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China Digital Media Corporation

OTC BB: CDGT

CURRENT PRICE: \$0.82

52-WEEK RANGE: \$0.77 - \$2.41

AVERAGE DAILY VOLUME (90-DAY): 14,508

FLOAT: 8.5 million

OUTSTANDING SHARES: 31.8 million

MARKET CAPITALIZATION: \$26.0 million

CONTINUING COVERAGE: SPECULATIVE BUY

COMPANY PROFILE

China Digital Media Corporation (www.chinadigimedia.com) is an integrated media company focused on digital cable television (DTV) operations, advertising sales and programming content production and management 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 (STB) and smart cards. Operating under a 20-year agreement since early 2004 as a sole contractor of a monopolistic cable TV provider owned by the local government, the Company has migrated approximately 200,000 out of 410,000 subscribers by the end of June 2006. 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 an extendable \$6.3 million advertising wholesaler contract for 2006, 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 is engaged in complete television channel management and production of programming content. Since May, the Company is operating a new 24-hours lifestyle channel in joint venture with a leading TV station in Guizhou Province. The Company has also invested in the production of two drama television series, which have begun generating revenue this year, and is continually undertaking additional investments through acquisitions and joint ventures. Overall, the Company has about 300 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 4th 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%. Although various current forecasts indicate a slowing GDP growth to a range of 8.5-9.5% in 2006, the Chinese Ministry of Commerce predicted 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 in 2006.

As private consumption accounts for only between a third and a half 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. The middle class, defined by the Chinese Academy of Social Science as families with assets valued from 150,000 (\$18,137) to 300,000 yuan (\$36,275), which is

responsible for bulk of consumption growth, was estimated to number some 120–150 million people or 40–50 million households in recent years, up five-fold from 8 million households in 1978. Household annual purchasing power is estimated at \$9,000–12,000 and household wealth is approximately \$36,000.

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, 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.

The Income from TV commercials is the major source of revenue for TV stations in China. In 2005, advertising income was over \$4.9 billion, which represents an increase of approximately 15% from 2004. In Guangdong Province, TV advertising income was about \$500 million, representing about 10% of the country total.

DTV OPERATIONS

In 2004, the Company entered into a 20-year 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 until the end of 2007 and service the market throughout the duration of the contract. 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 Nanhai local government provides a grant of 10 million yuan to the Company to finance the purchase of STBs and smart cards for each of the five years of the migration period until 2007, totaling approximately \$6 million. The Company also generates revenues from installation and reconnection services, as well as sales of additional STBs. 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.

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. The Company's proprietary operating support system automates many work 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. 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 June 30, 2006, approximately 200,000 subscribers had installed over 220,000 digital STBs, with over 15% subscribing for additional boxes. The Company installed over 30,000 STBs in May, the highest number in a single month.

The Company's DTV broadcasting and application platform, which decrypts the signal with STBs 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 148 channels, including 48-channel basic package and 100 pay channels bundled into various premium packages, such as World Movie, Life & Leisure, World Sports, News, Drama or Family. The basic subscription fee per annum is approximately \$25, while premium 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. Since May 2006, the Company provides HDTV broadcasts, currently offering three channels of dramatically improved resolution and sound quality to premium subscribers. Also last May, as one of a few DTV providers in China, the Company launched an IP based STB built on the IBM Power PC architecture and equipped with Java platform, Ethernet port for Internet connection and XML based information browser. Generating considerable interest in Nanhai and surrounding cities,

these features will be offered as a standard for the remainder of the migration project, enabling the Company to provide interactive information services and TV programming, profiled advertising, video-on-demand, online shopping and games and other value added services. The Company is currently negotiating partnerships with various vendors to provide interactive services, transforming a television set into an interactive multimedia platform.

Recently, the Company entered into a subscription and cooperation agreement to acquire a 20% ownership interest in Arable Media Limited, a Hong Kong company specializing in the development of middleware software and applications for digital broadcasting systems and STBs. In exchange for financial support in form of a line of credit or shareholder's loans not exceeding \$770,000, the Company will become the exclusive distributor and wholesaler of Arable Media's products and applications in China, with preferential rights to deploy and utilize them at no cost for the first 150,000 STBs in the first 18 months of the 3-year partnership.

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 sales 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.

In December 2005, 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 started on January 1, 2006, extendable for an additional year. The cost of the entire available advertising space of the channel was \$6,321,000. As of June 30, 2006, the Company generated approximately \$3.6 million in revenue from the contract, selling advertising slots for over 230 brand names.

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. 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. The Company has a right to assign key management to Guangdong HuaGuang DigiMedia Culture Development Limited. Through this arrangement, the Company is strategically partnering with Guangdong Runshi Movie & Music Production Co., Ltd. and 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 since the last quarter of 2005.

