

Industry In-Depth

11 August 2006 | 48 pages

China Lottery Market

On an Upward Trajectory

- Exciting growth potential** — We project China's lottery market to grow by CAGR of 31% to US\$34.5bn by 2010 to become the world's second-largest lottery market after the US, which turned over US\$54.2bn in 2005. In per capita terms this would equate to US\$26 for China's lottery, among the lowest in the world.
- Government support drives bullishness** — The potential to generate a strong tax revenue source and fight illegal gambling should drive government support for China's lottery, and lead to the introduction of new games, better distribution channels and, potentially, increased payouts.
- Growth in new product offerings** — We believe new lottery products, such as high frequency Keno, scratch instant lottery and video lottery terminals (VLTs) are likely to be especially effective in stimulating the market, given their higher frequencies, simplicity and greater variety. By 2008, we project instant lottery and VLTs will make up 21% of the market, up from 2% in 2005.
- Substantial risk as well** — China's lottery is still in its infancy and suffers from significant risks, including regulatory, technology, demand, intensifying competition and lack of transparency.
- Focus on large, established players** — Large players with a proven track record and well-entrenched operations are most likely to thrive in such an environment. We retain our Sell/Speculative Risk rating on China LotSynergy and reduce the target price by 18% to HK\$0.90 following 1H06 results. We initiate coverage on China Vanguard with a Buy/Speculative Risk rating and HK\$2.70 target price.

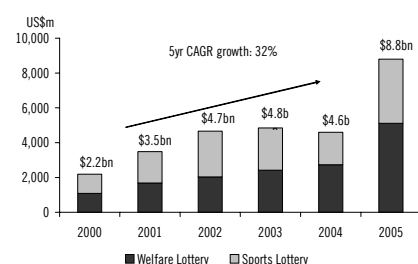
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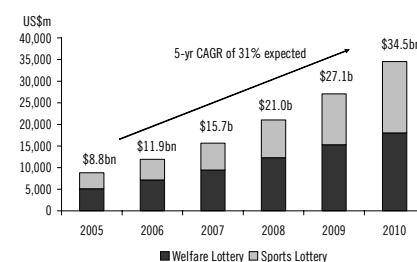
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Figure 1. Historical Lottery Turnover (US\$m)


Source: Ministry of Finance

Figure 2. Projected Lottery Turnover (US\$m)


Source: CIR estimates

See page 46 for Analyst Certification and important disclosures.

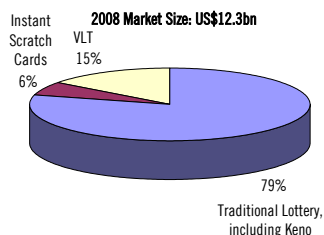
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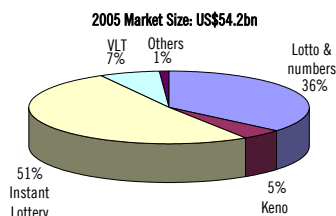
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Source: Company Reports

Figure 4. US Lottery Market Share (2005A)



Source: Company Reports

China Lottery Market: On an upward trajectory

After three years of stagnant growth, the China lottery industry came back to life in 2005 with 90% growth to become the world's seventh-largest market with sales of US\$8.8bn, driven largely by the popularity of new games. In an effort to combat the estimated US\$75bn illegal gambling market, we expect the stream of new products to increase over the coming years, and with better distribution networks and potentially higher payouts, to underpin significant growth in the industry. We forecast the China lottery market to grow by CAGR of 31% over the next five years to US\$34.5bn by 2010. This should place it as the world's second-largest market behind the US, which turned over US\$54.2bn in 2005.

Currently, the only way to participate in the expected growth is through the welfare lottery, and there are a number of ways to do so – either as a system provider or sales agent, across different products such as traditional lottery, video lottery terminals (VLTs) and/or instant lottery. Each is entitled to a different share of revenue and faces a different risk/return trade-off. However, given the relative infancy of the industry, all participants face significant regulatory uncertainty, technology risks, lack of transparency and more international competition. In addition, participants of new products such as VLTs face additional risk in the form of unproven demand and roll-out issues.

In such an environment, we recommend investors focus on large players with a proven track record and operations that are already well entrenched within the China lottery system. These players should face lower regulatory risks given proven good working relationships with government at all levels. In addition, their proven operating history should also mitigate the technology risk and better position them to compete with international players. These players are also best placed to take advantage of growth opportunities, including incremental contracts, new game offerings and a share of the sports lottery.

We initiate on China Vanguard with a Buy/Speculative Risk (1S) and target price of HK\$2.70, as it effectively enables investors to buy a stake in Aptus at half the price it trades in the market and get a China lottery business for free.

We retain our Sell/Speculative (3S) rating on China LotSynergy (“CLS”), but lower our target price to HK\$0.90 (from HK\$1.10) as we bring down the assumptions for VLT and Keno in line with our top-down view. With a ten-year exclusive contract to roll-out both Tabcorp's Keno and VLT terminals nationwide, CLS continues to offer strong potential, in our view. However, the question remains over its ability to implement such an ambitious plan. Until CLS demonstrates a record of meeting roll-out plans while maintaining desired turnover rates, we see the risk of investment as too high.

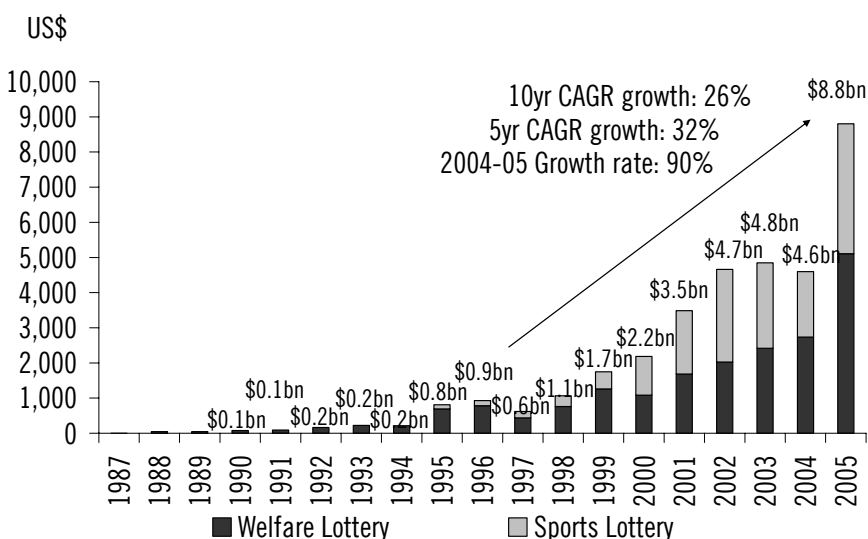
China lottery market: primed for 31% CAGR over the next five years

China ranks as seventh largest lottery market in the world

The past ten years has seen China's lottery industry grow by CAGR of 26%, and as at the end of 2005 it is a US\$8.8bn market, ranking seventh in the world (up from tenth in 2004). This seemingly impressive growth, however, masks significant volatility that saw growth grind to a halt in 2002-04, and then jump by 90% in 2005. While we can point to a number of factors that caused the volatility (new games and removal of scratch cards following scandals involving fake tickets), we believe it ultimately reflects an industry that only started in 1987 and is still in its infancy. This compares to the world's largest lottery market, the US, which began in 1964 and is five times larger. The extent of China lottery's underdevelopment is amplified further on a per capita basis – US\$7 per capita compared to US\$195 in the US and US\$74 in Japan.

China's lottery market has been flat for a number of years from 2002-04 as a result of scandals involving fake tickets. However in 2005, the market grew by 90% on the back of new games

Figure 5. China Lottery Market Since Inception in 1987



Source: Company Reports

Though ranking seventh in the world in 2005, China's lottery per capita spending is among the lowest

Figure 6. Top Ten Lottery Markets by Country

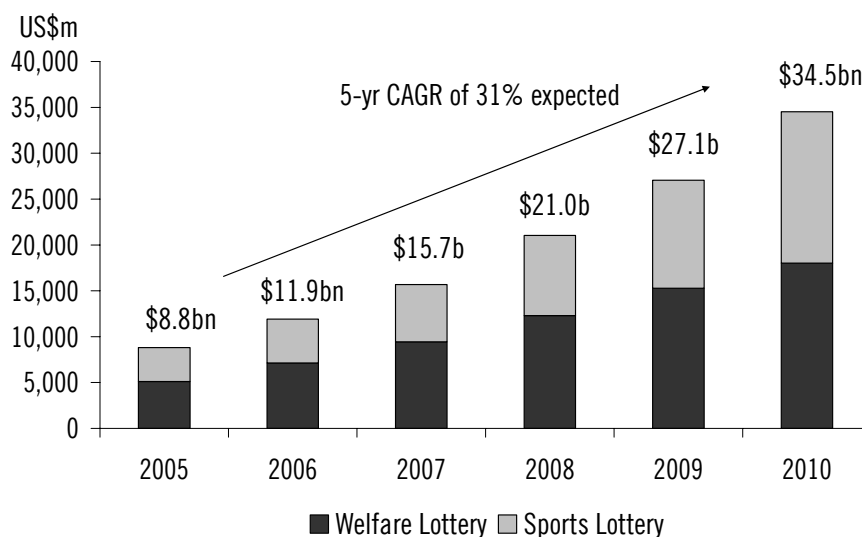
Rank	Country	Sales (US\$m)	Population (mn)	Per Capita (US\$)	% of GDP
1	US	54,152	278	194.79	0.43%
2	Italy	14,048	58.1	241.78	0.82%
3	Spain	13,521	40.3	335.51	1.20%
4	Germany	12,231	82.4	148.43	0.44%
5	France	10,566	62.9	167.98	0.50%
6	Japan	9,399	127.4	73.77	0.20%
7	China	8,800	1306.3	6.74	0.39%
8	UK	8,391	60.4	138.92	0.38%
9	Canada	8,317	32.2	258.30	0.75%
10	Greece	4,870	10.7	455.16	2.28%

Source: La Fleur's 2006 World Lottery Almanac

We believe China's lottery is on the cusp of a significant growth that typically accompanies an industry on a maturity path. Over the next five years, we project the market to grow by CAGR of 31% to reach US\$34.5bn by 2010, to become the world's second-largest market. This translates to lottery sales of US\$26 per capita, which still lags Malaysia and Thailand 2005 figures of US\$63 and US\$30. However, given a large portion of China's population is still poor and/or in remote areas that make access to lottery services difficult, we believe this is reasonable. We believe the China lottery market is currently growing at a 30% rate, consistent with our growth forecast.

Welfare lottery expected to grow at a faster rate in 2006-07 but sports lottery will take over from 2008 — by 2010, we expect the market to be split 50:50

Figure 7. Projected China Lottery Market 2005-2010E



Source: Citigroup Investment Research estimates

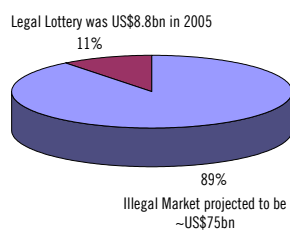
Figure 8. Projected Growth Rate of China Lottery Market

	2004	2005	2006	2007	2008	2009	2010
Total (US\$m)	4,596	8,800	11,923	15,677	21,040	27,065	34,530
- Welfare Lottery (US\$m)	2,734	5,108	7,123	9,438	12,305	15,273	18,020
- Sports Lottery (US\$m)	1,862	3,692	4,800	6,239	8,735	11,792	16,509
- Welfare Lottery (%)	59%	58%	60%	60%	58%	56%	52%
- Sports Lottery (%)	41%	42%	40%	40%	42%	44%	48%
Growth rates:							
- Total (%)	-5.2%	91.5%	35.5%	31.5%	34.2%	28.6%	27.6%
- Welfare (%)	13.2%	86.8%	39.4%	32.5%	30.4%	24.1%	18.0%
- Sports (%)	-23.4%	98.2%	30.0%	30.0%	40.0%	35.0%	40.0%

Source: CIR estimate

Government initiatives to drive a boom in China lottery

Our bullish stance on the growth of the China lottery market is underpinned by what we believe is the Chinese government's concerted attempts to grow the industry. Just as the boom in Macau gaming was driven largely by the Chinese government's commitment to transform Macau into an entertainment destination of Greater China, we believe a boom in the China lottery market is a likely consequence of government's commitment to crack down on illegal gambling.

Figure 9. Legal vs. Illegal Lottery Estimates

Source: Peking University Center for Lottery Research estimates; Ministry of Finance

University studies have consistently estimated the size of China's illegal gambling market at between US\$75.0-87.5bn per annum, eight to ten times that of the legal lottery market in 2005. With increasing media scrutiny over this issue and the enormous amount of lost potential revenues, the incentive to fight illegal gambling is immense. In addition to curbing the supply of illegal gambling via tougher crackdown on illegal syndicates (10-year imprisonment for involvement in illegal gambling), we understand the government sees offering attractive legal lotteries as a complementary initiative that also brings in tax revenue.

The key initiatives the government has or will adopt to increase the attractiveness of legal lottery are as follows:

1. Introduction of newer more interesting games

New interesting games are expected to stimulate interest in the lottery and lead to a greater shift from illegal lotteries to the legal lottery. The introduction of "3D" game by welfare lottery in October 2004 demonstrates the point, with the game capturing ~43% of the welfare lottery turnover in 2005. Similarly, the sports lottery's new game in 2005, "Pailie of 3/5", captured ~60% of the sports lottery market in its first year. In our opinion, the introduction of new games played a huge role in the 90% growth of the market in 2005.

We believe the pace of new game introduction will pick up in the coming years. The welfare lottery is in the process of rolling-out "High frequency" games such as Keno and Video Lottery Terminal ("VLT") (though VLT is still in testing phase), and re-introduced scratch cards in 2005. "High frequency" games exhibit more frequent draw (every 3-15mins for Keno and on a per touch basis for VLT) and greater varieties while scratch-cards are simple and highly accessible/affordable. As such, their ability to draw further interest in the lottery market is good.

2. Expand distribution networks

To be attractive, the lottery needs to be more accessible. As such, its point-of-sale ("POS") is in the process of being widened to include karaoke bars, hotel lounges and F&B outlets, where it would compete more directly with illegal lotteries. High frequency games such as Keno should be especially effective in these venues as it allows patrons to be passively involved in lottery games while engaging in their primary activities. Further, larger dedicated lottery/entertainment venues are also being developed.

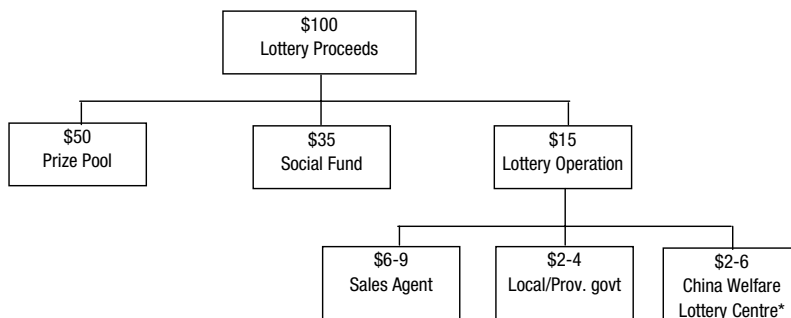
3. Higher payouts

We understand the government is exploring the possibility of raising the payout of lottery games from the current 50% to up to 75% which should make it more competitive against illegal gambling, which is thought to pay-out 80-90%.

While this will certainly make the lottery more attractive, we caution the difficulty in actually instituting such a change when it is unclear as to whose share of proceeds should be reduced. While many market participants indicate the social fund is the likely candidate for a share reduction, we believe this will involve some political backlash given the whole purpose of a welfare lottery is to raise funds for social welfare. To justify a halving of proceeds to the social fund (from 35% to 10-20%), lottery sales would need to double in size immediately if proceeds to the social fund are not to suffer. We believe this is unlikely, and hence regard an increase in payout as a longer-term possibility rather than immediate.

