

Hong Kong

ADD (no change)

Consensus ratings*: Buy 21 Hold 4 Sell 1

Current price:	HK\$33.90
Target price:	HK\$53.60
Previous target:	HK\$54.30
Up/downside:	58.1%
CGI / Consensus:	-25.3%

Reuters:	0772.HK
Bloomberg:	772 HK
Market cap:	US\$4,427m
	HK\$34,647m
Average daily turnover:	US\$17.41m
	HK\$142.5m
Current shares o/s:	1,000.0m
Free float:	19.1%

*Source: Bloomberg

Key changes in this note

- FY22F net profit decreased by 5.5%.
- FY23F net profit decreased by 4.8%.



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	-21.2	-30.2	-49.5
Relative (%)	-14.8	-25.7	-27.2

Major shareholders	% held
Tencent Holdings Ltd.	52.7
Carlyle Group L.P.	7.5

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China Literature Ltd

Promising outlook for IP business

- China Literature reported FY21 revenue of Rmb8.7bn, up 1.7% yoy, and core net profit of Rmb1.2bn, up 36.1% yoy, slightly above our expectation, because of better cost control, such as a reduction in New Classic Media (NCM)'s production costs.
- NCM will launch 6–8 dramas and 2–3 films in FY22F, and we expect 20% yoy sales growth for the IP business.
- Reiterate Add with a new DCF-based TP of HK\$53.6.

Strong results thanks to production efficiency improvement

Revenue from online business grew by 9.6%, while revenue from IP operations dropped by 8.7% yoy in FY21, since NCM produced more tailor-made dramas (before-tax profit of projects is recorded as China Literature revenue) rather than self-produced dramas. Online revenue from its self-owned platform dropped by 1.4% yoy because of the high base in FY20, but revenue from Tencent and third-party platforms grew by 28.0% and 110.7% yoy, respectively, driven by growth in advertising revenue and more channels. Free-reading DAU grew strongly by 50% yoy to 15m in FY21, and overall MAU grew 8.6% yoy to 249m. The FY21 gross margin was 53.1%, up 3.4% pts yoy, attributable mainly to a reduction in NCM's production costs. The selling and marketing expenses ratio grew by 1.9% pts yoy because of promotions of its films and drama series, and online business. The administration expenses ratio was up by 3.2% pts yoy because of an increase in compensation costs relating to the modification of the earn-out mechanism for NCM in FY20. FY21 non-IFRS net profit was Rmb1.2bn, up 36.1% yoy.

Ample projects in the pipeline to push up IP business

IP business will continue to be China Literature's key development strategy in FY22F. The Company will facilitate its IP monetization process through NCM, China Literature Pictures and Tencent Pictures to produce more IP-based comics, animations and games. Apart from the hot drama series *A Lifelong Journey* (人世间) and film *Too Cool to Kill* (这个杀手不太冷静) released during CNY, China Literature and NCM have *My Heroic Husband* (赘婿) Season II, *Joy of Life* (庆余年) Season II, *Dafeng Guardian* (大奉打更人) and a new animation season of *Battle through the Heavens* (斗破苍穹), which will start production in FY22F. China Literature and NCM will become the major operators of high-commercial projects under Tencent Pictures, which is expected to provide more project reserve for China Literature in the coming years. NCM aims to produce 6–8 dramas and 2–3 films in FY22F and is confident in achieving over Rmb500m in net profit in FY22F. Revenue growth from comics and animations is expected to be significant in FY22F. IP-related consumer products are expected to be launched in FY22F. China Literature is also developing its overseas IP business. For example, the broadcasting rights to *A Lifelong Journey* were purchased by Disney.

Online reading business expected to enjoy stable growth

Online reading is a mature business that incubates a large amount of high-quality IP and has attracted a growing number of mid-ranked authors. In FY21, although MPUs for paid reading dropped by 14.7% yoy to 8.7m, monthly ARPU for paid reading increased by 14.4% yoy to Rmb39.7. In FY22F, the performance of the online reading business is expected to be stable. We expect online reading revenue to grow by 5% yoy in FY22F.

