

Internet Investment Strategy during Economic Slowdown



中国国际金融有限公司
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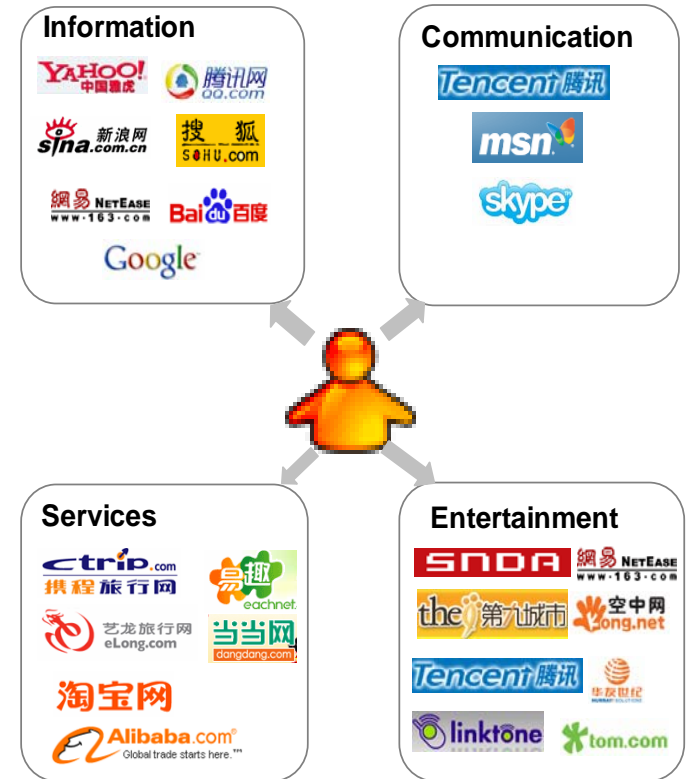
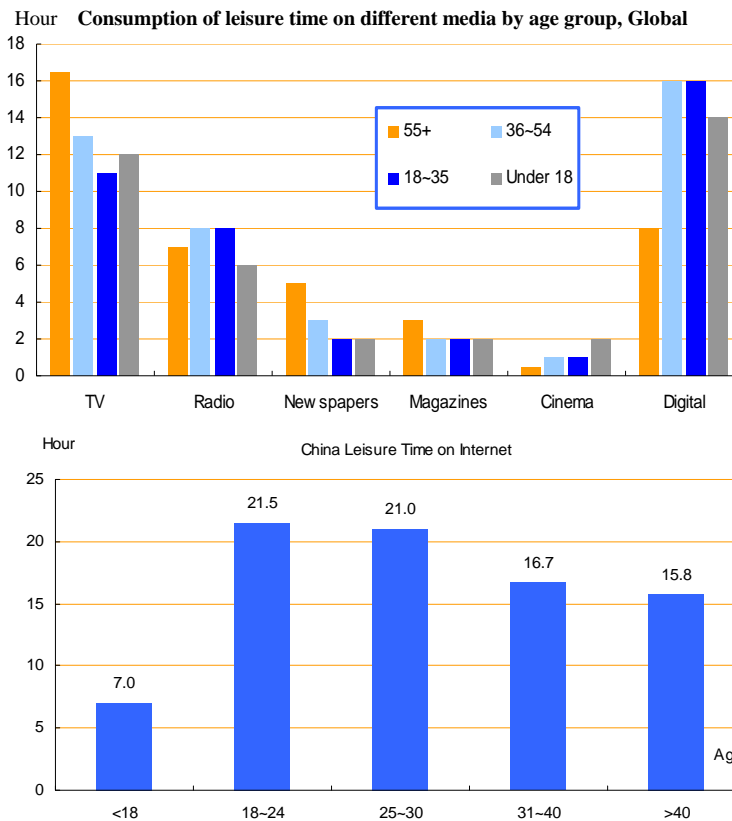
Industry : Growth As A Long-Term Trend Unchanged

Going Digital, a Long-Term Trend Nothing Can Reverse

Internet has already replaced TV as the most important media Globally.

Chinese Internet Population more indulgent than global peers.

A time for ubiquitous Internet.

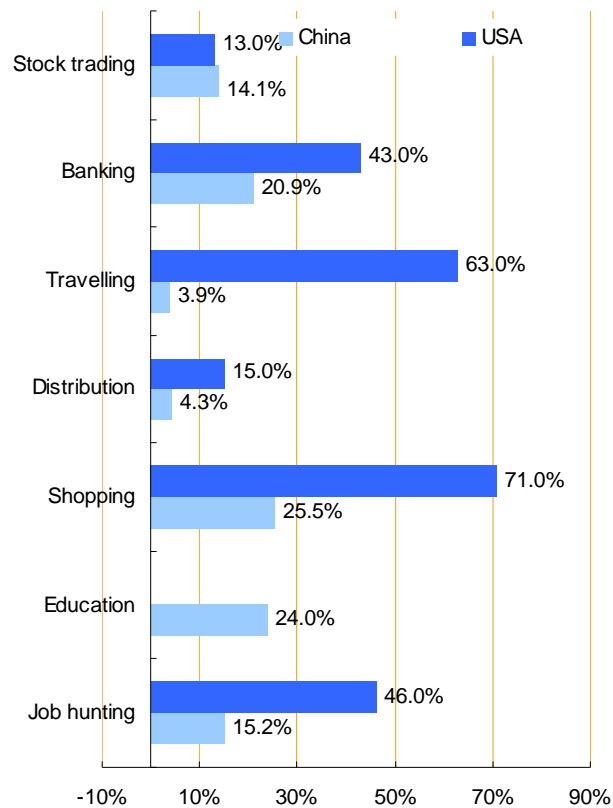


Source: CICC Research

Going Digital, a Long-Term Trend Nothing Can Reverse

A digital world closely interwoven with real life. In China, the digitalization is just beginning while the most used internet applications are mainly information and entertainment related.

Future growth driven by Internet user population growth and proliferation of new applications.



