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Name of University: London Business School

Programme: Masters in Financial Analysis

Expected Year of Graduation: 2020

Company: Focus Media Information Technology Co Ltd (China)

Ticker: 002027 CH Equity

Industry: Advertising & Marketing

Current Price: 7.72 CNY (as of 10/10/2018)

Target Price: 16.09 CNY

Market Cap: 113,313.2 mn CNY

P/E: 16.56

Average daily liquidity: 95,018,147

Recommendation & Investment Theses

I recommend longing Focus Media Information Technology, an advertisement agency company, which currently trades at 7.72 CNY per share, because it is undervalued by 80%-90%, the market has incorrectly estimated the threat of new entrants to elevator advertisement markets. However, I think there is potential upside in the stock because the fundamental of the company is positive. Catalysts to increase Focus Media's share price include:

- **Building elevator (LCD and frame poster) advertisement business** (78% of FM's total revenue) is expanding, regarding to Focus Media's increasing contracted buildings with lower-tier cities, higher penetration rate in residential and business buildings in tier-1 and -2 cities, and stable revenue generated per LCD screen and per frame poster.
- **Cinema pre-movie advertisement business** (20% of FM's total revenue) is contributing substantially to revenue growth because the rapid growth in Chinese cinema media industry and Focus Media has the largest market share among four dominant players.
- **High entry barriers.** The competency from new entrants (e.g. Xinchao Media which specializes in elevator frame poster advertisement) will have less impact and fewer market shares in the future, in contrast with the current market concern, because Focus Media has set high barriers in this industry which make price competition from competitors not sustainable.
- **Gross margin will continue to be stable.** Due to the fragmented upstream companies, the rental cost (which take up 70% of total operating cost) will be stable. Thus, the stable rental cost (thanks to Focus Media's strong bargaining power) will result in an increase by the same growth rate as the revenue. With the stable level of operating cost, I believe the gross margin will continue to be stable.
- **3 billion CNY stock repurchase (as of 25/04/2018 company announcement) will lead a rise in stock price.** Repurchase plan may boost the company stock price in the year following the announcement.

Business Description

Focus Media Information Technology was founded in 2003 by Mr. Nanchun Jiang and went public in 2005, as the first Chinese Advertisement Media stock listed in the U.S. stock market (Nasdaq: FMCN). Later in 2013, Focus Media was taken private and delisted from the US Nasdaq, and went public again in China Shenzhen Stock Exchange in 2015. Focus Media is now a leading advertising agency in China, mainly focuses on building elevator LCD and frame poster advertisement and cinema pre-movie advertisement. In the way to become the largest player in the building elevator advertisement, Focus Media also has been an aggressive acquirer – acquired Framedia at \$95 million and Target Media at \$325 million, which were main competitors to Focus Media.

The stock price of Focus Media went down for 15% from January 2017 to August 2017, which was in align with media sector (down 16%), but greatly underperformed CSI 300 (up 11%), it resulted from market taking the same view of a low revenue expectation growth on Focus Media as other media stocks in general. But from August 2017 to March 2018, the stock price went up 30%, which indicated the market started to regard Focus Media as one of the leading consumer company and reserved the discounted trading price. However, since March 2018, the stock price of Focus Media has been decreasing because market overreacted on the potential threat of new competitors.

