

# Archosaur Games (9990 HK)

## Negative profit alert due to the higher-than-expected R&D expense in 2020, but doesn't change the company's long term value

Hong Kong | TMT (Game) Sector | Update Report

16 Feb 2021

### Investment Summary

#### The company's adjusted net profit for 2020 fell 35%-40% yoy

The company issued a negative profit alert on January 21, that it is expected that the adjusted profit for 2020 will fall by about 35%-40% yoy. The main reason for the decline is the huge yoy increase in R&D expense and the delay in the launch of the games, causing a mismatch in return vs investment. According to the company's management, as of the end of 2020, the company has more than 1,200 employees, with 87% of them being R&D personnel. Further, the company has newly hired roughly 300 employees in 2020, of which about 90% of whom are R&D personnel. On the other hand, in addition to the R&D expenses brought by the new R&D personnel, the company also mentioned that since the company's original R&D team is one of the few R&D team in China who can effectively apply UE4 engine on mobile game development, hence the average salary of the team has increased by a certain amount in 2020. In the long run, we are confident in the company's R&D capabilities. The salary increase of the company's original R&D team in 2020 can bind the company's outstanding R&D talents and reduce the loss of R&D personnel. At the same time, the expansion of the R&D team will help the company to explore game genres other than MMORPG. Further, the company's continuous and substantial R&D investment can help the company maintain competitive advantages in the game industry that is gradually shifting toward premium games. We believe that with the successive launch of the games in the pipeline, the company's profit margin will rebound.

#### Noah's heart (諾亞之心) is expected be launched in 2021 year-mid

Noah's heart (諾亞之心) is expected be launched in 2021 year-mid. Noah's Heart (諾亞之心) is an open world MMORPG game based on UE4 and the company's own IP, and introduces new designs and gameplay such as the 8000x8000 spherical seamless big map. The company has spent a lot of investment in the design of the spherical seamless big map of the game. The introduction of the seamless big map eliminates the loading time when the game scene is switched, which can greatly enhance the continuity of the game and gamers' gaming experience. As for the design of the spherical map, it can make the gameplay more realistic. Up to now, Noah's Heart (諾亞之心) has no other competing products in the market. After the game is launched, it is expected to become a hit MMORPG game. Tencent will be responsible for the distribution of the game in China region, which fully demonstrates Tencent's high recognition of the game. At the same time, Tencent's strong game distribution capabilities and traffic support can greatly increase the gross billing performance of the game. According to the company's management, in addition to the China region, Noah's Heart (諾亞之心) will also be launched in overseas markets, including Europe, America, Japan and other regional markets. Given that the R&D team has incorporated a lot of elements from the US and Europe market in the design of the game, so we are also optimistic about the overseas distribution of the game.

We believe that the excellent performance of Genshin Impact (原神), also an open world game, in both China region and oversea regions have shown that market potential of an open world RPG game. At the same time, Genshin Impact (原神)'s distribution has also explored many potentials gamers for Noah's heart (諾亞之心).

### Buy (Maintain)

CMP HKD 20.55

(Closing price as of 10 Feb)

TARGET HKD 30.10 (+47%)

#### COMPANY DATA

O/S SHARES (MN) :	816
MARKET CAP (HKD MN) :	16,759
52 - WK HI/LO (HKD):	28.40/16.00

#### SHARE HOLDING PATTERN, %

Cresc Chorus Limited	34.13
Perfect World Interactive Entertainment	16.99
Image Frame Investment (HK) Limited	12.88
GIC Private Limited	6.83
Green Particle Limited	6.17

#### PRICE VS. HIS



Source: Wind, Phillip Securities

#### KEY FINANCIALS

CNY mn	FY19	FY20E	FY21E	FY22E
Net Sales	1,067	1404	2726	4413
Adj. Net Profit	355	215	714	1043
Adj. EPS	N/A	0.26	0.88	1.28
Adj. P/E, x	N/A	66.11	19.96	13.66
BVPS	N/A	1.72	3.34	5.41
P/BV, x	N/A	10.15	5.23	3.23
ROE (%)	N/A	5.78	16.04	18.96
ROA (%)	N/A	4.91	12.71	14.41

Market closing price as of 10<sup>th</sup> Feb

Source: Company Data, Phillip Securities Est.

