KONGZHONG CORP
Form 20-F
June 28, 2005

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2004

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission file number 000-50826

KONGZHONG CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

N/A	Cayman Islands
(Translation of Registrant s Name Into English)	(Jurisdiction of Incorporation or Organization)

35th Floor, Tengda Plaza
No. 168 Xizhimenwai Street
Beijing, China 100044
(Address of Principal Executive Offices)

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
None	

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

Ordinary shares, par value US$0.0000005 per share*
American depositary shares, each representing 40 ordinary shares
(Title of class)

* Not for trading, but only in connection with the listing on The Nasdaq Stock Market, Inc. of American depositary shares, or ADSs, each representing 40 ordinary shares.

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, 2004, 1,371,600,000 ordinary shares, par value US$0.0000005 per share, were issued and outstanding.

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 þ No o

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 o Item 18 þ

TABLE OF CONTENTS

Table of Contents

FORWARD-LOOKING STATEMENTS

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

- our financial performance and business operations;
- our ability to successfully execute our business strategies and plans;
- the state of our relationship with China s mobile telecommunications operators;
- our dependence on the substance and timing of the billing systems of mobile operators for our performance;
- our development and capital expenditure plans;
- the expected benefit and future prospects of our strategic alliances and acquisitions, and our ability to cooperate with our alliance partners or integrate acquired businesses;
- management estimations with respect to the growth rate of revenues from our advanced second-generation (2.5G) and other products and services;
- the development of our latest product offerings;
- the development of the regulatory environment; and
- competitive pressures and future growth in the wireless value-added services, telecommunications and related industries in China.

The words forecast , anticipate , believe , could , estimate , expect , intend , may , plan , seek , will , 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:

- any changes in our relationship with mobile operators in China;
- the effect of competition on the demand for and the price of our services;
- any changes in customer demand and usage preference for our products and services;

Table of Contents

- any changes in the mobile telecommunications operators systems for billing users of our wireless value-added services and remitting payments to us;

- any changes in the regulatory policies of the Ministry of Information Industry, or MII, the mobile telecommunications operators or other relevant government or industry authorities relating to, among other matters, the granting and approval of licenses, restrictions on wireless or Internet content, or the introduction of new technology platforms, products and services;

- any changes in wireless value-added, telecommunications and related technology and applications based on such technology;

- any changes in political, economic, legal and social conditions in China, including the PRC government s specific policies with respect to foreign investment and entry by foreign companies into the wireless value-added services and telecommunications markets, economic growth, inflation, foreign exchange and the availability of credit; and

- changes in population growth and GDP growth and the impact of those changes on the demand for our services.

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. Because of 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.

Table of Contents

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 historical consolidated financial data should be read in conjunction with our audited historical consolidated financial statements, the notes thereto and Item 5 Operating and Financial Review and Prospects . The selected historical consolidated statement of operations data for the period from May 6, 2002 to December 31, 2002 and for the years ended December 31, 2003 and 2004, and the selected historical consolidated balance sheet data as of December 31, 2003 and 2004 set forth below are derived from our audited historical consolidated financial statements included elsewhere in this annual report. The selected historical consolidated balance sheet data as of December 31, 2002 set forth below are derived from our audited historical consolidated financial statements that are not included in this annual report.

Our audited historical consolidated financial statements have been prepared and presented in accordance with U.S. GAAP.

Consolidated statements of operations data	For the period from May 6, 2002 to December 31, 2002	For the year ended December 31, 2003	2004
	(in thousands of U.S. dollars, except for share and per share data)		
Gross revenues	$ 200.3	$ 7,806.7	$ 47,969.2
Cost of revenues	(84.3)	(2,284.0)	(15,704.8)
Gross profit	116.0	5,522.7	32,264.4
Operating expenses:			
Product development	164.2	1,369.5	4,357.6
Sales and marketing	128.9	841.4	3,228.3
General and administrative	317.3	882.7	4,407.2
Amortization of deferred stock compensation		22.0	482.8
Total operating expenses	610.4	3,115.6	12,475.9

