MANAGEMENT DISCUSSION AND ANALYSIS OF THE TRACK RECORD PERIOD

Investors should read the following discussion and analysis in conjunction with our audited financial statements, including notes thereto, as set forth in the accountants' report in Appendix I to this document. The financial statements have been prepared in accordance with HKFRS.

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 market, such as offering online games to players free of charge and then generating revenue through 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 market.

Factors affecting our results of operations and financial condition

The major factors affecting our results of operations and financial condition include the following:

Growth of Internet penetration and online game market

Our results of operations and financial condition are affected by the growth of Internet penetration and online game market. The worldwide as well as the PRC rate of Internet penetration has continuously increased over the past few years and is expected to further increase in the future. As an online game developer and operator based in the PRC, the majority of our revenue is generated from online game operations in the PRC. The growth of Internet penetration in the PRC has facilitated the growth of online game market in the PRC as more and more people could reach online games through the Internet with easier access and lower cost. We believe that the continuing development of Internet value-added services, reduction in Internet access costs, lower PC prices and growth in broadband access will drive the increase in Internet usage as well as the growth of online game market. For more information, please refer to "Industry overview" in this document.

Popularity of our online games

Our financial results are affected by the popularity of our online games.

Popular games attract a large number of customers and generate significant revenue for the game developers and operators. Therefore, the ability to develop and operate popular games is essential to our commercial success.

Revenue generation

We operate our online games under the FTP model. Players can play the games without initial costs, which enables us to quickly attract new players to experience our online games. Our revenue is generated by selling virtual items to be used in the games. Our ability to design virtual items and enhance game features to attract players to increase spending is critical to our revenue generation. However, this model is a recent phenomenon and our future revenues and profits are substantially dependent upon the continued acceptance and use of the FTP model, and our ability to stimulate players' spending on virtual items.

Development capability

In order to maintain our long-term financial and operational success, we must continuously develop new games that are attractive to players, frequently upgrade our existing games to retain players, and constantly enhance the technical and artistic features of our games to meet players' preferences. The success of our games largely depends on our ability to anticipate and respond to the ever changing user demands. Developing games requires substantial investments prior to their launch and needs significant commitments of future resources to sustain their growth.

Technological change

As an online game developer and operator, our financial results and operations in the future are affected by rapid technological change. Advances in game development softwares enhance our game development capability as well as the novelty and complexity of online games. It enables us to offer a wider range of online games and attract more players. However, the introduction of new technologies may require us to upgrade our hardwares and softwares to remain competitive in the industry.

Foreign exchange fluctuation

We offer online games in various language versions, including English, French, Spanish and Portuguese. Our multi-language approach helps generate revenue from the non-Chinese language market of approximately RMB120.6 million, representing approximately 18.7% of our total revenue for the year ended 31 December 2007. Our financial statements are prepared in Renminbi, while a portion of the revenue and expenses are denominated in foreign currencies. It is possible that the value of the Renminbi may fluctuate in value against other currencies. Our results of operations and financial condition may be affected by changes in the exchange rates of the Renminbi against other currencies in which our revenue and expenses are denominated. For more information, please refer to the paragraph headed "Fluctuations in the exchange rate of currencies may adversely affect our business" set out under the section headed "Risk factors" in this document.

Basis of presentation

Our financial information has been prepared as a combination of business under common control. Our financial information presents our results of operations as if we had been in existence in current form as at 1 January 2005. Although we are not the equity holder of NetDragon (Fujian), we ultimately and effectively control the financial and operating activities of NetDragon (Fujian) through a

Management Committee. The Management Committee is established in accordance with the Structure Contracts, which were entered into by TQ Digital, NetDragon (Fujian) and the equity holders of NetDragon (Fujian) to oversee the business and operations of NetDragon (Fujian) in preparation for the GEM Listing. We are able to control the Management Committee through the mechanism mentioned in the Structure Contracts. In addition, TQ Digital is entitled to substantially all of the operating profit generated by NetDragon (Fujian). NetDragon (Fujian) is in essence controlled by TQ Digital and accordingly, we regard NetDragon (Fujian) as our subsidiary, notwithstanding the lack of equity ownership. Due to NetDragon (Shanghai) is a subsidiary of NetDragon (Fujian), NetDragon (Shanghai) is also regarded as our subsidiary. In view of the new enterprise income tax law adopted by the National People's Congress of the PRC on 16 March 2007, a wholly foreign owned enterprise, TQ Online has been established through Glory More, one of the wholly owned subsidiaries of NetDragon (BVI) incorporated in Hong Kong, to gradually substitute TQ Digital in the Group's operation in order to maximise the tax benefits to the Group under the new tax law. Consequentially, TQ Online has entered into the Structure Contracts with NetDragon (Fujian) on 16 May 2008 under which any new versions of the Group's existing games and new games will be operated by TQ Online and NetDragon (Fujian). As we, NetDragon (BVI), TQ Digital, NetDragon (USA), NetDragon (HK), Glory More, TQ Online, NetDragon (Fujian) and NetDragon (Shanghai) were ultimately controlled by the same group of parties before and after the formation of the Group, the financial information is thereby prepared using the principles of merger accounting and presents our combined results, combined changes in equity, combined cash flows and combined financial positions as if the current group structure had been in existence on 1 January 2005, the beginning of the earliest Track Record Period presented.

Critical accounting policies and estimates

We prepare financial statements in accordance with HKFRS, which requires us to adopt accounting policies and make estimates and assumptions that our management believes are appropriate in the circumstances for purposes of giving a true and fair view of our results and financial condition. However, different policies, estimates and assumptions in critical areas could lead to materially different results. We continually evaluate these estimates based on our own experience, knowledge and assessment of current business and other conditions, our expectations based on available information and other reasonable assumptions, which together form our basis for making judgments about matters that are not readily apparent from other sources. Since the use of estimates is an integral component of the financial reporting process, our actual results could differ from those estimates. Some of our accounting policies require a higher degree of judgment than others in their application. We believe the following accounting policies involve the most significant judgments and estimates used in the preparation of our financial statements.

(i) **Merger accounting**

We prepare our financial information using merger accounting. In determining the appropriate accounting method for preparing the Group's financial statement, we have assessed if the formation of the Group is a business combination involving entities under common control and whether such control is transitory.

(ii) **Online game revenue recognition**

In general, we recognise online game revenue based on the actual consumption of the game points. Under the FTP model, the relevant online games are free-to-play but game players can purchase virtual items with game points to enhance their experience in the online games. To acquire game points, game users can credit their game accounts through direct sales channel such as online payment systems or purchase of pre-paid cards. Online game revenue is recognised when the game points are utilised by game players to purchase virtual items.

We account for the amounts received in respect of unactivated pre-paid cards as well as the amounts received in respect of unutilised game points as deferred income in our consolidated balance sheets. The unutilised game points are valid to be used without a definite period. Our pre-paid cards are sold through third party sales distributors and our own distribution network in the PRC. For pre-paid cards which are sold but not yet activated by the ultimate players, the relevant amount received is recognised as deferred income.

As to the unutilised game points at period end, we have estimated the average sales value of the unutilised game points in arriving at the relevant amount of deferred income at that period end. In determining the amount of average sales value of the unutilised game points, we consider the discount rate applicable to each of the distribution and payment channels as discounts given to them are varied. In general, more than half of the revenue generated is attributable to the channel of direct sales via online payment systems and discount is not given in respect of this channel. The rest of the revenue is generated via the channels which are given discounts ranging from 15% to 55% in general. We also consider the mix of income received via the channels of direct sales and pre-paid cards sales through distributors. In a year when more income is received from the channel of direct online payment systems where discount is not given, we tend to use a lower average discount rate in determining the amount of deferred income for that year and vice versa. Having considered these factors, we determine an average discount rate which gives rise to the best estimate of the discount given to those unutilised game points at period end. The average sale value of each game point is then determined by factoring the average discount rate to the face value of the game points. If the actual sales value of the unutilised game points is greater than our estimated sales value, the amount of deferred income recognised in the consolidated balance sheets should be larger and the amount of online game revenue recognised in the consolidated income statements should be smaller correspondingly. On the contrary, if the actual sales value of the unutilised game points is smaller than our estimated sales value, the amount of deferred income recognised in the consolidated balance sheets should be smaller and the amount of online game revenue recognised in the consolidated income statements should be larger correspondingly.

Our existing system is able to capture the information necessary in determining the deferred revenue which includes income received from different distribution and payment channels in a given period, the number of game points consumed in a given period and the number of unutilised game points at period end. With reference to the actual sale value of game points sold via different distribution and payment channels in a given period of time, we are able to estimate the average discount rate in a given period and then to determine the amount of deferred income at the period end.

As a result of the above-mentioned factors, our online game revenue and deferred income during the Track Record Period are fairly stated despite the estimates and assumptions underlying the online game revenue recognition policy.

