

COMPANY RESULTS

NetEase (9999 HK)

1Q24: Results In Line; 2Q24 Game Growth Could Be Better Than Feared

NetEase's 1Q24 results are largely within consensus expectation. Revenue grew 7.2% yoy to Rmb26.9b, in line with our and consensus forecasts. Net profit rose 12.5% yoy to Rmb8.5b, 2% above consensus estimates. We believe Netease's online games revenue growth will be reignited in 2H24 due to the incremental grossing from upcoming game launches and agreement renewal with Blizzard. Maintain BUY with a lower target price of HK\$180.00 (US\$115.00).

1Q24 RESULTS

Year to 31 Dec (Rmbm)	1Q23	4Q23	1Q24	QoQ	YoY	UOBKH	Variance	Cons	Var
Net revenue	25,046	27,140	26,852	(1.1%)	7.2%	26,767	0.3%	26,737	(0.1%)
Online games	20,066	20,921	21,460	2.6%	7.0%	21,384	0.4%		
PC games	5,558	4,875	4,593	(5.8%)	(17.4%)	4,990	(8.0%)		
Mobile games	14,507	16,047	16,868	5.1%	16.3%	16,393	2.9%		
Cloud Music	1,960	1,986	2,030	2.2%	3.6%	2,025	0.2%		
Youdao	1,163	1,481	1,392	(6.0%)	19.7%	1,221	14.0%		
Innovative business	1,858	2,753	1,970	(28.4%)	6.1%	2,137	(7.8%)		
COGS	-10,150	-10,315	-9,836	(4.6%)	(3.1%)	-10,238	(3.9%)	-10,220	(6.7%)
Gross profit	14,897	16,825	17,016	1.1%	14.2%	16,529	2.9%	16,517	4.3%
Non-GAAP OP	8,032	7,666	8,499	10.9%	5.8%	8,951	(5.1%)	7,687	20.3%
Non-GAAP OPM	32.1%	28.2%	31.7%	3.4 ppts	-0.4 ppts	33.4%	-1.8 ppts		
Non-GAAP NPM	7,566	7,379	8,511	15.3%	12.5%	8,431	0.9%	8,327	21.4%
Non-GAAP NPM	30%	27%	32%	4.5 ppts	1.5 ppts	31%	0.2 ppts		

Source: NetEase, UOB Kay Hian

RESULTS

• **Strong mobile game revenue growth.** NetEase's online game revenue delivered decelerated growth of 7% yoy (4Q23: +10%, 1Q23: +8%) to Rmb21.5b, within our expectation, primarily dampened by: a) PC game revenue declining 17% yoy (4Q23: -24%, 1Q23: -10%) to Rmb4.6b, mainly due to the lack of blockbuster games releases and weak seasonality of legacy games despite solid momentum from Racing Master, and b) mobile game revenue growing 16% yoy, vs +27%/16% in 4Q23/1Q23 respectively, contributed by strong grossing of hit games including Eggy Party, Dunk City Dynasty which underwent overseas expansion and Identity V which achieved its record-high DAU in May. Gross margin for online games grew 10ppt yoy to 69.5%, the highest since 1Q15. This is primarily bolstered by increased revenue from Eggy Party. Deferred revenue jumped 14% yoy, the strongest growth since 4Q21, indicating a solid 2Q24 game revenue growth, better than market's bearish expectation on mobile game growth.

• **Improved growth in cloud music and Youdao.** Cloud music revenue grew 3.6% yoy to Rmb2b, supported by solid sales of membership subscriptions. Gross profit margin of the cloud music segment was 38% during 1Q24 (+16ppt yoy) due to one-off adjustment of certain copyright costs and prudent cost control. Youdao recorded an accelerated revenue growth of 20% yoy in 1Q24 (4Q23: +2%; 1Q23: -3%) at Rmb1,392m, propelled by monetisation from digital content services, online marketing services and AI-driven subscription-based membership services. Gross margin of Youdao shrank 3ppt yoy to 49%, with gross profit coming in at Rmb682m in 1Q24, due to increased revenue contribution from online marketing services, which generates lower gross margin. Revenue of the innovative business and others rose by 6% yoy to Rmb2b, dragged by subdued revenue from the e-commerce business from Yanxuan amid low seasonality.

