

G5 Entertainment

Quarter Update Q4'16



Share Price	147 SEK
Market Capitalisation	1,294 mSEK
Target Price	186 SEK

Last updated on the 27/02/2017

G5 Entertainment is a developer and publisher of high quality free-to-play games for smartphones and tablets. The group distributes games through iOS, Google Play, Kindle Fire, Mac, and Windows application stores.

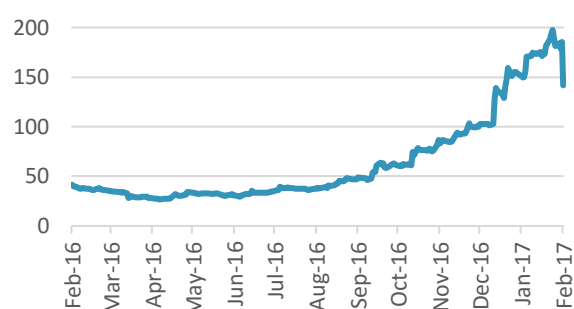
G5's portfolio includes popular games like Hidden City, Mahjongg Journey, Survivors: The Quest, The Secret Society and Virtual City. The company is publicly listed on Nasdaq Stockholm under trade symbol G5EN.ST.

Outstanding growth in Q4

- G5 Entertainment reported their fourth quarter results on 23rd February and achieved yet another record-breaking quarter.
- Revenue for Q4'16 came to SEK 185 M – up 82% from Q4 2015, and up 46% compared to the third quarter of 2016.
- The Board proposed a dividend of SEK 0.75 (0.0) per share, which will be the first dividend that the company will pay.
- Hidden City has officially become G5's best performing game, but other games in the portfolio also exhibit strong growth.
- Going forward, we expect G5 Entertainment to continue its strong performance, even though the high result in Q4 2016 was partially due to a seasonal high.
- Given the improvement in performance, we have upgraded our target price to **SEK 186 per share**.

Company	G5 Entertainment
Ticker	G5EN.STO
Currency	SEK
Industry	Mobile gaming
# of shares	8,800,000
Share price	147
Target price	186
Risk	LOW
Recommendation	BUY

SHARE PRICE PERFORMANCE



NEXT EVENT

4 May: Q1'17 Results

CONTACT

research@prestigoresearch.com

SEK (Thousand)	2013	2014	2015	2016	2017e	2018e	2019e
Sales	100,007	182,117	384,369	516,931	715,088	943,916	1,198,773
EBITDA	(11,826)	9,014	19,788	38,108	71,064	113,961	153,825
EPS	-1.34	0.77	1.74	3.77	6.29	10.09	13.63
DPS	N/A	N/A	N/A	0.75	1.50	3.00	4.00
Sales Growth	-12%	82%	111%	34%	38%	32%	27%
EBITDA margin	-12%	5%	5%	7%	10%	12%	13%
NIBD/EBITDA	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Debt/Equity	0%	0%	0%	0%	0%	0%	0%

See disclosures at the end of this report.

TABLE OF CONTENTS

INVESTMENT SUMMARY	3
OPERATIONAL PERFORMANCE	6
EXPECTATIONS.....	8
VALUATION	9
ESTIMATES.....	10
SIGNIFICANT SHAREHOLDERS	12
DISCLAIMER	13

INVESTMENT SUMMARY

Outstanding growth in the fourth quarter of the year

During the fourth quarter of the year, G5's revenue grew by 82% compared to Q4 2015 and 46% in comparison with Q3 2016. Typically, the fourth quarter of the year is very strong for G5 Entertainment due to the holidays. However, seasonality was only one reason for the growth – in addition, the company cashed on the growing success of Hidden City and other games, but also increased its paid user acquisition (UA) expenses.

EBIT for the period was SEK 7.3 M (8.4), a decrease of 12 per cent compared to 2015, but excluding UA expenses, EBIT increased by 119% and EBIT margin went from 25% in Q4'15 to 29% in Q4'16. In fact the company more than doubled its UA expenses from the third to the fourth quarter in order to capitalize on the high seasonal demand and the upward movement of Hidden City, Survivors and other games.