Current payout is just slightly lower than the US's 55% and Australia's 60%. Proceeds to Social fund is comparable

Figure 10. Current Allocation of Welfare Lottery Proceeds

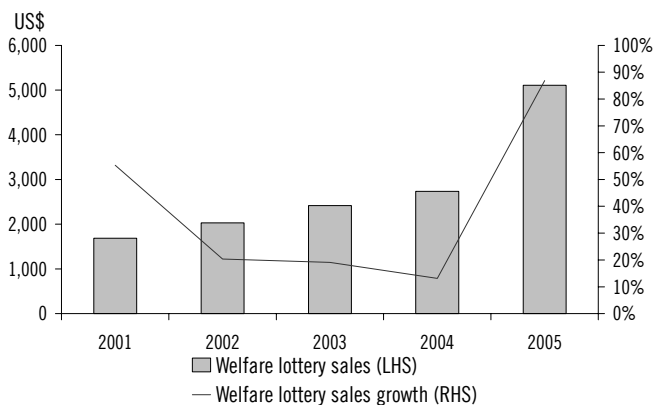


*It is from here that equipment suppliers such as China LotSynergy, Sinodata and Bozone will be paid by the Lottery center; Source: China LotSynergy; China Gloria

Welfare lottery vs sports lottery – which one will grow more?

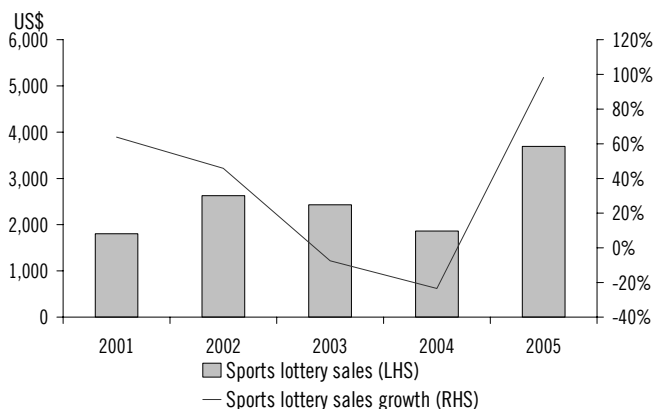
Only the welfare and sports departments currently have the authority to issue lotteries. In 2005, welfare lottery accounts for 58% of China's total lottery market, up from 48% in 2001. Share of sports lottery, on the other hand, tumbled to 42% (from 52%) over the same period as sales dropped by 29% over 2002-2004.

Figure 11. Welfare Lottery Sales and Sales Growth in 2001-2005



Source: Ministry of Finance

Figure 12. Sports Lottery Sales and Sales Growth in 2001-2005



Source: Ministry of Finance

The decrease in the popularity of sports lottery over the past few years has been attributed to numerous scandals involving fakes tickets issued by sales agents (the "BMW" case being the most famous) which diminished public confidence in the institution. Welfare lottery sales growth was relatively muted over the period, suggesting the scandals had been damaging to the entire sector, not just sports.

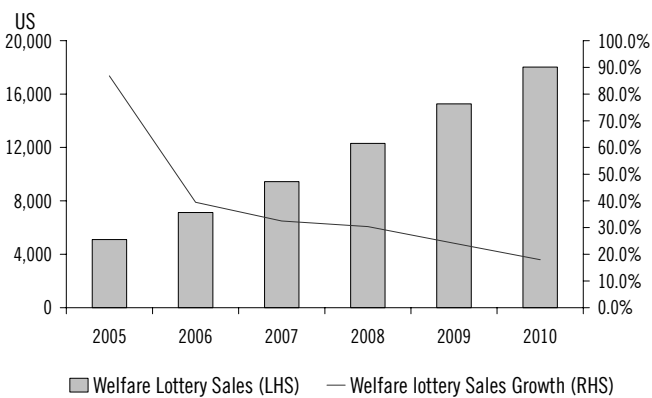
While the market recovered strongly in 2005 on the introduction of new games, sports lottery continues to lag welfare lottery on two fronts:

1. System integrity — sports lottery tickets are still batch processed rather than conducted online and on a real-time basis as in welfare lottery, which makes it less susceptible to manipulation; and
2. New games — welfare lottery has begun introducing high frequency games such as Keno and VLT, which are expected to undergo higher growth rates than traditional lottery products.

On this basis, we expect sports lottery to continue to lag that of welfare over the next two years. The gap is expected to narrow after that as sports lottery move to the real-time system as well as introducing high frequency games. As sports lottery upgrades itself, we believe it has higher growth prospects than the welfare lottery in the medium to long term. Sports lottery's advantage lies in sports betting, which is well understood by the public, but is an area we suspect is currently dominated by illegal gambling. But if legal sports betting can be liberalized to allow for variable-odds betting and betting during a game, its growth prospect is likely to be very substantial.

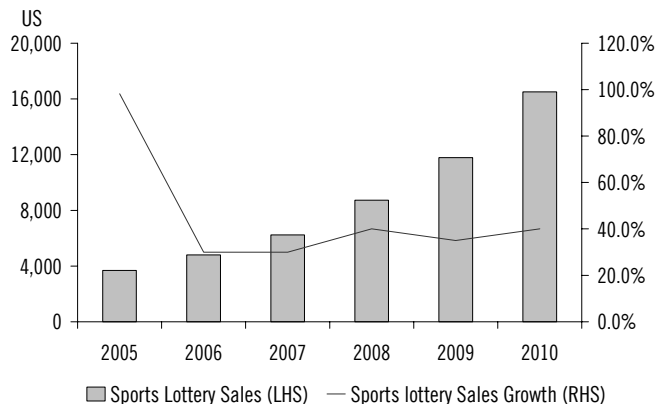
We understand the sports department is currently exploring ways to liberalize sports betting games, and we anticipate a decision could be made sometime over the next year or so. On the strength of sports betting, we expect sports lotteries will exhibit stronger growth from 2008-10 and its share of the lottery market improves to 48% by 2010.

Figure 13. Welfare Lottery Sales and Sales Growth In 2005-2010E



Source: Company Reports, Citigroup Investment Research estimates

Figure 14. Sports Lottery Sales and Sales Growth in 2005-2010E

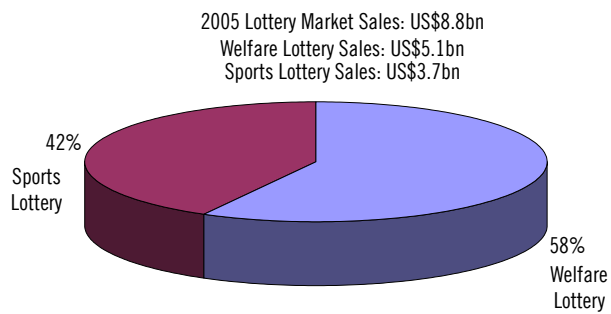


Source: Company Reports, Citigroup Investment Research estimates

China Lottery Market

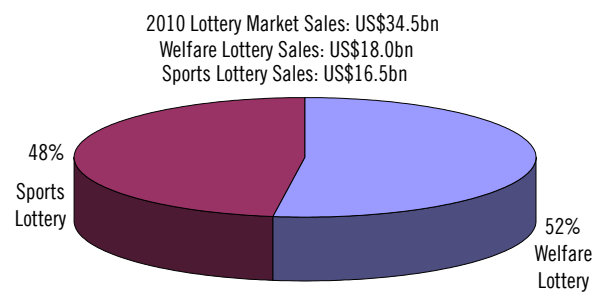
11 August 2006

Figure 15. Welfare vs Sports Lottery Market Share in 2005



Source: Ministry of Finance

Figure 16. Welfare vs Sports Lottery Market Share Forecast in 2010



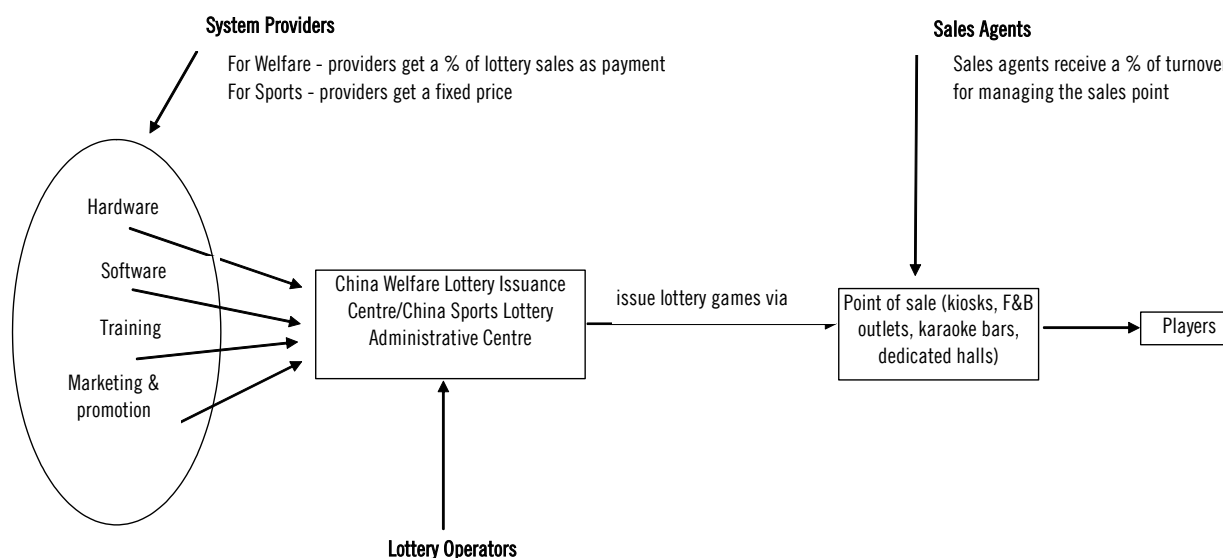
Source: Citigroup Investment Research estimates

How to participate in the expected growth?

There are two ways to participate in the anticipated growth of the China lottery industry, either as:

1. System providers; and/or
2. Sales agents.

Figure 17. China Lottery Supply Chain



Source: Citigroup Investment Research

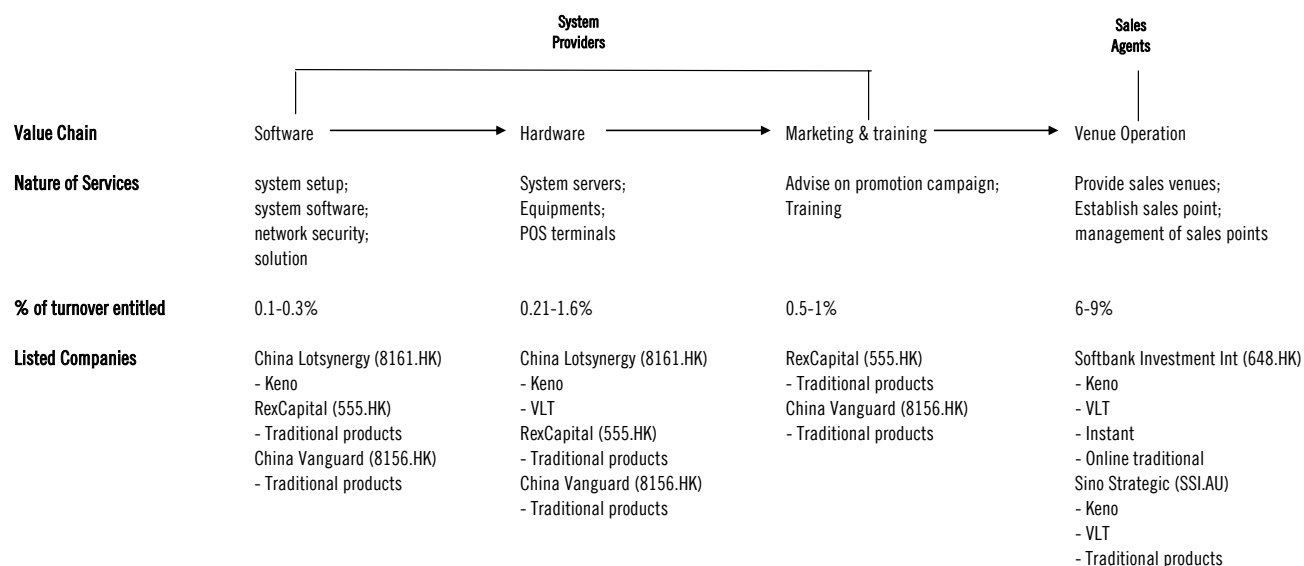
System Providers vs Sales Agents

Only the system provider to the welfare lottery participates in the growth of the market. System provider to the sports lottery receives a fixed amount

System providers refer to the suppliers of the software (including games), hardware and/or marketing and promotional services used by the Lottery Centers to run lottery services. These services were traditionally rendered for a fixed price. But following China Welfare Lottery Centre's ("CWLC") decision to upgrade the welfare lottery system/machines, the payment mechanism has now been revamped so that system providers receive a share of the 2-6% lottery turnover CWLC is entitled to instead. The purpose is to allow CWLC to upgrade its lottery system without having to bear the direct investment cost associated with such an upgrade at its own expense. As such, this effectively enables system providers of welfare lottery to participate in the potential growth of the market. These contracts are typically signed on a province-by-province basis over a three-four year terms (although China LotSynergy's contracts for Keno and VLTs are signed with entities controlled by the central government and for a ten-year term). It should be noted that system providers to the sports lottery are currently still paid a fixed fee basis, and hence do not benefit from any growth in the market.

Sales agents, on the other hand, manage the point-of-sales ("POS") of lotteries. Operating on behalf of the lottery centers, they pay all operating costs associated with running a venue, including shop rentals and fit-out, as well as collections. In exchange, they get a share of the lottery sales generated from their venues. While POS has traditionally only been confined to lottery kiosks run by sole traders, the current push by the CWLC will now see welfare lottery's POS expand to include karaoke and food & beverages outlets, as well as larger dedicated shops.

Figure 18. Services Offered by System Providers and Sales Agents



Source: Company Reports

While both system providers and sales agents are entitled to welfare lottery sales, they adopt very different business models. System provision is a high capex, high margin business while sales agent is a low capex, lower margin business.

Many VLT halls in Shanghai still making losses

Sales agent is typically entitled to 6-9% of sales turnover (5-7% typically in the US and 7-8% in Australia) and responsible for all operating expenses of the venue, a large component of which is fixed rental cost. As such, margins are typically volatile and negative until venue turnover passes the break-even point, after which margins should rise. We understand many of the CLO halls housing VLT machines in Shanghai are currently operating at a loss as turnover generated by the terminals are still insufficient to cover rental cost. System providers, on the other hand, typically receive only 1-3% of sales turnover, but given minimal operating costs, margins are significantly higher and more stable.

System providers, however, face significant upfront capex costs in order to deliver operating systems and terminals to the Welfare Centre. With receipts coming later in the form of a share of the turnover, there will be initial burden on cash flow and no guarantee receipts will be sufficient to recover its capex cost.

System providers of new lottery products are higher risk, higher return proposition

In relation to risk-reward, we would characterize system providers as higher risk/higher reward proposition compared to sales agents. Given the need to spend significant capex upfront, system providers stand to lose a large portion of their investment if the games/systems/terminals fail to gain acceptance in the market vs sales agents, whose loss would largely be limited to rental cost. However, if the games/systems/terminals receive wide acceptance by the market, returns should be much greater for system providers given minimal operating costs and a large potential market (usually province-wide) vs sales agents, whose returns would still fluctuate depending on location of their venues and how operating costs are controlled.

It is thus hardly surprising to see most of the listed China lottery companies are system providers that have come to the stock market to raise the necessary capital to finance their large capex needs. While there are quite a number of companies that have expressed their potential in entering the China lottery arena, the key ones are as follows:

1. REXCAPITAL (0555.HK; HK\$0.34; NR) – with 45.8% interest in SinoData, which is currently China's largest welfare lottery system supplier;
2. China LotSynergy (“CLS”) (8161.HK; HK\$1.15; 3S) – with a 33.3% interest in a Tabcorp JV, which is said to have a ten-year contract to roll-out Tabcorp's Keno game nationwide, and a 50% interest in Corich, which is said to have a ten-year contract to roll-out VLT machines nationwide;
3. China Vanguard (8156.HK; HK\$1.98; 1S) – with a 51% interest in Bozone, which is currently China's third largest welfare lottery system provider;
4. General Lottery (unlisted at the moment) – which is China's second largest welfare lottery system provider, and has plans to list on the NASDAQ next year;
5. Gtech (GTK.N; US\$34.46; 2M) – US's largest on-line lottery system provider is now rolling-out Keno games in Beijing; and
6. Scientific Games (SGMS.O; US\$29.28; 1H) – The US's largest instant lottery system provider is now rolling-out Keno games in Shanghai.

The only listed sales agents we are aware of are:

1. Softbank International (0648.HK; HK\$0.09; NR) – which has a 50% interest in a company that has a co-operation agreement with China Gloria, and is said to have sales agency rights in five provinces across China; and
2. Sino Strategic International (SSI.AU; A\$2.77; N.R) – which is a sales agent, distributing both Keno, VLT and traditional lottery games in Shanghai. It is listed in Australia.

