

Netease (NTES US)

Aiming for long-term growth

NetEase reported 4Q22 results on 23 Feb. 4Q22 revenue was up by 4% YoY to RMB25.4bn, in line with our and consensus estimate. Full-year revenue in FY22 grew by 8% YoY to RMB96.5bn. Non-GAAP net income declined by 27% YoY to RMB4.8bn in 4Q22, lower than the consensus estimate of RMB5.2bn, primarily due to the lower-than-expected gross margin. Overall GPM was down by 0.8pct YoY to 52.2% (vs. consensus 55.2%) in 4Q22, mainly due to the one-off recognition of c.RMB1bn royalty fees related to certain licensed games (c.4% of total revenue). With the normalisation of domestic game license approval and a clearer timeline for the new game launches, we remain upbeat on NetEase's games revenue growth in FY23/24. We raise FY23-24 total revenue forecast by 1-4% to factor in its quality titles planned for launch in FY23E and the longevity of its legacy titles. Our SOTP-based target price is US\$116.0 (previous: US\$112.3). Maintain BUY.

■ Games: short-term deceleration on high base; eyes on FY23 pipeline.

Online games revenue was RMB19.1bn in 4Q22, with YoY growth slowing down to 2% (2Q22/3Q22: +15/9% YoY) due to normalisation of revenue from *Harry Potter: Magic Awakened* and *Naraka: Bladepoint* which have been launched for over a year. PC games revenue grew by 5% YoY while mobile games revenue declined by 1% YoY in 4Q22. Looking ahead, several games are lined up for launch in 2023, including *Justice Mobile* (aim to launch in 1H23), *Westward Journey Returns* and *Racing Master*. Management noted that the overseas business remains at the investment phase, and they expect meaningful revenue will only come in FY25E or beyond.

■ Non-game businesses: developing self-sustained business models.

Cloud Music revenue increased by 26% YoY to RMB2.4bn and accounted for 9% of total revenue in 4Q22. Music GPM rose by 13.7pct YoY and 3.6pct QoQ to 17.8% in 4Q22, primarily due to the enhanced economies of scale and optimized content cost structure. Youdao revenue was up by 9% YoY to RMB1.5bn (6% of total revenue) and achieved first-ever positive operating profit in 4Q22, thanks to the solid revenue growth of new learning services and effective cost control initiatives. Innovative businesses revenue grew by 3% YoY to RMB2.4bn in 4Q22 (10% of total revenue), driven by growth in Yanxuan revenue.

■ Expect modest margin improvement. Overall GPM was down by 0.8pct YoY and 4.0pct QoQ to 52.2% in 4Q22, mainly attributable to the one-off recognition of royalty fees related to certain licensed games (c.RMB1bn, equivalent to 4% of total revenue). Operating profit was down 4% YoY to RMB4.4bn, with OPM dragged down by 1.4pct YoY to 17.5% in 4Q22. Management expect modest margin improvement over the next three years, as enhancing Cloud Music and Youdao margin will be offset by the investment in overseas gaming businesses.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	87,606	96,496	104,473	112,024	117,924
Gross margin (%)	53.6	54.7	54.7	55.1	55.6
Adjusted net profit (RMB mn)	19,761.9	22,808.4	22,708.0	25,221.3	27,244.6
EPS (Adjusted) (RMB)	29.71	34.95	34.79	38.64	41.74
Consensus EPS (RMB)	29.71	34.95	35.61	39.66	44.96
P/S (x)	4.5	4.1	3.7	3.5	3.3
P/E (x)	26.6	19.2	20.0	17.9	16.3

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price **US\$116.00**

(Previous TP **US\$112.30**)

Up/Downside **34.8%**

Current Price **US\$86.05**

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Stock Data

Mkt Cap (US\$ mn)	56,724.4
Avg 3 mths t/o (US\$ mn)	80.0
52w High/Low (US\$)	106.84/55.41
Total Issued Shares (mn)	659.2