(Loss) income from operations		(494.4)		2,407.1		19,788.5
Other expenses, net						(21.1)
Interest income, net		0.5		1.0		601.9
Net (loss) income before income taxes		(493.9)		2,408.1		20,369.3
Income tax expense						
Net (loss) income	$	(493.9)	$	2,408.1	$	20,369.3
Net (loss) income per share:						
Basic	$	0.00	$	0.01	$	0.02
Diluted	$	0.00(1)	$	0.00	$	0.02(2)
Shares used in calculating net (loss) income per share:						
Basic		415,547,794		469,000,000		903,010,929
Diluted		415,547,794(1)		1,094,824,434		1,250,640,982(2)

Table of Contents

(1) Anti-dilutive preferred shares and options were excluded from the weighted average ordinary shares outstanding for the diluted per share calculation. For 2002, basic loss per share did not differ from diluted loss per share.

(2) As of December 31, 2004, we had 33,260,000 ordinary share equivalents outstanding that could have potential diluted income per share in the future, but that were excluded in the computation of diluted income per share in the period, as their exercise prices were above the average market values in such period.

Consolidated balance sheet data	As of December 31, 2002	2003	2004
	(in thousands of U.S. dollars)		
Cash and cash equivalents	$ 2,646.2	3,742.6	$ 90,714.1
Accounts receivable	132.3	1,703.9	10,198.8
Property and equipment, net	251.0	848.5	2,484.2
Total assets	3,101.3	6,567.5	104,372.7
Total current liabilities	75.0	1,047.3	4,443.6
Series B redeemable convertible preferred shares	2,970.0	2,970.0	
Total shareholders equity	56.3	2,550.1	99,808.3
Total liabilities and shareholders equity	3,101.3	6,567.5	104,372.7

Other consolidated financial data	For the period from May 6, 2002 to December 31, 2002	For the year ended December 31, 2003	2004
	(in thousands of U.S. dollars)		
Net cash (used in) provided by:			
Operating activities	$ (579.7)	$ 1,959.7	$ 15,844.7
Investing activities	(292.4)	(864.0)	(2,430.2)
Financing activities	3,520.3		73,555.5

Unaudited operating data	For the period from May 6, 2002 to December 31, 2002	For the year ended December 31, 2003	2004
	(in thousands)		
2.5G[1]			
Subscriptions[2]	351.6	9,021.3	46,363.5
Downloads[3]		2,722.1	17,881.9
2G[4]			

Subscriptions[2]	50.0	1,925.4	9,305.9
Downloads[3]	800.0	6,127.4	7,418.3
Total			
Subscriptions[2]	401.6	10,946.7	55,669.4
Downloads[3]	800.0	8,849.5	25,300.2

Table of Contents

(1) Includes WAP, MMS and Java™. We began to provide WAP, MMS and Java™ services on a paid basis in September 2002, April 2003 and November 2003, respectively.

(2) Total number of paid monthly subscriptions in the relevant period.

(3) Total number of paid downloads in the relevant period, excluding downloads made pursuant to subscriptions.

(4) Includes SMS, IVR and CRBT. We began to provide SMS, IVR and CRBT services on a paid basis in July 2002, December 2003 and October 2003, respectively.

Exchange Rate Information

We present our historical consolidated financial statements in U.S. dollars. In addition, certain pricing information is presented in U.S. dollars and certain contractual amounts that are in Renminbi include a U.S. dollar equivalent solely for the convenience of the reader. Except as otherwise specified, this pricing information and these contractual amounts are translated at RMB8.2768 = US$1.00, the prevailing rate on December 31, 2004. 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.

The People s Bank of China sets and publishes daily a base exchange rate with reference primarily to the supply and demand of Renminbi against the U.S. dollar in the market during the prior day. The People s Bank of China also takes into account other factors such as the general conditions existing in the international foreign exchange markets. Although Chinese 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 security, requires the approval of the State Administration for Foreign Exchange and other relevant authorities.