KEY FINANCIALS

Year to 31 Dec (Rmbm)	2022	2023	2024F	2025F	2026F
Net turnover	96,496	103,885	113,228	124,693	137,321
EBITDA	30,137	36,700	40,307	43,956	43,121
Operating profit	27,328	33,890	36,842	41,148	40,375
Net profit (rep./act.)	27,412	35,597	36,231	39,569	36,014
Net profit (adj.)	22,808	32,608	34,993	37,836	40,555
EPS (Fen)	692.0	1,002.7	1,074.2	1,158.6	1,241.8
PE (x)	19.0	13.1	12.2	11.3	10.6
P/B (x)	4.1	3.4	2.9	2.4	2.1
EV/EBITDA (x)	13.1	10.8	9.8	9.0	9.2
Dividend yield (%)	1.4	2.8	2.2	2.4	2.5
Net margin (%)	28.4	34.3	32.0	31.7	26.2
Net debt/(cash) to equity (%)	(3.5)	(4.0)	(21.3)	(33.0)	(41.9)
ROE (%)	27.4	31.1	26.7	24.8	19.3
Consensus net profit	-	-	33,717	37,505	41,605
UOBKH/Consensus (x)	-	-	1.04	1.01	0.97

Source: NetEase, Bloomberg, UOB Kay Hian

BUY

(Maintained)

Share Price	HK\$141.50
Target Price	HK\$180.00
Upside	+27.2%
(Previous TP)	HK\$202.00

COMPANY DESCRIPTION

NetEase, Inc. is a Chinese Internet technology company providing online services centered on content, community, communications, and commerce.

STOCK DATA

GICS sector	Communication Services
Bloomberg ticker:	9999 HK
Shares issued (m):	3,224.8
Market cap (HK\$m):	456,303.6
Market cap (US\$m):	58,438.3
3-mth avg daily t'over (US\$m):	124.7

Price Performance (%)

52-week high/low HK\$183.20/HK\$122.00

1mth	3mth	6mth	1yr	YTD
(2.9)	(16.5)	(22.0)	4.8	0.6

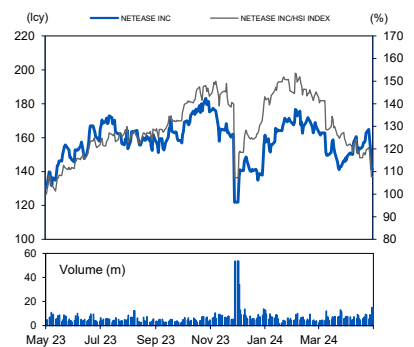
Major Shareholders

Shareholder	%
Lei Ding	43.6
JPMorgan Chase & Co	3.4
BlackRock Inc	2.5

FY24 NAV/Share (Rmb) 45.82

FY24 Net Cash/Share (Rmb) 9.75

PRICE CHART



Source: Bloomberg

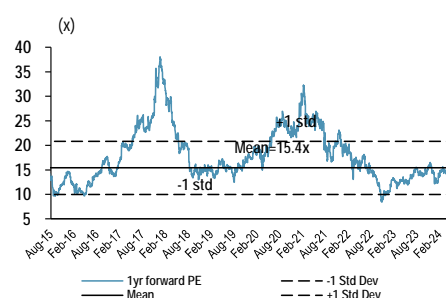
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STOCK IMPACT

