

29 March 2019

Technology | Internet & Software

NetDragon (777 HK)

Buy (from Neutral)

Strong Profit Ahead, High Education Potential

Target Price (Return) HKD28.39 (+55%)
 Price: HKD18.28
 Market Cap: USD1,291m
 Avg Daily Turnover (HKD/USD) 16m/2m

- **Reiterate BUY with a higher HKD28.39 TP from HKD26.87, 55% upside.** We believe NetDragon is undervalued, given that its online games wing alone is worth HKD20/share according to our conservative forecasts and valuations. It has HKD3/share in net cash too. We also see large potential from its education segment, with Promethean officially expanding into the China market and Edmodo kicking off an online tutoring business in 2019. Management sees 40% growth in net profit for FY19.

- **Improvements in existing games and launch of new games should guarantee strong FY19-20.** As shared by management, the gross billing for the *Eudemons Online* personal computer (PC) game has increased 50% YoY in the first two months of FY19. Overall, we expect existing PC and mobile games to drive 18% revenue growth this year. In addition, ND has 4-6 new mobile games set for launch in FY19 – the firm expects monthly gross billings of CNY50-plus and CNY100m-plus for some of these new titles.

- **Promethean is officially going after the China mass market.** Promethean has been growing its market share and maintained its No.1 position overseas. We expect FY19 revenue growth to be c.15% in for the latter market with stable gross margins. In 2019, the firm is partnering with some local network to sell its products in China. The price will be much lower there vs the international market, albeit a bit higher than its competitors, given the better quality, user experience, and connectivity. ND expects a few hundred million CNY in revenue to be booked this year from the China market.

- **Edmodo will kick off its online tutoring business.** Edmodo currently has 5m monthly active users and close to 100m registered ones. It is going to launch an online tutoring business with a US partner in FY19. We see online tutoring in America as a high-potential market with mild competition.

- **Another year of strong profit growth in 2019.** We expect strong online gaming profits to drive a strong year, with ND posting CNY757m in net profit for FY18F – roughly segmental profits of CNY1,600m from online games, net losses of CNY500m and CNY150m for China education and Edmodo, a profit of CNY200m from Promethean, and CNY400m in unallocated expenses. We see 39% and 28% earnings growth for FY19F-20F. We believe our forecast is conservative, as we have not yet modelled in revenue upsides from Promethean's China foray and Edmodo's online tutoring business.

- **Reiterate BUY with a higher SOTP-based HKD28.39 TP (Figure 1).** Our TP implies FY19F-20F P/Es of 17.7x and 13.8x, while we forecast the earnings CAGR at 30% for FY18-21F. We value the online games wing at 8x FY19F P/E, with Promethean at 12x FY19 P/E (see our SOTP table). We think the share price draw back over the past two days (largely due to profit-taking, in our view) provides a good entry point. Risk: Improvements in existing games revenues may not be sustainable.

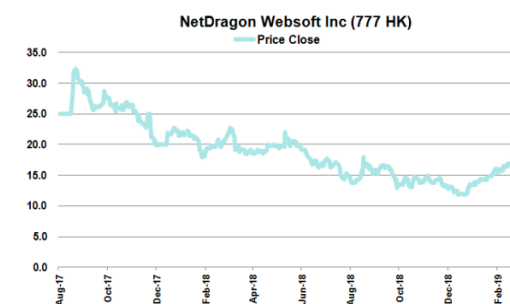
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Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	46.83	10.13	33.08	12.37	(18.61)
Relative	35.37	9.04	24.47	5.74	(9.77)
52-wk Price low/high (HKD)	11.30 – 23.5				



Source: Bloomberg

Forecasts and Valuations	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover (CNYm)	3,868	5,038	5,935	7,140	8,398
Recurring net profit (CNYm)	(21)	546	757	971	1194
Recurring net profit growth (%)	N/M	N/M	38.8	28.2	23.0
Recurring P/E (x)	N/M	15.9	11.4	8.9	7.3
P/BV (x)	1.8	1.7	1.5	1.3	1.1
P/CF (x)	19.4	24.2	8.7	7.2	5.9
Dividend Yield (%)	1.1	1.1	1.1	1.1	1.1
EV/EBITDA (x)	31.0	10.2	7.6	6.0	5.0
ROE (%)	(0.5)	10.9	13.4	14.8	15.6
Net debt to equity (%)	(12.4)	(11.3)	(10.0)	(8.6)	(7.4)
Interest coverage (x)	N/M	22.7	29.0	37.8	46.5