(iii) **Development costs**

We generally recognise development expenditures as expenses as they are incurred. Costs on development project are capitalised and recognised as intangible assets only when we can demonstrate (i) the technical feasibility of completing the intangible asset so that it will be available for use or sale; (ii) our intention to complete and our ability to use or sell the asset; (iii) how the asset will generate future economic benefits; (iv) the availability of technical and financial resources to complete; and (v) the ability to measure reliably the expenditure during the development.

Determining the level of development costs that warrant capitalisation requires significant management judgement and assumptions regarding the expected future cash flow of the assets, discount rates to be applied and the expected period of benefits. We have expensed all our development costs to date. We will only capitalise our development costs when our management is satisfied that the above conditions for capitalisation are met through sufficiently reliable estimates and judgement, and the reasonableness of which can be demonstrated objectively.

(iv) **Useful lives of property, plant and equipment**

Our property, plant and equipment primarily comprise servers, computers, vehicles and other office equipment. We depreciate these assets using the straight-line method over the estimated useful lives of the assets, taking into account the assets' estimated residual values. We estimate the useful lives based on our management's knowledge on the useful lives of similar assets in the market, and taking into account anticipated technological or other changes. On this basis, we have estimated the useful lives of our servers, computers, vehicles and office equipment to be five years. We review the estimated useful lives and residual values of assets, and adjust them if appropriate, at each balance sheet date.

If technological innovations are to occur more rapidly than anticipated, we may shorten the useful lives or lower the residual value assigned to these assets, which will result in increased depreciation expense in future periods.

(v) **Impairment of receivables**

Trade and other receivables are booked initially at fair value and subsequently measured at amortised cost less any impairment. A provision for impairment of trade and other receivables is established when there is objective evidence that we will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of a debtor, probability that a debtor will enter bankruptcy, and default or delinquency in payment are considered indicators that the trade receivable is impaired. When a receivable is determined uncollectible, it is written off against the allowance account for receivables and the amount of the loss is recognised in the consolidated income statement as part of administrative expenses. We review the provision for impairment, and adjust it if appropriate, at each balance sheet date after conducting aging analysis of the receivables and reviewing credit history of the debtors.

RESULTS OF OPERATIONS

The table below sets out a summary of our audited consolidated financial results during the Track Record Period. For more detailed information, please refer to the accountants' report in Appendix I to this document.

	Year ended 31 December		
	2005	**2006**	**2007**
	RMB'000	*RMB'000*	*RMB'000*
Revenue	35,119	122,061	645,214
Cost of revenue	(4,669)	(11,179)	(36,863)
Gross profit	30,450	110,882	608,351
Other revenue and gains	4,950	5,673	8,321
Selling and marketing expenses	(25,450)	(13,838)	(80,844)
Administrative expenses	(16,906)	(22,960)	(50,090)
Development costs	(15,464)	(12,835)	(37,253)
Other operating expenses	(8,501)	(15,377)	(21,404)
Operating (loss)/profit	(30,921)	51,545	427,081
Loss on disposal of an associate	—	(2)	—
(Loss)/Profit before income tax	(30,921)	51,543	427,081
Income tax credit/(expense)	1,721	(8,558)	(52,244)
(Loss)/Profit for the year	(29,200)	42,985	374,837
Attributable to			
Equity holders of the Company	(29,171)	42,856	374,854
Minority interests	(29)	129	(17)
	(29,200)	42,985	374,837
Dividends	—	—	295,162

The table below sets out a summary of the percentage of certain of the financial results to our revenue:

	Year ended 31 December		
	2005	**2006**	**2007**
Revenue	100.0%	100.0%	100.0%
Cost of revenue	(13.3)%	(9.2)%	(5.7)%
Gross profit	86.7%	90.8%	94.3%
Other revenue and gains	14.1%	4.6%	1.3%
Selling and marketing expenses	(72.5)%	(11.3)%	(12.5)%
Administrative expenses	(48.1)%	(18.8)%	(7.8)%
Development costs	(44.0)%	(10.5)%	(5.8)%
Other operating expenses	(24.2)%	(12.6)%	(3.3)%
Operating (loss)/profit	(88.0)%	42.2%	66.2%
Loss on disposal of an associate	—	—	—
(Loss)/Profit before income tax	(88.0)%	42.2%	66.2%
Income tax credit/(expense)	4.9%	(7.0)%	(8.1)%
(Loss)/Profit for the year	(83.1)%	35.2%	58.1%
Attributable to			
Equity holders of the Company	(83.0)%	35.1%	58.1%
Minority interests	(0.1)%	0.1%	0.0%
	(83.1)%	35.2%	58.1%

Year ended 31 December 2007 compared with year ended 31 December 2006

Revenue

Our revenue arising from principal activities for the year ended 31 December 2007 was approximately RMB645.2 million, representing an increase of approximately 428.6% as compared to the year ended 31 December 2006. The table below sets out the breakdown of our revenue by game for the years ended 31 December 2006 and 2007:

	Year ended 31 December			
	2006		**2007**	
	RMB'000	*% of total revenue*	*RMB'000*	*% of total revenue*
Online games				
Eudemons Online	69,489	56.9	448,603	69.5
Conquer Online	51,112	41.9	135,326	21.0
Zero Online	—	—	58,755	9.1
Tou Ming Zhuang Online	—	—	1,816	0.3
Others	1,460	1.2	714	0.1
Total	122,061	100.0	645,214	100.0

The increase of our total revenue was mainly due to the continuing popularity of Conquer Online, achieving a PCU and ACU of approximately 102,000 and 64,000, respectively for the year ended 31 December 2007 whereas it recorded a PCU and ACU of approximately 82,000 and 52,000, respectively for the year ended 31 December 2006. We also recorded a continuing popularity for Eudemons Online, achieving a PCU and ACU of approximately 574,000 and 269,000, respectively for the year ended 31 December 2007 whereas it recorded a PCU and ACU of approximately 325,000 and 70,000, respectively for the year ended 31 December 2006. Zero Online was launched in late April 2007 and achieved a PCU and ACU of approximately 91,000 and 36,000 from the date of its launch to 31 December 2007. In addition, Tou Ming Zhuang Online was launched in December 2007 and recorded a PCU and ACU of approximately 20,000 and 6,000 from the date of its launch to 31 December 2007. Revenue derived from Eudemons Online accounted for approximately 69.5% of our revenue for the year ended 31 December 2007. In addition, the revenue derived from Conquer Online increased by approximately 164.8% to approximately RMB135.3 million for the year ended 31 December 2007 from RMB51.1 million for the same period in 2006. Both Zero Online and Tou Ming Zhuang Online were launched during the year ended 31 December 2007 and contributed a revenue of approximately RMB58.8 million and RMB1.8 million to the Group respectively. With the popularity of the above key games, our revenue derived from other games including Monster & Me and Era of Faith decreased by approximately 51.1% to approximately RMB714,000 for the year ended 31 December 2007.

Cost of revenue

Our cost of revenue primarily consist of costs directly attributable to the provision of our services, which include fees paid to game operation service providers, server and bandwidth leasing expenses, depreciation of servers, transaction handling fees and other costs. These costs are recognised in the income statement as incurred or upon utilisation of the relevant services, as appropriate.

The following table shows the breakdown of our cost of revenue for the years ended 31 December 2006 and 2007:

	Year ended 31 December	
	2006	**2007**
	RMB'000	*RMB'000*
Fees paid to game operation service providers	2,521	8,065
Server and bandwidth leasing expenses	5,360	17,507
Depreciation of servers	1,088	4,127
Transaction handling fees	2,210	6,226
Others	—	938
	11,179	36,863

Cost of revenue for the year ended 31 December 2007 was approximately RMB36.9 million, representing an increase of approximately 229.8% from the year ended 31 December 2006. The increase in cost of revenue was mainly attributable to (i) increased server and bandwidth leasing expenses; (ii) the fee paid to game operation service providers, whereas we only started to pay such fees in the last quarter of 2006, the time the online games were started to generate revenue for that game operation service providers; (iii) the increased servers required from these game operation services providers; and (iv) increased transaction handling fees as a result of the increased revenue. With the expansion of our business, the servers and bandwidth leased by us increased by approximately 528.1% to about 2,000 units for the year ended 31 December 2007.

The services provided by the game operation service providers, which are all Independent Third Parties, 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. The effective dates of the agreements entered into between the game operation service providers and us varied from May 2006 to January 2007, and accordingly, relatively a small amount of cost of revenue was recorded for the year ended 31 December 2006.

The transaction handling fees are service fees charged by our online payment service providers for collecting money on our behalf.

Gross profit

As a result of the above-mentioned factors, our gross profit increased by approximately 448.6% to approximately RMB608.4 million for the year ended 31 December 2007. Gross profit margin increased from approximately 90.8% for the year ended 31 December 2006 to approximately 94.3% for the year ended 31 December 2007, which was mainly due to the increased player usage as demonstrated by the increases in ACU for each games as mentioned in the revenue section above.

Other revenue and gains

Other revenue and gains for the year ended 31 December 2007 increased by approximately 46.7% to approximately RMB8.3 million as compared with the year ended 31 December 2006. The increase was mainly due to the increase in interest income of approximately RMB3.6 million from the net proceed of the International Placing.

