

NetDragon Websoft (777.HK)

Loss diminishing quarter by quarter

Hong Kong | TMT | Company report

15 October 2015

The revenue of NetDragon in Q2 amounted to 266 million, up 15.6% yoy; with net loss of 7.46 million which has diminished for two consecutive quarters. Previously, the net loss recorded in 2014Q4 and 2015Q1 are 19.41 million and 10.91 million respectively. The online game business remains as the Company's main source of revenue, and it keeps stable growth. Income from online game in Q2 recorded 239 million, up 6.5% qoq or up 7.4% yoy. However, the Company is still in the key stage of promoting online education products. The administrative and R&D expenses these two expenses accounted for above 80% of the revenue. Therefore, the Company still incurred a net loss at the end.

We are optimistic on the Company's online game business in H2. Firstly, the performance of the game of Calibur of Spirit is better than expected and the Company also expressed that they would implement massive marketing promotion. Secondly, the Company would maintain the R&D capability in H2. The Company's first game in riding and stabbing category, namely Tiger Knight, is planned to have test run in Q3 and it would be launched online this year. Moreover, in June, the mobile game of Eudemons Online Pocket Version released the BOSS version on Apple Store and was quickly ranked among the top 10 paid mobile apps. Besides, the new mobile games of Blade and Sword and Dead Union would also be launched this year, which is expected by game users.

In H2, the Company's product of "101 student tablet" has been launched for large scale deployment. The Company put effort on enhancing the sales of collaborative intelligent classroom system, mobile communication software products, aiming at a coverage of more than 15 cities, and expected to cover 500 to 1000 classrooms. We believe the Company would achieve this target. Overall, with the expanding online education market, sufficient cash position of the Company, as well as the experience on game development through years, the Company would make education a process with fun by adding games into the learning materials, carry out analysis on user behaviors and provide innovative teaching mode. Moreover, the educational ecosystem of "hardware + software + content + cloud platform" constructed by the Company would provide an integrated solution for K12 education and we are optimistic towards its development prospect.

Enhanced income contribution from education segment is expected to improve valuation

With its international horizon, keen insight of the market, as well as outstanding research and development (R&D) capability, NetDragon has successfully operated online game portal and mobile internet platform. Currently, the Company's main business of online games continues its stable growth; while the market development of online education business is rewarding. Since the beginning of 2015H2, the income contribution from education business segment has been enhanced and thus the valuation of the Company's share would be gradually improved. Based on our valuation on the Company's cash value, game business and online education, we set the target price as HKD26.04 and grant a rating of "Buy". (Closing price at 13 Oct 2015)

Valuation by SOTP

Business	Estimated MV(RMB: mn)
Online Games-PER	2,795
Others(Online Education)-PSR	3,408
Cash and cash equivalents	3,144
Lands and others	1,320
Total value	10,667
Target Price(HK\$)	26.04

Source: Phillip Securities (HK) Research

Buy (Upgrade)

CMP: HKD 20.85
(Closing price at 13 Oct 2015)
TARGET: HKD 26.04 (+25%)

COMPANY DATA

O/S SHARES (MN) :	497
MARKET CAP (HKDMN) :	10,362
52 - WK HI/LO (HKD):	42.05/ 11.8

SHARE HOLDING PATTERN , %

Liu Dejian :	51.45
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PRICE PERFORMANCE , %

	1M	3M	1Y
NetDragon	18.01	-15.26	63.82
HSI	12.31	-5.38	65.60

PRICE VS. HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY13	FY14	FY15E	FY16E
Net Sales	885	963	1156	1603
Net Profit	164	177	29	134
EPS, CNY	0.33	0.35	0.06	0.27
PER, x	52.6	49.1	290.1	63.6
BVPS, CNY	9.07	9.14	9.17	9.30
P/BV, x	1.9	1.9	1.9	1.8
ROE, %	204.4	3.8	0.6	2.9
Debt/Equity (%)	17.89	13.28	21.21	21.95

Source: Company reports, Phillip Securities Est.