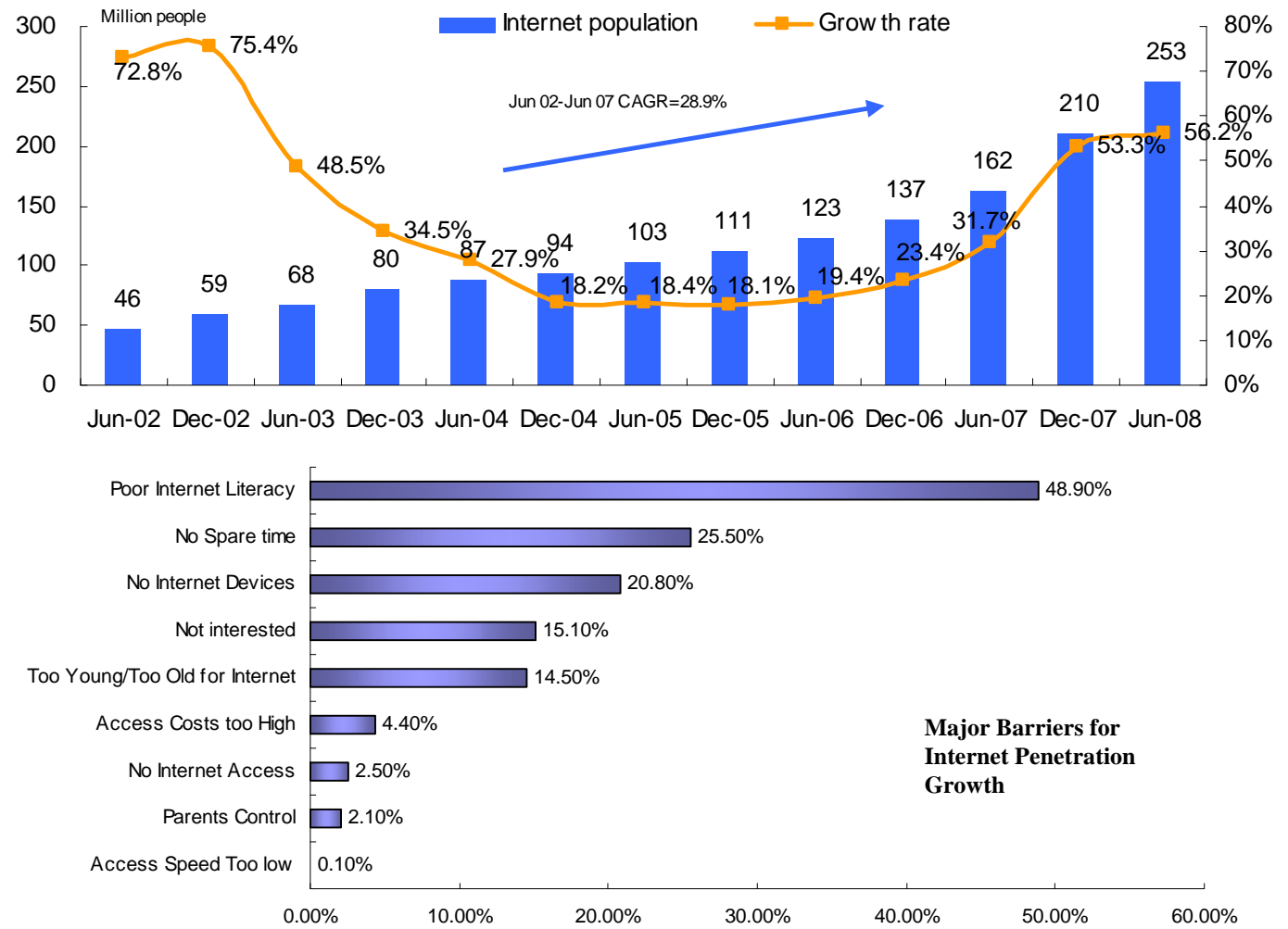
Function	Penetration Rate In China
Information	
News	77.30%
Search Engine	74.80%
Communication	
Instant Messaging	69.80%
E-Mail	55.40%
Blog	19.10%
Entertainment	
Online Music	68.50%
Online Video	61.10%
Online Gaming	47.00%
Services	
Online-Recruitment	15.20%
E-Learning	24.00%
Online-Shopping	25.50%
E-Business	4.30%
Online Travelling	3.90%
Internet Banking	20.90%
Online Stock Trading	14.10%

Source: CICC Research

Strong Foreseeable Internet Population Growth

The largest Internet population in the world at 253mn but 19.1% Internet penetration rate still below the 21% world average.

Poor Internet Literacy is the biggest barrier to improving internet penetration.



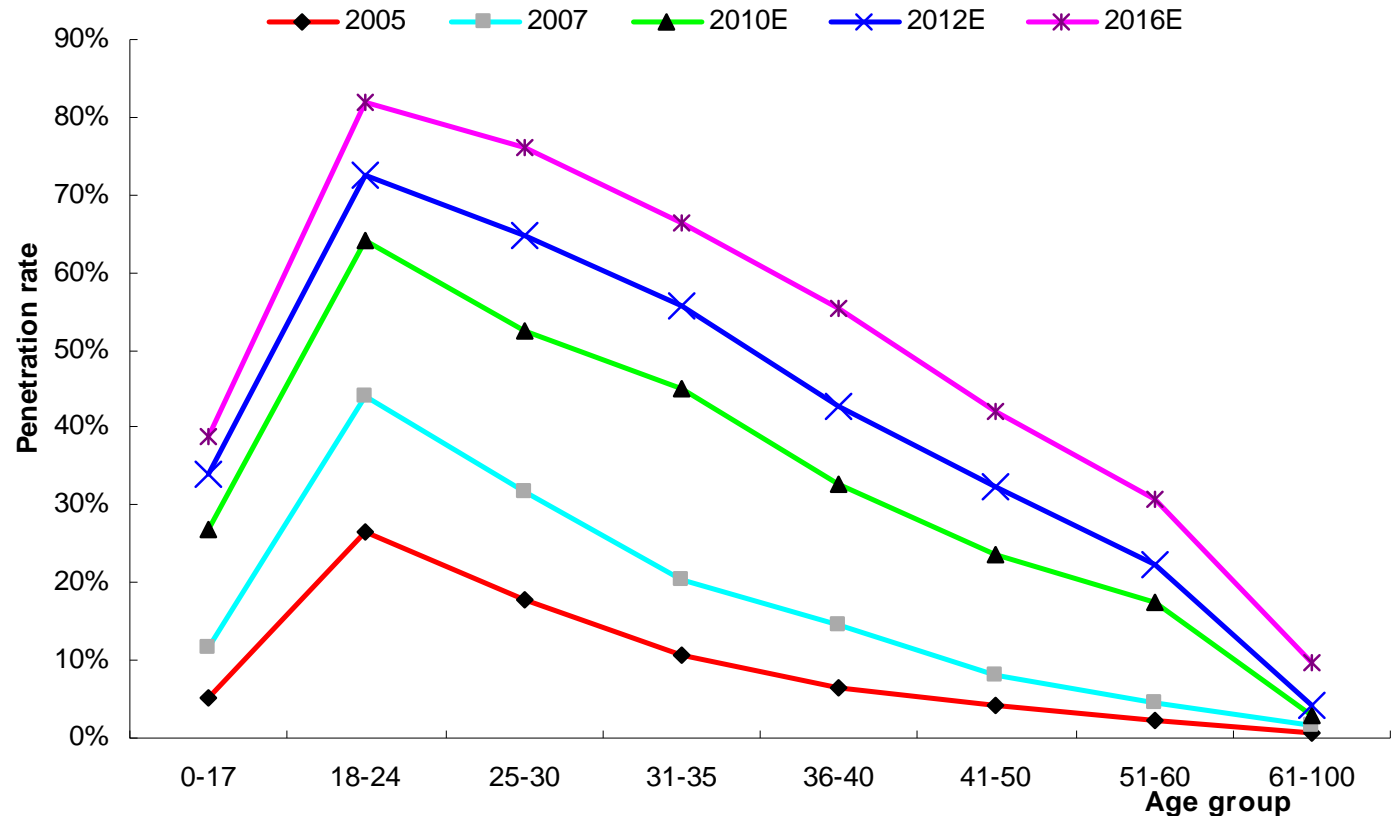
Source: CICC Research

Learning and Aging Raise Penetration

Internet literacy can be sustainably improved in China not only by learning but also by aging.

Younger generations are quicker to learn, older generations slower.

Younger generations with higher internet penetration will grow older to boost low penetration among older age groups.