- Margin overview.** Gross margin edged up 3ppt to 69.5%. Adjusted operating profit surged 6% yoy to Rmb8.5b, while non-GAAP operating margin remained flattish yoy at 31.7%, pressured by higher S&M expenses especially for Eggy Party due to competition with Tencent's Dream Star launch. S&M spending expanded 3ppt yoy to 15% and R&D expenses rose 11% yoy, attributed to higher staff-related costs. Non-GAAP net profit grew 12.5% yoy to Rmb8.5b, resulting in net margin edging up 1.5ppt yoy to 32%.
- Progress updates on key game titles:** a) Netease plans to publish Raid Shadow Legends in China, a widely popular Western fantasy themed card game and one of the best-selling RPG games in the US; b) Netease is also excited about the potential domestic or overseas launch of Once Human in 3Q24; c) Where Winds Meet, Netease's first AAA-grade, open-world Chinese martial arts game, is set to begin a new round of testing on 31 May and is slated for launch in 3Q24; d) Naraka: Bladepoint mobile has attracted over 30m pre-registrations and accumulated 40m users on the PC version; and e) solid progress of Justice Mobile with planned introductions in more regions.
- To address the disappointing results delivered by Condor Heroes,** Netease is working on modifications by enhancing the fun factor, improving social interactions, and refining the art style. With this, Netease is confident about the release of the updated version during summer vacation.
- Renewal of agreement with Blizzard.** On 10 April, NetEase announced the renewal of its agreement to bring Blizzard titles back to China and expand its collaboration with Microsoft Gaming. By returning to the market during summer 2024, we expect NetEase's PC game revenue growth will be revitalised starting 3Q24. However, we reckon that the online games gross margin will be dragged by increased revenue contribution from Blizzard's game titles.
- Further monetisation by leveraging the ongoing popularity of Eggy Party.** After two years of operation, Eggy Party achieved over 40m daily active users and continues to enhance its content offerings and strengthen its user-generated content (UGC) ecosystem. In 1Q24, Eggy Party expanded its thematic diversity by integrating the grandeur of the Forbidden City into the game and has been well accepted by users. To further support creativity and enrich its UGC ecosystem, NetEase launched an app known as Learn Programming with Eggy Party, which offers engaging and practical coding tutorials within the game, making it easier and enjoyable for players to create content. Meanwhile, NetEase will soon introduce Danzai Huahua, a match-free casual game based on the Eggy Party IP, which has been in development for some time.
- Constant return to shareholders.** The board of directors has approved a dividend of US\$0.0990 per share or US\$0.4950 per American Depositary Share (ADS) for 1Q24 to shareholders. As of 31 Mar 24, NetEase has repurchased shares amounting to US\$811m.

12-MONTH FORWARD PE BAND



Source: Bloomberg, UOB Kay Hian

EARNINGS REVISION/RISK

- We keep our 2Q24 revenue estimate unchanged but trimmed 2024 revenue estimate by 1% which implies revenue growth of 10%/9%, respectively.** We lower our 2Q24 earnings forecast by 2% on softer margin expectations. For 2Q24/2024, we forecast non-GAAP net profit at Rmb8b/Rmb35b, translating to net margin of 30%/31% respectively.
- Risks** include weaker-than-expected performance from new games, and lack of new game approvals for NetEase.

VALUATION/RECOMMENDATION

- Maintain BUY with a lower target price of HK\$180.00 (US\$115.00),** in view of the weaker-than-expected top-line growth. Our target price implies 15.4x 2024F PE. The company is currently trading at 12.8x 2024F PE, lower than its historical mean of 15x.

