



Data	
Price (22/12/2011)	HK\$1.75
Issued shares	2,000mn
Market cap	HK\$3,500mn
Free float ratio	25%
52week high/low	HK\$2.3/1.63
Major shareholders:	
Chen Yixi-Chairman (36.59%)	
Li Wei-CEO (20.01%)	
Miao Bingwen(18.4%)	

Stock performance			
	1M	3M	YTD
1028 HK Equity	-2.8%	-	-23.9%
HSI Index	0.7%	4.0%	-20.2%
HSCICG Index	0.5%	7.0%	-23.4%



Source: Bloomberg

Report date: 23 Dec, 2011

Analyst:

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Hongguo International (1028) – Initiating Coverage with ‘Buy’ rating

Hongguo International Holding Limited (“Hongguo”) is the second largest retailer by sales of mid-to-high end women’s footwear, with four self-developed brands (C.banner, EBLAN, Fabiola and Sundance) and one licensed brand Naturalizer. Hongguo implements multi-brands strategy to expand its market shares in different income and age groups of consumers in China.

We expect the group’s net profit to grow at CAGR of 41.72% between 2010 and 2013, based on its solid same stores sales growth (SSSG) and rapid expansion of new stores.

Hongguo is trading at FY2012 PER of 7.51x, a 59% discount to market leader Belle’s 18.21x. Given its fair value and solid growth of women’s footwear business, we initiate coverage with ‘Buy’ rating.

Valuation:

We set 12M target price at HK\$ 2.30, based on FY11PE of 13.5x and FY 2012PE of 10.0x. The target price represents FY 2012 P/B of 2.17x. In view of its FY 2012 ROAE of 24.15%, we believe the target price is reasonable.

Risk: 1) Intensive competition; 2) Fail to manage multi-brand; 3) Rental hike and concessionaire fees increase; 4) Low liquidity

Financial highlights

Yr ended Dec31 (Rmb mn)	2010	2011 E	2012 F	2013 F
Revenue	1,575	2,044	2,600	3,293
Chg (yoy)	22.57%	29.77%	27.20%	26.67%
Gross profit	972	1,265	1,625	2,058
Chg (yoy)	49.31%	30.12%	28.43%	26.67%
Net Income	170	286	382	483
Chg (yoy)	113.30%	68.65%	33.36%	26.54%
Diluted EPS (Rmb)	0.100	0.143	0.191	0.242
Chg (yoy)	113.30%	43.36%	33.36%	26.54%
P/E (x)	14.36	10.01	7.51	5.93
NBV (Rmb/share)	0.378	0.715	0.867	1.061
P/B (x)	3.80	2.01	1.65	1.35
DPS (Rmb/share)	0.113	0.061	0.038	0.048
Dividend yield	7.72%	4.17%	2.62%	3.31%
ROAE	26.16%	27.66%	24.15%	25.07%
ROAA	17.51%	21.24%	19.77%	20.61%