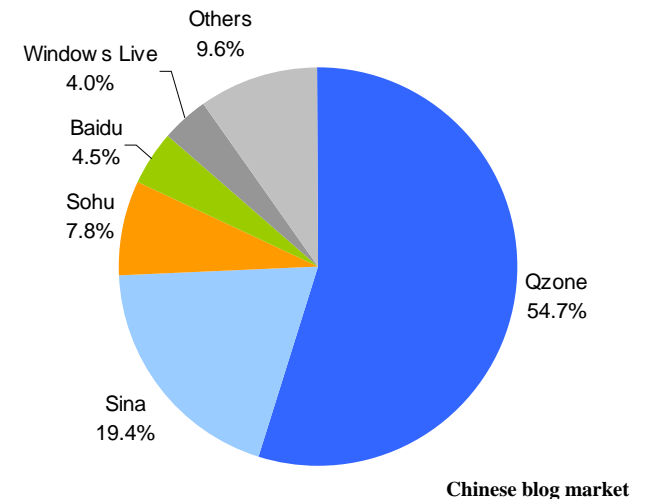
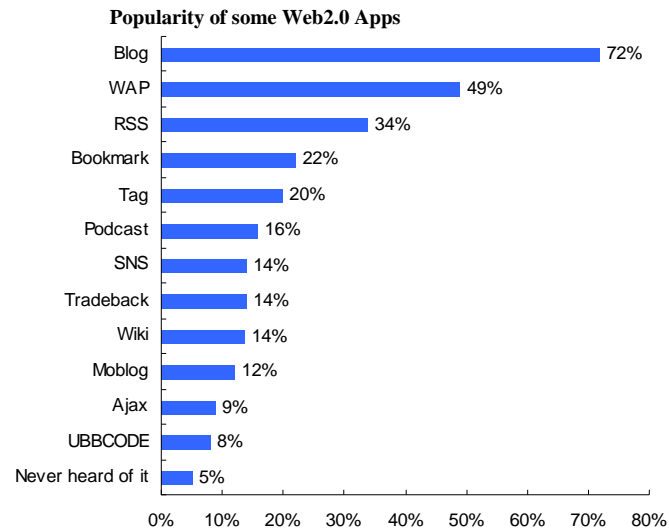
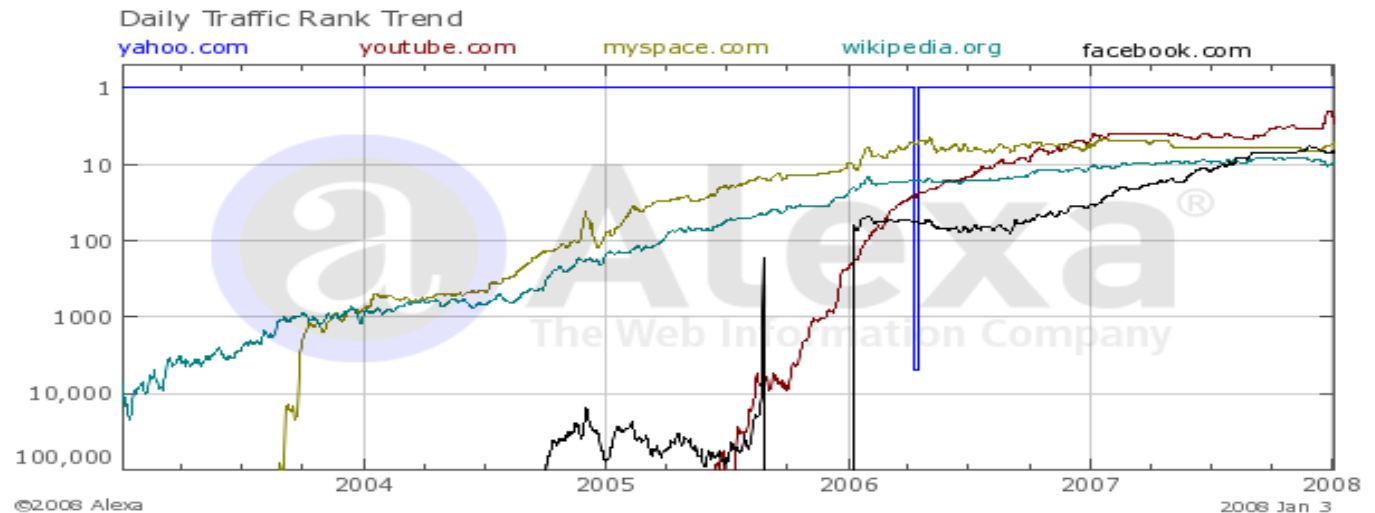
Source: CICC Research

Proliferation of New Applications

The rise of Web 2.0. Many 2.0 applications have been widely accepted by Chinese internet users and huge traffic generated.

More than 500mn mobile users represents a potential user base for mobile internet much greater than fix-lined Internet. Telecom restructuring introduced more competition among telecom operators and may free mobile internet from captivity.

Traditional Leaders such as Sina or Tencent maintain leadership in new applications.



Source: CICC Research

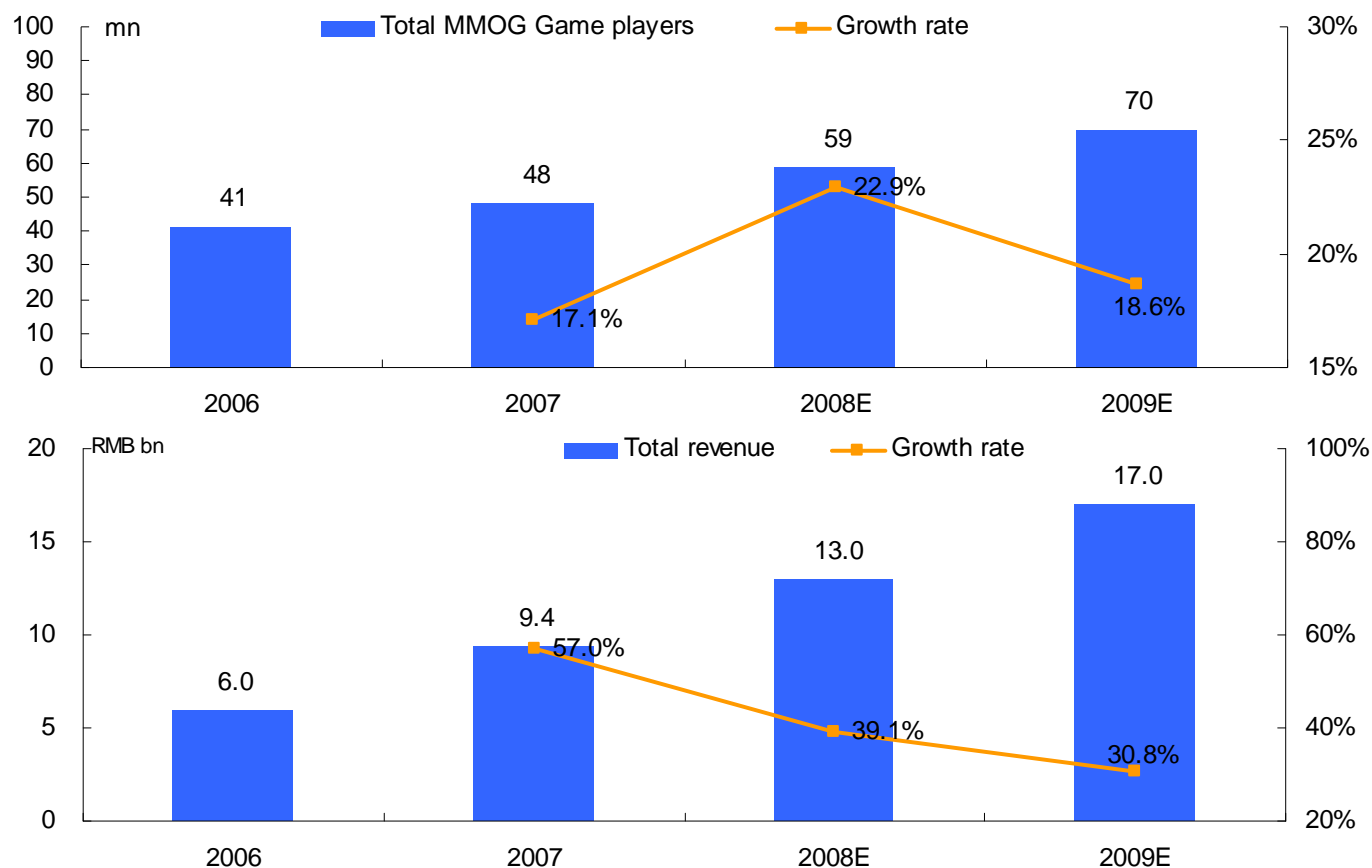
Online Gaming: Most Defensive to Slowdown

Strong Growth Outlook

Very defensive to economic slowdown since it is extremely cheap entertainment. One month cost = 3 big Macs = 1 movie ticket.

2007, the total number of MMOG game players reached 48mn, representing 17.1% YoY growth. It is expected that total game players will grow 23% to 59mn in 2008 and 18.6% to 70mn in 2009.

Online gaming is still the biggest sub-sector in the internet industry and in 2007, total revenue reached Rmb9.4bn and will grow 39% in 2008 to Rmb 13bn and 30.8% to Rmb17bn in 2009.



Source: CICC Research

Low P/E, Low Downside Risk

Average PE for Chinese online gaming companies is around 10x~15x. At least a 40% discount to Global Peers.

But Why?

- 1) Scale?
- 2) Low visibility?
- 3) Regulatory Risk?
- 4) Margin squeeze by intensified competition?