SHARE PRICE CATALYST

- a) Strong performance of game pipeline, and b) improving profitability of NetEase Cloud Music.**

SOTP VALUATION

	FY2024E revenue (Rmb b)	Net margin	FY2024E non-GAAP earnings	Valuation (2024) PE/PS (x)	Est fair value (Rmb b)	Fair values (HK\$)	Fair value per share (HK\$)
Online games	95	23%	21	16	343	373	115
Cloud music	8			3	25	27	8
Youdao	7			3	12	13	4
Innovative and others	10			1	10	11	3
Total EV					390	424	130
Net Cash					148	162	50
Target price (HK\$)							180.00

Source: UOB Kay Hian

PROFIT & LOSS

Year to 31 Dec (Rmbm)	2023	2024F	2025F	2026F
Net turnover	103,885	113,228	124,693	137,321
EBITDA	36,700	40,307	43,956	43,121
Deprec. & amort.	2,810	3,465	2,808	2,746
EBIT	33,890	36,842	41,148	40,375
Total other non-operating income	921	641	400	400
Associate contributions	1,307	1,224	1,224	1,224
Net interest income/(expense)	4,120	4,622	4,622	4,642
Pre-tax profit	40,238	43,328	47,393	46,641
Tax	(4,700)	(6,712)	(7,477)	(10,261)
Minorities	59	(385)	(348)	(366)
Net profit	35,597	36,231	39,569	36,014
Net profit (adj.)	32,608	34,993	37,836	40,555

CASH FLOW

Year to 31 Dec (Rmbm)	2023	2024F	2025F	2026F
Operating	35,331	37,456	36,972	38,379
Pre-tax profit	40,238	43,328	47,393	46,641
Tax	(4,700)	(6,712)	(7,477)	(10,261)
Deprec. & amort.	2,810	3,465	2,808	2,746
Working capital changes	(100)	2,380	104	(747)
Other operating cashflows	(2,917)	(5,005)	(5,857)	0
Investing	1,356	(2,265)	(2,494)	(2,746)
Capex (growth)	(1,489)	(2,265)	(2,494)	(2,746)
Others	2,845	0	0	0
Financing	(17,544)	(8,841)	(8,841)	(8,841)
Dividend payments	(8,841)	(8,841)	(8,841)	(8,841)
Issue of shares	8,833	0	0	0
Loan repayment	(1,628)	0	0	0
Others/interest paid	(15,908)	0	0	0
Net cash inflow (outflow)	19,143	26,351	25,638	26,791
Beginning cash & cash equivalent	27,588	24,206	50,557	76,195
Changes due to forex impact	(203)	0	0	0
Ending cash & cash equivalent	24,206	50,557	76,195	102,987

BALANCE SHEET

Year to 31 Dec (Rmbm)	2023	2024F	2025F	2026F
Fixed assets	8,075	6,875	6,560	6,561
Other LT assets	35,157	35,157	35,157	35,157
LT debt	n.a.	n.a.	n.a.	n.a.
Cash/ST investment	24,206	50,557	76,195	102,987
Other current assets	118,486	118,012	119,566	122,277
Total assets	185,925	210,601	237,479	266,982
ST debt	19,240	19,240	19,240	19,240
Other current liabilities	34,602	36,508	38,166	40,130
Other LT liabilities	3,998	3,998	3,998	3,998
Shareholders' equity	124,402	147,172	172,392	199,931
Minority interest	3,683	3,683	3,683	3,683
Total liabilities & equity	185,925	210,601	237,479	266,982

KEY METRICS

Year to 31 Dec (%)	2023	2024F	2025F	2026F
Profitability				
EBITDA margin	35.3	35.6	35.3	31.4
Pre-tax margin	38.7	38.3	38.0	34.0
Net margin	34.3	32.0	31.7	26.2
ROA	19.8	18.3	17.7	14.3
ROE	31.1	26.7	24.8	19.3
Growth				
Turnover	7.7	9.0	10.1	10.1
EBITDA	21.8	9.8	9.1	(1.9)
Pre-tax profit	25.9	7.7	9.4	(1.6)
Net profit	29.9	1.8	9.2	(9.0)
Net profit (adj.)	43.0	7.3	8.1	7.2
EPS	44.9	7.1	7.9	7.2
Leverage				
Debt to total capital	13.1	11.3	9.9	8.6
Debt to equity	15.5	13.1	11.2	9.6
Net debt/(cash) to equity	(4.0)	(21.3)	(33.0)	(41.9)

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