminish and eventually approach centralized procurement level. Thus, we assume Wasion's gross margin for three-phase metre will drop to 42.5% in FY12/10F and 40.0% in FY12/11F. For single-phase metre, the gross margin will be 35.0% 32.5%, respectively, during the same time period.

**Table 2. Gross margin assumption (%)**

Year end Dec	10F	11F	12F	13F	14F	15F
<b>New – blended</b>	40.3	38.0	36.4	35.3	35.8	36.0
Three-phase metre	42.5	40.0	38.5	37.5	37.5	37.5
Single-phase metre	35.0	32.5	31.0	30.0	30.0	30.0
Data collection terminals and related services	42.5	40.0	38.5	37.5	37.5	37.5
Water, gas and heat metre	38.0	38.0	38.0	38.0	38.0	38.0
<b>Old – blended</b>	45.1	45.5	45.4	45.2	44.9	45.1

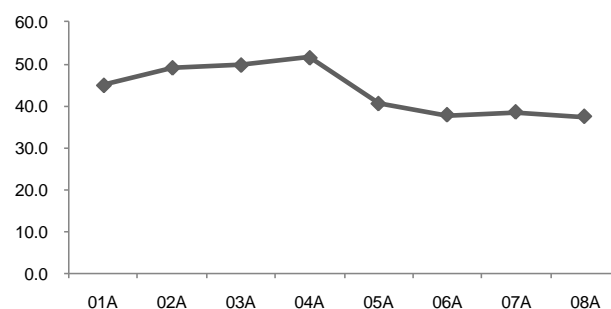
Source: SBI E2-Capital

**Industry estimates have been adjusted.** Other than revised assumptions on market share and gross margin, we also fine tuned our projection for the entire industry as our channel check suggests SGCC is rolling out its smart grid construction plan faster than expected (so does procurement of smart power metre). Also incorporating replacement demand based on technical requirement (four years for three-phase, six years for single-phase), we estimate China's demand for power metre will peak in 2014/15at approximately 80-90m units.

**Table 3. Estiamtes of China's demand for power metre (units m)**

Year end Dec	10F	11F	12F	13F	14F	15F
<b>New</b>	56.6	61.5	66.4	71.3	83.7	90.7
<b>Old</b>	n.a.	51.9	59.7	68.7	78.9	90.8

Source: SBI E2-Capital

**Chart 1. Comba's gross margin (%)**

Source: Comba's annual reports

**We cut down our FY12/09F earnings by 9.7%.** We wrote down our FY12/09F revenue forecast by 11.9% to RMB1,117.8m because SGCC postponed some purchase in 2H 09, waiting for the smart power metre standard. Net profit, correspondingly, was revised down by 9.7% to RMB259.2m. For FY12/10F and FY12/11F, we calculate the company's net profit at RMB343.8m and RMB409.8m based on new assumptions, versus previous RMB323.3m and RMB508.0m. The changes are made to reflect: 1) SGCC's delayed purchase in 2009, which will likely be realized in 2010; 2) substantial gross margin shrink industry wide.

**Table 4. Forecast adjustments**

Year end Dec (RMBm)	07A	08A	09F	10F	11F
<b>New forecasts</b>					
Turnover	804.0	1,059.4	1,117.8	1,739.4	2,299.4
Gross profit	378.9	497.6	506.3	701.2	872.8
Operating profit	250.6	305.5	303.0	393.4	469.4
Net profit	212.9	261.5	259.2	343.8	409.8
<b>Old forecasts</b>					
Turnover	804.0	1,059.4	1,268.9	1,490.6	2,214.6
Gross profit	378.9	497.6	585.5	672.4	1,008.4
Operating profit	250.6	305.5	346.5	398.1	611.0
Net profit	212.9	261.5	286.9	323.3	508.0

