

G5 Entertainment

Flash Note Nov'16



Share Price	82 SEK
Market Capitalisation	721 mSEK
Target Price	105 SEK

Last updated on the 21/11/2016

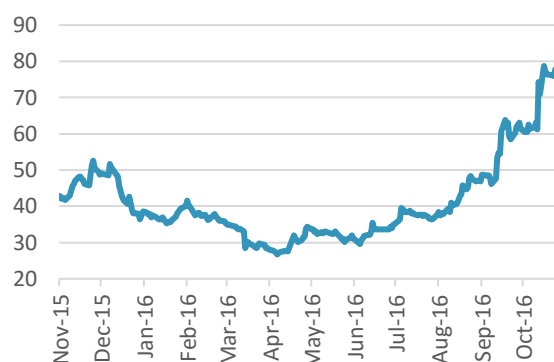
G5 Entertainment develops and sells casual games for different platforms. The company acts as both developer and publisher of their own games as well as actively working with third-party licenses. The company now focuses on Free-To-Play (FTP) games, where players buy virtual goods within the game rather than the old revenue model of unlockables where games are pre-paid.

Continued revenue growth

- G5 Entertainment has become one of the most dynamic companies on the OMX Stockholm exchange.
- The company combines high growth with very low risk profile. Unlike most gaming companies, G5 has stable revenue sources spread across multiple games and relatively low development costs.
- In addition, the company holds a leading position in its market niche – the Hidden Objects genre. After the success of Hidden City, which continues to climb the charts, the company is increasingly likely to release another major success on the market.
- We have upgraded our target price to **SEK 105 per share**, which translates into a BUY recommendation.

Company	G5 Entertainment
Ticker	G5EN.STO
Currency	SEK
Industry	Mobile gaming
# of shares	8,800,000
Share price	82
Target price	105
Risk	LOW
Recommendation	BUY

SHARE PRICE PERFORMANCE



NEXT EVENT

23rd Feb – Q4 2016 Results

CONTACT

research@prestigoresearch.com

SEK (Thousand)	2013	2014	2015	2016e	2017e	2018e
Sales	100,007	182,117	384,369	468,528	566,918	685,971
EBITDA	(11,826)	9,014	19,788	44,643	73,101	101,997
EPS	-1.34	0.77	1.74	4.13	6.39	8.92
DPS	N/A	N/A	N/A	N/A	N/A	N/A
Sales Growth	24%	82%	111%	22%	21%	21%
EBITDA margin	-12%	5%	5%	10%	13%	15%
NIBD/EBITDA	N/A	N/A	N/A	N/A	N/A	N/A
Debt/Equity	0%	0%	0%	0%	0%	0%
EV/Sales	14.22	7.81	3.70	3.04	2.51	2.07
EV/EBITDA	(120.28)	157.80	71.88	31.86	19.46	13.95

See disclosures at the end of this report.

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GAME DEVELOPMENT

Hidden City continues to rank among the top grossing games in the US

During third quarter of the year, G5's revenue grew by 32% compared to Q3 2015 and 21% in comparison with Q2 2016. Much of the growth was driven by the upward spiral in the performance of Hidden City and Survivors. G5 reports to have identified new growth opportunities within those two games and that profit and revenues from the games can grow substantially.

Hidden City is a hidden object game, developed externally and published by G5 Entertainment. The game was initially released in 2014, but has become a major success in 2016.

In many aspects, the game is already performing better than The Secret Society ever did and continues to climb the charts. In the last month, the game has consistently been among the 150 top grossing games on iPhone in the United States. On the 18th November, it reached its peak, ending as the 101st top grossing game.

Small differences in chart positions makes a huge difference in terms of gross revenue. For example, the difference between number one King of Avalon and number ten Slotomania is ten-fold - \$2,033,381 vs \$192,820 in gross revenue on iPhone in the United States.

Hidden City is a success across the board

Hidden City is performing quite in the Europe and Asia, as well. The game has appealed to the audience in South Korea and China and continues to grow in those countries. With Hidden City, G5 has managed to get significantly more traction in Asia than with other games, which shows that those markets can be penetrated further.

The game is performing strong on other devices as well. Data from thinkgaming.com shows that Hidden City was number 49 among the top 50 grossing iPad games in the United States, just one position behind The Secret Society.

