

06 March 2015

BUY
Unchanged

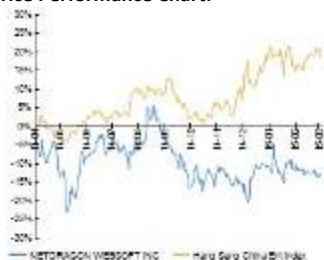
估值安全、静待教育起色

网龙 (777:HK)

Market Data: Mar, 05

Closing Price (HK\$)	13.08
Price Target (HK\$)	17.1
HSCEI	11,598
HSCCI	4,575
52-week High/Low (HK\$)	17.06/11.48
Market Cap (US\$m)	849
Market Cap (HK\$m)	6,450
Shares Outstanding (m)	493
Exchange Rate (Rmb-HK\$)	1.26

Price Performance Chart:



Source: Bloomberg

Analyst

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Related Reports

"Netdragon Websoft (777 HK) – Role player" Aug 25, 2014
"Netdragon Websoft (777 HK) – Mobile launch pad; upgrade to BUY" July 9, 2014
"Netdragon Websoft (777 HK) – Latent potential" Jan 29, 2014

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Financial summary and valuation

	2012	2013	2014E	2015E	2016E
Revenue (Rmbm)	826	885	923	974	1,030
YoY (%)	8.6	7.1	3.0	5.6	5.8
Net income (Rmbm)	282	164	252	263	288
YoY (%)	109.8	(44.1)	59.9	4.4	9.3
EPS (Rmb)	0.08	0.32	0.50	0.52	0.57
Diluted EPS (Rmb)	0.08	0.32	0.48	0.51	0.55
ROE (%)	2.8	132.8	5.0	4.6	4.7
Debt/asset (%)	42.1	15.2	7.1	6.7	6.5
Dividend Yield (%)	2.7	65.3	1.5	1.5	1.6
PE (x)	134.64	31.96	20.95	20.07	18.36
PB (x)	3.73	1.14	1.02	0.93	0.86
EV/Ebitda (x)	11.78	15.76	11.58	10.53	9.43

Note: Diluted EPS is calculated as if all outstanding convertible securities, such as convertible preferred shares, convertible debentures, stock options and warrants, were exercised. P/E is calculated as closing price divided by each year's EPS.

投资要点:

在线教育子公司完成 A 轮融资。一月，网龙宣布其在线子公司贝斯特教育获得 5250 万美元的 A 股股权融资，主要参与投资机构有 IDG 集团、祥峰基金（新加坡淡马锡集团全资子公司）以及奥飞动漫，分别将在配售之后持有 4.65%、2.33% 和 1.4%。网龙在贝斯特教育的股权比例将由 86.15% 稀释至 77.96%。根据此轮融资，贝斯特教育总估值高达 4.775 亿美金，是近期中国在线教育市场最高估值的公司；如此高的估值，表明参与配售投资机构看好中国在线教育市场的发展、贝斯特教育的潜力以及公司的执行能力。

2015 年将是教育平台搭建和市场培育期。凭借着多年丰富的互联网平台经验以及与教育出版社良好的战略合作关系，网龙致力于打造一个 K12 学习生态圈，包括硬件（专属打造 101 pad）、基于云的教学平台、软件（电子教材、题库、第三方接入应用软件等），以连接教室、老师、学生和家。此次融资完成之后，网龙将拥有更充沛的现金，将在教育业务上投入更多的财务、人力资源进行 101pad 的市场推广、教育平台落地、电子教材资源的整合等。公司预计将在 2014 年起 3-5 年，在教育领域投入 3-5 亿，主要用户内容成本和教育团队建设。作为一家互联网公司，我们认为公司更有可采用软件\平台使用收费，而不是单纯的卖硬件赚钱。我们预计大规模收入贡献将在 2016 年起来。

