

Clear strategy, best-in-class niche player; Buy

Initiate with Buy; Positive momentum, moderate upside

We initiate with a Buy on Perfect World. Our PO of US\$30 is based on forward 12-month EPS of US\$1.74 and a forward P/E of 17, at a 5% premium to the historical industry P/E average of 16 due to its good pipeline and a brand in 3D games. DCF, as a check, suggests a fair value of US\$25.

We see all existing games of Perfect World carrying positive momentum into 1Q08 with the flagship game, Zhuxian, continuing to achieve strong user growth. We expect it to beat consensus revenue estimate of RMB268m by 9%. Although we use a 25% tax rate for 1H08, we expect the government to approve its high-tech status before end-2008, resulting in a full-year tax rate of around 7%.

Efficient product development cycle to support land grasp

Perfect World emphasizes on quick development of games not only to control costs but also to produce games with different backgrounds to increase presence in niche segments ahead of competition. Its games are based on the same development platform, but feature different stories: martial arts, fantasy, history, ancient myth, etc. While sophisticated gamers may be skeptical about such game variants, the recent launches have found new users, the key growth driver.

Exports positive for margins; Testing the US market

Perfect World takes a low-risk approach in its export business by licensing its games to overseas partners. With an estimated gross margin of over 90%, we see this side business raising overall operating margin by 1-2%. We also expect it to expand its footprint in the US for game operations and sourcing. Risks are rapid loss of users, regulation and competition from game consoles.

Estimates (Dec)

(CNY)	2006A	2007A	2008E	2009E	2010E
Net Income (Adjusted - mn)	(31)	360	720	880	982
EPS	(1.02)	6.75	12.19	14.84	16.49
EPS Change (YoY)	-3.4%	NM	80.5%	21.8%	11.2%
Dividend / Share	0	0	0	0	0
Free Cash Flow / Share	1.84	10.20	(0.492)	15.34	17.41

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E	NM	26.91x	14.38x	11.81x	10.62x
Dividend Yield	0%	0%	0%	0%	0%
EV / EBITDA*	NM	23.36x	11.05x	8.81x	7.40x
Free Cash Flow Yield*	0.565%	4.33%	-0.281%	8.79%	10.01%

* For full definitions of *iQmethod*SM measures, see page 18.

Equity | China | Internet/e-Commerce
26 March 2008



Merrill Lynch

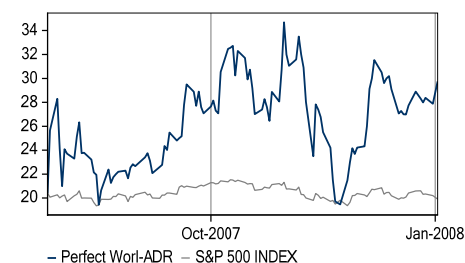
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Stock Data

Price	US\$24.87
Price Objective	US\$30.00
Date Established	26-Mar-2008
Investment Opinion	C-1-9
Volatility Risk	HIGH
52-Week Range	US\$16.00-US\$37.00
Mrkt Val / Shares Out (mn)	US\$1,392 / 56.0
Average Daily Volume	450,840
ML Symbol / Exchange	PWRD / NAS
Bloomberg / Reuters	PWRD US / PWRD.OQ
ROE (2008E)	41.2%
Net Dbt to Eqty (Dec-2007A)	-107.6%
Est. 5-Yr EPS / DPS Growth	27.1% / NA
Free Float	100.0%



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Refer to important disclosures on page 19 to 20. Analyst Certification on page 17. Price Objective Basis/Risk on page 16.

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*iQprofile*SM Perfect World Co Ltd-ADR

Key Income Statement Data (Dec)

	2006A	2007A	2008E	2009E	2010E
(CNY Millions)					
Sales	99	689	1,346	1,745	2,025
Gross Profit	75	570	1,150	1,489	1,728
Sell General & Admin Expense	(46)	(159)	(310)	(421)	(470)
Operating Profit	(27)	350	706	861	1,018
Net Interest & Other Income	0	23	70	91	137
Associates	NA	NA	NA	NA	NA
Pretax Income	(28)	374	776	952	1,155
Tax (expense) / Benefit	0	(12)	(55)	(71)	(173)
Net Income (Adjusted)	(31)	360	720	880	982
Average Fully Diluted Shares Outstanding	30	53	59	59	60

Key Cash Flow Statement Data

Net Income (Reported)	(28)	362	720	880	982
Depreciation & Amortization	1	7	50	86	110
Change in Working Capital	55	153	77	17	11
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	39	15	0	0	0
Cash Flow from Operations	67	537	847	984	1,103
Capital Expenditure	(12)	(112)	(875)	(122)	(121)
(Acquisition) / Disposal of Investments	0	0	0	0	0
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(12)	(112)	(875)	(122)	(121)
Shares Issue / (Repurchase)	43	1,008	0	0	0
Cost of Dividends Paid	0	0	0	0	0
Cash Flow from Financing	43	1,008	0	0	0
Free Cash Flow	55	425	(28)	862	982
Net Debt	(101)	(1,496)	(1,468)	(2,330)	(3,312)
Change in Net Debt	(97)	(1,395)	28	(862)	(982)

