

China Netcom Technology

Revolutionary lottery business structure

to summarize...

- Granted first ever in China, the license to privately operate "electronic lottery platform" gaming hall, Liaoning as the first testing spot
- First ever game type allows a high single bet and high payout with attractive jackpot plus 53% to 59% fixed payout
- Revolutionary business structure with 8% revenue share guaranteed by Welfare Lottery agreement, higher than listed equipments suppliers of ~1%
- Nationwide potential of expanding into other provinces besides Liaoning
- Extra funding serves to improve capital structure and open more lottery halls
- Unrealized upside at current market valuation of HK\$538m

Granted license to operate welfare lottery sales hall in Liaoning. In mid of May, China Netcom Technology (CNT) voluntarily announced that its first batch of lottery sales halls of "Happy 12" operated and managed by the company's controlled subsidiary were opened in Shenyang and Dalian, Liaoning Province. "Happy 12", introduced in Feb this year, is a quick-result lottery game in which people can pick at least one and up to eight numbers out of a total of twelve available numbers from 1 to 12 to form a bet and receive specific fixed payout ratio for each form of the bets. There are a total of 12 forms of betting which resemble theory of Mark Six, horse racing, Sci Bo (骰宝) and Roulette approved by related government bodies. Currently there are 3 centres in place and they were all granted operation license by Liaoning Province Welfare Lottery Issuing Centre (辽宁福利彩票发行中心) in Apr with name of the subsidiary and name of Chairman Mr Leung Ngai Man printed on it.

Revolutionary business structure and sound projected economics. Under CNT's model, lottery buyers are betting against the government. In practice, lottery buyers deposit cash at individual CNT halls and receive a security card which can log-on lottery terminals in the particular hall. With 53.0% to 58.7% expected payout ratio, statistically speaking individual hall is sufficient to cover cash requirement upon cash withdrawal by lottery buyers of the particular hall. While lottery results are centrally announced every 10 minutes, despite potentially win-and-loss of the government, CNT charges high percentage of 8% to 9% of dollar value in every bet. In addition to the pre-set payout, CNT plans to craft a portion of its sales and setup a jackpot for all qualified participants in competition on monthly basis. That said, if daily sales of a 40-terminal hall reaches RMB0.1m base on certain amount of cash deposit during the day, at 8% fee level, yearly turnover for CNT would be RMB2.9m, which could cover equipment depreciation, rental payment and staff cost up to RMB1.1m in a year before deducting jackpot contribution by CNT.

Listco focused on lottery business since 2010. In Aug 2010, the listco completed acquisition of 51% of Shenzhen Huancai Puda Technology from Mr Leung Ngai Man through a connected party transaction at HK\$2,112.5m, settled by HK\$67m cash, HK\$48m shares, HK\$1,200m promissory notes as well as HK\$797.5m CB. Later the subsidiary became wholly-owned at consideration of RMB73.5m with RMB10.8m cash and RMB62.7m common shares. Currently controlling shareholder and Chairman is Mr Leung Ngai Man at 35.4% shares before dilution. Mr Leung is also the Chairman of another listco Sino Prosper State Gold Resources (0766 HK).

Table 1. Shareholding structure of Harmonic Strait

Shareholder	Prior to CB conversion	Upon conversion at HK\$1.20
Leung Ngai Man	35.4%	39.3%
Public	64.6%	60.7%
Total	100.0%	100.0%

Source: HKEx

Ticker	8071 HK
Rating	Not Rated
Price (HK\$)	0.29
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.25 - 1.33
Market cap. (US\$m)	68.9
Daily t/o (US\$m)	0.1
Free float (%)	71.1

Financial summary

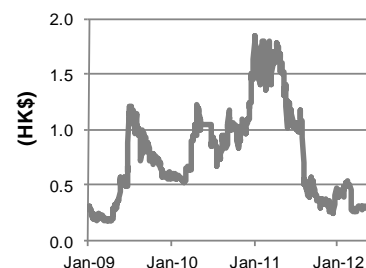
Year to Dec	10A	11A
Turnover (HK\$m)	2.58	2.01
Reported Net Profit (HK\$m)	(1887)	(619)
Reported EPS (HK\$)	(1.88)	(0.34)
Reported P/E (x)	n.a.	n.a.
P/B (x)	n.a.	n.a.
EV/EBITDA (x)	n.a.	n.a.
Yield (%)	0.00	0.00
ROE (%)	n.a.	n.a.
ROCE (%)	n.a.	n.a.
N. Gear. (%)	n.a.	n.a.

