

NetDragon Websoft Inc. (777.HK)

A Promising Leader in K12 Online Education

Hong Kong | TMT | Company report

26 Jun 2015

NetDragon, which is a developer and operator of online games and mobile Internet platform, was listed in 2007 and moved on to the main-board market in 2008. Looking at its over 10 years of development, it is our opinion that NetDragon's success can be attributed to multiple qualities. First, the Company's management has international horizon and keen understanding of the market. Next, the Company has outstanding R&D capability. Lastly, the Company has shown forward-looking vision by positioning accurately and seizing the opportunity.

According to the Q1 report released recently by the Company, its turnover rose to RMB246 million, up by 13.4% yoy. But it recorded a loss for the two consecutive quarters despite the loss narrowing from RMB19.40 million last quarters to RMB10.91 million, or losing RMB2.21 per share. In fact, the Company's existing main business of online games continues to maintain stable growth, with the numbers of both its maximum users and sync users reaching a new high. However, the greatly increased expenses result in the loss because it is promoting online education products.

The success gene that the Company has developed in its 17173 online games portal and 91 assistant platform will be introduced in online education business, and that its integrated solution for K12 teaching and learning aims to change the boring teaching in the traditional education system and raise students' learning competence. Taking into account the huge potential of the online education and the in-depth cooperation between the Company and top education companies and institutions, it is very likely that the Company becomes a leading K12 online education company in the near future.

A Promising Leader in K12 Online Education

Looking at its history, NetDragon has successfully operated an online game portal and a mobile Internet platform, with their broad horizon, sharp insights into the market and outstanding R&D capability. Currently, the Company's existing main business continues to grow stably and is planning to exploring the market for the online education business. Given its advanced integrated solution, we are optimistic that the NetDragon will become a leading K12 online education company in Mainland China. The values of the Company comprise cash value, games business and estimated value of the online education. We adopt SOTP method to set its target price at HK\$40.47, giving it an "Accumulate" rating initially. (Closing price as at 24 June 2015)

Valuation by SOTP

Business	Estimated MV(RMB: mn)
Online Games -PER	4,233
Others(Online Education)-PSR	7,050
Cash and cash equivalents	3,510
Lands	1,200
Total value	15,993
Target Price(HK\$)	40.47

Source: Phillip Securities (HK) Research

Accumulate (Initially)

CMP: HKD 34.45

(Closing price as at 24 June 2015)

TARGET: HKD 40.47 (+17.5%)

COMPANY DATA

O/S SHARES (MN) :	497
MARKET CAP (HKDMN) :	17,122
52 - WK HI/LO (HKD):	42.05/ 11.8

SHARE HOLDING PATTERN , %

Liu Dejian :	51.12
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PRICE PERFORMANCE , %

	1M	3M	1Y
NetDragon	-5.15	144.07	147.88
HSI	-2.79	132.05	128.41

PRICE VS. HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY13	FY14	FY15E	FY16E
Net Sales	885	963	1411	1964
Net Profit	164	177	50	129
EPS, CNY	0.33	0.35	0.10	0.26
PER, x	83.7	78.1	273.3	105.3
BVPS, CNY	9.07	9.14	9.19	9.32
P/BV, x	3.0	3.0	3.0	2.9
ROE, %	204.4	3.8	1.1	2.8
Debt/Equity (%)	17.89	13.28	11.11	11.11

Source: Company reports, Phillip Securities Est.

Research Analyst

Fan Guohe

(+ 86 21 51699400-110)

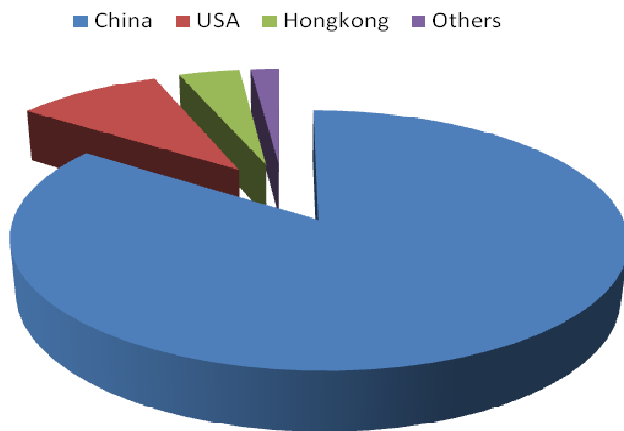
fanguohe@phillip.com.cn

Multiple Qualities Make Its Successful Operation

NetDragon, which is a developer and operator of online games and mobile Internet platform, was listed in 2007 and moved on to the main-board market in 2008. Looking at its over 10 years of development, we think that NetDragon’s success can be attributed to multiple qualities.

First, the Company’s management has international horizon and keen understanding of the market. Thanks to the management’s past immersion in the frontier market in the United States, the Company developed and operated 17173 games portal and 91 assistant platform, adapting respectively for the upcoming trends of online games and mobile Internet. What’s more, it is also an industry-leading player in China as an international operator of online games, with products made in 10 languages including English and French. The revenues from the overseas market contribute to over 15% of the Company’s total.