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 RMB8.2765 = US$1.00 on June 27, 2005. The following table sets forth the high and low noon buying rates between Renminbi and U.S. dollars for each of the periods shown:

	Noon Buying Rate RMB per $1.00	
Period	**High**	**Low**
December 2004	8.2767	8.2765
January 2005	8.2765	8.2765
February 2005	8.2765	8.2765
March 2005	8.2765	8.2765
April 2005	8.2765	8.2765
May 2005	8.2765	8.2765
June 2005 (through June 27)	8.2765	8.2765

The following table sets forth the average noon buying rates between Renminbi and U.S. dollars for each of 2000, 2001, 2002, 2003 and 2004, 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 $1.00
2000	8.2784
2001	8.2772
2002	8.2772
2003	8.2771
2004	8.2768

Table of Contents

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

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 an event, the trading price of our ADSs could decline and you might lose all or part of your investment.

Risks Relating to Our Business

We depend on China Mobile for substantially all of our revenue, and any loss or deterioration of our relationship with China Mobile may result in severe disruptions to our business operations and the loss of substantially all of our revenues.

We derive substantially all of our revenues from the provision of wireless value-added services. We rely on the networks and gateways of China Mobile Communications Corporation, or China Mobile, which has the largest mobile subscriber base in the world, to deliver our services. For each of the two years ended December 31, 2003 and 2004, we derived substantially all of our revenues from our cooperation arrangements with China Mobile.

Through Beijing AirInbox Information Technologies Co., Ltd., or Beijing AirInbox, and Beijing Wireless Interactive Network Technologies Co., Ltd., or Beijing WINT, we have entered into a series of cooperation agreements with China Mobile and a number of its provincial subsidiaries to provide wireless value-added services through China Mobile s networks. Pursuant to our agreements with China Mobile and its provincial subsidiaries, these mobile operators bill and collect fees from mobile phone users for the wireless value-added services we provide.

Our agreements with China Mobile or its subsidiaries are generally for terms of one year or less and approximately 40% of them do not have automatic renewal provisions. We usually renew these agreements or enter into new ones when the prior agreements expire, but on occasion the renewal or new contract can be delayed by periods of one month or more.

If China Mobile ceases to continue to cooperate with us, it will be difficult to find replacement operators with the requisite licenses and permits and comparable infrastructure and customer base to offer our existing wireless value-added services business. In addition, our existing customer base consists almost entirely of subscribers to China Mobile s mobile telephone services. It is unlikely that such customers would continue to use our services if they are not available through China Mobile.

Due to our reliance on China Mobile for our wireless value-added services, any loss or deterioration of our relationship with China Mobile may result in severe disruptions to our business operations, the loss of substantially all of our revenue and a material adverse effect on our financial condition and results of operations.

The termination or alteration of our cooperation agreements with China Mobile and its subsidiaries would materially and adversely impact our business operations and financial conditions.

Our negotiating leverage with China Mobile is limited given its leading market position. Our revenue and profitability could be materially adversely affected if China Mobile decides to change its transmission fees or its service fees. In addition, China Mobile or its subsidiaries could impose monetary penalties upon us or even terminate cooperation with us under the cooperation agreements with us, for a variety of reasons, such as the following:

if we fail to achieve the performance standards established by the applicable operator from time to time,

if we breach certain provisions under the agreements, which include, in many cases, the obligations not to deliver content that violates the operator s policies and applicable law, or

if the operator receives a high level of customer complaints about our services.

Due to our dependence on our relationship with China Mobile and its subsidiaries, any termination or material alteration of our cooperation agreements with China Mobile and its subsidiaries would materially and adversely impact our business operations and financial conditions.

In August 2004, China Mobile notified us that it had imposed sanctions on 22 wireless value-added service providers, including us. In our case, the notice stated that China Mobile found that one of our interactive voice response, or IVR, services in early June 2004 contained inappropriate content. For this infraction, China Mobile stated that it would suspend until the end of 2004 approval of our new applications for new products and services on all platforms and also suspended joint promotions with us. In addition, China Mobile suspended for one year, until June 30, 2005, the approval of our applications, if any, to operate on new platforms. We cannot guarantee that China Mobile or its subsidiaries will not impose penalities upon us in future, and such penalities could have a material impact on our results of operations.

We face risks related to the pending class action lawsuits filed against us and certain of our directors, officers and shareholders. These lawsuits could have a material adverse impact on us.