Company	Price 08-8-28	Market Cap.(US\$ mn) 08-8-28	2006A	P/E			EPS CAGR	PEG
				2007A	2008E	2009E	2007-2009E	2009E
Gaming								
Shanda	USD 26.55	1,901	57.3	10.2	10.9	8.5	10%	0.9
The 9	USD 18.50	532	13.1	15.7	8.7	7.3	47%	0.2
Giant	USD 9.43	2,261	n.a.	12.7	11.6	9.7	15%	0.7
Perfect	USD 25.07	1,429	n.a.	22.1	14.5	11.1	41%	0.3
Activision	USD 33.36	21,992	222.4	107.6	30.9	24.8	108%	0.2
THQ	USD 15.34	1,024	27.9	14.6	284.1	18.7	-12%	n.a.
Tencent	HKD 65.45	15,655	111.9	72.2	39.5	30.6	54%	0.6
Kingsoft	HKD 2.95	403	23.8	16.3	11.5	8.1	41%	0.2
Net Dragon	HKD 5.45	384	50.9	6.4	5.6	4.7	17%	0.3
EA	USD 48.88	15,584	62.7	195.5	51.0	32.0	147%	0.2
Ncsoft	KRW 52,200	983	27.6	23.1	26.0	17.2	16%	1.1
Square Enix	JPY 3,630	3,833	23.5	34.6	32.1	25.0	17%	1.4
Average			55.3	40.9	21.1	15.4	40%	0.6

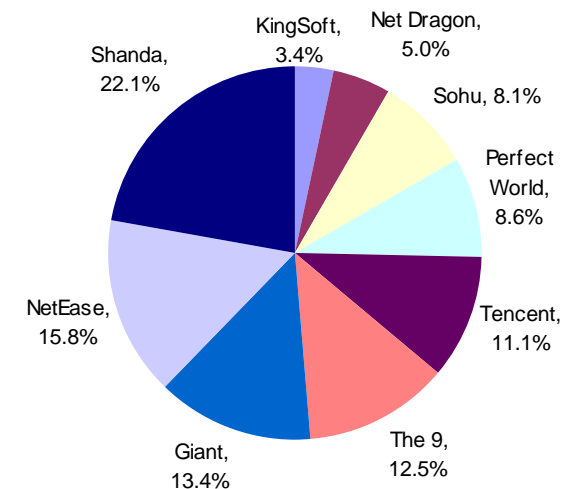
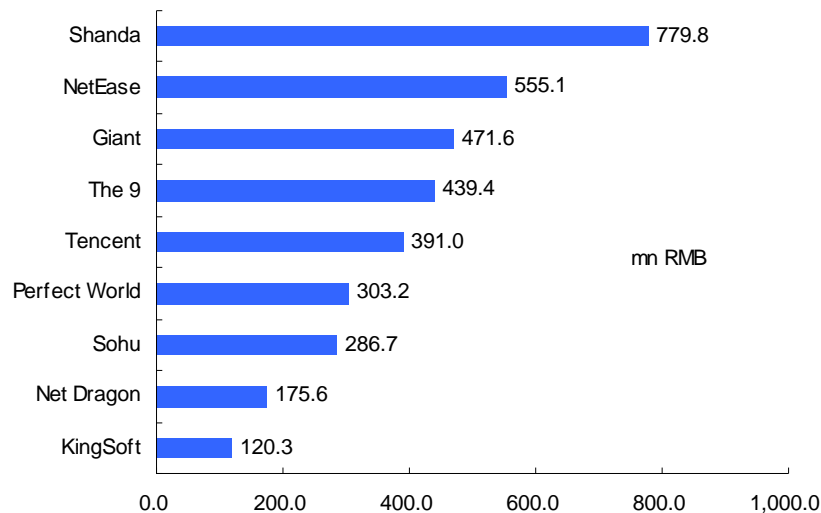
Source: CICC Research

How to grow: Content & Platform

The rise of The9 and Sohu prove the importance of Content, no matter whether developed in-house or licensed.

Tencent and Shanda's success in recent years comes from the success of their platform. With a strong platform, many 2nd-tier game titles could support a strong growth.

<u>Rmb (Mn)</u>	<u>2008Q1</u>	<u>2007Q1</u>	<u>+/-</u>	<u>Growth Rate</u>	<u>Description and Growth Driver</u>
KingSoft	120.3	77.1	43.1	55.9%	Strong in R&D. New Title
Net Dragon	175.6	107.3	68.3	63.7%	Strong in R&D. Many new titles
Sohu	286.7	11.3	275.4	2432.8%	Power of hit game
Perfect World	303.2	87.2	216.0	247.8%	Strong in R&D. Many new titles
Tencent	391.0	142.1	248.9	175.2%	Strong in Platform. Many new titles
The 9	439.4	270.0	169.4	62.7%	Power of hit Game
Giant	471.6	317.2	154.4	48.7%	Strong in R&D
NetEase	555.1	466.0	89.1	19.1%	Strong in R&D. No new title
Shanda	779.8	532.3	247.5	46.5%	Strong in R&D. Good Platform. New titles
Total	3,402.3	1,933.4		76.0%	



Market Share of major gaming companies(08Q1)

Many Concerns No Longer Valid

Regulatory policy has little impact on the gaming sector and the regulatory environment is improving. Both the Internet Café policy and the Fatigue system proved to be failures. Besides, after years of lobbying, gaming industry governing authorities seem gradually to be adopting a more benign attitude towards online games. Every year, there will be a game fair organized by governmental authorities to promote domestic game companies and titles.

To an established gaming company with a diversified game portfolio, it is not so difficult to maintain decent growth through careful planning of new game introductions and efficient market promotions.

In many sectors, low entry barriers and intensified competition usually mean margin squeezes and shakeouts. However, the gaming sector is a little different. Pricing is never a key factor whether in a CSP model or a time-based subscription model. Intensified competition will bring no direct margin squeeze.

Server Counts for Major Titles and Newly Opened Testing

The 7 most popular games in China: Legend of Mir, Woool, WWJII, FWWJ, WoW, Tianlongbabu, ZhengTu,

Cross Fire, Tianxia2, Dungeon & Fighter, and The First Myth 2 begin open beta in Q2.

Operators	Game Title	Server Count	Operators	Game Title	Server Count
Shanda	Legend of Mir	219	Kingsoft	CQ Online	220
	Woool	285		Shui Hu Q Zhuan	132
	The Sign	24		The First Myth	124
	The Age	24		The First Myth 2	149
	Magic Land	60		JX Online	32
	Tales of Dragon	8		JX Online 2	186
	Cang Tian Online	4		Jian Xia Shi Jie	44
	Qian Nian 3	16		Xian Lv Qi Yuan 2	119
	Rainbow Island Online	36	Perfect world	Perfect world	78
	Feng Yun Online	59		Legend of Martial Arts	65
Netease	Westward Journey Onlin II	335		Zhu Xian	99
	Westward Journey Onlin 3	97		Chi Bi	38
	Fantasy Westward Journey	472		Hot Dance Party	6
	Da Tang Hao Xia	19	Net dragon	Monster & Me	9
	Tian Xia 2	22		Conquer Online	21
	Fly For Fun	16		Eudemons Online	483
The9	World of Warcraft	319		Zero Online	146
Tencent	Cross Fire	125		Tou Ming Zhuang Online	39
	Fantasy Online	26		Heroes of Might and Magic O	2
	QQ Sanguo	44		Happiness Q	3
	Dungeon-Fighter	25	Giant	Giant	37
Sohu	Tian Long Ba Bu	271		Zheng Tu	102

Source: CICC Research

Tencent, Buy, Target Price @ HK\$80.64

A huge sticky user base is the core value of Tencent. PCU for QQ reach 42mn, PCU for Game portal reached 4mn.

