

Netease.com ----- **Maintain NEUTRAL**

3Q06 results: profit in line, but revenue below guidance; weak 4Q06 outlook

EPS: ▼ TP: ▼

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- 3Q06 dil. EPS were US\$0.286, up 7% QoQ, in line with consensus. But both online game and ad business were below guidance. Net profit was US\$39.8 mn or RMB314.8 mn, flat against 2Q06, yet in line with guidance owing to cost control and a lower effective tax rate.
- Online game revenue was down 4% QoQ, below guidance, as Fantasy ACU was down 5% QoQ, WJ2 down 12% QoQ due to in-game protest and seasonality. Fantasy will be stabilised but the game passed the peak already. NetEase will launch WJ3 in 3Q07, and will migrate WJ2 gamers to WJ3. Finally, Tianxia will be launched on open beta test in Dec 06. Despite weak brand ad revenue, management remains positive on brand ad business. We forecast NetEase brand ad revenue growth at 29% YoY in 2007.
- 4Q profit guidance implied 14-19% QoQ decline. We cut our 07 dil. EPS estimate by 3% and our target price from US\$18 to US\$17. Trading at 12.5x ex-cash PER, valuation is undemanding. We maintain our NEUTRAL rating. Tianxia open beta test performance in Dec 06 is critical to NetEase share price in next few months.

Weak game business outlook; spotlight on new games

Online game revenue was down 4% QoQ, below guidance but 1% above our forecast as Fantasy ACU was down 5% QoQ, WJ2 down 12% QoQ, whereas Datang contributed less than 2% of game revenue. Fantasy poor performance (over 70% of game revenue) is due to in-game protest and seasonality in Sep, but was rebounded by double digit in Oct. Fantasy expansion pack was delayed and will be launched in Dec 06. We expect Fantasy performance to stabilize but the game passed the peak already. Also, NetEase will launch a new game WJ3 (previously WJ2 upgrade version) in 3Q07, and expects to migrate WJ2 gamers to WJ3. We therefore expect WJ2 life will be cut from 7 to 6 year, and WJ3 will have a 3-year game life and attract 40,000 ACU in the first month of operation in Jul 07. Finally, Tianxia should be launched on open beta test in Dec 06.

Ad revenue was up 21% QoQ, but below guidance, as management has terminated several SMEs advertising contracts and paid search revenue down by around 12% QoQ. Management is improving content, revamping portal front page and is positive on brand ad business. We forecast NetEase brand ad revenue growth at 29% YoY in 2007.

Bbg/RIC	NTES US / NTES.OO	Price (7 Nov 06, US\$)	16.13		
Rating (prev. rating)	N (N) [V]	TP (US\$) (prev. TP)	17.00 (18.00)		
Shares outstanding (mn)	3,114.96	Est. pot. % chg. to TP	5		
Daily trad vol-6m avg (mn)	0.9	52-wk range (US\$)	24.80 - 14.04		
Daily trad val-6m avg (US\$ mn)	45.9	Mkt cap (US\$ mn)	2,009.8		
Free float (%)	50.0	Performance	1M 3M 12M		
Major shareholders	William Ding	Absolute	(2.9) (13.6) (20.6)		
		Relative	(11.6) (26.2) (49.2)		
Year	12/04A	12/05A	12/06E	12/07E	12/08E
Revenues (RMB mn)	904	1,612	2,129	2,380	2,824
EBITDA (RMB mn)	474	1,018	1,422	1,426	1,613
Net profit (RMB mn)	441.4	932.0	1,194.0	1,166.1	1,312.9
EPS (RMB)	0.13	0.26	0.34	0.35	0.39
- Change from prev. EPS (%)	n.a.	n.a.	0	-3	-5
- Consensus EPS (RMB)	n.a.	n.a.	0.36	0.40	0.44
EPS growth (%)	31.4	106.8	31.0	0.9	12.6
P/E (x)	40.2	19.4	14.8	14.7	13.1
Dividend yield (%)	0.0	0.0	0.0	1.5	1.7
EV/EBITDA (x)	5.3	3.0	2.1	1.2	0.4
P/B (x)	12.0	6.9	6.3	4.2	3.2
ROE (%)	32.6	39.0	47.8	31.0	27.9
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

Note 1: Ord/ADR=0.04. Note 2: NetEase is a leading online game operator and developer in China with over 80% of revenue generated from online games. Also, NetEase is one of the top three general portals in China and provides WVAS to mobile phone users.. Note 3: EPS = Diluted EPS; Net profit = Reported net profit

Profit in line, but revenue below guidance

3Q06 dil. EPS were US\$0.286, up 7% QoQ, in line with the consensus, 5% higher than our forecast. Gross revenue was US\$72.4 mn, below guidance, as both online game and advertising business were below guidance. Gross profit was RMB448 mn, down 2% QoQ, but 1% above guidance. As online game margin was down from 91% in 2Q to 89% in 3Q, operating margin (net) was down from 58.5% in 2Q to 57.7% in 3Q, despite operating expenses (down 2% sequentially). Net profit was US\$39.8 mn or RMB314.8 mn, flat against 2Q06, in line with guidance at US\$39.0-40.5 mn, and 6% above our forecast as effective tax rate was down from 9.5% in 2Q to 8.2% in 3Q. Net cash was US\$374 mn or US\$2.68 per share after US\$17 mn share repurchase in 3Q.

