

KONGZHONG CORP
Form 20-F
April 15, 2016

UNITED STATES

**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 20-F

**..REGISTRATION STATEMENT PURSUANT TO SECTION 12(B) OR (G) OF THE SECURITIES
EXCHANGE ACT OF 1934**

OR

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF
^x1934**

For the fiscal year ended December 31, 2015

OR

**..TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934**

OR

..SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report

Commission file number: 000-50826

KONGZHONG CORPORATION

(Exact name of registrant as specified in its charter)

N/A

(Translation of registrant's name into English)

Cayman Islands

35th Floor, Tengda Plaza
No. 168 Xizhimenwai Street
Beijing, China 100044

(Jurisdiction of incorporation or organization) (Address of principal executive offices)

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The People's Republic of China

(Name, Telephone, E-mail and /or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	Name of each exchange on which registered
Ordinary shares, par value US\$0.0000005 per share*	The NASDAQ Stock Market LLC
American Depositary Shares, each representing 40 ordinary shares	(The NASDAQ Global Select Market)

* Not for trading, but only in connection with the listing on The NASDAQ Global Select Market of American Depositary Shares, or ADSs, each representing 40 ordinary shares.

Securities registered or to be registered pursuant to Section 12(g) of the Act.

None
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2015, 1,884,133,063 ordinary shares, par value US\$0.0000005 per share, were issued and outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP International Financial Reporting Standards as issued by the International Accounting Standards Board Other

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow. Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Such forward-looking statements include, without limitation, statements that are not historical facts relating to:

- our ability to successfully execute our business strategies and plans;

- our financial performance and business operations;

- our development and capital expenditure plans;

- the expected benefit and future prospects of our long-term investments, strategic alliances and acquisitions;

- our ability to anticipate and launch games that respond to changing consumer tastes and preferences and predict trends in the Internet and mobile games market in the People's Republic of China, or the PRC;

- our ability to license quality Internet and mobile games from the PRC and overseas Internet and mobile game developers that complement our internally developed Internet and mobile games;

- our dependence on a small number of Internet games developed by third party Internet games developers for a significant portion of our Internet games revenues;

- management estimations with respect to revenues from our Internet games, mobile games, and wireless value-added services, or WVAS, businesses;

- our ability to collect outstanding loans extended to related parties;

- the successful remediation of the material weakness identified in our internal control over financial reporting and our ability to achieve and maintain the adequacy of our internal control;

the development of our latest product offerings, including, but not limited to, offerings in our Internet games and mobile games;

the development of the PRC smartphone mobile games market and the regulatory environment and changes in policies or guidelines relating to those markets;

the development of the regulatory environment and changes in the policies or guidelines of the telecommunications operators in the PRC, as well as our relationships with those operators;

our dependence on the substance and timing of the billing systems of the telecommunications operators in the PRC for our performance;

competitive pressures and future growth in the Internet games, mobile games, WVAS, telecommunications and related industries in the PRC; and

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our expectations with respect to the completion of our proposed going-private transaction.

The words “anticipate,” “believe,” “could,” “estimate,” “expect,” “forecast,” “intend,” “may,” “plan,” “seek,” “will,” “would” expressions, as they relate to us, are intended to identify a number of these forward-looking statements.

These forward-looking statements are subject to risks, uncertainties and assumptions, some of which are beyond our control. In addition, these forward-looking statements reflect our current views with respect to future events and are not a guarantee of future performance. Actual results may differ materially from the information contained in the forward-looking statements as a result of a number of factors, including, without limitation, the risk factors set forth in “Item 3 — Key Information — Risk Factors” and the following:

- the effects of competition on, as well as changes in, the demand for or the price of our products or services;
- any changes in our relationship with telecommunications operators in the PRC;
- any changes in our relationships with our Internet games licensors whose games we have the rights to operate in the PRC or other markets;
- any changes in technologies related to telecommunications, Internet games, mobile games, or WVAS or applications based on such technologies;
- future developments, trends, regulatory environment and consumer preferences in China with respect to Internet and mobile games and means by which these games are distributed;
- any changes in the regulatory regime or the policies for the Internet games industry in the PRC, including changes in the structure, functions or policies of the regulators, which include (i) the Ministry of Industry and Information Technology, or the MIIT (formerly the Ministry of Information Industry), (ii) the State Administration for Industry and Commerce, or the SAIC, (iii) the Ministry of Culture, or the MOC, (iv) the State Administration of Press, Publication, Radio, Film and Television, or the SAPPRFT (formerly the General Administration of Press and Publication and the State Administration of Radio, Film and Television), and (v) the Ministry of Public Security, or the MPS;
- any changes in the regulatory regime or the policies for the PRC telecommunications industry, including changes in the structure or functions of the primary industry regulator, the MIIT, or its policies, or the policies or other regulatory measures of other relevant government or industry authorities relating to, among other matters, the granting and approval of licenses, procedures for customers to access and subscribe to mobile games or WVAS ,

restrictions on Internet content, or the introduction of new technology platforms, products and services;

any changes in political, economic, legal or social conditions in the PRC, including the PRC government's specific policies with respect to (i) foreign investment and entry by foreign companies into the telecommunications, Internet games, mobile games or WVAS market, (ii) economic growth, (iii) inflation, (iv) foreign exchange or (v) the availability of credit; and

changes in population growth or gross domestic product, or GDP, growth or the impact of those changes on the demand for our products or services.

