

Heng Xin China

Penetrating in digital cable TV market

to summarize...

- The company started as a supplier of encryption chips with technology originated from CEC.
- It then gradually set up its presence in digital cable TV operation market. Four contracts have been signed, targeting 8.6m subscribers in total.
- There were 300,000 subscribers at end Dec-2010, which increased to 500,000 in Jun 2011. Effective monthly ARPU was calculated at HK\$47 for 3Q FY06/11A.
- With the four contracts fully implemented, the company can have as much as HK\$4.9b income from the operation each year with gross margin at 80%+, although uncertainty still relies on execution side.

The origin. The company's history can be traced back to Apr 2005 when Huzhou Maxium (HZM) was established for provision of IC solutions. In Mar 2008, Beijing Jinqiao (BJJQ) was set up as a 93:7 sino-foreign JV between Cambridge International and Beijing Hengtai (BJHT), a subsidiary of CIDC, a state-owned IC design house under China Electronics Corporation (CEC). Soon after its incorporation, BJJQ reached an intellectual property license agreement with BJHT in Apr, under which BJJQ was granted a sole and exclusive license to use BJHT's most IP rights. Thus, BJJQ became a supplier of encrypt ICs used in digital TV set-top boxes, government encrypt systems, encrypt mobile hard disks, USB keys and etc. In Sep 2008, both HZM and BJJQ were injected into a HK listco, Tiger Tech, through a RTO transaction at total consideration of HK\$549m (HK\$25m cash plus HK\$529m convertible notes with initial conversion price of HK\$0.34 each). Thereafter, Tiger Tech changed its name to Heng Xin China (HXC) in Jan 2009 and the company also expanded its business scope from encrypt chips to digital cable television operation.

Table 1. Corporate milestones

Time	Events
Jul 2011	entered into a business cooperation agreement in relation to digital mobile television project in Hebei province
May 2011	entered into business cooperation agreements in relation to the cable television network in Yagao county and Tianzhen county, Shanxi province
Dec 2010	acquired remaining 7% interest in Beijing Jinqiao
Nov 2010	entered into a business cooperation agreement in relation to the cable television network in Hebei province
Oct 2010	entered into a strategic cooperation framework agreement with Anhui Television Broadcasts and Media Industry Group
Apr 2010	entered into a business cooperation agreement in relation to the cable television network in Anhui province
Apr 2010	entered into a business cooperation agreement in relation to the cable television network in Nanchang county, Jiangxi province
Aug 2009	entered into a framework agreement in relation to the ground wireless digital television operating platform in Hubei province with estimated contracting revenue of RMB2b in five years
Jan 2009	changed name from Tiger Tech to Heng Xing China
Sep 2008	completed RTO by acquiring 93% interest in Beijing Jinqiao and 100% interest in Huzhou Maxium at total HK\$549m
Mar 2008	Beijing Jinqiao was established
May 2005	Huizhou Maxium was established

Source: compiled by SBI E2-Capital

Ticker	8046 HK
Rating	Not Rated
Price (HK\$)	1.39
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.687-1.92
Market cap. (US\$m)	443.2
Daily t/o (US\$m)	3.4
Free float (%)	71

Financial summary

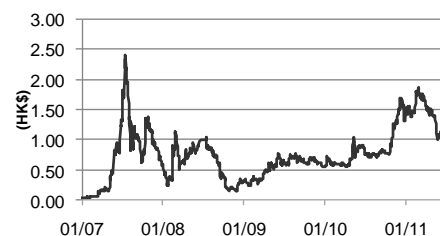
Year to Jun	09A	10A
Turnover (HK\$m)	339.4	653.3
Net Profit (HK\$m)	110.7	181.0
EPS (HK\$)	0.113	0.106
P/E (x)	12.3	13.1
P/B (x)	4.0	2.1
EV/EBITDA (x)	25.8	15.3
Yield (%)	0.0	0.0
ROE (%)	23.2	17.1
ROCE (%)	25.1	16.3
N. Gear. (%)	cash	10.5

Source: SBI E2-Capital

	11F	12F	13F
Consensus EPS (HK\$)	0.099	0.185	0.260
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	25.0	4.4	68.0
Actual price changes (%)	25.2	(3.5)	81.8



