



The Chinese Video Game Market: Market Entry for Canadian Firms

prepared by
Asia Pacific Research and Positioning

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This report has been commissioned by the Department of Canada Heritage/Trade Routes to outline some market entry strategies for Canadian video game developers wishing to enter the Chinese game market.

The following document represents desk research and interviews, both in person and by telephone, with game industry professionals in China and beyond. In many ways, it also represents the culmination of three years of work with game companies from around the world, in order to understand the dynamics of the Chinese game industry, and how best to tackle this potentially lucrative, yet notoriously fickle and demanding market.

The aim of this document is to provide the intended audience with practical, business focused knowledge that helps them in their decision to enter the Chinese market. It can also act as a benchmark of their own business/financial models, as numbers have been synthesized and factual information gleaned from industry heavyweights and insiders.

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1 Executive Summary

The truth of the Chinese video game market is that while it holds vast potential, a game developer must have a long time horizon (4-5 years), deep pockets, very savvy business instincts, and excellent interpersonal skills.

The Chinese market is a challenge to the best organizations in the world, whether they are diplomatic corps or multinational businesses, and it can take many years of intense lobbying and an active local presence before one's efforts bear fruit.

We suspect these challenges will be multiplied for the interactive game industry. This is because the product is very much a cultural product, so it is difficult making the transition from one culture to the next and secondly, because the majority of companies are relatively small so don't have the human or financial resources to dedicate to a China presence.

In a way, this is compounded by the type and style of content that is most popular. While North America is focused on console development, and many think the PC game will eventually become extinct, they need only visit Asia, especially Japan, to find another universe, one made up almost entirely of online games, played on the PC.

So, we must note at the outset that we have focused on the online game market. Single player PC or console games are an insignificant portion of the Chinese market, and wireless games are not covered by this report. In particular, we have focused on the MMOG/MMORPG (Massive Multiplayer Online Game/Massive Multiplayer Role Playing Game) as this is the type of content that is driving the market, as well as holding the most potential for Canadian game studios to participate.

This will also make it difficult for Canadian firms as very few aspire to be PC developers or have developed MMOGs.

That said, the Chinese market certainly has vast potential. Recent reports indicate the market will reach some USD\$ 1.6 billion in revenue by 2010. There should certainly be enough growth and profit to go around as this implies a compound annual growth rate of 24% between now and 2010. PricewaterhouseCoopers estimates that in the next few years the People's Republic of China may well become the largest online game market in the world.

So while we understand the enthusiasm concerning the Chinese market, it is also our job to dispel false hopes and provide concrete definitive answers to those who are considering the Chinese market.

On the positive side, there are several factors to consider:

- Online games are often the cheapest form of entertainment compared to attending movies, fast food or karaoke;
- More adults play online games in China compared to other Asian countries;

- Some forecast there will be approximately 180 million internet users and 40 million MMORPG players by 2010;
- The Chinese government has hundreds of millions of dollars to foster the growth of the domestic game development industry;
- Game development can cost 1/6 of that in Canada and there are companies who after spending USD\$ 500,000 in development and marketing costs, are profitable with only 20,000 concurrent users.

There is also the realistic side of the industry:

- Fickle government policies designed to support the local industry at the expense of foreign partners;
- Difficulty in finding and retaining quality talent;
- A very different business culture, one that some Westerners would consider to be unprincipled and ruthless;
- As mentioned, many Canadian studios are either not large enough or lack the experience to manage a full scale foreign based project;
- A value chain that is substantially different than the Western 'box retail' model. As it is somewhat more complicated, there are more ways to lose than gain in regards to revenue.

All of this said, this document does outline both the positives and negatives of entering the Chinese market and offers solutions to these challenges. Among these solutions are the following:

- The role of "Guan Xi" or connections and personal relationships in building a Chinese presence;
- Outsourcing art and or programming as a viable and best first step in tackling the Chinese market;
- A brief primer on MMOG operations and specifics pertaining to the Chinese market, including managing customer churn, finding the right pricing strategy and optimizing hardware utilization, especially in regards to the prevalence of hacks on game servers;
- Managing and training talent in the Chinese context means spending much more time than one is accustomed in order to match business cultures and develop the necessary project management skills.

We have also included a sample Contract between a Taiwanese developer and Chinese game operator for an idea of how deals are structured and what one can expect from both a legal and business perspective. This material is likely familiar to most business development personnel with the only differences being regarding point cards and concurrent user/registered user benchmarks.

What follows is by no means comprehensive in regards to total activity within the Chinese game industry, but again, our goal was to provide practical, business focused information and advice on how to enter the Chinese game industry. We are confident we have provided at least a foundation for such activities.

2 Drivers for the Chinese online game market

2.1 Strong internet population growth

There are several key drivers for the Chinese online game market. China is already the second largest internet country with 111 m users, after the USA with its 204 m. Currently, though, China's internet penetration rate remains low at 8%, compared with other leading countries; the US, for example, has a penetration rate of 67% (*Netratings*, November 2004).

The internet population in China is expected to increase an average of 13% year on year from 2004 to 2009. The strong growth will be driven by factors such as:

- **Increased computer penetration rate.** With lower computer prices and increasing spending power, computers are increasingly affordable. According to Gartner, PC penetration in China is expected to double from 2004 to 2009 from 44 per 1000 in 2004 to 87 per 1000 in 2009.
- **Lower internet access charge.** According to JP Morgan, internet access fees will continue to decrease in the near future. For example, the broadband Average Revenue Per User (ARPU) per month is expected to decline from above Renmenbi (Rmb) 100 to Rmb (mid) 70s in 2006.
- **More interesting online content.** With more services available, such as online games, freemusic and movies, more users will be attracted to the internet. In China, the number of web pages is on the rise – from 157 million in 2002 to 650 million in 2007.
- **Government support of the internet.** Contrary to popular belief, the government does indeed support internet usage in China. While the government encourages the use of healthy domestic content, one should notice that access to foreign content is somewhat controlled/filtered.

2.2 Upside from current online gamer penetration

According to IDC figures, China's online gamer penetration rate is 23% of the total internet population in 2004, below the Korean average of 49%. The figures include both paying and non-paying gamers. If one only looks at paying gamers as a percentage of internet population, China stands at 11%, below Korea's 14%.

China's paying gamer penetration could reach, or even surpass, Korea's figures, given that: (1) online games are a low cost form of entertainment in China; (2) the lack of alternative forms of entertainment; and (3) gamer demographics are spread evenly among different occupations (see Figure 2: MMORPG players by occupation below).

2.3 Online games/internet entertainment: Teenager spending

Online games can be seen as a low cost and easily available entertainment option for teenagers. As is illustrated in the table below of popular activities, it appears that online games are a very economic option.

Table 1: Entertainment spending comparison

Entertainment option	Fee Rmb	Fee \$CDN
Webcafes with online games	Rmb 2-4 per hour	\$0.28-0.56 per hour
Movie	Rmb 30-60	\$4.19 - 8.38
Big Mac meal	Rmb 20	\$2.79
Karaoke	Starting at Rmb 30 per hour	Starting at \$4.19 per hour
Beijing subway fee (one way)	Rmb 2-5	\$0.28 – 0.70

Source: APRP estimates

In August 2005, Renmin University and Chinese Communist Youth League (CCYL) conducted a survey on entertainment spending among the youth in Beijing. The survey found that online games and digital entertainment accounts for the largest spending in this category. This spending pattern will likely be replicated in other second and third-tier cities as well.

Table 2: Beijing youth entertainment spending

Entertainment type	Spending allocation
Online game/ internet entertainment	40%
Sports	18%
TV	12%
Handset entertainment	7%
Music	6%
Newspaper/ magazines	5%
Animation	4%
Gathering/ meals	3%
Karaoke	2%
Shopping	2%
Movie	1%
DIY projects	1%
Other	1%

Source: Renmin University, CCYL

Note: August 2005. Age 14-24

2.3.1 Why online gamers are more convenient and feasible

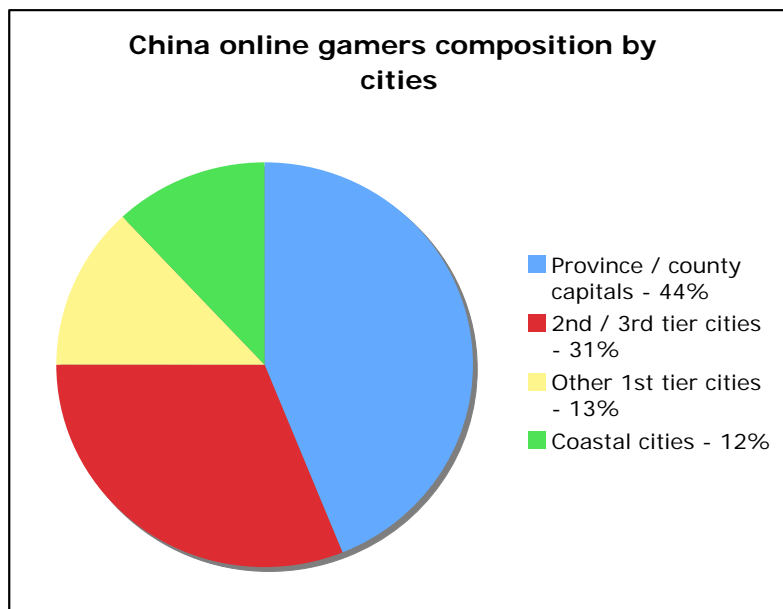
One may wonder why Chinese teenagers like to stay indoors for online games rather

than, say, playing baseball. Consider this: according to the Chinese government's 2003 statistics, the urban public green area per 1,000 people is only 0.65 square meters. This compares to 14,000 square meters of public park area per 1,000 people in New York City, or 59,000 in Hong Kong.

2.4 Additional online gamers from second, third-tier cities

Gamers from lower-tier cities have been on the rise, and one can expect the trend to continue, with internet user growth rate being higher in such cities compared with coastal cities. In 2003, 24% of gamers were from second and third-tier cities, and the number increased to 31% in 2004. One could expect online gamer penetration as a percentage of total internet users to be higher in lower-tier cities, due to less entertainment options compared with coastal cities.

Figure 1: China online gamers composition by cities



Source: IDC

2.5 More Adults and professionals play online games in China

There are some very interesting gamer demographics in China. As a percentage of total gamers, there are less teenagers and students playing MMORPGs in China, compared to other Asian countries. Teenagers account for 25% of the gamer population in China versus 47% in Korea. Also, in terms of gamer occupations, 29% of them are students in China versus 69% in Korea, while professionals/managers, white-collar workers, and blue-collar workers account for a higher portion of the gamers' population compared to other Asian countries.

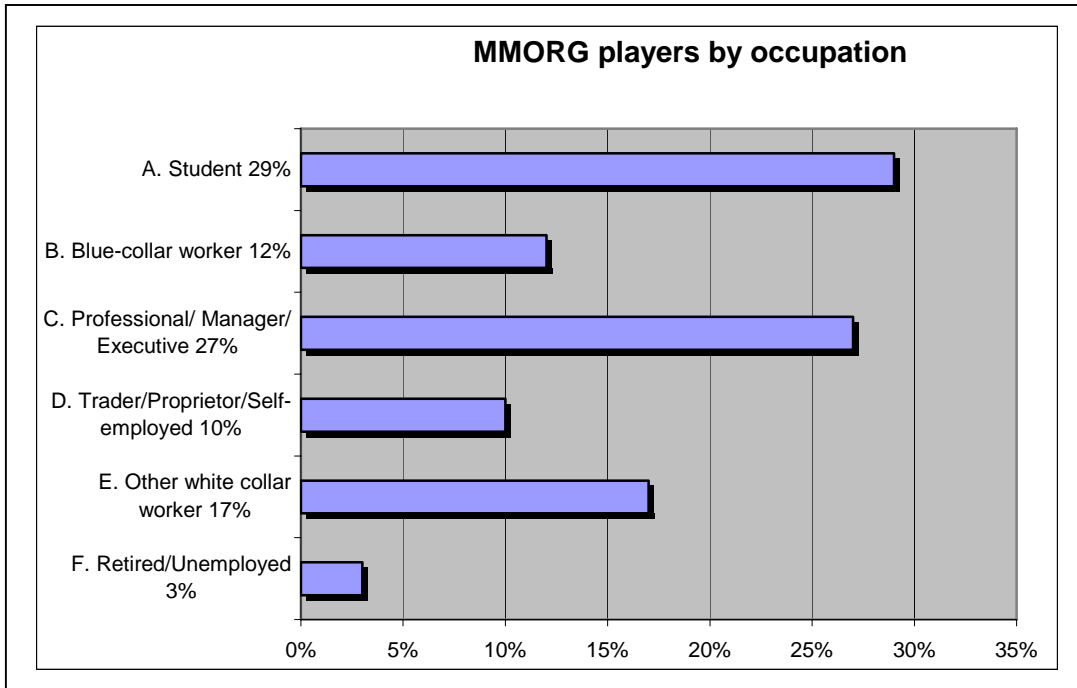
The more diversified demographics in China imply:

- Potentially higher online gamer adoption rates over other Asian countries

due to the popularity of online games across broader demographics. Again, the more diverse demographics are likely due to online games being a cheap and convenient entertainment option.