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We do not intend to update or otherwise revise the forward-looking statements in this annual report, whether as a result of new information, future events or otherwise. Due to these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this annual report might not occur in the way we expect, or at all. Accordingly, you should not place undue reliance on any forward-looking information. All forward-looking statements contained in this annual report are qualified by reference to the cautionary statements set out in this section.

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PART I

Item 1. Identity of Directors, Senior Management and Advisers

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

Selected Financial Data

The following selected consolidated financial data should be read in conjunction with our audited consolidated financial statements, the notes thereto and “Item 5 — Operating and Financial Review and Prospects.” The selected consolidated statement of operations data for the years ended December 31, 2013, 2014 and 2015 and the selected consolidated balance sheet data as of December 31, 2014 and 2015 set forth below are derived from our audited consolidated financial statements and the notes thereto, which are included elsewhere in this annual report. The selected consolidated statement of operations data for the years ended December 31, 2011 and 2012 and the historical consolidated balance sheet data as of December 31, 2011, 2012 and 2013 set forth below are derived from our audited consolidated financial statements and the notes thereto, which are not included in this annual report.

Our audited consolidated financial statements have been prepared and presented in accordance with the generally accepted accounting principles in the United States, or U.S. GAAP.

Consolidated statements of operations data	For the year ended December 31,				
	2011	2012	2013	2014	2015
	(in thousands of U.S. dollars, except shares and per share data)				
Revenues	US\$156,180.6	US\$180,586.1	US\$173,653.8	US\$227,595.9	US\$179,113.3
Internet games	37,076.2	82,902.8	93,792.3	118,099.8	105,045.3

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Mobile games	40,229.4	20,971.0	16,908.3	45,036.4	24,646.6
WVAS	78,875.0	76,712.3	62,953.2	64,459.7	49,421.5
Cost of revenues	(91,930.2)	(103,130.3)	(96,399.9)	(129,279.0)	(139,362.0)
Internet games	(15,923.6)	(39,539.8)	(45,283.8)	(61,443.1)	(52,368.0)
Mobile games	(25,248.0)	(10,935.0)	(7,780.3)	(22,977.3)	(14,776.0)
WVAS	(50,758.6)	(52,655.5)	(43,085.2)	(44,858.6)	(37,007.0)
Impairment loss on intangible assets (1)	—	—	(250.6)	—	(35,209.0)
Gross profit	64,250.4	77,455.8	77,253.9	98,316.9	39,750.9
Internet games	21,152.6	43,363.0	48,508.5	56,656.7	52,676.5
Mobile games	14,981.4	10,036.0	9,128.0	22,059.1	9,870.0
WVAS	28,116.4	24,056.8	19,868.0	19,601.1	12,414.3
Impairment loss on intangible assets (2)	—	—	(250.6)	—	(35,209.0)
Operating expenses:					
Product development	(15,416.9)	(18,382.4)	(26,401.7)	(25,107.4)	(24,189.0)
Selling and marketing	(20,891.6)	(24,586.0)	(26,674.0)	(42,522.7)	(25,890.0)

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Consolidated statements of operations data	For the year ended December 31,			
	2011	2012	2013	2014
	(in thousands of U.S. dollars, except shares and per share data)			
General and administrative	(11,582.2)	(11,629.3)	(8,976.2)	(12,564.6)
Impairment loss on goodwill	(20,255.3)	—	—	—
Impairment loss on intangible assets	(3.9)	—	(1,562.4)	(1,323.3)
Total operating expenses	(68,149.9)	(54,597.7)	(63,614.3)	(81,518.0)
Change in fair value of contingent consideration for business acquisition	(3,729.5)	—	—	—
Government subsidies	319.2	301.4	2,176.4	1,138.9
Income (loss) from operations	(7,309.8)	23,159.5	15,816.0	17,937.8
Interest income	3,569.2	5,231.3	6,764.0	8,864.7
Interest income from loans to third parties	1,193.2	453.6	—	—
Interest income from loans to related party	—	—	—	—
Interest expense	(487.8)	(262.7)	(693.3)	(895.0)
Impairment loss on cost method investment	—	—	(2,000.0)	(2,000.0)
Loss on extinguishment of debt upon prepayment of convertible senior note	(1,567.5)	—	—	—
Exchange gain (loss)	—	387.6	1,487.3	(271.6)
Gain on sale of trading securities	85.6	261.5	—	—
Gain on sale of available-for-sale securities	—	—	—	—
Dividend received	—	—	—	—
Net income (loss) before income tax expense and loss in equity method investments	(4,517.1)	29,230.8	21,374.0	23,635.9
Income taxes expense	(3,137.8)	(3,490.8)	(712.4)	(1,048.0)
Net income (loss) after income tax expense before loss in equity method investments	(7,654.9)	25,740.0	20,661.6	22,587.9
Loss in equity method investments	—	—	—	—
Net income (loss)	US\$(7,654.9)	US\$25,740.0	US\$20,661.6	US\$22,587.9
Net income (loss) per share:				
Basic	US\$(0.00)	US\$0.02	US\$0.01	US\$0.01
Diluted	US\$(0.00)	US\$0.01	US\$0.01	US\$0.01
Weighted average shares used in calculating net income (loss) per share:				
Basic	1,607,110,119	1,661,864,846	1,714,924,612	1,828,191,540
Diluted (3)	1,607,110,119	1,721,622,756	1,751,621,340	1,875,520,094

(1) Prior period information is presented in a manner that is consistent with the current period segment reporting.