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### **The company will focus on strengthening the ability of independent distribution in China region**

In recent years, with the changes in the Chinese game distribution channels, the company has strategically chosen to cooperate with Tencent in the game distribution in China. Under the escort of Tencent, the company's games have all achieved eye-catching performances. In the future, the company will focus on strengthening its ability of independent distribution in China region. We believe that the close integration of R&D and distribution operations can effectively lower the communication barriers between the R&D team and the distribution team, allowing the distribution team to formulate a more refined distribution strategy based on the characteristics of the games, thereby greatly increasing the performance of the games after launching. In the future, the company will focus on hiring distribution experts in various vertical fields (including SLG and female-oriented game genres), with the aim to build a top tier game distribution system.

### **Valuation and investment thesis**

We continue to be optimistic about the company's strong R&D capabilities and high probability of hit game output. Considering 1) the delayed launch of Under the Firmament (鴻圖之下) and The New World (夢想新大陸) have a higher impact on the company's actual gross billing than we previously predicted 2) The launch of Noah's Heart (諾亞之心) will be delayed until mid-2021 3) The company's higher-than-expected R&D expense, we lowered the company's adjusted net profit for 2020/2021/2022 to RMB 215/714/1043 million (-63.1%/-34.9%/-29.8%). We have rolled over the relative valuation to 2022 and maintain target adjusted PE of 20x. Our Dec-22 TP is HKD 30.10, with corresponding 2020/2021/2022 adjusted PE at 94.1x/29.2x/20.0x. We maintain Buy rating. (Market closing price as of 10th Feb) (exchange rate: RMB 0.85/HKD)

### **Risk**

1) The tightening on Game regulations 2) The Games underperform comparing to expectation 3) Games launching are delayed due to unexpected reasons

**Figure 1: Comparable valuation**

Company	Stock code	Closing Price	Market Cap	PE				PB			
				TTM	2020E	2021E	2022E	TTM	2020E	2021E	2022E
		(listed currency)	(RMB mn)								
<b>HK stocks</b>											
ARCHOSAUR GAMES	9990 hk equity	20.55	13,924	-	27.8x	13.0x	10.6x	-	4.5x	3.8x	3.1x
TENCENT	700 hk equity	761.00	6,066,500	49.1x	48.9x	38.9x	32.1x	10.5x	10.8x	8.6x	6.9x
NETEASE INC	9999 HK equity	204.40	586,780	-	36.9x	30.3x	26.0x	-	3.7x	3.2x	2.7x
FRIENDTIMES	6820 hk equity	2.92	5,291	11.6x	10.2x	8.0x	6.6x	4.1x	3.0x	2.0x	1.6x
NETDRAGON	777 hk equity	19.84	9,173	12.3x	12.3x	9.5x	8.3x	1.5x	1.5x	1.3x	1.2x
ZENGAME	2660 hk equity	1.35	1,141	5.1x	4.0x	3.7x	3.5x	1.6x	1.3x	1.0x	0.9x
XD INC	2400 hk equity	108.80	41,051	92.2x	98.9x	71.7x	54.8x	-	15.2x	12.8x	10.4x
IDREAMSKY	1119 hk equity	4.64	4,895	15.2x	10.8x	8.9x	7.7x	1.3x	1.2x	1.1x	-
CMGE	302 hk equity	3.62	7,550	25.7x	8.6x	6.8x	6.0x	1.8x	1.6x	1.4x	1.2x
IGG INC	799 HK equity	13.78	13,697	9.6x	10.8x	12.3x	11.5x	4.7x	4.3x	3.4x	2.8x
			<b>Average</b>	<b>27.6x</b>	<b>26.9x</b>	<b>20.3x</b>	<b>16.7x</b>	<b>3.6x</b>	<b>4.7x</b>	<b>3.9x</b>	<b>3.4x</b>
			<b>Median</b>	<b>13.7x</b>	<b>11.6x</b>	<b>10.9x</b>	<b>9.4x</b>	<b>1.8x</b>	<b>3.3x</b>	<b>2.6x</b>	<b>2.7x</b>
<b>A stocks</b>											
WUHU SANQI	002555 CH equity	29.22	61,720	21.7x	21.5x	18.3x	15.5x	7.6x	6.7x	5.0x	4.0x
GIANT NETWORK	002558 CH equity	17.37	35,163	36.0x	31.6x	29.4x	29.9x	4.1x	-	-	-
ZHEJIANG CENTURY	002602 CH equity	6.19	46,131	16.3x	11.3x	9.2x	8.6x	1.5x	-	-	-
PERFECT WORLD	002624 CH equity	23.69	45,957	25.7x	25.4x	16.3x	13.8x	4.3x	4.0x	3.3x	2.8x
G-BITS NETWORK	603444 CH equity	330.13	23,725	25.4x	21.4x	16.8x	14.2x	6.7x	6.2x	5.1x	4.1x
			<b>Average</b>	<b>25.0x</b>	<b>22.2x</b>	<b>18.0x</b>	<b>16.4x</b>	<b>4.8x</b>	<b>5.7x</b>	<b>4.5x</b>	<b>3.6x</b>
			<b>Median</b>	<b>25.4x</b>	<b>21.5x</b>	<b>16.5x</b>	<b>14.0x</b>	<b>4.2x</b>	<b>5.1x</b>	<b>4.2x</b>	<b>3.4x</b>
<b>US stocks</b>											
EA	EA US equity	146.11	270,696	35.6x	31.3x	26.9x	23.9x	5.3x	6.2x	5.5x	5.1x
NINTENDO	NTDOY US equity	74.16	503,172	-	3.9x	17.5x	20.0x	-	0.6x	-	-
SONY CORP	SNE US equity	112.64	914,959	-	25.3x	15.2x	20.2x	-	-	2.8x	2.5x
			<b>Average</b>	<b>35.6x</b>	<b>20.2x</b>	<b>19.9x</b>	<b>21.4x</b>	<b>5.3x</b>	<b>3.4x</b>	<b>4.1x</b>	<b>3.8x</b>
			<b>Median</b>	<b>35.6x</b>	<b>25.3x</b>	<b>17.5x</b>	<b>20.2x</b>	<b>5.3x</b>	<b>3.4x</b>	<b>4.1x</b>	<b>3.8x</b>

