

NetEase Inc. (NTES)

Earnings Review: 2Q22 beat, steady double digit growth; Maintain Buy

BUY

NTES	12m Price Target: \$121.00	Price: \$91.58	Upside: 32.1%
9999.HK	12m Price Target: HK\$189.00	Price: HK\$142.00	Upside: 33.1%

NetEase 2Q22 results beat, with revenue/OP/NP/game cash revenue coming in above estimates (first take). We see this result as another reflection of NetEase’s solid earnings defensiveness despite macro headwinds and no Banhao approval. The company’s capabilities to extend longevity and LTV across multiple legacy titles (incl. Naraka, FWJ, Infinite Lagrange, and most recently Diablo China with Rmb1.05bn grossing in the first month), alongside a pipeline to be unlocked in 2H (Harry Potter (HP) overseas etc.), and returning capital to shareholders (re-purchased a total of US\$2.3bn, c.4% of mkt cap worth of its share since Aug-21), should help the company navigate through a period of uncertainties surrounding the weaker macro backdrop.

Key surprises from 2Q22 results and mgmt call:

1) Strong PC games bring record-high gross margin for games.

The solid PC game revenue (+41% yoy) was underpinned by in-game item sales of Naraka and strength of FWJ PC, which also lifted core game gross margin (ex. CC Live Streaming) to a 7-year-high (though developer fee from Diablo International also helped) and solid 19% yoy growth in cash revenue, pointing to a healthy 3Q ahead.

2) Better longevity at Diablo China, with the game demonstrating strong grossing resiliency during its first month of operation, generating c.Rmb1.05bn for the first month (vs. our prior estimates of Rmb0.9bn), on track towards our estimated annual grossing of Rmb4.2bn.

3) Globalization accelerates, though international game still amounting to c.10% of group revenue, NetEase has announced onboarding of 3 game industry veterans from XBOX, Ubisoft and

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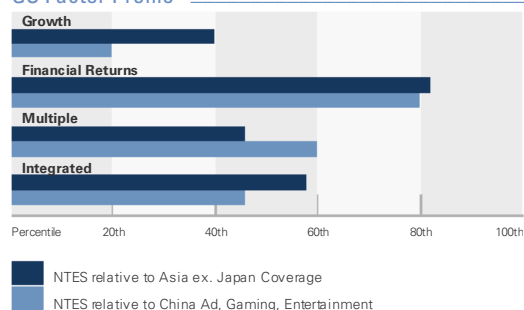
Key Data

Market cap: \$60.9bn
Enterprise value: \$46.2bn
3m ADTV: \$191.4mn
China
China Ad, Gaming, Entertainment
M&A Rank: 3
Leases incl. in net debt & EV?: No

GS Forecast

	12/21	12/22E	12/23E	12/24E
Revenue (Rmb mn) New	87,606.0	98,181.7	110,560.3	123,126.3
Revenue (Rmb mn) Old	87,606.0	97,103.3	110,100.4	122,690.4
EBITDA (Rmb mn)	22,624.1	25,902.3	29,587.7	33,386.1
EPS (\$) New	4.61	4.63	5.27	5.76
EPS (\$) Old	4.61	4.63	5.44	6.01
P/E (X)	22.7	20.5	17.4	15.9
P/B (X)	4.8	3.7	3.3	3.0
Dividend yield (%)	0.8	1.4	1.7	1.9
CROCI (%)	27.5	26.7	33.3	33.8
	3/22	6/22	9/22E	12/22E
EPS (\$)	1.22	1.23	1.06	1.19

GS Factor Profile



Source: Company data, Goldman Sachs Research estimates. See disclosures for details.

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Buy

NetEase Inc. (NTES)

Rating since Dec 4, 2019

Ratios & Valuation

	12/21	12/22E	12/23E	12/24E
P/E (X)	22.7	20.5	17.4	15.9
P/B (X)	4.8	3.7	3.3	3.0
FCF yield (%)	5.1	5.2	6.2	6.5
EV/EBITDAR (X)	16.2	11.9	10.0	8.6
EV/EBITDA (excl. leases) (X)	16.2	11.9	10.0	8.6
CROCI (%)	27.5	26.7	33.3	33.8
ROE (%)	22.3	20.0	20.3	19.9
Net debt/equity (%)	(87.4)	(89.6)	(92.7)	(94.3)
Net debt/equity (excl. leases) (%)	(87.4)	(89.6)	(92.7)	(94.3)
Interest cover (X)	-	-	-	-
Days inventory outst, sales	-	-	-	-
Receivable days	21.0	21.7	20.2	19.1
Days payable outstanding	9.5	8.4	8.5	8.7
DuPont ROE (%)	19.9	18.0	18.4	18.1
Turnover (X)	0.6	0.6	0.6	0.6
Leverage (X)	1.5	1.5	1.5	1.5
Gross cash invested (ex cash) (Rmb)	82,292.3	84,546.9	85,582.0	88,224.7
Average capital employed (Rmb)	104,229.7	103,932.6	102,446.4	100,779.9
BVPS (Rmb)	141.53	165.96	186.00	207.88

Growth & Margins (%)

	12/21	12/22E	12/23E	12/24E
Total revenue growth	18.9	12.1	12.6	11.4
EBITDA growth	9.6	14.5	14.2	12.8
EPS growth	28.2	1.7	18.1	9.4
DPS growth	(18.5)	69.1	20.4	12.3
EBIT margin	22.1	23.4	23.8	24.1
EBITDA margin	25.8	26.4	26.8	27.1
Net income margin	22.6	20.9	21.8	22.0

Price Performance



Source: FactSet. Price as of 17 Aug 2022 close.

Income Statement (Rmb mn)

	12/21	12/22E	12/23E	12/24E
Total revenue	87,606.0	98,181.7	110,560.3	123,126.3
Cost of goods sold	(40,635.2)	(45,133.8)	(50,166.3)	(55,290.4)
SG&A	(16,477.7)	(17,978.2)	(20,006.9)	(21,892.7)
R&D	(14,076.0)	(15,299.8)	(17,152.1)	(19,016.2)
Other operating inc./ (exp.)	2,931.3	3,186.9	3,035.9	2,765.3
Depreciation & amortization	(3,275.7)	(2,945.4)	(3,316.8)	(3,693.8)
Net interest inc./ (exp.)	1,519.7	2,011.9	2,276.7	2,728.4
Income/ (loss) from associates	-	-	-	-
Provision for taxes	(4,128.3)	(4,809.1)	(5,966.6)	(6,867.6)
Minority interest	417.6	314.4	314.4	314.4
Preferred dividends	(537.0)	(3.0)	(400.0)	(400.0)
Post-tax exceptionals	(2,931.3)	(3,186.9)	(3,035.9)	(2,765.3)
Net income	16,976.2	18,000.0	21,049.4	24,282.0
Net income (basic)	16,976.2	18,000.0	21,049.4	24,282.0
Net income (diluted)	16,976.2	18,000.0	21,049.4	24,282.0
DPS (Rmb)	5.21	8.81	10.60	11.91
Div. payout ratio (%)	17.5	28.1	29.7	30.5