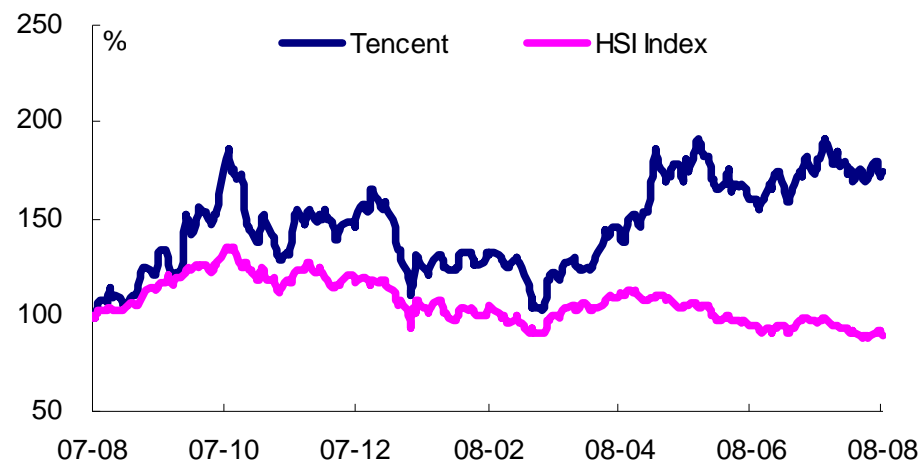
Very Strong performance by Crossfire, 125 servers, equal to a 500k PCU. Dungeon and Fighter, 25 servers, 100k PCU.

20% QoQ growth in Q2 and beat consensus for 10%. Strong growth outlook in 2nd half.

Risk 1 – quick expansion in headcount for gaming business, some pressure on costs.

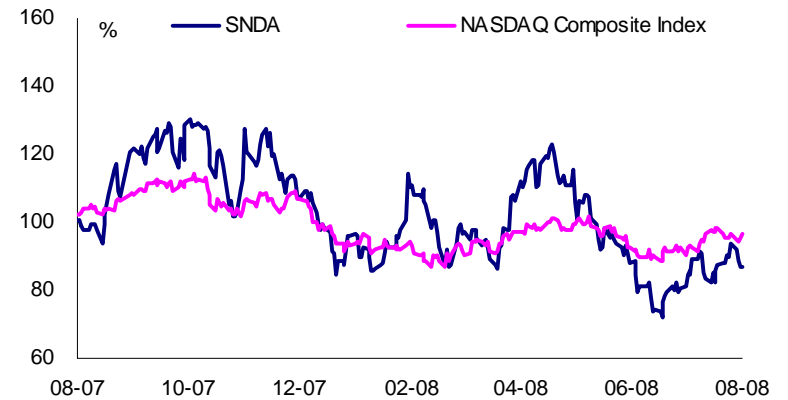
Risk 2 – Valuation comparatively richer than peers.

(Rmb mn)	2006A	2007A	2008E	2009E	2010E
Revenue	2,800	3,821	6,489	8,815	10,905
(+/-)	96%	36%	70%	36%	24%
Gross Profit	1,983	2,703	4,707	6,427	7,976
(+/-)	107%	36%	74%	37%	24%
Operating Profit	1163	1635	3157	4289	5357
(+/-)	140%	41%	93%	36%	25%
Net Profit	1064	1566	2619	3300	4115
(+/-)	119%	47%	67%	26%	25%
Diluted EPS (HK\$)	0.585	0.907	1.658	2.139	3.027
PE (x)	111.9	72.2	39.5	30.6	21.6



Shanda, Buy, Target Price @ US\$29.24

(Rmb mn)	2006	2007	2008E	2009E	2010E
Revenue	1,654	2,467	3,356	4,195	5,034
(+/-)	-13%	49%	36%	25%	20%
Gross Profit	965	1,664	2,379	2,974	3,569
(+/-)	-25%	72%	43%	25%	20%
Operating Profit	378	1,006	1,356	1,695	2,034
(+/-)	-39%	166%	35%	25%	20%
Net Profit	529	1,396	1,175	1,433	1,720
(+/-)	220%	164%	-16%	22%	20%
Net Income Attributable to Ordinary Shareholders	529	1,396	1,175	1,433	1,720
Diluted EPS (Rmb)	3.62	19.02	16.01	19.52	23.43
Diluted EPS (US\$)	0.46	2.61	2.44	3.13	3.75
PE (x)	57.3	10.2	10.9	8.5	7.1

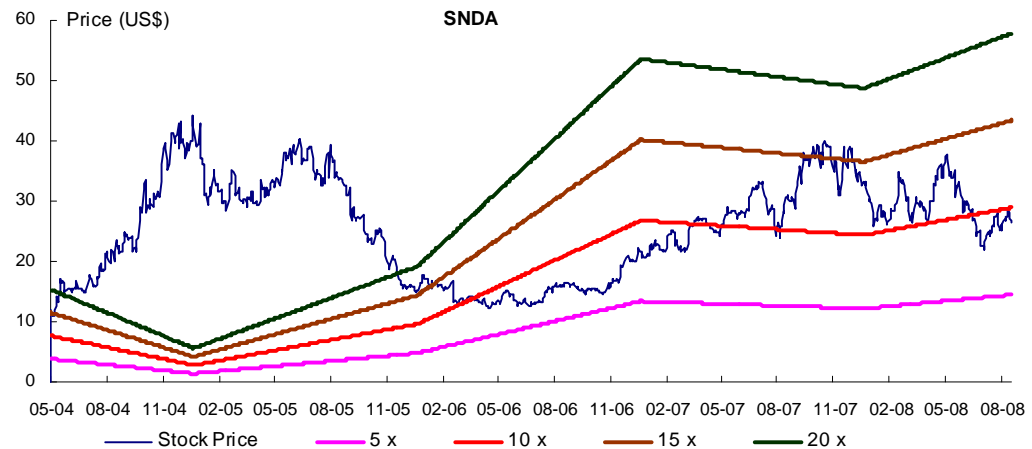


Leader in the industry

Strong pipeline and best content sourcing capability

2008 earnings decline is biased by investment gains. After adjustment, bottom line will grow 26%.

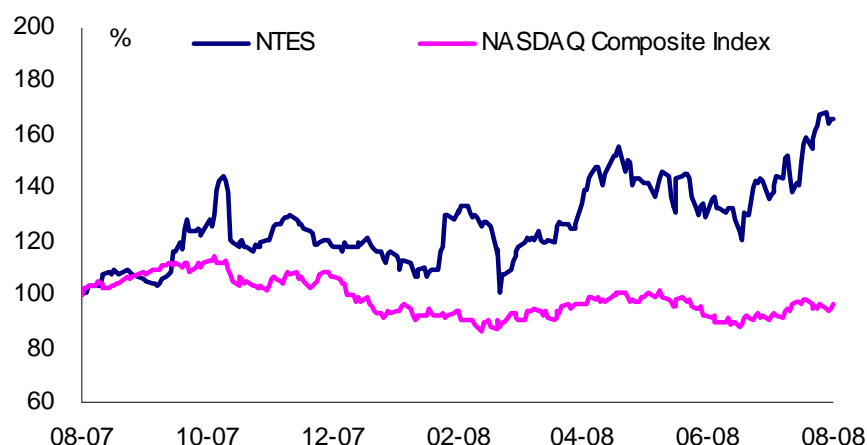
target price @ US\$29.24, 12x 2008 forward looking P/E.