Source: Hongguo, ABCI Securities estimates; @Forex: HK\$1.22/Rmb

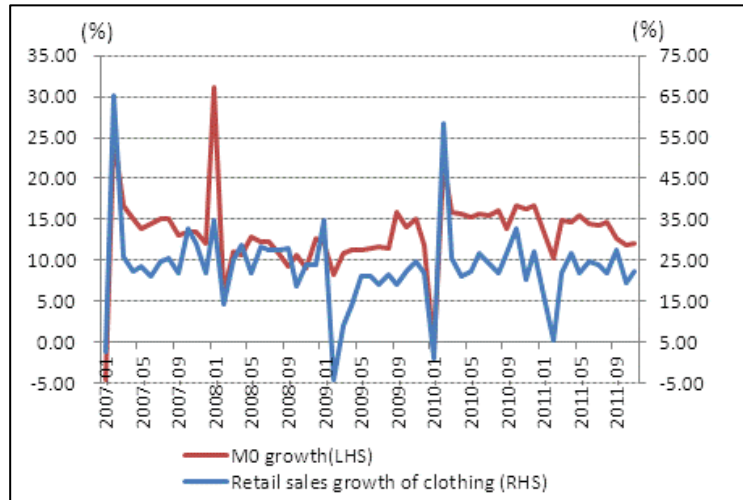


Macro economy

Retail sales growth is highly correlated to money supply growth

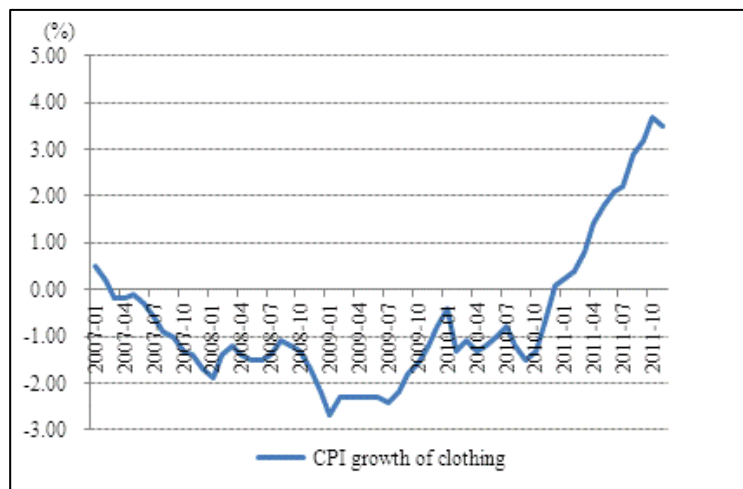
As we tracked the historical data from 2007 to 2011, we've found that the retail sales growth of clothing products (which include Garments, Footwear, Hats, Knitwear) are highly correlated to money supply growth (M0 growth). We used two group monthly data as our sample base: the monthly retail sales growth rate of clothing and M0 (M0 represents Cash) growth rate. The correlation ratio between the two samples was 0.70. The price growth of clothing started to rally at the beginning of 2011 due to increasing raw material cost and labor cost, while retail sales growth did not follow up with this trend. We believe purchasing power of consumers weakens when retail prices of clothing products increases.

Exhibit 1: 2007-2011 Retail sales growth of Clothing vs M0 Growth (yoy)



Source: National Bureau of Statistics of China, Winds

Exhibit 2: 2007-2011 CPI Growth of Clothing (yoy)



Source: National Bureau of Statistics of China, Winds



The slowing down of CPI growth and possibility for loosen monetary policy may boost retail sales growth

We expect CPI growth to drop from its high level (6.33% in July 2010) to 2%-3% of yoy growth rate in 2Q 2012, while money supply may lift up from the beginning of 2012. Owing to the decline of CPI and loosen money supply, the retail sales growth will lift up in 2012.



Industry overview

Women’s footwear market is mainly segmented by prices

The women’s footwear market can be classified into four segments, namely low-end, middle, mid-to-premium and luxury. Each segment is differentiated itself by price, sales channel and brand positioning. The luxury segment is dominated by foreign brands but accounted for 1.8%of total women’s footwear market share in 2010.

The market shares of middle and mid-to-premium segments are increasing

Currently, the local brands are concentrated on middle and mid-to-premium segments and these two segments captured 58% market shares in 2010. We expect the market shares of these two segments to increase to approx. 60% as the proportion of middle class in the population is growing. According to Euromonitor, retail sales of mid-to-premium women’s footwear in China is expected to grow at CAGR of 13% between 2010 and 2014.

Exhibit 3

Price segment	Price range	Sales channels	Brands
Low-end	< Rmb 300	Hypermarkets/Supermarkets/Multi-brand footwear stores	No brand
Middle	Rmb 300-600	Chained specialty stores/Middle-end department stores	Daphne/Comrade/Walker Shop
Mid-to-premium	Rmb 600-2,000	Chained specialty stores/Middle-to-high end department stores	Belle/Teenmix/Tata/C.banner/ST&SAT/Clarks/Ecco
Luxury	>Rmb 2,000	High-end department store/Mono-brand specialty stores	LV/Gucci/D&G/Salvatore Ferragamo