Balance Sheet (Rmb mn)

	12/21	12/22E	12/23E	12/24E
Cash & cash equivalents	14,498.2	31,846.4	53,109.0	75,209.5
Accounts receivable	5,508.0	6,172.9	6,080.8	6,771.9
Inventory	-	-	-	-
Other current assets	93,114.1	94,457.8	95,352.9	96,733.4
Total current assets	113,120.3	132,477.1	154,542.7	178,714.9
Net PP&E	5,433.9	5,924.8	6,477.6	7,093.2
Net intangibles	4,108.1	4,108.1	4,108.1	4,108.1
Total investments	0.0	0.0	0.0	0.0
Other long-term assets	30,981.7	30,981.7	30,981.7	30,981.7
Total assets	153,643.9	173,491.7	196,110.1	220,897.9
Accounts payable	985.1	1,104.0	1,243.2	1,384.5
Short-term debt	19,352.3	21,287.5	23,416.3	25,757.9
Short-term lease liabilities	-	-	-	-
Other current liabilities	30,164.0	33,235.4	36,733.7	40,330.8
Total current liabilities	50,501.3	55,626.9	61,393.2	67,473.2
Long-term debt	-	-	-	-
Long-term lease liabilities	-	-	-	-
Other long-term liabilities	3,718.7	3,718.7	3,718.7	3,718.7
Total long-term liabilities	3,718.7	3,718.7	3,718.7	3,718.7
Total liabilities	54,220.0	59,345.6	65,111.9	71,191.9
Preferred shares	145.2	145.2	145.2	145.2
Total common equity	95,328.1	110,050.3	126,902.4	145,610.1
Minority interest	3,950.6	3,950.6	3,950.6	3,950.6
Total liabilities & equity	153,643.9	173,491.7	196,110.1	220,897.9
Net debt, adjusted	(86,737.5)	(102,150.4)	(121,284.3)	(141,043.2)

Cash Flow (Rmb mn)

	12/21	12/22E	12/23E	12/24E
Net income	16,976.2	18,000.0	21,049.4	24,282.0
D&A add-back	3,275.7	2,945.4	3,316.8	3,693.8
Minority interest add-back	-	-	-	-
Net (inc)/dec working capital	782.2	783.8	47.1	832.4
Other operating cash flow	3,892.6	2,958.6	5,823.4	3,599.6
Cash flow from operations	24,926.7	24,687.9	30,236.7	32,407.8
Capital expenditures	(1,601.8)	(3,436.4)	(3,869.6)	(4,309.4)
Acquisitions	-	-	-	-
Divestitures	-	-	-	-
Others	(5,531.8)	0.0	-	-
Cash flow from investing	(7,133.6)	(3,436.4)	(3,869.6)	(4,309.4)
Repayment of lease liabilities	-	-	-	-
Dividends paid (common & pref)	(3,508.4)	(5,839.9)	(7,233.2)	(8,339.5)
Inc/(dec) in debt	1,708.2	1,935.2	2,128.8	2,341.6
Other financing cash flows	(10,785.4)	0.0	0.0	0.0
Cash flow from financing	(12,585.6)	(3,904.7)	(5,104.5)	(5,997.9)
Total cash flow	5,207.5	17,346.9	21,262.6	22,100.5
Free cash flow	23,324.9	21,251.5	26,367.1	28,098.4

Source: Company data, Goldman Sachs Research estimates.

CAPCOM with track records of producing Triple-A titles with expertise in shooting/action/open-world genre.

4) Yet no change in management's tone on expectation of receiving game approval to unlock monetization of Naraka Mobile (Rm6.1bn revenue in first 12M, GSe) and Justice Mobile.

For 2022-24E, factoring in 2Q results we fine tune our revenue forecasts by **+1%/+0.4%/+0.4%**. We trim our net income by **0%/-3%/-4%** for 2022-24E. With our revised earnings outlook and our updated share count assumption on NetEase's ongoing buyback, our 12-month SOTP-based target prices increased ~1% to **US\$121/HK\$189** for NTES/9999.HK. Maintain **Buy**.

The authors would like to thank Joy (Haoyang Yu) for her contributions to this report.

Exhibit 1: NTES: Key changes to GSe

Rmb mn	New 2022E	Change	New 2023E	Change	New 2024E	Change
Net Revenues	98,182	1.1%	110,560	0.4%	123,126	0.4%
Operating profit, non-GAAP	22,957	1.6%	26,271	-3.2%	29,692	-4.2%
Net profit, non-GAAP	20,562	0.8%	24,085	-2.0%	27,047	-2.8%

Source: Company data, Goldman Sachs Global Investment Research

Key highlights

Online games (73% of revenue, or 78% under new segmentation): 2022 a beat on PC, game %GPM highest since 2016; solid game cash revenue

Online game (ex. CC Live streaming and VAS) revenues were Rmb16.8bn (+3% vs. GSe/+3% vs. consensus), up **16.0% yoy**/-2% qoq, split +6%/+41% yoy by mobile/PC games, on **1) strong PC game** (+41% yoy, 4% ahead of GSe) led by growth re-acceleration in *Naraka Bladepoint* with its content updates and the launch of the Xbox version in June, as well as strength from legacy titles such as FWJ PC; and **2) stable mobile game revenue** (+6% yoy, 2% vs. GSe) in 2Q22, driven by successfully maintaining hit titles including Identity V and Infinite Lagrange.

Taking into account deferred revenue (ex. Youdao) growth of 8% yoy/2% qoq in 1Q22, **cash revenue** of NetEase Game was **+19% yoy** /-5% qoq to Rmb16.7bn, with %yoy outpacing industry by 26ppts (-7% according to CNG), pointing to a resilient 3Q22E.

Game gross margin (ex. VAS revenue) is estimated to be c.68%, the highest level since 2Q16, driven by **1)** higher contribution of PC game revenue; **2)** incremental revenue from *Naraka Bladepoint* sales on XBOX channel; **3)** Developer fees obtained from *Diablo Immortal* international (no deferral period).

NetEase has amended its segmentation and grouped CC live steaming and UU game simulator under the broader game segment starting 2Q22.