The growth of Hidden City is a direct result of growing G5's audience

The growth of Hidden Society can be explained by growth in the audience of the game. The success was a combination of good cross-selling between G5's game and good user acquisition strategy. Since the growth was the result of a specific strategy, not just the virality of the game, it makes it very likely that the company will be able to replicate this success in future games.

Every new successful game that the company can introduce to the market is likely to grow G5's audience and thus grow the market for its games. Being a leader in the hidden objects genre puts the company in a position to cross-sell better than most gaming companies can.

User acquisition is a subtler area. Increase in UA expenses will increase revenues in the long-term, but there might a time lag between the investment and the results. At this stage, we expect that UA costs will remain consistent as a percentage of revenue, but it is entirely possible that the company might prefer to pursue a more aggressive strategy later.

Twin Moons Society off to a good start

The Twin Moons Society is a new game that has been getting a lot of attention and progressively gaining more traction. It is too early to forecast whether the game will repeat the success of Hidden City, but the game is expected to start contributing significant and growing revenues in 2017.

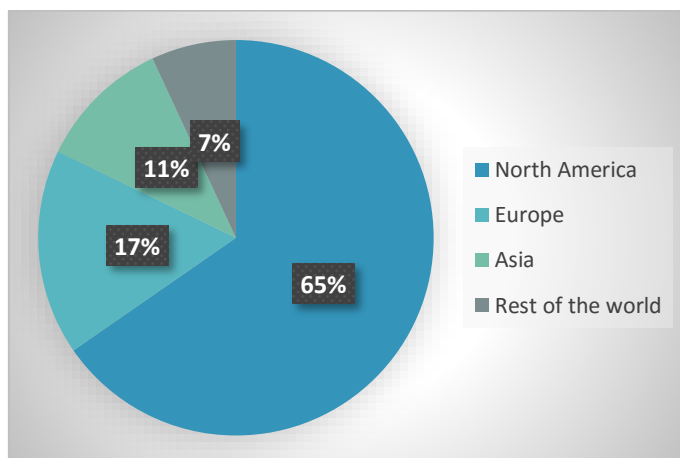
However, unlike Hidden City, Twin Moons Society has been entirely developed by the G5's team, meaning that the company will not pay any royalties and gets to keep all profits. G5 has clearly stated its intent to put emphasis on internal projects, but this does not exclude the possibility that it will also publish externally developed games.

As the company finds itself in a favourable financial position and a growing market, it is likely to pursue growth in any form – both organic and acquired.

G5 occupies a unique niche

G5 Entertainment occupies a very unique niche, putting emphasis on females over the age of 35, which is not the traditional gamer audience. According to the company's data, in some of its hidden object and adventure games, women comprise up to 90% of the audience, and 90% of them are over the age of 35. What's more, in some of its games, the core paying audience is females over the age of 55.

Figure 1:1: Revenue breakdown by geography, Q3 2016



Source: G5 Entertainment, 2016

FINANCIAL POSITION

Financial position is very strong

The company achieved record revenue of SEK 126 million and it is likely that it will top that in the next quarter with the upcoming holidays.

The commission paid to distributors (such as Google Play and Apple's App Store) grew in line with the revenue, but royalty to paid external developers experienced a more drastic increase. The reason for this is mainly the fact that the main revenue growth driver in the quarter was Hidden City, which was externally developed.

SEK 1,000	Q3'16	Q3'15	% change
Revenue	126,451	96,075	32%
Commission to distributors	-37,774	-29,245	29%
Royalty to external developers	-31,166	-21,967	42%
Gross profit	57,511	44,863	28%
Gross margin	45%	47%	
Operating costs excl. user acquisition costs	-22,738	-24,685	-8%
EBIT excl. user acquisition costs	34,772	20,178	72%
EBIT margin excl. user acquisition costs	27%	21%	
Costs for User acquisition	-21,643	-15,390	41%
EBIT	13,129	4,788	174%
EBIT-margin (%)	10%	5%	
Earnings per share	1,24	0,36	245%

User acquisition costs have remained the roughly same as a percentage of revenue (only slightly higher), but the higher revenue and lower operational costs led to a huge jump in EBIT after user acquisition costs – 174% in comparison to Q3 2015.

The company is able to balance its expenses very well

One of the major strengths of the company is its ability to balance its expenses very well. Last year, the company clearly demonstrated that it can reduce its User Acquisition expenses and still grow. While G5 is heavily investing to fuel its future growth, the company is consistently managing to post profits.