Source: FactSet

Shareholding Structure

William Lei Ding	44.2%
Invesco	2.2%

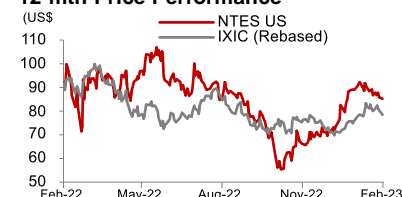
Source: Company data

Share Performance

	Absolute	Relative
1-mth	-3.4%	-6.4%
3-mth	31.4%	27.7%
6-mth	0.4%	8.2%

Source: FactSet

12-mth Price Performance



Source: FactSet

Figure 1: NetEase : earnings revision

RMB bn	Current			Previous			Change (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	104.5	112.0	117.9	102.8	107.5	-	1.6%	4.3%	-
Gross profit	57.2	61.8	65.6	56.0	58.5	-	2.0%	5.6%	-
Operating profit	21.7	24.4	26.7	21.0	22.5	-	3.5%	8.4%	-
Adjusted net profit	22.7	25.2	27.2	21.5	23.0	-	5.5%	9.8%	-
Adjusted EPS (RMB)	34.4	38.3	41.3	32.7	34.9	-	5.4%	9.8%	-
Gross margin	54.7%	55.1%	55.6%	54.5%	54.5%	-	0.2 ppt	0.7 ppt	-
Operating margin	20.8%	21.7%	22.6%	20.4%	20.9%	-	0.4 ppt	0.8 ppt	-
Adjusted net margin	21.7%	22.5%	23.1%	20.9%	21.4%	-	0.8 ppt	1.1 ppt	-

Source: CMBIGM estimates

Figure 2: CMBIGM estimates vs consensus

RMB bn	CMBIGM			Consensus			Diff (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	104.5	112.0	117.9	103.7	113.7	127.6	0.7%	-1.5%	-7.6%
Gross profit	57.2	61.8	65.6	57.8	63.4	70.4	-1.0%	-2.5%	-6.9%
Operating profit	21.7	24.4	26.7	22.4	25.4	28.1	-3.0%	-3.9%	-5.2%
Adjusted net profit	22.7	25.2	27.2	23.3	25.6	29.4	-2.5%	-1.5%	-7.2%
Adjusted EPS (RMB)	34.4	38.3	41.3	35.6	39.7	45.0	-3.3%	-3.5%	-8.1%
Gross margin	54.7%	55.1%	55.6%	55.7%	55.7%	55.2%	-1.0 ppt	-0.6 ppt	0.4 ppt
Operating margin	20.8%	21.7%	22.6%	21.6%	22.3%	22.1%	-0.8 ppt	-0.6 ppt	0.6 ppt
Adjusted net margin	21.7%	22.5%	23.1%	22.4%	22.5%	23.0%	-0.7 ppt	0.0 ppt	0.1 ppt

Source: Bloomberg, CMBIGM estimates

Figure 3: NetEase: key financial data forecasts

(RMB mn)	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	Cons.	Diff%	CMBI	Diff%
Online games revenue	15,775	17,146	18,792	18,642	18,140	18,699	19,086			19,664	-2.9%
YoY%	5.1%	14.7%	29.8%	15.7%	15.0%	9.1%	1.6%			4.0%	
As % of total revenue	76.9%	77.3%	77.1%	79.1%	78.3%	76.6%	75.3%				
Youdao revenue	1,293	1,387	1,334	1,201	956	1,402	1,454			1,367	6.4%
YoY%	107.5%	54.8%	20.5%	-10.4%	-26.1%	1.1%	9.0%			2.5%	
As % of total revenue	6.3%	6.3%	5.5%	5.1%	4.1%	5.7%	5.7%				
Cloud Music revenue	1,693	1,925	1,889	2,067	2,192	2,357	2,376			2,434	-2.4%
YoY%				38.6%	29.5%	22.5%	25.8%			28.8%	
As % of total revenue	8.2%	8.7%	7.8%	8.8%	9.5%	9.7%	9.4%				
Innovative businesses	1,764	1,733	2,359	1,646	1,872	1,968	2,438			2,485	-1.9%
YoY%	-19.4%	-23.6%	0.6%	4.2%	6.1%	13.6%	3.4%			7.9%	
As % of total revenue	8.6%	7.8%	9.7%	7.0%	8.1%	8.1%	9.6%				
Total revenue	20,525	22,191	24,374	23,556	23,159	24,427	25,354	25,330	0.1%	25,950	-2.3%
YoY%	12.9%	18.9%	23.3%	14.8%	12.8%	10.1%	4.0%			6.5%	
Gross profit margin (%)	54.5%	53.2%	53.0%	54.5%	55.9%	56.3%	52.2%			52.6%	
S&M expenses ratio (%)	14.7%	14.1%	13.5%	12.4%	14.3%	15.4%	13.5%			14.5%	
R&D expenses ratio (%)	16.6%	16.9%	15.8%	14.4%	15.5%	16.2%	16.1%			16.0%	
Non-GAAP NPM (%)	20.6%	17.4%	27.1%	21.7%	23.4%	30.6%	19.0%			17.6%	
Non-GAAP net profit	4,228	3,858	6,596	5,118	5,410	7,470	4,811	5,229	-8.0%	4,562	5.5%
YoY%	-19.1%	5.1%	312.8%	0.7%	28.0%	93.6%	-27.1%			-30.8%	