We forecast game revenue growth of +12% yoy in 3Q22E and +13% yoy in 2022E.
By platform:

- **We forecast +15%/+10% yoy for mobile game in 2Q22E/2022E**, driven by the solid 19% yoy cash revenue growth/12% deferred revenue growth to fall through in 3Q and Diablo China's contribution.
- **Internationally**, NetEase's grossing dropped 8% yoy in July, driven by a combination of a 21% decline in JPY:USD but offset by solid July traction in *Knives Out Japan*, through its IP collaboration with One Piece and Sword Art Online.
- **Domestically:**
 - **Diablo Immortal** was released on 25 July, contributing 11% of NetEase's July grossing. We now project the game to gross Rmb4.2bn for the first year, with the game demonstrating strong grossing resiliency during its first month of operation, generating **c.Rmb1.05bn** for the first month (vs. our prior estimates of Rmb0.9bn).
 - **Legacy games:** *Fantasy Westward Journey* (FWJ) saw grossing declined -21% yoy in July, after its 4th consecutive month of grossing growth (Mar-June 2022). **Harry Potter China** saw grossing -15% mom in July, remaining on a declining curve. *Infinite Lagrange* remains NetEase's 3rd largest mobile game domestically in July, which we expect to gross Rmb536mn/Rmb2.1bn revenue in 3Q22E/2022E, reflecting user re-acceleration on a major content expansion update and corresponding user acquisition spending.
- **We forecast +4%/+20% yoy for PC game in 3Q22E/2022E**, given:
 - **Naraka Bladepoint:** ongoing character/cosmetic updates, followed by the first map update in 2H22, yet we expect a high base from Naraka Bladepoint starting 3Q22E will weigh on growth.
 - **Resilient legacy titles:** yoy growth of **FWJ PC** grossing likely to continue in 3Q22E, inline with strong engagement of E-key (app to login into NetEase PC games, timespent +26% yoy per QM) and Cangbaoge (app to transact virtual items of NetEase games, timespent +35% yoy).

Exhibit 2: NetEase: China mobile game cash revenue by titles (Rmb mn)

Domestic mobile games cash revenue by titles						2018	2019	2020	2021	2022E	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22E	4Q22E
Diablo: Immortal	暗黑破坏神: 不朽																	
Harry Potter: Magic Awakened	哈利波特: 魔法觉醒																	
Revelation	天谕																	
Fantasy Westward Journey	梦幻西游	8,597	9,500	9,568	11,511	13,195												
Invincible	率土之滨	1,101	1,288	4,383	3,078	3,126												
Journey to the West	大话西游	2,730	3,230	3,160	3,386	2,705												
Onmyoji	阴阳师	2,560	3,887	3,685	3,296	2,358												
Mingri Zhihou	明日之后	722	1,663	2,060	1,949	2,350												
A Chinese Ghost Story	倩女幽魂	2,262	1,988	2,060	1,384	1,379												
Yimeng Jianghu	一梦江湖	2,845	1,243	1,453	898	611												
Menghuan Xiyou Wangyeiban	梦幻西游网页版	-	-	1,034	620	1,212												
Sky: Children of the Light	光·遇		14	471	1,234	1,991												
Pro Evolution Soccer	实况足球-2021	244	339	608	756	1,140												
Fantasy Westward Journey 3D	梦幻西游三维版	-	271	1,388	293	193												
Genesis Masterwork Apocalypse	幻书启世录	-	-	93	81	-												
Identity V	第五人格	420	394	507	415	581												
Infinite Lagrange	无尽的拉格朗日	-	-	-	304	2,227												
Other games		-	3,092	8,900	4,920	3,460												
Total		25,695	28,409	34,370	38,628	41,792												
% yoy - Domestic mobile games cash revenue						2018	2019	2020	2021	2022E	1Q21	2Q21	3Q21	4Q21	1Q22E	2Q22E	3Q22E	4Q22E
Diablo: Immortal	暗黑破坏神: 不朽																	
Harry Potter: Magic Awakened	哈利波特: 魔法觉醒																	
Fantasy Westward Journey	梦幻西游	0%	11%	1%	20%	15%												
Invincible	率土之滨	59%	153%	57%	-30%	2%												
Journey to the West	大话西游	-6%	18%	-2%	7%	-20%												
Onmyoji	阴阳师	-41%	52%	-5%	-11%	-28%												
Mingri Zhihou	明日之后		130%	24%	-5%	21%												
A Chinese Ghost Story	倩女幽魂	-49%	-12%	4%	-33%	0%												
Yimeng Jianghu	一梦江湖		-56%	17%	-38%	-32%												
Menghuan Xiyou Wangyeiban	梦幻西游网页版				-40%	96%												
Sky: Children of the Light	光·遇			3244%	162%	61%												
Pro Evolution Soccer	实况足球-2021		39%	80%	24%	51%												
Fantasy Westward Journey 3D	梦幻西游三维版			412%	-79%	-34%												
Genesis Masterwork Apocalypse	幻书启世录				-13%													
Identity V	第五人格		-6%	29%	-18%	40%												
Infinite Lagrange	无尽的拉格朗日					632%												
Revelation	天谕					-79%												
Other games				26%	26%	-30%												
Total		7%	11%	21%	12%	8%												

Source: Company data, Goldman Sachs Global Investment Research, SensorTower, QuestMobile

Exhibit 3: NetEase: international and domestic grossing performances

NetEase网易 - International		Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22
International Grossing % yoy		-9%	-28%	-22%	-5%	-29%	-29%	-8%
International Market share %		1.2%	1.1%	1.0%	1.1%	1.1%	0.9%	1.2%

NetEase网易 - domestic		Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22
Domestic Grossing % yoy - constant FX		-13%	-31%	-11%	4%	9%	4%	-9%
Domestic Grossing % mom - constant FX		-6%	-20%	12%	19%	4%	-16%	-4%

Grossing % yoy - by titles		Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22
Fantasy Westward Journey 梦幻西游								-21%
Day After 明日之后								-28%
Harry Potter:Magic Awakened 哈利波特：魔法觉醒								0%
Sky:Children of Light 光遇								-73%
Invincible 率土之滨								-40%
Westward Journey 大话西游								-62%
Onmyoji 阴阳师								-62%
A Chinese Ghost Story 倩女幽魂								-14%
Diablo Immortal 暗黑破坏神：不朽								0%
Infinite Lagrange 无尽的拉格朗日								0%

Domestic Market share %		Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22
Market share % - by titles		14.1%	13.2%	12.7%	14.0%	14.6%	14.1%	13.4%


Market share % - by titles		Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22
Fantasy Westward Journey 梦幻西游								4.4%
Day After 明日之后								0.5%
Harry Potter:Magic Awakened 哈利波特：魔法觉醒								0.3%
Sky:Children of Light 光遇								0.2%
Invincible 率土之滨								0.9%
Westward Journey 大话西游								0.4%
Onmyoji 阴阳师								0.5%
A Chinese Ghost Story 倩女幽魂								0.4%
Diablo Immortal 暗黑破坏神：不朽								1.5%
Infinite Lagrange 无尽的拉格朗日						0.5%		1.3%




Source: SensorTower, data compiled by Goldman Sachs Global Investment Research

Key titles updates:

Diablo: Immortal, the action RPG co-developed with Blizzard, was released in mainland China at 12AM, 25 July 2022. With the game consistently tracking at no.2-4 on the IOS grossing chart during its first month of release, we now project the game to gross Rmb4.2bn for the first year, with the game demonstrating strong grossing resiliency during its first month of operation, generating **c.Rmb1.05bn** for the first month (vs. our prior estimates of Rmb0.9bn).