估值安全。保守起见，上调营销和研发费用以反映未来 2-3 年公司在教育上的较大投资，但在教育业务模式清晰之前，还未考虑其未来收入贡献。2014/15/16 盈利预测由人民币 0.62/0.78/0.92 下调至人民币 0.50/0.52/0.57。截止 14 年三季度末，公司账上现金为 32 亿。不考虑教育业务估值，给予已有业务 15 年 8 倍 PE 加现金价值，公司每股估值约港币~13.59；当前股价下行风险相对有限。若考虑网龙 77.96% 的贝斯特股权，给予其 A 轮融资估值 60% 折扣，调整后目标价港币 17.1。维持买入评级。

催化剂。101pad 出货量强劲、在线教育业务落地进展良好

风险。101pad 出货进程慢于预期、PC 端游放缓快于预期

Investment highlight:

Online education equity funding. In January 2015, NetDragon announced Series A equity funding round for its online education subsidiary, Best Assistant Education (BAE), with strategic investors including IDG Capital Partners (4.65%), Vertex Venture (wholly-owned subsidiary of Temasek Group, 2.33%) and Alpha Animation (Shenzhen-listed animation producer, 1.40%). Following the Closing, Net Dragon's interest in BAE reduced from 86.15% to approx. 77.96%. With the net proceeds of US\$52.5mn, NetDragon will accelerate online education development in 2015. The total valuation of US\$477.5mn should be the highest valuation in China's online education industry; the participation of IDG and Vertex (previous investors of 91 Wireless) showed confidence from the investors that China's online education has huge growth potential, BAE's considerable opportunity and mgmt. execution ability.

Platform establishment and market exploration in 2015. Leveraging its long-term internet technology resources and strategic cooperation with academic institutions, NetDragon aims to build a K12 (kindergarten (K) to twelfth grade (12)) ecosystem. This will consist of hardware (tailor-made tablet device *101pad*), platforms and software (e-textbooks and other learning apps) to connect classroom, teachers, students and parents. In 2015, NetDragon will direct more resources to *101pad's* marketing and content acquisition, guiding spending of Rmb300-500m over the next three to five years. As an internet company, NetDragon's business model will likely focus on charging through its software/platform usage, rather than purely *101pad* sales. We expect large scale revenue contribution in 2016.

Safe play. Under our conservative view, we revise down our earnings forecasts, factoring in higher adspend and R&D expenses. However, we have not factored in any revenue contribution from its online education business (we shall update our model after more clarity over its business model is received). We lower our EPS from Rmb0.62 to Rmb0.50 in 14E, from Rmb0.78 to Rmb0.52 in 15E and from Rmb0.92 to Rmb0.57 in 16E. By end-3Q14, NetDragon held cash of Rmb3.2bn. Excluding online education and only applying 8x 15E PE plus cash value, we value the stock at HK\$13.59/share, indicating limited downside risk to current stock price. NetDragon should maintain a dividend payout ratio of 30%. Considering NetDragon's 77.96% stake in BAE and 60% discount to its Series A funding valuation, we arrive our target price at HK\$17.1. We maintain our BUY rating.

Catalysts. Strong shipment of *101pad* and positive development in its online education business.

Risks. Slower-than-expected *101pad* promotion and faster-than-expected slowdown in online client-based games.

We visited NetDragon (ND) recently to discuss with the company about its online education business and future development strategy.

Online education equity funding

In January, ND announced Series A equity funding round for its online education subsidiary, Best Assistant Education (BAE), with strategic investors including IDG Capital Partners (4.65%), Vertex Venture (wholly-owned subsidiary of Temasek Group, 2.33%) and Alpha Animation (Shenzhen-listed animation producer, 1.40%). Following the Closing, ND's interest in BAE reduced from 86.15% to approx. 77.96%. With the net proceeds of US\$52.5mn, NetDragon will accelerate online education development in 2015.

