

NetEase - S (9999 HK)

The 4Q20 revenue beat market expectation, the company will enter a new game launching cycle in 2021

Hong Kong | TMT sector | Update Report

Investment Summary

NetEase's 4Q20 revenue slightly beat the market expectation, while the NP is below market expectation

The company's 4Q20 revenue was RMB 19.8 billion (+25.6% yoy / +5.9% qoq), and the 4Q20 revenue exceeded the Bloomberg's consensus. In terms of the breakdowns, the company's revenue for online game sector/ Youdao sector/ innovative and other business sector were RMB 13.4 billion (+15.5% yoy / -3.3% qoq) / RMB 1.11 billion (+169.7% yoy / +23.5% qoq) / RMB 5.25 billion (+41.3% yoy / +34.7% qoq), respectively. The revenue proportion of online game/youdao/innovation and other businesses sector were 67.8%/5.6%/26.6%, respectively.

The company's 4Q20 GP was RMB 9.93 billion (+20.9% yoy / +0.4% qoq), and the GPM was 50.2%, which represented a decrease of 2.0ppts yoy / 2.8ppts qoq. The main reason for the decline in GPM was due to the gradual decrease in the revenue proportion of the company's higher GPM sector, namely the online game sector.

The company's 4Q20 operating profit was RMB 3.01 billion (+1.2% yoy / +4.9% qoq), with an operating profit margin of 15.2%, which represents a 3.7ppts yoy / 0.2ppts qoq decline. The company's 4Q20 NP was RMB 930 million (-69.8% yoy / -66.5% qoq), and Non-GAAP NP was RMB 1.6 billion (-56.4% yoy / -56.5% qoq). The sharp drop in 4Q20 NP and Non-GAAP NP were mainly attributable to the RMB 270 million investment loss and RMB 1.80 billion exchange loss recorded in 4Q20.

The online game sector is performing stably, and the company will enter a new game launching cycle in 2021

The company's 2020 revenue from online game sector was RMB 54.61 billion (+17.6% yoy) and mobile game revenue accounted for 71.9% of total online game revenue (+5ppts yoy). The growth momentum of online game revenue in 2020 was mainly derived from old games, such as Fantasy Westward Journey (梦幻西游), Western Journey Online mobile game (大话西游手游), Invincible (率土之滨) and Life-after (明日之后) etc. These games all ranked high on the 2020 IOS top grossing chart in China. The company's 4Q20 revenue from online game sector was RMB 13.40 billion (+15.5% yoy / -3.3% qoq). The qoq decline in the revenue of the online game sector in Q4 was mainly due to the company's weak game pipeline in Q4. The launching of the hardcore MMO mobile game, Revalation (天谕) was delayed to Jan 2021. The GPM of the online game sector in 4Q20 was 63.1% (+0.0ppts yoy / 0.5ppts qoq). The small qoq change in GPM was mainly affected by changes in the proportion of mobile games and PC games revenue as well as the changes in the proportion of revenue from self-developed and non-self-developed games.

As for new games, the company's game pipeline is very strong in 2021. Big IP titles such as, Revalation (天谕), Diablo® Immortal™ (暗黑破壞神: 不朽), Harry Potter: Magic Awakened (哈利波特: 魔法覺醒) and etc are all scheduled to be launched in 2021. The launching of these games will lead the company to enter a new game launching cycle in 2021. Revalation (天谕) was already launched in January 2021. Within the first month of launching, it has already reached 9th place on the Sensor Tower Jan 2021 IOS top grossing chart in China. On the other hand, Diablo® Immortal™ (暗黑破壞神: 不朽) and Harry Potter: Magic Awakened (哈利波特: 魔法覺醒) have both received launching approval and are expected to be launched globally in 2021.