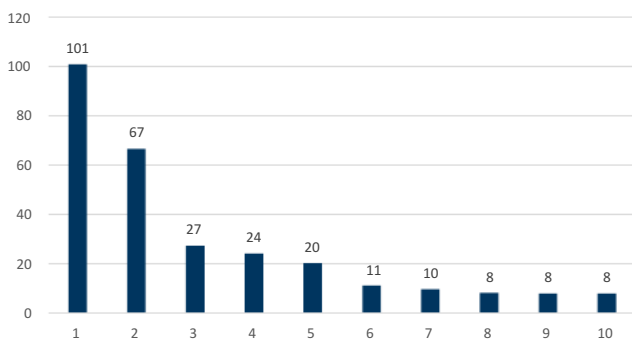
Exhibit 4: Diablo: revenue contribution sensitivity table (Rmb mn)

		Annualized ARPU (Rmb)				
 MAU (mn)	4,203	1,517	1,597	1,681	1,765	1,854
	1.6	2,428	2,556	2,690	2,825	2,966
	2.0	3,035	3,194	3,363	3,531	3,707
	2.5	3,793	3,993	4,203	4,413	4,634
	3.0	4,552	4,792	5,044	5,296	5,561
	3.6	5,462	5,750	6,053	6,355	6,673
As a % of our 22E domestic mobile game cash revenue		9.1%	9.6%	10.1%	10.6%	11.1%

Benchmark					
English	Invincible	Journey to the West	Harry Potter: Magic Awakened		
Chinese	率土之滨	大话西游	哈利波特: 魔法觉醒		
Genre	SLG	RPG	RPG/CCG		
GSe - 22E cash revenue (Rmb mn)	3,126	2,705	4,244	4,244	4,244
Diablo vs. benchmark	-22%	18%	-1%	25%	57%

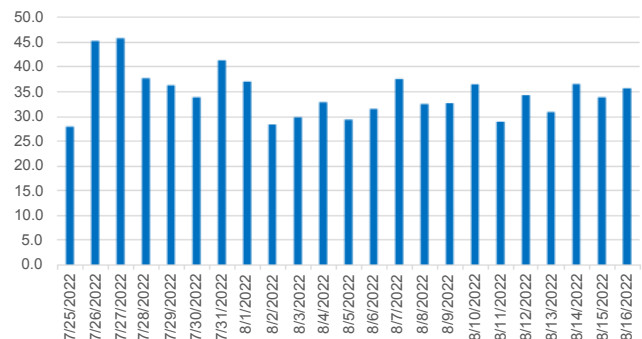
Source: Company data, Goldman Sachs Global Investment Research

Exhibit 5: China mobile game: implied daily grossing (Rmb mn) for respective ranking on the IOS grossing chart



Source: Goldman Sachs Global Investment Research

Exhibit 6: Diablo China: daily grossing (Rmb mn) has shown better-than-expected longevity



Source: SensorTower, Goldman Sachs Global Investment Research

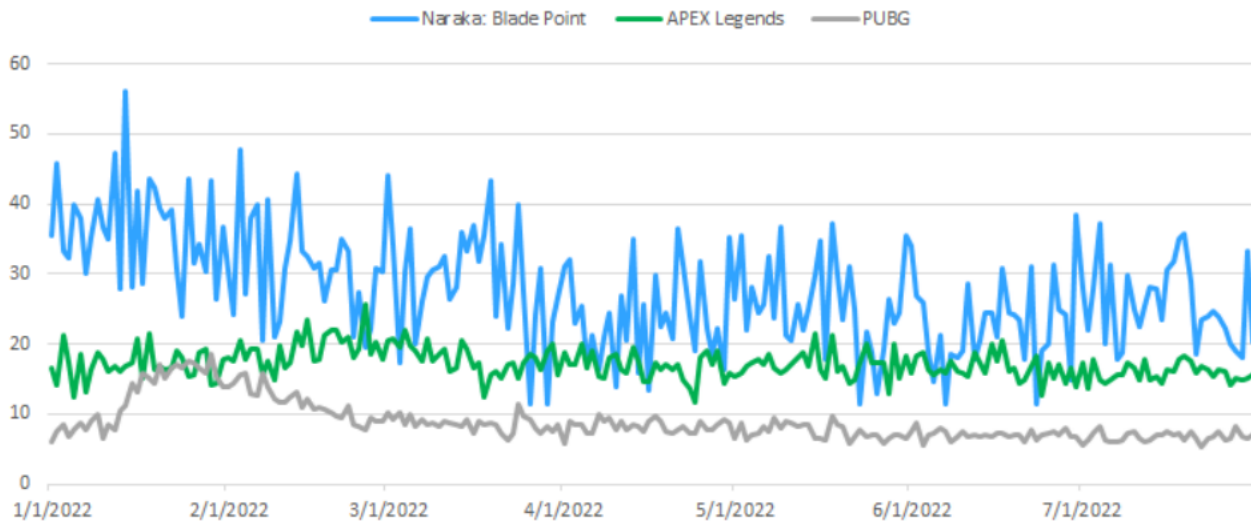
Naraka: Bladepoint, an Eastern-fantasy style PC-based battle royale game that has been consistently among the TOP 10 selling games on Steam even after its one year release. We attribute the strong **2022 PC game revenue growth** partly to Naraka: Bladepoint’s content updates and the first World Championship tournament, in addition

to strength from FWJ PC.

We expect the release of Naraka Blade Point on the Play Station Console in 4Q22 could bring incremental revenue contribution. **China is the no.6 largest market in terms of PlayStation 5 adoption**, according to SONY though its China console release remains contingent on game license approval.

Exhibit 7: Engagement comparison: % of owners that played the games in the past 2 weeks



Compared to PUBG (Krafton) and APEX Legends (Electronic Arts), two largest battle royale games by ownership, Naraka Bladepoint is relatively more engaged



Source: Steam

- **Framing potential mobile contribution.** As Naraka Bladepoint Mobile is still in the development stage, management do not expect the game to be launched in 2022. While we note the eventual release date remains contingent on **Banhao approval** and **development timeline**, we estimate the game could reach a potential **Rmb6.1bn** revenue (equivalent to 10% of our 2023E mobile game revenue assumption), by adopting:
 - **23mn average MAU**, based on a conservative 2.5x user conversion ratio from the number of domestic China PC users, vs. 150mn MAU of Peacekeeper Elites (6.4x conversion from its 24mn domestic China PC users).
 - **Annual ARPU of Rmb268**, 100% above our assumed annual ARPPU of Peacekeeper Elites (Rmb134, within its first 12months of monetization), which we deem achievable given average ARPPU of NetEase's game is 4x of Tencent, on our estimates.