Reiterate Add with new DCF-based TP of HK\$53.6

We cut our FY22F–23F earnings forecasts by 5.5% and 4.8%. We reiterate our Add rating, since we believe China Literature has great potential to monetize its IP in the long term. Management does not expect any further strict government policies in FY22F. Positive catalysts include stronger-than-expected IP revenue growth.

Financial Summary	Dec-20A	Dec-21A	Dec-22F	Dec-23F	Dec-24F
Revenue (Rmbm)	8,526	8,668	9,575	11,074	12,809
Operating EBITDA (Rmbm)	(4,289)	2,278	1,758	2,250	2,581
Net Profit (Rmbm)	(4,484)	1,847	1,401	1,831	2,102
Normalised EPS (Rmb)	0.92	1.23	1.40	1.87	2.22
Normalised EPS Growth	(23.4%)	34.1%	14.1%	33.6%	18.5%
FD Normalised P/E (x)	30.05	22.41	19.64	14.70	12.40
DPS (Rmb)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	22.64	16.57	21.15	12.79	7.79
P/FCFE (x)	NA	17.02	8.76	45.58	6.73
Net Gearing	(10.6%)	(19.5%)	(34.5%)	(33.9%)	(47.8%)
P/BV (x)	1.83	1.60	1.46	1.31	1.18
ROE	5.3%	7.6%	7.8%	9.4%	10.0%
% Change In Normalised EPS Estimates			(5.49%)	(4.82%)	
Normalised EPS/consensus EPS (x)			0.83	0.88	0.73

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

Promising outlook for IP business

Figure 1: China Literature 1H20 earnings results

(Rmb m)	2H20	2H21	yoy (%)	FY20	FY21
Revenues	5,265	4,326	-17.8%	8,526	8,668
Cost of revenues	(2,763)	(2,015)	-27.1%	(4,292)	(4,069)
Gross profit	2,503	2,311	-7.6%	4,234	4,599
<i>Gross margin (%)</i>	<i>47.5%</i>	<i>53.4%</i>	<i>5.9% pts</i>	<i>49.7%</i>	<i>53.1%</i>
Selling and marketing expenses	(1,228)	(1,353)	10.2%	(2,498)	(2,701)
General and administrative expenses	(653)	(664)	1.7%	(1,004)	(1,299)
Other gains/(losses), net	(1,793)	547	N/A	(5,323)	1,448
Operating profit/(loss)	(1,172)	841	N/A	(4,591)	2,047
<i>Operating margin (%)</i>	<i>-296.7%</i>	<i>-171.8%</i>	<i>124.8% pts</i>	<i>-543.0%</i>	<i>-144.6%</i>
Share based compensation	68	134	97.5%	120	188
Net (gain) from investee companies	1,859	(382)	N/A	5,260	(1,099)
Amortization of intangible assets	(16)	17	N/A	29	38
Adjusted operating profit	739	611	-17.3%	818	1,174
<i>Adjusted operating margin (%)</i>	<i>14.0%</i>	<i>14.1%</i>	<i>0.1% pts</i>	<i>9.6%</i>	<i>13.5%</i>
Net reversal of impairment losses	198	(17)	N/A	0	0
Finance costs	(31)	(34)	11.4%	(69)	(69)
Finance income	54	65	19.3%	116	125
Share of profit of investments	(77)	83	N/A	5	199
Profit/(loss) before income tax	(1,027)	938	N/A	(4,539)	2,303
<i>PBT margin (%)</i>	<i>-19.5%</i>	<i>21.7%</i>	<i>41.2% pts</i>	<i>-53.2%</i>	<i>26.6%</i>
Income tax expense	(163)	(176)	8.0%	39	(460)
Non-controlling interest	(2)	(2)	12.7%	(16)	(4)
Net profit/(loss) attributable to shareholde	(1,188)	764	N/A	(4,500)	1,843
<i>PAT margin (%)</i>	<i>-268.6%</i>	<i>-164.3%</i>	<i>104.3% pts</i>	<i>-510.6%</i>	<i>-141.0%</i>