We and certain of our directors, officers and shareholders were named as defendants in six securities class action lawsuits filed in federal district court in New York City. These lawsuits were brought on behalf of shareholders who acquired our ADSs in our initial public offering in 2004 and allege violations of the Securities Act of 1933. The lawsuits could have a material adverse impact on our financial condition and results of operations. However, the lawsuits are at an early stage and we not able to assess the potential liability, if any, that we may have.

Significant changes in policies or guidelines of China Mobile with respect to services provided by us may result in lower revenue or additional costs for us and materially adversely affect our financial condition or results of operations.

China Mobile may from time to time issue policies or guidelines, requesting or stating its preference for certain actions to be taken by all wireless value-added service providers using its networks. Due to our reliance on China Mobile, a significant change in its policies or guidelines may result in lower revenues or additional operating costs for us. Such a change in policies or guidelines may result in lower revenues or additional operating costs for us, and we cannot assure you that our financial condition and results of operation will not be materially adversely affected by policy or guideline changes by China Mobile in the future.

For example, beginning in the second half of 2004, China Mobile and its provincial subsidiaries have been gradually implementing a series of policies designed to improve customer service and satisfaction. These policies include:

not recognizing revenue to us and other SPs for multimedia messaging services, or MMS, messages that cannot be delivered because of network or handset problems,

- canceling subscriptions of users who have not accessed their wireless value-added service subscriptions for a certain period of time,

- requiring more complicated procedures for users to confirm new subscriptions to certain wireless value-added services, and

- removing from subscriber lists those users who fail to pay China Mobile or the provincial subsidiaries, or who cannot be billed because they use pre-paid telecommunications service cards.

As a result of these new policies, our 2G revenues, which accounted for approximately 16% of our total revenues for the year ended December 31, 2004, decreased 6% during the fourth quarter of 2004 as compared to the third quarter of 2004, and our MMS revenues, which accounted for 36% of our total revenues for the year ended December 31, 2004, declined approximately 54% in the first quarter of 2005 as compared to the fourth quarter of 2004. We cannot assure you that these new policies will not further adversely impact our financial performance in the future.

Our dependence on the substance and timing of the billing systems of China Mobile and its subsidiaries may require us to estimate portions of our reported revenues and cost of revenues for wireless value-added services. As a result, subsequent adjustments may have to be made to our wireless value-added services revenue in our financial statements.

As we do not bill our wireless value-added services users directly, we depend on the billing systems and records of the mobile operators, including China Mobile and its subsidiaries, to record the volume of our wireless value-added services provided, charge our users, collect payments and remit to us our portion of the fees. We generally do not have the ability to independently verify or challenge the accuracy of the billing systems of the mobile operators.

We record revenues based on monthly statements from the mobile operators confirming the value of our services that they billed to users in the month. Before the second half of 2004, mobile operators usually sent such statements within 30 days after the end of each month. Beginning in the second half of 2004, China Mobile has introduced several new policies that have had the effect of lengthening the billing cycle. These new policies include the following:

- revenue collection for certain wireless value-added services has been decentralized from the parent to the provincial subsidiaries through which we provide services, and

- the subsidiaries have begun implementing the Mobile Information Service Center, or MISC, a mobile data management platform that records, processes and analyzes information relating to the provision of certain wireless value-added services, including usage, transmission and billing information.

Since implementation of the new policies, mobile operators usually send us statements within 45 days after the end of each month, and, usually within 45 days after sending us the statements, the mobile operators pay us for the services, net of their service and transmission fees. On occasion such statements for particular operators may be delayed by up to 90 days or more. We cannot assure you that the length of the billing cycle will not increase further in future.

A small portion of our reported revenues and related cost of revenues may involve estimations due to late billing statements from operators. Our estimations are based on:

service and billing information in our internal data management system, our past experience, and

our verbal communications with the mobile operators.