Source: Company data, SBI E2-Capital

**Table 5. P&L**

Year end Dec (RMBm)	07A	08A	09F	10F	11F
Turnover	804.0	1,059.4	1,117.8	1,739.4	2,299.4
Cost of sales	(425.1)	(561.8)	(611.5)	(1,038.2)	(1,426.6)
Gross profit	378.9	497.6	506.3	701.2	872.8
Other revenue	28.6	23.1	17.5	15.0	21.2
Administrative expenses	(70.5)	(93.5)	(103.2)	(140.0)	(169.4)
Selling expenses	(68.5)	(92.0)	(95.0)	(147.8)	(195.4)
Research and development expenses	(17.8)	(29.7)	(22.6)	(34.8)	(59.7)
Operating profit	250.6	305.5	303.0	393.4	469.4
Loss on disposal of available-for-sale investment	0.0	(3.1)	0.0	0.0	0.0
Finance costs	(17.2)	(19.6)	(13.6)	(9.7)	(12.0)
Profit before taxation	233.4	282.9	289.3	383.8	457.4
Income tax expenses	(20.5)	(21.3)	(30.1)	(39.9)	(47.6)
Profit for the period	212.9	261.5	259.2	343.8	409.8
Attributable to:					
Equity holders of the Company	212.9	261.5	259.2	343.8	409.8
Minority interests	-	-	-	-	-
EPS - Basic (RMB)	0.290	0.320	0.302	0.369	0.437
EPS - Diluted (RMB)	0.280	0.310	0.297	0.363	0.431
Proposed DPS (RMB)	0.084	0.097	0.084	0.110	0.131
Proposed dividend	68.8	81.9	77.8	103.2	122.9

Source: Company data, SBI E2-Capital

**Target price is penciled down but BUY call remains due to over-sold.** The centralized procurement will surely hurt Wasion's profitability and, so, valuation. Nevertheless, the stock might have been over-sold recently. Our new DCF fair value in base-case scenario is HK\$6.39. In view of quite high equity risk premium embedded in this fair value (11.0% versus previous 9.1%), we think valuation downside risk is small and, therefore, employed a smaller 10.0% discount (previous: 15.0%) on the fair value to derive our new target price at HK\$5.75. The target price implies 17.6x FY12/09F P/E or 14.4x FY12/10F, which looks undemanding compared with A-share peers' average of 41.3x and 27.3x. We retain our BUY tag on the stock.

**Table 6. P&L in bear-case scenario**

Company	Ticker	Market cap (US\$m)	Historical P/E		1-Yr P/E (x)	2-Yr P/E (x)	ROE (%)	P/B	
			Fiscal Yr-end	(x)					
Wasion	3393	HK	607.7	12/2008	13.6	14.8	12.1	20.1	2.5
Star Power	000676	CH	294.9	12/2008	n.a	n.a	n.a	(6.1)	5.0
Shenzhen Clou	002121	CH	716.1	12/2008	64.4	48.2	31.2	13.7	10.5
Wuzhou Minovo	600873	CH	348.3	12/2008	266.2	34.4	23.4	3.7	10.1
Average					165.3	41.3	27.3	3.8	8.6

Source: Bloomberg, SBI E2-Capital

**Risks.** Any positive news flow from the second round centralized procurement could be a short-term catalyst. Meanwhile, we believe market share is a more controllable factor for the company. Thus, the major uncertainty relies on margin side and risk is both upside and downside. To assess downside risk, we built a bear-case scenario to test the company's profitability and valuation. Assuming gross margin for three-phase and sing-phase metre will decline to 30.0% and 20.0% in long run (OP: ~10%; ROE: ~10%), the DCF fair value then will be HK\$3.11.

**Table 7. P&L in bear-case scenario**

Year end Dec (RMBm)	07A	08A	09F	10F	11F
Turnover	804.0	1,059.4	1,117.8	1,540.9	2,045.7
Gross profit	378.9	497.6	506.3	502.7	619.1
Operating profit	250.6	305.5	303.0	219.1	250.2
Net profit	212.9	261.5	259.2	187.7	213.4
ROE (%)	23.5	20.1	14.6	8.4	9.0

Source: Company data, SBI E2-Capital

**Table 8. Bidding results of SGCC's first round centralized procurement for smart power metre – Single Phase**

	Order size (units)	% of total
上海东汇	110,125	4.2
北京博纳	171,600	6.5
江苏卡欧万泓	81,000	3.1
江苏林洋	383,575	14.6
杭州百富	375,250	14.3
杭州西力	255,250	9.7
杭州炬华	105,000	4.0
武汉奥统	91,000	3.5
<b>威胜集团</b>	<b>329,725</b>	<b>12.5</b>
浙江八达	140,125	5.3
浙江万胜	207,800	7.9
浙江松夏	22,000	0.8
常州八方	60,000	2.3
深圳科陆	229,600	8.7
慈溪市一得	31,000	1.2
溧阳市华鹏	40,000	1.5
<b>Total</b>	<b>2,633,050</b>	<b>100</b>

