

Launch Tech: Another leg to the booming sector

Recommendation: BUY (initiating coverage)

China Industrials

Price	HK\$2.12	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$3.09 (+45%)	Dec	RMBm	RMB	Δ %	x	x	%	%	%	%	
12 mth range	HK\$1.23-2.75	05A	37.1	0.071	(6.6)	29.9	3.3	15.3	1.8	11.0	7.8	19.3
Mkt.cap.(H shr)	US\$151.6m	06A	41.1	0.074	4.2	28.6	2.8	15.8	1.7	10.9	10.9	59.0
Daily t/o, 3 mth	US\$0.1m	07F	62.8	0.104	40.8	20.4	1.7	11.2	2.3	10.8	10.8	35.3
Free float %	42.9%	08F	86.4	0.143	37.6	14.8	1.2	8.1	3.2	9.4	9.4	20.9
Ticker	8196.HK/8196 HK	09F	113.5	0.188	31.4	11.3	0.9	6.3	4.2	8.8	8.8	12.6

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): 52.9%, 6.4%, -15.5%

Actual price changes (1 mth, 3 mth, 12 mth): 37.7%, 24.7%, 24.7%

Consensus EPS (07F-08F): RMB0.14, RMB0.16

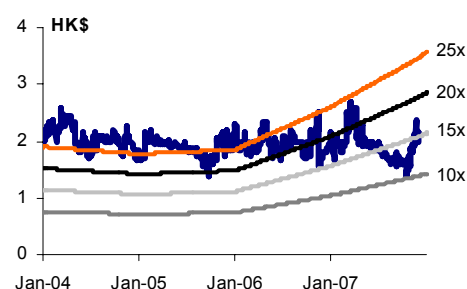
Key points:

- Niche player in the automotive aftermarket focused on China and overseas.
- To benefit from the growing second-hand market which is fuelling demand for diagnostic/testing equipment.
- Strong reputation of its core diagnostic product, X431 Electronic Eye.
- CRecorder to capitalize on the emerging DIY trend.
- Main board migration.
- Growth to come from: 1) booming automobile and automobile aftermarket; 2) second-hand market in China; 3) increasing 4S stores and maintenance stores in China; 4) DIY market and 5) new X431 and CRecorder.
- Initiate coverage with a BUY call, target price of HK\$3.09, representing 0.6x PEG or 21.7x FY12/08F P/E (on fully diluted basis). The counter is currently trading at 20.4x FY12/07F P/E and 14.9x FY12/08F P/E.

Company background. Founded in 1992, Launch Tech is a niche player in the automotive aftermarket, providing a range of automobile diagnostic, automobile equipment such as wheel aligner, tyre changer and injector cleaner and automobile lifts. Headquartered in Shenzhen, Launch has two production facilities – Shenzhen and Shanghai. The 50,000sqm Shenzhen plant focuses on the production of automobile diagnostic devices, maintenance and tire equipment. The current production capacity for diagnostic devices, maintenance and tire equipment is 3,000 units, 500 units and 900 units per month respectively. The Shanghai plant, the largest in Asia, produces automobile lifts (two-post, four-post and scissor) and has a total production capacity of 21,000 units.

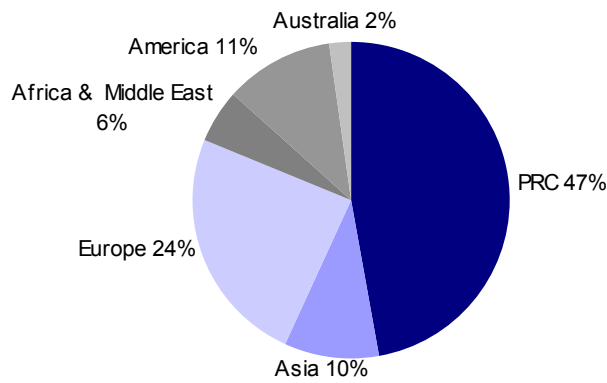
Domestic and overseas market coverage. Launch sells its products to automobile services centers (such as 4S or independent workshops) and end users through a network of 11 sub companies with sales offices in 65 cities in China. It also deals with many workshops with 600 sales and service staff. The company's 15 offices covering North America, South America, Europe, Asia Pacific, Middle East and Africa serve its 600 overseas clients. Domestic sales currently account for 47.1% and the remainder comes from overseas. The company currently has about 80.0% of the domestic market and 5.0% of the global market.

