

# NetEase Inc. (NTES US)

## Strong pipeline despite short-term deceleration

NetEase delivered solid 2Q22 result, with rev/adj. NP +13%/28% YoY (1%/12% above consensus). Game rev +16% YoY, beating our estimate on strong PC (+41% YoY). Deferred revenue (ex-Youdao) -1% QoQ. Stock price might see short-term volatility on 2H22E deceleration trend (PC high base) and license uncertainty. We suggest investors to look into its strong pipeline in the long run, such as *HP international*, console and mobile versions of *Naraka: Bladepoint* which might boost FY23E momentum. We slightly trimmed its earnings by 1%-4% in FY22-24E, to reflect license uncertainty and overseas traffic normalization, with new TP at US\$127.

- **2Q22 beat.** 2Q22 rev +13% YoY, 1%/3% above consensus/our estimate, in which game & cloud music beat while Youdao missed. Deferred rev (ex. Youdao) -1% QoQ. Non-GAAP net profit +28% YoY to RMB5.4bn, 12%/10% above consensus/our estimate, mainly on higher-than-expected GPM. We view this result as positive, but price might see volatility on 2H22E deceleration trend and license uncertainty.
- **Solid pipeline ahead, while 2H22E to decelerate on high base of PC games.** Games +16% YoY in 2Q22 (vs. +15% YoY in 1Q22), in which PC game +41% YoY (3% above our estimate, mainly on strong *Naraka*) and mobile games +6% YoY (moderate on flat HP). *Diablo: Immortal* performed well (ranked TOP2-5 in IOS grossing rank after its launch), with estimated grossing at RMB1bn in first month (in our estimate). Mgmt stated game approval in domestic market is a scarce resource (two games with licenses currently), leading to focus shift to high quality game development. As such, we expect *HP international* and *Diablo: Immortal* to be key drivers in 2H22E (targeting mobile game at double-digit YoY growth). PC game should slow down in 2H22E (or even decline YoY), given 1H21 high base with strong *Naraka: Bladepoint*.
- **Maintain BUY.** We slightly trimmed its earnings by 1%-4% in FY22-24E, to reflect 2H22E deceleration on high base and license uncertainty. Our new TP is US\$127 (implying 25x FY23E P/E). Further catalysts: upcoming launch of key titles and overseas expansion.

### Earnings Summary

(YE 31 Dec)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue (RMB mn)	73,667	87,093	96,146	107,135	117,655
YoY growth (%)	24.4	18.2	10.4	11.4	9.8
Adj. net income (RMB mn)	14,706	19,465	20,574	22,925	25,608
EPS (RMB)	22.0	28.9	30.3	33.5	37.0
YoY growth (%)	(8.9)	31.6	5.0	10.3	10.5
Consensus EPS (RMB)	NA	26.0	29.9	34.9	39.7
P/E (x)	26.1	19.8	18.9	17.1	15.5
P/S (x)	5.2	4.4	4.0	3.7	3.4
Yield (%)	0.8	1.1	1.1	1.2	1.3
ROE (%)	15.7	19.2	18.6	17.9	17.4
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

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

**BUY (Maintain)**

Target Price **US\$127**  
 (Previous TP **US\$132**)  
 Up/Downside **+47.7%**  
 Current Price **US\$86.0**

### China Internet Sector

**Sophie Huang**  
 (852) 3900 0889  
 sophiehuang@cmbi.com.hk

**Eason Xu**  
 (852) 3900 0849  
 easonxu@cmbi.com.hk

### Stock Data

Mkt Cap (US\$ mn)	60,347
Avg 3 mths t/o (US\$ mn)	192.79
52w High/Low (US\$)	118.2/ 68.6
Total Issued Shares (mn)	657

Source: Bloomberg

### Shareholding Structure

Invesco	2.47%
Lei Ding	1.35%
UBS AG	1.30%

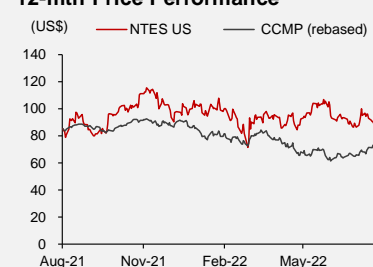
Source: Bloomberg

### Share Performance

	Absolute	Relative
1-mth	4.5%	-9.9%
3-mth	-0.6%	-10.1%
6-mth	-6.2%	-0.9%

Source: Bloomberg

### 12-mth Price Performance



Source: Bloomberg

**Auditor: PwC**

### Related Reports

1. Eyes on new titles launch— 25 May 2022
2. Looking into strong pipeline ahead — 28 Feb 2022
3. More bullish on 4Q21E & FY22E outlook — 17 Nov 2021

