

NetEase (NTES US)

Intact quality game portfolio despite short-term growth deceleration

NetEase reported inline 2Q24 results: total revenue grew by 6% YoY to RMB25.5bn, in line with our/consensus estimate of RMB25.1/26.1bn; operating profit grew by 15% YoY to RMB7.0bn, vs our/consensus estimate of RMB6.7/7.2bn. Looking ahead, we expect game revenue growth to bottom out and reaccelerate in 2H24E, underpinned by the resilient performance of legacy titles, incremental revenue contribution from new titles and the return of Blizzard's game portfolio. We maintain our FY24-26E total revenue forecast largely unchanged. We fine-tune our SOTP-derived target price to US\$130.0 (previous: US\$131.5). Maintain BUY.

- **Upbeat on 2H24 games revenue growth reacceleration.** Games & related VAS revenue grew by 7% YoY to RMB20.1bn in 2Q24. Mobile games revenue increased by 16% YoY to RMB14.7bn in 2Q24, driven by solid performance of legacy titles like *Identity V* and *Fantasy Westward Journey Mobile*, which achieved record-high revenue in 2Q24. Despite adjustments of certain PC titles, PC games revenue was flattish YoY at RMB4.5bn in 2Q24, in which we expect it to stabilize in 2H24. Several newly launched games achieved early success: 1) *Naraka: Bladepoint Mobile* ranked the top 3 on iOS grossing charts after its launch, and c.50% of the players are new players to NetEase; 2) *Once Human* attained over 230,000 peak concurrent users on Steam after its launch. Looking ahead, we are upbeat that games & related VAS revenue growth will reaccelerate to +9% YoY in 2H24E, supported by incremental revenue contribution from new titles and the return of Blizzard's game portfolio.
- **Non-gaming businesses focused on quality growth.** Cloud music revenue grew by 5% YoY to RMB2.0bn in 2Q24, driven by strong music subscription revenue growth (+26% YoY in 1H24). Cloud music GPM expanded by 5.1ppt YoY to 32.1% in 2Q24, thanks to the improvement of operating leverage. Revenue from innovative business and others was largely flat YoY at RMB2.1bn in 2Q24, with steady performance of Yanxuan. Youdao's revenue increased by 10% YoY to RMB1.3bn in 2Q24.
- **Maintain BUY.** NetEase's GPM increased by 3.1ppt YoY to 62.9% in 2Q24, primarily attributable to favourable revenue mix shift to high-margin self-developed games. R&D expenses were up by 14% YoY to RMB4.5bn and represented 17.5% of total revenue in 2Q24 (2Q23: 16.3%), as NetEase stepped up investments to improve quality and quantity of content development. Overall, OPM improved by 2.2ppt YoY to 27.4% in 2Q24. NetEase's current valuation of 13x FY24E non-GAAP PE offers attractive value, given its solid games revenue growth outlook in 2H24E, FY24-26E operating CAGR (13%) and commitment to shareholder return (c.3% dividend yield). Maintain BUY.

Earnings Summary

(YE 31 Dec)	FY22A	FY23A	FY24E	FY25E	FY26E
Revenue (RMB mn)	96,496	103,468	111,376	119,632	127,277
Gross margin (%)	54.7	60.9	63.1	63.8	64.0
Adjusted net profit (RMB mn)	22,808.4	32,608.3	33,901.6	36,876.8	40,185.9
EPS (Adjusted) (RMB)	34.95	50.69	52.27	56.86	61.96
Consensus EPS (RMB)	34.95	50.69	52.24	57.62	58.70
P/E (x)	21.9	14.4	14.1	12.8	11.7

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price	US\$130.00
(Previous TP)	US\$131.50)
Up/Downside	40.4%
Current Price	US\$92.59

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Stock Data

Mkt Cap (US\$ mn)	59,562.4
Avg 3 mths t/o (US\$ mn)	43.2
52w High/Low (US\$)	118.47/86.67
Total Issued Shares (mn)	643.3