Industry Analysis

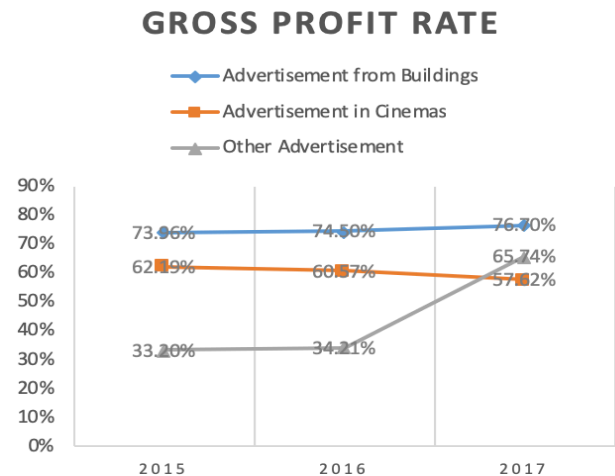
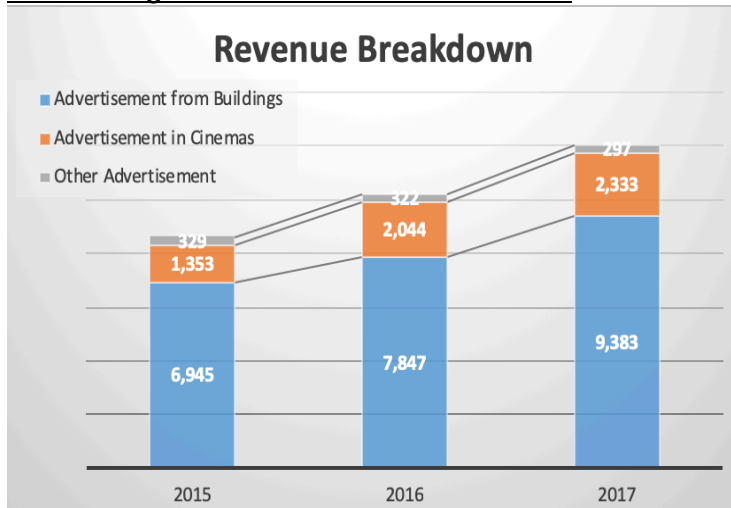
Advertising market in China has undergone tremendous change in the recent years.

➤ **Urbanization in China**

- **Most basic facility for urbanization is elevators**, and advertisement in elevators is a natural scene in the life of consumers, which is not an interruption or interference.
- **Tier-2 cities in China rise as regional business centers**, thus drawing more building advertisement business. Rising housing prices in tier-1 cities have drawn white-collar class to tier-2 cities, thus leading a dramatic increase in the office buildings in tier-2 cities. In addition, High GDP, entrepreneurship environment, relaxed regulations on purchasing houses and residency registration have attracted increasing number of graduates from home and abroad.

➤ **Growth in Chinese advertisement market, especially in cinema advertisement segment.**

- **Transition from traditional media to digital media.** In 2016, traditional media advertising costs such as the overall price of the advertisement fell by 0.6%, a 2.9% decline from 2015. However, new digital media, represented by the major media of buildings, cinemas and mobile Internet, has seen a steady increase, with the overall increase of 21.4% year-on-year, leading the domestic media advertising market. Since 2017, the advertising market has been reversed. The downward trend from 2015 to 2016 increased by 4.3% year-on-year, which was higher than the industry's previous forecast of 2.4%.
- **Rapid growth in cinema advertisement.** The fastest growing sub-track is a cinema advertisement. In 2017, the number of national cinema screens increased by 23.3% year-on-year.

Business Segments Characteristics & Forecasts

Focus Media is the first advertisement agency in China which merged advertising media in people's living circle, for example, LCD and frame advertisement in building elevators. Focus generates its revenue from advertisement in buildings elevators, cinemas and other shopping malls. The revenue graph indicates that advertisement from buildings contributes to total revenue at 80.50%, 76.83%, 78.11% in last three years – slightly decreased over the years; advertisement from cinemas contributes to total revenue at 15.68%, 20.02%, 19.42% – in an upward growing trend.

Advertisement from buildings: Focus Media is the inaugurator to start advertisement business in building elevators. The profit graph indicates that advertisement from buildings, as the most important revenue generator, gross profit is increasing over the last three years.

