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## BUSINESS

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### OVERVIEW

We are one of the leading online game developers and operators in the PRC as proven by the awards and recognition we and our online games have received. Our portfolio consists of a range of MMORPGs catering to various types of players. Our strong online game development capability enables us to create our own games and to upgrade our existing games in a timely and efficient manner. In addition, our proprietary customer information system tracks players' behaviour and purchasing patterns to allow us to design more appealing game contents. By employing our player-driven development philosophy and our integrated operation model, we have been able to swiftly adapt to trends in the online game industry, such as offering online games to players free of charge and then generating revenue from the sale of virtual items. With these strategies and capabilities, we believe we can effectively satisfy our customers' demand and capture the market opportunities to further strengthen our position in the industry.

We currently offer five proprietary games, namely Eudemons Online, Conquer Online, Zero Online, Monster & Me and Era of Faith. We have achieved significant revenue growth, particularly over the past two years from the strong performance of Eudemons Online and Conquer Online, our flagship games and major revenue generators. We launched Eudemons Online in March 2006 and had over 325,000 PCU and 70,000 ACU in the same year. The PCU and ACU further increased to more than 496,000 and 243,000, respectively for the six months ended 30 June 2007. As to Conquer Online, even in its fourth year of operation, we still enjoyed approximately 34.3% and 34.5% increases in PCU and ACU, respectively for the six months ended 30 June 2007 compared to the same period in 2006. We launched Zero Online in late April 2007 and we had over 53,000 PCU and 21,000 ACU during the period from its launch to 30 June 2007.

We have achieved significant growth in revenue during the Active Business Pursuit Period:

- Eudemons Online had revenue of approximately RMB69.5 million and RMB185.0 million for the year ended 31 December 2006 and the six months ended 30 June 2007, respectively.
- Conquer Online had revenue of approximately RMB51.1 million and RMB61.9 million for the year ended 31 December 2006 and the six months ended 30 June 2007, representing approximately 58.1% and 156.5% increases compared to the same periods in 2005 and 2006, respectively.
- We reported total revenue of approximately RMB122.1 million and RMB261.7 million for the year ended 31 December 2006 and the six months ended 30 June 2007, representing approximately 247.6% and 902.4% increases compared to the same periods in 2005 and 2006, respectively.

We currently have three games in our development pipeline, namely Happiness Q, Piao Miao Online and Heroes of Might and Magic Online. These new games offer different themes and gaming experience to attract various types of players. We expect to launch Happiness Q in 2007, Piao Miao Online and Heroes of Might and Magic Online in 2008.

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We operate our online games under the FTP model which encourages more players to experience our games. Under this model, our revenue is generated by selling virtual items, such as virtual weapons, armours and spells. Through continuous improvements and upgrades to our games, we believe that we can enhance the popularity, increase the revenue and extend the life cycle of our games.

We currently have three distribution and payment channels, comprising (i) direct sales; (ii) pre-paid card sales through distributors; and (iii) cooperation channels. Our direct sales includes online payment systems and other direct sales channels. Online payment systems under direct sales accounted for approximately 52.2%, 60.5% and 67.3% of our total revenue for each of the two years ended 31 December 2006 and the six months ended 30 June 2007, respectively.

In the PRC market, our revenue grew over 454.0% and 23.1 times for the year ended 31 December 2006 and the six months ended 30 June 2007, respectively compared to the same periods in 2005 and 2006, respectively.

We also enjoy significant sales by introducing non-Chinese language games, such as English, French and Spanish versions. This multi-language approach has proven to be a success, demonstrated by the 102.1% and 203.5% increases in revenue generated from the non-Chinese language market in the year ended 31 December 2006 and the six months ended 30 June 2007 compared to the same periods in 2005 and 2006, respectively.

### COMPETITIVE STRENGTHS

We believe that our success in the online game market is primarily attributable to our following competitive strengths:

#### **Our strong game development capabilities**

We possess strong game development capabilities. Our integrated game development process comprising game design, programming, graphics and testing, enables us to control all the quality, cost and pace of development. In addition, our core game development team has been working together for years and this close relationship provides a stable foundation for our future development. A majority of our game developers have at least three years of game development experience and hold university degrees. Further details of our game development team and our strategies to retain human resources are set out in “Business - Our operations - Game development” and “Directors, senior management and staff - Staff” of this prospectus, respectively. Coupled with advanced technologies, we have successfully developed a game portfolio with an extensive game development pipeline targeting different players for our future growth in the PRC and the overseas markets. With our game development capabilities and intellectual rights to our online games, we are also able to timely and efficiently launch our new online games and upgrade our existing online games to capture the market opportunities.

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### **Our player-driven development approach contributing to a proven portfolio and a well-planned game development pipeline**

We adopt a player-driven approach in developing our online games by focusing on the needs and demands of players. A majority of our new game players are referred through recommendations of other players. Leveraging on our game development capabilities and our proprietary data base, we have strategically created a diversified portfolio of online games and development pipeline targeted at various types of players. For example, Eudemons Online targets players who enjoy games of demon fantasy, Conquer Online targets at players who enjoy heroic spirit of the ancient martial era and Zero Online is for those players who prefer robot fighting games.

### **Our proprietary customer information system to capture customer usage information**

We have developed a comprehensive proprietary customer information system tracking data of our players daily, including their behaviour and purchasing patterns. Our management will first analyse the data to understand players' needs and preference, our game development team will then create new games or improve the existing games based on our management analysis. We can then quickly attract players to play our games, which operate under the FTP model. Our game development team also continues to adapt our games by adding more features to cater players' preference as shown in such analysis. Our proprietary data base has proven to be a useful and reliable source of players' information. Together with our strong game development capability, we believe that we can enhance the popularity, prolong the growth and extend the life cycle of our games.

### **Our geographically diversified player base**

Our online games, especially Eudemons Online, have proved to be very popular in the PRC market, generating revenue of approximately RMB69.5 million and RMB185.0 million for the year ended 31 December 2006 and the six months ended 30 June 2007. While maintaining a leading position in the PRC online game market as proven by the awards and recognition we and our online games have received, we have also successfully offered our online games in various languages, including English, French and Spanish. This multi-language approach has proven to be a success, demonstrated by revenue generated from our non-Chinese language players of approximately RMB20.6 million, RMB41.6 million and RMB53.0 million for the each of the two years ended 31 December 2006 and the six months ended 30 June 2007, respectively. This approach enables us to increase the return of the investment in our games, minimises the risk of market disruptions or downturns and to captures the high potential growth in any geographical market.

