

Netease (NTES US)

Upbeat on games revenue growth and margin expansion in 2H23E

NetEase announced 2Q23 financial results on 24 Aug: total revenue grew by 3.7% YoY to RMB24.0bn, below our/consensus estimate by 3.4/3.1%, mainly due to softer-than-expected PC game performance. But operating income was up 23% YoY to RMB6.1bn, ahead of our/consensus estimate by 7.8/6.5%, supported by the strong GPM improvement (+4.0pct YoY and beat consensus by 2.7pct). We raise FY23-25E operating income forecast by 6-8% to reflect the more positive GPM outlook, mainly due to the favourable revenue mix shift to self-developed games and optimized channel costs. We expect total revenue growth to reaccelerate and the margin expansion to sustain in 2H23E, driven by the solid performance of quality new game titles like *Justice Mobile*. Our SOTP-derived TP is fine-tuned to US\$125.0 (previous: US\$123.0). Maintain BUY.

- **Solid performance of new games to drive growth in 2H23.** Online games revenue grew by 4% YoY to RMB18.8bn in 2Q23 (1Q23/4Q22: +8/2% YoY), 4% below consensus, due to soft PC game performance. Mobile game revenue increased by 14% YoY to RMB12.7bn in 2Q23, driven by the solid performance of *Fantasy Westward Journey* series and *Eggy Party*. New title *Justice Mobile* topped China's iOS grossing chart and attracted over 40mn players in a month after its launch in June. PC games revenue declined by 20% YoY to RMB4.6bn in 2Q23, mainly due to termination of licensed Blizzard games (12-18% of PC games revenue on our estimate). For the future pipeline, management expects the highly-anticipated open-world RPG game *Where Winds Meet* (燕云十六声) to be launched before 2Q24E. NetEase in 2Q23 announced establishment of two overseas studios called PinCool and T-Minus Zero Entertainment, which will focus on developing console games and an online multiplayer action game respectively.
- **Non-game business delivers quality growth.** Cloud Music revenue decreased by 11% YoY to RMB1.9bn in 2Q23 (8% of total revenue), mainly due to the operation adjustment of its social entertainment business. Nonetheless, its gross margin reached a record-high of 27% in 2Q23 (+14.0pct YoY) on enhanced monetization and cost control. Youdao revenue grew by 26% YoY to RMB1.2bn in 2Q23 (5% of total revenue), primarily due to strong demand for its STEAM courses and solid growth of its online marketing revenue (+99% YoY). Innovative businesses revenue grew by 10% YoY to RMB2.1bn in 2Q23 (9% of total revenue), mainly driven by growth of Yanxuan.
- **Expect GPM expansion to sustain in 2H23.** GPM expanded by 4.0pct YoY to 59.9% in 2Q23, primarily due to solid expansion in games/cloud music GPM (+2.6pct/14.0pct YoY). And we expect its YoY GPM expansion trend to sustain in 2H23, driven by solid growth of higher-margin self-developed games and optimized channel costs. OPM expanded by 3.9pct YoY to 25.2% in 2Q23 on improved GPM and prudent expenses control.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	87,606	96,496	105,038	112,431	117,689
Gross margin (%)	53.6	54.7	59.3	59.7	60.1
Adjusted net profit (RMB mn)	19,761.9	22,808.4	27,482.4	29,381.4	31,370.8
EPS (Adjusted) (RMB)	29.71	34.95	42.20	45.11	48.17
Consensus EPS (RMB)	29.71	34.95	39.98	43.57	44.73
P/S (x)	5.5	5.0	4.6	4.3	4.1
P/E (x)	26.6	19.2	20.1	18.8	17.4

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price US\$125.00

(Previous TP) US\$123.00

Up/Downside 21.8%

Current Price US\$102.64

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Stock Data

Mkt Cap (US\$ mn)	66,075.2
Avg 3 mths t/o (US\$ mn)	81.9
52w High/Low (US\$)	109.67/55.41
Total Issued Shares (mn)	643.8
Source: FactSet	