Source: Euromonitor

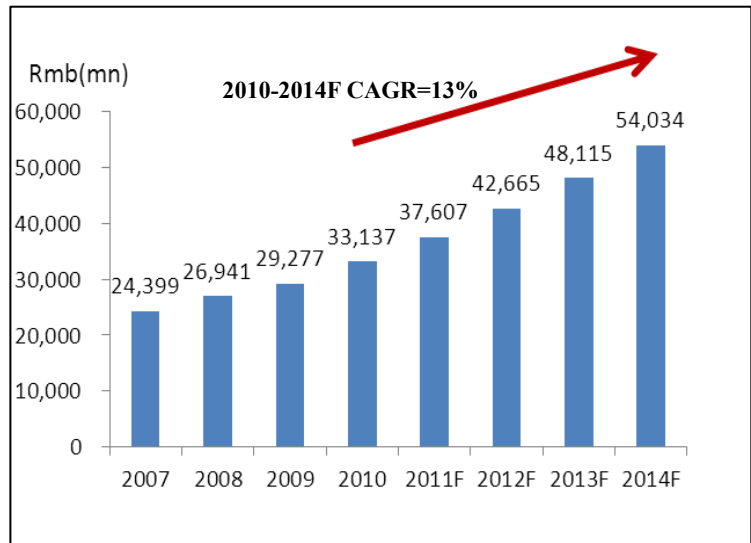
Exhibit 4: 2007-2014F market shares of the women's footwear segment in China



Source: Euromonitor



Exhibit 5: 2007-2014F retail sales of mid-to-premium women's footwear in China



Source: Euromonitor



Brand & Strategy

Well established brand -C.banner

The group has four self-developed footwear brands and one licensed brand in the market. The C.banner brand was launched in 1996 and has well established in the market. According to Euromonitor, C.banner ranked 4th in the mid-to-premium segment with a market share of 5%. C.banner has contributed 73.65% of total retail sales in 2010.

Implement multi-brand strategy to expand market shares

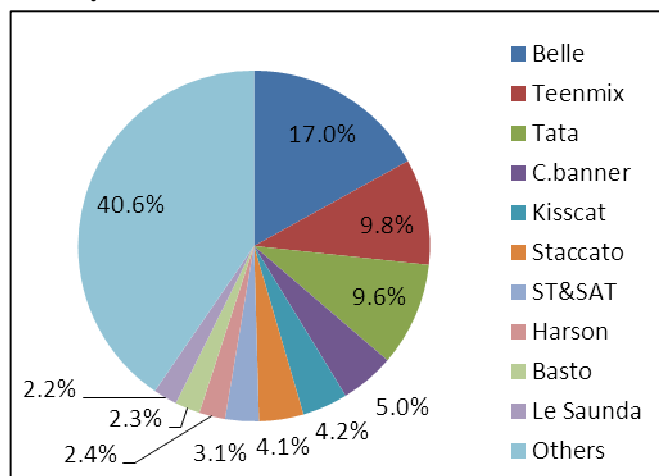
The group launched its second self-developed brand EBLAN in 2004, the brand EBLAN has contributed 22.76% of total retail sales in 2010. To expand market share in women's footwear market, the group sets up two new brands in 2011. The "Fabiola" brand is sold in the outlets of 'C.banner'. The "Fabiola" brand is aimed to consumers in the mid-to-premium segment while the "Sundance" brand is aimed at consumers in the middle segment. The number of specialty stores of Sundance will increase to 80 in 2011.

Exhibit 6: Hongguo's brand portfolio

Brand	Date of launch	Target customer(Age)	Spring & summer price(Rmb)	Fall & winter price(Rmb)	Sales as% of total retail sales(2010)	No. of stores(2010)	2010 ASP(Rmb)	2010 Retail sales per store(Rmbmn)
Self-developed footwear brands								
C.banner	1996	20-40	500-700	800-2,500	73.65%	894	391	1.44
EBLAN	2004	20-35	500-700	800-2,500	22.76%	418	381	0.90
Fabiola	1H 2011	25-39	1,000-1,500	1200-3,000	-	-	-	-
Sundance	Aug-11	18-35	400-600	700-2,200	-	-	-	-
Licensed footwear brand								
Naturalizer	2007	25-44	650-1,100	1,100-3,000	3.59%	47	494	1.07

Source: Hongguo, ABCI Securities

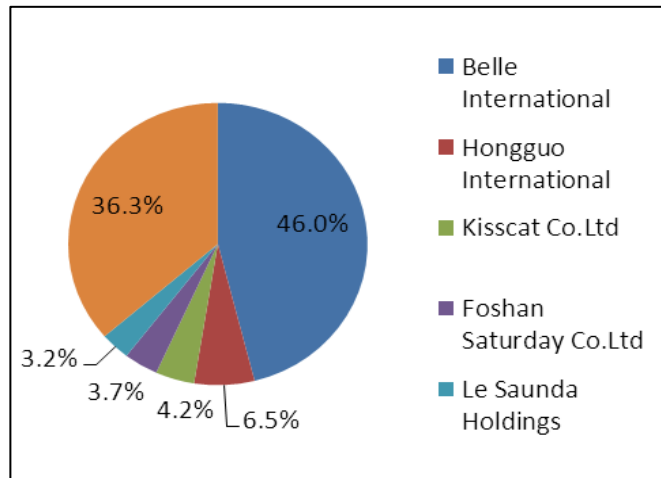
Exhibit 7: Market shares of mid-to-premium women's footwear in China by 2010 retail sales



