

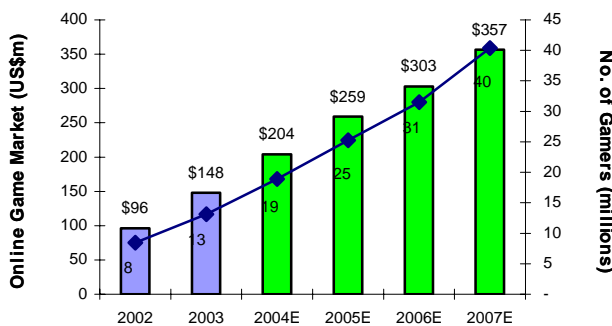
Online Games – China’s First Mass Market Interactive Entertainment Media

Overview

Online gaming is China’s first truly mass market interactive form of entertainment. In 2003, this market attracted an estimated 13 million players with total revenues that exceeded movie box office ticket sales in China. Although China’s online game industry is still in its infancy, a uniquely Chinese business model has emerged that has adapted to rampant software piracy and addresses payment collection issues. The conditions are ripe for this industry to become one of China’s fastest growing market sectors in the next few years.

proportion of broadband users as a percentage of total Internet users is forecasted to rise rapidly, improving access by potential Chinese gamers. Broadband costs are also decreasing rapidly, making online games even more affordable.

China Online Game Market



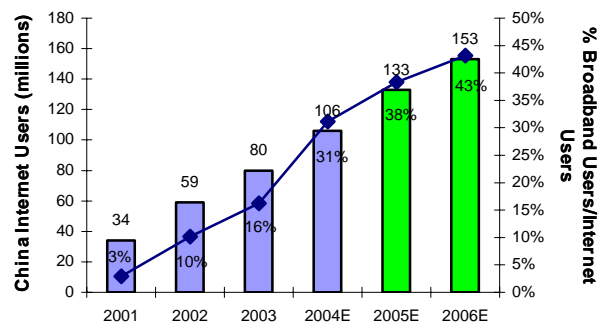
Source: IDC

Key Growth Drivers

Such phenomenal growth is driven by a number of factors:

- **Underdeveloped entertainment industry:** The PRC media and entertainment industry has been strictly controlled by the government. Compared with traditional media, such as television, film and print, the Internet has been able to operate with relatively minimal government intervention.
- **Fast growth in Internet users and broadband penetration:** China already has the second largest Internet user base in the world and the number of Internet users is predicted to almost double by 2006. Moreover, the

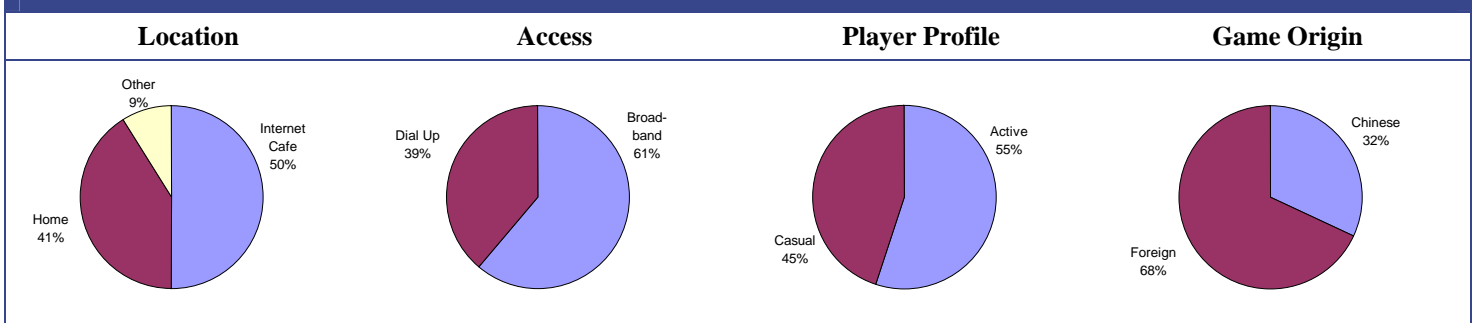
China Internet Users and Broadband Penetration



Source: CNNIC

- **Favorable government policies:** The PRC government is actively promoting the development of China’s online games sector and has adopted policy initiatives such as including online gaming in China’s flagship project to enhance technology R&D and adding “E-Athletics” (online sports games) to the government’s overall sports program.
- **Affordability:** Gamers in China pay on average only RMB0.40 (US\$0.05) per hour to be logged onto online game operators’ servers. This fee, combined with Internet access charges, remains relatively affordable to average Chinese players.