Traditional, VLT and Instant Lotteries

There are currently three broad types of lottery games offered in China:

1. Traditional lottery;
2. VLT; and
3. Instant scratch cards

Growth in CTG relies on high frequency products and better distributions

Currently, ~98% of the lottery sales by CWLC are via the Computerised Ticket Games (“CTG”) which is also known as “traditional lottery”. These are numbers-based games that Chinese lottery centers have been operating since inception (Lotto, 2D and 3D). There are national and provincial pools with top prize-money of RMB5m and frequency of draw varying from weekly to daily. Tickets are purchased through cash register-type terminals from lottery kiosks, though distribution channels will be expanded to include F&B outlets, karaoke bars and dedicated halls.

With the introduction of high-frequency Keno in late 2005 through Scientific Games in Shanghai, Gtech in Beijing, and Tabcorp/CLS nationally, we believe traditional lottery will undergo significant transformation. To compete with the high drawing frequencies of Kenos, we believe the existing system providers of traditional lottery will have no choice but to also introduce similar high-frequency games for 2Ds, 3Ds and even Lotto. This would involve more investment in technology. We understand SinoData, controlled by REXCAPITAL, currently already has the technology to roll-out such games. We believe its introduction, along with Keno, will be a major driver of growth in this segment of the market, and underpins our 20-30% growth in the market in 2006-2008.

Figure 19. Welfare Lottery Market Forecasts from 2006-2010E

Welfare Lottery Market	2005	2006	2007	2008	2009	2010
Total (US\$m)	5,108	7,123	9,438	12,305	15,273	18,020
- CTGs (US\$m)	4,997	6,496	8,119	9,743	11,205	12,325
- Scratch Cards (US\$m)	28	126	314	753	1,356	1,898
- VLT (US\$m)	84	502	1,004	1,808	2,712	3,797
- CTGs (%)	98%	91%	86%	79%	73%	68%
- Scratch Cards (%)	1%	2%	3%	6%	9%	11%
- VLT (%)	2%	7%	11%	15%	18%	21%
Growth rates:						
- Total Welfare (%)	87%	39.4%	32.5%	30.4%	24.1%	18.0%
- CTGs (%)		30.0%	25.0%	20.0%	15.0%	10.0%
- Scratch Cards (%)		350.0%	150.0%	140.0%	80.0%	40.0%
- VLT (%)		500.0%	100.0%	80.0%	50.0%	40.0%

Source: CIR estimates

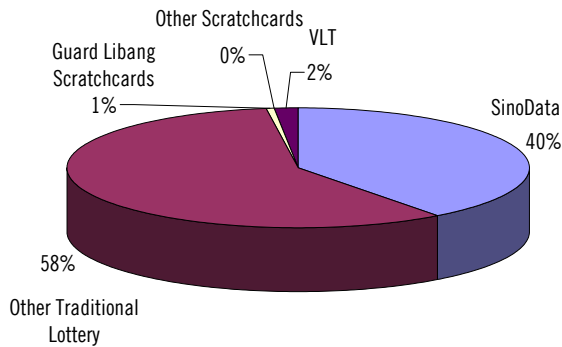
VLT has high growth prospects, but so are the risks. It is still in test phase

VLT (Video Lottery Terminal) is akin to western-styled slot machine where players sit at the terminal and choose a game to play (currently there are six games to choose from). Draw frequency is very high, as fast as the press of the button. This is a relatively new innovation, even by international standards. VLT sales in 2005 only totaled US\$6.8bn, accounting for ~3.6% of worldwide lottery sales. However, with high draw frequency and greater varieties, we believe it has significant growth opportunities. VLT sales only made up ~2% of the welfare lottery market in 2005 and are still in testing phase. We believe VLT sales would grow to US\$1.8bn by 2008 and account for 15% of the welfare lottery market and the second-largest VLT market in the world. Year-to-May, we understand VLT sales already reached ~RMB1.1bn, 63% higher than all of last year.

Instant scratch-cards has high growth prospects with lower risks given player familiarity with the products

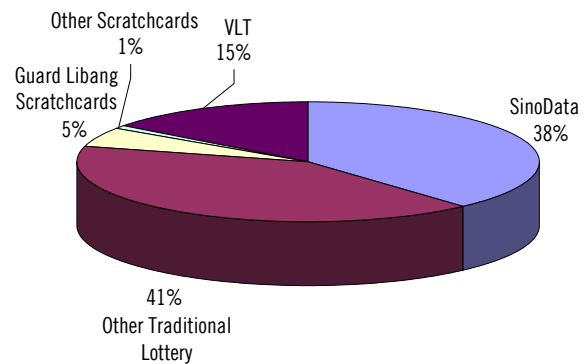
Instant scratch-cards were re-introduced to the market in 2005 following their removal in 2003 for the frequency of fake tickets. Its new anti-counterfeiting verification system, which has been tested for two years, is expected to overcome the problems of fake tickets. In 2005, they accounted for <1% of the market given slow geographic roll-out. But given it used to be US\$1bn market in its heyday in 1999, we believe its potential is immense. It should be noted that the instant lottery is a US\$27.6bn market in the US, making up 51% of the US lottery industry. Growth at instant games has averaged 8% over the past ten years in the US compared with 1% growth for traditional games. On this basis, we conservatively forecast instant lottery sales will grow to US\$753m by 2008, accounting for 6% of the welfare lottery market.

Figure 20. Market Share of Key Lottery Products in US (2005)



Source: La Fleur's 2006

Figure 21. Market Share Estimates of Welfare Lottery Products in PRC (2008)



Source: Citigroup Investment Research estimates

Waiting in the wings for a liberalization of sports Lottery

Though system providers to the sports lottery currently do not receive a share of lottery sales, our discussions with industry participants suggest this could change sometime over the next 6-18 months. As the China Sports Lottery Administration Centre (“CSAC”) moves to upgrade the sports lottery systems to match that of the welfare lottery, we believe it is also likely to adopt CWLC’s practice and offers system providers a share of lottery sales to avoid having to fund the upgrade themselves.

Given a potentially more lucrative market if and when the rules surrounding sports betting are relaxed, we believe system providers around the world with proven software, hardware and execution track record would be eager to secure a slice of the market. International players that already have operations in China, such as Gtech and Scientific Games, are well positioned, as are current system providers to the welfare lottery. China Vanguard recently announced its 51%-controlled JV, Guangdong Latech, is one of the approved sales terminal suppliers to CSAC. Furthermore, REXCAPITAL recently purchased a 58% stake in Kingsail, which is also one of the lottery system providers to the Sports Lottery.

Significant risks – Focus on proven players

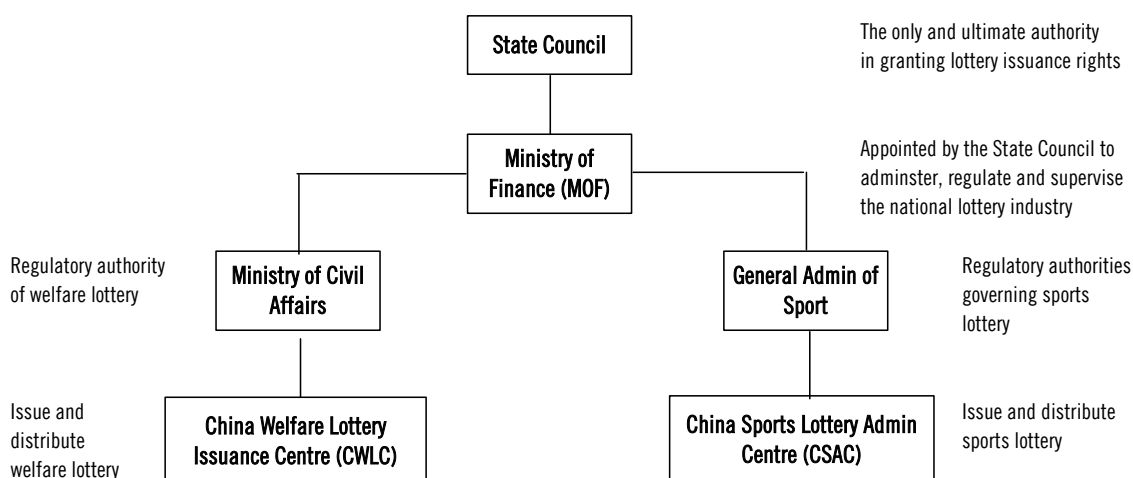
While the potential of China's lottery is great, so are the risks, which include regulatory uncertainties, technology risks, demand/roll-out risks and intensifying competition. Without the transparencies needed to make an assessment of the competitiveness of each player, our preference is for large players with a proven track record and whose operations are already well-entrenched in the lottery system. These players should face lower regulatory risk given good relationships with various levels of government, lower demand risk given more proven product offerings, and with better access to financing, should be able to make the necessary investment to mitigate technology risks.

Regulatory uncertainty

In our view, by far the single biggest risk facing investors in the China lottery market is the lack of clear regulatory regime that sets out the framework for the development of the industry. While the “Preliminary Regulations on the Licensing and Sales Administration of Lotteries” identifies the State Council as the body responsible for the licensing of the lottery, there are no existing laws and regulations governing the development, production and sales of lottery machines nor the provision of technical services and facilities.

There are currently two bodies of government with the authority to issue lottery licenses – 1) China Welfare Lottery Issuance Centre (“CWLC”) which issues welfare lottery licenses; and 2) China Sports Lottery Administration Centre (“CSAC”) which issues sports lottery licenses. CWLC is under the authority of the Ministry of Civil Affairs, while CSAC is under the General Administration of Sports, both supervised by the Ministry of Finance (“MOF”). MOF is a government department under the direct authority of the State Council.

Figure 22. China Regulatory Regime



Source: Company Reports

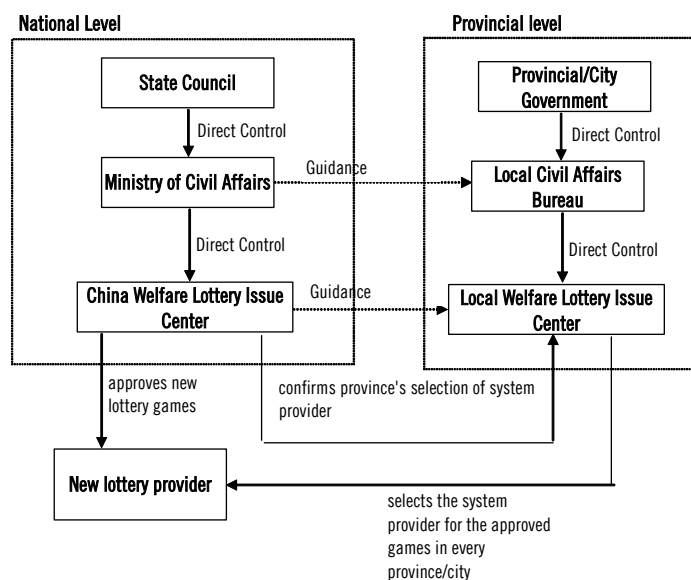
Both CWLC and CSAC are entitled to issue the same lottery, which is indeed what has been happening with welfare and sports lotteries, with both offering very similar numbers-based games (with different names). The effect is both bodies are able to grant “exclusive contracts” over the lotteries they issue. But without the ability to prevent other body from issuing the same lotteries, the “exclusive contracts” are effectively meaningless. Those who take the “exclusive contracts” to mean exclusivity over the whole province may end up disappointed and any feasibility studies based on it are likely to be flawed.

Furthermore, unlike developed markets such as the US and Australia which specifically empowers the provincial government with exclusive authority over lotteries, in the PRC, central and provincial governments are both involved in lottery matters, thereby significantly complicating the entire process of contract issuance. As we understand, all new lottery games (scratch cards, VLTs, Keno) need central government approvals (by either CWLC or CSAC). Once approved, the selection of lottery system providers is made on a province-by-province basis (local CWLC or CSAC). Provincial governments' decision on the contract winner will however still need to be later confirmed by the central government. Effectively, the approvals of both central and provincial governments are required before any lottery products can be rolled out in any province.

As such, the regulatory risk faced by new games such as VLTs and kenos are significantly higher than established games. Further, the practical value of a “national” contract is also questionable since the approvals of every provincial government are still necessary before it takes effect. For instance, whilst CLS/Tabcorp JV has an exclusive 10-year contract to roll out Keno, Gtech and Scientific Games are already operating the same Keno in Beijing and Shanghai. Additionally, a recent announcement by Chinese Peoples Gas (0681.HK, HK\$0.35; NR) has indicated the possibility of Hainan welfare center approving another version of VLT terminals, separate from what CLS is rolling-out.

In addition to jurisdictional issues, VLT faces a further regulatory risk from its similarity to western-style slot machines, which is prohibited in the PRC. The only real difference between VLT and slot machines are: 1) the proceeds are utilized to serve social good rather than pocketed by the gaming operators; and 2) unlike slots where each machine has its own random number generator, VLTs are linked to a central operating system. As such, the draw result is the same across all VLT terminals, theoretically making it easier to control. Nevertheless, we believe the government will be sensitive to any negative media coverage of the product. Hence, not only is VLT unlikely to be promoted heavily, but any media coverage of the social ills of VLT is likely to lead to a slow down in its roll-outs. The fact that VLT has been on trial for more than two years points to the high risk that the government attaches to the game.

Figure 23. Relationships between Central and Provincial Governments and Lottery Approval Process



Source: Citigroup Investment Research

Technology Risk

The success of a lottery hinges heavily on the technology, making it the primary operational risk of system providers. Not only do they need to deliver a system capable of linking all the POS across the province/s to a central system, the network needs to be fast, stable, capable to accommodate multiple games, and safeguard against counterfeit tickets, and have comprehensive sales and management systems. The demands on technology increase as the breath of distribution increases. As such, we believe CLS faces the greatest technology risk given its Keno and VLT terminals are to be linked nationally. The challenge is accentuated by the weak infrastructure at many regions across China.

Given the difficulty of assessing the technology capability of each player, we regard international players have the advantage over local players given the length of their operational track record. Tabcorp's involvement with CLS in the roll-out of keno has definitely brought some credibility into the venture.

Pricing pressure from increased competition

There are traditionally only five system providers to the welfare lottery with two players holding ~70% of the market. But with the potential growth of the industry, we believe competition will only increase, especially from international players. Gtech and Scientific Games have already secured a foothold of the market through its Keno offerings, and their ability to expand cannot be underestimated. Given contracts are typically only for 3-4 years, pressure on pricing as well as contract renewals are likely to be immense. As such, the risk to the 2% of turnover that SinoData and Bozone receive is high. CLS's position is more defensible given its contracts are for 10 years.

The pricing pressure exerted from competition can be highlighted by the relatively tiny revenue share CLS/Tabcorp JV secured (0.92%) for the supply of Tabcorp's Keno source code, system and hardware.

Demand/Roll-out risks

To capture the expected growth of the lottery market, we understand many system providers have set out aggressive roll-out targets. Failure to achieve the target will detrimentally hit earnings and hence valuation. The roll-out risk is especially high for new product offerings such as Keno and VLT where demand is not yet proven.

Lack of transparency

Unlike Macau gaming where the investment community can keep a close tab on its development from a month-by-month gaming revenue data as well as table numbers or conduct an actual site visit, China lottery suffers significantly from lack of visibility. Other than the annual welfare and sports lottery sales figures which are available from the Ministry of Finance, no other figures are provided by the government on a regular basis. As a result, it is difficult to get a good sense of the development of the industry on a timely manner.

Stick with proven players already entrenched in the system

Given the sizeable risk associated with an investment in the China lottery space, our recommendation is to focus on large players with proven track record whose operations are already well-entrenched in the lottery system. These players would face not only lower demand risk, but should also face lower regulatory and technology risks. The cost of replicating their systems is likely to be large, such that their platforms are more likely to be engaged in rolling out any new products on an effective manner. Hence, these players should face the highest growth prospects.

We initiate on China Vanguard with a Buy/Speculative Risk (1S) rating and a target price of HK\$2.70 on the value proposition offered by Aptus. However, on the China lottery front, it is a relatively small player with 13% market share and we believe it is likely to emerge as one of the key lottery players.