Source: Company data, CMBIGM estimates

Note: Non-GAAP net profit reported by NetEase include investment income/(loss) and exchange gain/(loss).

We use sum-of-the-parts (SOTP) valuation methodology to value NetEase's four main business segments. Our SOTP derived target price is US\$116.0, comprising:

1) US\$106.3 for the online game business (91.6% of total valuation), based on 16x 2023E EV/EBIT which is a premium over the industry average (15x). The premium in our view is justified by NetEase's strong content development capability and solid deployment in the overseas market;

2) US\$1.1 for Youdao (0.9% of total valuation), based on 1.6x 2023E EV/revenue, on a par with the industry average;

3) US\$4.1 (3.5% of total valuation) for the Cloud Music business, based on 3.0x 2023E EV/revenue, at a premium over the industry average due to its relatively strong revenue growth outlook over FY23-24E;

4) US\$2.7 (2.4% of total valuation) for the innovative businesses and others, based on 1.5x EV/2023E revenue, on a par with the industry average;

5) US\$1.7 for net cash.

Figure 4: NetEase: SOTP Valuation

(RMBmn)	Valuation basis	Multiple (x)	2023E sales	2023E EBIT	Valuation	Shareholding (%)	Valuation to NetEase	Valuation per ADS (US\$)
Online games	EV/EBIT	16.0	79,448	30,190	483,045	100.0%	483,045	106.3
Youdao	EV/revenue	1.6	5,916		9,465	52.9%	5,007	1.1
Cloud Music	EV/revenue	3.0	10,789		32,367	57.7%	18,676	4.1
Innovative businesses	EV/revenue	1.5	8,320		12,480	100.0%	12,480	2.7
Enterprise value							519,207	
Net cash							7,875	1.7
Equity value							527,082	
RMB/US\$							6.90	
Target valuation (US\$mn)							76,444	
No. of ADSs (mn)							659	
Value per ADS (US\$)							116.0	

Source: Company data, CMBIGM estimates

Figure 5: Peer comparison: online games

Companies	Ticker	Price (Local)	EBIT growth (YoY %)			EV/EBIT (x)		
			FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Tencent	700 HK	356.0	(26)	13	12	19	17	15
iDreamSky	1119 HK	3.9	(67)	838	77	na	17	9
Activision Blizzard	ATVI US	77.1	(21)	16	10	18	16	14
Electronic Arts	EA US	111.7	24	(16)	8	12	15	13
Take Two	TTWO US	111.2	(12)	18	1	30	26	26
Nexon	3659 JP	2,973.0	(4)	24	14	18	15	13
Nintendo	7974 JP	5,312.0	(18)	(13)	(4)	8	9	10
Bandai Namco	7832 JP	8,421.0	22	14	6	14	12	12
Perfect World	002624 CH	14.7	99	16	22	18	15	12
37 Interactive	002555 CH	23.0	(1)	16	13	14	12	10
Average EV/EBIT						17	15	13

