

T. H. Data Flash - NetEase, Inc. – December & 4Q19

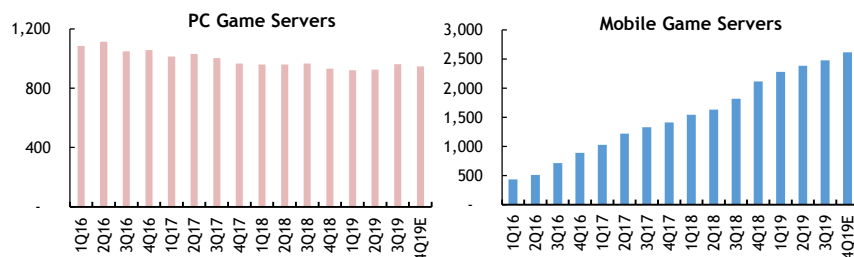
February 10, 2020

Finalized Streamlining Its Businesses; Focusing On Core Business May Lead To Better Margin; Maintain Buy And Raise Price Target

While China is experiencing an outbreak of the coronavirus, which is going to have significant impact on China's economy, we are positive on NTES's business outlook. One thing that came out of the outbreak is that the internet has become a mainstream channel for many businesses, including online education and remote telecommuting. For NTES, its online games and online education are benefiting from the nationwide self-confinement and delayed school opening schedules. We are positive on NTES's 4Q performance. In 4Q19, the company finalized its efforts to streamline its business. NTES sold Kaola to BABA (BABA, \$212.73 - Intraday, Buy) by the end of 3Q19, its music entity received a \$700M investment from Alibaba, and Youdao (DAO, \$23.95 - Intraday, Not Rated) IPOed in early October 2019. The company is now focusing on its core business of online games. As a result, we expect NTES's margin to recover in 4Q19 and 2020. At the same time, in recent months NTES published several new hit games, including *Xuanyuan Sword* and *Fantasy Westward Journey 3D*, both of which were contributing to better topline growth. Based on our data and model, NTES's 4Q19 revenue is likely to be higher than the Street consensus at RMB15,294M. We maintain our Buy rating.

- The number of servers for mobile games was up driven by new games** – In 4Q19, NetEase had 2,614 mobile game servers, up from 2,474 in 3Q19, including 957 iOS system servers, 1,028 Android system servers, and 629 interflow servers (supporting both systems) (*Figure 1*). New games, *Xuanyuan Sword* and *Fantasy Westward Journey 3D*, were contributing to the growth of mobile servers. The number of NetEase PC game servers was 947, down from 962 in 3Q19, mainly due to the server reduction of *Fantasy Westward Journey II* (*Figure 1*). The ACU of NetEase PC game was 2.1M, up 7.2% Y/Y, driven by the new version of *WoW* (*Figure 2*).
- Youdao course offerings** - In 4Q19, the number of Youdao course offerings was 1,742, flat with 3Q19. K-12 courses were ~50% of the offerings and subjects for K-12 also accounted for 50% of the total (*Figure 3*).
- Please refer to page 2 for a discussion of valuation and risks.**

Figure 1: NTES - Game Servers: PC Game (top), Mobile Game (bottom) 1Q16 – 4Q19E



Source: T.H. DATA (www.thdata.com)

NTES: BUY

Price: \$351.08 (Intraday)

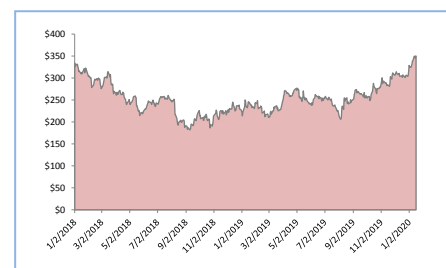
Target Price: \$380.00 (was \$310.00)

52 Week Range:	\$209.01 - \$354.94
Market Cap:	\$45.4B
Avg. Daily Vol. (100 day):	704,575
3-Yr. Est. Rev. CAGR:	9%
Net cash per share:	~\$48.00

