



Commission file number: 000-30666

**NETEASE, INC.**

(Exact name of Registrant as specified in its charter)

**N/A**

(Translation of Registrant's name into English)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**Building No. 7, West Zone,**

**Zhongguancun Software Park (Phase II),**

**No. 10 Xibeiwang East Road, Haidian District**

**Beijing 100193, People's Republic of China**

(Address of principal executive offices)

**Charles Zhaoxuan Yang**

**NetEase Building, No. 599 Wangshang Road**

**Binjiang District, Hangzhou, 310052**

**People's Republic of China**

**Phone (86 571) 8985-2070**

**Facsimile (86 571) 8738-1002**

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

**American Depositary Shares, each representing 25 ordinary shares, par value US\$0.0001 per share,**

**NASDAQ Global Select Market**

(Title of Each Class and Name of Each Exchange on Which Registered)

Securities registered or to be registered pursuant to Section 12(g) of the Act:

**NONE**

(Title of Class)

# Edgar Filing: NetEase, Inc. - Form 20-F

## Table of Contents

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

**NONE**  
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

3,199,018,406 ordinary shares, par value US\$0.0001 per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or (15) (d) of the Securities Exchange Act of 1934.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Emerging growth company

Edgar Filing: NetEase, Inc. - Form 20-F

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

The term new or revised financial accounting standard refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after April 5, 2012.

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financial Reporting Standards as issued  
by the International Accounting Standards Board

Other

If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes  No

---

Table of Contents

## TABLE OF CONTENTS

	<b>Page</b>
<u>INTRODUCTION</u>	1
<u>PART I</u>	1
<u>Item 1.</u>	1
<u>Item 2.</u>	1
<u>Item 3.</u>	2
<u>Item 4.</u>	28
<u>Item 4A.</u>	57
<u>Item 5.</u>	57
<u>Item 6.</u>	85
<u>Item 7.</u>	92
<u>Item 8.</u>	99
<u>Item 9.</u>	100
<u>Item 10.</u>	100
<u>Item 11.</u>	112
<u>Item 12.</u>	113
<u>PART II</u>	114
<u>Item 13.</u>	114
<u>Item 14.</u>	114
<u>Item 15.</u>	114
<u>Item 16A.</u>	114
<u>Item 16B.</u>	114
<u>Item 16C.</u>	115
<u>Item 16D.</u>	115
<u>Item 16E.</u>	116
<u>Item 16F.</u>	116
<u>Item 16G.</u>	116
<u>Item 16H.</u>	116
<u>PART III</u>	116
<u>Item 17.</u>	116
<u>Item 18.</u>	116
<u>Item 19.</u>	117

Table of Contents

**INTRODUCTION**

This annual report on Form 20-F includes our audited consolidated financial statements as of December 31, 2017 and 2018 and for the years ended December 31, 2016, 2017 and 2018. Translations in this annual report of amounts from RMB into U.S. dollars for the convenience of the reader were calculated at the noon buying rate of US\$1.00: RMB6.8755 on the last trading day of 2018 (December 31, 2018) as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. References to "China" and "PRC" are to the People's Republic of China, excluding, for the purposes of this annual report only, Hong Kong, Macau and Taiwan.

**Forward-Looking Information**

This annual report on Form 20-F contains statements of a forward-looking nature. These statements are made under the "safe harbor" provisions of the U.S. Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements by terminology such as "will," "expects," "anticipates," "future," "intends," "plans," "believes," "estimates" and similar statements. The accuracy of these statements may be impacted by a number of business risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, including risks related to:

- the risk that the online game market, including mobile games and PC-client games, will not continue to grow or that we will not be able to maintain our leading position in that market, which could occur if, for example, our new online games or expansion packs and other improvements to such existing games do not become as popular as management anticipates;
- the risk that we will not be successful in our product diversification efforts, including our focus on item-based games and mobile games, entry into strategic licensing arrangements, and expansion of our mobile Internet and e-commerce offerings;
- the risk of changes in Chinese government regulation of the online game or e-commerce markets that limit future growth of our revenues or cause our revenues to decline;
- the risk that we may not be able to continuously develop new and creative online services or that we will not be able to set, or follow in a timely manner, trends in the market;
- the risk that the e-commerce market or the Internet advertising market in China will not continue to grow and will remain subject to intense competition and the risk that investments by us in our e-commerce platforms and related services or in our advertising content and services may not increase the appeal of our websites, e-commerce platforms or mobile applications among users or result in increased e-commerce or advertising revenues;

- the risk that we will not be able to control our expenses in future periods;
- governmental uncertainties (including possible changes in the effective tax rates applicable to us and our subsidiaries and affiliates and our ability to receive and maintain approvals of the preferential tax treatments), general competition and price pressures in the marketplace;
- the risk that fluctuations in the value of the Renminbi with respect to other currencies could adversely affect our business and financial results; and
- other risks outlined in our filings with the Securities and Exchange Commission, or the SEC.

We do not undertake any obligation to update this forward-looking information, except as required under applicable law.

## **PART I**

### **Item 1. Identity of Directors, Senior Management and Advisors**

Not applicable.

### **Item 2. Offer Statistics and Expected Timetable**

Not applicable.

Table of Contents**Item 3. Key Information****A. Selected Financial Data**

The following table presents the selected consolidated financial information for our business. You should read the following information in conjunction with Item 5 Operating and Financial Review and Prospects below. The following data for the years ended December 31, 2016, 2017 and 2018 and as of December 31, 2017 and 2018 have been derived from our audited consolidated financial statements for those years, which were prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP, and should be read in conjunction with those statements, which are included in this annual report beginning on page F-1. The following data for the years ended December 31, 2014 and 2015 and as of December 31, 2014, 2015 and 2016 have been derived from our audited consolidated financial statements for those years, which were prepared in accordance with U.S. GAAP and are not included in this annual report.

	2014 RMB	2015 RMB	For the year ended December 31,		2018 RMB	2018 US\$
			2016 RMB	2017 RMB		
			(in thousands, except per share/ADS data)			
<b>Statement of Operations and Comprehensive Income Data:</b>						
Total net revenues	11,712,834	22,802,895	38,178,844	54,102,019	67,156,453	9,767,501
Cost of revenues	(3,261,544)	(9,399,260)	(16,515,032)	(28,189,326)	(38,752,957)	(5,636,384)
Gross profit	8,451,290	13,403,635	21,663,812	25,912,693	28,403,496	4,131,117
Operating expenses:						
Selling and marketing expenses	(1,894,998)	(2,958,229)	(4,481,815)	(6,957,596)	(9,526,470)	(1,385,568)
General and administrative expenses	(467,669)	(1,014,395)	(1,506,154)	(2,429,858)	(3,191,537)	(464,190)
Research and development expenses	(1,323,498)	(2,158,888)	(3,046,979)	(4,371,428)	(7,792,550)	(1,133,379)
Total operating expenses	(3,686,165)	(6,131,512)	(9,034,948)	(13,758,882)	(20,510,557)	(2,983,137)
Operating profit	4,765,125	7,272,123	12,628,864	12,153,811	7,892,939	1,147,980
Other income (expenses):						
Investment income	27,373	62,341	200,333	362,113	(22,266)	(3,238)
Interest income	601,502	596,930	541,969	667,323	587,518	85,451
Exchange (losses)/gains	(17,998)	133,776	146,510	(448,827)	(113,323)	(16,482)
Other, net	82,438	45,138	377,685	277,080	599,230	87,154
Income before tax	5,458,440	8,110,308	13,895,361	13,011,500	8,944,098	1,300,865
Income tax	(662,735)	(1,273,408)	(2,102,498)	(2,162,363)	(2,466,681)	(358,764)
Net income	4,795,705	6,836,900	11,792,863	10,849,137	6,477,417	942,101
Add: Accretion and deemed dividends in connection with repurchase of redeemable noncontrolling interests					(248,098)	(36,084)
Net income attributable to noncontrolling interests and redeemable noncontrolling interests	(39,082)	(101,792)	(188,343)	(141,198)	(76,912)	(11,186)
	4,756,623	6,735,108	11,604,520	10,707,939	6,152,407	894,831



## Edgar Filing: NetEase, Inc. - Form 20-F

Net income attributable to NetEase, Inc.'s shareholders						
Net income	4,795,705	6,836,900	11,792,863	10,849,137	6,477,417	942,101
Other comprehensive income		27,452	34,027	(24,894)	18,624	2,709
<b>Total comprehensive income</b>	<b>4,795,705</b>	<b>6,864,352</b>	<b>11,826,890</b>	<b>10,824,243</b>	<b>6,496,041</b>	<b>944,810</b>
Add: Comprehensive income attributable to noncontrolling interests and redeemable noncontrolling interests						
	(39,082)	(101,792)	(188,343)	(141,198)	(76,912)	(11,186)
<b>Comprehensive income attributable to NetEase, Inc.'s shareholders</b>	<b>4,756,623</b>	<b>6,762,560</b>	<b>11,638,547</b>	<b>10,683,045</b>	<b>6,419,129</b>	<b>933,624</b>
Net income attributable to NetEase, Inc.'s shareholders per share, basic						
	1.46	2.05	3.54	3.25	1.90	0.28
Net income attributable to NetEase, Inc.'s shareholders per share, diluted						
	1.45	2.04	3.51	3.23	1.89	0.27
Net income attributable to NetEase, Inc.'s shareholders per ADS, basic						
	36.43	51.27	88.40	81.36	47.54	6.91
Net income attributable to NetEase, Inc.'s shareholders per ADS, diluted						
	36.29	50.94	87.72	80.74	47.26	6.87
Weighted average number of ordinary shares outstanding, basic						
	3,264,450	3,284,382	3,281,729	3,290,312	3,235,324	3,235,324
Weighted average number of ADS outstanding, basic						
	130,578	131,375	131,269	131,612	129,413	129,413
Weighted average number of ordinary shares outstanding, diluted						
	3,277,049	3,305,213	3,307,109	3,315,478	3,254,689	3,254,689
Weighted average number of ADS outstanding, diluted						
	131,082	132,209	132,284	132,619	130,188	130,188
Share-based compensation cost included in:						
Cost of revenues	169,621	328,480	444,187	820,281	764,972	111,261
Selling and marketing expenses	23,253	36,023	52,689	95,382	116,611	16,960
General and administrative expenses	51,475	120,925	238,750	581,337	804,565	117,019
Research and development expenses	104,928	199,039	254,505	507,263	843,502	122,682
	349,277	684,467	990,131	2,004,263	2,529,650	367,922
<b>Other Financial Data:</b>						
Capital expenditures	537,376	866,314	1,135,533	1,842,933	2,528,149	367,704
Net cash provided by/(used in):						
Operating activities	5,873,023	8,076,920	15,488,266	11,889,238	13,415,877	1,951,260
Investing activities	(4,520,166)	(2,536,524)	(11,861,393)	(12,855,270)	(13,569,515)	(1,973,604)
Financing activities	(778,442)	(1,632,736)	(2,250,507)	(1,302,728)	1,587,419	230,880
	<b>2014</b>	<b>2015</b>	<b>As of December 31,</b>		<b>2018</b>	<b>2018</b>
	<b>RMB</b>	<b>RMB</b>	<b>2016</b>	<b>2017</b>	<b>RMB</b>	<b>US\$</b>
			<b>RMB</b>	<b>RMB</b>		
			<b>(in thousands)</b>			
<b>Balance Sheet Data:</b>						
Cash and cash equivalents	2,021,453	6,071,487	5,439,499	2,764,140	5,389,198	783,827
Time deposits-current	18,496,574	14,593,291	19,361,098	30,603,369	32,900,287	4,785,148

Edgar Filing: NetEase, Inc. - Form 20-F

Property, equipment and software, net	1,281,225	2,092,046	2,419,510	3,769,326	5,378,560	782,280
Total assets	30,354,671	41,157,430	58,031,860	71,031,415	86,967,928	12,648,961
Short-term loan	2,049,865	2,272,760	3,815,691	6,623,502	13,658,554	1,986,554
Total liabilities	6,862,877	11,833,831	19,568,919	23,981,579	35,556,347	5,171,456
Redeemable noncontrolling interests	133,634			614,696	5,385,736	783,323
Total shareholders equity	23,358,160	29,323,599	38,462,941	46,435,140	46,025,845	6,694,182

**B. Capitalization and Indebtedness**

Not applicable.

**C. Reasons for the Offer and Use of Proceeds**

Not applicable.

Table of Contents

**D. Risk Factors**

**RISKS RELATED TO OUR COMPANY**

**If we fail to develop and introduce new online games timely and successfully, we will not be able to compete effectively and our ability to generate revenues will suffer.**

We operate in a highly competitive, quickly changing environment, and our future success depends not only on the popularity of our existing online games but also on our ability to develop and introduce new games that our customers and users choose to buy. The development of new online games can be very difficult and requires high levels of innovation. Our ability to develop successful new online games will largely depend on our ability to anticipate and effectively respond to changing interests and preferences of game players and technological advances in a timely manner. If we are unsuccessful at developing and introducing new online games that are appealing to users with acceptable prices and terms, our business and operating results will be negatively impacted because we would not be able to compete effectively and our ability to generate revenues would suffer.

New technologies in online game programming or operations could render our current online titles or other online games that we develop in the future obsolete or unattractive to our users, thereby limiting our ability to recover development costs and potentially adversely affecting our future revenues and profitability. For example, the online game industry in China has been transitioning to mobile games, which have become increasingly popular as Internet users in China rely more and more on mobile devices, such as smart phones and tablets, to access the Internet. In response to this trend, we devote significant resources to developing games that can be operated on mobile devices. We have commercially launched over 100 self-developed and licensed mobile games as of December 31, 2018, including the Fantasy Westward Journey mobile game, Westward Journey Online mobile game, Onmyoji, the mobile version of New Ghost, Invincible, Knives Out, Chu Liu Xiang and Identity V. Each of our new games has required long periods of time for research and development, testing and also typically experience long ramp-up periods as players become familiar with the games. We are still relatively new to the development of mobile games, and we cannot guarantee that we will be able to develop successful mobile games that appeal to players. We are not able to predict if or when we will commercially launch additional new games and whether any of our new games will gain popularity in the Chinese online game market.

In addition, we are required to devote significant resources to the ongoing operations of our online games, such as staff costs related to our Game Masters which supervise the activities within our games and development costs for expansion packs of existing online games. We are unable to predict whether we will be able to maintain our profitability given the significant resources we are required to devote to game development and ongoing operations. Furthermore, our ability to introduce successful updates and expansion packs for our existing games will also depend on our ability to collect and analyze user behavior data and feedback from our online community in a timely manner and to effectively incorporate features into our updates and expansion packs to improve the variety and attractiveness of our virtual items. If we fail to anticipate our users needs and technological trends accurately or are otherwise unable to complete the development of games in a timely fashion, we will be unable to introduce new games into the market to successfully compete.

The demand for new games is difficult to forecast, in part due to the continuous evolution of the market and relatively short life cycles of online games. As we introduce and support additional games and as competition in the market for our games intensify, we expect that it will become more difficult to forecast demand. In particular, competition in the online game market is growing as more and more online games are introduced by existing and new market participants.

**We may not be able to maintain the popularity of our top-performing online games for a variety of reasons.**

The aggregate net revenue generated by our five top-performing online games in terms of revenue contribution constituted 46.3%, 44.3% and 30.2% of our total net revenues in 2016, 2017 and 2018, respectively. We expect that we will need to continually introduce new versions or substantive upgrades of these and our other online games on a frequent basis to maintain their popularity, although changes in users' tastes or in the overall market for online games in China could alter the anticipated life cycle of each version or upgrade or even cause our users to stop playing our games altogether. Because of the limited history of the online games market in China, which is also rapidly evolving, we cannot at this time estimate the total life cycle of any of our games, particularly our more recently launched mobile or PC-client games. If we are unable to maintain the popularity of our existing online games or are unable to introduce new online games which are popular with online game users in China (as discussed in the previous risk factor), our business and results of operations could be materially and adversely affected. In particular, we have devoted, and expect to continue to devote, significant resources to maintain and raise the popularity of our online games through the release of new versions and/or expansion packs on a periodic basis and various promotional activities such as media advertising, game tournaments and hosting the NetEase Da Shen forum, which provides an online community for elite game players, key opinion leaders and masters of the online game industry to interact.

Table of Contents

**We may not be successful in making our mobile games profitable and our profits from mobile games may be relatively lower than the profits we have enjoyed historically for PC-client games.**

Our profits from our mobile games, even if the games are successful, are generally lower than our profits generated from PC-client games, because, in order to gain access to our games on mobile application stores, which are the primary distribution channel for our mobile games, we must enter into revenue-sharing arrangements that result in lower profit margins compared with those of our PC-client games. In addition, our mobile games tend to cover a wider variety of genres, which has historically resulted in a relatively lower profitability than that of our PC-client games. Furthermore, we are releasing more of our mobile games overseas, which may involve additional marketing and distribution costs and further impact the profitability of our mobile games.

We have devoted and expect to continue to devote a significant amount of resources to the development of our mobile games, but the relatively lower profit margins and other uncertainties make it difficult to know whether we will succeed in making our mobile game operations profitable. If we do not succeed in doing so, our business and results of operations will be adversely affected.

**We rely on third-party platforms to distribute our mobile games and collect payments. If we fail to maintain our relationships with these platforms, if the platforms lose popularity among users, or if our revenue-sharing arrangements with these platforms change to our detriment, our mobile games business may be adversely affected.**

In addition to our proprietary distribution channels, we publish our mobile games through the Apple iOS app store and other mobile application stores or platforms owned and operated by third parties. We rely on these third parties to promote and publish our mobile games, record gross billings, maintain the security of their platforms to prevent fraudulent activities, provide certain user services and, in some instances, process payments from users.

We are subject to these third parties' standard terms and conditions for application developers, which govern the promotion, distribution and operation of games and other applications on their platforms. If we violate, or if a platform provider believes that we have violated, its terms and conditions, the particular platform provider may discontinue or limit our access to that platform, which could harm our business. Our business could also be harmed if these platforms decline in popularity with users or modify their discovery mechanisms for games, the communication channels available to developers, their terms of service or other policies such as distribution fees, how they label free-to-play games or payment methods for in-app purchases. These platforms' operators could also develop their own competitive offerings that could compete with our mobile games.

Furthermore, a few of these third-party platforms dominate the mobile application distribution channels. Any changes in the revenue-sharing arrangements that we have with any of the major third-party application distribution platforms may materially impact our revenue and profitability. Disputes with third-party platforms, such as disputes relating to intellectual property rights, distribution fee arrangements and billing issues, may also arise from time to time and we cannot assure you that we will be able to resolve such disputes in a timely manner or at all. If our collaboration with a major third-party platform terminates for any reason, we may not be able to find a replacement in a timely manner or at all and the distribution of our games may be adversely affected. Any failure on our part to maintain good relationships with a sufficient number of popular platforms for the distribution of our games could cause the number of our game downloads and activations to decrease, which will have a material adverse effect on our business, financial condition and results of operations.