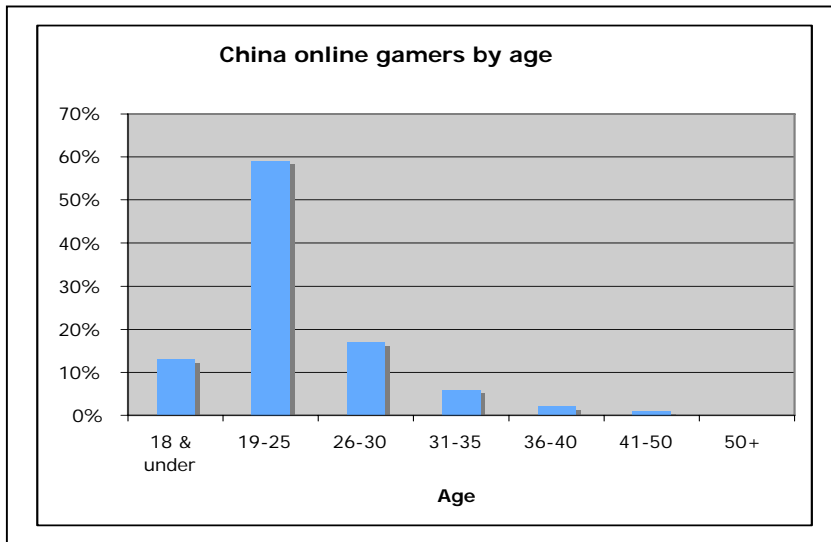
- Room for higher online games adoption among teenagers and students should have more time for entertainment. According to the Renmin University CCYL survey, 58% of the youth reported entertainment time of less than 10 hours per week. Teenagers may be likely to turn on the internet for entertainment if they have additional entertainment time.

Figure 2: MMORPG players by occupation



Source: IDC

Figure 3: China online gamers by age



Source: IDC

2.6 Other drivers

2.6.1 Better quality and innovative games to draw gamers

Games with better graphics and more innovative content in the market have appeared in recent months. This should attract more users to online games. For example, World of Warcraft developed by Blizzard has driven many non-online players to online games. In addition, different styles of online games are also available to suit various users, e.g. cute, casual, action.

Casual games with new interesting content also drive growth in market size. For example, O2Jam (dance and music-based games) and free style (basket ball games) have drawn many players to casual games.

2.6.2 Increased promotions; online games gaining awareness

With the game market becoming more competitive, online game companies are expected to increase promotions in order to drive players. A direct effect is to increase the awareness of non-game players.

For example, last December, Kingsoft launched a large-scale media campaign that includes TV advertisements and cooperation with a popular Chinese movie, “*Kung Fu Hustle*”. The9 co-marketed World of Warcraft through partnership with Coca-Cola last summer, while Tencent’s QQ Fantasy targeted promotions to QQ messaging users.

2.6.3 Increasing broadband penetration

Home broadband access makes online games more accessible to home users, and expands the games’ addressable market. One should note strong broadband usage

growth in China, which reached 53 million by June 2005.

3 Market size estimates

The total online game market is expected to reach US\$ 1.43 billion in 2009 - a 24% annual growth rate from 2004 to 2009. This strong growth will be driven by the reasons discussed above.

Table 3: China MMORPG market forecast

	2003	2004	2005E	2006E	2007E	2008E	2009E
MMORPG gamers (MM)	10.0	13.5	18.9	22.7	26.8	30.8	33.2
Internet users (MM)	79.5	94.0	111.2	128.5	143.1	157.7	173.9
MMORPG users' penetration	12.6%	14.4%	17%	17.6%	18.7%	19.5%	19.1%
Average ARPU/month (Rmb)	19.3	22.5	21.7	22.2	22.8	23.1	23.3
Market size (Rmb MM)	2314.1	3642.6	4917.5	6042.7	7308.6	8547.4	9310.7
Market size (\$US MM)	278.8	438.9	592.5	728.0	880.6	1029.8	1121.8
Market size (\$CDN MM)							
Growth (YY)	154%	57%	35%	23%	21%	17%	9%

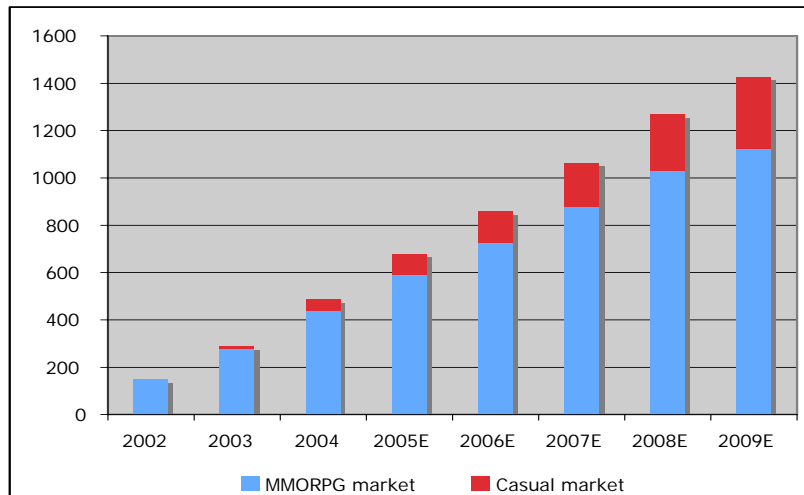
Source: JP Morgan; APRP estimates

Table 4: China casual market forecast

	2003	2004	2005E	2006E	2007E	2008E	2009E
Casual game players	8.6	16.2	24.4	34.1	42.6	51.2	58.8
Internet users	79.5	94.0	111.2	128.5	143.1	157.7	173.9
Casual player penetration	-	17.3%	21.9%	26.5%	29.8%	32.4%	33.8%
Ratio of paying users	15%	20%	22.0%	23.1%	24.3%	25.5%	26.7%
ARPU per month (Rmb)	5.8	10.0	11.0	11.6	12.1	12.7	13.4
Market size (Rmb MM)	89.3	389.9	707.6	1092.2	1505.2	1991.4	2524.9
Market size (\$US MM)	10.8	47.0	85.3	131.6	181.4	239.9	304.2
Market size (\$CDN MM)							
Growth (YY)	120%	337%	82%	54%	38%	32%	27%

Source: JP Morgan; APRP estimates

Figure 4: MMORPG and Casual market breakdown

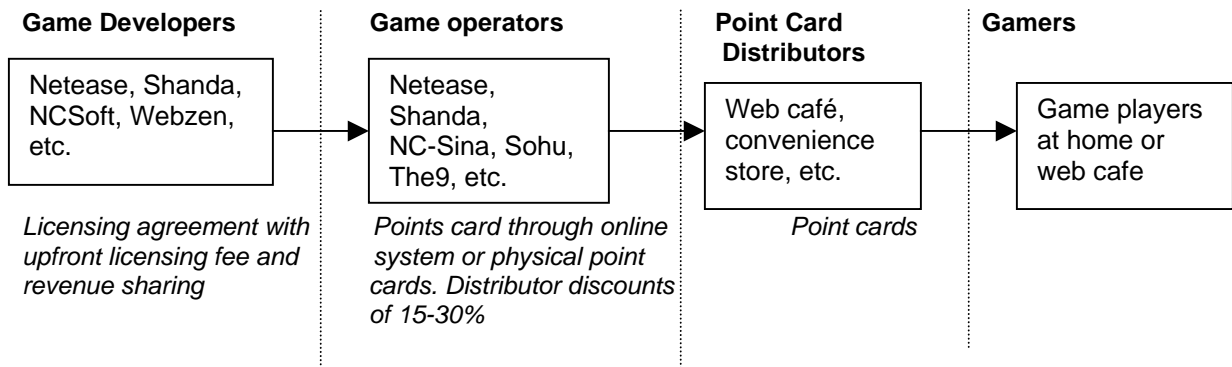


Source: JP Morgan; APRP estimates

4 Online Games Value Chain

There are four parties in the online games value chain: (1) game developers; (2) games operators; (3) point card distributors; and (4) gamers

Table 5: Online games supply chain



4.1 Game Developers

Games developers are designers of the games. In China, leading online games designers are NetEase, Kingsoft, Shanda, as well as smaller studios like Netdragon and Object Soft. Foreign online games developers include NCSoft, Webzen, Nexon, Blizzard and EA.

Games development is a high-risk business anywhere in the world, and this can especially be seen in China. However the returns on investments can be very high, often more than 100%. Initial investments are mainly labor costs. With game quality getting better, initial investments are also on the rise—from less than US\$1 million per MMORPG title a few years ago to around US\$2 million or above. The consensus is that this rise will continue.

Some industry watchers compare online games development to movie making—the common factors being large upfront investment and uncertain consumer acceptance. One should note that even after a game has been launched, it can still be changed on the fly with various patches. In addition, developers often produce new updates (or new areas in the virtual world) and online virtual activities. So, there is still room for improvement even after the initial launch.

The typical development cycle for MMORPGs is around two years. The first phase of 3-6 months comprises initial design (themes, story lines, characters). The second six-month phase is taken up by logic designing and programming. The last phase of about one year is for debugging/development/enhancements/live beta tests.

4.2 Game Operators

Unlike in North America, where the online game developer will take on game development *and* the activities of operating on online game, game operators in China are often distinct and separate from the game developer.

Although game developers may be experts in designing, they may not have the expertise for operations. Games developers, mostly foreign, grant operating rights to operating companies. In China, games operators address issues such as localizing promotions, point card distribution, server operations and government relationships.

The typical financial arrangement consists of the operating company paying an upfront licensing fee of a few million US dollars, and online royalty of around 20- 30% of the game's net revenue. The upfront licensing fee has been on the rise—from US\$500,000 a few years ago to a few million now.

It is worth noting the financial details of the WoW transaction. The9 has disclosed that it will commit US\$74.1 million on Blizzard's 3D MMORPG World of Warcraft (WoW). According to the prospectus, The9 paid an initial non-refundable license fee of US\$3.0 million to Blizzard's parent company Vivendi Universal in February 2005. The9 also guaranteed approximately US\$51.3 million in royalties, consisting of quarterly payments from US\$1.6 million to US\$3.7 million over a four-year period. In addition, The9 promised to spend US\$13 million for WoW marketing and promotions, as well as US\$6.8 million for certain events before the game's launch. Vivendi will receive 22 percent of the face value of sold WoW prepaid cards as royalties.

Large domestic games development companies, such as NetEase, Shanda and Kingsoft, operate their games in-house. Therefore, these companies are both developers and operators.

4.2.1 Will the games operating industry survive?

In the intermediate future, foreign game companies will likely continue to partner with the local operating companies in China. This is due to continued difficulties in point card distribution, localized marketing (webcafe promotions, marketing with local broadband operators), investments in 24x7 games customer service call centers, games localization (to merge with the local culture), and maintaining relationships with various regulatory bodies.