Exhibit 8: Framing monetization potential of Naraka Bladepoint and cross-checking with Peacekeeper Elites, as both games adopt a similar monetization model (battle royal + in-game item sales)

PC - Mobile conversion		Naraka:Blade Point PC		PUBG PC
Launch date		4-Jul-21		23-Mar-17
Genre		Battle Royale		Battle Royale
Developer		NetEase		Krafton
Licensed operator		NetEase		Krafton
Active user analysis				
First year sales vol. (mn) worldwide		10		40
% of players from China		90%		59%
China annual active user (mn) - PC		9		24
Mobile conversion ratio (x)		2.5		6.4
compared to Peacekeeper Elite		40%		100%
First year average mobile MAU (mn)		23		150
ARPPU analysis				
Annual ARRPU in first 12 months		268		134
compared to Peacekeeper Elite		200%		100%
Annual ARRPU in 12nd-24th months				231
Annualized revenue (Rmb mn)		6128		20085
compared to Peacekeeper Elite		31%		
As a % of 23E NTES mobile game		11%		

Source: Company data, Goldman Sachs Global Investment Research

Harry Potter: Magic Awakened: has confirmed its **2022 global release**, with its overseas closed beta testing (incl. Japan, where NetEase will be the main publisher) concluded on **30 July**. We estimate the Japan version to be launched in **4Q22E**, and reach a similar level of grossing as Knives Out (2-3% of Japanese mobile game market share), offsetting the relatively lagging grossing of existing international games (-20% yoy).

- **Japan is the world's 2nd largest market for the Harry Potter franchise** in terms of movie box office, 35% of the U.S. while 1.4x of that of the UK. Within Japan, Harry Potter is also the 2nd largest IP in terms of box office, only next to Doraemon. According to Shuppankagaku, 23mn of Harry Potter books were sold in Japan between 1999 and 2008, vs. 20mn in Mainland China.
- **NTES's established foothold** in the Japan mobile game industry, as evident from its success in Knives Out and Identity V.
- **Japanese gamers' high acceptance** to the RPG/CCG genre, relative to the world.

Other games in the pipeline include:

- **Viva Le Football**, a self-developed football simulation title that comes with a tentative release date of **1 Oct**.

Exhibit 9: NetEase: domestic game pipeline

English Name	Chinese Name	Genre	Platform	Banhao Approve	Approval Date	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Rest 2022
Game launched																				
Marvel Super War	漫威超级战争	MOBA	Mobile	Y	12/2/2020	Public testing on July 15														
Racing Master	王牌竞速	Racing	Mobile	Y	12/31/2020	Public testing on July 23														
Code: Moon	月神的迷宫	Card	Mobile	Y	7/1/2020	Public testing on July 27														
Shaqi 2	有杀气童话2	MMO	Mobile	Y	12/9/2019	Public testing on July 29														
EVE: Echos	星战前夜: 无烬星河	Sandbox	Mobile	Y	2/9/2021	Public testing on Aug 5														
NARAKA: BLADEPOINT 永劫无间																				
Primitive Civilization	洪荒文明	SLG	Mobile	Y	5/24/2021	Final testing on July 8	Public testing on Aug 12													
Infinite Lagrange	无尽的拉格朗日	Battle	Mobile	Y	10/23/2019	Public testing on Aug 12	Public testing on Aug 15													
Harry Potter: Magic Awakened	哈利波特: 魔法觉醒	Card/ RPG	Mobile	Y	8/6/2020	Public testing on Sept 9														
Marvel Duel	漫威对决	CCG	Mobile	Y	6/28/2021	Alpha testing on July 2	Beta testing on Aug 20	Public testing on Sept 29												
Dream Chaser: the Showbiz	绝对演绎	Simulation	Mobile	Y	3/19/2021															
Slick Fight: The Game	逗斗火柴人	Action	Mobile	Y	6/28/2021															
Roar of War	战争怒吼	RTS	Mobile	Y	9/29/2020															
Eggy Go	蛋仔派对	Casual	Mobile	Y	7/22/2021	Alpha testing on July 15	Beta testing on Sept 28													
Diablo Immortal	暗黑破坏神: 不朽	ARPG	Mobile	Y	2/9/2021	Alpha testing on July 15	Beta testing on Sept 28													
Game pipeline																				
Vive Le Football	绿茵信仰	Sports	Mobile	Y	4/27/2021		Beta testing on Aug 21													
Ghost World Chronicle	倩女幽魂: 宿命	CCG	Mobile	Y	8/8/2019															
Steam Fighter: Alliance	蒸汽战棋: 联盟	SLG	Mobile	Y	6/28/2021															
Fishing Contest	钓鱼大对决	Casual	Mobile	Y	6/28/2021															
Candy Crush Friends Saga	糖果传奇: 欢乐	Casual	Mobile	Y	12/2/2020															
Mission Zero	零号任务	Action	Mobile	N	-		Alpha testing on Aug 19													
Code name: Candle	代号: 烛	Action	Mobile	N	-															
Ormyoji: Yokai Class	阴阳师: 妖怪小班	CCG	Mobile	N	-		Alpha testing on July 9													
Firefly Assault	萤火突击	Shooting	Mobile	N	-			Alpha Testing on Sept 23												
NARAKA: BLADEPOINT console	永劫无间主机版	Action	Console	N	-															
NARAKA: BLADEPOINT mobile	永劫无间手机版	Action	Mobile	N	-															

Source: Company data, Goldman Sachs Global Investment Research

Framing the timeline for the next domestic blockbuster:

Following the release of Diablo Immortal Mobile China, NetEase has a domestic pipeline consisting of **5 mobile games with Banhao approval**.

We believe the Banhao approval grants to large players such as Tencent/NetEase which remain contingent on NPPA's decisions to prioritize smaller gaming companies (vs. the larger ones); nonetheless we attempt a reasonable effort to gauge the potential Banhao approval date by drawing from historical examples of NetEase's games. Our analysis of the time gap between NetEase's application of **software copyright** and **Banhao approval date** across its past 24 games (14 domestic, 10 international) suggests an average approval lead-time of 19 months. Specifically:

- **NPPA is more cautious on Banhao issuance of international games**, compared with domestic games. Average approval lead-time for NetEase's international games is **26 months** (782 days), almost twice the time of domestic games' **14 months** (432 days).
- **Games that lie in the genre of Anime/MMORPG that usually have high ARPPU also take a longer time to approve**, compared with casual games, including puzzlers, family and party games. (e.g, domestic anime games usually take more than 400 days from registering software copyright to obtaining Banhao, whereas strategy and casual games take less than 300 days).
- **Justice Mobile**: registered on 15 January 2021, we expect Banhao approval in end 2022 or 1H23 based on average lead-time of NetEase domestic games, or historical

martial-arts MMORPG games' lead-time as proxy.