G5 Entertainment also incurs significantly lower development costs with its studios in Ukraine and Russia compared to many other gaming company, which have their studios in Western Europe or California. Thus, the company is able to develop more games at a lower risk due to the lower development cost.

Within the last year, G5 has also managed to lower and stabilise its tax rate. In 2015, the company paid 22.3% tax rate, while for the first nine months of 2016 it has only paid 17.2%. We expect that the tax rate will remain solid below the 20% mark.

Reinvestment of extra profits

For the first nine months of the year, the company has already made over SEK 25 million in profit, which strongly exceeds the profit for the whole 2015 – SEK 15 million. As the company is expected to continue to grow, it is likely to make higher profits. We do not expect any major investments in tangible assets such as equipment or new office premises. Simultaneously, the company has the extra capacity to continue to produce new games, which means that staff increases are only likely to be slow and gradual.

One of the most logical ways to allocate the extra profits would be to increase User Acquisition expenses, as this will further fuel the growth of the company. However, we expect that for the moment UA expenditure will only grow in line with revenues and it will be maintained around 17%. One of the reasons for this is that paid UA is not as straightforward as it looks and the fact is that the company is increasingly getting better at cross selling its games.

Another possibility is that the Board of Directors might decide to pay dividends from the extra profits. However, this decision will not be taken before the AGM in May next year.

We believe that for the moment the company will not necessarily be looking to relocate its profits in any particular way. Rather it will be continually evaluating the situation and pursuing both organic and inorganic growth opportunities.

Positive cash-flow and zero net capitalization

The company is also demonstrating a clear trend of decrease in net capitalization. G5 is now very close to balance between capitalization and amortization and with current profitability levels, it is generating positive cash flow. Thus, any future increase in profitability is likely to translate into an increase in cash flow.

OUTLOOK AND ESTIMATES

We are now coming to the fourth quarter of the year, which is traditionally the strongest period of the year for most gaming companies, including G5 Entertainment due to the many holidays such as Halloween, Thanksgiving and Christmas. Adding to this the fact that Hidden City continues to climb the charts and the old games are declining rather slowly, we expect another record-breaking quarter for the company.

Apart from the growth in revenue, we expect the fourth quarter to be very similar to the third quarter. Gross margin is likely to stay around 45% due to the royalty that G5 pays to the game developers. User Acquisition costs are expected to be close to 17% and operating costs will rise only marginally.

MSEK	Q3'16A	Q4'16E
Revenue	126	136
Commission to distributors	-38	-41
Royalty to external developers	-31	-33
Gross profit	57	62
Gross margin	45%	45%
Operating costs excl. user acquisition costs	-23	-23
EBIT excl. user acquisition costs	35	39
EBIT margin excl. user acquisition costs	27%	28%
Costs for User acquisition	-22	-23
EBIT	13	16
EBIT-margin (%)	10%	11%

Looking into 2017, the company has a very exciting year ahead. Both Hidden City and Survivors are on an upward spiral and possess enough potential to grow further. In addition, Twin Moons Society is gaining traction among users.

With the recent successes, the company will be much more focused on making another breakthrough and releasing a number of top performing games. Thus, we expect revenues to continue to grow very fast, with only seasonal slowdowns. On the cost side, we do not expect any major changes – expenditure is likely to rise as the company grows, but this will happen marginally.

Valuation: great future potential

With the success of Hidden City and Survivors and the new-found growth opportunities, we have raised many of our estimates for the company.

The company has demonstrated ability to grow regardless of any changes in marketing expenditure, which shows that G5 can thrive in almost any environment. The company is very stable, with a healthy balance sheet, no debt and great growth prospects.

Given the continual growth over the last quarters and the particularly strong performance in Q2 2016, we upgrade our target price to **SEK 105 per share** and reiterate our BUY recommendation on the company.