We internally tabulate the value of a wireless value-added service provided based in part on delivery confirmations sent to us by the networks of the mobile operators with respect to each delivery of our services to a user within 72 hours of delivery. We record these confirmations in our internal data management system. There has historically been a discrepancy between the value that we estimate and the value that we are entitled to receive based on the monthly statements provided by the mobile operators. This discrepancy varies across different technology platforms and arises for various reasons, including late notification of delinquent customers, our customer database being out of synchronization with those of mobile operators, duplicate billing and delivery failure. As the internal tabulation may not be entirely consistent with the actual revenues confirmed by the monthly statements that we eventually receive, we would multiply our internal tabulation of expected revenue from mobile operators from whom we have not received monthly statements by a realization factor applicable to the relevant mobile operator and service and determined according to the average discrepancy over the previous 12 months between our internal tabulations of expected revenues and the actual revenues based on the monthly statements. In addition, our employees verbally communicate with the mobile operators billing personnel regarding the estimated revenue for the period in question. We may or may not get additional comfort from such verbal communications.

In future periods, we may continue to release our unaudited quarterly financial statements to the market. Due to our past experience with the timing of receipt of the monthly statements from the operators, we expect that we may need to rely on our own internal estimates for the portion of our reported revenues for which we will not have received monthly statements. In such an instance, our internal estimates would be based on our own internal estimation of expected revenues from services provided and the related cost of revenues, as discussed above. As a result of reliance on our internal estimates, we may overstate or understate our revenues and cost of revenues for the relevant reporting period. Any difference between our estimated and actual revenues and cost of revenues may result in subsequent adjustments to our revenues and cost of revenues reported in our financial statements.

As China Mobile s provincial subsidiaries increasingly implement MISC, we are adapting our own internal data management systems in order to align them with MISC and reduce the discrepancy between our revenue estimates and the revenue calculated by the mobile operators. We cannot assure you that these efforts will be successful. We also cannot assure you that any negotiations between us and China Mobile to reconcile billing discrepancies would be resolved in our favor or that our results of operations would not be adversely affected as a result. See Item 5 Operating and Financial Review and Prospects Critical Accounting Policies Revenue Recognition .

We have a limited operating history, which may make it difficult for you to evaluate our business.

We were incorporated in May 2002. As our operating history is limited, the revenue and income potential of our business and markets are unproven. In addition, we face numerous risks, uncertainties, expenses and difficulties frequently encountered by companies at an early stage of development. Some of these risks and uncertainties relate to our ability to:

maintain our current, and develop new, cooperation arrangements upon which our business depends;

increase the number of our users by expanding the type, scope and technical sophistication of the content and services we offer;

respond effectively to competitive pressures;

increase awareness of our brand and continue to build user loyalty; and

-7-

attract and retain qualified management and employees.

We cannot predict whether we will meet internal or external expectations of our future performance. If we are not successful in addressing these risks and uncertainties, our business, financial condition and results of operations may be materially adversely affected.

We have only recently attained profitability, and our historical financial information may not be representative of our future results of operations.

We have only attained profitability since the first quarter of 2003. We have experienced growth in our business in recent periods in part due to the growth in China s wireless value-added services industry, which may not be representative of future growth or sustainable. We cannot assure you that our historical financial information is indicative of our future operating or financial performance, or that our profitability will be sustained.

We depend on our key personnel, and our business and growth prospects may be severely disrupted if we lose their services.

Our future success depends heavily upon the continued service of our key executives. In particular, we rely on the expertise and experience of Yunfan Zhou and Nick Yang, our founders and senior officers, in our business operations, and on their personal relationships with our other significant shareholders, employees, the regulatory authorities, our clients, our suppliers, the mobile operators and our operating companies, Beijing AirInbox, Beijing Boya Wuji Technologies Co., Ltd., or Beijing Boya Wuji, and Beijing WINT. If Yunfan Zhou or Nick Yang, or both of them, become unable or unwilling to continue in their present positions, or if they join a competitor or form a competing company in contravention of their employment agreements, we may not be able to replace them easily, our business may be significantly disrupted and our financial condition and results of operations may be materially adversely affected. We do not currently maintain key-man life insurance for any of our key personnel.

If the PRC government finds that the agreements that establish the structure for operating our business do not comply with PRC government restrictions on foreign investment in the value-added telecommunications industry, we could be subject to severe penalties.

