

# NetEase Inc. (NTES US)

## More bullish on 4Q21E & FY22E outlook

NetEase delivered solid 3Q21, with rev/adj. net profit +19%/+5% YoY, 4%/0% above consensus. Game beat (PC/mobile +29%/9% YoY) while Youdao & others are largely in-line. Deferred rev (ex-Youdao) was strong at +24% QoQ, beating already-high expectation. We turn more bullish on NTES's 4Q21E & FY22E outlook, backed by strong HP, *Naraka*, and upcoming key titles (*HP international*, *Diablo: Immortal* and *Justice Mobile*). We forecast 4Q21E games +27% YoY, in which HP will deliver grossing at RMB1.5bn in its first month, and contribute 3% of total mobile grossing in 4Q21E. FY22E would be a fruitful year, backed by strong game pipeline and overseas potential. To reflect better game outlook, we raised our earnings forecast by 0.3%-2% in FY21-23E, with higher SOTP-based TP at US\$132.

- **3Q21 beat on topline.** 3Q21 rev was RMB22.2bn, up 19% YoY, 4%/0% above consensus/our estimate, in which game beat while Youdao & others was largely in-line. Non-GAAP net profit +5% YoY to Rmb3.86bn, 0%/5% above consensus/our estimate.
- **Stronger 4Q21E & FY22E game outlook ahead.** Games +15% YoY in 3Q21 (vs. +5% YoY in 2Q21), in which PC game +29% YoY (5% above our estimate) and mobile games +9% YoY. Such upbeat performance was mainly driven by strong key titles, including *Naraka* (6mn copies globally) and *Harry Potter: Magic Awakened*. Deferred rev (excluding Youdao) surprised us at +24% QoQ, beating already-high expectation. 4Q21E game acceleration would continue, backed by strong *HP* (estimating first monthly grossing at RMB1.5bn) and upcoming game license resumption as catalyst. We turn more bullish on FY22E momentum, with key pipeline of *HP international* (targeting similar grossing to China version), *Diablo: Immortal* (schedule depending on Activision, with lower GPM than *HP*), *Justice Mobile* <逆水寒> and *Lord of the Rings* <指环王>.
- **Maintain BUY.** To reflect better game outlook, we raised our earnings forecast by 0.3%-2% in FY21-23E, with higher SOTP-based TP at US\$132 (implying 27.6x/24.2x FY22/23E PE). Further catalysts: 1) upcoming launch of key titles and overseas version; and 2) game license resumption.

### Earnings Summary

(YE 31 Dec)	FY19A	FY20A	FY21E	FY22E	FY23E
Revenue (RMB mn)	59,241	73,667	88,112	103,336	118,561
YoY growth (%)	15.8	24.4	19.6	17.3	14.7
Adj. net income (RMB mn)	15,663	14,706	17,507	20,945	24,173
EPS (RMB)	24.1	22.0	25.9	30.8	35.2
YoY growth (%)	45.8	(8.9)	18.1	18.8	14.2
Consensus EPS (RMB)	NA	NA	26.0	30.4	35.2
P/E (x)	29.7	32.6	27.6	23.2	20.4
P/S (x)	7.9	6.5	5.5	4.7	4.2
Yield (%)	14.5	5.3	1.4	6.8	1.3
ROE (%)	21.4	15.7	16.9	18.5	18.3
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, CMBIS estimates, Bloomberg. EPS, ROE refers to adj. net income.

### BUY (Maintain)

Target Price	US\$132
(Previous TP)	US\$123
Up/Downside	+18.9%
Current Price	US\$111

### China Internet Sector

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### Stock Data

Mkt Cap (US\$ mn)	74,600
Avg 3 mths t/o (US\$ mn)	351.45
52w High/Low (US\$)	134.3/ 78.0
Total Issued Shares (mn)	671