- **Naraka: BladePoint**: registered on 11 August 2021, referring to the lead-time of *Naraka: BladePoint PC version*, Banhao approval is likely foreseeable in March 2023, or in July 2023 if directly using domestic average lead-time.

Exhibit 10: NetEase: Time gap between copyright registration and Banhao approval

Banhao	Gameplay	Visual	Game		Date: copyright registration	Date: Banhao approval	Days taken	Months taken
Domestic	Casual	Others	Eggy Party	蛋仔派对	12/28/2020	7/22/2021	206	7
Domestic	CCG	Anime	Onmyoji: Yokai House	阴阳师: 妖怪屋	2/2/2019	9/18/2019	228	8
Domestic	RTS	Western	Infinite Lagrange	无尽的拉格朗日	2/21/2019	10/23/2019	244	8
Domestic	Action	Martial Arts	Naraka BladePoint	永劫无间	11/13/2019	9/21/2020	313	10
Domestic	CCG	Anime	Unknown Future	黑潮之上	6/6/2019	4/28/2020	327	11
Domestic	Sports	Western	Viva Le Football	绿茵信仰	5/19/2020	4/27/2021	343	11
Domestic	Romance	Anime	For all time	时空中的绘旅人	5/21/2019	7/1/2020	407	13
Domestic	CCG	Anime	Show-biz	绝对演绎	1/15/2020	3/19/2021	429	14
Domestic	Racing	Others	Ace Racer	王牌竞速	10/8/2019	12/31/2020	450	15
Domestic	MMORPG	Martial Arts	FWJ 3D	梦幻西游三维版	6/25/2018	11/1/2019	494	16
Domestic	CCG	Anime	Genesis Book Apocalypse	幻书启世录	3/21/2019	9/1/2020	530	17
Domestic	CCG	Anime	Ghost: Chronicle	倩女幽魂隐世录	12/13/2017	8/8/2019	603	20
Domestic	MMORPG	Martial Arts	Revelation	天谕	4/19/2018	2/25/2020	677	22
Domestic	Action	Anime	Nightmare Breaker	超献斗梦境	1/3/2018	3/12/2020	799	26
Domestic average							432	14
International	Casual	Others	Candy Crush	糖果缤纷乐	5/31/2019	12/2/2020	551	18
International	MMORPG	Western	Harry Potter: Magic Awakens	哈利波特: 魔法觉醒	12/27/2018	8/6/2020	588	19
International	CCG	Anime	Pokémon Adventure	宝可梦大探险	4/25/2019	2/9/2021	656	22
International	Action	Western	Marvel Super War	漫威超级战争	12/14/2018	12/2/2020	719	24
International	MMORPG	Western	Diablo: Immortal	暗黑破坏神: 不朽	12/19/2018	2/9/2021	793	26
International	Casual	Others	Fishing Clash	钓鱼大对决	3/14/2019	6/28/2021	837	28
International	RTS	Western	EVE: Echoes	星战前夜: 无烬星河	10/11/2018	2/9/2021	852	28
International	Action	Others	Stickman Fight	逗斗火柴人	12/14/2018	6/28/2021	927	30
International	CCG	Anime	Yu-Gi-Oh: Duel Links	游戏王: 决斗链接	4/24/2018	12/2/2020	953	31
International	CCG	Western	Marvel Duel	漫威对决	11/14/2018	6/28/2021	957	31
International average							782	26
Pipeline: The blockbusters						Estimated Banhao release date		
Domestic	MMORPG	Martial Arts	Justice Mobile	逆水寒手游	1/15/2021	Dec-22	695	23
						Feb-23	758	25
						May-23	849	28
Domestic	Action	Martial Arts	Naraka BladePoint (Mobile/console)	永劫无间手游/主机	8/11/2021	Mar-23	576	19
						Jul-23	695	23

Source: Company data, Goldman Sachs Global Investment Research, Tianyancha

Music (9% of revenue): subscription % continued to improve; positive gross margin for the 5th consecutive quarter

Cloud Music revenue was Rmb2.2bn, +29.5% yoy, driven by **1)** strong social entertainment revenue (+57% yoy) and **2)** continued healthy growth of membership subscriptions (paying ratio reaching 21% in 2Q22), Cloud Music gross margin improved to 13.0% from 12.2%/4.1% a quarter/year ago.

As of 2Q22, Cloud Music content library consists of more than 106mn music tracks, and a pool of 529,000 registered independent artists.

We forecast Music revenue growth of +21%/+26% in 3Q22E/2022E and GPM of 13.0%/12.8% in 3Q22E/2022E.

Youdao (4% of revenue): Quarter with increasing net loss due to Covid and impact of

education regulation

Youdao Education revenue was Rmb956.2mn, -2.4% yoy, with smart learning devices reaching Rmb240mn (+16.3% yoy), still the key driver of Youdao's growth. Learning services revenue further declined to Rmb564mn (-7.3% yoy), mainly attributable to the decline of adult courses in the Covid backdrop. Online marketing services were Rmb153mn (-8.0% yoy), due to weaker advertising budgets of ad customers.

Segment gross profit margin decreased to 42.8%, compared to 51.0% in 2Q21, resulting from the decline in economies of scale due to lowered learning revenue.

We forecast Youdao revenue growth of -13%/-12% yoy in 3Q22E and 2022E and GPM of 52.8%/50.0% in 3Q22E/2022E.

Financials & valuation

For 2022-24E, factoring in 2Q results we fine tune our revenue forecasts by **+1%/+0.4%/+0.4%**. Specifically, we raise our 2022E but trim our 2023E-2024E **game revenue** on **1)** higher PC game revenue +3%/3%/3% on a promising monetization runway ahead from **Naraka: Blade Point** and strength of legacy titles, and **2)** 0%/2%/2% lower mobile game revenue due to domestic game release timeline disrupted by Banhao suspension.

We tweak our gross profit by **2%/0%/0%** on stronger PC game revenue growth, offset by mix shift towards the non-game segment. Meanwhile, we raise our S&M expense estimates by **5%** in 2022-24E on account of marketing budget to lengthen the longevity of legacy titles, as it was the case in 2Q22. As a result, we trim our net income by **0%/-3%/-4%** for 2022-24E. With our revised earnings outlook and our updated share count assumption on NetEase's ongoing buyback, our 12-month SOTP-based target prices are increased ~1% to **US\$121/HK\$189** for NTES/9999.HK. Maintain **Buy**.

