BUSINESS OVERVIEW

Gravity, based in Korea, develops online games.

INVESTMENT HIGHLIGHTS

- **Provides *Ragnarok Online*** (three-fourths of sales), a massively multiplayer online role-playing game (MMORPG) commercialized in 2002 and popular in Japan and Korea. Four other games add to sales.
- **Much-anticipated—and much-delayed—sequel *Ragnarok Online 2*** is scheduled to be released in Q4 2010, but management has little credibility on timing. A release could be a major upside catalyst, as it would likely result in sales and profit growth.
- **Net cash has grown to $55 million at March 31,** exceeding market value, up from $50 million at yearend 2008. The company's auditor is a Korean member firm of PricewaterhouseCoopers.
- **Reversed losses and reported adjusted EBIT of $11 million in 2009,** followed by $1.1 million in 1Q10. Gravity had raised $71 million in an IPO at $13+ per share in 2005, but losses had eroded cash.
- **Japan accounted for 56% of revenue in 2010,** comprised of royalties received from majority shareholder and licensee GungHo (Osaka: 3765). Gravity benefits when the yen gains versus the won.
- **Improved execution after CEO change in 2008.** The company is led by co-CEOs Yoon Kang (42) and Toshiro Ohno (49), with GungHo exerting tight control over management and the Board.
- **Buyout by majority owner?** GungHo, *de facto* controlled by Japanese giant Softbank, has boosted its Gravity stake to 59% in the past couple of years. An offer would make sense, but would it be fair?
- **Online multi-player game market is $4.2 billion,** based on a DFC estimate for 2009. The market is expected to grow to $5.9 billion by 2012. The total "online gaming" market was ~$11 billion in 2009.

INVESTMENT RISKS & CONCERNS

- **Major corporate governance concern.** A GungHo affiliate acquired 52% of the stock for $25 per share from Gravity's founder in 2005. The companies have not released the details of GungHo's license agreement, which accounts for >50% of revenue. A 20-F filed in June 2010 mentions the risk that ADS holder may be disadvantaged in a strategic deal.
- **Will *Ragnarok Online 2* be delayed yet again?** A delay beyond 4Q10 may lead to losses, as revenue from *Ragnarok Online* may erode over time.

SELECTED OPERATING DATA [1]

FYE December 31	2005	2006	2007	2008	2009
Revenue (KRW, bn)	53.4	41.0	40.2	53.2	57.4
% of revenue by type:					
Online games – royalties	70%	64%	61%	57%	22%
Online games – subscriptions	21%	21%	23%	24%	59%
Mobile games	3%	9%	10%	13%	14%
Character merchandising	6%	6%	5%	7%	5%
Revenue growth by major type:					
Online games – royalties	-17%	-30%	-5%	22%	1%
Online games – subscriptions	-31%	-25%	12%	34%	13%
Mobile games	343%	131%	6%	69%	15%
Δ total revenue [2]	-17%	-23%	-2%	32%	8%
% of revenue by major game:					
Ragnarok Online	88%	78%	77%	73%	74%
Ragnarok Online 2	*to be released in 4Q10 (may be delayed)*				
Requiem	0%	0%	2%	3%	5%
R.O.S.E.; Emil Chronicle	3%	5%	5%	3%	2%
% of revenue by major geography:					
Japan	32%	41%	47%	51%	56%
Korea	19%	25%	28%	26%	20%
North America	5%	7%	6%	7%	10%
% of revenue from GungHo	31%	38%	44%	50%	56%
Selected items as % of revenue:					
Gross profit	70%	57%	52%	48%	63%
SG&A	58%	67%	72%	44%	38%
R&D	17%	23%	14%	4%	3%
Adjusted EBIT	-5%	-33%	-35%	0%	22%
D&A and impairments	13%	23%	21%	16%	10%
Capex [3]	16%	-16%	7%	3%	1%
Capitalized software	11%	0%	13%	7%	5%
Δ shares out (period end)	0%	0%	0%	0%	0%

[1] Based on U.S. GAAP and local currency results (Korean Won=KRW).
[2] Recent revenue growth is partly driven by strengthening of Yen versus KRW.
[3] Capex was negative in 2006 due to a gain on disposal of PP&E.

COMPARABLE PUBLIC COMPANY ANALYSIS

	MV ($mn)	EV ($mn)	EV / Rev.	P / Tang. Book	This FY P/E	Next FY P/E
ERTS	5,240	3,240	.9x	3.7x	25x	18x
SNDA	2,490	830	1.0x	2.1x	16x	13x
TTWO	890	810	.9x	3.7x	n/m	8x
GRVY	**40**	**-20**	**n/m**	**.7x**	**n/a**	**n/a**

MAJOR HOLDERS

Management 0% | Japanese public company GungHo 59% | Moon 5% | Black Horse 2% | RenTech 1% | Sprott 1%

RATINGS

VALUE Intrinsic value materially higher than market value? ☆☆☆☆☆
DOWNSIDE PROTECTION Low risk of permanent loss? ☆☆☆☆
MANAGEMENT Capable and properly incentivized? ☆☆
FINANCIAL STRENGTH Solid balance sheet? ☆☆☆☆☆
MOAT Able to sustain high returns on invested capital? ☆☆☆
EARNINGS MOMENTUM Fundamentals improving? ☆☆☆
MACRO Poised to benefit from economic and secular trends? ☆☆☆

THE BOTTOM LINE

Gravity has frustrated value-oriented investors, as the shares have continued to trade at a discount to net cash despite a return to material profitability and cash generation in 2009. Major corporate governance issues centered around the potential intentions of 59% holder and licensee GungHo, as well as repeated delays of the much-anticipated release of the online game *Ragnarok Online 2*, the sequel to Gravity's key revenue generator, have made it difficult for investors to assess the value that may ultimately accrue that minority shareholders. While we point out the risks of a potential "takeunder" and continued delays of *RO 2,* the risk-reward remains compelling. If one objectively looks past the despondency priced into Gravity shares, it is quite conceivable that *RO 2* will be released in the next six to twelve months, materially boosting revenue and profits.