In December 2001, in order to comply with China s commitments with respect to its entry into the World Trade Organization, or WTO, the State Council promulgated the Administrative Rules for Foreign Investments in Telecommunications Enterprises, or the Telecom FIE Rules. The Telecom FIE Rules set forth detailed requirements with respect to capitalization, investor qualifications and application procedures in connection with the establishment of a foreign-invested telecommunications enterprise. Pursuant to the Telecom FIE Rules, the ultimate ownership interest of a foreign investor in a foreign-funded telecommunications enterprise that provides value-added telecommunications services, including Internet content services, shall not exceed 50%.

We and our subsidiary, KongZhong Information Technologies (Beijing) Co., Ltd., or KongZhong Beijing, are considered foreign persons or foreign-invested enterprises under PRC laws. As a result, we operate our wireless value-added services in China through Beijing AirInbox, Beijing Boya Wuji and Beijing WINT (since February 2005), each of which is owned by PRC citizens or entities. We do not have any equity interest in these operating companies and instead enjoy the economic benefit of them through contractual arrangements, including agreements on provision of loans, provision of services, license of intellectual property, and certain corporate governance and shareholder rights matters. These operating companies conduct substantially all of our operations and generate substantially all of our revenues. They also hold the licenses and approvals that are essential to our business.

There are substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations, including but not limited to the laws and regulations governing the validity and enforcement of our contractual arrangements. Accordingly, we cannot assure you that PRC regulatory authorities will not

Table of Contents

determine that our contractual arrangements with Beijing AirInbox, Beijing Boya Wuji and Beijing WINT violate PRC laws or regulations.

If we or our operating companies are found to violate any existing or future PRC laws or regulations, the relevant regulatory authorities would have broad discretion in dealing with such violation, including, without limitation, the following:

levying fines;

confiscating our or our operating companies income;

revoking our or our operating companies business license;

shutting down the servers or blocking our or our operating companies web sites;

restricting or prohibiting our use of the proceeds from this offering to finance our business and operations in China;

requiring us to restructure our ownership structure or operations; and/or

requiring us or our operating companies to discontinue our wireless value-added services business.

Any of these or similar actions could cause significant disruptions to our business operations or render us unable to conduct our business operations and may materially adversely affect our business, financial condition and results of operations.

Our contractual arrangements with Beijing AirInbox, Beijing Boya Wuji and Beijing WINT may not be as effective in providing operational control as direct ownership of these businesses and may be difficult to enforce.

PRC laws and regulations currently restrict foreign ownership of companies that provide value-added telecommunications services, which include wireless value-added services and Internet content services. As a result, we conduct substantially all of our operations and generate substantially all of our revenues through Beijing AirInbox, Beijing Boya Wuji and Beijing WINT pursuant to a series of contractual arrangements with them and their respective shareholders. These agreements may not be as effective in providing control over our operations as direct ownership of these businesses. In particular, our operating companies could fail to perform or make payments as required under the contractual agreements, and we will have to rely on the PRC legal system to enforce these agreements, which we cannot be sure would be effective.

Rapid growth and a rapidly changing operating environment may strain our limited resources.

We have limited operational, administrative and financial resources, which may be inadequate to sustain the growth we want to achieve. As our user base increases, we will need to increase our investment in our technology infrastructure, facilities and other areas of operations. In particular, our product development, customer service and sales and marketing are important to our future success. If we are unable to manage our growth and expansion effectively, the quality of our services and our customer support could deteriorate and our business may suffer. For example, any deterioration in performance could prompt China Mobile to cease offering our services over their networks. Our future success will depend on, among other things, our ability to:

develop and quickly introduce new services, adapt our existing services and maintain and improve the quality of all of our services, particularly as new mobile technologies such as the third generation, or 3G, are introduced;

Table of Contents

effectively maintain our relationships with China Mobile;

expand the percentage of our revenues which are recurring and are derived from monthly subscription-based services;

enter into and maintain relationships with desirable content providers;

continue training, motivating and retaining our existing employees and attract and integrate new employees, including into our senior management;

develop and improve our operational, financial, accounting and other internal systems and controls; and

maintain adequate controls and procedures to ensure that our periodic public disclosure under applicable laws, including U.S. securities laws, is complete and accurate.