Chart 1: P/E bands



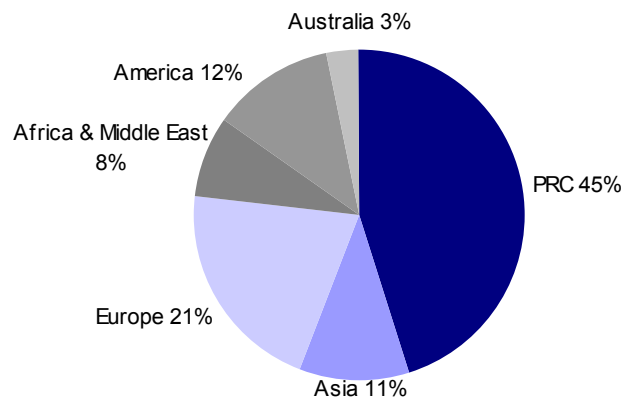
Source: SBI E2-Capital

Chart 2: Sales by region in 2006



Source: Company data

Chart 3: Sales by region in 2005



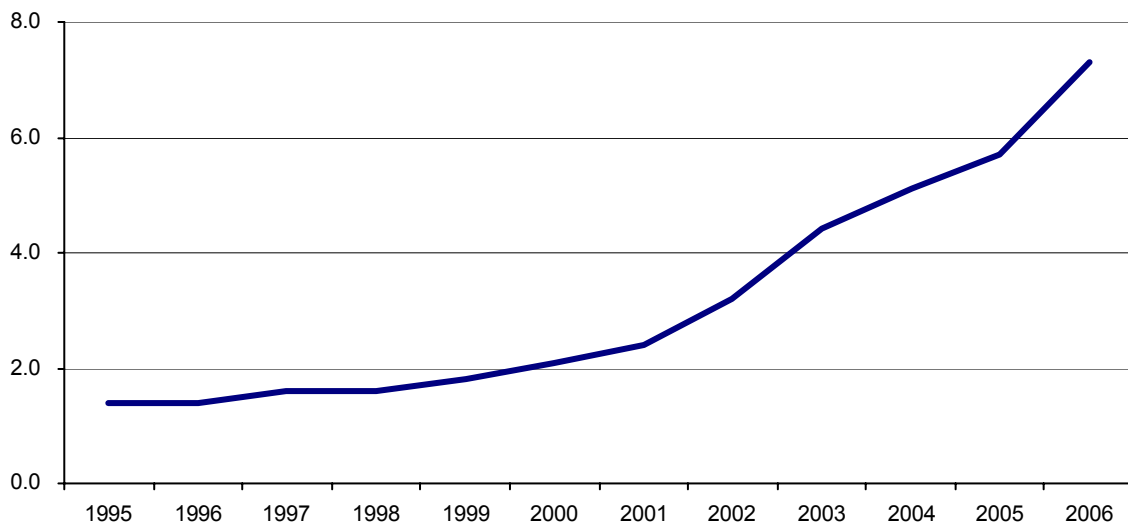
Source: Company data

Table 1: Vehicle production

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total global vehicle output (m)	50.7	52.2	54.9	52.9	56.3	59.8	57.7	60.3	62.0	62.7
YoY (%)	1.2	3.0	5.2	(3.6)	6.4	6.2	(3.5)	4.5	2.8	1.1
Total Chinese vehicle output (m)	1.4	1.4	1.6	1.6	1.8	2.1	2.4	3.2	4.4	5.1
YoY (%)	7.1	1.1	8.8	2.5	14.3	13.2	14.0	38.3	34.0	16.2
% China's share in global output	2.8	2.8	2.8	3.0	3.3	3.5	4.1	5.4	7.1	8.1