## Edgar Filing: NetEase, Inc. - Form 20-F

We rely on the continued operation of third-party platforms. We distribute our games through China's major mobile platforms, including major app stores and social networking platforms. Our games benefit from the strong brand recognition, large user base and the stickiness of these mobile platforms. If any of these mobile platforms lose their market positions or are no longer popular with users, our ability to reach more users will be limited. In addition, we would need to identify alternative channels for marketing, promoting and distributing our games, which would consume substantial resources and may not be effective.

**Any difficulties or delays in receiving approval from the relevant government authorities for the games operated by us or any expansion packs for, or material changes to, such games could adversely affect such games' popularity and profitability.**

All games we release in China require government approvals. Moreover, even after certain games have received government approvals, any expansion packs for or material changes to the content of those games may require further government approvals. We cannot be certain of the duration of any necessary approval processes, and any delay in receiving such government approvals may adversely affect the profitability and popularity of such games. In particular, game approvals in 2018 experienced certain delays, although the approvals resumed starting from the end of 2018. Since then, China's game regulatory authority has officially published several lists of newly approved game titles, pursuant to which a number of online games have received approvals. We are not certain what was the cause of the delays in 2018, and although our operations were not materially affected by such delays, we cannot predict the effect any future delay in approvals may have on our results of operations.

Table of Contents

**Reports of violence and crimes related to online games or any claims of our gaming contents to be, among others, obscene, superstitious, fraudulent, defamatory or impairing public interest, may result in negative publicity or a governmental response that could have a material and adverse impact on our business.**

The media in China has reported incidents of violent crimes allegedly inspired by online games and theft of virtual items between users in online games. While we believe that such events were not related to our online games, it is possible that our reputation, as one of the leading online game providers in China, could be adversely affected by such behavior. In response to the media reports, in August 2005 the Chinese government enacted new regulations to prohibit all minors under the age of 18 from playing online games in which players are allowed to kill other players, an activity that has been termed Player Kills, or PK. The Chinese government has also taken steps to limit online game playing time for all minors under the age of 18. See below Risks Related to the Telecommunications and Internet Industries in China The Chinese government has taken steps to limit online game playing time for all minors. These and any other new restrictions may materially and adversely impact our business and results of operations. If the Chinese government should determine that online games have a negative impact on society, it may impose certain additional restrictions on the online game industry, which could in turn have a material and adverse effect on our business and results of operations.

In addition, the Chinese government and regulatory authorities prohibit any Internet content that, among other things, violates PRC laws and regulations, impairs the national dignity of China or the public interest, or is obscene, superstitious, fraudulent, violent or defamatory. When Internet content providers and Internet publishers, including online game operators, find that information falling within the above-mentioned scope is transmitted on their websites or is stored in their electronic bulletin service systems, they are required to terminate the transmission of such information or delete such information immediately, keep records, and report to relevant authorities. Failure to comply with these requirements could result in the revocation of our Internet content provider, or ICP, license and other required licenses to operate our business. Internet content providers like us may also be held liable for prohibited information displayed on, retrieved from or linked to their websites. In addition, any claim of us failing to comply with these prohibitions may result in negative publicity and government actions, which in turn could have a material and adverse impact on our business.

**We may not be able to maintain stable relationships with our existing game licensors, and we may experience difficulties in the operation of the online games licensed from them.**

In addition to our internally-developed games, we also offer several mobile and PC-client games licensed from international developers, which accounted for 12.5%, 7.2% and 5.7% of our total net revenues in 2016, 2017 and 2018, respectively. For example, starting in August 2008, Blizzard Entertainment, Inc. (together with its affiliated companies, referred to as Blizzard in this annual report) agreed to license certain online games developed by it to Shanghai EaseNet Network Technology Co., Ltd., or Shanghai EaseNet, for operation in the PRC. Shanghai EaseNet is a PRC company owned by William Lei Ding, our Chief Executive Officer, director and major shareholder, and has contractual arrangements with us and with the joint venture established between Blizzard and us. In January 2019, Shanghai EaseNet and Blizzard extended the term of their joint venture as well as all existing game licenses by Blizzard to Shanghai EaseNet to January 2023. These games include World of Warcraft®, StarCraft® II, Diablo® III, Hearthstone®, Heroes of the Storm® and Overwatch®, all of which have been commercially launched. We are also currently co-developing Diablo Immortal™, a mobile massively multiplayer online action role-playing games, or MMO action-RPG, with Blizzard. In addition to our relationship with Blizzard, in May 2016, we entered into a five-year exclusive agreement with Mojang AB, a subsidiary of Microsoft, pursuant to which Microsoft and Mojang agreed to license the operation of Minecraft in the PRC to us.

If we are unable to maintain stable relationships with our existing game licensors, or if any of our licensors establishes similar or more favorable relationships with our competitors in violation of its contractual arrangements with us or otherwise, we may not be able to ensure the smooth operation of these licensed online games, and our licensors could terminate or fail to renew the license agreements with us, which could harm

## Edgar Filing: NetEase, Inc. - Form 20-F

our operating results and business. Moreover, the success of our arrangements with our game licensors depends on the popularity of the games licensed to us by them in the Chinese market, which is affected by, among other things, the frequency and success of updates and expansion packs to those games developed by them over which we have no control. In addition, certain events may limit our licensors' ability to develop or license online games, such as claims by third parties that their online games infringe such third parties' intellectual property rights or their inability to acquire or maintain licenses to use another party's intellectual property in their online games. In the case of such events, our licensors may be unable to continue licensing online games to us or to continue participating in any joint venture with us, regardless of the stability of our relationship with them.

Generally, the licenses between our game licensors and us require us, as licensee of the games, to pay them royalties for the games over the terms of the licenses, to make minimum marketing expenditure commitments, or to provide funds for hardware to operate the games. See Item 4.B. Business Overview Our Services Licensed Games. for details about these arrangements.

We believe that our current cash and cash equivalents and cash flow from operations will be sufficient to meet our foregoing obligations. To the extent our obligations exceed our cash resources, we may seek to sell equity or debt securities or to obtain a credit facility. The sale of equity or convertible debt securities could result in dilution to shareholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financial covenants that would restrict operations. Financing may not be available in amounts or on terms acceptable to us, if at all. If we are unable to meet our foregoing obligations, our licensed games operation and financial condition could be adversely affected and our licenses with our game licensors could be terminated.

In addition, we cannot be certain that these licensed online games will be viewed by the regulatory authorities as complying with content restrictions, will be attractive to users or will be able to compete with games operated by our competitors. We may not be able to fully recover the costs associated with licensing these online games if the games are not popular among users in the PRC, and any difficulties in the operation of these licensed games could harm our results of operations and financial condition.



Table of Contents

**Future alliances may expose us to potential risks.**

Strategic alliances with key players in the online game industry and other related industry sectors form part of our strategy to expand our portfolio of online games. However, our ability to grow through future alliances, including through joint ventures, will depend on the availability of suitable partners at reasonable terms, our ability to compete effectively to attract these partners, the availability of financing to complete larger joint ventures, and our ability to obtain any required governmental approvals. Further, the benefits of an alliance may take considerable time to develop, and we cannot be certain that any particular alliance will produce its intended benefits.

Future alliances could also expose us to potential risks, including risks associated with the assimilation of new operation technologies and personnel, unforeseen or hidden liabilities, the inability to generate sufficient revenue to offset the costs and expenses of alliances and potential loss of, or harm to, our relationships with employees, customers, licensors and other suppliers as a result of integration of new businesses. Further, we may not be able to maintain a satisfactory relationship with our partners, which could adversely affect our business and results of operations. We have relatively limited experience in identifying, financing or completing strategic alliances compared with some of our competitors. Such transactions and the subsequent integration process would require significant attention from our management. The diversion of our management's attention and any difficulties encountered with respect to the alliances or in the process of integration could have an adverse effect on our ability to manage our business.

**Our new games may attract game players away from our existing games, which may have a material adverse effect on our business, financial condition and results of operations.**

Our new online games, including mobile games and PC-client games, may attract game players away from our existing games and shrink the player base of our existing online games, which could in turn make those existing games less attractive to other game players, resulting in decreased revenues from our existing games. Players of our existing games may also spend less money to purchase time or virtual items in our new games than they would have spent if they had continued playing our existing games. In addition, our game players may migrate from our existing games with a higher profit margin to new games with a lower profit margin. The occurrence of any of the foregoing could have a material and adverse effect on our business, financial condition and results of operations.

**New or changed game features in our online games may not be well received by our game players.**

In the course of launching and operating online games, including the release of updates and expansion packs to existing games, certain game features may periodically be introduced, changed or removed. We cannot assure you that the introduction, change or removal of any game feature will be well received by our game players, who may decide to reduce or eliminate their playing time in response to any such introduction, change or removal. As a result, any introduction, change or removal of game features may adversely impact our business, financial condition and results of operations.

**Illegal game servers and acts of cheating by users of online games could harm our business and reputation and materially and adversely affect our results of operations.**

## Edgar Filing: NetEase, Inc. - Form 20-F

Several of our competitors have reported that certain third parties have misappropriated the source codes of their games and set up illegal game servers and let their customers play such games on illegal servers without paying for the game playing time. While we already have in place numerous internal control measures to protect the source codes of our games from being stolen and to address illegal server usage and, to date, our games have not to our knowledge experienced such usage, our preventive measures may not be effective. The misappropriation of our game server installation software and installation of illegal game servers could harm our business and reputation and materially and adversely affect our results of operations.

In addition, acts of cheating by users of online games could lessen the popularity of our online games and adversely affect our reputation and our results of operations. There have been a number of incidents in previous years where users, through a variety of methods, were able to modify the rules of our online games. Although these users did not gain unauthorized access to our systems, they were able to modify the rules of our online games during gameplay in a manner that allowed them to cheat and disadvantage our other online game users, which often has the effect of causing players to stop using the game and shortening the game's lifecycle. Although we have taken a number of steps to deter our users from engaging in cheating when playing our online games, we cannot assure you that we or the third parties from whom we license some of our online games will be successful or timely in taking corrective steps necessary to prevent users from modifying the rules of our online games.

If we suspect a player of installing cheating programs on our online games, or of engaging in other types of unauthorized activities, we may freeze that player's game account or even ban the player from logging on to our games and other media. Such activities to regulate the behavior of our users are essential to maintain a fair playing environment for our users. However, if any of our regulatory activities are found to be wrongly implemented, our users may institute legal proceedings against us for damages or claims. Our operation, business and financial performance may be materially and adversely affected as a result.

Table of Contents

**Some of our players make sales and purchases of our game accounts and virtual items through third-party auction websites, which may have a negative effect on our net revenues.**

Some of our players make sales and purchases of our game accounts and virtual items through third-party auction websites in exchange for real money. We do not generate any net revenues from these transactions. Accordingly, purchases and sales of our game accounts or virtual items on third-party websites could lead to decreased sales by us and also put downward pressure on the prices that we charge players for our virtual items and services, all of which could result in lower revenues generated for us by our games. New players may decide not to play our games as a result of any rule changes we might implement to restrict the players' ability to trade in game accounts or virtual items, which could materially adversely affect our business, results of operations and financial conditions.

In addition, such trading activities could run afoul of PRC regulations on virtual currency and subject traders and us to potential liability. See Restrictions on virtual currency may adversely affect our online game revenues.

**Our e-commerce business may expose us to new challenges and risks and may lower our profit margin.**

We established our two e-commerce platforms Kaola and Yanxuan, in January 2015 and April 2016, respectively. Kaola sells mainly imported goods that we source from overseas suppliers, including maternity and baby products, skincare and cosmetics and other general merchandise. Kaola also acts as a marketplace which allows pre-approved third-party vendors to sell their products on its platform. Therefore, we are subject to the Consumer Protection Law in China, both as a seller and as an e-commerce platform provider. Yanxuan primarily sells our private label products, including apparel, homeware, kitchenware and other general merchandise which we primarily source directly from original design manufacturers in China. We generate revenue from both these platforms primarily through merchandise sales and recognize revenue on a gross basis as we carry our own inventory and have discretion in setting prices. Our e-commerce business exposes us to new challenges and risks associated with, for example, managing a global logistical network, operating directly in foreign jurisdictions and handling more complex supply and product return issues. Furthermore, our e-commerce business has required us to make significant investments in building a global supply and logistics infrastructure. The PRC regulatory framework, as well as the implementation policies of local authorities, in respect of overseas direct purchase and sale of merchandise, including beauty products, are still evolving. New laws and regulations and new interpretations of existing laws and regulations may be adopted from time to time to regulate e-commerce in China, and additional licenses and permits may be required. For example, in March 2016, relevant PRC regulatory authorities introduced certain rules, which took effect on April 8, 2016, governing the taxation of cross-border e-commerce retail imports that caps the value of goods that may be imported at a reduced tax rate. The caps were subsequently raised in accordance with the Circular on Improving Tax Policies for Cross-border E-Commerce Retail Imports released in November 2018, which became effective on January 1, 2019. We see the increases in such caps as a sign that the Chinese government wishes to encourage cross-border e-commerce, and although the caps have not had a material impact on Kaola's transaction values since being introduced, there can be no assurance that any revision to such caps or any other future regulations on cross-border e-commerce will not have a negative impact on our operations. Substantial uncertainties still exist regarding the evolution of the regulatory system and the interpretation and implementation of current and future PRC laws and regulations applicable to our e-commerce business. For more information on this and other regulations affecting our e-commerce business, see Government Regulations E-commerce.

We have limited experience and operating history in the e-commerce business, which makes predicting our future results of operations difficult. Therefore, our past results of operations should not be taken as indicative of our future performance. In addition, we have incurred significant expenses on a variety of different marketing and brand promotion efforts designed to enhance the recognition of our e-commerce platforms and increase sales of our products on such platforms. However, our brand promotion and marketing activities may not be well received by our customers and may not result in the levels of product sales that we anticipate. To effectively compete with our competitors in the e-commerce industry, we are also required to adjust and refine our marketing approaches or to introduce new marketing approaches because the marketing approaches and tools in the consumer products market in China are constantly evolving. If we are unable to design marketing activities that will appeal to the Chinese consumers or market in a cost-effective manner, revenue from our e-commerce business will be adversely affected. Furthermore, our profit margin from the e-commerce business, even if the business is successful, is likely to be relatively lower than our profit margin from our online game business and advertising business. If we cannot successfully address new challenges specific to the e-commerce business and compete effectively, we may not be able to recover the costs of our investments, and our future results of operations and growth prospects may be materially and adversely affected.

Table of Contents

**If we are unable to offer products that attract new customers and new purchases from existing customers, our e-commerce business may be materially and adversely affected.**

The future growth of our e-commerce business depends on our ability to continue to attract new customers as well as new purchases from existing customers. Constantly changing consumer preferences have affected and will continue to affect the online retail industry. We must stay abreast of emerging consumer preferences and anticipate product trends that will appeal to existing and potential customers. We are relatively new to this business and our lack of relevant customer data may make it more difficult for us to keep pace with evolving customer demands and preferences. Our e-commerce platforms make personalized recommendations to customers based on their past purchases or on products that they viewed but did not purchase as well as general recommendations, and we also send e-mails to our customers with product recommendations tailored to their purchase profile. Our ability to make individually tailored recommendations is dependent on our business intelligence system, which tracks, collects and analyzes our users' browsing and purchasing behavior in accordance with our privacy policy. Our customers choose to purchase products on our platforms due in part to our ability to offer attractive prices, and they may choose to shop elsewhere if we cannot match the prices offered by other platforms or by physical stores. If our customers cannot find their desired products on our e-commerce platforms at attractive prices, they may lose interest in us and visit our platforms less frequently or even stop visiting our platforms altogether, which in turn may materially and adversely affect our e-commerce business.

**If we fail to manage and store our inventory effectively, our e-commerce business and financial position may be materially and adversely affected.**

Our e-commerce business requires us to manage a large volume of inventory effectively. We depend on our demand forecasts for various kinds of products to make purchase decisions and to manage our inventory. Demand for products, however, can change significantly between the time inventory is ordered and the date by which we hope to sell it, especially for direct sales for cross-border goods. Demand may be affected by seasonality, new product launches, changes in product cycles and pricing, product defects, changes in consumer spending patterns, changes in consumer tastes with respect to our products and other factors. In addition, our customers may not order products in the quantities that we expect. Moreover, when we begin selling a new product, it may be difficult to establish relationships with suppliers and original design manufacturers, determine appropriate product selection, and accurately forecast demand. The acquisition of certain types of inventory may require significant lead time and prepayment and they may not be returnable. For those products we sell directly, we normally do not have the right to return unsold items to our suppliers.

If we fail to manage our inventory effectively, we may be subject to a heightened risk of inventory obsolescence, a decline in inventory values, and significant inventory write-downs or write-offs. In addition, we may be required to lower sale prices in order to reduce inventory level, which may lead to lower gross margins. High inventory levels may also require us to commit substantial capital resources, preventing us from using that capital for other important purposes. Furthermore, we may need to build or lease additional warehouse space to maintain our inventory at an optimal level, which may require additional capital resources and expenditures. Any of the above may materially and adversely affect our results of operations and financial condition.

On the other hand, if we underestimate demand for our products, or if our suppliers fail to supply quality products in a timely manner, we may experience inventory shortages, which might result in missed sales, diminished brand loyalty and lost revenues, any of which could harm our e-commerce business and reputation.

**We are subject to risks associated with the expansion of our fulfillment infrastructure.**

The success of our e-commerce business also depends on our ability to expand and effectively manage our fulfillment infrastructure, which consists of strategically located warehouses and delivery and pickup stations. We are constructing and have future plans to construct additional warehouse space to increase our storage capacity and to restructure and reorganize our fulfillment workflow and processes. As we continue to add fulfillment and warehouse capability and expand our reach, our fulfillment network becomes increasingly complex and challenging to operate. We cannot assure you that we will be able to acquire land use rights and set up warehouses, or lease suitable facilities for the delivery stations, on commercially acceptable terms or at all. Moreover, we cannot be certain that we will obtain the required permits or licenses from the relevant government authorities to undertake the construction projects in relation to our fulfillment infrastructure expansion. Even after such constructions projects are completed, certain government procedures, including audits and applications for permits, are required before we can operate at these facilities. We may also be subject to risks associated with third-party contractors for such construction projects. In addition, the expansion of our fulfillment infrastructure may strain our managerial, financial, operational and other resources. If we fail to manage such expansion successfully, our growth potential, business and results of operations may be materially and adversely affected.

**We rely on third-party delivery services for our product delivery, and if such third-party delivery services fail to provide reliable delivery services, our e-commerce business and reputation may be materially and adversely affected.**

Our e-commerce business uses a number of third-party delivery companies to deliver our products to customers. Any interruption to or failure in delivery services could prevent the timely or proper delivery of our products. These interruptions may be due to events that are beyond our control or the control of these third-party delivery services, such as inclement weather, natural disasters, transportation interruptions or labor unrest or shortage. We may not be able to find alternative delivery companies to provide delivery services in a timely and reliable manner, or at all, to replace such third-party delivery services to the extent necessary. If our products are not delivered in proper condition or on a timely basis or at all, our e-commerce business and reputation would suffer.