Selling and marketing expenses

Our selling and marketing expenses primarily consist of staff costs, advertising and promotion expenses and other selling and marketing expenses.

The following table shows the breakdown of selling and marketing expenses for the years ended 31 December 2006 and 2007:

	Year ended 31 December	
	2006	**2007**
	RMB'000	*RMB'000*
Advertising and promotion	7,064	63,943
Staff costs	3,280	9,980
Others	3,494	6,921
	13,838	80,844

Selling and marketing expenses for the year ended 31 December 2007 increased by approximately 484.2% to approximately RMB80.8 million as compared with the year ended 31 December 2006. The increase in the amount of selling and marketing expenses was mainly attributable to our increased advertising and promotion expenses for Eudemons Online and Zero Online, and the increased staff costs as we raised employee compensations. The advertising and promotion expenses for Eudemons Online and Zero Online included advertisements on various online platforms and Internet cafés. The proportion of selling and marketing expenses to the total revenue for each of the year ended 31 December 2006 and 2007 was approximately 11.3% and 12.5%, respectively.

Administrative expenses

Our administrative expenses consist primarily of staff costs, depreciation, travel and entertainment expenses and other administrative expenses.

The following table shows the breakdown of administrative expenses for the years ended 31 December 2006 and 2007:

	Year ended 31 December	
	2006	**2007**
	RMB'000	*RMB'000*
Staff costs	11,362	22,687
Depreciation	2,636	4,806
Travel and entertainment expenses	2,885	4,557
Others	6,077	18,040
	22,960	50,090

Administrative expenses increased by approximately 118.2% to approximately RMB50.1 million for the year ended 31 December 2007 as a result of the continuous expansion of our online game business. The increase of our staff costs was due to the expansion of our administrative team to support the expansion of development team and the increase of compensation of employees during the year ended 31 December 2007. The increase in our travel and entertainment expenses and other administrative expenses for the year ended 31 December 2007 were primarily driven by the significant increase of our business development needs including cooperation with different business partners such as cooperation with China Film Group. Other administrative expenses consist primarily of office expenses and supplies, office facilities expenses, office rents and rates, legal and professional fees, exchange loss and miscellaneous expenses. The increase of other administrative expenses was principally due to our overall expansion for the Company and the exchange loss incurred from the inflation of RMB while converted from other currencies such as USD and HKD for the year ended 31 December 2007. The proportion of administrative expenses to total revenue for each of the year ended 31 December 2006 and 2007 was approximately 18.8% and 7.8%, respectively.

Development costs

The following table shows the breakdown of development costs for the years ended 31 December 2006 and 2007:

	Year ended 31 December	
	2006	**2007**
	RMB'000	*RMB'000*
Staff costs	12,171	36,268
Others	664	985
	12,835	37,253

Our development costs primarily consist of staff costs and other development-related expenses. The increase in our development costs was mainly due to the expansion of our development team and the increase of their compensation during the year ended 31 December 2007. The number of staff in our development team was 231 and 412 for each of the two years ended 31 December 2007, respectively. We increased the compensation in order to provide a competitive and attractive increment in the basic salary and distribution of discretionary bonus due to the success of Eudemons Online and to further motivate employees.

Other operating expenses

Our other operating expenses consist primarily of business tax for intercompany transactions and professional fees related to the GEM Listing.

The following table shows the breakdown of other operating expenses for the years ended 31 December 2006 and 2007:

	Year ended 31 December	
	2006	**2007**
	RMB'000	*RMB'000*
Business tax (intercompany transactions)	2,439	11,083
Professional fees related to the GEM Listing	8,113	10,899
Provision/(Over-provision) of withholding tax	3,222	(4,026)
Others	1,603	3,448
	15,377	21,404

Other operating expenses for the year ended 31 December 2007 increased by approximately 39.2% to approximately RMB21.4 million as compared with the year ended 31 December 2006. The increase in other operating expenses was mainly attributable to the increase in business tax for intercompany transactions as a result of our revenue increase, and the increase in our professional fees relating to the GEM Listing.

We are required to pay business tax not only for intercompany transactions but for all online game revenue. However, the business tax included in “other operating expenses” is only related to intercompany transactions. The intercompany transactions included (i) license fee charged by TQ Digital which determined as a percentage of NetDragon (Fujian)’s annual gross revenues for Chinese language games; (ii) license fee charged by TQ Digital which determined as a percentage of NetDragon (USA)’s annual gross revenues for non-Chinese language games; and (iii) charges on various services provided by NetDragon (Shanghai) to NetDragon (USA) in exchange for a flat fee calculated based on the number of servers running certain non-Chinese language games. Thus, the business tax for online game revenue is deducted from the gross revenue directly. Business tax is neither costs of revenue, nor selling and marketing expenses, nor administrative expenses, nor development costs. Business tax is also not an income tax in nature. Accordingly, they are classified as “other operating expenses”.

According to our accounting policies, professional fees that are directly attributable to new share issuance shall be deducted from equity (net of any income tax benefit) in the period they incur; while professional fees that relate to the stock market listing, or not incremental and directly attributable to new share issuance shall be recognized as an expense in the period they incur. Moreover, professional fees that are related to both new share issuance and stock market listing should be allocated between those functions on a rational and consistent basis. Accordingly, we have recognized those professional fees related to stock market listing as expenses in the period they incur.

For the year ended 31 December 2006, we recognized a provision for withholding tax of approximately RMB3.2 million which was provided for the withholding tax expected to be charged to NetDragon (USA) for the license fee paid to TQ Digital. During the year ended 31 December 2007, the withholding tax charged to NetDragon (USA) was less than the provision made in prior years. Accordingly, we have written back the withholding tax over-provided in prior years of approximately RMB4.0 million. Under the current operation, NetDragon (USA) no longer pays any license fee to TQ Digital and the withholding tax is not expected to be incurred in future.

Operating profit

As a result of the above-mentioned factors, our operating profit improved from approximately RMB51.5 million for the year ended 31 December 2006 to approximately RMB427.1 million for the year ended 31 December 2007. The increase in operating income was principally resulted from the increasing popularity of our online games and the fact that our revenue increased at a substantially higher rate than that of our operating expenses.

Profit before income tax

Because of the same factors as for operating profit, our profit before income tax increased by approximately 728.6% to approximately RMB427.1 million for the year ended 31 December 2007.

Income tax expense

Our income tax expense increased by 510.5% to RMB52.2 million for the year ended 31 December 2007. The increase was primarily due to that we had profit before tax of RMB427.1 million for the year ended 31 December 2007 as compared to profit before tax of RMB51.5 million for the year ended 31 December 2006. In addition, since a significant amount of profit for the year ended 31 December 2007 were contributed by TQ Digital which was subject to a lower enterprise income tax rate of 7.5% in the PRC in 2007 when compared with the respective income tax rates of 15%, 33% and 34% for NetDragon (Fujian), NetDragon (Shanghai) and NetDragon (USA), the Group's effective tax rate decreased from 16.6% for the year ended 31 December 2006 to 12.2% for the year ended 31 December 2007.

Profit for the year

As a result of the overall effect from the above-mentioned factors, our profit for the year ended 31 December 2007 increased by approximately 772.0% to approximately RMB374.8 million as compared with the year ended 31 December 2006. The net profit margin for the year ended 31 December 2007 was 58.1% as compared with approximately 35.2% for the year ended 31 December 2006.

Year ended 31 December 2006 compared with year ended 31 December 2005

Revenue

Our revenue arising from principal activities for the year ended 31 December 2006 was approximately RMB122.1 million, representing an increase of approximately 247.6% as compared to approximately RMB35.1 million for the year ended 31 December 2005. The table below sets out the breakdown of our online game revenue for the years ended 31 December 2005 and 2006:

	Year ended 31 December			
	2005		**2006**	
	RMB'000	*% of total revenue*	*RMB'000*	*% of total revenue*
Online games				
Eudemons Online	—	—	69,489	56.9
Conquer Online	32,338	92.1	51,112	41.9
Others	2,781	7.9	1,460	1.2
Total	35,119	100.0	122,061	100.0

The increase in our revenue for the year ended 31 December 2006 was mainly due to the popularity of Eudemons Online, which was launched in March 2006. Eudemons Online achieved a PCU and ACU of approximately 325,000 and 70,000, respectively for the year ended 31 December 2006. Revenue derived from Eudemons Online accounted for approximately 56.9% of our revenue for the year ended 31 December 2006. In addition, the 58.1% increase in revenue derived from Conquer Online added to the revenue growth for the year ended 31 December 2006. Conquer Online achieved a PCU and ACU of approximately 82,000 and 52,000, respectively for the year ended 31 December 2006 whereas it recorded a PCU and ACU of approximately 47,000 and 27,000, respectively for the year ended 31 December 2005. Revenue derived from Conquer Online accounted for approximately 92.1% and 41.9%, respectively, of our revenue for the year ended 31 December 2005 and 2006. With the continuous popularity of Conquer Online and the launch of Eudemons Online, our revenue derived from other games including Monster & Me and Era of Faith decreased by approximately 47.5% to approximately RMB1.5 million for the year ended 31 December 2006.

