

Netease (NTES US)

Games revenue growth accelerated with solid margin expansion

NetEase announced 3Q23 financial results on 16 Nov: total revenue increased by 12% YoY to RMB27.3bn, largely in line with our/consensus estimate of RMB28.2/27.3bn; operating income grew by 59% YoY to RMB7.6bn, beating our/consensus estimate by 9/4%, mainly due to enhanced games GPM (+4.0ppt YoY) on optimized channel costs and favourable revenue mix shift. Looking ahead, we expect total revenue growth to further accelerate in 4Q23, underpinned by the strong performance of new game titles. NetEase's quality game pipeline, with several highly-anticipated titles to be launched by 2Q24E, will also support its healthy revenue growth in 2024E, in our view. We raise FY23-25E non-GAAP earnings forecast by 4-9% to factor in the better-than-expected GPM expansion. We lift our SOTP-derived target price to US\$132.5 (previous: US\$125.0). Maintain BUY.

- **Games revenue growth accelerated on new titles.** Games revenue increased by 16% YoY to RMB21.8bn in 3Q23 (1Q23/2Q23: +8/4% YoY), with mobile/PC games revenue +33/-16% YoY respectively. The reaccelerating games revenue growth was mainly driven by the launch of new titles *Justice Mobile* and *Dunk City Dynasty*. Through innovative gameplays and quality content, *Justice Mobile* recorded strong revenue performance and accumulated over 50mn players, one third of which have never played NetEase's games before. Several highly-anticipated titles are planned for launch before 2Q24E, including *Where Winds Meet*, *SheDiao*, and *Mission Zero*, while *Naraka: Bladepoint Mobile* and *Project Mugen* are still pending license approval. Given the successful launches and experience accumulated in the past quarters, NetEase will continue to launch more large-DAU games and niche-genre games.
- **Non-gaming business to drive quality growth.** Cloud music revenue dropped by 16% YoY to RMB2.0bn in 3Q23 (7% of total revenue), as the company adjusted social entertainment business to enhance compliance and profitability. Cloud Music GPM was up 13.0ppt YoY to 27.2% in 3Q23. Innovative businesses revenue grew by 1% YoY to RMB2.0bn in 3Q23 (7% of total revenue). Youdao revenue increased by 10% YoY to RMB1.5bn in 3Q23 (6% of total revenue), primarily due to strong growth of digital content services and online marketing revenue.
- **GPM improvement supports strong earnings growth.** NetEase's GPM increased by 5.9ppt YoY to 62.2% in 3Q23, supported by the increase in revenue contribution from higher-margin channels and self-developed games. S&M expenses declined by 5% YoY despite the launch of multiple hit games in 3Q23, demonstrating NetEase operating leverage. As a result, OPM improved by 8.3ppt YoY to 27.7% in 3Q23 and we expect its healthy margin profile to sustain in 4Q23 and 2024E. NetEase also announced that Mr. Charles Yang has resigned as CFO for personal reasons, effective from Nov 30 and the company is searching for a successor.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	87,606	96,496	105,100	114,732	119,765
Gross margin (%)	53.6	54.7	60.8	61.6	61.7
Adjusted net profit (RMB mn)	19,761.9	22,808.4	32,573.7	34,364.6	35,645.0
EPS (Adjusted) (RMB)	29.71	34.95	50.01	52.76	54.73
Consensus EPS (RMB)	29.71	34.95	46.26	47.72	52.14
P/E (x)	26.6	19.2	18.5	17.6	16.8

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price US\$132.50

(Previous TP) US\$125.00

Up/Downside 15.1%

Current Price US\$115.08

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Stock Data

Mkt Cap (US\$ mn)	74,083.5
Avg 3 mths t/o (US\$ mn)	40.4
52w High/Low (US\$)	115.13/65.50
Total Issued Shares (mn)	643.8
Source: FactSet	

