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## China Digital Media Corporation

OTC BB: CDGT

CURRENT PRICE: \$1.45

52-WEEK RANGE: \$1.01 - \$8.50

AVERAGE DAILY VOLUME (90-DAY): 54,970

FLOAT: 7.8 million

OUTSTANDING SHARES: 31.0 million

MARKET CAPITALIZATION: \$45.0 million

**INITIATING COVERAGE: SPECULATIVE BUY**

### COMPANY PROFILE

China Digital Media Corporation ([www.chinadigimedia.com](http://www.chinadigimedia.com)) is an integrated media company focused on digital cable television (DTV) operations, advertising sales and programming content production in the People's Republic of China (PRC). Through its wholly owned subsidiary, Arcotect (Guangzhou) Limited, the Company developed a digital broadcasting technology platform and provides DTV services in Nanhai, Guangdong Province by converting analog cable television signals via digital set-top-boxes and smart cards. Operating since early 2004 as a sole contractor of a monopolistic cable TV provider owned by the local government, the Company has migrated approximately 150,000 out of 400,000 subscribers by yearend 2005. The Company is also engaged in television advertising sales business through its wholly owned subsidiary, Guangdong M-Rider Media Company Limited. Acting as an exclusive agent, the Company signed a \$6.3 million advertising wholesaler contract, its largest in history, to manage the commercial airtime of a provincial television station's channel. Finally, through a strategic partnership with Guangdong HuaGuang DigiMedia Culture Development Limited, a variable interest entity, the Company invests in production of programming content. The Company has invested in the production of two drama television series, one of which already started generating revenue, and is undertaking additional investments through acquisitions and joint ventures. Overall, the Company has about 240 employees located predominately in the PRC, with more than half committed to the sales and marketing function. Trading on the OTC Bulletin Board under the symbol CDGT, the Company is positioned to benefit from the vertical integration of its media investments and capitalize on the rapid transformation in the television business in China.

### CHINA'S CONSUMER MARKET

Economic reforms initiated in China in 1978 resulted in two-and-a-half decades of unparalleled growth fueled by massive investments and burgeoning exports. According to official figures recently released by the National Bureau of Statistics, China's GDP maintained its growth momentum at 9.9% in 2005, reaching 18.2 trillion yuan, or \$2.3 trillion, and ranking 4<sup>th</sup> among the world's largest economies. With a still mostly poor population of over 1.3 billion, per capita GDP reached \$1,700. Continuing its

well-controlled gradual transition towards a free market economy, the Chinese government has recently been shifting its focus to policies favoring domestic spending. In 2005, consumer spending reflected in inflation-adjusted retail sales soared 12.9% to 6.7 trillion yuan, while inflation was subdued at 1.8%.

As private consumption accounts for only just over a third of China's GDP, compared with the world average of around 70%, officials are vowing to continue stimulating consumer demand by expanding social services and cutting taxes, especially for rural residents. Last year, 297.5 billion yuan from the central government budget was spent on agriculture, rural areas and farmers, an increase of 34.9 billion yuan or 13.3% over 2004. The central and local governments also allocated 16.2 billion yuan for poverty alleviation, and the number of rural residents living in poverty decreased by 2.45 million. At the same time, agricultural tax was rescinded in 28 provinces, autonomous regions and municipalities directly under the central government, and the livestock tax was rescinded nationwide.

According to the Chinese Academy of Social Science the middle class, responsible for bulk of consumption growth, is currently estimated to number some 120–150 million people or 40–50 million households, up five-fold from 8 million households in 1978. Household purchasing power is between \$9,000–12,000 and household wealth is approximately \$36,000. Although various current forecasts indicate a slowing GDP growth to a range of 8.5-9.5% in 2006, the Chinese Ministry of Commerce predicts retail sales to continue growing at 12.5% in the first half of the year. In addition, an ACNielsen's latest global consumer confidence study revealed that China ranked as the most optimistic among all markets surveyed, with 78% of consumers looking forward to further economic improvement over the coming year. As such, consumer sales growth, as exemplified by household appliances and audio/video electronics, which increased 14.8% in 2005, is likely to continue.