**Figure 1: 2Q22 financial review**

RMB mn, Dec-YE	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	QoQ	YoY	Consensus	Diff %
Revenue	18,658	19,762	20,517	20,525	22,191	24,374	23,556	23,159	-1.7%	12.8%	23,037	1%
Operating Profit	2,870	3,012	4,276	3,758	3,775	4,608	5,507	4,946	-10.2%	31.6%	4,816	3%
Net profit	2,998	976	4,439	3,542	3,182	5,694	4,394	5,291	20.4%	49.4%	4,149	28%
Adj. net profit	3,669	1,598	5,081	4,242	3,870	6,697	5,140	5,431	5.7%	28.0%	4,847	12%
Adj. EPS (RMB)	5.35	2.34	7.47	6.26	5.76	10.08	7.75	8.22	6.0%	31.2%	6.15	33%
<b>Margin (%)</b>												
Gross margin	53.0%	50.2%	53.9%	54.5%	53.2%	53.0%	54.5%	55.9%			53.5%	
Operating margin	15.4%	15.2%	20.8%	18.3%	17.0%	18.9%	23.4%	21.4%			20.9%	
Adj. net margin	19.7%	8.1%	24.8%	20.7%	17.4%	27.5%	21.8%	23.5%			21.0%	
<b>Growth (%)</b>												
Revenue (YoY)	27.5%	25.6%	20.2%	12.9%	18.9%	23.3%	14.8%	12.8%			12.2%	
Revenue (QoQ)	2.6%	5.9%	3.8%	0.0%	8.1%	9.8%	-3.4%	-1.7%			-2.2%	
Operating Profit	-13.9%	1.2%	-4.7%	-9.9%	31.5%	53.0%	28.8%	31.6%			28.1%	
Adj. net profit	-22.4%	-56.4%	20.6%	-18.8%	5.5%	319.1%	1.2%	28.0%			14.3%	

Source: Company data, Bloomberg, CMBIGM estimates

**Figure 2: 2Q22 revenue breakdown**

RMB mn, Dec-YE	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	QoQ	YoY
<b>Total revenue</b>	<b>18,658</b>	<b>19,762</b>	<b>20,517</b>	<b>20,525</b>	<b>22,191</b>	<b>24,374</b>	<b>23,556</b>	<b>23,159</b>	<b>-2%</b>	<b>13%</b>
Online game	13,862	13,400	14,982	14,528	15,899	17,398	17,273	16,870	-2%	16%
Youdao	896	1,107	1,340	1,293	1,387	1,334	1,201	956	-20%	-26%
Cloud music	1,393	1,525	1,491	1,693	1,925	1,889	2,067	2,192	6%	29%
Others	2,508	3,730	2,704	3,011	2,980	3,753	3,015	3,141	4%	4%

Source: Company data

**Figure 3: CMBIGM estimates vs consensus**

RMB mn, Dec-YE	CMBIGM			Consensus			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	96,146	107,135	117,655	98,514	112,006	122,026	-2.4%	-4.3%	-3.6%
Gross profit	51,597	57,497	63,607	52,391	59,883	65,800	-1.5%	-4.0%	-3.3%
Operating profit	18,734	20,877	23,392	19,574	23,455	26,908	-4.3%	-11.0%	-13.1%
Adj. net profit	20,574	22,925	25,608	20,319	23,607	26,885	1.3%	-2.9%	-4.8%
EPS (RMB)	30.34	33.47	33.47	29.86	34.88	39.72	1.6%	-4.1%	-15.7%
Gross margin	53.7%	53.7%	54.1%	52.8%	52.9%	53.6%	+0.87ppts	+0.74ppts	+0.42ppts
Operating margin	19.5%	19.5%	19.9%	19.9%	20.9%	22.1%	-0.39ppts	-1.45ppts	-2.17ppts
Net margin	21.0%	21.5%	21.9%	20.6%	21.1%	22.0%	+0.39ppts	+0.42ppts	-0.12ppts

