Jacob Ma-Weaver, CFA June 23, 2014

Last Price	Diluted Shares Out	Market Cap	Net Debt/ (Cash)	Enterprise Value	Daily Liquidity	Insider Ownership
HKD	mm	USD m	USD m	USD m	30d average USD m	%
14.16	**512**	**935**	**(693)**	**242**	**2.2**	**68**

Dividend Yield	EV/Sales 2014E	EV/EBITDA 2014E	P/E 2014E	P/E Ex-Cash 2014E	Book Value	FCF Yield 2014E
%	x	x	x	x	HKD per share	%
2.8	**1.6**	**3.5**	**15.2**	**5.2**	**11.42**	**6.7**

Souces: FactSet, company filings, proprietary estimates. NetDragon reports in CNY and trades in HKD. HKD and USD translations are provided for convenience at CNYHKD of 1.244 and USDHKD of 7.751.

NetDragon is a pioneering Chinese Internet and education company masquerading as a game developer. Despite consistent cashflow from its gaming franchise and exciting growth prospects in education, mobile apps, and cloud computing, the company's market valuation scarcely exceeds book value. Assuming fair market value for the company's real estate holdings, investors are getting its cash cow game business and education ventures for free. NetDragon offers a compelling opportunity to invest alongside proven, trustworthy owner-operators in an absurdly underpriced portfolio of call options on large and fast-growing addressable markets.

I estimate fair value today at HKD 27 per share, a 90% premium to the close on June 23. Although short-term volatility in the sector is high, NetDragon offers a highly asymmetric risk-return profile for long term-oriented investors. Fundamental downside should be limited by book value of HKD 11.42 per diluted share (HKD 10.50 of which is net cash), while realistic scenarios for NetDragon's early stage businesses **could result in 3-5x potential return on investment** over the next few years.

Contents

NetDragon is that rare and exciting combination of something for both value and growth investors – a misperceived company that should be a "growth stock" but is trading below net asset value. NetDragon has been overlooked in an otherwise frothy market for Chinese Internet companies, but perhaps not for long. 777 HK is a core position for my clients.

Good things come in threes

NetDragon was founded in 1999 by Liu Dejian, a chemist by training and computer game enthusiast from Fujian province in southern China. Like Baidu's Robin Li, Liu was part of a generation of US-educated Chinese who recognized the potential for the Internet and returned to China to start technology companies. With his cousin Zheng Hui as co-founder and brother Liu Luyuan as CEO, Liu initially focused on distribution, building a popular online game portal before branching into self-developed massively multiplayer online role-playing games (MMORPGs). After a few hit games, the company listed on the SEHK in 2007.

Were NetDragon just another moderately successful MMORPG developer in a crowded field, its current low valuation might well be warranted. Indeed, gaming investors seem to lump NetDragon in with developers such as PWLD (*Perfect World)* and GAME (*Million Arthur)*, whose valuations have languished in recent years, favoring larger and better-known MMORPG players such as NTES (*Fantasy Westward Journey* and *World of Warcraft* in China) and GA (*ZT Online*). However, as I have come to learn more about the company, I increasingly view NetDragon as much more than a simple game developer. I think of the Liu brothers and Zheng Hui as technology visionaries and excellent stewards of capital.

Three times in a decade, the Liu family has been on the vanguard of the development of the Chinese Internet. As Internet penetration in China has increased, usage patterns and the value of different access points have shifted dramatically. Remarkably, NetDragon presciently identified several trends ahead of the market and made successful investments as a result:

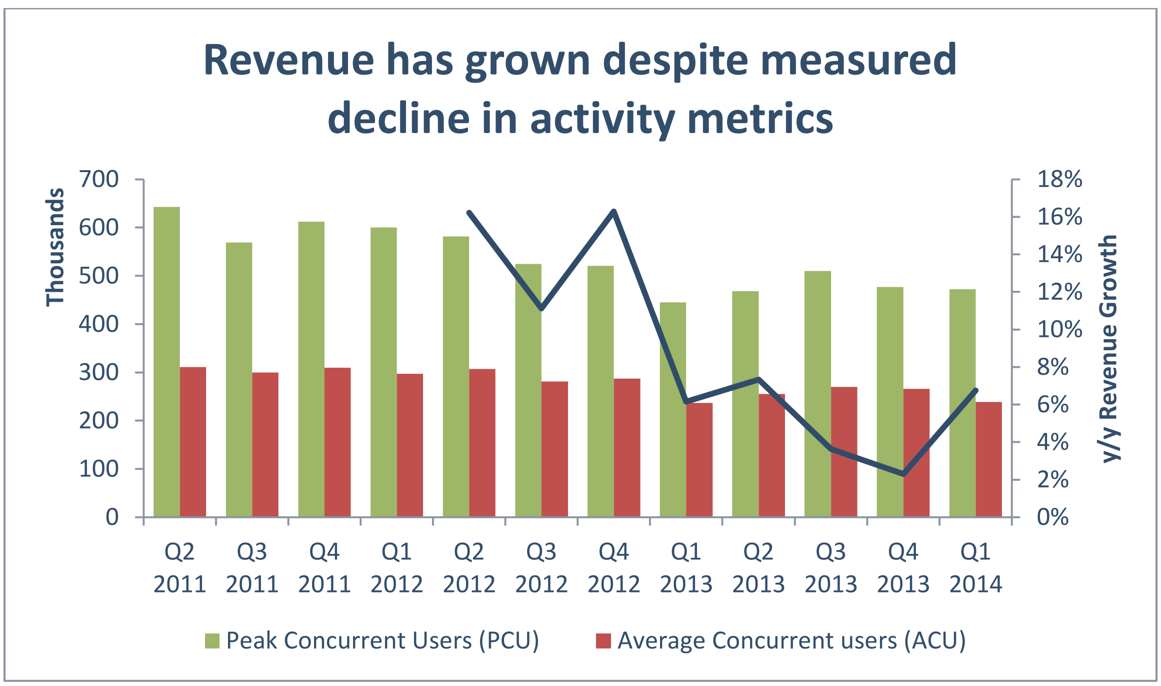
1. Early Chinese Internet users were dependent on web portals, such as those operated by SINA and SOHU, before search engines gained prominence. In 2003, ahead of this transition, NetDragon sold its gaming portal 17173.com to SOHU for $20 million, a very significant sum at the time for the young company.
2. As online gaming grew in popularity, virtual worlds became important access points to the Internet for a large population of avid gamers in China. Games were generally monetized through time-based subscription revenues. This dynamic encouraged user stickiness, but NetDragon recognized a way to better penetrate the market by emulating developers in other geographies. When it introduced *Eudemons* (魔域) in 2006, which today accounts for about 60% of revenues, it was one of the first free-to-play MMORPGs in China. NetDragon capitalized on a first-mover advantage by adopting the free-to-play pricing model. Users remain loyal thanks to in-game currencies, frequent expansion packs, and the proto-social network effects of multiplayer gaming.
3. Today, mobile apps are widely acknowledged as a key distribution channel as the Internet increasingly becomes mobile. NetDragon started investing in mobile Internet in 2008, well before many of its peers. NetDragon was ahead of the curve in developing not just mobile games and services, but also recognizing the critical importance of a distribution platform for the fragmented app market. The result was a controlling stake in 91 Wireless, the most popular app store in China, which NetDragon and the minority investors sold to Baidu (a relative laggard in recognizing the importance of mobile) for $1.9 billion in 2013. Notwithstanding high market valuations elsewhere in the sector, the deal was the largest transaction in Chinese Internet history. Liu Dejian joined Baidu's board and indicated that there may be opportunities to cooperate further with Baidu going forward. The 91 Wireless disposal was the source of NetDragon's HKD 7.77 special dividend last fall and much of its remaining cash on hand.