Exhibit 11: NetEase: Key changes to GSe

Rmb mn	New 2022E	Change	New 2023E	Change	New 2024E	Change
Net Revenues	98,182	1.1%	110,560	0.4%	123,126	0.4%
Operating profit, non-GAAP	22,957	1.6%	26,271	-3.2%	29,692	-4.2%
Net profit, non-GAAP	20,562	0.8%	24,085	-2.0%	27,047	-2.8%

Source: Company data, Goldman Sachs Global Investment Research

Exhibit 12: NetEase: Quarterly estimates snapshot

Rmb mn	1Q21	2Q21A	3Q21A	4Q21A	1Q22A	2Q22A	2Q22E	% diff	%QoQ	%YoY
Online game services	14,982	14,528	15,899	17,398	17,273	16,834	16,398	3%	-3%	16%
Youdao	1,340	1,293	1,387	1,334	1,201	956	970	-1%	-20%	-26%
Cloud Music	1,491	1,693	1,925	1,889	2,067	2,192	2,090	5%	6%	29%
Innovative businesses and others	2,704	3,011	2,980	3,753	3,015	4,390	2,740	60%	46%	46%
Net revenues	20,517	20,525	22,191	24,374	23,556	23,159	22,198	4%	-2%	13%
Cost of revenues	(9,465)	(9,335)	(10,380)	(11,456)	(10,719)	(10,218)	(9,986)	-2%	5%	-9%
Gross profit, GAAP	11,053	11,190	11,811	12,918	12,836	12,941	12,211	6%	1%	16%
Online game services	9,679	9,606	10,262	11,158	11,245	11,431	10,843	5%	2%	19%
Youdao	767	677	786	676	638	410	488	-16%	-36%	-39%
Cloud Music	(54)	41	32	77	252	286	174	64%	14%	595%
Gross profit, non-GAAP	11,241	11,387	11,991	13,185	13,035	13,115	12,398	6%	1%	15%
Selling and marketing	(2,767)	(3,013)	(3,134)	(3,300)	(2,915)	(3,301)	(2,882)	-15%	-13%	-10%
General and administrative	(950)	(1,011)	(1,140)	(1,162)	(1,016)	(1,113)	(1,019)	-9%	-10%	-10%
Research and development	(3,060)	(3,407)	(3,761)	(3,848)	(3,398)	(3,582)	(3,599)	0%	-5%	-5%
Total operating expense, GAAP	(6,777)	(7,431)	(8,036)	(8,310)	(7,329)	(7,995)	(7,500)	-7%	-9%	-8%
Operating profit, GAAP	4,276	3,758	3,775	4,608	5,507	4,946	4,711	5%	-10%	32%
Operating profit, non-GAAP	4,917	4,458	4,463	5,510	6,231	5,711	5,393	6%	-8%	28%
Investment income	695	889	(265)	1,628	(549)	(707)	-			
Interest come	389	386	350	395	458	506	430	18%	10%	31%
Other gain	279	(592)	153	(331)	(98)	865	-			
Profit before tax	5,787	4,590	4,131	6,597	5,535	5,731	5,358	7%	4%	25%
Income tax	(1,273)	(1,113)	(808)	(934)	(1,219)	(1,259)	(1,180)	-7%	-3%	-13%
Net profit, GAAP	4,514	3,476	3,323	5,663	4,316	4,472	4,178	7%	4%	29%
Net profit from continuing operations, non-GAAP	5,081	4,242	3,870	6,596	5,118	5,431	4,879	11%	6%	28%
GAAP EPADS (US\$)	1.00	0.81	0.73	1.34	1.05	1.05	1.00	6%	1%	30%
Non-GAAP EPADS (US\$)	1.14	0.97	0.89	1.56	1.22	1.23	1.16	6%	1%	26%
Non-GAAP margins	1Q21	2Q21A	3Q21A	4Q21A	1Q22A	2Q22A	2Q22E	diff (pp)	QoQ (pp)	YoY (pp)
Gross margin	54.8%	55.5%	54.0%	54.1%	55.3%	56.6%	55.9%	0.8	1.3	1.2
Online game services GM - GAAP	64.6%	66.1%	64.5%	64.1%	65.1%	67.9%	66.1%	1.8	2.8	1.8
Youdao GM - GAAP	57.3%	52.3%	56.6%	50.7%	53.1%	42.8%	50.3%	(7.4)	(10.3)	(9.5)
Cloud Music GM - GAAP	-3.6%	2.4%	1.7%	4.1%	12.2%	13.0%	8.3%	4.7	0.9	10.6
Operating margin, non-GAAP	24.0%	21.7%	20.1%	22.6%	26.5%	24.7%	24.3%	0.4	(1.8)	2.9
Net margin	24.8%	20.7%	17.4%	27.1%	21.7%	23.5%	22.0%	1.5	1.7	2.8
Game cash revenue (Rmb mn)	1Q21	2Q21A	3Q21A	4Q21A	1Q22A	2Q22A	2Q22E	% diff	%QoQ	%YoY
Total	15,941	14,052	18,348	16,027	17,527	16,703	16,009	4%	-5%	19%
-PC Cash Revenues	4,336	3,921	5,651	5,080	5,801	5,662	5,221	8%	-2%	44%
-Mobile Cash Revenues	11,605	10,132	12,697	10,946	11,726	11,041	10,788	2%	-6%	9%