Cost of revenue

The following table shows the breakdown of our cost of revenue for the years ended 31 December 2005 and 2006:

	Year ended 31 December	
	2005	**2006**
	RMB'000	*RMB'000*
Fees paid to game operation service providers	—	2,521
Server and bandwidth leasing expenses	2,927	5,360
Depreciation of servers	1,008	1,088
Transaction handling fees	734	2,210
	4,669	11,179

Cost of revenue for the year ended 31 December 2006 was approximately RMB11.2 million, representing an increase of approximately 139.4% as compared to the year ended 31 December 2005. The increase in cost of revenue was mainly attributable to (i) fees paid to game operation service providers for the year ended 31 December 2006 pursuant to an agreement entered between us and the game operation service provider in relation to the operation of Eudemons Online and Conquer Online; (ii) increase in our server and bandwidth leasing expenses due to the number of servers and bandwidth we leased increased by approximately 112.8% to about 300 units for the year ended 31 December 2006; and (iii) transaction handling fees primarily as a result of the increased revenue.

The services provided by the game operation service providers, which are all Independent Third Parties, 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. The effective dates of the agreements entered into between the game operation service providers and us varied from May 2006 to January 2007, and accordingly, no cost of revenue was recorded for the year ended 31 December 2005.

The transaction handling fees are service fees charged by our online payment service providers for collecting money on our behalf.

Gross profit

As a result of the above-mentioned factors, gross profit increased by approximately 264.1% to approximately RMB110.9 million in the year ended 31 December 2006. Gross profit margin increased from approximately 86.7% for the year ended 31 December 2005 to approximately 90.8% for the year ended 31 December 2006 mainly due to the increased player usage as demonstrated by the increases in ACU for each games as mentioned in the revenue section above, which in turn led to higher consumption of our virtual items and brought higher revenue. As our cost of server leasing expense is charged per server unit rather than per online game player, higher gross profit was generated as a result.

Other revenue and gains

Other revenue and gains for the year ended 31 December 2006 increased by approximately 14.6% to approximately RMB5.7 million as compared with the year ended 31 December 2005. The increase in other revenue and gains was mainly attributable to gain on investments and increases in our interest income offset by a decrease in game development fee income for the year ended 31 December 2006. The game development fee income was generated from our development of an online game for Guangdong Digital Communications Network Company Limited (廣東數據通信網絡有限公司), an Independent Third Party.

Selling and marketing expenses

The following table shows the breakdown of selling and marketing expenses for the years ended 31 December 2005 and 31 December 2006:

	Year ended 31 December	
	2005	**2006**
	RMB'000	*RMB'000*
Advertising and promotion	10,425	6,204
Staff costs	6,290	3,279
Others	8,735	4,355
	25,450	13,838

Selling and marketing expenses for the year ended 31 December 2006 decreased by approximately 45.6% to approximately RMB13.8 million as compared with the year ended 31 December 2005. The decrease in selling and marketing expenses was mainly attributable to our effort to focus on the development and operation of MMORPGs for the year ended 31 December 2006 instead of spreading our resources in developing each of MMORPGs, casual games and online portal for the year ended 31 December 2005. As a result, advertising and promotion expenses and staff related costs on non-MMORPG business was discontinued by closing down several related sales and marketing teams during the third quarter of 2005 to early 2006. The number of staff relating to selling and marketing were 247 and 88 for each of the year ended 31 December 2005 and 2006, respectively. The proportions of selling and marketing expenses to the total revenue for the year ended 31 December 2005 and 2006 were approximately 72.5% and 11.3%, respectively.

Administrative expenses

The following table shows the breakdown of administrative expenses for the years ended 31 December 2005 and 2006:

	Year ended 31 December	
	2005	**2006**
	RMB'000	*RMB'000*
Staff costs	8,560	11,362
Depreciation	1,509	2,636
Travel and entertainment expenses	529	2,885
Others	6,308	6,077
	16,906	22,960

Administrative expenses increased by approximately 35.8% to approximately RMB23.0 million for the year ended 31 December 2006. The increase of our staff costs was due to the increase of compensation for employees as incentive with the improved financial performance of the Group. The proportions of administrative expenses to total revenue for the year ended 31 December 2005 and 2006 were approximately 48.1% and 18.8%, respectively. We have increased the compensation for most of the staff, in particular the senior staff in administrative departments, for the year ended 2006. The staff costs of senior management under the administrative departments are classified as administrative expenses.

Development costs

The following table shows the breakdown of development costs for the years ended 31 December 2005 and 2006:

	Year ended 31 December	
	2005	**2006**
	RMB'000	*RMB'000*
Staff costs	13,958	12,171
Others	1,506	664
	15,464	12,835

The decrease in staff costs related to development was primarily due to our effort to focus on the development of MMORPGs in 2006 instead of the diversified development directions in MMORPGs, casual games and online portals in the year ended 31 December 2005 offset by an increase in overall compensation to our staff. Under our previous diversified development directions which commenced in early 2004, we believed that the result of such strategy was not satisfactory which was attributable to our loss for the year ended 31 December 2005. As such, we have decided to focus our resources on the development of MMORPGs since 2005.

Other operating expenses

The following table shows the breakdown of other operating expenses for the years ended 31 December 2005 and 2006:

	Year ended 31 December	
	2005	**2006**
	RMB'000	*RMB'000*
Business tax (intercompany transactions)	321	2,439
Professional fees related to the GEM Listing	4,985	8,113
Write-off of and loss on property, plant and equipment	629	1,261
Others	2,566	3,564
	8,501	15,377

Other operating expenses for the year ended 31 December 2006 increased by approximately 80.9% to approximately RMB15.4 million as compared with the year ended 31 December 2005. The increase in other operating expenses was mainly attributable to an increase in business tax for intercompany transactions which was driven by our increase in revenue for the year ended 31 December 2006. We are required to pay business tax not only for intercompany transactions but for all online game revenue. However, the business tax included in "other operating expenses" is only related to intercompany transactions. The intercompany transactions included (i) license fee charged by TQ Digital which determined as a percentage of NetDragon (Fujian)'s annual gross revenues for Chinese language games; (ii) license fee charged by TQ Digital which determined as a percentage of NetDragon (USA)'s annual gross revenues for non-Chinese language games; and (iii) charges on various services provided by NetDragon (Shanghai) to NetDragon (USA) in exchange for a flat fee calculated based on the number of servers running certain non-Chinese language games. Thus, the business tax for online game revenue is deducted from the gross revenue directly. Business tax is neither costs of revenue, nor selling and marketing expenses, nor administrative expenses, nor development costs. Business tax is also not an income tax in nature. Accordingly, they are classified as "other operating expenses".

We also recorded professional fees related to the GEM Listing of about RMB8.1 million as the preliminary expenses for our preparation of the GEM Listing for the year ended 31 December 2006. According to our accounting policies, professional fees that are directly attributable to new share issuance shall be deducted from equity (net of any income tax benefit) in the period they incur; while professional fees that relate to the stock market listing, or not incremental and directly attributable to new share issuance shall be recognized as an expense in the period they incur. Moreover, professional fees that are related to both new share issuance and stock market listing should be allocated between those functions on a rational and consistent basis. Accordingly, we have recognized those professional fees related to stock market listing as expenses in the period they incur.

In addition, we disposed of the unutilised and outdated computers which accounted for the write-off and loss on disposal of property, plant and equipment.

Operating (loss)/profit

As a result of the above-mentioned factors, profitability was improved from an operating loss of approximately RMB30.9 million for the year ended 31 December 2005 to an operating profit of approximately RMB51.5 million for the year ended 31 December 2006. The increase in operating profit was attributable to an increase in gross profit by approximately 264.1%, as well as a decrease in selling and marketing expenses by approximately 45.6%. The improvement in operation for the year ended 31 December 2006 was resulted from the increasing popularity of our online games.

Loss on disposal of an associate

Loss on disposal of an associate is only incurred for the year ended 31 December 2006. Loss on disposal of an associate of approximately RMB2,000 was resulted from the dissolution of Fuzhou Yikairui Network & Infotech Company Limited (福州易凱瑞網絡信息技術有限公司) with consideration of approximately RMB428,000 on 4 August 2006. The dissolution of Fuzhou Yikairui Network & Infotech Company Limited (福州易凱瑞網絡信息技術有限公司) had been completed and there is no actual or contingent liability for the dissolution of that associate.

(Loss)/Profit before income tax

As a result of the above-mentioned factors, profit before income tax for the year ended 31 December 2006 increased to approximately RMB51.5 million as compared with the loss before income tax of approximately RMB30.9 million for the year ended 31 December 2005.

