

Industry brief

China Online Games

Facing challenges

Not Rated

Summary

China's online game industry is one of the fastest growing Internet-related sectors, expected to register a CAGR of 33.0% in 2007-2010.

The sector is fragmented, with more than 100 MMOGs (massively multiplayer online game) on offer at any one time. Shanda is the industry leader, with a market share of 18.8% at end-2007.

We believe near-term challenges include: intense competition; aggressive title roll outs; launch schedule-altering effect of the Olympics and difficulties in repeating success.

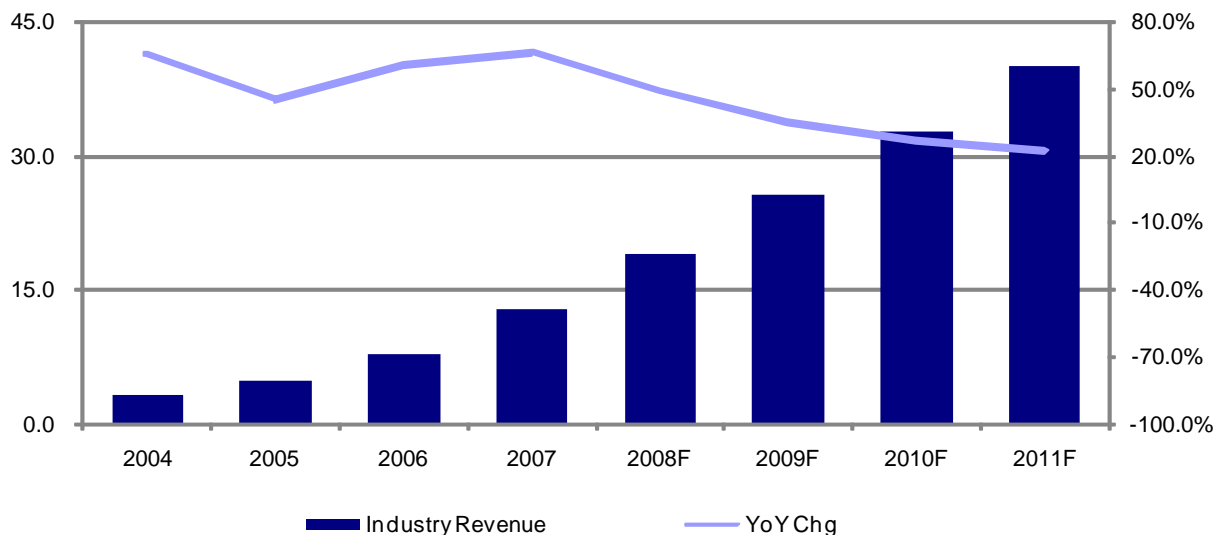
Among Hong-Kong listed four online game providers Kingsoft (3888 HK), Finet (8317 HK), Tencent (700 HK) and NetDragon (8288 HK), we prefer Tencent, although in terms of consensus valuations, NetDragon also looks attractive.

We remain positive on the sector's long-term outlook and recommend accumulating pure online game plays in the run up to the Olympics.

Industry overview

Strong growth to continue. China's online game industry has experienced fast growth in recent years, fuelled by the increasing availability of Internet broadband, growing online game/community culture amongst the country's youth and rising disposable incomes. iResearch expects China's online game market to grow from RMB12.8b in 2007 to RMB40.1b in 2011, at a CAGR of 33.0%. China's active gamer population is expected to increase from about 40m in 2006 to 70m by 2010. This paves the way for sustained growth in this sector.

Chart 1: China online game industry growth



Sources: iResearch

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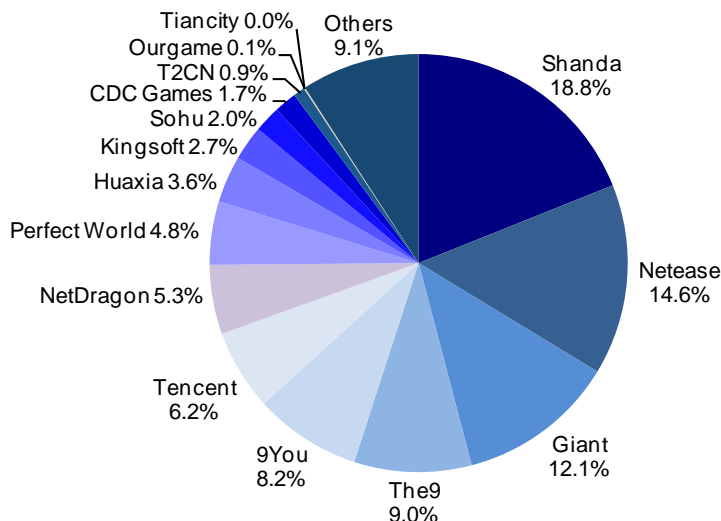
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Fragmented industry, intense competition. The boom has produced a proliferation of online game companies with more than 100 (MMOGs) to choose from at any one time. The competition is intensifying as these companies expand their capital resources through public listings in Hong Kong and overseas markets. The industry's largest player, Shanda (SNDA US), had only 18.8% of the market at end-2007, according to iResearch, while the top 14 online game providers accounted for just over 90% of the market.