### **Our well established and extensive distribution and payment channels**

We have developed extensive distribution and payment channels, including (i) direct sales; (ii) pre-paid card sales through distributors; and (iii) cooperation channels. Our direct sales through online payment systems accounted for approximately 52.2%, 60.5% and 67.3% of our total revenue for each of the two years ended 31 December 2006 and the six months ended 30 June 2007, representing an

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encouraging growth during the Active Business Pursuit Period. We have also established a diversified base of distribution and payment channels in the PRC comprising distribution partners under other direct sales channels, pre-paid card sales through nationwide distribution networks and retail outlets as well as channels provided by our cooperation partners.

### **Our experienced management team**

We believe that our success is largely attributable to our experienced management team. We have benefited from a stable management environment since our establishment. Our chairman, Liu Dejian, has more than seven years of experience in the Internet industry in various aspects, including game development, IT technology, marketing, business development, management and overseas operation. Our various experts in game development, management and operation in both the PRC and overseas markets are also the key factors for our success. We believe that our dedicated team of employees can enable us to remain competitive in the online game industry. Further details of our Directors, senior management and staff are set out in “Directors, senior management and staff” in this prospectus.

### **OUR MMORPGS**

Our MMORPGs are online computer role-playing games in which a large number of players interact with one another in a virtual world. Typical features of our MMORPGs include the following:

- Players assume the role of a fictional character and take control over many of that character’s actions.
- A game character has different strengths and weaknesses and each game character can gain experience and collect game features, including various virtual items.
- A game character can form teams or alliances to achieve certain game objectives.
- A game character can communicate extensively amongst themselves.
- A game character can assume real-life social experiences, such as getting married with another game character.
- Players can experience a world which continues to exist and evolve while the player is away from the game and the game does not have a natural ending.
- The game continues to have new features introduced.
- There is no official endings and players enjoy the games by competing with the other players on an on-going basis.

We believe that these features facilitate the development of players’ loyalty to our online games, to online communities among players and, ultimately, to us.

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Our online games can be accessed and played at any location with an Internet connection. Players can download free of charge the user-end software for respective game from the official website. After the user-end software is installed, players can set up a user account and password for the game, and then access and play the game from any location with an Internet connection.

### EXISTING GAMES

#### Eudemons Online

##### *Background*

Eudemons Online is a 2.5D MMORPG targeting players interested in demon fantasy games. The background of the game is based on a mythic world where players can choose to play the role as a warrior, mage or paladin. Players command game characters and eudemons to adventure on the vast virtual land in the game. The main feature of Eudemon Online is its highly interactive communication among players. Players advance and gain levels in the game by defeating devils and monsters. As at the Latest Practicable Date, we offered over 150 virtual items for Eudemons Online with price ranging from less than RMB0.1 to over RMB300. The virtual items for Eudemons Online can be classified into four categories, namely equipment (such as sword and armour to increase the ability of the game character), eudemons (such as fire and ice eudemons to assist the game character's adventure), function items (such as experience package and recovery items to enhance the experience of the game) and luxury items (such as clothing and flowers as gifts among the players).

##### *Milestone*

We formulated the game proposal of Eudemons Online in 2004. The closed beta testing of the Chinese version of Eudemons Online was conducted in the second quarter of 2005 and we launched the Chinese version of Eudemons Online in the PRC market in March 2006 under the FTP model. Since then, this game has become very successful with a large and growing player base.

For the non-Chinese language market, the English version of Eudemons Online was launched to the market in June 2006 under the FTP model.

Since the launch of Eudemons Online, we have enjoyed remarkable growth in PCU and ACU:

	For the three months ended					
	31 March 2006	30 June 2006	30 September 2006	31 December 2006	31 March 2007	30 June 2007
PCU	26,000	50,000	128,000	325,000	438,000	496,000
Approximate quarterly growth rate	—	92.3%	156.0%	153.9%	34.8%	13.2%
ACU	17,000	31,000	56,000	140,000	213,000	274,000
Approximate quarterly growth rate	—	82.4%	80.6%	150.0%	52.1%	28.6%

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We had two major upgrades in Eudemons Online during the Active Business Pursuit Period and a further upgrade in August 2007. In June 2006, the major enhancements of the upgrades include improving the images of the eudemons, adjusting the functions of the virtual items, adding more eudemons and introducing a new army combating format to the game. In February 2007, the major enhancements of the upgrades include upgrading of the eudemons' combating nature and improving the ranking of the armies in the game. We also expect to upgrade Eudemons Online in the fourth quarter of 2007 by introducing castle building element to the game.

Eudemons Online is highly regarded by the market and was awarded by QQ.com the Best New Online Game for 2006, the Most Popular MMORPG for 2006 and the Most Popular Online Game for 2006.

### **Conquer Online**

#### *Background*

Conquer Online is a 2.5D MMORPG targeting players interested in heroic spirit of the ancient martial era games. Players can choose to play from four different game characters, namely trojan, warrior, archer and taoist, which are customised with unique weapons and skills. Each player can gain numerous levels, skills and abilities in the game. Real-time one-to-one combat is a big feature of Conquer Online. As at the Latest Practicable Date, we offered over 130 virtual items for Conquer Online with price ranging from less than RMB0.1 to over RMB900. The virtual items for Conquer Online can be classified into two categories, namely equipment (such as sword and armour to increase the ability of the game character) and function items (such as experience package and recovery items to enhance the experience of the game).

#### *Milestone*

We formulated the game proposal of Conquer Online in 2002. The closed and open beta testing of the Chinese version of Conquer Online was conducted in the first half year of 2003. The Chinese version of Conquer Online was launched in September 2003 under the pay-to-play business model whereas the players were charged by time spent in playing the games. In June 2006, we converted the Chinese version of Conquer Online into the FTP model.

We launched the English version of Conquer Online under the FTP model in January 2004. Conquer Online is also provided to the players in various languages, including English, French and Spanish. A majority of our revenue in Conquer Online was generated by the English version of the game during the Active Business Pursuit Period.

