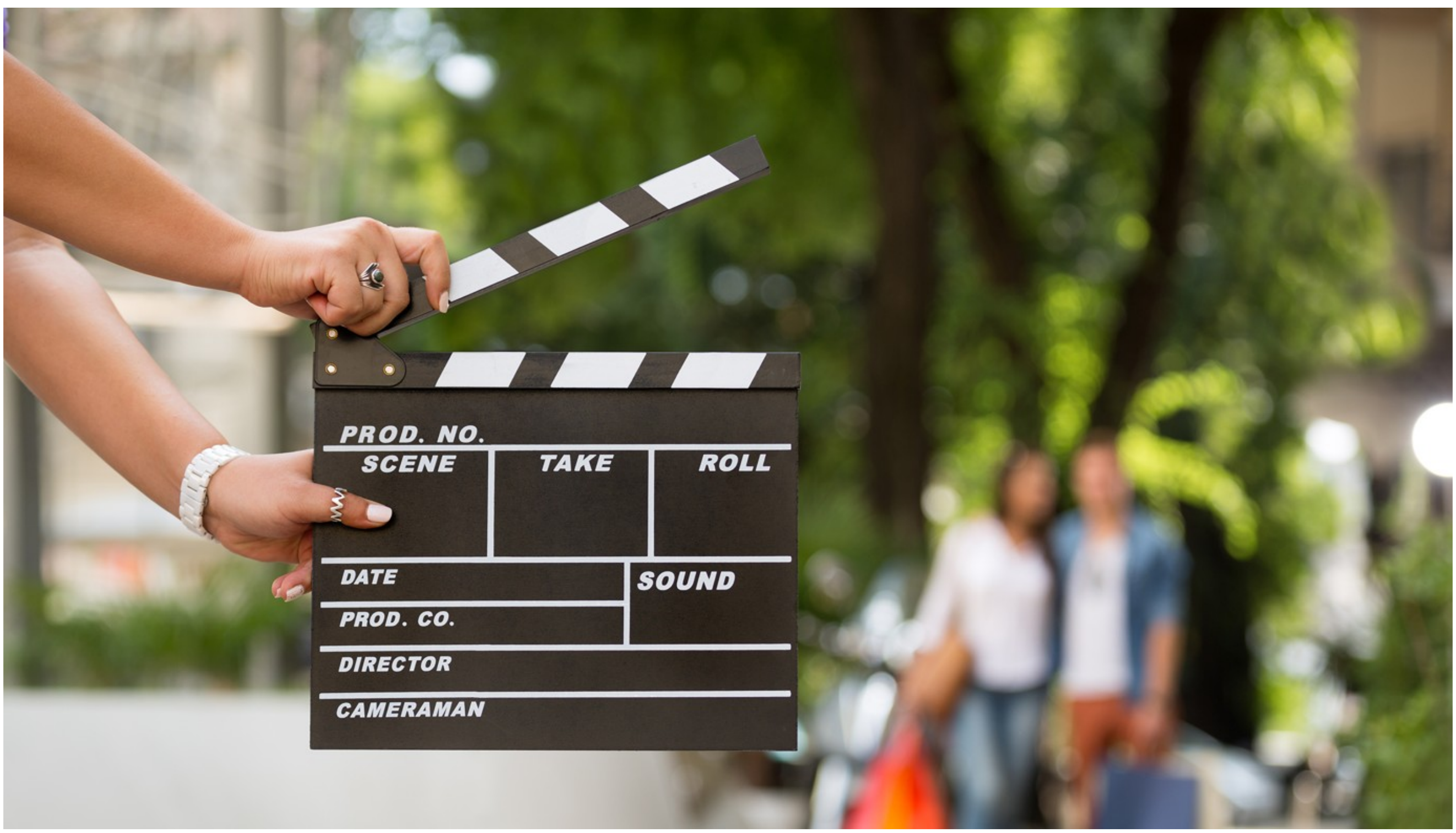
October 11, 2022 09:00 PM GMT

Linmon Media Ltd

Quality Production; Fairly Priced

Linmon's drama capacity expansion plans should result in healthy revenue growth. However, the hit-or-miss risk and downstream pressures pose challenges. New initiatives bring IP monetization potential, but are not yet proven. We initiate coverage at Equal-weight.



Quality Production; Fairly Priced

Drama capacity ramp-up drives visible growth... We like Linmon's position as a top-quality producer with a proven track record. Amid the industry's structural shift and still-fierce competition among video platforms, we believe having top-quality content will continue to garner strong demand, owing to its scarcity and high ROI. We forecast Linmon to achieve a 27% drama revenue CAGR over 2021-24, as it ramps-up capacity from three dramas in 2021 to seven in 2024, leveraging its IP reserve (a low-hanging fruit), rich internal and external resources, and sufficient cash flow amid benign supply-side competition for top players. Linmon also offers greater visibility than peers in a low-visibility business, thanks to its high pre-sale rate.

STOCK RATING
Equal-weight

INDUSTRY VIEW
In-Line

PRICE TARGET
HK$26.30

...but we also see challenges from hit-or-miss risk and downstream pressures: We foresee lower visibility on drama quality after Linmon ramps-up scale, as delivering more top-tier scripts and recruiting more experienced professionals might be challenging. Also, as downstream internet platforms face a plateauing user base and are taking a more stringent stance on content investment, Linmon may see greater pressure on profitability.

New initiatives suggest upside potential, but they are not yet proven: Leveraging the influence of its IP, Linmon is actively exploring new ad formats, ecosystem initiatives, and overseas distribution to further unlock any intellectual property (IP) monetization potential. However, we remain conservative during the early stage. Moreover, we see near-term challenges to its ad initiative given the gloomy ad market outlook.

Initiate at EW; PT HK$26.3: We forecast revenue growth of 17% and 47% and net profit growth of 35% and 25% in 2022-23, respectively. We like Linmon's position in the industry and see upside potential from its expansion plans, but uncertainties and challenges linger amid downstream pressures and macro headwinds. Our price target is derived from a target 2023 P/E of 18x, slightly below the target P/Es of (1) 20x that we assign to Huace, reflecting Huace's larger production scale, the A-H premium, and Linmon's lower liquidity, and (2) 22x that we assign to China Literature, reflecting the stronger potential of China Lit's IP business and, again, Linmon's lower liquidity.

Key risks: (1) Faster/slower expansion pace, (2) rising/declining quality of S-rated dramas and smaller-scale dramas, (3) faster/slower progress on new initiatives, and (4) faster/slower ad market recovery.

Linmon Media Ltd (9857.HK, 9857 HK)

Greater China Media | China

Stock Rating	**Equal-weight**
Industry View	**In-Line**
Price target	HK$26.30
Up/downside to price target (%)	19
Shr price, close (Oct 10, 2022)	HK$22.05
52-Week Range	HK$34.35-20.00
Sh out, dil, curr (mn)	360
Mkt cap, curr (mn)	Rmb7,203
EV, curr (mn)	Rmb5,885
Avg daily trading value (mn)	HK$5

Fiscal Year Ending	12/21	12/22e	12/23e	12/24e
ModelWare EPS (Rmb)	0.78	1.05	1.31	1.52
Revenue, net (Rmb mn)	1,249	1,459	2,143	2,561
ModelWare net inc (Rmb mn)	280	378	472	550
P/E	-	19.0	15.3	13.1
RNOA (%)	(22.8)	(15.1)	(14.5)	(18.4)
ROE (%)	NM	NM	NM	NM
FCF yld ratio (%)**	-	2.7	1.0	2.4
Leverage (EOP) (%)	NM	NM	NM	(1,365.8)

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework
** = Based on consensus methodology
e = Morgan Stanley Research estimates

Contents

Financial Summary

Exhibit 1: Linmon: Financial summary

INCOME STATEMENT

Years Ending December 31 Rmb mn	2019	2020	2021	2022E	2023E	2024E
Original drama series	1,633	1,207	1,051	1,291	1,853	2,175
Content marketing	59	66	110	109	217	298
Others	103	153	88	59	73	89
Total revenue	**1,794**	**1,426**	**1,249**	**1,459**	**2,143**	**2,561**
Original drama series	1,352	698	632	694	1,017	1,218
Content marketing	20	17	47	60	125	179
Others	21	165	10	26	54	67
Cost of sales	**1,393**	**880**	**690**	**780**	**1,197**	**1,464**
Gross profit	**401**	**546**	**559**	**679**	**946**	**1,097**
% margin	22.3%	38.3%	44.8%	46.5%	44.1%	42.8%
S&M expense	116	131	103	122	191	206
G&A expense	98	94	162	225	219	248
Other expenses/(gains)	10	25	55	-	-	-
Operating expenses	**224**	**250**	**320**	**347**	**410**	**454**
Operating profit	**177**	**296**	**239**	**332**	**536**	**642**
% margin	9.9%	20.7%	19.1%	22.7%	25.0%	25.1%
Depreciation of PPE	5	1	1	1	1	1
Depreciation of right-of-use assets	16	15	16	17	16	14
Amortization of intangible assets	5	1	1	-	-	-
EBITDA	**203**	**312**	**257**	**350**	**552**	**657**
% margin	11.3%	21.9%	20.6%	24.0%	25.8%	25.7%
Non-operating items	**(69)**	**(201)**	**(115)**	**(49)**	**73**	**70**
Finance costs	(21)	(12)	(5)	-	-	-
Share of P/L of associates	(3)	(1)	2	-	-	-
Changes in FV of convertible redeemable preferred shares	(94)	(239)	(226)	(140)	-	-
Other income and gains	49	51	113	91	73	70
Profit before tax	**108**	**94**	**124**	**283**	**609**	**713**
% margin	6.0%	6.6%	9.9%	19.4%	28.4%	27.8%
Income tax	27	31	63	105	152	178
% of PBT	25.3%	33.5%	50.8%	24.9%	25.0%	25.0%
Minority interests	(3)	12	-	-	-	-
Net profit (reported)	**83**	**50**	**61**	**178**	**457**	**535**
% margin	8.4%	17.0%	22.4%	25.9%	22.0%	21.5%
Extraodinary items	71	180	219	201	15	15
Adjusted net profit	**151**	**243**	**280**	**378**	**472**	**550**
% margin	8.4%	17.0%	22.4%	25.9%	22.0%	21.5%
EPS (reported)	**0.23**	**0.14**	**0.17**	**0.49**	**1.27**	**1.48**
EPS (adjusted)	**0.42**	**0.67**	**0.78**	**1.05**	**1.31**	**1.52**
EPS (adjusted) (HK$)	0.50	0.81	0.93	1.19	1.46	1.76

KPI

Years Ending December 31 Rmb mn	2019	2020	2021	2022E	2023E	2024E
Online and TV distribution						
No. of dramas	2	3	3	5	6	7
No. of episodes	105	127	115	145	204	232
Aggregate ASP	15.5	9.5	9.1	8.9	9.1	9.4

BALANCE SHEET

Years Ending December 31 Rmb mn	2019	2020	2021	2022E	2023E	2024E
Inventories	825	337	554	504	773	946
Trade and noes receivables	462	256	386	450	662	791
Prepayments, other receivables, and others	188	175	204	238	350	418
Financial assets at FV through P/L	591	670	325	348	371	394
Cash and cash equivalents	203	125	825	1,530	1,830	2,254
Restricted cash	120	-	-	-	-	-
Current assets	**2,390**	**1,563**	**2,294**	**3,071**	**3,986**	**4,803**
PPE	9	2	6	6	6	6
Right-of-use assets	46	23	29	26	23	21
Goodwill	30	-	-	-	-	-
Other intangible assets	3	1	3	3	3	3
Investments in associates	54	53	55	55	55	55
Advance payments for other intangibles	-	1	-	-	-	-
Deferred tax assets	389	457	54	54	54	54
Financial assets at FV through P/L	12	10	59	59	59	59
Trade receivables	-	-	-	-	-	-
Prepayments, other receivables, and others	70	82	114	133	195	233
Time deposits	-	350	350	350	350	350
Non-current assets	**613**	**979**	**669**	**686**	**745**	**781**
Total assets	**3,003**	**2,542**	**2,963**	**3,757**	**4,731**	**5,584**
Trade payables	58	12	76	86	132	162
Other payables and accruals	785	312	467	545	801	957
Interest-bearing bank and other borrowings	282	17	-	-	-	-
Convertible redeemable preferred shares	-	3,055	3,276	3,416	3,416	3,416
Lease liabilities	15	13	17	19	29	36
Tax payable	7	64	75	75	75	75
Current liabilities	**1,147**	**3,474**	**3,911**	**4,142**	**4,454**	**4,646**
Other payables and accruals	-	-	363	424	622	744
Interest-bearing bank and other borrowings	3	-	-	-	-	-
Convertible redeemable preferred shares	2,729	-	-	-	-	-
Lease liabilities	30	10	12	13	20	25
Non-current liabilities	**2,762**	**10**	**375**	**437**	**643**	**769**
Total liabilities	**3,909**	**3,484**	**4,286**	**4,579**	**5,096**	**5,415**
Share capital	-	-	24	347	347	347
Reserves	(906)	(942)	(1,346)	(1,169)	(712)	(177)
Non-controlling interests	0	-	-	-	-	-
Shareholders' equity	(906)	(942)	(1,322)	(822)	(365)	169
Total equity	**(906)**	**(942)**	**(1,322)**	**(822)**	**(365)**	**169**
Total liabilities and equity	**3,003**	**2,542**	**2,963**	**3,757**	**4,731**	**5,584**