Chart 2: China's online game market



Sources: iResearch

Shift towards self-development. China's online game industry started with an operator model, with local companies licensing online games from overseas developers, most notably Korea, for exclusive operation and distribution. Shanda initially licensed Legend of Mir II from Actoz, while The9 (NCTY US), which operates World of Warcraft (WoW) in China, licenses online game titles from the US and Korea. As the industry fosters its own value chain of designers (coders, artists and lead designers) and development processes, companies with strong R&D and distribution capabilities, such as Kingsoft (3888 HK) and Perfect World (PWRD US) emerge.

Near-term challenges. The industry has sound long-term fundamentals but in the near term it will face the following challenges:

Intense competition – leading to: 1) pressure to shorten product development times; 2) shorter product life cycles and 3) increasing royalty fees. Companies such as NetDragon (8288 HK) and Perfect World can develop and roll out MMOGs in six months. Shanda plans to launch some 20 new games (through licensing and self development) in 2008. Foreign non-Korean developers are looking to break into China to grab a slice of an already crowded market. We believe that online game companies will have to increase spending on marketing and distribution of their titles, placing greater strains on margins.

Distorted launch schedules in 2008 – Many online game companies are bringing forward launches of their new titles ahead of the 2008 Beijing Olympics in August, which we believe may lead to a glut of new releases in 1H of 2008 and increase pressure on marketing and distribution resources. The same goes for post-Olympics, as companies fight for returning gamers and queue up to launch more new titles after the event.

Declining usage before the Olympics – we expect online game log time to decrease in the run up to the Olympics, denting sentiment in the sector and affecting companies whose MMOG portfolios are dominated by time-based games. While we expect players to begin returning in September, sentiment may remain weak if the US and global economic slowdown continues.

Difficulty in repeating success – Many online game companies rely on blockbusters despite their solid portfolio of MMOG titles and development pipelines. The9 generates around 85% of its gaming revenue from WoW. Legend of Mir II and Wool account for around 70% of Shanda's top line, while Perfect World and NetDragon generates 50% and 67% from their core titles of ZhuXian and Eudemons Online, respectively.

Hong Kong-listed online game plays. Hong Kong has four listed companies with exposure to China's online game industry: NetDragon (8288 HK), Kingsoft (3888 HK), Tencent (700 HK) and Finet (8317 HK). In general, they are tier II players, which develop and operate their own games.

Company profiles**Kingsoft (3888 HK, HK\$2.59, NR)**

Background. Kingsoft is an application software and online game developer/operator. Established in 1988 as a developer of Internet security, dictionary and word processing applications, it diversified into online games in 2003. The company was listed on the HKEx in Oct 2007.

Existing portfolio and results. Kingsoft presently has five, with three titles (JX Online 剑侠情缘, The First Myth 封神榜 and JX Online II 剑侠情缘 II) developed in-house and two (Xian Lu Qi Yuan II 仙侣奇缘 and Shui Hu Q Zhuan 水浒 Q 传) licensed. JX Online and Shui Hu Q Zhuan accounted for around 60% of its online game revenue. The company does not break out its operating metrics for individual titles, but PCUs reached 529.8k, up 7.7% QoQ, driven by the launch of CQ. However, the company's number of paid users fell to 1,035,400 at end-3Q FY12/07A, from 1,136,200 in 2Q and 1,196,000 in 1Q, mainly due to the maturing of Shui Hu Q Zhuan, competition from rival titles and recently launched CQ. 3Q online games revenue was RMB101.2m, down 0.5% QoQ. Including contributions from its applications software business, Kingsoft's 3Q FY12/07A net profit fell 19.7% QoQ to RMB30.0m.

Solid pipeline. The company has five games under development. In 2008, it plans to launch JX Online World 剑侠世界, The First Myth II 封神榜 II and San Guo Online 铁血三国志. The remaining two, JX Online III and SA II, are slated for launch in 2009.

Valuation. Kingsoft is currently trading at 21.9x FY12/07F and 12.6x FY12/08F P/E based on consensus estimates.