Table of Contents

**We may be subject to allegations and negative publicity claiming that products sold by our e-commerce platforms are inauthentic or counterfeit and risks associated with third-party sellers.**

Our e-commerce business has in the past been the subject and may continue to be subject of allegations that products offered or sold through our e-commerce platforms are inauthentic or counterfeit and infringe third-party copyrights, trademarks and patents or other intellectual property rights. We have implemented measures in an effort to verify the authenticity and authorization of products offered or sold on our e-commerce platforms, including updating and monitoring the implementation of our product procurement policies and periodic internal audit of the sources of the products offered or sold by our e-commerce platforms. However, because we source our products from various suppliers, including many overseas suppliers, verifying the authenticity and authorization of the products sourced from these suppliers may sometimes be difficult. Any further measures we are required to take to verify and document the authenticity of the products offered and sold on our e-commerce platforms could require us to spend substantial additional resources and/or experience reduced revenues.

In addition, we do not have as much control over the products sold by third-party sellers using our e-commerce platform as marketplace as we do over the products that we sell directly ourselves. It is also more difficult for us to monitor and effectively manage customer satisfaction with respect to sales made by third-party sellers using our platform. If any third-party seller does not control the quality of the products that it sells on our websites, does not deliver the products or delivers them late or delivers products that are materially different from its description of them, sells counterfeit or unlicensed products on our websites, or sells certain products without licenses or permits as required by the relevant laws and regulations even though we have requested such licenses or permits in our standard form contract with the third-party seller, the reputation of our online marketplace and our brand may be materially and adversely affected and we could face claims that we should be held liable for any losses.

Furthermore, public perception that inauthentic or counterfeit goods are offered or sold by our e-commerce platforms either directly by us or by third-party sellers using our platform, even if factually incorrect, could damage our reputation, diminish the value of our brand, undermine the trust and credibility we have established and have a negative impact on our ability to attract new customers or retain our current customers. If we are unable to maintain our reputation, enhance our brand recognition or increase positive awareness of our websites, products and services, it may be difficult to maintain and grow our customer base, and our business and growth prospects may be materially and adversely affected.

**If we fail to manage and expand our relationships with suppliers of our e-commerce business, or otherwise fail to procure products at favorable terms, our business and growth prospects may suffer.**

We source products from third-party suppliers for a majority of sales made by our e-commerce business. These suppliers include manufacturers, distributors and resellers. Maintaining strong relationships with these suppliers is important to the growth of our business. In particular, we depend significantly on our ability to procure products from suppliers on favorable pricing terms. In addition, our agreements with suppliers typically do not restrict the suppliers from selling products to other buyers. We cannot assure you that our current suppliers will continue to sell products to us on commercially acceptable terms, or at all, after the term of the current agreement expires. Even if we maintain good relationships with our suppliers, their ability to supply products to us in sufficient quantity and at competitive prices may be adversely affected by economic conditions, labor actions, regulatory or legal decisions, natural disasters or other causes. In the event that we are not able to purchase merchandise at favorable prices, our revenues and cost of revenues may be materially and adversely affected. In the event any distributor or reseller does not have authority from the relevant manufacturer to sell certain products to us, such distributor or reseller may cease selling such products to us at any time. If our suppliers cease to provide us with favorable payment terms, our requirements for working capital may increase and our operations may be materially and adversely affected. We will also need to establish new supplier relationships to ensure that we have access to a steady supply of products on favorable commercial terms. If we are unable to develop and maintain good relationships with suppliers that would allow us to obtain a sufficient amount and variety of authentic and quality merchandise on acceptable commercial terms, it may inhibit our ability to offer sufficient products sought by our customers, or to offer these products at competitive prices. Any adverse developments in our relationships with suppliers could materially and adversely affect our business and growth prospects.

**If we fail to comply with relevant customs and other regulations on bonded areas in the PRC, our operations may be materially affected.**

Our cross-border e-commerce operations are subject to customs and other regulations on bonded areas in the PRC, where we temporarily store our imported goods before we take them through the customs process. Pursuant to the Customs Law of the People's Republic of China and the Implementations Rules on Administrative Penalties, any discrepancies between the goods actually stored in bonded areas and the declarations made by an importer, as well as omissions in an importer's declarations, may lead to administrative penalties or even criminal liabilities. In the event of any material non-compliance with any relevant customs rules or regulations on bonded areas, our operations may be adversely affected.

**We expect that a portion of our future revenues will continue to come from our advertising services, which represented approximately 3.7% of our total net revenues for 2018, but we may not be able to compete effectively in this market because it is evolving and intensely competitive, in which case our ability to generate and maintain advertising revenue in the future could be adversely affected.**

Although we anticipate that the revenues generated by our online games and e-commerce business will continue to constitute the major portion of our future revenues, we believe that we will continue to rely on advertising as an important source of revenue for the foreseeable future. The popularity of online advertising in China has been growing quickly in recent years and many of our current and potential advertisers have gained experience with using the Internet as an advertising medium. Many advertisers, however, still do not devote a significant portion of their advertising expenditures to Internet-based advertising. Some advertisers may also not find the Internet to be effective for promoting their products and services relative to traditional print and broadcast media. Our ability to generate and maintain significant advertising revenue will depend on a number of factors, many of which are beyond our control, including:



Table of Contents

- the development of a large base of users possessing demographic characteristics attractive to advertisers;
- the development of software that blocks Internet advertisements before they appear on a user's screen;
- downward pressure on online advertising prices; and
- the effectiveness of our advertising delivery and tracking system.

Changes in government policy could also restrict or curtail our online advertising services. Moreover, the acceptance of the Internet as a medium for advertising depends on the development of a measurement standard. Industry-wide standards may not develop sufficiently to support the Internet as an effective advertising medium. If these standards do not develop, advertisers may choose not to advertise on the Internet in general or through our media platforms.

In addition, competition in the online advertising industry in China is intense with numerous competitors such as Baidu, Inc., or Baidu, Sina Corporation, or Sina, Sohu.com Inc., or Sohu, Tencent Holdings Limited, or Tencent, Alibaba Group Holding Limited, or Alibaba, Phoenix New Media Limited, or iFeng.com and Beijing ByteDance Technology Co Ltd., or ByteDance, as well as virtual media such as SouFun Holdings Ltd., BitAuto Holdings Ltd. and Autohome Inc. The entry of additional, highly competitive Internet companies, whether domestic or international, into the Chinese market has and may continue to further heighten competition for advertising spending in China.

As competition intensified for advertising services, we launched new marketing strategies to grow our advertising business and to cater to changes in the needs of our advertising services customers. In addition, to increase traffic on the NetEase websites and other online and mobile platforms, particularly our mobile news platform, NetEase News App, and enhance their appeal to advertisers, we have been focusing on high profile events, such as the NetEase Annual Economist Conference and the China Women's Media Award, an awards ceremony for women who have made outstanding contributions to different sectors of society. We believe that these efforts, together with other factors, contributed to the growth of our net revenues from advertising services in recent years. We cannot assure you, however, that any of these efforts will continue to be successful in improving the financial results of our advertising business.

**If we fail to keep up with rapid changes in technologies and user behavior, our future success may be adversely affected.**

Our future success will depend on our ability to respond to rapidly changing technologies, adapt our products and services to evolving industry standards and improve the performance and reliability of our products and services. Our failure to adapt to such changes could harm our business. In addition, changes in user behavior resulting from technological developments may also adversely affect us. For example, the number of people accessing the Internet through mobile devices, including mobile phones, tablets and other hand-held devices, has increased in recent years, and we expect this trend to continue while 4G, 5G and more advanced mobile communications technologies are broadly implemented. If we fail to develop products and technologies that are compatible with all mobile devices, or if the products and services we develop are not widely accepted and used by users of various mobile devices, we may not be able to penetrate the mobile markets. In addition, the widespread adoption of new Internet, networking or telecommunications technologies or other technological changes could require

substantial expenditures to modify or integrate our products, services or infrastructure. If we fail to keep up with rapid technological changes to remain competitive, our future success may be adversely affected.

**We may be unable to obtain licenses to the music content necessary to provide our music streaming services or to obtain such licenses at an economically viable cost.**

Our ability to offer online music streaming services through our music streaming platform, Cloud Music, depends upon maintaining commercially viable licenses or arrangements with copyright owners for music content which is popular in China. Most of these licenses or arrangements we have are short-term and may be terminated at the convenience of the other party. Moreover, the majority of our agreements with copyright owners are usually non-exclusive, while some of our competitors have been entering into exclusive arrangements for music distribution rights in China. The competition in China for exclusive or non-exclusive licenses to distribute music content is fierce. As a result, certain owners of music content or exclusive rights to distribute music content have increased the fees they charge us for their content or distribution rights. This trend could increase our costs and operating expenses and could adversely affect our ability to obtain music content at an economically viable cost.

Table of Contents

Furthermore, there is no guarantee that the licenses or arrangements we have now will be renewed in the future. If we are unable to secure and maintain the licenses or similar arrangements that we desire, the size and quality of our music catalog offered by our music streaming platform and the financial condition and results of operations of this business may be materially and adversely affected, which in turn could negatively impact the attractiveness of our brand name and online services in general to our users.

**We cannot guarantee that our efforts to innovate and explore new areas of operations would be successful or bring positive financial impact to us.**

In addition to our existing businesses, we continue to invest significant resources in innovation and exploring new products, services and technologies to cater to the rapidly changing customer demands and trends in the Internet industry. However, the success of new products and services depends on a number of factors including the quality of our products or services, the acceptance by the targeted customers and our assessment of market demands and trends.

Furthermore, our competitors are constantly developing innovations, on both mobile devices and personal computers, to enhance users' online experience in areas that we currently operate or areas that we wish to expand our operations into. As a result, our efforts to continuously innovate and explore new growth strategies and introduce new products and services to attract more customers of our services, may not be successful, and we cannot guarantee that our innovation efforts could bring positive financial impact to us.

**A prolonged slowdown in the PRC economy may materially and adversely affect our results of operations, financial condition, prospects and future expansion plans.**

We derive substantially all of our revenue from China. As a result, our revenue and net income are impacted to a significant extent by economic conditions in China and globally, as well as economic conditions specific to online and mobile Internet usage and advertising. The global economy, markets and levels of consumer spending are influenced by many factors beyond our control, including consumer perception of current and future economic conditions, political uncertainty, levels of employment, inflation or deflation, real disposable income, interest rates, taxation and currency exchange rates.

The rate of economic growth in the PRC has been experiencing a significant slowdown. In addition, any future escalation of the ongoing trade war between the United States and China may negatively impact the growth in both the Chinese economy and the global economy as a whole. Although the PRC government has implemented a number of measures to address the slowdown, these measures may not be successful. Any continuing or worsening slowdown could significantly reduce domestic commerce in China, including through the Internet generally and within our ecosystem. An economic downturn, whether actual or perceived, a further decrease in economic growth rates or an otherwise uncertain economic outlook in China or any other market in which we may operate could have a material adverse effect on our business, financial condition and results of operations.

**We are subject to a variety of laws and other obligations regarding data protection.**

## Edgar Filing: NetEase, Inc. - Form 20-F

We are subject to laws in China relating to the collection, use, sharing, retention, security and transfer of confidential and private information, such as personal information and other data. These laws apply not only to third-party transactions, but also to transfers of information between our company and our subsidiaries and variable interest entities, or VIEs, and among our company, our subsidiaries, VIEs and other parties with which we have commercial relations. These laws are continuing to develop, and the PRC government may adopt other rules and restrictions in the future. According to the Cyber Security Law of the People's Republic of China, or Cyber Security Law, which was promulgated by the National People's Congress Standing Committee on November 7, 2016, and took effect on June 1, 2017, we, as a network operator, are obligated to provide technical assistance and support to public security and national security authorities in order to protect national security or assist with criminal investigations. In addition, the Cyber Security Law provides that personal information and important data collected and generated by an operator of critical information infrastructure in the course of its operations in the PRC must be stored in the PRC. We have undertaken significant measures in an effort to ensure compliance with the Cyber Security Law.

In addition to the Cyber Security Law, the General Administration of Quality Supervision, Inspection and Quarantine and Standardization Administration jointly issued the Standard of Information Security Technology Personal Information Security Specification, which took effect in May 2018. Pursuant to this new standard, any entity or person who has the authority or right to determine the purposes for and methods of using or processing personal information are seen as a personal data controller. Such personal data controller is required to collect information in accordance with applicable laws, and prior to collecting such data, the information provider's consent is required. We generally comply with industry standards and have established privacy policies to ensure such compliance. However, compliance with any additional laws could be expensive, and may place restrictions on the conduct of our business and the manner in which we interact with our customers. Any failure to comply with applicable regulations could also result in regulatory enforcement actions against us.

Furthermore, we may be subject to similar data protection laws and other obligations in jurisdictions outside of China where we operate. More generally, complying with emerging and changing requirements may cause us to incur substantial costs or require us to change our business practices. Non-compliance could result in penalties or significant legal liability, including fines and public announcements of misconduct by the relevant authorities which govern the telecommunications systems.

Table of Contents

Our privacy policies and practices concerning the use and disclosure of data are posted on the NetEase websites and other online and mobile platforms. Any failure by us, our business partners or other parties with whom we do business to comply with its posted privacy policies or with other applicable privacy-related or data protection laws and regulations could result in proceedings against us by governmental entities or others, which could have a material adverse effect on our business, results of operations and financial condition. In addition, any negative publicity on our website or platform's safety or privacy protection mechanism and policy could have a material and adverse effect on our business, results of operations and financial condition, public image and reputation.

**We may be subject to breaches of our information technology systems, including security breaches and improper access to or disclosure of our data or user data, which could materially adversely affect our reputation and our results of operations and financial position and expose us to liability claims.**

Any compromise of the security of our information technology systems could materially adversely affect the operations of NetEase's websites and other online and mobile platforms, and result in improper disclosure of personal information and other data. We transmit and store over our systems confidential and private information of our users, such as personal information, including names, user IDs and passwords, and payment or transaction related information. For example, we rely on our information technology systems to record and monitor the purchase and consumption of virtual items by our game players, which constitute a significant portion of the revenue generated from our online games. In addition, in relation to our e-commerce business, almost all of the orders and some of the payments for products we offer are made through our websites and our mobile applications, and some online payments for our products are settled through third-party online payment services. We also share certain personal information about our customers with contracted third-party couriers, such as their names, addresses, phone numbers and transaction records. Moreover, with the rapid development of our e-commerce businesses, we have accumulated a large volume of data, which covers customers' browsing and consumption behavior information, product manufacturing and sales information, warehousing and distribution information and customer service information.

Hackers develop and deploy viruses, worms, and other malicious software programs to attack websites or other online and mobile platforms and gain access to networks and data centers, and there have been a number of well-publicized malicious attacks against a variety of companies worldwide to gain access to non-public information. Hackers may also act in a coordinated manner to launch distributed denial of service attacks, or other coordinated attacks, that may cause service outages or other interruptions. In addition, we distribute our contents to users based on user interest levels indicated by their past viewing behavior. As a result, our content distribution platforms and the results of our user behavior analysis is subject to attempts of improper access or creating false or undesirable user accounts for purposes of spreading misinformation.

Although we believe that we have not experienced any hacking activity or security breach that allowed unauthorized access to any information stored on our information technology systems or caused any loss or corruption of personal information and other data, software or other computer equipment, we have been subject to denial of service attacks that have caused portions of our network to be inaccessible for limited periods of time. Although these are industry wide problems that affect many companies worldwide, we anticipate that we may be subject to additional attacks in the future because of the high profile of our company in the Chinese Internet industry.

We take a number of measures to ensure that our information technology systems are secure, including ensuring that our servers are hosted at physically secure sites and limiting access to server ports. We also use encryption and authentication technologies to secure the transmission and storage of data. These security measures may be compromised as a result of third-party security breaches, employee error, malfeasance, faulty password management, or other irregularities. Third parties may also attempt to fraudulently induce employees or customers into disclosing user names, passwords or other sensitive information, which may in turn be used to access our information technology systems. We expect that we will be required to continue to expend significant resources to system security, data encryption, and other security measures to protect our systems and data, but these security measures cannot provide absolute security.

In the case of a breach of our systems, our data on the purchase and consumption of virtual items by our game players may be compromised, and as a result, our ability to accurately recognize revenues from certain of our online games and the playing experience of our game players could be materially and adversely affected. Moreover, if a computer security breach allows unauthorized access to or release of personal information and other data of our users, our reputation and brand could be materially damaged and use of the NetEase websites and other online and mobile platforms could decrease. We could also be exposed to a risk of loss or litigation and possible liability, which could result in a material adverse effect on our business, results of operations and financial condition.

Table of Contents

**The success of our business is dependent on our ability to retain our existing key employees and to add and retain senior officers to our management.**

We depend on the services of our existing key employees. Our success will largely depend on our ability to retain these key employees and to attract and retain qualified senior and middle level managers to our management team. Future changes in management could cause material disruptions to our business. We also depend on our ability to attract and retain in the future highly skilled technical, editorial, marketing and customer service personnel, especially experienced online game software developers. We cannot assure you that we will be able to attract or retain such personnel or that any personnel we hire in the future will successfully integrate into our organization or ultimately contribute positively to our business. In particular, the market for experienced online game software programmers is intensely competitive in China. While we believe we offer compensation packages that are consistent with market practice, we cannot be certain that we will be able to hire and retain sufficient experienced programmers to support our online games business. We may also be unsuccessful in training and retaining less-experienced programmers on a cost-effective basis. The loss of any of our key employees would significantly harm our business. We do not maintain key person life insurance on any of our employees.

**Our revenues fluctuate significantly and may adversely impact the trading price of our American Depositary Shares, or ADSs, or any other securities which become publicly traded.**

Our revenues and results of operations have varied significantly in the past and may continue to fluctuate in the future. Many of the factors that cause such fluctuation are outside our control. Steady revenues and results of operations will depend largely on our ability to:

- attract and retain users to our websites and other online and mobile platforms in the increasingly competitive Internet market in China;
- successfully implement our business strategies as planned; and
- update and develop our Internet applications, services, technologies and infrastructure.

Historically, our revenues from advertising and certain other online services have followed the same general seasonal trend throughout each year with the first quarter of the year being the weakest quarter due to the Chinese New Year holiday and the traditional close of customers' annual budgets and the fourth quarter being the strongest. Usage of online games has generally increased around the Chinese New Year holiday and other Chinese holidays, in particular winter and summer school holidays during which school-aged users have more time to use such services and play games. For our e-commerce business, we have generally experienced the highest levels of revenue in the fourth quarter of each calendar year as e-commerce companies in China including us organize special promotional campaigns annually on November 11 and December 12. Accordingly, you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance. It is possible that future fluctuations may cause our results of operations to be below the expectations of market analysts and investors. This could cause the trading price of our ADSs or any other securities of ours which may become publicly traded to decline.