We maintain our Sell/Speculative Risk (3S) rating on China LotSynergy, but reduce our target price to HK\$0.90 on lower turnover assumption for VLT and Keno to be consistent with our top-down forecasts. While the products it is rolling out have significant growth potential (VLTs and Tabcorp's Keno), they are still unproven and hence suffers from the most demand risk. Additionally, roll-out of machines could be slower than their guidance as a result of the time needed to negotiate with provincial governments. But more importantly, we believe the market continues to be too bullish with its near-medium term prospects. We estimate CLS's current market capitalization assumes it will oversee ~US\$6.9bn of lottery sales in 2008, from virtually zero in 2005. This gives a market share of 54% of the welfare lottery market, based on our forecast of the market. While it is possible that our market forecasts are too low, it also highlights the bullishness still reflected in the share price. On the same methodology, China Vanguard is assumed to have 8% of the market vs 13% currently.

Figure 24. P/E Comparisons of China Lottery Plays

	Price (HK\$)	Market Cap (HK\$m)	Mkt Cap Lottery (HK\$m)	Earnings (HK\$m)		P/E	
				2007E	2008E	2007E	2008E
China LotSynergy	1.10	1,956	1,956	30	79	65.9	24.8
China Vanguard	1.89	1,179	584	17	30	36.7	20.0

Source: Company Reports, Citigroup Investment Research estimates

Figure 25. Market Share of Welfare Lottery Market as Implied by Market Capitalisation

Company	Price (HK\$)	Market Cap (HK\$m)	Mkt cap Lottery (HK\$m)	Implied 2008 Profits(HK\$m)	Implied Lottery Sales (US\$m)	Implied Mkt Share (%)	Current Mkt Share (%)
China LotSynergy	1.10	1,956	1,956	111	6,596	53.6%	4%
China Vanguard	1.89	1,179	584	34	930	7.6%	13%

Implied profits is arrived at based on a 17.6x 2008 P/E multiple which is the average of Gtech and Scientific Games;
Source: Citigroup Investment Research

Figure 26. Citigroup Global Gaming Valuation

Company	RIC	Rating	Price (LC, 9 Aug 06)	Mkt Cap (US\$m)	FY05 PE (x)	FY06 PE (x)	FY07 PE (x)	FY08 PE (x)	FY05 P/Bk (x)	FY06 P/Bk (x)	FY07 P/Bk (x)	FY08 P/Bk (x)
Harrah's Entertainment Inc	HET.N	1M	US\$59.44	10,982	16.9	16.6	14.7	12.5	1.2	1.1	1.0	1.0
Station Casinos Inc	STN.N	1M	US\$55.74	3,500	21.6	22.8	21.2	17.7	5.9	20.4	12.8	8.7
Boyd Gaming Corp	BYD.N	2H	US\$34.95	3,129	13.8	15.1	14.3	12.5	3.2	2.9	2.4	2.1
Rank Group PLC	RNK.L	1M	£2.08	2,309	36.4	17.5	15.2	14.1	8.3	-181.4	-159.0	35.1
Aztar Corp	AZR.N	2M	US\$51.79	1,890	34.5	35.8	29.3	27.2	2.9	3.1	2.9	2.6
Tanjong PLC	TJPL.KL	1L	RM13.50	1,484	13.8	14.5	12.6	11.3	2.3	2.0	1.9	1.7
Berjaya Sports Toto Bhd	BSTB.KL	1L	RM4.36	1,606	17.1	12.7	13.8	12.8	3.1	4.6	9.4	8.4
Hyatt Regency Hotels SA	HYAr.AT	2M	€11.00	1,186	20.0	16.9	14.2	NA	65.1	50.2	34.9	NA
Bally Technologies Inc	BYI.N	3S	US\$15.72	820	-800.9	51.2	23.3	18.4	4.5	4.1	3.5	2.9
Stanley Leisure Plc	SLY.L	2H	£6.00	812	29.4	31.6	19.3	17.1	1.3	2.4	1.7	1.6
International Game Technology Inc	IGT.N	1H	US\$37.25	12,631	30.2	27.6	24.8	21.0	7.2	7.0	6.0	5.1
OPAP SA	OPAr.AT	2H	€28.14	11,521	19.6	17.9	15.1	13.6	48.9	45.6	42.2	39.0
TABCORP Holdings Ltd	TAH.AX	1M	A\$15.11	6,030	15.2	14.8	13.6	12.9	2.3	2.2	2.2	2.1
Aristocrat Leisure Ltd	ALL.AX	1M	A\$11.90	4,241	23.2	22.6	15.9	14.6	15.9	15.7	12.2	9.8
Lottomatica Spa	LTO.MI	1M	€28.59	3,371	25.3	23.6	19.3	17.1	5.9	5.8	5.5	5.1
Intralot SA	INLr.AT	3H	€21.60	2,157	24.0	16.0	22.8	26.6	13.0	9.1	7.7	6.9
Unitab Ltd	UTB.AX	3L	A\$14.35	1,455	29.5	23.8	22.4	21.1	17.2	17.2	17.2	17.2
Tattersall's Ltd	TTS.AX	2M	A\$2.80	1,504	13.8	15.1	13.7	11.8	19.8	3.6	3.4	3.3
China LotSynergy	8161.HK	3S	HK\$1.16	264	NA	-295.1	24.3	8.4	NA	1.5	1.4	1.2
Ainsworth Game Technology Ltd	AGI.AX	2S	A\$0.39	57	-5.7	16.0	11.2	8.4	1.5	1.2	1.0	1.0
<i>Core Lottery Plays</i>												
Gtech Holdings Corp	GTK.N	2M	US\$34.46	4,390	24.0	20.7	20.3	18.4	6.1	3.9	3.3	2.8
Scientific Games Corp	SGMS.O	1H	US\$29.28	2,832	29.0	26.6	18.9	16.2	6.8	5.4	4.1	3.2
<i>Core Macau Gaming Plays</i>												
Las Vegas Sands Corp	LVS.N	2H	US\$61.20	21,684	53.8	49.1	35.1	22.0	13.5	10.6	7.2	5.4
MGM Mirage Inc	MGM.N	2H	US\$34.85	9,951	21.8	18.3	14.8	12.9	1.5	1.3	1.0	0.9
Wynn Resorts LTD	WYNN.O	1H	US\$71.00	7,163	358.2	163.9	31.8	26.1	4.5	4.4	2.7	2.4
Galaxy Entertainment	0027.HK	2H	HK\$6.88	2,915	-23.4	-39.2	-511.9	123.1	1.5	1.6	1.6	1.6
Melco	0200.HK	1M	HK\$17.22	2,712	37.5	869.0	48.2	12.3	6.2	6.3	5.7	4.0
Shun Tak	0242.HK	3M	HK\$9.74	2,744	83.4	38.4	41.4	20.0	3.0	2.8	2.7	2.4
Average (All)					37.6	30.2	9.7	18.5	10.6	6.4	5.2	7.3
Average (Core Macau)					83.7	51.3	-2.4	26.3	7.8	6.4	4.5	3.5
Average (Lottery)					26.0	23.0	19.8	17.6	6.3	4.5	3.6	3.0

Source: Powered by DataCentral

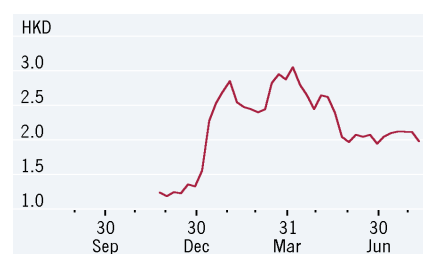
Figure 27. Types of Lotteries in the PRC

Lottery Type	Description
Welfare Lottery	
Lotto	<ul style="list-style-type: none"> - Pick seven numbers out of a total of 36 or 37 - Eight numbers are drawn - seven drawn numbers and one special number - Win by guessing at least four drawn numbers or three drawn and one special number - Drawn typically twice a week
2D	<ul style="list-style-type: none"> - Pick six numbers from a set of red balls numbered one to 33 and one number from a set of blue balls, one to 16 - Win by getting at least one blue number right - RMB2 per bet - Drawn three times a week
3D	<ul style="list-style-type: none"> - Pick a three-digit number from 000 to 999 - Win by guessing the number or any permutation of the digits - One draw a day but every hour in some province - Each province has its own prize pool
Scratch-and-win	<ul style="list-style-type: none"> - Buy a pre-printed ticket - Scratch the ticket to instantly reveal whether a prize has been won
Keno	<ul style="list-style-type: none"> - Choose 20 numbers from one to 80, and 10 numbers will be drawn - Win by guessing at least eight of the 20 numbers - high frequency, that is, one every five to 15 minutes
VLT	<ul style="list-style-type: none"> - Insert an electronic card into the video lottery terminal & choose to play any of the six games currently on offer - Cost as little as RMB0.20 per game - High frequency, that is, it is by the press of the button
Sports Lottery	
Sports Lotto	<ul style="list-style-type: none"> - Pick seven numbers out of a total of 29 - Eight numbers are drawn - seven drawn numbers and one special number - Win by guessing at least four drawn numbers or three drawn and one special number - Drawn typically three times a week - RMB2 per bet
Seven Stars	<ul style="list-style-type: none"> - Another type is pick five out of 22. Win by guessing at least three numbers. Cost RMB6 per game and drawn daily - Pick a seven-digit number from 0000000 to 9999999 - Win by guessing two (or above) digits - RMB2 per game - Drawn typically three times a week
Pailie3/5	<ul style="list-style-type: none"> - Choose three-digit number from 000 to 999 and win by getting the number or permutation - RMB2 per game and drawn daily - Another type is a five-digit number from 00000 to 99999 and win by getting the number. - RMB2 per game and drawn three times a week
Football Bet	<ul style="list-style-type: none"> - Bet on the result of each match out of a set of 14 matches - Players win by guessing a minimum of 13 results - RMB2 per match, totaling RMB28 for one set - Another type is bet on a total number of goals in each match out of 12 matches. Win by guessing at least 10 numbers
Basketball Bet	<ul style="list-style-type: none"> - Bet on the number of points for each time in the first half and the whole game - Win if guess the number correctly - RMB2 per game

Source: Company Reports

Buy/Speculative	1S
Price (11 Aug 06)	HK\$1.89
Target price	HK\$2.70
Expected share price return	42.9%
Expected dividend yield	1.1%
Expected total return	43.9%
Market Cap	HK\$1,179M US\$152M

Price Performance (RIC: 8156.HK, BB: 8156 HK)

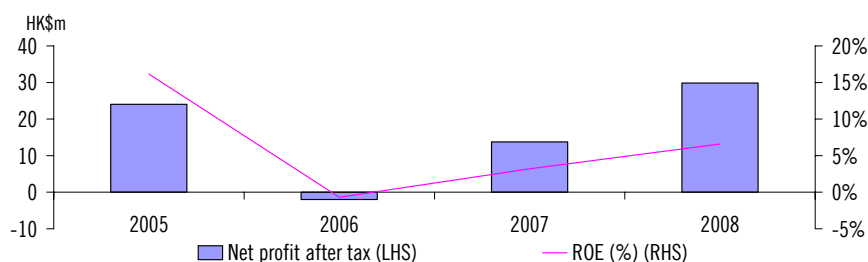


China Vanguard Group (8156.HK)

Value Proposition - Aptus at Half Price & China Lottery for Free

- Aptus at half price and China lottery for free** — The company's stake in Aptus is currently valued at HK\$2.3bn in the market, almost double China Vanguard's market cap. Investors effectively gain a share of Aptus at half price plus a China lottery business for free, on our estimates.
- Initiate at Buy** — Given such an attractive value proposition, we initiate coverage with a Buy/Speculative Risk (1S) rating and a sum-of-the-parts (SOTP) derived target price of HK\$2.70. For 55%-owned Aptus, we apply a 50% discount to current market value, and for the China lottery business we apply a multiple of 13.2x to 2008E earnings, a 25% discount to international peers.
- More oil & gas than lottery play** — With 69% of its valuation coming from Aptus, we regard China Vanguard as more an oil & gas play than a China lottery play.
- Valuation of Aptus driven by future injections** — Aptus' share price has priced in the potential injection of further oil and gas assets, in our view. If these injections take place and the market value of Aptus is reflected in the group's share price, our valuation could rise to as high as HK\$4.55. Given good working relationships with Hua You, a subsidiary of CNPC, we believe the prospects are good.
- Small lottery player** — With only 13% market share in 2005, Bozone is a small lottery player, which we believe will struggle in the face of tougher competition.
- Poor track record** — Since 2002, management has entered into three different businesses, sold one, and failed to proceed on a number of deals announced to the market. We consider lack of management track record greatest risk to the stock.

Figure 1. China Vanguard – Earnings Profile, 2005-08E



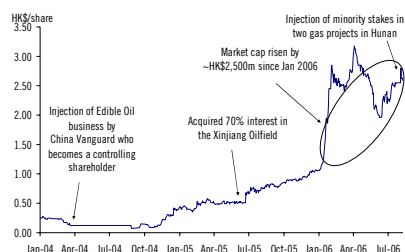
Source: Company Reports, Citigroup Investment Research estimates

Fiscal year end 30-Jun	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E adjusted (x)	na	38.1	nm	83.9	38.8
EV/EBITDA adjusted (x)	na	na	nm	11.0	6.1
P/BV (x)	na	5.7	2.8	2.6	2.5
Dividend yield (%)	na	1.1	1.1	1.1	1.1
Per Share Data (HK\$)					
EPS (adjusted)	na	0.05	0.00	0.02	0.05
EPS (reported)	na	0.07	0.03	0.08	0.05
BVPS	na	0.33	0.67	0.73	0.76
DPS	na	0.02	0.02	0.02	0.02
Profit & Loss (HK\$M)					
Net sales	na	189	95	189	316
Operating expenses	na	-165	-120	-139	-210
EBIT	na	24	-26	50	106
Net interest expense	na	-2	-3	3	-2
Non-operating/exceptionals	na	18	45	40	11
Pre-tax profit	na	40	16	92	115
Tax	na	-9	-3	-18	-20
Extraord./Min.Int./Pref.div.	na	1	4	-28	-65
Reported net income	na	32	18	46	30
Adjusted earnings	na	24	-2	14	30
Adjusted EBIT	na	24	-26	50	106
Growth Rates (%)					
EPS (adjusted)	na	na	-107.4	712.9	116.4
EBIT (adjusted)	na	na	-206.8	295.4	111.7
Sales	na	na	-50.0	100.0	66.9
Cash Flow (HK\$M)					
Operating cash flow	na	17	-35	106	137
Depreciation/amortization	na	3	4	34	53
Net working capital	na	4	0	-3	0
Investing cash flow	na	-8	-20	-353	-133
Capital expenditure	na	-1	-33	-183	-108
Acquisitions/disposals	na	-7	13	-170	-25
Financing cash flow	na	0	243	7	-24
Borrowings	na	8	0	0	0
Dividends paid	na	-9	-10	-12	-12
Change in cash	na	11	189	-240	-20
Balance Sheet (HK\$M)					
Total assets	na	248	530	618	689
Cash & cash equivalent	na	135	357	117	97
Net fixed assets	na	3	49	148	203
Total liabilities	na	78	78	85	85
Debt	na	56	56	56	56
Shareholders' funds	na	171	452	533	604
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	na	14.0	-23.1	44.5	50.3
ROE adjusted	na	na	-0.7	3.2	6.6
ROIC adjusted	na	na	-29.5	17.8	33.9
Net debt to equity	na	-46.3	-66.5	-11.4	-6.7
Total debt to capital	na	24.8	11.1	9.6	8.5

For further data queries on Citigroup's full coverage universe please contact CIR Data Services Asia Pacific at +852-2501-2791.

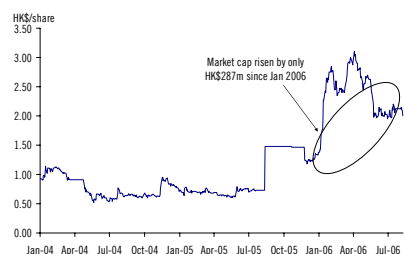


Figure 2. Aptus Market Cap Has Risen by HK\$2,500m since Jan 2006



Source: DataStream, CIR

Figure 3. China Vanguard Market Cap Has Only Risen by HK\$280m since Jan 2006



Source: DataStream, CIR

More oil and gas than China lottery play

We initiate coverage on China Vanguard Group (“China Vanguard”) with a Buy/Speculative Risk (1S) rating and a target price of HK\$2.70, based on our sum-of-the-parts (SOTP) valuation. We value 51%-owned Bozone, the third-largest lottery system supplier to the welfare lottery, on 13.2x 2008 earnings, which is at a 25% discount to the average of its international peers to reflect our view it will struggle to grow in the future. Aptus, China Vanguard's listed 55%-owned oil and gas play, is valued on a 50% discount to market value.