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PCU and ACU of Conquer Online continued to grow as it entered the fourth year of operation. Based on our data, the following table illustrates the number of PCU and ACU and the approximate quarterly growth rate of Conquer Online during the Active Business Pursuit Period:

	For the three months ended									
	31 March 2005	30 June 2005	30 September 2005	31 December 2005	31 March 2006	30 June 2006	30 September 2006	31 December 2006	31 March 2007	30 June 2007
PCU	31,000	34,000	40,000	47,000	60,000	66,000	74,000	82,000	85,000	89,000
Approximate quarterly growth rate	—	9.7%	17.6%	17.5%	27.7%	10.0%	12.1%	10.8%	3.7%	4.7%
ACU	23,000	24,000	29,000	33,000	43,000	50,000	54,000	59,000	61,000	64,000
Approximate quarterly growth rate	—	4.3%	20.8%	13.8%	30.3%	16.3%	8.0%	9.3%	3.4%	4.9%

We had four major upgrades on June 2005, January 2006, July 2006 and February 2007 in the Chinese version of Conquer Online during the Active Business Pursuit Period and a further upgrade in August 2007. As to the English version of Conquer Online, there were six major upgrades on May 2005, November 2005, March 2006, December 2006 and February 2007 during the Active Business Pursuit Period and a further upgrade in August 2007. The major enhancements include adding more maps, monsters and characters, adjusting the abilities of monsters, adjusting features of equipment, introducing new combating systems and upgrading the automatic navigating and team formation systems. We also expect to upgrade Conquer Online in January 2008 by upgrading the ranking and character acting functions.

Conquer Online was awarded by www.chinajoy.net “Golden Plume Prize” for the Best Original Online Game of 2005 and by Shanghai Municipal Informatisation Commission (上海市信息化委員會) and Shanghai Municipal Press Publication Bureau (上海市新聞出版局) as the Best Export Product Award for 2006.

### Zero Online

#### *Background*

Zero Online is a 2.5D MMORPG targeting players interested in robot fighting games. Players can choose among two types of robots specialising in melee and ranged combats. Apart from the conventional upgrade and skills, we also offer virtual item customisations which can enhance players’ in-game experience. As at the Latest Practicable Date, we offered over 80 virtual items for Zero Online with price ranging from less than RMB0.2 to over RMB300. The virtual items for Zero Online can be classified into three categories, namely equipment (such as engine and cannon to increase the ability of the robot controlled by the game character), function items (such as experience package and recovery items to enhance the experience of the game) and luxury items (such as special stones and flowers as gifts among the players).

#### *Milestone*

We formulated the game proposal of Zero Online in 2004. Zero Online was launched in April 2007 under the FTP model.

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We reported over 53,000 PCU and 21,000 ACU for Zero Online since the launch date and up to 30 June 2007.

We had a major upgrade in September 2007 for Zero Online. Major enhancements include introduction of new types of robots to the game. We also expect to upgrade Zero Online in the fourth quarter of 2007 by introducing large-scale galaxy wars and new commanders to the game.

### **Others**

Other MMORPGs launched by us include Monster & Me and Era of Faith.

Monster & Me is our first developed MMORPG. It was launched in July 2002. This 2D turn-based game features cartoon pets in series of battles mainly targeting at female players.

Era of Faith was launched in June 2004. It is a western-style mythical MMORPG featuring a virtual medieval fantasy world where players can customise their game characters with different development directions and in-game weapons.

As at the Latest Practicable Date, we offered over 40 virtual items for Monster & Me and Era of Faith with a price ranging from RMB1 to over RMB70. The virtual items for Monster & Me and Era of Faith include pets, weapons and recovery items.

### **GAME DEVELOPMENT PIPELINE**

We are currently developing the following online games:

#### **Happiness Q**

##### *Background*

Happiness Q is a 2.5D MMORPG. The turn-based game allows players to raise the cartoon virtual pets to assist the game characters in series of in-game battles. Players will be able to combat and gain level for their game characters by purchasing various virtual items, including virtual weapons, jewellery and pets.

##### *Current Status*

We formulated the game development project of Happiness Q in 2006. We have commenced its closed beta testing and expect to launch the game in the fourth quarter of 2007.

#### **Piao Miao Online**

##### *Background*

Piao Miao Online is a 2.5D MMORPG targeting players interested in martial art games. The game is set in a virtual traditional Chinese legacy background. The key strength of the game is the rich personification of its game characters, including their roles and appearances.



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### *Current Status*

We formulated the game development project of Piao Miao Online in July 2006. We have commenced the closed beta testing and expect to launch the game in the second quarter of 2008.

### **Heroes of Might and Magic Online**

#### *Background*

Heroes of Might and Magic Online is a 2.5D MMORPG. The game is being developed based on a well-known PC game licensed to us by Ubisoft. The game is targeted at the existing PC game players worldwide of Heroes of Might and Magic PC game and players who prefer strategic games. The game has an established storyline built on Ubisoft's existing Heroes of Might and Magic PC game. This turn-based strategic game is set in a virtual medieval heroic fantasy background where players are given control of a virtual hero who in turn controls an army in the game. Through the capture of towns in the game, players can hire additional armies to assist in the conquest. We intend to offer different virtual items for players, including virtual weapons and game maps.

#### *Current Status*

We formulated the game development proposal of Heroes of Might and Magic Online in 2004. We have commenced the closed beta testing of the game and expect to launch the game in 2008.

## **OUR OPERATIONS**

### **FTP Model**

We tactically operate our online games under the FTP model. We offer free download of our online games to players whereas our revenue is generated by selling virtual items. Players may register a game account under one of our game servers. Players can then enjoy our games without buying any virtual items. If they wish to further enhance the experience in our games, players can then purchase virtual items we offer where they can then credit respective game accounts through our distribution and payment channels for game points. Players can then purchase virtual items with the game points. The FTP model has proven to be very successful in attracting new players quickly. Moreover, by adding more features and contents to our games, our players are likely to purchase various virtual items to enhance their in-game experience over time and thereafter, to extend our game life cycles.

