

Net Dragon

Difficult 2008 over, better times coming

Not rated

Financial summary

Year to Dec	06A	07A	08A	09F	10F
Turnover (RMBm)	122.1	645.2	596	661.3	770.7
Net Profit (RMBm)	43.1	374.7	239.4	206	243.7
EPS (RMB)	0.097	0.85	0.445	0.393	0.457
EPS Δ%	-247.4	775.2	-47.7	-11.7	16.3
P/E (x)	30.8	3.5	6.7	7.8	6.7
P/B (x)	13.12	0.77	1.14	1.01	0.93
EV/EBITDA (x)	23.7	-0.4	2.1	-	-
Yield (%)	-	21.7	5.9	4.9	5.4
ROE (%)	59.7	40	14.9	13.7	15
ROCE (%)	70.4	44.8	-	-	-
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

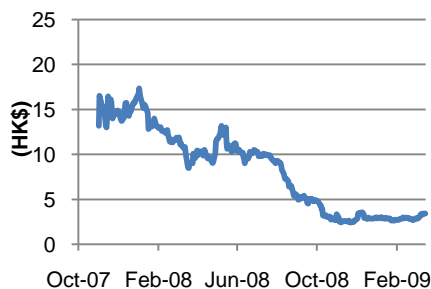
Source: Bloomberg

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+22.6	+37.9	-38.2
Actual price changes (%)	+15.3	+37.9	-64.8

	09F	10F
Consensus EPS (RMB)	0.445	0.393
Previous forecasts (RMBm)	-	-
Previous EPS (RMB)	-	-

Price Chart



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Ticker: 0777.HK

Price: HK\$3.40

Target: N.A.

12 mth range: HK\$2.33-13.60

Market cap: US\$230.6m

Daily t/o, 3 mth: US\$0.19m

Free float %: 30.4%

Key points:

- * 4Q revenues stabilized, suggesting that ND's private server issues are behind it
- * Launched EPs for Eudemons, Conquer and Zero between end of FY12/08 and 1Q FY12/09
- * Way of the Five was launched on 7 Mar. The MMOG, with actor Stephen Chow as its spokesperson, will be the company's key growth driver in FY12/09
- * 4 other titles slated for launch in 2009, including Disney Fantasy Online, Heroes of Might and Magic, Tian Yuan and CJ7 Online
- * Cash position of RMB1,273.3m represents 77% of market cap
- * Trading at 7.7x FY12/09F and 6.6x FY12/10F P/E on consensus

FY12/08A net profit RMB239.4m. Net Dragon (ND) announced its results for FY12/08A, a year which was marred by private server issues on its flagship Eudemons game. Revenue decreased 9.6% YoY to RMB596.0m as net profit dropped 36.1% YoY to RMB239.4m. The gross margin decreased 5.7pcp to 88.6% while net margin decreased 17.9pcp to 40.2%. Overseas segment was a bright spot for the ND. Revenue outside China was up 24.1% YoY to RMB149.6m, representing 25.1% of revenues. The company during the year launched Eudemons and Zero in Hong Kong, Taiwan, Thailand and Macau as well as Eudemons in Indonesia.

Revenue stabilised in 4Q. Revenues in 4Q FY12/08A stabilised, after sequential quarterly revenue declines since 4Q FY12/07A, suggesting that measures implemented (see "Good risk-to-reward ratio" (20 Nov 2008)) to address the private server problem was beginning to take a positive effect. 4Q revenue of RMB136.5m was flat compared to RMB136.6m in 3Q. 4Q net profit of RMB73.2m was up 43.8% QoQ though it was aided by a one-off tax credit of RMB6.5m.

ACU/PCUs up QoQ. More importantly began to show signs of rebound. Total ACU increased 1.9% QoQ to 317k and PCU increased 8.6% QoQ to 591k. This was achieved without contribution from any expansion packs (EP) for its MMOG titles. The EP for Conquer was launched in mid-Dec 2008 while the critical EP for Eudemons was only launched on 16 Jan 2009. ND is also launched an EP for Zero in end-Feb 2009. We expect to see contributions from

these EPs in 1Q and 2Q FY12/09F, which would further help the company's road to recovery.