Source: FactSet

Shareholding Structure

William Lei Ding	44.2%
Invesco	2.2%

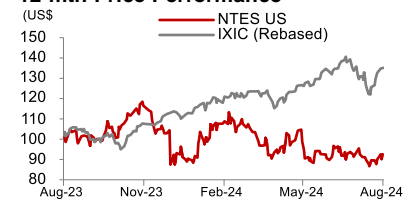
Source: Company data

Share Performance

	Absolute	Relative
1-mth	-1.0%	-0.5%
3-mth	-5.9%	-11.7%
6-mth	-14.9%	-23.8%

Source: FactSet

12-mth Price Performance



Source: FactSet

Figure 1: NetEase: earnings revision

RMB bn	Current			Previous			Change (%)		
	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Revenue	111.4	119.6	127.3	111.2	119.4	126.9	0.1%	0.2%	0.3%
Gross profit	70.3	76.3	81.4	70.3	76.3	81.4	-0.1%	0.0%	0.0%
Operating profit	31.4	35.6	39.7	31.8	35.5	39.0	-1.4%	0.4%	1.7%
Adjusted net profit	33.9	36.9	40.2	33.9	36.4	39.3	-0.1%	1.3%	2.3%
Adjusted EPS (RMB)	52.3	56.9	62.0	52.2	56.0	60.4	0.2%	1.5%	2.6%
Gross margin	63.1%	63.8%	64.0%	63.2%	63.9%	64.2%	-0.1 ppt	-0.2 ppt	-0.2 ppt
Operating margin	28.2%	29.8%	31.2%	28.6%	29.7%	30.8%	-0.4 ppt	0.0 ppt	0.4 ppt
Adjusted net margin	30.4%	30.8%	31.6%	30.5%	30.5%	30.9%	-0.1 ppt	0.3 ppt	0.6 ppt

Source: CMBIGM estimates

Figure 2: CMBIGM estimates vs consensus

RMB bn	CMBIGM			Consensus			Diff (%)		
	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Revenue	111.4	119.6	127.3	111.7	122.5	132.3	-0.3%	-2.3%	-3.8%
Gross profit	70.3	76.3	81.4	69.5	76.4	82.8	1.0%	-0.1%	-1.7%
Operating profit	31.4	35.6	39.7	31.8	36.0	39.5	-1.2%	-1.1%	0.5%
Adjusted net profit	33.9	36.9	40.2	33.9	37.4	40.9	0.1%	-1.3%	-1.8%
Adjusted EPS (RMB)	52.3	56.9	62.0	52.2	57.6	58.7	0.1%	-1.3%	5.6%
Gross margin	63.1%	63.8%	64.0%	62.2%	62.4%	62.6%	0.9 ppt	1.4 ppt	1.4 ppt
Operating margin	28.2%	29.8%	31.2%	28.4%	29.4%	29.9%	-0.3 ppt	0.4 ppt	1.3 ppt
Adjusted net margin	30.4%	30.8%	31.6%	30.3%	30.5%	31.0%	0.1 ppt	0.3 ppt	0.6 ppt

