

The push is on

China Media

GDC (8271 HK, HK\$2.90)

Not Rated

Top up placement to raise proceeds. GDC announced that on 4 Jul 2007, it placed 72.0m shares at a placing price of HK\$2.70 per share. The placing price represented approximately 6.9% discount to the last closing price of HK\$2.90. The placing shares represent 5.98% of the existing share capital and 5.64% of the enlarged share capital. On completion of the placement, GDC's largest shareholder, Shougang Grand (730 HK, HK\$0.88, NR) will have its majority stake diluted to 51.49% (from 54.57%). The placement will raise net proceeds of HK\$188.0m for the company, which will be used to deploy digital cinema distribution systems to facilitate its roll out of the digital cinema network operations in China.

Little known CEPA beneficiary. It is often overlooked that GDC is a beneficiary of CEPA. From 1 Jul 2007, the company will be able to receive exemption the current 14.0% import duty on import of its digital cinema distribution servers into China. To take advantage of this situation, the company will integrate the projectors, sourced from Belgium company Barco, into its server units to be imported into the Mainland as an integrated unit. Otherwise, the Barco projectors would be subject to import duties. Barco is a world leader in display and visualization solutions, offering digital cinema solutions from digital mastering to premier quality feature film screenings. In the digital cinema market, Barco is one of only three licenses of the Texas Instruments DLP Cinema technology.

Deployment of digital cinema network operations now ramping up. After signing the cinema JV agreement with China Film Group (CFG) in Jun 2007 (through Shougang Grand), the company now has the mandate to deploy and operate its digital cinema systems in the top 2,000 screens in China. Note that the rights to the JV will be fully transferred from Shougang to GDC once all the legal entities have been fully set up. Based on our discussions with the management, as well as our channel checks, GDC is scheduling to install 6 sets of systems in Jul, followed by 50 sets in August, with an aim to install around 700 sets by the end of the year. This is achievable given that it only takes 2 engineers around one day to install each set in an existing cinema complex. The time can be further accelerated if it is installed as part of a construction of a new cinema complex. The company has already locked in the supply of the 700 sets of projectors from Barco. In our view, the largest executing risk remains the signing of the agreements with the respective cinema operators. This requires CFG to take the lead, though being a stakeholder in the JV, the interests have been aligned.

After trial period, GDC has emerged as the default supplier in China. Similar to the overall movie industry, CFG has been trialing digital cinema systems in China since around 2002. From an initial 4 suppliers, it has now dwindled to 2 (one of which is GDC). With GDC now in a JV with CFG, the company has emerged as the defacto monopoly supplier of digital cinema systems on the Mainland. According to our channel checks, GDC has an estimated 90% market share in China.

China cinema box office is a lucrative space. As we have previously mentioned in "Emerging leader of China cinema" (15 May 2007), the China's cinema box office is growing at around 30.0% annually. In 2006, total box office receipts totaled RMB2.6b according to SARFT. Interestingly, ticket prices in China is not low. In general, ticket prices is around RMB60-80 compared to HK\$50-70 in Hong Kong. This makes the cinema platform the perfect vehicle to tap China's young spenders and emerging middle class consumers.

Leveraging leading position to conquer Hollywood. With the DCI digital cinema standard formally ratified by major Hollywood studios, the scene is set for the industry's transition into the digital era. We believe that GDC can leverage its leading market share in Asia, and technology prowess to capture this emerging opportunity. The company has a technology edge as it was: 1) World's first server provider to upgrade to DCI MXF format (Jul 2005) and 2) one of only three digital cinema equipment providers to meet full DCI compliance (Mar 2007).

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As a testament to its strength, GDC's current installed base in North America presently includes the famous Graumans Chinese Theatre in Los Angeles, as well as Mann Glendale Market Place and Pacific Sherman Oaks cinema complexes in the US. The company's systems are also installed in various cinema complexes in Korea, Netherlands, Hong Kong, Singapore and India.

Digital cinema standard can deter piracy. The digital cinema solution offered by GDC can deter piracy. The measures include: 1) coding encryption; 2) forensic marking and 3) control on number of times the movie is played and the period for which it can be played. Furthermore, it is our understanding that the refresh rate of the screen is slightly different from standard consumer video equipment, which means that any pirated material will suffer from a significant deterioration in quality.

Unique play in the technology/media space. GDC is a unique play with its synergistic business segments (digital cinema network operations, digital cinema solutions provider, CG animation and CG animation training). This combination allows the company to tap several emerging trends and industries including: 1) growing box office in China; 2) emerging middle class consumers in China; 3) worldwide roll out of digital cinema systems and 4) increasing CG outsourcing by North American studios to low cost countries such as China. This should command a valuation premium in the market. The company is currently trading at 27.1x FY12/08F P/E (fully diluted including the top up placing shares), based on our preliminary FY12/08F net profit estimate of HK\$139.8m. Our preliminary estimate is on the conservative side as it has yet to take into consideration any contribution from advertising revenue.

Table 7: P&L

Year to Dec (HK\$m)	04A	05A	06A	1Q06A	1Q07A
Turnover	50.0	32.2	54.9	8.6	19.7
Cost of sales	(35.3)	(34.8)	(30.1)	(5.1)	(7.5)
Allowance for production work in progress	(84.6)	(24.7)	-	-	-
Gross profit	71.9	(27.4)	24.8	(3.6)	12.2
Other income and gains	0.1	0.6	1.1	0.2	7.6
Selling and distribution costs	(4.2)	(2.0)	(6.5)	(2.3)	(1.9)
Administrative expenses	(34.7)	(37.4)	(38.4)	(8.9)	(9.8)
Impairment losses recognized in respect of PPE	(14.9)	(2.4)	-	-	-
Finance costs	(5.5)	(7.7)	(13.1)	(2.8)	(2.4)
Exceptionals	-	-	1.8	-	40.3
Profit/(loss) before taxation	(131.2)	(76.2)	(30.2)	(10.2)	45.9
Taxation	-	(0.2)	-	-	-
Profit/(loss) after tax	(131.2)	(76.4)	(30.2)	(10.2)	45.9
Minority interests	-	-	-	-	(0.9)
Profit/(loss) attributable to shareholders	(131.2)	(76.4)	(30.2)	(10.2)	45.1
% chg	n/a	41.8	60.5	n/a	n/a
Dividends	-	-	-	-	-

Source: Company data

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the sole bookrunner and placing agent for the GDC top-up placement of 72.0m shares at HK\$2.70 per share on 4 July 2007.