 As of 10<sup>th</sup> Feb Closing Price

Source: Bloomberg, PSHK

## Financial Statements

### Consolidated Statement of Profit or Loss

Dec Y/E, RMB mn	FY18	FY19	FY20E	FY21E	FY22E
<b>Revenue</b>	<b>870</b>	<b>1067</b>	<b>1404</b>	<b>2726</b>	<b>4413</b>
<b>Gross Profit</b>	<b>697</b>	<b>890</b>	<b>1138</b>	<b>2140</b>	<b>3451</b>
S&M expense	-94	-114	-216	-486	-728
Admin expense	-39	-57	-164	-111	-150
R&D expense	-328	-389	-632	-815	-1500
Other operating gain/(loss)	75	38	0	0	0
<b>Operating Profit</b>	<b>311</b>	<b>367</b>	<b>126</b>	<b>728</b>	<b>1072</b>
Net finance income	7	-9	19	54	70
Other non operating expense	-381	-212	-857	0	0
<b>Profit before tax</b>	<b>-64</b>	<b>145</b>	<b>-712</b>	<b>782</b>	<b>1142</b>
Tax	-12	-25	-12	-63	-91
NCI	1	-1	-1	-5	-8
<b>Profit for the year</b>	<b>-75</b>	<b>119</b>	<b>-724</b>	<b>714</b>	<b>1043</b>
<b>Adjusted profit for the year</b>	<b>311</b>	<b>355</b>	<b>215</b>	<b>714</b>	<b>1043</b>
<b>EPS</b>			<b>-0.89</b>	<b>0.88</b>	<b>1.28</b>
<b>Adjusted EPS</b>			<b>0.26</b>	<b>0.88</b>	<b>1.28</b>

### Key Financial Data

Dec Y/E	FY18	FY19	FY20E	FY21E	FY22E
<b>Valuation Ratio</b>					
P/E ratio, x	N/A	N/A	N/A	19.96	13.66
Adjusted P/E ratio, x	N/A	N/A	66.11	19.96	13.66
P/S ratio, x	N/A	N/A	10.15	5.23	3.23