Table 1: Operating metrics for Kingsoft

MMOG Title	Sep 2006	Dec 2006	Mar 2007	Jun 2007	Sep 2007
PCUs (000)	458.4	553.9	508.2	491.8	529.8
QoQ (%)	15.3	20.8	-8.3	-3.2	7.7
Paid Users (000)	1,086.6	1,172.2	1,196.7	1,136.2	1,035.4
QoQ (%)	-2.5	-7.9	2.1	-5.1	-8.9

Source: Company data

Table 2: Kingsoft's MMOG pipeline

Year end Dec (RMBm)	Description	Target launch
JX Online World	Special installment of JX Online, with a new virtual world based on ancient Chinese swordsman legends	1H 2008
The First Myth II	Second installment of original First Myth series	1H 2008
San Guo Online	Adventure game based on war stories from the Three Kingdoms period	2H 2008
JX Online III	Third installment of JX Online series, with full 3D graphics	2009
SA II	Cartoon style game featuring full 3D graphics with online communities competing against each other	2009

Source: Company data

Finet (8317 HK, HK\$0.40, NR)

Background. The developer and provider of financial information services and technology solutions to corporate clients and retail investors announced in Aug 2007 its foray into China's online game industry with the acquisition of Tianchang for RMB59.5m in cash and a commitment to inject a further RMB50.0m. After the deal, the company raised about HK\$30.7m in net proceeds via an issue of 46.08m new shares at HK\$0.68 each.

Tiancheng. Based in Chengdu, Tianchang was established in Jan 2005 and focuses on 3D games. Its Legend of Tang Dynasty 大唐风云, a time-based 3D MMOG, was launched in Sep 2006 and Tang Dynasty Online 大唐, a free-to-play 3D MMOG, in Oct 2006. According to its shareholder circular, Tianchang recorded a net loss of RMB12.2m in FY12/06A. The company currently has around 200 game development staff and their development time frame for a 3D MMOG is 1.5 years.

Latest developments. Tianchang has three self-developed 3D games in the pipeline, including Warfield 赤壁, New Knight-Errant Story 新笑傲江湖 and QQ Shui Hu 梦幻水浒, all of which are free-to-play, pay-for-items 3D games. Since the titles have yet to undergo open beta testing, we believe the company plans to delay their launch, originally scheduled for end-2007. Another six to eight games are slated for 2008, under a combination of self-developed and licensing agreements. As part of the acquisition agreement, Finet will inject its own

management team into Tianchang. Founder Guo Yu will resign from Tianchang but its chief technology officer and chief marketing officer will remain with the company.

Valuation. There are currently no consensus valuations for Finet.

Table 3: Finet's MMOG pipeline

Year end Dec (RMBm)	Description	Target launch
Warfield	3D online game featuring a combat setting for geographic territory	2008
New Knight Errant Story	3D online game based on the popular Chinese swordsman novel by Jin Yong	2008
QQ Shui Hu	Cartoon style 3D online game	2008

Source: Company data

NetDragon (8288 HK, HK\$11.40, NR)

Background. After setting up its renowned online games portal www.17173.com in 2001 and rolling out first MMOG Monster & Me 幻灵游侠 in 2002, Fuzhou-based NetDragon now has a portfolio of five proprietary games. The company has won several industry awards, including the Best Original Online Game for Eudemons Online 魔域 in 2006. NetDragon was listed on the GEM Board of the HKEx in Nov 2007.

Eudemons and Conquer Online - key drivers. NetDragon's current core titles are Eudemons and Conquer Online. In Jan-Sep FY12/07A, its revenues surged 699.6% YoY to RMB453.3m and net profit rose to RMB265.7m from RMB9.6m in the year-earlier period. Eudemons drove this explosive growth, generating RMB313.4m in the period from RMB20.0m. Eudemons and Conquer Online together accounted for 91.1% of the company's revenue. Eudemons' subscriber growth reached 6.3% QoQ in 3Q FY12/07A in peak concurrent users (PCU) and 7.3% in average concurrent users (ACU) to 527,000 and 294,000 respectively. Zero Online, launched in Apr 2007, is also showing promising prospects, with a 66.0% and 119.0% QoQ increase in PCUs and ACUs to 88,000 and 46,000 respectively.

Tou Ming Zhuang to coincide with film release. NetDragon adopts a modular approach to its 3D MMOG design and can therefore significantly shorten the developmental process. The company's 360-strong development team can design and roll out games in six months. It currently has four MMOGs in the pipeline: Tou Ming Zhuang 投名状, Happiness Q 开心 Q 传, Piao Miao Online 缥缈 and Heroes of Might and Magic Online 英雄无敌. Tou Ming Zhuang is based on the movie "The Warlords", starring popular actors Jet Li, Andy Lau and Takeshi Kaneshiro. Its launch was timed to coincide with the film's release in Dec 2007. The game is expected to start contributing in 1Q FY12/08F.