Fig 1: Shareholder structure of BAE after Series A Funding

Shareholders of Best Assistant Education	As at the date of this announcement		Immediately upon the Closing and assuming full conversion of all of the Series A Preferred Shares		Immediately upon the Closing and assuming full conversion of all of the Series A Preferred Shares and all Ordinary Shares are issued pursuant to the Best Assistant Share Award Scheme to staff or consultants other than connected persons of the Company	
	Approximate percentage		Approximate percentage		Approximate percentage	
	Number of Ordinary Shares	of shareholding (%)	Number of Ordinary Shares	of shareholding (%)	Number of Ordinary Shares	of shareholding (%)
NetDragon (BVI)	1,120,000,000	86.15	1,154,459,907	77.96	1,154,459,907	70.16
Idea Gain	180,000,000	13.85	180,000,000	12.15	180,000,000	10.94
IDG-Accel China Growth Fund L.P.	—	—	53,116,501	3.59	53,116,501	3.23
IDG-Accel China Growth Fund-A L.P.	—	—	10,854,871	0.73	10,854,871	0.66
IDG-Accel China Investors L.P.	—	—	4,948,443	0.33	4,948,443	0.30
Vertex	—	—	34,459,907	2.33	34,459,907	2.09
Alpha Animation	—	—	20,675,944	1.40	20,675,944	1.25
Catchy Holdings Limited	—	—	13,783,963	0.93	13,783,963	0.84
DJM	—	—	2,987,605	0.20	2,987,605	0.18
Creative Sky	—	—	5,627,372	0.38	5,627,372	0.35
Staff or consultants (pursuant to Best Assistant Share Award Scheme)	—	—	—	—	164,546,057	10.00
Total no. of Ordinary Shares in issue	1,300,000,000	100%	1,480,914,513	100%	1,645,460,570	100%

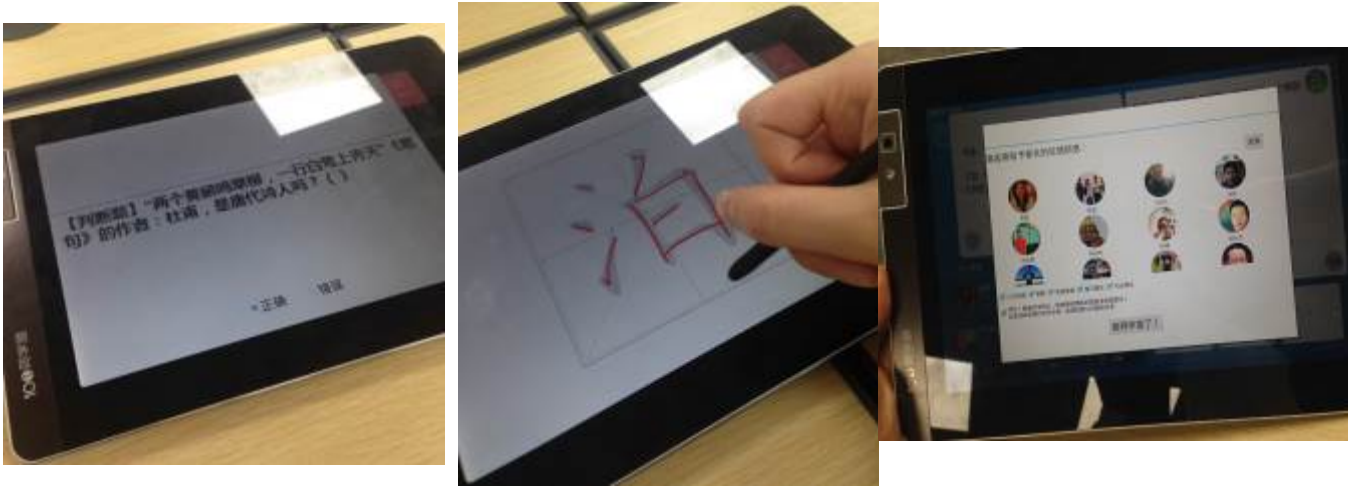
Source: Company announcement, SWS Research

The total valuation of US\$477.5mn should be the highest valuation for online education company in China's online education industry in recent years; the participation of IDG and Vertex (previous investors of 91 Wireless) showed confidence from the investors that China's online education has huge growth potential, BAE's considerable opportunity and mgmt. execution ability.

