

Argos Enterprise

Online lottery coming to your mobile

Non Rated

Financial summary

| Year to Dec | 06A | 07A | 08A |
|--------------------|---------|---------|---------|
| Turnover (HK\$m) | 156.2 | 185.1 | 185.2 |
| Net Profit (HK\$m) | (0.1) | (9.1) | (48.3) |
| EPS (HK\$) | (0.000) | (0.051) | (0.262) |
| EPS Δ% | n/a | n/a | n/a |
| P/E (x) | n/a | n/a | n/a |
| P/B (x) | 2.5 | 2.7 | 9.3 |
| EV/EBITDA (x) | 5.9 | 19.2 | n/a |
| Yield (%) | n/a | n/a | n/a |
| ROE (%) | n/a | n/a | n/a |
| ROCE (%) | n/a | n/a | n/a |
| N. Gear. (%) | cash | cash | cash |

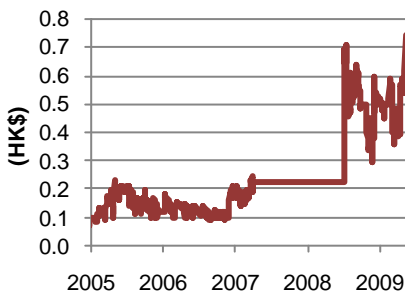
Source: Company data

Price Performance

| | 1 mth | 3 mth | 12 mth |
|--------------------------|-------|-------|--------|
| Relative to HSI (%) | +50.4 | +18.8 | +378.3 |
| Actual price changes (%) | +72.4 | +50.0 | +226.1 |

| | 08F | 09F | 10F |
|----------------------------|-----|-----|-----|
| Consensus EPS (HK\$) | n/a | n/a | n/a |
| Previous forecasts (HK\$m) | n/a | n/a | n/a |
| Previous EPS (HK\$) | n/a | n/a | n/a |

Price Chart



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| | |
|-----------------|-----------------------------|
| Ticker: 8022.HK | 12 mth range: HK\$0.27-0.85 |
| Price: HK\$0.75 | Market cap: US\$52.4m |
| Target: n/a | Daily t/o, 3 mth: US\$0.08m |
| | Free float %: 50.4% |

Key points:

- * Argos Enterprises has made a strategic entry into China's mobile online lottery market through acquisition of effective 52% of TLT. Company announce that it would change its name to "TLT Lottotainment Group Ltd."
- * TLT has 5-year exclusive rights to operate mobile e-wager and e-recharging platform in 6 provinces in China with Liaoning also currently under negotiations
- * Based on FY12/09 profit guarantee, the HK\$695m represents 8.7-11.7x P/E
- * Lottery industry in China grew at CAGR of 23.3% between 2001-2007 and still remains a nascent industry
- * Though under reform during 2008, China's lottery industry is showing signs of rebound backed by supportive government policies
- * Relative to the Internet, the mobile platform has the advantages of: 1) larger installed base; 2) less chances of fraud and abuse 3) standard mobile handsets can run relatively interactive and engaging games
- * The concept of mobility, improved product offerings, coupled with the "casual game" approach to mobile lottery can significantly drive lottery sales going forward, and TLT is suitably positioned as a prime beneficiary

Strategic entry into China's mobile lottery market. Previously focused on the transportation and travel agency business in China, Argos Enterprises (Argos) made a strategic entry into China's lucrative mobile online lottery space through the acquisition of an effective 52% of Tang Lu Technology Services (Shanghai) Ltd. (TLT). The "very substantial acquisition" (VSA) was completed on 8 Jan 2009. With the completion of the acquisition, Argos has the exclusive rights to be China Sports Lottery Administration Centre's wager platform operator and promoter of mobile-based instant lottery in 6 provinces including: Shandong, Hubei, Hainan, Qinghai, Gansu and Shaanxi. The agreements with Gansu and Shaanxi were secured after the completion of the VSA and TLT is currently in the process of securing the same rights for Liaoning province. On 11 May 2009, it was announced that the company proposes to change its name to "TLT Lottotainment Group Ltd." (唐路彩娛集團有限公司).

Structure of the acquisition. Argos's acquisition of an effective 52% stake in TLT was done through the 65% acquisition of BVI Wisdom In Holdings Ltd., whose HK registered wholly-owned subsidiary, Index HK Ltd. holds 80% equity stake in TLT. The remaining 20% of TLT is held by PRC registered TLT Shanghai Ltd.