Scenario	Fair value	Probability
Base	104.7	50%
Worst	69.9	25%
Best	138.8	25%
Weighted Fair Value per share	104.5	

WACC Calculation	
Debt to Equity Ratio	0.00%
Cost of Equity	10.50%
Cost of Debt	4.27%
WACC	10.50%

ESTIMATES

Profit and loss

SEK (Thousand)	2013	2014	2015	2016	2017	2018
PROFIT & LOSS STATEMENT						
Revenue	100,007	182,117	384,369	468,528	566,918	685,971
Production Cost	(78,925) -79%	(102,091) -56%	(201,094)	(246,149)	(293,228)	(352,845)
Gross Profit	21,082	80,026	183,275	222,379	273,690	333,126
Administrative, Development & Marketing Expenses	(34,342)	(69,584)	(160,690)	(180,294)	(202,831)	(233,256)
Other Operating Income	2,046	1,803	2,549	2,999	3,022	3,045
Other Operating Expense	(612)	(3,231)	(5,346)	(440)	(780)	(918)
Operating Result Before Financial Results	(11,826)	9,014	19,788	44,643	73,101	101,997
Financial Income	85	249	38	8	8	9
Financial Expense	(301)	(646)	(48)	(55)	(58)	(61)
Operating Result After Financial Results	(12,042)	8,617	19,778	44,596	73,051	101,945
Taxes	378 3%	(1,804) 21%	(4,448)	(8,250)	(16,802)	(23,447)
Net Result	(11,664)	6,813	15,330	36,346	56,249	78,498

Balance Sheet

SEK (Thousand)	2013	2014	2015	2016	2017	2018
FIXED ASSETS						
Intangible fixed assets						
Capitalized development costs	48,299	71,680	94,269	104,925	111,221	117,894
Goodwill	2,318	2,302	2,293	2,293	2,293	2,293
	50,617	73,982	96,562	107,218	113,514	120,187
Tangible Fixed Asstes						
Equipment	1,929	2,892	4,634	5,912	6,267	6,643
Deferred Tax	2,105	1,025	2,310	6,621	6,621	6,621
	4,034	3,917	6,944	12,533	12,888	13,264
Total fixed assets	54,651	77,899	103,506	119,751	126,401	133,451
Current assets						
Account receivable	7,156	7,569	9,881	530	12,220	14,420
Tax receivable	4,437	0	175	298	302	306
Other receivables	6,915	7,327	3,952	6,368	6,878	7,428
Developer Royalty Advance	0	0	0	0	0	0
Prepaid expenses and accrued income	10,916	21,536	25,197	35,422	33,651	31,968
Cash at bank	27,433	32,864	33,870	55,932	87,026	139,781
Total Current assets	56,857	69,296	73,075	98,550	140,077	193,904
TOTAL ASSETS	111,508	147,195	176,581	218,301	266,478	327,354
Equity						
Share capital	880	880	880	880	880	880
Other capital contribution	54,032	54,032	54,032	48,032	48,032	48,032
Other reserves	22	8,575	8,575	6,575	6,575	6,575
Retained Earnings	34,058	40,871	59,858	95,535	144,014	202,683
Total shareholders' equity	88,992	104,358	123,345	151,022	199,501	258,170
Non-current liabilities						
Deferred tax	0	0	0	0	0	0
Current liabilities						
Account payable	7,478	12,893	12,320	15,488	16,107	19,207
Other liabilities	464	1,593	1,225	2,537	2,563	2,588
Tax liabilities	6,505	2,326	6,438	15,134	14,529	13,947
Accrued expenses	8,069	26,025	33,253	34,120	33,779	33,441
Total current liabilities	22,516	42,837	53,236	67,279	66,977	69,184
TOTAL EQUITY AND LIABILITIES	111,508	147,195	176,581	218,301	266,478	327,354

Top Shareholders

Figure 3.0: Top 15 shareholders as of 31/09/2016

	Name	# shares	% ownership
1	Försäkringsaktiebolaget Avanza Pension	903,624	10,27%
2	Rite Internet Ventures Holding AB	677,447	7,70%
3	Wide Development Limited	624,800	7,10%
4	Proxima LTD	560,000	6,36%
5	Swedbank Robur Ny Teknik	550,000	6,25%
6	Purple Wolf Limited	530,000	6,02%
7	Nordnet Pensionsförsäkring AB	459,378	5,22%
8	Tommy Svensk	403,000	4,58%
9	ABG Sundal Collier ASA	276,298	3,14%
10	Peter Lindell	143,673	1,63%
11	Mattias Ståhlgren	116,800	1,33%
12	Robur Försäkring AB	111,877	1,27%
13	Svenska Handelsbanken Markets	105,000	1,19%
14	Old Mutual International IOM LTD	100,250	1,14%
15	Calgus	100,000	1,14%
	Top 15	5,662,147	64.34%
	Other	3,137,853	35.66%
	Total	8,800,000	100.00%

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