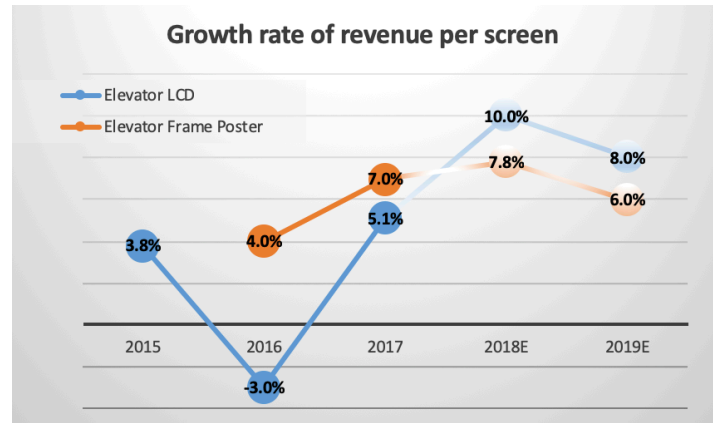
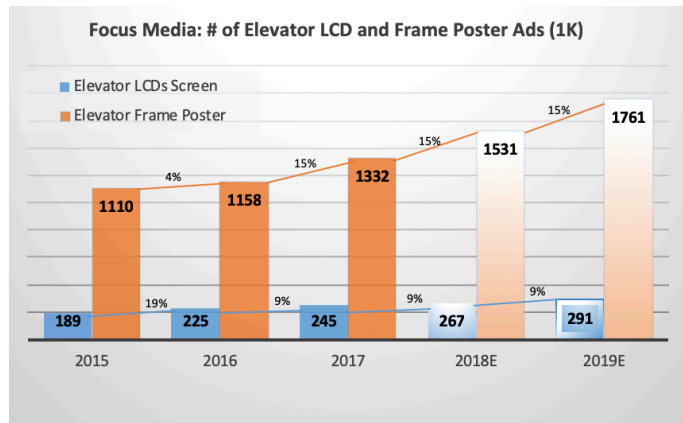
- 1) Elevator is a natural existence in people's daily life. It is inevitable to look at the advertisement in elevator if one is confined to a small box for at an average of 2 minutes. And it is not unusual that customers would proactively seek for advertisement inside elevators.
- 2) Revenue from building advertisement is not likely to be threatened by mobile advertisement. In the past years, there has been increasing number of premium members (who can skip online advertisement) of online video platform such as iQiyi, Tencent; plus, the advertisement fee on online video platform is 2-4 times higher than

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traditional television; moreover, unstable telecom signal in elevators drives customers concentrate on LCD and frame posters.

I believe the growing revenue generated from elevator LCD display advertisement and elevator frame poster will be a stable and sustainable contributor to Focus Media's business in the next several years. Followings are some catalysts to the increase:



➤ **Expansion of Focus Media's contracted building numbers**

- **Focus Media will embrace more clients from the rise of tier-2 cities as new regional business centers.** Focus Media has specifically chosen premium residential and business buildings in tier-1 and tier-2 cities to guarantee their potential targeted customers who have the most consumption power. Therefore, when brands look for advertisement agencies to advertise in new residential or business buildings in tier-2 cities, they are more likely to choose the one that has already collaborated with them in the past and generated profits for them in the similar cities. Thus, in 2018-2020, the supply area of office buildings in tier-1 and tier-2 cities expected to increase at a compound annual rate of 17%-20% will bring Focus Media increasing clients.
- **Focus Media will penetrate to tier-3 and tier-4 cities.** Currently, tier-3 and tier-4 cities are very marginalized in the network of Focus. Some national brands have not penetrated into these areas.