Income tax credit/(expense)

Income tax expense was RMB8.6 million for the year ended 31 December 2006 as compared with income tax credit of RMB1.7 million for the year ended 31 December 2005. This increase was primarily due to a turnaround in profit before income tax for the year ended 31 December 2006 as compared with the loss before income tax for the year ended 31 December 2005. The amount of income tax credit of the Group for the year ended 31 December 2005 amounting to RMB1.7 million is mainly attributable to the fact that TQ Digital, NetDragon (Fujian) and NetDragon (Shanghai) did not derive assessable income in the PRC during the year. In addition, there was no tax exemption entitled by TQ Digital resulted from loss making for the year ended 31 December 2005. Due to the above-mentioned reasons, the Group recorded a loss before income tax of RMB30.9 million and the effective tax rate of the Group was approximately 5.6% for the year ended 31 December 2005.

The amount of income tax expense for the year ended 31 December 2006 amounting to RMB8.6 million is mainly attributable to the fact that TQ Digital, NetDragon (USA), NetDragon (Fujian) and NetDragon (Shanghai) were making profit during the year. As a result of TQ Digital, NetDragon (USA) and NetDragon (Fujian) making significant amount of profit for the Group during the year and the income tax rate of TQ Digital, NetDragon (USA) and NetDragon (Fujian) is different at 7.5%, 34.0% and 15.0% respectively, the profit before income tax was RMB51.5 million and the tax charge for that year was higher than the amount of the year ended 31 December 2005. The effective tax rate of the Group changed to approximately 16.6% for the year ended 31 December 2006 accordingly.

(Loss)/Profit for the year

As a result of the overall effect from the above-mentioned factors, profit for the year ended 31 December 2006 turned around to approximately RMB43.0 million as compared with a loss of approximately RMB29.2 million for the year ended 31 December 2005. The net profit margin for the year ended 31 December 2006 was approximately 35.2%.

The following are unaudited consolidated results of the Group for the three months ended 31 March 2008 together with the comparative figures for the last corresponding periods which are extracted from the first quarterly report of the Group published on 14 May 2008:

The three months ended 31 March 2008 compared with three months ended 31 March 2007

CONSOLIDATED INCOME STATEMENT (UNAUDITED)

	Three months ended 31 March	
	2008	**2007**
	RMB'000	*RMB'000*
Revenue	175,556	107,274
Cost of revenue	(16,533)	(6,420)
Gross profit	159,023	100,854
Other revenue and gains	5,375	537
Selling and marketing expenses	(15,436)	(12,774)
Administrative expenses	(25,907)	(10,983)
Development costs	(17,679)	(6,970)
Other operating expenses	(7,908)	(5,488)
Profit before income tax	97,468	65,176
Income tax expense	(27,534)	(6,702)
Profit for the period	69,934	58,474
Attributable to		
— Equity holders of the Company	69,986	58,377
— Minority interests	(52)	97
	69,934	58,474
Dividends	—	44,839
	RMB cents	*RMB cents*
Earnings per share		
— attributable to the equity holders of the Company	12.79	16.35

Revenue

For the three months ended 31 March 2008, the Group recorded an unaudited revenue of approximately RMB175.6 million representing an increase of about 63.7% from the unaudited revenue of approximately RMB107.3 million for the corresponding period in last year. The increase of total revenue was mainly due to the continuing popularity of Conquer Online, Eudemons Online, Zero Online and Tou Ming Zhuang Online.

The following table sets out the breakdown of our revenue by game for the three months ended 31 March 2007 and 2008:

	Three months ended 31 March			
	2008		**2007**	
	RMB'000	*% of total revenue*	*RMB'000*	*% of total revenue*
Online games				
Conquer Online	39,437	22.4	29,883	27.8
Eudemons Online	105,395	60.0	76,684	71.5
Zero Online	19,271	11.0	—	—
Tou Ming Zhuang Online	11,173	6.4	—	—
Others	280	0.2	707	0.7
Total	175,556	100.0	107,274	100.0

The revenue derived from Conquer Online for the three months ended 31 March 2008 amounted to approximately RMB39.4 million, representing an increase of about 32.0% from approximately RMB29.9 million for the corresponding period in last year. Eudemons Online was launched in late March 2006. Revenue derived from Eudemons Online for the three months ended 31 March 2008 amounted to approximately RMB105.4 million, representing an increase of about 37.4% from approximately RMB76.7 million for the corresponding period in last year.

Both Zero Online and Tou Ming Zhuang Online were launched during the year ended 31 December 2007 and contributed a revenue of approximately RMB19.3 million and RMB11.2 million to the Group for the three months ended 31 March 2008, respectively.

The following table sets out the numbers of PCU and ACU of each game for the three months ended 31 March 2008:

	For the three months ended			
	31 March 2008	31 December 2007	31 March 2007	31 December 2006
PCU				
Conquer Online	99,000	102,000	85,000	82,000
Eudemons Online	479,000	574,000	438,000	325,000
Zero Online	67,000	91,000	—	—
Tou Ming Zhuang Online	24,000	20,000	—	—
ACU				
Conquer Online	64,000	65,000	61,000	59,000
Eudemons Online	210,000	294,000	213,000	140,000
Zero Online	30,000	42,000	—	—
Tou Ming Zhuang Online	9,000	6,000	—	—

Conquer Online was launched in September 2003. The PCU and ACU for Conquer Online was approximately 99,000 and 64,000, respectively for the three months ended 31 March 2008 whereas it recorded a PCU and ACU of approximately 85,000 and 61,000, respectively for the three months ended 31 March 2007, representing an increase of approximately 16.5% and 4.9% on PCU and ACU, respectively.

Eudemons Online was launched in late March 2006 and achieved a PCU and ACU of approximately 479,000 and 210,000, respectively for the three months ended 31 March 2008 whereas it recorded a PCU and ACU of approximately 438,000 and 213,000, respectively for the three months ended 31 March 2007, representing an increase of approximately 9.4% and a decrease of approximately 1.4% respectively when compared to the corresponding period in last year.

Zero Online was launched in late April 2007 and achieved a PCU and ACU of approximately 67,000 and 30,000, respectively for the three months ended 31 March 2008 whereas it recorded a PCU and ACU of approximately 91,000 and 42,000, respectively for the three months ended 31 December 2007.

The PCU for Conquer Online, Eudemons Online and Zero Online for the three months ended 31 March 2008 dropped by approximately 2.9%, 16.6% and 26.4%, respectively, whereas Conquer Online, Eudemons Online and Zero Online also recorded a decrease in ACU for the three months ended 31 March 2008 by approximately 1.5%. 28.6% and 28.6%, respectively, when compared to the three months ended 31 December 2007. The decreases in PCU and ACU for Conquer Online, Eudemons Online and Zero Online were principally caused by no major upgrades were launched and the seasonal factor of Chinese New Year holidays in PRC during the first quarter.

Tou Ming Zhuang Online was launched in late 2007 and achieved a PCU and ACU of approximately 24,000 and 9,000, respectively for the three months ended 31 March 2008 whereas it recorded a PCU and ACU of approximately 20,000 and 6,000, respectively from the date of its launch to 31 December 2007.

Gross profit

For the three months ended 31 March 2008, the unaudited gross profit reached approximately RMB159.0 million with a gross profit margin of about 90.6%, where the unaudited gross profit and gross profit margin were approximately RMB100.9 million and 94.0% respectively for the corresponding period in last year. The decrease in the percentage of gross profit margin was mainly due to the decrease in the player usage as demonstrated by the decreases in ACU for each game as mentioned in the revenue section above and the increase in depreciation of servers as a result of the increased number of servers owned by us as compared with the same period in 2007.

Other revenue and gains

Other revenue and gains for the three months ended 31 March 2008 increased by approximately 900.9% or 9 times to approximately RMB5.4 million as compared with the same period in 2007. The increase was mainly due to the increase in interest income from the net proceeds of the International Placing.

Selling and marketing expenses

Selling and marketing expenses for the three months ended 31 March 2008 increased by approximately 20.8% to approximately RMB15.4 million as compared with the same period in 2007. The increase in the amount of selling and marketing expenses was mainly attributable to our continued advertising and promotion expenses for Eudemons Online, Zero Online and Tou Ming Zhuang Online and the increase in the relevant staff cost. In accordance with the terms of agreement signed with China Film Group, the Company has provided marketing support for promoting the collaboration of Tou Ming Zhuang Online.

Administrative expenses

Administrative expenses increased by approximately 135.9% to approximately RMB25.9 million for the three months ended 31 March 2008 as a result of the continuous expansions of our online game business. The increase in the amount of administrative expenses for the three months ended 31 March 2008 was mainly attributable by i) the significant increase of our business development needs including cooperation with different business partners such as cooperation with China Film Group; ii) our overall expansion for the Company; and iii) the exchange loss incurred from the appreciation of RMB when converted from other currencies such as USD and HKD for the three months ended 31 March 2008.