Key Balance Sheet Data

Property, Plant & Equipment	11	107	932	968	979
Other Non-Current Assets	3	4	4	4	4
Trade Receivables	6	17	29	38	44
Cash & Equivalents	101	1,496	1,468	2,330	3,312
Other Current Assets	7	42	41	53	62
Total Assets	128	1,666	2,475	3,394	4,401
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	0	8	8	8	8
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	84	267	356	395	420
Total Liabilities	84	275	364	403	428
Total Equity	43	1,390	2,111	2,991	3,973
Total Equity & Liabilities	128	1,666	2,475	3,394	4,401

*iQmethod*SM - Bus Performance*

Return On Capital Employed	-142.6%	46.8%	39.9%	33.6%	28.2%
Return On Equity	-276.8%	50.2%	41.2%	34.5%	28.2%
Operating Margin	-27.6%	50.8%	52.5%	49.3%	50.3%
EBITDA Margin	-26.3%	51.9%	56.2%	54.3%	55.7%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	NM	1.5x	1.2x	1.1x	1.1x
Asset Replacement Ratio	8.9x	15.6x	17.6x	1.4x	1.1x
Tax Rate (Reported)	NM	3.1%	7.1%	7.5%	15.0%
Net Debt-to-Equity Ratio	-233.0%	-107.6%	-69.6%	-77.9%	-83.4%
Interest Cover	NA	NA	NA	NA	NA

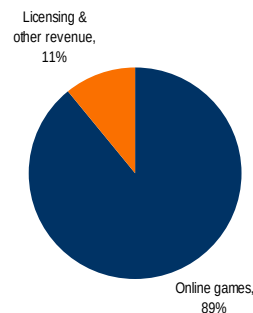
Key Metrics

* For full definitions of *iQmethod*SM measures, see page 18.

Company Description

Perfect World is a leading 3D games developer in China and listed in Nasdaq in July 2007. In 2007, it operates a number of popular MMORPG games in China including Perfect World, Perfect World II, Legend of Martial Arts, Zhu Xian & Chi Bi.

Chart 1: % of revenue breakdown in 4Q07



Source: Company and ML estimates

Stock Data

Price to Book Value 4.6x

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Bull & bear case

PWRD C-1-9	Bull case	Bear case	Merrill Lynch view
Internet user growth	- An increase of about 30m per year in 2008-2012E. - Significant drop in PC prices to below US\$200 and Internet access fees to about US\$6 per month	- Growth slows to about 10m per year in 2008-2012E - Economic slowdown limits Internet usage by non-adults, the key driver for Internet user growth (expected to add over 106m Internet users in next 10 years)	- An increase of about 20m per year in 2008-2012E - Penetration to rise to about 20% of population
Online gamer growth	- An increase of about 15m per year in 2008-2012E - Gamer penetration rises to 38% in 2012 as online games gain female and mature users	- An increase of about 5m per year in 2008-2012E - Gamer penetration remains relatively flat at 33% as online games fail to gain female and mature users	- An increase of about 10m per year in 2008-2012E - Gamer penetration rises to 36% in 2012 from 28% in 2007.
Government policy	- Content censorship relaxed - Tax benefits to support overseas expansion	- Stops offering tax benefits through high-tech status - Tighten up content censorship for all games instead of implementing a rating system.	- Offering tax benefits through high-tech status - Anti-fatigue system - To implement a rating system in 2008
Revenue growth	- One of the new games becomes a hit with over 300K peak concurrent users - Significant contribution (over 20% of total revenue) from casual games starting from 2009 - Success of overseas game operations	Growth drops below 20% due to faster-than-expected decline in existing games and unpopular new games	23% CAGR in 2008-10E - Zhuxian, a hit game, continues to achieve growth in 2009, and new games start to contribute
Margin	- Operating margins improve to over 55% - Higher-margin exported games obtain unexpected success - One of the new games becomes a major hit	Operating margins drop to below 50% due to a rapid increase in sales and marketing fees to support new launches	Operating margins to stay at about 52% due to economies of scale in cost of services to offset game launch costs and rising R&D headcount
Game portfolio & pipeline	- Launch of a new game engine to support the next generation of new games - Source games from local studios	- New games fail to attract users - Existing games decline quickly	- Continuous diversification as the company launches multiple games developed in-house - Existing games remain stable

Source: Merrill Lynch Research

Business analysis

Quick development cycle to support rapid penetration into new game segments

Perfect World emphasizes on software development efficiency through reusable software modules and a standard game development platform. It executes better than most peers, in our view. In particular, World 2, its major project, is a quality game that provides a solid foundation for future development and variations.

As a result, the company is able to come up with new games that are ready for commercialization as quickly as six to nine months with an R&D team that is not particularly large (Table 1). For comparison, other companies such as Shanda and Kingsoft would have their games developed on different software platforms adopted by different studios.

Table 1: Estimated R&D team of peers

	Game R&D staff (3Q07)	Commercialized inhouse MMORPGs
Perfect World	274	6
Kingsoft	550	4
Netdragon	309	7

Source: Company and Merrill Lynch

Perfect World has been able to launch games every three to six months and has announced four more MMORPGs in the pipeline (Table 2). This strategy not only provides cost efficiency, but also enables Perfect World to develop games rapidly with different story lines to attract different gamers. Since World 2, the company has launched 3D games based on the same software platform, but with different backgrounds: Chinese fantasy (Zhuxian), historical (ChiBi), martial arts (Legend of Martial Arts) and cutie style (Westward Journey).