FY (Dec)	2018A	2019E	2020E
Q1	14,173A	13,793A	15,337E
Q2	16,284A	14,448A	16,517E
Q3	16,855A	14,636A	17,417E
Q4	19,844A	15,027E	18,494E
FY Revenue	67,157A	57,903E	67,765E
Q1	10.11A	23.34A	25.07E
Q2	20.87A	30.19A	26.77E
Q3	17.50A	36.32A	27.85E
Q4	18.32A	22.71E	30.18E
EPS*	66.80A	112.56E	109.87E
P/E	36.1x	21.4x	21.9x

*Non-GAAP EPS

All figures in RMB millions unless otherwise noted



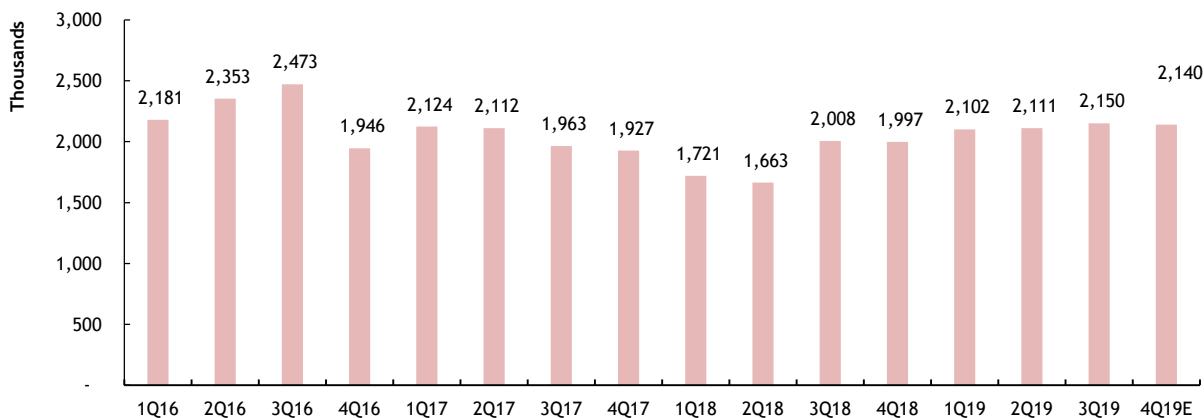
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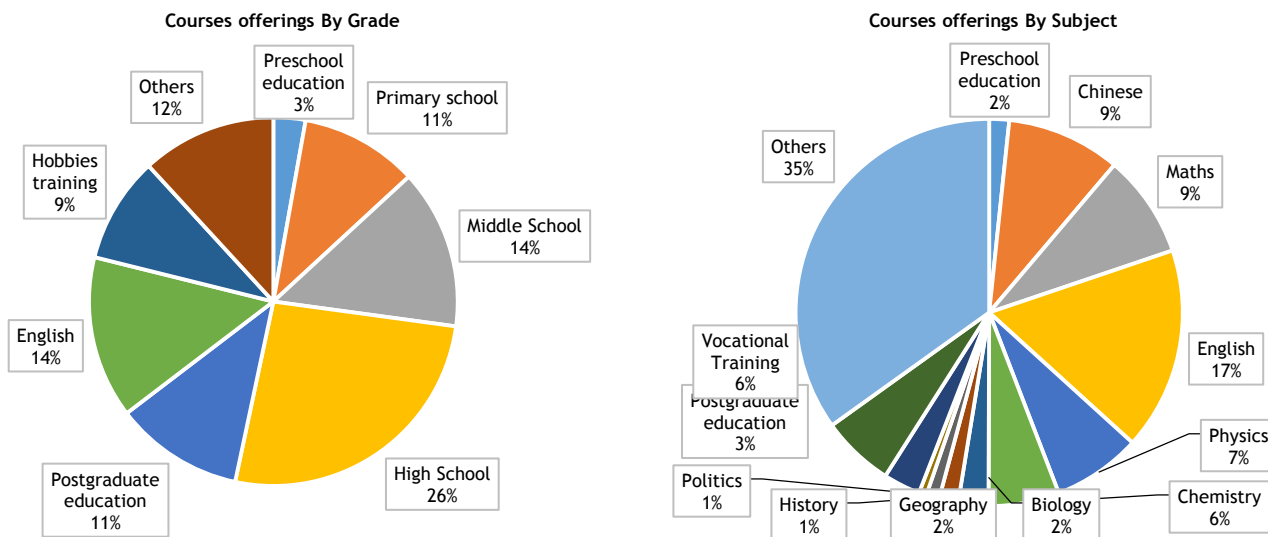
- Maintain Buy rating** – We maintain our Buy rating and raise our price target from \$310.00 to \$380.00, which is based on a 21.8X PE multiple to our new 2021E non-GAAP EPS estimate of \$17.46. Since the company is refocused on its core business mainly games as well as margins, we believe our EPS projection for 2021E at \$17.46 is likely to be conservative. Our prior price target of \$310.00 was based on a 21.3X PE multiple to our previous 2020E non-GAAP EPS estimate of \$14.56.
- Risks to our price target** – 1) Failure to launch new hit mobile games in a timely fashion; 2) The growth of mobile games and mobile initiatives are slower than expected; 3) Intense competition in mobile games, mobile app products and recruiting users; and 4) Slowdown in China’s economy.