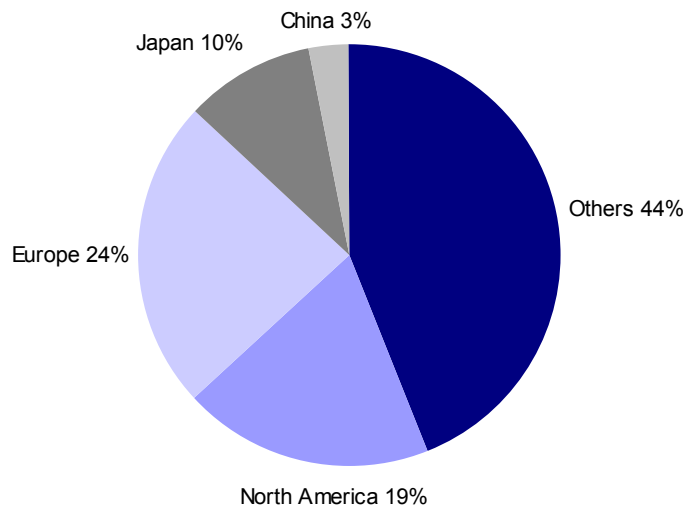
Source: Economist Intelligence Unit; Autopolis

Chart 4: China's 2006 automobile output



Source: Economist Intelligent Unit, CCID Consulting

Enormous growth potential in China. According to CCID Consulting, China's 2006 automobile output reached 7.3m units (up 27.3% YoY) and sales volume 7.2m units (up 25.1% YoY), making the country the world's third largest carmaker. According to the China Automobile Industry Association, the country's total car output is expected to reach 8.5m units in 2007, up 16.4% YoY. As a result, automobile services, such as maintenance and diagnostics, will also become new investment hotspots fuelling demand for aftermarket services and diagnostic equipment and benefiting Launch.

Chart 5: Global automotive aftermarket

Source: Frost & Sullivan, company data

Booming global automobile aftermarket. According to the 2007-2008 World Motor Vehicle, there were 789.8m vehicles in the world in 2005, up 7.1% from 2004. In the US, the after-sales service industry is called a “golden industry” with an annual production value of US\$140b, or more than c.50.0% of the country’s automobile market. In Europe, the automotive aftermarket is the main source of profit for the car industry. Driven by a shift towards technician handheld systems and rising demand for routine maintenance, we expect the sale of automobile diagnostic devices to rise significantly.

Increasing demand for after-sale services. China’s roaring automobile market has created a booming after sales market and demand for related services such as 3S and 4S (sales, spare parts, services and survey). As Chinese consumers become more aware of their consumer rights, they demand better and more comprehensive aftermarket service. Currently, the country has about 300,000 registered automobile maintenance enterprises/workshops. This enormous business opportunity has attracted foreign investors, who team up with local counterparts to invest in China. According to Freedonia’s research report, China’s automobile aftermarket is expected to grow 13.8% annually through to 2009. The overall automotive aftermarket is still immature and about to enter a period of fast growth, fuelling demand for after-sale services and automobile diagnostic devices.

Second-hand automobile business on the upswing. The second-hand automobile market in China is gaining prominence, as more car owners replace their cars or want to own a few cheaper cars. According to the Ministry of Commerce (MOC), about 1.9m second-hand cars were traded in 2006, up 31.5% YoY, representing about c.30.0% of production and sales of new automobiles, compared with up to three times of all new car transactions in developed countries. As sources of second-hand vehicle are enlarging, we believe the car replacement is on the upward trend. The MOC expects second hand transactions to top 5.3m in 2008. The rising car replacement trend will fuel demand for aftermarket accessories, performance parts and diagnostic equipment used by dealers to test second-hand cars before collection.

X431 Electronic Eye. Launch’s core revenue generator, X431 Electronic Eye is a scan tool that performs vehicle diagnosis, which covers engine analyzer, signal simulator and automotive database. In FY12/06A, X41 Electronic Eye accounted for 47.5% of the total sales. X431’s key five major functions are:

- ❑ **Vehicle diagnosis** - wireless diagnosis for electronic control systems of most models;
- ❑ **Engine ignition analysis** - displays engine primary and secondary ignition waveform with single-cylinder, raster, parade, bar pattern etc. The unique multi-cylinders synchronization simulation technology enables efficient and convenient testing;
- ❑ **Vehicle service database** – provides detailed information including electronic system and circuit diagrams; accurate location of electronic components and details of the connection principle; displays colour graphics on screen;
- ❑ **Vehicle oscilloscope** - adopts a maximal sampling frequency of 20MHz to test the output waveform of various sensor/ actuator available and analyses faults of sensor/actuator and
- ❑ **Sensor simulation and test** - simulates DC voltage signal, impulse signal, sensor standard waveform signal and hand-drawn waveform and simulates sensor standard waveform for the confirmation of sensor troubles.

