DQ Entertainment

Advise: SUBSCRIBE

08th March, 2010

Issue Details	
Offer Price Band	Rs. 75-80
Face Value	10
Shares Offered	16,048,011
Type	Fresh Issue
Promoters	Mr. Tapaas Chakravarti
Lead Manager	SBI Capital Markets
Listing (Stock Exchange)	BSE
Offer Open Date	08th Mar, 2010
Offer Close Date	10th Mar, 2010
Website: http://www.dqentertainment.com	

Scrip Estimates	
Market Cap (Rs Crores)	594.6-634.2
EPS – FY10E (Rs)	3.1
P/E(x) (fully diluted)	23.8-25.4
Market Cap/Sales(x) FY10E	3.9-4.2

Share Holding Pattern (%)	Pre Offer	Post Offer
Promoter	94.0	75.0
IDFC Investment	4.6	3.7
Others	1.4	1.5
Public	Nil	19.8

Financials (Rs Crores)	FY09	H1FY10
Sales	149.8	70.5
Expenditure	97.2	47.9
EBIDTA	52.6	22.6
EBIDTA (%)	35.1	32.1
PBT	19.9	10.8
PAT	16.1	10.2
Equity	1.6	59.5
EPS (Rs)	99.1	1.7

Investors should read the risk factors and more detailed information in the Prospectus and the application form before investing in the issue.

Website: www.way2wealth.com

Analyst: Nisha Harchekar
Email: nishaharchekar@way2wealth.com
Contact: 022 – 40192900

DQ Entertainment (International) (DQE), promoted by Tapaas Chakravarti & DQ Entertainment (Mauritius), is one of the leading producers of animation, visual effects, game art and entertainment content for the Indian as well as global media and entertainment industry. The company is a producer of animation videos and creators of game art. It has forayed into production and distribution of live action television and feature films. It has an asset base of over 350 hours of animation content (which can reach up to 500 hours by FY11) from which it can earn revenue through licensing and distribution activities.

Investment Rationale

- **Low-risk business model with presence across the value chain:** The Company has strategically moved upwards in the animation value chain, gaining greater exposure to IP ownership and distribution by following a co-production model for content development. It has adopted a low-risk approach, entering into co-production arrangements. As a result, they not only continue to receive production revenues generating its usual production margin, but also acquire rights to earn license revenues.
- **Robust Order Book:** DQE has a strong order book worth ~USD 95.07 million (Rs 457 crores approx.). More than 80% of FY10 revenues are identified with over 40% of the order book already in various stages of production and balance to commence during the year.
- **Backward and forward integration:** Apart from production of animated content either on an outsourced basis or a co-production basis, offering pre-production and post-production services would offer a larger share of the revenues collected from the IPs that they produce/co-produce.
- **Cost advantage vis-à-vis global peers:** Driven by the need to reduce protracted development cycles and high labour cost of developing animation in the West, animation companies are increasingly looking at Asian destinations such as India. The necessity for saving on labour costs has become more prominent of late on account the downturn in the global economic environment.

Investment Concerns: 92.8% of the total sales were derived from US and in FY09. 90% of revenues from production services are on price and fixed time contracts wherein the Company has to bear the risk of penalty provision, cost overruns and completion delays.

Valuations & Advise:

At the upper end of the price band of Rs 80, the issue quotes at P/E of 25.4x and at the lower end of Rs 75, it quotes at P/E of 23.8x. Considering its low risk business model, robust order book position and comparatively higher operating margins and return ratios, the asking price seems justified. The Company expects that the next major growth driver will be from licensing and distribution that include apparels, toys, furnishings, stationery, back- to-school products and we expect substantial revenue flow from this head in year ending March 2010. We thus recommend investors to ***Subscribe*** to the issue for a medium to long-term investment horizon.