Minimum 8.7x P/E acquisition valuation. The consideration for the acquisition was HK\$695.0m, comprising: 1) HK\$5.0m cash; 2) HK\$26.4m in the form of 44.0m consideration shares and 3) HK\$409.2m in convertible bonds and 3) HK\$254.4m in promissory notes (issued in 2 tranches). The acquisition involves a FY12/09 profit guarantee of HK\$153.0m (w/ Liaoning) or HK\$114.0m (w/o Liaoning). This translates to an acquisition valuation of 8.7x or 11.7x. Should the FY12/09 results of TLT not meet the profit guarantee, the 2nd tranche will be adjusted down by 52% of the difference between the profit guarantee and actual net profit of TLT.

Table 1: Consideration breakdown

| Item | Key details | HK\$m |
|----------------------|--------------------------------------------------------------------------|-------|
| Cash | | 5.0 |
| Consideration shares | ▪ 44,000,000 consideration shares at issue price of HK\$0.60 | 26.4 |
| Convertible bonds | ▪ 3-yr maturity, 1.0% coupon paid quarterly, strike price HK\$0.66 | 409.2 |
| Promissory notes | 2 Tranches (3-yr maturity, interest free) | |
| | ▪ Tranche 1 – HK\$154.4m on completion of the completion of acquisition | 154.4 |
| | ▪ Tranche 2 – HK\$100.0m after issue of TLT's FY12/09 audited financials | 100.0 |
| | Total | 695.0 |

Source: Company data, SBI E2-Capital

Table 2: Shareholding structure

| Shareholder | Current | | After issue of consideration shares | | After issue of consideration shares & conversion of CBs | | After issue of consideration shares & conversion of CBs (where Vendor holds <19.90%*) | |
|-------------------------|-------------|--------|-------------------------------------|--------|---------------------------------------------------------|--------|---------------------------------------------------------------------------------------|--------|
| | No. of shr | % | No. of shr | % | No. of shr | % | No. of shr | % |
| Sino Market Enterprises | 62,284,000 | 31.94 | 62,284,000 | 26.06 | 62,284,000 | 7.25 | 62,284,000 | 25.58 |
| Yeung Wai Hung | 1,400,000 | 0.72 | 1,400,000 | 0.59 | 1,400,000 | 0.16 | 1,400,000 | 0.58 |
| Wonderful Source Ltd. | 50,000,000 | 25.64 | 50,000,000 | 20.92 | 50,000,000 | 5.82 | 50,000,000 | 20.54 |
| Vendor | - | - | 44,000,000 | 18.41 | 664,000,000 | 77.30 | 48,444,000 | 19.90 |
| Public | 81,316,000 | 41.70 | 81,316,000 | 34.02 | 81,316,000 | 9.47 | 81,316,000 | 33.40 |
| Total | 195,000,000 | 100.00 | 239,000,000 | 100.00 | 859,000,000 | 100.00 | 243,444,000 | 100.00 |

* Due to restrictions under the Master Agreement and CBs as to avoid triggering a mandatory offer under Rule 26 of the Takeovers Code

Source: Company data

China's lottery industry. Lottery is the only sanctioned form of gambling in China. China Sports Lottery Administration Centre (CSLC), established in 1994, is the smaller and one of only two lottery operators in China. The other being China Lottery Welfare Issuance Centre (CWLC), which was established earlier in 1987. The industry is heavily regulated with both entities under the Ministry of Finance (MoF), which directly reports to the State Council. The main difference between the two lottery bodies is in the way in which they use their proceeds. CSLC uses its funds for sports-related developments while CWLC uses its funds for social and welfare development. In general, 50-65% of the lottery sales (depending on the game) are paid back as prize winnings, 15% used for administrative fees, with the remaining used for sports/social welfare development according to their respective mandates.

Surging growth up to 2007. From 2001 to 2007, China's lottery sales increased from RMB28.9b to RMB105.9b according to data from the MoF, implying a CAGR of 23.3%. Growth drivers during this period included:

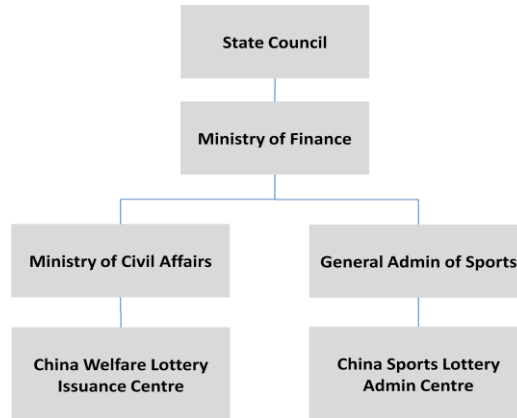
- General improvement of consumer wealth
- Increasing acceptance of lottery as a form of entertainment
- Increasing variety of lottery games and some with increasing levels of interactivity
- Launching of instant and higher frequency games, such as video lottery terminals (VLTs)