Good brand name. Since the initial launch in 2003, the company has developed five X431 diagnostic models and won numerous awards, establishing its strong brand name.

Table 2: Awards

Year	Description
2007	X431 INFINITE was selected as one of the Top Twenty Maintenance Tools in China by an authoritative journal
2006	X431 was rated the Top Product of the Year 2005 by the Professional Motor Mechanic Magazine
2005	X431 diagnostic computer won 2005 Torch Project certification X431 diagnostic computer won third prize for technical advancement in Shenzhen
2004	X431 won first rating in kft-Meister Service appraisal X431 was ranked among one of the Top Twenty Service Tools of the year X431 diagnostic computer won 2004 Torch Project certification X431 was ranked No. 1 scan tool in the automotive aftermarket competition in Holland

Source: Company data

Strong sales of X431 expected in 2H07. In 1H FY12/07A, Launch sold 10,000 units of X431 Electronic Eye (55.0% overseas and the rest in China), up from 9,500 in 1H FY12/06A, contributing 46.0% of total turnover. Strong sales are expected in 2H07, given new orders from the US, Japan and China. A new X431 series is in the pipeline and will be launched in Apr 2008, targeting at professional technicians. The company said its old series X431 Electronic Eye remained the bestseller, reinforcing its competitiveness strength. We expect the ASP for X431 to remain stable.

DIY popularity in the US used vehicle market. As petrol prices continue to rise and people are getting more environmental friendly, car owners are holding onto their cars longer, which will increase the need for routine maintenance and to save costs many will perform the task themselves. Besides, these days more people start to own cars at the younger age with less financial ability. Thus, to save the costs of owning a car, younger generation car owners will perform routine maintenance by themselves. To capitalize on this emerging trend, Launch is developing a comprehensive, consumer-focused product line targeted at DIY doers and automobile enthusiasts.

New product - CRecorder. In 1H07, the company invented first personal CRecorder for the global automobile DIY market. The small device is equipped with memory for recording different parameters such as speed, direction and driving condition. Though an USB interface and end-user software, users can connect their CRecorder to the company's servers and have the readings analyzed. Launch offers two types of reports, basic Class 1 (free of charge) and Class 2 (more comprehensive, costing about US\$15.0). Currently, the reports are available in English only but the company will start to provide a Japanese version soon.

To be as popular as Creader. Launch has so far distributed 20,000 units of free CRecorder to US users and 500 units in Hong Kong and Shenzhen on a trial basis, with no fee charged until end-2007. The company said that since the rollout of CRecorder, orders from the US and Japan have been encouraging. We are confident that the product will be as well received in the US as Creader, which offers similar features and sold 30,000 units last year. We believe that besides the US, Japan is a huge potential market because Japanese users are attracted to high-tech products.

Automobile lift business. In 1H FY12/07A, the company sold 7,500 car lifts, up from 6,000 1H FY12/06A, accounting for 24.0% of the total turnover. The company has indicated it may dispose of this underutilized (capacity of 21,000 units) and thin-margin non-core business in the future.

3Q FY12/07A results. Turnover rose 26.0% YoY to about RMB316.1m and net profit 24.9% to RMB51.0m. In the Jan-Sep period, the sales of X431 were satisfactory and totaled around 17,000 units, with about half exported overseas. The lift business also experienced satisfactory growth and achieved the set target of over 10,000 units.

Table 3: 3Q FY12/07A results

Nine months to Sept	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	EPS (RMB)	DPS (RMB)
3Q FY06	250.9	129.7	51.7	43.6	6.2	40.9	0.074	-
3Q FY07	316.1	148.7	47.0	51.0	-	51.0	0.091	-
YoY (%)	26.0	14.7		16.9		24.7	23.0	-

Source: Company data

Main board migration and A-share listing. Launch plans to withdraw from the GEM board and list on the Main Board in 2008 to raise its profile and increase the liquidity of the shares. If successful, the move will boost its image and recognition benefiting its future growth and development. Launch also intends to A-share listing after the company has successfully list on the Main Board next year. We are not certain about the time frame yet

but if successful, the move does not only boost the liquidity of shares but also secure sufficient capital to fund the company's future expansion plan.