MSEK	Q4'15	Q4'16	% change
Revenue	101	185	82%
Commission to distributors	-30	-56	83%
Royalty to external developers	-22	-41	90%
Gross profit	49	88	79%
Gross margin	49%	48%	-2%
Operating costs excluding costs for user acquisition	-24	-33	37%
EBIT excluding costs for user acquisition	25	54	119%
EBIT margin before costs for user acquisition	25%	29%	16%
Costs for user acquisition	-16	-47	186%
EBIT	8	7	-12%
EBIT margin (%)	8%	4%	-50%
Earnings per share	1.09	0.89	-18%

The gross margin remained fairly consistent and we expect that it will continue to be in the range of 47%-50%. The commission paid to external developers increased and the main reason for that is that Hidden City, which grew significantly in the last two quarters, was not developed by G5 Entertainment. Going forward, the company aims to publish own games, but in the short term, Hidden City is likely to push up the commissions paid to external developers.

EBIT and EPS were lower in the quarter, as the company invested heavily in paid user acquisition. We believe that both EBIT and EPS are not good metrics for the performance of the company as G5 Entertainment has clearly stated that it will re-invest a significant proportion of its profit to acquire new users, and hence drive future growth.

An interesting metric to look at is "Net" EBIT, which is EBIT with capitalization and amortization effects taken out. Even with the increased marketing expenditure, G5 achieved 129 % growth in "Net" EBIT year-on-year and delivered free cash flow of 16.5 MSEK.

How to interpret the high growth

It is interesting to note some of the strategic shifts the company made during the fourth quarter in comparison to the third quarter of the year. Since August 2016, G5 has witnessed a tremendous growth in the popularity of Hidden City and Survivors. It was obvious that those games will continue to grow in the fourth quarter, especially given the seasonally high interest in mobile games.

Having achieved high EBIT in Q3'16, the company decided to maximize the upward movement in its games and invest more heavily in paid user acquisition. User Acquisition expenses amounted to SEK 47 million, which is more than twice as high as the third quarter. As percentage of revenues, UA was 25% in Q4'16 compared to 17% in Q3'16.

MSEK	Q3'16	Q4'16	% change
Revenue	126	185	46%
Commission to distributors	-38	-56	47%
Royalty to external developers	-31	-41	32%
Gross profit	57	88	54%
Gross margin	45%	48%	7%
Operating costs excl. user acquisition costs	-23	-33	43%
EBIT excl. user acquisition costs	35	54	54%
EBIT margin excl. user acquisition costs	27%	29%	7%
Costs for User acquisition	-22	-47	114%
EBIT	13	7	-46%
EBIT-margin (%)	10%	4%	-60%

Clearly, the strategy gave effect, as the company grew its revenue by 46% from the third to the fourth quarter. Besides UA costs, the company also had to increase its operating expenses by SEK 10 million or 43% from Q3 to Q4.

Due to the higher expenditure, EBIT was significantly lower than in the previous quarter, but the company successfully grew both its user base and the popularity of its games.

In addition to the higher UA expenditure and the growth in Hidden City, G5 Entertainment also released a number of important end-of-the-year holiday updates, which helped to boost the revenue from the overall game portfolio. Besides Hidden City, the company also enjoyed high growth in Mahjong Journey and Survivors: The Quest.

Annual revenue grew by 34% YoY

Year-on-year revenue grew with 34% and amounted to SEK 516.9 M (384.4). The main driver for the growth was Hidden City but G5's own portfolio has also grown substantially over the year. Cost of revenue remained at the same rate and thus gross profit grew in line with revenue by 34%.

Operating costs increased with 29% compared to 2015. User acquisition increased to SEK 105.9 M (74.6). Excluding costs for user acquisition the operating costs amounted to SEK 101.9 M (86.1). The operational costs were impacted by depreciation and amortization of SEK 40.7 M (29.6) and write-downs of SEK 5.7 M (8.2).

MSEK	2016	2015	% change
Revenue	517	384	34%
Commission to distributors	-155	-115	34%
Royalty to external developers	-116	-86	36%
Gross profit	245	183	34%
Gross margin	48%	48%	
Operating costs excluding costs for user acquisition	-102	-89	15%
EBIT excluding costs for user acquisition	144	94	53%
EBIT margin before costs for user acquisition	28%	25%	
Costs for user acquisition	-106	-75	42%
EBIT	38	20	93%
EBIT margin (%)	7%	5%	
Earnings per share	3.77	1.74	117%

Financial position is very strong

The company achieved record revenue of SEK 185 million, which broke the previous record of SEK 126 million, set in the third quarter. The financial position of the company is more than stable and cash and cash equivalents more than doubled in the past 12 months. As of 31st December 2016, G5 Entertainment had SEK 71 million cash and cash equivalents on its balance sheet.