Even with this staggering growth, the industry is still in a nascent stage. The industry is still dominated by underdeveloped offerings, with many relatively simple "chance" and number games. Per capita spending in lottery sales is still low at 0.66% of per capita income, compared to over 2% in more mature markets. Most importantly however, is that some research suggests that China's official lottery market represents only around 10% of the overall gambling market, suggesting that there is still around 90% of the market (illegal forms of gambling) untapped.

Industry reforms in 2008. Despite the size of the industry, a formal regulatory framework has yet to be put in place. To date, the industry is still presided by a "provisional regulation" on the management of lottery distribution and sales issued in 2002. This lack of clear regulatory regime to set out the framework for the development of the industry has undermined the positive externalities while worsening the negative externalities of China's lottery market during the last decade. Over the years, this has resulted in instances of fraud, establishment of illegal lotteries, over indulgence of some players and abuse of under regulated platforms such as VLT halls and Internet based lottery. To undertake corrective restructuring and ensure the long term sustainable development of the industry, the MoF, Ministry of Civil Affairs and General Administration of Sports and Ministry of Public Security in late 2007 jointly issued a series of reforms to restructure the industry and improve overall practices. This included

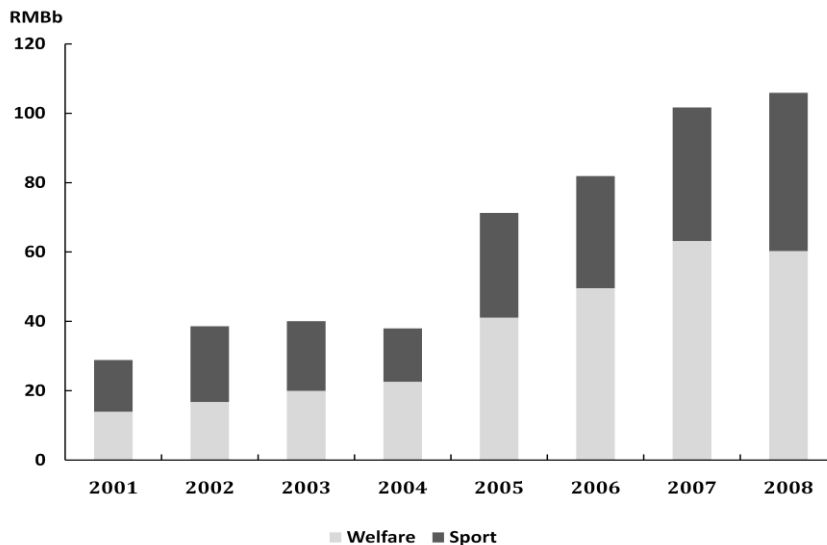
amongst others, shortening operating hours of VLT and lottery halls, ceasing of selling lottery tickets online, reducing the daily maximum bet per person to RMB200, cancellation of several games, raising percentage of prize payout to attract more players etc. This reform had a disruptive impact industry-wide in the form of: 1) slowing the overall growth of the industry (Internet and VLT platforms were particularly hard hit) and 2) industry uncertainty slowing development of new products. In 2008, China's lottery sales totaled RMB105.9b, up only 4.1% from 2007. However, most of the slowdown came from CWLC, whose lottery sales fell 4.6% YoY as it had more exposure to the VLT platform. CSLC on the other hand, were still able to grow their lottery sales by 18.4% YoY to RMB45.6b. For 2008, CSLC accounted for 43.1% of the lottery market, with CWLC accounting for the remainder 56.9%.