Shareholding Structure

William Lei Ding	44.2%
Invesco	2.2%

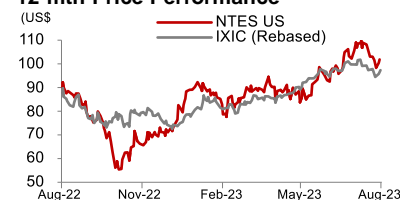
Source: Company data

Share Performance

	Absolute	Relative
1-mth	-2.8%	-0.4%
3-mth	22.9%	11.9%
6-mth	30.5%	8.4%

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	105.0	112.4	117.7	105.0	112.6	118.1	0.0%	-0.2%	-0.4%
Gross profit	62.3	67.1	70.7	60.7	65.6	69.2	2.7%	2.2%	2.2%
Operating profit	26.5	29.5	31.8	24.9	27.4	29.8	6.6%	7.9%	6.7%
Adjusted net profit	27.5	29.4	31.4	25.0	27.5	29.6	9.8%	7.0%	6.1%
Adjusted EPS (RMB)	42.2	45.1	48.2	38.4	42.2	45.4	9.8%	7.0%	6.1%
Gross margin	59.3%	59.7%	60.1%	57.8%	58.3%	58.6%	1.5 ppt	1.4 ppt	1.5 ppt
Operating margin	25.2%	26.3%	27.0%	23.7%	24.3%	25.2%	1.5 ppt	2.0 ppt	1.8 ppt
Adjusted net margin	26.2%	26.1%	26.7%	23.8%	24.4%	25.0%	2.3 ppt	1.7 ppt	1.6 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	105.0	112.4	117.7	106.2	117.0	128.6	-1.1%	-3.9%	-8.5%
Gross profit	62.3	67.1	70.7	61.3	67.8	74.7	1.7%	-1.1%	-5.3%
Operating profit	26.5	29.5	31.8	26.0	28.8	32.1	2.1%	2.6%	-1.0%
Adjusted net profit	27.5	29.4	31.4	26.3	28.7	31.5	4.4%	2.4%	-0.5%
Adjusted EPS (RMB)	42.2	45.1	48.2	40.0	43.6	44.7	5.5%	3.5%	7.7%
Gross margin	59.3%	59.7%	60.1%	57.7%	57.9%	58.1%	1.6 ppt	1.7 ppt	2.0 ppt
Operating margin	25.2%	26.3%	27.0%	24.4%	24.6%	25.0%	0.8 ppt	1.7 ppt	2.0 ppt
Adjusted net margin	26.2%	26.1%	26.7%	24.8%	24.5%	24.5%	1.4 ppt	1.6 ppt	2.1 ppt

Source: Bloomberg, CMBIGM estimates

Figure 3: NetEase: key financial data forecasts

(RMB mn)	2Q22	3Q22	4Q22	1Q23	2Q23	Cons.	Diff%	CMBI	Diff%
Online games revenue	18,140	18,699	19,086	20,066	18,799	19,529	-3.7%	19,493	-3.6%
YoY%	15.0%	9.1%	1.6%	7.6%	3.6%	7.7%		7.5%	
As % of total revenue	78.3%	76.6%	75.3%	80.1%	78.3%				
Youdao revenue	956	1,402	1,454	1,163	1,207	1,153	4.7%	1,162	3.9%
YoY%	-26.1%	1.1%	9.0%	-3.1%	26.2%	20.5%		21.5%	
As % of total revenue	4.1%	5.7%	5.7%	4.6%	5.0%				
Cloud Music revenue	2,192	2,357	2,376	1,960	1,949	2,062	-5.5%	2,231	-12.7%
YoY%	29.5%	22.5%	25.8%	-5.2%	-11.1%	-5.9%		1.8%	
As % of total revenue	9.5%	9.7%	9.4%	7.8%	8.1%				
Innovative businesses	1,872	1,968	2,438	1,858	2,057	2,068	-0.5%	1,981	3.9%
YoY%	6.1%	13.6%	3.4%	12.8%	9.9%	10.5%		5.9%	
As % of total revenue	8.1%	8.1%	9.6%	7.4%	8.6%				
Total revenue	23,159	24,427	25,354	25,046	24,011	24,775	-3.1%	24,867	-3.4%
YoY%	12.8%	10.1%	4.0%	6.3%	3.7%	7.0%		7.4%	
Gross profit margin (%)	55.9%	56.3%	52.2%	59.5%	59.9%				
S&M expenses ratio (%)	14.3%	15.4%	13.5%	11.6%	13.6%				
R&D expenses ratio (%)	15.5%	16.2%	16.1%	15.0%	16.3%				
Non-GAAP NPM (%)	23.4%	30.6%	19.0%	30.2%	37.6%				
Non-GAAP net profit	5,410	7,470	4,811	7,566	9,017	5,988	50.6%	5,671	59.0%
YoY%	28.0%	93.6%	-27.1%	47.8%	66.7%	10.7%		4.8%	

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\$125.0, comprising:

- 1) US\$117.7 for the online game business (94.1% of total valuation), based on 15x 2023E EV/EBIT which is on par with the industry average.
- 2) US\$0.9 for Youdao (0.7% of total valuation), based on 1.4x 2023E EV/revenue, on par with the industry average;
- 3) US\$2.3 (1.8% of total valuation) for the Cloud Music business, based on 2.0x 2023E EV/revenue, largely on par with the industry average;
- 4) US\$2.5 (2.0% of total valuation) for the innovative businesses and others, based on 1.3x 2023E EV/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	15.0	82,413	35,850	537,748	100.0%	537,748	117.7
Youdao	EV/revenue	1.4	5,464		7,650	54.2%	4,147	0.9
Cloud Music	EV/revenue	2.0	8,523		17,046	60.9%	10,380	2.3
Innovative businesses	EV/revenue	1.3	8,637		11,228	100.0%	11,228	2.5
Enterprise value							563,502	
Net cash							7,875	1.7
Equity value							571,377	
RMB/US\$							7.10	
Target valuation (US\$mn)							80,476	
No. of ADSs (mn)							644	
Value per ADS (US\$)							125.0	

Source: Company data, CMBIGM estimates

Figure 5: Peer comparison: online games

Companies	Ticker	Price (Local)	EBIT growth (YoY %)			EV/EBIT (x)		
			FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Tencent	700 HK	318.0	2	16	10	17	15	13
Activision Blizzard	ATVI US	91.7	24	8	7	18	16	15
Electronic Arts	EA US	121.3	(16)	9	8	16	14	13
Nexon	3659 JP	2,801.0	15	14	9	13	12	11
Nintendo	7974 JP	6,174.0	(20)	(2)	(12)	11	12	13
Bandai Namco	7832 JP	3,444.0	5	1	11	15	15	14
Perfect World	002624 CH	13.3	(10)	22	15	17	14	12
37 Interactive	002555 CH	24.6	7	15	12	13	11	10
Average EV/EBIT						15	14	13

Source: Bloomberg consensus estimates, CMBIGM

Note: data as of market close on 23 Aug

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

Companies	Ticker	Price	Revenue growth (YoY %)			EV/revenue (x)		
		(Local)	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Education								
New Oriental	EDU US	54.3	(4)	29	18	2.0	1.5	1.3
TAL Education	TAL US	6.8	(77)	33	21	1.4	1.1	0.9
Gaotu	GOTU US	3.1	14	21	14	0.8	0.7	0.6
Average PS						1.4	1.1	0.9
Music community								
TME	TME US	6.4	(10)	2	10	2.1	2.1	1.9
Spotify	SPOT US	138.2	13	17	13	1.7	1.5	1.3
BiliBili	BILI US	14.9	0	17	14	1.7	1.4	1.2
Kuaishou	1024 HK	64.4	15	15	13	2.1	1.9	1.6
Average PS						1.9	1.7	1.5
E-commerce								
Alibaba	BABA US	89.8	6	9	10	1.2	1.1	1.0
JD	JD US	33.8	(1)	10	9	0.3	0.3	0.3
Pinduoduo	PDD US	77.9	31	23	18	3.2	2.6	2.2
Vipshop	VIPS US	16.0	2	6	4	0.4	0.4	0.4
Average PS						1.3	1.1	1.0