Although direct point card sales are available and various online payment methods are offered, the pick up will likely be slow over the next one to two years, as a large portion of internet users are still concerned about the safety of online payments. Therefore, webcafes or physical point card distribution outlets will continue to dominate.

There is some concern about the margin squeeze of the games operating business given the competition among Chinese games operators and higher fees and royalties from licensors. On the other hand, it is not realistic to expect zero margins or believe that no differentiation exists among different operators. For example, The9 has a good reputation and has proved its capability as a leading games company.

With the exception of Mir2 (operated by Shanda), The9 operates two of the most successful foreign games in China: Mu of Webzen (more than 300,000 peak concurrent users) and WoW. On this note, it is also worth mentioning that Shanda eventually got into a legal battle with the games licensor, Actozsoft of South Korea. Actoz accused Shanda of stealing the Legend of Mir intellectual property, by developing and operating its own game entitled 'World of Legends' at the expense of Legend of Mir. Shanda eventually settled the alleged IP theft with a US\$ 91.7 million purchase of a controlling 20% stake in Actoz.

4.2.2 Competition among games operators

Online games operation is not a high barrier-of-entry business—with a few servers, a small call center and a contract with a national point card distributor, the business is ready to go. In particular, given the flood of VC funds available in the market, some small start-up games operators would just pay a high licensing fee and take a chance.

As a result, there are many games operators in the market. There are approximately more than 100 online games operators in the market for around 200 online games. This recent rise in the number of game operators will likely benefit larger games operators as: (1) small operators cannot afford the high upfront license fee for promising games; (2) VCs are more cautious about investing in small games companies, and such small game upstarts, cannot blindly bid for licensing fees in the absence of VC money; (3) developers are more cautious about choosing the right partners in China; and (4) larger games operating companies can leverage on their scale to get better margins from point card distributors.

Table 6: Competitive landscape in China's online game operator market

Companies	Positives	Negatives
The9	<i>Focus on games operations with proven success in WoW and Mu</i>	<i>Because of strong dependence on the licensing model, more difficult to negotiate a 'good deal' with developers.</i>
Shanda	<i>Large established distribution network and experience in operating leading games in China</i>	<i>Company changing business model and is less focused on online games operations/ developments. Company has recently moved to 'Free to play' online game model and become a hardware manufacturer.</i>
Optisp	<i>Focus on games operations</i>	<i>Does not have track record of operating top five online games in China.</i>
NetEase	<i>Proven development (Westward Journey I and II) and operating capabilities</i>	<i>No interest in games licensing model.</i>
Kingsoft	<i>Proven development and operating capabilities</i>	<i>No interest in licensing model and no experience with top five online games.</i>

Source: APRP

4.2.3 Partnership with telecom operators

Typically, games operators rent physical space from internet data centers (IDC) to put their servers, as well as pay a bandwidth fee to IDC. In this case, operators own physical servers and incur depreciation charges.

However, in some cases, operators would only put the software on IDC's servers (game operators do not own servers). They would typically pay a fixed monthly service fee plus a performance fee. The performance fee is usually based on the number of concurrent users.

Most operators use a mix of both the models. For example, at locations where operators do not have a strong presence, they choose the second model, such that local telecom operators can help promote the games. The decision on which model will be used is also based on the scale of operations, relationship with IDC, and local marketing capabilities.

4.2.4 Point card distributors

In China, the online payment system is still in the early stages of adoption. Credit cards or debit card usage is still not very popular among players. Hence, cash-based point card sales (both virtual and physical cards) have been the most popular payment method. In addition, pre-paid point cards are familiar to most Chinese including long-distance calling cards, mobile phone recharge cards, and online access pre-paid cards.

Direct point card sales by games operators are still limited. Shanda has the most success with direct sales, with 17% of sales through credit/debit cards as of 3Q05. Cash is still the preferred way for small-amount transactions.

In addition to point card distribution, these distributors also add value to games operators by organizing offline promotion events, distributing products (posters, souvenirs) and other marketing activities.

4.2.5 Nationwide distribution of point cards

In order to make point cards available across the country, operators turn to distributors for point card distribution. These distributors are typically: (1) general point card distributors who distribute different types of cards such as calling cards; or (2) IT products (software, hardware) distributors.

These point card distributors can generally be classified into three tiers: (1) national; (2) regional (covering few provinces); and (3) city-wide distributors.

The few leading online game point card distributors in China are Junnet, Jing He, Gotogame, Federal, CnCard and Soft-world.

Table 7: Leading point card distributors in China: card types and game cards

Company	Card Types	Game cards available
<i>Junnet</i>	<i>Virtual and physical cards</i>	<i>Kingsoft games, Mu, Mystina, NetEase games etc. Exclusive distributor for Mu</i>
<i>Jing He</i>	<i>Physical and virtual cards</i>	<i>Exclusive card distributors for Sohu, Ro Online, Legend 3, Crossgate, NetEase games etc.</i>
<i>Gotogame.com.cn</i>	<i>Virtual cards only</i>	<i>Legend 3 A3, Xianluiqiyuan A3, Lineage 1&2, Ro Online etc.</i>
<i>Federal CnCard</i>	<i>Physical and virtual cards Virtual card only</i>	<i>Legend 3 A3, Xianluiqiyuan A3, Lineage 1&2, Ro Online etc.</i>
<i>SoftWorld</i>	<i>Physical and virtual cards</i>	<i>Ro Online, Story of Swordsmen</i>

Source: APRP

4.2.6 Physical cards versus virtual cards

Physical cards are “scratch” cards with pass-codes printed on them. After scratching the card, players enter the pin to recharge the game account. Operators incur manufacturing and inventory costs for physical cards.

Virtual “cards” are essentially a list of pass-codes. Players usually pay cash to a webcafe, after which the cashier writes the pass-code on a piece of paper (or in some cases, the cashier will charge the gamers’ account directly). Large operators have their own proprietary “eSales” system which tracks virtual card transactions from operators to different levels of distributors, and then finally sales at webcafes.

4.2.7 All point cards are pre-paid; no accounts receivable risk

In most cases, operators receive cash before distributing point cards. Similarly, top-level distributors require pre-payment before delivering cards to lower-level distributors. There are no account receivable issues. In addition, cards are typically not refunded.

4.2.8 Game cards inventory

From our checks, first level distributors and webcafes typically hold about one week of point card inventory. The channel should aim to keep minimum inventory, as each participant pays for the point cards on delivery. Point card delivery is usually done within 24 hours, so there is no reason for webcafes and distributors to keep a high inventory level.

4.2.9 Discounts given to point card distributors

The amount of discount depends on the popularity of the card (or expected sales volume) and also the tier of distributors. Typically, if sales volumes are expected to be high, the distributor’s discount is lower (more goes to the game operators). This is because distributors are expected to generate high absolute profit.

The distributors' discount also depends on the tier of distributors the operators work with. For example, Junnet was The9 Mu game's exclusive national distributor. The9 paid a discount of 30% to Junnet, as the latter takes care of all the logistics of working with lower-tier distributors. In the case of WoW, The9 works with regional distributors, so it is able to cut the discount lower—to the high teens. NetEase works directly with about 500 city-wide distributors, and thus can further cut down the discount to around 14%.

Table 8: Game developers and game cards: physical vs. virtual

Company	Physical Cards	Virtual Cards
<i>NetEase</i>	14%	12%
<i>Shanda</i>	17%	20%
<i>The9</i>	20% (30%)	13%

Source: APRP

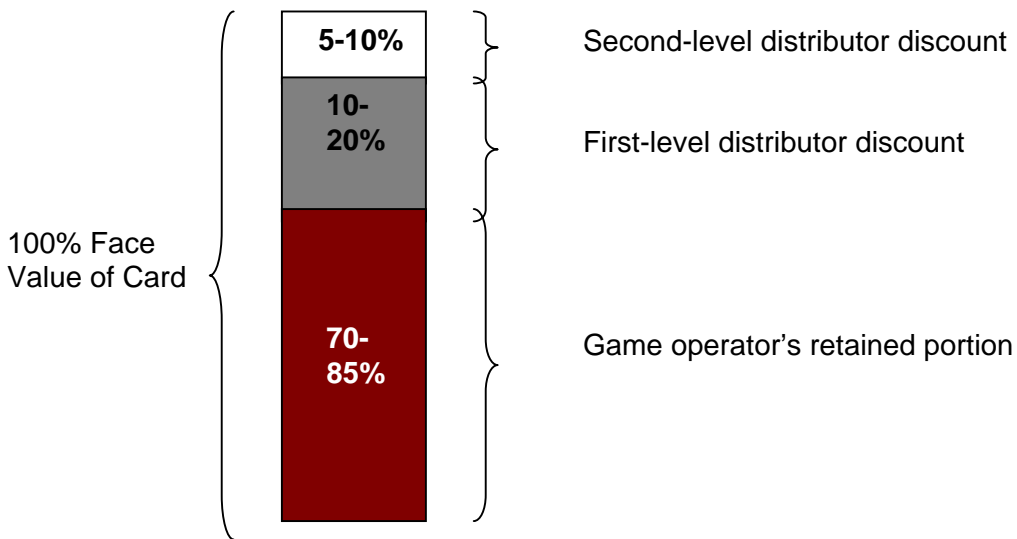
In some cases, smaller operators would likely pay a higher discount of up to 40%, because of low sales volumes and inventory risks exposure (poorly selling cards are still not refundable).

4.2.10 Economics of point cards for each card distribution level

First level distributors (national and regional distributors) typically get 15-30% discount off the face value of the cards. First-tier distributors take the largest share of profit, typically two-thirds of the channel discount. The other one-third of discount is passed on to the second-level distributors and/or webcafes.

First level distributors pay operators once the card is delivered, therefore they are exposed to inventory risks. The lower the sales volume, the higher the risk these distributors are exposed to, which is why they demand a large discount.

Figure 5: Point card distribution channel economics



Source: APRP estimates

4.2.11 Number of points-of-sale (POS)

The number of sales outlets determines the size of gamers a game can reach. However, if a game is popular, distributors and webcafes actively seek the game's cards in order to drive traffic (main revenue source of webcafes is from hourly computer rental fee, rather than from point card sales.)

Table 9: Number of sales outlets

Company	Number of outlets
Netease	800 sub-distributors and web cafes
Shanda	1700 sub-distributors, reaching 310,000 outlets
The9	Approximately 200,000 outlets

Source: Company, APRP

Note: both physical and virtual card outlets combined

5 Online Game Economics

Based on our discussions with both Chinese and Taiwanese developers, most believe that the required number of concurrent users is low for a MMORPG to break even. Excluding development costs or licensing fees, a game can achieve operational breakeven at 4,000 to 5,000 average concurrent users.

With relatively low breakeven user numbers, the number of MMORPGs titles is likely will continue to grow. However, many of these will be small-scale games, which will target niche audiences, much like the different types of movies—action- adventure, science-fiction, martial arts, war, mystery, medieval, etc.

Table 10: Estimated gross income of a MMORPG under various concurrent users

	Case 1	Case 2	Case 3
Average concurrent users	1,000	4,000	10,000
Active paying users	11,000	44,000	110,000
ARPU per user (Rmb)	9	9	9
Revenue after distributor's discount	79,200	316,800	792,000
Number of servers	3	4	9
Monthly server amortization and bandwidth cost	16,375	21,833	49,125
Game masters and other labor cost	48,000	64,000	144,000
Marketing and promotion	55,440	110,880	158,400
Other operating expenses	47,520	95,040	158,400
Gross monthly income (Rmb)	(88,135)	25,047	282,075
Gross monthly income (\$US)	(10,997)	3119	35,133

Source: Company sources, APRP estimates

6 Recent industry issues

6.1 More 'free-to-play' (item based) games

Most MMORPGs are "subscription based" (pay-to-play), meaning gamers need to pay either a monthly subscription or a per hour fee in order to play a game. Recently, "item-based" games have been in the news. Shanda recently announced that most of its servers for Mir 2, Wool and Magical Land will change from the "subscription-based" model to an "item-based" model. In addition, Yulgang, a Korean game operated by China.com, has seen peak concurrent users (PCU) of over 250,000.