Source: Company data, Bloomberg, CMBIGM estimates

**Figure 4: Earnings revision**

RMB mn, Dec-YE	New			Old			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	96,146	107,135	117,655	99,064	109,911	121,829	-2.9%	-2.5%	-3.4%
Gross profit	51,597	57,497	63,607	51,908	58,593	65,612	-0.6%	-1.9%	-3.1%
Operating profit	18,734	20,877	23,392	18,326	21,334	24,313	2.2%	-2.1%	-3.8%
Adj. net profit	20,574	22,925	25,608	20,625	23,620	26,692	-0.2%	-2.9%	-4.1%
EPS (RMB)	30.34	33.47	33.47	30.41	34.48	34.48	-0.2%	-2.9%	-2.9%
Gross margin	53.7%	53.7%	54.1%	52.4%	53.3%	53.9%	+1.27ppts	+0.37ppts	+0.16ppts
Operating margin	19.5%	19.5%	19.9%	18.5%	19.4%	20.0%	+0.98ppts	+0.09ppts	-0.12ppts
Net margin	21.4%	21.4%	21.8%	20.8%	21.5%	21.9%	+0.60ppts	-0.10ppts	-0.13ppts

Source: Company data, CMBIGM estimates

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Revenues</b>	<b>73,667</b>	<b>87,093</b>	<b>96,146</b>	<b>107,135</b>	<b>117,655</b>
Online game	54,609	62,806	70,314	78,535	86,316
Youdao	3,168	5,070	4,293	4,831	5,508
Others	15,891	19,216	21,540	23,770	25,831
COGS	(34,684)	(40,635)	(44,549)	(49,638)	(54,048)
<b>Gross profit</b>	<b>38,983</b>	<b>46,457</b>	<b>51,597</b>	<b>57,497</b>	<b>63,607</b>
S&M	(10,704)	(12,214)	(13,015)	(14,503)	(15,927)
R&D	(10,369)	(14,076)	(15,256)	(17,000)	(18,669)
G&A	(3,372)	(4,264)	(4,592)	(5,117)	(5,619)
<b>Operating profit</b>	<b>14,538</b>	<b>15,904</b>	<b>18,734</b>	<b>20,877</b>	<b>23,392</b>
Other income	834	4,776	4,062	4,474	4,971
Pre-tax Income	15,372	20,680	22,795	25,352	28,363
Income Tax	(3,042)	(4,128)	(5,266)	(5,857)	(6,553)
Net income after tax	12,330	16,551	17,529	19,495	21,810
Deemed dividends	(787)	(537)	(400)	(400)	(400)
Loss to NCI	520	418	80	80	80
Net income	12,063	16,432	17,209	19,175	21,490
<b>Adj. net profit</b>	<b>14,706</b>	<b>19,465</b>	<b>20,574</b>	<b>22,925</b>	<b>25,608</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Net income</b>	<b>12,330</b>	<b>16,432</b>	<b>17,209</b>	<b>19,175</b>	<b>21,490</b>
D&A	3,458	2,613	3,345	4,632	5,157
Change in WC	4,771	518	3,830	133	2,280
Others	4,329	3,033	3,365	3,750	4,118
Operating CF	24,888	22,595	27,749	27,689	<b>33,045</b>
CAPEX	(3,290)	(1,825)	(4,460)	(4,632)	(4,951)
Others	(25,902)	(7,108)	0	0	0
<b>Investing cash flow</b>	<b>(29,192)</b>	<b>(8,933)</b>	<b>(4,460)</b>	<b>(4,632)</b>	<b>(4,951)</b>
Repurchase	(11,491)	(6,671)	(6,671)	0	0
Dividends	(4,280)	(4,962)	(4,937)	(5,459)	(6,107)
Others	25,685	1,950	2,146	2,360	2,596
<b>Financing cash flow</b>	<b>9,913</b>	<b>(9,683)</b>	<b>(9,462)</b>	<b>(3,098)</b>	<b>(3,511)</b>
<b>Net change in cash</b>	<b>5,609</b>	<b>3,979</b>	<b>13,827</b>	<b>19,959</b>	<b>24,584</b>
Cash & res cash	6,398	12,169	16,148	29,974	49,933
Fx effect	162	0	0	0	0
Cash & res cash	12,169	16,148	29,974	49,933	74,517
Restrict cash	3,051	3,051	3,051	3,051	3,051
<b>Cash and cash equivalents</b>	<b>9,117</b>	<b>13,096</b>	<b>26,923</b>	<b>46,882</b>	<b>74,517</b>