We may face increasing competition, which could reduce our market share and materially adversely affect our financial condition and results of operations.

The PRC wireless value-added services market has seen increasingly intense competition. The Ministry of Information Industry, or MII, reported on its website that more than 500 service providers held nationwide licenses in 2004 to supply content and services on China Mobile s Monternet™ network. We compete with these companies primarily on the basis of brand, type and timing of service offerings, content, customer service, business partners and channel relationships. We also compete for experienced and talented employees. While we believe that we have certain advantages over our competitors, some of them may have more human and financial resources and a longer operating history than us. For example, Internet portals providing wireless value-added services may have an advantage over us with their more established brand names, user base and Internet distribution channels. Furthermore, our competitors may be able to offer a broader range of products and services than we are presently able to offer.

We are facing increasing competition as additional service providers develop new technology and cooperation relationships with key business partners. According to Analysys International, a Beijing-based information technology and telecommunications market research firm, our primary competitors in the advanced second generation, or 2.5G, wireless value-added services market in China include Internet portals as well as wireless value-added service providers focused on 2.5G services. Our competitors that hold significant market share in WAP are TOM Online Inc., Shenzhen Xuntian Telecommunication Technology Ltd., Beijing Enterprise Mobile Technology Co., Ltd. and Beijing G. Feel Technology Co., Ltd., and our competitors that hold significant market share in MMS are Sina Corporation, TOM Online Inc., Linktone Limited and Tencent Technology Limited.

Competition is particularly intense in China s second generation, or 2G, based wireless value-added services market as the barriers to entry are relatively low compared to the 2.5G market, resulting in a much higher number of wireless value-added service providers. Our primary competitors in this market include Internet portals. Our competitors that hold significant market share in this market are Sina Corporation, Tencent Technology Limited, TOM Online Inc., Linktone Ltd. and Sohu.com Inc.

We may need additional capital and may not be able to obtain such capital on acceptable terms.

Capital requirements are difficult to plan in our rapidly changing industry. We currently expect that we will need capital to fund our future acquisitions, service development, technological infrastructure and sales and marketing activities.

Our ability to obtain additional capital on acceptable terms is subject to a variety of uncertainties, including:

- investors perceptions of, and demand for, securities of telecommunications value-added services companies;
- conditions of the U.S. and other capital markets in which we may seek to raise funds;
- our future results of operations, financial condition and cash flows;
- PRC governmental regulation of foreign investment in value-added telecommunications companies;
- economic, political and other conditions in China; and
- PRC governmental policies relating to foreign currency borrowings.

Any failure by us to raise additional funds on terms favorable to us, or at all, may have a material adverse effect on our business, financial condition and results of operations. For example, we may not be able to carry out parts of our growth strategy to acquire assets, technologies and businesses that are complementary to our existing business or necessary to maintain our growth and competitiveness.

The dividends and other distributions on equity we may receive from our subsidiary are subject to restrictions under PRC law or agreements that it may enter into with third parties.

We are a holding company. Our wholly-owned subsidiary, KongZhong Beijing, has entered into contractual arrangements with Beijing AirInbox, Beijing Boya Wuji and Beijing WINT, through which we conduct our wireless value-added activities and receive substantially all of our revenues in the form of service fees. We rely on dividends and other distributions on equity paid by our subsidiary and service fees from Beijing AirInbox, Beijing Boya Wuji and Beijing WINT for our cash requirements in excess of any cash raised from investors and retained by us. If our subsidiary incurs debt in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us. In addition, PRC law requires that payment of dividends by our subsidiary can only be made out of its net income, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, our subsidiary is also required to set aside no less than 10% of its after-tax net income each year to fund certain reserve funds unless such reserve funds have reached 50% of the registered capital of our subsidiary, and these reserves are not distributable as dividends. See note 12 to our historical consolidated financial statements included in this annual report. Any limitation on the payment of dividends by our subsidiary could have a material adverse effect our ability to grow, fund investments, make acquisitions, pay dividends, and otherwise fund and conduct our business.

