



## Company Report: NetEase (NTES US)

公司报告: 网易 (NTES US)

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# NetEase's Onmyoji Game Recorded Over 200 Million Downloads, Maintain "Buy"

阴阳师录得下载次数超过2亿次, 维持“买入”

- **1Q17 results (non-GAAP net income grew 62.6% yoy) met expectations**, driven by the launch of popular game titles and upgrade packs for old games.
- **We cut FY17-FY19 online game revenue by 5.4%/ 6.8%/ 7.0%, respectively**, due to fierce market competition and the change in business model of several games. 1Q17 online game revenue grew 78.5% yoy, contributed by the launch of new game titles and upgrade packs. Onmyoji recorded over 200 million downloads and NetEase will leverage its success into overseas markets. Tencent's (00700 HK) Honor of Kings ranked top position in China's iOS market, which may affect NetEase's game revenue.
- **Change in business models for several important game titles.** NetEase will convert the PC game titles Overwatch and Minecraft to free of charge in May 2017 to boost user growth. Minecraft is the second most downloaded online game on record, which can contribute significantly to NetEase.
- **Maintain the investment rating of "Buy" but cut the TP from US\$340.00 to US\$330.00.** We cut FY17-FY19 earnings per ADS by 3.0%/ 3.8%/ 4.2%, respectively, due to market competition and the change in operating models for several game titles. The new TP represents 21.7x FY17 PER, 19.6x FY18 PER, 18.2x FY19 PER and 1.8x FY17-FY19 PEG.
- **2017 年第 1 季度业绩符合预期(Non-GAAP 净利润同比增长 62.6%)**, 因推出新流行游戏和老游戏的升级版本。
- **我们分别下调 2017-2019 年在线游戏收入 5.4%/ 6.8%/ 7.0%**, 因市场竞争加剧及多款游戏收费模式的转变。2017 年第 1 季度网络游戏收入同比增长 78.5%, 因多款受欢迎的手游和升级包推出。《阴阳师》的下载次数超过 2 亿, 网易将进一步把游戏的优势拓展至海外市场。腾讯(00700 HK)的《王者荣耀》在中国的 iOS 市场取得前列排名, 可能会影响网易的游戏盈利。
- **更改几个重要游戏的收费模式。** 网易将在 2017 年 5 月把计算机游戏《守望先锋》和将推出的游戏《我的世界》改为免费下载以提升用户增长。《我的世界》录得全球下载次数第二的排名, 相信可为网易带来贡献。
- **维持投资评级为“买入”及目标价从 340.00 美元下调至 330.00 美元。** 分别下调 2017-2019 年每 ADS 盈利预测 3.0%/ 3.8%/ 4.2%, 因市场竞争加剧及多款游戏收费模式的转变。新目标价相当于 21.7 倍 2017 年市盈率、19.6 倍 2018 年市盈率、18.2 倍 2019 年市盈率及 2017-2019 年 PEG 为 1.8 倍。

Rating:

**Buy**

Maintained

评级:

买入 (维持)

6-18m TP 目标价:

**US\$330.00**

Revised from 原目标价:

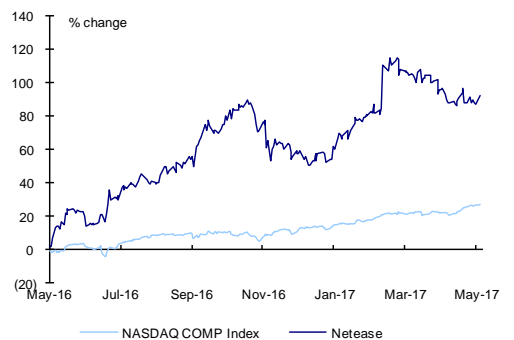
US\$340.00

Share price 股价:

US\$248.250

### Stock performance

股价表现



Change in Share Price 股价变动	1 M 1 个月	3 M 3 个月	1 Y 1 年
Abs. % 绝对变动 %	2.1	5.9	76.9
Rel. % to NASDAQ index 相对纳指变动 %	(3.3)	0.7	47.1
Avg. ADS price(US\$) 平均 ADS 股价 (美元)	194.0	208.3	193.2

Source: Bloomberg, Guotai Junan International.