### Balance sheet

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Non-current assets</b>	<b>34,044</b>	<b>33,256</b>	<b>34,371</b>	<b>34,371</b>	<b>34,165</b>
PP&E	4,555	3,768	4,883	4,883	4,677
Land use right, net	4,178	4,178	4,178	4,178	4,178
Time deposits	6,630	6,630	6,630	6,630	6,630
Others	18,680	18,680	18,680	18,680	18,680
<b>Current assets</b>	<b>107,831</b>	<b>117,569</b>	<b>131,775</b>	<b>155,170</b>	<b>180,388</b>
Cash and cash eq.	9,117	13,096	26,923	46,882	71,466
Time deposits	71,079	78,187	78,187	78,187	78,187
Short-term investments	13,273	13,273	13,273	13,273	13,273
Other current asset	14,361	13,012	13,391	16,828	17,462
<b>Current liabilities</b>	<b>46,743</b>	<b>47,862</b>	<b>54,217</b>	<b>60,146</b>	<b>65,657</b>
AP & accrued liabilities	1,134	1,237	1,366	1,522	1,671
Salary payables	3,539	3,166	3,495	3,894	4,276
Short-term loan	19,505	21,455	23,601	25,961	28,557
Others	22,566	22,004	25,755	28,769	31,152
<b>Non-current liabilities</b>	<b>1,337</b>	<b>1,337</b>	<b>1,337</b>	<b>1,337</b>	<b>1,337</b>
Other long-term payable	624	624	624	624	624
Deferred tax liabilities	713	713	713	713	713
<b>Shareholders' equity</b>	<b>93,794</b>	<b>101,626</b>	<b>110,592</b>	<b>128,058</b>	<b>147,559</b>

### Key ratios

YE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Sales mix (%)</b>					
Online game	74.1	72.1	73.1	73.3	73.4
Youdao	4.3	5.8	4.5	4.5	4.7
Others	21.6	22.1	22.4	22.2	22.0
Total	100.0	100.0	100.0	100.0	<b>100.0</b>
<b>Growth rate (%)</b>					
Revenue	24.4	18.2	10.4	11.4	9.8
Gross profit	23.6	19.2	11.1	11.4	10.6
EBIT	5.4	9.4	17.8	11.4	12.0
Adj. net profit	(6.1)	32.4	5.7	11.4	11.7
<b>P&amp;L ratios (%)</b>					
Operating margin	19.7	18.3	19.5	19.5	19.9
Pre-tax margin	20.9	23.7	23.7	23.7	24.1
Adj. net margin	20.0	22.3	21.4	21.4	21.8
Effective tax rate	(19.8)	(20.0)	(23.1)	(23.1)	(23.1)
<b>Returns (%)</b>					
ROE	15.7	19.2	18.6	17.9	17.4
ROA	10.4	12.9	12.4	12.1	11.9
<b>Per share</b>					
EPS (RMB)	22.0	28.9	30.3	33.5	37.0
DPS (RMB)	0.8	1.1	1.1	1.2	1.3
BVPS (RMB)	28.0	30.2	32.6	37.4	42.6

Source: Company data, CMBIGM estimates

# Disclosures & Disclaimers

## Analyst Certification

The research analyst who is primary responsible for the content of this research report, in whole or in part, certifies that with respect to the securities or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by that analyst in this report.

Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the stock(s) covered in this research report 3 business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong listed companies covered in this report; and (4) have any financial interests in the Hong Kong listed companies covered in this report.