China Online Games Market Profile



Source: 17173.com

Market Characteristics

China's online game market, in comparison with markets in developed countries such as the U.S., displays a number of unique characteristics:

- **Simpler game content/shorter product life cycle:** Games in the China market are generally less graphic intensive and less complex in terms of functionality than U.S. games, resulting in a relatively shorter average product life cycle of around two years. This is due to the following factors:
 - A sizable proportion of Chinese gamers still access the Internet via dial-up connections and older computers with slower processors. As a result, Chinese game developers have to balance developing sophisticated graphics and game play with bandwidth and other technical constraints faced by many customers.
 - Moreover, Chinese online gamers are roughly evenly split between active players (mostly students who play on average more than 12 times a month) and casual players (mostly young professionals with jobs). As the total number of gamers increases in China, the proportion of casual players is expected to grow. These casual players are generally unwilling or unable to spend long hours playing a very complex game and prefer new titles instead of additional new features of existing games.
- **Stronger sense of community:** Chinese gamers view online games as a sociable form of mass entertainment. Many visit Internet cafes with friends to play games on broadband the way Americans go to movies with friends. In addition, Chinese gamers prefer role-playing games, where they and their friends can play together as a team while adopting different online personalities. As a result, almost all games on the China market feature built-in chat functions that allow gamers to chat with their friends and other players.
- **Market evolving from foreign games to domestic games:** Foreign games, especially those licensed from Korean developers, currently account for approximately 70% of the market. This is due to the relative inexperience of local companies in the area of product development. Korean games are also more popular with Chinese gamers compared to those from Europe and the U.S. because of the cultural similarity between Korea and China. In order to move up the value chain and capture a greater portion of game revenue, a few major local players, such as Shanda and Netease, have developed strong in-house product development capability and launched a few successful locally developed games. Domestic games are expected to capture a larger share of the market in the future.

Major Online Game Titles in China



China's two most popular multi-player online games each attract between 300,000 to 400,000 concurrent users

Evolving Business Models

Driven by software piracy, affordability and lack of sophisticated collection methods, a unique and profitable business model has emerged in China's online game industry:

- **Game software distributed free of charge:** Unlike U.S. companies that charge for game software, PRC online game companies distribute software free of charge to their users. The habit of Chinese users illegally copying software and distributing it to their friends actually facilitates the efforts of Chinese game service providers ("GSPs") to widely distribute their games and create brand awareness. To play a game, a gamer must log onto the GSP's server. Chinese GSPs charge a fee based on the amount of time a gamer is connected to the server and rely on these recurring subscription fees for revenue, rather than one-time charges for software.
- **Payment through prepaid cards:** Due to low penetration of credit cards, prepaid cards for playing time are now the main form of payment and sold through a network of retail stores, Internet cafes, newsstands and other outlets. Prepaid cards eliminate collection issues and improve cash flow.
- **New games versus game enhancements:** Unlike U.S. companies that regularly enhance the features and functionality of existing game titles, Chinese GSPs continuously launch new titles to retain and attract gamers. This is due to the fact that casual gamers are similar to moviegoers in that they prefer different genres and stories rather than the same plot sequence.
- **Time billing versus monthly subscription:** Unlike U.S. gamers that pay a monthly subscription fee for unlimited play, Chinese GSPs bill gamers on the actual amount of time gamers are logged on to the servers of GSPs. Time billing gives casual players more flexibility in trying out a number of different games.
- **Licensed versus self-developed games:** The China market is still dominated by games licensed from Korean developers. Chinese GSPs typically pay an upfront license fee ranging from US\$300,000 to US\$1.5 million as well as 30-50% of the recurring revenue stream. As Chinese game developers gain experience, Chinese GSPs are now shifting to producing their own games for the following reasons:

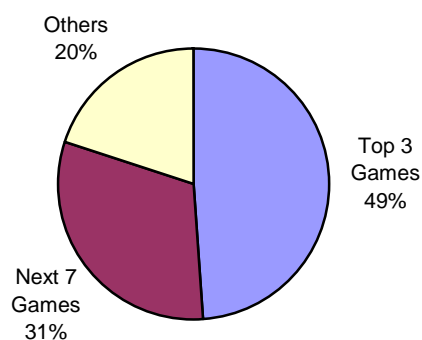
China Online Games Sector Review

- The cost of game development in China is at least 50% cheaper than in Korea or the U.S. (approximately US\$1.8-2.5 million per title versus US\$5-10 million per title).
- A significant part of game development cost lies in debugging software. Chinese game developers use extensive public beta trials as part of new game launches to help reduce testing costs as well as generate market interest in their new games.
- As a result, GSPs running self-developed games can usually break-even after attracting 20,000 concurrent users, compared with at least 25,000 for licensed titles.
- **Expanded revenue streams:** GSPs in China are also actively exploring new ways to generate additional revenue streams, such as advertising, merchandising, auction or sale of game-related goods and licensing of titles to traditional media.

Industry Dynamics

There are currently more than 200 GSPs in the China market. However, the market is concentrated around top games and GSPs. Since the market is still in the early stage of development, the position of established players is by no means entrenched and new entrants could challenge more established GSPs for market share.

Market Concentration of Online Games



Source: Niko Partners

Segmentation

In view of the market's compelling growth potential, online game developers and GSPs are eager to attract investment and expand vertically and horizontally:

- **Game/Software Developers:** These companies have extensive experience in game development and through the GSP sector are expanding their own online platforms and consolidating their distribution networks. Prime examples include:
 - **Shanda:** Shanda was one of the first game developers in China to license a popular Korean game and localize it for the China market. "The Legend of Mir" helped catapult Shanda to become China's leading online game operator. The company received US\$40 million funding from Softbank in March 2003.
 - **The9.com:** A joint venture with Webzen, a Korean game developer, the company operates MU, one of the 10 most popular Chinese online games. It is currently China's second largest GSP.
 - **Kingsoft:** Kingsoft started as an application software company in 1988 and entered the GSP market with its self-developed game "Swordman Online" in September 2003, which now ranks among the top 10 games in China. Legend, China's largest computer company, owns a 30% interest in the company.
- **Portals:** China's major portals have extensive experience in managing online platforms and possess sizeable user bases. They entered the online game market by launching licensed or self-developed games on their existing online platforms. Almost 40% of Netease's revenue is currently derived from online gaming. The other portals are trying to acquire, license or form joint ventures with game developers to enter the market:
 - **Chinadotcom:** In February 2004, the company acquired 17game.com, a leading GSP.
 - **Sina:** Sina formed a joint venture with NCSOFT, the Korean game developer, in January 2003 to exclusively distribute the latter's "Lineage I and II" in China.
 - **Sohu:** After the failure of "Knight Online", the Korean game it licensed in 2003, Sohu acquired 17173.com, a leading Chinese game portal, and is currently developing the online version of the popular PC game "Blade Online".
 - **Tom Online:** Tom launched its first online game "Thunderbolt Squad" in November 2003, which is licensed from DragonFly, a Korean developer.
- **Software Distributors:** With control over the vital distribution network, software distributors may opt to move up the value chain and into game development and operation. Companies in this sector include:
 - **Kinghope:** Kinghope is China's second largest software retail chain with 16 regional sales offices across the country. The company distributes to 18,000 nationwide outlets through 400 chain stores either operated directly or by franchisees throughout the country. The company used to be one of Shanda's principal distributors of prepaid cards.
 - **Junnet Group:** Junnet currently has 12 sales companies, serving some 15,000 retail outlets across China. It is distributing prepaid cards for GSPs such as The9.com, but has a well-recognized brand in China to market its own game products.