Source: Bloomberg

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Diversification into digital cable TV operation. With patented encryption chip as a stepping-stone to establish relationship with TV operators (e.g. local television stations), HXC then diversified itself into digital cable television operation. It entered into cooperation agreements in 2010-2011 with television operators in Anhui, Jiangxi and Hebei provinces as well as Yanggao and Tianzhen counties in Shanxi provinces. According to these agreements, HXC will provide equipment and develop and operate cable TV services jointly with its partners in above regions. In exchange, a certain proportion of subscription fees (either from basic package or value-added services subject to terms of each contract) collected from end users will be paid to HXC as compensation. When steam of encryption chip business is cooling down due to maturity of the entire market, the management puts its faith on this digital cable television two-way conversion business for the latter's recurrent nature in terms of revenue generation as well as a simple fact that China will cease analog TV broadcasting by 2015, which will certainly boost usage of digital cable TV services significantly.

Table 2. Signed digital cable TV agreements

Province	Contract length	Target number of subscribers	Revenue stream	Revenue entitled*
Nanchang, Jiangxi	15 years	1.5m	Value-added service	70% in the first 5 years, 50% in the following 10 years
Anhui	12 years	4m	Value-added service	70% in the first 3 years, 50% in the next 3 years, 40% in the last 6 years
Hebei	15 years	3m	Basic package, value-added service	80% in the first 5 years, 60% in the next 5 years, HK\$50 each subscriber in the last 5 years
Yangao & Tianzhen, Shanxi	15 years	0.1m	Basic package, value-added service	70% in the first 5 years, 60% in the next 5 years, 50% in the last 5 years

Source: Company data

Note: * after split (e.g. 50:50) with content providers

Table 3. Digital cable TV services

Package	Annual charge (RMB)	Subscription rate
Basic package	240	95%
Value-added services		
Time Shifting over cable	30	30%
HD broadcast	180	11%
VOD broadcast	350	16%
Paid HD channel	480	10%
Broadband business	600	20%
E – pay	60	60%
Push HDVOD	240	20%

Source: Company data

Huge earnings potential based on signed contracts. The company reported HK\$204m revenue for 3Q FY06/11A (HK\$522m for 1-3Q), comprising HK\$79m from wireless digital terrestrial television network equipment integration business, HK\$43m from digital cable television two-way conversion business, HK\$14m from encrypted integrated circuits and the derived integrated business and remaining HK\$68m from wireless digital audio products business. According to the management, there were 300,000 digital cable TV users at end of the reporting period (i.e. end-Dec 2010). Thus, we can roughly estimate an effective monthly ARPU of HK\$47 for 3Q. Applying this figure on the aggregate 8.6m target subscribers in the four signed contracts, we can derive an indicative annual income of HK\$4.9b. On the cost side, we understand upfront needs to be paid by the company to set up cable TV connection, which includes hardware (e.g. cable, set-top box, etc) costs and installation expenses. The management estimates all-in cost is ~RMB400/subscriber in Anhui and Jiangxi, ~RMB500 in Shanxi and ~RMB550 in Hebei. By using a weighted (target number of users) average of RMB453 and assuming 5-year direct-line depreciation, such investment will be paid back within 12 months and an apparent gross margin (i.e. revenue less depreciation cost) will be 80%+.

Trading at 23 multiples of FY12/10A net profit. The stock is trading at 23x of FY12/10A earnings (incl. potential issuance of 546m shares upon exercise of existing equity instruments). There are other two Chinese cable TV operators, Shenzhen Topway (0002238 CH) and Beijing Gehua (600037 CH), listed in Shenzhen and Shanghai, respectively. They are trading at 74x and 35x one-year forward P/E. Of course, considering HXC's still relatively small cable TV operation at present, the two peers' valuation can only be used as reference.

Risks. A major operation risk is associated with execution of the four cable TV contracts. The exact progress, in our view, will largely depend on local TV operators' attitude, which, in turn, will be sensitive to government policy. According to the management, the number of its subscribers increased from 300,000 at end-Dec 2010 to ~500,000 in Jun 2010, implying a net increase of ~400,000 a year, which seems a bit slow. Under such pace, it will take near 20 years to reach the target of 8.6m subscribers. In addition, we also highlighted the company's dispersed ownership structure. As a typical RTO case, large shareholders own only 29% interest of HXC. We think a small company like HXC may need a more concentrated shareholder structure to better carry out its developing strategy.