Significant value propositions drive our Buy rating on the stock. Even after applying large discounts to the value of key businesses, our SOTP valuation of Hk\$2.70 is still 43% above the current share price. The current market value of its 55% stake in Aptus is HK\$2.3bn, almost double China Vanguard's market capitalization of HK\$1.2bn. At current levels, China Vanguard effectively offers investors a share in Aptus at half its value in the market place and a China lottery business for free, on our estimates.

Aptus' current share price anticipates the injection of further oil and gas assets, and in the event this does not happen significant downside risk exists, in our view. On DCF, with the oil price remaining at US\$68/share (YTD average), we estimate Aptus is worth ~HK\$1.4bn, still 17% higher than China Vanguard's market capitalization.

Figure 4. China Vanguard SOTP Valuation, Aptus Valued on 50% of Market Cap (Base)

Business	Rate	HK\$m	HK\$/share
China Lottery	@ 13.2x 2008 P/E	449.7	0.74
Aptus	@ 50% mkt cap	1,128.5	1.85
Other businesses	@ 2005 BV	10.0	0.02
Net Cash/(Net Debt)	@ Jun 2007	60.73	0.10
Total		1,649.0	2.70

Source: Company Reports, Citigroup Investment Research estimates

Figure 5. China Vanguard SOTP Valuation, Aptus Valued on Market Cap (Scenario I)

Business	Rate	HK\$m	HK\$/share
China Lottery	@ 13.2x 2008 P/E	449.7	0.74
Aptus	@ market cap	2,257.0	3.70
Other businesses	@ 2005 BV	10.0	0.02
Net Cash/(Net Debt)	@ Jun 2007	60.73	0.10
Total		2,777.4	4.55

Source: Company Reports, Citigroup Investment Research estimates

Figure 6. China Vanguard SOTP Valuation, Aptus Valued on 2008 DCF (CIR oil price est) (Scenario II)

Business	Rate	HK\$m	HK\$/share
China Lottery	@ 13.2x 2008 P/E	449.7	0.74
Aptus	@ 2008 DCF	563.5	0.92
Other businesses	@ 2005 BV	10.0	0.02
Net Cash/(Net Debt)	@ Jun 2007	60.7	0.10
Total		1,083.9	1.78

Source: Company Reports, Citigroup Investment Research estimates

Figure 7. China Vanguard SOTP Valuation, Aptus Valued on 2008 DCF (CIR oil price est) (Scenario III)

Business	Rate	HK\$m	HK\$/share
China Lottery	@ 13.2x 2008 P/E	468.9	0.77
Aptus	@ 2008 DCF	1,379.4	2.26
Other businesses	@ 2005 BV	10.0	0.02
Net Cash/(Net Debt)	@ Jun 2007	66.4	0.11
Total		1,924.6	3.16

Source: Company Reports, Citigroup Investment Research estimates

Valuation of Aptus the key

Although China Vanguard is officially a China lottery company, a greater driver of valuation for the foreseeable future is oil and gas, through 55%-owned listed Aptus.

Aptus a bigger valuation driver than lottery

Aptus currently has a market capitalization of HK\$4.1bn, valuing the group's 55% stake at HK\$2.3bn, about 90% higher than its own current market capitalization of HK\$1.2bn. On this basis, the group would be valued at HK\$2.8bn (see Figure 5) with Aptus making up 81% of the total, which implies the current share price is trading at a 58% discount.

Aptus' share price anticipating injection of further oil and gas assets

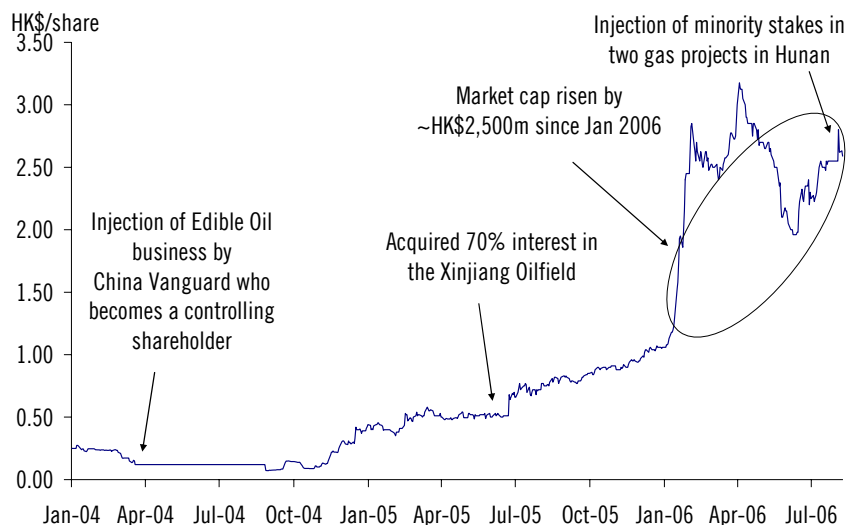
Aptus' current share price anticipates the injection of further oil and gas assets, in our view. And the recent injections of two gas projects in Hunan have firmed up such expectations. While management has a good working relationship with Hua You (a subsidiary of CNPC), and hence should benefit from more injections, such negotiations take time. As such, we believe the risk that such expectations will not be realized in the short term is high, which would likely have detrimental effects on the share price of Aptus.

However, even if the above risk is realized and Aptus' share price falls by, say, 50%, China Vanguard's stake in Aptus would still be ~HK\$1.1bn, very close to its current market cap. In such a scenario, investors in China Vanguard would still have effectively acquired an interest in the China lottery business at zero cost.

What is the fair value of Aptus?

What is the fair value of Aptus? It currently houses two businesses, a loss-making edible-oil business and an oilfield in Xinjiang province, and it is in the process of acquiring two natural gas businesses in Hunan province. Ignoring the loss-making edible oil business, which we understand will be sold shortly, we value China Vanguard's share in Aptus at HK\$564m on 2008 DCF and using CIR's oil price assumptions. This is about a quarter of Aptus' current market capitalisation. However, if the oil price remains at US\$68/bbl (average YTD), then our DCF valuation of the existing three assets rises to HK\$1,379m, still 17% above the group's market capitalisation.

Figure 8. Share Price of Aptus Holdings Since Jan 2004



Source: Company Reports

Aptus' assets

70% of Xinjiang oilfield

CNPC Investment's sole asset is development rights in a Xinjiang oilfield

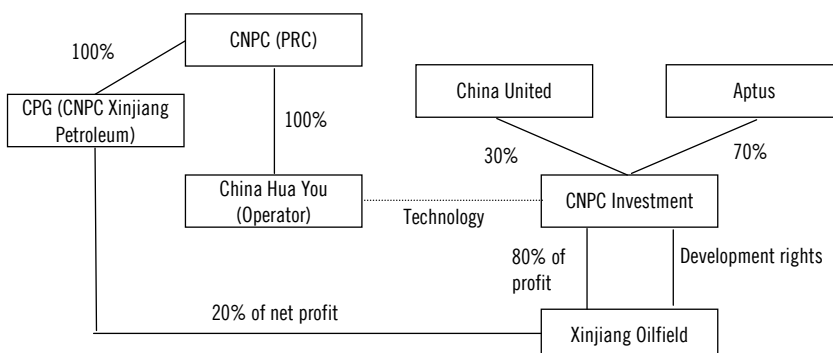
In June 2005, Aptus acquired a 70% stake for HK\$15m in CNPC Investment, whose sole asset is development rights in a Xinjiang oilfield containing 44mmbbl of crude reserves with mining rights expiring in 31 December 2016.

CNPC Investment's role in the venture is the provision of capital. China Hua You (a subsidiary of CNPC) is the operator and provides all the technology know-how. There is a profit-sharing agreement whereby CNPC is entitled to 20% of net profit from the investment and 80% will go to CNPC Investment (split 70:30 with Aptus and China United). At same time, all oil produced will be sold to CNPC for two-thirds of the WTI price.

Oil production will not hit a peak until May/June 2007

Aptus is obliged to invest RMB70m as an initial investment. Further capex of ~US\$70m will be needed over the next few years (Aptus responsible for 70% of the capex) to fund the drilling of exploration wells. While oil has begun to trickle through, the geographic location of the oilfield means no production is possible during the winter months of Dec-Feb. We understand oil production will not hit a peak until May/June 2007.

Figure 9. Xinjiang Oilfield Organizational Structure



Source: Company Reports

Figure 10. Aptus Financials

Year end 30 June	2006E	2007E	2008E	2009E	2010E
Turnover					
- existing business	27.1	13.6	6.8	6.8	6.8
- Oil business	0.0	55.6	124.8	234.0	623.9
- Others	0.1	0.1	0.1	0.1	0.1
Total Turnover	27.2	69.3	131.7	240.8	630.8
Existing business operating exp	-43.7	-21.9	-10.9	-10.9	-10.9
Oil business operating exp	0.0	-27.2	-68.4	-137.9	-416.3
Existing business EBITDA	-16.5	-8.2	-4.1	-4.1	-4.1
Oil business EBITDA	0.0	28.4	56.3	96.1	207.6
Existing business D&A	0.0	0.0	0.0	0.0	0.0
Oil business D&A	0.0	-23.3	-40.4	-57.4	-74.5
Existing business EBIT	-16.5	-8.2	-4.1	-4.1	-4.1
Oil business EBIT	0.0	5.2	16.0	38.6	133.1
Group EBIT	-16.5	-3.0	11.9	34.6	129.0
Profit from associates (b/f tax)		0.3	11.3	20.9	44.3
net interest expense	-1.9	-2.4	-2.7	-2.8	-2.8
EBT	-18.4	-5.2	20.5	52.7	170.5
income tax	-0.3	-2.0	-6.1	-17.9	-58.0
Net profit after tax	-18.7	-7.2	14.4	34.8	112.5
minorities	-0.1	-1.0	-3.0	-7.2	-24.7
Net profit attrib to minorities	-18.7	-8.1	11.5	27.6	87.8

Source: Company Reports, Citigroup Investment Research estimates

Two natural gas assets in Hunan

On 25 July 2006, Aptus announced it has acquired a 48.33% interest in Changde JV for Rmb131.7m and 33.0% interest in Hunan JV for Rmb79.6m.

Hunan JV is engaged in the construction and operation of a main gas pipeline

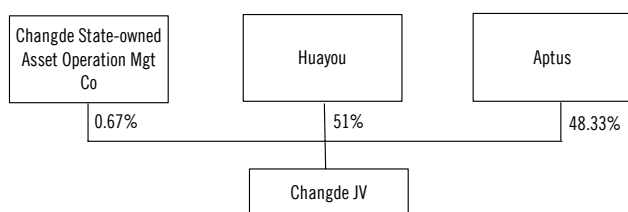
The Hunan JV is engaged in the construction and operation of the main gas pipeline extending from Changsha City to Changde City in Hunan province. It is a provincial level main gas pipeline, a branch of the West-East Gas pipeline. Construction of the pipeline is essentially complete (capex estimated at RM320m), and operations have begun. Revenue is derived by charging the city level gas distributors (such as Changde JV) a transportation fee based on each cubic metre of natural gas transported along the pipeline. We understand the pipeline has a capacity to transport 250m cubic metre of gas per annum, which could rise to 350m cubic metre in the future.

The Changde JV, on the other hand, is a city level distributor, responsible for supplying natural gas to end-users including residential, commercial and industrial units within the Changde region. Revenue is derived from two sources: 1) connection fee to end-user – a one-off cost for residential and on-going for commercial users dependent on usage size; and 2) markup fees from the sale of the natural gas. We forecast a mark-up of 25%.

Vastly different business models

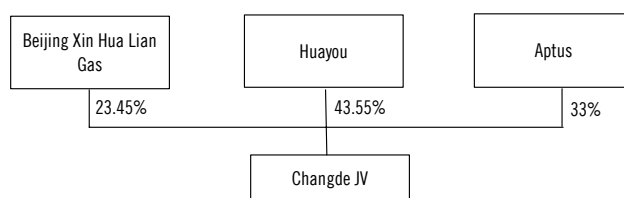
The business models for Hunan JV and Changde JV are vastly different. Hunan JV operates on economies of scale given its high fixed cost. As such, it is likely to operate on very low margins at the beginning, EBITDA margin should rise to ~50% as it hits capacity. Changde JV, on the other hand, receives significant connection fees at the start as it signs up customers, but growth will slow as penetration increases (one-off fees for residential). As a result, we expect its EBITDA margin to fall over time.

Figure 11. Ownership Structure of Changde JV



Source: Ministry of Finance

Figure 12. Ownership Structure of Hunan JV



Source: Ministry of Finance

Bozone: A small China lottery player

China's third-largest system provider to CWLC

Bozone was acquired in March 2006, and is China's third largest system provider to CWLC with a market share of ~13% in 2005, behind SinoData's ~40% and General Lottery's ~30%. Although it has been operating since 2000, it only has supply contracts with three provinces (Heilongjiang, Zhejiang and Fujian) and one municipality (Shenzhen — Fujian contract is new). Bozone's services were traditionally confined to that of a software provider to the lottery department with no hardware and/or marketing & promotion contracts with the provinces. However, with a more aggressive approach over the past two years, it has expanded the services it offers and increased the number of provinces it pursues. Share of revenue is expected to rise from ~0.2% in 2005 to ~2% by 2008 (similar to SinoData). Management recently purchased a 51% stake in Jinan Weita in order to acquire hardware manufacturing capability.

Given its size, Bozone is likely to struggle in the marketplace

Despite its recent contract winning and management's efforts to shore up its capability, Bozone remains a small China lottery player. Without size as a bargaining chip and operating history other than in the software department, we believe it will struggle to compete effectively in a marketplace which is becoming increasingly competitive.

In our forecast, we assume it retains all four of its existing provinces/municipals, whose lottery turnover increases at same rate as the market, and its share of lottery revenue increases to 2% by 2009. By 2008, we estimate its market share of the welfare lottery market would slip to ~12%, although as a percentage of the traditional lottery market, it increases slightly to 15%.

Bozone unlikely to offer same growth opportunities as SinoData

China Vanguard believes it is able to acquire five new contracts over FY07-08 which would increase its market share to 36% by end FY08. However, incremental contract wins have not been shown in our numbers. On current credentials, however, we do not believe Bozone offers the same growth opportunities as SinoData.

Nevertheless, we expect Bozone's financials to jump significantly from FY2005 to FY2008 as it receives a greater percentage of lottery turnover. We forecast Bozone's EBIT to rise from Rmb31m in CY2006 to Rmb116m in CY2008 on EBIT margin of 59%.

Figure 13. Bozone Financial Forecasts (Rmbm)

Calendar Year	2006	2007	2008	2009	2010
Ownership interest	51.00%	51.00%	51.00%	51.00%	51.00%
Turnover	63.1	145.1	197.5	256.6	282.3
Operating expenses	-28.4	-58.0	-69.1	-89.8	-98.8
EBITDA	34.7	87.0	128.4	166.8	183.5
D&A	-3.2	-10.3	-11.9	-13.2	-16.2
EBIT	31.5	76.7	116.4	153.7	167.3
Net Interest Expense	0	0	0	0	0
Earnings b/f tax	31.5	76.7	116.4	153.7	167.3
Income tax	-4.7	-11.5	-17.5	-23.0	-25.1
Earnings a/f tax	26.8	65.2	99.0	130.6	142.2
minority interest	-8.3	-20.1	-30.7	-40.5	-44.1
Earnings a/f tax attrib to Bozone	18.5	45.1	68.3	90.1	98.0
Earnings a/f tax attrib to B&B	9.4	23.0	34.8	45.9	50.0

Source: Company Reports

Inconsistent management operational record the key risk

Deal-making is a management strength

The primary concern we have on the group and the key reason for applying a holding company discount is the lack of operational track record of the management team. Since listing on GEM market in late 2002, the company has ventured into three different businesses, sold one, failed to proceed with a number of deals which it had announced to the market, and changed its name three times (four times if one includes a proposed name which was rejected by the Cayman Islands). All these were overseen by essentially the same management team. Over four years since listing, its share price has jumped by >500%, yet net profit after tax has only risen by 130%.