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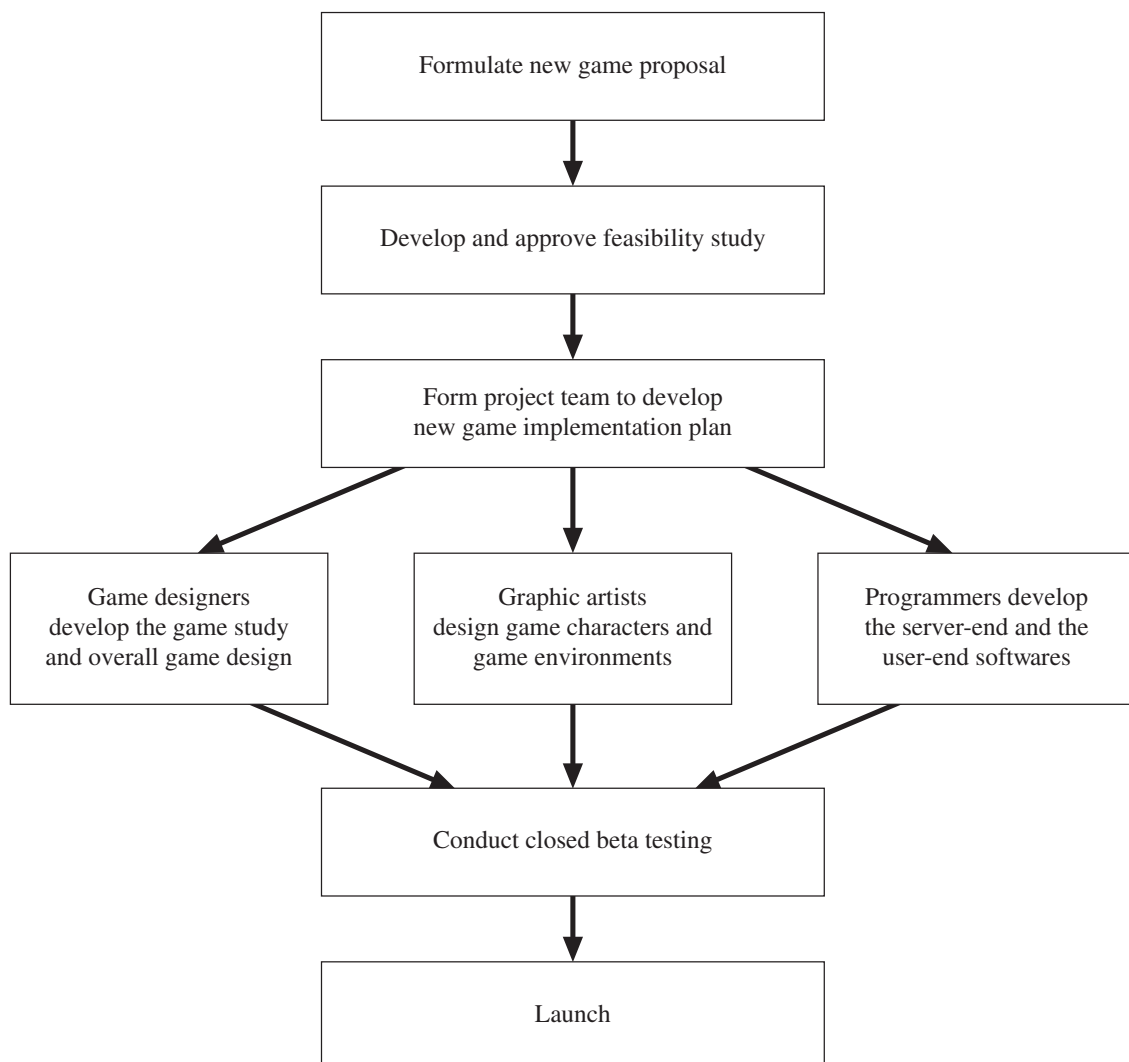
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### Game development

Our game development centre is located in Fuzhou, the PRC. As at 30 June 2007, we had 309 game development employees in our game development department. Our game development department is responsible for both new game development and game improvement and upgrade. As at 30 June 2007, a majority of the members in our game development team have at least three years of game development experience and hold university degrees in game development related subjects. Our game development department includes (i) games designers, who are responsible for the development of the game study and the overall game design; (ii) graphic artists, who are responsible for the design of game characters and game environments; and (iii) programmers, who are responsible for development of the server-end and the user-end softwares. Our game development department is led by the chief game designer and our chairman, Liu Dejian, an executive Director, details of which are set out in “Directors, senior management and staff” of this prospectus. We have an integrated game development system that comprises the process from game design, programming, graphics to testing activities. We continue to improve and upgrade our online games and introduce new features to attract existing and potential players.

Our senior management team meets regularly to evaluate the market trend and formulate new game proposals. For our new online games, we have established a game development process as follows:



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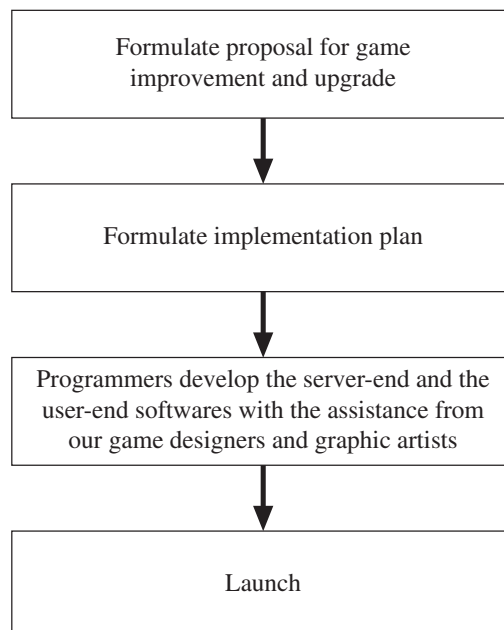
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A new game proposal is usually generated by the game designer team which is led by our chief game designer. When a written proposal is formulated, our marketing research team will conduct a market feasibility study with reference to a number of information including online survey, external player group feedback and product analysis. The report will be reviewed by a committee formed by our game designer, technology officer, game operation officer and financial officer. The formulation of the same proposal and the feasibility study usually last for six months to nine months. Upon approval of the feasibility study, we will form a project team to develop new game implementation plan. Based on the new game implementation plan, (i) game designers will develop the game study and overall game design; (ii) graphic artists will design game characters and game environments; and (iii) programmers will develop the server-end and the user-end softwares. Each step of their work has to be approved by its own project leader and the final written approval by our chief game designer. The programme development typically lasts for six months.