Source: Company data, Goldman Sachs Global Investment Research

Exhibit 13: NetEase: Summary of financials

RMB mn	2020	2021	2022E	2023E	2024E	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22E	4Q22E
Revenue	73,667	87,606	98,182	110,560	123,126	20,517	20,525	22,191	24,374	23,556	23,159	24,627	26,840
% yoy	24%	19%	12%	13%	11%	20%	13%	19%	23%	15%	13%	11%	10%
1. Online games net revenue	54,609	62,805	71,014	79,538	88,712	14,982	14,528	15,899	17,398	17,273	16,834	17,760	19,147
%yoy	18%	15%	13%	12%	12%	11%	5%	15%	30%	15%	16%	12%	10%
a. Mobile games	39,264	44,279	48,704	56,083	64,537	10,907	10,475	11,002	11,883	11,555	11,127	12,649	13,534
%yoy	18%	13%	10%	15%	15%	15%	5%	9%	22%	6%	6%	15%	14%
b. PC Games	15,345	18,528	22,310	23,456	24,175	4,075	4,053	4,897	5,515	5,717	5,707	5,111	5,614
%yoy	16%	21%	20%	5%	3%	1%	6%	29%	49%	40%	41%	4%	2%
Online games cash revenue	55,968	64,369	72,448	81,039	90,327	15,941	14,052	18,348	16,027	17,527	16,703	19,967	18,251
%yoy	19%	15%	13%	12%	11%	8%	7%	26%	18%	10%	19%	9%	14%
a. Mobile games	40,241	45,380	49,688	57,141	65,712	11,605	10,132	12,697	10,946	11,726	11,041	14,022	12,900
%yoy	20%	13%	9%	15%	15%	12%	7%	20%	11%	1%	9%	10%	18%
b. PC Games	15,727	18,988	22,760	23,898	24,615	4,336	3,921	5,651	5,080	5,801	5,662	5,945	5,351
%yoy	17%	21%	20%	5%	3%	-1%	8%	43%	35%	34%	44%	5%	5%
2. Youdao	3,168	5,354	4,692	5,655	6,535	1,340	1,293	1,387	1,334	1,201	956	1,207	1,328
%yoy	143%	69%	-12%	21%	16%	147%	108%	55%	21%	-10%	-26%	-13%	0%
a. Learning services	2,155	3,780	2,947	3,566	4,139	999	921	996	864	826	564	777	781
b. Learning products	540	980	1,138	1,446	1,720	202	206	255	318	253	240	280	365
b. Online marketing	473	594	607	644	676	139	166	137	152	121	153	151	182
3. Cloud Music	4,896	6,998	8,796	9,830	10,794	1,491	1,693	1,925	1,889	2,067	2,192	2,330	2,207
%yoy	111%	43%	26%	12%	10%	75%	51%	38%	24%	39%	29%	21%	17%
a. Online music	2,623	3,290	3,767	4,286	4,770	760	845	831	854	885	899	989	994
b. Live streaming	2,273	3,708	5,029	5,544	6,023	732	848	1,093	1,035	1,182	1,293	1,341	1,212
4. Other Innovative business	10,995	12,448	13,680	15,536	17,085	2,704	3,011	2,980	3,753	3,015	3,178	3,329	4,158
%yoy	20%	13%	10%	14%	10%	26%	15%	19%	1%	12%	6%	12%	11%
GP (GAAP)	38,983	46,971	53,048	60,394	67,836	11,053	11,190	11,811	12,918	12,836	12,941	13,070	14,200
Gross Margin	52.9%	53.6%	54.0%	54.6%	55.1%	53.9%	54.5%	53.2%	53.0%	54.5%	55.9%	53.1%	52.9%
Online games	63.7%	64.8%	64.9%	64.9%	64.9%	64.6%	66.1%	64.5%	64.1%	65.1%	67.9%	63.5%	63.5%
Youdao	45.9%	54.3%	50.0%	54.2%	55.0%	57.3%	52.3%	56.6%	50.7%	53.1%	42.8%	52.8%	49.8%
Cloud Music	-12.2%	1.4%	12.8%	19.5%	24.3%	-3.6%	2.4%	1.7%	4.1%	12.2%	13.0%	13.0%	13.0%
EBIT (non-GAAP)	17,182	19,348	22,957	26,271	29,692	4,917	4,458	4,463	5,510	6,231	5,711	5,156	5,859
%yoy	6%	13%	19%	14%	13%	-4%	-8%	26%	52%	27%	28%	16%	6%
%margin	23.3%	22.1%	23.4%	23.8%	24.1%	24.0%	21.7%	20.1%	22.6%	26.5%	24.7%	20.9%	21.8%
Net profit (non-GAAP)	14,706	19,788	20,562	24,085	27,047	5,081	4,242	3,870	6,596	5,118	5,431	4,720	5,293
%yoy	-6%	35%	4%	17%	12%	21%	-19%	5%	313%	1%	28%	22%	-20%
%margin	20.0%	22.6%	20.9%	21.8%	22.0%	24.8%	20.7%	17.4%	27.1%	21.7%	23.5%	19.2%	19.7%

Source: Company data, Goldman Sachs Global Investment Research

Exhibit 14: NetEase: Our 12-month SoTP-based TPs for NTES/9999 HK are US\$121/HK\$189

US\$m	PER 2023E	Valuation	Stake	to NTES	Value per sh	% total value	Comments
Games	17.1 x	73,715	100%	73,715	108	89%	
PC games	12.0 x	18,856	100%	18,856	28	23%	vs. Tencent's SOTP 12x P/E for PC Games
Mobile games	20.0 x	54,859	100%	54,859	80	66%	vs. Tencent's SOTP 22x P/E for Mobile Games
Other businesses		5,073		4,095	6	5%	
Youdao		650	53%	344	1	0%	Market cap
Yanxuan		1,671	100%	1,671	2	2%	JD's TP implied ave 2023E EV/Sales
Advertising		272	100%	272	0	0%	Assuming 1x P/S for legacy business
Cloud Music		1,790	63%	1,119	2	1%	Market cap
CC Live Streaming		323	100%	323	0	0%	Huya's spot price implied 2023E P/S
Email and others		366	100%	366	1	0%	Assuming 1x P/S for legacy business
Total	21.3 x	78,788		77,810	114	94%	
Net cash				12,756	19	15%	Prudent use of cash, through cycle
Dividend paid				885	1	1.1%	
Total valuation	25.1 x			91,451	134	111%	
Holdco. discount			-10%	(9,145)	(13)	-11%	
SOTP (US\$)	22.6 x			82,306	121		
in HK\$				643,634	189		

Note: PC games multiple revised from 10.0x to reflect a faster growth profile.

Source: Company data, Goldman Sachs Global Investment Research

Key risks: **1)** Weaker performance of legacy games; **2)** slower-than-expected monetization ramp-up of new games; **3)** more intensive competition in games, e-commerce, education and other business areas; **4)** rising content costs associated with music and advertising expenses related to the online education business.

Disclosure Appendix

Reg AC

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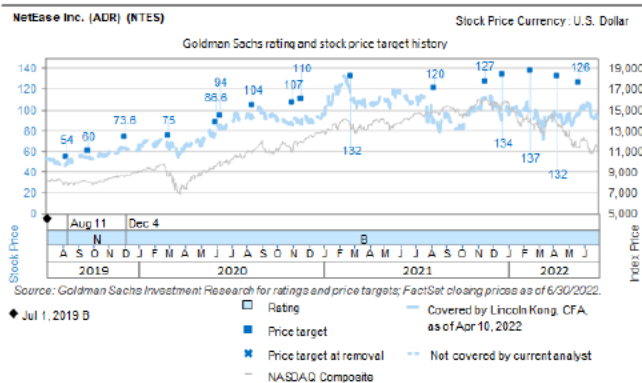
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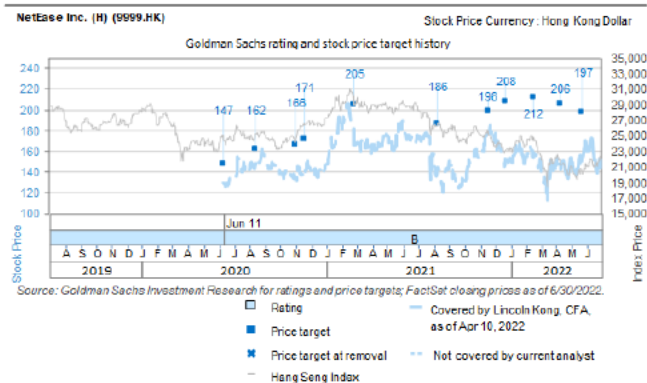
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