

Net Dragon



Good risk-to-reward ratio

Not Rated

Update. The company announced 3Q FY12/08A results with net profit down 54.1% at RMB50.9m. The weak results were expected given the company's flagship Eudemons' private server issues. After a discussion with management, we understand that the company is solving the problem by: 1) significant internal security upgrades; 2) redesigning work processes; 3) deploying its anti-hacking team and working with police to shut down private servers. The measures have already helped Eudemons' game metrics to stabilize. The company has also announced its strategic agreement with Electronic Arts (EA US) to develop MMOGs based on the gaming giants' franchise titles. It plans to launch Way of the Five (Happiness Q) and an expansion pack for Eudemons in Jan 2009, Tian Yuan (a 2.5D MMORPG with ancient oriental legendary settings) in spring 2009 and a Disney-themed MMORPG in summer 2009.

Online games market still robust. China's online games sector continue to be robust. iResearch estimated that the industry in 3Q grew 51.9% YoY and 7.7% QoQ in 3Q 2008 to RMB5.5b. Moreover, many online games companies announced solid 3Q results recently, but more importantly, guided for a positive 4Q (see Table 3)

Our view. The counter is currently trading at its cash level. The company had a net cash position of around HK\$1.4b at end-3Q FY12/08A, representing HK\$2.58 cash per share. We think downside risks are limited given that the investment community has essentially valued its online games business at zero. Cash flow drain is not a problem as even with private servers' cannibalising its revenue, the company still expects to generate FCF of around RMB100.0m in FY12/08F. We believe that with the latest security measures, the worst may be over. Meanwhile, its pipeline and strategy remains strong. If the company can stabilize its PCUs and ACUs for Eudemons and show reasonable results with its Eudemons expansion pack and Way of the Five launch in Jan 2009, we see some meaningful re-rating potential. The current price level offers a good entry point, in our view.

Valuation. The counter is trading at 6.1x FY12/08F P/E on consensus.

China Online Games

Thu, 20 Nov 2008

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Stock data

Price	HK\$2.63
Target price	n/a
12 mth range	HK\$2.33-16.85
Market cap.	US\$179.0m
Daily t/o, 3 mth	US\$0.4m
Free float %	32.8%
Ticker	0777.HK/777 HK

Financial summary

Year to Dec	06A	07A	08F	09F
Turnover (RMBm)	122.1	645.2	598.0	635.0
Net profit (RMBm)	42.9	374.9	203.0	234.0
EPS (RMBm)	0.110	0.850	0.380	0.440
EPS Δ %	n/a	672.7	(55.3)	15.8
P/E (x)	21.1	2.7	6.1	5.3
P/B (x)	7.78	0.58	0.87	0.82
EV/EBITDA (x)	20.7	n/a	n/a	n/a
Yield (%)	-	24.0	20.7	3.2
ROE (%)	41.1	21.2	12.8	16.1
ROCE (%)	41.1	21.2	12.8	16.1
N. Gear. (%)	Cash	Cash	Cash	Cash

Source: Bloomberg

Price Chart



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Table 1: 3Q FY12/08A results summary

3 months to Sep.	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)
3Q FY12/08A	136.6	119.3	87.3	50.4	-	50.9
3Q FY12/07A	191.6	181.5	94.7	123.8	9.5	111.9
YoY (%)	-28.7	-34.2		-59.3		-54.5

Source: Company data

Table 2: Net Dragon's pipeline schedule

Game title	Genre	Scheduled launch
Eudemons EP	Expansion pack for Eudemons	Jan 2009
Way of the Five (Kaixin)	2.5D MMOG with cartoon-version of turn-based online game	Jan 2009
Tian Yuan	2.5D MMOG based on ancient oriental legend	Spring 2009
Disney Fantasy (working title)	Turn based online fantasy world based on Disney characters	Summer 2009
Dungeon Keeper	MMOG based on Electronic Arts (EA) franchise	2010

Table 3: Peers outlook

Ticker	Company	Takeaways from 3Q results announcement
NTCY US	The 9	3Q net profit below expectations due to Olympics and seasonal weakness, which is related game play. Management expects rebound in 4Q.
700 HK	Tencent	Online games currently biggest driver for Tencent's revenues/profits. Management expects solid organic growth in 4Q. Most of company's new title launches have been completed.
NTES US	Netease	3Q (ex. one-off) net profit above consensus estimates. Street expects company's revenues to grow low to mid single digits in 4Q.
GA US	Giant	Monetisation strategy shift for ZT Online affected 3Q results, which came in below expectations. However, management is guiding 4Q revenue to increase 21-30% QoQ
PWRD US	Perfect World	3Q results beats consensus estimates. Management is guiding for 5-10% QoQ revenue increase for 4Q and has a bullish outlook for PWRD for 2009.
SNDA US	Shanda	3Q results to be announced on 1 Dec.