

14 March 2019

Technology | Internet & Software

NetDragon (777 HK)

Buy (from Neutral)

Strong Online Games; U/G To BUY

Target Price (Return)	HKD26.87 (+53%)
Price:	HKD17.60
Market Cap:	USD12,41m
Avg Daily Turnover (HKD/USD)	16m/2m

- **Upgrade to BUY from Neutral with a new HKD26.87 TP from HKD17.56, 53% upside.** We expect NetDragon to deliver good results for FY18-19 – driven mainly by the improving performance of existing key personal computer (PC) games and mobile titles since 4Q18, as well as cost controls and operating leverage for its education business. We raise FY18-20F net profits by more than 30% and expect to see an earnings upgrade and re-rating of the stock.

- **Improving performance of key game titles in 4Q18 should guarantee strong FY18-19.** Based on some media reports and our industry sources, we believe NetDragon's *Eudemons Online* PC game has had its monthly gross billings improved significantly following in-game promotions, and issuance of an extension pack in 4Q18. Also, two key mobile titles based on the *Eudemons* intellectual property (IP) saw monthly gross billing growth in 4Q18 after some adjustments and updates were made to the game. We think both improvements were beyond market expectations. Given that these three titles contributed the bulk of total games revenue, we believe the improvements should provide CNY100-150m earnings upside in FY18-19.

- **Solid online game pipeline with three new games obtaining licenses –** two based on the *Eudemons* IP and another based on the *Heroes Evolved* IP. We expect these three games – to be launched in FY19 – to drive NetDragon's online gaming growth further.

- **Education business should see losses narrowing.** From our discussions with management last month, there are plans for zero headcount additions for its China education business in FY19. We believe costs will be under control. We also see Promethean improving profitability from a low base, thanks to solid revenue growth and operating leverage.

- **FY18F results preview.** We expect strong online gaming profit to drive the strong year for NetDragon by posting CNY315m in net profit for FY18F, with roughly segmental profit of CNY930m from online games, net loss of CNY430m for China education, profit of CNY60m from Promethean, and CNY250m for unallocated expenses. We see 21% and 18% earnings growth for FY19-Y20. We raise earnings for the following years on higher online gaming revenue.

- **Upgrade to BUY with a new HKD26.87 TP,** as we lift online gaming profit in our SOP valuation. We expect a re-rating, given strong earnings upside, a friendlier regulatory environment for online games, and the stock market's improving overall sentiment. Risk to our call: improvements in existing game revenues may not be sustainable.

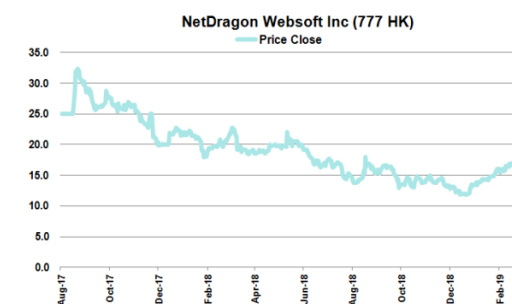
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Share Performance (%)

	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 Valuation	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYm)	2,793	3,868	4,958	5,501	6,229
Recurring net profit (CNYm)	(324)	5	316	381	448
Recurring net profit growth	290.2	nm	nm	20.6	17.6
Recurring P/E (x)	nm	nm	25.3	21.0	17.8
P/B (x)	2.1	1.8	1.7	1.6	1.5
P/CF (x)	nm	18.7	38.3	14.9	12.8
Dividend Yield (%)	1.1	1.1	1.2	1.2	1.2
ROE (%)	nm	29.7	15.4	15.0	13.4
EV/EBITDA (x)	(5.3)	(0.5)	6.6	7.5	8.3
Net debt to equity (%)	(14.7)	(12.4)	(11.8)	(11.2)	(10.4)
Interest coverage (x)	nm	nm	26.5	26.1	29.8