However, operationally the track record is wanting

Based on this record, deal-making is a strength of the management, to which its ability to secure the injections of three oil and gas assets into Aptus over the past is testament. However, the management has not proven itself operationally. Most of the businesses it has operated have deteriorated over the years. Turnover and margins at its natural products business has contracted over the past year and is a key driver behind its decision to exit. Furthermore, the edible oil business has been loss-making for the past two years and it recently sold its department store JV that it established only 2.5 years ago on concerns over margins. While China lottery and oil & gas certainly appear to be more attractive

industries than natural products and retailing, management's lack of operational track record is a concern.

Corporate governance is a potential risk

Another risk is corporate governance. Bozone was the group's second foray into China lottery (announced in December 2005). Its first foray (announced in August 2005) failed. However, the circumstances under which the deal were announced and terminated do not bode well for the management team, in our view. First, the deal involved the injection of an entity privately-held by Madam Cheung and Mr. Chan Ting (the controlling shareholder of China Vanguard) for HK\$330m. This was despite the entity only having a net asset value of HK\$3,000. Second, the entity is said to have a co-operative agreement with a "license holder" of the welfare lottery with the license to operate and manage the lottery POS in the PRC. The deal was subsequently terminated two weeks later when it was discovered the partner did not have such a "license". The management and the board of directors' failure to clarify such a basic, yet critical, point before announcing to the market indicates weak corporate governance within the group, in our view.

Controlling shareholders own 39.5% of the shares

Shareholding Structure

The number of shares outstanding totals 609.87m. Controlling shareholders (Madam Cheung and Mr. Chan) control 39.5% of the shares, mostly through their wholly-owned company, Best Frontier Investments. Its interest has been diluted down from 65.5% at the time of listing. It has sold a total of 20m shares over the period. Haven Associates, an entity controlled by one of its directors, holds 7.64% of the shares. 52.5% of the issued shares are controlled by the public, although Oppenheimer Funds, alone, owns 18.0%.

Figure 14. China Vanguard Shareholding Structure as at 24 May 2006

Shareholders	No of shares (millions)	%
Best Frontier Investments Ltd, Chan Tung Mei and Cheung Kwai Lan and associates	242.51	39.54%
Oppenheimer Funds Inc	110.00	18.04%
Haven Associates Ltd	46.60	7.64%
Lau Hin Kun	0.45	0.07%
Public shareholders	210.31	34.49%
Total shares outstanding	609.87	100.00%

Source: Company Reports, Citigroup Investment Research

Over the past year, it has placed 92.1m shares in the open market to finance the acquisition and expansion of Bozone – 24.1m shares at HK\$0.912/share in December 2005 and 68m shares at HK\$2.15 in January 2006.

Financials

Figure 15. China Vanguard P&L (HK\$m)

For the period ending 30 Jun	2005	2006	2007	2008	2009	2010
Bozone		15.3	105.9	179.1	237.5	281.8
Aptus		27.2	69.3	131.7	240.8	630.8
Other business		52.1	14.0	5.0	5.0	5.0
Total Turnover	189.1	94.6	189.2	315.8	483.3	917.6
Bozone operating expenses		-6.9	-44.0	-66.5	-83.1	-98.6
Aptus operating expenses		-43.7	-49.1	-79.4	-148.8	-427.3
Other operating expenses	-162.7	-65.8	-10.0	-6.0	-6.0	-6.0
Bozone EBITDA		8.4	61.9	112.6	154.4	183.2
Aptus EBITDA		-16.5	20.2	52.3	92.0	203.5
Other EBITDA		-13.8	4.0	-1.0	-1.0	-1.0
Group EBITDA	26.4	-21.9	86.2	163.9	245.4	385.7
Bozone D&A		-3.1	-10.5	-12.5	-13.8	-17.0
Aptus D&A		0.0	-23.3	-40.4	-57.4	-74.5
Other D&A	-2.5	-0.6	-0.6	-0.6	-0.6	-0.6
Bozone EBIT		5.3	51.5	100.2	140.6	166.2
Aptus EBIT		-16.5	-3.0	11.9	34.6	129.0
Other EBIT		-14.3	3.4	-1.6	-1.6	-1.6
Head office expenses			-2.0	-5.0	-8.0	-8.0
Group EBIT	23.9	-25.5	49.9	105.5	165.6	285.7
Net interest expense	-1.8	-3.2	2.6	-2.2	-2.6	-1.5
Operating Profit	22.0	-28.7	52.5	103.4	163.1	284.1
Share of profit/(loss) of associates	17.7	20.9	0.3	11.3	20.9	44.3
Other adjustments		23.9	39.6			
Profit before tax	39.7	16.2	92.4	114.7	184.0	328.4
Income tax	-9.1	-2.5	-17.9	-19.7	-40.2	-88.6
Profit after tax	30.6	13.6	74.5	95.0	143.8	239.9
Minority interest	1.1	4.1	-28.0	-65.1	-100.7	-167.8
Group Profit attrib to shareholders	31.7	17.8	46.5	29.9	43.1	72.1
Stripping out once-off/revaln	-7.6	-19.7	-32.7			
Profit excluding once-off	24.1	-2.0	13.8	29.9	43.1	72.1
Per share data:						
Period end no of shares (m)	482.1	609.9	609.9	609.9	609.9	609.9
Fully diluted period end no of shares (m)	485.5	612.7	612.7	612.7	612.7	612.7
Weighted average no of shares (m)	481.9	532.2	609.9	609.9	609.9	609.9
Fully diluted weighted average no of shares (m)	485.3	535.0	612.7	612.7	612.7	612.7
Basic EPS	0.066	0.033	0.076	0.049	0.071	0.118
Fully diluted EPS	0.065	0.033	0.076	0.049	0.070	0.118
Core Basic EPS	0.050	-0.004	0.023	0.049	0.071	0.118
Core Fully diluted EPS	0.050	-0.004	0.023	0.049	0.070	0.118
DPS:	0.020	0.020	0.020	0.020	0.020	0.020
- Interim	0.005	0.005	0.005	0.005	0.005	0.005
- Final	0.015	0.015	0.015	0.015	0.015	0.015
Dividend Pay-out	40.3%	-544.3%	88.8%	41.0%	28.4%	17.0%
Book Value per share	0.35	0.84	0.87	0.99	1.14	1.41

Source: Company Reports, CIR estimates

Figure 16. China Vanguard Balance Sheet (HK\$m)

	2005	2006	2007	2008	2009	2010
Current Assets						
Cash	135.5	357.1	117.2	97.2	150.3	264.1
Pledged bank deposits	31.8	15.9	5.9	5.9	5.9	5.9
Inventories	5.7	5.7	5.7	5.7	5.7	5.7
Trade and other receivables and prepayments	24.9	24.9	17.6	17.6	17.6	17.6
Total Current Assets	197.9	403.7	146.4	126.5	179.5	293.3
Non-Current Assets						
Property, Plant and equipment	3.3	48.7	148.3	203.1	224.2	228.7
Associates	0.0	14.0	260.3	296.6	317.5	361.8
Interest in associate	31.1	0.0	0.0	0.0	0.0	0.0
Goodwill	12.2	59.4	59.4	59.4	59.4	59.4
Deposits made on acquisition of PPE	3.8	3.8	3.8	3.8	3.8	3.8
Total Non Current Assets	50.4	125.8	471.7	562.8	604.8	653.7
Total Assets	248.4	529.5	618.1	689.2	784.3	947.0
Current Liabilities						
Trade and other payables	20.6	20.6	10.6	10.6	10.6	10.6
Taxation	0.5	0.5	0.5	0.5	0.5	0.5
Bank borrowings	51.7	51.7	51.7	51.7	51.7	51.7
Total Current Liabilities	72.9	72.9	62.9	62.9	62.9	62.9
Non-Current Liabilities						
Bank borrowings	4.7	4.7	4.7	4.7	4.7	4.7
Other non-current liabilities			17.3	17.3	17.3	17.3
Total Non-Current Liabilities	4.7	4.7	22.0	22.0	22.0	22.0
Total Liabilities	77.6	77.6	84.9	84.9	84.9	84.9
Net Assets	170.8	451.9	533.2	604.4	699.5	862.1
Shareholders' equities						
Share Capital	4.8	246.3	246.3	246.3	246.3	246.3
Reserves	155.8	164.0	198.3	215.9	246.8	306.7
Shareholders' equities to ord shareholders	160.6	410.2	444.5	462.2	493.1	553.0
Minority interest	10.1	41.7	88.7	142.2	206.3	309.2
Total equities	170.8	451.9	533.2	604.4	699.5	862.1

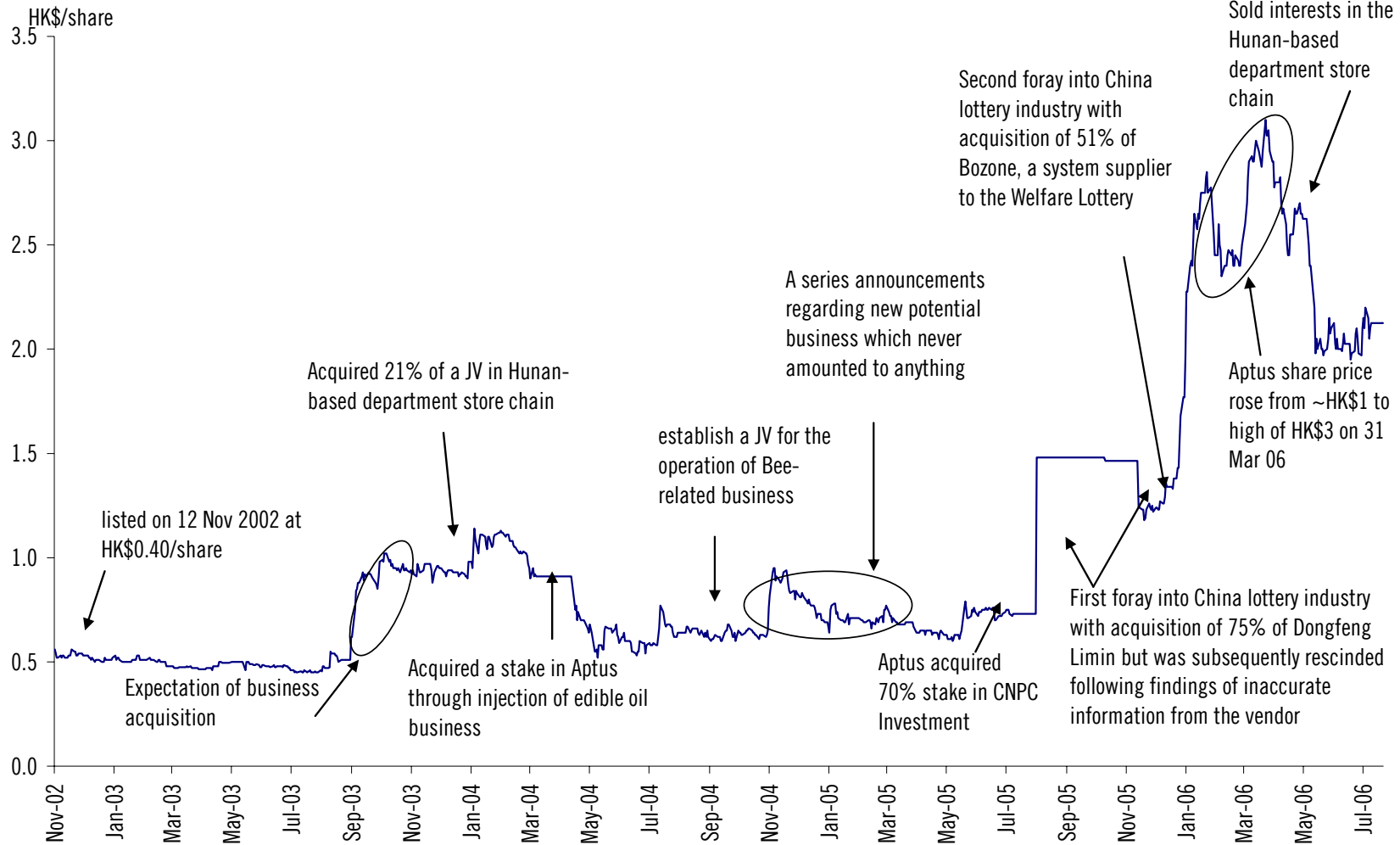
Source: Company Reports; CIR estimates

Figure 17. China Vanguard Cash Flow Statement (HK\$m)

	2005	2006	2007	2008	2009	2010
Profit before tax	39.7	16.2	92.4	114.7	184.0	328.4
D&A	1.4	3.7	34.3	53.4	71.7	92.0
Other Adjustments	-23.2	-49.0	-2.9	-9.1	-18.4	-42.8
Operating Cashflow b/f WC changes	17.9	-29.2	123.8	158.9	237.4	377.7
WC Changes	4.1	0.0	-2.7	0.0	0.0	0.0
Cash Generated from operations	22.0	-29.2	121.1	158.9	237.4	377.7
Net Interest paid	-1.6	-3.2	2.6	-2.2	-2.6	-1.5
Tax paid	-2.9	-2.5	-17.9	-19.7	-40.2	-88.6
Net cashflow from operating activities	17.5	-34.9	105.9	137.0	194.6	287.6
Investing Activities						
Purchase of fixed assets	-0.6	-33.0	-182.6	-108.2	-92.8	-96.6
Acquisition of subsidiaries	-10.6	-77.7	-25	-25		
Proceeds from disposal of subsidiaries	5.9	35.0	76			
Proceeds from disposal of jointly controlled entities	-2.4	55.9	-221.0			
Net Cash used in investing activities	-7.8	13.2	-352.6	-133.2	-92.8	-96.6
Financing Activities						
Issue of shares	0.2	241.5				
Share issue expenses	0.0	-6.4				
Repayment of convertible notes	-1.5					
Dividends paid	-8.7	-9.6	-12.2	-12.2	-12.2	-12.2
borrowings	9.8					
Capital contribution/(payment) from/(to) minorities	0.3	17.9	19.0	-11.6	-36.5	-65.0
Net Cash from financing activities	0.0	243.3	6.8	-23.8	-48.7	-77.2
Net Cash changes	9.7	221.7	-240.0	-20.0	53.1	113.8