### CHINA'S TELEVISION INDUSTRY

Under the communist regime, China's central government has held tight reins on mass media and television in particular, using it to spread its political ideology and reinforce control. Over the years of progressive economic liberalization and introduction of new broadcasting technologies from abroad, the national television network, China Central Television (CCTV), has

lost its monopoly. Nevertheless, it remains the dominant broadcaster with eight channels available across the country and the largest audience base.

China's first official cable television network, Beijing Cable, was established in 1992. By the end of 2003, China had 37 national, 1,424 provincial and 363 city-level cable television stations, permitted to have their own localized channels and programs. In early 2000, the State Administration of Radio, Film and Television (SARFT), China's national regulatory authority for the broadcasting industry, began actively promoting DTV. As part of a broader government project to develop interactive e-government system for its citizens, in 2003 SARFT established a formal DTV rollout timetable, which calls for a complete nationwide broadcasting switchover from analog to digital signal by 2015, taking advantage of much higher penetration of cable TV in Chinese households compared to the Internet. Since then the government has been offering subsidized or even free DTV decoders on a trial basis in certain cities and providing low-interest loans to cable companies to facilitate the shift. Currently about ten Chinese cities are undergoing a citywide migration, but about 90% of them have necessary infrastructure to broadcast DTV programs. In fact, according to Analysys International, a leading market information source on technology, media and telecom industries in China, only 15% of consumers are aware of DTV.

In 2004, there were over 1 million DTV subscribers in China. Analysys International expects this figure to grow to over 5 million by the end of 2005 and 50 million by the end of 2008, resulting in an annually compounded growth rate of about 165% since 2004. The number of digital television sets sold from 2004 to 2008 is expected to exceed 25 million, growing 80% annually, and the number of digital STBs sold during the same time is expected to exceed 21 million, representing a compounded growth rate of 126%.

Due to the PRC's admission to the World Trade Organization (WTO) in 2001 and growing demand for suitable TV programming, the government has also been relaxing regulations relating to content producers, allowing foreign investors to own up to a 49% equity interest in program production ventures since December 2004, mainly in an effort to attract foreign expertise to China's often tedious TV output and help meet unfulfilled content demands of DTV carriers. Currently, foreign programming can account for only up to 30% of cable TV's total broadcast time and just 25% for free TV. With the exception of most provincial level stations and a few private production houses holding Class A license, the distribution of programming content in China must generally be approved by relevant governmental departments before the production even begins, creating a significant bottleneck on the development of quality content.

Television advertising time sales is the major source of revenue for television stations and operators in China. Ads are sold to advertisers predominantly in line with international standards on a Cost Per Rating Point (CPRP) basis, especially in case of members of American Association of Advertising Agencies (4A

Agents), which determine spot pricing according to viewership reports provided by ACNielsen or CCTV's Central Viewer Survey and Consulting Center. Foreign equity interest of up to 100% is already permitted in the advertising business. Recently, many cable TV stations have been tendering their air time to advertising agencies at fixed cost in order to generate guaranteed income. In 2005, TV advertising sales estimated by Analysys International were expected to reach 44 billion yuan in 2005, growing at 4.5% and comprising about 20% of the entire Chinese advertising market, which was expanding at 20% in the first half of 2005, according to the Wall Street Journal. However, Analysys International forecasts that the TV advertising market will increase its share of 30% in 2009. Meanwhile, competition between advertising agencies and television channels at the provincial and city levels is increasingly expected to lead to vertical integration of their business into program sourcing and production in order to increase their channels' viewership.

### **DTV OPERATIONS**

In 2004, the Company entered into a cooperative agreement with Nanhai Network Company, a city-owned cable network operator in Guangdong Province, to carry out a complete migration of all cable television subscribers in Nanhai from an analog to a digital system by the end of 2007. The Company developed a state-of-the-art DTV broadcasting and application platform. Progressing on a district by district basis from temporary service centers, the Company's representatives provide STB installation, training and new service promotion to several thousand subscribers in three to four weeks. After completion of all installations within a district, the analog signal is no longer available, effectively rendering any previously existing illegal connections obsolete. As of the end of 2005, the Company migrated over 150,000 out of approximately 400,000 subscribers in Nanhai. Under the agreement, the Company is responsible for supplying the subscribers with the first digital STB and providing operational support services including migration planning, marketing and sales, software development, customer service and logistics administration, in exchange for a share of basic subscription fees and additional service charges. The Company's proprietary operating support system automates many of the processes, such as database management, billing, work orders and inventory control, and assists in the operation of a 24/7 call center for technical support and customer care. The Company also generates revenues from installation and reconnection services, as well as sales of additional STBs. Moreover, the Nanhai government provides a grant of 10 million yuan to the Company for each of the five years of contract duration, totaling approximately \$6 million. Nanhai Network Company retains management of the cable broadcasting system with the fiber-optic network and pays most of the Company's operating costs for outsourced functions.