Source: Company data, RHB

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Figure 3: 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	2,170.8	2,551.1	2,837.3
Education	N/A	N/A	N/A	242.8	1,526.3	2,105.3	2,689.2	2,838.5	3,267.8
Mobile solution and mobile marketing	N/A	N/A	N/A	44.0	56.8	89.5	98.5	111.1	124.0
Total revenue	825.7	884.5	962.8	1,272.2	2,793.1	3,867.6	4,958.5	5,500.7	6,229.1
YoY	17.7%	7.1%	8.9%	32.1%	119.5%	38.5%	28.2%	10.9%	13.2%
Cost of revenue	(54.4)	(81.4)	(102.8)	(314.2)	(1,203.2)	(1,687.9)	(2,095.5)	(2,299.4)	(2,591.8)
Gross profit	771.3	803.1	860.0	958.0	1,589.9	2,179.8	2,863.0	3,201.3	3,637.3
YoY	12.4%	4.1%	7.1%	11.4%	66.0%	37.1%	31.3%	11.8%	13.6%
Gross profit margin	93.4%	90.8%	89.3%	75.3%	56.9%	56.4%	57.7%	58.2%	58.4%
Selling & marketing expenses	(113.6)	(106.2)	(152.5)	(206.8)	(519.7)	(624.7)	(727.5)	(842.0)	(986.2)
Administrative expenses	(206.1)	(366.1)	(326.9)	(520.1)	(721.0)	(734.6)	(858.9)	(959.2)	(1,086.6)
Development costs	(146.2)	(162.9)	(249.3)	(446.2)	(759.9)	(844.1)	(971.9)	(1,099.3)	(1,221.8)
Operating profit	305.4	167.9	131.3	(215.1)	(410.7)	(23.6)	304.7	300.8	342.6
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%	6.1%	5.5%	5.5%
Other income & gains	48.9	45.0	157.1	187.9	91.2	96.0	118.6	173.8	197.1
Other expenses	(22.2)	(10.0)	(34.0)	(24.1)	(67.1)	(101.0)	(80.2)	(52.0)	(49.8)
Net (loss) gain on derivatives	-	-	0.5	(18.4)	(21.8)	3.3	(4.2)	-	-
Interest income, net	4.8	4.9	2.8	6.0	-	2.6	3.6	3.7	3.7
Share of losses of JC entities	(0.5)	(0.0)	(2.4)	(9.9)	(0.9)	(1.4)	3.5	8.0	8.0
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	26.9	-	-
PBT	332.2	216.7	236.0	(87.3)	(208.8)	(31.7)	361.8	422.9	490.0
Income tax	(50.4)	(50.3)	(64.2)	(100.7)	(28.0)	(57.2)	(85.0)	(71.0)	(71.0)
Effective tax rate	15.2%	23.2%	27.2%	-115.4%	-13.4%	-180.3%	23.5%	16.8%	14.5%
Profit from discontinued operations	(242.9)	6,056.0	-	-	-	-	-	-	-
MI	(0.2)	81.7	(4.9)	(44.9)	(34.0)	(68.1)	(39.0)	(29.0)	(29.0)
Reported net profit	39.2	6,140.8	176.7	(143.0)	(202.7)	(20.8)	315.7	380.9	448.0
YoY	-71.0%	15574.8%	N/A	N/A	N/A	N/A	N/A	20.6%	17.6%
Reported NPM	4.7%	694.3%	20.0%	-14.5%	-16.8%	-1.2%	14.5%	14.9%	15.8%
Recurring net profit	282.0	122.0	225.4	(83.0)	(323.9)	4.8	315.7	380.9	448.0
YoY	68.9%	-56.8%	84.8%	N/A	N/A	N/A N/A		20.6%	17.6%
Recurring NPM	34.2%	13.8%	23.4%	-6.5%	-11.6%	0.1%	6.4%	6.9%	7.2%

Source: RHB

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