(2) Prior period information is presented in a manner that is consistent with the current period segment reporting.

As of December 31, 2011, 2012, 2013, 2014 and 2015, we had 210 million, 285 million, 11 million, 97 million and 77 million ordinary share equivalents, respectively, outstanding that could potentially dilute income per share in the future, but that were excluded in the computation of diluted income per share in the periods as their effect would have been anti-dilutive.

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Consolidated balance sheet data	As of December 31,				
	2011	2012	2013	2014	2015
	(in thousands of U.S. dollars)				
Cash and cash equivalents	US\$ 129,511.5	US\$ 120,694.7	US\$ 123,427.7	US\$ 105,093.2	US\$ 38,304.4
Term deposits	—	—	4,448.8	16,907.3	25,121.4
Available-for-sale securities	—	—	—	20,013.5	64,755.5
Held-to-maturity securities	17,299.1	17,465.3	51,866.5	24,358.6	26,746.6
Trading securities	7,754.6	—	—	—	—
Loans to third parties	22,187.3	—	—	—	14,686.0
Loans to related party	—	—	—	—	32,851.0
Amount due from related party	—	—	—	—	285.0
Accounts receivable, net	19,903.0	23,699.7	17,230.8	30,244.3	24,484.9
Property and equipment, net	3,620.3	3,065.5	5,842.5	5,659.2	4,653.9
Intangible assets, net	2,347.9	75,069.3	78,726.6	55,509.8	12,515.6
Long-term investments	—	4,000.0	2,000.0	—	4,772.8
Goodwill	72,967.1	87,551.0	90,266.6	90,019.1	84,770.0
Restricted cash	—	35,773.3	36,870.7	64,261.3	58,466.8
Total assets	280,248.0	372,784.1	419,240.3	432,580.7	418,706.6
Total current liabilities	32,526.0	71,229.6	67,370.8	100,790.5	106,945.6
Convertible note payable	1,272.6	—	—	—	—
Total shareholders' equity	246,177.7	282,884.1	332,609.5	321,930.2	311,761.0
Total liabilities and shareholders' equity	280,248.0	372,784.1	419,240.3	432,580.7	418,706.6

Consolidated cash flow data	For the year ended December 31,				
	2011	2012	2013	2014	2015
	(in thousands of U.S. dollars)				

Net Cash (used in) provided by:

Operating activities	US\$ 33,433.8	US\$ 46,655.9	US\$ 35,729.5	US\$ 31,069.3	US\$ 31,792.4
Investing activities	(40,284.8)	(41,206.8)	(43,944.6)	(32,117.6)	(93,944.9)
Financing activities	(26,335.0)	(14,313.0)	8,956.8	(16,914.8)	(1,922.7)

Exchange Rate Information

We present our consolidated financial statements in U.S. dollars. In addition, this annual report contains translations of certain Renminbi amounts to U.S. dollar amounts for transactions denominated in Renminbi. Unless otherwise specified or indicated by context, the translations of Renminbi amounts into U.S. dollar amounts have been made at the rate of RMB6.4936 = US\$1.00, the central parity rate set by the People's Bank of China, or the PBOC, China's central bank, on December 31, 2015. The translations are not a representation that the Renminbi amounts could actually be converted to U.S. dollars at this rate. For a discussion of the exchange rates used for the presentation of our financial statements, see Note 2 to our financial statements included elsewhere in this annual report on Form 20-F.

The PBOC sets and publishes daily central parity rates with reference primarily to the supply and demand of Renminbi against a basket of currencies in the market. The PBOC also takes into account other factors such as the general conditions existing in the international foreign exchange markets. Although PRC governmental policies were introduced in 1996 to reduce restrictions on the convertibility of Renminbi into foreign currency for current account items, conversion of Renminbi into foreign exchange for capital items, such as foreign direct investment, loans or securities, requires the approval of the State Administration for Foreign Exchange, or the SAFE, and other relevant authorities. We make no representation that the Renminbi or U.S. dollar amounts referred to in this annual report could have been or could be converted into U.S. dollars or Renminbi, as the case may be, at any particular rate or at all.