Business Overview

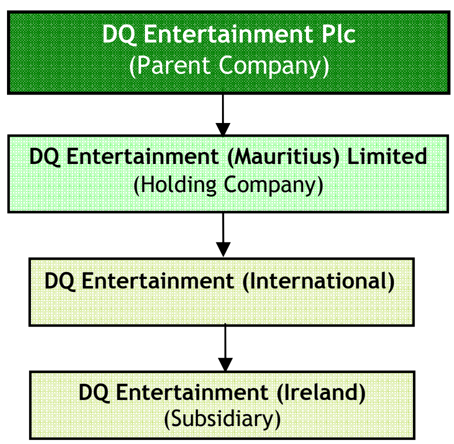
Incorporated in 2007, DQ Entertainment (International) Limited (DQE) is one of the leading producers of animation, visual effects, game art and entertainment content for the Indian as well as global media and entertainment industry. They are a producer, co-producer and global distributor of TV series, direct-to-home videos and feature films. DQ Entertainment is also creators of game art for online, mobile and next-generation consoles. They have forayed into production and distribution of live action television and feature films.

DQ Entertainment has 10 production facilities in India (eight in Hyderabad and one each in Mumbai and Kolkata) and worldwide third-party sales representatives in Paris, Tokyo and Los Angeles. Its workforce include 3500+(2788 permanent employees and 712 freelancers and trainees). DQ Entertainment (International) Limited operates as a subsidiary of DQ Entertainment (Mauritius) Limited.

Its history

The company was originally incorporated in 1987 as Dataquest Management and Communications Private Limited, which was changed to DQ Entertainment in 1993 to engage in IT training and consultancy. In 2000, it established an in-house training centre for training production staff. In 2002, it established a traditional two-dimensional (2D) animation studio. In 2004, it established three-dimensional (3D) animation process. Its first commercial 3D animation project was a French TV series, *'Les Gnoufs'*. It started game assets development in 2007. The company has since launched its own IP in 2009, with the launch of the first homegrown 3D computer generated imagery (3D CGI) television series, *'The Jungle Book'*, based on Rudyard's Kipling epic novel as well as three special TV features, *'Balkand'*, *'Omka'r'* and *'Ravan'*, based on Indian mythology, for India and the Indian diaspora across the globe.

Holding Structure



Source: RHP, W2W Research

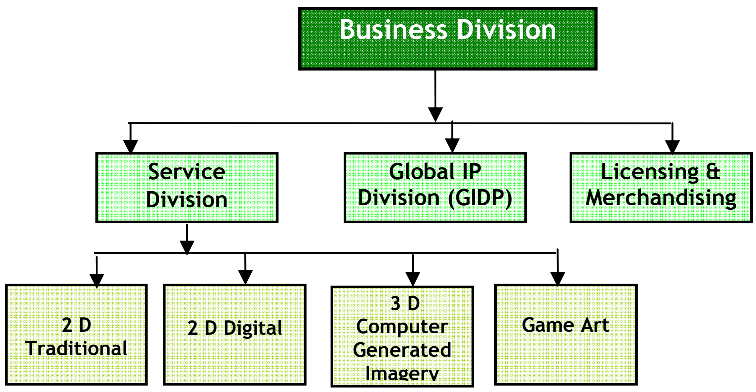
The Company's corporate promoter, DQ Entertainment (Mauritius) Limited, is incorporated and registered in Mauritius. It is a wholly owned subsidiary of DQE Plc; an Isle of Man incorporated entity. In December 2007, DQE Plc listed on Alternative Investment Market, London (AIM) at an issue price of 136 pence and raised funds for investment in strategic alliances, global and local IP development and partnerships, and foraying into live action and expansion of production facilities and workforce. The company had raised GBP 26.8 million through the AIM listing. The main reason was to give an exit to the hedge funds, which have to be liquidated on completion of investment life.

The individual promoter (Mr Tapaas Chakravarti) holds about 12.66% of DQE Plc through his company Zenithal Pvt Ltd, thereby holding 11.9% (pre-issue) and 9.5% (post-issue) of DQ Entertainment (International).

Company Promoters:
The individual promoters of the Company are:
1. **Mr. Tapaas Chakravarti** - Chairman, Managing Director and Chief Executive Officer.
2. **Ms. Rashmi Chakravarti** - Executive and Non-Independent Director.
3. **Mr. Kunchithapadam Balasubramanian** - Non-executive and Independent Director.
4. **Mr. Girish Kulkarni** - Non-Executive and Non-Independent Director.

