MERITZ Securities

NC Soft (036570)

Market Perform

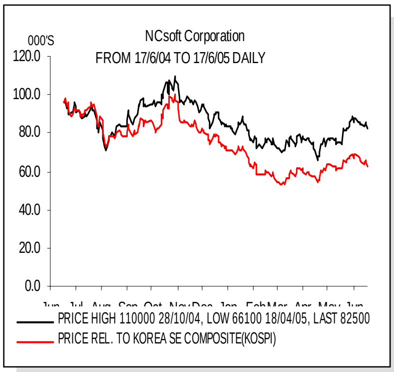
Sector: Internet
2005.06.20

Guildwars posting disappointing performance in domestic market

Rating & Target Price	
MKT PFM (New)	KRW90,000
MKT PFM (Old)	KRW94,000
Closing price (6/17)	KRW82,500

Market Data	
KOSPI	1,003.68pt
KOSDAQ	491.03pt
Mkt cap	KRW1,664.1bn
No. of shares issued	20.17mn
Foreign ownership	45.0%
Dividend rate (FY04)	45.00%

Reuters	036570.KS
Bloomberg	03657KS
Price Range(52week)	KRW66,100~ 110,000
60dys avg. trade vol	159,122shrs
60dys avg. trade amount	KRW12.46bn



- Lineage 1, 2 domestic sales expected to slightly drop q-o-q in 2Q05
- Lineage 1, 2 exports also expected to slightly drop q-o-q in 2Q05
- Sales from Guildwars remain strong in the US market despite bearish performance noted in the domestic market
- Overall 2Q05 performance forecast to fall below initial expectations owing to disappointing performance of Lineage 2 and Guildwars in the domestic market.
- 6M TP revised down to KRW90,000, maintain Market Perform
- Share price to lack visible momentum until direction of the company's casual game division (game portal) becomes clearer in 2Q06

Valuation

(KRWbn, KRW, %, x)		2004	2005E	2006E	2007E
Sales		246.9	242.1	263.0	311.6
Growth rate (%)		48.3	-1.9	8.6	18.5
Operating profit		109.0	86.5	87.0	104.5
Net profit		74.1	69.5	72.2	90.1
Growth rate (%)		134.0	-6.1	3.8	24.7
EPS		3,692	3,452	3,585	4,471
Growth rate (%)		119.5	-6.5	3.8	24.7
BPS		16,515	19,974	23,567	28,036
P/E	29.8	18.1	23.9	23.0	18.5
P/CF	26.3	16.0	21.4	20.9	17.1
P/BV	6.7	4.1	4.1	3.5	2.9
EV/EBITDA	16.3	9.1	14.2	13.4	10.5
ROE		27.0	18.9	16.5	17.3
Debt ratio		11.0	9.1	8.4	8.2
Net Int. Exp. to Sales*		-2.7	-4.8	-5.8	-6.0
Times interest earned (x)**		-	-	-	-

Relative strength to market: 1m(1.02), 3m(1.06), 6m(0.80)

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Overall FY05 and 2Q05 performance forecast to fall short of expectations owing to disappointing performance of Lineage 2 and Guildwars in domestic market

1) Lineage 1 has already matured and is now starting to see a decline in sales. As a result, in line with initial forecasts, we expect to see a q-o-q drop in both domestic and overseas sales of Lineage 1 in 2Q05.

2) We believe Lineage 2 has also reached maturity. Exports should steadily climb in 2Q05 while domestic sales are expected to decline slightly q-o-q in 2Q05 contrary to our initial expectations. Although seasonal demand tends to become stronger in 1Q, the commercial release of World of Warcraft in 1Q05 caused Lineage 2 sales to drop significantly below previous quarter results. While we had expected delays in the release of WOW's expansion pack to help push up Lineage 2 sales above 1Q05 levels in 2Q05, a recent company visit showed that actual performance results may drop even below previous quarter results in 2Q05.

3) Guildwars has commercially been released in the US and European market on April 28 of this year. NC Soft targets to hit sales of KRW20.0bn in FY05 (500,000 copies, average shipping prices of 40$/Copy) but may actually reap twofold results if sales continue to remain at current levels going forward. The company generates 2/3 of its exports from the US market and the remaining 1/3 from the European market. We expect NC Soft's US division to post sales up to KRW26.7bn in FY05. Our previous earnings forecasts included equity method gain estimates of KRW23.0bn for FY05, indicating that most of the growth in sales from exports have already been reflected in our initial forecasts. The game was commercially released on May 25 in the domestic market, but continued to report sluggish sales compared to its overseas performance. The company had initially targeted to raise domestic sales to KRW30.0bn in FY05 and we had expected actual sales to reach around KRW25.8bn. However, reflecting current growth rates, sales are not even expected to reach near KRW10.0bn in FY05.