Sales by regions in 2014



Source: Company reports, Phillip Securities (HK) Research

Next, the Company has outstanding R&D capability. By far, it has developed and operated dozens of large-scale online games of different styles, including Zork, Conquer, Monster and Me and so on.

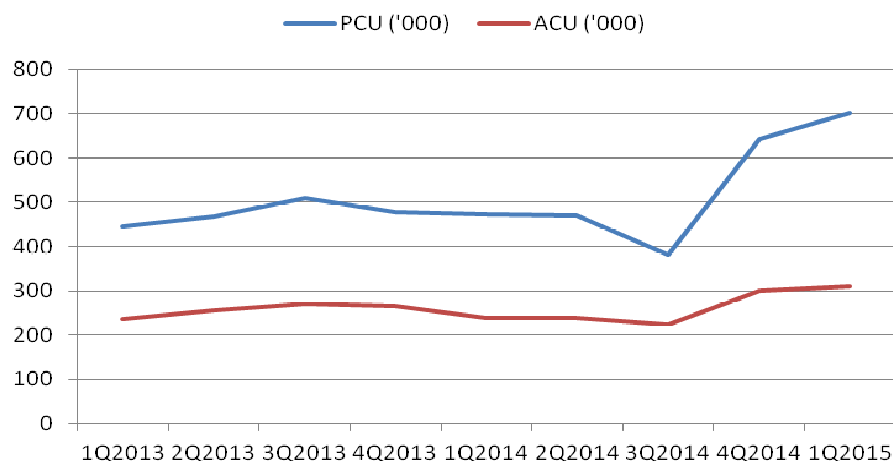
Lastly, the Company has shown forward-looking vision by positioning accurately and seizing the opportunity. Its strategic thinking can be found in its games portal and intelligent terminal assistant platform.

Loss in Q1 due to the Increased Investment in the Transformation Period

According to the Q1 report released recently by the Company, its turnover rose to RMB246 million, up by 13.4% yoy. But it recorded a loss for the two consecutive quarters despite the loss narrowing from RMB19.40 million in 4Q14 to RMB10.91 million, or losing RMB2.21 per share.

In fact, the Company’s existing main business of online games continues to maintain stable growth, with the numbers of both its maximum users and sync users reaching a new high. Cos, the MOBA games developed independently by the Company started its OBT (Open Beta Test) early in the year and recorded remarkable user growth and eye-catching operation indexes, and the active users exceeded 7.90 million in the following month, a major growth engine in that quarter. Besides, for mobile phone games, the pocket edition of Zork had a strong performance since its OBT in January and the monthly revenues constantly hit RMB10 million. The latest overseas version of its flagship games Conquer reported a new high revenue in March. We believe that the online games will continue to be the main support for NetDragon’s results growth and cash flow.

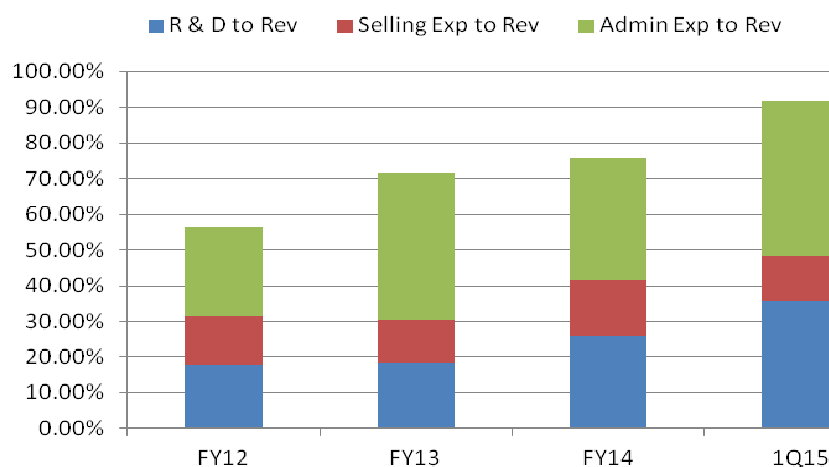
The PCU and ACU rise sharply



Source: Company reports, Phillip Securities (HK) Research

The Company, however, recorded a loss mainly because it is promoting online education products. Its employees cost, depreciation and amortization, consumables and office spending all increased, driving the admin expense up by 88% yoy to RMB107 million, accounting for 43.4% of its revenues. In the meantime, its R&D expense increased by 115% yoy to RMB87.89 million, accounting for 35.7% of its revenues.