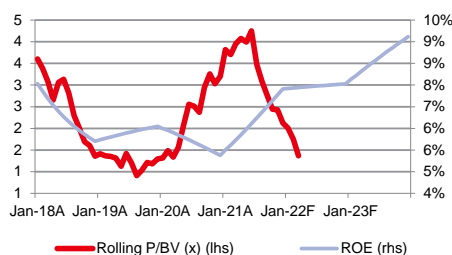
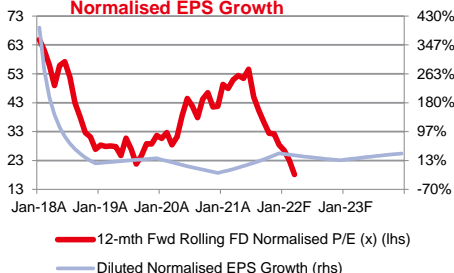
SOURCES: CGIS RESEARCH, COMPANY DATA

Figure 2: China Literature earnings revision

(Rmb m)	FY22F			FY23F			FY24F		
	Old	New	% Chg.	Old	New	% Chg.	Old	New	% Chg.
Revenue	10,025	9,575	-4.5%	11,766	11,074	-5.9%	N/A	12,809	N/A
GPM (%)	50.6%	54.7%	4.1% pts	51.7%	56.0%	4.3% pts	N/A	56.9%	N/A
OPM (%)	16.7%	16.0%	-0.7% pts	18.7%	18.2%	-0.5% pts	N/A	18.3%	N/A
Net profit	1,493	1,401	-6.1%	1,955	1,831	-6.3%	N/A	2,102	N/A
Adjusted net profit	1,484	1,403	-5.5%	1,970	1,875	-4.8%	N/A	2,222	N/A

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

BY THE NUMBERS

P/BV vs ROE

12-mth Fwd FD Normalised P/E vs FD Normalised EPS Growth


Profit & Loss

(Rmbm)	Dec-20A	Dec-21A	Dec-22F	Dec-23F	Dec-24F
Total Net Revenues	8,526	8,668	9,575	11,074	12,809
Gross Profit	4,234	4,599	5,240	6,202	7,292
Operating EBITDA	(4,289)	2,278	1,758	2,250	2,581
Depreciation And Amortisation	(302)	(230)	(231)	(232)	(233)
Operating EBIT	(4,591)	2,047	1,528	2,018	2,348
Financial Income/(Expense)	48	57	20	67	74
Pretax Income/(Loss) from Assoc.	5	199	199	199	199
Non-Operating Income/(Expense)	0	0	0	0	0
Profit Before Tax (pre-EI)	870	1,430	931	1,529	1,943
Exceptional Items					
Pre-tax Profit	(4,539)	2,303	1,747	2,284	2,622
Taxation	39	(460)	(349)	(456)	(524)
Exceptional Income - post-tax					
Profit After Tax	(4,500)	1,843	1,398	1,828	2,098
Minority Interests	16	4	3	4	4
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Preference Dividends (Australia)					
Net Profit	(4,484)	1,847	1,401	1,831	2,102
Normalised Net Profit	901	1,226	1,400	1,871	2,218
Fully Diluted Normalised Profit	917	1,230	1,403	1,875	2,222

Cash Flow

(Rmbm)	Dec-20A	Dec-21A	Dec-22F	Dec-23F	Dec-24F
EBITDA	(4,289)	2,278	1,758	2,250	2,581
Cash Flow from Inv. & Assoc.	(5)	(199)	(199)	(199)	(199)
Change In Working Capital	(342)	(384)	1,698	(1,554)	1,630
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense	6,298	(579)	475	538	615
Other Operating Cashflow	(343)	34	101	99	99
Net Interest (Paid)/Received	(69)	(69)	(132)	(132)	(132)
Tax Paid	(141)	39	(460)	(349)	(456)
Cashflow From Operations	1,110	1,118	3,240	652	4,137
Capex	(288)	(15)	(115)	(115)	(115)
Disposals Of FAs/subsidiaries	0	0	0	0	0
Acq. Of Subsidiaries/investments	0	0	0	0	0
Other Investing Cashflow	(3,901)	952	153	199	207
Cash Flow From Investing	(4,189)	936	38	84	92
Debt Raised/(repaid)	(34)	(435)	(132)	(132)	(132)
Proceeds From Issue Of Shares	0	323	0	0	0
Shares Repurchased					
Dividends Paid					
Preferred Dividends					
Other Financing Cashflow	(59)	(237)	0	0	0
Cash Flow From Financing	(92)	(350)	(132)	(132)	(132)
Total Cash Generated	(3,171)	1,705	3,146	605	4,097
Free Cashflow To Equity	(3,112)	1,619	3,146	605	4,097
Free Cashflow To Firm	(3,010)	2,123	3,410	869	4,361