4) FY05 and 2Q05 earnings estimates have significantly been revised down: Reflecting the disappointing performance of Lineage 2 and Guildwars in the domestic market, we significantly revise down our sales and operating profit forecasts for NC Soft. Since sales of Guildwars, which were expected to generate strong growth in 2Q05 through sales generated from lump-sum license sales instead of monthly fixed fee structures, have been falling short of expectations. As a result, performance forecasts for 2Q05 have been revised down the most from our previous estimates. With Guildwars continuing to post strong growth in the US market, we revised up our forecasts for NC Soft's equity method gains from 2Q05 onwards. However, with most of the bullish forecasts for US sales already reflected in our previous forecasts, the increase remains marginal.

2Q05 sales and OP forecast to remain near 1Q05 levels, RP expected to significantly increase q-o-q
Due to the bearish performance of Lineage 2 and Guildwars in the domestic market, NC Soft's overall 2Q05 performance is forecast to remain near its 1Q05 results. Recurring profit, on the other hand, should significantly surge q-o-q based on the increase in equity method gains from the strong performance of the company's US subsidiary.

<Chart 1> Revised earnings estimates for 2Q05 onwards

(KRWbn, KRW, %)	04	05 1Q	05 2QE	05 3QE	05 4QE	05E	06E	07E
Sales	246.9	60.4	62.4	61.9	57.5	242.1	263.0	311.6
Lineage1	138.0	31.6	31.0	31.3	29.8	123.6	107.6	95.1
Domestic	111.7	26.3	25.7	26.2	25.0	103.1	91.0	81.4
Exports	26.3	5.4	5.3	5.1	4.8	20.5	16.6	13.7
Lineage2	108.8	28.2	27.8	28.4	27.0	111.4	102.9	92.9
Domestic	97.2	22.5	21.9	22.2	20.8	87.4	75.6	66.8
Exports	11.6	5.7	5.9	6.2	6.2	24.0	27.3	26.0
Guildwars	0.0	0.0	3.6	2.2	0.8	6.6	8.9	9.5
Domestic	0.0	0.0	3.6	2.2	0.8	6.6	8.9	9.5
Iron (new)	0.0	0.0	0.0	0.0	0.0	0.0	43.6	114.2
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	43.6	102.1
Exports	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.1
Everquest	0.1	0.5	0.0	0.0	0.0	0.5	0.0	0.0
Exports	0.1	0.5	0.0	0.0	0.0	0.5	0.0	0.0
Operating profit	109.0	21.3	22.2	22.6	20.4	86.5	87.0	104.5
OP margin (%)	44.1	35.3	35.6	36.5	35.4	35.7	33.1	33.5
Recurring profit	97.4	17.3	30.0	25.5	22.3	95.0	98.7	123.0
Net profit	74.1	12.6	21.9	18.6	16.3	69.5	72.2	90.1
EPS	3,692.5	585.0	1,015.0	862.6	754.7	3,217.3	3,340.9	4,166.4

Note: Possible dilution from stock options fully reflected in EPS estimates

Source: NC Soft, Meritz Research

<Chart 2> Previous earnings estimates

(KRWbn, KRW, %)	04	05 1Q	05 2QE	05 3QE	05 4QE	05E	06E	07E
Sales	246.9	60.4	75.3	68.8	60.4	264.8	297.0	347.4
Lineage1	138.0	31.6	31.0	31.1	29.6	123.4	107.4	94.9
Domestic	111.7	26.3	25.8	26.0	24.8	102.9	90.7	81.2
Exports	26.3	5.4	5.3	5.1	4.8	20.5	16.6	13.7
Lineage2	108.8	28.2	30.0	29.2	27.7	115.1	106.2	95.7
Domestic	97.2	22.5	24.1	23.0	21.5	91.1	78.8	69.7
Exports	11.6	5.7	5.9	6.2	6.2	24.0	27.3	26.0
Guildwars	0.0	0.0	14.3	8.5	3.0	25.8	40.0	42.6
Domestic	0.0	0.0	14.3	8.5	3.0	25.8	40.0	42.6
Iron (new)	0.0	0.0	0.0	0.0	0.0	0.0	43.6	114.2
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	43.6	102.1
Exports	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.1
Everquest	0.1	0.5	0.0	0.0	0.0	0.5	0.0	0.0
Exports	0.1	0.5	0.0	0.0	0.0	0.5	0.0	0.0
Operating profit	109.0	21.3	30.7	27.7	22.1	101.8	108.8	122.6
OP margin (%)	44.1	35.3	40.7	40.3	36.5	38.4	36.6	35.3
Recurring profit	97.4	17.3	35.5	30.2	26.4	109.4	120.6	142.1
Net profit	74.1	12.6	26.0	22.1	19.3	80.1	88.3	104.0
EPS	3,692.5	585.0	1,202.7	1,022.1	894.3	3,704.2	4,085.7	4,811.2