16 March 2021

Buy (Maintain)

CMP HKD 167.40

(Closing price as of 12 March)

TARGET HKD 202.50 (+21.0%)

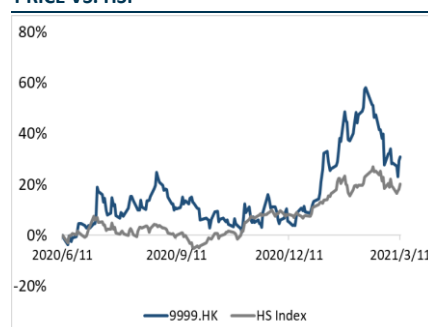
COMPANY DATA

O/S SHARES (MN) :	3,455
MARKET CAP (HKD MN) :	278,387
52 - WK HI/LO (HKD):	207.8/125.0

SHARE HOLDING PATTERN, %

Ding Lei	44.70%
Orbis Investment Management	5.10%

PRICE VS. HSI



Source: Wind, Phillip Securities

KEY FINANCIALS

CNY mn	FY20	FY21E	FY22E	FY23E
Net Sales	73667	87334	101116	115772
NS per share	22.29	26.43	30.60	35.03
P/S, x	6.38	5.38	4.65	4.06
Non-GAAP NI	14706	18104	20798	25133
Non-GAAP EPS	4.45	5.48	6.29	7.60
Non-GAAP P/E, x	31.98	25.98	22.61	18.71
ROE, Adj (%)	17.7	19.1	19.2	20.1
ROA, Adj (%)	10.4	11.6	12.1	13.1

Market closing price as of 12 March

Source: Company Data, Phillip Securities Est.

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The revenue growth of Youdao has accelerated and margin has increased significantly

The revenue of Youdao in 4Q20 was RMB 1.11 billion (+169.7% yoy / +23.3% qoq). Among different sector of Youdao, the revenue growth of learning service sector and learning products sector were the most significant. The revenue of Youdao learning service sector/ Youdao learning products sector in 4Q20 were RMB 730 / 240 million, up by 198.8%/253.8% yoy respectively. In terms of Youdao learning services, the gross billing of Youdao online course was RMB 1.12 billion (+222.8% yoy) and the gross billing of Youdao premium course was RMB 1.04 billion (+268.8% yoy). The gross billing of Youdao K-12 premium course, the signature product of the Youdao premium course, was RMB 767 million (+354.6% yoy) and has reached a new record high. Regarding the learning products sector, the company has launched Youdao Dictionary Pen 3.0 in 4Q20.

The GPM of Youdao in 4Q20 was 47.5%, (+17.7ppts yoy / +1.6ppts qoq). The increase in Youdao GPM was mainly attributable to 1) the enhancement of scale effect 2) the further optimization of teacher salary structure 3) the significant increase in sales of Youdao dictionary pens, which has higher GPM. In addition, although the S&M expenses of Youdao in 4Q20 was still at a relatively high level, with expense ratio of 73%. Nonetheless, it has dropped significantly comparing to the 123% in 3Q20. On the whole, we believe that with the high revenue growth and the further enhancement of Youdao's brand imagine, Youdao is expected to achieve stronger scale effect.

The revenue of Innovative and other business segment showed high growth in 4Q20, the monetization ability of cloud music is expected to be further strengthen in the future

The revenue of the innovative and other business segment in 4Q20 was RMB 5.25 billion (+41.3% yoy / +34.6% qoq), and the high growth was mainly driven by the cloud music sub-sector. At present, the revenue source of the cloud music sub-sector can be divided into three parts: membership, advertising, and live broadcast value-added services. The company's management mentioned that the quality of the music content on the cloud music platform will be continued to be enhanced in the future. Hence, we believe that the membership revenue will be the major revenue source of the cloud music sub-sector. With the further development of the paying habits of China music platform users as well as the further increase in the penetration rate of paying music platform in China, we believe that the monetization ability of Netease Cloud Music will be strengthen.