We may not be able to adequately protect our intellectual property, and we may be exposed to infringement claims by third parties.

We believe the copyrights, service marks, trademarks, trade secrets and other intellectual property we use are important to our business, and any unauthorized use of such intellectual property by third parties may adversely affect our business and reputation. We rely on the intellectual property laws and contractual arrangements with our employees, clients, business partners and others to protect such intellectual property rights. Third parties may be able to obtain and use such intellectual property without authorization. Furthermore, the validity, enforceability and scope of protection of intellectual property in the Internet and wireless value-added related industries in China is uncertain and still evolving, and these laws may not protect intellectual property rights to the same extent as the laws of some other jurisdictions, such as the United States. Moreover, litigation may be necessary in the future to enforce our intellectual property rights, which could result in substantial costs and diversion of our resources, and have a material adverse effect on our business, financial condition and results of operations.

Table of Contents

Due to the manner in which we obtain, collect, produce and aggregate content and applications for our wireless value-added services, and because our services may be used for the distribution of information, claims may be filed against us for defamation, negligence, copyright or trademark infringement or other violations. In addition, third parties could assert claims against us for losses in reliance on information distributed by us. For example, if we are found to have infringed any intellectual property rights of others, we may be enjoined from using such intellectual property, and we may incur licensing fees or be forced to develop alternative intellectual property. We may also incur significant costs in investigating and defending the claims even if they do not result in liability. We have not purchased liability insurance for these types of claims.

We are not able to register the Chinese name of our service mark KongZhong Network in China, and we may not be able to effectively prevent its unauthorized use by third parties.

We are unable to register the Chinese name of KongZhong Network as our service mark because it is deemed a generic term under existing PRC trademark laws and regulations, which prohibit registration of generic terms as trademarks or service marks. As a result, we may not be able to effectively prevent the unauthorized use of the Chinese name of our service mark, KongZhong Network , and our brand name and reputation may be adversely affected by such unauthorized use.

Future acquisitions may have an adverse effect on our ability to manage our business.

Selective acquisitions form part of our strategy to further expand our business. In February 2005, we completed an agreement with Beijing WINT, its shareholders and our designees pursuant to which our designees acquired the total equity interest of Beijing WINT, a WAP services provider. In May 2005, our operating companies, Beijing AirInbox and Beijing WINT, acquired the total equity interest of Tianjin Mammoth Technology Co., Ltd., or Mammoth, a China-based mobile game developer. If we are presented with appropriate opportunities, we may acquire additional businesses, technologies, services or products that are complementary to our core wireless value-added services business. Future acquisitions and the subsequent integration of new companies into ours would require significant attention from our management, in particular to ensure that the acquisition does not disrupt our relationships with the mobile operators or affect our users opinion of our services and customer support, and to ensure that the acquisition is effectively integrated with our existing operations and wireless value-added services. The diversion of our management s attention and any difficulties encountered in any integration process could have an adverse effect on our ability to manage our business. Future acquisitions would expose us to potential risks, including risks associated with the assimilation of new operations, services and personnel, unforeseen or hidden liabilities, the diversion of resources from our existing businesses and technologies, the inability to generate sufficient revenue to offset the costs and expenses of acquisitions and potential loss of, or harm to, relationships with employees and content providers as a result of integration of new businesses. Any acquisitions also could result in potentially dilutive issuances of equity securities or impairment related to goodwill or other intangible assets. Given the sophisticated technologies used in the wireless value-added services industry, the successful, cost-effective integration of other businesses technology platforms and services into our own would also be a critical and highly complex aspect of any acquisition.

We have limited business insurance coverage.

The insurance industry in China is still at an early stage of development. Insurance companies in China offer limited business insurance products, and do not, to our knowledge, offer business liability insurance. As a result, we do not have any business liability insurance coverage for our operations. Moreover, while business disruption insurance is available, we have determined that the risks of disruption and cost of the insurance are such that we do not require it at this time. Any business disruption, litigation or natural disaster might result in substantial costs and diversion of resources.

Table of Contents

Risks Relating to Our Industry