MSEK	Q4'15	Q4'16	% change
Cash flow before financing activities	3,052	16,211	431%
Cash and cash equivalents	33,870	70,584	108%

OPERATIONAL PERFORMANCE

User metrics are indicative for future growth

For the free-to-play games the average Monthly Active Users (MAU) was 5.1 million, up 75% from Q4 2015. Average Monthly Unique Payers (MUP) was 175,400, an increase of 69% and average Monthly Average Gross Revenue Per Paying User (MAGRPPU) was USD 37.5, an increase of 10% compared to the same period in 2015.

Those metrics show that the company has done a very good effort to increase its audience, which underlies its growth. In our opinion, those three metrics are more indicative for the company's future growth than its EBIT or profitability, which can be easily manipulated from quarter to quarter.

It is interesting to note that the company is not only expanding its audience, but continually finding ways to monetize users in better ways. This happens in an environment that is highly competitive and user monetization become more difficult.

F2P	Q4'16	Q4'15	% change
Average MAU (mn)	5.1	2.9	75%
Average MUP (thousands)	175.4	103.8	69%
Average MAGRPPU (USD)	37.5	34.2	10%

Hidden City and smartphones increase their importance

Hidden City has become the company's biggest revenue-generating game on a monthly basis, and the revenue generated by G5's wholly owned games have likewise increased. Game number two by revenue is The Secret Society, which for a long time was the company's greatest success.

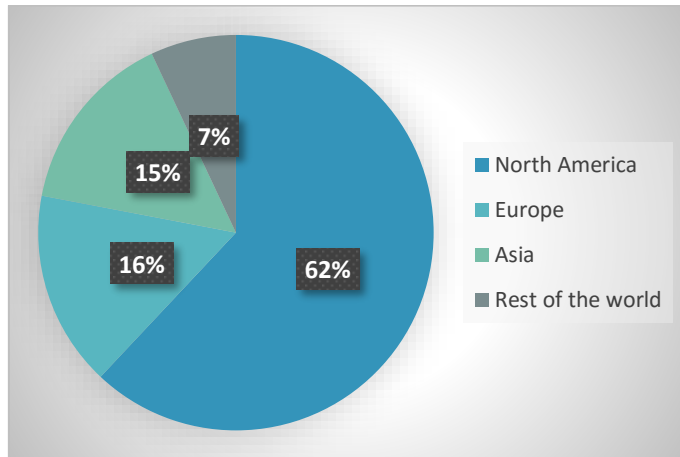
The company is also reporting a good start for its most recent games - Twin Moons Society and Supermarket Mania Journey. Considering that Hidden City took more than a year to become a hit, we would not hype expectations too much.

G5 has also put increasing focus on increasing revenue coming from smartphone users. The company is much better positioned on the tablet market, but clearly wants to improve its market share across the board.

Games portfolio

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. In some of its games, the core paying audience is females over the age of 55.

Figure 2.0: Revenue breakdown by geography, Q4 2016



Source: G5 Entertainment, 2017

During the quarter, the company grew quite significantly in Asia and the region increased its revenue contribution from 12% in Q3'16 to 15% in Q4'16 (10% in Q4'15). USA, Japan and China are the largest App Store markets in the world, and historically USA is where most of G5's revenue has been generated.

Market potential is growing significantly

Up to the third quarter of 2016, G5's most successful game of all time was The Secret Society. However, key metrics show that Hidden City has exceeded the performance of The Secret Society, demonstrating that the company is able to repeats its successes.

Another major advantage that G5 Entertainment possess is the fact that it has a leading position in the F2P Hidden Objects Genre, which to a degree means that the company is creating the market. As more successful games are released, it is likely that the target audience will grow, which means that the company's market potential is growing substantially with each new successful game.

EXPECTATIONS

Q1'17 Expectations

Growth for the first quarter of the year is very difficult to project. Revenue in the fourth quarter of the year was highly affected by the holiday spike and the major updates that the company released. Typically, the first quarter of the year is slower for gaming companies and it would be unrealistic to expect another of record-revenue.

On the other hand, G5 Entertainment has stated that "The new higher level of revenue that we have achieved in Q4 2016 and December 2016 specifically has continued into January and February 2017", which clearly suggest that we may be up for a surprise in Q1.

