

## Ming Fai International

### Margin hurts from increasing costs...

to summarize...

- Revenue increased 35.9% YoY to HK\$1,475.4m. Gross profit of the period increased 6.6% YoY to HK\$323.5m. Operating profit of the period decreased 30.1% YoY to HK\$84.9m and net profit decreased 38.3% YoY to HK\$71.7m.
- Earnings per share decrease by 42.6% to HK\$10.9 cent and propose a final dividend of HK\$3.5 cents per share.
- The hotel related business amounted to HK\$1,227.7m accounted for 83.2% of total sales compare to 81.1% in FY12/2010A. Net profit amounted to HK\$73.2m. The retail business accounted for 16% compare to 18.3% in sales, and amounted to HK\$33.3m in net profit.
- The overall gross margin of the group dropped to 21.9% from 27.9%. And the overall net margin of the group dropped to 4.6% from 10.1%. The dropped was mainly due to increase in cost of raw materials and labour.
- The company is going through its rough patches due to the adverse market and operating condition in the current economics period. However, Ming Fai has a good reputation and a stable existing hotel & airlines amenities business.
- The retail business has a potential to become a significant contributor after current consolidation period through FY2012. We maintain our Hold recommendation at a target price of HK\$1.21. Our target price represents 10.0x FY12/12F P/E and 5.8x FY12/13F P/E.

**Latest reported results:** The group reported annual result of FY12/11A. Revenue increased 35.9% YoY to HK\$1,475.4m. Gross profit of the period increased 6.6% YoY to HK\$323.5m. Operating profit of the period decreased 30.1% YoY to HK\$84.9m. Net profit decreased 38.3% YoY to HK\$71.7m. Earnings per share decrease by 42.6% to HK\$10.9 cents and propose a final dividend of HK\$3.5 cents per share.

Table 1. FY 12/11A result

| 12 months to Dec | Turnover (HK\$) | Gross Profit (HK\$) | Gross margin (%) | Pre-tax profit (HK\$) | Tax rate (%) | Net profit (HK\$) |
|------------------|-----------------|---------------------|------------------|-----------------------|--------------|-------------------|
| FY 12/11A        | 1,475.4         | 323.5               | 21.9             | 90.2                  | 25.2         | 71.7              |
| FY 12/10A        | 1,085.9         | 303.4               | 27.9             | 135.9                 | 19.3         | 116.1             |
| YoY(%)           | 35.9%           | 6.6%                |                  | (33.6)                |              | (38.3)            |

Source: Company data

**Business segments:** The hotel related business amounted to HK\$1,227.7m accounted for 83.2% of total sales compare to 81.1% in FY12/2010A. Net profit amounted to HK\$73.2m. The retail business accounted for 16% compare to 18.3% in sales, and amounted to HK\$33.3m in net profit. The 7 Magic businesses were acquired in FY2010, sales contribution started only for the last four months in 2010. The newly launched Laundry business widened loss to HK\$15m from a loss of HK\$2.8m in the previous year. The Parel business widened loss to HK\$8m from a loss of HK\$1.2m in the previous year. everyBody Labo business narrowed loss to HK\$3.7m from HK\$5.5m in the previous year.

**Margin:** The overall gross margin of the group dropped to 21.9% from 27.9%. The overall net margin of the group dropped to 4.6% from 10.1%. The dropped was mainly due to increase in cost of raw materials and labor. The hotel and airline business segment enjoyed a gross profit margin of 21% (FY12/10A: 27.4% 1H FY12/11A: 24.8%) and net profit margin of 4.6% (FY12/10A: 9.4% 1H FY12/11A: 9.2%). The 7 Magic business enjoyed a gross profit margin of 32.6% (FY12/10A:

| Ticker                 | 3828 HK       |
|------------------------|---------------|
| Rating                 | HOLD          |
| Price (HK\$)           | 0.84          |
| Target Price (HK\$)    | 1.21 (+44.0%) |
| 12m Price Range (HK\$) | 0.73-2.73     |
| Market cap. (US\$m)    | 73.8          |
| Daily t/o (US\$m)      | 0.3           |
| Free float (%)         | 62.4          |