Source: Euromonitor



Exhibit 8: 2010 market shares of mid-to-premium women's footwear in China



Source: Euromonitor



Expansion of sales network

The group has an extensive distribution network with 1,181 proprietary outlets and 421 third-party outlets located in 31 provinces as of September 30, 2011. We expect the number of outlets to increase at CAGR of 23% between 2010 and 2013. As around 75% outlets are located in the department store, the group is expected to penetrate into 3-4 tier cities with the expansion of department stores.

Exhibit 9: Distribution network

	2009	2010	2011F	2012F	2013F
Proprietary outlets	785	972	1202	1452	1737
Growth (yoy)	8.9%	23.8%	23.7%	20.8%	19.6%
Third-party outlets	260	317	437	557	667
Growth (yoy)	25.6%	21.9%	37.9%	27.5%	19.7%

Source: Hongguo, ABCI Securities

Exhibit 10: No. of department store outlets

Brand	2008	2009	2010	Mar 31, 2011
C.banner	485	539	616	636
EBLAN	182	208	303	323
Naturalizer	38	31	42	47
Total	705	778	961	1006
% of total outlets	76.0%	74.4%	74.6%	74.0%

Source: Hongguo, ABCI Securities



Facility& supply chain

Vertical integration saves the cost

The group has three production facilities located in Nanjing, Dongguan and Suining in China. We expect its capacity to reach to 8.1million pairs by end of 2013 as new production lines in Suining put into operation. This may gradually lift its in-house production ratio to save the cost as we expect in-house production costs to be10%-15% lower than outsourcing production.

Tight supply chain management enhances operation efficiency

The group adopts a sales-based supply chain to enhance its operation efficiency. The first order ratio (as % of total sales for new season) is approximately 50% to 60%, while 40% to 50% are manufactured in subsequent batch according to orders for replenishment. The tight supply chain management will lower the backlog of inventory.



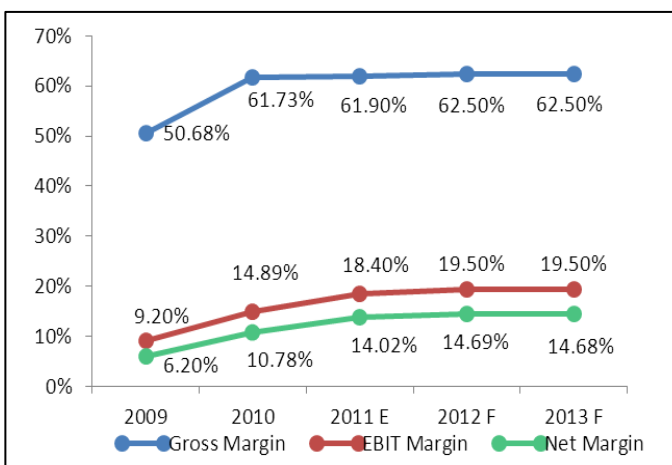
Comparison with peers

Expansion of retail network: The group only has less than 1/5 outlets compared with market leader Belle and 1/4 outlets compared with Daphne based on the stores number in 2010. We expect Hongguo will expand rapidly for next 2-3years to set up more POS.

Lift in-house production ratio: The in-house ratio of Hongguo is only around 50% that are lowest among other peers. We expect Hongguo will expand production capacity to lift its in-house ratio gradually to improve gross profit margin.

Improve its GPM and NPM: Hongguo’s net profit margin is in line with market leader Belle and better than Daphne and Saturday in FY 2011. As the group will gradually enhance its operating efficiency and achieve economy of scale due to expansion of production capacity and new stores, we expect the GPM and NPM will increase to 62.5% and 14.68% respectively in 2013F.