Source: Bloomberg consensus estimates, CMBIGM

Note: data as of market close on 23 Aug

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	73,667	87,606	96,496	105,038	112,431	117,689
Cost of goods sold	(34,684)	(40,635)	(43,730)	(42,719)	(45,363)	(46,957)
Gross profit	38,983	46,971	52,766	62,319	67,068	70,733
Operating expenses	(24,445)	(30,554)	(33,138)	(35,818)	(37,552)	(38,955)
Selling expense	(10,704)	(12,214)	(13,403)	(14,180)	(14,616)	(15,064)
Admin expense	(3,372)	(4,264)	(4,696)	(4,832)	(4,947)	(5,061)
R&D expense	(10,369)	(14,076)	(15,039)	(16,806)	(17,989)	(18,830)
Operating profit	14,538	16,417	19,629	26,501	29,516	31,777
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	2,352	2,673	3,023
Foreign exchange gain/loss	(3,112)	(490)	1,571	0	0	0
Pre-tax profit	15,372	21,104	24,250	28,853	32,189	34,800
Income tax	(3,042)	(4,128)	(5,032)	(4,761)	(6,438)	(6,960)
After tax profit	12,330	16,976	19,218	24,092	25,751	27,840
Minority interest	(267)	(119)	494	239	258	278
Net profit	12,063	16,857	19,713	24,331	26,008	28,118
Adjusted net profit	14,706	19,762	22,808	27,482	29,381	31,371
BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	107,831	113,120	131,603	148,010	165,753	185,057
Cash & equivalents	9,117	14,498	24,889	31,610	38,861	46,979
Restricted cash	3,051	2,877	2,699	2,834	2,976	3,124
Account receivables	4,576	5,508	5,003	5,337	5,598	5,743
Inventories	621	965	994	971	1,031	1,067
Prepayment	6,112	6,236	5,448	5,812	6,097	6,254
ST bank deposits	71,079	70,755	84,948	93,442	102,787	113,065
Other current assets	13,273	12,282	7,623	8,004	8,404	8,824
Non-current assets	34,044	40,524	41,158	45,619	49,435	53,632
PP&E	4,555	5,434	6,342	7,403	8,640	10,085
Other non-current assets	29,488	35,090	34,815	38,217	40,794	43,548
Total assets	141,875	153,644	172,761	193,629	215,188	238,689
Current liabilities	46,743	50,501	56,829	60,759	63,830	67,548
Short-term borrowings	19,505	19,352	23,876	26,855	27,687	29,927
Account payables	1,134	985	1,507	1,472	1,563	1,618
Tax payable	4,283	4,537	2,813	3,062	3,278	3,431
Other current liabilities	14,484	16,266	17,252	18,251	19,496	20,351
Accrued expenses	7,338	9,361	11,381	11,118	11,806	12,221
Non-current liabilities	1,337	3,719	7,059	7,133	7,594	7,890
Other non-current liabilities	1,337	3,719	7,059	7,133	7,594	7,890
Total liabilities	48,081	54,220	63,888	67,891	71,424	75,437
Total shareholders equity	82,127	95,328	104,731	121,835	140,118	159,885
Minority interest	11,667	4,096	4,142	3,901	3,644	3,365
Total equity and liabilities	141,875	153,644	172,761	193,628	215,186	238,687

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	15,372	21,104	24,250	28,853	32,189	34,800
Depreciation & amortization	3,458	3,276	2,858	3,171	3,701	4,320
Tax paid	(3,042)	(4,128)	(5,032)	(4,761)	(6,438)	(6,960)
Change in working capital	4,771	3,188	3,497	275	1,634	1,139
Others	4,329	1,487	2,135	0	0	0
Net cash from operations	24,888	24,927	27,709	27,539	31,086	33,300
Investing						
Capital expenditure	(3,273)	(3,038)	(2,602)	(4,245)	(4,953)	(5,779)
Net cash from investing	(29,192)	(7,078)	(7,370)	(16,435)	(16,800)	(18,921)
Financing						
Dividend paid	(4,280)	(4,240)	(6,724)	(7,228)	(7,725)	(8,352)
Net borrowings	4,041	3,992	5,119	2,980	832	2,240
Proceeds from share issues	21,912	(2,297)	(274)	0	0	0
Others	(11,759)	(10,040)	(8,359)	0	0	0
Net cash from financing	9,913	(12,586)	(10,238)	(4,248)	(6,894)	(6,112)
Net change in cash						
Cash at the beginning of the year	6,398	12,169	17,376	27,588	34,444	41,837
Exchange difference	162	(55)	110	0	0	0
Others	0	0	0	0	0	0
Cash at the end of the year	12,169	17,376	27,588	34,444	41,837	50,103
GROWTH	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Revenue	24.4%	18.9%	10.1%	8.9%	7.0%	4.7%
Gross profit	23.5%	20.5%	12.3%	18.1%	7.6%	5.5%
Operating profit	5.4%	12.9%	19.6%	35.0%	11.4%	7.7%
Net profit	(43.3%)	39.7%	16.9%	23.4%	6.9%	8.1%
Adj. net profit	(6.1%)	34.4%	15.4%	20.5%	6.9%	6.8%
PROFITABILITY	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Gross profit margin	52.9%	53.6%	54.7%	59.3%	59.7%	60.1%
Operating margin	19.7%	18.7%	20.3%	25.2%	26.3%	27.0%
Adj. net profit margin	20.0%	22.6%	23.6%	26.2%	26.1%	26.7%
Return on equity (ROE)	16.8%	19.0%	19.7%	21.5%	19.9%	18.7%
GEARING/LIQUIDITY/ACTIVITIES	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Net debt to equity (x)	(0.7)	(0.7)	(0.8)	(0.8)	(0.8)	(0.8)
Current ratio (x)	2.3	2.2	2.3	2.4	2.6	2.7
Receivable turnover days	22.7	22.9	18.9	18.5	18.2	17.8
Payable turnover days	11.9	8.8	12.6	12.6	12.6	12.6
VALUATION	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
P/E	30.6	26.6	19.2	20.1	18.8	17.4
P/E (diluted)	31.0	27.0	19.4	20.0	18.7	17.3
P/B	4.5	4.7	3.6	4.0	3.5	3.1

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

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