Valuation

After considered that 1) the company is entering a new game launching cycle in 2021-2022 2) revenue growth of Youdao beat our previous forecast 3) the monetization ability of the company's innovative and other business sector is expected to be further strengthen, we revise our 2021/2022 revenue forecast upward to RMB 87.3/101.1 billion (our previous forecast was RMB 83.3/96.3 billion) and we introduce our 2023 revenue forecast of RMB 115.8 billion. However, since 1) we expect Youdao to continue to spend high in customer acquisition for the following years 2) The S&M expense of games tend to be higher at the beginning of their life cycles, we revised our 2021/2022 Non-GAAP NP forecast downward to RMB 18.1/20.8 billion (our previous forecast was RMB 19.9/22.6 billion). We have rolled-over our SOTP valuation to 2022 and maintain target PE of 25x for online game sector, raise target PS to 5x for the Youdao as well as the innovative and other business sectors. We raise TP to HKD 202.50 (+17.2%), with corresponding 2021/2022/2023 Non-GAAP PE at 31.4x/27.4x/22.6x. We maintain Buy rating. (Market closing price as of 12 March) (exchange rate: RMB 0.85/HKD)

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

Figure 1: Comparable valuation

Company	Stock code	Closing Price	Market Cap	PE				PS			
				TTM	2020E	2021E	2022E	TTM	2020E	2021E	2022E
		(listed currency)	(RMB mn)								
HK listed game companis											
NETEASE INC*	9999 HK equity	167.40	484,641	-	31.3x	26.5x	22.1x	-	6.6x	5.4x	4.7x
TENCENT	700 hk equity	650.50	5,229,700	42.3x	41.9x	33.6x	27.7x	11.4x	10.9x	8.8x	7.3x
XD INC	2400 hk equity	55.10	20,966	47.1x	57.5x	39.1x	31.2x	5.8x	6.7x	5.4x	4.4x
FRIENDTIMES	6820 hk equity	2.80	5,117	11.2x	9.8x	7.7x	6.5x	2.7x	2.2x	1.8x	1.5x
NETDRAGON	777 hk equity	18.54	8,645	11.6x	11.4x	8.9x	7.7x	1.4x	1.4x	1.2x	1.1x
ZENGAME	2660 hk equity	1.27	1,083	4.9x	3.8x	3.5x	3.3x	1.3x	1.1x	0.9x	0.8x
ARCHOSAUR GAMES	9990 hk equity	16.14	11,029	-	23.4x	10.6x	8.7x	-	7.0x	3.6x	2.5x
IDREAMSKY	1119 hk equity	3.82	4,064	12.6x	9.0x	7.4x	6.4x	1.3x	1.3x	1.1x	1.0x
CMGE	302 hk equity	2.98	6,268	21.3x	7.2x	5.7x	4.9x	1.6x	1.4x	1.2x	1.0x
