

4 June 2018

Technology | Software & Services

NetDragon

Neutral (Maintained)

China Education Facing Challenges; Others On Track

Target Price: HKD21.90
 Price: HKD20.50
 Market Cap: USD1,390m
 Bloomberg Ticker: 777 HK

Maintain NEUTRAL with lower SOP-based TP of HKD21.90 from HKD23.16, 7% upside, as we adjust our forecasts to reflect the consolidation of Edmodo, and our target multiple and estimates for the China education business to reflect slower growth. We spoke with NetDragon's corporate development director and finance manager last Friday. Key takeaways include NetDragon being on track to achieve breakeven at the group level in 2018, the promethean and online gaming business to deliver solid growth, and its China education business to see softer topline growth but generating better margins.

Share Data

Avg Daily Turnover (HKD/USD) 19.1m/2.45m
 52-wk Price low/high (HKD) 17.9 - 32.4
 Free Float (%) 38
 Shares outstanding (m) 534
 Estimated Return 7%

Shareholders (%)

DJM Holdings 46.8
 IDG 14.6

Next Eudemons mobile game to be launched in 2019. According to the group's latest plan, the highly anticipated mobile 3D version of *Eudemons Online* will most likely be launched in 2019, later than previously communicated in 2H18.

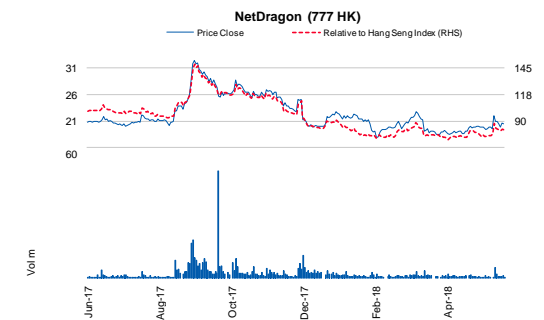
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(5.8)	7.2	(1.9)	(9.9)	(1.2)
Relative	(7.7)	8.2	(0.1)	(14.8)	(19.3)

The other mobile game based on *Eudemons Online*'s IP that was developed by NetDragon is being distributed by Kingsoft (3888 HK, BUY, TP: HKD32.50), with monthly gross billing now stabilising at CNY30-50m (RHB estimate).

Source: Bloomberg

The 3D version of *Eudemons Online* will be distributed by a more powerful distributor and will likely generate higher monthly gross billing, based on our estimates.



Source: Bloomberg

Promethean growth supported by large tender win. The recent tender win in Russia will translate to ~CNY60m in revenue in 2Q18, and ~CNY20-30m in 3Q18. Promethean is well positioned to win phase II and III of the project also.

In addition, Promethean sees strong demand in regions such as the Middle East. Over the long run, we are expecting Promethean's margin to improve but over the short term, margins are not expected to increase significantly due to the lower-margin projects in Russia.

China education business may shift focus to improve revenue quality. Its China business continues to face challenges in maintaining high revenue growth due to fierce competition and low user acceptance.

NetDragon is planning to sell more virtual reality (VR)-based education solutions, which should generate better gross margins (15% vs high single-digit for non-VR solutions).

We expect NetDragon to focus more on revenue quality in future (eg improving margins) and user acquisition for its China education business.

Maintain NEUTRAL with lower TP of HKD21.90 from HKD23.16, as we lower our price-to-sales target multiple for its China education business to 3x from 5x, and reduced our sales forecast for this business. We have also factored in a negative ~CNY50m impact on NetDragon's net profit from the consolidation of Edmodo.

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYm)	2,793	3,868	4,527	5,252	5,787
Reported net profit (CNYm)	(203)	(21)	94	142	192
Recurring net profit (CNYm)	(324)	5	94	142	192
Recurring net profit growth (%)	290.2		1866.6	50.3	35.2
Recurring EPS (CNY)	(0.63)	0.01	0.18	0.27	0.37
DPS (CNY)	0.17	0.17	0.18	0.18	0.18
Recurring P/E (x)	na	1,798	91	61	45
P/B (x)	2.20	1.86	1.86	1.84	1.80
P/CF (x)	na	20.7	77.8	21.1	21.1
Dividend Yield (%)	1.0	1.0	1.1	1.1	1.1
EV/EBITDA (x)	na	28.6	38.7	28.8	23.5
Return on average equity (%)	(5.0)	(0.5)	2.1	3.1	4.1
Net debt to equity	net cash	net cash	net cash	net cash	net cash
Our vs consensus EPS (adjusted) (%)			23.4	(32.1)	(30.1)

Source: Company data, RHB

Analyst

Yujie Li
 +852 2103 5680
li.yu.jie@rhbgroup.com



Financial Exhibits

Financial model updated on : 2018-06-01.