**We do not own Guangzhou NetEase Computer System Co., Ltd., or Guangzhou NetEase, and certain other affiliated entities, and if they or their ultimate shareholders violate our contractual arrangements with them, our business could be disrupted, our reputation may be harmed and we may have to resort to litigation to enforce our rights, which may be time consuming and expensive.**

Certain of our affiliated companies are owned by shareholders whose interests may differ from ours and those of our shareholders because they own a larger percentage of such companies than of our company. In particular, the business and operations of Guangzhou NetEase, the operator of the NetEase websites and a provider of online games and other online services, Wangyibao Co., Ltd., or Wangyibao, the operator of our NetEase Pay (previously known as Wangyibao) online payment platform and a wholly-owned subsidiary of Guangzhou NetEase, Beijing NetEase Youdao Computer System Co., Ltd., or Youdao Computer, the operator of our online dictionary, online education and other cloud application services, Beijing NetEase Media Co., Ltd. (previously named Beijing Guangyitong Advertising Co., Ltd.), or NetEase Advertising, an advertising firm, Hangzhou NetEase Leihuo Network Co., Ltd., or Hangzhou Leihuo, a provider of mobile games, and certain other affiliated companies, are subject to Chinese laws and regulations that differ from the laws and regulations that govern the business and operations of NetEase. For example, Chinese laws and regulations require us to verify the content of third-party advertising we place on the NetEase websites and other online and mobile platforms, and we are partly dependent upon the conduct of NetEase Advertising in order to ensure that we remain compliant with those laws and regulations. These affiliated companies or their ultimate shareholders could violate our arrangements with them by, among other things, failing to operate and maintain the NetEase websites and other online and mobile platforms, or their various businesses in an acceptable manner, failing to remit revenue to us on a timely basis or at all or diverting customers or business opportunities from our company. In addition, the operation of the online games licensed from Blizzard is dependent on Shanghai EaseNet, which is owned by William Lei Ding, our Chief Executive Officer, director and major shareholder, and has contractual arrangements with us and with the joint venture established between Blizzard and us. The interests of Mr. Ding and the joint venture may differ from ours and those of our shareholders. A violation of the foregoing agreements could disrupt our business and adversely affect our reputation in the market. If these companies or their ultimate shareholders violate our agreements with them, we may have to incur substantial costs and expend significant resources to enforce those arrangements and rely on legal remedies under the PRC laws. The PRC laws, rules and regulations are relatively new, and because of the limited volume of published decisions and their non-binding nature, the interpretation and enforcement of these laws, rules and regulations involve substantial uncertainties. These uncertainties may impede our ability to enforce these agreements, or cause us to suffer significant delay or other obstacles in the process of enforcing these agreements, and may materially and adversely affect our results of operations and financial position.



Table of Contents

**Because our contractual arrangements with Guangzhou NetEase and certain other affiliated entities and their ultimate shareholders do not detail the parties' rights and obligations, our remedies for a breach of these arrangements are limited.**

Our current relationship with Guangzhou NetEase and certain other affiliated entities and their ultimate shareholders is based on a number of contracts, and these affiliated companies are considered our VIEs for accounting purposes. The terms of these agreements are often statements of general intent and do not detail the rights and obligations of the parties. Some of these contracts provide that the parties will enter into further agreements on the details of the services to be provided. Others contain price and payment terms that are subject to monthly adjustment. These provisions may be subject to differing interpretations, particularly on the details of the services to be provided and on price and payment terms. It may be difficult for us to obtain remedies or damages from Guangzhou NetEase and certain other affiliated entities or their ultimate shareholders for breaching our agreements. Because we rely significantly on these companies for our business, the realization of any of these risks may disrupt our operations or cause degradation in the quality and service provided on, or a temporary or permanent shutdown of, the NetEase websites or other online and mobile platforms.

**A majority of the share capital of Guangzhou NetEase, NetEase Advertising, Wangyibao, Youdao Computer and certain other affiliated entities and the entire share capital of Shanghai EaseNet are held by our major shareholder, who may cause these agreements to be amended in a manner that is adverse to us.**

Our major shareholder, William Lei Ding, directly or indirectly holds the majority interest in Guangzhou NetEase, NetEase Advertising, Wangyibao, Youdao Computer and certain other affiliated entities. As a result, Mr. Ding may be able to cause the agreements related to those companies to be amended in a manner that will be adverse to our company, or may be able to cause these agreements not to be renewed, even if their renewal would be beneficial for us. Although we have entered into an agreement that prevents the amendment of these agreements without the approval of the members of our Board other than Mr. Ding, we can provide no assurances that these agreements will not be amended in the future to contain terms that might differ from the terms that are currently in place. These differences may be adverse to our interests. In addition, William Lei Ding also holds the entire share capital of Shanghai EaseNet, and we can provide no assurance that Mr. Ding will not cause the agreements related to Shanghai EaseNet to be amended in the future in a manner that will be adverse to us or to contain terms that might differ from the terms that are currently in place. These differences may be adverse to our interests.

**We may not be able to conduct our operations without the services provided by Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer, and certain other affiliated entities.**

Our operations are currently dependent upon our commercial relationships with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer and certain other affiliated entities, and we derive most of our revenues from these companies. If these companies are unwilling or unable to perform the agreements which we have entered into with them, we may not be able to conduct our operations in the manner in which we currently do. In addition, Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer and certain other affiliated entities may seek to renew these agreements on terms that are disadvantageous to us. Although we have entered into a series of agreements that provide us with substantial ability to control these companies, we may not succeed in enforcing our rights under them. If we are unable to renew these agreements on favorable terms, or to enter into similar agreements with other parties, our business may not expand, and our operating expenses may increase.

**One of our shareholders has significant influence over our company.**

## Edgar Filing: NetEase, Inc. - Form 20-F

Our founder, Chief Executive Officer and director, William Lei Ding, beneficially owned, as of December 31, 2018, approximately 45.5% of our outstanding ordinary shares and is our largest shareholder. Accordingly, Mr. Ding has significant influence in determining the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including mergers, consolidations, the sale of all or substantially all of our assets, election of directors and other significant corporate actions. He also has significant influence in preventing or causing a change in control. In addition, without the consent of this shareholder, we may be prevented from entering into transactions that could be beneficial to us. The interests of Mr. Ding may differ from the interests of our other shareholders.

**Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and VIEs, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.**

NetEase, Inc. is a holding company with no significant assets other than cash on hand and its equity interests in its directly and indirectly-owned subsidiaries, including those set forth in the organizational diagram appearing in Item 4.B. Business Overview Our Organizational Structure. As a result, our primary internal source of funds for our cash and financing requirements is dividend payments and other distributions on equity from our subsidiaries. If these subsidiaries incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends or make other distributions to us, which in turn would limit our ability to pay dividends on our ADSs and service any debt we may incur. PRC tax authorities may also require us to amend our contractual arrangements with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer and certain other affiliated entities and their respective shareholders in a manner that would materially and adversely affect the ability of our subsidiaries to pay dividends and other distributions to us. In addition, Chinese legal restrictions permit payment of dividends only out of net income as determined in accordance with Chinese accounting standards and regulations. Under Chinese law, our PRC subsidiaries and VIEs are also required to set aside a portion of their net income each year to fund certain reserve funds, except in cases where a company's cumulative appropriations have already reached the statutory limit of 50% of that company's registered capital. These reserves are not distributable as cash dividends. Also see We may be treated as a resident enterprise for PRC tax purposes following the promulgation of the Enterprise Income Tax Law on January 1, 2008, which may subject us to PRC income tax for our global income and result in dividends payable by us to our foreign investors, and gains on the sales of our ordinary shares or ADSs, becoming subject to taxes under PRC tax laws, which may materially reduce the value of your investment. below for further details. Any limitation on the ability of our PRC subsidiaries and VIEs to transfer funds to us in the form of dividends or other distributions could materially and adversely limit our ability to grow, make investments or acquisitions that could be beneficial to our businesses, pay debt or dividends, and otherwise fund and conduct our business.

Table of Contents

In addition, any transfer of funds from us to any of our PRC subsidiaries or VIEs, either as a shareholder loan or as an increase in registered capital, is subject to certain statutory limit requirements and registration or approval of the relevant PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Our PRC subsidiaries and VIEs are not permitted under PRC law to directly lend money to one another.

Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our PRC subsidiaries or VIEs. These limitations on the free flow of funds between us and our PRC subsidiaries and VIEs could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.

**Our arrangements with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer and certain other affiliated entities and their respective shareholders may cause a transfer pricing adjustment and may be subject to scrutiny by the PRC tax authorities.**

We could face material and adverse tax consequences if the PRC tax authorities determine that our contracts with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer and certain other affiliated entities and their respective shareholders were not entered into based on arm's-length negotiations. Although our contractual arrangements are similar to those of other companies conducting similar operations in China, if the PRC tax authorities determine that these contracts were not entered into on an arm's-length basis, they may adjust our income and expenses for PRC tax purposes in the form of a transfer pricing adjustment which may result in an increase in our taxes.

**A transfer of shares of Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer or certain other affiliated entities may trigger tax liability.**

If we need to cause the transfer of shareholdings of Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer or certain other affiliated entities from their current respective shareholders to any other individual, we may be required to pay individual income tax in the PRC on behalf of the transferring shareholder. Such individual income tax would be based on any gain deemed to have been realized by such shareholder on such transfer, and may be calculated based on a tax rate of 20% applied to the transferring shareholder's interest in net book value of the entity whose shares are being transferred minus the original investment cost. A significant tax obligation arising from any such transfer of shares could materially adversely affect our business and results of operations.

**Our business benefits from certain PRC government incentives. Expiration of, or changes to, these incentives and PRC tax laws could have a material adverse effect on our operating results.**

Under China's Enterprise Income Tax Law, the enterprise income tax, or EIT, rate payable by domestic and foreign-invested enterprises is 25.0%. Preferential tax treatments are granted to entities that conduct business in encouraged sectors and to entities that are classified as High and New Technology Enterprises, or HNTEs, or Software Enterprises or Key Software Enterprises, whether such entities are foreign invested enterprises or domestic companies.

## Edgar Filing: NetEase, Inc. - Form 20-F

A number of our subsidiaries enjoy preferential tax rates by being recognized as an HNTE and/or a Key Software Enterprise. For example, NetEase Beijing, Boguan and NetEase (Hangzhou) Network Co., Ltd., or NetEase Hangzhou, and NetEase Media Technology (Beijing) Co., Ltd., or Media Beijing, were qualified as HNTEs and enjoyed a preferential tax rate of 15% for 2016, 2017 and 2018. In addition, Boguan, NetEase Hangzhou and Media Beijing were each qualified as a Key Software Enterprise in 2016, 2017 and 2018 and enjoyed a further reduced preferential tax rate of 10% for 2015, 2016 and 2017. See Item 5.A. Operating Results Income Taxes.

Table of Contents

Although we will attempt to obtain or maintain similar preferential tax statuses for our subsidiaries in the future, we cannot assure you that we will obtain or maintain any particular preferential tax status, and typically the relevant government agencies do not confirm that we have obtained or maintained a particular tax status until late in a given tax year or the following tax year. The qualifications for HNTE or Software Enterprise status are subject to an annual assessment by the relevant government authorities in China. Without any preferential tax status, the standard EIT rate of 25.0% will apply. Moreover, if there are further changes to the relevant income tax laws and their implementation, our subsidiaries and VIEs may need to pay additional taxes, which could have a material adverse effect on our results of operations.

**We may be treated as a resident enterprise for PRC tax purposes under the Enterprise Income Tax Law, which may subject us to PRC income tax for our global income and result in dividends payable by us to our foreign investors, and gains on the sales of our ordinary shares or ADSs, becoming subject to taxes under PRC tax laws, which may materially reduce the value of your investment.**

Under the Enterprise Income Tax Law, enterprises established outside of the PRC whose de facto management bodies are located in the PRC are considered resident enterprises, and will generally be subject to the uniform 25.0% EIT rate for their global income. Under the implementation rules of the Enterprise Income Tax Law, de facto management body is defined as the body that has material and overall management control over the business, personnel, accounts and properties of the enterprise. In April 2009, the PRC tax authority promulgated a circular to clarify the criteria for determining whether the de facto management bodies are located within the PRC for enterprises established outside of the PRC that are controlled by entities established within the PRC. However, the relevant laws and regulations remain unclear regarding treatment of an enterprise established outside the PRC that is not controlled by entities established within the PRC.

Some of our management is currently located in the PRC. Accordingly, we may be considered a resident enterprise and may therefore be subject to the EIT rate of 25.0% of our global income, and as a result, the amount of dividends we can pay to our shareholders could be reduced. We cannot confirm whether we will be considered a resident enterprise because the implementation rules are unclear at this time.

Under the implementation rules of the Enterprise Income Tax Law, dividends paid to non-resident enterprises by resident enterprises on profits earned after January 1, 2008 are regarded as income from sources within the PRC and therefore subject to a 10.0% withholding income tax, while dividends on profits earned before January 1, 2008 are not subject to the withholding income tax. Similarly, gains realized on the transfer of ordinary shares or ADSs by non-resident enterprises are also subject to a 10.0% PRC EIT if such gains are regarded as income derived from sources within the PRC. A lower withholding income tax rate of 5.0% is applied if the non-resident enterprises are registered in Hong Kong or other jurisdictions that have a favorable tax treaty arrangement with China. Nevertheless, the PRC State Administration of Taxation promulgated a tax notice on October 27, 2009, or Circular 601, which provides that tax treaty benefits will be denied to conduit or shell companies without business substance, and a beneficial ownership analysis will be used based on a substance-over-form principle to determine whether or not to grant tax treaty benefits. It is unclear at this stage whether Circular 601 applies to dividends from our PRC subsidiaries paid to us through our Hong Kong subsidiaries. It is possible that under Circular 601 our Hong Kong subsidiaries would not be considered to be the beneficial owners of any such dividends, and that, if such dividends are subject to withholding, such withholding rate would be 10% rather than the favorable 5% rate generally applicable under the tax treaty between mainland China and Hong Kong.

Because we may be treated as a resident enterprise, any dividends paid to the corporate shareholders or shareholders appearing as corporate entities on the share registers of NetEase, Inc. which are considered non-resident enterprises may be subject to withholding income tax, and gains realized on the transfer of our ordinary shares or ADSs by such shareholders may be subject to PRC income tax, which may adversely and materially affect the value of the investment in our shares or ADSs.

**If we fail to maintain an effective system of internal control over financial reporting, we may lose investor confidence in the reliability of our financial statements which in turn could negatively impact the trading price of our ADSs or otherwise harm our reputation.**

The SEC, as required under Section 404 of the Sarbanes-Oxley Act of 2002, has adopted rules requiring public companies to include a report of management on the effectiveness of such companies' internal control over financial reporting in their respective annual reports. In addition, an independent registered public accounting firm for a public company may be required to issue an attestation report on the effectiveness of such company's internal control over financial reporting.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting and concluded that our internal control over financial reporting was effective as of December 31, 2018. Our independent registered public accounting firm has also, in its audit report, concluded that our internal control over financial reporting was effective in all material aspects as of December 31, 2018. Please refer to Item 15 Controls and Procedures. However, if we fail to maintain effective internal control over financial reporting in the future, our management and our independent registered public accounting firm may not be able to conclude that we have effective internal control over financial reporting in accordance with the Sarbanes-Oxley Act of 2002. Moreover, effective internal control over financial reporting is necessary for us to produce reliable financial reports. As a result, any failure to maintain effective internal control over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could negatively impact the trading price of our ADSs or otherwise harm our reputation. Furthermore, we may need to incur additional costs and use additional management and other resources in an effort to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and other requirements going forward.

Table of Contents

**Unexpected network interruption caused by system failures may reduce visitor traffic and harm our reputation.**

Both the continual accessibility of the NetEase websites and other online and mobile platforms and the performance and reliability of our technical infrastructure are critical to our reputation and the ability of the NetEase websites and other online and mobile platforms to attract and retain users and advertisers. Any system failure or performance inadequacy that causes interruptions in the availability of our services or increases the response time of our services could reduce user satisfaction and traffic, which would reduce the NetEase websites and other online and mobile platforms' appeal to users and advertisers. As the number of NetEase websites, mobile applications and traffic increase, we cannot assure you that we will be able to scale our systems proportionately. Any system failures and electrical outages could materially and adversely impact our business.

**Our operations are vulnerable to natural disasters, widespread public health problems and other events.**

We have limited backup systems and have experienced system failures and electrical outages from time to time in the past, which have disrupted our operations. Most of our servers and routers are currently located at several different locations in China. Our disaster recovery plan cannot fully ensure safety in the event of damage from fire, floods, typhoons, earthquakes, power loss, telecommunications failures, break-ins and similar events. If any of the foregoing occurs, we may experience a system shutdown. We do not carry any business interruption insurance. To improve performance and to prevent disruption of our services, we may have to make substantial investments to deploy additional servers. We carry property insurance with low coverage limits that may not be adequate to compensate us for all losses, particularly with respect to loss of business and reputation that may occur.

In addition, our business could be adversely affected by widespread public health or other outbreaks and epidemics. In recent years, there have been recent reports of outbreaks of an avian flu caused by the H7N9 influenza and H5N6 influenza including confirmed human cases in China. The spread of avian flu or any other widespread public health problem in China, where substantially all of our revenue is derived, or in Beijing, Shanghai, Guangzhou or Hangzhou, where most of our employees are located, could have a material and adverse effect on our business and operations. Our operations may be impacted due to closures of our offices or the sickness or death of our key officers and employees. Our operations could also be severely disrupted if such health problems or outbreak lead to a general slowdown in the Chinese economy or if our suppliers, customers or business partners were affected by such natural disasters, outbreaks or health epidemics.

**Merger, acquisitions and investments could result in operating difficulties, dilution and other harmful consequences.**

We from time to time evaluate and enter into discussions regarding a wide array of potential long-term investments, merger or acquisition transactions. Any transactions that we enter into could be material to our financial condition and results of operations. The process of integrating with another company or integrating an acquired company, business, asset or technology may create unforeseen operating difficulties and expenditures. The areas where we face risks include:

- significant costs of identifying and consummating acquisitions;
- diversion of management time and focus from operating our business to acquisition integration challenges;

- difficulties in integrating the management, technologies and employees of the acquired businesses;
- implementation or remediation of controls, procedures and policies at the acquired company;
- coordination of products and services, engineering and sales and marketing functions;
- retention of employees from the businesses we acquire;
- liability for activities of the acquired company before the acquisition;
- potential significant impairment losses related to goodwill and other intangible assets acquired or investments in other businesses;
- litigation or other claims in connection with the acquired company;
- significant expenses in obtaining approvals for the transaction from shareholders and relevant government authorities in China;
- in the case of overseas acquisitions, the need to integrate operations across different cultures and languages and to address the particular economic, currency, political and regulatory risks associated with specific countries; and



Table of Contents

- failure to achieve the intended objectives, benefits or revenue-enhancing opportunities.

Our failure to address these risks or other problems encountered in connection with our future acquisitions and investments could cause us to fail to realize the anticipated benefits of such acquisitions or investments, incur unanticipated liabilities and expenses and harm our business generally. If we use our equity securities to pay for acquisitions, we may dilute the value of your ADSs and the underlying ordinary shares. If we borrow funds to finance acquisitions, such debt instruments may contain restrictive covenants that could, among other things, restrict us from distributing dividends. Such acquisitions and investments may also lead to significant amortization expenses related to intangible assets, impairment charges or write-offs.

**If our providers of bandwidth and server custody service fail to provide these services, our business could be materially curtailed.**

We rely on affiliates of China Unicom, China Telecom and China Net Center to provide us with bandwidth and server custody service for Internet users to access the NetEase websites and other online and mobile platforms. If China Unicom, China Telecom, China Net Center or their affiliates fail to provide such services or raise prices for their services, we may not be able to find a reliable and cost-effective substitute provider on a timely basis or at all. If this happens, our business could be materially curtailed.