K12 ecosystem building

Leveraging on its long-term internet technology resources and strategic cooperation with academic teaching material institutions, ND is aiming to build a K12 ecosystem, consisting of hardware (tailor-made 101pad), platform and software (e-textbooks and other learning apps) to tightly connect classroom, teachers, students and parents.

Fig 2: NetDragon’s tailor-made 101pad I



Source: Company materials, SWS Research

The tailor-made Android-based 101pad is made by Foxteq, equipped by advanced components and several unique functions serving for K12 education, such as eyesight protection screen, hand-writing and etc. More important, 101pad allows teacher to assign questions in any forms to students during the class and get feedback once finished; after class, teachers can send students’ performances during the day to their parents.

Fig 3: NetDragon’s tailor-made 101pad II



Source: Company materials, SWS Research

ND's actively cooperating with several well-known K12 teaching contents providers, and purchased copyrights from these instructions. Leveraging on its large scale internet technology, ND's working to produce digital contents, which help teachers to prepare lessons.

The cloud-based platform would help teachers to better know every students and give personalized assignments to students, targeting different shortage of knowledge, and better communication with parents about students' performance.

Fig 4: Ecosystem building



Source: Company materials, SWS Research

Year of investment

In 2015, NetDragon would direct more resources on 101pad marketing promotion and content acquisition and guided Rmb300-500mn spending during 3-5 years period since 2014. As internet companies, NetDragon is likely to adopt business model to charge on software/platform usage, rather than marking money from 101pad sales. We expect large scale revenue contribution from 2016, as it would take some time before large scale shipment and market cultivation.

Safe valuation, limited downside risks

To be conservative, we revised down our earnings forecasts to factor in possible higher spending on S&M and R&D on online education business, but haven't factored in any revenue contribution from online education (we shall update model with more clear sight on business model). We tuned down EPS from Rmb0.62/0.78/0.92 to Rmb0.50/0.52/0.57 for 2014/15/16 respectively.

SOTP valuation

By end of 3Q14, NetDragon has cash of Rmb3.2bn. Excluding online education and only applying 8x to 2015PE plus cash value, we got valuation of HK\$13.59 per share, which indicating limited downside risk to current stock price. NetDragon would also maintain dividend payout ratio at 30%.

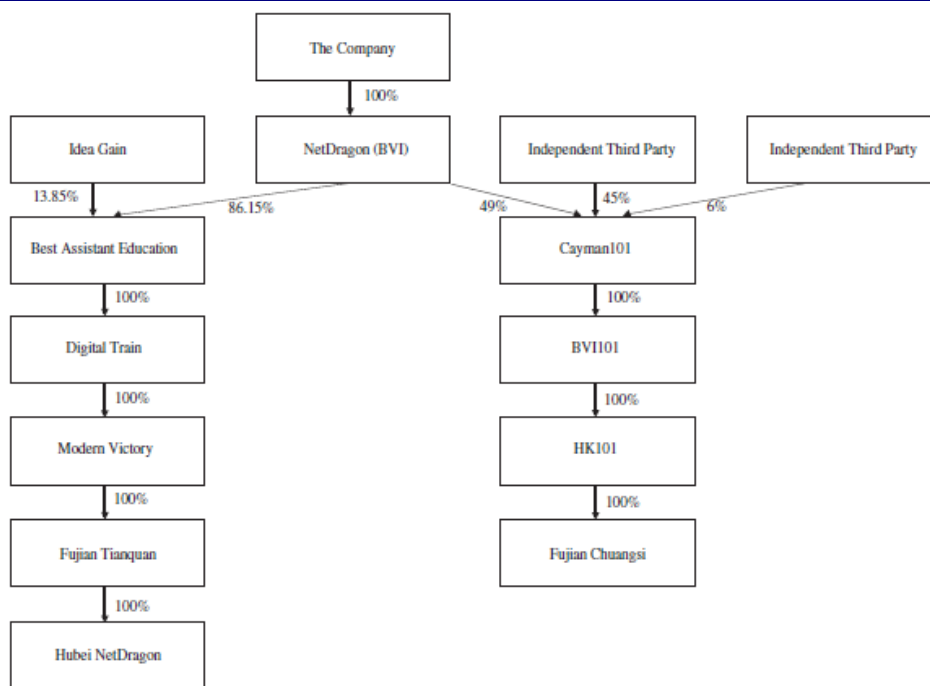
Further adding in NetDragon's 77.96% stake in BAE and 60% discount to its Series A funding valuation, we derived our new target price at HK\$17.1 per share. We maintain Buy rating.