Source: CICC Research

Netease, Accumulate, Target Price @ US\$22.60

(Rmb mn)	2006A	2007A	2008E	2009E	2010E
Net Revenue	2,164	2,213	3,014	3,525	4,567
(+/-)	34%	2%	36%	17%	30%
Gross Profit	1,783	1,798	2,486	2,762	3,358
(+/-)	33%	1%	38%	11%	22%
Operating Profit	1,280	1,206	1,841	1,997	2,380
(+/-)	31%	-6%	53%	8%	19%
Net Income	1,243	1,264	1,545	1,746	2,102
(+/-)	33%	2%	22%	13%	20%
Diluted EPS-ADS (Rmb)	8.88	9.55	11.92	13.47	16.22
Diluted EPS-ADS (US\$)	1.14	1.29	1.78	2.05	2.54
PE (x)	23.3	20.6	15.0	13.0	10.4



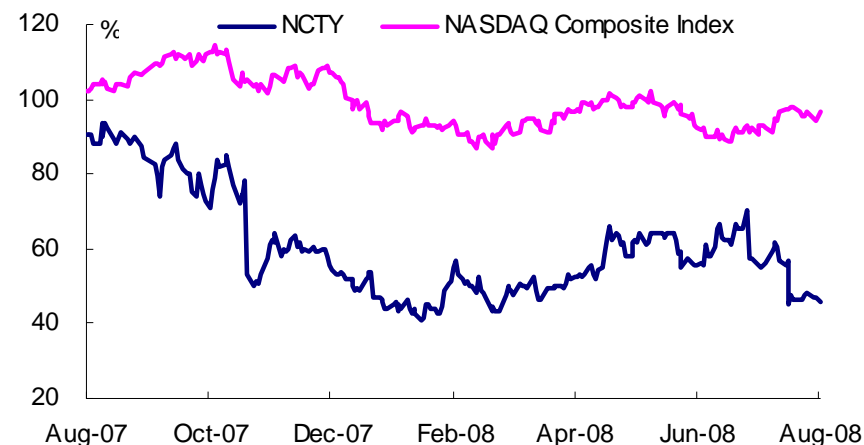
2 hit games FWWJ and WWJII remain healthy, providing the company with stable and considerable free cash flow and time to find new hits.

Performance by Tianxia II is not bad. TianXia II began Open beta in June, and the server count reached 22, representing around 100K PCU.

Cooperation with Blizzard could be something big.

The9, Hold, Target Price @ US\$25.24

(Rmb mn)	2006A	2007A	2008E	2009E
Net Revenue	986	1,280	1,857	2,197
(+/-)	112%	30%	45%	18%
Gross Profit	462	580	890	964
(+/-)	106%	26%	54%	8%
Operating Profit	270	236	431	485
(+/-)	352%	-13%	83%	13%
Net Profit	313	241	413	470
(+/-)	332%	-23%	71%	14%
Diluted EPS (Rmb)	11.02	8.72	14.93	16.99
Diluted EPS (US\$)	1.41	1.18	2.13	2.54
PE (x)	13.1	15.7	8.7	7.3



WoW contributed around 90% Revenue. However, the license agreement will expire in 2009. the terms for renewal could be very tough even if The9 manage to get it.

No new game can replace WoW and the license renewal has become crucial to the company's survival.

No need to take such a big risk.

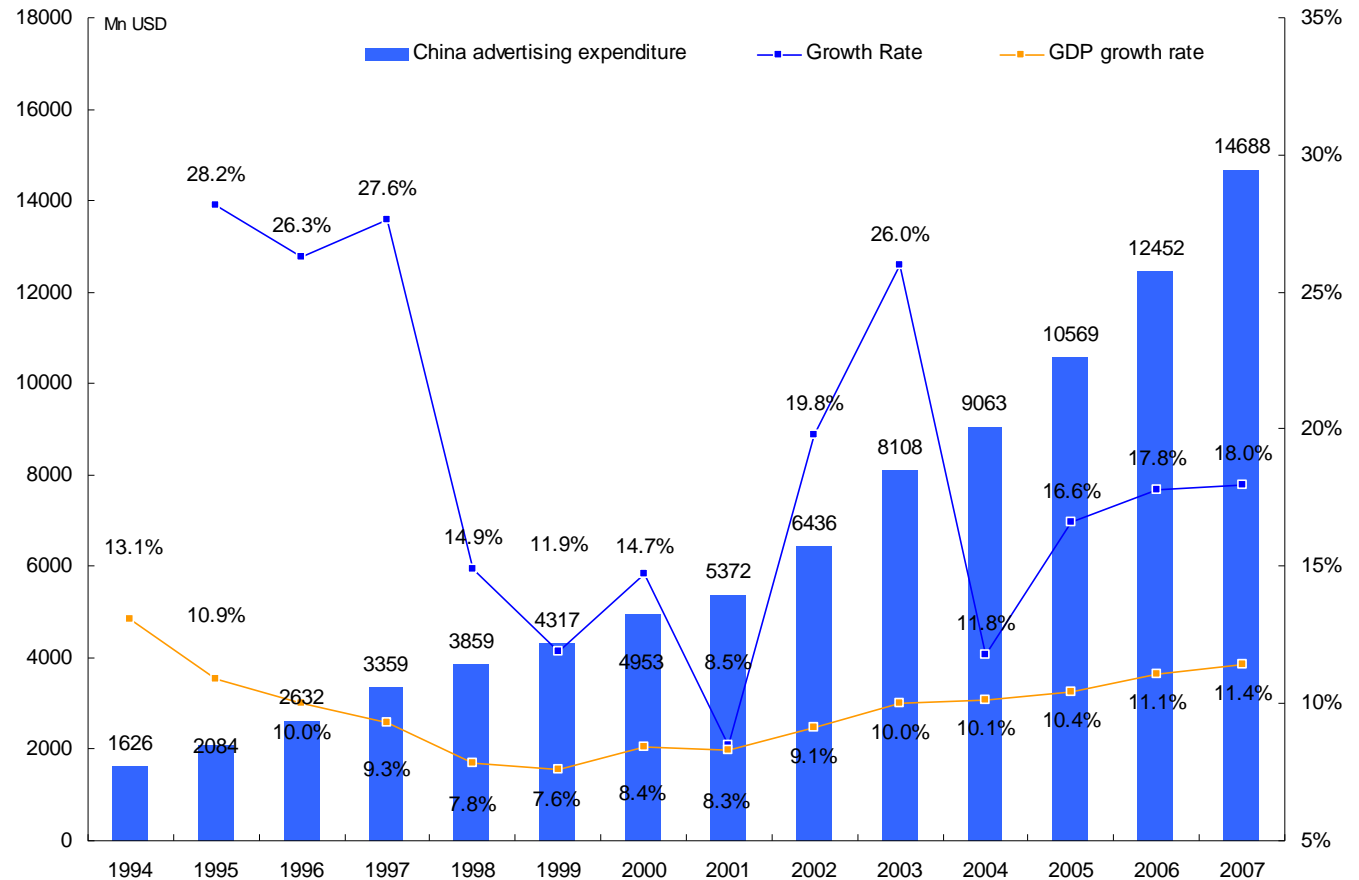
***Online Advertising: Gaining Market Share From
Traditional Media***

Higher than GDP Growth

Largest advertising market in Asia excluding Japan. CAGR around 18% in the last 14 years. Higher than GDP growth.

Very low per capita advertising expenditure at US\$8 in 2005, far below the world average at US\$82.2 (developed countries US\$300~500).

High long term growth potential. Short-term, strongly correlated with macro-economy.



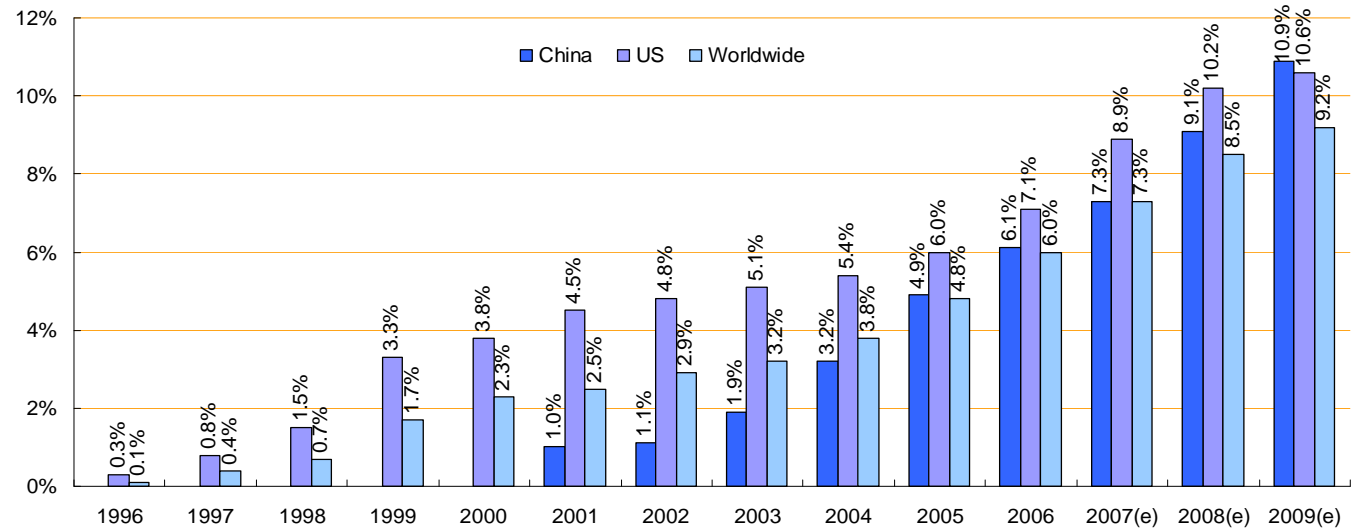
Source: CICC Research

Internet Advertising, More Defensive than Traditional Advertising

Internet advertising growing more strongly than traditional platforms such as TV and newspapers.