New H share placement. In 17 Nov 2007, Launch placed 45.6m shares at the subscription price of HK\$1.63 each to Templeton. The subscription shares represent c. 20.0% of its existing H share capital and c.8.2% of its total existing issued share capital. The gross proceeds of HK\$74.3m will be used to build Phase II of its lift plant in Shanghai (HK\$34.5m), replace machinery at its Shenzhen plant (HK\$13.6m), for R&D of new products (HK\$10.2m, to develop overseas marketing channels and loan repayment.

Forecast. We expect Launch to grow organically though increasing orders from new customers in FY12/07F, with X431 Electronic Eye remaining its core-earning driver and the lift business' contribution declining. We project the net profit should rise from HK\$41.1m to HK\$62.8m, representing an increase of 52.7%. In FY12/08F, with additional contribution from CRecorder and new X431 Electronic Eye series, earnings should increase to HK\$85.8m. The automobile diagnostic business will account for the bulk of the growth and its increasing contribution will widen the gross margin. We project the sales of X431 will increase 41.0% to 22,000 units in FY12/07F and 31.8% to 29,000 in FY12/08F.

Corporate governance. Launch was listed on GEM in Oct 2002. The company replaced its auditor Deloitte with Grand Thornton in 2005. Its major shareholder, Lin Xin and Liu Jun, hold 23.0%, McCarthy Kent C. 20.2%, Templeton 7.6% and IFC 6.3%. Public shareholders account for 42.9%.

Initiating coverage with BUY call, target price of HK\$3.09. We initiate coverage on Launch with a BUY call and a target price of HK\$3.09, representing 0.6x PEG, comparing with peers' average PEG of 1.3x. We believe the company is operating in an attractive market, set to expand as car maintenance becomes more complicated and diagnosis equipment essential. Its growth will be fuelled by: 1) the booming automobile industry and automobile aftermarket; 2) second-hand market in China; 3) increasing number of 4S and maintenance stores in China 4) DIY market. With its innovative products, we believe Launch is well positioned to take advantage of new trends in the car market. Based on the target price, the counter is trading at 21.7x FY12/08F P/E (on a fully diluted basis). We have applied a 50.0% valuation discount to comparables given Launch's smaller liquidity and market capitalization. The valuation of this counter looks appealing, trading at 20.4x FY12/07F P/E and 14.8x FY12/08F P/E or PEG of 0.4x,

Risk. 1) Counterfeiting; 2) RMB appreciation and 3) execution risks.

Table 4: Peer comparison

Company name	Ticker	Market Cap (US\$m)	P/E (x)			ROA (%)	ROE (%)
			Historical	Current	1-yr forward		
Bosch Corporation	6041 JP	2,341.5	11.8	13.9	14.5	8.6	14.3
Autobacs	9832 JP	799.6	9.3	19.8	14.9	3.9	5.6
Snap-On Inc	SNA US	2,721.6	28.0	15.4	13.3	4.3	9.8
3M Co.	MMM US	57,771.6	16.0	16.3	14.9	18.4	37.8
Stanley Works	SWK US	4,090.1	14.4	12.4	11.0	7.7	19.3
SPX Corporation	SPW US	5,083.9	34.3	20.3	16.1	3.2	8.1
<i>Average</i>			<i>19.0</i>	<i>16.4</i>	<i>14.1</i>		