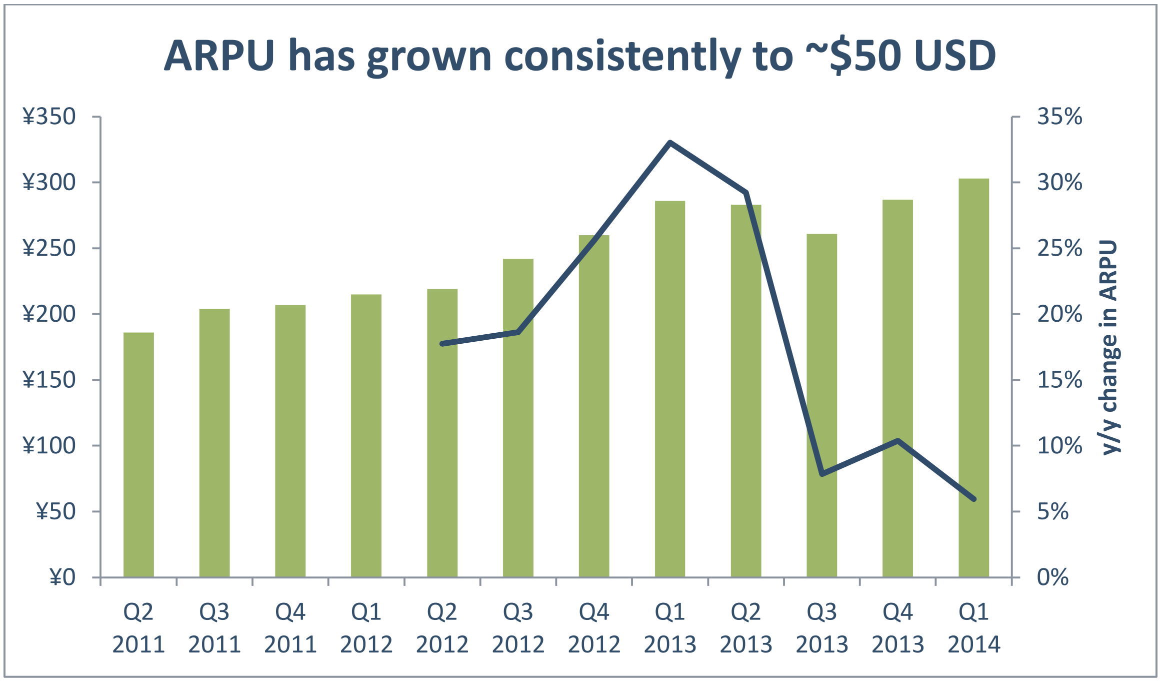
One such success might have been luck, but I believe that with three prescient moves, management has demonstrated a clear pattern of identifying emerging trends in the Chinese Internet. Additionally, by selling non-core businesses at high valuations and reinvesting with a long-term approach, they've shown a rare degree of valuation discipline not often found in the tech industry. With 49% ownership among the three (an additional 19% is held by other insiders and IDG Group, an early venture backer), the Liu family fits the classic model of shareholder-friendly owner-operators. They return capital, allocate resources prudently, and act like investors, not just technologists.

Game developer or tech incubator?

Before discussing online education, the area I hope will be the Liu family's fourth notable call, it is important to understand NetDragon's existing businesses.

Following the 91 Wireless disposal, NetDragon's near-term financial performance is dominated by its legacy MMORPG franchise. Together, *Eudemons* and *Conquer Online* (征服), NetDragon's most popular game overseas, comprised about 90% of 2013 revenues. Eudemons and Conquer are high margin cash cows – they have an established and stable user base with minimal distribution costs and low incremental investment requirements. While management recognizes the secular decline in desktop gaming, *Eudemons* and *Conquer Online* are far from run-off income streams at this point. NetDragon continues to make judicious investments in user engagement by introducing updates and seasonal in-game promotions and competitions. The result has been continued revenue growth despite a slow decline in overall usage metrics. As demonstrated by the continued growth in ARPU, the current ACU base of over 200,000 gamers remains highly engaged.