Asia	Financial summary	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Hong Kong	Recurring EPS (CNY)	(0.63)	0.01	0.18	0.27	0.37
Technology	EPS (CNY)	(0.39)	(0.04)	0.18	0.27	0.37
NetDragon	DPS (CNY)	0.17	0.17	0.18	0.18	0.18
Bloomberg 777 HK	BVPS (CNY)	7.58	8.95	8.96	9.06	9.26
Neutral	Weighted avg adjusted shares (m)	516	516	516	516	516
Valuation basis	Valuation metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
We use SOP to value NetDragon, as its businesses are quite diverse and it holds a significant amount of cash.	Recurring P/E (x)	na	1,798	91	61	45
Key drivers	P/E (x)	na	na	91.4	60.8	45.0
i. Interactive classroom and VR/AR classroom penetrating into more schools;	P/B (x)	2.20	1.86	1.86	1.84	1.80
ii. The continuing strong performance of <i>Heroes Evolved</i> and potential launch of 2-3 mobile versions of <i>Eudemons Online</i> ;	FCF Yield (%)	(3.6)	3.7	1.0	4.6	4.8
iii. Promethean to resume growth on more sales resources and budget post its acquisition.	Dividend Yield (%)	1.0	1.0	1.1	1.1	1.1
Key risks	EV/EBITDA (x)	na	28.6	38.7	28.8	23.5
Downside risks:	EV/EBIT (x)	na	na	486	119	73
i. Potential failure in the integration and cost optimisation for Promethean;	Income statement (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
ii. Stiffer competition in the education business.	Total turnover	2,793	3,868	4,527	5,252	5,787
Upside risks:	Gross profit	1,590	2,180	2,562	2,967	3,306
i. Successful launches of its VR solutions;	EBITDA	(31)	246	186	247	300
ii. Stronger-than-expected orders for interactive classrooms.	Depreciation and amortisation	(379)	(270)	(171)	(187)	(203)
Company Profile	Operating profit	(411)	(24)	15	60	97
Downside risks:	Net interest	0	3	4	4	4
i. Potential failure in the integration and cost optimisation for Promethean;	Income from associates & JVs	(1)	(1)	8	8	8
ii. Stiffer competition in the education business.	Exceptional income - net	179	(4)	(12)	(12)	(12)
Upside risks:	Pre-tax profit	(209)	(32)	126	184	234
i. Potential VR solutions launch being successful;	Taxation	(28)	(57)	(64)	(71)	(71)
ii. Stronger-than-expected orders for interactive classrooms.	Minority interests	34	68	32	29	29
	Recurring net profit	(324)	5	94	142	192
	Cash flow (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Change in working capital	(101)	118	(187)	37	(28)
	Cash flow from operations	(200)	417	111	408	409
	Capex	(111)	(98)	(29)	(13)	3
	Cash flow from investing activities	68	(129)	22	(13)	3
	Proceeds from issue of shares	(0)	3	0	0	0
	Cash flow from financing activities	(653)	503	(293)	(320)	(338)
	Cash at beginning of period	1,717	932	1,724	1,563	1,638
	Net change in cash	(785)	791	(160)	75	74
	Ending balance cash	932	1,724	1,563	1,638	1,712
	Balance sheet (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Total cash and equivalents	932	1,724	1,563	1,638	1,712
	Tangible fixed assets	1,866	1,960	1,989	2,002	1,998
	Intangible assets	1,072	1,108	1,058	1,058	1,058
	Total investments	35	44	44	44	44
	Total other assets	24	28	36	37	41
	Total assets	4,779	5,836	5,753	5,976	6,125
	Total liabilities	951	1,352	1,264	1,436	1,486
	Shareholders' equity	3,854	4,549	4,554	4,605	4,703
	Minority interests	(26)	(65)	(65)	(65)	(65)
	Total equity	3,828	4,484	4,489	4,540	4,638
	Net debt	(698)	(1,409)	(1,248)	(1,323)	(1,397)
	Total liabilities & equity	4,779	5,836	5,753	5,976	6,125
	Key metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Revenue growth (%)	119.5	38.5	17.0	16.0	10.2
	Recurrent EPS growth (%)	290.2		1866.6	50.3	35.2
	Gross margin (%)	56.9	56.4	56.6	56.5	57.1
	Operating EBITDA margin (%)	(1.1)	6.4	4.1	4.7	5.2
	Net profit margin (%)	(7.3)	(0.5)	2.1	2.7	3.3
	Dividend payout ratio (%)	(41.5)	(420.3)	94.8	64.3	48.5
	Capex/sales (%)	4.0	2.5	0.6	0.2	(0.1)