Item-based games are free-to-play games, but charge for special weapons or in-game items. For example, if players want to gain an advantage over other players, or would like to dress up their virtual characters, they need to pay a fee to get a sword or a new piece of clothing.

Games that are switched to a free model in the middle of their commercial life are usually of a lower quality or are finding it difficult to retain users. Also, games that are not successful since their beta launch are being offered in item sales, in order to keep a higher user base and to get some marginal income.

We believe that as more quality games become available in the market, older games or lower quality games will be offered for free with item sales. However, we believe serious gamers will turn to higher quality games for insignificant additional fees.

6.1.1 "Subscription based" versus "item based": Which model is more profitable?

Assuming two similar quality games, we believe the "subscription-based" model generates more profit over the game's lifecycle. The initial launch of an item-based game generates high user traffic due to its free nature. Paying users form only a small portion (typically less than 20-30%) of the total active players. They usually spend more (or higher ARPU) to stock up their avatars and weapons.

However, the lower paying user base compared with the subscription model leads to slower initial revenue uptake in an item-based model. During the lifecycle of a game, we expect the highest PCU to be multiple times higher for item-based models than for subscription-based models. However, item-based games are usually less sticky, simply because gamers do not devote as much effort to achieve a high status compared with subscription-based games. As a result, item-based games tend to have a shorter lifecycle. Additionally, in the later phase of the game lifecycle, most players already have a stockpile of items, and are thus likely to continue playing the game without additional purchases. This, in turn, leads to faster revenue decline.

Over the lifecycle of a game, subscription-based models would generate high accumulated revenue (area under the curve of Figure 6, below) compared with item-based models, despite the peak PCU being multiple times higher in the item-based models. Many industry observers believe the comparison is indeed quite crude.

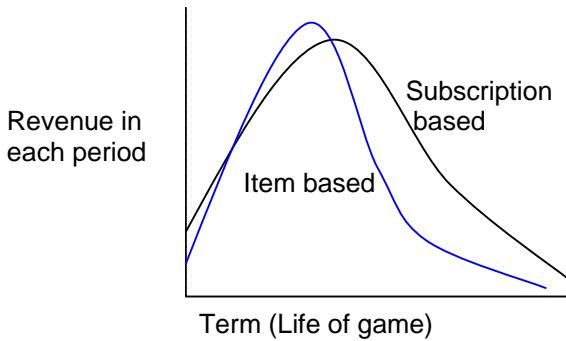
The designing and playing are quite different between the two models, and therefore it is difficult to compare the quality of the games. Also, for high quality games, operators will naturally turn to subscription-based models. On the other hand, some games that were originally designed for subscription, are, due to their low quality, now item-based models. This also leads to unfair comparison between the two models.

Table 11: Advantages and Disadvantage of ‘Item-based’ vs. ‘Subscription based’ models

Metric	‘Item based’	‘Subscription based’
Initial user uptake	Faster Due to free nature of game	Slower PCU typically drops by 50% after commercial launch. Also, it takes time to build up community
Initial paying user ARPU	Higher Serious games stock up for new items. Initial ARPU could reach more than Rmb60 (US\$7.50). After game matures, ARPU will be similar between two models	Lower ARPUs are in line with typical MMORPGs of Rmb20-40 (US\$ 2.50-5.00)
Initial revenue uptake	Slower Due to lower portion of users who pay for game	Faster 100% of users pay for the game, despite lower concurrent users
Highest PCU over game life	Higher Due to free nature of game	Lower Due to paying nature of game
Life cycle	Shorter Due to lower stickiness and switching cost	Longer More loyal customers due to time and energy invested in games
Revenue over lifecycle	Lower Shorter life cycle and lower revenue after initializing uptake	Higher Recurring revenue from players over a longer life cycle

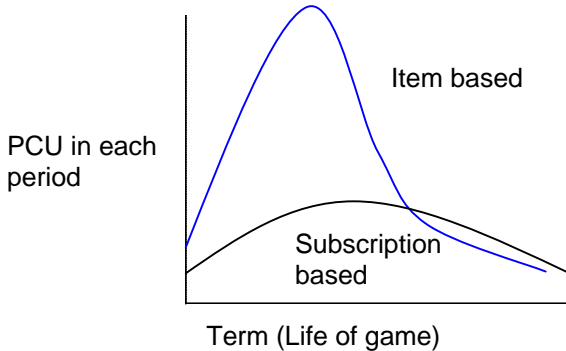
Source: APRP

Figure 6: Illustrative revenue during game lifecycle for ‘item-based’ and ‘subscription based’ models



Source: APRP

Figure 7: Illustrative peak concurrent users (PCU) during game life cycle for ‘item-based’ and ‘subscription-based’ models



Source: APRP

6.1.2 What do players want: “Subscription based” or “item based”?

Gamers within item-based models into two groups—paying and non-paying users. Paying users enjoy better features and advantages over non-paying gamers. This is done as an incentive for gamers to pay.

Let us look at paying gamers in item-based models. Before choosing between subscription-based and item-based models (assuming this is the dominating factor for choosing a game), these are a few things that users will consider:

- **What is the cost difference?**

In an item-based model, paying users have to pay for items in order to have a pleasant game experience. From our checks, the average spending for paying users is similar to subscription-based models. Hence, there is not a significant cost difference between the models.

- **Fairness of a game**

In an item-based model, rich players who can buy the best tools, have an absolute advantage over poor non-paying users. This, in our view, creates an unhealthy social balance in the game, and would disappoint some players. As a result, the game may be less appealing to players.

- **General quality of game which is lower for “item-based” models**

As mentioned above, quality games will likely be offered in subscription-based models, and gamers would likely get lower quality games if they choose item-based models. Gamers invest hours of their time in online games, and they would like to invest in games that are more fun and interesting.

Some industry observers believe subscription-based models offer more benefits to players. Over the long-run, with a similar fee for both models, paying users are likely to prefer the subscription-based model.

6.1.3 The main investor concern: Will paying players become non-paying gamers in “item-based” models?

There are obviously many different reasons for players playing online games—entertainment, make friends, to kill time, or challenge one’s intelligence. “Free” is definitely attractive. Some users may be more price sensitive compared with others, and free games will draw them away from subscription-based models.

One of the main reasons why MMORPG has become popular in China is its economic nature compared to other forms of entertainment. For example, the average monthly ARPU of NetEase’s game is approximately Rmb20—the same cost as a MacDonald’s Big Mac meal. The question is what would a user pick? Would he/she choose a mediocre game and a Big Mac meal or a high quality game for a month?

6.1.4 The “item-based” model impact on good quality game titles is small

We believe most players would pick the latter option and pay for high quality games. Empirical evidence also supports this thesis. Despite the large availability of free casual games and the introduction of Yulang, the MMORPG market continues to see strong growth in early 2006.

We expect the MMORPG market size to continue to grow despite more item-based games being available given that: (1) users will pay for quality game titles; (2) the price for quality titles is already low compared with other entertainment options; and (3) big hits in the market are likely to be offered in subscription-based models.

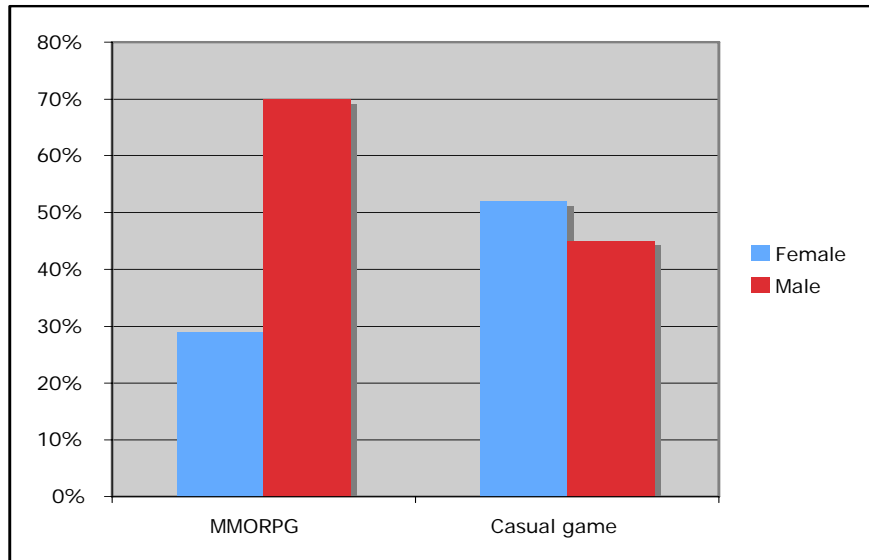
6.2 Market Share - Casual games vs. MMORPG

6.2.1 Casual and MMORPG are complementary rather than competing products

Casual games and MMORPG satisfy the needs of players at different times. For example, a player with 15 minutes to kill will likely play casual games. But if a player has a few hours every day, playing a simple casual game is likely to become too boring. Therefore, the player could play both types of games at different times, depending on the time at his disposal and his/her needs.

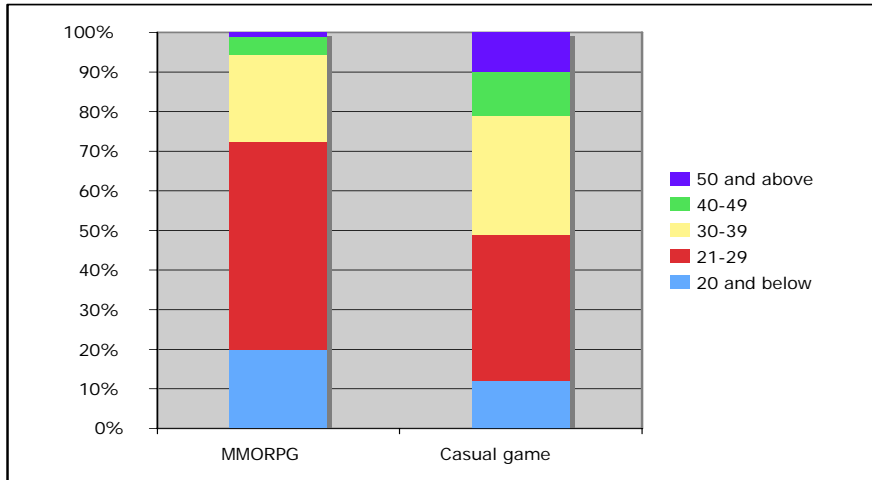
One sees the development of new, innovative and advanced casual games that attract non-game players to online games, further expanding the gamer base. This is evident from the demographics in Figures 8 and 9 below. These additional players could become MMORPG gamers down the road, if they find online games interesting.

Figure 8: Gender comparison between Casual games and MMORPG



Source: IDC

Figure 9: Age Comparison between Casual games and MMORPG

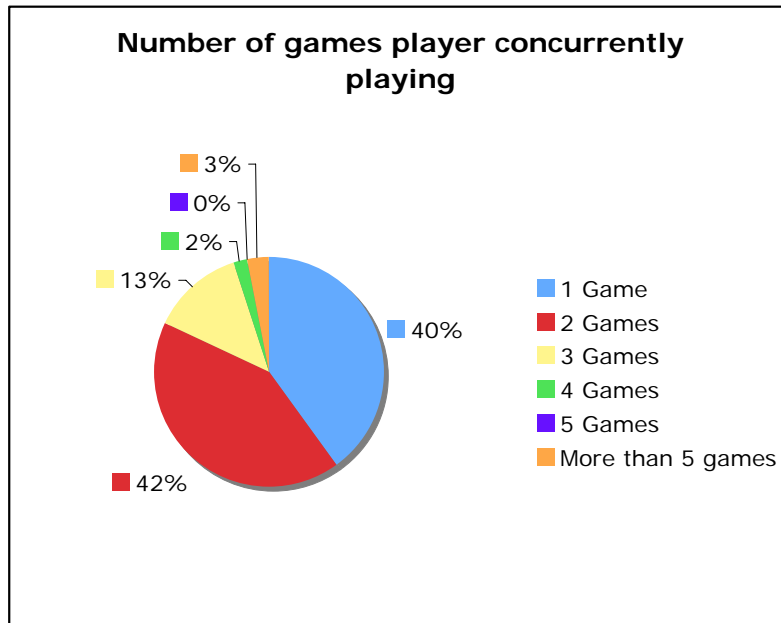


Source: IDC

6.2.2 Do gamers have time to play both advanced casual and MMORPG?

In China, the market trend is to develop advanced casual games that are more complex and involving, and as such these casual games consume more time than before. Investors are concerned that this would reduce spending on MMORPGs. This may be true, but the effects on MMORPG would be minimal. First, it is not uncommon for users to play multiple games, so they can play both MMORPG and casual games during the same day. Second, an expanding casual game user base also brings new users to MMORPG.