We conduct closed beta testing with a selected group of players in preparation for the commercial launch of each of our new MMORPGs. Players under the closed beta testing will report any technical problems that they encountered and recommendations of additional features. We will then improve our new MMORPGs. Our quality assurance team will follow its pre-determined testing procedure to test the game before launch. After our quality assurance team and legal department approve the game, we will conduct a final review on the game for a final written approval. Depending on the results generated by our performance evaluations, the closed beta testing period usually lasts up to six months. As we adopted the FTP model, the closed beta testing is followed by the commercial launch of the games. After the commercial launch of our games, we will continue to closely monitor the performance, consistency and stability of operational systems for the game. We have not experienced any failure in the development of our MMORPGs during the Active Business Pursuit Period.

We have a game improvement and upgrade team, adopting the following procedures:



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Our new games under development include Happiness Q, Piao Miao Online and Heroes of Might and Magic Online, details of which are set out in “Business - Game development pipeline” to this prospectus.

To further improve our game development capability, we have licensed Unreal 3 game engine, a software to develop 3D games, from Epic Games Inc. in October 2006 for the development of our new 3D games. We have already started a trial 3D project. It is our goal to develop 3D online games.

### **Pricing**

Our pricing strategy focused on maintaining the attractiveness of each game product, stimulating players’ spending on our virtual items and maximising our revenue. Our game designers are responsible for the pricing of our virtual items. The price of each virtual item is determined by the data from our customer information system. As at the Latest Practicable Date, the Group had over 400 virtual items available for sale with price ranging from less than RMB0.1 to over RMB900 to suit different demands from players. We offer special virtual items during seasonal occasions to attract players to enjoy the games. Those virtual items will only be valid within the seasonal occasions. Other than that, the virtual items we offer to the players are valid to be used without a definite period.

### **Marketing**

Word-of-mouth referral is a major channel for promoting our online games. Our internal data shows that a majority of players are attracted to our games through others’ recommendations.

Our customer information system tracks daily usage data and produces a comprehensive report. Based on such report, marketing plans will be formulated accordingly. We promote our games in two channels: (i) in-game marketing; and (ii) marketing through external channels. As to in-game marketing, we offer bonus game points and organise in-game events, such as combat competitions.

As to marketing through external channels, we post advertisements in various Internet portals and online game websites. We have also participated in various exhibitions, including the international computer games exhibition, E3, and the PRC nationwide game exhibition, ChinaJoy, for years. In addition, we conduct focused promotional activities targeting distributors and Internet cafes, and provide sponsored prizes and posters.

To strengthen our marketing capability, we have also engaged Ogilvy as our marketing consultant to design, manage and help implement our marketing strategy in the PRC. Ogilvy provides us specialised advertising and publicity services in the PRC, including promotion of our corporate image and our online games.

NetDragon (Fujian) is responsible for the online game operation, including sales and marketing, whereas NetDragon (Shanghai) is mainly responsible for customer services for our oversea market. In addition, NetDragon (Shanghai), being a subsidiary of NetDragon (Fujian), assists NetDragon (Fujian) in carrying out its sales and marketing activities. Our PRC legal adviser, Dacheng Law Offices, has confirmed that NetDragon (Fujian) is allowed under the PRC laws and regulations to be engaged in

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the marketing of online games and NetDragon (Shanghai) is allowed to assist NetDragon (Fujian) in carrying out its sales and marketing activities. NetDragon (Shanghai) does not charge any fees for such facilitating activities in sales and marketing. Thus, such facilitating activities are not its profit-aiming operation activities.

### Distribution and payment

We have established the following distribution and payment channels with extensive coverage in the PRC and the overseas markets:

- Direct sales;
- Pre-paid card sales through distributors; and
- Cooperation channels.

The table below is a breakdown of our online game revenue by our different distribution and payment channels during the Active Business Pursuit Period:

	For the year ended 31 December				For the six months ended 30 June 2007	
	2005		2006		RMB'000	%
	<i>RMB'000</i>	%	<i>RMB'000</i>	%	<i>RMB'000</i>	%
Direct sales						
— online payment systems	18,332	52.2	73,893	60.5	176,147	67.3
— other direct sales channels	6,553	18.6	23,045	18.9	53,070	20.3
Pre-paid card sales through distributors	7,961	22.7	21,856	17.9	26,949	10.3
Cooperation channels	<u>2,273</u>	<u>6.5</u>	<u>3,267</u>	<u>2.7</u>	<u>5,583</u>	<u>2.1</u>
Total	<u><u>35,119</u></u>	<u><u>100.0</u></u>	<u><u>122,061</u></u>	<u><u>100.0</u></u>	<u><u>261,749</u></u>	<u><u>100.0</u></u>

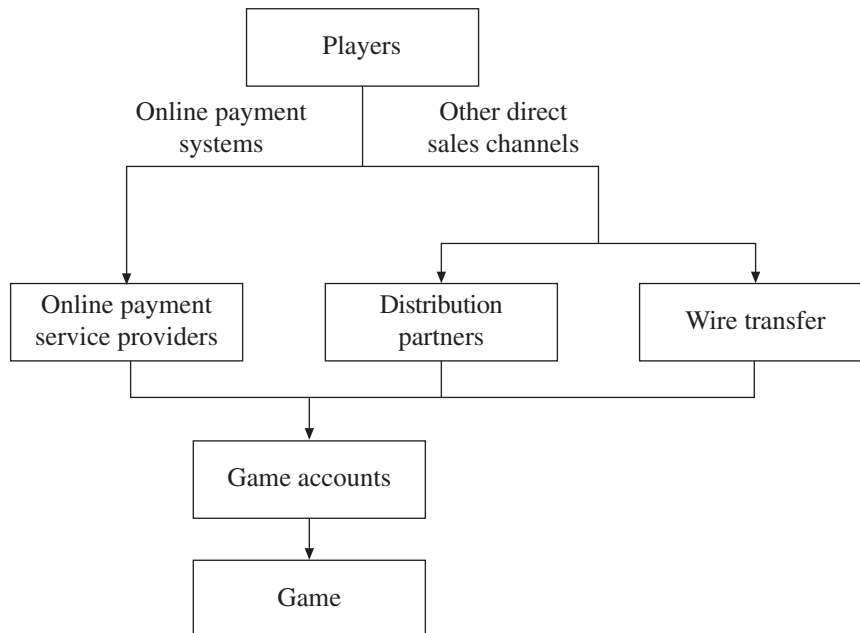
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### *Direct sales*