Source: Company data, RHB

Figure 1: Forecast changes

FYE 31 Dec (CNYm)	FY18F			FY19F			FY20F		
	Original	New	Change	Original	New	Change	Original	New	Change
Total game revenue	1,984.7	1,887.0	-4.9%	2,285.8	2,248.0	-1.7%	2,604.1	2,434.0	-6.5%
Education	2,618.0	2,538.0	-3.1%	3,029.1	2,893.1	-4.5%	3,399.6	3,228.6	-5.0%
Mobile solution and mobile marketing	101.9	101.9	0.0%	111.1	111.1	0.0%	124.0	124.0	0.0%
Total revenue	4,704.5	4,526.8	-3.8%	5,426.1	5,252.2	-3.2%	6,127.6	5,786.5	-5.6%
Cost of revenue	(2,069.5)	(1,964.3)	-5.1%	(2,345.5)	(2,285.1)	-2.6%	(2,600.8)	(2,480.6)	-4.6%
Gross profit	2,635.0	2,562.5	-2.8%	3,080.5	2,967.1	-3.7%	3,526.8	3,305.9	-6.3%
GPM	56.0%	56.6%		56.8%	56.5%		57.6%	57.1%	
Selling expenses	(753.1)	(724.1)	-3.8%	(865.0)	(832.8)	-3.7%	(983.7)	(916.0)	-6.9%
Administrative costs	(863.6)	(843.4)	-2.3%	(984.9)	(953.5)	-3.2%	(1,132.6)	(1,052.9)	-7.0%
Development costs	(1,011.0)	(980.2)	-3.1%	(1,165.9)	(1,121.1)	-3.8%	(1,316.8)	(1,240.2)	-5.8%
Operating profit	7.4	14.8	101.3%	64.7	59.8	-7.7%	93.8	96.9	3.3%
OPM	0.2%	0.3%		1.2%	1.1%		1.5%	1.7%	
Other income & gains	171.9	147.4		171.5	165.8		193.7	182.8	
Other expenses	(37.6)	(36.2)		(43.4)	(42.0)		(49.0)	(46.3)	
Net (loss) gain on derivatives	0.0	0.0		0.0	0.0		0.0	0.0	
Interest income, net	3.7	3.7		3.7	3.7		3.7	3.7	
Share of losses of JC entities	8.0	8.0		8.0	8.0		8.0	8.0	
Finance cost	(8.6)	(8.6)		(9.5)	(9.5)		(10.4)	(10.4)	
Net (loss) gain on financial assets	0.0	0.0		0.0	0.0		0.0	0.0	
PBT	144.7	129.1	-10.8%	195.1	185.7	-4.8%	219.4	214.4	-2.3%
Income tax	(63.9)	(63.9)		(71.0)	(71.0)		0.0	0.0	
Effective tax rate	45.1%	50.6%		36.8%	38.7%		0.0%	0.0%	
Profit from discontinued operations	0.0	0.0		0.0	0.0		0.0	0.0	
MI	(32.0)	(32.0)		(29.0)	(29.0)		0.0	0.0	
Net profit - reported	109.9	94.3	-14.2%	151.1	141.7	-6.2%	196.6	191.6	-2.5%
NPM - reported	2.3%	2.1%		2.8%	2.7%		3.2%	3.3%	
Net profit - recurring	109.9	94.3	-14.2%	151.1	141.7	-6.2%	196.6	191.6	-2.5%
NPM - recurring	2.3%	2.1%		2.8%	2.7%		3.2%	3.3%	

Source: RHB

Figure 2: Annual P&L (restated to exclude 91 Wireless)