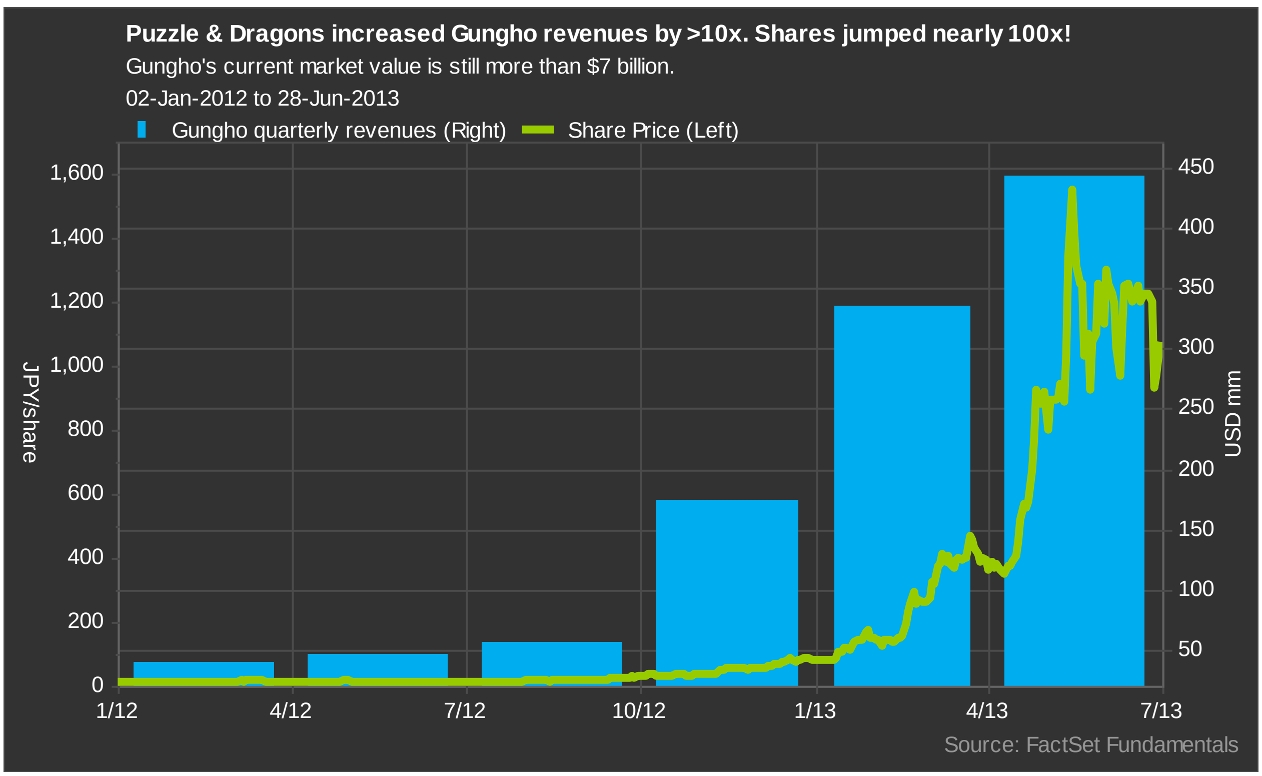
Source: NetDragon investor presentation, company filings

While there are valid reasons for bearishness on the long-term future of desktop MMORPGs, most notably the intense competitive environment and cannibalization from other platforms, I believe rumors of the industry's demise have been greatly exaggerated. In China, role-playing games remain a popular pastime for a meaningfully large subculture. While other gaming alternatives will likely continue to limit the growth prospects of legacy games, *Eudemons* and *Conquer Online* retain a loyal following and continue to attract new players even after 8 and 11 years, respectively. In my opinion, many analysts underestimate several factors that lead to player stickiness and recurring revenue: 1) in-game chat and strong communities, analogous to social networks that keep players engaged, 2) the opportunity cost of leaving a game after investing significant time and effort to reach a high level, which makes gameplay more enjoyable, 3) the ability of the developers to keep gameplay fresh and interesting through periodic updates and promotions, and 4) growth in player incomes as they age, supporting higher ARPU.

Combined, these factors make it likely that legacy MMORPGs will continue to produce stable cash flows that can be reinvested into other businesses or returned to shareholders. In the near term, there is also potential for some uplift from updates and introduction of versions for new platforms. NetDragon plans to introduce a mobile version of *Eudemons* later this year; *Conquer Online's* English iPhone app already makes regular, modest appearances on the top grossing lists for its category. Although mobile games have lower gross margins due to revenue share with distribution platforms, experience from other Internet and gaming companies suggests that usage is largely incremental. Mobile gameplay tends to be more casual – either from new mass market players who would not have played the desktop version anyway, or marginal gameplay from existing desktop players checking in while on the go. Management anticipates mobile will represent about 10% of gaming revenue this year.

With a 1,246-person development team (out of a lean total staff of 2,285), 707 of whom work in gaming, NetDragon is now focused on future business prospects. Some opportunities still remain in gaming, and there are signs the company retains robust development capabilities. NetDragon has a well-established process and a strong animation and programming talent base, which continue to bear fruit. Just this quarter, NetDragon launched a new web game distributed through Tencent, *Caliber of Spirit* (英魂之刃), which has already reached over 160,000 PCU. Though the economics may not be as attractive as its self-distributed MMORPGs, the high level of activity relative to existing games is encouraging.