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

BY THE NUMBERS... cont'd
Balance Sheet

(Rmbm)	Dec-20A	Dec-21A	Dec-22F	Dec-23F	Dec-24F
Total Cash And Equivalents	2,848	4,528	7,674	8,279	12,375
Total Debtors	4,031	3,779	3,005	4,719	4,080
Inventories	572	654	523	418	335
Total Other Current Assets	4,049	3,769	3,878	3,998	4,130
Total Current Assets	11,500	12,730	15,080	17,414	20,920
Fixed Assets	40	45	47	46	45
Total Investments	1,514	2,256	2,456	2,655	2,854
Intangible Assets	7,676	7,455	7,338	7,221	7,105
Total Other Non-Current Assets	586	810	810	810	810
Total Non-current Assets	9,815	10,567	10,651	10,732	10,814
Short-term Debt	554	793	793	793	793
Current Portion of Long-Term Debt					
Total Creditors	2,548	2,638	3,463	3,493	4,420
Other Current Liabilities	1,115	1,081	1,047	1,299	1,478
Total Current Liabilities	4,217	4,512	5,302	5,585	6,691
Total Long-term Debt	691	383	383	383	383
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	1,121	1,067	1,067	1,067	1,067
Total Non-current Liabilities	1,812	1,450	1,450	1,450	1,450
Total Provisions	188	149	149	149	149
Total Liabilities	6,217	6,110	6,901	7,183	8,290
Shareholders' Equity	15,094	17,186	18,832	20,969	23,453
Minority Interests	5	1	(2)	(6)	(10)
Total Equity	15,099	17,187	18,830	20,963	23,443

Key Ratios

	Dec-20A	Dec-21A	Dec-22F	Dec-23F	Dec-24F
Revenue Growth	2.1%	1.7%	10.5%	15.7%	15.7%
Operating EBITDA Growth	(26.1%)	25.4%	(33.0%)	58.7%	27.3%
Operating EBITDA Margin	13.1%	16.2%	9.8%	13.5%	14.9%
Net Cash Per Share (Rmb)	1.60	3.35	6.50	7.10	11.20
BVPS (Rmb)	15.09	17.19	18.83	20.97	23.45
Gross Interest Cover	11.90	17.08	5.38	9.55	12.63
Effective Tax Rate	0.0%	20.0%	20.0%	20.0%	20.0%
Net Dividend Payout Ratio	NA	NA	NA	NA	NA
Accounts Receivables Days	143.0	127.2	88.0	88.0	88.2
Inventory Days	50.23	54.97	49.54	35.26	24.98
Accounts Payables Days	87.9	97.2	123.3	129.8	135.2
ROIC (%)	5.7%	7.1%	4.4%	9.1%	10.8%
ROCE (%)	4.98%	7.42%	4.47%	6.89%	7.97%
Return On Average Assets	3.59%	5.29%	5.65%	6.75%	7.21%

Key Drivers

	Dec-20A	Dec-21A	Dec-22F	Dec-23F	Dec-24F
Average MPU growth (%)	4.1%	-14.7%	2.0%	7.1%	5.9%
Online reading revenue per MPU growth (%)	37.2%	14.4%	10.0%	3.0%	3.0%

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

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	Rating Distribution (%)	Investment Banking clients (%)
Add	71.1%	1.5%
Hold	21.8%	0.0%
Reduce	7.1%	0.0%

Spitzer Chart for stock being researched (2 year data)

China Literature Ltd (772 HK)

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