**We may be held liable for information or content displayed on, retrieved from or linked to the NetEase websites and other online and mobile platforms.**

We may face liability for defamation, negligence, copyright, patent or trademark infringement and other claims based on the nature and content of the materials that are published on the NetEase websites and other online and mobile platforms. We are involved in several intellectual property infringement claims or actions and are occasionally subject to defamation claims. We believe that the amounts claimed in these actions, in the aggregate, are not material to our business. However, these amounts may be increased for a variety of reasons as the claims progress, and we and our affiliates could be subject to additional defamation or infringement claims which, singly or in the aggregate, could have a material adverse effect on our business and results of operations, if successful. We also could be subject to claims based upon user-generated content that is accessible on the NetEase websites or other online and mobile platforms such as content and materials posted by users on message boards, online communities, voting systems, e-mail, chat rooms or livestreams that are offered on the NetEase websites or online and mobile platforms. By providing technology for hypertext links to third-party websites, we may be held liable for copyright or trademark violations by those third-party sites. Third parties could assert claims against us for losses incurred in reliance on any erroneous information distributed by us. Moreover, users of the NetEase web-based e-mail services could seek damages from us for:

- unsolicited e-mails;
- lost or misplaced messages;
- illegal or fraudulent use of e-mail; or

- interruptions or delays in e-mail service.

We may incur significant costs in investigating and defending these claims, even if they do not result in liability.

**Information displayed on, retrieved from or linked to the NetEase websites and other online and mobile platforms may subject us to claims of violating Chinese laws.**

Violations or perceived violations of Chinese laws arising from information displayed on, retrieved from or linked to the NetEase websites and other online and mobile platforms could result in significant penalties, including a temporary or complete cessation of our business. China has enacted regulations governing Internet access and the distribution of news and other information. Furthermore, multiple organizations are involved in the administering of such regulations, including the Propaganda Department of the Chinese Communist Party, which has been given the responsibility to censor news published in China to ensure, supervise and control a particular political ideology, and the Cyberspace Administration of China, or CAC, which has been given the responsibility to protect, supervise and administer cyber security issues in China. In addition, the PRC Ministry of Industries and Information Technology, or MII, has published implementing regulations that subject online information providers to potential liability for content included in their media and the actions of subscribers and others using their systems, including liability for violation of PRC laws prohibiting the distribution of content deemed to be socially destabilizing. The Ministry of Public Security has also from time to time prohibited the distribution over the Internet of information which it believes to be socially destabilizing.

The Ministry of Public Security has the authority to require any local Internet service provider to block any website maintained outside China at its sole discretion. The State Secrecy Bureau, which is directly responsible for the protection of state secrets of all PRC government and Chinese Communist Party organizations, is authorized to block any website it deems to be leaking state secrets or failing to meet the relevant regulations relating to the protection of state secrets in the distribution of online information. The term "state secrets" has been broadly interpreted by Chinese governmental authorities in the past. We may be liable under any of these pronouncements for content and materials posted or transmitted by users on message boards, virtual communities, chat rooms or e-mails. Furthermore, where the transmitted content clearly violates the laws of the PRC, we will be required to delete it. In the case where we consider transmitted content suspicious, we are required to report such content. We must also undergo computer security inspections, and if we fail to implement the relevant safeguards against security breaches, we may be shut down. In addition, under the relevant regulations, Internet companies which provide bulletin board systems, chat rooms or similar services, such as our company, must apply for the approval of the State Secrecy Bureau. As the implementing rules of these new regulations have not been issued, we do not know how or when we will be expected to comply, or how our business will be affected by the application of these regulations.

Table of Contents

If the Chinese government takes any action to limit or eliminate the distribution of information through the NetEase websites or other online and mobile platforms, or to limit or regulate any current or future community functions available to users or otherwise block the NetEase websites or other online and mobile platforms, our business would be significantly harmed.

**We may not be able to adequately protect our intellectual property, and we may be exposed to infringement claims by third parties.**

We rely on a combination of copyright, trademark, patent and trade secrecy laws and contractual restrictions on disclosure to protect our intellectual property rights. Our efforts to protect our proprietary rights may not be effective in preventing unauthorized parties from copying or otherwise obtaining and using our technology. Monitoring unauthorized use of our services is difficult and costly, and we cannot be certain that the steps we take will effectively prevent misappropriation of our technology.

From time to time, we may have to resort to litigation to enforce our intellectual property rights, which could result in substantial costs and diversion of our resources. In addition, third parties have initiated litigation against us for alleged infringement of their proprietary rights, and additional claims may arise in the future. In the event of a successful claim of infringement and our failure or inability to develop non-infringing technology or content or to license the infringed or similar technology or content on a timely basis, our business could suffer. Moreover, even if we are able to license the infringed or similar technology or content, license fees that we pay to licensors could be substantial or uneconomical. See Item 4.B. Business Overview Intellectual Property and Proprietary Rights.

**Our ability to conduct business in international markets may be adversely affected by legal, regulatory and other risks.**

International expansion of our online games is an important component of our growth strategy and may subject us to additional risks and challenges, including but not limited to challenges in formulating effective local sales and marketing strategies targeting users from various jurisdictions and cultures, who have a diverse range of preferences and demands; challenges in identifying appropriate local business partners and establishing and maintaining good working relationships with them; exposure to different tax jurisdictions that may subject us to greater fluctuations in our effective tax rate and potentially adverse tax consequence; and risks of increased costs associated with doing business in foreign jurisdictions. If we fail to address any of these risks and challenges associated with our international expansion, our reputation, business and results of operations may be adversely affected.

**We may be or become a passive foreign investment company, or PFIC, which could result in adverse U.S. federal income tax consequences to U.S. investors.**

We may be classified as a passive foreign investment company, or PFIC, by the U.S. Internal Revenue Service for U.S. federal income tax purposes. Such characterization could result in adverse U.S. federal income tax consequences to you if you are a U.S. investor. For example, U.S. investors who owned our shares or ADSs during any taxable year in which we were a PFIC generally are subject to increased U.S. tax liabilities and reporting requirements for that taxable year and all succeeding years, regardless of whether we actually continue to be a PFIC, although a shareholder election to terminate such deemed PFIC status may be available in certain circumstances.

## Edgar Filing: NetEase, Inc. - Form 20-F

The determination of whether or not we are a PFIC is made on an annual basis and depends on the composition of our income and assets, including goodwill, from time to time. Specifically, we will be classified as a PFIC for U.S. tax purposes for a taxable year if either (a) 75% or more of our gross income for such taxable year is passive income, or (b) 50% or more of the average percentage of our assets during such taxable year either produce passive income or are held for the production of passive income. For such purposes, if we directly or indirectly own 25% or more of the shares of another corporation, we generally will be treated as if we (a) held directly a proportionate share of the other corporation's assets, and (b) received directly a proportionate share of the other corporation's income.

We do not believe that we were a PFIC for the taxable year 2018. The PFIC determination is highly fact intensive and made at the end of each taxable year. For these reasons, there can be no assurance that we were not a PFIC in 2018 or that we will not be a PFIC in any future taxable year or that the U.S. Internal Revenue Service will not challenge our determination concerning our PFIC status.

If we are or become a PFIC, and, if so, if one or more of our subsidiaries are treated as PFICs, U.S. holders of our shares or ADSs would be subject to adverse U.S. federal income tax consequences, such as ineligibility for any preferential tax rates on capital gains or on actual or deemed dividends, interest charges on certain taxes treated as deferred, and additional reporting requirements under U.S. federal income tax laws and regulations. Whether U.S. holders of our shares or ADSs make (or are eligible to make) a timely qualified electing fund, or QEF, election or a mark-to-market election may affect the U.S. federal income tax consequences to U.S. holders with respect to the acquisition, ownership and disposition of our shares and ADSs and any distributions such U.S. holders may receive. We do not, however, expect to provide the information regarding our income that would be necessary in order for a U.S. holder to make a QEF election if we are classified as a PFIC. Investors should consult their own tax advisors regarding all aspects of the application of the PFIC rules to our shares and ADSs.

Table of Contents

If we are a PFIC in any year with respect to a U.S. Holder (as defined below), the U.S. Holder will be required to file an annual information return on IRS Form 8621 regarding distributions received on our shares or ADSs and any gain realized on the disposition of our shares or ADSs, and certain U.S. Holders will be required to file an annual information return (also on IRS Form 8621) relating to their ownership of our shares or ADSs. U.S. Holders should consult their tax advisors regarding the potential application of the PFIC regime and related reporting requirements.

For further discussion of the adverse U.S. federal income tax consequences of our possible classification as a PFIC, see Item 10.E Additional Information Taxation United States Federal Income Taxation.

**RISKS RELATED TO DOING BUSINESS IN CHINA**

**The uncertain legal environment in China could limit the legal protections available to you.**

The Chinese legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In the late 1970s, the Chinese government began to promulgate a comprehensive system of laws and regulations governing economic matters. The overall effect of legislation enacted over the past 40 years has significantly enhanced the protections afforded to foreign invested enterprises in China. However, these laws, regulations and legal requirements are relatively recent and are evolving rapidly, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to foreign investors.

**Substantial uncertainties exist with respect to how the 2019 Foreign Investment Law may impact the viability of our current corporate structure, corporate governance and business operations.**

On March 15, 2019, the Standing Committee of National People's Congress promulgated the Law of Foreign Investment, or the 2019 Law of Foreign Investment, which is expected to become effective on January 1, 2020. The 2019 Law of Foreign Investment replaces the trio of existing laws regulating foreign investment in China, namely, the Sino-Foreign Equity Joint Venture Enterprise Law, the Sino-Foreign Cooperative Joint Venture Enterprise Law and the Wholly Foreign-Owned Enterprise Law, together with their implementation rules and ancillary regulations, and embodies an expected PRC regulatory trend to rationalize its foreign investment regulatory regime in line with prevailing international practice and the legislative efforts to unify the corporate legal requirements for both foreign and domestic investments. However, uncertainties still exist in relation to interpretation and implementation of the 2019 Law of Foreign Investment, especially in regard to, including, among other things, the nature of VIE contractual arrangements, the promulgation schedule of both the negative list under the 2019 Law of Foreign Investment and specific rules regulating the organization form of foreign-invested enterprises within the five-year transition period. The variable interest entity structure, or VIE structure, has been adopted by many PRC-based companies, including us, to obtain necessary licenses and permits in the industries that are currently subject to foreign investment restrictions in China. See Risks Related to Our Corporate Structure and Our Organizational Structure. While the 2019 Law of Foreign Investment does not define contractual arrangements as a form of foreign investment explicitly, we cannot assure you that future laws and regulations will not provide for contractual arrangements as a form of foreign investment. Therefore, there can be no assurance that our control over our VIEs through contractual arrangements will not be deemed as foreign investment in the future.

## Edgar Filing: NetEase, Inc. - Form 20-F

In the event that any possible implementing regulations of the 2019 Law of Foreign Investment, any other future laws, administrative regulations or provisions deem contractual arrangements as a way of foreign investment, or if any of our operations through contractual arrangements is classified in the restricted or prohibited industry in the future negative list under the 2019 Law of Foreign Investment, our contractual arrangements may be deemed as invalid and illegal, and we may be required to unwind the variable interest entity contractual arrangements and/or dispose of any affected business. Also, if future laws, administrative regulations or provisions mandate further actions to be taken with respect to existing contractual arrangements, we may face substantial uncertainties as to whether we can complete such actions in a timely manner, or at all. In addition, the 2019 Law of Foreign Investment provides that foreign invested enterprises established according to the existing laws regulating foreign investment may maintain their structure and corporate governance within a five-year transition period, which means that we may be required to adjust the structure and corporate governance of certain of our PRC subsidiaries in such transition period. Failure to take timely and appropriate measures to cope with any of these or similar regulatory compliance challenges could materially and adversely affect our current corporate structure, corporate governance and business operations.

Table of Contents

**Contract drafting, interpretation and enforcement in China involve significant uncertainty.**

We have entered into numerous contracts governed by PRC law, many of which are material to our business. As compared with contracts in the United States, contracts governed by PRC law tend to contain less detail and are not as comprehensive in defining contracting parties' rights and obligations. As a result, contracts in China are more vulnerable to disputes and legal challenges. In addition, contract interpretation and enforcement in China is not as developed as in the United States, and the result of any contract dispute is subject to significant uncertainties. Therefore, we cannot assure you that we will not be subject to disputes under our material contracts, and if such disputes arise, we cannot assure you that we will prevail. Any dispute involving material contracts, even without merit, may materially and adversely affect our reputation and our business operations, and may cause the price of our ADSs to decline.

**Changes in China's political and economic policies could harm our business.**

The economy of China has historically been a planned economy subject to governmental plans and quotas and has, in certain aspects, been transitioning to a more market-oriented economy. Although we believe that the economic reform and the macroeconomic measures adopted by the Chinese government have had a positive effect on the economic development of China, we cannot predict the future direction of these economic reforms or the effects these measures may have on our business, financial position or results of operations. In addition, the Chinese economy differs from the economies of most countries belonging to the Organization for Economic Co-operation and Development, or OECD. These differences include:

- economic structure;
- level of government involvement in the economy;
- level of development;
- level of capital reinvestment;
- control of foreign exchange;
- inflation rates;
- methods of allocating resources; and

- balance of payments position.

As a result of these differences, our business may not develop in the same way or at the same rate as might be expected if the Chinese economy were similar to those of the OECD member countries.

**Fluctuation in Renminbi exchange rates could adversely affect the value of our ADSs and any cash dividend declared on them.**

The value of the RMB against the U.S. dollar and other currencies is affected by changes in China's political and economic conditions and by China's foreign exchange policies, among other things. On July 21, 2005, the PRC government changed its policy of pegging the value of the RMB to the U.S. dollar, and the RMB appreciated more than 20% against the U.S. dollar over the following three years. Between July 2008 and June 2010, this appreciation halted and the exchange rate between the RMB and the U.S. dollar remained within a narrow band. The PRC government allowed the RMB to appreciate slowly against the U.S. dollar again, and it had appreciated more than 10% since June 2010 until it began to depreciate against the U.S. dollar in January 2014. Between January 2014 and December 2018, the RMB depreciated against the U.S. dollar by approximately 13.6%. It is difficult to predict how market forces or PRC or U.S. government policy may impact the exchange rate between the RMB and the U.S. dollar in the future. In addition, there remains significant international pressure on the PRC government to adopt a substantial liberalization of its currency policy, which could result in more uncertainties in the value of the RMB against the U.S. dollar. Our revenues are primarily denominated in Renminbi, and any significant depreciation of the RMB may affect the value of, and dividends (if any) payable on, our ADSs in U.S. dollar terms.

**Restrictions on currency exchange may limit our ability to utilize our revenues effectively.**

Most of our revenues and operating expenses are denominated in Renminbi. The Renminbi is currently freely convertible under the "current account" which includes dividends, trade and service-related foreign exchange transactions, but not under the "capital account" which includes foreign direct investment and loans.

Under existing PRC foreign exchange regulations, payments of current account items, including payment of dividends, interest payments and trade and service-related foreign exchange transactions, can be made in foreign currencies without prior approval of the State Administration of Foreign Exchange, or SAFE, by complying with certain procedural requirements. Our PRC subsidiaries and affiliates may also retain foreign exchange in its current account to satisfy foreign exchange liabilities or to pay dividends.



Table of Contents

Since a significant amount of our future revenues will be denominated in Renminbi, the existing and any future restrictions on currency exchange may limit our ability to utilize revenues generated in Renminbi to fund our business activities outside China, if any, or expenditures denominated in foreign currencies. In order to limit the flow of capital out of China, the overall current regulatory environment relating to foreign exchange controls in China suggests that, as a matter of practice, SAFE has been making it increasingly difficult to obtain foreign exchange approvals for offshore dividend payments or capital account settlement.

In addition, foreign exchange transactions under the capital account are subject to limitations and require registration with or approval by the relevant PRC governmental authorities. In particular, any transfer of funds from us to any of our PRC subsidiaries or VIEs, either as a shareholder loan or as an increase in registered capital, is subject to certain statutory limit requirements and registration or approval of the relevant PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Our ability to use the U.S. dollar proceeds of the sale of our equity or debt to finance our business activities conducted through our PRC subsidiaries or VIEs will depend on our ability to obtain these governmental registrations or approvals. In addition, because of the regulatory issues related to foreign currency loans to, and foreign investment in, domestic PRC enterprises, we may not be able to finance the operations of our PRC subsidiaries or VIEs by loans or capital contributions. We cannot assure you that we can obtain these governmental registrations or approvals on a timely basis, if at all. Any future restrictions imposed by SAFE or tightened foreign exchange control by SAFE as a matter of practice may adversely affect our ability to utilize our revenues effectively and pay dividends to our shareholders.

**Failure to comply with PRC regulations regarding the registration requirements for employee equity incentive plans may subject our PRC citizen employees or us to fines and other legal or administrative sanctions.**

On March 28, 2007, SAFE promulgated the Application Procedure of Foreign Exchange Administration for Domestic Individuals Participating in Employee Stock Holding Plan or Share Option Plan of Overseas-Listed Company, or the Share Option Rule. On February 15, 2012, SAFE issued the Notices on Issues Concerning the Foreign Exchange Administration for Domestic Individuals Participating in Stock Incentive Plan of Overseas-Listed Company, or the Stock Incentive Plan Rule, which replaced the Share Option Rule. Under the Stock Incentive Plan Rule, PRC citizens who are granted share options or other employee equity incentive awards by an overseas publicly-listed company are required, through a qualified PRC agent or a PRC subsidiary of such overseas publicly-listed company, to register with SAFE and complete certain other procedures related to the share options or other employee equity incentive plans. We have registered with and obtained approvals from the SAFE office in Beijing for the participants of our equity compensation plans who are PRC citizens. Nevertheless, if we or such PRC participants fail to comply with these regulations, we or such PRC participants may be subject to fines and other legal or administrative sanctions.

**The Chinese government has strengthened the regulation of investments made by Chinese residents in offshore companies and reinvestments in China made by these offshore companies. Our business may be adversely affected by these restrictions.**

The SAFE has adopted certain regulations that require registration with, and approval from, Chinese government authorities in connection with direct or indirect control of an offshore entity by Chinese residents. The term "control" under SAFE regulation is broadly defined as the operation rights, beneficiary rights or decision-making rights acquired by PRC residents in the offshore special purpose vehicles or PRC companies by means of acquisition, trust, proxy, voting rights, repurchase, convertible bonds or other arrangements. The SAFE regulations retroactively require registration of investments in non-Chinese companies previously made by Chinese residents. In particular, the SAFE regulations require Chinese residents to file with SAFE information about offshore companies in which they have directly or indirectly invested and to make follow-up filings in connection with certain material transactions involving such offshore companies, such as mergers, acquisitions, capital increases and decreases, external equity investments or equity transfers. In addition, Chinese residents must obtain approval from SAFE before they transfer domestic assets or equity interests in exchange for equity or other property rights in an offshore company. A newly established enterprise in China which receives foreign investments is also required to provide detailed information about its controlling shareholders and to certify whether it is directly or indirectly controlled by a domestic entity or resident.