Our direct sales includes (i) online payment systems; and (ii) other direct sales channels. The following diagram illustrates our direct sales channel:



Under our online payment systems, players may credit their game accounts through our online payment service providers. As at 30 June 2007, we had an aggregate of six online payment service providers, covering most of the major banks in the PRC, of which players may credit their game accounts by debiting their bank accounts, credit cards or debit cards online. The online payment service providers in the PRC typically charge us commissions of 0.1% to 1.0% of the total amount players made for their services and we generally offer credit terms ranging from one to 30 days for the online payment service provider in the PRC. In the overseas market, players can pay through payment service provider, PayPal, which typically charges us commissions of 1.9% to 2.9% plus US\$0.3 per transaction made by players for its services.

Under our other direct sales channels, players in the PRC may credit their game accounts through our distribution partners. Distribution partners market and sell their own virtual points by issuing pre-paid cards or other distribution and payment methods through their platforms. Our players can utilise the virtual points of these distribution partners, such as Shanda and Tencent, to credit their respective game accounts with us. A majority of our distribution partners charge us a commission of approximately 25% of the total amount paid by the players. We generally offer credit periods ranging from 30 to 45 days to the distribution partners. Players can also credit their game accounts through telecommunication voice service and mobile SMS service providers, which generally charge us fees ranging from 15% to 51% of the total amount paid by the players while we generally offer them credit periods ranging from 30 to 45 days.

In addition, players can directly credit their game accounts by wire transfer.

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The income earned and received from our direct sales in the PRC is recognised net of the commission and discounts.

### *Pre-paid cards sales through distributors*

Our pre-paid cards are sold in both virtual and physical forms through third party sales distributors. Each pre-paid card contains a unique access code and password that enables players to credit their respective game accounts.

We offer pre-paid virtual cards to various sales distributors in the PRC. Each of our sales distributors has an account in our online sales system. A sales distributor must first order pre-paid virtual cards and make the corresponding payments. Upon receipt of their payment, we will allocate to the sales distributor the pre-paid virtual cards, in the form of access codes and passwords. Players may purchase our pre-paid virtual cards in various denominated amounts and they can then credit the value of the virtual cards to their game accounts using the access code and password contained thereof. We currently offer sales distributors a sales discount of approximately 25% which represents the difference between the price at which we sell pre-paid virtual cards to the sales distributors and the face value of the cards.

In the PRC, we also distribute our physical pre-paid game cards through our distribution network, which in turn distribute our physical pre-paid cards through newsstands, convenience stores, software stores and book stores. We have not set any actual deadline for the pre-paid game cards and the pre-paid game cards can be used anytime after they are bought by distributors and the ultimate users. We generally enter into a one year distribution agreement with each physical game card distributor for a designated sales territory. Our distributors purchase our physical pre-paid game cards, which they then resell to sub-distributors and retail points of sale. We require full payment prior to delivery of physical pre-paid game cards to distributors. Players may purchase our physical pre-paid cards in various denominated amounts. We currently offer a sales discount of approximately 25% to our distributors. The sales discount represents the difference between the price at which we sell pre-paid cards to the sales distributors and the face value of the cards.

The income earned and received from our pre-paid cards sales through distributors is recognised net of the commission and discounts.

### *Cooperation Channels*

Our certain online games are operated through the platforms of cooperation partners including TOM.com operated by Leitingwanjun and the online platforms operated by Xunlei. We share the revenue under such cooperation arrangements. Our revenue sharing ratio is calculated based on a pre-determined percentage, generally ranging from 25% to 55%, of the revenue generated from operating the online games by these cooperation partners. We generally offer credit periods ranging from 30 to 45 days to the cooperation partners. In addition, we generally have to provide our cooperation partners, amongst other things, server settings, instructions for maintaining servers, technical training, advertising and promotional materials. Our share of revenue generated from the cooperation arrangements with the cooperation partners is net of commission and discounts being incurred and we are not obliged to pay any additional charges to the cooperation partners for the use of their online platforms.

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The online games are operated through the platforms of the cooperation partners and the online game revenue is received by the cooperation partners directly through their own sales channels. Then, the cooperation partners will pay the Group according to the agreed sharing ratio in a monthly basis.

The revenue generated from such cooperation arrangements is collected by TQ Digital on behalf of NetDragon (Fujian). As confirmed by our PRC legal adviser, Dacheng Law Offices, the arrangements, including the terms of the corporation arrangements between NetDragon (Fujian) and the cooperation partners and the settlement arrangement between TQ Digital and NetDragon (Fujian), do not contravene any applicable PRC laws and regulations.

### **Customer management**

We offer customer services to our players, including 24-hour call centre and email replies. In addition, we offer bulletin board services for players to post questions to, and receive responses from, other players. Other services provided to players include addressing problems in payment methods, retrieving forgotten passwords and recovering lost user accounts. In addition, we investigate and address irregularities in game operation reported by players, including eliminating cheating programmes that are used by players to enable their game characters to acquire superior in-game capabilities.

To further enhance our customer management services, we have outsourced part of our customer services functions to our PRC based players to a related company, Fuzhou Tianliang, which is specialising in customer management services. Details of the relationship and the connected transactions between Fuzhou Tianliang and us are set out under the section headed “Relationship with the controlling shareholders and non-competition undertakings - Continuing connected transactions” in this prospectus. We provide customer services to our overseas market internally.

In addition, we establish a VIP system to provide priority customer services to our high usage players. We offer various incentives under our VIP system, including priority customer services, such as first hand game updated information. Our VIP players may also credit their accounts through our online payment systems. We also offer our VIP players a special forum where they can share their experience and communicate with our game designers directly. The VIP players can also participate in special online events we organised. Our VIP players are divided into six categories based on our players’ accumulated usage. As at 30 June 2007, we had over 260,000 registered VIP players which accounted for approximately 32.2% and 54.7% of our total revenue for the year ended 31 December 2006 and the six months ended 30 June 2007, respectively. Our VIP system assists us to identify high usage players with more data to analyse their preference and requirements. Consequentially, we can provide customised services and products to our customers to enhance their loyalty.