Internet advertising is one of the few platforms with nationwide coverage targeted at an above average population while the traditional media market is pretty fragmented.

Internet can target an audience more precisely.



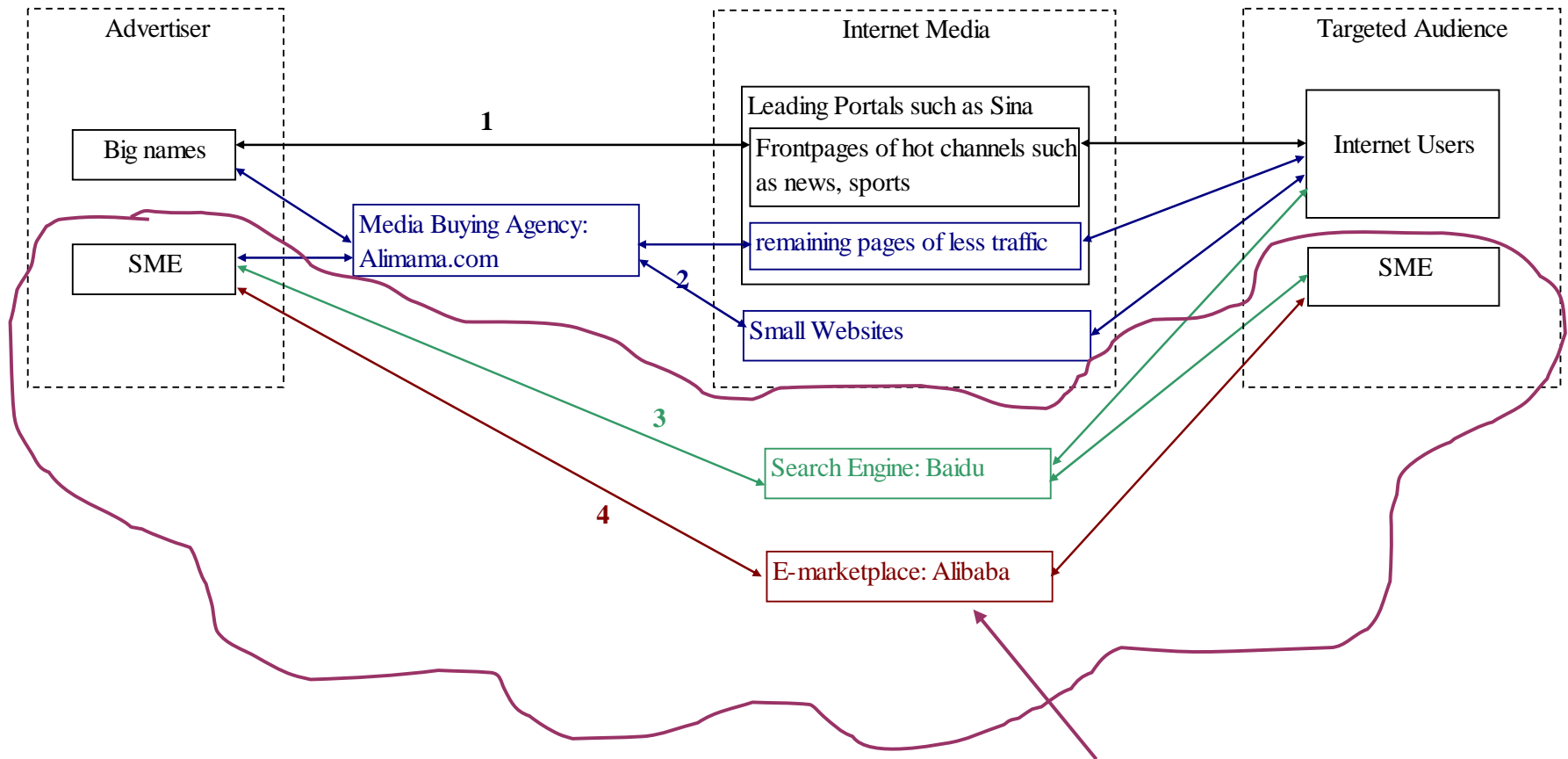
Leading attention-grabbing internet advertising methods

1. Relevant advertisements shown while searching a certain item
2. Relevant advertisements shown while visiting vertically-integrated websites for certain items
3. Marketing e-mails on interesting products
4. Relevant advertisements shown while browsing news
5. Pop-up of advertisements on similar items while linking to classified websites

Leading factors considered in posting internet advertisements

1. Focusing on specific user groups
2. Volume of user visits
3. Web contents relating to products promoted
4. Popularity of website
5. Evaluation of advertising effect provided by website

SME-related Companies may suffer first



As SME are much more vulnerable to economy slowdown, its seems SME related advertising are the same.

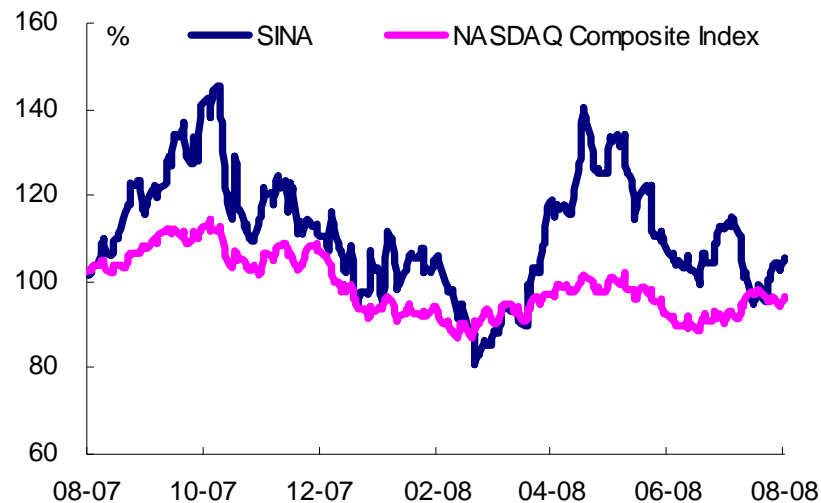
Sina, Buy, Target Price @ USD\$53.06

Impact of Economic slowdown less than expected due to Internet advertising efficiency.

Top line Spike in Q3 due to Olympic Games, but bottom line may just stay flat.

Long term value for its strong brand name in China.

(USD mn)	2006A	2007A	2008E	2009E	2010E
Revenue	213	246	366	470	573
(+/-)	10%	16%	49%	28%	22%
Gross Profit	133	151	222	290	358
(+/-)	2%	13%	47%	31%	23%
Operating Profit	35	51	80	106	133
(+/-)	-16%	46%	56%	33%	25%
Net Income	40	58	89	107	133
(+/-)	-7%	45%	54%	20%	25%
Diluted EPS (US\$)	0.68	0.96	1.48	1.77	2.16
PE (x)	62.5	44.1	28.7	24.0	19.6



Alibaba, Buy, Target Price @ HK\$17.12

International Marketplace suffers from the slowdown, low single digit growth but possibility for a QoQ decline is still slim.

China marketplace keeps pretty strong momentum so far, as domestic trading is still pretty healthy.