CASH FLOW

Years Ending December 31 Rmb mn	2019	2020	2021	2022E	2023E	2024E
Profit before tax	108	94	124	283	609	713
Depreciation and amortization	26	17	18	18	16	15
Other non-cash adjustments	117	279	269	117	(23)	(23)
Net change in working capital	34	175	126	81	(154)	(101)
Income tax paid	(92)	(42)	(100)	(105)	(152)	(178)
Operating cash flow	**193**	**523**	**436**	**394**	**296**	**425**
Capex	(1)	(0)	(6)	(1)	(1)	(1)
Acquisition/disposal of financial assets	(99)	(51)	336	-	-	-
Other investing cash flow	0	(355)	(2)	(14)	(13)	(12)
Investing cash flow	**(100)**	**(407)**	**329**	**(15)**	**(14)**	**(12)**
Net issuance/(repayment) of debt	(80)	(267)	(17)	-	-	-
Net issuance/(repurchase) of equity	-	-	(5)	323	-	-
Interest and dividend paid	(34)	(33)	(9)	-	-	-
Other financing cash flow	(48)	106	(23)	4	17	11
Financing cash flow	**(163)**	**(194)**	**(54)**	**326**	**17**	**11**
Net change in cash	**(69)**	**(77)**	**700**	**705**	**300**	**424**

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

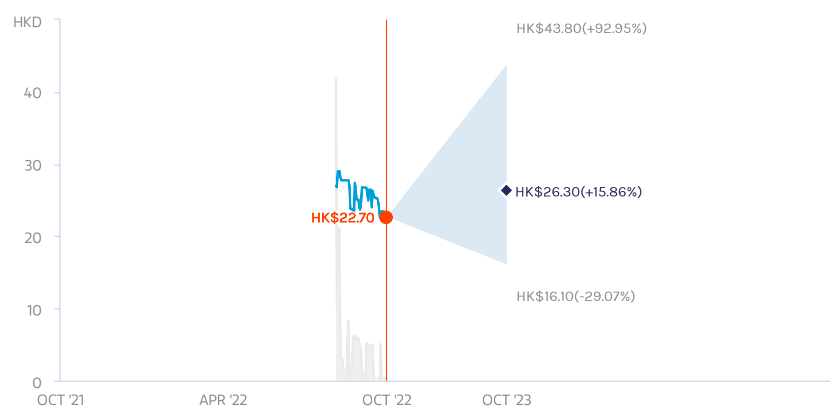
Risk Reward – Linmon Media Ltd (9857.HK)

Expansion from Production Quality

PRICE TARGET HK$26.30

Base case, derived from a target 2023 P/E of 18x. This multiple is lower than (1) Huace's 3-year historical average P/E of 21-22x and the 20x that we assign, mainly reflecting Huace's larger production scale, the A-H premium and Linmon's lower liquidity, and (2) China Literature's 3-year historical average P/E of 35-36x and the 22x that we assign, reflecting the greater potential of China Lit's IP business and, again, Linmon's lower liquidity.

RISK REWARD CHART



Key: — Historical Stock Performance ● Current Stock Price ◆ Price Target

Source: Refinitiv, Morgan Stanley Research

EQUAL-WEIGHT THESIS

- We like Linmon's strong positioning as a top-quality producer with a proven track record.
- Linmon's drama capacity expansion plans should result in visible growth, as it leverages its production expertise, IP, and track record. However, hit-or-miss risk and downstream pressures pose some challenges.
- New format ads, overseas distribution, and ecosystem initiatives bring IP monetization potential, but they are yet to be proven.
- We are EW relative to our coverage, given the uncertainties and challenges, despite capacity ramp-up and new initiatives that suggest upside potential.

Risk Reward Themes

Market Share: *Positive*
Self-help: *Positive*

View descriptions of Risk Rewards Themes here

BULL CASE HK$43.80

22x 2023 bull-case EPS

Faster capacity expansion and improving quality

Number of S-rated dramas: 1, 4, 4 in 2022-24.

ASP of S-rated dramas: Rmb9.0, 9.6, 10.2 in 2022-24.

BASE CASE HK$26.30

18x 2023 base-case EPS

On-track capacity expansion and sustained quality

Number of S-rated dramas: 1, 3, 3 in 2022-24.

ASP of S-rated dramas: Rmb9.0, 9.4, 10.0 in 2022-24.

BEAR CASE HK$16.10

17x 2023 bear-case EPS

Delayed capacity expansion and worsening quality

Number of S-rated dramas: 1, 2, 3 in 2022-24.

ASP of S-rated dramas: Rmb9.0, 9.2, 9.8 in 2022-24.

Risk Reward – Linmon Media Ltd (9857.HK)

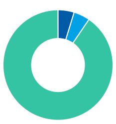
KEY EARNINGS INPUTS

Drivers	2021	2022e	2023e	2024e
No. of espisodes of S-rated dramas (Rmb, mn)	82	40	120	120
No. of episodes of A-rated dramas (Rmb, mn)	33	105	84	112
Average ASP of S-rated dramas (Rmb, mn)	9.7	9.0	9.4	10.0
Average ASP of A-rated dramas (Rmb, mn)	6.0	7.8	7.2	7.5
Content marketing revenue growth (%)	66	(0)	98	37

INVESTMENT DRIVERS

- Pace of drama capacity ramp-up
- Ability to sustain or improve drama quality
- New ad formats, overseas distribution, and ecosystem initiatives

GLOBAL REVENUE EXPOSURE



- 0-10% APAC, ex Japan, Mainland China and India
- 0-10% North America
- 90-100% Mainland China

Source: Morgan Stanley Research Estimate
View explanation of regional hierarchies here

RISKS TO PT/RATING

RISKS TO UPSIDE

- Faster expansion pace
- Better quality from S-rated dramas and smaller-scale dramas
- Greater progress on new initiatives
- Faster advertising market recovery

RISKS TO DOWNSIDE

- Slower expansion pace
- Declining quality from S-rated dramas and smaller-scale dramas
- Slower progress on new initiatives
- Slower advertising market recovery

MS ESTIMATES VS. CONSENSUS

FY 2022e

Sales / Revenue (Rmb, mn)
◆ 1,459
Note: There are not sufficient brokers supplying consensus data for this metric

EBIT (Rmb, mn)
◆ 532
Note: There are not sufficient brokers supplying consensus data for this metric

Net income (Rmb, mn)
◆ 378
Note: There are not sufficient brokers supplying consensus data for this metric

EPS (Rmb)
◆ 1.05
Note: There are not sufficient brokers supplying consensus data for this metric

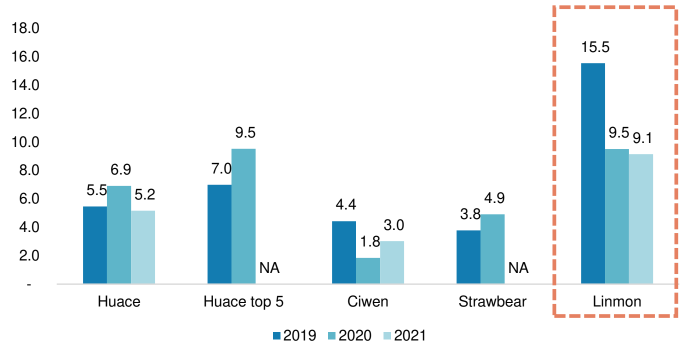
◆ Mean ◆ Morgan Stanley Estimates

Source: Refinitiv, Morgan Stanley Research

Key Charts

Exhibit 2: Linmon's focus on producing top quality dramas has garnered industry-leading ASP...

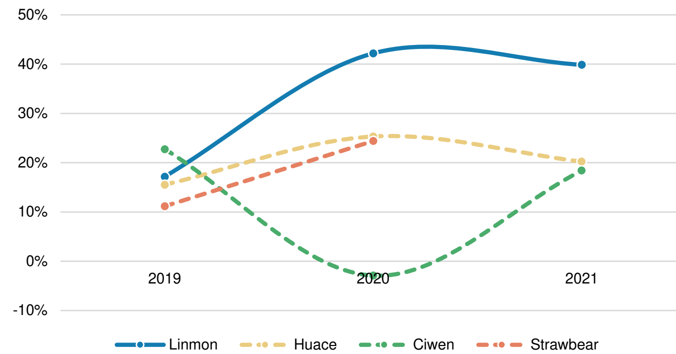
Drama ASP (Rmb mn/episode)



Source: Company data, Morgan Stanley Research.

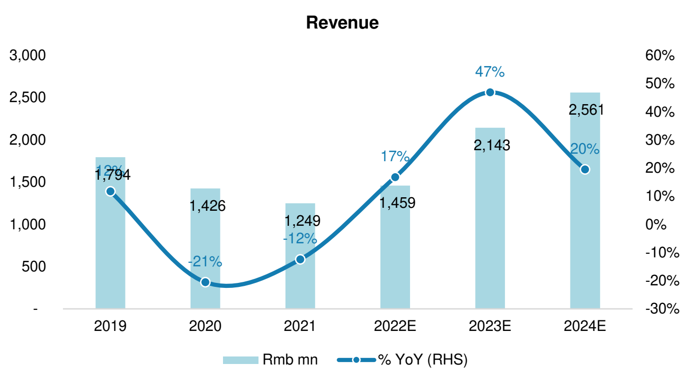
Exhibit 3: ...and healthy margins

Drama business gross margin



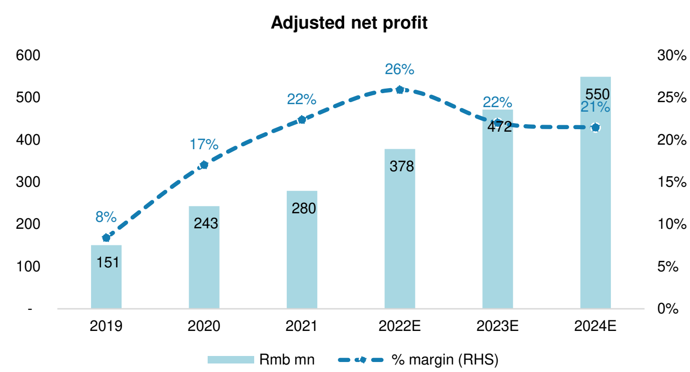
Source: Company data, Morgan Stanley Research.

Exhibit 4: We forecast revenue to grow 17% YoY in 2022 and 47% in 2023



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 5: We forecast net profit to grow 35% YoY in 2022 and 25% in 2023



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Investment Summary

We initiate coverage on Linmon Media with an Equal-weight rating and a price target of HK$26.30. Linmon is a leading drama producer based in China that focuses exclusively on top-tier content. It is especially skilled in the modern day-to-day-life genre – for example, its "*Xiao collection*" has grown into a famous intellectual property (IP) series. Although more producers are pivoting their focus toward such genres, Linmon's titles still represent a scarce and high-quality supply that attracts strong downstream demand.

Amid the healthy supply-demand dynamic, we see upside potential from Linmon's drama business in light of its capacity ramp-up, although it faces hit-or-miss risk and downstream pressures. Moreover, new initiatives in advertising, overseas distribution, and its ecosystem could yield additional upside potential, but they are not yet proven.

Investment positives

(1) Linmon's top-quality content should continue to see strong demand, which we think suggests sustained high ASP and healthy margins. We believe downstream platforms will continue to invest in its top-tier content, owing to its proven track record in user/subscriber acquisitions and the still-fierce competitive landscape. We also note that only a few other producers can match the quality of Linmon's content.

(2) Visible growth outlook driven by drama capacity ramp-up: We expect Linmon's drama production capacity to increase from three in 2021 to five in 2022 and seven in 2024, because (i) its accumulated IP reserve and established reputation could improve visibility on content performance, (ii) its healthy cash reserve and preferential cash flows (thanks to pre-selling) should mitigate any concerns on its financial health, (iii) it has developed systematic operational workflows to support its capacity ramp-up, and (iv) the supply-side landscape is benign for top-quality producers.

(3) More clarity in a low-visibility industry: Despite the hit-or-miss risk in the drama industry, we believe Linmon's high-quality content yields higher earnings visibility versus peers, considering (i) 14 of its 33 pipeline projects have been pre-sold (as of June 2022), (ii) its focus on popular day-to-day life topics should appeal to a wider audience and such content is less susceptible to regulatory concerns, (iii) the release of sequels can attract a return audience, leveraging its incubated drama IP, and (iv) Linmon has a proven track record.

(4) Expanding monetization levers: Leveraging its accumulated drama IP and advertiser client base, Linmon is leveling up its monetization efforts in content marketing areas such as product placement, customized creative ads, and integrated marketing (more ad formats and channels). We forecast content marketing revenue to remain flat in 2022 versus 2021 (due to weak macro conditions), but to grow 98% YoY in 2023. We also see upside potential from the overseas distribution of Linmon's dramas.

Investment concerns

(1) Hit-or-miss risk remains a concern, especially amid capacity ramp-up. If its miss ratio rises, Linmon's traditional core drama business could see its margins shrink for non-pre-sold dramas and a lower pre-sale rate on its future pipeline, while its other new initiatives could suffer as synergies with dramas weaken.

(2) Regulatory overhang remains as content faces increased scrutiny. The risk of potential celebrity misconduct may also not be fully manageable by the producers themselves. In addition, advertising and subscription regulation on platforms' monetization could indirectly pressure Linmon's growth.

(3) Stagnant downstream internet platforms may pressure profitability. Downstream platforms face revenue growth deceleration and near-term financial stress amid user plateau, while Linmon's drama content has not delivered significant improvement in viewership in the past two years. Thus, it could be difficult for its core drama licensing margin to expand significantly, and growth in content marketing may be hindered despite its capacity ramp-up.

(4) Gloomy advertising outlook and yet-to-be-proven integrated marketing: We expect the total ad market (especially branding ads) to remain under pressure, with low visibility on a potential recovery amid the macro uncertainty in 2022. This would significantly weigh on Linmon's content marketing growth. Visibility is also low on Linmon's integrated marketing initiatives given its lack of experience in this arena.

Initiate at Equal-weight; price target HK$26.3

We forecast respective revenue and adjusted net profit of Rmb2.1bn (+47%) and Rmb472mn (+25%) in 2023. Our growth outlook is mainly driven by drama capacity ramp-up, largely sustained drama quality, and expanding monetization levers.