Source: SGCC

**Table 9. Bidding results of SGCC's first round centralized procurement for smart power metre – Three Phase**

	Order size (units)	% of total
上海东汇	18,000	6.9
宁波三星	35,000	13.4
宁波迦南	10,950	4.2
安徽中天	10,950	4.2
杭州百富	43,125	16.6
杭州炬华	21,125	8.1
杭州海兴	15,000	5.8
河南许继	11,450	4.4
浙江万胜	21,125	8.1
深圳浩宁达	30,450	11.7
烟台东方威思顿	43,225	16.6
<b>Total</b>	<b>260,400</b>	<b>100</b>

Source: SGCC

P&L (RMBm)	07A	08A	09F	10F	11F	Cash Flow (RMBm)	07A	08A	09F	10F	11F	
<b>Year to Dec</b>						<b>Year to Dec</b>						
<b>Turnover</b>	804.0	1,059.4	1,117.8	1,739.4	2,299.4	EBIT	243.1	301.6	299.4	389.7	463.0	
% chg		31.8	5.5	55.6	32.2	Depre./amort.	36.9	70.1	77.3	99.5	118.0	
<b>Gross profit</b>	378.9	497.6	506.3	701.2	872.8	Net int. paid	8.2	15.7	10.0	5.9	5.7	
						Tax paid	(6.9)	(14.7)	(21.5)	(30.1)	(39.9)	
EBITDA	280.1	371.8	376.7	489.2	581.0	Dividends received	0.0	0.0	0.0	0.0	0.0	
Depre./amort.	(36.9)	(70.1)	(77.3)	(99.5)	(118.0)	<b>Gross cashflow</b>	281.3	372.7	365.3	465.0	546.8	
EBIT	243.1	301.6	299.4	389.7	463.0	Chgs. in working cap.	(199.1)	(59.0)	(456.1)	(178.9)	71.1	
Net int. income/(exp.)	(9.7)	(15.7)	(10.0)	(5.9)	(5.7)	<b>Operating cashflow</b>	82.2	313.8	(90.8)	286.1	617.9	
Exceptionals	0.0	(3.1)	0.0	0.0	0.0	Capex	(180.1)	(441.9)	(84.0)	(123.3)	(180.3)	
Associates						<b>Free cashflow</b>	(97.9)	(128.1)	(174.8)	162.8	437.6	
Jointly-controlled entit.						Tax	(20.5)	(21.3)	(30.1)	(39.9)	(47.6)	
<b>Pre-tax profit</b>	233.4	282.9	289.3	383.8	457.4	Minority interests	0.0	0.0	0.0	0.0	0.0	
Tax	(20.5)	(21.3)	(30.1)	(39.9)	(47.6)	Net profit	212.9	261.5	259.2	343.8	409.8	
Minority interests	0.0	0.0	0.0	0.0	0.0	% chg		22.8	(0.9)	32.6	19.2	
<b>Net profit</b>	212.9	261.5	259.2	343.8	409.8	Dividends	(68.8)	(81.9)	(77.8)	(103.2)	(122.9)	
% chg		22.8	(0.9)	32.6	19.2	Retained earnings	144.0	179.6	181.5	240.7	286.8	
Dividends	(68.8)	(81.9)	(77.8)	(103.2)	(122.9)	Investments	(37.0)	(27.6)	(31.3)	(48.7)	(56.3)	
Retained earnings	144.0	179.6	181.5	240.7	286.8	Disposals	0.1	17.6	0.0	0.0	0.0	
						New shares	483.0	(21.4)	478.6	16.3	16.4	
EPS (RMB) - Basic	0.290	0.320	0.302	0.369	0.437	Change in bank loans	42.2	106.7	(261.1)	(43.0)	(50.0)	
EPS (RMB) - F.D.	0.280	0.310	0.297	0.363	0.431	Others	19.4	42.3	(57.9)	36.9	56.5	
DPS (RMB)	0.084	0.097	0.084	0.110	0.131	<b>Net cashflow</b>	360.5	(77.3)	(136.8)	46.1	300.4	
No. sh.s o/s (m) - W.A.	734.8	816.6	857.6	932.1	936.7	Cash reserve - Beg.	229.7	590.1	512.8	376.0	422.1	
No. sh.s o/s (m) - Y.E.	816.9	812.9	929.8	934.4	939.1	Cash reserve - End.	590.1	512.8	376.0	422.1	722.5	
No. sh.s o/s (m) - F.D.	752.1	844.5	871.6	946.2	950.9							
						<b>Interim Results (RMBm)</b>	<b>07A</b>	<b>08A</b>	<b>09A</b>			
						<b>Six months to Jun</b>						
<b>Margins (%)</b>						<b>Turnover</b>	291.7	345.5	411.7			
Gross	47.1	47.0	45.3	40.3	38.0	% chg		18.4	19.1			
EBITDA	34.8	35.1	33.7	28.1	25.3	Profit from operations	67.9	79.1	91.2			