In the event that a Chinese shareholder with a direct or indirect stake in an offshore parent company fails to make the requisite SAFE registration, the Chinese subsidiaries of such offshore parent company may be prohibited from making distributions of profit to the offshore parent and from paying the offshore parent proceeds from any reduction in capital, share transfer or liquidation in respect of the Chinese subsidiaries. Further, failure to comply with the various SAFE registration requirements described above can result in liability under Chinese law for foreign exchange evasion.

These regulations may have a significant impact on our present and future structuring and investment. We have requested our shareholders who to our knowledge are PRC residents to make the necessary applications, filings and amendments as required under these regulations. We intend to take all necessary measures to ensure that all required applications and filings will be duly made and all other requirements will be met. We further intend to structure and execute our future offshore acquisitions in a manner consistent with these regulations and any other relevant legislation. However, because it is presently uncertain how the SAFE regulations, and any future legislation concerning offshore or cross-border transactions, will be interpreted and implemented by the relevant government authorities in connection with our future offshore financings or acquisitions, we cannot provide any assurances that we will be able to comply with, qualify under, or obtain any approvals required by the regulations or other legislation. Furthermore, we cannot assure you that any PRC shareholders of our company or any PRC company into which we invest will be able to comply with those requirements. The inability of our company or any PRC shareholder to secure required approvals or registrations in connection with our future offshore financings or acquisitions may subject us to legal sanctions, restrict our ability to pay dividends from our Chinese subsidiaries to our offshore holding company, and restrict our overseas or cross-border investment activities or affect our ownership structure.

Table of Contents

**Our auditor, like other independent registered public accounting firms operating in China, is not permitted to be subject to inspection by the Public Company Accounting Oversight Board, and consequently you are deprived of the benefits of such inspection.**

Our auditor, the independent registered public accounting firm that issued the audit report included elsewhere in this annual report, as an auditor of companies that are registered with the SEC and traded publicly in the United States and a firm registered with the U.S. Public Company Accounting Oversight Board, or PCAOB, is subject to the laws in the United States pursuant to which the PCAOB conducts regular inspections to assess its compliance with the applicable professional standards. Our auditor is located in, and organized under the laws of, the PRC, which is a jurisdiction where the PCAOB has been unable to conduct inspections without the approval of the Chinese authorities. The PCAOB announced on May 24, 2013 that it had entered into a Memorandum of Understanding on Enforcement Cooperation, or the MOU, with the China Securities Regulatory Commission, or the CSRC, and the PRC Ministry of Finance, or the MOF. The MOU establishes a cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in the US and the PRC. The PCAOB continues to engage in discussions with the CSRC and the MOF to permit joint inspections in China of audit firms that are registered with the PCAOB and audit China-based companies that trade on U.S. exchanges. However, the implementation procedures of the MOU remain uncertain.

On December 7, 2018, the SEC and the PCAOB issued a joint statement highlighting continued challenges faced by the U.S. regulators in their oversight of financial statement audits of U.S.-listed companies with significant operations in China. However, it remains unclear what further actions, if any, the SEC and PCAOB will take to address the problem.

This lack of PCAOB inspections in China prevents the PCAOB from fully evaluating audits and quality control procedures of our independent registered public accounting firm. As a result, we and our investors are deprived of the benefits of such PCAOB inspections. The inability of the PCAOB to conduct inspections of auditors in China makes it more difficult to evaluate the effectiveness of our independent registered public accounting firm's audit procedures or quality control procedures as compared to auditors outside of China that are subject to PCAOB inspections, which could cause investors and potential investors in us to lose confidence in our audit procedures and reported financial information and the quality of our financial statements.

**We may be adversely affected by the outcome of the administrative proceedings brought by the SEC against the Big Four PRC-based accounting firms.**

In December 2012, the SEC brought administrative proceedings against the Big Four accounting firms in China, including our independent registered public accounting firm, alleging that these accounting firms had violated U.S. securities laws and the SEC's rules and regulations thereunder by failing to provide to the SEC the firms' audit papers and other documents related to certain PRC-based companies that are publicly traded in the United States.

On January 22, 2014, the administrative law judge presiding over the matter reached an initial decision that the firms had each violated the SEC's rules of practice by failing to produce the audit work papers and related documents directly to the SEC. The initial decision further determined that each of the firms should be censured and barred from practicing before the SEC for a period of six months.

On February 6, 2015, the four PRC-based accounting firms each agreed to a censure and to pay a fine to the SEC to settle the dispute and avoid suspension of their ability to practice before the SEC and to audit U.S.-listed companies. The settlement required the Chinese firms to follow detailed procedures and to seek to provide the SEC with access to these firms' audit documents via the CSRC. Under the terms of the settlement,

## Edgar Filing: NetEase, Inc. - Form 20-F

the underlying proceeding against the four China-based accounting firms was deemed dismissed with prejudice four years after entry of the settlement. The four-year anniversary occurred on February 6, 2019. While we cannot predict if the SEC will further challenge the Big Four PRC-based accounting firms' compliance with U.S. law in connection with U.S. regulatory requests for audit work papers or if the results of such a challenge would result in the SEC imposing penalties such as suspensions, if the accounting firms are subject to additional remedial measures, we may not be able to continue to meet our reporting obligations under the Securities Exchange Act of 1934, as amended, or the Exchange Act, which may ultimately result in our deregistration by the SEC and delisting from the NASDAQ, in which case our market capitalization may decline sharply and the value of your investment in our ADSs may be materially and adversely affected.

Table of Contents

**RISKS RELATED TO THE TELECOMMUNICATIONS AND INTERNET INDUSTRIES IN CHINA**

**Changes in government regulation of the telecommunications and Internet industries in China may result in uncertainties in interpretation and/or the Chinese government requiring us to obtain additional licenses or other governmental approvals to conduct our business, both of which may restrict our operations.**

The telecommunications and Internet industry, including ICP services and online games, is highly regulated by the Chinese government. In addition, the telecommunication and Internet-related laws and regulations are relatively new and constantly evolving, and their interpretation and enforcement involve significant uncertainties. As a result, in certain circumstances, it may be difficult to determine what actions or omissions may be deemed to be in violation of applicable laws and regulations in this area.

Currently, to operate our business in compliance with all the relevant ICP-related Chinese regulations, we have control over our websites and other online and mobile platforms through contractual arrangements. For example, we rely exclusively on contractual arrangements with Guangzhou NetEase and its approvals to operate as an ICP as a result of restrictions on foreign investment for businesses providing value-added telecommunications services in China, including Internet information services. In addition, Shanghai EaseNet holds the Value-Added Telecommunications Business Operating License issued by the Shanghai Provincial Telecommunications Bureau and the Internet Culture Operating License from the Ministry of Culture, or the MOC (later superseded by the Ministry of Culture and Tourism, or the MOCT), and we rely on contractual arrangements with Shanghai EaseNet for our operations of online games licensed from Blizzard.

The evolving PRC regulatory system for the telecommunications and Internet industries may lead to the establishment of new regulatory agencies. For example, in May 2011, the State Council, in collaboration with the State Council Information Office, the MIIT and the Ministry of Public Security, announced the establishment of the CAC, whose primary role is to facilitate the policy-making and legislative development in the telecommunications and Internet industries by coordinating with other relevant governmental agencies in connection with online content administration and handling cross-ministry regulatory matters in relation to such industries.

In addition, we are uncertain as to whether the Chinese government will reclassify our business as a media or retail company, due to our acceptance of fees for Internet advertising, online games, e-commerce, and other innovative services as sources of revenues, or as a result of our current corporate structure. Such reclassification could subject us to penalties or fines or significant restrictions on our business. Moreover, NetEase, Inc. may have difficulties enforcing its rights under the agreements with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Youdao Computer, Shanghai EaseNet or other affiliated entities if any of these parties breaches any of the agreements with them because NetEase, Inc. does not have approval from appropriate Chinese authorities to provide Internet content services, Internet advertising services, e-commerce services or other innovative services. Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services, online advertising and online gaming may impose additional regulatory requirements on us or our service providers or otherwise harm our business.

**The Chinese government restricts the ability for foreign investors to invest in and operate in the value-added telecommunications businesses.**

In July 2006, the MII issued a notice to strengthen management of foreign investment in and operation of value-added telecommunications services. The notice emphasizes that foreign investors who wish to engage in value-added telecommunications services must strictly follow the relevant rules and regulations on foreign investment in telecommunication sectors. The notice also prohibits domestic telecommunications

## Edgar Filing: NetEase, Inc. - Form 20-F

services providers from leasing, transferring or selling telecommunications business operating licenses to any foreign investor in any form, or providing any resources, sites or facilities to any foreign investor for their illegal operation of a telecommunications business in China. According to the notice, either the holder of a value-added telecommunication service license or its shareholders must directly own the domain names and trademarks used by such license holders in their provision of value-added telecommunications services. The notice further requires each license holder to have the necessary facilities, including servers, for its approved business operations and to maintain such facilities in the regions covered by its license. Value-added services license holders are required to evaluate the compliance with the requirements set forth in the notice. To comply with these requirements, Guangzhou NetEase submitted its self-correction report to MII in 2007.

In September 2009, General Administration of Press and Publication, or GAPP (later superseded by the State Administration of Radio and Television, or the SART), together with the National Copyright Administration and National Office of Combating Pornography and Illegal Publications issued a Notice on Further Strengthening on the Administration of Pre-examination and Approval of Online Games and the Examination and Approval of Imported Online Games, or the GAPP Notice. The GAPP Notice restates that foreign investors are not permitted to invest in online game operating businesses in China via wholly-owned, equity joint venture or cooperative joint venture investments and expressly prohibits foreign investors from gaining control over or participating in domestic online game operators through indirect ways such as establishing other joint venture companies, or contractual or technical arrangements. In addition, the Administration of Online Publishing Service jointly issued by the State Administration of Press, Publication, Radio, Film and Television, or the SAPPRFT (later superseded by the SART) and MII, effective on March 10, 2016, forbids foreign investments in the online publishing business.

Table of Contents

With respect to our Internet media business, the CAC's Administrative Provisions for Internet-based News Information Services, which became effective from June 1, 2017, expressly prohibit any Sino-foreign equity joint venture or cooperative joint venture or any foreign-funded enterprise to conduct Internet-based news information services. We believe we are in compliance with such requirement because our Internet media business is conducted through our contractually controlled VIEs that are PRC entities. Additionally, in accordance with the Several Opinions on the Introduction of Foreign Capital to the Culture Sector (Wen Ban Fa [2005] No. 19) by the MOC (later superseded by the MOCT), foreign investors (excluding Hong Kong and Macau) are prohibited from establishing or operating Internet-based cultural institutions. It is unclear what activities count as operating Internet-based cultural institutions, however certain services we provide in our innovative businesses and others segment, particularly our online education platforms, are likely to be deemed as such. We believe we are also in compliance with this requirement because we operate our other innovative businesses and other services through our contractually controlled VIEs.

It is unclear whether the authorities will deem our VIE structure as a kind of such indirect ways by foreign investors to gain control over or participate in domestic online game operators, Internet-based news information services or Internet-based cultural institutions. If our VIE structure is deemed as one such indirect way, our VIE structure may be challenged by the authorities and the authorities may require us to restructure our VIE structure and take action to prohibit or restrict our business operations. In such case, we may not be able to operate or control business in the same manner as we currently do and may not be able to consolidate the VIEs.

Although for our e-commerce business, according to the Notice on Lifting the Restriction to Foreign Shareholding Percentage in Online Data Processing and Transaction Processing Business (Operational E-commerce) promulgated by the MIIT on June 19, 2015, foreign investors are allowed to hold up to 100% of the equity interests in an online data processing and transaction processing business (operational e-commerce) in China, other requirements provided by the SART and MIIT regulations still apply. It is unclear how this notice will be implemented. More generally, the authorities in China have broad discretion in the determination and interpretation of the rules and regulations regarding foreign investment in the value-added telecommunications industry, which may adversely impact our financial statements, operations and cash flows.

**The Chinese government has taken steps to limit online game playing time for all minors and to otherwise control the content and operation of online games. These and any other new restrictions on online games may materially and adversely impact our business and results of operations.**

As part of its anti-addiction online game policy, the Chinese government has taken several steps to discourage minors under the age of 18 from continuously playing online games once they exceed a set number of hours of continuous play. For example, in July 2005, the MOC (later superseded by the MOCT) and the MII jointly issued an opinion which requires online game operators to develop systems and software for identity certification, to implement anti-addiction modifications to game rules and to restrict players under 18 years of age from playing certain games. Subsequently, in August 2005, GAPP (later superseded by the SART) proposed an online game anti-addiction system that would have reduced and eliminated experience points that a user can accumulate after three and five hours of consecutive playing, respectively. In March 2006, GAPP (later superseded by the SART) amended its proposal to require players to register with their real names and identity card numbers and to apply the anti-addiction system only to players under 18 years of age. In April 2007, GAPP (later superseded by the SART) and several other government authorities jointly promulgated the Notice Concerning the Protection of Minors Physical and Mental Well-being and Implementation of Anti-addiction System on Online Games, or the Anti-Addiction Notice, which confirmed the real-name verification proposal and required online game operators to develop and test their anti-addiction systems from April 2007 to July 2007, after which no online games can be registered or operated without an anti-addiction system in accordance with the Anti-Addiction Notice. Accordingly, we implemented our anti-addiction system to comply with the Anti-Addiction Notice. Since its implementation, we have not experienced a significant negative impact on our business as a result of the Anti-Addiction Notice.

In addition, on June 3, 2010, the MOC (later superseded by the MOCT) issued a decree on Interim Measures for the Administration of Online Games, or the Online Games Measures, which became effective as of August 1, 2010. The Online Games Measures set forth certain

requirements regarding online games, including requirements that game operators follow new registration procedures, publicize information about the content and suitability of their games, prevent access by minors to inappropriate games, avoid certain types of content in games targeted to minors, avoid game content that compels players to kill other players, manage virtual currency in certain ways and register users with their real identities. Furthermore, in July 2010, the MOC (later superseded by the MOCT) enacted the Notice on Implementing Interim Measures for the Administration of Online Games, or the Online Games Notice, in which several provisions of the Online Games Measures are supplemented, including the required standard clauses for online games service contracts between game operators and users and the timing for the implementation of a real identity registration system. The Online Games Notice also adopts several new measures, including requirements for the domestic online games joint operation by game developers and operators. On December 1, 2016, the MOC (later superseded by the MOCT) issued the Notice on Regulating the Operations of Online Games and Strengthening Interim and Ex Post Supervision (Wen Shi Fa [2016] No. 32), or Notice 32, which became effective on May 1, 2017. Notice No. 32 clarified that technical testing of online games by means of, among others, making the online games available for user registration, opening the fee-charging system of the online games or providing client-end software with direct server registration and log-in functions shall be deemed as part of the operations of online games and shall comply with applicable online game regulations. Although many of these requirements reflect previously issued government regulations with which we already comply, certain new requirements may cause us to change the way we launch and operate our online games. Because Notice 32 is relatively new and it is unclear how the MOCT will interpret and enforce them, we are unable to fully assess what impact, if any, these new requirements may have on our business. On August 30, 2018, the Implementation Scheme on Comprehensive Prevention and Control of Adolescent Myopia, or the Implementation Scheme, was issued jointly by eight PRC regulatory authorities at the national level, including the GAPP and the SART. The Implementation Scheme provides that as a part of the plan to prevent myopia among children, the GAPP will control the number of new online games and take steps to restrict the amount of time children spend on playing online games. We do not believe that the Implementation Scheme has had any material impact on our gaming operations, but we cannot be sure that any future regulations or restrictive rules will not negatively impact our operations.



Table of Contents

**The Chinese government has not enacted any laws regarding virtual asset property rights and, accordingly, it is not clear what liabilities, if any, online game providers may have for virtual assets.**

One of the features of our PC-client and mobile massively multiplayer online role-playing game, or MMORPG, which helps to build a large user base and maintain loyalty is that users can accumulate virtual tools, powers and rankings as they play the games. We believe that these virtual assets are highly valued by our users, particularly long-term users, and are traded among users. However, on occasion, such assets can be lost if, for example, a user's identity is stolen by another user or we experience a system error or crash. Other than the General Rules on the Civil Law of the People's Republic of China, which was passed by the National People's Representative Meeting on March 15, 2017 and took effect on October 1, 2017, which prescribes that network virtual property will be protected according to the laws and regulations stipulating the protection of such property, the Chinese government has not yet enacted any specific laws regarding virtual property rights. Accordingly, we have no basis to determine what are the legal rights, if any, associated with virtual assets and what liabilities we could be exposed to for the loss or destruction of virtual assets. We could therefore potentially be held liable for the way in which we handle and protect virtual assets.

**Restrictions on virtual currency may adversely affect our online game revenues.**

Our online game revenues are collected through the sale of physical and virtual prepaid point cards, as described elsewhere on this annual report, including below in the "User Fees" section in Item 4.B of this annual report.

On February 15, 2007, the MOC (later superseded by the MOCT) issued the Notice on the Reinforcement of the Administration of Internet Cafés and Online Games, or the Internet Cafés Notice, which directs the People's Bank of China, or PBOC, to strengthen the administration of virtual currency in online games to avoid any adverse impact on the PRC economy and financial system. Under the Internet Cafés Notice, the total amount of virtual currency issued by online game operators and the amount purchased by individual users should be strictly limited, with a clear distinction between virtual transactions and real transactions, so that virtual currency should only be used to purchase virtual items.

On June 4, 2009, the MOC (later superseded by the MOCT) and the Ministry of Commerce jointly issued the Notice on Strengthening the Administration of Online Game Virtual Currency, or the Virtual Currency Notice, which defined "Virtual Currency" as a type of virtual exchange instrument that is issued by online game operators, purchased directly or indirectly by the game user by exchanging legal currency at a certain exchange rate, saved outside the game programs, stored in servers provided by the online game operators in electronic record format and represented by specific numeric units. In addition, the Virtual Currency Notice categorizes companies involved with virtual currency as either issuers or trading platforms and prohibits companies from simultaneously engaging both as issuers and as trading platforms. The Virtual Currency Notice's stated objective is to limit the circulation of virtual currency and thereby reduce concerns that it may impact real world inflation. To accomplish this, the Virtual Currency Notice requires online game operators to report the total amount of their issued virtual currencies on a quarterly basis and to refrain from issuing disproportionate amounts of virtual currencies in order to generate revenues. In addition, the Virtual Currency Notice reiterates that virtual currency can only be provided to users in exchange for an RMB payment and can only be used to pay for virtual goods and services of the issuers. Online game operators are strictly prohibited from conducting lucky draws or lotteries in which participants pay cash or virtual currency to win game items or virtual currency. The Virtual Currency Notice also requires online game operators to keep transaction data records for no less than 180 days and to not provide virtual currency trading services to minors.

In order to comply with the requirements of the Virtual Currency Notice, we may need to change our prepaid point card distribution and database systems, resulting in higher costs of our online game operation, lower sales of our prepaid cards, or other changes in our business model. Such changes may therefore have an adverse effect on our revenues from online games.