We derive our price target from 18x 2023 P/E. Our target multiple is lower than (1) Huace's 3-year historical average P/E of 21-22x and the 20x that we assign, mainly reflecting Huace's larger production scale, the A-H premium, and Linmon's lower liquidity, and (2) China Literature's 3-year historical average P/E of 35-36x and the 22x that we assign, reflecting greater potential from China Lit's IP business and Linmon's lower liquidity, which we think is justified.

Investment Positives

Positive #1 – Top-quality content continues to see strong demand and high bargaining power

We see strong demand for top-quality drama content, and we believe it garners high, sustainable bargaining power, given:

Downstream's focus on top-quality content investment: Management from leading online video platforms such as iQIYI and Mango have repeatedly conveyed that top-quality content offers them higher-than-average ROI. During an iQIYI conference in September 2022, CEO Dr. Gong reiterated that the company will continue to focus on investing in core top-quality content, even amid its cost efficiency program. Top dramas also have proven track records in attracting new subscribers – iQIYI and Tencent Video have reported robust subscriber growth following the release of blockbuster drama content.

Fierce competition landscape of downstream platforms that is likely to remain as the industry's user base plateaus. Thus, we believe platforms will continue to exhibit strong demand for top-quality content to attract subscribers.

We believe Linmon garners high bargaining power, which is demonstrated by:

Proven track record: 75% of Linmon's titles were ranked in the top 20 by viewership over 2019-21, according to Frost & Sullivan.

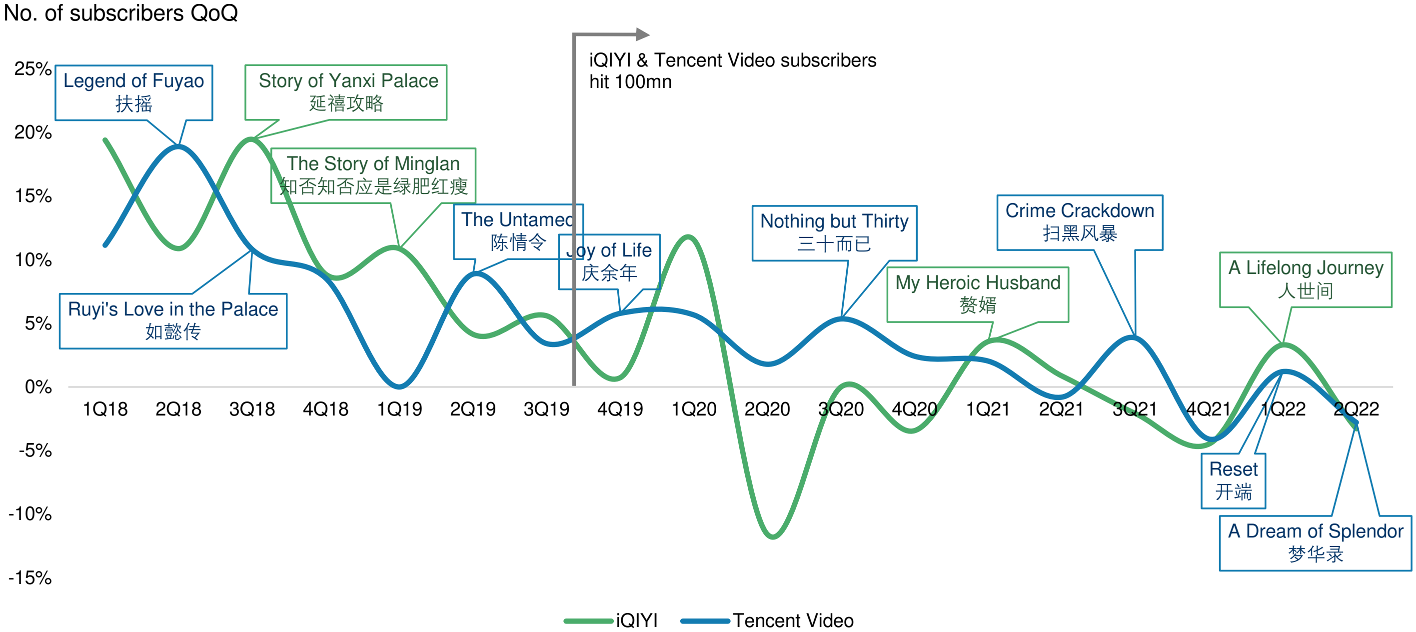
High pre-sale ratio: As of June 2022, 14 of Linmon's 33 drama pipeline assets (after concept development and before broadcasting stage) were pre-sold to platforms (see pre-selling definition in positive #3 below). Only a few top-tier peers in the industry have demonstrated an ability to achieve such a high pre-sale rate.

Leading ASP: Compared with other top drama producers, Linmon has maintained an industry-leading ASP – ~100% above Huace; ~40% above Huace's top 5 dramas; and ~280% above Ciwen, on average, over 2019-21. Moreover, Linmon sometimes earns a certain portion of income as an "extra reward" from platforms on some dramas, based on actual performance (e.g., indexed to subscriber acquisition, etc.), which is very rare in the industry.

Healthy margin: Linmon has sustained above-average margin performance – ~40% drama gross margin in 2020-21 versus peers' <25%. We note that 2019's margin was 17%, mainly due to the low margin of a large-scale costume drama.

Exhibit 6: Top dramas drive subscriber growth

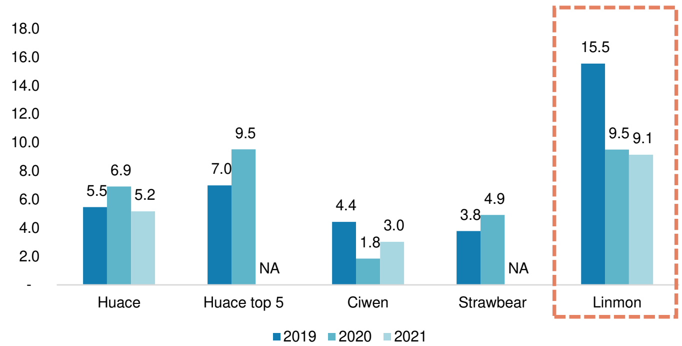
No. of subscribers QoQ



Source: Company data, Morgan Stanley Research.

Exhibit 7: Drama ASP comparison of major drama producers

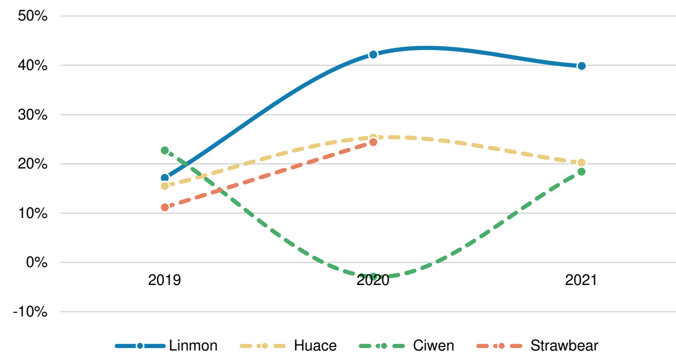
Drama ASP (Rmb mn/episode)



Source: Company data, Morgan Stanley Research.

Exhibit 8: Drama business gross margin comparison

Drama business gross margin



Source: Company data, Morgan Stanley Research.

Positive #2 – Capacity ramp-up drives visible growth

We see capacity ramp-up as a key driver for Linmon's core business growth in the near to medium term. We expect drama production capacity to gradually increase from three dramas in 2021 to five in 2022, six in 2023, and seven in 2024. We believe such targets are achievable given four main reasons:

(1) IP drama series are the low-hanging fruit: In our view, leveraging the IPs that it cultivates could provide enhanced visibility into potential content performance given the loyal viewer base and established reputation. For example, Linmon's blockbuster IP series "*Xiao collection*" is known for resonating with viewers through discussion of popular day-to-day life topics. The trilogy, centering on education topics, of *A Love for Separation (Xiao Bie Li)*, *A Little Reunion (Xiao Huan Xi)*, and *A Little Dilemma (Xiao She De)*, has built itself an influential brand-name recognition. We believe Linmon has an opportunity to expand into other trending topics, such as housing and healthcare, and replicate its "*Xiao collection*" success. Moreover, Linmon also has other similar IP collections, such as its "*20, 30, 40 age collection*" that focuses on female topics for different generations, with the two released dramas both ranking top 20 by online viewership in 2020 (per Enlightent), while several more are in the planning stage or are soon to be released.

(2) Rich internal and external resources to support:

Top-tier talent and rich external resources: Since its inception, Linmon has integrated creative talent, including directors, scriptwriters, actors and actresses onto its platform through both long-term contracting and strategic partnership arrangements. All of Linmon's co-founders have more than 15 years of industry experience. As for external resources, Linmon acquires external scripts and IP from sources such as China Literature (connected party owned by Tencent), which is a well-established online literature platform in China.

Systematic operational workflow ensures strong production capability:

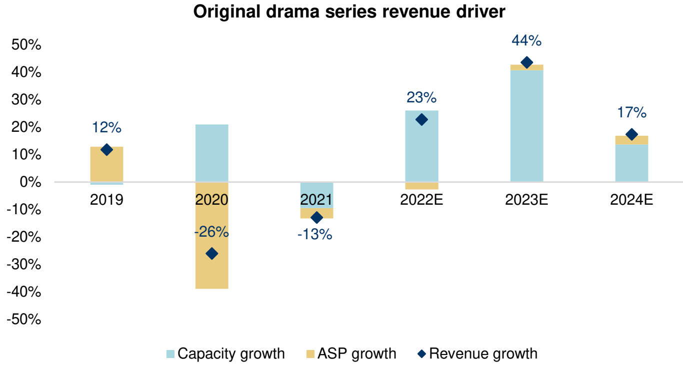
- **Script creation:** Linmon possesses various concept/script creation facilities and resources, such as an R&D center, script center, internal experts, employees, and external audience community. These rich resources have helped Linmon build an abundant IP reserve.
- **Filming:** Linmon has developed a set of strict and practical quality control standards to ensure project completion and budget schedule. Both internal and external professionals are assigned to dedicated projects at filming and post-production stages.
- **Distribution:** The promotion process starts prior to filming on various social media and video sharing platforms on an ongoing basis. Linmon also sets out a dedicated distribution strategy for each project, leveraging its effective market analysis and feedback mechanism.

(3) Sufficient cash flow: Unlike many peers that see cash flow as a main concern to their business because of the long lead time nature of content development and production, Linmon has managed to maintain a stable and healthy balance of cash and cash equivalents (including short-term financial assets) – at above ~Rmb800mn in 2019-21. The company's healthy cash flow condition is supported, in particular, by its high pre-sale ratio.

(4) Benign supply-side landscape: We believe the top players face less intense competition from peers. The number of Radio and Television Program Production and Operation Permits increased at a CAGR of 21.8% from 2016 to 2020. However, there are only 41 companies holding Class A (the highest class ranked by overall quality) TV Series Production Licenses for the period of 2021-23, according to the National Radio and Television Administration (NRTA), and this number has declined significantly over the past few years.

Cross-checking against Huace, we believe our target capacity of seven dramas in 2024 is realistic. Huace had 11-19 new dramas that started shooting in 2017-21. In addition, other top-quality players have also been ramping up their capacity since 2019, so we believe Linmon's capacity ramp-up is achievable.

Exhibit 9: Linmon: Drama revenue growth driver breakdown



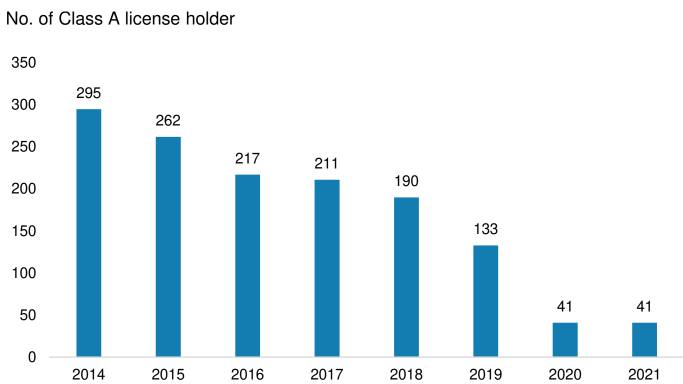
Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 10: Linmon: Rich internal and external resources to craft IP and scripts

Source	Description
IP	
R&D center	- Brainstorming ideas related to the latest social trends; - Seeking quality IPs from various sources - books, online literature, movie, etc.; - Crafting stories through workshops and seminars with scriptwriters.
Employee weekly	Internal employees meet weekly to share latest market trend and brainstorm ideas.
"Mengju" community	An external community hosting discussion panels with drama audiences.
China Literature	Online literature platform that offers vast IP selection. Linmon is a connected party.
Script	
Script center	Dedicated team, separate from R&D center.
External advisors	Providing professional opinions on draft script.
Downstream clients	Communicating with leading online video platforms and TV channels to evaluate commercial value of draft scripts and future distribution plan.

Source: Company data, Morgan Stanley Research.

Exhibit 11: Number of Class A license holders has declined significantly



Source: National Radio and Television Administration (NRTA), Morgan Stanley Research.

Exhibit 12: Number of episodes of top-quality players

No. of episodes (book revenue)	2017	2018	2019	2020	2021	2022E	2023E	2024E
Linmon		106	105	127	115	145	204	232
Huace	562	632	362	494	613	560	578	594
Ciwen	147	229	255	180	125			
Strawbear	88	93	151	105				
New Classics Media	227	169	191	170	248	280	300	320

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates. Note: Strawbear drama refers to self-made licensing drama. New Classics Media is China Literature's subsidiary.