The DTV broadcast system, which decrypts the signal with the Company's STB and appropriate smart cards, can carry up to 800 digital channels of pay-TV programs and value added multimedia services. Currently, the offer

consists of 130 channels, including 38-channel basic package and 92 pay channels bundled into various value added packages, such as World Movie, Life & Leisure, World Sports, News, Drama or Family. The basic subscription fee per annum is approximately \$25, while value-added packages range from \$15 to \$74 each. Since May 2005, the service includes Sunshine e-Government, a digital information system presenting government structure and policy, social affairs, public announcements and other communications to the citizens.

The Company's system is designed to assimilate cutting-edge technologies. In September 2005, the Company commenced trials of HDTV broadcasts, providing dramatically improved resolution and sound quality to select subscribers. As one of a few DTV providers in China, the Company also deployed on a trial basis an IP (Internet Protocol) based STB equipped with an Ethernet port to facilitate various Internet services, such as video-on-demand, online shopping and games, as well as interactive education services. The Company is currently negotiating partnerships with various vendors to provide interactive services and expects to launch the new STB in 2006, transforming a television set into an interactive multimedia platform.

#### **ADVERTISING SALES**

In August 2005, the Company acquired a 100% interest in Guangdong M-Rider Media Company Limited, an advertising sales company engaged in the distribution of television commercials. The Company pays fixed fees to the television stations and is responsible for reselling ad space to international and local advertising customers, either directly or through agents. The Company also provides consulting on scheduling and other issues like ad design and production to enhance the effectiveness of their clients' advertisements.

Recently, the Company signed its largest wholesaler contract with Southern International Media Advertising Co., Ltd., to manage and operate the commercial airtime of a provincial station's channel for a one year term starting on January 1, 2006, extendable for an additional year. The cost of the entire available advertising space of the channel was \$6,321,000. The Company announced in January 2006 that it has already pre-sold over \$4 million worth of airtime.

#### **PROGRAM PRODUCTION**

In order to invest in program production before related SAFRT regulations and policies are relaxed for foreign investors, the Company has strategically partnered with a Chinese registered company, Guangdong HuaGuang DigiMedia Culture Development Limited through a variable interest entity (VIE) arrangement. The Company is not the direct owner, but has obtained control and manages the operations and receives 90% of resulting gross profit through various agreements signed between its subsidiaries and the formal original owner of the business. The Company has a right to assign key management to Guangdong HuaGuang DigiMedia Culture Development Limited. Through this arrangement, the Company has made two minority investments in the production of two television series, XiGuan Affairs, with

40 episodes, and The Story of a Small Town, with 24 episodes, participating at a level of 34% and 20% of the total production costs, respectively. XiGuan Affairs has already generated revenue for the Company in the last quarter of 2005. This arrangement is expected to last until further sufficient relaxation of broadcasting policies in China, when transfer of the entire equity interest becomes possible pursuant to the alliance agreement.

In addition, in January 2006, the Company has entered into an acquisition agreement, through its VIE, to purchase the media assets and personnel of Guiyang Classic & Fashion Advertising Co., Ltd., a television program production and advertising company in China. The target's management team has over a decade of business experience in the media industry and a track record of successful television program production for different television channels, including a well-known Chinese hit "The True Man Show," as well as adventure, nature and tourism programs, which received several national awards in the last few years. With closing of the acquisition expected in the first quarter of 2006, the Company agreed to pay \$2.2 million in a combination of cash and restricted common stock, subject to reduction in the event that the acquired assets generate a cumulative profit of less than \$2.5 million over the next 2 years.