Table 2: Estimated games portfolio and pipeline

Game name	Type	Developer	Stage	Launch	4Q2005	1Q2006	2Q2006	3Q2006	4Q2006	1Q2007	2Q2007	2H2007	1H2008	2H2008	2009
Perfect World	MMORPG, 3D	Perfect World (China)	Commercial	15/1/2006	Open beta										
Perfect World 2	MMORPG, 3D	Perfect World (China)	Commercial	15/11/2006		Open beta									
Chi Bi	MMORPG, 3D	Perfect World (China)	Open beta	Jan, 2008									Open beta		
Legend of Martial Arts	MMORPG, 3D	Perfect World (China)	Open beta	Sep, 2006				Open beta							
Perfect World 2 International	MMORPG, 3D	Perfect World (China)	Open beta	Jan, 2007						Open beta					
Zhuxian	MMORPG, 3D	Perfect World (China)	Open beta	28/5/2007							Open beta				
Hot Dance Party	Casual	Perfect World (China)	Closed beta	n/a									Open beta		
Casual 1	Casual	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
Casual 2	Casual	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
Casual 3	Casual	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
MMORPG 1	MMORPG, 3D	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
MMORPG 2	MMORPG, 3D	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
MMORPG 3	MMORPG, 3D	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
MMORPG 4	MMORPG, 3D	Perfect World (China)	Forthcoming/Development	n/a										Open beta	
Second World	Virtual Community, 3D	Perfect World (China)	Forthcoming/Development	n/a											Open beta

Source: Company and Merrill Lynch research

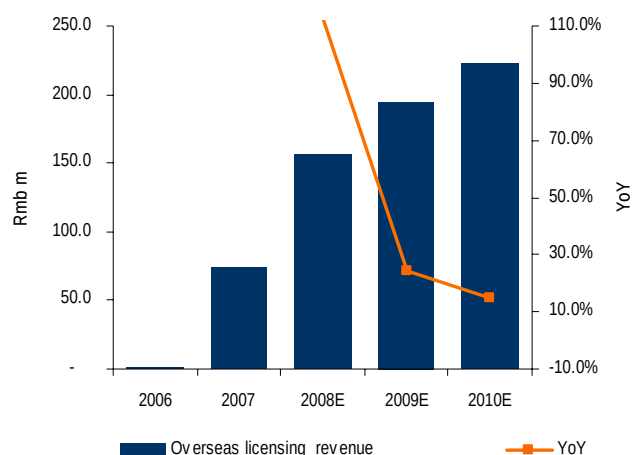
Although we believe such an approach would discourage some high-end sophisticated players who notice similarities between the various games, we also see the benefits of gaining new users rapidly. For Perfect World, which is relatively new to the industry and does not inherit a large old user base, focusing on gaining new users should provide better growth opportunities, in our opinion. On the other hand, long-time market leaders like Shanda should emphasize more on diversification of game style to retain old users who may have left / be about to leave their existing games.

We expect this approach to translate into fast revenue growth for Perfect World, estimated at 23% CAGR in 2008-10E, versus industry growth of 21% in the same period.

Game export to support margins

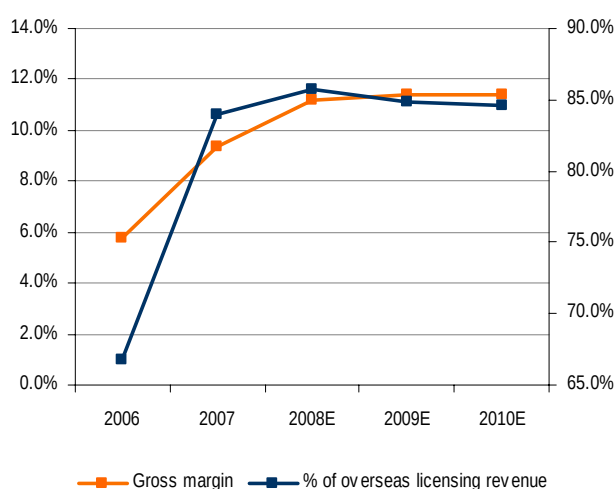
Unlike the top three game companies for which revenues from overseas markets would be insignificant relative to domestic revenues, the export business can be an attractive add-on to leading niche players such as Perfect World, Kingsoft and Netdragon. Perfect World began to have its in-house developed games run by overseas operators in Dec 06 and has 11% of total revenues in 4Q07 from this export business. It now has three games licensed to 13 areas outside of China. We see the overseas business achieving a 19% CAGR in 2008-10E and representing a stable 11% of total revenues. With an estimated gross margin of well over 90%, this export business helps support overall margins even as Perfect World spends to support frequent new launches in the domestic market.

Chart 2: Overseas licensing revenue – 2006-10E



Source: Company and Merrill Lynch estimates

Chart 3: Gross margin & % of overseas licensing revenue – 2006-10E



Source: Company and Merrill Lynch estimates

Perfect World, like Kingsoft, takes a low-risk approach in developing overseas markets through licensing to partners, while Netdragon operates its own foreign language versions in more important markets such as the US (in addition to a licensing approach). We believe Perfect World is learning the markets and is likely to set up its own operations in one or two major markets before 2010 to capture more upside. An obvious target is the US, which the company sees lower language barriers in and a break-even level of about 30K PCU.

