Shanda Games Ltd. (GAME)

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Shanda Games – business

- MMO games in China: 28 MMORPGs and 6 advanced casual games
- MMOs 67% of revenues in 2010: Mir 2: 45%, World of Legend 21%
- In 2010 60.5% licensed games
- http://sec.gov/Archives/edgar/data/1470157/000095012311053813/c17656e20vf.htm

Shanda Games – business (cont'd)

Shanda Games – Misc thoughts

- What can go wrong?
  - Chinese fraud issues:
    - GAME is not RTO, it's legit IPO, but even IPO'd companies are getting bad rap
    - PWRD was accused (slandered?) about CEO self-dealing/tax evasion, SEC and Chinese authority investigation last week
    - Possible misstated results, self dealing, dealing with related parties
  - GAME is majority owned (72% shares, 96% votes) by SNDA that went private
    - Shanda/CEO/management incentives might not be aligned with minority shareholders
    - GAME uses SNDA platforms for payments, etc. These may not be competitively priced
  - GAME and most other public Chinese internet companies use a structure that is legally questionable (illegal?), since Chinese law does not allow foreign ownership of Internet/gaming companies
    - Contractual arrangements that may be not enforceable
  - Chinese regulatory issues:
    - Internet café regulations, anti fatigue regulations, anti gaming regulations, anti virtual currency regulations

Shanda Games – Misc thoughts

- Opportunities:
  - $1.02 special dividend per ADR to be paid on January 20th.
  - SNDA may buy out remaining GAME shares and fold it back into mothership

Strategic considerations

- Moat (*switching costs, habit, low cost*):
  - What are the moats? Popularity/hits. Not big moats, preferences shift.
  - What does it take to sustain the moats? Continued development of good games
  - Bargaining power of suppliers/customers? None
- Is it a low risk business? Somewhat.
- Is there high uncertainty? Medium
- How capital intensive is the business? Somewhat
- Future growth – saturation? Unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Probably not, unless results are misstated

Management

- I don’t usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Piotroski Score

Only applicable to Graham Cos – N/A to GAME

1. Net Income: Bottom line. Score 1 if last year net income is positive.
2. Operating Cash Flow: Better earnings gauge. Score 1 if last year cash flow is positive.
3. Return On Assets: Measures Profitability. Score 1 if last year ROA exceeds prior-year ROA.
4. Quality of Earnings: Warns of Accounting Tricks. Score 1 if last year operating cash flow exceeds net income.
5. Long-Term Debt vs. Assets: Is Debt decreasing? Score 1 if the ratio of long-term debt to assets is down from the year-ago value. (If LTD is zero but assets are increasing, score 1 anyway.)
6. Current Ratio: Measures increasing working capital. Score 1 if CR has increased from the prior year.
7. Shares Outstanding: A Measure of potential dilution. Score 1 if the number of shares outstanding is no greater than the year-ago figure.
8. Gross Margin: A measure of improving competitive position. Score 1 if full-year GM exceeds the prior-year GM.
9. Asset Turnover: Measures productivity. Score 1 if the percentage increase in sales exceeds the percentage increase in total assets.

- Total: / 9

Is it a good business?

- 5 year history of profits
- ROE:
  - 2009: 48 2010:30 2011:24
- Margins
  - 2009: 30 2010:28 2011: 24
- No growth: 3 year sales growth 5%, earnings growth -2%
- No dilution
- Strong balance sheet
  - Debt << cash/short term investments
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - ~ ROE

Is it a good business? Cash flow

- Good operating cash flow, FCF:
  - http://sec.gov/Archives/edgar/data/1470157/000095012311099631/c25058exv99w1.htm
  - 2011 9mo 153M earnings, 155M operating cash flow, 138M (?) FCF (FCF = OCF – capital expenditures)
  - Free Cash Flow/Share higher than dividends paid (not counting special dividend)

Is business cheap? – Buffettology calculations

- ROE 20%
- Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $846M
- Equity in 10 years = Equity*$(1+ROE)^9$ = $4.2B
- Market cap = 846M x P/E (15) = $12.7B
- Rate of return = 24% after tax (calculations omitted), 16% at 15% ROE

- 9 year earnings growth: N/A.

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of 200M
  - 10% growth for 5 years, leveling after that
    - 15% discount -> $1.9B current valuation (if you buy company at <$1.9B , you will get 15% return or higher)
  - 5% growth for 10 years, leveling after that
    - 15% discount -> $1.8B current valuation
  - 10% growth for 10 years, leveling after that
    - 15% discount -> $2.4B current valuation
- Owner’s yield = earnings / (market cap + debt - cash) = earnings/EV
  - 200B / (1.2B+150M-600M) = 28%

- What makes up the margin of safety? Cheap valuation, OK results
- Is there a sufficient margin of safety? Yes.

Is business cheap? – Graham investment considerations

- N/A for GAME – included for completeness
- 1.43 P/Book – not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)