In addition, the fourth quarter performance was pushed up by the high User Acquisition expenses. We believe that the company will not be as aggressive in its marketing efforts, but it will look to increase its UA expense beyond the level of 17% of revenue that was typical in mid-2016.

G5 Entertainment started increasing their UA as early as September/October when Hidden City and Survivors were climbing the charts. Therefore, the high UA investment was not only due to the holidays, but due to a shift in the company's strategy. With UA being 25% of revenue in the fourth quarter, we expect that it will remain in the range of 20%-25% in the first quarter of 2017.

We firmly believe that revenue in Q1 2017 will exceed the SEK 126 million achieved in the Q3 2016. Our base case scenario assumes that G5 will not surpass the SEK 185 million revenue from the fourth quarter, but it may come close to that number. However, our best case scenario, which assumes the same UA level as in December puts the company at around SEK 200 million, which 12 months ago looked highly improbable, but now has become a realistic scenario.

VALUATION

Great future potential

G5 Entertainment has a clear portfolio approach, relying on multiple games and trying to release new hits in the market. Coupled with the fact that the company has a leadership position in its market niche, the growth path ahead looks straightforward.

Hidden City is just the latest hit that G5 had, but the company is very clear in its plans to release more games that will achieve its success. Operating in just one specific market genre and studying its audience in-depth, G5 Entertainment looks well positioned to double and triple on its success.

Quarter to quarter growth will depend on a number of factors such as the performance of the games in the current portfolio, the company's ability to improve that performance, and its ability to release new games. But on annual basis, there is almost no doubt that the company will be growing at strong double digit rates, while maintaining both profitability and positive cash flow.

Our DCF yields an average price of **SEK 186 per share**, which translates into a BUY recommendation.

Scenario	Fair value	Probability
Base	197.30	50%
Worst	110.95	25%
Best	238.51	25%
Weighted Fair Value per share	186.02	

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

We expect the growth rate in 2017 to be around 38%, which is higher than the growth rate of 34% in 2016. However, the first two quarter of 2016 were rather weak compared to the strong performance in Q3 and Q4. G5 Entertainment has clearly been growing month to month ever since August 2016 and we expect that growth to continue in 2017.

However, we also believe that it is in the second half of 2017 that G5 will manage to surprise investors. The reasons for that are multiple – the company is shifting to higher UA expenditure, the Twin Moon is likely to take more time to take off and the company is still gaining market shares in both Asia and the smartphone market. Thus, the second half of 2017 promises to be where the company will be capitalizing on its current efforts.

We believe that cost of production will remain unchanged and approximately 52.5% of revenue on average. Expenses are likely to grow – both marketing and operating – but this will be at a controlled pace and in line with the goal to increase revenues.

SEK (Thousand)	2014	2015	2016	2017	2018	2019
PROFIT & LOSS STATEMENT						
Revenue	182,117	384,369	516,931	715,088	943,916	1,198,773
Production Cost	(102,091)	(201,094)	(271,070)	(375,595)	(494,397)	(629,374)
Gross Profit	80,026	183,275	245,861	339,493	449,519	569,399
Administrative, Development & Marketing Expenses	(69,584)	(160,690)	(207,729)	(267,970)	(334,963)	(412,005)
Other Operating Income	1,803	2,549	320	322	324	325
Other Operating Expense	(3,231)	(5,346)	(344)	(780)	(918)	(3,895)
Operating Result Before Financial Results	9,014	19,788	38,108	71,064	113,961	153,825
Financial Income	249	38	39	41	43	45
Financial Expense	(646)	(48)	(109)	(114)	(120)	(126)
Operating Result After Financial Results	8,617	19,778	38,038	70,991	113,884	153,744
Taxes	(1,804)	(4,448)	(4,833)	(15,618)	(25,055)	(33,824)
Net Result	6,813	15,330	33,205	55,373	88,830	119,920
EPS	0.77	1.74	3.77	6.29	10.09	13.63