Business Divisions

The Company conducts its operations through three business divisions namely Services Division, Global IP Division (GIPD) and Licensing & Merchandising Division.



Source: RHP, W2W Research

I) Services Division

DQE has the flexibility to produce different styles of animation including traditional 2D animation; digital and technology based 2D digital and 3D animation. The Company has expanded its product offering across various methodologies of animation, VFX, game art, porting and testing, as well as licensing and merchandising, IP creation and new media.

2D Animation is the classical method of animation in which each frame is drawn by hand by an artist. For traditional 2D assignments, the Company receives a script and a storyboard from clients which guide the production process. DQE is one of studios which undertake hand drawn 2D traditional animation in India.

2D digital animation is a process by which animation similar to traditional 2D animation is done digitally using software such as flash, etc. Since it is done digitally, there are no drawings rendered manually by hand as is done in traditional 2D. All the animation is created using initially created assets, which are stored on a central server library and available to all the animators involved in production. This makes re-use possible making Digital 2D animation more economical for production in comparison with traditional hand drawn 2D animation.

3D computer animation (in contrast to 2D animation) uses a three-dimensional representation of characters and properties. 3D animation creates more life-like animations. It is more technology and resource intensive but has gained wider popularity over classical animation. As with 2D animation, 3D projects start with a script and rough story board. The script describes the whole series about the characters and the shots. The rough storyboard shows the acting, dialogue and timing required.

3D Game Art and Full Motion Videos
DQE is working with significant players in the gaming industry and have delivered assets, level designs, In Game Cinematic (IGCs) and Full Motion Videos (FMVs) for various kinds of projects for all platforms such as PS2, PS3, PSP, XBOX 360, Wii, DS, and PC. Few of the famous titles are:

Battleforge PC, Electronic Arts - Phenomics, Germany
The Simpsons Game, Electronic Arts, Redwoodshores, USA
FIFA 2009, Electronic Arts, Canada
NBA 2009, Electronic Arts, Canada
Zubo, Electronic Arts, UK
SIMS 3, Electronic Arts, USA.
Maestro, Chevy Soft, USA

II) Global IP Division (GIDP)

The focus of GIPD is to develop IPs, either on their own or through joint-participation with other animation production companies. The Company intends to produce and distribute these IPs in the Indian and Asian markets as also to the Indian diasporas across the globe.

III) Licensing & Merchandising

Its international productions such as *The Jungle Book*, *Tara Duncan*, *Iron Man*, *Little Nick*, *Casper*, *Pinky & Perky*, *Twisted Whiskers* as well as its various previous co-productions have enabled its L&D division to create a library of over 350 hours of international animated programs for revenue exploitation.

Objects of the issue

Breakup	Total est. cost	Amt to be financed from net proceeds	Schedule of deployement		
			FY10	FY11	Deployed as on Jan 18, 2010
Investment in co-production agreements, focusing on IP content creation	105.0	54.9	21.2	38.1	21.0
Development of office premises and production facilities; Development of infrastructure and additional facilities at the SEZ Unit	51.9	39.2	8.7	32.0	9.8
Investment in Subsidiary, DQ Entertainment (Ireland) Limited	14.6	12.9	11.4	3.2	10.4
General corporate purposes	[*]	[*]	[*]	[*]	-
Total	[*]	[*]	[*]	[*]	41.2

The company intends to deploy the IPO proceeds in investment in co-production agreements, focusing on IP content creation; development of office premises and production facilities; development of infrastructure and additional facilities at the SEZ Unit; Investment in subsidiary, DQ Entertainment (Ireland) Limited; and General corporate purposes.

The company had raised Rs 25.69 crores in a pre-IPO placement in January 2010 with IDFC subscribing for Rs 20 crores worth of shares at a price of Rs 68.11/share.

Investment Highlights

Low-risk business model with presence across the value chain
Its revenue streams comprise production and licensing & distribution revenues and each of the two have various sub-streams. Service revenues comprise revenues from traditional 2D animation, digital 2D animation, 3D animation and 3D game art. IP exploitation revenues comprise revenues from licensing for free and pay televisions, cable television, home videos, DTO, publishing, merchandising and distribution.