Year End 年结	Turnover 收入	Net Profit 股东净利	Earnings / ADS 每股 ADS 净利	Earnings / ADS 每股净利变动	PER 市盈率	BPADR 每 ADR 净资产	PBR 市净率	DPS 每股股息	Yield 股息率	ROE 净资产收益率
12/31	(RMB m)	(RMB m)	(RMB)	(%)	(x)	(RMB)	(x)	(RMB)	(%)	(%)
2015A	22,803	6,735	51.266	40.7	36.0	223.205	8.3	11.174	0.6	25.6
2016A	38,179	11,605	88.403	72.4	22.2	293.009	6.7	19.397	1.0	34.4
2017F	52,881	13,734	104.868	18.6	18.7	349.753	5.6	23.080	1.2	32.9
2018F	64,753	15,189	116.240	10.8	16.9	442.572	4.4	25.583	1.3	29.7
2019F	75,042	16,275	124.837	7.4	15.7	532.647	3.7	27.475	1.4	26.0

Shares in issue (m) 总股数 (m)	131.1	Major shareholder 大股东	Mr. William Lei Ding 44.8%
Market cap. (US\$ m) 市值 (US\$ m)	37,322.0	Free float (%) 自由流通比率 (%)	55.2
3 month average vol. 3 个月平均成交股数 ('000)	1,220.4	FY17 Net gearing (%) FY17 净负债/股东资金 (%)	5.1
52 Weeks high/low (US\$) 52 周高/低	304.500 / 158.900	FY16-19 PEG (x)	1.5

Source: the Company, Guotai Junan International.

## 1Q17 Results Review

**1Q17 results met expectations with 62.6% yoy growth in non-GAAP net income**, driven by the launch of popular game titles and upgrade packs for old games.

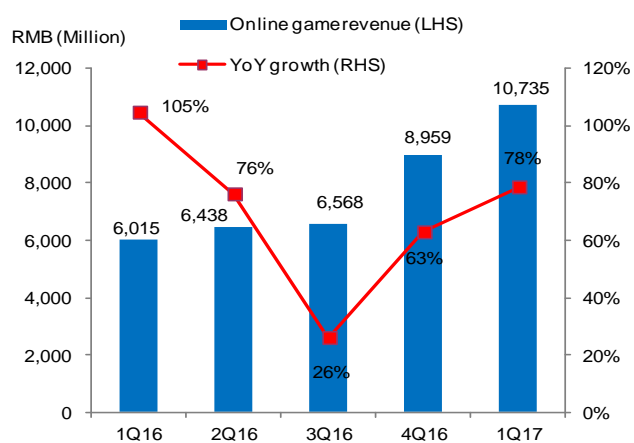
**Table-1: NetEase's Income Statement Analysis**

RMB (Million)	1Q17	1Q16	YoY	Comments
Online game services revenue	10,735	6,015	78.5%	Driven by popular mobile games contributions
Advertising services revenue	445	393	13.2%	
E-mail, e-commerce & others revenue	2,460	1,507	63.2%	Contributed by adoption of e-commerce platforms (Kaola.com)
Total net revenue	13,641	7,915	72.3%	
Gross profit	7,484	4,587	63.2%	
S&M expenses	(1,229)	(782)	57.2%	Higher spending for promotional activities of mobile games
G&A expenses	(558)	(314)	77.7%	
R&D expenses	(925)	(623)	48.5%	
Operating profit	4,772	2,868	66.4%	
Investment income	43	40	7.5%	
Interest income	150	137	9.5%	
Exchange gains/(losses)	(49)	(36)	36.1%	
Others	38	24	58.3%	
Net income	3,923	2,461	59.4%	
Non-GAAP net income	4,336	2,666	62.6%	
Earnings per ADS (RMB)	29.83	18.70	59.5%	
Gross profit margin (%)	54.9	58.0	(3.1ppt)	Affected by higher revenue proportion from lower margin mobile games
Operating profit margin (%)	35.0	36.2	(1.2ppt)	
Net profit margin (%)	28.8	31.1	(2.3ppt)	

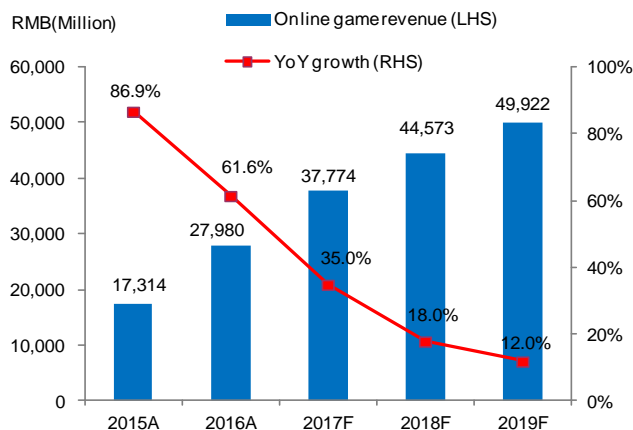
Source: the Company.