Note: Possible dilution from stock options fully reflected in EPS estimates

Source: NC Soft, Meritz Research

Valuation & Recommendation

NC Soft plans to open its game portal site in 4Q05, around October. A successful launch of the new site should generate stronger growth in sales from 2Q06. Until the site starts to generate actual sales, costs incurred for the project should continue to hurt the company's profit margins going forward. A successor game to Lineage 2 (project name Iron) is scheduled for a closed beta test in 4Q05 and an open beta test in 1Q06. If all proceeds as planned, the game will be commercially launched in 2Q06. Since the game will only start to generate sales from 2H06, it may not help to improve the company's growth momentum in the mid- to short-term. However, we have high expectations for the new game from 2H06. The market is fully aware that Lineage 1 and 2 are passing through maturity at present and that Guildwars continues to post sluggish growth in the domestic market. With the investment into the new game portal weighing on the company's profit margins in addition to the weak growth in sales, NC Soft shares may lack momentum in FY05. Reflecting these concerns, we revise down our six-month target price from the previous KRW94,000 to KRW90,000 and maintain our investment recommendation at Market Perform. In this report, we revised down our EPS estimates for FY05, FY06 and FY07 by 13.1%, 18.2% and 13.4%, respectively, from our previous forecasts. Our target price has been revised down by only 4.4% from our previous target of KRW90,000 since only the costs and not the sales from the new game portal have been reflected in our earnings forecasts. Although game portal related costs continue to weigh on performance, we highly expect sales to grow from FY06.

Income Statement

(bil.won)	2004	2005E	2006E	2007E
Sales	247	242	263	312
Export portion (%)	15.4	18.6	16.7	12.7
COGS	35	39	44	51
Gross profit	212	203	219	261
SG&A	103	117	132	157
Operating profit	109	87	87	104
Net Non-OP profit	-12	8	12	19
Net interest gain	7	12	15	19
Net Forex. gain	-1	0	0	0
Recurring profit	97	95	99	123
Extraordinary profit	0	0	0	0
Profit before tax	97	95	99	123
Tax	23	25	26	33
Net profit	74	70	72	90

Source: Meritz Securities

Statement of Cash Flow

(bil.won)	2004	2005E	2006E	2007E
Cashflow from Operation	131	81	82	96
Net profit	74	70	72	90
Depreciation	9	8	7	7
Amortization	0	0	0	0
Working capital	0	1	-2	-4
Cashflow from Investment	-141	-21	-7	-7
Net tangible asset change	-14	-5	-6	-6
Net investment asset	-22	0	0	0
Cashflow from Financing	34	2	0	0
Increase in borrowing	0	0	0	0
Increase in capital	34	2	0	0
Increase(Decrease) in Cash	24	62	76	88
Beginning Cash Balance	6	30	92	168
Ending Cash Balance	30	92	168	256

Source: Meritz Securities

Balance Sheet

(bil.won)	2004	2005E	2006E	2007E
Current Asset	273	349	427	520
Cash & Deposits	30	92	168	256
A/R	21	20	22	26
Inventory	0	0	0	0
Fixed Asset	95	91	88	91
Investment asset	80	78	77	80
Equity investment	51	49	46	47
Tangible asset	15	12	11	11
Non-tangible asset	1	0	0	0
Total asset	368	440	515	611
Current Debt	32	31	33	38
A/P	0	0	0	0
Short-term debt	0	0	0	0
Long-term liability	0	0	0	0
Long-Term Debt	5	5	7	8
Bond	0	0	0	0
Long-term liability	0	0	0	0
Total Debt	36	37	40	46
Capital	10	10	10	10
Capital surplus	133	135	135	135
Retained earning	200	268	340	430
Capital adjustment	-10	-10	-10	-10
Shareholder's Equity	332	403	475	565

Source: Meritz Securities