The company also recognizes that much of the over RMB 100 billion Chinese gaming industry's future growth will come from mobile. In addition to updating existing and new desktop games, NetDragon has many "shots on goal" in the form of new mobile games. Mobile games generally have a shorter release cycle and lifetime, and in 2014 alone, NetDragon expects to release 10 mobile games. Each is a bit of a lottery ticket in what is very much a hit-driven industry. However, mobile games are inexpensive to develop and can contribute significantly if they attract a following. For instance, King Digital, the maker of *Candy Crush Saga*, recently went public at over 7x NetDragon's valuation. Another example that illustrates the potential option value of a mobile game development franchise is Gungho Online Entertainment (3765 JP), once the sleepy majority owner of the maker of *Ragnarok*, a Korean MMORPG. However, with the overnight success of its mobile game *Puzzle & Dragons*, which by some accounts wasn't even particularly well-designed, the company's valuation skyrocketed:



To be clear, I do not ascribe significant value to as-yet undeveloped mobile games. However, at a minimum, NetDragon's pipeline should serve to offset any future declines in its legacy MMORPGs. King and Gungho's experience may be atypical, but it illustrates the potential value of an experienced development team and even a single successful game.

Gaming aside, where NetDragon distinguishes itself today is in the activities of the other 539 developers. In addition to investing in its education platform, NetDragon has been running its own internally developed, cloud-based content management system for several years. The company has suggested that this cloud platform could have external enterprise applications, in addition to forming the backbone for its forthcoming online education offering. Baidu and Alibaba have competing services and superior development resources in this arena, but NetDragon's foray into such areas speaks to management's ambitions for the company. NetDragon also has a suite of free e-learning reference apps on various topics for iPhone and Android, and various other software projects such as a virtual reality interior design application. Although some of NetDragon's developer talent was lost to 91 Wireless, the core leadership team that incubated 17173 and 91 Wireless is intact.

Broadly, I believe NetDragon is positioning itself as an up-and-coming Internet software player worthy of mention in the same breath as Baidu, Alibaba, and Tencent. Management is investing heavily in adjacencies and trying to build a lasting franchise. To that end, the company is cooperating with the Fujian government to build an 8,000-student extension campus of the Fuzhou Software Technology Vocational College adjacent to NetDragon's new campus in Changle, Fujian. Much as Alibaba has had to work to attract developer talent from larger cities to Hangzhou, NetDragon is playing the long game of building up technical know-how in its own backyard.

A $28 billion market opportunity

A recent report by iResearch estimated that the Chinese online education market is growing over 20% per year and will reach RMB 173 billion (~$28 billion) by 2017. China has a strong cultural emphasis on education. Test prep and tutoring services are popular, and public education expenditures account for over 4% of GDP, according to government statistics. Online education services have great potential to complement and potentially disrupt traditional education service providers through additional channels and methods of content delivery. Although developers have been experimenting with a variety of business models and monetization strategies are still in early stages, the high level of demand for education content is attracting investor interest. Online education includes not just headline efforts like massive open online courses, but also the use of web-based platforms to deliver supplemental content like tutoring and vocational training. Educational content can also be provided through mobile apps, which may be particularly effective with a game-like element. "Gamification" of educational content is a natural adjacency for NetDragon.

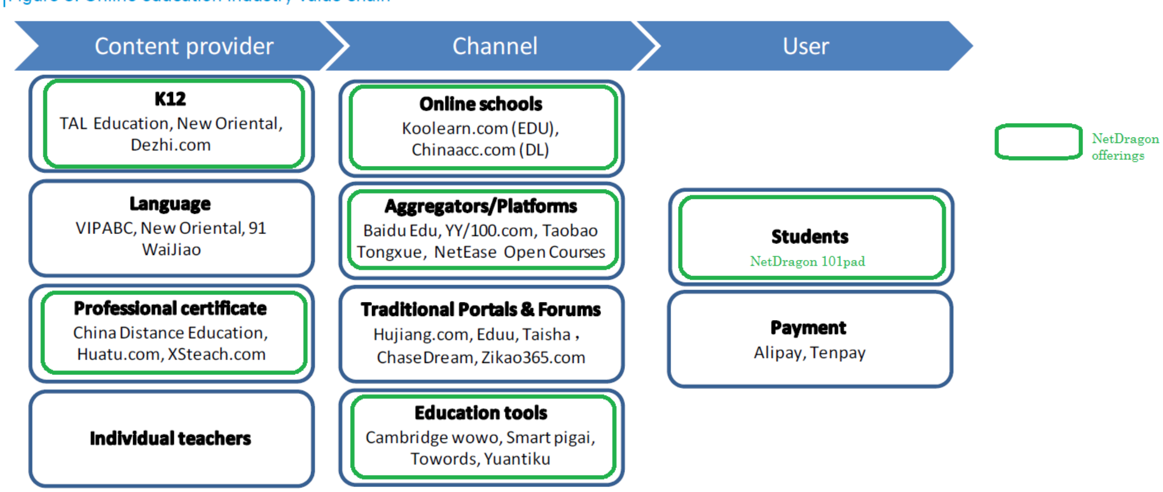
With this backdrop, NetDragon's pivot to education appears foresighted. Last year, management began publicizing technology investments in an education platform that have been underway since 2009. NetDragon is planning a full-scale K-12 and vocational education platform under its brand 101.com. To complement its online efforts, NetDragon also announced a joint venture with Hon Hai to develop an educational tablet for use in the K-12 market. The company has yet to share many details with the market, and only a few of its consumer-facing services are currently available. No pricing or monetization details are known at this time. However, in light of the market potential, some speculation may yet be worthwhile.