Source: Company data, RHB

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Figure 1: SOP valuation

	FY19F net profit (CNYm)	Multiple (x)	NAV (CNYm)	NAV (HKDm)	ND's Stake	Target Discount	TP(HKD)
Online gaming business	1,150	8	9,200	10,764	100%	0%	20.18
Promethean	225	12	2,700	3,159	74%	30%	3.05
	FY19F revenue (CNYm)	Price to sales (x)	NAV (CNYm)	NAV (HKDm)	ND's Stake	Target Discount	TP(HKD)
China Online Education	300	2	600	702	74%	30%	0.68
Cherrypicks				283	100%	30%	0.37
Jumpstart				202	100%	30%	0.26
Edmodo				1,066	74%	30%	1.03
Cash Balance (CNYm)							
Net Cash as of end-FY18		1,290	1,290	1,509		0%	2.83
NetDragon Total							28.39

Source: RHB

Figure 2: Annual P&L

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	2,367.4	2,817.2	3,310.2
Education	N/A	N/A	N/A	242.8	1,526.3	2,105.3	2,565.6	2,980.0	3,665.4
Mobile solution and mobile marketing	N/A	N/A	N/A	44.0	56.8	89.5	104.6	138.0	164.3
Total revenue	825.7	884.5	962.8	1,272.2	2,793.1	3,867.6	5,037.5	5,935.3	7,139.9
YoY	17.7%	7.1%	8.9%	32.1%	119.5%	38.5%	30.2%	17.8%	20.3%
Cost of revenue	(54.4)	(81.4)	(102.8)	(314.2)	(1,203.2)	(1,687.9)	(1,990.3)	(2,317.7)	(2,841.7)
Gross profit	771.3	803.1	860.0	958.0	1,589.9	2,179.8	3,047.2	3,617.5	4,298.2
YoY	12.4%	4.1%	7.1%	11.4%	66.0%	37.1%	39.8%	18.7%	18.8%
Gross profit margin	93.4%	90.8%	89.3%	75.3%	56.9%	56.4%	60.5%	61.0%	60.2%
Selling & marketing expenses	(113.6)	(106.2)	(152.5)	(206.8)	(519.7)	(624.7)	(697.9)	(781.6)	(898.9)
Administrative expenses	(206.1)	(366.1)	(326.9)	(520.1)	(721.0)	(734.6)	(853.2)	(955.6)	(1,089.3)
Development costs	(146.2)	(162.9)	(249.3)	(446.2)	(759.9)	(844.1)	(922.9)	(1,061.3)	(1,241.7)
Operating profit	305.4	167.9	131.3	(215.1)	(410.7)	(23.6)	573.3	819.1	1,068.3
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%	11.4%	13.8%	15.0%
Other income & gains	48.9	45.0	157.1	187.9	91.2	96.0	118.2	128.0	116.0
Other expenses	(22.2)	(10.0)	(34.0)	(24.1)	(67.1)	(101.0)	(150.3)	(162.0)	(168.0)
Net (loss) gain on derivatives	-	-	0.5	(18.4)	(21.8)	3.3	(10.0)	-	-
Interest income, net	4.8	4.9	2.8	6.0	-	2.6	3.6	3.5	7.4
Share of losses of JC entities	(0.5)	(0.0)	(2.4)	(9.9)	(0.9)	(1.4)	(3.1)	(2.0)	(2.0)
Finance cost	(4.3)	(4.7)	(3.2)	(5.4)	(8.7)	(8.1)	(8.6)	(14.2)	(15.1)
Net (loss) gain on financial assets	0.1	13.6	(16.1)	(8.3)	209.2	4.6	97.7	-	-
PBT	332.2	216.7	236.0	(87.3)	(208.8)	(31.7)	568.2	758.3	991.7
Income tax	(50.4)	(50.3)	(64.2)	(100.7)	(28.0)	(57.2)	(91.3)	(71.0)	(71.0)
Effective tax rate	15.2%	23.2%	27.2%	-115.4%	-13.4%	-180.3%	16.1%	9.4%	7.2%
Profit from discontinued operations	(242.9)	6,056.0	-	-	-	-	-	-	-
MI	(0.2)	81.7	(4.9)	(44.9)	(34.0)	(68.1)	(68.8)	(70.0)	(50.0)
Reported net profit	39.2	6,140.8	176.7	(143.0)	(202.7)	(20.8)	545.6	757.3	970.7
YoY	-71.0%	15574.8%	N/A	N/A	N/A	N/A	N/A	38.8%	28.2%
Reported NPM	4.7%	694.3%	20.0%	-14.5%	-16.8%	-1.2%	23.0%	26.9%	29.3%
Recurring net profit	282.0	122.0	225.4	(83.0)	(323.9)	4.8	694.2	757.3	447.0
YoY	68.9%	-56.8%	84.8%	N/A	N/A	N/A	N/A	9.1%	-41.0%
Recurring NPM	34.2%	13.8%	23.4%	-6.5%	-11.6%	0.1%	13.8%	12.8%	6.3%

Source: RHB

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