EBIT	7.0	7.0	7.0	7.0	7.0	Interest expenses	(6.9)	(8.4)	(8.4)			
Pre-tax	29.0	26.7	25.9	22.1	19.9	Associates						
Net	26.5	24.7	23.2	19.8	17.8	Jointly-controlled entit.	0.0	0.0	0.0			
						Pre-tax profit	61.0	70.7	82.8			
						Tax	(2.0)	(4.3)	(9.5)			
						Minority interests	0.0	0.0	0.0			
						Net profit	59.1	66.4	73.3			
						% chg		12.4	10.5			
<b>Balance Sheet (RMBm)</b>	<b>07A</b>	<b>08A</b>	<b>09F</b>	<b>10F</b>	<b>11F</b>	EPS (RMB) - Basic	0.084	0.081	0.089			
<b>Year to Dec</b>						DPS (RMB)	-	-	-			
Fixed assets	532.9	680.8	708.7	780.4	827.9	<b>Shareholding Structure</b>						
Intangible assets	358.3	344.6	340.5	331.1	320.2							
Other LT assets	5.0	5.0	5.0	5.0	5.0							
Cash	512.8	376.0	422.1	722.5	818.7							
Accounts receivable	766.6	1,387.9	1,709.2	1,663.8	1,987.1	Ji Wei				466.9	50.1	
Other receivables						Fidelity				62.4	6.7	
Inventories	255.6	496.7	657.8	649.0	795.0	Others				404.5	43.4	
Due from related co.s	110.7	0.0	0.0	0.0	0.0	Total				931.3	100.0	
Other current assets	2.1	2.1	2.1	2.1	2.1							
<b>Total assets</b>	2,543.8	3,293.1	3,845.3	4,153.9	4,755.9							
						<b>Background</b>						
Accounts payable	(472.1)	(878.4)	(1,181.9)	(1,198.8)	(1,468.4)	Wasion is a leading manufacturer of electricity data collection products in China.						
Other payable						Headquartered in Changsha, the company employs over 2,500 staffs and has set up						
Tax payable	(21.5)	(30.1)	(39.9)	(47.6)	(54.5)	a national sales / service network (2005: 25 liaise offices). Major products include						
Due to related co.s	(179.8)	0.0	0.0	0.0	0.0	three-phase power metre, single-phase power metre, data collection terminals and						
ST debts	(234.1)	0.0	0.0	0.0	0.0	power management software.						
Other current liab.												
LT debts	(220.0)	(193.0)	(150.0)	(100.0)	(50.0)							
Other LT liabilities	(31.2)	(31.2)	(31.2)	(31.2)	(31.2)							
<b>Total liabilities</b>	(1,158.7)	(1,132.7)	(1,403.0)	(1,377.6)	(1,604.1)	<b>Key Ratios</b>	<b>07A</b>	<b>08A</b>	<b>09F</b>	<b>10F</b>	<b>11F</b>	
						Net gearing (%)	Cash	Cash	Cash	Cash	Cash	
Share capital	8.4	9.5	9.6	9.6	9.7	Net ROE (%)	16.3	14.8	11.3	13.2	13.8	
Reserves	1,376.7	2,150.8	2,432.7	2,766.6	3,142.1	EBIT ROCE (%)	14.7	14.4	12.1	14.3	15.2	
<b>Shareholders' funds</b>	1,385.1	2,160.3	2,442.3	2,776.2	3,151.8	Dividend payout (%)	32.3	31.3	30.0	30.0	30.0	
Minority interest	-	-	-	-	-	Effective tax rate (%)	8.8	7.5	10.4	10.4	10.4	
<b>Total</b>	1,385.1	2,160.3	2,442.3	2,776.2	3,151.8	Net interest coverage (x)	24.9	19.2	29.8	66.2	81.7	
						A/R turnover (days)	311.1	371.1	505.7	353.9	289.8	
Capital employed	1,839.2	2,353.3	2,592.3	2,876.2	3,201.8	A/P turnover (days)	170.1	232.6	336.4	249.8	211.7	
Net (debt)/cash	58.7	183.0	272.1	622.5	768.7	Stock turnover (days)	174.1	244.4	344.5	229.7	184.7	

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