Balance Sheet

SEK (Thousand)	2014	2015	2016	2017	2018	2019
FIXED ASSETS						
Intangible fixed assets						
Capitalized development costs	71,680	94,269	109,104	120,014	132,016	145,217
Goodwill	2,302	2,293	2,292	2,292	2,292	2,292
	73,982	96,562	111,396	122,306	134,308	147,509
Tangible Fixed Assets						
Equipment	2,892	4,634	6,275	6,777	7,319	7,905
Deferred Tax	1,025	2,310	6,100	6,527	6,984	7,473
	3,917	6,944	12,375	13,304	14,303	15,377
Total fixed assets	77,899	103,506	123,771	135,610	148,611	162,887
Current assets						
Account receivable	7,569	9,881	0	9,387	10,326	11,358
Tax receivable	0	175	474	356	267	200
Other receivables	7,327	3,952	5,906	6,378	6,889	7,440
Developer Royalty Advance	0	0	0	0	0	0
Prepaid expenses and accrued income	21,536	25,197	57,030	54,179	51,470	48,896
Cash at bank	32,864	33,870	70,584	80,475	121,153	169,437
Total Current assets	69,296	73,075	133,994	150,775	190,104	237,332
TOTAL ASSETS	147,195	176,581	257,766	286,385	338,714	400,218
Equity						
Total shareholders' equity	104,358	123,345	161,169	201,035	247,827	302,882
Current liabilities						
Account payable	12,893	12,320	30,828	20,581	27,090	34,486
Other liabilities	1,593	1,225	2,840	2,868	2,897	2,926
Tax liabilities	2,326	6,438	13,276	12,745	12,235	11,746
Accrued expenses	26,025	33,253	49,653	49,156	48,665	48,178
Total current liabilities	42,837	53,236	96,597	85,350	90,887	97,336
TOTAL EQUITY AND LIABILITIES	147,195	176,581	257,766	286,385	338,714	400,218

Top Shareholders

Figure 3.0: Top 15 shareholders as of 31/12/2016

	Name	# shares	% ownership
1	Försäkringsaktiebolaget Avanza Pension	835,554	9,49%
2	Rite Internet Ventures Holding AB	677,447	7,70%
3	Wide Development Limited	624,800	7,10%
4	Swedbank Robur Ny Teknik	550,000	6,25%
5	Proxima LTD	531,000	6,03%
6	Purple Wolf Limited	530,000	6,02%
7	Tommy Svensk	403,000	4,58%
8	Nordnet Pensionsförsäkring AB	377,191	4,29%
9	ABG Sundal Collier ASA	251,094	2,85%
10	Peter Lindell	143,673	1,63%
11	Old Mutual International IOM LTD	100,250	1,14%
12	Svenska Handelsbanken Markets	100,000	1,14%
13	SEB Life	99,653	1,13%
14	Daniel Eriksson	92,500	1,05%
15	Swedbank Försäkring AB	91,061	1,03%
	Top 15	5,407,223	61.45%
	Other	3,392,777	38.55%
	Total	8,800,000	100.00%

DISCLAIMER

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete. The particulars are not a complete analysis of every material fact respecting any company, industry, or security. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. The opinions expressed here therefore reflect the judgment of the research analyst(s) at this date and are subject to change. Prestigo Research makes no guarantee, representation or warranty as to the accuracy or completeness of the particulars. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst(s) in this equity research report. The analyst does not own any shares directly or indirectly (or any derivative thereof) of the company that is subject to this research report. The analyst or member of the analyst's household does not serve as officer, director or advisory board member of the company that is subject to this research report. This research product is designed for professional investor clients only. This report has been issued by Prestigo Research. Prestigo is not regulated by the Financial Services Authority and does not give investment advice. However, Prestigo conducts its business to at least match the highest regulatory standards available. Prestigo believes that it is the portfolio/fund/money manager that is best placed to make investment decisions. Prestigo research is designed strictly for professional investors only as defined by MiFD and the Financial Services Authority. This research product is solely for the information of the addressee only and is not an offer, or solicitation of an offer, to sell, or buy, any securities or any derivative instruments or any other rights pertaining thereto. The company in coverage in this report is a subscriber of Prestigo Quarter Update reports and therefore receives our updates simultaneously as other paid subscribers. The company also pays a premium for Prestigo Distribution Licence. This simply allows the company to freely distribute all Prestigo Quarter Update material on its own website, seven days after the original publication date of the given report(s) and compensates for the costs, which Prestigo incurs in distributing the report(s) to various media and interested third parties that are not paying clients of Prestigo. This research product is designed for Institutional Investors only. This report is not intended for use or distribution to US corporations that do not meet the definition of a major US institutional investor in the United States or for use by any citizen or resident of the United States.

These materials may not be reproduced, distributed or published by any recipient for any purpose. Please cite source when quoting.