Source: Bloomberg

### Shareholding Structure

BlackRock	3.61%
Orbis Allan Gray	2.75%
Invesco	2.58%

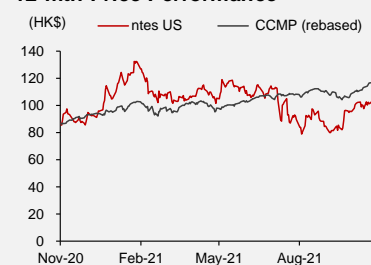
Source: Bloomberg

### Share Performance

	Absolute	Relative
1-mth	16.3%	9.3%
3-mth	24.0%	15.9%
6-mth	5.5%	-10.6%

Source: Bloomberg

### 12-mth Price Performance



Source: Bloomberg

Auditor: PwC

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Figure 1: 3Q21 financial review

RMB mn, Dec-YE	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	QoQ	YoY	Consensus	Diff %
Revenue	17,062	18,185	18,658	19,762	20,517	20,525	22,191	8.1%	18.9%	21,244	4%
Operating Profit	4,486	4,170	2,870	3,012	4,276	3,758	3,775	0.5%	31.5%	3,805	-1%
Net profit	3,551	4,538	2,998	976	4,439	3,542	3,182	-10.2%	6.1%	3,133	2%
Adj. net profit	4,213	5,226	3,669	1,598	5,081	4,242	3,858	-9.1%	5.1%	3,873	0%
Adj. EPS (RMB)	6.43	7.96	5.35	2.34	7.47	6.26	5.74	-8.4%	7.4%	5.79	-1%
<b>Margin (%)</b>											
Gross margin	55.0%	53.8%	53.0%	50.2%	53.9%	54.5%	53.2%			53.0%	
Operating margin	26.3%	22.9%	15.4%	15.2%	20.8%	18.3%	17.0%			17.9%	
Adj. net margin	24.7%	28.7%	19.7%	8.1%	24.8%	20.7%	17.4%			18.2%	
<b>Growth (%)</b>											
Revenue (YoY)	18.3%	25.9%	27.5%	25.6%	20.2%	12.9%	18.9%			13.9%	
Revenue (QoQ)	8.4%	6.6%	2.6%	5.9%	3.8%	0.0%	8.1%			3.5%	
Operating Profit	19.5%	12.0%	-13.9%	1.2%	-4.7%	-9.9%	31.5%			32.6%	
Adj. net profit	25.6%	33.3%	-22.4%	-56.4%	20.6%	-18.8%	5.1%			5.5%	

Source: Company data, Bloomberg

Figure 2: 3Q21 revenue breakdown

RMB mn, Dec-YE	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	QoQ	YoY
<b>Total revenue</b>	<b>17,062</b>	<b>18,185</b>	<b>18,658</b>	<b>19,762</b>	<b>20,517</b>	<b>20,525</b>	<b>22,191</b>	<b>8%</b>	<b>19%</b>
Online game	13,518	13,828	13,862	13,400	14,982	14,528	15,899	9%	15%
Youdao	541	623	896	1,107	1,340	1,293	1,387	7%	55%
Others	3,003	3,733	3,900	5,255	4,196	4,703	4,904	4%	26%

Source: Company data

Figure 3: CMBIS estimates vs consensus

RMB mn, Dec-YE	CMBIS			Consensus			Diff (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Revenue	88,112	103,336	118,561	86,173	100,188	113,444	2.3%	3.1%	4.5%
Gross Profit	47,053	54,971	63,278	45,800	52,664	59,699	2.7%	4.4%	6.0%
Operating Profit	16,431	19,925	23,069	16,457	20,192	24,189	-0.2%	-1.3%	-4.6%
Adj. net profit	17,507	20,945	24,173	17,819	20,794	24,203	-1.7%	0.7%	-0.1%
EPS (RMB)	25.92	30.80	35.17	26.31	31.34	35.85	-1.5%	-1.7%	-1.9%
Gross Margin	53.4%	53.2%	53.4%	53.1%	52.6%	52.6%	+0.25ppts	+0.63ppts	+0.75ppts
Operating Margin	18.6%	19.3%	19.5%	19.1%	20.2%	21.3%	-0.45ppts	-0.87ppts	-1.87ppts
Net Margin	19.9%	20.3%	20.4%	20.7%	20.8%	21.3%	-0.81ppts	-0.49ppts	-0.95ppts