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The noon buying rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York was RMB6.4628= US\$1.00 on April 8, 2016. The following table sets forth the high and low noon buying rates between Renminbi and U.S. dollars for each of the periods shown:

Period	Noon Buying Rate RMB per US\$1.00	
	High	Low
October 2015	6.3591	6.3180
November 2015	6.3945	6.3180
December 2015	6.4896	6.3883
January 2016	6.5932	6.5219
February 2016	6.5795	6.5154
March 2016	6.5500	6.4480
April 2016 (through April 8, 2016)	6.4780	6.4599

The following table sets forth the average noon buying rates between Renminbi and U.S. dollars for each of 2011, 2012, 2013, 2014, 2015 and 2016 (through April 8, 2016), calculated by averaging the noon buying rates on the last day of each month of the periods shown:

Period	Average Noon Buying Rate RMB per US\$1.00
2011	6.4630
2012	6.3088
2013	6.1478
2014	6.1704
2015	6.2869
2016 (through April 8, 2016)	6.5096

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

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Risk Factors

You should consider carefully all of the information in this annual report, including the risks and uncertainties described below. If any of the following risks actually occurs, our business, financial condition or results of operations could be harmed. In such event, the trading price of our ADSs could decline and you could lose all or part of your investment.

Risks Relating to Our Business

We face increasing competition in the PRC from providers of Internet games, mobile games and WVAS, which could reduce our market share and materially and adversely affect our business, financial condition and results of operations.

The Internet games business is highly competitive in the PRC. We expect more companies to enter the Internet games industry in the PRC and a wider range of Internet games to be introduced to the PRC market. Our principal competitors in the PRC include Perfect World Co., Ltd., Shanda Games Limited, NetEase, Inc., Changyou.com Limited, Giant Interactive Group Inc. and Tencent Holdings Limited. Our potential competitors include major Internet portal operators, other domestic and foreign game developers and publishers and alliances between our existing and new competitors. Many of our competitors have significantly greater financial and marketing resources and name recognition than we do. Some of our competitors or potential competitors, especially major foreign Internet games developers, have greater game development resources than we do. In addition, many of our competitors have developed and operated games that have proven commercially successful for a longer period of time than our games and have a larger portfolio of Internet games than we do.

Moreover, our competitors may introduce new business models that may be more attractive to customers than the business models we currently use. We believe that competition in the PRC Internet games market may become more intense as increasing numbers of Internet games are introduced in the market. We cannot assure you that we will be able to compete successfully against any new or existing competitors, or against any new business models implemented by them. In addition, the increased competition in the Internet games industry may reduce the number of our players or growth rate of our player base, or create pressure for us to reduce usage fees or the prices of certain in-game items. Any of these events could materially decrease our revenues and profitability.

The development, distribution and sale of mobile games are also highly competitive in the PRC. We compete for customers primarily on the basis of game quality, brand and price. In addition, we compete for mobile game distribution platforms and telecommunications operators to distribute our mobile games, principally on the basis of the popularity of our games among customers, our historical performance, perception of our sales potential and our

relationships with content and brand licensors. Furthermore, we compete for content and brand licensors who supply game content and brands, mainly on the basis of the economic terms, such as royalty rates, of our cooperation agreements with the licensors, the licensors' perception of our ability to develop games and pre-load games in mobile handsets, our speed of execution, diversity of distribution channels and relationships with telecommunications operators. We also compete for experienced and talented employees in the mobile games business. Moreover, the entry of new competitors, such as developers of personal computer-based Internet games, major media companies, traditional video game developers, content aggregators, mobile software providers and independent mobile games developers, would likely intensify competition in the mobile games market. Increasing competition in this market could make it difficult for us to maintain or increase our market share and have a material adverse effect on our business, financial condition, results of operations and prospects.

The PRC WVAS market has also experienced increasingly intense competition. The MIIT reported on its website that more than 3,800 service providers held nationwide licenses as of December 31, 2015 to supply WVAS on the PRC telecommunications operators' networks. We compete with these companies primarily on the basis of brand, price, type and timing of service offerings, content, customer service, business partners and distribution channel relationships. We also compete with these companies for experienced and talented employees. While we believe that we have certain advantages over our competitors, some of them may have greater personnel and financial resources and a longer operating history than we do. In particular, Internet portal companies that provide WVAS may have an advantage over us as a result of their more established brand names, user bases and Internet distribution channels. Furthermore, our competitors may be able to develop or exploit new technologies faster than we can, or offer a broader range of products and services than we are presently able to offer.

Our ability to succeed in the PRC Internet games market is subject to many challenges and uncertainties.

Our ability to succeed in the PRC Internet games market is subject to many challenges, such as our ability to develop and license popular games. In particular, new Internet games are regularly introduced in the PRC, but only a relatively small number of high quality, popular games account for a significant portion of the PRC Internet games market. Moreover, it is difficult to predict prior to the introduction of an Internet game whether any particular game would be well received by PRC game players. Accordingly, any negative development relating to our Internet games could materially and adversely affect our business, financial condition, results of operations and prospects. Potential negative developments include:

- our failure to make quality upgrades, expansion packs, enhancements or improvements to our Internet games in a timely manner;

- our failure to avoid, or detect and correct, defects in our Internet games in a timely manner;

- any reduction in our server capacity, including our failure to adequately project our future server needs and make advanced purchases of servers to accommodate the expected increase in the number of game players;

- any reduction in or failure to grow our games or player base, or any decrease in the popularity of our Internet games;

- any failure to license popular Internet games from external game developers that complement our internally developed Internet games;

- any failure to properly tailor and localize any foreign games we have licensed for PRC game players;

- any decrease in or failure to grow the amount of revenues generated from our Internet games;

- a failure in our Internet games billing system, which we rely on for revenue recognition and tracking of the consumption patterns of game players; or

- any breach of game-related software security or prolonged server interruption due to network failures or hacking activities.