Source: SBI E2-Capital

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

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	10.3	(33.5)	(66.0)
Actual price changes (%)	0.0	(42.0)	(72.4)



Source: Bloomberg

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Liaoning a leading province in lottery sales with apparent marketable lottery sales up to RMB10b. Through 2000 to 2011, while growth rates were especially volatile in certain years, CAGR of lottery industry in China was as high as 25% to 26%. In particular, welfare lottery was larger in market size than sports lottery at RMB127.8b in 2011, compared to RMB93.8b of the latter. Table 2 shows total lottery sales in China in last 11 years. Of 31 provinces and area tracked by Ministry of Finance of PRC, Liaoning province achieved RMB6.3b and RMB3.6b welfare lottery and sports lottery sales which together ranked number 5 in China at RMB9.9b after Jiangsu, Guangdong, Shandong and Zhejiang. “Happy 12” operated and managed by the company is a challenging and rewarding lottery game, in our view. With potentially high reward and good gameplay experience, the reach of “Happy 12” may not be restricted to welfare lottery market in Liaoning. This quick-result lottery version of Lotto (乐透型) has essentially a current marketable size of RMB9.9b and may possibly stimulate further growth in Liaoning lottery market. Table 3 shows Liaoning and China lottery sales breakdown in 2011A, where lotto is the dominant form of lottery with 64% shares of China market in the year.

Table 2. Total lottery sales in China in last 11 years

RMBb	Welfare lottery sales	Total sports lottery sales	Total lottery sales
2000	10.7	7.4	18.1
2001	14.0	14.9	28.9
2002	16.9	21.7	38.6
2003	20.0	20.1	40.1
2004	22.7	15.4	38.1
2005	41.2	30.2	71.4
2006	49.6	32.3	81.9
2007	62.0	38.0	100.0
2008	60.3	45.6	105.9
2009	75.6	56.8	132.4
2010	96.8	69.5	166.3
2011	127.8	93.8	221.6
CAGR	25.2%	26.0%	25.6%

Table 3. Lottery sales breakdown in Liaoning and China 2011

RMBb	Liaoning 2011A	China 2011A
Welfare lottery	6.3	127.8
Lotto (乐透型)		90.7
China Welfare Lottery Online (中福在线)		17.0
Instant scratch card (即开型)		20.0
Sports lottery	3.6	93.8
Lotto (乐透型)		52.0
Single match game (竞猜型)		21.8
Instant scratch card (即开型)		20.0
Total	9.9	221.6

Source: Ministry of Finance of PRC

Revolutionary business structure. Lottery halls are under supervision of Ministry of Civil Affairs (民政部) and Ministry of Finance (财政部). Traditionally, private companies receive small fees such as 1%-3% of sales for providing equipments and technical supports to local welfare lottery issuance centres (地方福利彩票发行中心), which are the government bodies actually running the lottery halls. In practice, China Welfare Lottery Issuance and Administration Centre (中国福利彩票发行管理中心) and regional offices control the total number of halls in China. According to agreement with Liaoning Province Welfare Lottery Issuing Centre, CNT is entitled to setup “Happy 12” lottery halls with its own expansion plan. Upon matching the standards set by the authority, each of the halls would be granted separate license and CNT gains the right to operate the specified welfare lottery game. Ji Feng Qing, the ex-CEO of the acquired subsidiary Shenzhen Huancai Puda Technology, has been in the industry of lottery business operation in China since 1993 and led a team to develop “Happy 12” in recent years. With this strong team in lottery and IT, the subsidiary succeeded in getting approval from the government and introducing “Happy 12” to the market. As such, CNT is required to pay initial costs including equipment and other setup costs as well as bearing operating costs. In return, CNT receives income on revenue share basis between 8% and 9%. It represents a more direct involvement and higher exposure in China lottery market, in our view. Moreover, we believe “Happy 12” itself is challenging as well as rewarding.

Potentially high reward and good gameplay experience of “Happy 12” – how to play? “Happy 12” has 8 basic betting formats to form at least 12 different specific bets that pay different fixed rates. Magnifying a standard bet of RMB2 a bet to the maximum of 99 times, one single largest bet could pay as much as RMB153,450. Table 4 shows general gameplay formats and respective payout. In addition to fixed payout, the management targets to organize competition for “Happy 12”, which essentially asks participants to start from a certain amount of money and earns as much as they can until the end of a month. A certain number of participants ranking top of the list are set to receive jackpots, initially set at RMB300,000 for the champion. We believe gameplay experience and there is potentially attractive reward.