FYE 31 Dec (CNYm)	FY12	FY13	FY14	FY15	FY16	FY17	FY18F	FY19F	FY20F
Online gaming	N/A	N/A	N/A	985.4	1,210.0	1,672.8	1,887.0	2,248.0	2,434.0
Education	N/A	N/A	N/A	242.8	1,526.3	2,105.3	2,538.0	2,893.1	3,228.6
Mobile solution and mobile marketing	N/A	N/A	N/A	44.0	56.8	89.5	101.9	111.1	124.0
Total revenue	825.7	884.5	962.8	1,272.2	2,793.1	3,867.6	4,526.8	5,252.2	5,786.5
YoY	17.7%	7.1%	8.9%	32.1%	119.5%	38.5%	17.0%	16.0%	10.2%
Cost of revenue	(54.4)	(81.4)	(102.8)	(314.2)	(1,203.2)	(1,687.9)	(1,964.3)	(2,285.1)	(2,480.6)
Gross profit	771.3	803.1	860.0	958.0	1,589.9	2,179.8	2,562.5	2,967.1	3,305.9
YoY	12.4%	4.1%	7.1%	11.4%	66.0%	37.1%	17.6%	15.8%	11.4%
Gross profit margin	93.4%	90.8%	89.3%	75.3%	56.9%	56.4%	56.6%	56.5%	57.1%
Selling & marketing expenses	(113.6)	(106.2)	(152.5)	(206.8)	(519.7)	(624.7)	(724.1)	(832.8)	(916.0)
Administrative expenses	(206.1)	(366.1)	(326.9)	(520.1)	(721.0)	(734.6)	(843.4)	(953.5)	(1,052.9)
Development costs	(146.2)	(162.9)	(249.3)	(446.2)	(759.9)	(844.1)	(980.2)	(1,121.1)	(1,240.2)
Operating profit	305.4	167.9	131.3	(215.1)	(410.7)	(23.6)	14.8	59.8	96.9
YoY	74.1%	-45.0%	-21.8%	N/A	N/A	N/A	N/A	N/A	N/A
Operating margin	37.0%	19.0%	13.6%	-16.9%	-14.7%	-0.6%	0.3%	1.1%	1.7%
Other income & gains	48.9	45.0	157.1	187.9	91.2	96.0	147.4	165.8	182.8
Other expenses	(22.2)	(10.0)	(34.0)	(24.1)	(67.1)	(101.0)	(36.2)	(42.0)	(46.3)
Net (loss) gain on derivatives	-	-	0.5	(18.4)	(21.8)	3.3	-	-	-
Interest income, net	4.8	4.9	2.8	6.0	-	2.6	3.7	3.7	3.7
Share of losses of JC entities	(0.5)	(0.0)	(2.4)	(9.9)	(0.9)	(1.4)	8.0	8.0	8.0
Finance cost	(4.3)	(4.7)	(3.2)	(5.4)	(8.7)	(8.1)	(8.6)	(9.5)	(10.4)
Net (loss) gain on financial assets	0.1	13.6	(16.1)	(8.3)	209.2	(2.4)	-	-	-
PBT	332.2	216.7	236.0	(87.3)	(208.8)	(31.7)	126.2	183.7	233.6
Income tax	(50.4)	(50.3)	(64.2)	(100.7)	(28.0)	(57.2)	(63.9)	(71.0)	(71.0)
Effective tax rate	15.2%	23.2%	27.2%	-115.4%	-13.4%	-180.3%	50.6%	38.7%	30.4%
Profit from discontinued operations	(242.9)	6,056.0	-	-	-	-	-	-	-
MI	(0.2)	81.7	(4.9)	(44.9)	(34.0)	(68.1)	(32.0)	(29.0)	(29.0)
Reported net profit	39.2	6,140.8	176.7	(143.0)	(202.7)	(20.8)	94.3	141.7	191.6
YoY	-71.0%	15574.8%	N/A	N/A	N/A	N/A	N/A	50.3%	35.2%
Reported NPM	4.7%	694.3%	20.0%	-14.5%	-16.8%	-1.2%	5.0%	6.3%	7.9%
Recurring net profit	282.0	122.0	225.4	(83.0)	(323.9)	4.8	94.3	141.7	191.6
YoY	68.9%	-56.8%	84.8%	N/A	N/A	N/A	1866.6%	50.3%	35.2%
Recurring NPM	34.2%	13.8%	23.4%	-6.5%	-11.6%	0.1%	2.1%	2.7%	3.3%