Valuation. NetDragon is trading a 15.4x FY12/07F and 12.0x FY12/08F P/E, on a consensus basis. The company has recently been buying back its stock. As of 14 Feb 2008, it acquired 6,564,000 shares on the open market, representing 1.18% of its issued share capital.

Table 4: Operating metrics for NetDragon

MMOG Title	Sep 2006	Dec 2006	Mar 2007	Jun 2007	Sep 2007
<u>Eudemons</u>					
PCUs (000)	128	325	438	496	527
QoQ (%)	156.0	153.9	34.8	13.2	6.3
ACUs (000)	56	140	213	274	294
QoQ (%)	80.6	150.0	52.1	28.6	7.3
<u>Conquer Online</u>					
PCUs (000)	74	82	85	89	92
QoQ (%)	12.1	10.8	3.7	4.7	4.6
ACUs (000)	54	59	61	64	64
QoQ (%)	8.0	9.3	3.4	4.9	-
<u>Zero Online</u>					
PCUs (000)	-	-	-	53	88
QoQ (%)	-	-	-	-	66.0
ACUs (000)	-	-	-	21	46
QoQ (%)	-	-	-	-	119.0

Source: Company data

Table 5: NetDragon's revenue breakdown

Year end Dec (RMBm)	1-9M 06A	%	1-9M 07A	%
Conquer Online	35.6	62.7	99.8	22.0
Eudemons	20.0	35.3	313.4	69.1
Zero Online	-	-	39.0	8.6
Others	1.1	2.0	1.2	0.3
Total	56.7	100.0	453.3	100.0

Source: Company data

Table 6: NetDragon MMOG pipeline

Year end Dec (RMBm)	Description	Target launch
Happiness Q	"Cute" game aimed at first time gamers and younger audience	1Q 2008
Piao Miao Online	Variation of Eudemons online incorporating monsters and pets drawn from Chinese history and legends	2Q 2008
Heroes of Might and Magic	Licensed from Ubisoft, the online game is targeted at hardcore gamers	2H 2008

Source: Company data

Table 7: NetDragon's revenue breakdown

Year end Dec (RMBm)	1-9M 06A	%	1-9M 07A	%
Conquer Online	35.6	62.7	99.8	22.0
Eudemons	20.0	35.3	313.4	69.1
Zero Online	-	-	39.0	8.6
Others	1.1	2.0	1.2	0.3
Total	56.7	100.0	453.3	100.0

Source: Company data

Tencent (700 HK, HK\$49.90, NR)

Company description. Tencent is China's largest Internet company, with a market cap of over US\$10.7b. Founded in 1988, it moved from its instant messenger (IM) service provider origins to communication (IM, QQ.com, Mobile QQ), content/entertainment (QQ Games, QQ Show, QQ Pets, WVAS), community (QQ Group, Qzone) and commerce (Paipai, Tenpay).

Diversified platform. Tencent's first MMOG was its in-house developed QQ Fantasy, launched in 2005. After two years, the MMOG matured and its performance weakened. However, two new titles, QQ Huaxia (licensed from minority shareholder Shenzhen Domain) and QQ San Guo (in-house developed), have been able to take up the slack. In 3Q FY12/07A, PCUs for the company's MMOG products surged from 153,000 to 302,000 QoQ, driven by the commercial launch of QQ San Guo on 29 Jun 2007 and a seasonally strong 4Q. QQgame, the company's mini casual game platform, is the largest in China. With a PCU of around 3.6m at end-Sep 2007, it is significantly larger than equivalent platforms operated by Ourgame (4x+) and Shanda (9x+). Meanwhile, it also has a strong portfolio of advanced casual games, such as QQ Tang, QQ SG and R2Beat.

More advanced casual games in 2008. At the end of 3Q FY12/07, the company launched an item-based beta test version of QQ Fantasy to extend the life cycle of the MMOG. For FY12/08, Tencent aims to roll out one licensed MMOG and three advanced casual games with "car racer" and "flying shooter" themes. Considering its good track record of promotions and launches, the relatively less competitive sub-segment and less time required to play casual games, we expect the games to be successful. Coupled with the company's sticky user base, this platform may be less affected by the Olympics effect. The company's upcoming MMOG, "Journey to Fairyland" is expected to be launched in 2H FY12/08.