IGG INC	799 HK equity	10.74	10,793	6.2x	8.4x	8.9x	8.5x	2.4x	2.4x	2.1x	2.0x
			Average	19.7x	20.4x	15.2x	12.7x	3.5x	4.1x	3.1x	2.6x
			Median	12.1x	10.6x	8.9x	8.1x	2.0x	2.3x	1.9x	1.8x
China listed game companis											
WUHU SANQI	002555 CH equity	29.23	64,828	21.7x	21.7x	18.3x	15.5x	4.1x	4.1x	3.4x	2.9x
GIANT NETWORK	002558 CH equity	14.92	30,204	30.9x	27.1x	25.3x	25.7x	12.2x	13.5x	12.4x	11.2x
ZHEJIANG CENTURY	002602 CH equity	7.58	56,490	20.0x	14.2x	12.0x	11.1x	3.5x	3.4x	3.1x	2.8x
PERFECT WORLD	002624 CH equity	22.15	42,970	24.0x	23.4x	15.3x	12.9x	4.3x	4.2x	3.5x	3.0x
G-BITS NETWORK	603444 CH equity	356.79	25,641	27.4x	23.5x	18.3x	15.3x	9.6x	9.2x	6.9x	5.7x
			Average	24.8x	22.0x	17.8x	16.1x	6.8x	6.9x	5.8x	5.1x
			Median	24.0x	22.5x	16.8x	14.1x	4.2x	4.1x	3.4x	3.0x
US listed game companis											
EA	EA US equity	131.34	245,723	32.0x	28.1x	24.2x	21.5x	6.7x	7.3x	6.3x	5.9x
NINTENDO	NTDOY US equity	69.39	475,435	-	3.8x	-	-	-	5.4x	-	-
SONY CORP	SNE US equity	103.20	846,517	-	24.2x	14.5x	19.0x	-	1.7x	1.6x	1.6x
ACTIVISION BLIZZARD	ATVI equity	92.94	468,368	31.6x	27.4x	25.5x	21.8x	8.9x	8.9x	8.6x	7.6x
			Average	31.8x	20.9x	21.4x	20.8x	7.8x	5.8x	5.5x	5.0x
			Median	31.8x	25.8x	24.2x	21.5x	7.8x	6.3x	6.3x	5.9x
HK listed online education company											
KOOLEARN	1797 hk equity	18.74	15,698	-	-	-	-	12.4x	14.6x	10.5x	6.1x
US listed online education company											
TAL EDU	TAL US Equity	68.53	267,602	2074.0x	250.1x	503.9x	70.9x	10.4x	12.2x	9.5x	6.6x
GSX TECH EDU	GSX US Equity	82.05	135,903	-	-	-	-	12.0x	19.3x	11.2x	7.6x
YOUDAO	DAO US Equity	32.78	26,435	-	-	-	-	7.6x	8.5x	4.4x	2.9x
CHINA ONLINE EDU	COE US Equity	23.34	3,264	23.5x	46.2x	223.3x	20.9x	1.6x	1.6x	1.2x	1.0x
			Average	1048.7x	148.2x	363.6x	45.9x	7.9x	10.4x	6.6x	4.5x
			Median	1048.7x	148.2x	363.6x	45.9x	9.0x	10.3x	6.9x	4.7x
US listed music platform											
SPOTIFY	SPOT US Equity	286.96	355,044	-	-	-	-	5.7x	5.8x	4.9x	4.1x
TENCENT MUSIC	TME US Equity	27.78	303,126	151.2x	62.9x	51.5x	40.6x	21.3x	10.4x	8.5x	7.0x
			Average	151.2x	62.9x	51.5x	40.6x	13.5x	8.1x	6.7x	5.6x
			Median	151.2x	62.9x	51.5x	40.6x	13.5x	8.1x	6.7x	5.6x

