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**

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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%

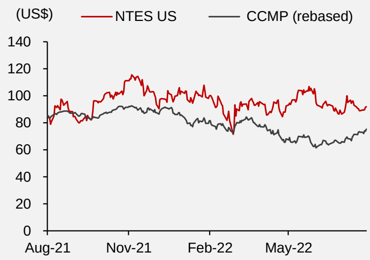
Source: Bloomberg

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

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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%
Margin (%)												
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%	
Growth (%)												
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
Total revenue	**18,658**	**19,762**	**20,517**	**20,525**	**22,191**	**24,374**	**23,556**	**23,159**	**-2%**	**13%**
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

	CMBIGM			Consensus			Diff (%)		
RMB mn, Dec-YE	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

	New			Old			Diff (%)		
RMB mn, Dec-YE	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
Revenues	**73,667**	**87,093**	**96,146**	**107,135**	**117,655**
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)
Gross profit	**38,983**	**46,457**	**51,597**	**57,497**	**63,607**
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)
Operating profit	**14,538**	**15,904**	**18,734**	**20,877**	**23,392**
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
Adj. net profit	**14,706**	**19,465**	**20,574**	**22,925**	**25,608**

Cash flow summary

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Net income	**12,330**	**16,432**	**17,209**	**19,175**	**21,490**
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	**33,045**
CAPEX	(3,290)	(1,825)	(4,460)	(4,632)	(4,951)
Others	(25,902)	(7,108)	0	0	0
Investing cash flow	**(29,192)**	**(8,933)**	**(4,460)**	**(4,632)**	**(4,951)**
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
Financing cash flow	**9,913**	**(9,683)**	**(9,462)**	**(3,098)**	**(3,511)**
Net change in cash	**5,609**	**3,979**	**13,827**	**19,959**	**24,584**
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
Cash and cash equivalents	**9,117**	**13,096**	**26,923**	**46,882**	**74,517**

Balance sheet

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Non-current assets	**34,044**	**33,256**	**34,371**	**34,371**	**34,165**
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
Current assets	**107,831**	**117,569**	**131,775**	**155,170**	**180,388**
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
Current liabilities	**46,743**	**47,862**	**54,217**	**60,146**	**65,657**
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
Non-current liabilities	**1,337**	**1,337**	**1,337**	**1,337**	**1,337**
Other long-term payable	624	624	624	624	624
Deferred tax liabilities	713	713	713	713	713
Shareholders' equity	**93,794**	**101,626**	**110,592**	**128,058**	**147,559**

Key ratios

YE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Sales mix (%)					
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	**100.0**
Growth rate (%)					
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
P&L ratios (%)					
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)
Returns (%)					
ROE	15.7	19.2	18.6	17.9	17.4
ROA	10.4	12.9	12.4	12.1	11.9
Per share					
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

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