In addition, our ability to succeed in the Internet games market is subject to many uncertainties beyond our control. As the Internet games industry is a relatively new and evolving industry, the growth of the Internet games industry and the level of demand and market acceptance of our Internet games are subject to a high degree of uncertainty. Our future operating results will depend on numerous factors, including:

- the Internet infrastructure and the continued growth of personal computer, Internet and broadband penetration in the PRC and other markets in which we offer our games;

whether the Internet games industry, particularly in the PRC and the rest of the Asia-Pacific region, continues to grow and the rate of any such growth;

our ability to license or operate our games in overseas markets;

laws, rules, regulations and policies affecting the Internet games industry, including those affecting Internet cafes in the PRC, where a substantial portion of our game players access Internet games;

general economic conditions, particularly those affecting discretionary consumer spending;

the availability and popularity of other forms of entertainment, particularly console game systems, which are already popular in developed countries and may gain popularity in the PRC and other countries in which we market our games;

public opinion regarding Internet games;

the popularity, pricing and business model of new Internet games and in-game items that we and our competitors launch and distribute; and

our ability to upgrade and improve our existing games to extend their life spans and to maintain their competitive positions in the Internet games market in a timely manner.

Due to these challenges and uncertainties, we cannot assure you that our Internet games business will make a positive contribution to our future revenues and profitability. Our failure to successfully develop this business could have a material adverse effect on our business, financial condition, results of operations and prospects.

If we fail to anticipate and launch games that respond to changing consumer tastes and preferences or predict trends in the PRC Internet games market, our revenues and profitability could be materially reduced, and our growth and prospects would suffer.

The success of our Internet games business will largely depend on our ability to anticipate and launch games that effectively respond to changing consumer tastes and preferences, as well as technological advances, in a timely manner. For example, we may need to license from overseas developers popular game titles that we believe may be popular with game players in the PRC. These licenses may subject us to significant up-front non-refundable license fees, and there is no assurance these games will be commercially viable in the PRC market. In addition, we will need

to replace our existing Internet games as they reach the end of their useful economic lives, which we believe are typically one to three years, as well as operate a larger number of Internet games to continue increasing our overall player base and revenues to meet our growth strategy. If we fail to launch and operate these games successfully in the PRC in a timely manner to meet PRC consumers' changing tastes and preferences, or if these games fail to respond to their tastes and preferences, our revenues could decrease materially, operating costs could increase significantly, profitability could be materially reduced, and we may need to write down all or part of the up-front non-refundable license fees paid to game developers. For example, as a result of the unsatisfactory performance and uncertainty in the localization development of certain Internet games, we recognized an impairment loss of US\$1.32 million and US\$35.21 million, respectively, in 2014 and 2015. See "Item 4 — Information on the Company — Business Overview — Our Internet Games Business."

Moreover, any failure by us to predict and adapt our Internet games to meet market trends could materially reduce our revenues and profitability, and severely harm our growth and prospects. For example, a majority of our Internet games depend on players to download and install large client-side software, which may require significant computing resources as well as many hours to download. Game players in the PRC have been increasingly turning to web browser-based games in cases where downloading large client-side software is inconvenient or impracticable. As such, we cannot assure you that game players in the PRC will continue to download and install such types of software to play Internet games, or otherwise prefer the convenience and ease of use offered by browser-based or other games.

In addition, expanding our Internet games portfolio may add complexities to our Internet games business and require us to effectively adapt our business and management processes to address particular operational challenges and different requirements of new Internet games in which we operate, which we may not be able to do due to the lack of institutional expertise or otherwise. Accordingly, if we fail to anticipate and successfully launch and operate games that effectively respond to changing consumer tastes and preferences in a timely manner, our revenue and profitability could be materially reduced, and our growth and prospects would suffer.

We apply item-based and CD-key revenue models for a number of our current Internet games, which are relatively new revenue models and may have a negative impact on our financial condition and results of operations.

We have adopted an item-based revenue model for a number of our Internet games, including World of Tanks, World of Warplanes and World of Warships, under which players are able to play the Internet games free of charge for an unlimited amount of time, but are charged for purchases of in-game items, such as performance-enhancing items, clothing, accessories and pets. While several other Internet games companies have adopted the item-based model, it is still relatively new compared to time-based billing models, and may create new risks and uncertainties for us. The item-based model will require us to design games that not only attract players to spend more time playing, but also encourage them to purchase in-game items. The sale of in-game items will require us to track closely consumer tastes and preferences, particularly as shown by in-game spending trends. In addition, the item-based model may raise additional concerns for the PRC regulators, who have expressed reservations over the amount of time that Chinese youths spent on Internet games. A model that does not charge based on time spent may be viewed by the PRC regulators as undesirable. We cannot assure you that the item-based revenue model will be successful, or that it will not have a negative impact on our financial condition and results of operations.