For the tablet, Hon Hai will control the manufacturing, and NetDragon will develop the software. Margins for low-end tablets from other manufacturers vary widely, but to size the opportunity, suppose Hon Hai and NetDragon could earn hypothetical 10% net margins on a $200-300 device, or $10-15 each per device (assuming a 50/50 split). China has about 200 million K-12 students, making the total potential profit pool nationwide $2-3 billion. It is improbable that every Chinese student would end up with a 101 tablet, but investment by individual school systems would likely be a politically driven, local government decision. It is not hard to imagine the Fujian government supporting a local champion for its roughly 5 million students. Again, the numbers are purely hypothetical at this stage, but selling 5 million tablets could add HKD 0.75-1.00 of earnings per share.

Source: 101.com

Recent announcements by YY.com (YY), which launched an education platform (100.com), and NetEase (NTES), which partnered with Coursera to distribute content in China, have focused investor attention on the nascent online education market. Remarkably, Deutsche Bank released a 57-page background report on the industry in May 2014 that fails to make so much as a mention of NetDragon. The sector is competitive, and established education specialists (e.g. XUE, TAL) are likely to dominate certain niches (e.g. web delivery of live tutoring). However, once its tablet is commercialized, NetDragon appears likely to be the only player with a fully end-to-end offering, providing original content, an online platform, and hardware. I have edited Deutsche Bank's chart to highlight where NetDragon currently operates or plans to compete:

Figure 8: Online education industry value chain



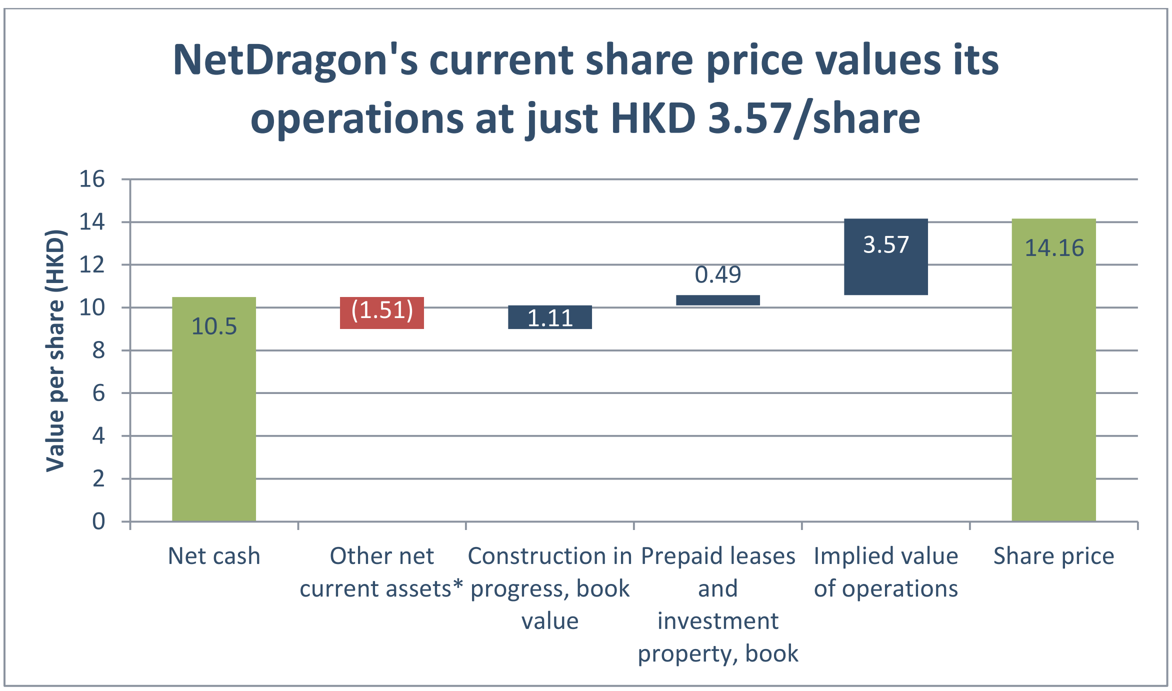
Source: Deutsche Bank, company information

In my valuation discussion below, I ascribe zero value to the education business today, but I think it has the potential to one day dwarf the value of the existing gaming business. Although I am reluctant to pay for growth that may not materialize, the market may be more forgiving once more details about the business become clear. If iResearch estimates are in the right ballpark, even a 0.5% market share could double NetDragon's current revenue. By comparison, what proportion of YY's current $4 billion market cap is attributable to aggressive expectations for the equally early-stage 100.com?

Lastly, NetDragon provided a hint of its monetization strategy with the acquisition of the mobile advertising business of the Cherrypicks Group this month. Cherrypicks is a leading Hong Kong mobile technology developer and advertising firm that will add to NetDragon's mobile development capabilities. But perhaps more importantly, it has established relationships with many large consumer companies doing business in Asia. Should NetDragon attempt to introduce advertising into its portfolio of free education apps or a future mobile education platform, Cherrypicks' mobile marketing expertise will be very valuable. As further evidence of NetDragon's valuation discipline, the USD $30.5 million maximum consideration (subject to an earn-out) for Cherrypicks is only 8x 2014 target operating profit for the rapidly growing business.

Hidden assets

By rights, valuing NetDragon ought to be a debate over the right multiple to put on an MMORPG business, as well as an exercise in comparing reference venture capital valuations for early stage mobile and education businesses. However, the current market valuation is low that a discussion of net asset value is the more appropriate starting point. Perhaps overseas investors are still leery of investing in cash-rich Chinese companies and question if the money exists, rather than viewing it as an important source of downside protection. Never mind that most of the cash originated at Baidu and that a substantial portion was paid out in a special dividend (as I can personally attest). Perhaps NetDragon's cash has yet to show up on most quantitative screens for a transaction that closed in early Q4 2013. Whatever the reasons, based on book value excluding PP&E in use, NetDragon's share price values its operating business at only HKD 3.57/share.