## CMBIGM Ratings

**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

## CMB International Global Markets Limited

**Address:** 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

**CMB International Global Markets Limited ("CMBIGM") is a wholly owned subsidiary of CMB International Capital Corporation Limited (a wholly owned subsidiary of China Merchants Bank)**

## Important Disclosures

There are risks involved in transacting in any securities. The information contained in this report may not be suitable for the purposes of all investors. CMBIGM does not provide individually tailored investment advice. This report has been prepared without regard to the individual investment objectives, financial position or special requirements. Past performance has no indication of future performance, and actual events may differ materially from that which is contained in the report. The value of, and returns from, any investments are uncertain and are not guaranteed and may fluctuate as a result of their dependence on the performance of underlying assets or other variable market factors. CMBIGM recommends that investors should independently evaluate particular investments and strategies, and encourages investors to consult with a professional financial advisor in order to make their own investment decisions.

This report or any information contained herein, have been prepared by the CMBIGM, solely for the purpose of supplying information to the clients of CMBIGM or its affiliate(s) to whom it is distributed. This report is not and should not be construed as an offer or solicitation to buy or sell any security or any interest in securities or enter into any transaction. Neither CMBIGM nor any of its affiliates, shareholders, agents, consultants, directors, officers or employees shall be liable for any loss, damage or expense whatsoever, whether direct or consequential, incurred in relying on the information contained in this report. Anyone making use of the information contained in this report does so entirely at their own risk.

The information and contents contained in this report are based on the analyses and interpretations of information believed to be publicly available and reliable. CMBIGM has exerted every effort in its capacity to ensure, but not to guarantee, their accuracy, completeness, timeliness or correctness. CMBIGM provides the information, advices and forecasts on an "AS IS" basis. The information and contents are subject to change without notice. CMBIGM may issue other publications having information and/or conclusions different from this report. These publications reflect different assumption, point-of-view and analytical methods when compiling. CMBIGM may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.

CMBIGM may have a position, make markets or act as principal or engage in transactions in securities of companies referred to in this report for itself and/or on behalf of its clients from time to time. Investors should assume that CMBIGM does or seeks to have investment banking or other business relationships with the companies in this report. As a result, recipients should be aware that CMBIGM may have a conflict of interest that could affect the objectivity of this report and CMBIGM will not assume any responsibility in respect thereof. This report is for the use of intended recipients only and this publication, may not be reproduced, reprinted, sold, redistributed or published in whole or in part for any purpose without prior written consent of CMBIGM.

Additional information on recommended securities is available upon request.

For recipients of this document in the United Kingdom

This report has been provided only to persons (I) falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended from time to time) ("The Order") or (II) are persons falling within Article 49(2) (a) to (d) ("High Net Worth Companies, Unincorporated Associations, etc.") of the Order, and may not be provided to any other person without the prior written consent of CMBIGM.

For recipients of this document in the United States

CMBIGM is not a registered broker-dealer in the United States. As a result, CMBIGM is not subject to U.S. rules regarding the preparation of research reports and the independence of research analysts. The research analyst who is primary responsible for the content of this research report is not registered or qualified as a research analyst with the Financial Industry Regulatory Authority ("FINRA"). The analyst is not subject to applicable restrictions under FINRA Rules intended to ensure that the analyst is not affected by potential conflicts of interest that could bear upon the reliability of the research report. This report is intended for distribution in the United States solely to "major US institutional investors", as defined in Rule 15a-6 under the US Securities Exchange Act of 1934, as amended, and may not be furnished to any other person in the United States. Each major US institutional investor that receives a copy of this report by its acceptance hereof represents and agrees that it shall not distribute or provide this report to any other person. Any U.S. recipient of this report wishing to effect any transaction to buy or sell securities based on the information provided in this report should do so only through a U.S.-registered broker-dealer.

For recipients of this document in Singapore

This report is distributed in Singapore by CMBI (Singapore) Pte. Limited (CMBISG) (Company Regn. No. 201731928D), an Exempt Financial Adviser as defined in the Financial Advisers Act (Cap. 110) of Singapore and regulated by the Monetary Authority of Singapore. CMBISG may distribute reports produced by its respective foreign entities, affiliates or other foreign research houses pursuant to an arrangement under Regulation 32C of the Financial Advisers Regulations. Where the report is distributed in Singapore to a person who is not an Accredited Investor, Expert Investor or an Institutional Investor, as defined in the Securities and Futures Act (Cap. 289) of Singapore, CMBISG accepts legal responsibility for the contents of the report to such persons only to the extent required by law. Singapore recipients should contact CMBISG at +65 6350 4400 for matters arising from, or in connection with the report.