**We cut FY17-FY19 online game revenue by 5.4%/ 6.8%/ 7.0%, respectively.** NetEase's 1Q17 online game revenue grew 78.5% yoy due to the launch of new game titles and expansion packs for old games. PC game revenue in 1Q17 was RMB2.6 billion, up 30% yoy and down 11% qoq, due to mobile game substitutions and slowdown in launches of licensed games. NetEase launched expansion packs for PC games such as Heathstone, New Ghost and Kung Fu Master II in 1Q17 to refresh user experience for gamers. In the coming quarter, NetEase will also launch a number of expansion packs for popular game titles (Tianxia III, Heroes of Tang Dynasty Zero, Demon Seals, Revelation and New Westward Journey Online II). Mobile game revenue in 1Q17 was RMB8.1 billion, up 37% qoq and 107% yoy, thanks to the contributions from the launch of expansion packs and new titles. The expansion packs for mobile games launched in 1Q17 included Demon Seals, Westward Journey: Rage, and Land of Glory. NetEase has a number of popular mobile games with good ratings such as Fantasy Westward Journey, Westward Journey, New Ghost and Onmyouji. Onmyouji recorded over 200 million downloads, contributed by the domestic and Japan market. NetEase will further launch Onmyouji to other overseas regions (Canada, Korea, Europe and the United States) to boost user growth. NetEase will launch the mobile version of Minecraft in July 2017, which can help to support revenue growth in 2017. Minecraft has the second most downloads on record since 2009 with over 122 million aggregate downloads with 55 million MAU. Unlike business models overseas with pre-installed download fees, NetEase will offer Minecraft as a free download in the China market and operate with the in-app sales business model. NetEase will convert the game title Overwatch to free of charge in May 2017 to boost user growth. 1Q17 deferred revenue was RMB7.0 billion, down 7.6% qoq, affected by the volatility of mobile game contributions and the change in operating models. Tencent has a number of popular game titles (Honor of Kings and Dragon Nest), which showed a steady improvement in adoption from

online game players in China. Honor of Kings ranked top in China's iOS online game chart which may impose a negative effect to NetEase's market share. Tencent's Honor of Kings ranked the most popular mobile game in China's iOS market with MAU of over 80 million, and we estimate it may affect NetEase's mobile game monetization success. We cut NetEase's FY17-FY19 online game revenue by 5.4%/ 6.8%/ 7.0%, respectively, due to fierce market competition and the change in charging model for several game titles.

**Figure-1: NetEase's Quarterly Online Games Revenue and YoY Growth**


Source: the Company.

**Figure-2: NetEase's Annual Online Games Revenue and YoY Growth**


Source: the Company, Guotai Junan International.

**Table-2: China's iOS Top 10 Online Grossing Games Chart in April 2017**

Ranking	Grossing Games	Developers
1	Honor of Kings (王者荣耀)	Tencent
2	Onmyouji (阴阳师)	NetEase
3	Fantasy Westward Journey (梦幻西游)	NetEase
4	Dragon Nest (龙之谷)	Tencent
5	We Fly (全民飞机大战)	Tencent
6	Yulang Online (热血江湖)	Mgame
7	Yong Zhe Da Zuo Zhan (勇者大作战)	Hoolai Games
8	New Ghost(新倩女幽魂)	NetEase
9	Cross Fire (穿越火线)	Tencent
10	Beng Huai3 (崩坏3)	miHoYo

Source: App Annie.

**Table-3: Some of NetEase's Online Game Pipeline in 2017**

	Games Title	Chinese Title Name
1	Mist World	迷雾世界
2	Eternal Frontier	永恒边境
3	World of Tanks: Blitz	坦克世界:闪电战
4	Minecraft	我的世界
5	Chu Liu Xiang	楚留香
6	Index	魔法禁书目录
7	Apocalypse Alliance	天启联盟
8	Tribes and Empires: Storm of Prophecy	九州岛·海上牧云记
9	Realm of Duels	
10	Twilight Spirits	

Source: the Company.

## Profit Revision

**We cut FY17-FY19 earnings per ADS by 3.0%/ 3.8%/ 4.2%, respectively.** We cut FY17-FY19 online game revenue by 5.4%/ 6.8%/ 7.0%, respectively, due to fierce competition and the change in operating model for some game titles. FY17-FY19 earnings per ADS has been revised down by 3.0%/ 3.8%/ 4.2%, respectively.

