

NetDragon (777 HK)

Hold (maintained)

Target price: HK\$16.15



Ryan Zhu, CPA

SFC CE No. BDK820

zhuran@gfgroup.com.hk

+86-0755-88263160

Joseph Ho, CFA

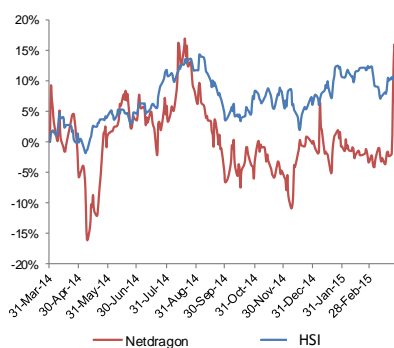
SFC CE No. AFP308

josephho@gfgroup.com.hk

+852-37191030

GF Securities (Hong Kong) Brokerage Limited
29-30/F, Li Po Chun Chambers
189 Des Voeux Road Central
Hong Kong

Stock performance



Source: Bloomberg

Key data

Mar 30 price (HK\$)	17.40
Shares in issue (m)	493
Major shareholder	Liu Dejian 50.8%
Market cap (HK\$ bn)	8.58
3M avg. vol. (m)	1.10
52W high/low (HK\$)	17.40 / 11.76

Source: Bloomberg

Greater earnings visibility needed in online education; maintain Hold and raise TP to HK16.15

What's new? NetDragon posted a 20% decline in non-GAAP net profit to Rmb225m in FY14, below consensus and our estimate. We maintain Hold rating and raise our target price.

Poor 4Q14 results The company posted a non-GAAP net loss of Rmb7m in 4Q14, compared with profit of Rmb7m in 4Q13 and Rmb63m in 3Q14, mainly due to an increase in R&D costs and promotion expenses for its online education products and new games. The number of R&D staff rose by 50% to 1,850 as of end-FY14, from 1,230 one year ago.

New games to drive revenue growth 4Q14 revenue totaled Rmb283m, up 24% YoY and 22% QoQ, mainly on the contribution from its new PC game Calibur of Spirit and new mobile games. Its first multiplayer online battle arena (MOBA) game Calibur of Spirit was licensed by Tencent in Jan 2015 and has seen strong growth in monthly gross revenue from Rmb10m in Oct 2014 to Rmb21m in Feb 2015. Officially launched in Jan 2015, the mobile game Eudemons Online Pocket Version (魔域口袋版) is expected to generate gross revenue over Rmb10m in Mar 2015. In addition, the company indicated that there are 3 to 5 new mobile games in the pipeline for FY15. Another big client game titled Tiger Knight (虎豹騎) will begin the second stage of testing in 2Q15.

Increasing investment in online education business The company has shifted the focus of its development to the emerging online education sector following the disposal of 91 Wireless. The company is building integrated full-service online education products, covering pre-class, in-class and after-class activities. Its key product "101 student tablet" is expected to be launched in 3Q15. However, the focus will remain on its user base and product improvement, rather than profit, for the next two years. The company should see further margin pressure in FY15 given its ongoing heavy investment in new employees and content as well as the increase in promotion expenses set for its tablet in 2H15.

Earnings forecast cut We raise our revenue forecasts by 13%/13% to Rmb1,155m and Rmb1,271m in FY15/16 on the impressive performance of its newly-launched games, as well as its solid game pipeline. However, we cut our FY15/16 non-GAAP net profit forecasts by 37%/ 34% to Rmb218m/244m to reflect the financial impact from increasing investment in online education and new games promotion.

Maintain Hold and raise TP to HK16.15 NetDragon's shares have rebounded by over 30% MTD on significant expectation for its development in the hot online education sector. We see online education as a long-term strategy and do not expect substantial revenue from this business in the next two years – it is still at an early stage of improving products and cultivating users. Based on the US\$477.5m valuation given to its subsidiary Best Assistant Education Online in Series-A funding in Feb 2015, we assume a valuation of HK\$1.56bn for NetDragon's online education business in our sum-of-the-parts valuation, based on a 70.16% stake and a 40% discount given its limited short-term earnings visibility. We raise our target price from HK\$15.00 to HK\$16.15, based on a valuation of 10x FY15E P/E for its gaming business, HK\$7.91 per share for net cash, and HK\$3.02 per share for online education. We maintain our Hold rating and suggest waiting for greater earnings visibility in online education. Key risks include the high uncertainty in online education and lower-than-expectation performance for new games.