#### Financial summary

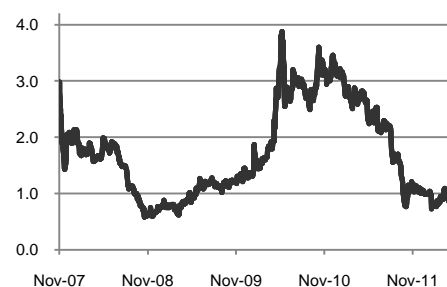
| Year to Dec       | 09A   | 10A     | 11A     | 12F     | 13F     |
|-------------------|-------|---------|---------|---------|---------|
| Turnover (HK\$)   | 811.3 | 1,085.9 | 1,475.4 | 1,763.2 | 2,105.8 |
| Net Profit (HK\$) | 96.3  | 109.7   | 67.5    | 88.0    | 125.4   |
| EPS (HK\$)        | 0.163 | 0.184   | 0.107   | 0.121   | 0.210   |
| P/E (x)           | 5.0   | 4.3     | 7.4     | 6.3     | 3.7     |
| P/B (x)           | 0.61  | 0.51    | 0.51    | 0.48    | 0.42    |
| EV/EBITDA (x)     | -     | 1.8     | 2.9     | 2.0     | 1.2     |
| Yield (%)         | 9.9   | 10.3    | 4.4     | 7.7     | 11.0    |
| ROE (%)           | 12.4  | 12.4    | 6.7     | 8.2     | 10.6    |
| ROCE (%)          | 14.1  | 14.4    | 8.5     | 12.6    | 13.6    |
| N. Gear. (%)      | Cash  | Cash    | Cash    | Cash    | Cash    |

Source: SBI

|                      | 12F   | 13F   |
|----------------------|-------|-------|
| Consensus EPS (HK\$) | 0.175 | 0.215 |

#### Price performance

| Year to Dec              | 1m    | 3m     | 12m    |
|--------------------------|-------|--------|--------|
| Relative to HSI (%)      | (1.2) | (19.1) | (62.9) |
| Actual price changes (%) | (2.3) | (12.2) | (68.1) |



Source: Bloomberg

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33.9% 1H FY12/11A: 35.3%) and net profit margin of 14.5% (FY12/10A: 20.5% 1H FY12/11A: 22.1%). The everyBody Labo segment enjoyed a gross profit margin of 62.4% (FY12/10A: 71.8% 1H FY12/11A: 62.3%).

**Costs structure:** Among the cost, raw materials accounted for 72.7% compare to 73.6% in FY12/10A, staff costs accounted for 16.6% increased from 15.6%, utilities accounted for 2.2% decreased from 3.1%, and depreciation accounted for 1.8%.

**Table 2. Revenue breakdown by sales channels**

| Sales Channels     | 31 Dec. 2009 (%) | 31 Dec. 2010 (%) | 31 Dec. 2011 (%) |
|--------------------|------------------|------------------|------------------|
| Distribution Sales | 61               | 57               | 55               |
| Direct Sales       | 39               | 43               | 45               |
| <i>Total</i>       | <i>100</i>       | <i>100</i>       | <i>100</i>       |

Source: Company data

## Business Prospect

**Hotel and Airlines business:** Greater China is the largest market contributed 39%, follow by North America contributed 32%, Europe contributed by 17%, Asia Pacific contributed 9% and Australia contributed 3%. Margin suffered due to cost pressures of rising raw material and labor cost. The hotel and airline business enjoyed a gross profit margin of 21% down from 27.4% in FY12/10A and net profit margin of drop to 6% from 10.6%.