**Table-4: Financial Estimation Revisions**

RMB (Million)	2017F	OLD 2018F	2019F	2017F	NEW 2018F	2019F	2017F	CHANGE 2018F	2019F
Online games revenue	39,930	47,825	53,680	37,774	44,573	49,922	(5.4%)	(6.8%)	(7.0%)
Advertising services revenue	2,475	2,748	2,981	2,475	2,748	2,981	0.0%	0.0%	0.0%
Email, e-commerce & others revenue	12,632	17,432	22,139	12,632	17,432	22,139	0.0%	0.0%	0.0%
Total net revenue	55,489	68,233	79,747	52,881	64,753	75,042	(4.7%)	(5.1%)	(5.9%)
Net profit	14,159	15,789	16,989	13,734	15,189	16,275	(3.0%)	(3.8%)	(4.2%)
Earnings per ADS (RMB)	108.111	120.832	130.310	104.868	116.240	124.837	(3.0%)	(3.8%)	(4.2%)

Source: Guotai Junan International.

## Valuation

**Maintain the investment rating of “Buy” but cut the TP from US\$340.00 to US\$330.00.** We think NetEase can maintain its strong online game revenue growth through the launch of new game titles (Minecraft in 2H17) and expansion packs. By launching its popular mobile game titles (Omnyoji) in overseas markets, NetEase can leverage its success and boost online game user growth. We maintain the investment rating of NetEase as “Buy” due to its solid online game revenue growth. We cut the TP from US\$340.00 to US\$330.00. The new TP represents 21.7x FY17 PER, 19.6x FY18 PER, 18.2x FY19 PER and 1.8 FY16-FY19 PEG.

**Figure-3: NetEase's PE Graph**



Source: Bloomberg.

**Table-5: Peers Comparison**

				PER (x)			PBR (x)			ROE(%)	ROA(%)
Company	Ticker	Currency	Price	16F	17F	18F	16F	17F	18F	17F	17F
US Online Game Companies											
Changyou	CYOU US	USD	31.200	10.3	8.9	7.7	1.1	1.0	0.8	12.2	7.0
Electronic Arts Inc	EA US	USD	110.90	20.8	20.9	18.6	6.9	5.9	4.6	35.8	17.5
Activision Blizzard Inc	ATVI US	USD	56.410	19.3	17.9	15.6	3.3	3.0	2.6	15.1	9.1
NetEase	NTES US	USD	284.250	18.3	15.7	13.1	5.6	4.3	3.5	33.8	24.5
Simple Average				17.2	15.9	13.7	4.2	3.5	2.9	24.2	14.6
Weighted Average				19.2	17.8	15.4	5.1	4.2	3.4	27.6	17.0
HK Online Game Companies											
Tencent	00259 HK	HKD	258.200	37.3	28.4	22.3	10.6	7.9	6.0	30.8	13.3
Boyaa Interactive Int.	00434 HK	HKD	3.720	11.1	10.4	9.4	1.4	1.3	1.1	12.4	11.5
IGG	00799 HK	HKD	11.760	17.1	13.8	13.0	5.0	4.3	3.5	29.6	25.4
Netdragon	00777 HK	HKD	22.500	n.a.	107.1	52.0	2.7	2.7	2.6	(0.3)	(0.3)
Simple Average				21.8	39.9	24.2	4.9	4.0	3.3	18.1	12.5
Weighted Average				37.1	28.9	22.5	10.5	7.8	6.0	30.6	13.3
Advertising Companies											
Sohu.Com Inc	SOHU US	USD	41.100	n.a.	n.a.	n.a.	1.2	1.4	1.3	(18.6)	(6.4)
Weibo	WB US	USD	62.900	68.5	40.2	26.2	12.8	9.7	6.9	19.0	12.4
Bitauto Holdings	BITA US	USD	30.490	32.8	18.3	11.4	1.0	1.0	1.0	0.9	0.7
Cheetah Mobile	CMCM US	USD	11.480	99.0	31.7	21.2	3.0	2.6	2.3	(3.5)	(0.8)
58.com	WUBA US	USD	42.760	n.a.	29.5	15.2	1.7	1.7	1.5	(2.8)	(0.5)
Soufun	SFUN US	USD	3.420	n.a.	30.3	11.2	2.2	1.1	1.0	(22.1)	(7.9)
Phoenix New Media	FENG US	USD	3.350	73.0	23.9	20.0	1.1	1.1	1.1	1.5	1.1
Sina	SINA US	USD	83.500	63.4	37.0	21.6	1.7	1.6	1.4	3.1	1.7
Facebook	FB US	USD	150.190	29.1	22.7	18.4	5.8	4.7	3.8	20.9	19.2
Simple Average				60.9	29.2	18.1	3.4	2.8	2.3	(0.2)	2.2
Weighted Average				30.9	23.4	18.5	5.8	4.7	3.8	19.8	18.2
E-commerce Companies											
Alibaba	BABA US	USD	121.400	n.a.	28.8	23.2	6.8	5.8	4.7	39.3	23.1
VIPSHOP	VIPS US	USD	14.780	n.a.	15.7	13.0	8.7	5.7	4.1	50.3	11.1
Jumei	JUMEI US	USD	3.230	n.a.	8.0	6.5	1.2	1.1	1.0	9.3	6.3
EBay	EBAY US	USD	34.070	n.a.	13.7	12.6	4.5	4.0	3.4	30.5	11.6
JD.com	JD US	USD	40.560	15.7	122.7	53.8	7.6	7.4	6.6	(6.7)	(2.5)
AMAZON	MZN US	USD	954.950	12.7	51.4	36.6	19.5	13.5	10.2	22.2	5.4
Gome Electrical Appliances	00493 HK	HKD	1.010	n.a.	19.0	16.5	0.9	0.9	0.8	3.3	1.1
Simple Average				14.2	37.0	23.2	7.0	5.5	4.4	21.2	8.0
Weighted Average				12.9	44.6	31.2	13.5	9.8	7.7	27.4	11.6
Search Engine Companies											
Alphabet Inc	GOOG US	USD	955.140	22.4	18.8	16.0	3.8	3.2	2.7	15.1	13.8
Baidu Inc - Spon Adr	BIDU US	USD	186.830	35.6	27.2	19.4	4.1	3.6	2.9	12.0	6.4
Simple Average				29.0	23.0	17.7	4.0	3.4	2.8	13.5	10.1
Weighted Average				23.7	19.6	16.3	3.8	3.2	2.7	14.8	13.1
Overall Average				28.6	29.0	19.4	4.7	3.8	3.1	15.4	9.5
Overall Weighted Average				24.8	26.9	20.8	7.7	6.0	4.7	24.0	14.6