Source: Company data, Bloomberg, CMBIS estimates

Figure 4: Earnings revision

RMB mn, Dec-YE	New			Old			Diff (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Revenue	88,112	103,336	118,561	86,754	101,285	116,154	1.6%	2.0%	2.1%
Gross Profit	47,053	54,971	63,278	46,100	53,662	61,741	2.1%	2.4%	2.5%
Operating Profit	16,431	19,925	23,069	16,259	19,439	22,494	1.1%	2.5%	2.6%
Adj. net profit	17,507	20,945	24,173	17,453	20,660	23,810	0.3%	1.4%	1.5%
EPS (RMB)	25.92	30.80	35.17	25.75	30.28	34.54	0.7%	1.7%	1.8%
Gross Margin	53.4%	53.2%	53.4%	53.1%	53.0%	53.2%	+0.26ppts	+0.21ppts	+0.22ppts
Operating Margin	18.6%	19.3%	19.5%	18.7%	19.2%	19.4%	-0.09ppts	+0.09ppts	+0.09ppts
Net Margin	19.9%	20.3%	20.4%	20.1%	20.4%	20.5%	-0.25ppts	-0.13ppts	-0.11ppts

Source: Company data, CMBIS estimates

**Figure 5: SOTP valuation**

Business (RMB bn)	'22E Rev	OP Margin	'22E EBIT	Methodology	Multiple	Stake	Value
Online game services	72.5	46.0%	33.4	EV/EBIT	13.0x	100%	434
Youdao	5.7	-20.0%	(1.1)	EV/Sales	1.5x	66%	6
Innovative businesses and others	25.2	-34.5%	(8.7)	EV/Sales	2.0x	100%	50
<b>Enterprise Value</b>							<b>490</b>
(+) Net Cash							89
<b>Equity Value</b>							<b>579</b>
Diluted Shares Outstanding (mn)							678
<b>Price Target (US\$)</b>							<b>132</b>

Source: CMBIS estimates

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Revenues</b>	<b>59,241</b>	<b>73,667</b>	<b>88,112</b>	<b>103,336</b>	<b>118,561</b>
Online game	46,423	54,609	62,203	72,450	82,643
Youdao	1,305	3,168	5,735	5,677	5,614
Others	11,514	15,891	20,174	25,209	30,303
COGS	(27,686)	(34,684)	(41,060)	(48,365)	(55,283)
<b>Gross profit</b>	<b>31,555</b>	<b>38,983</b>	<b>47,053</b>	<b>54,971</b>	<b>63,278</b>
S&M	(6,221)	(10,704)	(12,588)	(14,151)	(16,236)
R&D	(8,413)	(10,369)	(13,712)	(15,938)	(18,286)
G&A	(3,130)	(3,372)	(4,321)	(4,957)	(5,687)
<b>Operating profit</b>	<b>13,791</b>	<b>14,538</b>	<b>16,431</b>	<b>19,925</b>	<b>23,069</b>
Other income	2,593	834	2,212	2,298	2,622
Pre-tax Income	16,383	15,372	18,643	22,222	25,691
Income Tax	(2,915)	(3,042)	(3,873)	(4,953)	(5,726)
Net income after tax	13,469	12,330	14,770	17,270	19,965
Deemed dividends	(272)	(787)	(585)	(400)	(400)
Loss to NCI	78	520	408	459	459
Net income	13,275	12,063	14,593	17,328	20,024
<b>Adj. net profit</b>	<b>15,663</b>	<b>14,706</b>	<b>17,507</b>	<b>20,945</b>	<b>24,173</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Net income</b>	<b>13,469</b>	<b>12,330</b>	<b>14,593</b>	<b>17,328</b>	<b>20,024</b>
D&A	2,614	3,458	2,643	3,378	4,694
Change in WC	(358)	4,771	1,092	2,582	141
Others	1,492	4,329	2,914	3,617	4,150
Operating CF	17,216	24,888	21,243	26,905	29,008
CAPEX	(3,329)	(3,290)	(1,847)	(4,504)	(4,694)
Others	(18,808)	(25,902)	(7,108)	0	0
<b>Investing cash flow</b>	<b>(22,137)</b>	<b>(29,192)</b>	<b>(8,955)</b>	<b>(4,504)</b>	<b>(4,694)</b>
Repurchase	11	(11,491)	(6,671)	(6,671)	0
Dividends	(8,841)	(4,280)	(920)	(4,643)	(5,590)
Others	9,913	25,685	1,950	2,146	2,360
<b>Financing cash flow</b>	<b>1,083</b>	<b>9,913</b>	<b>(5,641)</b>	<b>(9,168)</b>	<b>(3,230)</b>
<b>Net change in cash</b>	<b>(3,838)</b>	<b>5,609</b>	<b>6,647</b>	<b>13,232</b>	<b>21,084</b>
Cash (beg of yr)	10,207	6,398	12,169	18,816	32,048
Fx effect	29	162	0	0	0
Cash (end of yr)	6,397	12,169	18,816	32,048	53,132
Restricted cash	3,150	3,051	3,051	3,051	3,051
<b>Cash &amp; cash eq.</b>	<b>3,246</b>	<b>9,117</b>	<b>15,765</b>	<b>28,997</b>	<b>50,081</b>