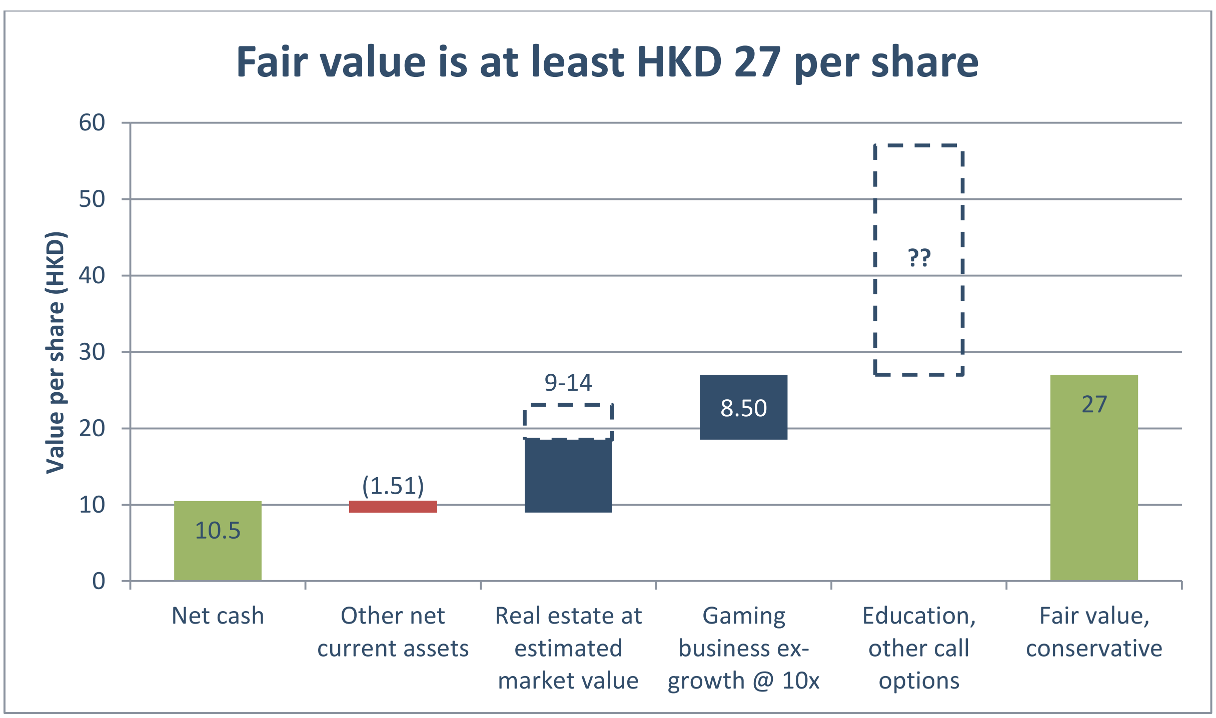
**Note: NetDragon's business model benefits from low capital intensity. Net current assets are negative, largely due to tax withholdings from the 91 Wireless transaction and customer prepayment of in-game credits. The substantial cash balance is not required for operations and should in my view be considered excess.*

Despite the growth opportunities discussed above, that figure is only 5.2x my conservative 2014E EPS estimate of HKD 0.69 (excluding estimated net interest income of HKD 0.24), approximately 5% year-on-year growth adjusted for one-time costs. 5.2x is far too low a multiple for a growing business with predictable cash flows, even in an industry facing secular headwinds.

Simplified Income Statement Forecast (RMB mm)	2012R*	2013R*	2014E	2015E
Revenue	826	885	969	1,036
EBITDA, adj**	341	355	433	463
EBIT, adj**	310	305	381	411
Net income, adj**	292	273	383	406
EPS, adj**	HK$0.71	HK$0.66	HK$0.93	HK$0.99

* Restated to excluded 91 Wireless, ** adj excludes f/x translation, stock comp, and transaction costs

Considering the legacy gaming business alone, I believe fair value should be closer to a market multiple on pre-interest EPS. A 14x 2014E multiple on current operations alone would imply an additional HKD 6 (+43%) to the current share price. Another important consideration is that much of NetDragon's expense structure is discretionary. The company's R&D activities are self-financing through its legacy games. Were the company to cease all reinvestment in its gaming franchise, R&D personnel could be reduced by at least half, with potential SG&A savings as well. Assuming only this reduction in R&D, the legacy gaming franchise would generate about HKD 0.85 of EPS, for a conservative value of at least HKD 8.50 at a no-growth multiple of 10x. The conservative fair value estimate below implicitly assumes the IRR of the company's R&D in new games, mobile apps, cloud computing, and education is zero.



In addition to these assets hiding in plain sight, the balance sheet may also be understating the value of NetDragon's real estate portfolio. NetDragon is in the process of building a new headquarters on a prime parcel of oceanfront land in Fujian. The Changle campus will include not only the company's own office buildings, but also space NetDragon can lease to related businesses as part of an industrial cluster, the college campus mentioned above, and housing and commercial areas for the company's own employees. The multi-year project is still in progress, but NetDragon already holds most of the necessary land use rights. The cost of construction is recorded at cost on the balance sheet as incurred. Since the project's inception, property values have risen dramatically, and the development of the industrial cluster itself will serve to increase the value of the surrounding land. Fujian, like much of China, is still developing. It was once a very poor province but has been making strides.