Source: Bloomberg.

**Financial Statements and Ratios**

INCOME STATEMENT					
Year end Dec, RMB m	2015A	2016A	2017F	2018F	2019F
Online games	17,314	27,980	37,774	44,573	49,922
Advertising services	1,789	2,152	2,475	2,748	2,981
Email, e-commerce and others	3,699	8,046	12,632	17,432	22,139
Net revenue	22,803	38,179	52,881	64,753	75,042
Cost of revenue	(9,399)	(16,515)	(25,678)	(33,514)	(40,588)
Gross profit	13,404	21,664	27,203	31,239	34,454
S&G expenses	(2,958)	(4,482)	(5,817)	(6,993)	(7,954)
G&A expenses	(1,014)	(1,506)	(2,062)	(2,525)	(2,927)
R&D expenses	(2,159)	(3,047)	(4,125)	(4,856)	(5,478)
Operating profit	7,272	12,629	15,199	16,864	18,095
Investment income	62	200	80	89	99
Interest income	597	542	647	696	731
Exchange losses	134	147	117	105	95
Other, net	45	378	453	489	529
Income before tax	8,110	13,895	16,497	18,244	19,548
Income tax	(1,273)	(2,102)	(2,496)	(2,760)	(2,958)
Net income	6,735	11,605	13,734	15,189	16,275
Non-controlling interest	102	188	266	294	315
Non-GAAP net income	7,420	12,861	15,231	16,860	18,081
Earnings per ADS (RMB)	51.266	88.403	104.868	116.240	124.837
Non-GAAP Earnings per ADS (RMB)	56.476	97.977	116.298	129.026	138.694