### Balance sheet

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Non-current assets</b>	<b>27,019</b>	<b>34,044</b>	<b>33,247</b>	<b>34,373</b>	<b>34,373</b>
PP&E	4,622	4,555	3,759	4,885	4,885
Land use right, net	3,707	4,178	4,178	4,178	4,178
Time deposits	2,360	6,630	6,630	6,630	6,630
Others	16,330	18,680	18,680	18,680	18,680
<b>Current assets</b>	<b>85,105</b>	<b>107,831</b>	<b>120,399</b>	<b>134,696</b>	<b>159,869</b>
Cash and cash eq.	3,246	9,117	15,765	28,997	50,081
Time deposits	53,487	71,079	78,187	78,187	78,187
Short-term investments	15,313	13,273	13,273	13,273	13,273
Other current asset	13,059	14,361	13,174	14,239	18,328
<b>Current liabilities</b>	<b>38,243</b>	<b>46,743</b>	<b>48,599</b>	<b>54,391</b>	<b>60,981</b>
AP & accrued liabilities	1,212	1,134	1,252	1,468	1,684
Salary payables	2,957	3,539	3,203	3,756	4,309
Short-term loan	16,828	19,505	21,455	23,601	25,961
Others	17,245	22,566	22,689	25,566	29,026
<b>Non-current liabilities</b>	<b>839</b>	<b>1,337</b>	<b>1,337</b>	<b>1,337</b>	<b>1,337</b>
Other long-term payable	457	624	624	624	624
Deferred tax liabilities	382	713	713	713	713
<b>Shareholders' equity</b>	<b>73,041</b>	<b>93,794</b>	<b>103,710</b>	<b>113,341</b>	<b>131,924</b>

### Key ratios

YE 31 Dec	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Sales mix (%)</b>					
Online game	78.4	74.1	70.6	70.1	69.7
Youdao	2.2	4.3	6.5	5.5	4.7
Others	19.4	21.6	22.9	24.4	25.6
Total	100.0	100.0	100.0	100.0	100.0
<b>Growth rate (%)</b>					
Revenue	15.8	24.4	19.6	17.3	14.7
Gross profit	15.4	23.5	20.7	16.8	15.1
EBIT	38.2	5.4	13.0	21.3	15.8
Adj. net profit	45.5	(6.1)	19.0	19.6	15.4
<b>P&amp;L ratios (%)</b>					
Operating margin	23.3	19.7	18.6	19.3	19.5
Pre-tax margin	27.7	20.9	21.2	21.5	21.7
Adj. net margin	26.4	20.0	19.9	20.3	20.4
Effective tax rate	(17.8)	(19.8)	(20.8)	(22.3)	(22.3)
<b>Returns (%)</b>					
ROE	21.4	15.7	16.9	18.5	18.3
ROA	14.0	10.4	11.4	12.4	12.4
<b>Per share</b>					
EPS (RMB)	24.1	22.0	25.9	30.8	35.2
DPS (RMB)	14.5	5.3	1.4	6.8	1.3
BVPS (RMB)	22.5	28.0	30.7	33.3	38.4

Source: Company data, CMBIS estimates

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