### **TECHNOLOGY INFRASTRUCTURE**

We have developed an extensive technology infrastructure that supports the operation of our online games across the PRC and the overseas markets. As at 30 June 2007, our server network for our online game operations consisted of about 1,267 servers and among them, 759 are game servers



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with the capacity to accommodate up to an aggregate of over 1.1 million concurrent online players. As at 30 June 2007, the number of the total PCU of all online games was approximately 600,000, representing approximately 54.5% of our server capacity. The table below sets out the numbers and locations of our servers as at 30 June 2007:

Location of servers	Fuzhou, the PRC	Shenyang, the PRC	Guangzhou, the PRC	Beijing, the PRC	Changzhou, the PRC	California, the USA
Number of servers	781	274	87	1	15	109

The stable operation of our online games requires a significant number of servers and bandwidth. We have located game servers for online games in major regions in the PRC. As to our overseas market, game servers are located in the USA. We have a contingency plan to deal with emergency incidents, including server failure. In case of server failure, the contingency server room in Guangzhou will commence operation. Data will be uploaded to keep our players' data up to date. At the same time, our server providers will assist us to rebuild the network.

As at 30 June 2007, NetDragon (Fujian) owned approximately 61.3% of the servers in our server network and we lease the remaining 38.7% from Independent Third Parties. We have three types of server leasing service providers. For those we prepaid the charges half-yearly or yearly, the monthly rental charges are calculated with reference to the configuration of servers, the bandwidth capacity and number of Internet portal address. For those we pay monthly in advance which are mainly paid for the rental charges of the bandwidth services of our own servers, the monthly rental charges are calculated with reference to the specified bandwidth capacity. For those we pay monthly, the charge is calculated with reference to the monthly ACU. If we are required to establish our own servers, the potential cost in establishing each of our own server will be approximately RMB26,000. In our experience, we are generally able to add additional servers as we require within a matter of several days.

We have exclusive access to the data and software on the servers. We monitor the operation of our server network 24 hours a day and seven days a week. We can access our server network in real time to track our concurrent online players, and to discover and fix problems in the operation of hardware and software on a timely basis.

Our server network is linked to our centralised billing system which, acts as a meter to deduct game points used by players from their accounts as they purchase virtual items. Our server network is also linked to our data backup system, which backs up data from all login system servers and game servers on a real-time basis.

## CUSTOMERS

Our customers are individual players under our direct sales, pre-paid card distributors and cooperation partners.

Our largest customer for each of the two years ended 31 December 2006 and the six months ended 30 June 2007 accounted for approximately 5.9%, 4.6% and 1.2% of our revenues during these periods, respectively. Our five largest customers for each of the two years ended 31 December 2006 and the six months ended 30 June 2007, accounted for approximately 15.4%, 11.1% and 4.7% of its revenues during those periods.

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As at the Latest Practicable Date, none of the Directors, their associates or any shareholders of the Company (who or which to the knowledge of the Directors owned more than 5% of the Company's issued share capital) had any interest in any of the Group's five largest customers.

### SUPPLIERS

Our suppliers include primarily server and bandwidth leasing companies and game operation service providers. The services provided by the game operation service providers includes (i) provision of servers for online game operation; (ii) provision of network security; (iii) fixing of any technical problems; (iv) provision of technical and customer services; and (v) provision of promotional and advertising activities. We operate the online games and the game operation service providers offer technical and promotional services to us for the operation. The online game revenue is received through our established distribution and payment channels and we pay the game operation service providers the charges for the services provided.

The largest supplier for each of the two years ended 31 December 2006 is the same entity who provided server and bandwidth leasing services to us. The largest supplier for the six months ended 30 June 2007 is a game operation service provider.

Our largest supplier for each of the two years ended 31 December 2006 and the six months ended 30 June 2007 accounted for approximately 51.6%, 45.7% and 35.7% of our purchases during those periods, respectively. Our five largest suppliers for each of the two years ended 31 December 2006 and the six months ended 30 June 2007 accounted for approximately 97.5%, 94.9% and 97.4% of our purchases during those periods, respectively.

As at the Latest Practicable Date, none of the Directors, their associates or any shareholders of the Company (who or which to the knowledge of the Directors owned more than 5% of the Company's issued share capital) had any interest in any of our five largest suppliers.

### COMPETITION

The online game industry is highly competitive. We compete primarily with other online game operators that are based in the PRC. Currently, few, if any, international online game operators directly offer services in the PRC. We believe that domestic operators, including us, are likely to have a competitive advantage over international online game operators which lack operational experience and content localisation experience for the PRC market. We also face competition from international online game operators in our overseas market. The competition in the overseas market is very intensive as we are actually competing with online game developers and operators all over the world, in particular, those in Korea which have already built a strong reputation in the industry.

In addition, we compete for players against various offline games, including PC games, console games, arcade games and handheld games, as well as various other forms of traditional or online entertainment.

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We consider diversified product portfolio, high quality products, strong game development capabilities, extensive distribution network are crucial to the establishment of a successful online game developer or operator and that these factors pose a barrier to new entrants.

### FACILITIES

Our three principal offices are located in Fuzhou, Fujian Province with an aggregate of approximately 3,153 sq.m. of office space under current leases that will expire in December 2007, March 2008 and June 2010, respectively. In addition, we have entered into a letter of intent with Fuzhou 851 to lease additional gross floor area of approximately 4,200 sq.m. in Fuzhou, Fujian Province for office purpose. Pursuant to that letter of intent, we are allowed to use the property without any consideration until the landlord obtains the building ownership certificate, upon which a formal tenancy agreement will be entered into between Fuzhou 851 and us. We also occupy an additional approximately 257.3 sq.m. of leased office space in Shanghai and approximately 111.76 sq.m. of leased office space in the USA. We believe that our existing facilities are adequate for our current requirements and that additional space can be obtained on commercially reasonable terms to meet our future requirements.

### INSURANCE

We maintain the social insurance for our employees in the PRC in accordance with the applicable laws of the PRC and requirements from the competent local authorities, of which the insurance premium is borne by us and the employees in a specific proportion regulated by the relevant PRC laws.