Table 3: Overseas market of Perfect World

Licensing (launch date)	Perfect World 2	Legend of Martial Arts	Zhuxian
Taiwan	Dec-06	Dec-07	
Hong Kong	Dec-06	Dec-07	
Malaysia	Mar-07	Licensed	Licensed
Macau	Dec-06	Dec-07	
Japan	Mar-07	Dec-07	
Vietnam	Feb-07	Licensed	Licensed
Singapore	Mar-07	Licensed	Licensed
The Philippines	Jul/Aug-07		
Brazil	Licensed		
Thailand	Jan-08	Mar-08	Licensed
Korea	Oct-07		
Indonesia	Licensed		
Russia	Licensed		

Source: Merrill Lynch research

Table 4: Overseas business of peers

	No. of games operating in overseas market	No of areas/ languages	Overseas business started in	Quarterly revenues (3Q07 US\$m)	% of total revenue
Perfect World	3	13	Dec-06	16.4	7.7%
Kingsoft	6	7	Nov-04	16.9	11.5%
Netdragon	4	8	May-03	34.4	17.9%

Source: Company and Merrill Lynch research

Strong near-term momentum offers time for evolution

After the success of Zhuxian in 2H07, Perfect World is expected to carry strong momentum into 1Q08, thanks to – 1) sustained growth of 15% QoQ in Zhuxian revenues, which is supported by rising ARPU and paying accounts as the game is a hit with over 350K PCU; 2) Contribution from ChiBi, with an estimated number of users one-fourth that of Zhuxian; 3) Single-digit growth of other existing games; 4) Increase of 20% QoQ (or RMB5.7m) in overseas revenues, mainly from “Legend of Martial Arts” in Taiwan and Japan and from “World 2” in Korea.

The company plans to launch four casual games and four MMORPGs in the rest of 2008. We conservatively expect commercialization of only half of them in 2008 because of limitations in marketing and operations and the Beijing Olympics, which has pushed up advertising prices and competition for audience in summer.

To transform into a sustainable platform for long-term success, we believe Perfect World would need to strengthen – 1) its national coverage for more market share in lower-tier cities, 2) community features to build user loyalty, 3) R&D capabilities and 4) overseas operations. In particular, it would need to develop the next generation of MMORPGs that can offer new experiences to gamers familiar with its existing games, after picking the low-hanging fruit with quick launches.

We are cautiously optimistic given the strong execution capabilities of the company, but will watch market expectations closely as investors may be too carried away by strong near-term results and underestimate the necessary steps Perfect World has to take to rise to the next level.

Valuation

Good momentum with moderate upside; Initiate with Buy and PO of US\$30

We see all existing games carrying momentum into 1Q08 with the flagship game, Zhuxian, continuing to achieve strong user growth. We expect the company to beat consensus revenue estimate of RMB268m by 9%. Although we use a 25% tax rate for 1H08, we expect the government to approve the company's high-tech status before end-2008, resulting in a full-year tax rate of around 7%. We expect Perfect World to deliver EPS CAGR of 16% during 2008-10E. The company would have to increase its capex to over 870mn in 2008E from RMB112mn in 2007 due to the purchase of new office space.

We use P/E as the main valuation method and DCF, which reflects companies' operating cash flows and capex requirements, as a check. We use historical industry average forward 12-month P/E as the base and apply premiums or discounts according mainly to earnings momentum, business risks and sustainability of individual companies. We also keep an eye on any structural change in the industry which may imply the need for a shift of the reasonable trading range and the benchmark average.

We take reference to the historical P/E average to capture opportunities and risks brought by market overreaction to game hits and disappointments in this hit-driven business. We adopt the historical industry trading average of 16x in China as the benchmark, versus expected industry growth of 21% in 2008-10E and a gradual slowdown from a higher base.

We also compare our benchmark with the P/Es of other major Internet segments in China and the Korean game leader. As the online game industry is characterized by high margins but also pertained hit-related risks, we believe that lower industry P/E ratios relative to leaders in online advertising (22x to 51x) and e-commerce/ e-booking (21x to 51x) are justified. The leading Korean game company, NcSoft, was largely trading at 12-month forward P/E multiples ranged from 15x to 30x over the past 2 years. We note that the Korean online game market has gone through the consolidation stage and the remaining leaders like NcSoft should be trading at a premium to Chinese game companies. Given the upcoming consolidation in the Chinese online game history, we are reluctant to apply the Korean industry P/E at this stage.

When considering P/E premiums and discounts, we analyze factors that affect earnings momentum, business risks and particularly sustainability of individual companies. The last one is affected by 1) game pipeline; 2) platform strength including operating experiences, marketing and distribution; 3) game franchises and branding. In the case of Perfect World, we apply a 5% premium to the historical industry average P/E due to a good pipeline and a brand in 3D games.

Our PO of US\$30 is based on forward 12-month EPS of US\$1.74 and a target P/E of 17x, at a 5% premium to the historical industry forward P/E average of 16, due to the company's good pipeline and a brand in 3D games. We suggest a lower premium than that for a strong national platform.

We note that the normal trading range for leading game companies is 10-25x forward P/E in China and 16-27x in Korea. The latter market has gone through consolidation.