As of 12th March Closing Price, US Stocks closing price as of 11th March

Source: Bloomberg

*The PE and PS are Bloomberg forecast

Financial Statements

Consolidated Statement of Profit or Loss

Dec Y/E, RMB mn	FY19	FY20	FY21E	FY22E	FY23E
Revenue	59241	73667	87334	101116	115772
Gross Profit	31555	38983	46627	54523	62037
S&M expense	-6221	-10704	-13973	-16179	-16208
Admin expense	-3130	-3372	-4454	-5056	-5789
R&D expense	-8413	-10369	-12401	-14358	-16440
Other operating gain/(loss)	0	1	2	3	4
Operating Profit	13791	14538	15798	18930	23601
Net finance income	822	1599	698	924	1655
Other non operating gain/(loss)	1771	-765	2347	2347	2347
Profit before tax	16383	15372	18844	22202	27603
Tax	-2915	-3042	-3491	-4114	-5114
NCI	-194	-267	-230	-271	-337
Profit for the year	21238	12063	15122	17817	22152
Non-GAAP profit for the year	15663	14706	18104	20798	25133
EPS	6.59	3.65	4.58	5.39	6.70
Non-GAAP EPS	4.86	4.45	5.48	6.29	7.60

Key Financial Data

Dec Y/E	FY19	FY20	FY21E	FY22E	FY23E
Valuation Ratio					
P/E ratio, x	21.59	38.98	31.10	26.39	21.23
Non-GAAP P/E ratio, x	29.28	31.98	25.98	22.61	18.71
P/S ratio, x	7.74	6.38	5.38	4.65	4.06

Per share data (RMB)

EPS	6.59	3.65	4.58	5.39	6.70
Non-GAAP EPS	4.86	4.45	5.48	6.29	7.60
Revenue per Share	18.38	22.29	26.43	30.60	35.03

Growth & Margin

Revenue Growth	15.2%	15.8%	24.4%	18.6%	15.8%
Operating income growth	-23.2%	38.2%	5.4%	8.7%	19.8%
Net income Growth	-42.5%	245.2%	-43.2%	25.4%	17.8%
Non-GAAP Net income growth	N/A	45.5%	-6.1%	23.1%	14.9%
Gross Profit Margin	53.4%	53.3%	52.9%	53.4%	53.9%
Operating profit Margin	19.5%	23.3%	19.7%	18.1%	18.7%
Net Profit Margin	12.0%	35.8%	16.4%	17.3%	17.6%
Non-GAAP Net profit margin	21.0%	26.4%	20.0%	20.7%	20.6%

Key Ratios

ROE, Adj	25.0%	17.7%	19.1%	19.2%	20.1%
ROA, Adj	14.0%	10.4%	11.6%	12.1%	13.1%

Market closing price as of 12 March

Consolidated Statement of Financial Position

Dec Y/E, RMB mn	FY19	FY20	FY21E	FY22E	FY23E
Non Current Asset					
PPE	4622	4555	5073	5649	6290
Land use rights, net	3707	4178	4178	4178	4178
others	18690	25310	26920	28530	30140
Total Non Current Assets	27019	34044	36171	38357	40609
Current Asset					
T/R	4169	4576	5881	6809	7796
Inventories	651	621	1357	1580	1891
Prepayments	4817	6112	6112	6112	6112
Cash and cash equivalents	6397	12169	21671	34703	50972
Others	69071	84352	84352	84352	84352
Total Current Assets	85105	107831	119374	133557	151123
Total Assets	112124	141875	155545	171914	191732
Non Current Liabilities					
Deferred tax liabilities	382	713	713	713	713
Other long-term payable	457	624	624	624	624
Others	1	0	0	0	0
Total Non Current Liabilities	840	1337	1337	1337	1337
Current Liabilities					
Loan	16828	19505	19505	19505	19505
T/P	1212	1134	1697	1943	2241
Deferred revenue	8602	10945	11788	13648	15627
Others	11600	15159	15851	16481	17072
Total Current Liabilities	38243	46743	48841	51577	54444
Equity					
Attributable to Parent	61454	82127	93468	106831	123445
Non controlling interest	1139	871	1101	1373	1710
Total Equity	62593	82998	94570	108204	125155
Redeemable NCI	10449	10796	10796	10796	10796
Total Liabilities and Equity	112124	141875	155545	171914	191732

Cashflow Statement

Dec Y/E, RMB mn	FY19	FY20	FY21E	FY22E	FY23E
Profit (loss) before tax	21431	12330	15353	18088	22489
Depreciation and amortization	2,614	3,458	1,086	1,209	1,346
change in working capital	4,771	57	1,585	1,569	0
Others	4,329	-1,124	-1,124	-1,124	0
CFO	17,216	24,888	15,371	19,758	24,280
Capex	-3,329	-3,290	-1,603	-1,785	-1,988
Others	-18,808	-25,902	0	0	0
CFI	-22,137	-29,192	-1,603	-1,785	-1,988
CFF	1,083	9,913	-4,266	-4,940	-6,024
Net Change in Cash	-3,838	5,609	9,502	13,033	16,268
Foreign exchange	29	162	0	0	0
cash equivalents for sales	-1	0	0	0	0
Cash at year end	6,397	12,169	21,671	34,703	50,972

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

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