Chart 1: Regulatory framework



Source: Ministry of Finance

Chart 2: China lottery sales growth



Source: Ministry of Finance

Signs of re-ignition of growth. However, the lottery industry remains an important industry to the Central Government from its social and economic perspective and there are several signs recently that the Chinese government is about to re-ignite growth in the industry. These include:

- **Lottery as an avenue to fund Sichuan disaster relief** – The Chinese government announced that it has a goal to generate an incremental RMB40b of lottery sales by 2010 (from its base in 2008). Part of the proceeds from this growth will be used for funding Sichuan earthquake's disaster relief
- **Consultative paper on lottery regulations** – On 28 Mar 2009, the State Council issued a draft management regulation on lotteries for consultation. The regulation covers items including formal reporting structures to the State Council, specifically stating that CSLC and CWLC are the only two legitimate lottery outlets as well as mechanisms to cover transparency of money taken in and how it is spent, identity of prize winners and manner in which the fund is managed

- **Launch of new games** – New games such as “刮刮樂” 與 “快樂十分” have being strongly promoted. In addition, Keno will be the first lottery game being sanctioned to operate in public areas

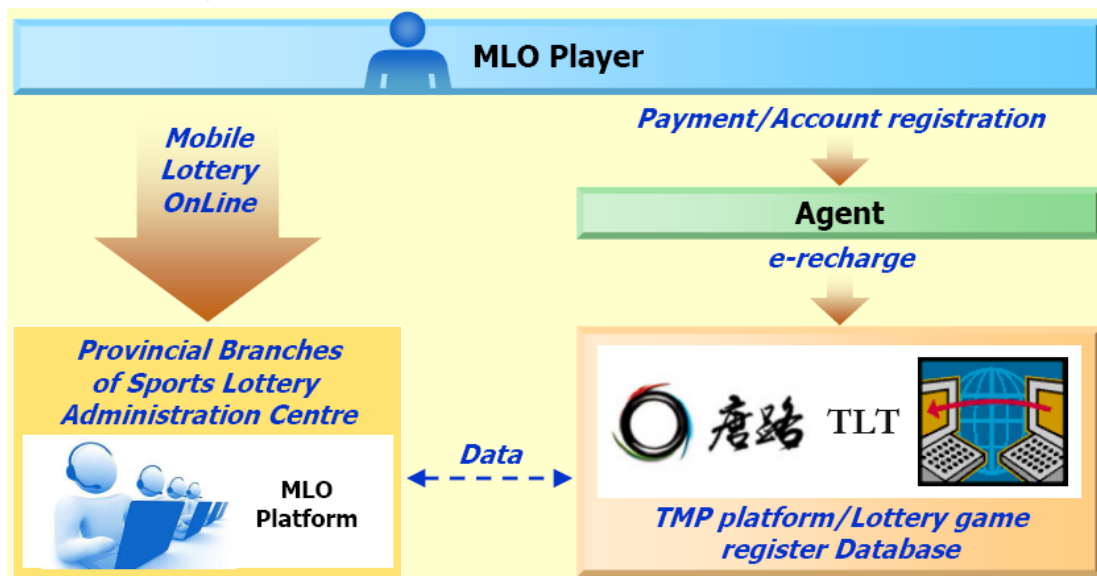
In our view, these are very positive signs for the industry. When the lottery regulations are approved later this year, this will formalize China’s lottery structure, paving the way for the industry’s return to high growth under an improved operating environment. Meanwhile, the aggressive growth target set by the government can only be met through launching of new, but regulated platforms such as mobile, as well as the launch of higher frequency and more interactive/engaging games, such as VLTs and Keno and this should drive the appetite for new games and platforms. In this sense, we think that China’s wireless value-added services (WVAS) industry could serve as a good proxy for China’s lottery industry. After a series of reforms in 2H 2006 to stamp out aggressive billing practices, which slowed the previous high growth WVAS industry in 2007, the sector has subsequently rebounded in 2008 and most WVAS players, such as Tencent (700 HK), A8 (800 HK) and Sina (SINA US) has returned to high growth trajectory, citing an improved operating environment as a key driver.

(Follow up note: It since been announced that the "Lottery Regulations" was passed by the State Council during the 58th Executive Meeting. The new law will come into effect from 1 Jul 2009.)

Mobile the next emerging platform for China lottery. Many industries such as e-payment, online games and music see mobile as the next generation platform to drive revenues and we think that the same applies to China’s lottery industry. While there have been SMS or IVR based mobile lottery games in China since 2001, these tend to be one-dimensional in game play and relatively un-engaging. Going forward, we expect mobile online based lottery games to gradually become an accepted and popular mode of play on the mobile platform. Relative to the broadband Internet, the mobile platform has the advantages of: 1) a larger installed base (670.3m vs 88.1m at the end of Mar); 2) more close technology platform, leading to less chances of fraud and abuse 3) processing power of mobile phones have improved to the point where even “standard” mobile handsets can run relatively interactive and engaging games. In our view, the concept of having a handset with you at all times, improved product offerings and UIs, coupled with the “casual game” approach to mobile lottery can significantly drive lottery sales going forward, and TLT is suitably positioned as a prime beneficiary. Other attributes of the mobile platform include:

- Easily accessible to consumers
- High degree of privacy in playing
- “Casual” nature of lottery games suitable for the mobile platform, where users often prefer a short duration game
- Low transaction cost paid by consumers, game-providers and service providers
- Large installed base relative to the Internet
- Oncoming 3G network and associated handset technology will allow for launch of mobile lottery games with a higher degree of user interactivity

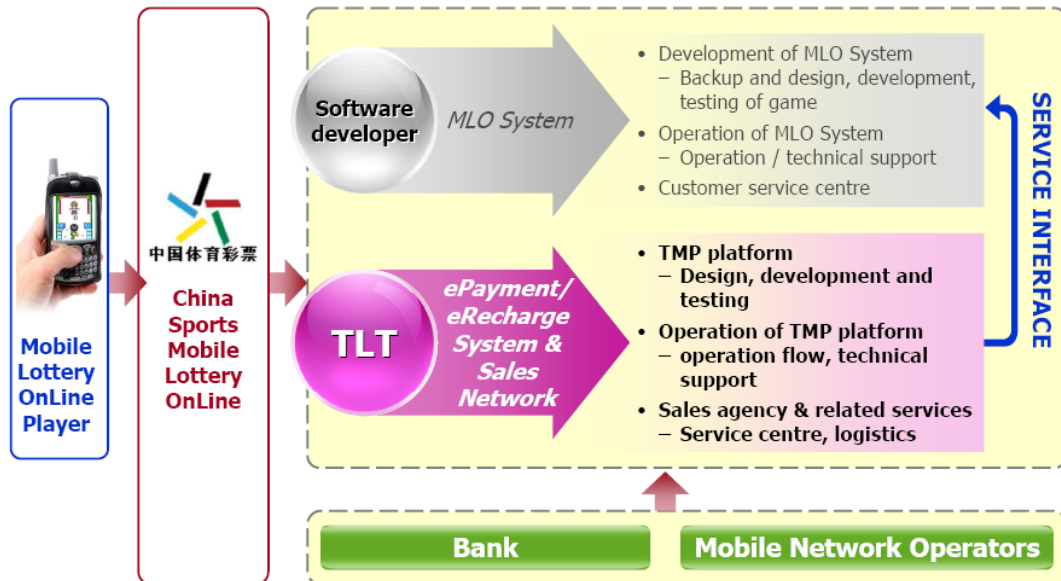
Chart 3: TLT’s operating model



* MLO denotes Mobile online lottery

Source: Company data

Chart 4: TLT's services



* MLO denotes Mobile online lottery

Source: Company data

TLT provides e-wager services. Under the newly proposed regulations, all service providers shall enter into service contracts with either CSLC or CWLC. To this end, TLT has entered into exclusive business contracts with six provincial CSLC branches; namely Shandong, Hainan, Hubei, Gansu, Qinghai and Shaanxi while business contract for Liaoning is under negotiation. According to the management of Argos, TLT was the first entity in China to secure such a service agreement from either CSLC or CWLC. Pursuant to the contracts, TLT will be the system, as well as the service provider on the CSLC's mobile online lottery platform as follows:

- **System provider** – Development and management of the e-wager and e-recharge services for CSLC's mobile online lottery platform
- **Service provider** – Development and management of sales/distribution network for CSLC for mobile online lottery for each province under contract

Ready for launch and scalable. The duration of the contracts is typically for a 5-year period (start date based on commissioning date of the system) with a right of first refusal for subsequent extension. The first province to be signed by TLT was Shandong, in mid 2007. The system in Shandong was launched in Jan 2009 and is still currently in trail/testing mode. There was a time lag for the launch due to: 1) need to develop the wager platform; 2) industry wide restructuring that took place for the most of 2008 and 3) government's passive stance towards any initiatives during the Beijing Olympics in 2008. In the short space since launch however, the Shandong operations have already built up an agent network of 700 and 5,000+ customers. TLT plans to commence trialing the service in Hainan next and have all 6 provinces operating by year's end. The platform is very scalable given that the same platform structure is applied across all the platforms and that only one set of operations is required within each province to serve all of the mobile lottery players within that province.