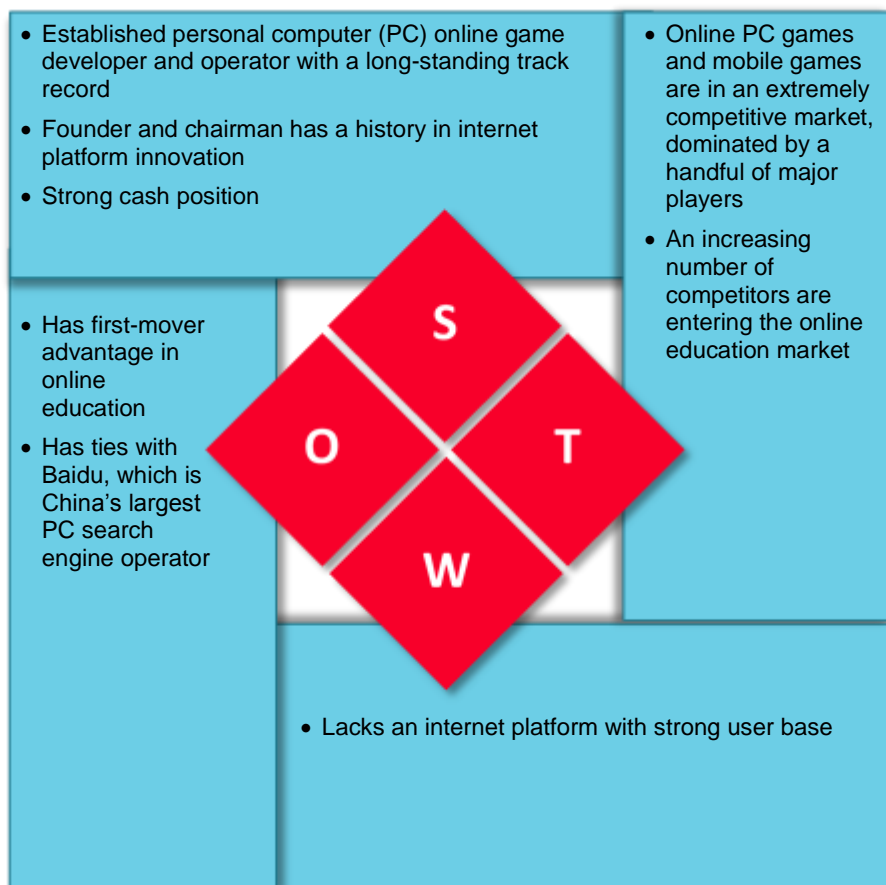
Source: RHB, Company data

Figure 3: SOP valuation

	FY18F net profit (CNYm)	Multiple (x)	NAV (CNYm)	NAV (HKDm)	NAV/share (HKD)	Target Discount	TP(HKD)	
Online gaming business	491	11	5,397	6,206	100%	12.26	0%	12.26
	FY18F revenue (CNYm)	Price to sales (x)	NAV (CNYm)	NAV (HKDm)	NAV/share (HKD)	Target Discount	TP(HKD)	
China Online Education	415	3	1,245	1,432	74%	2.08	0%	2.08
Promethean				1,310	74%	1.90	0%	1.90
Cherrypicks				283	100%	0.56	0%	0.56
Jumpstart				202	100%	0.40	0%	0.40
Edmodo				1,066	74%	1.55	0%	1.55
	Cash Balance (CNYm)							
Net Cash as of end-4Q17		1,375	1,375	1,595		3.15	0%	3.15
NetDragon Total								21.90

Source: RHB, Company data

SWOT Analysis



Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2018-03-23	Neutral	23.2	19.1
2017-12-07	Neutral	26.8	21.3
2017-08-31	Take Profit	26.5	28.8
2017-06-14	Trading Buy	24.1	21.3
2017-03-24	Neutral	24.6	23.7
2016-09-01	Neutral	26.3	25.0
2016-06-27	Neutral	24.8	24.1
2016-04-06	Buy	26.6	21.7
2015-12-18	Neutral	23.7	22.7
2015-08-28	Buy	23.0	17.6

Source: RHB, Bloomberg

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Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

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RHB Research Institute Sdn Bhd Level 3A, Tower One, RHB Centre Jalan Tun Razak Kuala Lumpur 50400 Malaysia Tel : +(60) 3 9280 8888 Fax : +(60) 3 9200 2216	RHB Securities Hong Kong Ltd. 12 th Floor World-Wide House 19 Des Voeux Road Central, Hong Kong Tel : +(852) 2525 1118 Fax : +(852) 2810 0908	RHB Research Institute Singapore Pte Ltd. 10 Collyer Quay #09-08 Ocean Financial Centre Singapore 049315 Tel : +(65) 6533 1818 Fax : +(65) 6532 6211
Jakarta	Shanghai	Bangkok
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