DCF, as a check, suggests a fair value of US\$25 on US\$3.4 cash per share, a discount rate of 12% and a terminal growth rate of 2%. We calculate the discount rate based on long-term risk free rate, historical equity risk premium of 4.8%, and historical beta as a proxy to capture stock volatility contribution to the market portfolio. We prefer to leave non-systematic risks to be reflected in financial forecasts, using sensitivity tests or expected averages if necessary.

Chart 4: PE band of Perfect World



Source: Merrill Lynch Research

Table 5: Perfect World valuation model

(RMBm)	FY01	FY02	FY03	FY04	FY05E	FY06E	FY07E	FY08E	FY09E	FY10E	FY11E	FY12E
Period from YTD					0	0	0	1	2	3	4	5
Net Revenue				0.00	0.00	99.41	689.12	1345.67	1744.81	2024.99	2328.74	2561.61
Cost of services				0.00	0.00	-24.60	-118.98	-195.80	-255.87	-297.30	-341.89	-376.08
Product development				-6.04	-15.15	-18.82	-52.46	-116.18	-187.94	-217.92	-250.61	-275.67
SG&A				-0.83	-14.41	-45.51	-159.21	-310.15	-420.87	-470.47	-541.04	-595.14
Amort of Goodwill & Intangibles				0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Stock Based Compensation				0.00	0.00	-37.93	-8.22	-17.60	-19.36	-21.29	-24.49	-26.94
Business Tax and Surcharges				0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Others				0.00	0.00	0.00	0.00	0.00	0.00	0.00	0	0
EBIT				-6.88	-29.56	-27.45	350.25	705.95	860.76	1018.01	1170.71	1287.78
Tax Rate				0.0%	0.0%	-0.7%	3.1%	7.1%	7.5%	15.0%	0.17	0.19
EBIT * (1-Tax Rate)				-6.88	-29.56	-27.65	339.38	655.51	796.20	865.31	995.11	1094.62
Depreciation				0.04	0.31	1.30	7.16	49.82	86.44	110.49	127.06	139.76
Working capital				-4.71	21.07	54.62	152.64	76.88	17.33	10.96	12.61	13.87
Capex				-0.64	-2.55	-11.58	-112.01	-874.69	-122.14	-121.50	-139.72	-153.70
Taxes				0.00	0.00	0.20	11.59	55.43	71.36	173.23	199.21	219.13
Free Cash Flow				-12.19	-10.73	16.69	387.18	-92.47	777.84	865.26	995.05	1094.55
FCF (US\$m)				-1.47	-1.33	2.14	51.41	-13.17	110.81	123.26	141.75	155.93
YoY					-10%	-261%	2305%	-126%	-941%	11%	15%	10%
Net Income				-6.81	-29.43	-27.95	361.95	720.42	880.15	981.62	1128.86	1241.75
Rf	4.2%											
Beta	1.6											
Market premium	4.8%											
Discount rate	12%											
PV of discounted cash flow (US\$m)								-11.77	88.53	88.02	90.47	88.95
Terminal growth rate												2.0%
Terminal value (US\$m)												1609.76
PV of terminal value (US\$m)												918.33
PV of all future cash flows (US\$m)	1,262.53											
Cash on hand (US\$m)	205.09											
Debt (US\$m)	-											
Equity value (US\$m)	1,467.61											
Outstanding shares	59.0											
Value per share (US\$)	24.86											

Source: Merrill Lynch research estimates, company data

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Table 6: Perfect World historical and forecast Profit and loss statement from 2006-2009

Unit: (RMBm)	2006A	1Q07A	2Q07A	3Q07A	4Q07A	2007A	1Q08F	2Q08F	3Q08F	4Q08F	2008F	2009F
Online games	98	77	112	197	230	616	259	284	306	339	1189	1551
Licensing & other revenue	1	11	18	16	28	73	34	37	42	43	156	194
Sales	99	87	130	214	258	689	293	321	349	383	1,346	1,745
Gross Profits	75	68	104	178	220	570	251	275	298	325	1,150	1,489
R&D Expense	19	7	11	13	22	52	21	24	31	40	116	188
SG&A Expense	46	19	38	46	56	159	64	72	66	107	310	421
Stock Comp	38	0	1	3	4	8	4	4	4	4	18	19
Operating Profits	-27	42	54	116	137	350	162	175	196	173	706	861
Net Non-Op Income	0	0	1	9	13	23	17	17	17	17	70	91
PBT	-28	42	55	126	150	374	179	192	214	191	776	952
Net Income	-28	40	52	123	146	362	134	144	188	254	720	880
Adjusted EPS (US\$)	-0.13	0.10	0.14	0.29	0.34	0.90	0.32	0.35	0.45	0.61	1.74	2.11
Margins												
Gross Margin	75.2%	78.0%	80.1%	83.4%	85.1%	82.7%	85.7%	85.7%	85.5%	85.0%	85.4%	85.3%
R&D Expense % of Sales	18.9%	7.7%	8.1%	6.2%	8.5%	7.6%	7.0%	7.5%	9.0%	10.5%	8.6%	10.8%
SG&A Expense % of Sales	45.8%	21.6%	29.1%	21.6%	21.8%	23.1%	22.0%	22.5%	19.0%	28.0%	23.0%	24.1%
Operating Margin	-27.6%	48.1%	42.0%	54.4%	53.2%	50.8%	55.2%	54.3%	56.3%	45.3%	52.5%	49.3%
Net Non-Op Margin	-0.3%	0.1%	0.6%	4.3%	5.1%	3.4%	6.0%	5.4%	5.0%	4.6%	5.2%	5.2%
PBT Margin	-27.9%	48.3%	42.6%	58.8%	58.2%	54.2%	61.2%	59.8%	61.3%	49.9%	57.7%	54.5%
Net Income Margin	-28.1%	45.9%	40.4%	57.7%	56.6%	52.5%	45.9%	44.8%	53.9%	66.3%	53.5%	50.4%