Exhibit 11: GPM, EBIT Margin and NPM (2009-2013F)



Source: Hongguo, ABCI Securities



Exhibit 12: Peers comparison

	Belle(Footwear)	Daphne	*Hongguo	Saturday
Code	1880 HK	210 HK	1028 HK	2291 CH
Market positioning	Mid-to-high end	Mid end/Low end	Mid-to-high end	Mid-to-high end
Operation statistics-FY 2010				
Market share of mid-to-premium women's footwear in China	46%	-	6.50%	3.70%
No.of stores	8,312	5255	1289	1713
New store growth	23%	18%	23%	22%
Same store sales growth	17%	4.6%(core brands)	12%	-
Production capacity(mn pairs)	24	25-30	5.4	4.5
In-house production ratio	70-80%	Shoebox-80%, Daphne-30%	50%	92%
Financial data				
Inventory turnover days-2011/ 1H	142	145	207	359
AR turnover days-2011/ 1H	28	31	37	90
AP turnover days-2011/ 1H	28	70	85	86
2011E revenue(Rmb mn)	29,551.87	6,727.52	2,043.89	1,429.00
Growth (yoy)	24.7%	16.6%	29.8%	25.1%
2011E net profit (Rmb mn)	4,317.17	723.96	286.47	124.75
Growth (yoy)	26.1%	39.6%	68.7%	24.4%
2011E EPS (Rmb)	0.51	0.42	0.14	0.35
Growth (yoy)	26.1%	31.2%	43.4%	27.5%
Gross profit margin	56.9%	59.7%	61.9%	49.9%
Net profit margin	14.6%	10.8%	14.0%	8.7%
ROAE	23.5%	25.2%	27.7%	7.7%

Source: Hongguo, Bloomberg, ABCI Securities



Earnings Assumptions and Forecast

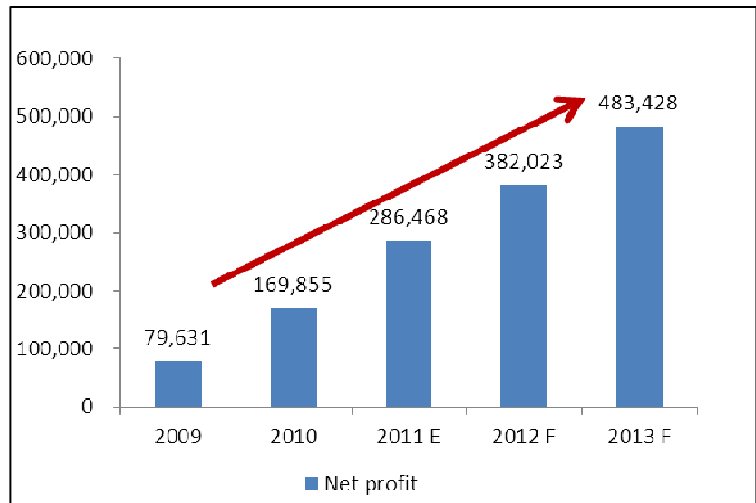
We expect the group will achieve a 41.72% CAGR of net profit from 2010 to 2013 base on its solid SSSG and rapid expansion of new stores. During 2011 to 2013, its net profit will reach Rmb 286mn, Rmb 382mn and Rmb 483mn respectively. Our key assumptions are as below:

Exhibit 13: Key operating assumptions

	2009	2010	2011F	2012F	2013F
SSSG(%)	17.7%	12.3%	16.0%	13.4%	13.0%
Total stores No.	1,045	1,289	1,639	2,009	2,404
New stores added	117	244	350	370	395
Business segment breakdown as % of total sales					
	2009	2010	2011F	2012F	2013F
Retail	75.7%	77.1%	79.6%	80.4%	81.1%
Wholesale	9.6%	9.7%	9.6%	10.7%	11.6%
OEM	14.7%	13.2%	10.8%	8.9%	7.4%

Source: Hongguo, ABCI Securities

Exhibit 14: 2010-2013F net profit CAGR=41.72%



Source: Hongguo, ABCI Securities

**Valuation**

Given Hongguo's aggressive expansion of retail network and high growth rate of net profit,(NP CAGR of 41.72% over 2010-2013F) we initiate with BUY rating and set 12M target price at HK\$ 2.30, based on 13.5x FY 11PE and 10.0x FY 12PE. The valuation is at 45% discount to the market leader Belle.