**We are subject to consumer protection laws that could require us to modify our current business practices and incur increased costs.**

Our e-commerce business is subject to numerous PRC laws and regulations that regulate retailers generally or govern online retailers specifically, such as the Consumer Protection Law. If these regulations were to change or if we or our suppliers were to violate them, the costs of certain products or services could increase, or we could be subject to fines or penalties or suffer reputational harm, which could reduce demand for the products or services offered on our e-commerce platforms and hurt our business and results of operations. For example, the amended Consumer Protection Law, which became effective in March 2014, strengthens the protection of consumers and imposes more stringent requirements and obligations on business operators, with a particular focus on businesses that operate via the Internet. Pursuant to the Consumer Protection Law, consumers are generally entitled to return goods purchased within seven days upon receipt without giving any reasons if the purchased are made through the Internet. Consumers whose interests have been harmed due to their purchase of goods or acceptance of services on e-commerce platforms may claim damages from sellers or service providers. An e-commerce platform's failure to provide detailed contact information of sellers using its platform will give consumers the right to claim damages from the platform itself. Once the customer has been duly compensated, the operators of an e-commerce platform then have the right to recover the compensation from supplier or service providers.

Table of Contents

The majority of products sold on our e-commerce platforms are purchased directly from us, however our Kaola platform allows certain reputable third-party vendors to sell their products on such platform. Therefore, we are subject to the Consumer Protection Law both as a seller and as an e-commerce platform provider. Laws and regulations regarding consumer protection, particularly those involving transactions conducted over the Internet, frequently change and are subject to interpretation. We are therefore unable to predict the ultimate cost of compliance of the relevant laws or regulations or their effect on our operations. We may be required to make significant expenditures or modify our business practices to comply with existing or future laws and regulations, which may increase our costs and materially limit our ability to operate our business.

**Regulatory restrictions on financial transactions may adversely affect the operation and profitability of our business.**

On June 14, 2010, the PBOC issued the Measures for the Administration of Non-financial Institutions Engaging in Payment and Settlement Services, or the PBOC Measures, which were effective as of September 1, 2010 and require that non-financial institutions engaging in the business of effecting payments and settlements before June 14, 2010 obtain a permit from the PBOC by August 31, 2011 to continue such business. We currently operate an online payment platform used by both distributors of our prepaid point cards and end-users of our online services, which requires a permit under the PBOC Measures. We have obtained such permit from the PBOC. In addition, on December 28, 2015, the PBOC issued a notice regarding the Administrative Measures for the Online Payment Business of Non-bank Payment Institutions, or PBOC Notice 18, which took effect on July 1, 2016. According to the PBOC Notice 18, a payment institution is required to follow the principles of know your clients, and maintain records on its clients using their real names when opening payment accounts for its clients. Pursuant to the PBOC Notice 18, a payment institution shall not engage in, including in a disguised form, such businesses as securities, insurance, credit loans, financing, wealth management, guarantee, trust, currency exchange, cash deposit and withdrawal services. In addition, a payment institution is required to, based on client identity, conduct affiliated management of all the payment accounts opened by the same client. On January 13, 2017, the PBOC issued the Notice on Matters Related to Implementation of Centralized Custody of Clients Reserve Funds of Payment Institutions, which requires that from April 17, 2017, payment institutions transfer a portion of customer reserve funds to a specifically designated bank account upon the request of the PBOC and that no interest be allowed to accrue upon the transferred customer reserve funds. On June 29, 2018, the PBOC issued a further notice that requires payment institutions to cause up to 100% of the customer reserve funds to be transferred to the above-mentioned account.

We are in compliance with the PBOC Notice 18 and the recent PBOC requirement to transfer our customer reserve funds to its designated bank account with no interest accrual, however, we cannot predict how the regulations relating to financial transactions will evolve or be certain that we will be able to maintain compliance with all relevant regulations at a reasonable cost. Any inability to continue operating our current online payment platform would likely materially and adversely affect the operation and profitability of our business.

**We may be unable to compete successfully against new entrants and established industry competitors.**

The Chinese market for Internet content and services is intensely competitive and rapidly changing. Many companies offer competitive products or services including online games, retrieval and navigation services, e-commerce services and extensive Chinese language content, informational and community features, and e-mail.

Currently, our competition comes from Chinese language-based and U.S.-based Internet media companies, online game developers and operators, Internet service providers, e-commerce service providers, website operators and providers of web browser software that incorporate search and retrieval features. Some of our current and potential competitors are much larger than we are, and currently offer, and could further develop or acquire, content and services that compete with the NetEase websites. With respect to online games, we believe that more

competitors are entering this market in China and that our competitors are becoming more active in both licensing foreign-developed games and developing games in-house, which trends, if they continue, could adversely affect our online game revenues in the future. In addition, while our e-commerce business has experienced significant growth in recent years, representing 28.6% of our total revenue for 2018, we may not be able to keep growing the e-commerce business at this rate because this market is intensely competitive and is dominated by a few major competitors including Alibaba and JD.com. We believe that competition in the online advertising industry in China is intense with numerous competitors such as Baidu, Sina, Sohu, Tencent, Alibaba, Qihoo, iFeng.com, ByteDance and other vertical Internet media. Any of our present or future competitors may offer products and services that provide significant performance, price, creativity or other advantages over those offered by us and, therefore, achieve greater market acceptance than ours.

Because many of our existing competitors as well as a number of potential competitors have longer operating histories in the Internet market, greater name and brand recognition, better connections with the Chinese government, larger customer bases and databases and significantly greater financial, technical and marketing resources than we have, we cannot assure you that we will be able to compete successfully against our current or future competitors, and competitive pressures may have a material and adverse effect on our business, financial condition and results of operations.

Table of Contents

**Item 4. Information on the Company**

**A. History and Development of the Company**

Our business was founded in June 1997, and we began offering search services and free web-based e-mail starting mid-1997 and early-1998, respectively. In mid-1998, we changed our business model from a software developer to an Internet technology company and commenced developing the NetEase websites. In mid-1999, we established our advertising sales force to sell advertisements on the NetEase websites and also began to offer online platforms and provide online shopping mall and other online services in China. In 2001, we also began focusing on fee-based premium services and online entertainment services, including online games, wireless value-added services, premium e-mail services and other subscription-type services. We launched our two e-commerce platforms, Kaola and Yanxuan, in January 2015 and April 2016, respectively.

In addition to organic growth, we have also recently made, or have entered into agreements to make, strategic investments, acquisitions and alliances that are intended to further our strategic objectives. In the last quarter of 2018, we entered into definitive agreements with a group of investors for an over-\$600 million financing for Cloud Music, our music streaming platform. Following the closing of such financing in 2018, we maintained a majority ownership in Cloud Music.

Our company was incorporated in the Cayman Islands on July 6, 1999, and it operates under the Cayman Islands Companies Law (2018 Revision). Our principal executive offices are located at Building No. 7, West Zone, Zhongguancun Software Park (Phase II), No. 10 Xibeiwang East Road, Haidian District, Beijing, People's Republic of China 100193. Our telephone number is (86-10) 8255-8163.

Our principal capital expenditures for 2018 consisted mainly of the construction of our new office buildings and warehouses in Hangzhou, Guangzhou and Ningbo in China, acquisition of new servers in connection with the operation of our online games and developing the expansion packages of such games, and upgrades of our online service infrastructure, for a total of approximately RMB2,528.1 million (US\$367.7 million). Our principal capital expenditures for 2017 consisted mainly of costs incurred for the construction of our new office buildings and warehouses in Zhoushan, Guangzhou, Hangzhou and Ningbo in China, acquisition of new servers in connection with the operation of our online games and developing the expansion packages of such games, and upgrades of our online service infrastructure, for a total of approximately RMB1,842.9 million. Our principal capital expenditures for 2016 consisted mainly of cost incurred for the construction of our new office buildings and warehouses in Beijing, Guangzhou, Hangzhou, Zhoushan and Ningbo in China, acquisition of new servers and investment in the expansion and upgrade of our mailbox infrastructure for a total of approximately RMB1,135.5 million.

In addition, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC, during the respective terms of the licenses, Shanghai EaseNet as licensee of the games is required to pay royalty fees to Blizzard for the games, have a minimum marketing expenditure commitment, and provide funds for hardware to operate the games. For further details, see Item 4.B. Business Overview Our Services Online Games Game Licensing and Joint Venture with Blizzard.

As of December 31, 2018, we had capital expenditure commitments of RMB1,900.4 million (US\$276.4 million) for 2019 onwards, which primarily consist of commitments made in connection with the construction of new office buildings and warehouses in Guangzhou, Shanghai, Ningbo and Hangzhou. Our capital expenditures in 2018 have been, and future capital expenditures are expected to continue to be, funded by operating cash flows and our existing capital resources.

The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us, at <http://www.sec.gov>. Our company website can be accessed at <http://ir.netease.com>.

**B. Business Overview**

**OVERVIEW**

Through our subsidiaries and contracts with our affiliates Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet and certain other affiliated companies and their respective shareholders, we operate a leading interactive online community in China and are a major provider of Chinese language content and services through our online games, e-commerce, Internet media, and other innovative businesses.

We generate revenues from fees we charge users of our online games, sales of a wide range of products offered on our e-commerce platforms, sales of advertisements, and sales, service or commission fees from our innovative businesses and other services. Our ability to leverage our Internet media traffic to generate revenues in each of these segments is a key component of our growth strategy.

Table of Contents

**Online Games Services**

Our online games business focuses on offering a variety of games in a wide range of genres through mobile devices and PCs, including role playing games, or RPG, MMORPGs, battle arena games, simulation games, or SLGs, collectible card games, or CCGs, first-person shooter games, sandbox games and other types of games to the Chinese market.

MMORPGs are played over the Internet or mobile networks in virtual worlds that exist on networked game servers to which thousands of players simultaneously connect to interact with each other. Battle arena games allow a player to control a single character who competes with other players in a mapped field. SLGs players control, manage and use game characters and items, and design and implement their own strategies to win the games. CCGs allow players to collect cards and compete by using card sets with different functions. We develop and operate online games that are targeted at or localized to the Chinese market, and we strive to provide the highest quality game playing experience to our users.

In addition, we offer mobile and PC-client games in China from various international developers including Blizzard and Microsoft, as discussed below under Our Services Licensed Games.

We offered over 100 self-developed and licensed mobile games of various genres as of December 31, 2018, such as the Fantasy Westward Journey mobile game, Westward Journey Online mobile game, Onmyoji, Invincible, the mobile version of New Ghost, Demon Seals mobile, Rules of Survival, Knives Out, Chu Liu Xiang, Identity V and Night Falls: Survival. In China, we distribute our mobile games by partnering with major Android- and iOS-based app stores as well as through our proprietary distribution channels, such as our websites. Mobile game revenues are primarily derived from sales of in-game virtual items, including avatars, skills, privileges or other in-game consumables, features or functionalities, within our games.

We use two revenue models for PC-client games: an item-based model, in which players can play the basic features of the game for free and can purchase virtual items that enhance their playing experience, and a time-based model, in which players pay for game playing time. A majority of our revenues from PC-client games come from our games that use the item-based model, including our self-developed item-based PC-client MMORPG games, such as Tianxia III, New Ghost (a new version of Ghost II) and an item-based version of New Westward Journey Online II. Games that use the time-based model include self-developed PC-client games such as New Westward Journey Online II, Fantasy Westward Journey Online and Justice, as well as licensed games such as World of Warcraft.

We have also recently commenced offering our online games internationally. We started with licensing our games to local distributors and have gradually moved to launching and operating our own games in various markets. For example, as of December 31, 2018, we had launched and promoted our self-developed games such as Onmyoji, Rules of Survival, Knives Out and Identity V globally. In the first half of 2019, we plan to introduce our popular hit Night Falls: Survival in Japan and the United States. In addition, we continued to establish and deepen collaboration with leading international game studios in 2018, including reaching a joint development agreement with Codemasters, a leading UK game studio focusing on racing games, as well as making minority investments in Bungie, an independent game Studio in Washington state, the United States, and Quantic Dream, a French independent game studio based in Paris. We are also currently co-developing Diablo Immortal™, a mobile action-RPG, with Blizzard. We expect to continue the international expansion of our online games business by both partnering with local gaming industry leaders and continuing to introduce our self-developed games internationally.

**E-commerce**

We sell merchandise through our two e-commerce platforms, Kaola and Yanxuan. Kaola sells mainly imported goods that we source from overseas suppliers, including maternity and baby products, skincare and cosmetics and other general merchandise. Kaola also acts as an online marketplace through which reputable third-party sellers are able to offer their products. Yanxuan primarily sells our private label products, including apparel, homeware, kitchenware and other general merchandise which we primarily source from original design manufacturers in China. Through these e-commerce platforms which are accessible on their respective websites and mobile applications, we offer a wide selection of imported products and private label products at competitive prices. We have experienced a significant expansion of our e-commerce business, and as of December 31, 2018, we made available to our e-commerce platform customers imported products from over 50 countries and regions, covering more than 4,300 brands.

We have established and aim to maintain strong relationships with our suppliers to source high-quality products which are delivered to our customers by third-party delivery companies with whom we partner. As a promotional tool, we regularly provide discount coupons to customers of our e-commerce platforms. To further expand the capacity of our e-commerce business, we have built and leased warehouses in various locations in China, such as Hangzhou, Ningbo, Tianjin, Zhengzhou, Chongqing, Suzhou and Shenzhen. We also have developed a logistical system comprising fulfillment centers located in Hong Kong, Germany, Australia, Japan and the United States.



Table of Contents

**Our Internet Media Business**

Our Internet media business, which is conducted mainly through the NetEase News App and NetEase websites, provide Internet users with Chinese language-based online services that are centered around content and interactive community.

*Content* The NetEase News App offers content channels covering news, information, popular sports events, industry forums, celebrity close-ups, technology and fashion trends, and online entertainment to the Chinese public via a variety of mobile devices. This wide range of content appeals to a broad audience spanning all age groups, although this application is particularly popular among younger audiences between the ages of 23 and 35 who often use mobile devices as their primary means of obtaining news and information. We are continually working to reinforce the popularity of the NetEase News App among its large and loyal user base, as well as with new users, through premium content and service development and innovation. Users can also access various content channels on the NetEase websites.

In addition, the main homepage of the NetEase websites, www.163.com, serves as a one-stop gateway for users to conveniently access our other online services, such as online games, e-mail, e-commerce, video and music streaming, e-reading and a set of other websites and mobile applications.

*Interactive Community* The NetEase News App and NetEase websites offer a wide range of tools for our users to interact with each other and with the content we provide, opening up avenues for a lively exchange of information. For example, our users can instantly share any content displayed on the NetEase News App with other users and easily provide commentary to such content, which then becomes viewable by other users. We also offer a membership profile function, which allows users to monitor their past activities and viewing preferences.

Our Internet media business generates revenue mainly from selling advertising space on the NetEase News App and websites, and our large user base attracts many well-known advertisers. The various content channels and interactive community offered through our Internet media business forms an effective medium for our clients to conduct integrated marketing campaigns. Our online advertising offerings include banner advertising, channel sponsorships, direct e-mail, interactive media-rich sites, sponsored special events, games, contests and other activities.

**Innovative Businesses and Others**

We offer a wide range of other online services, which primarily include NetEase CC, our live video streaming platform, NetEase Cloud Music, our music streaming platform, NetEase Youdao Education, including Youdao Courses, our online platform offering educational content and a number of educational solutions, EaseRead, our online reading platform, and NetEase Pay, our payment platform.

## Edgar Filing: NetEase, Inc. - Form 20-F

Our CC live streaming platform offers various live streaming content with a primary focus on games, including mobile, PC and console games. We launched the NetEase Cloud Music streaming platform in April 2013. Since then, NetEase Cloud Music has focused on delivering a differentiated and premium user experience in terms of the quality and variety of music offered, and has been steadily increasing its user base. As of the date of this annual report, NetEase Cloud Music had over 600 million registered users. Our Youdao Education platform offers educational content, including courses relating to test preparations, language learning and tutoring courses to supplement K-12 students' school education, as well as a variety of educational solutions. We continue to build out the Youdao Education platform with new content and services.

In addition, as one of the largest e-mail services providers in China, we offer free and fee-based premium e-mail services to our individual users and corporate users. Through a joint venture with China Telecom in which we hold a minority ownership stake, we also offer a social instant messaging application for smart phones called Yichat, which offers proprietary environmental noise reduction technology, high-quality photo messaging and various original stickers and emoticon designs.

### **OUR ORGANIZATIONAL STRUCTURE**

We conduct our business in China solely through our subsidiaries and VIEs. Under current Chinese regulations, there are restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of Internet content, online games, e-commerce and our other innovative services. In order to comply with these restrictions and other Chinese rules and regulations, NetEase, Inc. and certain of its subsidiaries have entered into a series of contractual arrangements for the provision of such services with certain affiliated companies, including Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Youdao Computer as well as certain other affiliated entities. Under the contracts, we provide our mobile applications, services and technologies and advertising services to such affiliated companies and they operate the NetEase online games, websites, e-commerce platforms, the online advertising business as well as our other online businesses. Guangzhou NetEase also has a wholly-owned subsidiary, Wangyibao, the operator of our NetEase Pay online payment platform. For more information on these agreements, see Item 7.B. Major Shareholders and Related Party Transactions. Related Party Transactions.

Table of Contents

Each of Guangzhou NetEase and NetEase Advertising is 99.0% beneficially owned by our founder, Chief Executive Officer and major shareholder, William Lei Ding, and 1.0% owned by one of our employees. Youdao Computer, the operator of our online dictionary, online education and other cloud application services, is 71.1% owned by William Lei Ding and 28.9% owned by one of our employees. Wangyibao is 100.0% owned by Guangzhou NetEase. Hangzhou Leihuo is owned by two of our employees. We do not have any direct ownership interest in those companies.

Under our agreements with Guangzhou NetEase, we have agreed to pay its operating costs. Under our agreements with NetEase Advertising, Hangzhou Leihuo and Youdao Computer, we have agreed to provide performance guarantees and guarantee loans for working capital purposes to the extent required by Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo or Youdao Computer for their operations. Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo and Youdao Computer are each prohibited from incurring any debt without our prior approval.

Starting in August 2008, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC. Shanghai EaseNet is a PRC company owned by William Lei Ding, our Chief Executive Officer, director and major shareholder and has contractual arrangements with the joint venture established between, and owned equally by, Blizzard and us. The joint venture was established concurrently with the licensing of games from Blizzard in August 2008 and provides technical services to Shanghai EaseNet.

As a result of our contractual arrangements with these companies, we bear the risks of, and enjoy the rewards associated with, and therefore are the primary beneficiary of our investments in them. They are therefore considered our VIEs, and we consolidate the results of operations of these VIEs and their subsidiaries in our historical consolidated financial statements. See also Item 5 Operating and Financial Review and Prospects.

Any violations by Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Youdao Computer or any other VIEs of our agreements with them could disrupt our operations, degrade our services or shut down our services. See Item 3.D. Risk Factors for a detailed discussion of the risks to NetEase, Inc. regarding its dependency on these companies.

