

# NetEase - S (9999 HK)

The 3Q20 results slightly beat the market, Youdao's growth has accelerated

Hong Kong | TMT sector | Update Report

3 Dec 2020

## Investment Summary

### NetEase's 3Q20 result slightly beat the market

NetEase's 3Q20 revenue was RMB 18.60 billion (+27.5% yoy). Within it, the revenue for online game business / Youdao / Innovative and other businesses were RMB 13.86 billion (+20.2% yoy) / RMB 0.90 billion (+159.0% yoy) / RMB 3.90 billion (+41.6% yoy). In terms of the revenue mix, the revenue share of online game business / Youdao / Innovative businesses were 74.3%/4.8%/20.9%, respectively. The company's 3Q20 gross profit was RMB 9.8 billion, with respective GPM at 52.9%, down by 0.8 ppts/0.9ppts yoy/qq, respectively. More specifically, the GPM of online game business was 63.6%, which was basically the same both yoy/qq. The GPM of Youdao was 45.9%, up by 20.1ppts yoy and 0.7ppts qq. The GPM for innovative and other businesses was 16.8%, up by 1.6 ppts yoy and down by 1.7 ppts qq. The company has realized a net profit / Non-GAAP net profit of RMB 3.0 billion / RMB 3.7 billion. Overall, the company's 3Q20 result slightly beat the market expectation, the online game business is growing at a stable rate with accelerated growth in Youdao business.

### Steady Growth in the online game business

NetEase's 3Q20 online game revenue was RMB 13.86 billion, of which mobile game and PC game revenue were RMB 10.08 billion and RMB 3.78 billion, respectively, with a yoy growth of 23%/13% and a qq growth of 1%/-1%. As compared with Tencent, Tencent's 3Q20 mobile game revenue was up by 61.2% yoy, the growth rate was significantly higher than NetEase in the same period. We believe that the difference in this growth is mainly due to the difference in the mobile game genres of the two companies (please refer to our initiation report). The social attributes and the lower entry thresholds characteristics of Tencent's main games "Honor of Kings" and "PUBG Mobile" are more suitable for beginners during the COVID-19 period in 20H1. Having said that, we believe that hardcore games' grossing billing of NetEase will be more stable, especially after the COVID-19 period. In terms of overseas game business, the NetEase Game's international presence was strengthened with strong performances from Knives Out, LifeAfter and Identity V in Japan. According to the management, the company remains very optimistic about the prospects of the global game market and will continue to focus on expanding overseas markets, including Europe, America and the United States. Besides that, the company has many quality games in reserve, including Revelation mobile game, Infinite Lagrange, Harry Potter: Magic Awakened, The Lord of the Rings: Rise to War, Diablo® Immortal™ and Pokémon Quest. Several of these games, including Revelation mobile game, will be released before Chinese New Year.

### Youdao is experiencing a high growth period

In 2Q20, Youdao has realized revenue of RMB900 million (+159% yoy). This extremely high growth was mainly driven by Youdao's learning services and products segment. The revenue of the learning services and products segment was RMB 763 million (+239% yoy). The turnover of Youdao online course was RMB 955 million (+228% yoy). Within it, the K-12 premium course was the main driver for the growth in the online course turnover, the turnover of K-12 premium course was up by 369% and reached RMB 676 million, and accounted for 77% of the total turnover of online premium course. Further, the turnover of adult courses was RMB 201 million (+185% yoy). On the other hand, the GPM of Youdao was further optimized and reached 45.9% in 3Q20 (+20.1ppts yoy). The optimization of GPM was driven by the improved economies of scale, and faculty compensation structure optimization for its learning services and products. In addition, Youdao's S&M expense was up by 397% yoy and reached RMB 1.1 billion, with S&M expense ratio at 123%. According to the management, they believe the current stage is the best time frame to spend high for acquiring customers. Although, we believe that the S&M expense will remain high in short term, nonetheless, the S&M expense ratio is likely to drop as high growth in revenue.