In addition, our revenue recognition policy for the item-based games relies on our estimates of the useful lives of various items associated with each of our item-based games. We have relatively limited operating history and data for our item-based games on which to base our revenue recognition policy for these games. With respect to permanent ownership items that we sell to players, we recognize revenues over the estimated useful lives of such items. We take into account paying player behavior patterns in estimating the lives of permanent life in-game items, including the average period that the typical player plays our games based on log-on data, which are affected by various factors such as acceptance and popularity of the game, game updates and other in-game items, promotional events launched, future operating strategies and market conditions. We calculate the actual playing periods of the players based on historical

log-on patterns of all the paying players over years of game operations starting from the launch of the games. We review the actual average playing periods for all active games and evaluate other various factors, such as acceptance and popularity of the game, game updates and other in-game items, promotional events launched, future operating strategies and market conditions at least annually, to assess if the estimated life of permanent ownership items remains reasonable. Given the relatively short operating history of our item-based games, however, our estimate of the period that players typically play our games may not accurately reflect the actual useful lives of the items, and changes in player behavior observed over time may also affect the estimate. We revise our estimates as we continue to gather operating data, and refining our estimation process and results accordingly. Any future revisions to estimates could affect the time period during which we recognize revenues from these items. In particular, an increase in the estimated lives of these items would increase the period of time over which the revenues from the items are recognized. If we are required to make adjustments to our financial statements as a result of revisions to our estimates, it could materially and adversely affect market sentiments toward us, and the trading price of our ADSs could decline significantly.

Moreover, we have adopted other business models in our Internet games business to supplement our item-based revenue model, such as the CD-Key model, under which players are able to have full access to our Internet games but only after they have paid an upfront fee. We have adopted the CD-Key model for the Guild Wars 2 game and may in the future apply such model or other revenue models to our other Internet games. We cannot assure you that these new business models will be successful, or that it will not have a negative impact on our financial condition and results of operations, including our revenues, profitability and cash flows.

We depend on a small number of Internet games for a significant portion of our Internet games revenues, and any factors that could have an adverse impact on the development, marketing and distribution of these Internet games, or on our business relationships with the licensors of these Internet games, could materially decrease our Internet games revenues, and have a material adverse effect on our business, financial condition, results of operations and prospects.

A substantial majority of our Internet games revenues is generated from purchases of in-game items by game players based on a small number of Internet games we offer. The revenues generated from these Internet games are responsible for a disproportionate amount of our Internet games revenues. In 2015, revenues generated by in-game items purchased by game players who play the World of Tanks game represented over 86.33% of our Internet games revenues. If the World of Tanks game players become dissatisfied with the World of Tanks game or with the in-game items, they may choose not to purchase additional in-game credits in the future.

Moreover, we depend on Internet games licensors whose games we have the rights to operate in the PRC or other markets to make quality in-game items, upgrades, enhancements, and localized updates and improvements to our licensed Internet games. For example, we entered into a licensing agreement with Wargaming.net LLP, or Wargaming LLP, in August 2010. Wargaming LLP, the licensor of the World of Tanks game, is responsible for developing upgrades, enhancements and improvements to the World of Tanks game. In addition, Wargaming LLP is responsible for providing timely localized updates and enhancements to the game, as well as developing new in-game items that track the preferences and tastes of game players in the PRC. If Wargaming LLP ceased to cooperate with us, we would no longer be able to provide the World of Tanks game to game players in the PRC or generate the corresponding revenues from the game. In December 2015, Wargaming LLP assigned its rights and obligations under the licensing agreement to an affiliate, Wargaming.net Limited, or Wargaming Ltd.

Due to the concentration of our Internet games revenue in a small number of Internet games and our dependence on licensors of certain Internet games to continue to develop new in-game items and to upgrade and enhance those games, any factors that could have an adverse impact on the development, marketing and distribution of these Internet games, or on our business relationships with the licensors of these Internet games, could materially reduce our Internet games revenues, and have a material adverse effect on our business, financial condition, results of operations and prospects.

Our Internet games business depends on our ability to acquire and maintain licenses to popular Internet games developed by other developers, and if we are unable to acquire or maintain licenses to these Internet games, our business, financial condition, results of operations and prospects could be materially and adversely affected.

During 2015, approximately 98.5% of our Internet games revenues were generated from Internet games that we licensed from third party Internet games developers. Our ability to acquire and maintain licenses to popular Internet games from third party developers depends on a number of factors, such as:

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identifying and maintaining good relationships with licensors whom we rely on to provide our game players with upgrades, expansion packs, enhancements or improvements;

changes in the terms, or termination, of or the failure to renew, the Internet games licenses with our licensors, which could be caused by, among others, contractual breach by us or our licensors, demand for new royalty payments by our licensors or refusal by our licensors to renew licenses;

maintaining the reputation and continued marketability of our licensed games if our licensors are unable to provide our game players with satisfactory upgrades, expansion packs or enhancements;

protecting our intellectual property rights both inside and outside the PRC;

complying with the different commercial and legal requirements of the international markets from which we license our games, such as Internet games import regulatory procedures, taxes and other restrictions and expenses;

fluctuations in currency exchange rates; and

interruptions in cross-border Internet connections or other system failures.