**Table 3. Revenue breakdown by geographic region**

| Geographic    | 31 Dec. 2009 (%) | 31 Dec. 2010 (%) | 31 Dec. 2011 (%) |
|---------------|------------------|------------------|------------------|
| China         | 39               | 35.5             | 39               |
| North America | 31               | 35.7             | 31.6             |
| Europe        | 16               | 14.4             | 16.6             |
| Asia Pacific  | 11               | 9.7              | 8.8              |
| Australia     | 3                | 3.6              | 2.7              |
| Others        | 0                | 1.1              | 1.3              |
| <i>Total</i>  | <i>100</i>       | <i>100</i>       | <i>100</i>       |

Source: Company data

**Production capacity:** The annual production capacity is 866 million pieces at the end of FY12/11A. The toiletries has annual capacity of 430 - 500 million pieces, soap production has capacity of 150 - 190 million pieces and gift-set production (i.e. toothbrush, vanity, comb, shower cap. etc) has capacity of 240 - 250 million pieces. The existing utilization rate is currently running around 86% which outputs around 748 million pieces, with 389 million pieces from toiletries, 148 million pieces from soaps and 211 million pieces from gift-sets.

**Table 4. Production capacity**

| Product items   | Capacity 2010<br>(million pcs) | Output 2010<br>(million pcs) | Utilization rate<br>2010 (%) | Capacity 2011<br>(million pcs) | Output 2011<br>(million pcs) | Utilization rate<br>2011 (%) |
|---|--------------------------------|------------------------------|------------------------------|--------------------------------|------------------------------|------------------------------|
| Toiletries (item batching & filling)                  | 420                            | 334                          | 79.5                         | 430-500                        | 389                          | 78-90                        |
| Soaps   | 187                            | 156                          | 83.4                         | 150-190                        | 148                          | 79-99                        |
| Gift-sets (toothbrush, vanity, comb, shower cap, etc) | 246                            | 188                          | 76.4                         | 240-250                        | 211                          | 84-88                        |
| <i>Total</i>  | <i>853</i>                     | <i>678</i>                   | <i>79.5</i>                  | <i>866</i>                     | <i>748</i>                   | <i>86</i>                    |

Source: Company data

**7 Magic:** Revenue of the retail business amounted to HK\$235.9m and net profit amounted to HK\$33.3m. The net profit was disappointment from the previous expectation of meeting the RMB50m in net profit. The gross profit margin decrease to 32.6% from 33.9%, and net profit margin decrease to 14.5% from 20.5%. Margin decreased due to increase in spending of advertising & promotion and discounting due to slow down of the economics environment.

**Table 5. Sales network**

| Number of outlets               | 31 Dec. 2010 | 30 June 2011 | 31 Dec. 2011 | 2012 Forecast | 2013 Forecast |
|---------------------------------|--------------|--------------|--------------|---------------|---------------|
| Shops under franchise contracts | 1,013        | 1,150        | 1,255        | 1,655         | 2,055         |
| Unofficial dealers              | 366          | 359          | -            | -             | -             |
| Self-owned shops                | 2            | 3            | 3            | 3             | 3             |
| <i>Total</i>                    | <i>1,381</i> | <i>1,512</i> | <i>1,258</i> | <i>1,658</i>  | <i>2,058</i>  |

Source: Company data

**POS:** Currently there are 1,258 shops compare to 1,381 at the end of Dec. 2010. The company has been closing down unofficial dealers which led to the decrease in overall POS. Going forward, the company target to open around 400 shops every year. The estimate should be approximately 1,658 shops by the end of FY12/12F and 2,058 by the end of FY12/13F.

**Improving efficiency:** Ming Fai will implement a new comprehensive ERP system for all "7 Magic" retail networks in attempt to allow better monitoring of the inventory level of each product. They will upgrade the supply chain system by implementing in-store ERP and POS

systems to better manage their franchise operators.

**Products breakdown:** Currently the cosmetics and skincare products accounted for 44% of store sales, fashion and hair accessories accounted for 34%, toys and stationary accounts for 15% and other gift items accounts for 7%. The gross margin on the cosmetics & skincare products ranges from 35% to 50%, fashion & hair accessories gross margin is approximately 15% to 25%, toys & stationary gross margin ranges approximately 51% to 25% and other gift items has gross profit margin is approximately 10% to 20%.