- **Mobile Gaming Companies:** With over 260 million mobile subscribers in China, all major GSPs and developers have set up mobile gaming divisions. As the mobile device and PC markets converge, some of the mobile game companies to watch include:
 - **BBMF:** BBMF is a Nanjing-based mobile game development company with a library of mobile games. BBMF has an exclusive distribution agreement with Tencent, China's premier wireless data service provider and one of China's top 10 GSPs.
 - **5Wan.com:** 5Wan.com is a Beijing-based wireless data service company. The company provides a series of mobile games across the Java, WAP, SMS, GPRS and MPEG4 platforms.
 - **Kongzhong.com:** Kongzhong.com is a Beijing-based wireless data service company. The company provides a series of mobile games across the Java, WAP and SMS platforms.
 - **Magus Soft:** A Beijing-based mobile game developer, with a broad game portfolio across the SMS, WAP, J2ME and Brew platforms. The company now serves both China Mobile and China Unicom.
 - **MIG:** A Beijing-based publisher of entertainment services for mobile subscribers, including mobile games based on Brew and Java platforms. The company supplies to both China Mobile and China Unicom and is the winner of the Brew 2003 prize for best game awarded by China Unicom.

Summary

We believe that China's online games market is analogous to the movie industry: game developers instead of screenwriters; game distributors instead of movie producers; and Internet cafes instead of movie theaters. Just as there are thousands of screenplays being written at any given time, there will be

hundreds of games in development. In each case, only a fraction get to "theatrical" release and of those only a handful hit box office gold.




Nevertheless, the rewards are lucrative enough to keep attracting new entrants into the industry. The biggest GSPs, just like the Hollywood studios, try to cater to the broadest tastes while niche players produce lower budget, specialized content for specific tastes. Both business models can be profitable. As the movie, television, video and cable markets have converged, so too will the online and mobile "infotainment" sector. In that context, a few broad observations can be made about China's online games market:

- **Ascendancy of Chinese Games:** Although the China market is currently dominated by foreign games, domestic companies, with increasing R&D investment, better understanding of local gamers' tastes and favorable government policies, are expected to increase their market share.
- **Game Development Outsourcing:** Due to China's low cost base and abundant local talent, international software companies have been moving their R&D activities to China. We believe that international game development companies are likely to follow that example and outsource part of their R&D work to China.
- **Export Potential of Chinese Games:** As Chinese game development companies build up their operations, they are likely to emulate their current Korean partners and export their products internationally.