Development costs

The increase in development costs was mainly due to the expansion of our development team and the increase of compensation for our employees. The numbers of staff in our development team were

261 and 527 for each of the three months ended 31 March 2007 and 2008, respectively. We also increased the compensation in order to provide a competitive and attractive increment in the basic salary, and we have distributed discretionary bonus for the success of Eudemons Online to further motivate employees.

Other operating expenses

Other operating expenses for the three months ended 31 March 2008 increased by approximately 44.1% to approximately RMB7.9 million as compared with the same period in 2007. The increase in other operating expenses was mainly attributable to the increase in business tax for intercompany transactions as a result of revenue increase. However, the business tax included in "other operating expenses" is only related to intercompany transactions while the business tax for online game revenue is deducted from the gross revenue directly.

Income tax expenses

Income tax expenses for the three months ended 31 March 2008 increased by approximately 310.8% to approximately RMB27.5 million as compared with the corresponding period in 2007. The increase was primarily due to the fact that we had profit before tax of approximately RMB97.5 million for the three months ended 31 March 2008 as compared with a profit before tax of approximately RMB65.2 million for the same period in 2007. In addition, the EIT tax rates applicable to TQ Digital and NetDragon (Fujian) were changed to 25% for the three months ended 31 March 2008.

Profit for the period

The unaudited profit for the three months ended 31 March 2008 of the Group increased by approximately 19.6% to approximately RMB69.9 million as compared with the corresponding period in 2007.

ANALYSIS FOR SELECTED BALANCE SHEET ITEMS

Debtor's turnover period

Debtor's turnover period is calculated by dividing the amount of trade receivables as at the respective period end and revenue for the relevant period times the number of days in the relevant period. We generally request debtors to pay in advance or within a credit period of 30 to 45 days. The credit periods granted to debtors in different distribution and payment channels vary based on their reputation. For each of the year ended 31 December 2005, 2006 and 2007, debtor's turnover period for us was approximately 12 days, 19 days and 15 days, respectively. The increase in debtor's turnover period in the year ended 31 December 2006 was primarily due to the increase in the revenue generated from distribution partners and telecommunication voice service and mobile SMS service providers with credit period ranging from 30 to 45 days we granted. The online game revenue generated from them for each of the years ended 31 December 2005 and 2006 were approximately RMB6.6 million and RMB23.0 million, respectively. The popularity and wide coverage of the distribution partners' platforms provide players more convenient channels to play our games. It leads to the substantial increase in the revenue generated from distribution partners. As to the increase in the revenue generated from telecommunication voice service and mobile SMS service providers, it was mainly attributable to the popularity of Eudemons Online and increase in revenue derived from Conquer Online during the year. The decrease in debtor's turnover period for the year ended 31 December 2007 was due to the improvement of outstanding debt collection during the period. Due to the increase of debtor's turnover period in the year ended 31 December 2006, we negotiated with some of the online payment service providers and successfully shorten the credit period for less than 30 days during the year ended 31 December 2007. It was proved by the decrease in the outstanding balances over 90 days for the year ended 31 December 2006 in comparing with the year ended 31 December 2007. The outstanding balances over 90 days for each of the two years ended 31 December 2006 and 2007 were RMB379,000 and RMB200,000 respectively.

As of 31 December 2005, 2006 and 2007, we had trade receivables amounted to approximately RMB1.1 million, RMB6.2 million and RMB26.9 million, respectively, representing approximately 3.2%, 5.2% and 1.5% of our current assets and approximately 1.9%, 4.2% and 1.5% of our total assets, respectively. As at 31 January 2008, approximately 94.6% of our trade receivable as at 31 December 2007 had been received.

Creditor's turnover period

Our suppliers are mainly game operation service providers and online payment service providers. Normally, we settle their billing on an advanced or monthly basis. Creditor's turnover period is calculated by dividing the amount of trade payables as at the period end and cost of revenue for the relevant period times the number of days in the relevant period. For the years ended 31 December 2005, 2006 and 2007, creditor's turnover period for us was approximately 8 days, 3 days and 5 days, respectively.

Return on equity

Return on equity for the years ended 31 December 2006 and 2007 was approximately 41.1% and 21.2%, respectively, as compared with that of a net loss for the year ended 31 December 2005. This decrease in return on equity in 2007 was mainly due to the increase in shareholders' equity as a result of the fund raised in the GEM Listing. Shareholders' equity amounted to RMB1,769.4 million as at 31 December 2007, increased by approximately 15.9 times from that as at 31 December 2006.

Return on total assets

Return on total assets for the years ended 31 December 2006 and 2007 was approximately 29.4% and 20.3%, respectively, as compared with that of a net loss for the year ended 31 December 2005. This decrease in return on total assets in 2007 was mainly due to the increase in total assets as a result of the fund raised in the GEM Listing. Total assets amounted to RMB1,844.7 million as at 31 December 2007, represented an increase of approximately 11.6 times as compared to the same as at 31 December 2006.

Deferred income

As at 31 December 2005, 2006 and 2007, we had deferred income of approximately RMB2.4 million, RMB8.6 million and RMB18.4 million, respectively. The deferred income of RMB18.4 million as at 31 December 2007 was fully recognised by end of 31 March 2008.

The amount of sales arising from unactivated pre-paid game cards are approximately RMB1.8 million, RMB1.1 million and RMB1.1 million for each of the three years ended 31 December 2005, 2006 and 2007 respectively.

Cash and cash equivalents

As at 31 December 2005, 2006 and 2007, we had cash on hand and at bank of approximately RMB14.0 million, RMB60.8 million and RMB1,650.1 million, respectively. In addition, as at 31 December 2005, 2006 and 2007, we had cash deposited with an online payment service provider of approximately RMB1.3 million, RMB5.5 million and RMB1.3 million, all in the form of U.S. dollars, respectively. Cash deposited with that online payment service provider can be readily withdrawn by us. The accounts maintained with this online payment service provider were held by the directors of NetDragon (USA) on our behalf for the exclusive use of accepting online payments from customers. We note that such online payment service provider did not offer business accounts to NetDragon (USA) at the time when NetDragon (USA) first commenced its business operation on such provider's platform. To accommodate that restriction, the directors of NetDragon (USA) decided to open personal accounts at that online payment service provider on trust for NetDragon (USA) to facilitate our business growth. During the year of 31 December 2007, we have set up a corporate account at that online payment service provider which is owned by and under the name of NetDragon (USA). The personal accounts previously set up by the directors of the NetDragon (USA) are no longer used by NetDragon (USA) and all the funds deposited in those accounts, of approximately RMB1.3 million in the form of U.S. dollars, were transferred to our corporate account when we ceased to use those personal accounts.

Available-for-sale financial asset/Investment in trading securities

Our investment objective is to identify potential targets which can maximise the investment return within reasonable and prudent level of risk. In assessing a potential target for investment, we consider its relative competitive position in its market, revenues, profitability as well as size of operations. Once we have made an investment, we regularly review the performance of investment and would consider disposing of an investment if we believe this would be in our best interests. For instance, we would dispose of an investment if we consider that there is deterioration in the operational or financial performance of an investee.

In recent years, we have spent majority of our time and resources in operating, managing and developing our online game business and we plan to focus on these principal activities in the coming years. Accordingly, we have minimised our investment activity during the Track Record Period and the percentage of investment in debt and equity securities to net assets has reduced from 21.5% as at 31 December 2005 to 4.6% as at 31 December 2006 and further reduced to 0.2% as at 31 December 2007.

Our available-for-sale financial asset as at the end of each of the Track Record Period represents a 9.5% equity interest in Fujian Yang Zhenhua 851 Bio Science Co., Ltd (福建楊振華851生物科技股份有限公司), a PRC established entity which is principally engaged in processing of healthcare products. The entity is a related party because Liu Dejian and Zheng Hui, our Directors, are directors of the entity and Lin Yun, a beneficial owner of the Company, has equity interest in the entity. We intend to hold the investment for long-term in view of its investment potential. Despite the difference in business natures, we consider that the health food product market in the PRC is fast growing with potential investment value and accordingly, we have retained our investment in Fujian Yang Zhenhua 851 Bio Science Co., Ltd (福建楊振華851生物科技股份有限公司) since 2000. We currently have no intention to dispose the investment even though it is not our principal activity. Our unlisted debt securities represent bonds and certificate of deposits issued by US corporations with maturity period ranged from six months to 24 months in general. The balance of unlisted debt securities reduced from RMB4.6 million as at 31 December 2005 to RMB0.9 million as at 31 December 2006; and further reduced to nil as at 31 December 2007 as certain bonds and certificate of deposits were disposed or matured. As mentioned in the previous paragraphs, we plan to focus on our principal activities in respect of online game business and accordingly, we have no plan to further invest in debt securities.

Deferred tax assets

As at 31 December 2007, we did not have any deferred tax assets arising from tax losses; while we had deferred tax asset of approximately RMB0.1 million as at 31 December 2006 (2005: RMB5.1 million) arising from tax losses. The decrease was mainly due to utilisation of tax losses by TQ Digital, NetDragon (Fujian) and NetDragon (Shanghai) during the years.