#### **CHANNEL MANAGEMENT**

In February 2006, the Company's VIE, Guangdong HuaGuang DigiMedia Culture Development Limited, entered into two joint venture agreements with a leading provincial television station, effectively engaging the Company in all aspects of a new TV channel operation to be launched in May, including content management, advertising sales and program production. Pursuant to the contracts, the provincial television station provides the exclusive use of a television channel, including production resources and equipment, while outsourcing its entire advertising time slots into the two joint ventures for a term of five years. One of them, with 49% of the interest owned by the Company, is responsible for sourcing and producing content, as well as schedule planning. The second joint venture, with 51% ownership interest by the Company, will serve as the exclusive advertising agent to manage commercials. The Company has committed to invest approximately \$2.5 million into the two joint ventures over a two year period. With a potential audience of 30 million people, the channel is scheduled to have approximately 1,700 hours of self-produced new television content each year, focusing on lifestyle and entertainment programs.

#### **MANAGEMENT**

Daniel C.S. Ng, the Company's President and Chief Executive Officer, is the founder of Arcotect Digital Technology Limited, the Company's subsidiary established to capitalize on the numerous opportunities in China arising from the digitization of cable television services and the reform of state owned cable television enterprises prior to the public reverse merger in 2005. Mr. Ng has over 15 years of experience in cable TV operations, Internet and information technology industry and is recognized as one of Hong Kong's top digital

technology executives. Previously in his career, Mr. Ng was the President of Hong Kong Star Internet Ltd., the first commercial Internet Service Provider in Hong Kong, which he founded in 1995. He is a founding member and was elected the first Chairman of Hong Kong Internet Service Providers Association during 1996 to 1999. Mr. Ng is also the President of Hong Kong Information Technology Federation, a non-profit trade association founded in 1980 with more than 300 corporate members. In addition, Mr. Ng served as Director of Cable Multimedia Services of Hong Kong, the first cable TV operator in Hong Kong. In 2000, Mr. Ng was elected as Hong Kong's "Ten Outstanding Young Digi Persons" by Hong Kong Productivity Council and Hong Kong Junior Chamber. Between 2000 and 2001, Mr. Ng has also been the Chairman and CEO of DCP Holdings Limited, a listed company in Hong Kong, which specializes in personal computer manufacturing and Internet related investment projects.

Daniel Lui, the Company's Chief Financial Officer has over two decades of experience in commercial and merchant banking, investment & software industry. Prior to joining the Company, Mr. Lui was also the founder and managing director of Beth Group, a company providing ERP system development and services, as well as general manager and director of a number of other companies in Hong Kong, including Tomson Group, a Hong Kong listed company (HSE: 00258).

Y.K. Ma, the Company's Secretary, has ten years of experience in business valuation, consultancy and project investment. Prior to joining the Company, Mr. Ma was the investment manager at ENM Holdings Ltd., a Hong Kong listed company (HSE: 00128) and the manager of business valuation division in Sallmanns (Far East) Ltd., a leading valuation company in Hong Kong.

## FINANCIALS AND OUTLOOK

For the year ended December 31, 2005, the Company reported revenues of \$7,862,281, compared to \$3,864,407 for the previous year, an increase of \$3,997,874, or 103%, mainly due to the good progress of the Nanhai migration project. While the number of residential and commercial subscribers increased by 114% to 149,182, from 69,788 at the end of 2004, the number of additional STBs provided by the Company increased by 151%, from 8,434 at the end of 2004 to 21,165 this year, and the number of value added packages subscriptions grew by 122%, from 6,776 to 15,011. The annual revenue figures incorporate four months of results from advertising wholesale operation and a portion of program production sale proceeds, which together accounted for about 10% of the Company's revenues. EBITDA for the fiscal year 2005 was \$5,059,031, increasing 89% from \$2,672,017 in 2004, and the net income reached \$4,041,619, or \$0.14 per basic share, versus \$1,945,743 for the previous fiscal year, representing an increase of \$2,095,876, or 108%.