Source: Bloomberg consensus estimates, CMBIGM

Note: data as of 22 Feb market close

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

Companies	Ticker	Price	Revenue growth (YoY %)			EV/revenue (x)		
		(Local)	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Education								
New Oriental	EDU US	42.5	(26)	(10)	16	1.2	1.3	1.1
TAL Education	TAL US	7.5	2	(77)	19	0.4	1.9	1.6
Average PS						0.8	1.6	1.4
Music community								
TME	TME US	7.9	(16)	4	8	2.7	2.6	2.4
Spotify	SPOT US	120.1	18	12	15	1.7	1.5	1.3
BiliBili	BILI US	21.9	4	21	20	3.1	2.6	2.1
Kuaishou	1024 HK	55.5	8	16	16	2.0	1.7	1.5
Average PS						2.4	2.1	1.8
E-commerce								
Alibaba	BABA US	94.8	(4)	11	10	1.5	1.4	1.3
JD	JD US	46.5	(2)	19	14	0.4	0.4	0.3
Pinduoduo	PDD US	83.4	24	26	20	4.6	3.7	3.1
Vipshop	VIPS US	13.6	(19)	6	6	0.4	0.4	0.4
Average PS						1.8	1.5	1.3

Source: Bloomberg consensus estimates, CMBIGM

Note: data as of 22 Feb market close

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	73,667	87,606	96,496	104,473	112,024	117,924
Cost of goods sold	(34,684)	(40,635)	(43,730)	(47,313)	(50,252)	(52,350)
Gross profit	38,983	46,971	52,766	57,159	61,772	65,573
Operating expenses	(24,445)	(30,554)	(33,138)	(35,416)	(37,416)	(38,915)
Selling expense	(10,704)	(12,214)	(13,403)	(14,417)	(15,123)	(15,566)
Admin expense	(3,372)	(4,264)	(4,696)	(4,910)	(5,041)	(5,189)
R&D expense	(10,369)	(14,076)	(15,039)	(16,089)	(17,252)	(18,160)
Operating profit	14,538	16,417	19,629	21,743	24,356	26,659
Investment gain/loss	1,610	2,948	54	0	0	0
Other gains/(losses)	737	710	847	0	0	0
Interest income	1,599	1,520	2,150	2,223	2,422	2,680
Foreign exchange gain/loss	(3,112)	(490)	1,571	0	0	0
Pre-tax profit	15,372	21,104	24,250	23,966	26,778	29,339
Income tax	(3,042)	(4,128)	(5,032)	(4,793)	(5,356)	(5,868)
After tax profit	12,330	16,976	19,218	19,173	21,422	23,471
Minority interest	(267)	(119)	494	192	214	235
Net profit	12,063	16,857	19,713	19,365	21,636	23,706
Adjusted net profit	14,706	19,762	22,808	22,708	25,221	27,245
BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	107,831	113,120	117,766	127,421	139,433	152,948
Cash & equivalents	9,117	14,498	10,304	10,522	12,384	15,107
Restricted cash	3,051	2,877	3,020	3,171	3,330	3,497
Account receivables	4,576	5,508	5,946	6,308	6,629	6,839
Inventories	621	965	1,038	1,123	1,193	1,243
Prepayment	6,112	6,236	6,731	7,142	7,505	7,742
ST bank deposits	71,079	70,755	77,830	85,613	94,175	103,592
Other current assets	13,273	12,282	12,896	13,541	14,218	14,929
Non-current assets	34,044	40,524	50,303	55,665	60,285	65,407
PP&E	4,555	5,434	6,482	7,732	9,223	11,001
Other non-current assets	29,488	35,090	43,821	47,933	51,063	54,406
Total assets	141,875	153,644	168,069	183,086	199,719	218,356
Current liabilities	46,743	50,501	51,156	52,421	53,770	55,764
Short-term borrowings	19,505	19,352	17,213	15,683	14,548	14,672
Account payables	1,134	985	1,060	1,147	1,218	1,269
Tax payable	4,283	4,537	4,997	5,411	5,802	6,107
Other current liabilities	14,484	16,266	17,812	19,281	20,626	21,656
Accrued expenses	7,338	9,361	10,074	10,899	11,576	12,060
Non-current liabilities	1,337	3,719	4,036	4,368	4,655	4,869
Other non-current liabilities	1,337	3,719	4,036	4,368	4,655	4,869
Total liabilities	48,081	54,220	55,192	56,788	58,425	60,632
Total shareholders equity	82,127	95,328	109,900	123,513	138,723	155,387
Minority interest	11,667	4,096	3,599	3,407	3,193	2,958
Total equity and liabilities	141,875	153,644	168,690	183,708	200,341	218,978