While there is widespread concern about a potential property bubble in China, NetDragon's real estate is likely worth multiples of the cost of construction and the initial land use rights even if market prices are too high. Book value is currently RMB 659 million for a project that totals 270,000 square meters of office and residential space on 1680 mu (112 hectares or 1.12 million square meters) of land. Estimating a range for the value of this property is inexact, but reference prices support estimates well above cost. On the low end, considering only the value of the built up areas, commercial real estate in Fuzhou, the nearest city, had an average price per square meter of RMB 14,000 (~$215/square foot) according to a news article last year. At that price, NetDragon's new construction could be worth RMB 3.8 billion, or about HKD 9/share. On the high end, a recent NBER study of land prices in China estimated average mixed-use and residential plots in Fujian at RMB 5,139 per square meter. A 2011 Reuters report cited a figure of RMB 4,100 for residential land. If comparable, NetDragon's holdings could be worth 5.8 billion, or about HKD 14/share.

In either case, even after a substantial correction, NetDragon would own property worth significantly more than book value, which the market entirely ignores today. What's more, the real estate portfolio should be partially monetized through sales and leases to employees and tenants over the coming years.

Source: OPEN Architecture artist's rendering of the NetDragon commune at http://openarch.com/task/1870

I think there is little question NetDragon trades below the value of its existing businesses, but for the potential value of its future prospects, I turn to comps. NetDragon owns a portfolio of free call options: on successful new mobile or web games, on Cherrypicks, on the tablet joint venture, on 101.com, and on the rest of the education and cloud services platform. Many peer Chinese Internet companies, gaming companies, and online education businesses are being valued at multiples that suggest significant upside potential if NetDragon succeeds in any of its ventures. These multiples may not all be fundamentally justified, but they reflect current investor optimism about Internet and online education companies. By way of illustration, it seems plausible from comps that NetDragon could receive a 4-5x sales multiple on a successful new game or education income stream. Could the company capture 1% of the online education market and thereby add HKD 8-10 billion to its market cap? Could a single hit game triple the share price? Will the joint venture with Hon Hai be sold in a few years for another 91 Wireless-like payout? The bottom line today is that shareholders have a large margin of safety and can collect a nice dividend while waiting to find out.

Ticker	Name	Category	Market Cap	Net Debt/ (Cash)	Ent. Value	EV/ Sales	EV/ EBITDA	P/E
KING	King Digital	Games (UK)	5,404	(678)	4,726	2.1	4.9	8
3765 JP	Gungho	MMORPG, Games (JP)	7,595	(436)	7,159	4.0	7.6	13
TWOU	2U, Inc.	Online Education (US)	617	92	710	7.9	NA	NA
YY	YY, Inc.	Internet, Online Edu	4,170	(482)	3,688	5.8	13.4	42
NTES	NetEase	MMORPG, Online Edu	10,036	(3,340)	6,695	4.4	7.9	14
GA	Giant Interac.	MMORPG	2,835	(757)	2,078	5.4	7.6	8
PWRD	Perfect World	MMORPG	913	(409)	504	0.7	3.4	13
GAME	Shanda Gms	MMORPG	1,800	(32)	1,768	1.9	4.1	7
700 HK	Tencent	Internet, Games	139,568	(5,109)	134,460	12.6	26.5	47
QIHU	Qihoo 360	Internet, Games	11,165	(362)	10,803	9.2	21.1	74
Figures above are in USD millions					**Median**	**4.9**	**7.6**	**13.1**

Source: FactSet

Good housekeeping

Following the history of reverse merger frauds, ongoing audit working paper dispute, and concerns over accounting, a wave of US-listed Chinese companies have gone private or are in the process of going private, some with the stated aim of relisting on domestic Chinese exchanges (including GA, above). With several new Chinese ADR listings in the past year and strong sell-side support, the argument that companies can expect better valuations in China is not true in all cases. Ironically, NetDragon might have a significantly higher valuation were it listed in the US (the company has only a level 1-unsponsored ADR that rarely trades). One might expect Deutsche Bank or other firms to write for a large US audience about how 101.com, not 100.com, could be an emerging player in online education. Perhaps NetDragon would sport the premium 6x sales, 42 P/E multiple rather than a little-known live cam website with alleged links to criminal activity (YY).

Instead, NetDragon is covered primarily by small regional sell-side firms, who cater to retail investors and misinterpret the company's reporting. Unlike most US investors, analysts covering NetDragon typically do not exclude stock-based compensation or one-time items from published results. Management does not generally compute adjusted figures. As a result, some analysts have viewed recent performance negatively, failing to account for one-time stock awards related to the 91 Wireless disposal, transaction costs, and unfavorable f/x developments. After adjusting for these factors, reported earnings have been growing, though the optics of negative year-on-year growth (due to the disposal) may be weighing on shares.

Prior to the 2013 annual report, most sell-side reports completely ignored the company's asset value, even though the 91 Wireless transaction closed in October. Now, many analysts apply arbitrary discounts to the company's cash and compare the operations only to MMORPG comps to back into prices near current trading levels. A recent example from Phillip Securities Hong Kong applied a 20% discount to NetDragon's cash and a low P/E of 7 to the core business, for no discernible reason.

> **Valuation:** Based on the highly competitive online gaming market faced by the company, while contribution from the online education business is still a doubt, we temporarily give "neutral" rating, with target price HK $ 14.64. This is calculated from the core business valuation of HK $ 5.95 (Forecasted P/E of 7.0x for FY14) plus the discounted 20% of rich cash on hand, valued HK $ 8.69 per share.

Applying haircuts to large cash balances is a common practice, but it does not have solid theoretical justifications. Unlike US companies that could face taxes on repatriated earnings, NetDragon's listing is not on the mainland, and its overseas cash has already been taxed. While value investors often worry that company management will waste capital through ill-advised M&A, not all M&A destroys value. Assuming all future investments will generate negative returns is an aggressive indictment that is not appropriate for a disciplined management team. Other analysts justify discounting cash on the basis of a DCF, arguing that excess cash does not yield returns above the cost of equity. This is wrong – the cash is in the bank today and could be returned at any time. Equities still have value even when they do not return capital to shareholders. While I would ultimately like to see NetDragon return more of its excess cash or invest it prudently, there is no justification for valuing liquid assets below par other than assuming those assets will be squandered.