Potentially lucrative/high margin business. The mobile lottery business is potentially a lucrative and high margin business. TLT initially sets up an account with CSLC and deposits around RMB5.0-7.0m with the lottery body, depending on the expected sales activity of the province. TLT then sets up its agent distribution network, which in turn individually deposits an initial amount with TLT. The amount of deposit varies widely (HK\$1,000 to HK\$10,000) depending on the size and scale of the agent. Typically, a mobile user will set up its mobile online lottery account through the agent, with TLT acting as the backbone platform operator. The mobile user will then charge up his account through the agent via charge cards. After the charge is completed, a confirmation SMS will be sent to both the agent and the mobile user and the mobile user can proceed to play the mobile online lottery game and lay a wager. For each game, players wage from RMB2.0 to RMB198.0. TLT receives a service fee based on the sales derived from mobile online lottery CSLC (~mid single digit percentage), of which a proportion (~low single digit percentage) is rebate to its agent partners. Transactions are checked daily while settled monthly. Meanwhile, CSLC will also subsidise a maximum of 1% of the mobile lottery sales for marketing/promotional purposes. Given that TLT's fixed operating cost structure is relatively low (~RMB0.5m/month operating cost for its provincial offices and ~RMB1.0m for its head office in Shanghai), the business model is likely to record healthy margins.

Management team of TLT. TLT appears to have a solid management team with previous government and army experience, which we think is an advantage given the government ties of the lottery industry. President and CEO Wu Hong was formerly with the PRC Air Force and Executive Director Zhang Wei Ting was previously with the PRC Department of Foreign Trade. Keon Fang, Vice President and Head of IT is a information systems technology, information system management and databank specialist with previous experience in Ford (USA).

Recent FY12/08A results. For the recently announced FY12/08A results, Argos recorded HK\$185.2m, flat YoY. Net loss was HK\$48.3m, compared to a net loss of HK\$9.1m a year ago. The losses mainly came from its public transportation and hire-a-bus segments, which recorded a combined segment loss of HK\$55.0m. After the completion of TLT, management plans to dispose of all its non-core businesses, in particular the public transportation business, which has relatively high replacement capex commitments going into FY12/09 and FY12/10. They intend to only keep the travel agency business segment. At end-FY12/08A, Argos had a gross cash position of HK\$36.6m and net cash position of HK\$4.1m.

Capex. We estimate the company's capex requirement to be around RMB70.0m for 2009 (assuming all 6 provinces are in operation). Around RMB15.0m is required to commence operations in each province, comprising office, staffing and technology platform set up, agent network build out and training as well as RMB5.0-7.0m working capital deposit into CSLC's account.

Other recent corporate actions. 1) to concentrate on its new business, the company announced that it will dispose of its bus transportation business for a total consideration of HK\$8.0m. The company will need to record a one-off disposal loss of HK\$11.0m in its FY12/09 P&L results; 2) Argos on 17 Apr appointed Mr. Wong Wai Sing as the Chairman and Non-Executive Director of the company and 3) on 9 Mar, company appointed Mr. Chan Kin Yip as Executive Director and 4) on 8 Jan, the company changed its auditor to Cliff, improving on its previous auditor Ting Ho Kwan & Chan (THKC).

Risks. 1) delay of launch of mobile lottery in the 6 provinces under TLT; 2) competition from CWLC and 3) further regulatory restructuring.

Table 3: P & L

| Year to Dec (HK\$m) | 06A | 07A | 08A |
|----------------------------------------------|--------------|---------------|---------------|
| Turnover | 156.2 | 185.1 | 185.2 |
| Cost of sales | (136.6) | (173.3) | (199.9) |
| Gross profit | 19.5 | 11.8 | (14.6) |
| Other revenue | 14.7 | 20.4 | 42.4 |
| Other net (loss)/income | - | 0.4 | (11.0) |
| Selling and distribution costs | - | - | - |
| Administrative expenses | (28.5) | (33.6) | (42.6) |
| Impairment loss on PPE | - | (10.0) | (41.0) |
| Operating profit | 5.7 | (11.0) | (66.9) |
| Financial costs | (1.5) | (1.7) | (3.3) |
| Share of loss of a jointly controlled entity | - | - | - |
| Share of loss of an associate | - | - | - |
| Pre-tax profit | 4.3 | (12.7) | (70.2) |
| Tax | (2.1) | (0.3) | - |
| Minority interests | (2.2) | 3.9 | 21.9 |
| Net profit | (0.1) | (9.1) | (48.3) |

Source: Company data

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