Stock valuation

	Turnover (Rmb m)	YoY (%)	Net profit (Rmb m)	Non-GAAP net profit (Rmb m)	Non-GAAP EPS (Rmb cents)	YoY (%)	P/E (x)	BPS (Rmb)	P/B (x)	ROE (%)	ROA (%)
2013	885	7	164	283	55	-6	25.7	8.9	1.6	3.6	3.0
2014	963	9	177	225	44	-20	32.2	9.1	1.5	3.8	3.6
2015E	1,155	20	206	218	42	-3	33.3	9.2	1.5	4.4	4.1
2016E	1,271	10	232	244	47	12	29.7	9.3	1.5	4.8	4.6
2017E	1,398	10	269	281	54	15	25.8	9.5	1.5	5.5	5.1

Sources: Company data, GF Securities (HK)

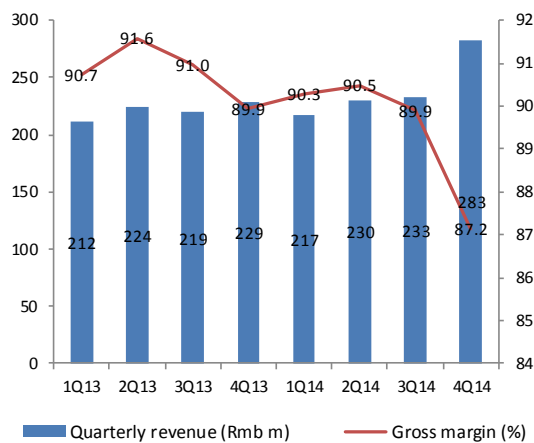
Note: calculated based on diluted shares

Figure 1: FY14 Results summary

Rmb m	4Q13	1Q14	2Q14	3Q14	4Q14	YoY (%)	QoQ(%)	Rmb m	FY13	FY14	YoY (%)
Turnover	229	217	230	233	283	24%	22%	Turnover	885	963	9%
Cost of sales	-23	-21	-22	-24	-36			Cost of sales	-81	-103	
Gross profit	206	196	208	209	247	20%	18%	Gross profit	803	860	7%
Gross margin (%)	90	90	90	90	87	-2.8	-2.7	Gross margin (%)	91	89	-1.5
Other income	15	47	41	36	32			Other income	45	157	
Selling&marketing exp.	-32	-29	-34	-39	-51			Selling&marketing exp.	-106	-152	
Admin exp.	-141	-57	-72	-78	-121			Admin exp.	-366	-327	
R&D costs	-44	-41	-52	-67	-89			R&D costs	-163	-249	
Operating profit	-2	114	76	58	4	n/a	-93%	Operating profit	203	252	24%
Op. margin (%)	-1	53	33	25	1	2.1	-23.4	Op. margin (%)	23	26	3.2
Pre-tax profit	14	116	76	57	-13	-191%	-122%	Pre-tax profit	217	236	9%
Taxation	-17	-38	-13	-4	-9			Taxation	-50	-64	
Effective tax (%)	119	33	16	7	-74			Effective tax (%)	23	27	
Net profit	-5	80	64	53	-19	n/a	-137%	Net profit	164	177	8%
Net margin (%)	-2	37	28	23	-7	-4.8	-29.5	Net margin (%)	19	18	-0.2
								Non-GAAP net profit	283	225	-20%
								Non-GAAP net margin (%)	32	23	-8.6

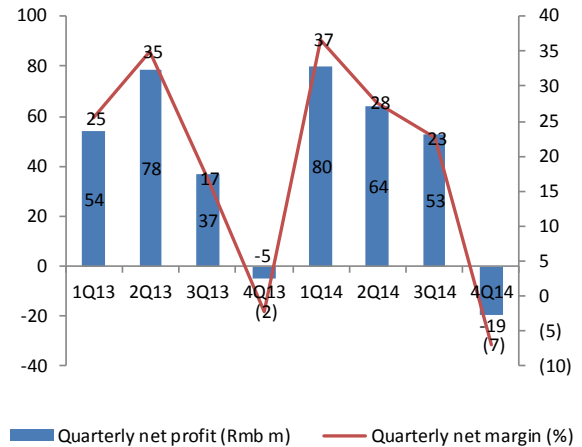
Sources: Company data, GF Securities (HK)

Figure 2: Quarterly revenue and gross margin trend



Sources: Company data, GF Securities (HK)

Figure 3: Quarterly net profit and net margin



Sources: Company data, GF Securities (HK)

Figure 4: Forecast adjustments

Rmb m	FY15E	FY16E
Revenue (new)	1,155	1,271
Revenue (previous)	1,022	1,124
Revision	13%	13%
Non-GAAP net profit (new)	218	244
Non-GAAP net profit (previous)	344	371
Revision	-37%	-34%