Positive #3 – Offering more clarity in a low-visibility industry

Content producers typically see uncertainty on the return of content and cash flow because of embedded hit-or-miss risk and long production periods (normally 32-48 months from concept development to broadcasting). However, we believe Linmon offers better visibility, thanks mainly to four factors:

(1) Pre-selling: Pre-selling refers to the sale of drama series to online video platforms prior to, or shortly after, the commencement of filming and before the completion of scripts owing to the high content quality. Specifically, in the second half of each year, Linmon provides a pre-sale list showing the names and outlines of all the drama series that are under development to potential customers. Linmon enters into pre-sale agreements with customers that are interested in such drama series and secures prepayments in advance. Much of its content is pre-sold to platforms/TV channels, even in early development stages. This alleviates concerns about overstocked inventory and potential inventory writedown risk. 14 of its 33 future pipeline (after concept development and before broadcasting stage) dramas have been pre-sold as of June 2022.

(2) Focus on day-to-day life topics: Linmon's content often centers on the popular day-to-day life topics and promotes positive social values. We believe such content is less susceptible to regulatory concerns amid ongoing regulatory tightening. Further, we believe the social topics on which Linmon focuses resonate with viewers. This helps Linmon garner a large viewer base by stimulating viewers' interests. In turn, these dynamics enhance visibility on a drama's potential performance, helping to mitigate hit-or-miss risk.

(3) Sequels: Leveraging its incubated drama IP, the production of a sequel and collection series can attract a return audience, offering better visibility on a new series' potential viewership performance.

(4) Track record: Linmon's good track record of delivering top-quality content, evidenced by its sustained high viewership drama series rate, should also enhance confidence in the potential of its productions, in our view.

Exhibit 13: Top five drama producers, by high viewership drama series rate, in China

2021

Ranking	Company	Rate
1	Company B	80%
2	**Linmon**	**67%**
3	Company A	33%
4	Company C	0%
5	Strawbear	0%

2020

Ranking	Company	Rate
1	Company C	100%
2	**Linmon**	**100%**
3	Company B	25%
4	Company A	23%
5	Strawbear	17%

2019

Ranking	Company	Rate
1	Company C	100%
2	Company B	50%
3	**Linmon**	**50%**
4	Strawbear	33%
5	Company D	27%

Source: Frost & Sullivan, company data, Morgan Stanley Research.

Positive #4 – Expanding monetization levers

We see potential new monetization levers both domestically and internationally, leveraging its incubated IP and expertise in production and idea creativity.

Domestic drivers

Domestically, we see potential from its marketing initiatives:

Product placement advertising: We forecast revenue to grow from Rmb85mn in 2021 to Rmb121mn in 2023, representing a 20% CAGR, mainly driven by more brands served along with drama capacity ramp-up, but also dragged by near-term advertising market headwinds. As we expect Linmon to step up its production scale, its placement ad inventory should increase in tandem. The average placement ad revenue per drama was Rmb25mn/19mn/28mn in 2019/2020/2021.

Customized creative advertising: Beyond traditional product placement ads, Linmon also offers other formats of customized ads displayed on online video platforms, such as in-stream ad ("mini theatre"), which has become another popular video ad format in recent years. We forecast revenue to grow from a low base of Rmb12mn in 2021 to Rmb43mn in 2023, representing an 88% CAGR.

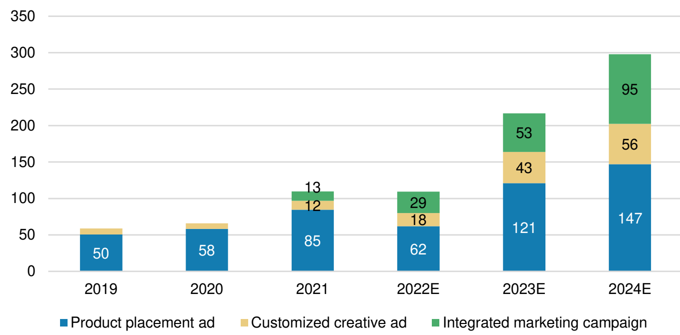
Integrated marketing: Linmon first started expanding into this field in 2021. Unlike traditional product placement ads, integrated marketing services provide innovative marketing solutions to clients on various different channels beyond long video platforms (such as social networks and short video platforms). Integrated marketing services are project-based in nature, and the details of the campaigns vary significantly depending on the project – for example, producing short video content based on Linmon's drama IP and releasing such content on social platforms and short video platforms. In addition, integrated marketing's revenue upside is not constrained by the number of drama releases – whereas we believe that a traditional product placement ad's effectiveness is likely to decline after surpassing a threshold of ad load. We see promising potential in advertiser demand for such a comprehensive promotion service. Taking "*Xiaomin's House*" as an example, after the drama was broadcast, many of its content advertisers also carried out various promotional activities on other channels, such as topic discussion panels on Weibo, and marketing events on Tmall and Hema (e-commerce platforms). We believe Linmon's expertise bodes well for its potential to capture such demand, as it knows its content well and already has good relationships with the advertisers – Linmon served a total of 61 brands in 2021, up from 29 in 2019 and 37 in 2020 (for its overall content marketing business). In the near term, we believe this business will mainly leverage the influence of its own drama IPs – providing drama-related content advertising solutions. While, in the long term, if Linmon manages to build its know-how and reputation in this field, we believe the service could expand further, which does not necessarily require integration with its own dramas (e.g., could be third-party dramas, or not related to drama at all) – suggesting much greater upside potential. Furthermore, we believe Linmon's approach in the field is a natural expansion step given the influence of its established drama IP and its content's presence on short video platforms and other media. We forecast revenue to grow from a low base of Rmb13mn in 2021 to Rmb53mn in 2023, representing a 101% CAGR.

International drivers

Internationally, we believe market upside could be substantial, given that Chinese content producers are in the very early stage of overseas expansion. For example, Netflix and Disney have two times more subscribers internationally than domestically as of end-2021. We believe Linmon is well placed to capture the upside potential overseas, owing to its influential content, overseas distribution track record, and ongoing collaboration with leading foreign platforms. Nonetheless, we believe it will take some time before Linmon's international initiatives see any breakthrough because of the underdeveloped business model and the granularities and challenges underlying foreign distribution. We forecast its overseas distribution ASP to rise from Rmb0.1mn in 2021 (MSe) to Rmb0.2mn by 2023.

Exhibit 14: Linmon: Content marketing revenue breakdown

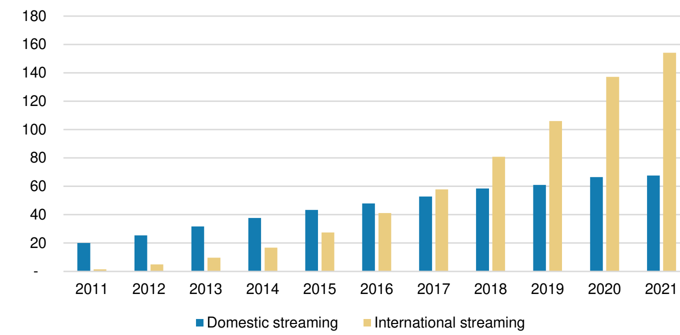
Content marketing revenue breakdown (Rmb mn)



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 15: Netflix: Domestic and international subscribers

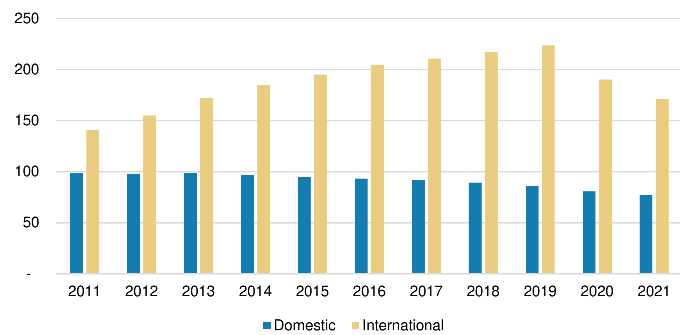
Netflix paid subscribers (mn)



Source: Company data, Morgan Stanley Research.

Exhibit 16: Disney channel: Domestic and international subscribers

Disney channel subscribers (mn)



Source: Company data, Morgan Stanley Research.

Investment Concerns

Concern #1 – Hit-or-miss risk lingers

In an industry with embedded hit-or-miss risk, we do not believe Linmon is fully shielded despite its strong track record in high-viewership drama. More specifically, we think it would be difficult to maintain a high hit ratio while production capacity scales up significantly, as:

(1) We have low visibility on the dramas' quality after Linmon's capacity ramp-up – delivering more top-tier scripts could be a challenging task, while the expertise of new production teams also remains uncertain.

(2) Linmon's high viewership rate is starting from a high base and sustaining it could be challenging.

We are concerned about the following potential consequences of a rising miss ratio:

(1) Margin compression: Although 42% of its future drama pipeline has signed pre-sale contracts (after concept development and before broadcasting stage), a declining quality rate could still affect pre-sold dramas' extra reward revenue mechanism and other non-pre-sold dramas' ASP, and we could see Linmon's margin deteriorate from ~40% currently toward the peer average of <25%.

(2) More stressed cash flow: We expect Linmon's pre-sale rate to decline especially in the outer years if the miss ratio were to rise. This is mainly a concern from a cash flow perspective.

(3) Weakened synergies: Beyond the impact on the drama business, its content marketing initiatives would also be negatively affected, as the proprietary advantage of these businesses centers on drama IPs' influence.

In addition, despite the fact that top-quality content has a generally higher hit ratio, we believe downstream platforms will demand a higher standard going forward, as they pivot the emphasis to investment efficiency and profitability.

Concern #2 – Regulatory concerns remain

In 2021, a series of regulatory tightening measures were introduced in China's long-video industry. We believe both direct and indirect regulatory impacts are likely to linger.

In terms of direct regulation on the drama industry, we see tightening mainly on two fronts:

(1) On the content front, regulators have increasingly emphasized the importance of promoting positive and healthy social values through content, and they caution against "overly entertaining" content. Under such tightening, we expect the drama review and approval process will see increased scrutiny and might be prolonged, evidenced by the fact that many platforms experienced drama pipeline scheduling delays in 2H21, likely due to a longer/stricter approval process. We also expect such tightened oversight to remain in the medium term.

(2) On the celebrity front, regulators have put in stricter oversight on potential celebrity misbehavior since 2021, and we expect they will continue to do so. We believe companies have to be more cautious in cast selection, conduct more background checks, and sign more stringent contracts, among other precautions, which may not be easy to implement.

In terms of indirect regulation, we see potential impacts arising from:

(1) Advertising regulation: This remains an overhang in the near term, in our view, as it could weigh on downstream platforms' monetization and thus pressure upstream players. In November 2021, The State Administration for Market Regulation (SAMR) drafted rules on online ad oversight. The proposed rules reiterated pop-up ad guidelines to ensure that users can close pop-up ads with one click, among other measures. We have low visibility on implementation details for video pre-roll ads. Separately, the implementation of the Personal Information Protection Law (PIPL), which came into effect in November 2021 and has a broad impact on online marketing, could also affect downstream platforms' monetization.

(2) Subscription extra charge: In October 2021, iQIYI, Tencent Video, and Youku all announced that they will cancel drama advance previews. This came after the China Consumers Association (CCA) called for the protection of online video VIP membership privileges. We see such a guideline weighing on online platforms' subscription monetization, especially blockbuster content's monetization.

Exhibit 17: Regulation timeline

May 2021	*Content, celebrity*	iQIYI's idol audition show *Youth with You 3* suspended by government.
Jun 2021	*Celebrity*	Cyberspace Administration of China (CAC) started a two-month review of online media/social networks.
Aug 2021	*Content*	National Radio and Television Administration (NRTA) conducted a month-long review of online variety shows and released a document outlining regulation guidelines.
Aug 2021	*Celebrity*	Cyberspace Administration of China (CAC) issued a notification to rectify what it described as chaotic celebrity fan culture, ordering platforms to remove celebrity rankings, regulate fan organizations and discipline fan behavior.
Aug 2021	*Content, Celebrity*	iQIYI's founder and CEO, Dr. Yu Gong, stated that iQIYI will cancel idol talent shows and offsite voting features on the platform for the next few years.
Sep 2021	*Subscription, Advertising*	China Consumers Association (CCA) opined that online video platforms should 1) ensure certain early access privileges for existing VIP members who have been subscribing prior to the industry-wide launch of advance previews last year; 2) avoid deliberately slowing down updates of episodes to promote advance previews; 3) provide members with more advance preview options; 4) comply with advertising law and eliminate illegal push ads to protect ad-free membership privileges; and 5) specify auto-renewal notifications and changes in terms of service.
Oct 2021	*Subscription*	iQIYI, Tencent Video, and Youku all announced that they will cancel drama advance previews.
Oct 2021	*Content*	Hunan Broadcasting Group suspended variety show *Happy Camp* as it undergoes revisions.
Nov 2021	*Advertising*	State Administration for Market Regulation (SAMR) issued a statement seeking feedback on draft rules to improve online ads supervision. The proposed rules reiterated pop-up ad guidelines to ensure users can close by one-click.

Source: Sina, Xinhua Net, Morgan Stanley Research.

Concern #3 – Stagnant growth of downstream platforms may pressure profitability

Linmon generates a majority of its revenue from internet long-video platforms (e.g., >75% of its original drama licensing revenue over 2019-21). While downstream internet platforms see growth deceleration, we believe it would pressure Linmon's profitability as (1) it may be difficult for core drama licensing margin to expand significantly, and (2) content marketing initiatives growth may be hindered.