Exhibit 15: Valuation Table

Stock Code	Stock Name	Mkt cap(HK\$m)	Price(HK\$)	PER			Net profit growth(%)		
				2010	2011	2012	2010	2011	2012
002291 ch equity	SATURDAY	4,210	11.58	29.69	22.62	17.59	-10.8%	32.0%	32.1%
1880 hk equity	BELLE	116,730	13.84	29.45	21.97	18.21	36.8%	35.3%	20.7%
210 hk equity	DAPHNE	13,784	8.40	23.33	16.47	13.33	52.7%	44.6%	23.8%
1836 hk equity	STELLA	13,330	16.78	13.98	11.34	9.43	19.1%	25.3%	19.1%
738 hk equity	LE SAUNDA	1,662	2.60	10.00	8.13	6.67	37.7%	20.3%	22.7%

Source: Bloomberg



Site visit to Maoye Department Store at Huaqiangbei district in Shenzhen

We've chosen a peak hour (Saturday 3:00pm to 5:00pm at 17th Dec) to visit Maoye Department Store at Huaqiangbei district in Shenzhen, where it is a hot mid-to-high end shopping center. Our observations are as follows.

- **Intensive competition:** Women's shoes are crowded in the 1st floor of the department store with 53 brands, which reflects intensive competition in women's brand shoes market.
- **High homogeneity:** As we walked through each shoe counter, we've found different brands provide very similar products. There are no obvious difference in designation, pricing and product display among mid-to-high end women's footwear brands.
- **High concentration:** 1/4 brands (13 brands) are under Belle's brand portfolio, which confirmed its dominate position in this mid-to-high end women's shoe market. Daphne has 4 brands located in the department store which is the second largest brand retailer. Others are diversified with single retailers such as Hongguo, Saturday, Le Saunda and Stella etc.
- **Popular brands:** Belle, Tata, Teenmix and Daphne's counters were more crowded compared with other brands with almost 10 peoples were trying shoes in their counters. C.banner, Joy&Peace and Le Saunda also attract numerous people in their counters (6 to 7ppls in each counters). We also observed peoples are in long queue to pay the bill in the shoe cashier counter. The purchasing power is strong due to weekend and year-end promotion.

We conclude that the demand for brand women shoes is strong. The strong demand will provide growth momentum of the women's shoe industry. Major brand enjoy stronger competitive advantages due to extensive sales channels, stronger bargaining power with department store and economy of scale to achieve operating efficiency. Industry consolidation may happen as smaller players fail to catch up consumers' preference and fast change of fashion trend.



Risk Factors

Competition: The women's footwear industry in China is highly competition with numerous brands. If the group fails to catch up fashion trend and cater customer's taste, the existing brand retailers and new enters may split up Hongguo's market share.

Fail to manage multi-brand: Hongguo launched two new brands this year in order to further diversify its brand portfolio. The new brands need more time to be aware by the market. If Hongguo fail to set up new brands and execute multi-brand strategy, it may take huge new brands development cost and high inventory risk.

Heavily rely on department store: The group generated more than 70% of its total revenue from department store during last three years. Hongguo do not have strong bargaining power with department stores on concessionaire fees, outlets location etc. Any increase in concessionaire fees and rental rates can drag down Hongguo's profit.

Lower liquidity of its shares: Due to its short listing history on the Hong Kong market and small market cap, Hongguo's average trading volume over past one month is quite low. The liquidity risk is very high.