### Per share data (RMB)

EPS	N/A	N/A	-0.89	0.88	1.28
Adjusted EPS	N/A	N/A	0.26	0.88	1.28
Revenue per Share	N/A	N/A	1.72	3.34	5.41

### Growth & Margin

Revenue Growth	-34%	37%	20%	60%	38%
Operating income growth	11%	18%	-66%	476%	47%
Net income Growth	N/A	N/A	N/A	N/A	46%
Adjusted Net income Growth	-27%	14%	-39%	231%	46%
Gross Profit Margin	80%	83%	81%	79%	78%
Operating profit Margin	36%	34%	9%	27%	24%
Net Profit Margin	-9%	11%	-52%	26%	24%
Adjusted Net Profit Margin	36%	33%	15%	26%	24%

### Key Ratios

ROE, Adj	N/A	N/A	5.78%	16.04%	18.96%
ROA, Adj	N/A	N/A	4.91%	12.71%	14.41%

Source: Company, PSHK

Market closing price as of 10th Feb

### Consolidated Statement of Financial Position

Dec Y/E, RMB mn	FY18	FY19	FY20E	FY21E	FY22E
<b>Non Current Asset</b>					
PPE	10	9	9	9	9
ROU assets	39	42	65	100	155
Intangible assets	34	44	62	87	121
others	33	27	27	27	27
<b>Total Non Current Assets</b>	<b>115</b>	<b>122</b>	<b>163</b>	<b>224</b>	<b>314</b>
<b>Current Asset</b>					
T/R	281	546	495	962	1557
Prepayments	34	33	51	51	51
Cash and cash equivalents	588	728	3345	4047	4982
Others	531	474	331	331	331
<b>Total Current Assets</b>	<b>1434</b>	<b>1781</b>	<b>4223</b>	<b>5392</b>	<b>6922</b>
<b>Total Assets</b>	<b>1549</b>	<b>1903</b>	<b>4386</b>	<b>5615</b>	<b>7235</b>
<b>Non Current Liabilities</b>					
Lease Liabilities	10	23	46	81	136
Contract Liabilities	14	10	21	45	68
Others	1201	1434	174	174	174
<b>Total Non Current Liabilities</b>	<b>1225</b>	<b>1467</b>	<b>241</b>	<b>301</b>	<b>378</b>
<b>Current Liabilities</b>					
Lease Liabilities	23	15	15	15	15
T/P	165	157	259	572	939
Contract Liabilities	67	62	108	245	369
Others	16	33	33	33	33
<b>Total Current Liabilities</b>	<b>271</b>	<b>266</b>	<b>414</b>	<b>865</b>	<b>1356</b>
<b>Total Equity</b>	<b>53</b>	<b>170</b>	<b>3731</b>	<b>4450</b>	<b>5501</b>
<b>Total Liabilities and Equity</b>	<b>1549</b>	<b>1903</b>	<b>4386</b>	<b>5615</b>	<b>7235</b>

### Cashflow Statement

Dec Y/E, RMB mn	FY18	FY19	FY20E	FY21E	FY22E
<b>Profit (loss) before tax</b>	<b>-64</b>	<b>145</b>	<b>-712</b>	<b>782</b>	<b>1142</b>
Depreciation and amortization	30	41	15	20	26
change in working capital	-120	195	135	-153	-228
Others	289	-280	830	100	57
<b>CFO</b>	<b>135</b>	<b>101</b>	<b>268</b>	<b>748</b>	<b>997</b>
Capex	-19	-26	-33	-45	-61
Others	416	84	142	0	0
<b>CFI</b>	<b>397</b>	<b>58</b>	<b>109</b>	<b>-45</b>	<b>-61</b>
Proceeds from share issuance	0	0	2500	0	0
Others	-342	-24	-261	-1	-1
<b>CFF</b>	<b>-342</b>	<b>-24</b>	<b>2239</b>	<b>-1</b>	<b>-1</b>
<b>Net Change in Cash</b>	<b>190</b>	<b>135</b>	<b>2617</b>	<b>702</b>	<b>935</b>
Foreign exchange	41	5	0	0	0
<b>Cash and CE at Y/E</b>	<b>615</b>	<b>728</b>	<b>3345</b>	<b>4047</b>	<b>4982</b>

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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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