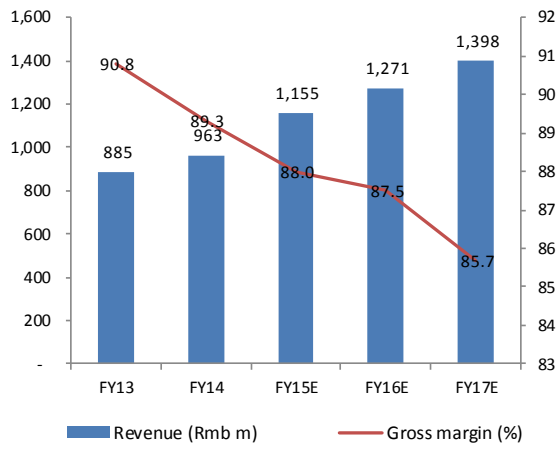
Sources: Company data, GF Securities (HK)

Figure 5: Sum-of-the-parts valuation

Sum-of-the-parts valuation	Value attributable to NetDragon (HK\$ m)	Value per share (HK\$)	Percentage (%)
Online gaming	2,695	5.22	32%
Online education	1,558	3.02	19%
Cash	4,083	7.91	49%
Total	8,336	16.15	

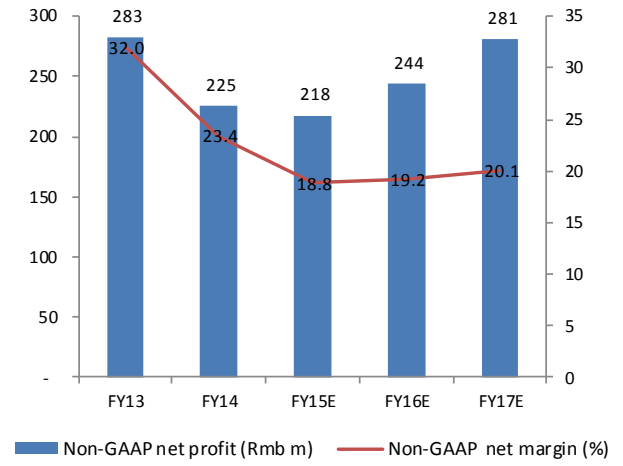
Sources: Company data, GF Securities (HK)

Figure 6: Revenue and gross margin forecasts



Sources: Company data, GF Securities (HK)

Figure 7: Non-GAAP net profit and net margin forecasts



Sources: Company data, GF Securities (HK)

Figure 8: Financial statements

Income Statement						Balance Sheet					
Year end Dec (Rmb m)	2013	2014	2015E	2016E	2017E	Year end Dec (Rmb m)	2013	2014	2015E	2016E	2017E
Turnover	885	963	1,155	1,271	1,398	Cash/ST deposits	4,463	3,296	3,308	3,282	3,435
YoY (%)	7	9	20	10	10	Trade and other receivables	111	166	167	199	204
Cost of sales	(81)	(103)	(139)	(159)	(200)	Held for trading investments	21	186	186	186	186
Gross profit	803	860	1,017	1,112	1,198	Other Current Assets	8	8	8	8	8
Other income and gains	35	123	173	191	210	Total current assets	4,603	3,656	3,669	3,676	3,833
Selling & marketing exp.	(106)	(152)	(196)	(216)	(224)	Property, plant & equipment	533	702	729	747	753
Admin exp.	(366)	(327)	(381)	(407)	(419)	Intangible assets	-	139	163	179	188
R&D costs	(163)	(249)	(324)	(356)	(391)	Prepaid lease payments	186	379	379	379	379
Share of profit of associates	(0)	(2)	(2)	(2)	(2)	Other LT Assets	121	95	100	100	100
Operating profit	203	252	286	322	371	Total non-current assets	839	1,315	1,370	1,405	1,420
Interest income	5	3	3	3	3	Total Assets	5,442	4,971	5,039	5,081	5,253
Finance costs	(5)	(3)	(3)	(3)	(3)	Accounts and other payables	153	150	213	186	253
Others	14	(16)	(10)	(10)	(10)	ST debts	105	-	-	-	-
Pre-tax income	217	236	276	311	360	Deferred revenue	27	25	37	31	44
Taxation	(50)	(64)	(69)	(78)	(90)	Income tax payable	540	100	50	50	50
MI	2	(5)	1	1	1	Other Current Liabilities	3	1	1	1	1
Net profit	164	177	206	232	269	Total current liabilities	827	276	301	268	348
YoY (%)	(42)	8	17	13	16	Total non-current liabilities	-	3	3	3	3
Non-GAAP net profit	283	225	218	244	281	Minority Interests	8	5	6	7	8
YoY (%)	(6)	(20)	(3)	12	15	Shareholders' Equity	4,607	4,687	4,729	4,803	4,895
Diluted EPS (Rmb cents)	32	34	40	45	52	Total equity	4,615	4,692	4,735	4,810	4,902
YoY (%)	(42)	8	17	13	16	Total Equity & liabilities	5,442	4,971	5,039	5,081	5,253
Non-GAAP diluted EPS (Rmb cents)	55	44	42	47	54	BPS (Rmb)	8.9	9.1	9.2	9.3	9.5
YoY (%)	(6)	(20)	(3)	12	15	YoY (%)	234	2	1	2	2