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 third quarter of 2006, subject to due diligence and government approval, 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 20-year joint venture agreements with a leading provincial television station in Guizhou Province, effectively engaging the Company in all aspects of a new TV channel operation 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, Guishi DigiMedia, with 51% ownership interest by the Company, will serve as the exclusive advertising agent to manage commercials. The second joint venture, Guishi HuaGuang, with 49% of the interest owned by the Company, is responsible for sourcing and producing content, as well as schedule planning. 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 approximately 30 million people in about 8 million households, the channel is

scheduled to have approximately 1,700 hours of self-produced new television content each year, focusing on fashion, lifestyle and entertainment programs. 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.

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.

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 fiscal 2004, an impressive increase of 103%, due mainly to the progress of the Nanhai migration project. While the DTV sales continued to roughly double this year, the Company's growth accelerated to even higher rates, reflecting advertising sales coming primarily from the annual Guangdong M-Rider Media contract. For the three months ended

June 30, 2006, revenues increased by \$3,159,793 or 241% to \$4,470,604, from \$1,310,811 for the same period last year, while the six months sales reached \$8,167,325, a 254% increase compared to \$2,304,283 for the same period in 2005. The Company reported net income of \$786,173 and \$1,230,723, or \$0.02 and \$0.04 per share for the three and six months period ended June 30, 2006, compared to the net income of \$705,651 and \$1,143,504 for the same period in 2005, respectively. The earnings growth materialized despite significantly lower gross margins resulting from the Company's expansion into the advertising and channel management business and recognition of income taxes on profits from the DTV project, which were not accrued in 2005 due to expected tax exemption based on foreign status of the Company's subsidiary.

The Company has a strong balance sheet, free of long term debt, with \$12,827,744 in net worth as of June 30, 2006. Despite large cash outlays for purchases of STBs and a working capital deficit of \$1,824,137 on June 30, 2006, the Company is successfully managing its liquidity, reporting cash of \$472,446 and positive operating cashflow of \$3,804,621 for the last six months. Since December 2005, the Company raised \$1,387,500 through private placements of restricted common stock at \$1.25, issuing 800,000 shares to Manta Finance Limited and 310,000 to another corporate investor. In addition, in July 2006, the Company sold 22 units of securities composed of convertible debentures and associated warrants for \$1,100,000.

The Company can be expected to continue experiencing explosive growth throughout the remainder of 2006 and possibly beyond. Given the May introduction of the IP based STB, the Company's DTV migration project in Nanhai has generated significant interest, providing a boost in the number of subscribers, especially in form of commercial accounts. Although volume growth becomes increasingly difficult at the current levels of subscribers due to escalating customer service requirements and other scale management issues, the Company's signal digitalization revenues are growing at a relatively quicker pace, benefiting from value added services. While the number of migrated subscribers in the first six months of 2006 increased 33%, from approximately 150,000 at the end of 2005 to about 200,000 at the end of June 2006, the Company's revenues from the project, exclusive of any software development fees, grew over 86%, from \$2,273,243 to \$4,232,376. As the Company develops a more comprehensive service offering utilizing the technological capabilities of its new STB equipment, the trend is expected to intensify, potentially resulting in fiscal 2006 revenues in excess of \$8.5 million. Longer term, 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 and earlier this year, the Company is generating significant advertising sales, greatly hastening revenue growth. Together with \$117,842 in revenue resulting from two months of operations of the joint venture in Guiyang since their commencement in May, the television advertising segment contributed \$3,726,706 in the first six months of 2006. Having successfully served 230 brand names, 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. The Company's expanding nationwide sales team is also expected to enhance the advertising revenue stream by providing effective targeting and media planning consultancy services on top of selling commercial time. Even in the absence of additional television station contracts, the fiscal 2006 advertising revenues could approach \$8 million.

Finally, the Company's revenues will be augmented with program production activities, generate licensing fees from two television series produced in conjunction with Guangdong HuaGuang DigiMedia Culture Development Limited and other potential projects, including those resulting from the pending acquisition of Guiyang Classic & Fashion Advertising Co., Ltd.

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. 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 the Company can generate DTV subscriber fees of at least \$8.5 million and advertising sales of \$8 million this fiscal year, total annual revenues in 2006, together with the government grant of \$1.2 million and additional program production fees, but without meaningful organic growth from new contracts or new investments, could reach \$18 million. Depending on the Company's ability to replicate the profitability trends from the first two quarters of 2006, the EPS should range between \$0.07 and \$0.10, yielding a PE multiple of 8 to 12, clearly not reflecting the Company's strong roll-up expansion 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. We rate the stock a speculative buy based on the Company's historical strong revenue growth, its respectable level of earnings and low PE ratio for the sector. 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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