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	15,372	21,104	24,250	23,966	26,778	29,339
Depreciation & amortization	3,458	3,276	2,717	3,241	3,866	4,611
Tax paid	(3,042)	(4,128)	(5,032)	(4,793)	(5,356)	(5,868)
Change in working capital	4,771	3,188	1,788	1,936	1,731	1,374
Others	4,329	1,487	0	0	0	0
Net cash from operations	24,888	24,927	23,723	24,350	27,019	29,456
Investing						
Capital expenditure	(3,273)	(3,038)	(3,696)	(4,423)	(5,290)	(6,324)
Net cash from investing	(29,192)	(7,078)	(19,869)	(16,699)	(17,437)	(19,648)
Financing						
Dividend paid	(4,280)	(4,240)	(5,766)	(5,752)	(6,427)	(7,041)
Net borrowings	4,041	3,992	(2,140)	(1,530)	(1,135)	124
Proceeds from share issues	21,912	(2,297)	0	0	0	0
Others	(11,759)	(10,040)	0	0	0	0
Net cash from financing	9,913	(12,586)	(7,905)	(7,282)	(7,562)	(6,917)
Net change in cash						
Cash at the beginning of the year	6,398	12,169	17,376	13,324	13,693	15,714
Exchange difference	162	(55)	0	0	0	0
Others	0	0	0	0	0	0
Cash at the end of the year	12,169	17,376	13,324	13,693	15,714	18,604
GROWTH	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Revenue	24.4%	18.9%	10.1%	8.3%	7.2%	5.3%
Gross profit	23.5%	20.5%	12.3%	8.3%	8.1%	6.2%
Operating profit	5.4%	12.9%	19.6%	10.8%	12.0%	9.5%
Net profit	(43.3%)	39.7%	16.9%	(1.8%)	11.7%	9.6%
Adj. net profit	(6.1%)	34.4%	15.4%	(0.4%)	11.1%	8.0%
PROFITABILITY	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Gross profit margin	52.9%	53.6%	54.7%	54.7%	55.1%	55.6%
Operating margin	19.7%	18.7%	20.3%	20.8%	21.7%	22.6%
Adj. net profit margin	20.0%	22.6%	23.6%	21.7%	22.5%	23.1%
Return on equity (ROE)	16.8%	19.0%	19.2%	16.6%	16.5%	16.1%
GEARING/LIQUIDITY/ACTIVITIES	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Net debt to equity (x)	(0.7)	(0.7)	(0.6)	(0.7)	(0.7)	(0.7)
Current ratio (x)	2.3	2.2	2.3	2.4	2.6	2.7
Receivable turnover days	22.7	22.9	22.5	22.0	21.6	21.2
Payable turnover days	11.9	8.8	8.8	8.8	8.8	8.8
VALUATION	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
P/E	30.6	26.6	19.2	20.0	17.9	16.3
P/E (diluted)	31.0	27.0	19.4	20.2	18.1	16.5
P/B	4.5	4.7	3.4	3.1	2.8	2.5

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

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BUY	: Stock with potential return of over 15% over next 12 months
HOLD	: Stock with potential return of +15% to -10% over next 12 months
SELL	: Stock with potential loss of over 10% over next 12 months
NOT RATED	: Stock is not rated by CMBIGM
OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
MARKET-PERFORM	: Industry expected to perform in-line with the relevant broad market benchmark over next 12 months
UNDERPERFORM	: Industry expected to underperform the relevant broad market benchmark over next 12 months

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