**Table 6. Product breakdown & gross profit margin**

|                            | 31 Dec. 2010 (%) | 31 Dec. 2011 (%) | Previous Target GP Margin (%) | Actual GP Margin (%) |
|----------------------------|------------------|------------------|-------------------------------|----------------------|
| Cosmetics & Skincare       | 39               | 44               | 40 – 50                       | 35 – 50              |
| Fashion & Hair Accessories | 38               | 34               | 20 – 30                       | 15 – 25              |
| Toys & Stationary          | 16               | 15               | 20 – 25                       | 15 – 25              |
| Other Gifts                | 7                | 7                | 20 – 30                       | 10 – 20              |
| Total                      | 100              | 100              |                               |                      |

Source: Company data

**Laundry & everyBody Labo:** Both Laundry business and everyBody Labo continues to be lost making. The Laundry business amounted to a loss of HK\$15m, a widening from HK\$2.8m, company expect to breakeven by yearend. The everyBody Labo business amounted to a loss of HK\$3.7m, narrowing loss from HK\$5.5m. The narrowing of the lost was due to the closing of self-operating store in Causeway Bay and Mongkok. The company expects to make a modest profit in FY2012.

**Table 7. Off-site laundry services capacity**

|         | Capacity                   | Operation Status        |
|---------|----------------------------|-------------------------|
| Phase 1 | 5,000 hotel rooms per day  | Operation started       |
| Phase 2 | 5,000 hotel rooms per day  | Expect to start in 2012 |
| Phase 3 | 5,000 hotel rooms per day  | Expect to start in 2013 |
| Total   | 15,000 hotel rooms per day |                         |

Source: Company data

**Laundry capacity:** In 2011 the company signed up 12 new contracts. The target is to sign up between fifteen to twenty hotels for FY12/13F which estimate to have 4,500 to 5,800 rooms for service per day. During the first phase of the operation, the available capacity can accommodate up to 5,000 hotel rooms per day. The second phase of the operation expansion can accommodate another 5,000 hotel rooms per day. For the third phase of the operation expansion, capacity can accommodate further 5,000 rooms, thus the entire capacity can accommodate up to 15,000 rooms per day.

**Growth driver:** The China hotel industry is experiencing robust growth with overall occupancy rate remain at 49%. Industrial research shows new hotels rooms in the pipeline are more than 120,000 rooms with half of these in the four to five stars hotels. There are also upgrade trend where three-star hotels are converting into a four or five-star hotels. Ming Fai should stand to benefit greatly since most of their clients are mainly four-star and five-star hotels. The group targets to sign up between fifteen to twenty hotels for FY12/12F which estimate to have 4,500 to 5,800 rooms.

**Forecasts:** We estimate that revenue for full year FY12/13F to be HK\$1,763.2m, a 20% YoY increase, with HK\$1,473.2m contribution from the hotel and airlines amenities business and HK\$290m contribution from the retail business. We forecast net profit to be HK\$88m for FY12/12F which represents a 30% YoY increase. For FY12/13F we forecast revenue to be HK\$2,105.8m, a 19% YoY increase. With HK\$1,753.1m contribution from the hotel and airlines amenities business and HK\$352.7m contribution from the retail business. We forecast net profit to be HK\$125.4m for FY12/13F, representing a 42% YoY increase.

**Target price and our view:** Our new DCF-derived target price is HK\$1.21 based on 2% terminal growth and 19% discount rate. We maintain our rating of Hold. The target price represents 10.0x FY12/12F P/E and 5.8x FY12/13F P/E. We believe that the company is going through its rough patches due to the adverse market and operating condition in the current economics period. However, Ming Fai has a good reputation and a stable existing hotel & airlines amenities business. We hope that the retail business will have a potential to become a significant contributor after the current consolidation period through FY2012. At the moment we're advising a hold rating on this stock counter.