Source: Bloomberg, SBI E2-Capital

Table 5: P&L

Year end Dec (RMBm)	05A	06A	07F	08F	09F
Turnover					
Automobile diagnostic devices and other equipments	293.6	231.2	352.4	502.3	665.1
Automobile lift	49.0	73.0	99.4	125.6	165.9
	342.6	304.2	451.7	627.9	831.0
Cost of sales	(190.2)	(141.3)	(208.1)	(286.9)	(383.6)
Gross profit	152.4	162.9	243.6	341.1	447.4
Other income	38.2	19.8	19.8	19.8	19.8
Selling expenses	(69.5)	(64.9)	(96.4)	(134.0)	(177.3)
Administrative expenses	(44.9)	(37.7)	(56.0)	(77.8)	(103.0)
R&D expenses	(8.5)	(12.9)	(16.8)	(21.8)	(28.3)
Loss on disposal of assets	-	(7.8)	-	-	-
Write off of payment for other investment	-	(5.4)	-	-	-
Other operating expenses	(17.2)	(2.1)	(19.1)	(19.1)	(19.1)
Finance costs	(8.4)	(11.1)	(8.1)	(7.3)	(6.6)
Share of result of an associate	-	-	(1.0)	-	-
Before tax profit	41.2	39.1	67.9	101.6	133.6
Tax	(4.1)	2.0	(5.1)	(15.2)	(20.0)
Profit of the year	37.1	41.1	62.8	86.4	113.5
Minority interest	(0.0)	-	-	-	-
Net profit	37.1	41.1	62.8	86.4	113.5

