

NetEase, Inc.

November 9, 2017

Stronger eCommerce in 3Q17 to Drive Topline; New Games Launched in Early November Bring Popularity; LT Margins May be Impacted by Higher Investment in E-Commerce; Maintain BUY

NTES: BUY
Price: \$310.79 (Intraday)
Target Price: \$330.00

NTES will report 3Q17 results on Wednesday, November 15th after the close of the market followed by an 8pm EST conference call. Based on our data for 3Q17, we believe NTES's 3Q revenue is likely to be better than consensus at \$1,890.6M (RMB12,550M) driven by better ecommerce while the game business was a bit soft. In 4Q17, we expect the company's game business to improve along with higher seasonality for ecommerce business. Going forward, we believe NTES may make significant investments in e-commerce, which will bring down its operating as well as net margin. We maintain our Buy rating as we believe in NTES's long term growth and game development capability.

52 Week Range:	\$211.11 - \$337.55
Market Cap:	\$41.4B
Avg. Daily Vol. (100 day):	1,37795
3-Yr. Est. Rev. CAGR:	62%
Net cash per share:	\$43.00

- Two new Battle Royal mobile games launched in Nov. 2017** – The two games, 荒野行动 was launched on November 3rd and 终结者2 on November 4th. Since launch, they have been on the top of download ranks, pushing *Honor of Kings*, which used to be the most popular game, to number 3 in terms of rank. While we are excited about the games, we have seen several companies release similar battle royal mobile games. XiaoMi launched 小米枪战 on May 3, 2017, and Tencent (700.HK, HK\$387.80, Not Rated) did a soft release of the mobile game on November 8th with plans for a hard launch later. At this point, these games are free to download and play, with no in-game purchases at this point. In the future, in-game items may be set up for purchase. For now, these mobile games have received high DAUs, but no revenue.
- Expect 3Q17 revenue to be slightly better than consensus** – According to our proprietary data, the number of NetEase game servers was 2,392 (+35.8% Y/Y, +3.8% Q/Q), of which mobile game servers were 1,386 (+94.7% Y/Y, +8.7% Q/Q) and PC-client game servers were 1,006 (-4.1% Y/Y, -2.3% Q/Q) in 3Q17 (Figure 1). Also, in 3Q17, the popularity level of NTES's games decreased 23% Q/Q, mainly due to the declines in *Westward Journey* and *Onmyoji* (Figure 2 and Figure 3). Based on our calculations, NTES's revenue is likely to be slightly better than consensus at RMB12,550 (36% Y/Y growth).
- Please refer to page 2 for a discussion of valuation and risks.**

FY (Dec)	2016A	2017E	2018E
Q1	\$1,227.6A	\$1,981.7A	\$2,266.2E
Q2	\$1,347.1A	\$1,973.1A	\$2,476.3E
Q3	\$1,381.4A	\$2,015.6E	\$2,654.9E
Q4	<u>\$1,742.6A</u>	<u>\$2,154.9E</u>	<u>\$2,864.2E</u>
FY Revenue	\$5,698.7A	\$8,125.2E	\$10,261.6E
Q1	\$2.88A	\$4.29A	\$4.34E
Q2	\$3.10A	\$3.31A	\$3.87E
Q3	\$3.11A	\$2.92E	\$4.32E
Q4	<u>\$4.01A</u>	<u>\$3.33E</u>	<u>\$6.41E</u>
FY GAAP EPS	\$13.10A	\$13.85E	\$18.94E
P/E	23.7x	22.4x	16.4x

All figures in millions unless otherwise noted

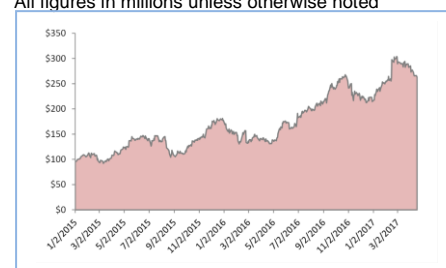
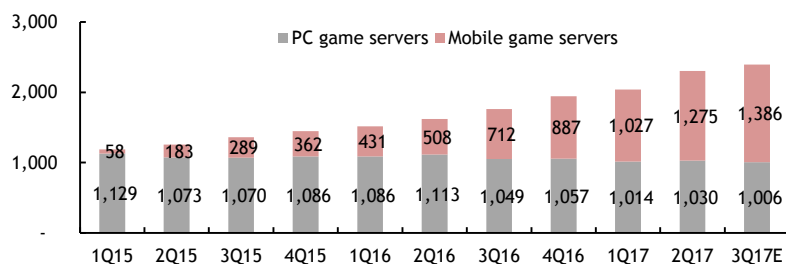


Figure 1: Total Number of Servers by PC and Mobile Games, 1Q15 – 3Q17E



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

For details of our data services, please visit www.thdata.com or contact any person listed below.

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- **Maintain Buy rating and price target** – We maintain our Buy rating and our price target of \$330.00, which is based on a 13.4X PE multiple to our new 2018E non-GAAP EPS estimate of \$21.34 plus ~\$46.00 net cash.
- **Risks to our price target** – 1) E-commerce is not NTES's area of expertise and it may hurt the margin; 2) Failure to launch new hit mobile games in a timely fashion; 3) The growth of mobile games and mobile initiatives are slower than expected; 4) Intense competition in mobile games, mobile app products and recruiting users; and 5) Slowdown in China's economy.

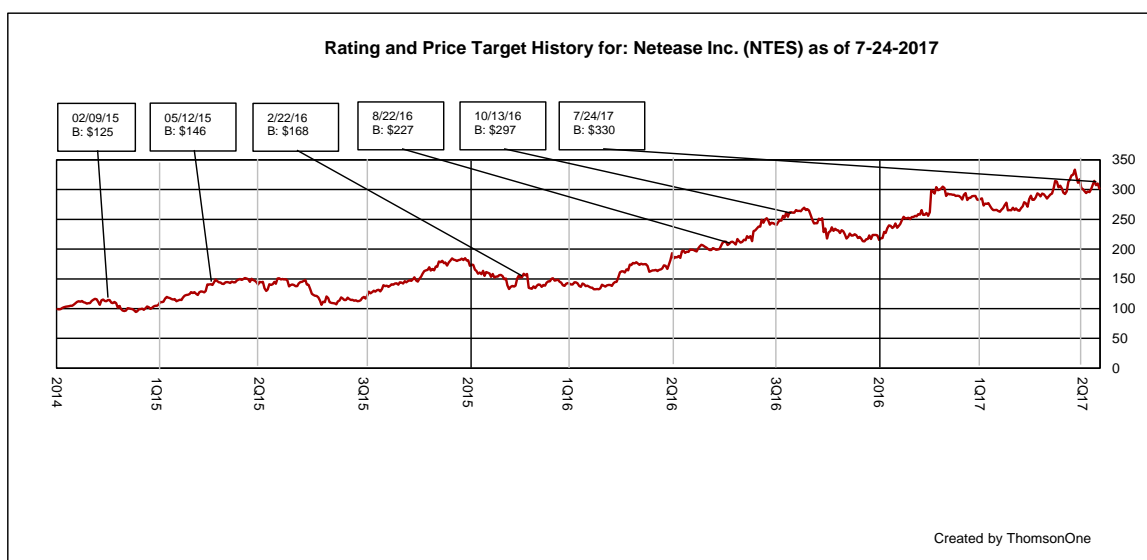
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