

**Industry transition begins****China Internet****TOM Online (8282 HK, HK\$1.06)****Not Rated****2Q FY12/06 results at low end of expectations**

- ❑ 2Q FY12/06 revenues rose 3.1% QoQ to US\$50.1m while net profit came in at US\$11.8m, down 3.2% QoQ. The results were at the low end of our expectations. Wireless value added services (WVAS) revenues were up 0.5% QoQ to US\$45.7m.
- ❑ The main difference on our estimates was the gross margin. WVAS gross margin dropped 4.4 pcp QoQ to 35.3%, mainly due to increased content costs during the World Cup period.
- ❑ World Cup had a strong positive effect on short messaging services (SMS) revenues, which increased 8.7% QoQ to US\$19.0m. Colour ringback tones (CRBT) revenue was also strong, up 31.4% QoQ to US\$3.2m. However, continuous user clean-up hurt wireless access protocol (WAP) revenues, which contracted 14.7% QoQ to US\$6.7m.
- ❑ Online advertising was the main surprise. Driven by enlarging customer base and the World Cup, online revenues surged 43.9% QoQ or 111.7% YoY to US\$3.9m. At the end of 2Q, online advertising accounted for 7.8% of total revenues, up from 5.6% in 1Q. Segment gross margin rose to 69.9% from 65.5% in the previous quarter.
- ❑ TOMO did well in controlling opex in 2Q FY12/06. Including a management bonus accrual reversal of US\$0.7m, opex totalled US\$8.0m. A 36.3% QoQ rise in selling expenses (US\$2.0m) was offset by a 25.5% QoQ reduction in G&A costs (US\$5.4m). The G&A cost reduction would have been 15.5% if the management bonus reversal was excluded.

**Summary of new policies.** New mobile operator policies that will have impact on TOMO's earnings going forward include: 1) conversion of subscriptions from per-message to per-month, 2) double confirmation for new subscriptions, 3) one month trial period, 4) one time subscription reminders to existing subscribers and 5) temporary limitations on cross selling activities in order to coordinate with MII/China Mobile (941 HK, HK\$51.55, NR) to achieve industry clean up. Several policies (items 3, 4, & 5) will be reviewed by MII in the coming months. Management has indicated that MII might withdraw the cross selling limitation (item 5) in Sep 2006.

**Key strength temporarily compromised.** TOMO's key strength is its extensive network of multi-platform distribution channels (400+) such as television, radio and print. In our view, the temporary limitation on cross selling activities is the most restrictive to TOMO's operations, as it will affect its ability to maintain the current subscriber base and acquire new subscribers.

**Mitigating initiatives will take time.** TOMO has already started introducing more "usage based" products such as WAP and IVR services. It has also taken advantage of the longer free trial period by expanding its CRM database and is also exploring alternative revenue streams such as mobile advertising. Meanwhile, the monetization of Skype through banner ads is behind schedule by about one month due to coordination activities with Skype's parent company. Skype now expects to generate advertising revenues over the next 1 to 2 quarters. While these initiatives show management's proactive approach, positive effects will take some time to filter through and hence unable to arrest its expected revenue decline over the coming quarters.

**Scaling back capex.** Similar to other service providers (SPs) such as Sina and Sohu, TOMO will be scaling back investment until the regulatory environment clears up. Management plans to suspend capex investment in 4Q 2006 and 1Q 2007.

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. If you would like to access our research reports and know more about our services, please contact Raymond Jook, Head of Research, on (852) 2533 3715 or [raymondjook@softbank.com.hk](mailto:raymondjook@softbank.com.hk). Find our research on: [sbie2capital.com](http://sbie2capital.com), [thomsononeanalytics.com](http://thomsononeanalytics.com) and [multex.com](http://multex.com)

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other primary businesses with the companies in this report.

**Analyst certification:** the views expressed in this report accurately reflects the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

**Disclaimer:** the information and opinions in this report were prepared by SBI E2-Capital Securities Limited. SBI E2-Capital Securities Limited does not undertake to advise you of changes in its opinion or information. SBI E2-Capital Securities Limited and others associated with it may have positions in and effect transactions in securities of companies mentioned and may also perform or seek to perform investment banking services for those companies. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell the securities mentioned.

