

**BEA securities**

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HONG KONG RESEARCH**9th November 2004**

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Main Board Listing – Research

直真節點控股有限公司

ZZNode Holdings Company Limited [Stock Code: 2371]**Sponsor** : First Shanghai Capital Limited**Lead Manager & Bookrunner** : First Shanghai Securities Limited**Sector** : Software**Business** : Developer and provider of Operational Support System products in the PRC

| | |
|--|---|
| Total share offer: <u>100,000,000</u> shares (25% of the enlarged share capital) Public Offer: 10,000,000 shares (10%) Placing: 90,000,000 shares (90%) | <u>Business of ZZNode</u> The Group is principally engaged in the development and provision of Operational Support System (OSS) products and solutions, and providing one-stop integrated services to the telecommunications service providers in the PRC. OSS is a set of integrated software programs that assist telecommunications service providers and private network operators to monitor, control, analyze and manage problems within their telecommunication networks (including transport, voice and data). The business includes the sale of self-developed OSS software, provision of system integration, as well as maintenance, training and other after-sales services as total solutions. The Group is the 2 nd largest OSS software vendor in the PRC with a market share of 16.62% in 2003. The products are sold directly to end-users including China Mobile and indirectly through renowned telecommunications equipment providers such as Alcatel Shanghai Bell, which bundles with its own products to become a total solution to the telecommunications service providers. |
| Price: HK\$0.50 – HK\$0.68 per share Market Cap.: HK\$200 million – HK\$272 million Historical FY2003 P/E: 8.47x – 11.53x Adjusted NTA per share: HK\$0.249 – HK\$0.292 Staffing: 266 | |
| Book opens: 5 th November 2004 Book closes: 5 th November 2004 HK Public Offer period: 8 th November 2004 – 11 th November 2004 Receiving bank: Standard Chartered Bank Share registrar: Tricor Investor Services Limited Listing date: 18 th November 2004 | |

Major Shareholders after Listing (Assuming the over-allotment option is not exercised)

| | |
|--|---------------|
| Bright Pearl (BVI) – held by 9 individuals including 5 senior management | 40.61% |
| New Wingo (BVI) – wholly owned by Ms. Hu Rong, Executive Director | 8.43% |
| IDGVC Venture Capital Fund | 7.50% |
| Happy Choice (BVI) – wholly owned by Mr. Ying Zhaohui | 7.21% |
| Grand Advance (BVI) – equally owned by Mr. Yang Fei and Mr. Wang Shu | 6.75% |
| Silver Well (BVI) – trustee of the employee share option scheme | 4.50% |
| | <u>75.00%</u> |

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Use of Proceeds

Net proceeds from the offer are estimated to be HK\$46 million.

(Assuming the over-allotment option is not exercised and an issue price of HK\$0.59 per share, being the midpoint of the proposed range of HK\$0.50 and HK\$0.68)

| | HK\$ million |
|---|--------------|
| Expansion of products and services portfolio | 15 |
| R&D activities in relation to 3G | 12 |
| Setting up a JV with one of its strategic partners | 12 |
| Expansion in sales channel and marketing activities | 2 |
| Expanding OSS laboratory | 3 |
| CMMI Level 3 project | 2 |

Financial Highlights

| | 6 months ended 30 th June 2004 RMB'000 | Year ended 31 st December 2003 RMB'000 | 2002 RMB'000 | 2001 RMB'000 |
|--------------------|---|---|-----------------|-----------------|
| Turnover | 47,010 | 92,197 | 74,726 | 77,709 |
| Gross profit | 23,089 | 43,103 | 39,963 | 36,118 |
| Operating profit | 15,535 | 27,406 | 16,896 | 24,921 |
| Net profit | 15,460 | 25,347 | 16,833 | 24,955 |
| EBITDA | 16,914 | 29,844 | 18,821 | 25,643 |
| EPS – basic | RMB0.0515 | RMB0.0845 | RMB0.0561 | RMB0.0832 |
| Profitability | | | | |
| • Gross margin | 49.1% | 46.8% | 53.5% | 46.5% |
| • Operating margin | 33.0% | 29.7% | 22.6% | 32.1% |
| • Net margin | 32.9% | 27.5% | 22.5% | 32.1% |
| • EBITDA margin | 36.0% | 32.4% | 25.2% | 33.0% |

Strengths/Opportunities

- ✓ Telecom service providers in the PRC are shifting the battlefield from capacity expansion towards operation efficiency. Given the uniqueness of OSS on network enhancement, telecom service providers are expected to increase their investments in OSS applications (the amount of investment is estimated to grow at a CAGR of 18.3% until 2008).
- ✓ The OSS industry has high entry barriers given its lengthy research and development horizon. In addition, high switching costs to meet with network compatibility also help maintain customers' loyalty.
- ✓ The valuation of ZZNode at 8.47x-11.53x FY2003 P/E is not very demanding, compared with 8.8x FY2003 P/E for Digital China (stock code: 0861).

Weaknesses/Threats

- × Other OSS participants in the PRC like Asiainfo, Bright Oceans and Digital China are at the same time providing network and other information applications, whereas ZZNode depends entirely on OSS products for revenue. Its lack of a diversified business profile exposes the company to higher cyclical impact from the software industry.
- × The sale of 3rd party products accounts for about 50% of the company's total revenue. However, the gross profit margin of this business contracted from 31% in FY2001 to 17% in 1H2004. As the OSS industry shifts towards software solutions, the contribution from its 3rd party products would continue to shrink. The overall gross margin would be difficult to maintain until we see more penetration into higher-margin propriety software segment.
- × Though the introduction of 3G is expected to accelerate the development of OSS in the PRC, there are uncertainties on the compatibilities of ZZNode's existing products to enhance to 3G environments.

Recommendation: Speculative Subscribe but with high business risk