Deposits and prepayments

As at 31 December 2005, 2006 and 2007, we had deposits and prepayments of approximately RMB6.6 million, RMB15.3 million and RMB34.2 million, respectively. The increase in deposits and prepayments was mainly attributable to (i) increase in advanced payment to advertising agencies; (ii) increase in advanced payment to server leasing service providers; (iii) increase in advanced payment for office furniture, fixtures and equipments; and (iv) increase in payment of deposits for office facilities and utilities due to expansion of the business.

TAX

We operate in the PRC and the USA, and are subject to the PRC enterprise income tax and the US income tax.

Certain of our affiliates and subsidiaries enjoy preferential tax treatments, in the form of reduced tax rates and/or tax holidays, provided by the PRC government or its local authorities or bureaus. TQ Digital is a foreign-invested enterprise located in the high technology industrial development zone approved by the State Council. Pursuant to the Circular on Some Preferential Policies for the Enterprise Income Tax (關於企業所得稅若干優惠政策的通知) issued by the Ministry of Finance (財政部) and the State Administration of Taxation (國家稅務總局) on 29 March 1994, hi-tech enterprises in the high technology industrial development zone approved by the State Council are entitled to paying the income tax at the reduced tax rate of 15%. The qualification of hi-tech enterprises are subject to review once every two years. TQ Digital has been recognised as a hi-tech enterprise on 29 July 2005 and 16 August 2007 and thus is entitled to a preferential enterprise income tax of 15%.

TQ Digital was recognised as a software enterprise on 25 December 2003. Pursuant to the Circular on the Tax Policies for Encouraging the Development of Software and Integrated Circuit Industries (關於鼓勵軟件產業和集成電路產業發展有關稅收政策問題的通知) issued by the Ministry of Finance (財政部), the State Administration of Taxation (國家稅務總局) and the General Administration of Customs (海關總署) on 22 September 2000, TQ Digital can enjoy tax benefits of tax exemption for two years and a reduction in tax payable for three succeeding years. It was exempted from paying the enterprise income tax between 2003 and 2004 and has been entitled to paying the enterprise income tax at the reduced tax rate of 7.5% from 2005 to 2007.

NetDragon (Fujian) continued to be recognised as a hi-tech enterprise on 9 November 2004 and 16 August 2007. As NetDragon (Fujian) is located in the state-level high technology industrial development zone, it was entitled to paying the enterprise income tax at the reduced tax rate of 15% between 2005 and 2006. NetDragon (Fujian) was suspended to be qualified as a hi-tech enterprise during the review in 2006 though it finally obtained the qualification on 16 August 2007. As such, we consider the tax rate of enterprise income tax applicable to NetDragon (Fujian) for the year ended 31 December 2007 is 15%.

NetDragon (Shanghai) currently pays the PRC enterprise income tax at the tax rate of 33%.

The Tenth National People's Congress enacted a new Enterprise Income Tax Law on 16 March 2007, which provides for a unified income tax rate of 25% to both domestic enterprises and foreign-invested enterprises. The new tax law will become effective on 1 January 2008. As a result, the tax rate for domestic enterprises will be reduced to 25% from the previous 33%, whereas the tax rate for foreign-invested enterprises will be increased to 25% upon expiration following of the preferential treatment. Termination of the preferential tax treatment that we enjoyed during the Track Record Period may have a negative impact on our results of operations and financial condition. See "Risk Factors — We cannot assure that we will continue to enjoy preferential tax treatments or financial incentives in the future and changes in the PRC laws or policies may increase the tax burdens of us or our investors" to this document.

NetDragon (USA), as a U.S. corporation, is subject to U.S. federal income on its net income (i.e., gross income less allowable deductions) at graduated rates that are generally 34% but that may be as high as 35%. To the extent that NetDragon (USA) pays tax to a government other than that of the United States or one of the fifty States or the District of Columbia, it may be entitled to claim a credit for such tax against its U.S. federal income tax liability.

NetDragon (USA) is also subject to California State income tax at a rate of 8.84% on its net income.

TQ Digital, in addition to engaging in the development of online games, has also been providing access to users of online game, Conquer Online, in English language since 1 January 2007 and access to users of other non-Chinese language games since 1 June 2007. The fees attributable to such operations are generally not subject to any US tax.

LIQUIDITY AND CAPITAL RESOURCES

We have historically met our working capital and other capital requirements principally from cash provided by our operations and cash at hand, while raising the remainder of our capital requirements through advances from shareholders.

As of 31 December 2005, 2006 and 2007, we had net current assets of RMB15.8 million, RMB77.3 million and RMB1,702.8 million, respectively. The net current assets position of the Group as at 31 March 2008, being the latest practicable date for the purpose of this statement is as follows:

	RMB'000
Current assets	
Trade and other receivables	80,467
Amounts due from related parties	1,376
Term deposits with initial maturity over 3 months	150,000
Cash at bank and in hand	1,397,608
	1,629,451
Current liabilities	
Trade and other payables	(49,206)
Amounts due to related parties	(70)
Income tax payable	(43,095)
	(92,371)
Net current assets	1,537,080

As shown in the table above, we had net current assets of approximately RMB1,537.1 million as at 31 March 2008. The current assets principally comprised cash and cash equivalents, and term deposits with initial term of over three months. The current liabilities principally comprised trade and other payables, and income tax payable. All the balances due to the related parties as at 31 March 2008 were fully settled in April 2008. All the amounts due from related parties as at 31 March 2008 were the outstanding balance of the Discloseable Continuing Connected Transaction as mentioned in the section head "Relationship with Controlling Shareholders and non-competition undertakings" in this document and were in trade nature.

Included in other receivables as at 31 December 2006 was a balance of RMB14.5 million which was paid to a PRC entity, Guolun Holdings Limited (高能控股有限公司), an Independent Third Party, which provided us asset management services pursuant to an agreement signed in December 2006 (the "Asset Management Agreement"). In order to seek a higher return for our investors by capturing the fast growth of the PRC stock markets, we entered into the Asset Management Agreement with Guolun Holdings Limited (高能控股有限公司). Pursuant to the Asset Management Agreement, Guolun Holdings Limited (高能控股有限公司) would assist us to manage and invest a total amount of RMB14.5 million in the PRC stock market. We settled the payment of the RMB14.5 million under the Asset Management Agreement in December 2006. In view of the fluctuation of the stock markets in the PRC and to avoid disruption of the investment in the PRC stock market to our business, TQ Digital entered into an agreement with Liu Dejian, one of our executive Directors and beneficial owner, on 27 May 2007 to dispose its rights underlying the Asset Management Agreement at a consideration of RMB14.5 million, representing our contribution under the Asset Management Agreement. Our consideration has been settled on 13 June 2007 and 13 August 2007. Guolun Holdings Limited (高能控股有限公司) has not utilised any amounts under the Asset Management Agreement to purchase any investments during the term of the Asset Management Agreement between Guolun Holdings Limited (高能控股有限公司) and us. We consider that the transactions are fair and reasonable, and on an arm's length basis. There is no previous relationship between Guolun Holdings Limited (高能控股有限公司) and us or the Directors, save as to this transaction.

Cash flows

The following table sets forth certain information regarding our consolidated cash flows for the years ended 31 December 2005, 2006 and 2007:

	Year ended 31 December		
	2005	**2006**	**2007**
	(RMB'000)	*(RMB'000)*	*(RMB'000)*
Net cash (used in)/generated from operating activities	(18,832)	39,597	376,472
Net cash (used in)/generated from investing activities	(7,185)	(10,018)	(90,876)
Net cash (used in)/generated from financing activities	(3,465)	21,755	1,302,088
Net (decrease)/ increase in cash and cash equivalents	(29,482)	51,334	1,587,684

Net cash generated from operating activities

The net cash generated from operating activities for the year ended 31 December 2007 increased to approximately RMB376.5 million from approximately RMB39.6 million for the year ended 31 December 2006. The increase in net cash generated from operating activities was mainly attributable to our increased profit before income tax for the year ended 31 December 2007 of approximately RMB427.1 million from approximately RMB51.5 million for the year ended 31 December 2006.

The net cash generated from operating activities for the year ended 31 December 2006 amounted to approximately RMB39.6 million as compared with net cash used in operating activities of approximately RMB18.8 million in the year ended 31 December 2005. The increase in net cash generated from operating activities was mainly attributable to the change in loss before income tax of approximately RMB30.9 million for the year ended 31 December 2005 to a profit before income tax of approximately RMB51.5 million for the year ended 31 December 2006.

Net cash used in investing activities

Net cash used in investing activities amounted to approximately RMB90.9 million for the year ended 31 December 2007, representing an increase of approximately 807.1% as compared to the year ended 31 December 2006. The increase was mainly due to (i) our acquisition of property, plant and equipment, including servers, computers and vehicles purchased to manage our expanded operations; and (ii) a term deposit of RMB50 million was deposited for an initial term of over three months.