Source: Company Reports, CIR estimates

Figure 18. China Vanguard Share Price Since Listing



Source: DataStream, China Vanguard

Figure 19. Citigroup Global Gaming Valuation

Company	RIC	Rating	Price (LC, 9 Aug 06)	Mkt Cap (US\$m)	FY05 PE (x)	FY06 PE (x)	FY07 PE (x)	FY08 PE (x)	FY05 P/Bk (x)	FY06 P/Bk (x)	FY07 P/Bk (x)	FY08 P/Bk (x)
Harrah's Entertainment Inc	HET.N	1M	US\$59.44	10,982	16.9	16.6	14.7	12.5	1.2	1.1	1.0	1.0
Station Casinos Inc	STN.N	1M	US\$55.74	3,500	21.6	22.8	21.2	17.7	5.9	20.4	12.8	8.7
Boyd Gaming Corp	BYD.N	2H	US\$34.95	3,129	13.8	15.1	14.3	12.5	3.2	2.9	2.4	2.1
Rank Group PLC	RNK.L	1M	£2.08	2,309	36.4	17.5	15.2	14.1	8.3	-181.4	-159.0	35.1
Aztar Corp	AZR.N	2M	US\$51.79	1,890	34.5	35.8	29.3	27.2	2.9	3.1	2.9	2.6
Tanjong PLC	TJPL.KL	1L	RM13.50	1,484	13.8	14.5	12.6	11.3	2.3	2.0	1.9	1.7
Berjaya Sports Toto Bhd	BSTB.KL	1L	RM4.36	1,606	17.1	12.7	13.8	12.8	3.1	4.6	9.4	8.4
Hyatt Regency Hotels SA	HYAr.AT	2M	€11.00	1,186	20.0	16.9	14.2	NA	65.1	50.2	34.9	NA
Bally Technologies Inc	BYI.N	3S	US\$15.72	820	-800.9	51.2	23.3	18.4	4.5	4.1	3.5	2.9
Stanley Leisure Plc	SLY.L	2H	£6.00	812	29.4	31.6	19.3	17.1	1.3	2.4	1.7	1.6
International Game Technology Inc	IGT.N	1H	US\$37.25	12,631	30.2	27.6	24.8	21.0	7.2	7.0	6.0	5.1
OPAP SA	OPAr.AT	2H	€28.14	11,521	19.6	17.9	15.1	13.6	48.9	45.6	42.2	39.0
TABCORP Holdings Ltd	TAH.AX	1M	A\$15.11	6,030	15.2	14.8	13.6	12.9	2.3	2.2	2.2	2.1
Aristocrat Leisure Ltd	ALL.AX	1M	A\$11.90	4,241	23.2	22.6	15.9	14.6	15.9	15.7	12.2	9.8
Lottomatica Spa	LTO.MI	1M	€28.59	3,371	25.3	23.6	19.3	17.1	5.9	5.8	5.5	5.1
Intralot SA	INLr.AT	3H	€21.60	2,157	24.0	16.0	22.8	26.6	13.0	9.1	7.7	6.9
Unitab Ltd	UTB.AX	3L	A\$14.35	1,455	29.5	23.8	22.4	21.1	17.2	17.2	17.2	17.2
Tattersall's Ltd	TTS.AX	2M	A\$2.80	1,504	13.8	15.1	13.7	11.8	19.8	3.6	3.4	3.3
China LotSynergy	8161.HK	3S	HK\$1.16	264	NA	-295.1	24.3	8.4	NA	1.5	1.4	1.2
Ainsworth Game Technology Ltd	AGI.AX	2S	A\$0.39	57	-5.7	16.0	11.2	8.4	1.5	1.2	1.0	1.0
<i>Core Lottery Plays</i>												
Gtech Holdings Corp	GTK.N	2M	US\$34.46	4,390	24.0	20.7	20.3	18.4	6.1	3.9	3.3	2.8
Scientific Games Corp	SGMS.O	1H	US\$29.28	2,832	29.0	26.6	18.9	16.2	6.8	5.4	4.1	3.2
<i>Core Macau Gaming Plays</i>												
Las Vegas Sands Corp	LVS.N	2H	US\$61.20	21,684	53.8	49.1	35.1	22.0	13.5	10.6	7.2	5.4
MGM Mirage Inc	MGM.N	2H	US\$34.85	9,951	21.8	18.3	14.8	12.9	1.5	1.3	1.0	0.9
Wynn Resorts LTD	WYNN.O	1H	US\$71.00	7,163	358.2	163.9	31.8	26.1	4.5	4.4	2.7	2.4
Galaxy Entertainment	0027.HK	2H	HK\$6.88	2,915	-23.4	-39.2	-511.9	123.1	1.5	1.6	1.6	1.6
Melco	0200.HK	1M	HK\$17.22	2,712	37.5	869.0	48.2	12.3	6.2	6.3	5.7	4.0
Shun Tak	0242.HK	3M	HK\$9.74	2,744	83.4	38.4	41.4	20.0	3.0	2.8	2.7	2.4
Average (All)					37.6	30.2	9.7	18.5	10.6	6.4	5.2	7.3
Average (Core Macau)					83.7	51.3	-2.4	26.3	7.8	6.4	4.5	3.5
Average (Lottery)					26.0	23.0	19.8	17.6	6.3	4.5	3.6	3.0

Source: Powered by DataCentral

China Vanguard Group

Company Description

The group was recently renamed China Vanguard. Prior to that it was known as Bee & Bee Natural Life Products when it listed on the GEM market in November 2002 as a provider of natural supplementary food. Given the increasingly unattractive nature of the industry, the group has since ventured into other businesses, including department stores, oil and gas, and China lottery. It has recently divested a number of businesses, department stores and bee-products in order to focus on the core businesses of oil and gas (55%-owned Aptus, which is also listed on GEM) and China lottery (51%-owned Bozone).

Investment Thesis

We rate China Vanguard Buy/Speculative Risk (1S) with a target price of HK\$2.70, based on a sum-of-the-parts valuation. Our Buy recommendation is driven by the company's 55% stake in Aptus being currently valued in the market at almost double China Vanguard's market cap. This is effectively akin to buying Aptus at half the market price and getting a China lottery business for free, in our view. While we recognise that Aptus' share price reflects significant blue-sky expectations of ongoing injections of oil and gas projects, our base case sum-of-the-parts valuation applies a 50% discount to Aptus's market value. With 69% of the valuation coming from Aptus, China Vanguard is at this stage more of an oil & gas play than a China lottery play, in our view. Bozone, its 51%-owned China lottery business, is a relatively small player with 13% market share in 2005. With management likely to be pre-occupied with securing more projects for Aptus, the risk is Bozone will be neglected. As such, our base case is for Bozone to remain relative small with limited growth opportunities. Management has flagged it is likely to win five additional contracts over FY07-08, which would be a big boost for Bozone and the group's valuation. However, we believe it is too early to price in.

Valuation

We value the group at HK\$2.70 based on a sum-of-the-parts valuation. We value Bozone on 13.2x 2008 earnings, a 25% discount to its leading international peers, which reflect our belief it lacks the market position to be a leading China lottery play. We value Aptus by applying a 50% discount to its market capitalization. The other way to value Aptus is on DCF, which is highly sensitive to oil price assumptions. Using a WACC of 9% for its two gas projects (consistent with Xinao Gas), a WACC of 10% for the Xinjiang oilfield, and CIR oil price estimates, Aptus on 2008 DCF is valued at HK\$564m, some three times less than its current market valuation. However, using the YTD oil price would yield a DCF at around double that level. As such, our DCF valuation on Aptus gives a sum-of-the-parts value range of HK\$1.78-3.16.

Risks

We rate China Vanguard Speculative Risk based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Key risks that could prevent the shares reaching our target price include: a decline in the market value of Aptus; inconsistent management track record — management to date have excelled in deal-making rather than in actual business operations; a decline in the oil price; other risks include regulatory and technology risks which all China lottery players suffer from.

Sell/Speculative	3S
Price (11 Aug 06)	HK\$1.10
Target price	HK\$0.90 from HK\$1.10
Expected share price return	-18.2%
Expected dividend yield	0.0%
Expected total return	-18.2%
Market Cap	HK\$1,950M US\$251M

Price Performance (RIC: 8161.HK, BB: 8161 HK)



China LotSynergy (8161.HK)

Current Price Still Too Bullish; Target Cut to HK\$0.90

- **Reducing target 18% to HK\$0.90** — We switch from a DCF- to a P/E-based valuation, in line with the methodology we use for other lottery players.
- **Cutting 2007-08 earnings by 66-68%** — Our earnings estimates fall by a significant 66-68% in 2007-08, as we adjust video lottery terminal (VLT) and Keno sales in line with our top-down view of the market (see *China Lottery Market*, 11 August 2006). We now assume VLT and Keno turnover of US\$3.8bn (vs. US\$9.9bn previously), comprising 30% of the welfare lottery market, up from <2% in 2005 .
- **Falling VLT daily turnover** — Although VLT turnover grew significantly in 1H06 on increasing roll-out of CLO halls, daily turnover appears to have dropped over the period. For the two months of May-June, daily turnover averaged an estimated ~Rmb1,500 per terminal vs. ~Rmb1,393 per terminal in the last week of June. This compared to ~Rmb2,000 in April.
- **Keno roll-out delayed to Sep/Oct** — The much-anticipated roll-out of Tabcorp's Keno in July did not eventuate, as a technical report was not finalized on time. Latest guidance is for roll-out in September or October, although we await guidance from Tabcorp, which ultimately controls and runs the JV.
- **Maintains Sell** — We continue to see good prospects for the group's Keno and VLT terminals over the next few years. However, in our view, too much bullishness is reflected in the share price: current market cap implies VLT and Keno turnover by 2008 of US\$6.6bn, ~54% of our welfare lottery market forecast. This compares with our forecast of 31% by 2008.

Figure 1. Statistical Abstract

FYE	Net Profit (HK\$M)	EPS (HK\$)	P/E (x)	D. Yld (%)
31 Dec				
2003A	na	na	na	na
2004A	na	na	na	na
2005A	na	na	na	na
2006E	2	0.00	nm	0.0
2007E	30	0.02	65.9	0.0
2008E	79	0.04	24.8	0.0

Source: CIR estimates

Figure 2. Earnings Revisions

FYE	Net Profit (HK\$M)	EPS (HK\$)	% chg	DPS (HK\$)
31 Dec				
2006E	2	0.00	N.M	0.00
Prev	-7	0.00		0.00
2007E	30	0.02	-65.5	0.00
Prev	87	0.05		0.00
2008E	79	0.04	-68.0	0.00
Prev	250	0.14		0.00

Source: CIR estimates

Fiscal year end 31-Dec	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E adjusted (x)	na	na	nm	65.9	24.8
EV/EBITDA adjusted (x)	na	na	na	20.7	9.2
P/BV (x)	na	na	1.4	1.3	1.3
Dividend yield (%)	na	na	0.0	0.0	0.0
Per Share Data (HK\$)					
EPS (adjusted)	na	na	0.00	0.02	0.04
EPS (reported)	na	na	0.00	0.02	0.04
BVPS	na	na	0.81	0.82	0.87
DPS	na	na	0.00	0.00	0.00
Profit & Loss (HK\$M)					
Net sales	na	na	71	161	307
Operating expenses	na	na	-73	-98	-154
EBIT	na	na	-2	63	153
Net interest expense	na	na	15	2	1
Non-operating/exceptionals	na	na	-1	2	14
Pre-tax profit	na	na	12	67	169
Tax	na	na	-2	-10	-25
Extraord./Min.Int./Pref.div.	na	na	-8	-27	-65
Reported net income	na	na	2	30	79
Adjusted earnings	na	na	2	30	79
Adjusted EBIT	na	na	-2	63	153
Growth Rates (%)					
EPS (adjusted)	na	na	na	1,741.3	165.1
EBIT (adjusted)	na	na	na	2,910.7	142.1
Sales	na	na	na	127.2	89.9
Cash Flow (HK\$M)					
Operating cash flow	na	na	-59	48	118
Depreciation/amortization	na	na	15	24	50
Net working capital	na	na	-5	-1	-34
Investing cash flow	na	na	-1,263	-114	-170
Capital expenditure	na	na	-235	-104	-160
Acquisitions/disposals	na	na	-1,008	0	0
Financing cash flow	na	na	1,189	63	-9
Borrowings	na	na	0	50	0
Dividends paid	na	na	0	0	0
Change in cash	na	na	-133	-3	-61
Balance Sheet (HK\$M)					
Total assets	na	na	1,614	1,737	1,879
Cash & cash equivalent	na	na	109	106	45
Net fixed assets	na	na	215	295	405
Total liabilities	na	na	66	118	127
Debt	na	na	0	50	50
Shareholders' funds	na	na	1,549	1,618	1,752
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	na	na	17.9	54.0	66.3
ROE adjusted	na	na	na	2.1	5.2
ROIC adjusted	na	na	na	4.1	9.0
Net debt to equity	na	na	-7.0	-3.4	0.3
Total debt to capital	na	na	0.0	3.0	2.8

For further data queries on Citigroup's full coverage universe please contact CIR Data Services Asia Pacific at +852-2501-2791.



Figure 3. China LotSynergy 1H06 P&L

(HK\$m)	1H 2006
Provision of VLT	10.4
Repair & maintenance of VLT	2.6
Others	-0.6
Turnover	12.4
EBITDA	-12.8
EBIT	-13.9
Net Interest Expense	9.8
Associates	0.9
EBT	-3.2
Tax	0.0
Profit after Tax	-3.2
Discontinued Operations	-1.5
	-4.7
Minorities	4.3
Net Profit Attrib to Shs	-9.0

Source: Company Reports, CIR

Current price still too bullish; TP cut to HK\$0.90

China LotSynergy ("CLS") reported 1H06 results on 10 August 2006, recording an operating loss of HK\$4.7m including a loss of HK\$1.5m from discontinued operations; thus the core operating loss was HK\$3.2m. However, this effectively included only two months of contribution from video lottery terminal (VLT), since this business was only formally completed on 28 April 2006. The test roll-out of ~400 Keno machines yielded a profit of HK\$0.912m.

We have cut our 2007-08 earnings by 66-68% as we reduce VLT and Keno turnover to bring them in line with our top-down market forecasts. By 2008, we assume VLT will make up ~15% of the welfare lottery market and, together with Keno, assume CLS controls 30% of the market.

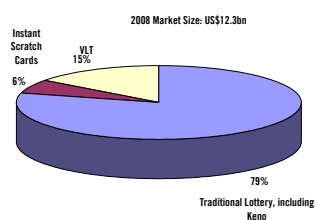
We also change our valuation methodology from DCF to P/E to be consistent with the valuation methodology used to value international lottery players such as Gtech and Scientific Games. Given the China lottery market is still in its infancy and thus lacks transparency, we feel that a DCF-based approach, which relies heavily on long-term assumptions, may not be appropriate. On P/E, we reduce our sum-of-the-parts valuation to HK\$0.91 per share and hence cut our target price to HK\$0.90 (from HK\$1.10 previously).

Figure 4. China LotSynergy SOTP Valuation

	Rate	(HK\$m)	(HK\$/share)
Keno	@ 21.1x 2008 P/E	440.1	0.25
VLT	@ 21.1x 2008 P/E	1,077.1	0.61
Existing business	value @ zero	0.0	0.00
Net Cash/(debt)	end 2006	109.1	0.06
Total		1,626.3	0.91

Source: CIR estimates

Figure 5. Welfare Lottery Market (2008E)



Source: CIR estimates

Figure 6. China LotSynergy Market Share Assumptions

	2006E	2007E	2008E	2009E	2010E
Keno	77	738	1,882	3,443	4,919
VLT	606	984	1,938	2,603	3,227
Total	683	1,722	3,820	6,047	8,146
Keno	1%	8%	15%	23%	27%
VLT	9%	10%	15%	17%	18%
Total	10%	18%	30%	40%	45%

Source: CIR estimates

Slowing VLT daily turnover; 2007-08 roll-out assumptions cut

CLS reported VLT provisional revenue of HK\$10m for two months of operation. Given it is entitled to 1.6% of VLT sales, this means VLT sales reached HK\$625m for the May-June. This is consistent with indications from Chinese press that total VLT sales for the year to mid May 2006 were ~Rmb1.1bn. According to the CEO of CLS, the China Welfare Lottery Issuance Center (CWLC) has set a target of Rmb5bn for VLT sales for 2006. This is 33% higher than the annualized May/June figures. If this eventuates, this would make up ~9% of our forecast welfare lottery turnover of ~US\$7,123m vs. our forecast of 7%.

While the growth in the VLT market is encouraging, it should be noted that daily turnover per terminal appears to be falling. In April 2006, CLS disclosed average daily turnover per terminal was ~Rmb2,000. Based on the HK\$10m VLT sales figures for May/June and an average of 7,000 terminals over the period (8,000

by end June, vs. ~6,000 in April), this suggests daily turnover of ~Rmb1,500. However, by the end of June weekly turnover of Rmb78m over 8,000 terminals suggests this has fallen further to Rmb1,393. This supports our view that as CLS aggressively rolls out VLTs, daily turnover would suffer.

The group reiterated its estimate of 25,000 VLT terminals by the end of 2005. We continue to question its ability to reach that figure, given it currently still only has ~8,000 machines, up from ~6,000 in April. Even if it reaches its target, we question what will happen to daily turnover rates. As such, we assume it to reach 15,000 by end 2005, but averaged 10,000 for the year on daily turnover of Rmb1,300.

We cut sharply our roll-out estimate over 2007-08 to 25,000 and 45,000 (vs. 45,000 and 90,000 previously, and CLS target of 300,000 by 2008) and cut daily turnover from Rmb2.250 to Rmb1,250 in 2007. We have undertaken these cuts to be consistent with our top-down view that VLT will be a U\$1.8bn market by 2008, accounting for 15% of the welfare lottery market of US\$12.3bn. Our previous forecast assumed VLT turnover of US\$7.2bn by 2008 and to account for 59% of the lottery market. This would mean VLT rising tenfold from the CWLC's 2006 forecast of Rmb5bn over a two-year period. While possible, we believe it is too early to assume this, given the early stage of VLT's development and that it is still in the testing phase. Our forecast of close to a threefold increase is already sufficiently aggressive, in our view.