Valuation. Tencent is currently trading at 53.5x FY12/07F and 37.6x FY12/08F P/E, based on consensus estimates.

Table 8: Operating metrics for Tencent

	3Q06	4Q06	1Q07	2Q07	3Q07
QQgame					
PCUs (000)	2.9	2.9	3.5	3.4	3.9
QoQ (%)	11.5	-	20.7	(2.9)	14.7
MMOGs					
PCUs (000)	163	209	212	153	302
QoQ (%)	-18.9	28.2	1.4	(27.8)	97.4
ACUs (000)	88	84	73	52	NA
QoQ (%)	-11.1	-4.5	13.1	(27.8)	

Source: Company data

Our view. We believe that in the short-term, China's online game plays will be plagued by weak sentiment due to: 1) competition concerns; 2) the Olympics effect; 3) comparisons with a strong 4Q 2007. Nevertheless, we remain positive on the sector due to the industry's strong fundamentals and believe an opportune time to accumulate pure online game plays is the run up to the Olympics, when sentiment for these stocks should be at its weakest. Online game companies generally trade at a discount to other Internet-related stocks due to their relatively short product life cycles, difficulty in repeating blockbuster success and need to develop a solid pipeline of new titles to keep paying subscribers and maintain earnings momentum. In general, Hong Kong-listed online game plays are trading at similar valuations to their Nasdaq-listed counterparts. From a valuation perspective, NetDragon (8288 HK) looks attractive and we also like its genre diversity. We have a neutral-to-negative view on Kingsoft (3888 HK) and Finet (8317 HK). While we believe CQ may re-ignite paying subscriber, revenue and bottom line growth, the company's development portfolio, dominated by sequel titles in a similar "action fighting" genre, is a potential weakness. As for Finet, we believe the departure of Tianchang's founder is a negative and the listed vehicle will need some time to demonstrate its execution ability and gain investment confidence.

Tencent – a sector favourite. From an online game perspective, we like the company for its diversified platform of MMOGs, advanced casual games and causal games. Genre-wise, its portfolio is also varied, with "cute" games, action fighting games and music games. Its core competency of a massive active IM user base (288.7m as of Sep 2007) which creates a great economies of scale advantage in marketing and distribution, through cross-selling and user community viral marketing. This also increases Tencent's bargaining power with domestic and foreign online game developers in licensing negotiations. The stickiness of its user network, generated by functional needs (IM client), the frequency of usage, branding and network effects, facilitates retention and prolongs the life of its online game products. This stickiness should allow the company to lessen the effect of an expected decline in online games' log time in 2008 because of the Olympics.

Table 9: 17173.com rankings (30 Jan 2007)

Ranking	Download	Company	Ranking	PV	Company
1	Fantasy Westward Journey	Netease	1	Audition	9You
2	World of Warcraft	The9	2	Fantasy Westward Journey	Netease
3	TLBB	Sohu	3	Crazy Racing	Tiancity
4	Audition	9You	4	QQ Speed	Tencent
5	Chi Bi	Perfect World	5	World of Warcraft	The9
6	Fantasy Journey Online	9You	6	Freestyle	GigaMedia (T2CN)
7	Crazy Racing	Tiancity	7	Special Force	CDC Games
8	Zhu Xian	Perfect World	8	Fantasy Journey Online	9You
9	Maple Story	Shanda	9	Chi Bi	Perfect World
10	Great Voyage	ZRPlay	10	Yulgang	CDC Games

Source: 17173.com

Table 10: Valuation comparison

Company name	Ticker	Country	Mkt Cap (US\$m)	Last price (local)	Est Curr Yr P/E (x)	Est Nxt Yr P/E (x)	ROE (%)
Perfect World	PWRD US	China	1,292.0	US\$23.40	28.7	15.7	-
Shanda	SNDA US	China	2,108.8	US\$28.52	14.5	15.0	26.5
Netease	NTES US	China	2,410.8	US\$18.68	14.4	13.2	47.6
The9	NCTY US	China	503.5	US\$17.17	16.5	11.0	27.8
Giant Interactive	GA US	China	2,930.7	US\$11.32	15.4	10.9	179.4
Kingsoft	3888 HK	China	346.0	HK\$2.60	21.9	12.6	70.8
NetDragon	8288 HK	China	814.3	HK\$11.7	15.4	12.0	59.3
Tencent	700 HK	China	10,912.4	HK\$49.6	53.5	37.6	32.0
GigaMedia	GIGM US	China	994.3	US\$19.5	30.0	22.7	26.2
Finet	8317 HK	China	29.8	HK\$0.4	-	-	-
Sector average					23.4	16.8	

Source: Bloomberg