The Company has strategically moved upwards in the animation value chain, gaining greater exposure to IP ownership and distribution by following a co-production model for content development. It has adopted a low-risk approach, entering into co-production arrangements. As a result, they not only continue to receive production revenues generating its usual production margin, but also acquire rights to earn license revenues.

Robust Order Book
DQE has a strong order book worth ~USD 95.07 million (Rs 457 crores approx.). More than 80% of FY10 revenues are identified with over 40% of the order book already in various stages of production & balance to commence during the year. USD 28 million (Rs 134 crores) are to be executed in FY10 and USD 33 million (Rs 158 crores) and the balance beyond FY10.

Consistent high quality standards
DQE has been awarded ISO 9001:2000 certification by M/s. Det Norske Veritas, Norway, which endorses the high working practices within the organization.

Backward and forward integration
Apart from production of animated content either on an outsourced basis or a co-production basis, offering pre-production and post-production services would offer a larger share of the revenues collected from the IPs that they produce/co-produce. As part of this strategy, they have set up DQ Entertainment (Ireland) Limited, its Subsidiary in Ireland which provides a gateway to large access of talent for pre-production and post production services.

Diversified client base
DQE has a client base of over 90 companies which include internationally recognized brands such as the Disney Group, Nickelodeon, American Greetings, BBC, Moonscoop Group, ZDF-Germany, Australian Broadcasting Corporation and NBC Universal.

Cost advantage vis-à-vis global peers
Driven by the need to reduce protracted development cycles and high labour cost of developing animation in the West, animation companies are increasingly looking at Asian destinations such as India. Inherent cost advantages such as low cost labour and availability of English speaking employees makes India a favorable destination for the global production houses. The necessity for saving on labour costs has become more prominent of late on account the downturn in the global economic environment.

Animation industry

According to NASSCOM, the global animation industry is one of the fast growing components of the global media and entertainment industry. The global animation market was estimated at USD 68 billion in 2008 and is expected to grow at a CAGR of 10% to reach USD 100 billion by 2012.

At an estimated size of USD 494 million in 2008, the Indian animation industry is miniscule as compared to the global animation industry with estimated revenues of USD 68 billion in 2008. However, the Indian animation industry has been growing with an estimated CAGR of 25.43% during 2006-08 and is estimated to reach a size of about USD 1 billion by 2012. Increased emphasis on IP creation and attractive domestic opportunity has been the principal growth drivers for the animation production services.

In USD million	2008	2009	2010
Education	67	98	173
Visual Effects	65	106	174
Animation entertainment	107	139	207
Custom content development and multimedia/ web design	256	339	542
Total	**494**	**682**	**1095**

Financials

(YE March 31) Rs crores	FY09	H1FY10
Net Sales	149.8	70.5
- Animation	135.7	66.1
- Gaming	6.7	0.1
- Distribution	7.5	4.3
Total Expenditure	97.2	47.9
EBIDTA	52.6	22.6
Interest	5.6	2.7
Depreciation	28.2	12.4
PBT	19.9	10.8
PAT	16.1	10.2
Equity Paid Up	1.6	59.5
EPS (Rs)	99.1	1.7
EBIDTA (%)	35.1	32.1
PBT (%)	13.3	15.4
PAT (%)	10.8	14.5
Capital Employed	183.8	194.1
Gross Block	135.0	175.4
Networth	76.4	108.5
Book Value	898.1	26.3
Debt	36.5	37.8
Dividend (%)	-	-
Payout (%)	-	-
Debt: Equity (x)	0.3	0.2
ROCE (%)	27.7	27.8
RONW (%)	11.0	13.0

Most of the revenues (91%) of the company in FY09 were from television production. Licensing and distribution activities contributed a meager 5% of revenues, whilst full motion video and game development contributed 4%. The company has high dependence on the European and American geographies, which together have contributed over 90% to the revenues over FY08 and FY09. Around 72% of the work in FY09 was from 3-D animation, whilst low margin 2-D animation services accounted for the remaining 28%.