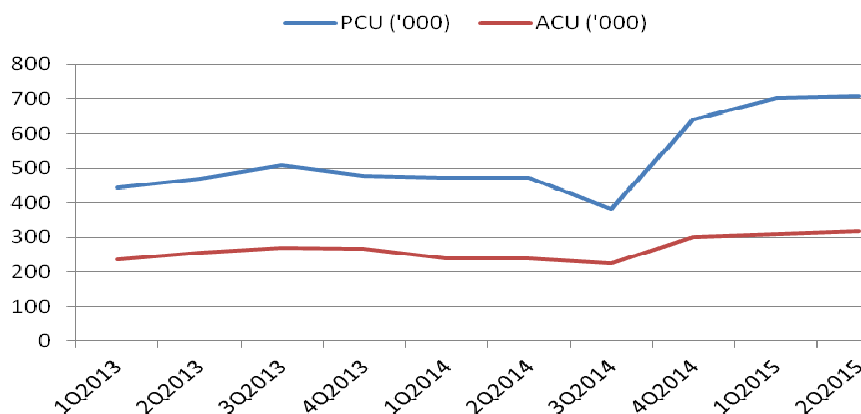
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Loss diminishing quarter by quarter

According to the 2015 interim report, NetDragon recorded the revenue of RMB512 million, up 14.5% yoy; in which income from online education increased 49.4% yoy. Net loss in the period under review amounted to 18.37 million and basic EPS is -3.72 cents. Dividend payout is HKD0.1 per share. From the perspective of quarter, the revenue in Q2 amounted to 266 million, up 15.6% yoy; with net loss of 7.46 million which has diminished for two consecutive quarters. Previously, the net loss recorded in 2014Q4 and 2015Q1 are 19.41 million and 10.91 million respectively.

In fact, online game business remains as the Company's main source of revenue, and it keeps stable growth. Income from online game in Q2 recorded 239 million, up 6.5% qoq or up 7.4% yoy. The peak concurrent users (PCU) of the Company's online games recorded 708,000, up 0.7% qoq; while average concurrent users (ACU) recorded 318,000, up 2.9% qoq. In terms of MOBA games, the Company's flagship game, Conquer, has launched new style, and its income from overseas version hit a record high. The new game, Calibur of Spirit, has been well-received by the market. In May, it recorded a new record high of flow as RMB26 million; and its PCU exceeded 400,000 in July.

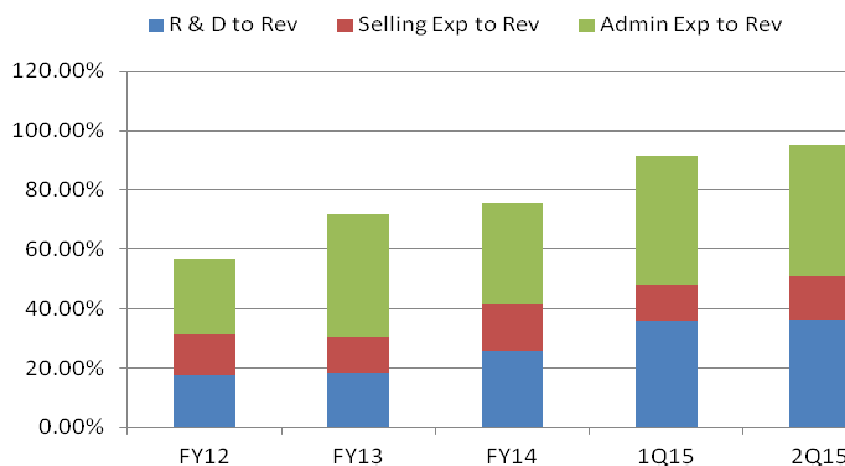
The PCU and ACU rise steadily



Source: Company reports, Phillip Securities (HK) Research

However, the Company is still in the key stage of promoting online education products. In addition to the increase in labour cost, depreciation and amortization, consumables and office spending, which drove the administrative expenses of the first two quarters yoy up 88% and 65% respectively, R&D expense also surged yoy 115% and 86% respectively. R&D staff increased from 1354 in the same period last year, to 2093. R&D expense per head increased more than 20% yoy. As a total, these two expenses accounted for above 80% of the Company's revenue. Therefore, the Company still incurred a net loss at the end.

Increasing opex ratio of NetDragon



Source: Company reports, Phillip Securities (HK) Research

Expected stable growth for online game business

We are optimistic on the Company's online game business in H2. Firstly, the performance of the game of Calibur of Spirit is better than expected and the Company also expressed that they would implement massive marketing promotion. Thus, consistent attention from game users in the market is expected and ACU and PCU would continue the growth trend.