Shareholding Structure

William Lei Ding	44.2%
Invesco	2.2%

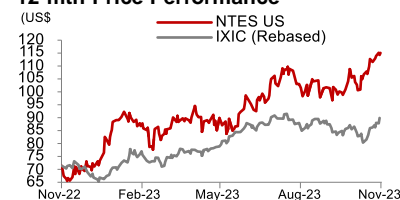
Source: Company data

Share Performance

	Absolute	Relative
1-mth	8.4%	4.3%
3-mth	13.3%	8.3%
6-mth	28.4%	12.4%

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	105.1	114.7	119.8	106.7	114.1	119.4	-1.5%	0.5%	0.3%
Gross profit	63.9	70.7	73.9	64.1	69.1	72.8	-0.4%	2.3%	1.5%
Operating profit	29.0	33.6	35.1	28.7	31.6	34.0	1.1%	6.2%	3.4%
Adjusted net profit	32.6	34.4	35.6	29.8	32.1	34.3	9.4%	6.9%	3.8%
Adjusted EPS (RMB)	50.0	52.8	54.7	45.7	49.3	52.7	9.4%	6.9%	3.8%
Gross margin	60.8%	61.6%	61.7%	60.1%	60.5%	60.9%	0.7 ppt	1.1 ppt	0.8 ppt
Operating margin	27.6%	29.3%	29.3%	26.9%	27.7%	28.4%	0.7 ppt	1.6 ppt	0.9 ppt
Adjusted net margin	31.0%	30.0%	29.8%	27.9%	28.2%	28.7%	3.1 ppt	1.8 ppt	1.0 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	105.1	114.7	119.8	105.2	116.4	128.0	-0.1%	-1.4%	-6.4%
Gross profit	63.9	70.7	73.9	62.0	68.9	76.0	3.0%	2.6%	-2.8%
Operating profit	29.0	33.6	35.1	27.6	30.9	34.3	5.1%	8.8%	2.3%
Adjusted net profit	32.6	34.4	35.6	29.9	30.7	34.0	9.0%	12.1%	5.0%
Adjusted EPS (RMB)	50.0	52.8	54.7	46.3	47.7	52.1	8.1%	10.6%	5.0%
Gross margin	60.8%	61.6%	61.7%	58.9%	59.2%	59.4%	1.8 ppt	2.4 ppt	2.3 ppt
Operating margin	27.6%	29.3%	29.3%	26.2%	26.5%	26.8%	1.4 ppt	2.7 ppt	2.5 ppt
Adjusted net margin	31.0%	30.0%	29.8%	28.4%	26.3%	26.5%	2.6 ppt	3.6 ppt	3.2 ppt

Source: Bloomberg, CMBIGM estimates

Figure 3: NetEase: key financial data forecasts

(RMB mn)	3Q22	4Q22	1Q23	2Q23	3Q23	Cons.	Diff%	CMBI	Diff%
Online games revenue	18,699	19,086	20,066	18,799	21,780	21,551	1.1%	22,582	-3.6%
YoY%	9.1%	1.6%	7.6%	3.6%	16.5%	15.3%		20.8%	
As % of total revenue	76.6%	75.3%	80.1%	78.3%	79.9%				
Youdao revenue	1,402	1,454	1,163	1,207	1,539	1,618	-4.9%	1,530	0.6%
YoY%	1.1%	9.0%	-3.1%	26.2%	9.7%	15.4%		9.1%	
As % of total revenue	5.7%	5.7%	4.6%	5.0%	5.6%				
Cloud Music revenue	2,357	2,376	1,960	1,949	1,973	2,109	-6.4%	1,960	0.7%
YoY%	22.5%	25.8%	-5.2%	-11.1%	-16.3%	-10.6%		-16.8%	
As % of total revenue	9.7%	9.4%	7.8%	8.1%	7.2%				
Innovative businesses	1,968	2,438	1,858	2,057	1,979	2,172	-8.9%	2,139	-7.5%
YoY%	13.6%	3.4%	12.8%	9.9%	0.5%	10.3%		8.7%	
As % of total revenue	8.1%	9.6%	7.4%	8.6%	7.3%				
Total revenue	24,427	25,354	25,046	24,011	27,270	27,253	0.1%	28,211	-3.3%
YoY%	10.1%	4.0%	6.3%	3.7%	11.6%	11.6%		15.5%	
Gross profit margin (%)	56.3%	52.2%	59.5%	59.9%	62.2%				
S&M expenses ratio (%)	15.4%	13.5%	11.6%	13.6%	13.1%				
R&D expenses ratio (%)	16.2%	16.1%	15.0%	16.3%	15.9%				
Non-GAAP NPM (%)	30.6%	19.0%	30.2%	37.6%	31.7%				
Non-GAAP net profit	7,470	4,811	7,566	9,017	8,645	7,099	21.8%	7,114	21.5%
YoY%	93.6%	-27.1%	47.8%	66.7%	15.7%	-5.0%		-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\$132.5, comprising:

- 1) US\$124.7 for the online game business (94.2% of total valuation), based on 14x 2024E EV/EBIT which is on par with the industry average.
- 2) US\$1.2 for Youdao (0.9% of total valuation), based on 1.7x 2024E EV/revenue, on par with the industry average;
- 3) US\$2.2 (1.7% of total valuation) for the Cloud Music business, based on 2.0x 2024E EV/revenue, at a premium over the industry average due to its relatively strong margin expansion outlook over FY23-24E;
- 4) US\$2.6 (2.0% of total valuation) for the innovative businesses and others, based on 1.4x 2024E 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)	2024E sales	2024E EBIT	Valuation	Shareholding (%)	Valuation to NetEase	Valuation per ADS (US\$)
Online games	EV/EBIT	14.0	91,572	41,299	578,184	100.0%	578,184	124.7
Youdao	EV/revenue	1.7	5,902		10,033	54.2%	5,439	1.2
Cloud Music	EV/revenue	2.0	8,524		17,047	60.9%	10,380	2.2
Innovative businesses	EV/revenue	1.4	8,735		12,229	100.0%	12,229	2.6
Enterprise value							606,232	
Net cash							7,875	1.7
Equity value							614,107	
RMB/US\$							7.20	
Target valuation (US\$mn)							85,293	
No. of ADSs (mn)							644	
Value per ADS (US\$)							132.5	

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	322.6	2	16	10	17	15	13
Activision Blizzard	ATVI US	94.4	24	8	7	18	17	16
Electronic Arts	EA US	134.4	(16)	9	8	17	16	15
Nexon	3659 JP	3,035.0	15	14	9	15	13	12
Nintendo	7974 JP	6,994.0	(20)	(2)	(12)	13	13	15
Bandai Namco	7832 JP	3,096.0	5	1	11	14	13	12
Perfect World	002624 CH	13.3	(10)	22	15	17	14	12
37 Interactive	002555 CH	23.7	7	15	12	12	11	9
Average EV/EBIT						15	14	13

Source: Bloomberg consensus estimates, CMBIGM

Note: data as of market close on 15 Nov

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

Companies	Ticker	Price (Local)	Revenue growth (YoY %)			EV/revenue (x)		
			FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Education								
New Oriental	EDU US	67.8	(4)	29	18	3.1	2.4	2.0
TAL Education	TAL US	9.6	(77)	33	21	2.8	2.1	1.8
Gaotu	GOTU US	2.7	14	21	14	0.6	0.5	0.4
Average PS						2.2	1.7	1.4
Music community								
TME	TME US	8.3	(10)	2	10	2.7	2.7	2.4
Spotify	SPOT US	173.8	13	17	13	2.2	1.9	1.6
BiliBili	BILI US	15.2	0	17	14	1.7	1.4	1.3
Kuaishou	1024 HK	58.3	15	15	13	1.9	1.7	1.5
Average PS						1.9	1.7	1.5
E-commerce								
Alibaba	BABA US	87.1	6	9	10	1.2	1.1	1.0
JD	JD US	28.6	(1)	10	9	0.3	0.2	0.2
Pinduoduo	PDD US	114.4	31	23	18	4.6	3.8	3.2
Vipshop	VIPS US	15.8	2	6	4	0.4	0.4	0.4
Average PS						1.6	1.4	1.2