Figure 7. VLT Business Financial Forecasts

	2006E	2007E	2008E	2009E	2010E
Number of machines:					
- average	10,000	16,000	32,500	45,000	57,500
- end of year	15,000	25,000	40,000	50,000	65,000
- growth in machines (%) (average)					
- growth in machines (%) (end)		66.7%	60.0%	25.0%	30.0%
Cost per machine (US\$)	2,000	1,400	1,435	1,471	1,508
Cost per machine (RMB)	15,660	10,388	10,648	10,914	11,187
Turnover per machine per day (RMB):	1,300	1,250	1,213	1,176	1,141
Total turnover (Rmbm)	4,745	7,300	14,383	19,318	23,943
Corich (VLT)					
Service Fee to JV (% of turnover)	1.60%	1.60%	1.60%	1.60%	1.60%
Repair & maintenance fee (% of turnover)	0.40%	0.40%	0.40%	0.40%	0.40%
P&L					
Service revenue (Rmb m)	75.92	116.80	230.13	309.09	383.09
Repair & maintenance rev (Rmb m)	18.98	29.20	57.53	77.27	95.77
Total Rev	94.90	146.00	287.67	386.36	478.87
less: Operating cost	-18.98	-29.20	-57.53	-77.27	-95.77
less: SG&A expenses	-23.73	-29.20	-28.77	-38.64	-47.89
EBITDA	52.20	87.60	201.37	270.45	335.21
Depreciation	-22.37	-23.74	-49.44	-70.16	-91.89
EBIT	29.82	63.86	151.93	200.29	243.32
Tax	-4.47	-9.58	-22.79	-30.04	-36.50
After tax profit	25.35	54.28	129.14	170.25	206.82

Source: Company Reports, Citigroup Investment Research estimates

Keno – still awaiting for a roll-out

CLS's Keno JV with Tabcorp contributed HK\$0.912m to 1H06 profit based on ~400 test machines. The much-anticipated mass rollout did not happen in July. In a conference call, CLS indicated the delay was due to the technical report having not yet been completed. Guidance for the roll-out has now been pushed back to Sep/Oct. Given Tabcorp controls and effectively runs the JV, we look for more concrete guidance from Tabcorp in its 1H06 results.

CLS previously guided for 10,000 Keno machines by the end of 2006. This looks unattainable now. We assume 5,000 machines by the end of the year, with an average of 1,650 for the year. No figures for daily turnover were disclosed other than suggestions that it has not done as well as originally expected. We continue to assume Rmb1,000 per day in 2006, rising to 2,000 by 2009.

Figure 8. Keno JV Financials

Year ending 31 Dec	2006E	2007E	2008E	2009E	2010E
Number of machines:					
- end of year	5,000	15,000	30,000	40,000	60,000
- average	1,650	10,000	22,500	35,000	50,000
Cost per machine (Rmb)	12,500	12,500	12,500	12,500	12,813
Turnover per machine per day:	1,000	1,500	1,700	2,000	2,000
Total turnover (Rmb m)	602	5,475	13,961	25,550	36,500
CLS-Tabcorp JV					
Service Fee to JV (% of turnover)	0.92%	0.92%	0.92%	0.92%	0.92%
Technical fee to Tabcorp (% of turnover)	0.20%	0.20%	0.20%	0.20%	0.20%
Technical fee to CLS (% of turnover)	0.10%	0.10%	0.10%	0.10%	0.10%
Value of machines (start of year)	0.00	58.30	165.45	312.77	425.27
add: capex	61.25	125.00	187.50	175.00	306.25
less: depn	(2.95)	(17.86)	(40.18)	(62.50)	(91.52)
Value of machines (end of year)	58.30	165.45	312.77	425.27	640.00
P&L					
JV revenue (Rmb m)	5.54	50.37	128.44	235.06	335.80
less: technical fee to Tabcorp	(1.20)	(10.95)	(27.92)	(51.10)	(73.00)
less: technical fee to CLS	(0.60)	(5.48)	(13.96)	(25.55)	(36.50)
Operating cost	(24.00)	(24.00)	(25.20)	(26.46)	(27.78)
SG&A expenses	<i>21.37</i>	<i>15.24</i>	<i>28.55</i>	<i>32.59</i>	<i>36.54</i>
EBITDA	1.11	25.19	89.91	164.54	235.06
Depreciation	(2.95)	(17.86)	(40.18)	(62.50)	(91.52)
EBIT	(1.84)	7.33	49.73	102.04	143.54
Tax	0.28	(1.10)	(7.46)	(15.31)	(21.53)
After tax profit	(1.56)	6.23	42.27	86.74	122.01

Source: Company Reports, Citigroup Investment Research estimates

Figure 9. China LotSynergy P&L (HK\$m)

For the period ending 31 Dec	2006E	2007E	2008E	2009E	2010E
VLT turnover	63.27	146.00	287.67	386.36	478.87
Technical fee from Keno	0.60	5.48	13.96	25.55	36.50
other rev	7.20	10.00	5.00	5.00	5.00
Total Turnover	71.07	161.48	306.63	416.91	520.37
Operating Expenses	-28.56	-59.22	-88.39	-119.74	-149.14
SGA expenses	-29.81	-15.00	-15.00	-15.00	-15.00
EBITDA	12.69	87.25	203.23	282.17	356.23
D&A	-14.94	-24.02	-50.13	-71.44	-93.72
EBIT	-2.25	63.24	153.10	210.73	262.52
Net Interest expense	14.52	1.56	1.43	1.79	1.68
Operating Profit (HK\$m)	12.27	64.80	154.53	212.52	264.19
Share of profit from associates	(0.52)	2.08	14.09	28.91	40.67
Profit before tax (HK\$m)	11.75	66.88	168.62	241.43	304.86
Income tax (HK\$m)	-1.76	-10.03	-25.29	-36.21	-45.73
Profit after tax (HK\$m)	9.99	56.84	143.33	205.21	259.13
Minority interest (HK\$m)	-8.45	-27.14	-64.57	-85.12	-103.41
Profit attributable to s/hs (HK\$m)	1.54	29.71	78.76	120.09	155.72
Per Share Data:					
Period end no of shares (m)	1,778.29	1,778.29	1,778.29	1,778.29	1,778.29
Fully diluted period end no of shares (m)	1,778.29	1,778.29	1,778.29	1,778.29	1,778.29
Weighted average no of shares (m)	1,694.15	1,778.29	1,778.29	1,778.29	1,778.29
Fully diluted weighted average no of shares (m)	1,694.15	1,778.29	1,778.29	1,778.29	1,778.29
Basic EPS	0.001	0.017	0.044	0.068	0.088
Fully diluted EPS	0.001	0.017	0.044	0.068	0.088
DPS:	0.00	0.00	0.00	0.00	0.00
- Interim	0.00	0.00	0.00	0.00	0.00
- Final	0.00	0.00	0.00	0.00	0.00
Dividend Pay-out	0.00%	0.00%	0.00%	0.00%	0.00%
Book Value per share	0.85	0.82	0.87	0.93	1.02

Source: Company Reports, Citigroup Investment Research estimates

Figure 10. China LotSynergy Balance Sheet (HK\$m)

As at 31 Dec	2006E	2007E	2008E	2009E	2010E
Current Assets					
Cash and bank balances	109.1	105.8	44.7	41.9	79.8
Accounts receivables	40.0	43.8	86.3	115.9	143.7
Amount due from associates/related company	21.0	21.0	21.0	21.0	21.0
Prepayment and others	88.8	88.6	87.9	86.6	84.8
Total Current Assets	258.9	259.1	239.8	265.4	329.3
Non-Current Assets					
Fixed assets	215.0	295.1	405.4	444.4	520.3
Investment in associate	138.9	171.1	212.8	237.2	289.9
Long-term investment	0.0	0.0	0.0	0.0	0.0
Intangible assets	961.3	961.3	961.3	961.3	961.3
Others	40.0	50.0	60.0	70.0	80.0
Total Non-Current Assets	1,355.2	1,477.5	1,639.5	1,712.9	1,851.5
Total Assets	1614.1	1736.7	1879.3	1978.3	2180.8
Current Liabilities:					
Accounts Payable	15.0	17.8	26.5	35.9	44.7
Accruals and other payables	50.0	50.0	50.0	50.0	50.0
Tax payable	0.5	0.5	0.5	0.5	0.5
Total Current Liabilities	65.5	68.3	77.0	86.4	95.2
Non-Current Liabilities					
Borrowings	0.0	50.0	50.0	0.0	0.0
Total Non-Current Liabilities	0.0	50.0	50.0	0.0	0.0
Total Liabilities	65.5	118.3	127.0	86.4	95.2
Net Assets	1548.6	1618.4	1752.3	1891.9	2085.6
Capital and Reserves					
Share Capital	1,155.8	1,155.8	1,155.8	1,155.8	1,155.8
Reserves	332.8	332.8	332.8	332.8	332.8
Retained profit/(Accumulated loss)	-57.0	-27.3	51.5	171.6	327.3
Shareholders' equities to ord shareholders	1,431.6	1,461.3	1,540.1	1,660.1	1,815.9
Minority interest	117.0	157.1	212.2	231.7	269.7
Total equities	1,548.6	1,618.4	1,752.3	1,891.9	2,085.6

Source: Company Reports, Citigroup Investment Research estimates

Figure 11. China LotSynergy Cash Flow Statement (HK\$m)

Year ending 31 Dec	2006E	2007E	2008E	2009E	2010E
Operating Profit (HK\$m)	12.3	64.8	154.5	212.5	264.2
D&A	14.9	24.0	50.1	71.4	93.7
Other adjustments	-14.5	-1.6	-1.4	-1.8	-1.7
Operating Profit b/f working capital changes	12.7	87.3	203.2	282.2	356.2
working capital changes	-5.0	-1.0	-33.7	-20.2	-18.9
Cash generation from operations	7.7	86.2	169.5	262.0	337.3
net interest received/(paid)	14.5	1.6	1.4	1.8	1.7
Div received/(contribution) from/(to) associates	-79.4	-30.1	-27.6	4.5	-12.1
Tax paid	-1.8	-10.0	-25.3	-36.2	-45.7
Net cash flow from operations	-59.0	47.6	118.1	232.0	281.1
Capex	-234.9	-103.9	-159.7	-109.1	-167.8
Acquisition of subsidiaries	-1,008.1	0.0	0.0	0.0	0.0
Other investing cash flow	-20.0	-10.0	-10.0	-10.0	-10.0
Total investing cash flow	-1,263.0	-113.9	-169.7	-119.1	-177.8
Free cash flow b/f financing	-1,322.0	-66.2	-51.7	112.9	103.3
Issue of shares	1,095.5	0.0	0.0	0.0	0.0
borrowings	0.0	50.0	0.0	-50.0	0.0
(dividends)/contribution (to)/from minorities	93.6	12.9	-9.4	-65.6	-65.5
dividend to shareholders	0.0	0.0	0.0	0.0	0.0
Cash flow from financing	1,189.0	62.9	-9.4	-115.6	-65.5
Net Cash changes	-132.9	-3.3	-61.1	-2.7	37.9

Source: Company Reports, Citigroup Investment Research estimates

China LotSynergy

Company Description

China LotSynergy supplies gaming machines to the Chinese government. Its joint venture with Tabcorp (33% shareholding) has a 10-year exclusive contract with the central government's operator of high frequency lottery games to provide the necessary software and hardware to run Keno games nationwide.

Investment Thesis

Our rating on China LotSynergy (CLS) is Sell/Speculative (3S) and our target price is HK\$0.90. Despite being positive on the growth of the China lottery market, we note that CLS's high frequency lottery products are unproven in China. Moreover, management has set aggressive rollout targets that have a high risk of not being met especially in the infancy phase in which testing, location selection and approvals on the provincial level could take longer than expected. Even if the company achieves management's ambitious targets, the significant jump in terminals could lead to a reduction in daily machine turnover. As such, until the company can prove to the market that it can achieve its roll-out targets for Keno and VLT without affecting on daily turnover rates, we remain cautious.

Valuation

We change our primary valuation tool to P/E from DCF to be consistent with the valuation methodology of other lottery players (China Vanguard, Gtech and Scientific Games). Given the infancy and lack of transparencies of the China lottery market, we now believe a DCF approach which relies heavily on long-term assumptions is inappropriate.

We value both its VLT and Keno businesses on 21.1x 2008 earnings, at a 20% premium to the average of its international lottery peers, to reflect the higher growth prospects of the products. We forecast the VLT market will grow from ~US\$84m in 2005 to US\$1.8bn by 2008 to make up 15% of the market (from <2%). Further, we also Keno would drive much of the growth in the traditional lottery segment.

Despite assuming such aggressive growth rates, our assumptions are still way below management guidance. Management guides there will be 60,000 Keno machines and ~300,000 VLT machines rolled-out by 2008 with daily turnover of ~Rmb8,000 for Keno and ~Rmb3,000 for VLT. If so, this would make VLT and Keno a US\$68bn market, larger than the entire US lottery industry of US\$54.2bn in 2005.

Risks

We rate CLS as Speculative Risk based on our quantitative risk rating system, which tracks 260-day historical share price volatility. The key (upside) risks that could prevent the shares reaching our target include: if the company were able to aggressively roll out both Keno and VLT as planned without hurting its per-machine daily turnover rate; if the newly-signed IT joint venture were to secure VLT software provision contracts from CLO, then it would likely provide an additional revenue stream to CLS, and hence add to the company's valuation. The key downside risks would be: a slower-than-forecast rollout of the Keno and VLT terminals; any delays in testing and location selection could detrimentally affect the company's ability to meet the target; and, daily turnover coming in significantly lower than our forecasts.

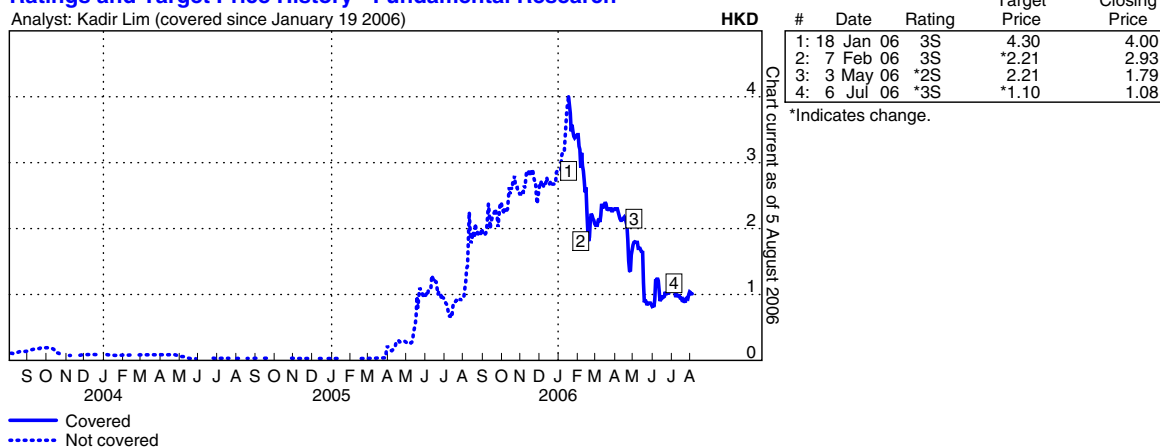
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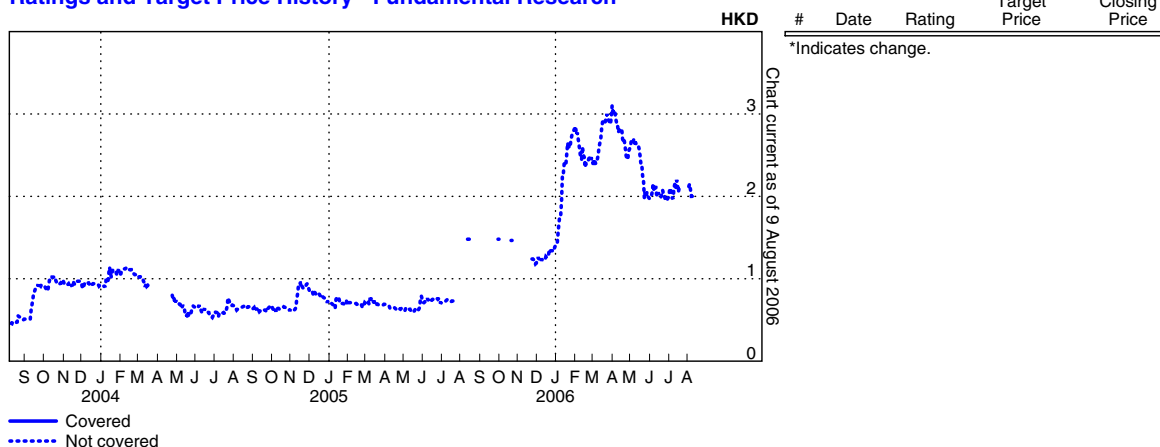
IMPORTANT DISCLOSURES

China LotSynergy Holdings Ltd (8161.HK) Ratings and Target Price History - Fundamental Research

Analyst: Kadir Lim (covered since January 19 2006)



China Vanguard Group Ltd (8156.HK) Ratings and Target Price History - Fundamental Research



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