Source: Merrill Lynch estimates, company data

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Table 7: Perfect World balance sheet

(RMBm)	FY05	FY06	FY07	FY08E	FY09E	FY10E
ASSETS						
Cash and Cash Equivalent	4.27	101.36	1496.03	1468.46	2330.25	3311.82
Marketable Securities	0.00	0.00	0.00	0.00	0.00	0.00
Account Receivables	0.00	5.57	16.80	29.49	38.24	44.38
Prepayment	1.37	6.70	40.81	40.23	52.58	61.09
Inventory	0.00	0.00	0.00	0.00	0.00	0.00
Due from related parties, net	0.00	0.00	0.00	0.00	0.00	0.00
Other current assets	0.00	0.24	0.73	0.73	0.73	0.73
Total Current Assets	5.65	113.87	1554.37	1538.92	2421.80	3418.02
Net PP&E	2.84	10.58	107.33	932.20	967.89	978.90
Long Term Investment	0.00	0.34	1.59	1.59	1.59	1.59
Intangible Assets	0.00	2.74	1.72	1.72	1.72	1.72
Other LT Assets	0.00	0.00	0.73	0.73	0.73	0.73
Total LT Assets	2.84	13.66	111.37	936.24	971.93	982.95
Total Assets	8.49	127.53	1665.74	2475.16	3393.74	4400.97
LIABILITIES & EQUITY						
ST Borrowing + current port. of LT debt	12.00	0.00	0.00	0.00	0.00	0.00
Account Payable	1.56	6.75	23.46	18.43	23.90	27.74
Deferred Revenue	0.00	32.98	134.73	228.76	261.72	283.50
Others	16.18	44.31	109.22	109.22	109.22	109.22
Current Liabilities	29.74	84.03	267.42	356.42	394.85	420.46
Long Term Borrowing	0.00	0.00	0.00	0.00	0.00	0.00
Convertible Bond	0.00	0.00	0.00	0.00	0.00	0.00
Other Long Term Liabilities	0.00	0.00	7.95	7.95	7.95	7.95
Total Liabilities	29.74	84.03	275.37	364.37	402.79	428.41
Share capital	15.00	45.89	1124.39	1124.39	1124.39	1124.39
Retained Earnings	(36.25)	(64.35)	236.07	956.48	1836.63	2818.25
Other reserves	0.00	61.96	29.92	29.92	29.92	29.92
Shareholders Equity	(21.25)	43.50	1390.38	2110.79	2990.94	3972.56
Total Liabilities and Equities	8.49	127.53	1665.74	2475.16	3393.74	4400.97

Source: Merrill Lynch estimates, company data

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Table 8: Perfect World cashflow statement

(RMBm)	FY05	FY06	FY07	FY08E	FY09E	FY10E
Net Profit	(29.43)	(27.95)	361.95	720.42	880.15	981.62
Minority Interest and Misc Expense	0.00	0.00	0.00	0.00	0.00	0.00
Depreciation and Amortization	0.31	1.30	7.16	49.82	86.44	110.49
Investment Income	0.00	0.00	0.00	0.00	0.00	0.00
Fixed Asset Sales	0.00	0.00	0.00	0.00	0.00	0.00
Others	0.00	38.98	15.18	0.00	0.00	0.00
WC Change	21.07	54.62	152.64	76.88	17.33	10.96
Operation Cash Flow	(8.05)	66.95	536.93	847.12	983.92	1,103.07
CAPEX	(2.55)	(11.58)	(112.01)	(874.69)	(122.14)	(121.50)
Proceeds from disposal of Assets	0.00	0.00	0.00	0.00	0.00	0.00
Proceeds from disposal of investments	0.00	0.00	0.00	0.00	0.00	0.00
ST investments	0.00	0.00	0.00	0.00	0.00	0.00
LT investments	0.00	0.00	0.00	0.00	0.00	0.00
Others	0.00	0.00	0.00	0.00	0.00	0.00
Investment Cash Flow	(2.55)	(11.58)	(112.01)	(874.69)	(122.14)	(121.50)
ST financing	0.00	0.00	0.00	0.00	0.00	0.00
LT financing	0.00	0.00	0.00	0.00	0.00	0.00
Equity financing	0.00	54.51	1,008.23	0.00	0.00	0.00
Proceeds From Shareholder Notes	12.00	(12.00)	0.13	0.00	0.00	0.00
Cash Dividend	0.00	0.00	0.00	0.00	0.00	0.00
Director and employee bonus	0.00	0.00	0.00	0.00	0.00	0.00
Others	0.00	0.00	0.00	0.00	0.00	0.00
Financing Cash Flow	12.00	42.51	1,008.35	0.00	0.00	0.00

Source: Merrill Lynch estimates, company data

Company background

Perfect World is a leading 3D games developer in China and listed on the Nasdaq in July 2007. It operates MMORPG including “Perfect World”, “Perfect World II”, “Legend of Martial Arts”, “Zhu Xian” and “Chi Bi”. It also generates revenues from licensing its games like Perfect World II and Legend of Martial Arts to other countries such as Taiwan, Indonesia, Vietnam and Russia.