Source: Bloomberg consensus estimates, CMBIGM

Note: data as of market close on 15 Nov

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	73,667	87,606	96,496	105,100	114,732	119,765
Cost of goods sold	(34,684)	(40,635)	(43,730)	(41,235)	(44,065)	(45,872)
Gross profit	38,983	46,971	52,766	63,865	70,667	73,893
Operating expenses	(24,445)	(30,554)	(33,138)	(34,841)	(37,059)	(38,804)
Selling expense	(10,704)	(12,214)	(13,403)	(13,348)	(14,227)	(14,971)
Admin expense	(3,372)	(4,264)	(4,696)	(4,940)	(5,163)	(5,389)
R&D expense	(10,369)	(14,076)	(15,039)	(16,553)	(17,669)	(18,444)
Operating profit	14,538	16,417	19,629	29,025	33,609	35,089
Investment gain/loss	1,610	2,948	54	1,316	658	329
Other gains/(losses)	737	710	847	619	0	0
Interest income	1,599	1,520	2,150	3,376	4,004	4,647
Foreign exchange gain/loss	(3,112)	(490)	1,571	277	0	0
Pre-tax profit	15,372	21,104	24,250	34,613	38,271	40,065
Income tax	(3,042)	(4,128)	(5,032)	(5,365)	(7,654)	(8,013)
After tax profit	12,330	16,976	19,218	29,248	30,616	32,052
Minority interest	(267)	(119)	494	173	306	321
Net profit	12,063	16,857	19,713	29,421	30,923	32,373
Adjusted net profit	14,706	19,762	22,808	32,574	34,365	35,645
BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	107,831	113,120	131,603	153,569	176,235	199,608
Cash & equivalents	9,117	14,498	24,889	37,196	49,133	61,343
Restricted cash	3,051	2,877	2,699	2,834	2,976	3,124
Account receivables	4,576	5,508	5,003	5,340	5,713	5,844
Inventories	621	965	994	937	1,001	1,042
Prepayment	6,112	6,236	5,448	5,815	6,221	6,364
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	45,620	49,456	53,652
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	40,816	43,567
Total assets	141,875	153,644	172,761	199,189	225,691	253,260
Current liabilities	46,743	50,501	56,829	62,875	67,414	72,232
Short-term borrowings	19,505	19,352	23,876	29,560	31,428	34,719
Account payables	1,134	985	1,507	1,421	1,519	1,581
Tax payable	4,283	4,537	2,813	3,064	3,345	3,491
Other current liabilities	14,484	16,266	17,252	18,098	19,654	20,502
Accrued expenses	7,338	9,361	11,381	10,732	11,468	11,939
Non-current liabilities	1,337	3,719	7,059	6,967	7,498	7,813
Other non-current liabilities	1,337	3,719	7,059	6,967	7,498	7,813
Total liabilities	48,081	54,220	63,888	69,842	74,912	80,045
Total shareholders equity	82,127	95,328	104,731	125,378	147,115	169,872
Minority interest	11,667	4,096	4,142	3,967	3,661	3,340
Total equity and liabilities	141,875	153,644	172,761	199,186	225,688	253,257

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	15,372	21,104	24,250	34,613	38,271	40,065
Depreciation & amortization	3,458	3,276	2,858	3,171	3,701	4,320
Tax paid	(3,042)	(4,128)	(5,032)	(5,365)	(7,654)	(8,013)
Change in working capital	4,771	3,188	3,497	(286)	1,828	1,212
Others	4,329	1,487	2,135	0	0	0
Net cash from operations	24,888	24,927	27,709	32,133	36,146	37,584
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)	(16,601)	(16,750)	(18,900)
Financing						
Dividend paid	(4,280)	(4,240)	(6,724)	(8,774)	(9,185)	(9,616)
Net borrowings	4,041	3,992	5,119	5,684	1,868	3,291
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)	(3,090)	(7,317)	(6,325)
Net change in cash						
Cash at the beginning of the year	6,398	12,169	17,376	27,588	40,030	52,109
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	40,030	52,109	64,468
GROWTH	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Revenue	24.4%	18.9%	10.1%	8.9%	9.2%	4.4%
Gross profit	23.5%	20.5%	12.3%	21.0%	10.6%	4.6%
Operating profit	5.4%	12.9%	19.6%	47.9%	15.8%	4.4%
Net profit	(43.3%)	39.7%	16.9%	49.2%	5.1%	4.7%
Adj. net profit	(6.1%)	34.4%	15.4%	42.8%	5.5%	3.7%
PROFITABILITY	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Gross profit margin	52.9%	53.6%	54.7%	60.8%	61.6%	61.7%
Operating margin	19.7%	18.7%	20.3%	27.6%	29.3%	29.3%
Adj. net profit margin	20.0%	22.6%	23.6%	31.0%	30.0%	29.8%
Return on equity (ROE)	16.8%	19.0%	19.7%	25.6%	22.7%	20.4%
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	2.8
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	18.5	17.6	16.8
P/E (diluted)	31.0	27.0	19.4	18.4	17.5	16.8
P/B	4.5	4.7	3.6	4.3	3.7	3.2

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

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