**Difficult quarters ahead.** We expect significant deterioration of TOMO's financials over the next two quarters as each province implements the new policies. The revenue contraction will be broad base, affecting all WVAS products, though impact on SMS should be the most severe. With a smaller revenue base, we also expect de-leveraging effects to kick in. We estimate FY12/06 net profit to come in at US\$33.7m (EPS: US\$0.796). 2H FY12/06 profit is expected to be US\$9.8m, down 59.1% HoH. Gross margin is projected to drop 5.0 pcp HoH to 34.5%. Management predicts that the WVAS industry will stabilise in 1Q FY12/07. However, we believe that the visibility of this is not high as it is predicated on MII/China Mobile's gradual relaxing of regulatory policies as well as industry consolidation occurring. We estimate that TOMO's FY12/07 profit will further drop 21.3% YoY to US\$26.5m (EPS: US\$0.614). While we view the introduction of new policies will ensure the sustainable development of the WVAS industry and benefit large SPs such as TOMO, the company will need to endure short term pain.

**Valuation.** TOMO is currently trading at 17.1x FY12/06F and 22.1x FY12/07F P/E respectively compared to an industry average of 25.4x and 20.5x.

**Table 1: P&L**

| Year to Dec (US\$m)                        | 2003A       | 2004A        | 2005A        |
|--|-------------|--------------|--------------|
| <b>Turnover</b>                            |             |              |              |
| Wireless value added services              | 55.8        | 112.9        | 161.9        |
| Advertising                                | 5.8         | 7.6          | 9.2          |
| Commercial enterprise                      | 13.8        | 2.2          | 1.0          |
| Internet access                            | 1.6         | 0.1          | -            |
|  | <b>77.1</b> | <b>122.7</b> | <b>172.1</b> |
| <i>% chg</i>                               | 157.1       | 59.2         | 40.2         |
| Cost of sales                              | (44.1)      | (64.8)       | (98.8)       |
| Gross profit                               | 33.0        | 58.0         | 73.3         |
| Selling and marketing expenses             | (2.8)       | (7.7)        | (7.7)        |
| General and administrative expenses        | (9.1)       | (12.4)       | (22.0)       |
| Product development expenses               | (0.7)       | (0.9)        | (1.5)        |
| Amortization of intangibles                | (0.6)       | (5.6)        | (1.0)        |
| Provisions/impairment of goodwill          | -           | (0.3)        | -            |
| <b>Operating profit</b>                    | <b>19.8</b> | <b>31.0</b>  | <b>41.0</b>  |
| Finance costs, net                         | (0.3)       | 3.1          | 2.7          |
| Exchange gains                             | -           | -            | 1.1          |
| Exceptionals                               | -           | -            | 0.4          |
| <b>Profit before taxation</b>              | <b>19.4</b> | <b>34.2</b>  | <b>45.2</b>  |
| Tax  | 0.3         | -            | -            |
| <b>Profit after taxation</b>               | <b>19.7</b> | <b>34.2</b>  | <b>45.2</b>  |
| Minority interests                         | (0.1)       | (0.3)        | (0.2)        |
| <b>Profit attributable to shareholders</b> | <b>19.6</b> | <b>33.9</b>  | <b>45.0</b>  |
| <i>% chg</i>                               | n/a         | n/a          | n/a          |
| Dividend                                   | -           | -            | -            |

Source: Company data

**Table 2: Quarterly revenue breakdown**

| Year to Dec (US\$m)           | 3Q 2005A    | 4Q2005A     | 1Q2006A     | 2Q 2006A    |
|-------------------------------|-------------|-------------|-------------|-------------|
| Wireless value added services |             |             |             |             |
| SMS                           | 17.6        | 17.8        | 17.4        | 19.0        |
| MMS                           | 3.1         | 4.4         | 4.1         | 4.0         |
| WAP                           | 8.4         | 8.1         | 7.8         | 6.7         |
| IVR                           | 10.5        | 10.9        | 12.3        | 11.9        |
| CRBT                          | 2.3         | 2.3         | 2.5         | 3.2         |
| Others                        | 1.3         | 1.2         | 1.4         | 1.0         |
|                               | <b>43.1</b> | <b>44.6</b> | <b>45.5</b> | <b>45.7</b> |
| Advertising                   | 2.6         | 3.2         | 2.7         | 3.9         |
| Commercial enterprise         | 0.2         | 0.3         | 0.4         | 0.5         |
|                               | <b>45.9</b> | <b>48.1</b> | <b>48.6</b> | <b>50.1</b> |
| <i>% chg</i>                  | 7.4         | 4.7         | 1.0         | 3.1         |

Source: Company data