Growth deceleration for platforms:

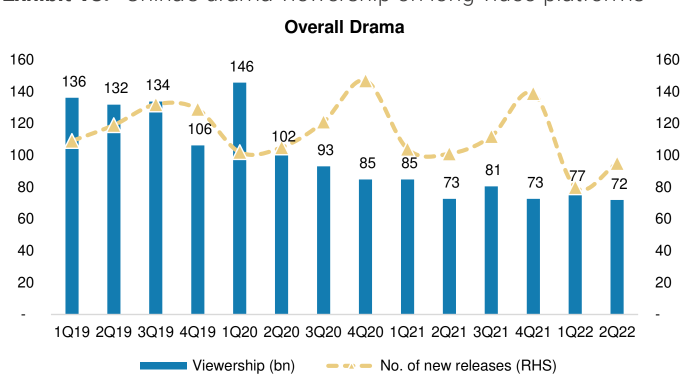
- **Declining viewership:** For the overall industry, drama viewership has exhibited a clear downward trend since 2019 (except in 1Q20 due to the positive stay-at-home impact), according to data from Enlightent.
- **Stagnant userbase:** iQIYI and Tencent Video (the top two long-video platforms in China in terms of users) both saw their MAU remain largely stagnant over the past two years, while Youku's (the No.3 long-video platform in China) MAU shrank significantly before stabilizing since mid-2020, according to data from QuestMobile. In terms of paid subscribers, iQIYI and Tencent Video have seen subscriber growth deceleration after their subscribers both hit 100mn in 2H19.
- **Focus on efficiency:** In 2022, both iQIYI and Tencent Video specified their goal to focus more on efficiency and profitability, through strict cost controls. They are taking a more stringent stance on content investment, although investment in top content is less affected.

Stagnant viewership growth in Linmon's content: Over 2019-21, Linmon's dramas did not show any improvement in viewership, albeit industry viewership has declined as well, according to Enlightent. We do not expect its overall viewership to improve meaningfully, given the lingering hit-or-miss risk. That said, it is difficult to see any increase in the content ROI it offers to platforms.

Considering both downstream platforms' growth deceleration and stagnant viewership, we are concerned about:

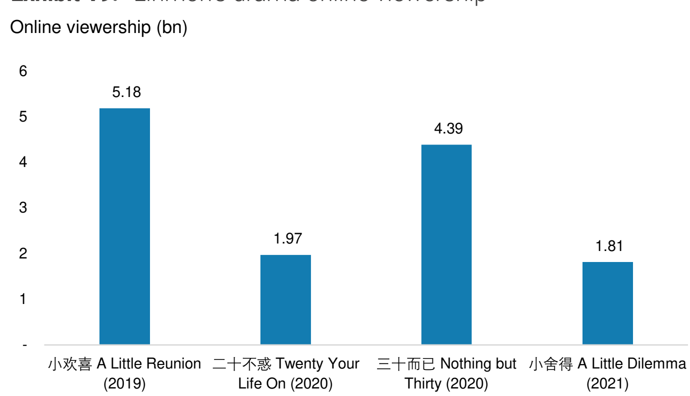
- **Stagnant margin from core drama licensing**, as (1) it is difficult to see an increase in the content ROI Linmon offers to platforms, and (2) platforms are taking a more stringent stance on content investment after China's regulatory reset in 2021, although we expect the impact to be milder for top-quality content.
- **Hindered growth of content marketing**, as the core of this business depends heavily on the content's influence, which is not likely to be enhanced from a high base currently. Nonetheless, we see Linmon's expansion into short video and other content formats as an effective self-help initiative.

Exhibit 18: China's drama viewership on long video platforms



Source: Enlightent, Morgan Stanley Research.

Exhibit 19: Linmon's drama online viewership



Source: Enlightent, Morgan Stanley Research. Note: Only includes viewership during the first year of release.

Concern #4 – Gloomy advertising market outlook and yet-to-be-proven integrated marketing

We foresee a weak overall ad market significantly weighing on Linmon's content marketing growth. Moreover, we have limited visibility on Linmon's integrated marketing initiative, given a lack of track record.

Gloomy ad market outlook: We have limited visibility on the potential recovery trend, given a gloomy macro outlook and uncertain Covid exit. Under such an ad market downcycle, we expect branding ads will be under more pressure than performance ads, as advertisers tend to allocate their limited ad budgets to ad formats that offer greater efficiency. This will significantly weigh on Linmon's overall content marketing growth in 2022 and potentially beyond that.

Integrated marketing has yet to be proven: We view Linmon's approach into providing a more comprehensive set of marketing services on new channels, such as social networks and short-video platforms, as an upside risk, leveraging its IP. Nonetheless, its influence on these new channels has not yet been demonstrated, and its business model has not yet been proven.

Earnings Forecasts

Base case forecasts

Revenue to increase 47% YoY in 2023

We forecast revenue to grow from Rmb1.2bn in 2021 to Rmb1.5bn in 2022 (+17% YoY) and Rmb2.1bn (+47% YoY) in 2023, mainly driven by visible growth in the core drama business and a second growth engine from content marketing. The key assumptions behind our revenue forecasts are:

Original drama series to grow 23% to Rmb1.3bn in 2022 and 44% to Rmb1.9bn in 2023, mainly driven by capacity improvement (from 115 episodes in 2021 to 204 episodes in 2023). We view this segment as offering the most stable and visible growth amongst its business lines.

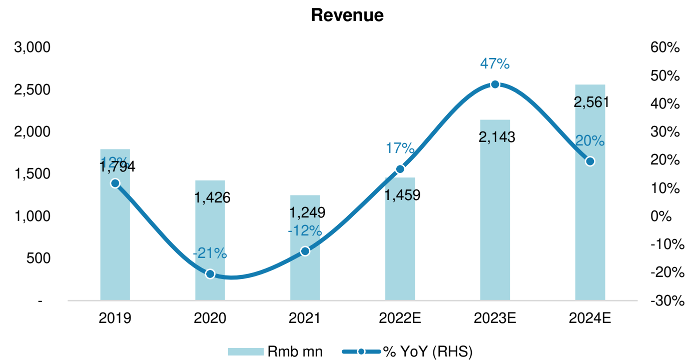
Content marketing to remain flat at Rmb109mn in 2022 mainly due to weak ad market conditions, but grow 98% to Rmb217mn in 2023 - consisting of Rmb121mn (+95%) from product placement ads, Rmb43mn (+139%) from customized creative ads, and Rmb53mn (+80%) from integrated marketing campaigns. The growth will be mainly driven by the capacity ramp-up in drama and expanded service offerings in integrated marketing.

Net profit to expand 25% YoY in 2023

The key assumptions behind our **gross margin** forecasts are:

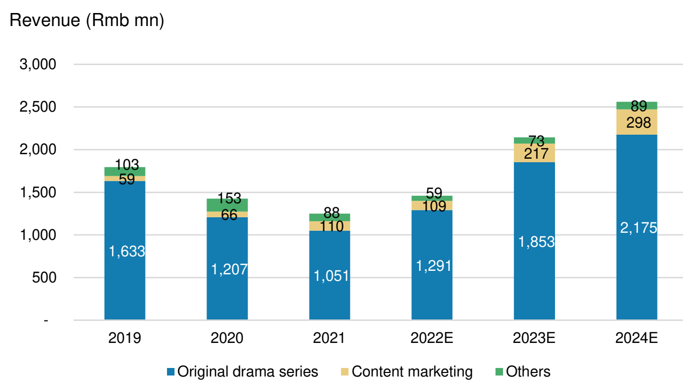
- **Original drama series:** We assume gross margin fluctuates slightly, between 45-46% in 2022-23, mainly due to the differences in each year's pipeline mix (of S-rated and A-rated dramas). But, regardless of the pipeline differences, we believe overall margin should remain stable because (1) top-quality content will continue to see strong demand, (2) cost is not likely to decrease meaningfully as Linmon prioritizes quality, and (3) ASP is not likely to increase meaningfully, as noted previously.
- **Content marketing:** We expect overall margin to gradually decline from 57% in 2021 to 42% in 2023, as the mix of lower-margin business increases. (1) We expect product placement ad margin to decline to 60% in 2022-23, versus >70% in 2019-21 (per our estimate), as drama directors and casts are taking more commissions from such revenues. (2) We assume the customized creative ad margin is ~20% in 2022-23. (3) Our integrated marketing margin forecasts are ~20-30% for 2022-23.

Exhibit 20: Linmon: Revenue growth



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 21: Linmon: Revenue breakdown



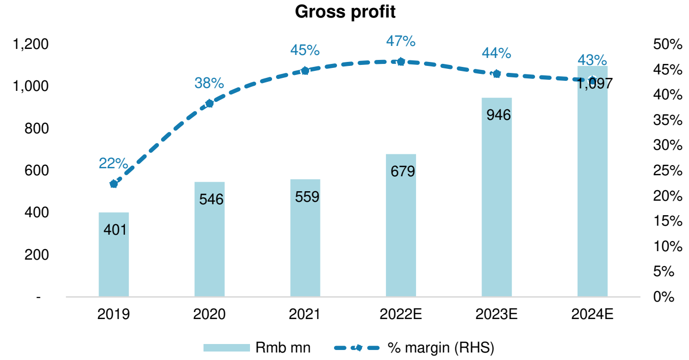
Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

We expect **S&M expense** as a percentage of revenue to remain largely stable at 8-9% over 2022-23. For marketing & promotion expense (accounting for ~80% of total S&M expense), we expect per-drama expense to gradually fall over the long term, mainly as Linmon becomes more well-known. Also, the introduction of collections and sequels should require lower promotion expenses owing to previous series' return audiences.

We project **G&A expense** as a percentage of revenue should remain high at 15.4% in 2022, versus 5-7% in 2019-20 and 13% in 2021, because of the administrative and operational needs arising from drama's capacity ramp-up and the various new business initiatives. But, we expect G&A expense as a percentage of revenue to gradually decline, to 9-10% in 2023-24, thanks to economies of scale.

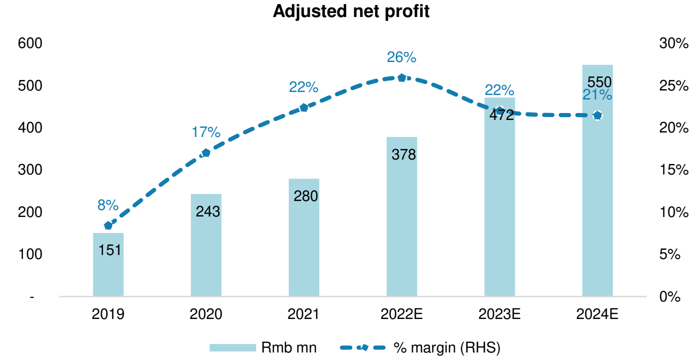
We forecast gross profit growth of 21% in 2022 and 39% in 2023, and net profit growth of 35% in 2022 and 25% in 2023.

Exhibit 22: Linmon: Gross profit and margin



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 23: Linmon: Net profit and margin



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

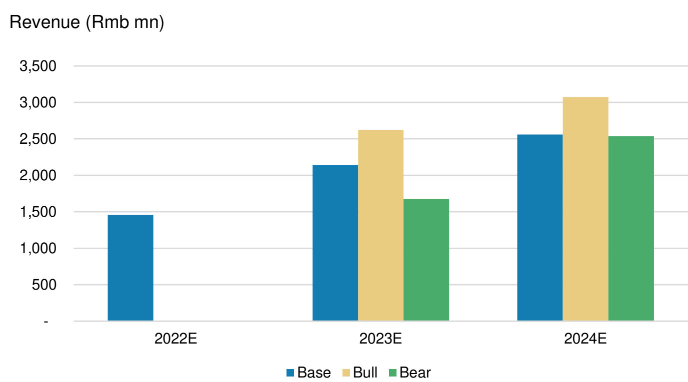
Scenario forecasts

In our scenario analysis, we mainly forecast faster/slower expansion on the back of execution tailwinds or risks and higher/lower ASP on the back of hit-or-miss risk and pressures from downstream platforms.

In our bull case, we forecast stronger revenue growth of 80% and net profit growth of 70% in 2023.

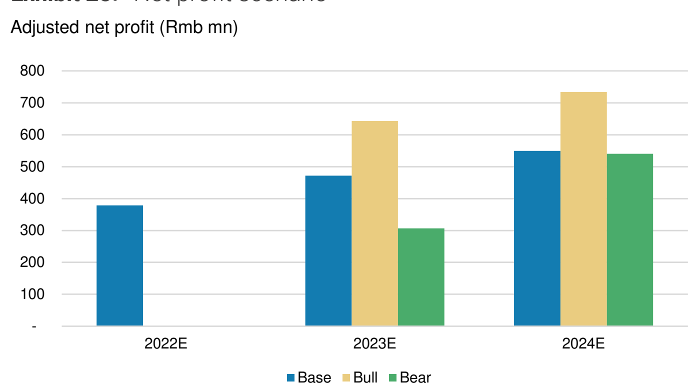
In our bear case, we forecast weaker revenue growth of 15% and net profit decline of 19% in 2023, mainly due to project delays.

Exhibit 24: Revenue scenario



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 25: Net profit scenario



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Valuation

We derive our price target from a target 2023 P/E of 18x. We believe this is justified given: **(1)** This multiple is lower than Huace's 3-year historical average of 21-22x and the 20x we assign to it, as Huace has larger production scale while Linmon has not yet proven itself in terms of capacity ramp-up. Moreover, we believe Linmon should trade below Huace due to the A-H premium and Linmon's lower liquidity (HK$5mn ADTV); and **(2)** Our target multiple is also lower than China Literature's 3-year historical average P/E of 35-36x and the 22x we assign to it, due to China Lit's stronger potential from IP business and Linmon's lower liquidity.