Figure 2: NTES - PC Game ACUs, 1Q16 – 4Q19E



Source: T. H. DATA (www.thdata.com)

Figure 3: Youdao – Course Offerings by Grade (LHS) and Subject (RHS), 4Q19E



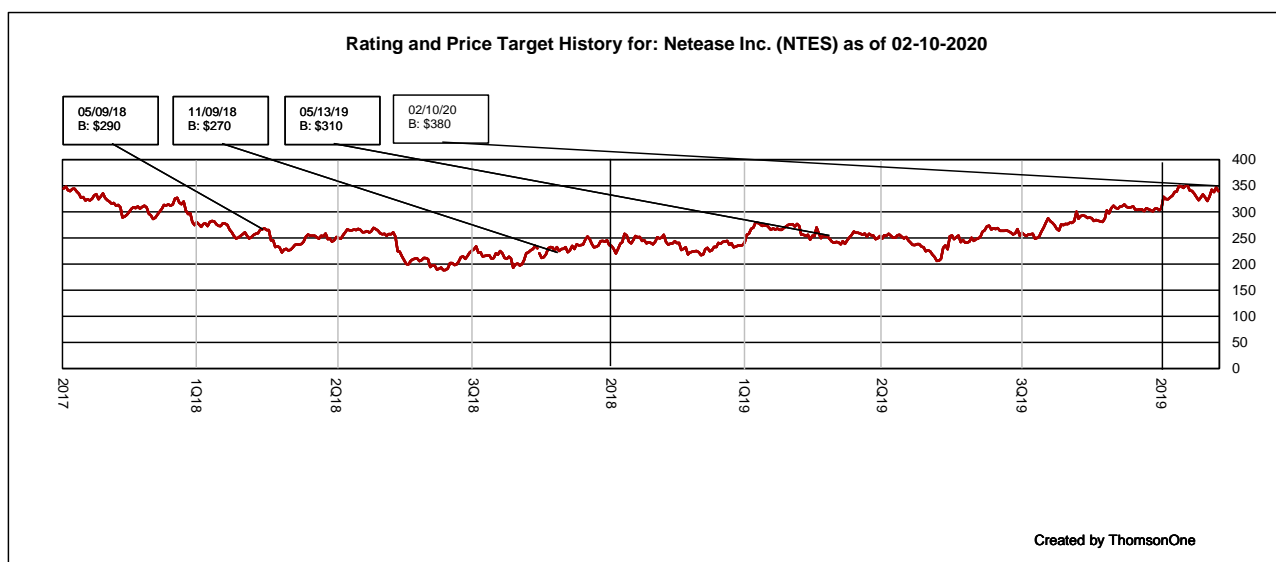
Source: T. H. DATA (www.thdata.com)

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