Increasing opex ratio of NetDragon



Source: Company reports, Phillip Securities (HK) Research

Explore Online Education with Promising Future

Back in 2010, NetDragon started its online education business by focusing on vocational education and K12 education. In terms of K12 education, the Company intended to create an integrated solution incorporating hardware, platform and software. As for the hardware, 101PAD is scheduled to realize mass production in the second half of the year. As for content software, the Company has been licensed by authorization and acquired contents in addition to over 20 self-developed e-learning applications. Regarding the platform, the Company has established “Smart Learning Institute” in collaboration with Beijing Normal University and developed smart education solutions with Pearson Education. Furthermore, the Company will expand user base by using offline channel, online B2C and nationwide distribution channels.

Over the past two months, the Company made a few moves. First it appointed Mr. Simon L.K. Leung, the former Chairman of Microsoft China as its Vice Chairman responsible for determining the 101 Education’s overall strategy and its daily operation, as well as NetDragon’s plan for global education

business. It also displayed its intention to explore India, the United States and other overseas markets.

The Company also made active merger and acquisition. On June 4, it announced that it acquired 100% equity interests of Suzhou Chivox, which provided over 200 organizations with speech assessment, spoken foreign language technology and other relevant services in the past five years, holding an industry-leading position. NetDragon will integrate Chivox's speech recognition technology into its education business in terms of speech assessment, speech recognition and speech teaching. On June 9, the Company announced that it was deliberating on the acquisition of Premethean, an international education company at the ceiling price of USD130 million. As a leading interactive education company, Premethean's core business is interactive whiteboard and PAD and its interactive display products take 25% of the global market shares besides China and Turkey markets. In our opinion, the acquisitions fit the Company's development strategy and help create a classroom ecosphere consisting of whiteboard and 101PAD, further improving its competitiveness in K12 teaching field.

We believe that the success gene that the Company has developed in its 17173 online games portal and 91 assistant platform will be introduced in online education business, and that its integrated solution for K12 teaching and learning aims to change the boring teaching in the traditional education system and raise students' learning competence. Taking into account the huge potential of the online education and the in-depth cooperation between the Company and top education companies and institutions, it is very likely that the Company becomes a leading K12 online education company in the near future.

Catalyst

Online games business grows better than expected;
K12 online education business develops faster than expected.

Risks

The online education solution is not as good as what is expected;
Business expansion drives the cost and expenses too high.

Financials

Periodicity:	2012	2013	2014	2015F	2016F
Valuation Ratios					
Price Earnings	353.1x	83.7x	78.1x	273.3x	105.3x
Price to Book	9.9x	3.0x	3.0x	3.0x	2.9x
Dividend Yield	1.0%	1.2%	1.2%	0.2%	0.5%
Per share data(RMB)					
EPS Adjusted	0.08	0.33	0.35	0.10	0.26
Book Value Per Share	2.76	9.07	9.14	9.19	9.32
Dividends Per Share	0.28	0.32	0.32	0.05	0.13
Growth & Margin					
Revenue growth	8.5%	7.1%	8.9%	46.5%	39.2%
Gross profit growth	12.4%	4.1%	7.1%	38.0%	38.3%
Net profit growth	-71.1%	319.5%	7.5%	-71.9%	159.5%
Gross Margin	93.4%	90.8%	89.3%	84.1%	83.6%
Net Profit Margin	4.7%	18.6%	18.4%	3.5%	6.6%
Dividend Payout Ratio	51.4%	3884.6%	90.6%	50.0%	50.0%
Key ratios					
Return on Assets	1.8%	155.6%	3.3%	1.0%	2.5%
Return on Equity	2.7%	204.4%	3.8%	1.1%	2.8%
Effective Tax Rate	15.2%	23.2%	27.2%	27.0%	27.0%
Liability ratio	42.09%	15.18%	11.72%	10.00%	10.00%
Income Statement (RMB:mn)					
Revenue	826	885	963	1,411	1,964
- Cost of Goods Sold	54	81	103	224	322
Gross Income	771	803	860	1,187	1,642
- Selling, General & Admin Expenses	493	616	772	1,241	1,610
Operating Income	292	208	135	5	111
- Net Non-Operating Losses (Gains)	-26	-38	-83	-50	-50
Pretax Income	332	217	236	65	171
- Income Tax Expense	50	50	64	18	46
Net Income Adjusted*	39	164	177	50	129

Source: Company reports, Phillip Securities (HK) Research Estimates
(Financial figures as at 24 June 2015)

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm 5\%$ from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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Contact Information (Regional Member Companies)

SINGAPORE

Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

HONG KONG

Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites: www.phillip.com.hk

INDONESIA

PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

THAILAND

Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website: www.phillip.co.th

UNITED KINGDOM

King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

AUSTRALIA

PhillipCapital Australia
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96188238
Fax (613) 92002272
Website: www.phillipcapital.com.au

MALAYSIA

Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

JAPAN

PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website: www.phillip.co.jp

CHINA

Phillip Financial Advisory (Shanghai) Co. Ltd
No 436 Hengfeng Road,
Greentech Unit 604,
Postal code 200070
Tel (86-21) 51699400
Fax (86-21) 63532643
Website: www.phillip.com.cn

FRANCE

King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED STATES

Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005