Source: Bloomberg, CMBIGM estimates

Figure 3: NetEase: key financial data forecasts

(RMB mn)	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	Cons.	Diff%
Online games revenue	20,066	18,799	21,780	20,921	21,460	20,056	20,643	-2.8%
YoY%	7.6%	3.6%	16.5%	9.6%	7.0%	6.7%		
As % of total revenue	80.1%	78.3%	79.9%	77.1%	79.9%	78.7%		
Youdao revenue	1,163	1,207	1,539	1,481	1,392	1,322	1,370	-3.5%
YoY%	-3.1%	26.2%	9.7%	1.8%	19.7%	9.5%		
As % of total revenue	4.6%	5.0%	5.6%	5.5%	5.2%	5.2%		
Cloud Music revenue	1,960	1,949	1,973	1,986	2,030	2,041	2,035	0.3%
YoY%	-5.2%	-11.1%	-16.3%	-16.4%	3.6%	4.7%		
As % of total revenue	7.8%	8.1%	7.2%	7.3%	7.6%	8.0%		
Innovative businesses	1,858	2,057	1,979	2,753	1,970	2,067	2,181	-5.2%
YoY%	12.8%	9.9%	0.5%	12.9%	6.1%	0.5%		
As % of total revenue	7.4%	8.6%	7.3%	10.1%	7.3%	8.1%		
Total revenue	25,046	24,011	27,270	27,140	26,852	25,486	26,115	-2.4%
YoY%	6.3%	3.7%	11.6%	7.0%	7.2%	6.1%	8.8%	
Gross profit margin (%)	59.5%	59.9%	62.2%	62.0%	63.4%	62.9%		
S&M expenses ratio (%)	11.6%	13.6%	13.1%	15.6%	15.0%	13.7%		
R&D expenses ratio (%)	15.0%	16.3%	15.9%	16.5%	15.5%	17.5%		
Non-GAAP NPM (%)	30.2%	37.6%	31.7%	27.2%	31.7%	30.7%		
Non-GAAP net profit	7,566	9,017	8,645	7,379	8,511	7,819	7,981	-2.0%
YoY%	47.8%	66.7%	15.7%	53.4%	12.5%	-13.3%	-11.5%	

Source: Company data, CMBIGM estimates

We use sum-of-the-parts (SOTP) valuation methodology to value NetEase's four main business segments. Our SOTP-derived target price is US\$130.0, comprising:

- 1) US\$122.3 for the online game business (94.1% of total valuation), based on 15x 2024E EV/EBIT which is on par with the industry average.
- 2) US\$1.1 for Youdao (0.8% of total valuation), based on 1.5x 2024E EV/revenue, on par with the industry average;
- 3) US\$2.6 (2.0% of total valuation) for the Cloud Music business, based on 2.4x 2024E EV/revenue, on par with the industry average;
- 4) US\$2.1 (1.6% of total valuation) for the innovative businesses and others, based on 1.1x 2024E EV/revenue, on par with the industry average;
- 5) US\$2.0 for net cash.

Figure 4: NetEase: SOTP Valuation

(RMBmn)	Valuation basis	Multiple (x)	2024E sales	2024E EBIT	Valuation	Shareholding (%)	Valuation to NetEase	Valuation per ADS (US\$)
Online games	EV/EBIT	15.0	88,180	37,917	568,758	100.0%	568,758	122.3
Youdao	EV/revenue	1.5	6,063		9,094	54.2%	4,930	1.1
Cloud Music	EV/revenue	2.4	8,141		19,538	60.9%	11,897	2.6
Innovative businesses	EV/revenue	1.1	8,992		9,892	100.0%	9,892	2.1
Enterprise value							595,476	
Net cash							9,083	2.0
Equity value							604,559	
RMB/US\$							7.2	
Valuation (US\$mn)							83,618	
No. of ADSs (mn)							643	
Value per ADS (US\$)							130.0	

Source: Company data, CMBIGM estimates

Figure 5: Peer comparison: online games

Companies	Ticker	Price (LC)	EBIT growth (YoY %)			EV/EBIT (x)		
			FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Tencent	700 HK	371.6	21	14	12	15	14	12
Electronic Arts	EA US	149.8	11	5	4	17	16	15
Take Two	TTWO US	160.1	(31)	13	125	NA	NA	22
Nexon	3659 JP	2,970.0	13	12	4	12	11	11
Nintendo	7974 JP	8,295.0	(6)	(17)	21	17	21	17
Bandai Namco	7832 JP	3,085.0	(36)	58	5	20	13	12
Perfect World	002624 CH	7.9	25	29	21	13	10	8
Sanqi Interactive	002555 CH	12.7	(4)	15	11	7	6	5
Average EV/EBIT						15	13	13