Catalysts. Strong shipment of 101pad; positive development on online education business

Risks. Slower-than-expected 101pad promotion; faster-than-expected slowdown in online client-base game

Appendix

Fig 5: Shareholder structure of BAE before Series A Funding



Source: Company announcement, SWS Research

Fig 6: Consolidated income statement of NetDragon

Rmbm	2012	2013	2014E	2015E	2016E
Revenue	826	885	923	974	1,030
Cost of Sales	(54)	(81)	(91)	(93)	(98)
Gross Profit	771	803	832	881	932
Other Income	49	45	161	120	120
Distribution expenses	(114)	(106)	(141)	(156)	(165)
Administrative expenses	(375)	(539)	(543)	(526)	(546)
Ebitda	367	259	367	379	407
EBIT	336	221	324	326	347
Finance Costs	1	0	(1)	1	1
Profit before tax	332	217	320	321	342
Income tax expense	(50)	(50)	(59)	(58)	(55)
Minority interests	(0)	2	0	0	0
Profit for the year	282	164	252	263	288

Source: Company reports, SWS Research

Fig 7: Consolidated cash flow statement of NetDragon

Rmbm	2012	2013	2014E	2015E	2016E
Profit before taxation	114	217	320	321	342
Plus: Depr. and amortization	31	38	25	27	29
Finance cost	28	5	4	5	5
Losses from investments	284	5	(9)	0	0
Change in working capital	(24)	(62)	74	7	9
Others	(9)	(5)	(25)	(22)	(20)
CF from operating activities	394	721	229	308	327
CAPEX	(179)	(306)	(241)	(82)	(86)
Other CF from investing activities	(576)	(2,614)	(37)	(27)	(27)
CF from investing activities	(724)	2,730	(89)	(54)	(39)
Equity financing	13	110	100	80	65
Net change in liabilities	184	(70)	0	0	0
Dividend and interest paid	(113)	(3,294)	(78)	(79)	(86)
Other CF from financing activities	(26)	27	(254)	45	(75)
CF from financing activities	46	(3,304)	(302)	(4)	(132)
Net cash flow	(285)	147	(162)	250	157
FCFF	215	(59)	241	335	354
FCFE	370	(133)	237	330	349

Source: Company reports, SWS Research

Fig 8: Consolidated balance sheet of NetDragon

Rmbm	2012	2013	2014E	2015E	2016E
Current Assets	1,883	4,603	4,442	4,778	5,038
Bank balances and cash	1,143	1,304	1,142	1,392	1,551
Trade and other receivables	137	112	89	94	99
Inventories	-	-	-	-	-
Other current assets	603	3,187	3,211	3,291	3,388
Long-term investment	35	5	7	9	12
PP&E	345	533	704	891	1,046
Intangible and other assets	183	231	415	440	467
Total Assets	2,423	5,442	5,563	6,113	6,558
Current Liabilities	513	827	394	410	428
Borrowings	-	-	-	-	-
Trade and other payables	294	693	258	273	288
Other current liabilities	219	134	135	137	140
Long-term liabilities	516	-	-	-	-
Total Liabilities	1,029	827	394	410	428
Minority Interests	22	8	5	5	5
Shareholder Equity	1,394	4,615	5,169	5,703	6,130
Share Capital	38	38	38	38	38
Reserves	1,356	4,577	5,131	5,666	6,092
Equity attributable	1,394	4,615	5,169	5,703	6,130
Total Liabilities and equity	2,423	5,442	5,563	6,113	6,558

Source: Company reports, SWS Research

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