## Buy (Maintain)

CMP HKD 141.80

(Closing price as of 1 Dec)

TARGET HKD 172.80 (+21.9%)

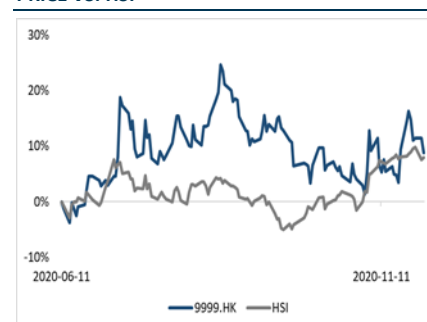
### COMPANY DATA

O/S SHARES (MN) :	3,455
MARKET CAP (HKD MN) :	485,997
52 - WK HI/LO (HKD):	167.0/125.0

### SHARE HOLDING PATTERN, %

Ding Lei	44.70%
Orbis Investment Management	5.10%

### PRICE VS. HSI



Source: Wind, Phillip Securities

### KEY FINANCIALS

CNY mn	FY19	FY20E	FY21E	FY22E
Net Sales	59,241	71,588	83,375	96,643
Net income	21,238	14,518	16,872	19,592
EPS	6.59	4.20	4.88	5.67
P/E, x	18.9	29.7	25.6	22.0
Non-GAAP NI	15,663	17,499	19,853	22,573
Non-GAAP EPS	4.86	5.06	5.75	6.53
Adj. P/E, x	25.7	24.6	21.7	19.1
BVPS	19.42	27.56	31.27	35.58
P/BV, x	6.6	4.5	4.0	3.5
ROE, Adj (%)	25.0	18.4	18.4	18.4
ROA, Adj (%)	14.0	11.9	12.3	12.6

Market closing price as of 1<sup>st</sup> Dec

Source: Company Data, Phillip Securities Est.

### Research Analyst

Kevin Chiu (+ 852 2277 6514)

kevinchiu@phillip.com.hk

**Valuation**

We maintain our previous forecast to the company, steady growth in online game business, high revenue growth in Youdao, while innovative and other business continued to seek for the optimal monetization business model. We forecast the company's 2020/2021/2022 Non-GAAP EPS to be RMB 5.06/5.75/6.53, maintain TP at HKD 172.8, with respective 2020/2021/2022 Non-GAAP PE at 29.85x/26.31x/23.14x. We maintain Buy rating.

**Risk**

1) The tightening on Game regulations 2) The Games underperform comparing to expectation 3) The growth of Youdao is worse than expected 4) Failure in monetization for innovative businesses

## Financial Statements

### Key Financial Data

	2018	2019	2020E	2021E	2022E
<b>Valuation Ratio</b>					
P/E ratio, x	65.7	18.9	29.7	25.6	22.0
Adjusted P/E ratio, x	37.5	25.7	24.6	21.7	19.1
P/B ratio, x	8.8	6.6	4.5	4.0	3.5
<b>Per share data (RMB)</b>					
EPS	1.90	6.59	4.20	4.88	5.67
Non-GAAP EPS	3.33	4.86	5.06	5.75	6.53
BVPS	14.14	19.03	27.56	31.27	35.58
<b>Growth &amp; Margin</b>					
Revenue Growth	25.6%	-10.0%	40.4%	14.6%	14.0%
Operating income growth	-23.2%	38.2%	13.5%	17.3%	16.2%
Net income Growth	-42.5%	245.2%	-31.6%	16.2%	16.1%
Non-GAAP Net income Growth	N/A	45.5%	11.7%	13.5%	13.7%
Gross Profit Margin	53.4%	53.3%	53.6%	53.3%	53.1%
Operating profit Margin	19.5%	23.3%	21.9%	22.0%	22.1%
Net Profit Margin	12.0%	35.8%	20.3%	20.2%	20.3%
Non-GAAP Net Profit Margin	21.0%	26.4%	24.4%	23.8%	23.4%
<b>Key Ratios</b>					
ROE, Adj	23.4%	25.0%	18.4%	18.4%	18.4%
ROA, Adj	12.4%	14.0%	11.9%	12.3%	12.6%