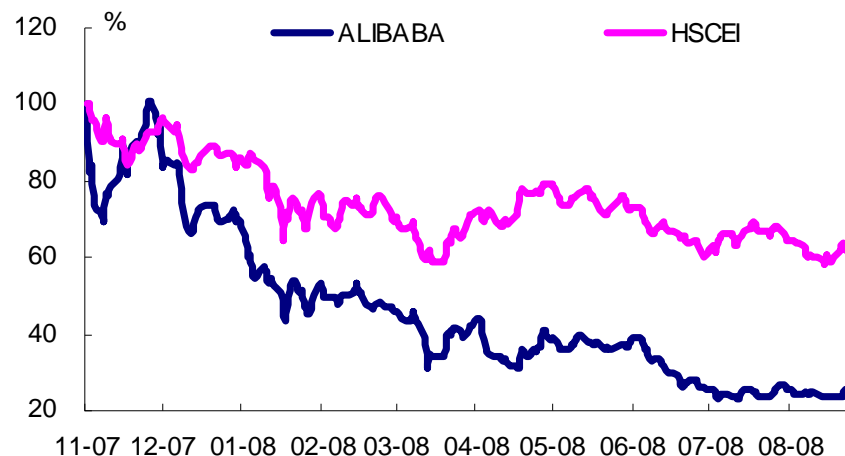
Huge deferred revenues smooth out the top line.

Valuation is much more realistic now.

Risk 1 - Expiration of lockup may put some pressure on Stock Price.

Risk2 – possible deterioration in economic environment

(Rmb mn)	2006A	2007A	2008E	2009E	2010E
Revenue	1,364	2,163	3,011	3,929	5,258
(+/-)	85%	59%	39%	30%	34%
Gross Profit	1,126	1,883	2,657	3,457	4,627
(+/-)	84%	67%	41%	30%	34%
Operating Profit	268	804	1,283	1,847	2,507
(+/-)	181%	200%	60%	44%	36%
Net Income	220	968	1,329	1,747	2,340
(+/-)	212%	340%	37%	31%	34%
Diluted EPS (HK\$)	0.05	0.21	0.31	0.41	0.58
Diluted EPS (HK\$)*	0.05	0.14	0.31	0.41	0.58
PE (x)	221.0	74.0	32.7	24.3	17.3



Baidu, Hold, Target Price @ USD\$297.28

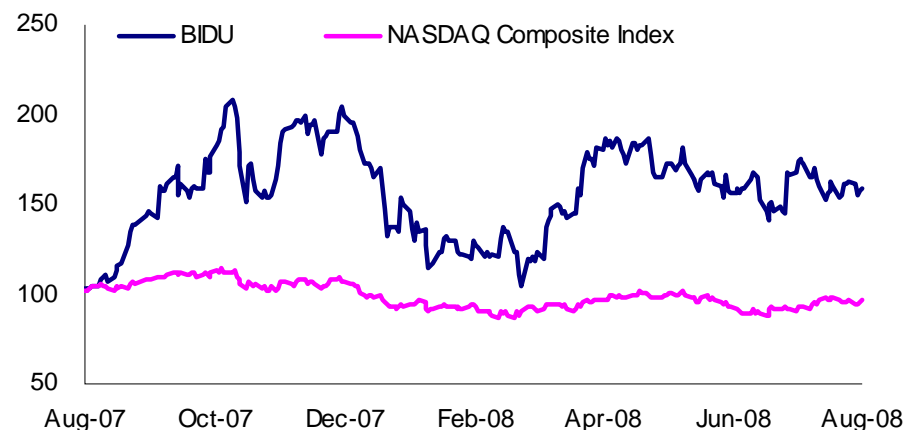
Good business model and strong leadership.

Increasing pressure from competitors like Google.

Lost lawsuit with Shanghai company. More lawsuits waiting.

Rich Valuation.

<i>(Rmb mn)</i>	2006A	2007A	2008E	2009E	2010E
Net Revenue	786	1,636	3,147	5,078	7,311
(+/-)	163%	108%	92%	61%	44%
Gross Profit	594	1,101	2,090	3,373	4,816
(+/-)	175%	85%	90%	61%	43%
Operating Profit	263	547	1,043	1,734	2,465
(+/-)	633%	108%	91%	66%	42%
Net Profit	302	629	1,054	1,690	2,412
(+/-)	534%	108%	68%	60%	43%
Diluted EPS (Rmb)	8.72	18.11	30.29	48.56	69.30
Diluted EPS (US\$)	1.12	2.45	4.61	7.78	11.11
PE (x)	283.4	129.3	68.7	40.7	28.5



Ctrip, Hold, Target Price @ US\$44.92

Short-Term - Negative

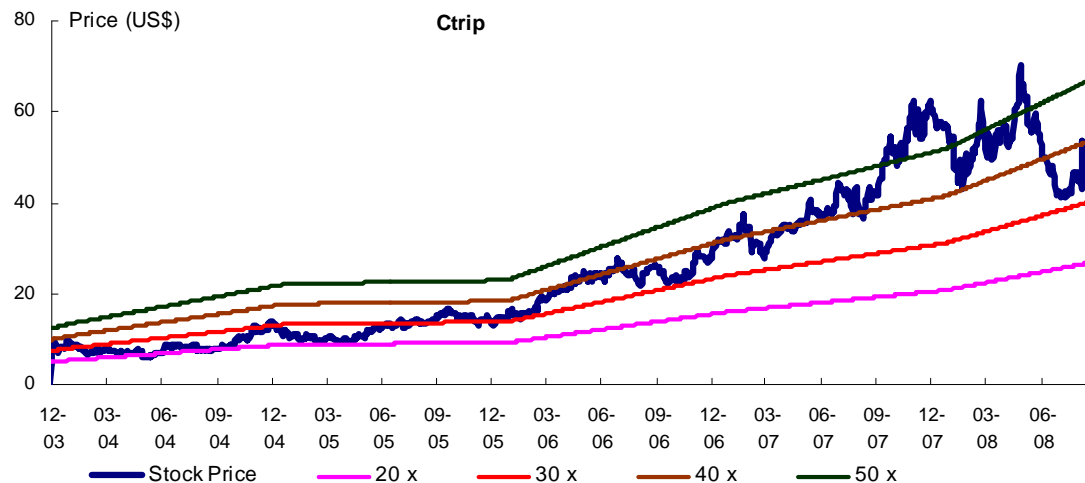
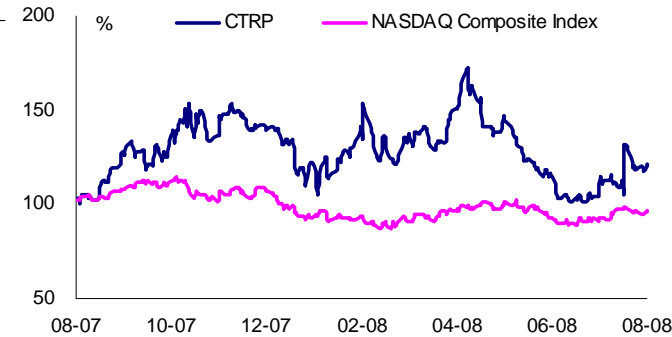
- Q2 - Earthquake in Sichuan
- Q3- Olympics
- Economic environment

Long-term - Positive

Investment thesis unchanged: leading consolidator in the fragmented Chinese travel industry

Target Price @ US\$ 44.92, representing 40x 2008 forward looking P/E.

(Rmb mn)	2006A	2007A	2008E	2009E	2010E
Revenue	780	1,199	1,765	2,510	3,375
(+/-)	50%	54%	47%	42%	34%
Gross Profit	627	963	1,394	1,983	2,666
(+/-)	45%	54%	45%	42%	34%
Operating Profit	255	404	591	866	1,147
(+/-)	16%	58%	46%	46%	33%
Net Profit	241	398	502	695	915
(+/-)	7%	66%	26%	38%	32%
Diluted EPS per ADS (Rmb)	3.59	5.83	7.26	10.05	13.23
Diluted EPS per ADS (US\$)	0.46	0.79	1.08	1.53	2.08
PE (x)	106.9	62.4	45.4	32.1	23.7



Source: CICC Research