Figure 10: Number of games that players play concurrently



Source: IDC

6.3 How fast would a game decline from its peak?

As a rule of thumb, popular MMOPRGs reach their peak at around three years. The rate of decline from the peak varies depending on various factors. Some games decline at a faster rate compared with others. For example, Mu Online, operated by 9Webzen (a joint venture between The9 and Webzen), experienced a step-function (around 50% drop each step) type of sharp fall, mainly due to hacking and cheating tools. While Mir 2 declined 30% Q/Q in 3Q05, mainly due to pirated servers.

The rate of decline from the peak varies depending mainly on the following factors: (1) hacking or pirated server issues; (2) ongoing promotion and user activities; and (3) the availability of upgrade/expansion packs.

Given the above three factors, NetEase's Westward Journey2 (WWJ2) is not likely to decline at a fast rate. WWJ2 is likely to decline with a long-tail, given that it does not have pirated server issues and very limited cheating tools, and also the company is committed to offering upgrades and ongoing activities for the game. Some industry observers forecast WWJ2 to decline at around 2% Q/Q in 2H06, and by 30% in 2007, which may be quite conservative.

Key Market Trends

6.4 Users to be more focused on content

After five years of online games development in China, the most frequent user complaints are not for high fees or customer service, but for non-differentiating content. It would appear that many of the existing games, particularly those from smaller games companies, are more or less copies of successful games in the market, and this has created negative sentiment in the industry. Recently, O2Jam and Freestyle have drawn much attention from users because of their differentiating content.

We believe both foreign and domestic games can be successful in China—through different competitive advantages. Foreign game titles often bring in new, interesting/high-quality games to China; this will obviously attract users who look for innovative games. On the other hand, domestic game companies tend to be behind in terms of technology, will likely compete on their Chinese cultural understanding, and local tastes. One example is the Westward Journey series offered by NetEase.

6.5 Consolidation: Larger companies grab market share

As larger companies are grabbing market share, smaller game companies are beginning to lose out. Some smaller games development companies, which had venture capital (VC) investments, have begun to close down or are virtually offering their games for free. On the other hand, from our conversations with VC fund managers, VC investments are moving their focus away from on online game companies. We believe going forward, non-differentiating smaller games development companies will find it difficult to survive.

There is also a similar trend in the operations business. With licensing fees increasing and upfront guarantees for hot foreign titles, it will be challenging for smaller companies to license good quality games from overseas. The9, Shanda and Optisp will likely become major games operators in China.

6.6 Chinese government encourages domestic games development

GAPP (the General Administration of Press and Publication of PRC) has implemented “China National Online Games Publishing Project”. From 2004 to 2008, the agency will offer policy and financial help for 100 domestically developed online game titles, and ensure their successful launches. The project indicates the government’s support of the domestic games industry. On the other hand, some government officials suggest more stringent approval requirements for imported games. Thus, Chinese game companies may get more favorable treatment from the government.

Furthermore, with the Chinese government’s support of the online game industry, domestic companies are publishing games that are tailored to Chinese culture.

6.7 Chinese cultural understanding

It may seem obvious, but nevertheless it is worth stressing the fact that online games can only succeed when there is cultural resonance with their target market.

In this way, local Chinese games development companies have the advantage of

cultural understanding, compared with foreign developers, and thus, can develop games that are more appealing to Chinese gamers. Examples of such themes are the Westward Journey series of games by NetEase and other companies, and also “Fung Shen” series by Kingsoft and a few other companies. The “Westward Journey” theme is a huge success in China. In 3Q05, both Westward Journey theme games combined achieved a PCU rate of more than 1.3 million users.

NetEase also has Da Tang 2 and Tian Xia in the pipeline, both with unique cultural relevance. In this regard, NetEase is likely adopting the right strategy by focusing on games with deep Chinese cultural roots, rather than competing with foreign games purely on the technology front.

7 Regulatory environment

Currently, three government bodies oversee online games companies in China. As the online games industry is still in the early stages of growth, one should not be surprised if these regulatory bodies change in the future.

In addition, the development and distribution of games in China requires a joint venture agreement with an approved Chinese partner. The Chinese partner must have majority ownership and control of the Joint Venture.

The three government bodies are:

- **The General Administration of Press and Publication of PRC (GAPP) or State Press and Publication Administration:** According to the Tentative Measures for Internet Publication Administration (2002), the provision of online games is deemed an internet publication activity. Therefore, an online game operator must obtain approval from GAPP in order to carry on its online gaming businesses in China.
- **Ministry of Information Industry:** The ministry has promulgated rules requiring ICP license holders that provide online bulletin board services to register with, and obtain approval from, the relevant telecommunication authorities.
- **Ministry of Culture:** Since online games fall into the definition of “internet culture products” under The Tentative Measures for Internet Culture Administration (2003), an operator of online games must obtain an internet culture operation license, in addition to the ICP license.

7.1 Approval requirements for a particular game title

Each game title must be submitted to the Ministry of Culture and to GAPP for approvals (software product registration and software licensing).

7.2 Additional approval for foreign games

Foreign games are also subject to review by the Ministry of Culture and GAPP. However, the standards for foreign games at the GAPP office are more stringent, given the “imported” content. Foreign games are required to register with the Ministry of Commerce and the State Copyright Bureau in order to publish or reproduce imported games software in China. Otherwise, operators cannot remit licensing fees out of China to any foreign game licensor.

Content restrictions include violating the “One China” policy (Taiwan is a province of China and not an independent country. More specifically, internet cafes, the primary venue for game distribution, are prohibited from displaying "audio and video products and electronic games" that threaten national security or disparage other nationalities or races. Specifically, the entertainment may not "damage China's unification, sovereignty, or territorial integrity," referring to the dispute over the status of nominally independent Taiwan).

As mentioned, the government has an aggressive mandate to promote the game

industry, but especially work to build up the domestic industry and favor local content and talent. In order to produce content for local distribution, one must have an approved Joint Venture partner.

That said, even with a local partner with significant Guan Xi, getting locally produced co-developed content approved can take significantly longer than 'plain vanilla' domestically produced content. For example, the China News Publishing Administration reviews all new games to check for illegal content: this process took around six months for the Korean game A3, versus under one month for domestically developed games such as Fantasy Westward Journey (Netease).

7.3 Regulations and processes for establishing Chinese JV

We have prepared the following points as information regarding the establishment of a JV as well as the distribution of online games. While it is by no means all-inclusive, it does provide insight into the regulations and restrictions of online games in China.

7.3.1 Application procedures for setting up an Internet Culture Business Unit

Applications for establishing an Internet Culture Business Unit shall be submitted to the local cultural administrative department of the relevant provincial, autonomous region or municipal government. Upon preliminary examination by the local cultural administrative department, the application will be referred to the Ministry of Culture for approval.

In addition, when applying to establish an business-based Internet Culture Business Unit, the applicant shall organize itself as an enterprise and provide the following documents:

- A written application;
- A notice that prior approves the company title or a business license and prospectus;
- Documentary proofs of source and amount of capital and the relevant credit documents;
- Credentials and identity papers of the statutory representative(s) or the primary responsible person(s) and the principal management and technical staff;
- Documentary proofs for the right to use the work site;
- Business development report;
- Other documents required for submission under law.

7.3.2 Establish a Mainland party holding majority shareholding company

For enterprises jointly funded by domestic and foreign companies, the proportion of foreign capital shall not exceed 49%.

7.3.3 Requirements for establishing an Internet Culture Business Unit

The following conditions must be met in order to establish an Internet Culture Business

Unit:

- The unit shall have a title, address, organizing agency and prospectus; The areas of Internet cultural activities shall be clearly defined;
- The unit shall be run by at least eight management and technical staff who have the necessary qualifications for operating Internet cultural activities;
- The unit shall have at least RMB\$10 million (USD\$ 1.25 million) in capital and the facilities, work site and necessary operational managerial technical measures for operating Internet cultural activities;
- The unit shall follow other provisions set forth in relevant laws, regulations and rules.

7.3.4 Vetting procedures for Internet Culture Business Units

To import foreign online games, approval from the Ministry of Culture is required. The Ministry of Culture is responsible for monitoring the contents of Internet cultural products. According to Chinese law, activities related to the import of Internet cultural products are to be conducted by business-based Internet Culture Business Units with Internet Culture Business Operating Permits issued by the Ministry of Culture.

The contents of the Internet cultural products must be submitted to the Ministry of Culture for vetting. The General Administration of Press and Publication is also responsible for monitoring the contents of on-line publishing.

In addition, prior approval is mandatory for on-line publishing. No entities or individuals should be engaged in on-line publishing without approval.

7.4 Games rating system

In late 2004, the China Youth Association for Network Development published a draft document on game rankings. Similar game rating systems have already been implemented in other countries, such as: (1) Entertainment Software Ratings Board (ESRB) in the US—Early Childhood (EC), Everyone (E), Teenagers (T), Mature (M), Adult Only (AO); (2) Korea Rating Board (KRB), and Japan's Computer Entertainment Rating Organization (CERO).

The rating is based on the level of violence, sexual content, ethics and cultural content. The five different categories are all ages, junior-high school, senior high school, above 18, and dangerous. The rating system was launched in late 2004 and is a voluntary standard. Thus, one should expect this system to take some time before it is widely adopted by the industry.

The Chinese rating system is voluntary and has not been widely adopted by the games industry in China. However, a sophisticated rating system would help address addiction issues and social pressure.

7.5 The “Fatigue System”

In July 2005, the Chinese government began to take measures, to address growing

concerns about the addictive nature of online games and the excessive time many people, especially school aged children and youths, were spending on this pastime.

Specifically, the government firstly announced a ban on all "violent" gameplay for minors under 18. Chinese officials defined 'violent' as any game that involves player vs. player combat, a common feature among MMORPGs. They then met with the leading gaming companies and required them to start building into their games certain co-called "Fatigue Systems" that would diminish the rewards for playing the games for extended periods of time. The system, which was to be gradually implemented over an unspecified periods of months/quarters, calls for a 50% reduction in experience points to be awarded after three hours of play, and then after five hours of play, no experience points are awarded.

At this point, the Fatigue System has been implemented on only a few servers for each game of the major companies, including The9. As such, the ultimate impact is still unknown, but almost assuredly the full effects have not, and will not, be felt until this system is fully applied to all servers on all games, which will probably be sometime in the late first-half, or second half of 2006.

The impact of Fatigue Systems, while negative for most if not all MMORPGs, is likely to be most acute for *new* MMORPGs. Indeed, as most experienced gamers will recognize, one of the most critical elements to getting player's "hooked" on a game is the ability to play for extended periods of time and level up quickly so the game is more interesting. This is at no point more critical than when players first start playing a game.

Finally, general expectations are that the government regulation of the online gaming sectors is just beginning, rather than reaching its end. Indeed, despite its very early stage of roll-out, some within the government are already frustrated by the relative lack of success of the Fatigue System, and are pushing behind the scenes for stricter, more immediately effective measures be adopted that would curtail the number of hours youths are playing online games.