Source: SBI E2-Capital

P & L (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	342.6	304.2	451.7	627.9	831.0
% chg	23.4	(11.2)	48.5	39.0	32.3
Gross profit	152.4	162.9	243.6	341.1	447.4
EBITDA	72.4	74.3	113.6	159.2	203.6
Depre./amort.	(20.1)	(26.1)	(38.5)	(51.1)	(64.1)
EBIT	52.3	48.2	75.2	108.2	139.5
Net int. income/(exp.)	(11.1)	(8.1)	(7.3)	(6.6)	(5.9)
Exceptionals	-	-	-	-	-
Associates	-	(1.0)	-	-	-
Jointly-controlled entit.	-	0.0	-	-	-
Pre-tax profit	41.2	39.1	67.9	101.6	133.6
Tax	(4.1)	2.0	(5.1)	(15.2)	(20.0)
Minority interests	(0.0)	-	-	-	-
Net profit	37.1	41.1	62.8	86.4	113.5
% chg	(6.3)	10.8	52.7	37.6	31.4
Dividends	(19.5)	(19.5)	(29.8)	(41.0)	(53.9)
Retained earnings	17.6	21.6	33.0	45.4	59.7
EPS (RMB) - Basic	0.071	0.074	0.113	0.155	0.204
EPS (RMB) - F.D.	na	na	0.104	0.143	0.188
DPS (RMB)	0.037	0.035	0.049	0.068	0.089
No. sh.s o/s (m) - W.A.	522.5	555.4	557.1	557.1	557.1
No. sh.s o/s (m) - Y.E.	522.5	555.4	602.7	602.7	602.7
No. sh.s o/s (m) - F.D.	na	na	602.7	602.7	602.7
Margins (%)					
Gross	44.5	53.6	53.9	54.3	53.8
EBITDA	21.1	24.4	25.2	25.4	24.5
EBIT	15.3	15.8	16.6	17.2	16.8
Pre-tax	12.0	12.9	15.0	16.2	16.1
Net	10.8	13.5	13.9	13.8	13.7
Balance Sheet (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	94.5	215.5	339.4	454.4	561.1
Intangible assets	2.6	3.7	5.2	7.3	10.2
Other LT assets	65.3	70.4	85.9	104.8	129.1
Cash	90.0	45.2	36.8	7.2	1.7
Accounts receivable	195.3	233.8	347.2	482.6	638.7
Other receivables	84.7	105.6	156.8	218.0	288.5
Inventories	69.3	82.2	122.1	169.7	224.6
Due from related co.s	0.7	1.3	1.3	1.3	1.3
Other current assets	12.4	20.8	27.8	38.4	51.3
Total assets	614.8	778.5	1,122.5	1,483.5	1,906.4
Accounts payable	(70.9)	(68.1)	(100.3)	(138.3)	(184.9)
Other payable	(16.9)	(16.5)	(24.3)	(33.5)	(44.8)
Tax payable	(4.3)	(0.4)	(7.4)	(11.2)	(15.5)
Due to related co.s	-	-	-	-	-
ST debts	(155.2)	(173.3)	(156.0)	(124.8)	(99.8)
Other current liab.	(30.0)	(6.3)	(9.3)	(12.8)	(17.1)
LT debts	-	(95.0)	(85.5)	(73.8)	(63.9)
Other LT liabilities	-	-	-	-	-
Total liabilities	(277.3)	(359.6)	(382.8)	(394.3)	(426.0)
Share capital	52.0	55.8	55.8	55.8	55.8
Reserves	285.5	363.3	683.9	1,033.3	1,424.6
Shareholders' funds	337.5	419.1	739.7	1,089.1	1,480.4
Minority interest	-	-	-	-	-
Total	337.5	419.1	739.7	1,089.1	1,480.4
Capital employed	492.7	687.4	981.2	1,287.7	1,644.1
Net (debt)/cash	(65.2)	(223.1)	(204.7)	(191.4)	(162.0)
Cash Flow (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	52.3	48.2	75.2	108.2	139.5
Depre./amort.	20.1	26.1	38.5	51.1	64.1
Net int. paid	(11.1)	(8.1)	(7.3)	(6.6)	(5.9)
Tax paid	(9.1)	(1.9)	(1.6)	(2.4)	(3.3)
Dividends received	-	-	-	-	-
Gross cashflow	95.1	81.6	116.4	158.1	202.4
Chgs. in working cap.	282.2	125.0	145.0	167.9	188.1
Operating cashflow	(187.1)	(43.4)	(28.6)	(9.8)	(14.3)
Capex	(137.6)	(150.0)	(150.0)	(150.0)	(150.0)
Free cashflow	(324.7)	(193.4)	(178.6)	(159.8)	(164.3)
Dividends paid	(18.2)	(18.2)	(18.2)	(18.2)	(18.2)
Net distribution to MI	-	-	-	-	-
Investments	(30.2)	(141.3)	(83.2)	(58.1)	(98.9)
Disposals	2.6	3.4	2.9	2.9	2.9
New shares	-	67.2	70.0	-	-
Others	264.5	124.4	225.5	246.5	307.9
Net cashflow	(106.0)	(157.9)	18.4	13.3	29.4
Net (debt)/cash - Beg.	40.8	(65.2)	(223.1)	(204.7)	(191.4)
Net (debt)/cash - End.	(65.2)	(223.1)	(204.7)	(191.4)	(162.0)
Interim Results (RMBm)	05A	06A	07A		
Six months to Jun					
Turnover	158.9	159.1	202.8		
% chg	14.5	0.1	27.5		
Profit from operations	40.1	36.9	42.7		
Interest expenses	(7.7)	(6.9)	(9.0)		
Associates	-	-	-		
Jointly-controlled entit.	-	-	-		
Pre-tax profit	32.4	29.9	33.3		
Tax	(3.8)	(1.8)	-		
Minority interests	0.0	-	-		
Net profit	28.6	28.2	33.3		
% chg	50.5	(1.4)	18.1		
EPS (RMB) - Basic	0.055	0.051	0.060		
DPS (RMB)	-	-	-		
Shareholding Structure					
				Shares o/s (m)	%
Liu Xin and Liu Jun				138.8	23.0
Mc Carthy Kent				121.9	20.2
Templeton				45.9	7.6
IFC				38.0	6.3
Public				258.9	42.9
Total				603.6	100.0
Background					
Launch Tech is a niche player in automotive aftermarket. It engaged in manufacturing and distributing automotive diagnostic devices, automobile equipment such as wheel aligner and automobile lift. Headquarter in Shenzhen, Launch has two production facilities - Shanghai and Shenzhen. The company's flagship product is a handheld diagnostic devices, knowns as X431 Electronic Eye.					
Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	19.3	59.0	35.3	20.9	12.6
Net ROE (%)	11.0	10.9	10.8	9.4	8.8
EBIT ROCE (%)	10.6	8.2	9.0	9.5	9.5
Dividend payout (%)	52.6	47.4	47.4	47.4	47.4
Effective tax rate (%)	10.0	(5.1)	7.5	15.0	15.0
Net interest coverage (x)	4.7	6.0	10.3	16.5	23.6
A/R turnover (days)	208.1	257.4	234.7	241.2	246.2
A/P turnover (days)	75.5	83.4	68.0	69.3	71.0
Stock turnover (days)	133.0	195.7	179.1	185.6	187.5

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HOLD : absolute return of -10% to +10% over the next six months

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

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