Secondly, the Company would maintain the R&D capability in H2. The Company's first game in riding and stabbing category, namely Tiger Knight, is planned to have test run in Q3 and it would be launched online this year.

Moreover, in June, the mobile game of Eudemons Online Pocket Version released the BOSS version on Apple Store and was quickly ranked among the top 10 paid mobile apps. Besides, the new mobile games of Blade and Sword and Dead Union would also be launched this year, which is expected by game users.

Online education business start contributing income

Previously, the revenue of the Company's education business mainly came from Fuzhou Software Technology Vocational College, and it generated more than RMB20 million in H1. However, according to the company's guidance, excluding that piece of income, contribution from online education business would range from 50 million to 100 million in H2. With the continual growth of online education business, it would gradually become the Company's core growth momentum.

In H2, the Company's product of "101 student tablet" has been launched for large scale deployment. The Company put effort on enhancing the sales of collaborative intelligent classroom system, mobile communication software products, aiming at a coverage of more than 15 cities, and expected to cover 500 to 1000 classrooms. We believe the Company would achieve this target. Firstly, in regard of channel construction, the Company has already built sale network throughout the whole country, with sales teams covering six major zones and more than 20 provinces. Secondly, the product R&D is undergoing the final stage, and the electronic learning materials cover all major subjects of primary and junior secondary curriculum. In addition, the Company constantly enhances the technological standard of products by merger and acquisition. In June, the Company acquired 100% equity interest in Suzhou ChiVox Co. Ltd. so as to integrate ChiVox's best-in-class intelligent voice and speech technology into its language assessment platform. In July, the Company announced an acquisition a global leader in interactive learning technology, Promethean, for a total consideration of RMB800 million. The products of Promethean cover 1.1 million classrooms worldwide, with 2.2 million classrooms adopting the technology by Promethean.

Overall, with the expanding online education market, sufficient cash position of the Company, as well as the experience on game development through years, the Company would make education a process with fun by adding games into the learning materials, carry out analysis on user behaviors and provide innovative teaching mode. Moreover, the educational ecosystem of "hardware + software + content + cloud platform" constructed by the Company would provide an integrated solution for K12 education and we are optimistic towards its development prospect.

Catalyst

Better-than-expected growth of online game business;
Faster-than-expected development of K12 online education business.

Risks

The online education solution is not as good as expected;
Business expansion drives up expenses too high.

Financials

Periodicity:	2012	2013	2014	2015F	2016F
Valuation Ratios					
Price Earnings	222.0x	52.6x	49.1x	290.1x	63.6x
Price to Book	6.2x	1.9x	1.9x	1.9x	1.8x
Dividend Yield	1.6%	1.9%	1.9%	0.2%	0.8%
Per share data(RMB)					
EPS Adjusted	0.08	0.33	0.35	0.06	0.27
Book Value Per Share	2.76	9.07	9.14	9.17	9.30
Dividends Per Share	0.28	0.32	0.32	0.03	0.13
Growth & Margin					
Revenue growth	8.5%	7.1%	8.9%	20.1%	38.7%
Gross profit growth	12.4%	4.1%	7.1%	15.5%	36.8%
Net profit growth	-71.1%	319.5%	7.5%	-83.3%	356.2%
Gross Margin	93.4%	90.8%	89.3%	85.9%	84.7%
Net Profit Margin	4.7%	18.6%	18.4%	2.5%	8.4%
Dividend Payout Ratio	51.4%	3884.6%	90.6%	50.0%	50.0%
Key ratios					
Return on Assets	1.8%	155.6%	3.3%	0.5%	2.4%
Return on Equity	2.7%	204.4%	3.8%	0.6%	2.9%
Effective Tax Rate	15.2%	23.2%	27.2%	27.0%	27.0%
Liability ratio	42.09%	15.18%	11.72%	17.50%	18.00%
Income Statement (RMB:mn)					
Revenue	826	885	963	1,156	1,603
- Cost of Goods Sold	54	81	103	163	245
Gross Income	771	803	860	993	1,358
- Selling, General & Admin Expenses	493	616	772	1,064	1,315
Operating Income	292	208	135	-10	124
- Net Non-Operating Losses (Gains)	-26	-38	-83	-50	-60
Pretax Income	332	217	236	38	179
- Income Tax Expense	50	50	64	10	48
Net Income Adjusted*	39	164	177	29	134

Source: Company reports, Phillip Securities (HK) Research Estimates

(Financial figures as at 13 Oct 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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