CASH FLOW					
Year end Dec, RMB m	2015A	2016A	2017F	2018F	2019F
Net income	6,837	11,793	14,000	15,483	16,590
Adjustments					
Share-based compensation	684	990	1,218	1,498	1,798
D&A	182	328	283	320	424
Others	(306)	(263)	(274)	(242)	(211)
Change in working capital	679	2,640	(763)	(5,068)	(3,164)
Cash flow from operating activities	8,077	15,488	14,465	11,991	15,436
CAPEX	(866)	(1,136)	(1,170)	(1,205)	(1,241)
Change in short term investments	(2,584)	(2,560)	2,548	1,272	1,386
Change in time deposits	3,565	(3,990)	(886)	(946)	(1,008)
Others	(2,651)	(6,317)	(6,004)	(7,092)	(8,357)
Cash flow from investing activities	(2,537)	(14,002)	(5,511)	(7,972)	(9,219)
Proceeds from short term bank loans	5,829	11,355	(3,816)	(2,671)	(1,335)
Dividends paid to shareholders	(1,468)	(2,546)	(3,023)	(3,343)	(3,582)
Others	(5,994)	(11,059)	(1,174)	2,275	604
Cash flow from financing activities	(1,633)	(2,251)	(8,012)	(3,739)	(4,313)
Effect of exchange rate changes on cash held in foreign currencies	142	132	125	119	113
Net increase (decrease) in cash and cash equivalents	4,050	(632)	1,067	400	2,018
Cash and cash equivalent at the beginning of year	2,021	6,071	5,439	6,506	6,906
Cash and cash equivalent at the end of year	6,071	5,439	6,506	6,906	8,924

Source: the Company, Guotai Junan International.

BALANCE SHEET					
Year end Dec, RMB m	2015A	2016A	2017F	2018F	2019F
Cash and equivalents	6,071	5,439	6,506	6,906	8,924
Time deposits	14,593	19,361	20,329	21,346	22,413
Prepayments and other current assets	3,513	5,276	5,751	6,269	6,833
Short-term investments	5,013	11,582	14,130	15,402	16,788
Others	5,217	8,261	9,801	11,630	13,803
Total current assets	34,409	49,920	56,518	61,553	68,760
Property & equipment, net	2,092	2,420	2,733	3,618	4,435
Time deposits	1,110	550	468	397	338
Others	3,546	5,143	4,877	5,237	5,537
Total non-current assets	6,749	8,112	8,078	9,252	10,309
AP	701	1,396	1,522	761	533
Salary and welfare payables	921	1,491	1,641	984	768
Deferred revenue	4,652	7,531	7,183	5,028	3,520
Others	5,394	9,116	8,413	6,175	4,786
Total current liabilities	11,667	19,535	18,759	12,948	9,606
Other long term payables	85	0	0	0	0
Deferred tax liabilities	81	34	29	26	22
Total non-current liabilities	166	34	30	26	22
Total liabilities	11,834	19,569	18,789	12,974	9,629
Total shareholders' equity	29,240	38,191	45,269	56,998	68,293
Non-controlling interest	84	272	538	832	1,147
Total equity	29,324	38,463	45,807	57,830	69,441
Book per ADS (RMB)	223.205	293.009	349.753	442.572	532.647

FINANCIAL RATIOS					
Year end Dec	2015A	2016A	2017F	2018F	2019F
Profitability					
Gross margin (%)	58.8	56.7	51.4	48.2	45.9
Operating margin (%)	31.9	33.1	28.7	26.0	24.1
Net margin (%)	30.0	30.9	26.5	23.9	22.1
ROE (%)	25.6	34.4	32.9	29.7	26.0
ROA (%)	18.8	23.4	22.4	22.4	21.7
Net gearing (%)	7.0	9.2	5.1	1.5	0.2

16 May 2017

NetEase 网易 (NTES US)

Company Report



## Company Rating Definition

The Benchmark: NASDAQ Composite Index

Time Horizon: 6 to 18 months

Rating	Definition
Buy	Relative Performance >15%; or the fundamental outlook of the company or sector is favorable.
Accumulate	Relative Performance is 5% to 15%; or the fundamental outlook of the company or sector is favorable.
Neutral	Relative Performance is -5% to 5%; or the fundamental outlook of the company or sector is neutral.
Reduce	Relative Performance is -5% to -15%; or the fundamental outlook of the company or sector is unfavorable.
Sell	Relative Performance <-15%; or the fundamental outlook of the company or sector is unfavorable.

## Sector Rating Definition

The Benchmark: NASDAQ Composite Index

Time Horizon: 6 to 18 months

Rating	Definition
Outperform	Relative Performance >5%; or the fundamental outlook of the sector is favorable.
Neutral	Relative Performance is -5% to 5%; or the fundamental outlook of the sector is neutral.
Underperform	Relative Performance <-5%; or the fundamental outlook of the sector is unfavorable.

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