Table 4. Major capital market activities

Time	Events
Nov 2010	issued options (90m shares at HK\$1.32 each) to a consulting firm owned by Mr. Li Zhenguo and Ms. Jing Lihua, both independent third parties, as incentive to marketing services
Dec 2010	entered into agreement to issue up to HK\$400m worth of shares under an equity line of credit
Dec 2010	Issued HK\$200m convertible bonds with initial conversion price of HK\$2.00 to Sandmartin (0482 HK)
Nov 2010	issued 61m bonus shares on a basis of one for each 30 existing shares
Sep 2010	issued 200m new shares at HK\$0.75 each via a top-up placement
Nov 2009	established a level 1 ADR facility
Nov 2009	issued options (90m shares at HK\$0.73 each) to a consulting firm owned by Mr. Sun Yan, an independent third party, as incentive to consulting services
Sep 2009	issued 100m new shares at HK\$0.70 each via a top-up placement
Feb 2009	issued options (80m shares) under share option scheme
Feb 2009	issued options (60m shares at HK\$0.305 each) to Kingsway International as advisory fee
Nov 2008	issued HK\$10m convertible bonds with initial conversion price of HK\$0.05
Nov 2010	issued options (90m shares at HK\$1.32 each) to a consulting firm owned by Mr. Li Zhenguo and Ms. Jing Lihua, both independent third parties, as incentive to marketing services

Source: compiled by SBI E2-Capital

Table 5. Key financials

Year to Jun (HK\$ m)	09A	10A
Revenue	339.4	653.3
Gross profit	163.3	263.0
Operating profit	127.8	215.4
EBITDA	128.6	216.9
Net profit	110.7	181.0
EPS (HK\$)	0.113	0.106
Fixed assets	1.9	7.2
Inventories	4.0	2.9
Receivables	299.5	709.3
Payables	178.0	261.9
Cash	92.4	65.4
Short-term debt	0.0	0.0
Long-term debt	0.0	176.7
Shareholders' fund	477.0	1,058.0
Total equity	486.5	1,087.6
Net cash from operating activities	11.9	(103.0)
Net cash used in investing activities	17.1	(19.2)
Net cash from financing activities	39.7	94.4
Net change in cash and cash equivalents	68.7	(27.7)

Source: Company data

Table 6. P&L

Year to Dec (Rmbm)	09A	10A	3Q 10A	3Q 11A
Turnover	32.8	339.4	115.3	203.5
Cost of sales	(32.3)	(176.0)	(48.4)	(122.7)
Gross profit	0.5	163.3	67.0	80.9
Other income	10.1	11.6	0.0	17.8
Operating expenses	(16.1)	(47.1)	(8.6)	(18.9)
Selling and marketing expenses	-	(2.3)	(0.6)	(1.2)
Other expenses	(16.1)	(44.9)	(8.0)	(17.7)
Profit from operations	(5.5)	127.8	58.4	79.8
Gain on disposal of subsidiaries	-	0.5	-	-
Impairment loss on available-for-sale investments	(10.4)	(2.2)	-	-
Loss on disposal of available-for-sale investments	-	(0.8)	-	-
Finance costs	-	(2.0)	(3.8)	(3.8)
Profit before taxation	(15.8)	123.4	54.6	76.0
Taxation	-	(5.4)	(0.1)	(8.0)
Profit for the period	(15.8)	118.0	54.5	68.0
Attributable to:				
Owners of the Company	(15.8)	110.7	50.0	68.0
Non-controlling interests	-	7.3	4.4	-
EPS - Basic (HK\$)	(0.029)	0.113	0.033	0.027
EPS - Diluted (HK\$)	-	0.113	0.033	0.026

Source: Company data

Table 7. Shareholding structure (after exercise of all equity instruments)

Shareholders	Interest
Team Effort Investment Ltd	20%
Lomond Group Ltd	11%
Sandmartin	3%
Weatheme	1.4%
GEM	9.3%
Consultancy firm	2.7%
Others	53%
Total	100%

Source: Company data

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