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Tuning in on Future Growth

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It's no secret that 2008 was an abysmal year on Wall Street—the worst, in fact, since 1931. The Dow lost 33.8% of its value, while the S&P 500 and the Nasdaq fell 38.5% and 40.5%, respectively.

On the other side of the globe the markets fared even worse. The Chinese economy, while still growing rapidly, has hit a major speed bump. After a red-hot 2007 that saw China's benchmark CSI 300, a cap-weighted index tracking 300 A-share stocks listed on the Shanghai and Shenzhen Stock Exchanges, gain over 125%, Chinese stocks cooled considerably in 2008. After all was said and done, the index sank 66%.

With the easy money approach to investing in China—such as loading up on the iShares FTSE/Xinhua China 25 Index ETF (NYSE: FXI)—long gone, savvy types are investing their hard-earned money by managing well-edited portfolios of carefully-selected stocks, often in niche markets.

An example of the type of holdings that defy the current slump can be found in one of China's fastest growing industries. A generation ago, less than half of Chinese households owned a television set—only one in 10 rural homes. Two decades later, things look decidedly different. Today, TV ownership in China is almost universal, and the Chinese channel surf with the best of us. All of China, it seems, has embraced the latest technology wholeheartedly, and the country is poised for a digital television boom.

That's where China Digital TV Holding Co. Ltd. (NYSE: STV) enters the picture. It is a company few American investors have heard of. But if you're not familiar with this top provider of CA (Conditional Access) systems to China's fast-growing digital television market, it might be time to get acquainted.

Beijing-based China Digital's CA systems, which include security code-programmed smart cards and software that communicates with smart cards, allow television network operators and TV set-top box manufacturers to provide custom content, electronic program guides and subscriber management systems (SMS). China Digital's head-end software gives its customers the ability to selectively charge subscribers on a per-channel or per-view basis, and to restrict viewers from copying the programs they watch. Its SMS software is capable of maintaining subscriber information databases; processing orders for new services; maintaining billing, payment and authorization records; and processing service requests (to repair or replace defective or lost equipment).

The company also licenses its designs of set-top boxes to manufacturers, and provides its customers with computer chips for set-top boxes made to its specifications by third-party fabricators. The majority of China Digital's revenues are derived from smart card sales.

The digital cable TV market is one of the China's fastest-growing consumer sectors (it is expected to grow at a five-year compound annual growth rate of 45% between 2007 and 2012), as the nation preps for a digital television explosion. The government has mandated a transition from older analog signals to state-of-the-art technology in all major cities by the end of this year and nationwide by 2015. Eyeing the huge potential of the marketplace, China Digital TV is looking to broaden its reach in China (it already has contracts with close to 200 digital television network operators in 26 of China's 32 provinces, autonomous regions and centrally administered municipalities).

Last year was a busy one for the company.

In March, China Digital inked a collaboration agreement with Intel Corporation (Nasdaq: INTC), a move that allowed China Digital to package its software with Intel's CE 2110 advanced media processor. The integrated product, which will improve digital transmission by making it easier for TV systems to read digital signals, will be sold to set-top box manufacturers in China. The deal and the company's ongoing relationship with Intel will bring next-generation high-definition digital television solutions to the Chinese market.

The company and co-developer ViXS Systems later launched a new product: an ultra secure PC-based digital TV capture solution and conditional access PCI card, the first PC capture card with enhanced security available in the Chinese market. The video capture card gives users the ability to inexpensively capture HD broadcast video content on their PCs for real-time viewing or recording onto their hard drive for later playback. As digital television penetration deepens and PC sales continue to soar in China, the future is bright for this type of value-added product tailored to the wants of Chinese consumers.

And in December, China Digital announced the availability of a new PC-TV tuner service, which, in effect, converts a PC into a digital television set. A product of its collaboration with Microsoft, the service allows computer users throughout China to watch and record encrypted digital cable TV programming on personal computers that run Windows Vista and Windows XP Media Center Edition operating systems.

China Digital's third-quarter 2008 top-line saw healthy year-over-year growth in revenues, but declined on a quarterly sequential basis, due to lower smart card sales volumes and average selling prices. Profitability took a hit because of rising operational and tax expenses. Despite this, the stock finished the year 69% higher. The long-term growth prospects remain encouraging given favorable regulatory conditions and the firm's dominant position in the conditional access systems market.

According to market research firm CCID Consulting, at the end of 2008, some 27 million Chinese homes had access to digital TV, double the number from the previous year. Even so, household penetration in China is only 3.5%, compared with 76% in the United Kingdom and 56% in the United States. The number of households making the switch from analog rabbit-ear sets to slick digital flat-panel displays is expected to reach 46 million this year, 111 million by 2011 and some 250 million by 2015.

While China's market for digital television CA systems and software applications is highly competitive, China Digital is the leading provider of smart cards in China, with about 45% domestic market share (it also has plans to expand internationally into the greater Asian marketplace). The company's leading position in a high-growth industry makes it a good play on China's digital television revolution. Its high level of cash reserves in relation to its current share price along with the fact that it carries no long-term debt makes it even more attractive.

The stock's 52-week trading range is \$4.25 to \$25.89. Analysts' consensus one-year target is \$9.28.

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