As an employer in California, NetDragon (USA) contributes its portion of the social security tax and medicare tax under the federal system of old-age, survivors, disability, and hospital insurance. NetDragon (USA) also pays unemployment tax under the relevant federal and state laws as required under the federal and state unemployment insurance systems. In addition, NetDragon (USA) provides health insurance benefits to all of its employees and all the premium for such insurance are paid by us.

The insurance industry in the PRC is still at an early stage of development. In particular, PRC insurance companies offer limited business insurance products. In addition, it is not compulsory for an online game developer and operator to maintain an insurance policy to cover losses relating to its business operation. Therefore, we have not yet taken out any insurance to cover our business operations in both the PRC and the overseas markets.

During the Active Business Pursuit Period, we have not experienced any insurance claims in relation to our business.

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### INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS

Our intellectual property is an essential element of our business operations. We rely on copyright, trademark, trade secret and other intellectual property law, as well as non-competition, confidentiality and license agreements with our employees, suppliers, business partners and others to protect our intellectual property rights. Our employees are generally required to sign agreements acknowledging that all inventions, trade secrets, works of authorship, developments and other processes generated by them on our behalf are our property, and assigning to us any ownership rights that they may claim in those works.

The copyrights under the software products developed by us are required to be registered with the NCAC which are valid for a period of 50 years. In order to sell and operate the software products developed by us in the PRC, upon obtaining the copyrights registration as mentioned above, we are required to register the software products with the Fujian Provincial MII in compliance with the Administrative Measures on Software Products (軟件產品管理辦法), which are valid for a period of five years and renewable upon application to the relevant authority approximately four months prior to expiration of the software product registrations at the earliest. The renewal process typically lasts for approximately 45 days to 135 days, depending on the time of submission of application which are only formally accepted and processed by the relevant authority four times a year. Since none of our current computer software product registrations are going to expire until August 2008, we have not yet filed the applications for their renewal as at the Latest Practicable Date. If any of the copyrights of our software products cannot be renewed or applied and filed for any reasons, we will not be able to operate such software products in the PRC and we will not be able to enjoy the benefits offered to the registered software products by the relevant PRC authority. As at the Latest Practicable Date, we were the registered owner of the 12 copyrights of computer software products in the PRC.

Besides, we have 11 registered domain names, including our official website and domain names registered in connection with each of the games we offer. We generally renew our domain name registrations once every year and applications for their renewal are usually submitted approximately two weeks prior to their expiration. Under normal circumstances, the renewal process usually takes approximately three to five days. If any of our domain name registrations cannot be renewed for whatever reason, the domain name registrar may deregister the relevant domain name.

As at the Latest Practicable Date, we had duly registered all necessary copyrights for software products and domain names currently in use. As the registration renewal procedures for both domain names and copyrights of the computer software products are largely procedural, we believe that we would not encounter any problem or unnecessary delay during the registration renewal process and hence do not foresee any risk of non-registration upon expiry of their respective terms.

Details of our intellectual property rights are set out in the section headed “Further information about the business - Intellectual property” in Appendix V of this prospectus.

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### AWARDS AND RECOGNITION

Over the past years, we have received various awards and recognition in respect of the superb quality and reputation of our products, among which include the following:

Awards	Date of award	Awarding institution/authority	Subsidiary/ Product
Recommended software products 2003 (2003年度推薦優秀軟件產品)	2003	China Software Industry Association (中國軟件行業協會)	NetDragon (Fujian) - Monster & Me
China Top Ten Game Developer in 2004 (2004 中國十佳遊戲開發商)	December 2004	CGPA and GAPP	TQ Digital
Award for Overseas Promotion of Chinese Games for 2004 (2004 中國遊戲海外拓展獎)	December 2004	CGPA and GAPP	TQ Digital
“Golden Plume Prize” for the Best Original Online Game of 2005 ChinaJoy Expo (2005 年度 ChinaJoy 展會優秀遊戲評選大賽 最佳原創網絡遊戲金翎獎)	October 2005	www.chinajoy.net	Conquer Online
Award for Overseas Promotion of Chinese Domestic Games for 2005 (2005 中國民族遊戲海外拓展獎)	October 2005	GAPP and MII	TQ Digital
International Software China 2006 - Gold Prize (中國國際軟件博覽會 — 金獎)	June 2006	Organising Committee of the China International Software Expo & Technology Symposium (中國國際軟件博覽會及技術研討會組委會)	TQ Digital - Conquer Online
Most Popular Free Online Game for 2006 (2006 最受歡迎免費網遊)	January 2007	QQ.com (騰訊網)	Eudemons Online
Most Popular Online Game for 2006 (2006 最受歡迎網絡遊戲)	January 2007	QQ.com (騰訊網)	Eudemons Online

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Awards	Date of award	Awarding institution/authority	Subsidiary/ Product
Most Popular MMORPG for 2006 (2006 最受歡迎 MMORPG)	January 2007	QQ.com (騰訊網)	Eudemons Online
Best New Online Game for 2006 (2006 最佳新銳網絡遊戲)	January 2007	QQ.com (騰訊網)	Eudemons Online
Most Anticipated Online Game for 2007 (2007 年最受期待網遊)	January 2007	QQ.com (騰訊網)	機戰 (Zero Online)
Award for Overseas Development of Chinese Domestic Games for 2006 (2006 年度中國民族遊戲海外拓展獎)	January 2007	GAPP and MII	TQ Digital
Top 10 Game Developers in China for 2006 (2006 年度中國十佳遊戲開發商)	January 2007	GAPP and MII	TQ Digital
Best Export Product Award for 2006 (2006 年度最佳出口產品獎)	January 2007	Shanghai Municipal Informatisation Commission (上海市信息化委員會), and Shanghai Municipal Press Publication Bureau (上海市新聞出版局)	Conquer Online
Best Originality Award for 2006 (2006 年度最佳原創作品獎)	January 2007	Shanghai Municipal Informatisation Commission (上海市信息化委員會), and Shanghai Municipal Press Publication Bureau (上海市新聞出版局)	Eudemons Online
Best Customer Service Provider for 2006 (2006 年最佳客服廠商)	January 2007	QQ.com	TQ Digital