Table 4. Gameplay and reward ratio of “Happy 12” (excluding jackpot)

Frequency	Every 10 minutes			
Drawing outcome	Drawing 5 numbers out of "1 to 12", one at a time (drawn numbers never repeat)			
Bet size	RMB2 a bet (can be made 2-99 times)			
Basic betting format	Specific bet	Payout per winning bet	Expected payout per bet	
Choose 1 number	Chosen number is the first drawn number	14	1.167	
Choose 2 numbers	2 chosen numbers are all drawn in the 5 drawn numbers	7	1.061	
	2 chosen numbers are first 2 drawn numbers	77	1.167	
Choose 3 numbers	2 chosen numbers are first 2 drawn numbers in specified order	155	1.174	
	3 chosen numbers are all drawn in the 5 drawn numbers	25	1.136	
Choose 4 numbers	3 chosen numbers are first 3 drawn numbers	255	1.159	
	3 chosen numbers are first 3 drawn numbers in specified order	1550	1.174	
Choose 5 numbers	4 chosen numbers are all drawn in the 5 drawn numbers	115	1.162	
Choose 6 numbers	5 chosen numbers are the 5 drawn numbers	930	1.174	
Choose 7 numbers	All 5 drawn numbers can be found in the 6 chosen numbers	155	1.174	
Choose 8 numbers	All 5 drawn numbers can be found in the 7 chosen numbers	44	1.167	
Choose 9 numbers	All 5 drawn numbers can be found in the 8 chosen numbers	16	1.135	

Source: SBI E2-Capital

Photo set 1. Shenyang flagship sales hall (ground floor)



Photo set 2. Shenyang flagship sales hall (1st floor)



Source: Site visit

Preliminary return assessment of running a "Happy 12" sales hall. For Shenyang flagship lottery hall, CAPEX on equipment is counted at RMB880,000 for 44 machines with a unit cost of RMB20,000. On operation side, expenses include RMB40,000 staff cost and another RMB40,000 on other operating expenses a month. Total costs would be up to RMB80,000 a month. On the income side, we believe we can take references from comparative halls and similar welfare lottery sales launched Feb this year. According to our channel checks, there is a China Welfare Lottery Online sales hall near the Shenyang flagship with average daily lottery sales of RMB100,000. On the other hand, with 1,200 single-machine point of sales in Liaoning, a similar 11-choose-5 game records total daily sales of up to RMB8m. As such, we preliminarily assume daily sales of the flagship at RMB100,000 a day, which is equivalent to RMB3m a month. At 8% revenue share, monthly income of this illustration case is expected to be RMB240,000m. With a monthly pre-tax return of RMB160,000, an expected payback period should be less than 6 months. While there is a jackpot contribution of potentially 1%-2% of total sales and financing and tax effect on return, actual payback period may be between 6 to 12 months. Table 5 is a preliminary return assessment of running a "Happy 12" sales hall based on Shenyang flagship hall.

Table 5. Preliminary return assessment of running a "Happy 12" sales hall - Shenyang flagship case

RMB	Welfare lottery sales
Daily sales	100,000
Monthly income at 8% revenue share	240,000
Staff costs a month	40,000
Other depreciation and operating costs a month	40,000
Total expected cost a month	80,000
CAPEX - 44 machines (lifetime 6 years)	880,000
Expected payback (pre-tax)	5.5 months
Potential system-wide jackpot contribution	Beginning with RMB300,000 a month
Single hall contribution at 10 halls	360,000, or 1% of yearly sales

Source: SBI E2-Capital

Expansion plan and potential impact on profit and loss in short-term. By the end of May, CNT has 3 "Happy 12" lottery halls in operation. According to the management, by the end of year the company could provide sufficient capital and human resources to run 20 to 30 halls in Liaoning. Assume each hall is equipped with 30 machines at RMB20,000 each, initial CAPEX on equipment would be between RMB12m and 18m in 2012F, which does not represent heavy pressure on capital. In longer-term, with an average of 15 machines in each hall, the management expects to reasonably fully cover Liaoning province with 200 halls. Table 6 shows short-term expansion targets. With halls rolling out in 1-2 years, we have made a quick forecast on "Happy 12" segment based on 20-hall scenario and 100-hall scenario at full year impact. For the 2 scenarios, sales income at 8% revenue share will be RMB58.4m and RMB292.0m respectively; while segment profit before centralized cost, finance expense and tax charge would be RMB29.9m and RMB149.5m. In the forecast, with 100 halls we essentially assume "Happy 12" lottery sales is equivalent to 58% welfare lottery or 37% overall lottery sales in Liaoning in 2011A, which may not be especially conservative. Table 7 shows segment profit illustration for the 2 scenarios.