Figure 1: 3Q06 results summary and 4Q06E results forecast

(RMB mn)	2Q06A	3Q06A	QoQ (%)	3Q06E	Act./Est.	4Q06E
WVAS & others	19.7	19.9	1%	20.5	-3%	19.9
Online game services	470.0	452.5	-4%	446.9	1%	430.8
Advertising	62.9	76.3	21%	80.9	-6%	68.4
Total revenue	552.6	548.6	-1%	548.3	0%	519.1
Gross profit	457.4	448.1	-2%	444.5	1%	409.9
Operating profit	323.0	316.7	-2%	311.3	2%	272.2
Net profit	314.1	314.8	0%	298.1	6%	271.5
EPS (US\$) (dil.)	0.27	0.29	7%	0.27	5%	0.24
Net margin (%)	57%	57%		57%		52%

Source: Company data, Credit Suisse estimates.

Short-term price pressure; undemanding valuation

4Q profit guidance at US\$32.3-34.3 mn implied 14-19% QoQ decline. As such, we have cut NetEase 07 dil. EPS by 3%. And target price was cut from US\$18.0 to US\$17.0. Share price could be under pressure due to the weak 4Q guidance. Trading at 12.5x ex-cash P/E and 7% free cash flow yield, valuation is undemanding. We maintain our NEUTRAL rating on NetEase. Tianxia open beta test performance in Dec 06 is critical to NetEase share price in the next few months.

Figure 2: Key changes in earning estimate

(RMB mn)	FY06 forecast			FY07 forecast		
	Old	New	Chg. %	Old	New	Chg. %
WVAS & others	78	77	-2%	108	102	-6%
Online game services	1,814	1,789	-1%	2,056	1,948	-5%
Advertising	277	264	-5%	354	331	-7%
Total revenue	2,169	2,129	-2%	2,519	2,380	-6%
Gross profit	1,764	1,736	-2%	1,914	1,824	-5%
Operating profit	1,241	1,219	-2%	1,266	1,196	-6%
Net profit	1,195	1,194	0%	1,200	1,166	-3%
EPS (US\$) (dil.)	1.08	1.08	0%	1.12	1.09	-3%
Operating margin (%)	59%	57%		57%	50%	
Net margin (%)	56%	56%		52%	49%	

Source: Company data, Credit Suisse estimates.

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Companies Mentioned (*Price as of 07 Nov 06*)
 Netease.com (NTES.OQ, \$16.13, NEUTRAL [V], TP \$17.00, OVERWEIGHT)

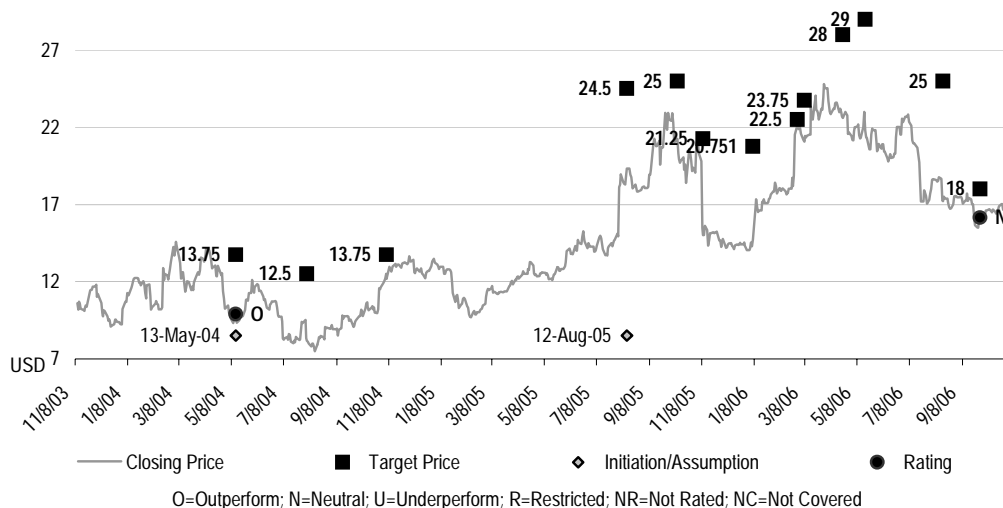
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3-Year Price, Target Price and Rating Change History Chart for NTES.OQ



NTES.OQ Date	Closing Price Price (US\$)	Target Price Price (US\$)	Rating	Initiation/Assumption
5/13/04	9.905	13.75	OUTPERFORM	X
8/4/04	8.173	12.5		
11/5/04	12.19	13.75		
8/12/05	19.338	24.5		X
10/10/05	21.245	25		
11/9/05	15.018	21.25		
1/6/06	14.72	20.751		
2/27/06	22.168	22.5		
3/7/06	21.07	23.75		
4/21/06	22.61	28		
5/17/06	21.8	29		
8/16/06	17.22	25		
9/28/06	16.14	18	NEUTRAL	

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Price Target: (12 months) for (NTES.OQ)

Method: Our discounted cash flow (DCF) analysis, based on an estimated 13.34% cost of capital and a 4.0% terminal growth rate, supports our US\$17.0 target price for NetEase. At US\$17.0, NetEase would trade at 15.8x times our 2006 diluted earnings per ADS estimate of US\$1.08, versus an average price-to-earnings multiple of 32.9 for the peer group, or at an enterprise value to earnings before interest, taxes, depreciation and amortization multiple of 10.0, versus the group's 22.6.

Risks: The risks that may impede achievement of our US\$17.0 target price are: (1) potential implementation of anti-fatigue system and other government policy in the online game sector, (2) intensifying competition and (3) potential disappointment on new games demand. We have analyzed a possible downside case in which we assume NetEase all new games can only fulfil 50% of our forecast. The stock price on the downside is US\$1.25, or approximately 8% below the current price. Naturally, there is the risk that the future game demand is even lower than 50% of our forecast and even government may suspend operation of all online games. In this case, the value of NetEase would drop more than we have modeled. We believe this scenario is unlikely given strong R&D capability of NetEase and government supportive policy on software development in China.

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