**Table 8. Valuation comparison**

| Company name   | Ticker  | Mkt cap<br>(US\$m) | Last Price<br>(Local) | His P/E<br>(x) | Curr-Yr P/E<br>(x) | 1-Yr P/E<br>(x) | PB<br>(x) | Est. ROE<br>(%) |
|----------------|---------|--------------------|-----------------------|----------------|--------------------|-----------------|-----------|-----------------|
| L'Occitane     | 973 HK  | 3,616.7            | 19.10                 | 27.5           | 24.3               | 20.6            | 4.9       | 27.7            |
| Sa Sa          | 178 HK  | 1,670.8            | 4.63                  | 23.3           | 20.3               | 16.5            | 9.9       | 40.1            |
| Bonjour        | 653 HK  | 436.3              | 1.13                  | 14.1           | 11.6               | 9.4             | 12.5      | 105.7           |
| Natural Beauty | 157 HK  | 385.0              | 1.50                  | 25.9           | 16.7               | 10.7            | 3.8       | 20.4            |
| Magic          | 1633 HK | 360.9              | 2.79                  | 16.3           | 12.7               | 9.4             | 2.3       | 3.8             |
| Modern Beauty  | 919 HK  | 130.0              | 1.16                  | 12.0           | -                  | -               | 2.6       | 13.1            |
| Water Oasis    | 1161 HK | 111.7              | 1.14                  | 10.3           | -                  | -               | 2.9       | 15.6            |
| Veeko          | 1173 HK | 59.2               | 0.21                  | 6.7            | -                  | -               | 0.8       | 28.1            |
| Average        |         |                    |                       | 16             | 15.1               | 11.8            |           |                 |

|                  |           |         |       |      |    |      |     |      |
|------------------|-----------|---------|-------|------|----|------|-----|------|
| Shanghai Jahwa-A | 600315 CH | 1,742.5 | 32.13 | 37.8 | 28 | 21.4 | 7.7 | 22.2 |
|------------------|-----------|---------|-------|------|----|------|-----|------|

Source: Bloomberg

**Peers comparison:** The Hong Kong listed cosmetics and personal care peers are currently trading at average 15.1x FY12/12F fwd-P/E and 11.8x FY12/13F fwd-P/E based on market consensus. With the highest PE from Sa Sa trading at 20.3x FY12/12F fwd-P/E and 16.5x FY12/13F fwd-P/E based on market consensus. The China listed peers are currently trading at 28x fwd-FY12/12F and 21.4x FY12/13F fwd-P/E based on market consensus.

**All Team:** On January 3, 2012, the group announced the proposed buyback of 8.5% issued share capital of All Team. All Team is a wholly owned subsidiaries of the Group. Ming Fai Holdings and All Team are both wholly-owned subsidiaries of the Group. All Team is principally engaged in the manufacturing and distribution of cosmetics and fashion accessories in the PRC, also known as “7 Magic - 七色花”. On August 31, 2010, the Group acquired the entire issued share capital of All Team for a consideration of RMB250m (HK\$284,975,000).

**SP Agreement:** On August 15, 2011, Ming Fai Holdings and the All Team entered into the SP Agreement with Mr. Leung, Ms. Guo, Ms. Wu and Employee Purchasers, where Ming Fai has agreed to sell a total of 14% of the issued share capital of All Team for a total consideration of RMB35m. Mr. Leung is an Executive Director of the Company, Ms. Guo is Director of subsidiaries of the Company and Ms. Wu is an associate of Ms. Guo. The SP agreement allows each of Mr. Leung, Ms. Guo, Ms. Wu and the Employee Purchasers on the 30<sup>th</sup> day of June or 31<sup>st</sup> day of December in each to propose transfer all or part of his Shares in All Team with notice. The sale shares shall only be sold to Ming Fai Holdings at the Transfer Price. As All Team has received the Transfer Notice from each of Ms. Guo, Ms. Wu and Employee shareholder (representing 8.5% of issued share capital of All Team) desiring to transfer all their shares in All Team on December 31, 2011 and All Team has served the same on Ming Fai Holdings. More disclosure will be release upon the completion of the buyback. Our view is that Ms. Guo, Ms. Wu and Employee shareholder are involved in the distribution of cosmetics and fashion accessories business. Given that the involving parties are part of running the day-to-day activities implies a downbeat signal.

## Company Background

**Description:** Ming Fai International engages in the supply and manufacturing of amenity products to high-end hotel chains (4 and 5-star) and airlines. Its product lines include a wide range of personal care, toiletries, rooms and desk accessories. To move further downstream into the retail consumption market, they acquired a cosmetics retail business name “7 magic” or in Chinese “七色花” in the PRC in August of 2010.