Hongguo: Financial Summary

Income statement

Yr ended Dec31 (Rmb mn)	2009	2010	2011 E	2012 F	2013 F
Continuing operations:					
Sales	1,285	1,575	2,044	2,600	3,293
Cost of sales	(634)	(603)	(779)	(975)	(1,235)
Gross profit	651	972	1,265	1,625	2,058
Selling and distribution expense	(468)	(653)	(787)	(988)	(1,251)
Administrative expense	(65)	(85)	(102)	(130)	(165)
Other income	11	9	9	4	4
EBITDA	137	250	392	525	666
Depreciation & amortization	18	16	16	18	24
EBIT	118	235	376	507	642
Finance cost	(1)	(1)	(2)	(2)	(2)
Share of loss of a joint venture	(4)	(3)	(1)	0	0
PBT	124	240	382	509	645
Taxation	(33)	(68)	(95)	(127)	(161)
Net Income from continuing operations	91	172	286	382	483
Discontinued operations	(11)	(2)	0	0	0
Net profit attributable to equity holders of the co.	80	170	286	382	483
Non-controlling interests	0	0	0	0	0
Basic EPS(Rmb)	0.047	0.100	0.143	0.191	0.242
Diluted EPS(Rmb)	0.047	0.100	0.143	0.191	0.242
Dividend	0	192	122	76	97
DPS(cents)	0.000	0.113	0.061	0.038	0.048
Shares outstanding	1,700	1,700	2,000	2,000	2,000
Dividend payout ratio(%)	0%	113%	42%	20%	20%
Growth & Margin(%)					
Sales growth	23.08%	22.57%	29.77%	27.20%	26.67%
Gross profit growth	15.34%	49.31%	30.12%	28.43%	26.67%
Net profit growth	-25.18%	113.30%	68.65%	33.36%	26.54%
EPS growth	-99.25%	113.30%	43.36%	33.36%	26.54%
Gross profit margin	50.68%	61.73%	61.90%	62.50%	62.50%
EBIT margin	9.20%	14.89%	18.40%	19.50%	19.50%
Net margin	6.20%	10.78%	14.02%	14.69%	14.68%

Source: Hongguo, ABCI Securities estimates



Balance sheet					
Yr ended Dec31 (Rmb mn)	2009	2010	2011 E	2012 F	2013 F
Non-current assets:	161	173	186	219	246
Property, plant and equip	79	86	99	132	159
Intangible assets	2	2	2	2	2
Prepaid land lease payments	16	16	16	16	16
Investment properties	45	46	46	46	46
Goodwill	0	0	0	0	0
Other non-current assets	19	23	23	23	23
Current assets:	783	824	1,515	1,944	2,282
Cash and cash equivalents	278	161	693	898	1,057
Pledged deposits	30	34	34	34	34
Trade receivables	175	180	281	297	419
Prepayments and other receivables	30	38	38	38	38
Inventories	270	410	469	678	733
Total asset	944	997	1,701	2,163	2,528
Current liabilities:	282	348	265	422	399
Short-term bank loans	41	0	0	0	0
Trade and bill payables	132	197	114	271	249
Other payables	93	95	95	95	95
Income tax liabilities	15	46	46	46	46
Deferred revenue	0	9	9	9	9
Other current liabilities	15	55	55	55	55
Non-current liabilities:	6	7	7	7	7
Interest-bearing bank borrowings	0	0	0	0	0
Deferred tax liabilities	6	7	7	7	7
Total liabilities	287	355	272	429	407
Total equity	656	642	1,429	1,735	2,122
NBV(Rmb)	0.386	0.378	0.715	0.867	1.061
Ratios					
Ratios	2009	2010	2011 E	2012 F	2013 F
Inventory days	177	206	206	215	209
AR days	44	41	41	41	40
AP days	63	100	73	72	77
Net debt/equity(%)	36%	25%	48%	52%	50%

Source: Hongguo, ABCI Securities estimates

**Cash flow statement**

Yr ended Dec31 (Rmb mn)	2009	2010	2011 E	2012 F	2013 F
PBT	113	237	382	509	645
D&A add-back	18	16	16	18	24
Change in working capital	81	(115)	(243)	(68)	(200)
Others	15	10	(2)	(2)	(2)
Cash flow from operations	227	149	153	457	466
Interest paid	(1)	(1)	(2)	(2)	(2)
Income tax paid	(26)	(39)	(95)	(127)	(161)
Net cash from operating activities	200	109	55	327	303
Proceeds from disposals of items of PPE	1	0	0	0	0
Disposals of a subsidiary	0	34	0	0	0
Interest received	3	3	4	4	4
Decrease/(increase) in pledged deposits	(5)	(4)	0	0	0
Capex	(37)	(27)	(29)	(51)	(51)
Net cash flow from investing	(37)	6	(24)	(46)	(46)
New bank loans	0	0	0	0	0
Repayment of bank loans	0	(41)	0	0	0
Dividend paid	0	(192)	(122)	(76)	(97)
Proceed from share issuance	0	0	622	0	0
Net cash flow from financing	0	(232)	501	(76)	(97)
Net change in cash	163	(117)	532	205	160
Beginning cash	115	278	161	693	898
Ending cash	278	161	693	898	1,057

Source: Hongguo, ABCI Securities estimates



Disclosures

Analyst Certification

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