In 2008, Perfect World is planning to launch new games such as “Journey to the West” (MMORPG) and Hot Dance Party (casual game).

Major games

Perfect World

Perfect World is the first self-developed 3D MMORPG by Perfect World and uses a time-based model. The game began closed beta testing in June 2005, followed by open beta testing in late November 2005.

It is an adventure and fantasy game with traditional Chinese settings. Players can take on various roles, including swordsmen, magicians, archers, priests and magical creatures. The game allows players to design and customize the appearance of their characters. It also offers innovative features, including day-and-night shifting and weather effects. The characters could fly freely and move in a continuous and changing terrain and environment seamless without having to wait for scenery changes, as is often the case in many other online games.

The game received several awards in 2006, recognizing it as one of the most popular 3D online games in China.

The game generated revenue of RMB9.138mn with ACU of 39,000 for the 1Q2006. Revenues and ACU grew sequentially by 74.2% QoQ and 12.8% QoQ, reaching revenue of RMB15.914mn and ACU of 44,000, respectively, in 2Q06. Both revenue and ACU reached all-time highs in 2Q06, and then steadily declined to RMB8.404mn and 24,318 respectively by 3Q07. In our view, the short growth phase in the game’s life may have been due to migration to an item-based Perfect World II and increasing competition in the market.

The Legend of Martial Arts (Wu Lin Wai Zhuan)

This martial art game is based on a popular TV drama series, attempting to capture the look and feel that has made the TV series a hit with the Chinese public. In addition to the customization features found in Perfect World, The Legend of Martial Arts includes new features designed to provide players with an experience of traditional Oriental culture.

Perfect World introduced an item-based revenue model for this game, and designed this game to encourage player purchases by improved attractiveness of in-game items, including personalized virtual clothes, virtual riding animals and performance-enhancing items.

The game began closed beta testing in the late August 2006, followed by open beta/commercialization in late September 2006. The game achieved 300K PCU a month after its commercial launch.

The Legend of Martial Arts, like Perfect World, received several awards from IDC, Ministry of Education, ChinaJoy and China e-Game Industrial Association in 2006, to recognize its popularity in the Chinese online game industry.

Exhibit 1: Screenshot of Perfect World



Source: Sina

Exhibit 2: Screenshot of Legend of Martial Arts



Source: Sina

Perfect World II (Perfect World International Edition)

Perfect World II is actually the same as the Perfect World, but in an item-based model. It was commercially launched in January 2007. In addition to cannibalizing users and revenues from Perfect World, Perfect World II is able to tap into a new revenue stream as it is the first game the company has licensed to overseas markets like Taiwan, Indonesia, Korea, etc.

Zhu Xian

Zhu Xian is the forth game launched in late May 2007, after closed beta testing in April 2007. It operates on a item-based model and was developed based on a popular Internet novel with the same name. The Internet novel was ranked No.1 and was among the top five in the click statistics of Baidu.com for 2005 and 2006. The basic story concept of Zhu Xian is a martial arts-focused adventure. Players experience several fantastic scenes and plots that made the Internet novel popular, increasing their interest in the game environment.

Chi Bi

Closed beta testing of Chi Bi began on 18 December 2007. It is based on the well-known Chinese history over the ancient Three Kingdoms period. Based on our checks, the game has been very popular during the closed beta testing. As the number of accounts was limited during the closed beta testing, we believe many are seeking account logins due to its high-standard 3D graphics quality.

Chi Bi launched its open beta on January 25 with 19 sever groups initially. We expect this game to provide significant revenues to Perfect World in the coming two years. The War of the Red Cliff, a movie (directed by John Woo) featuring a number of celebrities, with the same Chinese name as "Chi Bi", is expected to be released in 2008. Given the promotion provided by the movie and the Three Kingdom background, we see "Chi Bi" as one of the hit games in 2008.

Exhibit 3: Screenshot of Chi Bi



Source: Sina

Major games in the pipeline

Hot Dance Party

A small-scale closed beta testing for the game was launched in Dec 07. Hot Dance Party is a self-developed 3D casual game with community features like the building of own small homes by game characters. With an increasing number of female players and Internet users, we expect the game to capture the untapped segment despite a number of dancing casual games in the market.

Second World

Second World is a 3D online virtual community, comprising user-created characters and content, including houses, shopping malls, cinemas, office buildings and fortresses. A user of the game is represented by an "avatar", a virtual identity expressed through a human-like image, to interact with other avatars in this virtual environment.

Management background

Mr. Michael Yufeng Chi (Founder, Chairman and Chief Executive Officer)

Prior to founding Perfect World, Mr. Chi founded Beijing Golden Human Co., Ltd., a leading education software company in 1996. From 2003 to 2004, Mr. Chi served as a Vice President and the Chief Technology Officer of Tsinghua Unisplendour Corporation Ltd., an information technology company listed on the Shenzhen Stock Exchange.

Mr. Ge Song (Director)

Mr. Song has been the director of Perfect World since September 2006. He has been served as senior management in technology and media companies for many years.