Market closing price as of 1<sup>st</sup> Dec

### Consolidated Statement of Profit or Loss

(RMB million)	2018	2019	2020E	2021E	2022E
<b>Net Revenue</b>					
Online game	40,190	46,423	55,707	63,506	71,762
Youdao	732	1,305	2,871	5,167	8,268
Innovative business and others	10,257	11,514	13,010	14,702	16,613
<b>Total Net Revenue</b>	<b>51,179</b>	<b>59,241</b>	<b>71,588</b>	<b>83,375</b>	<b>96,643</b>
Cost of Sale	(23,832)	(27,686)	(33,245)	(38,917)	(45,341)
<b>Gross Profit</b>	<b>27,346</b>	<b>31,555</b>	<b>38,343</b>	<b>44,458</b>	<b>51,302</b>
S&M expense	(6,912)	(6,221)	(8,734)	(10,005)	(11,404)
Admin expense	(3,079)	(3,130)	(3,723)	(4,252)	(4,832)
R&D expense	(7,378)	(8,413)	(10,237)	(11,839)	(13,723)
<b>Operating profit</b>	<b>9,977</b>	<b>13,791</b>	<b>15,650</b>	<b>18,362</b>	<b>21,343</b>
Investment income (loss), net	(22)	1,306	1,306	1,306	1,306
Interest income (net)	587	822	675	882	1,273
Exchange losses	(52)	25	-	-	-
Others	587	439	368	368	368
<b>Pre tax income</b>	<b>11,077</b>	<b>16,383</b>	<b>17,999</b>	<b>20,918</b>	<b>24,290</b>
Income tax	(2,461)	(2,915)	(3,335)	(3,876)	(4,500)
Net (loss)/income from discontinued operation	(2,139)	7,963	-	-	-
<b>Net income</b>	<b>6,477</b>	<b>21,431</b>	<b>14,664</b>	<b>17,043</b>	<b>19,790</b>
Non controlling interest	325	194	147	170	198
<b>Net Income Attributable To Parent</b>	<b>6,152</b>	<b>21,238</b>	<b>14,518</b>	<b>16,872</b>	<b>19,592</b>
<b>Non-GAAP Net Income Attributable to Parent</b>	<b>10,761</b>	<b>15,663</b>	<b>17,499</b>	<b>19,853</b>	<b>22,573</b>
<b>EPS</b>	<b>1.90</b>	<b>6.59</b>	<b>4.20</b>	<b>4.88</b>	<b>5.67</b>
<b>Non-GAAP EPS</b>	<b>3.33</b>	<b>4.86</b>	<b>5.06</b>	<b>5.75</b>	<b>6.53</b>

**Consolidated statement of Financial Position**

(RMB million)	2018	2019	2020E	2021E	2022E
<b>Current Asset</b>					
Cash and cash equivalent	4,977	3,246	34,216	46,250	60,266
Accounts receivable	4,002	4,169	5,106	5,947	6,893
Inventories	1,066	651	1,235	1,506	1,832
Others	58,670	77,039	77,039	77,039	77,039
<b>Total Current Asset</b>	<b>68,716</b>	<b>85,105</b>	<b>117,597</b>	<b>130,741</b>	<b>146,029</b>
<b>Non Current Asset</b>					
Property, equipment and software, net	4,672	4,622	5,363	6,223	7,221
Land use rights, net	3,272	3,707	3,707	3,707	3,707
Operating lease right-of-use assets, net	-	464	464	464	464
Long-term investments	5,245	9,294	10,600	11,907	13,213
Others	5,064	8,933	8,933	8,933	8,933
<b>Total Non Current Asset</b>	<b>18,252</b>	<b>27,019</b>	<b>29,067</b>	<b>31,233</b>	<b>33,538</b>
<b>Total Asset</b>	<b>86,968</b>	<b>112,124</b>	<b>146,663</b>	<b>161,975</b>	<b>179,567</b>
<b>Current Liabilities</b>					
Accounts payable	1,201	1,212	1,517	1,776	2,069
Short-term loans	13,659	16,828	16,828	16,828	16,828
Deferred revenue	7,718	8,602	9,745	11,350	13,156
Others	12,531	11,600	12,069	12,692	13,294
<b>Total Current Liabilities</b>	<b>35,109</b>	<b>38,243</b>	<b>40,159</b>	<b>42,646</b>	<b>45,347</b>
<b>Total Non Current Liabilities</b>	<b>447</b>	<b>840</b>	<b>840</b>	<b>840</b>	<b>840</b>
<b>Total Liabilities</b>	<b>35,556</b>	<b>39,083</b>	<b>40,999</b>	<b>43,486</b>	<b>46,187</b>
<b>Equity</b>					
Ordinary shares	3	3	3	3	3
Additional paid-in capital	-	3,914	3,914	3,914	3,914
Reserve	45,229	57,537	90,013	102,667	117,361
Noncontrolling interests	794	1,139	1,286	1,456	1,654
<b>Total Equity</b>	<b>46,026</b>	<b>62,593</b>	<b>95,215</b>	<b>108,040</b>	<b>122,932</b>
<b>Redeemable noncontrolling interests</b>	<b>5,386</b>	<b>10,449</b>	<b>10,449</b>	<b>10,449</b>	<b>10,449</b>
<b>Total Liabilities, Equity and Redeemable NCI</b>	<b>86,968</b>	<b>112,124</b>	<b>146,663</b>	<b>161,975</b>	<b>179,567</b>