**Hotel & Airline business model:** The group owns its own plant facilities in Shenzhen, China to produce comprehensive range of amenity products. Other products that are not produce in-house are sourced from suppliers. Through this model they are able to offer a one-stop shopping service to luxury hotels and airlines operators. The group also has its own design team they allows them to offer a customization of products to enhance the brand image awareness of the hotel and airline operators.

**Client profiles:** The group’s clients comprise of world renowned hotel and airline groups. Its top five customers are Accor Hotel group, Shangri-La Hotel group, and distributors. Together they accounted for close to 30% of this segment’s revenue and around 25% of total revenue.

**About “7 Magic - 七色花”:** The “7 Magic” retail networks sell cosmetics and skin care accessories targeting young female consumer age between 15 to 25 in the PRC. As of the end of Dec 31st, 2011, the sales network had 1,258 POS in China compare to 1,381 at the end of FY12/10A. All of the outlets are operating under a franchise model but three are self-owned. Among the sales network, 96% of the shops are located in second and third tier cities. Each shop has an average size of 50 sq. meter selling on average of 2,500 number of SKU items. The average selling price is ranging approximately from RMB10 to RMB60. Ming Fai is a major supplier of products to all “7 Magic’s franchise stores. Including the eight series of self-owned label exclusively designed by Ming Fai. The merchandise is sold at 45% of retail prices to the franchisees.

**Franchise model:** Majority of the retail chains are operating under a franchise model and will continue to do so. New franchisee can apply for a start-up at a new point of sale by first finding a suitable location and submit to Ming Fai for approval. Ming Fai makes sure that there won’t be any overlapping of shops within the 1.2KM radius. Each franchisee pays a franchise fee of around RMB10,000 per year, with the first three years paid up-front. Under the agreement, each shop designs, layouts and promotional activities are coordinated nationwide. Each franchisee must purchase merchandises directly from “7 Magic” at a 45% discount to the retail price.

**New Off-site Laundry:** To further becoming a one-stop hospitality solution for their customers, Ming Fai has started a new off-site laundry services. The operation was commenced in March 2011. The newly launched laundry service is catering to a hotel clusters in major cities. The new site was open at Jiangsu at the end of 2010. Clients are charged RMB \$18 (HK\$20) per room per day for the service.

**The everyBody Labo:** The everyBody Labo brand carries a full line of high-end body care product. Penetration through strategic partners’ extensive sales network. Products are now in sales at Manning’s and Harvey Nichols in Hong Kong since the end of 2010. Total points of sales up to over 180 in Hong Kong. Products have also entered the China market through around 80 distributors to counters in cosmetics shops.

Table 9. Sales and earnings forecast

| (HK\$m)            | 2009A        | 2010A          | 2011A          | 2012F          | 2013F          |
|--------------------|--------------|----------------|----------------|----------------|----------------|
| Hotel & Airlines   | 811.3        | 1,001.1        | 1,227.7        | 1,199.6        | 1,259.6        |
| Retails            | -            | 84.8           | 229.5          | 393.9          | 537.7          |
| Other              | -            | -              | 18.2           | -              | -              |
| <b>Sales Total</b> | <b>811.3</b> | <b>1,085.9</b> | <b>1,475.4</b> | <b>1,763.2</b> | <b>2,105.8</b> |
| Gross Profit       | 234.6        | 303.4          | 323.5          | 401.5          | 478.2          |
| Operating Profit   | 106.7        | 121.5          | 84.9           | 135.9          | 160.9          |
| Profit before Tax  | 119.7        | 135.9          | 90.2           | 142.5          | 167.6          |
| Tax                | 23.4         | 26.2           | 22.8           | 35.9           | 42.3           |
| <b>Net Profit</b>  | <b>96.3</b>  | <b>109.7</b>   | <b>67.5</b>    | <b>88.0</b>    | <b>125.4</b>   |

Source: Company data, SBI E2-Capital

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