If we are unable to maintain a stable relationship with third party Internet game developers due to any of the factors listed above, or if these developers establish similar or more favorable relationships with our competitors in violation of its contractual arrangements with us or otherwise, we may not be able to properly manage our operation of licensed online games, which could materially harm our business as well as our operating results. Moreover, we have incurred significant payment obligations to third party developers. If we are unable to meet these obligations, or if financing is not available in amounts or on terms acceptable to us, our ability to operate our licensed games could be materially disrupted and our licenses with third party developers could be terminated, which could materially reduce our revenues and profitability.

Any difficulties or delays in receiving approval from the relevant government authorities for the operation of games we license from Internet games developers outside of the PRC or any expansion packs for, or material changes to, such games could significantly reduce their popularity and profitability.

We currently license six Internet games from third party developers outside of the PRC. We are required to obtain relevant PRC government approvals before we are permitted to operate these games within the PRC. In addition, after such government approvals have been obtained, any expansion packs for or material changes of content to those games may require further government approvals. We may not be able to receive such government approvals, and we

cannot be certain of the duration of any necessary approval processes. Any difficulties or delays in receiving these government approvals may significantly reduce the profitability and popularity of the licensed games and may entitle licensors to terminate their licenses with us.

If we fail to manage risks associated with licensing our internally developed games outside the PRC, our business, financial condition, results of operations and prospects could be adversely affected.

We have licensed three of our Internet games to operators outside the PRC. We plan to license our existing and new internally developed games in additional countries and regions in the future. The offering of our internally developed games to the international markets exposes us to a number of risks, including:

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identifying and maintaining good relationships with licensees who are knowledgeable about, and are able to effectively distribute and operate our Internet games in, international markets;

· developing Internet games and expansion packs catered to markets outside the PRC;

· renewing our license agreements with licensees upon their expiration;

· maintaining the reputation of our company and our games that are being operated by licensees in international markets pursuant to their own standards;

· protecting our intellectual property rights both inside and outside the PRC;

· complying with the different commercial and legal requirements of the international markets in which we offer our games, such as Internet games import regulatory procedures, taxes and other restrictions and expenses;

· fluctuations in foreign currency exchange rates; and

· interruptions in cross-border Internet connections or other system failures.

We could be liable for breaches of security of our website and third party online payment channels, which may materially harm our reputation, business and prospects.

A portion of our Internet games revenues is generated from sales through third party online payment platforms. In such transactions, secure transmission of confidential information, such as customers' credit card information, personal information and billing addresses, over public networks, in some cases including the websites for our Internet games, is essential to maintain consumer confidence. While we have not experienced any breach of our security measures to date, we cannot assure you that our current security measures are sufficient. In addition, we expect that an increasing amount of our sales will be conducted over the Internet as a result of the growing use of online payment systems over time. Over the same period, online theft of confidential information will likely increase and we must be prepared to increase our security measures and efforts so that our customers have confidence in the reliability of the online payment systems that we use. We do not have control over the security measures of our third party online payment vendors, and we cannot assure you that these vendors' security measures are sufficient or will be sufficient with the expected increased usage of online payment systems. Security breaches of the online payment systems that we use could expose us to litigation and possible liability for failing to secure confidential customer information, and could harm our reputation, ability to attract customers and ability to encourage customers to purchase in-game items, any of which could materially harm our reputation, business and prospects.

Undetected errors or flaws in our services or failure to maintain effective customer service could harm our reputation or decrease market acceptance of our games, which may materially and adversely affect our financial condition and results of operations.

Our products and services, such as our Internet games, mobile games and WVAS, may contain errors or flaws, which may only become apparent after their release, particularly as we often launch new products or services or introduce new features to existing products or services under tight time constraints. From time to time, our customers have informed us of flaws affecting their experience with our products or services, which we were generally able to resolve promptly. Furthermore, customer service is critical for retaining customers, and we may not be able to maintain and continuously improve the quality of our services to meet customers' expectations. If our products or services contain programming errors or other flaws, or if we fail to provide effective customer service, our customers may be less inclined to continue using our products or services or recommend them to other potential customers, and may use our competitors' products and services. Undetected errors, defects and unsatisfactory customer service can disrupt our operations, adversely affect the experience of our customers, harm our reputation, cause our customers to stop using our products and services, and delay market acceptance of our products and services, any of which could materially and adversely affect our financial condition and results of operations.

Our mobile games business has experienced high volatility in its operations, and the mobile games market in the PRC is subject to many uncertainties.

Our mobile games business has experienced high volatility in its operations. For example, revenues from our mobile games business increased 166.4% from US\$16.9 million in 2013 to US\$45.0 million in 2014, and decreased 45.3% from US\$45.0 million in 2014 to US\$24.6 million in 2015. We may continue experiencing high volatility in developing our mobile games business, the success of which will depend, among other things, on our ability to:

respond to market developments, including the development of new platforms and technologies, such as smartphone mobile gaming platform, and changes in pricing and distribution models, such as the advent of application stores, or “app stores,” operated by handset manufacturers;

respond to changes in policies of China Mobile or other PRC telecommunications operators relating to mobile games distributed through them;

maintain and diversify our distribution channels, including through China Mobile and the other PRC telecommunications operators and handset manufacturers;

develop new mobile games that achieve significant market acceptance, and timely improve our existing mobile games to extend their life spans and to maintain their competitiveness;

successfully identify, acquire and integrate other mobile games development companies that could complement our internal mobile games development resources;

acquiring mobile games from third party mobile game developers or cooperating with third party mobile game developers to jointly develop mobile games; and

develop and upgrade our mobile games platform technologies.