The Company has a strong balance sheet, free of long term debt and \$10,582,961 in net worth as of December 31, 2005. The Company is successfully managing its liquidity despite its relative large cash outlays for purchase of STBs. At yearend, available cash amounted to \$1,124,912 and a working capital deficit equaled

\$446,454, but the Company had a positive operating cashflow of \$3,760,857 and overall net cashflow of \$1,003,441 for the fiscal year. In December 2005, the Company completed a \$1,000,000 private placement issuing 800,000 shares of restricted common stock at \$1.25 to Manta Finance Limited, a limited liability corporation organized in Hong Kong acting as the Company's technical consultant on DTV development.

The Company is expected to experience significant growth in all of its operating segments in 2006 and beyond. Continuing its profitable DTV migration project in Nanhai, the Company forecasts to double the number of digital TV subscribers from 150,000 to 300,000 by the end of this year, generating commensurate revenue increase from basic subscription fees and potentially accelerated growth from additional STBs and value-added packages, if its increased marketing and promotion efforts are successful. Based on its proven technology platform and operating experience, the Company also plans to replicate the DTV migration model elsewhere in China when sufficient funds required for initial investment and other necessary resources utilized in the current project become available. With a number of cities already expressing interest in cooperating with the Company, one to two comparable DTV migration projects in cities of similar size to Nanhai are likely to be undertaken by 2007 or 2008.

Capitalizing on the acquisitions and investments completed in 2005, the Company should report even stronger revenue growth in its advertising sales and program production divisions. Following the \$6.3 million contract secured with a provincial television station in Guangdong Province in December 2005 and early reselling success, the Company is building valuable relationships with domestic and international branded advertising clients, as well as strengthening its expertise and reputation in managing commercial airtime, which could allow it to secure additional large wholesaler agreements with major television stations in China and further strengthen its presence in the television ad business. In 2006, the Company also expects to generate licensing revenue from its two television series. Finally, the Company's revenues will be augmented by the recent formation of two joint ventures to manage the operations of a new channel of a provincial television station. These operations are beginning to provide considerable experience in the sourcing and planning of programs for television channels, advance the integration of the advertising sales and program production capabilities and improve the Company's competitive advantage in the China media industry. In an effort to continue building greater economies of scale in the advertising, program production and channel management business, the Company remains highly focused on continuing its expansion through acquisition and joint ventures that could rapidly expand its operations and profit potential, capitalizing on the quick growth of the media market. In addition, the Company's management appears to be well positioned and capable of negotiating favorable terms for its M&A transactions, as evidenced by the most recent Guiyang Classic & Fashion Advertising Co., Ltd. proposed acquisition terms, which call for a reduction of the 17.5 million yuan (\$2.2

million) purchase price in the event that the acquired assets generate a cumulative profit of less than 20 million yuan (\$2.5 million) over the next two years, or the terms of the Guangdong M-Rider Media Company Limited acquisition last year, which make the payment of a purchase price balance of 7 million yuan (\$0.9 million) conditional on achieving a net operating cashflow of at least 10 million yuan (\$1.2 million) in the first year of operations.

Assuming this year the Company can double its DTV subscriber revenues of \$5.4 million, secure additional advertising sales contracts, which in the last quarter contributed only over \$1.0 million to overall 2005 results and start generating meaningful proceeds from its two produced television series, the fiscal 2006 revenues, together with the government grant of \$1.2 million, could double with respect to 2005 performance and yield significant profitability, especially if the new channel management costs are contained within the confines of the joint venture agreements. The Company's shares could be considered undervalued given its \$0.11 fully-diluted EPS reported in fiscal 2005, which at the current price level places a P/E multiple of 13, not reflecting the strong growth potential in 2006 and beyond. As such, the

shares at these levels appear to present an excellent opportunity for speculative long-term investors willing to accept the general high risks associated with emerging growth companies, such as potential dilution, the relative lack of trading liquidity and substantial price volatility of bulletin board companies, as well as certain business risks specific to media operations in China, including a complex political system, quickly evolving regulatory climate, intense competition and foreign exchange fluctuations. Due to its relatively short operating history and despite the management's excellent credentials, the Company still also faces a risk of not being able to effectively execute its roll-up strategy. However, if the management can successfully continue integrating the expanding ventures and revenue trends continue as expected, the shareholders seem likely to benefit from strong profit margins and growth in one of the most rapidly developing industries in China. Given the anticipated rapid growth, the Company seems to be at a good value vis a vis other media companies.

**Alan Stone, Managing Director**

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