Fortunately, management has demonstrated signs of shareholder-friendly behavior. In addition to its ongoing (~HKD 0.40/year) and special dividends and judicious acquisition strategy, NetDragon put in place a buyback authorization for up to 10% of current shares outstanding. The company made its first, modest purchases at prices up to 15 HKD/share under the authorization this month. The Liu family has also added to its stake recently, buying 5 million shares in late April at an average price of HKD 14.62. As the saying goes, there are many reasons insiders might sell shares, but only one reason to make a nearly $10 million open market purchase.

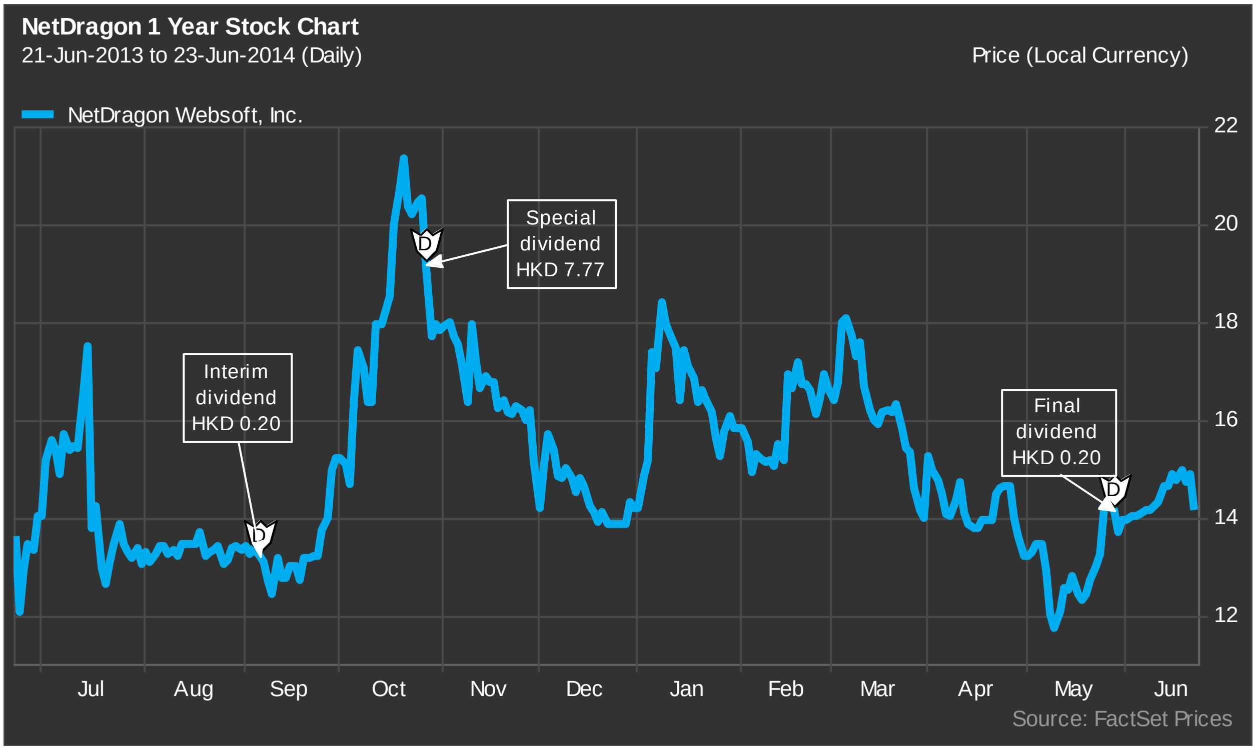
While any successful new game or news about education could serve as a catalyst, buybacks and insider activity should help support the share price in the near term. Later this year, the launch of the mobile version of *Eudemons*, lapping the disposal of 91 Wireless in reported figures, and early monetization of some of the real estate assets could spark renewed interest in the shares.

NetDragon also suffers from a lack of awareness in the US, which this report can perhaps help ameliorate. Investors who might be inclined to lump it in with some of the bad apples in recent years, or who are worried about corporate governance in Chinese companies, can take some comfort from management's alignment with shareholders and past behavior. The company is audited by Deloitte, and one advantage to its Hong Kong listing is that any potential deregistration of US auditors due to the working paper dispute will not affect its listing. NetDragon does make use of variable interest entities (VIEs), like all foreign-incorporated businesses operating in the Internet and education industries in China. However, compared to many of the more problematic structures found in US-listed entities, NetDragon's VIEs have strong contracts with best practices such as providing audit rights to the holding company and limiting the amount of assets that can be held within the VIE. With asset-light VIEs and cash held in the holding company, I worry more about management eventually deciding to go private at today's low valuation than I do about VIE nominees looting assets.

Given the hard assets on the books, downside risks are largely mark-to-market. It is of course possible for stocks to trade below their cash balances, but given management's attention to valuation I think such a situation would be unlikely to persist. Perennial worries about the Chinese macroeconomic environment sometimes contribute to volatility, and a sustained macroeconomic correction could hamper the company's future growth prospects. Gaming is a discretionary expense at the end of the day, and it is possible that the secular shift away from MMORPGs could accelerate faster than management anticipates. However, in such a scenario, NetDragon would remain solidly capitalized and able to reduce its expense structure easily. Even in a severe recession, demand for education services and entertainment would not disappear entirely.

A bigger concern is that hoped-for developments in education and mobile never really materialize, and NetDragon's legacy businesses decline gradually over time. In that case, NetDragon's shares might not see the kind of exciting performance I have tried to make the case for. Yet at the current valuation, shareholders would be unlikely to lose much either. In my opinion, that makes for an ideal investment.

Thank you for reading. Feedback is welcomed: jacob@cablecarcapital.com.



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