Mr. Daniel Dong Yang (Director)

Mr. Yang has been appointed by SAIF Partners, a private equity firm holding Perfect World's Series "A" Preferred Shares, as a director of Perfect World since September 2006. Mr. Yang has been a partner of SAIF Partners since 2004 and served as a director from 2001 to 2004. He served as an investment officer and director at Softbank China Venture Capital from 2000 to 2001. He currently serves as a director of several companies, such as MainOne Information Technology Co., Ltd. and Mobi Antenna Technologies (Shenzhen) Co., Ltd.

Mr. Kelvin Wing Kee Lau (Chief Financial Officer)

He has served as Perfect World's Chief Financial Officer since March 2007. Prior to Perfect World, Mr. Lau was the CFO of Beijing Media Corporation Ltd., from 2004 to 2007. He was also an audit senior manager at PricewaterhouseCoopers in 2000.

Mr. Di He (Vice President and Chief Technology Officer)

Mr. He has served as Vice President and Chief Technology Officer of Perfect World since February 2006 and he has been in charge of research and development of Angelica 3D game engine and its game development. Prior to Perfect World, He had extensive programming experience of PC games and Online games, including "Great Qin Warriors", "Shanghai Dragon" and "War in Burma", "Honor & Freedom I" and "Honor & Freedom II".

Mr. Qing Li (Vice President and Chief Design Officer)

Mr. Li has served as Vice President and Chief Design Officer since February 2006. Mr. Li was in charge of the design of several PC games, including "Great Qin Warriors", "Shanghai Dragon" and "War in Burma", "Honor & Freedom I" and "Honor & Freedom II".

Mr. Qi Zhu (Vice President)

Mr. Zhu has been a Vice President of Perfect World since November 2004, in charge of operations of the company. Prior to joining Perfect World, Mr. Zhu has extensive experience working as senior management at various technology/Internet companies, including Beijing CIMO Technology, Beijing Globallink Computer Technology and Lenovo (Beijing) Co. Ltd.

Mr. Davis Jian Li (Vice President)

Mr. Li has served the position of Vice President since June 2006, in charge of Perfect World's business development since June 2006. He was the president of Beijing Unismobile Communication technology from 2003 to 2006. And, he held various management positions with Motorola (China) Electronics Ltd., from 1996 to 2001.

Mr. Bill Weizheng Wang (Vice President)

Mr. Wang has served as Vice President since April 2007, in charge of overseas business. Prior to joining Perfect World, Mr. Wang held business development position at various foreign companies.

Price objective basis & risk

Perfect Worl-ADR (PWRD)

Our PO of US\$30 is based on forward 12-month EPS of US\$1.74 and a forward P/E of 17, which is at a 5% premium over historical industry P/E average of 16, due to its a good pipeline and a brand in 3D games.

We take reference to the historical P/E average to capture opportunities and risks brought by market overreaction to game hits and disappointments in this hit-driven business. When considering P/E premiums and discounts, we analyze factors that affect business risks and sustainability of individual companies: 1) game pipeline; 2) platform strength including operating experiences, marketing and distribution; 3) game franchises and branding. In the case of Perfect World, we apply a 5% premium to the historical industry average P/E due to a good pipeline and a brand in 3D games.

We believe the downside risks to our investment thesis are related to quick decline of gamer interest due to similarities between its games, government regulation, as well as console games.

Quicker-than-expected decline in user interest (negative). If gamers mature faster than expected and lose interest in existing games, Perfect World may not have the time it needs to develop the next generation games and penetrate into lower-tier cities (where 3D games are relatively less popular).

Government regulations (negative). Government regulation and their implementation can hurt the company in terms of – 1) game content; 2) user acquisitions (e.g. age restrictions / rating system); 3) distribution (e.g. massive crackdown on / shutdown of non-registered Internet cafes); 4) sourcing (e.g. long approval process for licensed games). The government has indicated that a rating system is under consideration, but not likely to be released in 2008.

In 2008, online game companies are required to rollout the anti-fatigue system and to validate the names and ID numbers entered by the gamers to decide whether they are adults. For gamers under 18, the system will limit the experience points obtained after 3 hours of playing. We expect the impact on revenues will be limited as 1) gamers may find ways to fulfill the requirements; 2) gamers who play long hours may not necessarily be the heavy spenders in a free-to-play/pay-for-item model.

The government has also stepped up enforcement of regulation on Internet cafes, non-registered websites and Internet Data Centers, since end of 2007, due perhaps to the Olympics and People's Congress in 1H08. We believe this has had limited impact on the industry so far, given ample number of Internet cafes and increasing access to online games from home, which is estimated at 60% from less than 30% in 2004.

Competition from game consoles (negative). Game consoles largely remain an underdeveloped market in China due to affordability issues and entry barriers such as distribution networks, piracy software, local government support, operator license (hard to obtain), etc. As console games enhance their online connectivity and emphasize group play, they could develop into a major competitor for online PC games if the regulatory environment becomes increasingly friendly to consoles (in particular, in terms of a crackdown on software piracy).

Analyst Certification

I, Eddie Leung, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Buy	92	36.65%	Buy	22	26.51%
Neutral	129	51.39%	Neutral	23	19.33%
Sell	30	11.95%	Sell	1	4.00%

Investment Rating Distribution: Global Group (as of 01 Jan 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1714	46.25%	Buy	445	29.10%
Neutral	1653	44.60%	Neutral	454	30.55%
Sell	339	9.15%	Sell	67	21.82%

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