Source: Bloomberg consensus estimates, CMBIGM

Note: Data as of market close on 21 Aug

Figure 6: Peer comparison: education, online music, and e-commerce

Companies	Ticker	Price (LC)	Revenue growth (YoY %)			EV/revenue (x)		
			FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Education								
New Oriental	EDU US	68.4	46	22	22	1.7	1.4	1.2
TAL Education	TAL US	8.7	44	45	28	1.7	1.2	0.9
Gaotu	GOTU US	4.2	54	39	34	1.2	0.9	0.6
Average						1.5	1.2	0.9
Community								
TME	TME US	10.4	3	10	10	3.6	3.2	2.9
Spotify	SPOT US	343.7	21	15	12	3.8	3.3	2.9
BiliBili	BILI US	14.0	16	13	11	1.3	1.2	1.1
Kuaishou	1024 HK	40.0	13	11	10	1.0	0.9	0.8
Average						2.4	2.2	1.9
E-commerce								
Alibaba	BABA US	83.5	8	9	8	1.0	0.9	0.8
JD	JD US	27.0	5	6	5	0.2	0.1	0.1
Pinduoduo	PDD US	145.9	77	31	23	2.9	2.2	1.8
Vipshop	VIPS US	12.7	(2)	3	4	0.3	0.3	0.3
Average						1.1	0.9	0.8

Source: Bloomberg consensus estimates, CMBIGM

Note: Data as of market close on 21 Aug

Risks

Decline in revenue of legacy games; intensifying competition; tightening gaming sector regulations.

Financial Summary

INCOME STATEMENT	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec (RMB mn)						
Revenue	87,606	96,496	103,468	111,376	119,632	127,277
Cost of goods sold	(40,635)	(43,730)	(40,405)	(41,122)	(43,329)	(45,840)
Gross profit	46,971	52,766	63,063	70,254	76,303	81,437
Operating expenses	(30,554)	(33,138)	(35,354)	(38,870)	(40,675)	(41,747)
Selling expense	(12,214)	(13,403)	(13,969)	(15,815)	(16,748)	(17,182)
Admin expense	(4,264)	(4,696)	(4,900)	(4,678)	(4,785)	(4,837)
R&D expense	(14,076)	(15,039)	(16,485)	(18,377)	(19,141)	(19,728)
Operating profit	16,417	19,629	27,709	31,384	35,628	39,690
Investment gain/loss	2,948	54	1,307	653	327	163
Other gains/(losses)	710	847	1,054	0	0	0
Interest income	1,520	2,150	4,120	5,002	5,057	4,969
Foreign exchange gain/loss	(490)	1,571	(133)	0	0	0
Pre-tax profit	21,104	24,250	34,057	37,039	41,012	44,823
Income tax	(4,128)	(5,032)	(4,700)	(7,223)	(8,202)	(8,965)
After tax profit	16,976	19,218	29,357	29,817	32,809	35,858
Minority interest	(119)	494	59	298	328	359
Net profit	16,857	19,713	29,417	30,115	33,137	36,217
Adjusted net profit	19,762	22,808	32,608	33,902	36,877	40,186
BALANCE SHEET	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec (RMB mn)						
Current assets	113,120	131,603	142,693	163,028	185,164	207,544
Cash & equivalents	14,498	24,889	21,429	30,620	40,550	49,694
Restricted cash	2,877	2,699	2,777	2,916	3,062	3,215
Account receivables	5,508	5,003	6,422	6,775	7,132	7,436
Inventories	965	994	695	708	746	789
Prepayment	6,236	5,448	6,077	6,410	6,748	7,035
ST bank deposits	70,755	84,948	100,856	110,942	122,036	134,239
Other current assets	12,282	7,623	4,436	4,658	4,891	5,135
Non-current assets	40,524	41,158	43,232	47,820	53,200	59,537
PP&E	5,434	6,342	8,075	10,281	13,090	16,666
Other non-current assets	35,090	34,815	35,157	37,539	40,110	42,871
Total assets	153,644	172,761	185,925	210,849	238,364	267,081
Current liabilities	50,501	56,829	53,842	57,688	61,961	65,301
Short-term borrowings	19,352	23,876	19,240	21,537	23,519	24,521
Account payables	985	1,507	881	897	945	1,000
Tax payable	4,537	2,813	2,572	2,768	2,973	3,163
Other current liabilities	16,266	17,252	18,219	19,327	20,658	21,947
Accrued expenses	9,361	11,381	12,930	13,160	13,866	14,670
Non-current liabilities	3,719	7,059	3,998	4,204	4,481	4,756
Other non-current liabilities	3,719	7,059	3,998	4,204	4,481	4,756
Total liabilities	54,220	63,888	57,841	61,893	66,442	70,057
Total shareholders equity	95,328	104,731	124,286	145,456	168,750	194,210
Minority interest	4,096	4,142	3,798	3,500	3,172	2,813
Total equity and liabilities	153,644	172,761	185,925	210,849	238,364	267,081