8 Lessons for Canadian Game Studios

Without wanting to state the obvious, it is worthwhile to stress the fact that entering the Chinese market could perhaps be the most crucial and far reaching decision a studio can make in its lifetime. While senior management would certainly only consider such a decision if grounded in firm reality, one cannot ignore the hype and expectations surrounding the Chinese market.

We believe the entering the Chinese market is one of the riskiest value propositions a studio can make. It has the potential to be successful far beyond what is envisioned and at the same time could entrap management in an exercise that could bankrupt a company in both financial and time management terms.

All of this said, we do believe that the right mix of game content, management expertise, and the appropriate Chinese partner can lead to a very successful enterprise. However one must also be aware that this is should be a long-term exercise that transpires over 3-5 years.

It is with this in mind that we've prepared the following section that will hopefully provide both strategic and operational advice to help enterprising Canadian studios enter the Chinese market with open eyes so that 'wishful thinking' never enters the decision making process.

8.1 Characteristics of Western and Chinese Game development

While the majority of the document covers the Chinese game market from a business perspective, we believe it is worthwhile to also include salient characteristics that define the differences between Chinese content and gameplay characteristics and Western models.

In this regard, China's online game market, in comparison to developed countries such as Canada, displays a number of unique characteristics:

8.1.1 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 North American games, resulting in a relatively shorter product life cycle of 18-24 months. 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.
- As we've previously mentioned, Chinese online gamers are roughly evenly split between active players (mostly students who play an average of 25 hours per month) and casual players (mostly young professionals). As the total number of gamers increases in China, we expect the proportion of casual gamers to grow. These casual players are generally unwilling or unable to spend long hours

playing complex games and prefer new titles instead of additional new features of existing games.

8.1.2 Aversion to risk and quantity over quality

For simple reasons of nascent game development expertise, development costs and the competitive nature of the industry, there is more of a focus on getting the product quickly to market, than taking the time to develop a blockbuster.

The primary thinking behind this first-to-market mentality is that one's competitors are working on somewhat equivalent product, and if the product isn't placed first, then one will lose out on market share.

Because of this development/marketing regime, the life cycle of game product is also noticeably shorter than what Western publishers/developers would hope for. While AAA titles such as WoW or Everquest have a product lifecycle of 3-5 years, domestic Chinese titles run for one to two years.

This lifecycle naturally coincides with development costs that must be recouped over time. The higher the cost, the longer one would hope for product reach and marketability, but in the Chinese context, there is an implicit understanding that quality need only exceed a relatively low threshold.

This is supported by the belief that the consumer is not very discerning in their appetite for online content as well as the continual search for the best content at the lowest price. Hence, the recent arrival of item based games that cost nothing to play at their basic level, but for character advancement, one pays for extra/enhanced items.

This is contrasted with most Canadian studios in PC and console development, in which they are accustomed to taking 18-24 months for full game development and ensuring they have achieved high production values.

Moving to a system in which 12 months is considered a long development cycle would probably be a challenge, not necessarily in expertise, but in a mindset change that would likely be difficult for most Canadian developers.

8.1.3 Stronger sense of community

Chinese gamers view online games as a sociable form of entertainment. Many visit Internet cafes to play games on broadband connections the way North Americans would go to movies with their peer group. In addition, Chinese players in Asia are focused more on community, hanging out with friends in the game, and trading game items and less concerned with graphics (most available PCs are not very powerful anyway) and fast-paced action required by many Western gamers.

8.1.4 MMOG Gameplay (Hack & Slash vs. Role Playing)

MMOGs developed in the West are generally focused on limiting repetitive action tasks (killing the same monsters 100 times in order to move up a level), fast action, player versus player combat, smaller penalties for a user's character dying and limited

downtime.

On the other hand, MMORPGs that are successful in Asia are more community focused, discourage unsolicited player-versus-player combat and encourage item trading. Thus, Asian hits like 'Lineage II' have not been popular in the Western markets.

In addition to the community element and trading features, competitive 'hack & slash' is a very popular gameplay style as opposed to the more time consuming and complex Role Playing style that appeals to Western consumers.

To enhance the community element, in-game chat functions have long been a central feature of Chinese online games, compared to the relatively recent addition of Western games that feature easy-to-use and transparent chat functions.

8.1.5 Market evolving from foreign games to domestic games

Foreign games, especially those licensed from Korean developers, account for approximately 60% of the market. The key reason for this phenomenon is the relative inexperience of local studios in the area of product development.

The key reasons for the dominance of Korean content is both a Korean and Chinese story. The Korean game industry took off in the late 1990s. By 2001/2002, the industry was already mature enough to export its product. As a business decision the Koreans looked for a large, yet proximate foreign market. Yet substantiating this business decision was the cultural similarities and shared histories, the Korean's could easily export their content to other North Asian markets including China and Taiwan. For example, Korea and China share stories and myths about the Three Kingdoms and the 'Monkey King'.

During this time, were relatively small operations, but had strong investment backing. When the Koreans entered the market wishing to license their product (MU Online, The Legend of Mir) they found companies such as The9 and Shanda, which were relatively small, but had ample financial resources to pay license fees in excess of USD\$ 500,000.

As Chinese internet infrastructure and disposable income rose, so did the popularity on online games. Without a domestic talent pool, the Chinese relied on Korean content to satisfy consumer demand and fuel their own business growth.

This relationship generally worked very well for all parties, with consumers very satisfied with the quality and scope of content, the Koreans making money because of license fees and royalties as well as Chinese game operators making substantial profits from their own activities. However, as of 2005, the Chinese government also took notice of the situation and made it a national imperative to ensure monies made in China originated with domestic projects rather than paying license fees and royalties to foreign parties.

As a result of the Korean/Chinese partnerships, the domestic game industry is making progress. Local sources estimate there are approximately 5000 game industry professionals in China, from development/art personnel to marketing expertise. To put this in perspective, Vancouver has approximately 2000 professionals within one city.

So, one can see that China still has some way to go insofar as game industry expertise is concerned and will continue to rely on foreign content for at least the next five years.

That said, there are domestic studios such as Netease, which has released two successful MMOGs, *Westward Journey II* and *Da Tang*.

However, one should note that the reliance on foreign content, even though it may continue for the next five years, will gradually decrease, not just because of market conditions and greater expertise, but the Chinese government has a mandate to severely restrict foreign content and promote domestic development.

This mandate includes restricting the types and quantity of joint venture/co-development projects taken on by Chinese studios and foreign partners. The profile of the partners and type of content to be developed are restricted/permited by the government.

8.2 Risks and Priorities for Canadians' China Strategy

While there is significant interest in entering the Chinese market, the fact remains that this strategy is appropriate for very few Canadian game companies. When considering entering the Chinese market, whether it is for domestic game development or as an outsourcing strategy, it should be seen as a long-term strategy. One should not expect to see substantial benefits of entering the market until approximately 3-5 years after first establishing a local presence.

The obstacles to entering any new market are difficult, but China has its own set of challenges, and for Canadian game companies, they primarily concern online game development proficiency and the nature of business relationships within Chinese culture.

The following section will outline the key risks, opportunities and priorities for Canadians wishing to enter the Chinese game development industry.

8.2.1 Finding the right partner and Guan Xi (Relationships matter most)

Of paramount importance in China is the notion of Guan Xi or connections. This cannot be overestimated in Chinese business. Simply put, it means the type of number of connections one has, with the more high profile people one knows the better. However, in the Chinese context, this does not mean having acquired someone's business card, but having developed a real and recognizable personal/business relationship.

Canadians must be prepared to spend an extraordinary amount of time fostering and maintaining relationships among their business contacts.

We must also note that it is almost impossible to develop the relationships necessary for a successful business relationship without being, living, and working in China. In addition, it is not unreasonable to expect to spend one year fostering a key business relationship and then another year working out the formalities and cementing the deal.

It is also worth noting that it is very difficult finding partners that can be trusted in China. This is more a matter of cultural business practices than outright dishonesty. Competition is fierce within China, and it is a given fact that one will and *should* search

for the best deal/relationship, even if this means turning back on a previous agreement.

A prime example is Shanda, which is lauded as a Chinese success story, but essentially made its way by copying Intellectual Property from its licensor ActozSoft (see Section 4.2.1 of this report). Many developers within the North American game development community are surprised that Shanda's North American representative continues to make his rounds, searching for business opportunities, with such a corporate history.

The key lesson here regards the cultural differences in business relationships. It is almost certain that if ActozSoft had the proper Guan Xi with Shanda, with other high profile industry executives, and especially within the government, the episode wouldn't have transpired as it did.

So Canadians must be prepared to heighten their business instincts as well as be prepared for an extended period of relationship building with their Chinese counterparts.

And of course, aside from the generic concern of finding an appropriate joint venture partner, one should also keep in mind the issues of due diligence, investment structuring, repatriation strategies, financing strategies, China tax minimization, intellectual property management, site selection and joint venture structuring.

8.2.2 Choices: outsourcing and/or domestic market entry

Companies such as EA and Ubisoft have set up development facilities in China, with Ubisoft even developing the latest Splinter Cell title out of its Shanghai studio.

We mention these two companies, as they are among the industry's largest, with deep pockets, extensive expertise, the patience to survive in the Chinese market and not least, the financial resources to survive if their strategy fails.

One should also note the EA and Ubisoft have a *long-term* goal of Chinese development, meaning developing content for local consumption is not yet in the works. Their primary goal is to capitalize on the cost savings of developing in China for worldwide consumption. Obviously, these companies have the reach and scale for this medium-term strategy to make sense as they build up internal expertise and market knowledge.

Unfortunately, there are not any Canadian studios with the same global presence as these two firms, so the opportunities and risks are not only very different from an EA, but also very acute. The obvious concern is the reservoir of funds dedicated to entering a new market, but as we mentioned, even more important than finances, is the Guan Xi of the Canadian developer within the Chinese market.

For Canadian studios, following the example of EA and Ubisoft in establishing offshore development facilities rather than a dedicated studio for domestic consumption is probably a better choice.

8.2.3 Recommendation: Outsourcing as first step

For the majority of Canadian studios, we would go one step further in recommending an initial outsourcing strategy with a Chinese partner, in which art and progressively, programming capabilities are outsourced. This offers the advantages of cost savings, building relationships and finding partners one can trust as well as an incremental approach in acquiring market knowledge and regarding development, operations and marketing know-how.

In fact we are aware of a couple of Canadian studios who are actively pursuing outsourcing facilities not only in China, but throughout the region. While the main advantage is well known; art asset production at up to 1/6 the cost of Canadian production, the downsides are rarely mentioned.

The fact is the real cost savings will not be up to 1/6 that of Canada, but about 1/3, *if and only if*, the process is managed well enough. This is because one should factor in the cost of Canadian salaries, bonuses, overtime and overhead expenses. The first efforts at outsourcing may not provide the results that were hoped for, and it will probably take a few months/projects to iron out the wrinkles in the process.

While many may say that a cost reduction of 33% is worth the effort, outsourcing also has its challenges. Provided a studio can manage the following challenges, it is then worthwhile pursuing the steps of outsourcing to a Chinese partner.

- If outsourcing will account for more than 25% of a project's art assets, it is worthwhile assigning a dedicated professional to the outsourced project;
- The person responsible for the outsourcing must have outstanding communication, interpersonal and project management skills as outsourcing is above all, a process of managing internal and external talent. If China is the outsourcing choice, then the person must also have exemplary patience and intercultural skills;
- Ideally, the outsourcing partner should be on a *personal* and *friendly* name-to-name basis with not only the producer in charge of outsourcing, but also the art/technical director and art leads at the Canadian studio. This relationship will help when problems and mistakes arise in the process and ensure there is always a firm working relationship;
- Following from the above, the priorities in an outsourcing project should be: 1, cultural fit/working relationship; 2, quality and; 3, cost savings;
- Establish definitive internal technical and artistic parameters from which to build external pipelines;
- Ensure that one's own art asset and technical production processes are solid and there are few problems with the internal processes;
- Establish and manage benchmarks to determine outsourcing partner's capabilities;
- Help to establish internal group readiness for outsourcing projects;
- Build strong and robust internal communication flows and feedback processes;
- Act as relationship/communications manager between the Canadian studio and external outsourcing partners;
- Help to build strong relationships between internal and external teams.