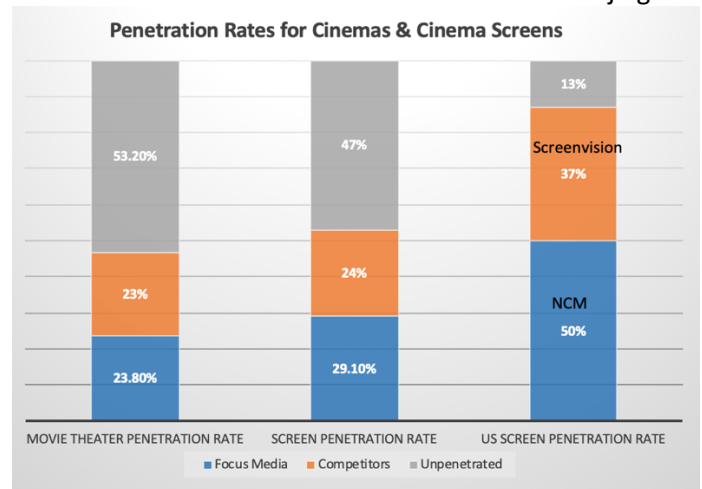
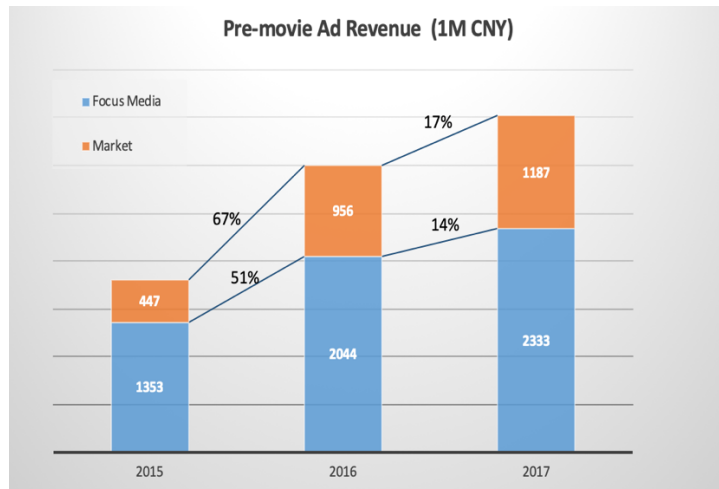
➤ **Stable growth of revenue per screen.** There is high barrier for the competitors since Focus Media has been dominating the elevator advertisement industry. Also, the highly fragmented upstream companies and downstream real estate agencies set high barrier for new entrants – negotiating with large number of individual clients and property agencies is time-consuming and costly. Therefore, Focus Media has high bargaining power over the price per LCD screen and I estimate in 2018 and 2019 the revenue growth rate generated per LCD screen will be 10%/8%. As for revenue growth rate for elevator frame poster, considering the new competitor Xinchao Media, I estimate it will be 7.8%/6% in the coming two years.

➤ **Loyal and high-quality clients:** In July 2018, Alibaba invested RMB 15 billion in Focus Media, aiming to achieve an innovative business model combining new retail with digital marketing.

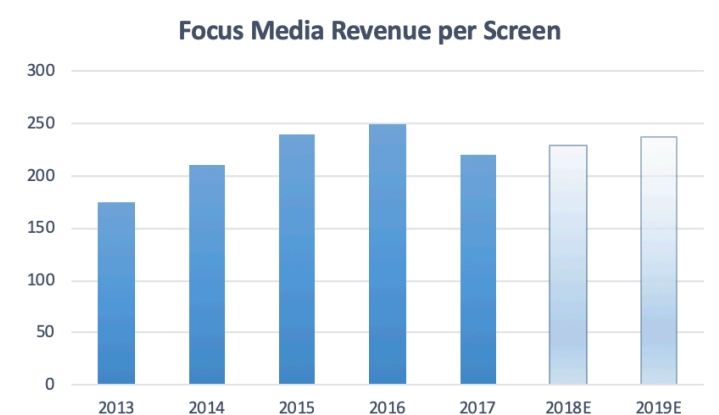
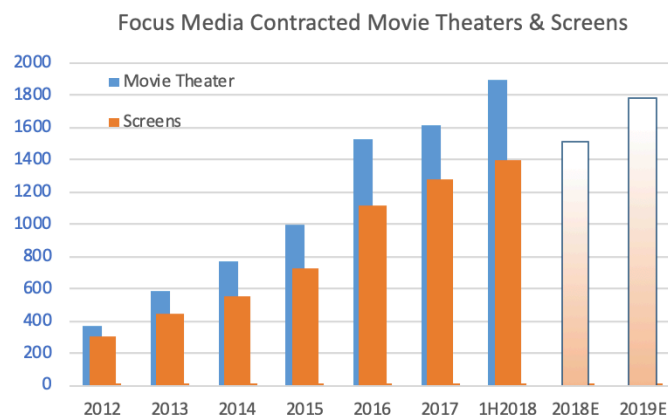
- **Innovative promotion:** receive coupon in front of advertisements screen in building's lift through some ultrasonic trigger technology.
- **Accurate distribution:** The competitive business in retail area and the strong big data analysis of Alibaba makes Focus Media precisely advertise to the right audience with more influential impact.