Net cash used in investing activities amounted to approximately RMB10.0 million for the year ended 31 December 2006, representing an increase of approximately 39.4% as compared to the year ended 31 December 2005. The increase in net cash flow used in investing activities for the year ended 31 December 2006 was mainly due to an increase in the purchase of property, plant and equipment, including server purchases to cope with the increased demand of our online games.

Cash flows from financing activities

Net cash generated from financing activities was approximately RMB1,302.1 million for the year ended 31 December 2007, representing an increase of approximately 5,885.2% as compared to the year ended 31 December 2006. The increase was mainly due to the proceeds from the International Placing.

Net cash generated from financing activities was approximately RMB21.8 million for the year ended 31 December 2006, while the net cash used in financing activities for the year ended 31 December 2005 was approximately RMB3.5 million, which was for the 2004 dividend paid by NetDragon (BVI) in 2005.

Capital resources

We generally finance our operations through internally generated cash flows. Following completion of the Introduction, our Directors expect to fund our capital and operating requirements through internally generated cash flows and cash on hand. Our Directors believe that on a long-term basis, our liquidity will be funded from operations and, if necessary, additional equity financing or bank borrowings.

Gearing ratio is defined as total debt (interest bearing banking loans) over total assets. As we did not have any interest bearing banking loans, our gearing ratio was zero during the Track Record Period.

Capital expenditures and commitments

Our capital expenditures were RMB3.4 million, RMB15.7 million and RMB47.5 million for each of the three years ended 31 December 2007, respectively, and were primarily attributable to the purchase of servers and computer equipment and buildings.

The following table sets out our capital commitments as of the dates indicated:

	At 31 December		
	2005	**2006**	**2007**
	RMB'000	*RMB'000*	*RMB'000*
Contracted, but not provided for:			
- acquisition of property, plant and equipment	—	2,471	2,547

The following table sets out our operating lease commitments as of the dates indicated:

	At 31 December		
	2005	**2006**	**2007**
	RMB'000	*RMB'000*	*RMB'000*
Within one year	1,899	2,626	2,752
In the second to fifth years	1,888	655	2,526
After five years	—	—	—
	3,787	3,281	5,278

Indebtedness

Borrowings

As at the close of business on 31 March 2008, being the latest practicable date for the purpose of the indebtedness statement prior to the printing of this document, we had no outstanding borrowings and any banking facilities.

Contingent liabilities

As at the close of business on 31 March 2008, we did not have any material contingent liabilities or guarantees.

Off-balance sheet arrangements

As at the close of business on 31 March 2008, we did not have any material off-balance sheet arrangements.

Disclaimer

Apart from any intra-group liabilities and normal trade payables, the Group did not have any outstanding bank overdrafts, loans or other similar indebtedness, debentures or other loan capital (issued or agreed to be issued), mortgages, charges, hire purchase or finance lease commitments, guarantees or other material contingent liabilities at the close of business on 31 March 2008.

No material changes

Our Directors have confirmed that there have been no material change in the Group's indebtedness and contingent liabilities since 31 March 2008.

Directors' opinion on sufficiency of working capital

Our Directors are of the opinion that, taking into account the internally generated resources of the Group, we have sufficient working capital for our foreseeable capital requirements for at least the next 12 months from the date of this document.

Foreign currency exposure

Our present operations are carried out in the USA and the PRC. All our receipts and payments in relation to the operations are principally denominated in RMB and US$. In this respect, our Directors consider there is no significant currency mismatch in our operational cashflows and we are not exposed to any significant foreign currency exchange risk in our operation.

PROPERTY INTERESTS

Property interests in Hong Kong

As at the Latest Practicable Date, the Group rented Unit 306, 3rd Floor, Beautiful Group Tower, 77 Connaught Road Central, Hong Kong with a gross floor area of approximately 926 sq.ft.. The Group uses the property as its head office and principal place of business in Hong Kong.

Property interests in the PRC

As at 29 February 2008, the Group also rented certain office units in Fujian and Shanghai, with a total gross floor area of approximately 3,003 sq.m. and 257.3 sq.m., respectively. The properties rented in Fujian are occupied by the Group for office and research purposes; while the property rented in Shanghai is occupied by the Group for office purpose.

As at 29 February 2008, the Group owned Units 1406, 1803, 2005, 2303 and 3003, Jinan Building, Zone B of Jinyuan Garden located at the west of Liuyibei Road, Gulou District, Fuzhou City, Fujian Province, The PRC with a total gross floor area of approximately 561.2 sq. m.; and Units 1707, 2104, 2107, 2203, 2208 and 2706, Yuansheng Building, Zone A of Jinyuan Garden located at the west of Liuyibei Road, Gulou District, Fuzhou City, Fujian Province, The PRC with a total gross floor area of approximately 716.74 sq.m.. The properties are occupied by the Group for residential purpose.

As at 29 February 2008, the Group has entered into a letter of intent where the Group agreed to rent portions of New 851 Building, No. 58 Hot Spring Branch Road, Gulou District, Fuzhou City, Fujian Province, The PRC with a floor area of approximately 4,200 sq. m. after the property has obtained the relevant certificates.

Property interest in the USA

As at 29 February 2008, the Group also rented a office unit in the USA with a rentable area of approximately 223.52 sq. m.. The property is occupied by the Group for office purpose.

Further details of the Group's property interests as at 29 February 2008 are set out in the valuation report issued by Jones Lang LaSalle Sallmanns Limited, independent professional property valuers, the full text of which is contained in Appendix III to this document.

The table below shows the reconciliation of the net book value of the property interests from the audited financial statements of the Group as at 31 December 2007 to the valuation of the property interest as at 29 February 2008:

		RMB'000
Net book value as at 31 December 2007 included in the accountants' report set out in appendix I to this document		
Land use rights		1,174
Buildings		1,491
		2,665
Movements for the two months ended 29 February 2008		
Acquisition of land and buildings		
Land use rights	2,186	
Buildings	1,081	
		3,267
Amortisation on land use rights		(6)
Depreciation on buildings		(15)
Net book value as at 29 February 2008		5,911
Valuation surplus		2,439
Valuation as at 29 February 2008 included in valuation report set out in appendix III to this document		8,350

DISCLOSURE UNDER CHAPTER 13 OF THE MAIN BOARD LISTING RULES

Our Directors have confirmed that, as at the Latest Practicable Date, there was no circumstance which would give rise to a disclosure requirement under Rules 13.13 to 13.19 of the Main Board Listing Rules.

DIVIDEND AND DIVIDEND POLICY

For the year ended 31 December 2007, we declared dividend amounted to approximately RMB295.2 million of which approximately RMB44.8 million and RMB34.2 million were special dividends declared to our then existing shareholders on 3 February 2007 and 20 June 2007, respectively. The declaration and the amount of special dividends are in the sole discretion of our Directors, subject to such factors similar to our general dividend policy as disclosed below.

We may not distribute dividends exceeding the lower of our distributable reserves as determined under PRC GAAP and those under the HKFRS.

We are a holding company incorporated in the Cayman Islands and conduct our core business operations through our PRC operating subsidiaries. As a result, our profits available for dividend distribution are dependent on the profits available for distribution from our PRC subsidiaries. The PRC laws permit payment of dividends only out of net income as determined in accordance with PRC accounting standards and regulations. Determination of net income under PRC accounting standards and regulations may differ from determination under the HKFRS in significant aspects, such as the use of different principles for recognition of revenues and expenses. Our PRC subsidiaries are required to set aside at least 10% of their net income each year to fund the designated statutory reserve fund in connection with certain mandatory social welfare programs. Such statutory reserve fund is not distributable as cash dividends. As a result, our primary source of funds for dividend payments is subject to these and other legal restrictions and uncertainties.

The declaration and the amount of dividends are in the sole discretion of our Directors, subject to our results of operations, financial condition, capital requirements and any other factors which the Board may deem relevant.

DISTRIBUTABLE RESERVES

The Company's reserves available for distribution comprise dividend reserve and retained profits. As of 31 December 2007, we had approximately RMB216.5 million reserves available for distribution to the equity holders of the Company.

NET TANGIBLE ASSETS

The following table illustrates the Group's net tangible assets as at 31 December 2007:

Consolidated net tangible assets value of the Group as at 31 December 2007 *(Note 1)*	RMB1,769,382,000
Net tangible asset value per Share *(Note 2)*	RMB4.01

Notes:

1. The Group did not have any intangible assets as at 31 December 2007, accordingly, the consolidated net tangible assets value of the Group is equal to the consolidated net assets value of the Group.

2. The calculation of net tangible asset value per Share is calculated based on consolidated net tangible asset value of the Company as at 31 December 2007 and the weighted average number of 440,953,947 Shares for the year ended 31 December 2007 as adjusted to reflect the Shares issued for capitalisation as a result of the new Shares issued in connection with the GEM Listing.

NO MATERIAL ADVERSE CHANGE

We confirm that there has been no material adverse change in our financial or trading position of the Company or its subsidiaries since 31 December 2007 (being the date to which our latest audited consolidated financial statements were prepared).