8.2.4 Taiwan as a strategic entry point into Mainland China

Taiwanese game developers/operators have a long history in China, almost on par with the Koreans. There are several successful MMOGs Taiwanese operating in Mainland China, though none can claim the success of titles such Legend of Mir or Ragnarok Online. Though as mentioned, the Korean's success is largely the due to the benefits of first mover advantage.

All of this said, we recommend working with a Taiwanese partner as this strategy has the following benefits:

- Deep experience in China, knowing the intricacies of business in Mainland China, having experienced many successes and many failures
- Are more apt to work with Canadians on a good faith basis, by sharing their experiences with Canadian partners and benefiting from Canadian's own strengths and expertise.
- Are more familiar with Western business practices having dealt with Western companies for some decades
- English proficiency if not fluency from senior management to line management.

Many Taiwanese companies are eager to move forward and try new content, adopt new game play styles as well as the access opportunities that expand their reach beyond the intensely competitive Greater China market.

In adopting the above strategy, one is not forced into a severe 'sink or swim' environment that is common in the Mainland China market by working with a partner who has the network, market knowledge and industry expertise to succeed. One also gains a partner that is looking for a strategic partner, who sees potential benefits beyond purely financial considerations (license fees, royalties), which is often the case for Mainland Chinese companies.

To this end, we have included a short list of Taiwanese industry contacts, found in the section 'References, Other Useful Information,' that are open to possible collaboration with Western game studios.

8.2.5 Online PC focus/ MMOG operations

The obvious distinction of the Chinese game industry is the focus on online PC content rather than console development, for the reason of rampant piracy that exists among console games. First party publishers simply don't support console marketing in China, because piracy approaches 100%.

Thus, the online industry evolved as it is easier to manage, police and also market online content than single player console or even PC content.

If a company does decide to develop content for the local market, the standard provisions of online development and operations will apply. We mention these issues here only briefly as online game development and operations/management is a whole topic within itself. However, there are concerns that are unique to the Chinese market, so we'll focus on these relevant issues:

- *Managing churn* – In China, customer churn is especially troublesome as the number of online titles, both MMORPG and casual is increasing. One could even say there is a significant amount of churn within available content, which then promotes increased customer churn.
 - Churn is augmented by the number of public beta vs. commercial release titles, as beta titles will often compete with commercial titles for concurrent users. As mentioned, the manner in which games are developed (short development cycles with limited budgets), ensures churn is a systemic challenge, not to be overcome by exceptional marketing or high quality content.

- *Managing conversion from registrations to customers* – Related to the above, ensuring consumers registration to paying customers is especially difficult, given the amount of beta and free-to-play content.
 - While some games such as Yulang, boast 9 million registered users, the actual number of concurrent users is often a closely held secret. Some estimate that Yulang has at most 215,000 concurrent users, which is less than 1/30th of its registered base. There is then the question of costs associated with conversion and even the server costs of supporting millions of non-paying users.

- *Managing multiple sales channels on an ongoing basis* – The Chinese game value chain entails significant challenges to both marketing and distribution executives. With both online and ‘retail’ (corner store) channels for actual game content, combined with point card distribution and subscription/free-to-play models, there are few Western professionals with the relevant expertise to manage such an enterprise. To manage these operations, some Chinese operators employ sophisticated CRM (Customer Relationship Management) software to ensure both the channels and relevant consumers are adequately matched

- *Targeting content production to address drop-out stages in customer life cycle and to deliver what customers want* – This is a difficult proposition for most games in China as by the time new content should be released, users have left the game for the next fad or cheaper product.

- *Optimizing pricing models* – As mentioned, this has become a crucial issue in within the Chinese game industry as Shanda has moved from a subscription to an item-based pricing model. It is still too early to tell what the impact on the industry at large will be as some companies struggle with the economics. However, it is worth noting that in the most recent quarter, Shanda lost US\$66 million as a result of this conversion as well as recent efforts to expand into hardware manufacturing and distribution.

- *Optimizing hardware utilization* – Generally speaking, hardware specifications for PCs are lower than in North America. The number of broadband users also impacts the type of games developed as those with dial-up cannot play graphic intensive games due to bandwidth considerations.

- Another key issue regarding the configuration and programming of server hardware is the prevalence of piracy and hacking. Pirated servers are common enough among older titles, in which independent operators set up their own servers and host games on these servers.
- The ongoing management and careful monitoring of content on servers is extremely important as hackers often attempt to exploit cheats within the game. This can bring down a game and the associated market. In 2005, hackers effectively killed off Priston Tales, a Korean game popular elsewhere in Asia, by developing a 'nuclear option' allowing them to eliminate every other player with a single key stroke.

8.2.6 Managing and Training Talent

Provided a Canadian firm wishes to build up their own studio based on their own management style, processes and benchmarks, they should be prepared to spend a great deal of time training local talent. This is because firstly, there are relatively few game professionals and secondly, attempting to transplant one's business culture is especially daunting, especially considering one must first bridge national and ethnic cultures before business culture can be approached.

The consensus is that once trained and are integrated into company processes and culture, artists can produce extraordinary work, most often matching what is produced in Canada.

However, training professional managers rather than artists or programmers is more difficult, probably because of cultural differences in work ethic and expectations. An organization used to pervasive project management and interpersonal skills may find themselves frustrated at the difference in performance.

We recommend spending approximately two years in developing and training management talent before letting local talent make important decisions on their own.

8.2.7 Talent Flight

Perhaps because there is so much interest in the industry and also because there are so few development professionals, talent is difficult to hold onto.

Again, back to cultural differences, Chinese may see an opportunity to work with an established studio as a stepping stone to acquire the necessary skills and business network to set up their own studio. There is concern that some employees only work at an established business precisely so they can take software, art assets, Intellectual Property or even customers away from their employer and set up their own business.

Some in the industry believe this phenomenon is more prevalent in Shanghai than Beijing, and therefore would consider Beijing as a more stable environment to establish a studio.

9 Conclusion

This document has been all about answering the question “How do Canadian game companies enter the Chinese market?”

While the factual issues of market size, demographics, game economics, value chains and government regulations garner most of the attention, the real work – and potential success - begins in addressing the ‘soft’ side of business. By this we mean the cultural differences, both ethnic and business related, as well as the interpersonal relationships that will define a successful venture into the Chinese market.

It is understood that the last sections pertaining to the soft skills of talent management, fostering ‘Guan Xi’, and even doing what game developers do best – being aware of and tapping into the cultural sensitivities of target markets to produce interactive entertainment that matches the culture – will be the defining characteristics of a successful enterprise.

In this regards, Canadians should naturally gain all the market knowledge they can and then settle in for the long haul by taking it slow at first, hence our recommendation to commence with outsourcing or working with Taiwanese partners. They can then focus on developing relationships and gain the market knowledge that will prepare them for a time when they have the relationships, business case and internal resources to tackle the market on their own terms.

10 Appendices

10.1 Company Profiles: Shanda

(www.snda.com)

Company description

Shanda was founded in 1999 by Tianqiao Chen and Danian Chen. In March 2003, Softbank invested in the company. Tianqiao Chen, Qianqian Luo, and Danian Chen currently own 60.4% of Shanda through Skyline Media.

Shanda has approximately 2,000 employees, with 700 R&D staff. The company is separated into three divisions:

- SDE (Shanda Entertainment): The division responsible for all contents creation and licensing (online game development, movie site partnerships, etc.)
- SDO (Shanda Operation): Operates all Shanda contents. It includes marketing, customer service, payment and distribution, technical support, and security access.
- SDS (Shanda System): Primarily focuses on Shanda's new EZ platform.

Management Team

Tianqiao Chen – CEO and Founder. Mr. Chen started Shanda with Danian Chen in 1999. Prior to establishing Shanda Networking, Mr. Chen served as vice director of the office of the president of Kinghing Trust and Investment from 1998 to 1999. From 1994 to 1998, Mr. Chen served in various management positions with Shanghai Lujiazui Group.

Mr. Chen holds a bachelor's degree in economics from Fudan University.

Jun Tang, President – Jun Tang has been president since February 2004. Prior to joining Shanda, Mr. Tang served as president of Microsoft China from March 2002 to January 2004. Mr. Tang received his doctorate degree, master's degree and bachelor's degree in the U.S, Japan and China, respectively.

Online Games

- Legend of Mir II - 2-D, most popular game in 2002 and 2003. Licensed from Korean Actoz. Recently changed from subscription pricing plan to item-based.
- World of Legend (WOOOL) – Inhouse development. 2-D martial arts game. 1st installment of game trilogy
- The Age – 2-D fantasy game, sequel to WOOOL
- Magical Land – 2-D fantasy cartoon, 3rd episode of WOOOL trilogy.
- RO Online – Licensed from Korean developer Gravity. 2-D fantasy cartoon style MMORPG
- The Sign – In-house development.
- Tactical Commanders - 3-D futuristic real-time strategy game. Similar to Star

- Wars struggle for humanity's survival
- D.O. – Licensed from Korean CR-Space. 3-D martial arts adventure

Financials

2005 Revenue USD\$ 235 million. Net Income USD\$ 23 million. Total peak concurrent users for all games 2.68 million.

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10.2 Company Profiles: The9

(www.corp.The9.com)

Company Description

The9 is an online game operator and developer in China. Through 9Webzen Limited, a joint venture in which they own 51%, The9 is a leading online game operator in China.

The9 began to offer our self-developed online virtual community game "the9 City" in 2000 and commercialized the9 City in December 2000. Currently, The9's business is primarily focused on operating massively multiplayer online role playing game, or MMORPG. The9 has obtained exclusive licenses to localize and operate MMORPGs in China, including "MU", "World of Warcraft," or WoW, "Mystina Online" and "Granado Espada".

The9 is also aggressively expanding their own product development capabilities to develop a suite of proprietary online games, including MMORPGs. "Joyful Journey West" is the first side scrolling MMORPG developed in-house. The9's other products and services include game operating support, Website solutions and advertisement services, and game-related short messaging services (SMS).

Management

Jun Zhu – CEO and Chairman of the Board – Mr. Jun is a co-founder of The9. He has served as the Chairman of the Board of Directors and Chief Executive Officer since its inception. Prior to founding The9, Mr. Zhu co-founded Flagholder New Technology Co. Ltd., an information technology company based in China, in 1997 and served as its director from 1997 to 1999.

Jie Qin – Senior Vice President – Mr. Jie a co-founder of The9 and has served as Senior Vice President since March 2004. Prior to founding The9, Mr. Qin co-founded Flagholder New Technology Co. in 1998 and served as its director from 1998 to 1999. From 1995 to 1998, Mr. Qin was an engineer of Inventec (Shanghai) Electronics Technology Co. Ltd. Mr. Qin received his Bachelor's degree from Shanghai Jiao Tong University.

Online Games

- World of Warcraft – Licensed from US developer Blizzard Entertainment.
- Mystina Online – Licensed from Taiwanese Developer Lager Interactive
- MU – Licensed from Korean developer Webzen
- Granado Espada – Licensed from Korean developer IMC Entertainment, not yet released
- GuildWars – Licensed from Korean developer NCSoft, not yet released
- Soul of the Ultimate Nation (SUN) – Licensed from Korean developer Webzen
- Joyful Journey West – Inhouse development, not yet released, in public beta since September 2005

Financials

2005 Revenues USD\$ 57.8 million, Net Income USD\$ 9 million. In Q4 2005, WoW had 530,000 peak and 270,000 average concurrent users, with 3.3 million paid accounts. Revenues attributable from WoW in Q4 totaled USD\$ 26.2 million.

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10.3 Company Profiles: Netease

(corp.163.com/eng/home.shtml)

Company Description

Netease is perhaps the strongest online game company in China, with very high margins and a well rounded business model.