Exhibit 26: Linmon: P/E valuation scenario

P/E

2023E (HK$)	Bear
Target P/E (2023e)	17
Adjusted EPS (2023e)	0.95
Value per share	16.12
Bear case	**16.10**

2023E (HK$)	BASE
Target P/E (2023e)	18
Adjusted EPS (2023e)	1.46
Value per share	26.28
Price target	**26.30**

2023E (HK$)	Bull
Target P/E (2023e)	22
Adjusted EPS (2023e)	1.99
Value per share	43.78
Bull case	**43.80**

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 27: Valuation comparison of China entertainment stocks

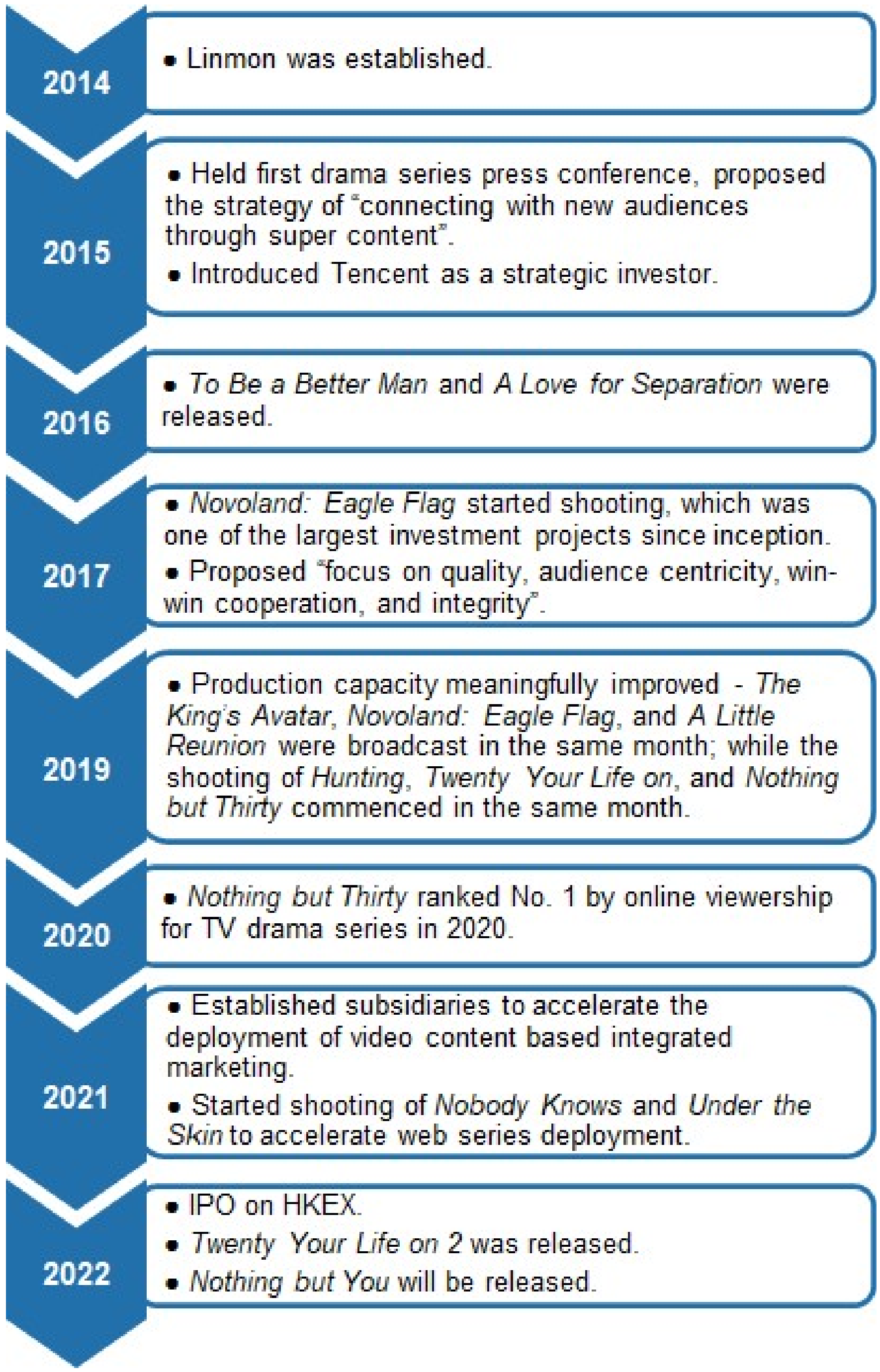
	NTM Normalized P/E			
Company	3yr avg.	5yr avg.	22E	23E
Offshore				
China Literature	35.3	35.1	16.1	14.3
Strawbear Entertainment	11.6	11.6	5.1	5.4
Maoyan Entertainment	14.4	14.0	11.6	8.8
Alibaba Pictures	62.3	67.4	36.9	24.3
IMAX China	16.0	17.3	16.7	6.9
Tencent	26.5	28.1	27.3	21.6
NetEase	20.7	21.7	20.2	19.2
Tencent Music Entertainment	25.0	26.4	11.9	11.6
Average	*26.5*	*27.7*	*18.2*	*14.0*
Median	*22.9*	*24.0*	*16.4*	*12.9*
Onshore				
Zhejiang Huace	21.5	21.4	25.6	21.2
Ciwen Media	17.3	15.9	NA	NA
Mango Excellent Media	40.7	37.6	22.4	19.7
Wanda Film	28.0	27.1	NA	25.2
China Film	26.5	24.6	139.4	31.8
Beijing Enlight Media	31.9	28.2	44.9	28.4
Huayi Brothers	76.8	51.2	NA	49.8
Perfect World	18.0	18.1	17.9	14.3
37 Interactive Entertainment	18.6	17.3	13.3	11.9
G-bits Technology Network	19.8	18.3	12.2	12.0
Focus Media	22.0	21.1	24.1	15.5
Average	*30.0*	*25.9*	*39.2*	*23.2*
Median	*24.3*	*22.8*	*22.4*	*19.7*

Source: Refinitiv, Morgan Stanley Research. E = Morgan Stanley Research estimates, except for Strawbear and Ciwen forecasts, which are consensus estimates. Note: Prices as of October 10, 2022.

Company Overview

Founded in 2014, Linmon is a leading content production company in China that focuses on creating high-quality drama series, especially based on its proprietary IPs. Linmon has established industry-leading advantages in its core drama production business, which accounted for 84% of total revenue in 2021. Beyond its core, it is also expanding into new business areas within the content marketing field as a second growth driver, leveraging proprietary IPs.

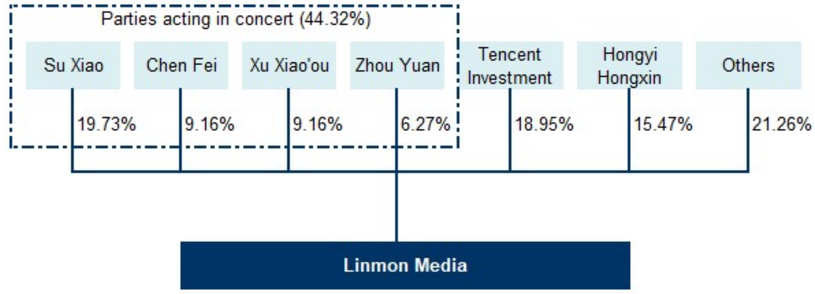
Exhibit 28: Linmon: History and key milestones



Source: Company data, Morgan Stanley Research.

Linmon is led by its four co-founders who all possess 15+ years of experience in the industry. Chairman Mr. Su Xiao and CEO Ms. Chen Fei were both leaders at Shanghai Media Group's (SMG; a leading provincial TV group in China) content departments previously. The four co-founders (deemed parties acting in concert) collectively own 44.32% of the company (August 2022). Other substantial shareholders include Tencent (18.95%) and Hongyi Hongxin (Hony Capital) (15.47%).

Exhibit 29: Linmon: Shareholding structure as of August 2022



Source: Company data, Morgan Stanley Research.

Exhibit 30: Linmon: Management biography

Directors	Age	Date of joining	Position	Responsibility
Su Xiao	51	Jul 2014	Executive Director, chairman of the Board and president	Responsible for the Group's overall strategic planning, financial and talent management and government public affairs
Chen Fei	41	Sep 2014	Executive Director and chief executive officer	Responsible for the Group's strategy and organization innovation and full chain management, including product positioning planning and distribution and marketing
Xu Xiao'ou	49	Sep 2014	Executive Director and vice president	Responsible for intellectual property development, script development and production
Zhou Yuan	43	Jul 2014	Executive Director and vice president	Responsible for film business, overseas business, capital operation, commercialization and innovative business
Sun Zhonghuai	49	Jul 2018	Non-executive Director	Providing professional advice to the Board
Zhang Rong	37	Jan 2021	Non-executive Director	
Long Yu	49	Dec 2020	Independent non-executive Director	Supervising and offering independent judgment to the Board
Jiang Changjian	56	Dec 2020	Independent non-executive Director	
Tang Songlian	40	Jan 2021	Independent non-executive Director	

Source: Company data, Morgan Stanley Research.

Business segments

Linmon's business can be broken down into three main segments – original drama series, content marketing, and others.

Original drama series: This has been Linmon's key focus since inception. The company produces high-quality drama series and licenses the related broadcasting rights mainly to top domestic and overseas online video platforms and TV channels. Linmon typically retains the copyrights of the series for future monetization opportunities. In 2019, 2020, and 2021, it released a respective 2, 3, and 3 original drama series, and we believe it has room to further expand. Linmon's dramas are mainly modern genres that focus around popular day-to-day life topics.

Exhibit 31: Limon: Original drama series pipeline details

Title		Release date	Episodes	Release platform		2019-1Q22 Revenue (Rmb mn)	
				Online platform	TV channel	Original drama	Content marketing
Released pipeline							
好先生	To Be a Better Man	5/1/2016	42	LeTV	Beijing, Zhejiang, Jiangsu	-	-
小别离	A Love for Separation	8/1/2016	45	Tencent	Zhejiang, Beijing, Jiangsu	2	-
择天记	Fighter of the Destiny	4/1/2017	52	iQIYI, Mango, Youku	Hunan	-	-
南方有乔木	Only Side by Side with You	3/1/2018	40	Tencent	CCTV, Jiangsu, Zhejiang	2	-
扶摇	Legend of Fuyao	6/1/2018	66	Tencent	Zhejiang	-	-
九州缥缈录	Novoland: Eagle Flag	7/1/2019	56	Youku	Zhejiang	1,006	5
小欢喜	A Little Reunion	7/1/2019	49	iQIYI	Dragon, Zhejiang	624	54
猎狐	Hunting	4/1/2020	44	Youku	Dragon, Beijing	429	14
二十不惑	Twenty Your Life On	7/1/2020	40	iQIYI	Hunan	357	15
三十而已	Nothing but Thirty	7/1/2020	43	Tencent	Dragon	430	38
小舍得	A Little Dilemma	4/1/2021	42	iQIYI	CCTV, Dragon	426	54
陪你逐風飛翔	To Fly with You	11/22/2021	33	Tencent	Hunan	223	13
小敏家	Xiaomin's House	12/11/2021	40	Youku	Hunan	426	50
超越	Beyond	1/9/2022	29	iQIYI, Tencent, Youku	CCTV, Dragon	300	5
獵罪圖鑑	Under the Skin	3/6/2022	20	iQIYI	NA	124	1
膽小鬼	Nobody Knows	8/8/2022	16	Youku	NA		
二十不惑2	Twenty Your Life On 2	8/17/2022	40	iQIYI, Mango	Hunan TV		
Future pipeline							
爱情而已	Nothing but You	4Q22					
赤子之心	Utter Innocence	Mar-23	40				
一念关山	Yinian Moutain Guan	Aug-23	40				
小欢喜2	A Little Reunion 2	Dec-23	40				
宸宫	Palace of Chen	Oct-24	40				
四十正好	Fourty is Just Right	Nov-24	40				
小宅门	The Small Mansion Gate	Dec-24	40				
月明千里	The Moon Shines Bright	Dec-24	40				
...and 23 more pipeline under script development or pre-production							

Source: Company data, Morgan Stanley Research.

Exhibit 32: Limon: Original drama series pipeline

Source: Company data, Morgan Stanley Research.

Exhibit 33: Limon: Examples of product placement ads

Source: Company data, Morgan Stanley Research.