The business is somewhat seasonal in nature as second half is always better than first half. Majority of new launches takes place during September-April/May period which is vacation time for schools. It follows conservation accounting policies. All intellectual property is written off over 10 year's time even if the Company enjoys IP rights for 20-25 years or forever.

Key Concern

- Concentration of clients in U.S and European countries: 92.8% of the total sales were derived from US (41.6%) and Europe (51.2%) in FY 09. Significant dependence on a single region can severely affect company's future sustenance in event of any economical downturn or social unrest or political issues.
- 90% of revenues from production services are on price and fixed time contracts wherein the Company has to bear the risk of penalty provision, cost overruns and completion delays. Failure to estimate the resources and time required for a project can cause serious dent to its revenues and profitability.
- The market for animation entertainment is characterized by short product lifecycles and frequent introduction of new products.

Outlook and Valuations

The Indian animation industry, estimated at US$494 million in 2008, is miniscule as compared to the global animation industry. However, it holds huge potential considering rapid advancement of technology, wider target audience and increasing trend in outsourcing by U.S and Europe.

At the upper end of the price band of Rs 80, the issue quotes at P/E of 25.4x and at the lower end of Rs 75, it quotes at P/E of 23.8x. Considering its low risk business model, robust order book position and comparatively higher operating margins and return ratios, the asking price seems justified. The Company expects that the next major growth driver will be from licensing and distribution that include apparels, toys, furnishings, stationery, back- to-school products and we expect substantial revenue flow from this head in year ending March 2010. We thus recommend investors to ***Subscribe*** to the issue for a medium to long-term investment horizon.

Peer Comparison (FY09)

Particulars (Rs crores)	DQE	Crest Animation	Prime Focus	Compact Disc
Net Sales	149.8	57.1	354.4	187.1
EBITDA	52.6	4.1	48.6	40.4
EBITDA margin (%)	*35.1*	*7.2*	*13.7*	*21.6*
Adj. PAT	16.1	(13.4)	5.2	39.5
PAT (%)	*10.8*	-	*1.5*	*21.1*
Equity Capital	79.3	22.6	12.8	9.6
EPS (Rs)	3.1	-	4.1	40.9
CMP (Rs)	75-80	72	211	57
Marketcap	595-634	162.5	271.6	54.7
P/E (x)	24-25*	-	51.5	1.4
Marketcap/Sales	3.9-4.2*	2.8	0.8	0.3
Business Model	Presence through the value chain	Outsourced Production & Own IP	VFX, post production and animation	Outsourced Production & Own IP

* based on FY10E earnings

RESEARCH TEAM

K.N.Rahaman	Deputy Research Head	Equities & Commodities	rahaman@way2wealth.com
Jigisha Jaini	Sr. Research Analyst	Capital Goods & Engineering	jigishajaini@way2wealth.com
Nisha Harchekar	Sr. Research Analyst	FMCG, Hotels, Media	nishaharchekar@way2wealth.com
Sejal Jhunjhunwala	Sr. Research Analyst	Auto, Shipping & Metals	sejal@way2wealth.com
Abhishek Kothari	Research Analyst	Banking, NBFC & Financial Services	abhishekkothari@way2wealth.com
Vishwa Doshi	Research Analyst	IT, Telecom, Midcaps	vishwadoshi@way2wealth.com
Krishna Reddy	Research Analyst	Commodities, Economic Update	krishnareddy@way2wealth.com
MSR Prasad	Research Analyst	Commodities	Prasad.m@way2wealth.com
Prateek Jain	Sr. Research Analyst	Mutual Funds & Economic update	prateek@way2wealth.com
Ritu Gupta	Research Analyst	Mutual Funds	ritugupta@way2wealth.com
Aditya Agarwal	Sr. Derivative Analyst	Derivative Strategist & Technicals	aditya@way2wealth.com
Amrut Deshmukh	Sr. Technical Analyst	Technical Analysis	amrut@way2wealth.com
Parag Joshi	Technical Analyst	Technical Analysis - Commodities	paragjoshi@way2wealth.com
Rupali Prabhu	Research Assistant	Database Management	rupali@way2wealth.com
Contact		022-40192900	

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