Selected Chinese Online Game/Mobile Game Operators

Company Name	Main Game Titles	Game Categories	Game Development	Comments
 亚联游戏 Asiagame.com	Thousand Years The Red Moon Hellbreath – The Crusade The Worms	MMORPG MMORPG MMORPG Strategy	Licensed from Actoz Soft Licensed from Eden Licensed from Siementech Licensed from Titus	- Affiliate of OurGame and a subsidiary of China's Searainbow
 Bbmf	Mobile games on JAVA and BREW platforms, WAP and SMS games	Casual	Self or co-development	- Nanjing-based mobile game development company - Exclusive distribution agreement with Tencent
Beijing Oriental Interactive	A3	MMORPG	Developed by Actoz Soft	- Joint venture between China's Searainbow and Korean game developer Actoz Soft
CIMO	The Repent Online SilkRoad	MMORPG MMORPG	Licensed from Mgame Co-developed with Mgame	- The online game subsidiary of Sinohome, a network solutions company
 5wan 我玩网	A series of mobile games across the Java, WAP, SMS, GPRS and MPEG4 platforms	Casual		- A Beijing-based wireless data services company
 gamania	Jushang	MMORPG	Licensed from Joyon	- A Taiwan-based GSP, operating in Greater China
Happy Digital	With Your Destiny	MMORPG	Developed by HanbitSoft	- Joint venture between Sichuan Telecom and Korean game developer HanbitSoft - Received US\$2.4 million from New Margin, Motorola, Uni-President and Alcatel
 LVP	Crossgate (top 10 game) Xuanyuan Jian Online	MMORPG MMORPG	Developed by Enix/Square Developed by Softstar	- Joint venture between Japanese game developer Enix/Square and Taiwan game developer Softstar
 KINGSOFT 金山软件股份公司	Swordman online (top 10 game)	MMORPG	Self-developed	- A Chinese software development company, products including business application software
 空中网 手机·娱乐·生活	A series of mobile games across the Java, WAP and SMS platforms	Casual	Self and co-development	- A Beijing-based wireless data service company
Magus Soft	A broad game portfolio across all genres on the SMS, WAP, J2ME and Brew platforms	Casual	Self-developed	- A Beijing-based mobile game developer for China Mobile and China Unicom
 米格	A broad game portfolio based on Brew and Java platforms	Casual	Licensed	- A Beijing-based mobile game publisher for China Mobile and China Unicom
NCSOFT Sina	Lineage I/II	MMORPG	Developed by NCSOFT	- Joint venture between Sina and NCSOFT of Korea
NHN China	A series of casual games		Developed by NHN	- Joint venture between PCCW, a HK telecom carrier, and Korean game developer NHN
 object SOFTWARE	Prince of Qin	MMORPG	Self-developed	- A Chinese PC game software development company
 光通信 OPTIS	Legend of Mir III (top 10 game)	MMORPG	Licensed from NCSOFT	- A telecom/IT service provider based in Guangzhou, China
 联众世界 OurGame.com	More than 30 types of chess and board games	Casual game	Self-developed	- China's premier casual game operator - 79% owned by China's Searainbow
 SHANDA 盛大网络	Legend of Mir II (Top 10 game) The World of Legend (Top 10 game) The Sign The Age BNB (Top 10 game)	MMORPG MMORPG MMORPG Casual game	Licensed from Actoz Soft Self-developed Self-developed Self-developed Licensed from Nexon	- Leading Chinese online game operator - Strong in-house R&D capability - Softbank invested US\$ 40 million in March 03
 智冠电子(北京)有限公司 Softworld	Ragnorok Online (top 10 game)	MMORPG	Self-developed	- Taiwan game developer

Selected Chinese Online Game/Mobile Game Operators

Company Name	Main Game Titles	Game Categories	Game Development	Comments
TD Digital	Monster & Me Conquest	Casual MMORPG	Self-development Self-development	- Fuzhou-based game development company, a subsidiary of Netdragon, a network solutions company
	Portfolio of online and mobile games	Casual	Licensed	- Leading wireless data service provider in China with approximately 234 million subscribers
	MU (Top 10 game)	MMORPG	Developed by Webzen	- Chinese online game operator - Joint venture with Korean game developer Webzen
	Stone Age	MMORPG	Self-developed	- Taiwan game developer - Pioneer in marketing pre-paid cards to unlock a surprise in the game

Latitude Market Perspectives is a series of research reports on recent developments in the industry sectors covered by Latitude Capital Group. This report is published for clients and business associates of Latitude Capital Group.

Latitude Capital Group is an Asian merchant banking firm focused on serving middle market and emerging growth companies. We provide a broad range of advisory services as well as private equity capital to help build Asia's next generation of industry leaders. Latitude Capital Group is headquartered in Hong Kong with an office in Beijing, providing local coverage of our core market – Greater China.

The information and statistical data herein has been obtained from sources we believe to be reliable but in no way are warranted by us as to accuracy or completeness. We do not undertake to advise you as to any change of our views. This is not a solicitation or any offer to buy or sell. Latitude Capital Group (“Latitude”) has produced this report for private circulation only. All information and advice is given in good faith but without any warranty. Latitude, our affiliates or companies or individuals connected with Latitude, may have used the information set forth herein before publication and may have positions in, may from time to time purchase or sell, or may be materially interested in any of the securities mentioned or related securities.