Table 6. Sales hall expansion targets in short-term

Average number of machines in a sales hall	15 units
Number of machines expected to cover Liaoning province	3,000 units
Expected number of sales halls in 1-2 years	200 halls
Short-term target (2012 year end) number of halls	20 to 30 halls

Table 7. Segment profit illustration for 20-hall and 100-hall scenario

RMBm	20 halls full year impact	100 halls full year impact
Average daily sales per hall	0.1	0.1
Total lottery sales per year	730	3,650
Revenue (at 8% revenue share)	58.4	292.0
Staff costs	(9.6)	(48.0)
Other depreciation and operating costs	(9.6)	(48.0)
Equipment depreciation (30 machines each hall; 6-years depreciation)	(2.0)	(10.0)
Jackpot contribution	(7.3)	(36.5)
"Happy 12" profit (before centralized cost, finance expense and tax charge)	29.9	149.5

Source: SBI E2-Capital

Historical financial summary. Table 8 and Table 9 shows balance sheet summary and selected profit and loss item for CNT. On the asset side, the company had total asset of RMB941.8m, including RMB728.5m other intangible asset and RMB161.5m cash. On the liability side, there was RMB79.9m CB and RMB577.7m promissory note on the book. Noted that, however, actual 0.15%-yield 5-year promissory note was outstanding at HK\$1,060m. In accordance to accounting rules, there was an annual non-cash interest of 17.35% based on the liability on the book until maturity, which would affect profit and loss in the 5 years. For instance, there was non-cash financing expenses on promissory note of RMB88.9m and RMB23.6m for 2011A and Q1 2012A respectively.

Table 8. Balance sheet summary

RMBm	FY12/09A	FY12/10A	FY12/11A
Non-current assets			
Property, plant and equipment	0.3	2.1	2.3
Goodwill	1,002.2	402.0	34.4
Other intangible assets	22.2	746.9	728.5
Other non-current assets	0.0	0.5	0.2
Current assets			
Inventories			0.5
Trade and other receivables	0.6	1.7	13.8
Cash and cash equivalents	11.4	348.2	161.5
Other current assets	0.2	0.7	0.7
Non-current liabilities			
Convertible bonds	0.0	90.9	79.9
Promissory notes	0.0	559.9	577.7
Deferred tax liabilities	0.0	125.9	118.5
Current liabilities			
Trade and bills payable	1.9	13.0	14.9
Other current liabilities	0.0	0.2	0.2
Equity			
Total equity	1,035.0	711.9	150.6
Shareholders' equity	1,033.1	401.0	(154.4)

Source: SBI E2-Capital

Table 9. Selected P&L items

HK\$m	FY12/10A	FY12/11A	Q1 FY12/12A
Revenue	2.6	2.0	0.7
Cost of goods sold	(2.1)	(1.9)	(0.6)
Gross profit	0.5	0.1	0.1
Other income and gains	0.3	11.3	0.7
Administrative expenses	(30.7)	(41.1)	(15.3)
Impairment loss of goodwill	(1,082.3)	(392.0)	(0)
Impairment loss of other intangible asset	(1,629.6)	(24.2)	(0)
Loss on early redemption of promissory note	(11.5)	(70.5)	(10.3)
Other operating expenses	(23.9)	(22.2)	(0)
EBIT	(2,777.1)	(538.6)	(24.8)
Interest expense on bank OD	(0.0)	(0.0)	(0.0)
Effective interest on CB	(11.3)	(14.9)	(2.8)
Effective interest on promissory note	(32.5)	(88.9)	(23.6)
Share of loss of an associate	(0.1)	(0.3)	(0.0)
EBT	(2,821.0)	(642.7)	(51.3)
Income tax expenses	237.4	3.1	1.3
Total profit from continuing operation	(2,583.6)	(639.5)	(50.0)
Net profit	(1,887.3)	(618.8)	(46.2)

Source: SBI E2-Capital

Our view and risk factors. With 3 halls official approved and actually came online, we believe policy risk and execution risk are somehow lowered and the economics is sound. We believe CNT may capture good market share and enjoy double-digit organic growth in Liaoning market. Besides, there is further upside by expanding to other provinces either by direct operation or other methods, subject to negotiation terms. Note that CNT was still loss-making in Q1 2012 as small number of lottery halls is just beginning to contribute revenue and profit this month. By end of 2011, CNT was with HK\$941.8m total asset while HK\$728.5m was intangible asset. Associating with HK\$1,060m outstanding promissory notes and HK\$144.1m CB at HK\$1.20 conversion price, negative net equity of CNT was HK\$154.4m by end of last year. CNT have to deal with capital structure and secure funding in order to realize "Happy 12" real potential.

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SELL : absolute downside of >10% over the next six months

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