Content marketing: We expect this segment to deliver the fastest revenue growth from a low base in 2021, and it can be broken down into three sub-segments:

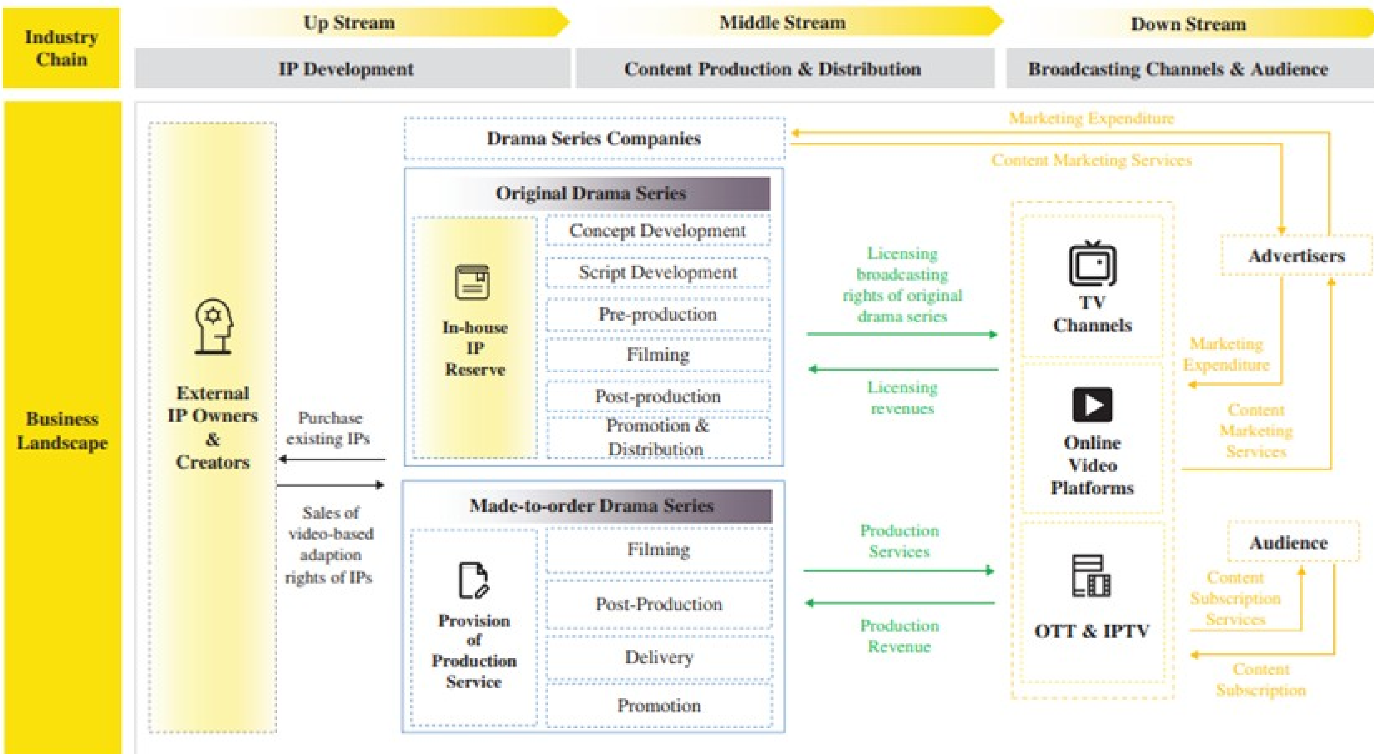
- **Product placement** is a traditional ad format that seamlessly integrates advertisers' products or services with a drama's storyline and scenes. Growth in this segment is largely driven by drama supply and the perceived quality of the drama.
- **Customized creative advertisements** include ad formats beyond product placement on online video platforms, such as in-stream ads ("mini theatre"), which has been a popular format in recent years.
- **Integrated marketing campaign** is a service newly introduced by Linmon that offers marketing on other new channels beyond long video platforms, such as short video and social networks.

Other revenue sources mainly include film production, made-to-order drama, drama investment, IP derivatives, and others.

Industry Overview

Industry value chain

Exhibit 34: China drama series industry value chain, 2022



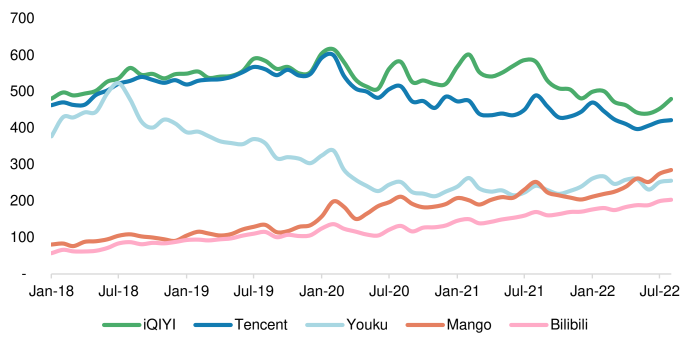
Source: Frost & Sullivan.

Upstream mainly consists of the suppliers of production elements, such as IP, scripts, actors, and crew. For IP, most drama IP adaptation is from online literature work, mainly owned by online literature platforms such as China Literature.

Downstream customers mainly include TV stations and online platforms. Over the past decade, we have seen an ongoing structural shift of viewer preference from linear channels (cable TV channels) to non-linear channels (online platforms, IPTV, OTT TV), and we expect the trend to continue. For online video platforms, after years of fierce competition, many players have exited the market (such as LeTV) or faded away (such as Sohu Video). Currently, the market mainly has iQIYI and Tencent Video as the incumbents with ~500-600mn MAU, while Youku and Mango are catching up with ~200-300mn MAU, according to QuestMobile. Thus, amid the plateaued industry user base and time spent, we still see fierce competition amongst the four platforms.

Exhibit 35: MAU of major long-video platforms

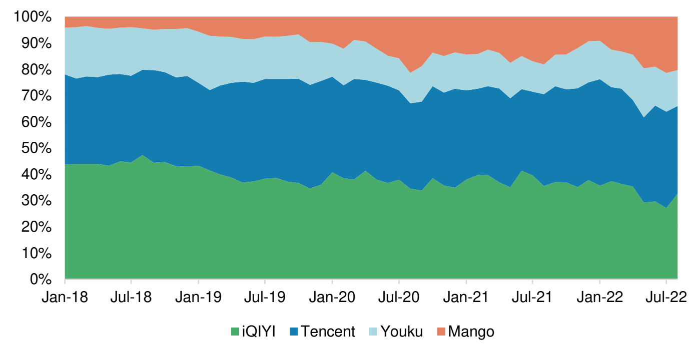
MAU of major long-video platforms (mn)



Source: QuestMobile, Morgan Stanley Research.

Exhibit 36: User time spent market share of major long-video platforms

% Monthly time spent share



Source: QuestMobile, Morgan Stanley Research.

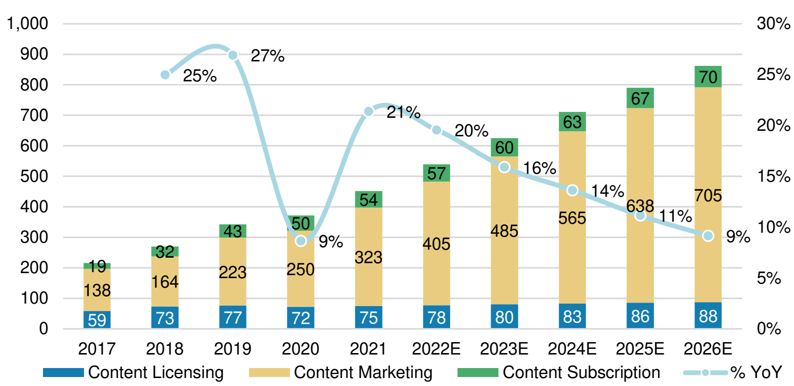
Industry forecasts

China's video-based content market is expected to grow 20% YoY to Rmb540bn in 2022, with a 12% CAGR over 2022-26 versus a 20% CAGR over 2017-21, according to Frost & Sullivan.

By revenue type, the content licensing industry, i.e., the main revenue source for content producers, is expected to grow at 4% YoY to Rmb78bn in 2022, with an 3% CAGR over 2022-26, according to Frost & Sullivan. Within the market, drama content licensing is anticipated to account for ~60% in 2017-26. The drama licensing market is expected to grow 4% YoY to Rmb44bn in 2022, with a 4% CAGR over 2022-26, per Frost & Sullivan.

Exhibit 37: China's video-based content market

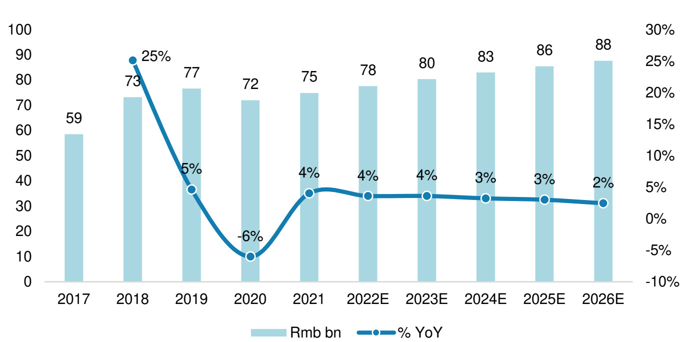
China video-based content market (Rmb bn)



Source: Frost & Sullivan, Morgan Stanley Research. E = Frost & Sullivan estimates.

Exhibit 38: China's content licensing industry

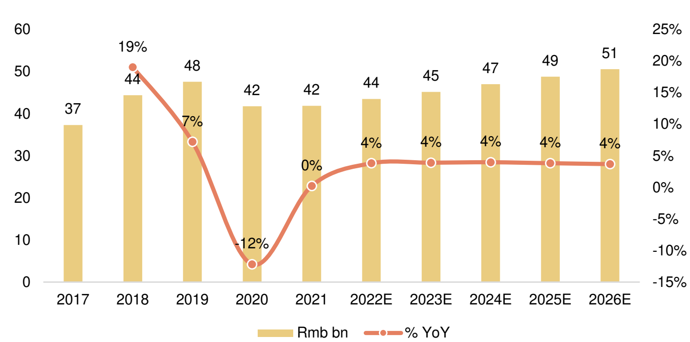
China's content licensing market



Source: Frost & Sullivan, Morgan Stanley Research. E = Frost & Sullivan estimates.

Exhibit 39: China's drama licensing industry

China's drama licensing market



Source: Frost & Sullivan, Morgan Stanley Research. E = Frost & Sullivan estimates.

Industry development history

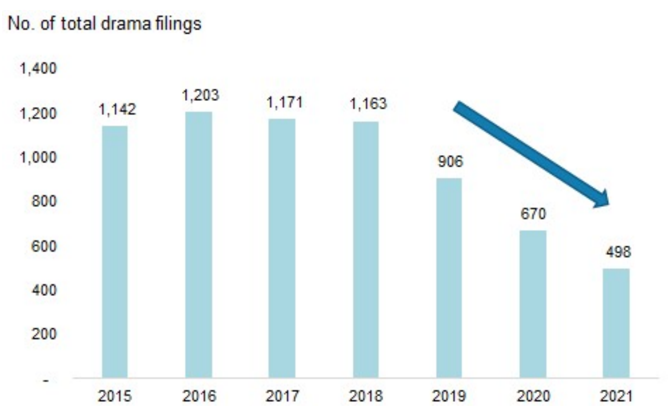
2008-15: Demand-driven upcycle – China's entertainment industry entered a phase of fast-paced development in 2011, after the central government released a document outlining a series of reforms aimed at accelerating such development. Prior to the internet, state-owned TV stations were the main buyers of drama content. With the emergence of online video platforms since 2013, we see these platforms starting to compete for users aggressively, which prompted a demand-driven upcycle for content.

2016-18: Cost-driven inflation due to overinvestment – Starting in 2015, investments started to flood into long videos. Costs of key production elements were pushed up significantly by the surging downstream demand, driven by strong growth in investment. During this period, TV stations and online video platforms competed aggressively to procure content, in order to gain viewer time spent. Online platforms also bid aggressively for high-quality content to compete with each other for online advertising and premium subscription market share.

2019-21: Various rounds of regulatory tightening – Starting in 2H18, regulatory oversight became stricter especially on actors' salary and drama's ASP limit, triggered by concerns about potential tax evasion on the part of some performers. As the Covid pandemic further weighed on the industry in 2020, another round of regulatory tightening, mainly on content and celebrities, hit in 2021. Amid these challenges, many content producers (CPs) endured severe financial stresses, evidenced by significant inventory writedowns and bad debt charges. Moreover, capital support became scarcer and there has been increasing demand for higher quality, which squeezed some smaller players that mainly focus on medium- and low-quality content out of the market.

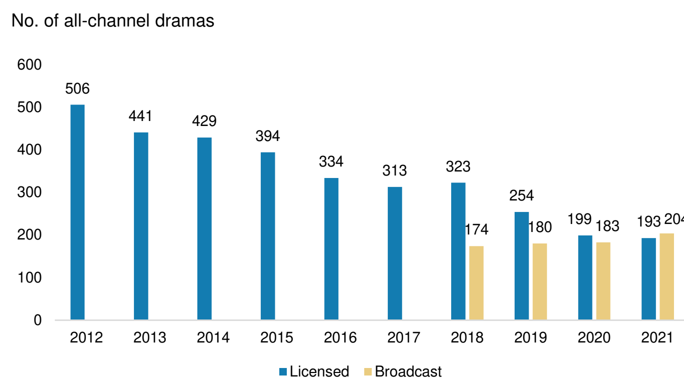
2022: Focus on efficiency – Confronted with the various challenges, major long-video platforms have shifted their emphasis to improving content investment efficiency and profitability. This has further damaged the demand for medium-quality content, while the demand for top-quality content remained resilient.

Exhibit 40: Production investment has diminished meaningfully since 2018



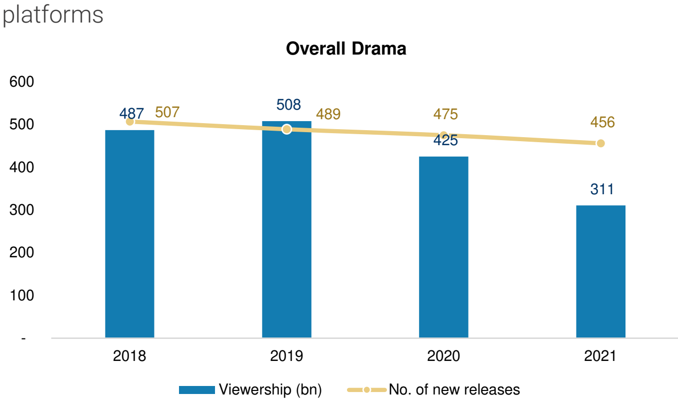
Source: NRTA, Morgan Stanley Research. Note: Drama filing refers to the approval application to start filming.

Exhibit 41: Oversupply has rationalized, but we expect it to persist in the near term



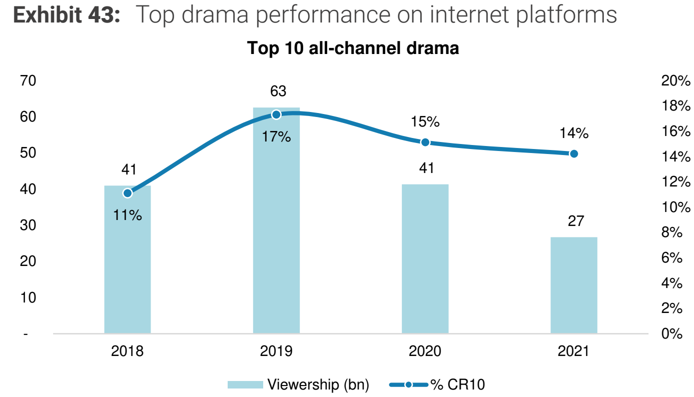
Source: NRTA, Enlightent, Morgan Stanley Research. Note: Licensed dramas refer to those that are eligible to be broadcast. All-channel dramas refer to those broadcast on both online platforms and TV stations.