Cash Flow Statement						Financial Ratio					
Year end Dec (Rmb m)	2013	2014	2015E	2016E	2017E	Year end Dec	2013	2014	2015E	2016E	2017E
Profit for the year	6,222	259	207	233	270	Margins					
Taxation	654	66	69	78	90	Gross margin (%)	90.8	89.3	88.0	87.5	85.7
Depr/Amort	50	77	105	120	135	EBITDA margin (%)	28.5	34.2	33.9	34.8	36.2
Change in working capital	110	(61)	74	(65)	75	Operating margin (%)	22.9	26.2	24.8	25.3	26.5
Income tax paid	(90)	(506)	(119)	(78)	(90)	Non-GAAP operating margin (%)	36.3	29.6	24.8	25.3	26.5
Others	(6,226)	(7)	0	0	0	Net margin (%)	18.6	18.4	17.8	18.3	19.2
Operational cash flow	721	(173)	336	288	481	Non-GAAP net margin (%)	32.0	23.4	18.8	19.2	20.1
Purchase of PP&E	(245)	(235)	(105)	(105)	(100)	Returns and profitability					
Purchase of intangible assets	-	(150)	(50)	(50)	(50)	ROE (%)	3.6	3.8	4.4	4.8	5.5
Assoc, MI, Invsmt	5,546	(325)	(5)	-	-	Assets/equity (x)	1.2	1.1	1.1	1.1	1.1
Investment cash flow	5,300	(710)	(160)	(155)	(150)	ROA (%)	3.0	3.6	4.1	4.6	5.1
Net Change in Debt	40	(105)	-	-	-	Sales/assets (x)	0.2	0.2	0.2	0.3	0.3
New Capital/share repurchase	(50)	(20)	(20)	(20)	(20)	Working capital					
Dividend	(3,294)	(162)	(144)	(138)	(157)	Receivables (days)	50.6	52.6	52.6	52.6	52.6
Others	(0)	2	(0)	(0)	(0)	Payable (days)	77.4	57.4	57.4	57.4	57.4
Financing cash flow	(3,304)	(284)	(165)	(159)	(178)	Deferred revenue ratio (%)	2.9	2.7	2.7	2.7	2.7
FX and others	15	-	-	-	-	Financial health					
Chg in Cash	2,717	(1,167)	12	(26)	153	Current ratio (x)	5.6	13.3	12.2	13.7	11.0
Beginning cash	1,731	4,463	3,296	3,308	3,282	Quick ratio (x)	5.6	13.3	12.2	13.7	11.0
Ending cash	4,463	3,296	3,308	3,282	3,435	Gearing ratio (%)	cash	cash	cash	cash	cash
						Per share data					
						DPS (Rmb)	0.3	0.3	0.3	0.3	0.3
						Net cash/share (Rmb)	8.4	6.4	6.4	6.4	6.7
						Others					
						Dividend payout (%)	57.0	71.1	60.0	60.0	60.0
						Effective tax ratio(%)	23.2	27.2	25.0	25.0	25.0

Sources: Company data, GF Securities (HK)

Rating definitions

Benchmark: Hong Kong Hang Seng Index
Time horizon: 12 months

Company ratings

Buy	Stock expected to outperform benchmark by more than 15%
Accumulate	Stock expected to outperform benchmark by more than 5% but not more than 15%
Hold	Expected stock relative performance ranges between -5% and 5%
Underperform	Stock expected to underperform benchmark by more than 5%

Sector ratings

Positive	Sector expected to outperform benchmark by more than 10%
Neutral	Expected sector relative performance ranges between -10% and 10%
Cautious	Sector expected to underperform benchmark by more than 10%

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29-30/F, Li Po Chun Chambers, 189 Des Voeux Road Central, Hong Kong
Tel: +852 3719 1111 Fax: +8522907 6176 Website: <http://www.gfgroup.com.hk>