Way of the Five – main growth driver for FY12/09F. ND officially launched Way of the Five (Kaixin), a cartoon-version MMOG on 7 Mar. The company also engaged Mr. Stephen Chow, a famous movie star, to act as the "Ambassador of Happiness" to promote the game. In our view, Way of the Five provide the new option to the market and explore the different type of group than the main stream player, which may bring the new value to the game market. The management said that the feedback for the game so far is positive. Although they would not expect the new game will be as successful as Eudemons, they believe this game would be a new opportunity for the company. We expect to contribution from this MMOG to materially contribute to ND's bottom line in 3Q FY12/09F.

4 other new MMOGs slated for 2009 launch. ND will turn its focus back to MMOG development and launch in 2009. In addition to the EPs and Kaixin launched thus far, ND has another 4 MMOGs in its 2009 pipeline. This includes its Disney character based MMOG "Disney Fantasy Online" in around May 2009. Also, the company is slated to launch Heroes of Might and Magic (late 2Q), as well as Tian Yuan and CJ7 Online (both in 4Q). The company's agreement with Electronic Arts (EA) for development and exclusively distribution of a MMOG based on its "Dungeon Keeper™" franchise is currently scheduled for a 2010 launch. We think the ND has the development team to meet the heavy launch schedule. The company had a development team of 1,465 at the end of FY12/08A (FY12/07A: 412)

Cash represents 77.9% of market cap. At end-FY12/08A, ND was in a cash position of RMB1,273.3m (incl. RMB311.8m financial asset) and no debt, representing about 77.9% of its total market value. The company plans to unwind its principle protected US\$30m and A\$21m credit-linked notes (and a related hedging foreign currency forward contract) as soon as they are due in mid-2009. The company booked a fair value loss of RMB35.2m for FY12/08A (4Q: RMB12.9m) for the debt instruments, which as offset by a gain of RMB32.2m fair value gain for the foreign currency forward contract (4Q: RMB11.8m).

2009 a critical year for ND. 2009 will be a critical year for ND. The company put all its resources into fighting its private server issues in 2008 and this has put back the launch of several of its games into 2009. While we think that earnings in 1H FY12/09F may still be on the weak side as the company places more efforts into marketing and ensuring good take up of its new titles/EPs, a successful take up of these games would return the company's P&L back to a high growth scenario in 2H FY12/09F in our view.

Valuation. The counter is currently trading at 7.7x FY12/09F P/E and 6.6x FY12/10F P/E based on consensus.

Table 1: 4Q FY12/08A results

3 months to Dec	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	EPS (RMB)
4Q FY08	136.5	118.1	86.6	66.7	n/a	73.2	0.14
3Q FY08	136.6	119.3	87.3	50.4	n/a	50.9	0.09
QoQ (%)	(0.1)	(0.9)		32.2		43.8	46.3

Source: Company data

Table 2: Operating Metrics for ND

	4Q FY12/08	3Q FY12/08	2Q FY12/08	1Q FY12/08	4Q FY12/07
PCU(k)	591	544	697	669	787
QoQ(%)	8.6	(22.0)	4.2	(15.0)	
ACU(k)	317	311	355	313	407
QoQ(%)	(1.9)	(12.4)	13.4	(23.1)	

Source: Company data

Table 3: P & L

Year to Dec (RMBm)	06A	07A	08A	09F	10F
Turnover	122.1	645.2	596.0	661.3	770.7
Cost of sales	(11.2)	(36.9)	(68.1)		
Gross profit	110.9	608.4	527.9		
Other net (loss)/income	5.7	8.3	95.1		
Selling and distribution costs	(13.8)	(80.8)	(103.6)		
Administrative expenses	(23.0)	(50.1)	(112.7)		
Development costs	(12.8)	(37.3)	(89.8)		
Other operating expenses	(15.4)	(21.4)	(54.7)		
Operating profit	51.5	427.1	262.2		
Share of loss of an associate	-	-	(0.276)		
Pre-tax profit	51.5	427.1	261.9	251.0	292.0
Tax	(8.6)	(52.2)	(22.6)		
Minority interests	(0.1)	(0.1)	0.1		
Net profit	42.9	374.9	239.4	206.0	243.7

Source: Company data and Bloomberg Estimate

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