Exhibit 42: Overall drama viewership and new releases on internet platforms



Source: Enlightent, Morgan Stanley Research.

Exhibit 43: Top drama performance on internet platforms



Source: Enlightent, Morgan Stanley Research.

Competition landscape

Competition remains fierce due to oversupply: Due to the issue of oversupply, evidenced by the gap between licensed and broadcast dramas, producers underwent a period of inventory destocking and shrinking new supply. The number of drama filings (applications for production starts) to the NRTA meaningfully declined from 2018 to 2021. Although the number of licensed and broadcast dramas has balanced in 2021, we expect oversupply to persist in the near term because of overstocking in previous years.

Stable market share of top players: In terms of licensing revenue, the total market share of the top five drama content producers accounted for 18.2% of the entire drama licensing market in 2021, versus 19% and 16.1% in 2020 and 2019, respectively. Furthermore, the top five spots have only been held by six different producers over 2019-21. Linmon has remained within the top five during 2019-21, according to Frost & Sullivan. We also observe the same trend in terms of high viewership drama series rate, and Linmon has secured a top three spot during 2019-21.

Benign competition at the top: In addition to the stable market share, we also note that top players see less intense competition from peers. The number of Radio and Television Program Production and Operation Permits increased at a CAGR of 21.8% from 2016 to 2020. However, there are only 41 companies holding Class A (the highest class ranked by overall quality) TV Series Production Licenses for 2021-23, according to NRTA, and this number has been declining significantly over the past years.

Exhibit 44: Top five drama producers in China, by licensing revenue

2021

Ranking	Company	Revenue
1	Company A	2.5
2	Strawbear	1.6
3	Company C	1.4
4	**Linmon**	**1.1**
5	Company B	1.0

CR5 market share: 18.2%

2020

Ranking	Company	Revenue
1	Company A	2.7
2	Company B	1.6
3	Company C	1.5
4	**Linmon**	**1.2**
5	Strawbear	1.0

CR5 market share: 19.0%

2019

Ranking	Company	Revenue
1	Company B	2.2
2	**Linmon**	**1.6**
3	Company A	1.5
4	Company C	1.5
5	Company D	0.9

CR5 market share: 16.1%

Source: Frost & Sullivan, company data, Morgan Stanley Research.

Exhibit 45: Top five drama producers in China, by high viewership drama series rate

2021

Ranking	Company	Rate
1	Company B	80%
2	**Linmon**	**67%**
3	Company A	33%
4	Company C	0%
5	Strawbear	0%

2020

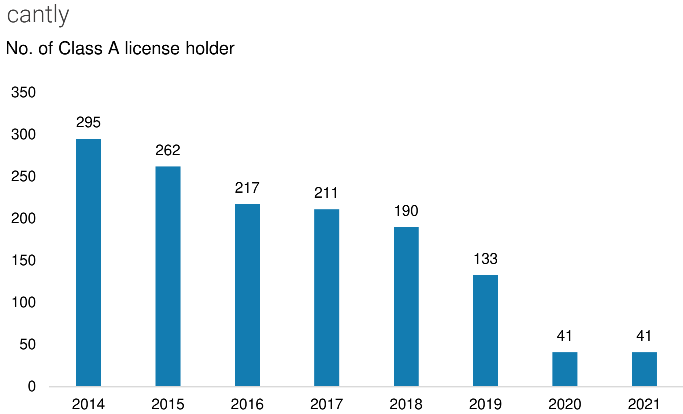
Ranking	Company	Rate
1	Company C	100%
2	**Linmon**	**100%**
3	Company B	25%
4	Company A	23%
5	Strawbear	17%

2019

Ranking	Company	Rate
1	Company C	100%
2	Company B	50%
3	**Linmon**	**50%**
4	Strawbear	33%
5	Company D	27%

Source: Frost & Sullivan, company data, Morgan Stanley Research.

Exhibit 46: Number of Class A license holders has declined significantly



Source: NRTA, Morgan Stanley Research.

Valuation Methodology and Risks

China Literature Ltd (0772.HK)
Base case, derived from 22x 2022e P/E - near its trough valuation since listing. We remain conservative amid market volatility.
Risks to Upside

Faster-than-expected paying reader growth
Better-than-expected ARPU growth with more time spent on reading
Higher advertising revenue from free-to-read model
Faster-than-expected synergies with Tencent

Risks to Downside

Pirated content, which impedes paying ratio improvement and ARPU expansion
Macroeconomic weakness that slows overall entertainment spending
Slowdown in content investment

Zhejiang Huace Film and TV (300133.SZ)
Base case scenario value, derived by applying a target 2023e P/E multiple of 20x - slightly lower than the historical average of ~25x since 2016, given industry challenges and conservative market sentiment.
Risks to Upside

Drama ASP increases, driven by more liquidity or a turnaround in downstream players' profitability.
More episodes are produced and sold to gain more market share.

Risks to Downside

Weaker-than-expected earnings arise from lower drama ASP or margins.
Sentiment deteriorates further, prompted by restrictive policy changes.
Shooting suspension is extended.

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Global Stock Ratings Distribution

(as of September 30, 2022)

The Stock Ratings described below apply to Morgan Stanley's Fundamental Equity Research and do not apply to Debt Research produced by the Firm.

For disclosure purposes only (in accordance with FINRA requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight, Not-Rated and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Not-Rated to hold and Underweight to sell recommendations, respectively.

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1342	38%	295	41%	22%	590	39%
Equal-weight/Hold	1582	45%	335	47%	21%	702	46%
Not-Rated/Hold	0	0%	0	0%	0%	0	0%
Underweight/Sell	610	17%	84	12%	14%	219	14%
Total	3,534		714			1511	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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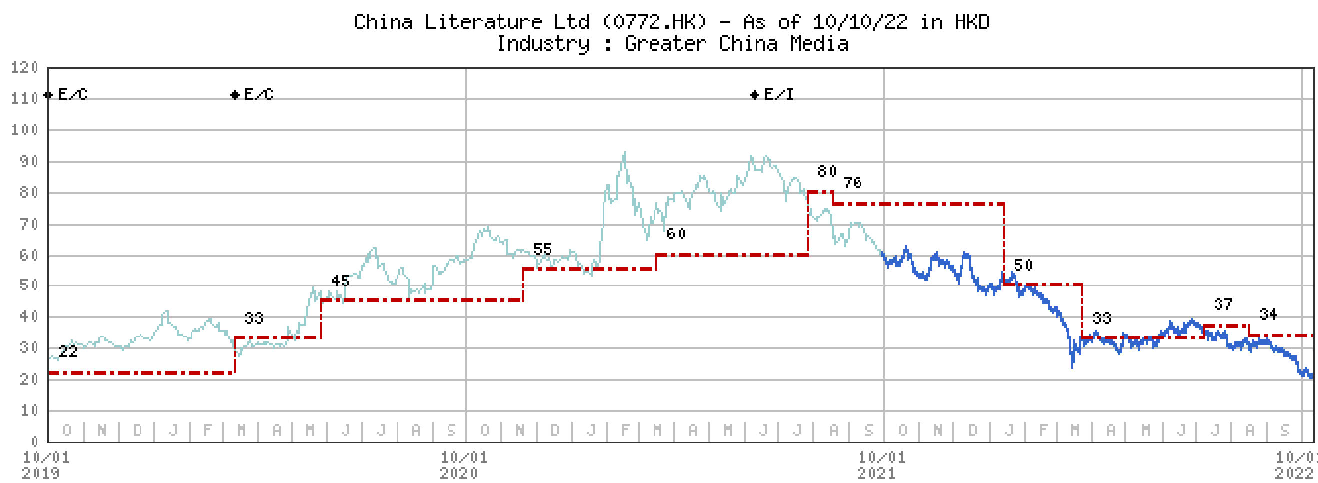
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 10/1/17 : /NR; 12/12/17 : E/NR; 1/4/19 : E/NR; 2/22/19 : E/C; 8/15/19 : E/C; 3/12/20 : E/C; 6/10/21 : E/I

Price Target History: 12/12/17 : 85; 8/15/19 : 22; 3/12/20 : 33; 5/27/20 : 45; 11/20/20 : 55; 3/16/21 : 60; 7/26/21 : 80; 8/17/21 : 76; 1/14/22 : 50; 3/23/22 : 33; 7/8/22 : 37; 8/16/22 : 34

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)
Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View
Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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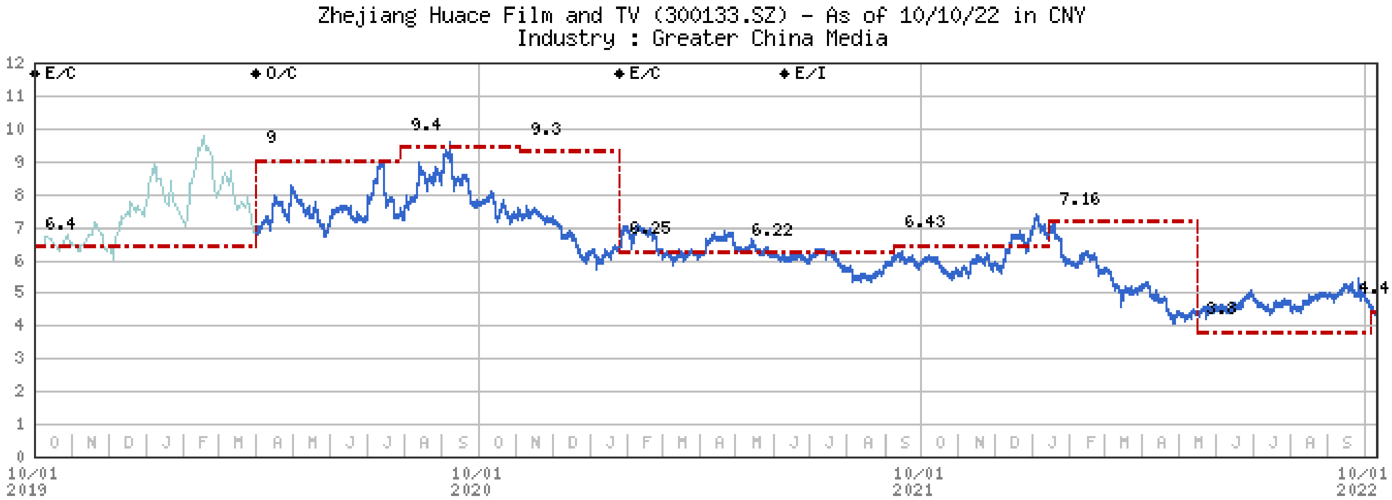

Stock Rating History: 10/1/17 : E/NR; 1/29/18 : O/NR; 1/4/19 : O/NR; 2/22/19 : E/C; 3/31/20 : O/C; 1/25/21 : E/C; 6/10/21 : E/I

Price Target History: 1/10/17 : 13; 1/29/18 : 16; 8/23/18 : 15.5; 2/22/19 : 6.4; 3/31/20 : 9; 7/28/20 : 9.4; 11/5/20 : 9.3; 1/25/21 : 6.25; 5/6/21 : 6.22; 9/8/21 : 6.43; 1/14/22 : 7.16; 5/16/22 : 3.8; 10/7/22 : 4.4

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)
Stock and Industry Ratings (abbreviations below) appear as ◆ Stock Rating/Industry View
Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

Effective January 13, 2014, the stocks covered by Morgan Stanley Asia Pacific will be rated relative to the analyst's industry (or industry team's) coverage.

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INDUSTRY COVERAGE: Greater China Media

COMPANY (TICKER)	RATING (AS OF)	PRICE* (10/10/2022)
Alex Poon		
Tencent Music Entertainment Group (TME.N)	E (07/16/2021)	US$4.04
Rebecca Xu		
37 Interactive Entertainment (002555.SZ)	O (07/04/2022)	Rmb16.80
Alibaba Pictures Group Ltd (1060.HK)	E (03/28/2022)	HK$0.36
Alpha Group (002292.SZ)	U (05/10/2022)	Rmb4.26
Beijing Enlight Media (300251.SZ)	E (09/04/2020)	Rmb6.83
China Film Co. Ltd. (600977.SS)	E (04/09/2020)	Rmb9.77
China Literature Ltd (0772.HK)	E (03/12/2020)	HK$20.70
Focus Media Information Technology (002027.SZ)	O (05/20/2020)	Rmb5.44
G-bits Network Technology (603444.SS)	E (07/04/2022)	Rmb244.45
Guangdong South New Media Co.Ltd (300770.SZ)	E (09/14/2021)	Rmb30.03
Huayi Brothers Media Corporation (300027.SZ)	U (09/10/2021)	Rmb2.17
IMAX China (1970.HK)	E (03/28/2022)	HK$5.18
Linmon Media Ltd (9857.HK)	E (10/11/2022)	HK$22.05
Mango Excellent Media Co Ltd (300413.SZ)	E (03/21/2022)	Rmb23.63
Maoyan Entertainment (1896.HK)	O (05/10/2022)	HK$5.45
Oriental Pearl Group Co Ltd (600637.SS)	E (12/18/2020)	Rmb6.09
Perfect World Co Ltd (002624.SZ)	E (07/26/2021)	Rmb12.31
Songcheng Performance Development Co Ltd (300144.SZ)	E (07/26/2021)	Rmb11.20
Wanda Film Holding Co Ltd (002739.SZ)	E (12/09/2021)	Rmb9.77
Zhejiang Huace Film and TV (300133.SZ)	E (01/25/2021)	Rmb4.35

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* Historical prices are not split adjusted.

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