In addition, the mobile games market is still relatively underdeveloped in the PRC. The continued growth of this market and the level of demand and market acceptance of our mobile games are subject to many uncertainties. The development of this market and our ability to derive revenues from this market depend on a number of factors, some of which are beyond our control, including:

- the growth rate of mobile data services in the PRC;
- changes in consumer demographics, tastes and preferences;
- changes in handset platform technologies that accommodate consumer needs and preferences;
- changes in mobile games distribution channels that accommodate consumer needs and preferences;

the extent that the mobile games business remains a key area of development for our telecommunications operator partners;

potential competition from established companies that develop and operate personal computer-based Internet games and may enter the mobile games market; and

the popularity and price of new mobile games and merchandise and premium features embedded in games that are launched and distributed in the future.

Due to the uncertainties in connection with our mobile games business in particular and the PRC mobile games market generally, we cannot assure you the extent to which our mobile games business will contribute to our future revenues. Our failure to successfully develop this business could have a material adverse effect on our business, financial condition, results of operations and prospects.

We depend on China Mobile and other PRC telecommunications operators for a significant portion of our revenues, and any loss or deterioration of our relationship with these telecommunications operators could result in severe disruptions to our business operations and significant loss of revenues.

We derive a significant portion of our revenues from the provision of mobile games and WVAS through the networks of the PRC telecommunications operators. We rely primarily on the networks of China Mobile Limited, or China Mobile, to deliver our products and services. In 2015, we derived approximately 22.6% of our total revenues and approximately 49.0% and 57.5%, respectively, of our mobile games and WVAS revenues from our cooperation arrangements with China Mobile. The remainder of our mobile games and WVAS revenues is derived from cooperation arrangements with China United Telecommunications Corporation, or China Unicom, and China Telecommunications Corporation, or China Telecom.

Through our consolidated variable interests entities, Beijing AirInbox Information Technologies Co., Ltd., or Beijing AirInbox, Beijing Boya Wuji Technologies Co., Ltd., or Beijing Boya Wuji, Beijing Wireless Interactive Network Technologies Co., Ltd., or Beijing WINT, Beijing Chengxitong Information Technology Co., Ltd., or Beijing Chengxitong, Nanjing Net Book Culture Co., Ltd., or Zhulang, Beijing Xinrui Technology Co., Ltd., or BJXR, Shanghai Mailifang Communications Ltd., or Mailifang, and Xiamen Xinreli Technology Co., Ltd., or Xinreli, as the case may be, we have entered into a series of cooperation agreements with the subsidiaries of China Mobile and other PRC telecommunications operators to provide mobile games and WVAS through the networks of these telecommunications operators. Pursuant to our agreements with these telecommunications operators, the telecommunications operators bill and collect fees from mobile phone users for the mobile games and WVAS we provide. Our agreements with the telecommunications operators are generally for terms of one year or less, and are typically not renewed automatically. We usually renew these agreements or enter into new agreements when the prior agreements expire, but on occasion the actual renewals, or entering into, of new contracts could be delayed for one

month or more. Any inability to renew these contracts or enter into new contracts could severely disrupt our business and operations and materially decrease our revenues and profitability.

Furthermore, telecommunications operators could discontinue or de-emphasize the use of external mobile games or WVAS providers, such as our company. If any of the PRC telecommunications operators ceases or de-emphasizes its cooperation with us, we would no longer be able to distribute mobile games or provide WVAS to such operator's customers or generate related revenues, and our revenues from such operator's customers would decrease substantially. In particular, if China Mobile ceases or de-emphasizes its cooperation with us, it is unlikely that we would be able to build up sufficient number of new customers through the networks of other PRC telecommunications operators to timely replace those lost from China Mobile. Due to our reliance on China Mobile and other PRC telecommunications operators to deliver our mobile games and WVAS to our customers, any loss or deterioration of our relationship with China Mobile or other PRC telecommunications operators could result in severe disruptions to our business operations, significant loss of revenues and have a material adverse effect on our financial condition and results of operations.

The termination or alteration of our cooperation agreements with China Mobile or other PRC telecommunications operators could materially harm our business and have a material adverse effect on our financial condition and results of operations.

Our negotiating leverage with China Mobile and other PRC telecommunications operators is limited because China Mobile and other PRC telecommunications operators operate the telecommunications networks through which we deliver our products and services to mobile phone users in China. Our revenues and profitability could be materially reduced if China Mobile or other PRC telecommunications operators decided to change the terms of their cooperation agreements with us, such as by increasing their transmission or service fees, or if they fail to comply with the terms of these agreements. We cannot assure you that China Mobile will not seek to terminate or materially alter our cooperation agreements with its provincial subsidiaries.

In addition, China Mobile or other PRC telecommunications operators could impose monetary penalties on us or terminate their cooperation agreements with us for a variety of reasons, including, if:

we fail to achieve the performance standards established by the relevant telecommunications operator from time to time;