With approximately 1600 employees, Netease has three business divisions: 1. Online games; 2. an Internet Portal (www.163.com) and; 3. Wireless VAS (Value Added Services) i.e. ringtones, wallpapers, SMS, MMS email etc.

NetEase was founded in June 1997 in Guangzhou, China, and started as a software development company offering Internet search services and free Web-based e-mail. In mid-1998, the company shifted its focus and started developing the NetEase Web Sites. Approximately one year later, NetEase began to offer eCommerce platforms and provided online shopping malls and other e-commerce services in China through "Guangzhou NetEase," a related party.

In 2001, the company evolved again, and began focusing on fee-based premium services and online entertainment services, including Wireless Value-Added Services, online games, premium e-mail services and other subscription type products.

In 2002, Wireless VAS and online games enjoyed greater popularity (and generated greater profit) than the company's other fee-based premium services. From a corporate perspective, NetEase undertook a restructuring of its operations and, on July 6, 1999, NetEase.com, Inc. was incorporated in the Cayman Islands, and the company operates under the Cayman Islands Companies Law (2003 Revision). In September 1999, the company restructured its operations to place its Internet portal operations in Guangzhou NetEase Computer System Co., Ltd.

The Company's principal place of business is in Beijing, PRC.

Management Team

- William Ding, Founder & Chief Executive Officer – Mr. Ding is the company's majority shareholder, and had previously served, among other positions, as Chief Architect since March 2001. Ding has also served on NetEase's Board of Directors since July 1999.

- Denny Lee, Chief Financial Officer – Mr. Lee has served as a Director and as Chief Financial Officer since April 2002. Prior to NetEase, he was a Senior Manager at KPMG where he specialized in international audits for more than 10 years. Mr. Lee graduated from the Hong Kong Polytechnic University majoring in accounting and is a member of The Hong Kong Society of Accountants and The Chartered Association of Certified Public Accountants.

- Michael Tong, Executive Director of Online Gaming – Mr. Tong has seven+ years of investment banking experience. He is currently involved in the overall management of the Company with a focus on online gaming. Before NetEase, he was Executive Director

of techpacific.com Venture Capital Limited, where he managed venture funds totaling US\$100 million. Prior to that, he was with Softbank China Venture Investments Limited, and also the Nomura Group. Mr. Tong has B.B.A. in Accounting from the University of Wisconsin, Madison. He is a member of the American Institute of Certified Public Accountants and a Chartered Financial Analyst

Online Games

Westward Journey II (WWJ2) and Fantasy Westward Journey (FWJ). WWJ2 is the most popular MMORPG in China and FWJ is regularly in the top three in regards to concurrent users. Peak concurrent users for WWJ2 was 550,000 and over 1 million for FWJ at the end of December 2005.

Financials

Revenue 2005 USD\$ 196 million. Net Income USD\$ 113 million. Gross Margin 82.6%, Operating margin 62.3%

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10.4 Company Profiles: Optisp

(www.optisp.com/english/index.html)

Company Description

Optisp commenced operation in 1999. Initially the company provided network installations for companies and office buildings, including broadband connections, in various parts of China. Optisp's business remained in the field of broadband and network development until March of 2003, when, with the establishment of Optic Entertainment, Optisp shifted its focus to online games.

The company was having difficulty turning a profit with its ISP business, so Yang decided Optisp should enter the internet business with its own product. Instead of spending time developing games themselves, Optisp chose the route of licensing Legend of Mir for release in China.

Optisp has also worked on developing its own online games, though none have yet been released and are in various states of Quality Assurance.

Optisp has four game centred services.

- Online Games - the operation, promotion and development of several online games.
- VAS Wireless Services - providing SMS services to online gamers through its Legend of Mir3 game. Presently Optisp Wireless provides SMS services such as news subscription, game inquiries, Mir fortune, original emotion, and psycho-test and role renewal for players.
- Internet Game Center - provides game support through management of the game server and membership, including handling online payments and member accounts.
- E-Sports - Optisp runs an ongoing online FIFA tournament, and has even signed several top gamers for the development of its own team to compete in upcoming competitions.

Management

President- Yang Jing. Mr. Yang is a graduate of the People's Liberation Army (PLA) University of Science and Technology in Nanjing. After graduation, he served for 23 years in the army in Xinjiang and then Guangzhou, working in communication technology. During his time in the army, Yang was involved in the development of the first CDMA-based phones in China, which were forerunners of the CDMA phones used today. He was named one of the top 10 leaders in the software industry in China.

Online Games

Legend Mir3, the sequel to Legend of Mir2, Legend of Mir3 was developed by Korean game producer Wemade and licensed to Optisp on March 20, 2003. Optisp agreed to pay license fees of USD \$1 million and 30 percent of future revenue to Wemade.

In early 2004, Optisp started FIFA online tournament by joining with EA Sports and

CCTV-5 (a local television channel) to hold the first online FIFA football game tournament.

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10.6 References, Other Information

References and Further Reading

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- “2006 Online Game Report - Pacific Epoch Red Innovation Report Series.” Pre-Release: January 20, 2006. Available from: http://www.pacificepoch.com/products/60039_0_11_0_M/
- “China Online Gaming – Dispelling Concerns of an Industry Slowdown”. Bear Stearns. From <http://www.bearstearns.com/bear/bsportal/CorporateHome.do>; December 15, 2005
- “China Internet – Coming of age; initiating coverage”. Deutsche Bank. From www.dbresearch.com, February 2, 2005
- China Entertainment: Online Games; Shanda Interactive Entertainment (SNDA). Goldman Sachs. From www.gs.com, June 23, 2004
- Internet/Gaming: NetEase 2006: Not a NetEasy Transition. Citigroup. January 5, 2006

Other Information on Game Development markets can be found with these organizations, and many others

- PricewaterhouseCoopers
<http://www.pwc.com/extweb/pwcpublishations.nsf/docid/5AC172F2C9DED8F5852570210044EEA7?opendocument&vendor=none>
- DFC Intelligence www.dfcint.com/
- Pacific Epoch www.pacificepoch.com/

Top 15 Online Games in China (as of March 2, 2006)

1. World of Warcraft (The9)
 2. QQ Fantasy (Tencent)
 3. Fantasy Westward Journey (Netease)
 4. O2Jam/Audition (9you)
 5. QQ Games (Tencent)
 6. JX Online 2 (Kingsoft)
 7. Westward Journey 2 (Netease)
 8. Legend of Mir 2 (Shanda, Nasdaq: SNDA)
 9. Yulgang (China.com, 8006.HK)
 10. BnB (Shanda)
 11. Dekaron (Baihai Information)
 12. World of Legend (Shanda)
 13. Ourgame (Kingsoft)
 14. World 2 (Perfect World)
 15. Legend of Mir 3 (Optisp)
- (Source: Junnet)

The Major Game Developer Event in China

ChinaJoy – July 21-23 2006. Shanghai Expo (<http://www.chinajoy.net/weben/index.asp>)

11 Glossary

APAC: Asia Pacific.

ARPU (Average Revenue per User): The average monthly services revenue received from a company's customers.

Avatar (previously termed 'Player Character'): the character(s) the player controls in the game world. Predominately used to refer to the player's character in an online game.

Consoles: Systems, specifically designed for playing video games. The two dominant products within APAC are the Sony Playstation and the Microsoft Xbox.

Concurrent Users: The number of users playing simultaneously within an online game.

Cut scene: a non-interactive part of a game in which story elements are advanced. The screen may go to a 'letterbox' format to inform the player that the sequence is non-interactive. Usually, there is an option to advance the cut scene instantly if the player is already familiar with the material.

Developer: an organization of artists, programmers, game designers, testers, and writers who create a playable game from its initial concept.

Distributor: an organization that buys (usually from a Publisher) and warehouses non-competing products for eventual shipping/sale to retailers. Contrast to a wholesaler, which carries a range of brands within a particular product line.

Game Designer: a person who constructs/co-ordinates the mechanical, parametric and high-level design of a game. If the person also writes dialogue for the game, they can be considered a writer-designer.

Game Engine: A program code that runs all aspects of the game.

Game Master: An individual in charge of customer service for an MMOG. Game Masters handle operations such as in-game queries, bug fixes, server optimization and overall supervision of an MMOG.

Game Network Operator: Organizations that provide the link between the Publisher and the network infrastructure provider (ISP/Telco). They manage online distribution, customer service, Game Master services and, occasionally, marketing support.

Game Writer: a person who contributes to the narrative design and/or script writing for a game.

IDC: Internet data centers

Immersive game-play: a story or visual presentation that enables the player to convincingly enter and participate in a virtual world.

Interactive plot: a game in which the progression of the plot changes according to player actions.

Licensing: A right given to use a brand name or theme from another company for a game. For instance, many movies have been licensed for video games (e.g. Goldeneye).

Middleware: Software that acts as an intermediary in the development process. Examples of middleware include rendering engines, graphics engines, and billing and payment systems.

Minimum Guarantee: The minimum guarantee of future royalties. In addition to the license payment, the upfront payment a publisher sometimes requires to distribute a game within a particular market. The minimum guarantee is secured to ensure that the holder of the Intellectual Property is adequately compensated for the distribution of their property. The minimum guarantee is then deducted, over time, against the future royalties agreed to be paid to the license holder.

MOCAP: Motion Capture. MOCAP is a technique of digitally recording the movements of real things -- usually humans -- so their movements can be played back with computer animation. A motion capture session only records the movements of the actor, not his visual appearance. These movements are recorded as *animation data*, which is then "mapped" onto a 3D model (which can be of a normal human, giant robot, or anything else) that was created by a computer artist, and the model can then be made to perform the same movements that were recorded.

Milestone: a pre-established date used to define important events such as major deliverables, project/phase completion and payment triggers.

MMOG: Massively Multiplayer Online Game. Games built with MMOG support have the ability to connect hundreds or thousands of players throughout the world into a single and continuous game-play.

MMORPG: Massive Multi-Player Online Role Playing Game (see MMOG and RPG).

MOD: Short for Modification. Many current games have tools that have been developed by the creators or players. Among others, these allow the game plot to be changed and/or permit the creation of different looking characters or in-game vehicles and objectives.

Narrative design: high-level story design that dictates the overall flow of the story together with the nature of the characters and their interactions.

Online Game: A game designed for play with one or more other people while connected to the Internet or a network.

PCU (Peak Concurrent Users): The maximum number of concurrent users within a given time frame.

PRC: The People's Republic of China

Publisher: an organization that provides marketing and distribution support for the developer. Within APAC, they often develop games themselves.

Rendering: In computer graphics, rendering is the process of producing a digital image from more abstract image information, such as vector graphics or 3D computer graphics information (typically consisting of geometry, viewpoint, texture and lighting information).

Royalties: a payment based on a percentage of revenue generated by a game.

RPG: Role Playing Game. A game where people take on a persona (e.g. fantasy or, in the APAC context, historical) and, interactively, play out a role to accomplish an objective (e.g. quest, win a battle).

SD: Super-Deformed. Characters in MMORPG that take on the form often seen in Asian Mangas (comic books) or anime (animation).

Storyboard: a plot or outline of a game presented as a series of sketches. Typically used during the initial development of levels, game play, and when mapping out character options/actions (see Super Storyboard).

Super Storyboard: the graphical roadmap that describes all audio, video, graphic and game-play for an interactive project.

Third Party Developer: A developer that is not owned or run by the maker of a platform or operating system. For instance, all developers besides Microsoft are third party developers for Windows. Developers for consoles need to be licensed by their console manufacturer before they are allowed to develop for the platform.

Triple-A (AAA) Title: Refers to the most successful games. Benchmarks include the cost of production as well as the revenue garnered from such games.

12 Sample Business Contract

The following link is to a sample business contract between 'Party A' which is Lager Interactive, a Taiwanese game developer and 'Party B', The9, a Chinese game operator.

This and other game developer contract samples are found at:
<http://contracts.onecle.com/the9/lager.coop.2004.07.19.shtml>