**Cash Flow Statement**

(RMB million)	2018	2019	2020E	2021E	2022E
Net income	6,477	21,431	14,664	17,043	19,790
Depreciation and amortization	2,060	2,614	1,089	1,263	1,466
change in working capital	-1,301	-1,072	395	1,376	1,428
Others	6,179	-5,757	-887	-887	-887
<b>Net cash generated from operating activities</b>	<b>13,416</b>	<b>17,216</b>	<b>15,261</b>	<b>18,794</b>	<b>21,796</b>
Capex	-3,911	-3,329	-1,830	-2,123	-2,464
Others	-9,659	-18,808	0	0	0
<b>Cashflow from investing activities</b>	<b>-13,570</b>	<b>-22,137</b>	<b>-1,830</b>	<b>-2,123</b>	<b>-2,464</b>
<b>Cashflow from financing activities</b>	<b>1,587</b>	<b>1,083</b>	<b>17,539</b>	<b>-4,637</b>	<b>-5,317</b>
<b>Net change in cash and cash equivalents</b>	<b>1,434</b>	<b>-3,838</b>	<b>30,970</b>	<b>12,034</b>	<b>14,015</b>
Cash at beginning	8,691	10,207	6,397	37,367	49,401
Foreign exchange	82	29	0	0	0
<b>Cash and cash equivalents at the year end</b>	<b>10,207</b>	<b>6,398</b>	<b>37,367</b>	<b>49,401</b>	<b>63,416</b>
Cash, cash equivalents and restricted cash of held	-537	-1	0	0	0
<b>Cash, cash equivalents and restricted cash of continuing operations, end of the year</b>	<b>9,669</b>	<b>6,397</b>	<b>37,367</b>	<b>49,401</b>	<b>63,416</b>

### PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm$ 5% from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

#### GENERAL DISCLAIMER

This publication is prepared by Phillip Securities (Hong Kong) Ltd ("Phillip Securities"). By receiving or reading this publication, you agree to be bound by the terms and limitations set out below.

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

The information contained in this publication has been obtained from public sources which Phillip Securities has no reason to believe are unreliable and any analysis, forecasts, projections, expectations and opinions (collectively the "Research") contained in this publication are based on such information and are expressions of belief only. Phillip Securities has not verified this information and no representation or warranty, express or implied, is made that such information or Research is accurate, complete or verified or should be relied upon as such. Any such information or Research contained in this publication is subject to change, and Phillip Securities shall not have any responsibility to maintain the information or Research made available or to supply any corrections, updates or releases in connection therewith. In no event will Phillip Securities be liable for any special, indirect, incidental or consequential damages which may be incurred from the use of the information or Research made available, even if it has been advised of the possibility of such damages.

Any opinions, forecasts, assumptions, estimates, valuations and prices contained in this material are as of the date indicated and are subject to change at any time without prior notice.

This material is intended for general circulation only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. The products mentioned in this material may not be suitable for all investors and a person receiving or reading this material should seek advice from a financial adviser regarding the suitability of such products, taking into account the specific investment objectives, financial situation or particular needs of that person, before making a commitment to invest in any of such products.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any product described in this material is suitable or appropriate for the recipient. Recipients should be aware that many of the products which may be described in this publication involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Nothing in this report shall be construed to be an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in this research should take into account existing public information, including any registered prospectus in respect of such security.

#### Disclosure of Interest

Analyst Disclosure: Neither the analyst(s) preparing this report nor his associate has any financial interest in or serves as an officer of the listed corporation covered in this report.

Firm's Disclosure: Phillip Securities does not have any investment banking relationship with the listed corporation covered in this report nor any financial interest of 1% or more of the market capitalization in the listed corporation. In addition, no executive staff of Phillip Securities serves as an officer of the listed corporation.

#### Availability

The information, tools and material presented herein are not directed, intended for distribution to or use by, any person or entity in any jurisdiction or country where such distribution, publication, availability or use would be contrary to the applicable law or regulation or which would subject Phillip Securities to any registration or licensing or other requirement, or penalty for contravention of such requirements within such jurisdiction.