CASH FLOW	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	21,104	24,250	34,057	37,039	41,012	44,823
Depreciation & amortization	3,276	2,858	3,055	4,038	5,141	6,545
Tax paid	(4,128)	(5,032)	(4,700)	(7,223)	(8,202)	(8,965)
Change in working capital	3,188	3,497	376	851	1,559	1,702
Others	1,487	2,135	2,543	0	0	0
Net cash from operations	24,927	27,709	35,331	34,705	39,509	44,106
Investing						
Capital expenditure	(3,038)	(2,602)	(4,266)	(6,198)	(7,904)	(10,076)
Net cash from investing	(7,078)	(7,370)	(17,043)	(18,727)	(21,571)	(25,054)
Financing						
Dividend paid	(4,240)	(6,724)	(8,014)	(8,945)	(9,843)	(10,758)
Net borrowings	3,992	5,119	(8,305)	2,297	1,982	1,003
Proceeds from share issues	(2,297)	(274)	0	0	0	0
Others	(10,040)	(8,359)	(5,148)	0	0	0
Net cash from financing	(12,586)	(10,238)	(21,467)	(6,648)	(7,861)	(9,755)
Net change in cash						
Cash at the beginning of the year	12,169	17,376	27,588	24,207	33,536	43,612
Exchange difference	(55)	110	(202)	0	0	0
Others	0	0	0	0	0	0
Cash at the end of the year	17,376	27,588	24,207	33,536	43,612	52,909
GROWTH	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec						
Revenue	18.9%	10.1%	7.2%	7.6%	7.4%	6.4%
Gross profit	20.5%	12.3%	19.5%	11.4%	8.6%	6.7%
Operating profit	12.9%	19.6%	41.2%	13.3%	13.5%	11.4%
Net profit	39.7%	16.9%	49.2%	2.4%	10.0%	9.3%
Adj. net profit	34.4%	15.4%	43.0%	4.0%	8.8%	9.0%
PROFITABILITY	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec						
Gross profit margin	53.6%	54.7%	60.9%	63.1%	63.8%	64.0%
Operating margin	18.7%	20.3%	26.8%	28.2%	29.8%	31.2%
Adj. net profit margin	22.6%	23.6%	31.5%	30.4%	30.8%	31.6%
Return on equity (ROE)	19.0%	19.7%	25.7%	22.3%	21.1%	20.0%
GEARING/LIQUIDITY/ACTIVITIES	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec						
Net debt to equity (x)	(0.7)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)
Current ratio (x)	2.2	2.3	2.7	2.8	3.0	3.2
Receivable turnover days	22.9	18.9	22.7	22.2	21.8	21.3
Payable turnover days	8.8	12.6	8.0	8.0	8.0	8.0
VALUATION	2021A	2022A	2023A	2024E	2025E	2026E
YE 31 Dec						
P/E	26.1	21.9	14.4	14.1	12.8	11.7
P/E (diluted)	26.4	22.1	14.6	14.2	12.9	11.8
P/B	4.6	4.1	3.4	2.9	2.5	2.2

Source: Company data, CMBIGM estimates. Note: The calculation of net cash includes financial assets.

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