Advertisement from cinemas: Focus mainly offers pre-movie advertisement in cinemas. In the past three years, the gross profit rate is slightly down-ward sloping and the year-on-year growth on the revenue generated from it was 41.53%, 51.06%, and 14.14% (resulted from the box office disappointments in 2017).

I believe the growing Chinese cinema advertisement market along with Focus Media's strategy to expand its business will bring stable growth to its total revenue. Followings are some catalysts to the increase:



- **Expansion of pre-movie advertisement Chinese market.** Cinema advertisement media in China is only dominated by four companies and Focus Media has the largest share of around 60% (see from the first graph). And in China, the movie theaters' number is increasing and the movies played in the theaters are increasing as well. Plus, compared with the US pre-movie advertisement market (see from the second graph), there is still huge market capacity for Chinese pre-movie advertisement market (since many theaters in tier-3 and tier-4 cities have not been contracted for advertisement). Therefore, as a dominating player in this growing market, Focus Media will benefit from this trend in the next years.



- **Focus Media's strategy to penetrate into tier-3 and tier-4 cities and stable pricing per screen.** From the past years' figure (see from the first graph), Focus Media has been expanding its business into more cities in a stable pace. Based on the company's management announcement, I estimate that in the coming years, the screens contracted with Focus Media will be increasing in an averaged growth rate. And the revenue generated per screen will be increasing at a 4% level.

Valuations & Returns

I forecast that the target price of Focus Media is 16.09 CNY, given P/E ratio as 28× as of 2018. I derive the target price based on a DCF valuation.

I estimate advertisement from buildings segment revenue to generate a CAGR of 20% in 2018-2020, driven by 12% screen expansion and a 4% increase in ASP. I believe both of Focus LCD and frame screens will penetrate into tier-3 and tier-4 cities especially tier-2 cities. I forecast advertisement from cinemas segment revenue to generate a CAGR of 15% in 2018-2020. Despite the downturn of the economy in recent Chinese market, there is still a stable growth in cinemas' screens.

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I estimate WACC is 8.45% and terminal growth rate is 6% in the base case; and WACC is 10.90% and terminal growth rate is 3% in the bear case. Thus, getting the enterprise value at 81 bn CNY – 155.6 bn CNY.

Assumptions	CY 15	CY 16	CY 17	CY 18E	CY 19E	CY 20E
Advertisement from Buildings	13%	13%	20%	20%	20%	20%
Advertisement in Cinemas	42%	51%	14%	16%	16%	16%
Brief Financials (CNY Mn)	CY 15	CY 16	CY 17	CY 18E	CY 19E	CY 20E
Revenue	8,317	9,854	11,615	14,264	16,949	20,153
Revenue Growth	15%	18%	18%	23%	19%	19%
EBIT	3,369	4,172	6,380	6,854	9,425	11,001
EBIT Margin	41%	42%	55%	48%	56%	55%
Free Cash Flow		4,705	3,895	7,445	7,383	8,716
Effective Tax Rate		16.33%	17.40%	17.00%	17.00%	17.00%

Investment Risks

- High goodwill: from 2005 to 2007, Focus has acquired more than 60 companies (including building advertisement, cinema advertisement, internet advertisement, etc.), goodwill being 100 billion CNY, 5.8 billion CNY, 7 billion CNY each year (16.67%, 339.77%, 188.27% of the sales).
 - However, during this period, ROIC decreased from 19.61 to 9.93; ROE dropped from 12.3 to 7.79. If employ DuPont Equation, it is easy to see the drop in the ROE is mainly due to the drop in Sales/Total Assets (35.01%, 19.68%, 23.68% from 2005 to 2007). The growth rate of sales is comparatively lower than that of total assets due to the increasing goodwill, leading to a drop in total asset turnover.
 - Goodwill impairment: in 2008 and 2009 tremendous goodwill impairment happened due to internet advertisement and mobile advertisement.
- A slowdown in the Chinese movie industry
 - Online distribution competitors and new media
 - Weakness in overall Chinese macro-economy