Information contained herein is based on sources that Phillip Securities (Hong Kong) Limited ("PSHK") believed to be accurate. PSHK does not bear responsibility for any loss occasioned by reliance placed upon the contents hereof. PSHK (or its affiliates or employees) may have positions in relevant investment products. For details of different product's risks, please visit the Risk Disclosures Statement on <http://www.phillip.com.hk>.

© 2020 Phillip Securities (Hong Kong) Limited

**Contact Information (Regional Member Companies)**

## SINGAPORE

**Phillip Securities Pte Ltd**

250 North Bridge Road, #06-00 Raffles City Tower,  
Singapore 179101

Tel : (65) 6533 6001 Fax: (65) 6535 3834

[www.phillip.com.sg](http://www.phillip.com.sg)

## INDONESIA

**PT Phillip Securities Indonesia**

ANZ Tower Level 23B, Jl Jend Sudirman Kav 33A,  
Jakarta 10220, Indonesia

Tel (62) 21 5790 0800 Fax: (62) 21 5790 0809

[www.phillip.co.id](http://www.phillip.co.id)

## THAILAND

**Phillip Securities (Thailand) Public Co. Ltd.**

15th Floor, Vorawat Building, 849 Silom Road,  
Silom, Bangrak, Bangkok 10500 Thailand

Tel (66) 2 2268 0999 Fax: (66) 2 2268 0921

[www.phillip.co.th](http://www.phillip.co.th)

## UNITED STATES

**Phillip Futures Inc.**

141 W Jackson Blvd Ste 3050  
The Chicago Board of Trade Building  
Chicago, IL 60604 USA

Tel (1) 312 356 9000 Fax: (1) 312 356 9005

## MALAYSIA

**Phillip Capital Management Sdn Bhd**

B-3-6 Block B Level 3, Megan Avenue II,  
No. 12, Jalan Yap Kwan Seng, 50450 Kuala Lumpur

Tel (60) 3 2162 8841 Fax (60) 3 2166 5099

[www.poems.com.my](http://www.poems.com.my)

## CHINA

**Phillip Financial Advisory (Shanghai) Co. Ltd.**

No 436 Heng Feng Road, Green Tech Tower Unit 604  
Shanghai 200 070

Tel (86) 21 5169 9400 Fax: (86) 21 6091 1155

[www.phillip.com.cn](http://www.phillip.com.cn)

## FRANCE

**King & Shaxson Capital Ltd.**

3rd Floor, 35 Rue de la Bienfaisance  
75008 Paris France

Tel (33) 1 4563 3100 Fax : (33) 1 4563 6017

[www.kingandshaxson.com](http://www.kingandshaxson.com)

## AUSTRALIA

**PhillipCapital Australia**

Level 10, 330 Collins Street  
Melbourne VIC 3000 Australia

Tel: (61) 3 9618 8238 Fax: (61) 3 9200 2277

[www.phillipcapital.com.au](http://www.phillipcapital.com.au)

## HONG KONG

**Phillip Securities (HK) Ltd**

11/F United Centre 95 Queensway Hong Kong

Tel (852) 2277 6600 Fax: (852) 2868 5307

[www.phillip.com.hk](http://www.phillip.com.hk)

## JAPAN

**Phillip Securities Japan, Ltd**

4-2 Nihonbashi Kabutocho, Chuo-ku  
Tokyo 103-0026

Tel: (81) 3 3666 2101 Fax: (81) 3 3664 0141

[www.phillip.co.jp](http://www.phillip.co.jp)

## INDIA

**PhillipCapital (India) Private Limited**

No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg,  
Lower Parel West, Mumbai 400013

Tel: (9122) 2300 2999 Fax: (9122) 6667 9955

[www.phillipcapital.in](http://www.phillipcapital.in)

## UNITED KINGDOM

**King & Shaxson Ltd.**

6th Floor, Candlewick House, 120 Cannon Street  
London, EC4N 6AS

Tel (44) 20 7929 5300 Fax: (44) 20 7283 6835

[www.kingandshaxson.com](http://www.kingandshaxson.com)

## SRI LANKA

**Asha Phillip Securities Limited**

Level 4, Millennium House, 46/58 Navam Mawatha,  
Colombo 2, Sri Lanka

Tel: (94) 11 2429 100 Fax: (94) 11 2429 199

[www.ashaphillip.net/home.htm](http://www.ashaphillip.net/home.htm)