HQG Inc., HQG Limited and Hangzhou Youmai were established by us in 2014. HQG Limited and Hangzhou Youmai now operate our cross-border e-commerce business Kaola. Hangzhou NetEase Yanxuan Trading Co., Ltd. or Hangzhou Yanxuan, was established by us in 2016. Hangzhou Yanxuan now operates our e-commerce platform Yanxuan through which we sell our private label products.

The following diagram shows the group structure of our principal subsidiaries and certain affiliated companies as of April 19, 2019, other than our joint venture arrangements with Blizzard, which are described separately in this section.

Table of Contents

Table of Contents

**OUR SERVICES**

**Online Games**

*Mobile Games*

Mobile games have gained increasing popularity and user base as Internet users in China rely more and more on mobile devices, such as smart phones and tablets, to access the Internet. In response to this trend, we are developing games that can be operated on mobile devices and, as of December 31, 2018, we had commercially launched over 100 mobile games of various genres, including self-developed and licensed CCGs, first-person shooter games, battle arena games, SLGs and MMORPGs. To date, the majority of our most popular mobile games are self-developed games such as Onmyoji, Invincible, Knives Out, Identify V, Chu Liu Xiang and Night Falls: Survival. We also offer the mobile versions of our self-developed PC-client MMORPGs, such as the Fantasy Westward Journey mobile game, Westward Journey Online mobile game and the mobile version of New Ghost.

We distribute our mobile games through partnerships with major Android- and iOS-based application stores in China as well as proprietary distribution channels, such as our websites. Mobile game revenues are primarily derived from sales of in-game virtual items, including avatars, skills, privileges or other in-game consumables, features or functionality within our games. Users have a variety of payment options for in-game virtual items, including our prepaid point cards, online payments through application stores and other online payment channels.

Our development strategy for our mobile games is focused on identifying trends in users' preferences to develop games that will appeal to new users and at the same time leveraging the popularity of our established PC-client games among the game player community in China to develop attractive mobile versions of such games. In addition, for certain of our mobile games, we periodically introduce content updates. The timing and success of content updates have a strong influence on the popularity and profitability of mobile games.

*PC-client Games*

We launched our first PC-client MMORPG, Westward Journey Online, in December 2001. Subsequently, we launched Westward Journey Online II in August 2002 and our second internally developed PC-client MMORPG, Fantasy Westward Journey, in January 2004. Westward Journey Online II and Fantasy Westward Journey were upgraded to New Westward Journey Online II and Fantasy Westward Journey Online in 2013. We have subsequently launched a number of additional online games, as set forth in the table below.

Our principal internally developed games, in terms of the number of users and revenue generated, are Fantasy Westward Journey Online, New Westward Journey Online II, New Ghost, Tianxia III and Justice. These games are PC-client MMORPGs set in classical Chinese-themed fantasy worlds.

## Edgar Filing: NetEase, Inc. - Form 20-F

Our PC-client game titles can be accessed from any location with an Internet connection by registered users of the NetEase websites. Users may enter our network with a password and a user ID after downloading our installation software. In our item-based games, players can also purchase virtual items that enhance their playing experience such as special powers, costumes, weapons and other accessories. We regularly introduce new virtual items or change the features of virtual items based on player feedback, market trends and other factors.

Users of our time-based games pay a pre-determined fee per hour of game playing time. For our item-based games, we charge users a separate fee for each virtual item purchased within the games.

Similar to our mobile games, we periodically develop and release expansion packs, which expand game content and gameplay features for previously launched PC-client games. These periodic expansion packs are designed to retain the interest of existing users and to attract new users.

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

The table below sets forth certain of our major mobile and PC-client games.

<b>Game</b>	<b>Type</b>	<b>Genre</b>	<b>Revenue Model</b>	<b>Date of Initial Commercial Launch</b>
Tianxia III	PC-client Game	3D MMORPG, classical Chinese setting	Item-based	October 2011
Fantasy Westward Journey Online (previously known as Fantasy Westward Journey II)	PC-client Game	2D MMORPG, classical Chinese setting	Item-based Time-based	July 2013
New Westward Journey Online II (a comprehensive upgrade of Westward Journey Online II)	PC-client Game	2D MMORPG, classical Chinese setting	Item-based Time-based	September 2013 August 2014
Fantasy Westward Journey mobile game	Mobile Game	Turn-based MMORPG	Item-based	March 2015
Westward Journey Online mobile game	Mobile Game	Turn-based MMORPG	Item-based	September 2015
New Ghost (a new version of Ghost II)	PC-client Game	2.5D MMORPG, classical Chinese setting	Item-based	September 2015
Invincible	Mobile Game	SLG	Item-based	October 2015
The mobile version of New Ghost	Mobile Game	Real-time MMORPG	Item-based	May 2016
Onmyoji	Mobile Game	CCG & RPG	Item-based	September 2016
Demon Seals Mobile	Mobile Game	RPG	Item-based	January 2017
Land of Glory	Mobile Game	MMORPG	Item-based	March 2017
Knives Out	Mobile Game	Battle Arena	Item-based	November 2017
Rules of Survival	Mobile Game	Battle Arena	Item-based	November 2017
Chu Liu Xiang	Mobile Game	Real-time MMORPG	Item-based	January 2018
Identity V	Mobile Game	Asymmetrical Battle Arena	Item-based	April 2018
Justice	PC-client Game	3D MMORPG, classical Chinese setting	Time-based Item-based	June 2018
Ancient Nocturne	Mobile Game	CCG & RPG	Item-based	September 2018
Night Falls: Survival	Mobile Game	Cooperative Survival RPG	Item-based	November 2018

In connection with the introduction of our online games, we developed a prepaid point card system to facilitate payment of fees for our online games services and, to a lesser extent, our other fee-based value-added services. Users can buy prepaid point cards at a variety of locations in China, including Internet cafés, convenience stores, software stores, bookstores and newspaper stands. Electronic point cards can also be purchased through credit cards or online payment platforms through which players can directly credit their accounts. Each prepaid card contains an account number and a password. The points represented by these cards can then be transferred into users' individual accounts on the NetEase websites and used to pay for our online services, including playing time for online games, and virtual items purchased in the games.

### *Game Masters and Customer Service*

Gameplay for our mobile games and PC-client MMORPGs are monitored by game masters, who appear as game characters within the game world and provide assistance and guidance to players, as well as policing behavior of players in the game world to maintain an atmosphere of fun and fair play.

In addition, we believe that providing strong, dependable customer support is a key component to success in the online games business. Our customer service center provides 24 hour-a-day, 7 day-a-week customer service and technical support and can be contacted via telephone or e-mail. As of December 31, 2018, our company employed approximately 1,700 personnel in our call center as customer service specialists for our online games as well as for our other services.



Table of Contents

*Licensed Games*

In addition to our self-developed mobile and PC-client games, we also offer mobile and PC-client games in China licensed from international developers, including the games licensed to us by Blizzard and Microsoft.

Commencing in August 2008, Blizzard has entered into various license agreements to license games to Shanghai EaseNet on an exclusive basis in China, including World of Warcraft, StarCraft II series, Diablo III, Hearthstone, Heroes of the Storm and Overwatch. In January 2019, Blizzard and Shanghai EaseNet agreed to extend the licenses to operate all of the foregoing games to January 2023. Blizzard has also licensed to Shanghai EaseNet on an exclusive basis in China its Battle.net® platform, which enables multi-player interaction within these games and other online services. Blizzard has the right to terminate the license of the foregoing games and platform under certain circumstances. Concurrently with the licensing of games from Blizzard in August 2008, we entered into arrangements to establish a joint venture with Blizzard. The joint venture provides technical services to Shanghai EaseNet in return for a fee. Net profits of the joint venture are shared equally between Blizzard and us, after the deduction of, among others, various fees and expenses payable to Blizzard and us.

In addition, in May 2016, we entered into a five-year exclusive agreement with Mojang AB, a subsidiary of Microsoft, pursuant to which Microsoft and Mojang agreed to license both the mobile and PC versions of Minecraft to us. We successfully introduced both versions of Minecraft in China across various platforms in 2017. We also license various other online games from a number of other developers.

Revenues from our online games accounted for 73.3%, 67.0% and 59.9% of our total net revenues in 2016, 2017 and 2018, respectively. Revenues from licensed games accounted for 12.5%, 7.2% and 5.7% of our total revenues in 2016, 2017 and 2018, respectively.

**E-commerce Business**

We operate two major e-commerce platforms for consumers in China. The first e-commerce platform, Kaola sources goods from mainly overseas suppliers, maintains its own inventory and sells such imported goods, including maternity and baby products, skincare and cosmetics and other general merchandise, to Chinese consumers. We also allow pre-screened third-party vendors to use Kaola as a marketplace to sell their products. As the Chinese government further encourages cross-border e-commerce through including raising both the cross-border duty-free cap per transaction and the duty-free annual cap per individual, we expect the volume of cross-border e-commerce sales on Kaola to continue to grow in the coming years. See Government Regulations E-commerce for details. The second e-commerce platform, Yanxuan sells our private label goods, including apparel, homeware, kitchenware and other general merchandise, which we primarily source directly from original design manufacturers, to Chinese consumers. We generate revenues from both these platforms primarily through merchandise sales and recognize revenue on a gross basis (excluding sales made by third-party vendors using Kaola as a platform), as we carry our own inventory and have discretion in setting prices.

*Pricing and Products*

Through both our online and mobile e-commerce platforms, we provide a broad spectrum of apparel, fashion goods, cosmetics, home goods and lifestyle products. We offer competitive pricing to attract and retain customers and a selection of discounted products on special occasions, such as the online shopping promotion events on June 18, November 11, and on important holidays such as Christmas and Chinese New Year. Our customers are able to pay for their orders through third-party online payment platforms, our own online payment platform, NetEase Pay, and other online payment channels.

*Inventory management, quality control and delivery service*

To ensure we have an adequate supply of products to meet our customers' needs, we typically make estimates of market demand for our products based on historical sales data and market research reports. We focus on continuously improving our inventory management system by conducting market demand studies in-house and analyzing various sales trends such as the seasonality of sales of particular categories of products when making demand estimates.

Table of Contents

With respect to sourcing products, we have implemented a strict and systematic selection process to identify high quality suppliers and third-party vendors globally based on our selection guidelines. We generally choose to cooperate with reputable suppliers and third-party vendors with good track records and high quality products. In addition, we have adopted stringent quality assurance and control procedures for products delivered from our own fulfillment centers or warehouses to ensure we provide our customers with high-quality products on a timely basis. Kaola seeks to build relationships with distributors, other retailers and brand owners to continuously expand the variety of products it offers. These relationships are generally non-exclusive and we invest significant resources to establish and maintain these relationships. For Yanxuan, we select manufacturers after careful evaluation and enter into supply arrangements to produce goods according to our specifications.

To ensure timely delivery of products sold on our e-commerce platforms, we partner with a number of reputable delivery service providers. We have also entered into arrangements with certain of these providers to use their warehouse space for temporary products storage. In addition, we have expanded our own storage and logistical capacity by building and leasing warehouses across China, particularly in cities where our major customer base is located, including Hangzhou, Ningbo, Tianjin, Zhengzhou, Chongqing, Suzhou and Shenzhen. We are in the process of constructing additional warehouses in Hangzhou and Ningbo. If our e-commerce business continues to expand, we expect that we will need additional warehouses in the future.

*Customer Service*

We have a dedicated customer service team responsible for handling general customer enquiries and requests, assisting customers with their ordering process, investigating the status of orders, shipments and payments, resolving customer complaints, and providing other after-sales services. Our customers can contact customer service representatives through our online platforms, real-time online chat, and our customer service hotline. We also offer our customers a competitive return policy compared with market standards for products sold through Kaola and Yanxuan.

Revenues from our e-commerce business accounted for 11.9%, 21.6% and 28.6% of our total net revenues in 2016, 2017 and 2018, respectively.

**Internet Media Business**

Our Internet media business, which is conducted mainly through the NetEase News App and the NetEase websites, offers the Chinese Internet users a network of Chinese language-based online content channels and an interactive community to share news and opinions, which in turn creates an attractive venue for our online advertising clients.

*Content*

NetEase News App is a leading mobile news application, offering simple and useful tools to enable our users to access a wide range of content including news, information, popular sports events, industry forums, celebrity close-ups, technology and fashion trends, and online entertainment. We source our content from traditional professional media organizations, independent media professionals and content creation studios, as well as from our in-house team of editors who focus on creating specific content that appeals to different demographic groups. In

## Edgar Filing: NetEase, Inc. - Form 20-F

addition, both the NetEase News App and NetEase websites also allow users to generate and share their own content. We believe that this user-generated content is highly effective in maintaining user interest and ensuring repeat visits to the NetEase News App and websites.

The NetEase News App's content display interface is organized by interest-based, location-based, and media format-based columns in an effort to make navigation convenient for users. Content is then grouped by channel for easy access, including channels focusing on news, entertainment, sports, finance, information technology, automobiles, education and real estate. The membership profile function offered on both the NetEase News App and websites, which allows users to monitor their past activities and viewing preferences, is also highly popular among our users.

Table of Contents

In order to stay abreast of the developments in mobile and wearable devices, we have cooperated with leading global telecommunications equipment manufacturing companies to make our NetEase News App available on their latest products. Content displays on the NetEase News App is generally optimized for the screen-size of the mobile devices, with font size easily adjustable by the users.

In addition, the main homepage of the NetEase websites, www.163.com, provides a destination for our users to identify and access various resources, services, content and information, aiming to provide our users with an efficient and easy way to explore and utilize a wealth of information and content organized around a variety of topics. Similar to the NetEase News App, the NetEase websites currently include various channels focusing on different topics of interest. Moreover, www.163.com serves as a one-stop gateway for users to conveniently access our other online services, such as online games, e-mail, e-commerce, video and music streaming, e-reading and a set of other websites and mobile applications.

We believe that the breadth and relevance of our content offerings increase both the number of visits to and the time spent by our users on the NetEase News App and websites.

*Interactive Community*

We value user interaction as a core attribute of our brand value, and we have embedded user interaction tools in the NetEase News App and websites. Our users can interact through a variety of tools, including:

- *Comment.* Our comment posting feature allows users to post their reactions to and thoughts on substantially all of our content items, be it text, image or video-based content. We provide users a suite of tools to interact with the comments of other users. In addition to browsing, archiving and replying to comments left by others, the NetEase News App enables users to click on the *Like* button to express their support for comments posted by others. Comments receiving the most support are placed more prominently in the commentary sections.
- *Sharing.* Our users can conveniently share nearly every piece of content displayed on the NetEase News App, such as articles, images, videos and user comments and reactions, on various social media networks through links set out on the same interface. In addition to direct sharing, the NetEase News App enables users to take screenshots of our content and edit them with our stylish and trendy emoticons before sharing such modified content with a personal touch with their friends across various social media platforms.

*Advertising Services Revenues*

Revenue generated by our Internet media business consists mainly of fees we receive from the sale of advertising space on the NetEase News App and websites. Our free content and services attract a large number of visitors who generate page views, which form the audience for us to provide advertising services for advertisers on our mobile applications and websites. Our advertising services utilize many advertising formats

and techniques. These include sponsorships of our channels, advertisements such as animated and interactive banners, floating buttons, text-links, in-stream video and other formats, advertising through interactive media-rich sites and sponsored special events that integrate live events with online promotion and other media.

To strengthen our overall brand and increase traffic on the NetEase News App and websites and enhance their appeal to advertisers, we periodically sponsor high profile events, such as the NetEase Annual Economist Conference and the China Women's Media Award.

Furthermore, in compliance with applicable laws and ensuring the confidentiality of the information of our users, we transmit and store over our systems information regarding our users, such as age, geographic location and interest, and integrate such information to generate demographic profiles which enable us to better tailor our advertising services.

Table of Contents

We generate a majority of our advertising revenues from brand advertising. We focus our brand advertising service on delivering value-based integrated advertising solutions to mainstream brand advertisers. For our brand advertising services, we typically charge our advertisers based on the time of their advertising exposure on a *per diem* fixed fees basis. We also offer advertising services based on performance-based pricing models, such as based on cost per thousand impressions or cost per action by the consumers after viewing our advertisements, including but not limited to clicking on links to our customers' products.

Youdao Computer also enters into other advertising business contracts which provide priority placements in a search directory and other online marketing services.

Revenues from our Internet media accounted for 5.6%, 4.5% and 3.7% of our total net revenues in 2016, 2017 and 2018, respectively.

**Innovative Businesses and Others**

Our wide range of other online services include offering live video streaming through our most popular streaming platform CC, music streaming through Cloud Music, online education services through Youdao Education and online reading services through NetEase EaseRead.

- Our CC platform streams gameplay shows (where viewers watch people compete in online games) and game-related shows. Viewers can watch these shows for free and can also purchase virtual items from us (such as a thumbs-up image) to show support for their favorite broadcasters who provide commentary for the shows.
- Cloud Music offers certain music content for free and other premium content for fees. Users may choose to purchase subscriptions to access a variety of premium contents offered by Cloud Music or make item-based purchases for specific music.
- Our Youdao Education platform provides a variety of content and services through its websites and mobile applications, including primarily courses relating to test preparations, language learning and tutoring courses to supplement K-12 students' school education. In addition, the Youdao Education platform also provides a variety of educational solutions, including Youdao Dictionary, Youdao Translator and Youdao Cloud Note.
- Our NetEase EaseRead platform provides its users with access to our online content library, covering classic literature to our original content.

- We also provide registered users with free and fee-based premium e-mail services which support both the Chinese and English languages. As of December 31, 2018, we had approximately 1,030 million registered free e-mail users. In addition, we also offer fee-based premium e-mail services to corporate users, who can use their corporate name as the e-mail address and enjoy our custom-made functions, such as group instant message, push mail services and Internet disk services.

Revenues from innovative businesses and others accounted for 9.2%, 6.9% and 7.8% of total net revenues in 2016, 2017 and 2018, respectively.



Table of Contents

**SALES AND MARKETING**

**Sales**

*Online Games*

For our mobile games, the Apple app store for iOS and third-party Android app stores such as Qihoo 360 Mobile, Xiaomi, UCWeb and Baidu are the dominant distribution channels in China. In addition, to leverage our existing user bases, we also publish our mobile games through our websites and other Internet and mobile platforms. Mobile users in China have a variety of payment options for our mobile games, including prepaid cards, online payments through app stores and other online payment channels. App stores collect a portion of our revenues for mobile games downloaded through the app store, which is generally 30% for the iOS app store and generally 50% for Android app stores.

We sell game playing time and virtual items to users of the PC-client games that we operate largely in the form of prepaid point cards. Users can purchase virtual prepaid cards online and receive the prepaid point information instantly. We also sell prepaid point cards to users through a wide range of distributors who arrange for our cards to be offered at various retail points in China. We sell prepaid point cards to distributors at a discount off of their face value. The discount for each distributor varies based on that distributor's volume of point cards purchased.

*E-commerce*

We believe that the continued enhancement of our customer online shopping experience will promote word-of-mouth referrals and attract repeat customers' visits and purchases. We direct customers to our online and mobile e-commerce platforms primarily through a number of traditional online and offline channels, such as our sponsored searches, social and online advertising, television advertising and other advertising channels. In December 2018 and January 2019, we opened our first brick-and-mortar Yanxuan store and our flagship Kaola store, respectively, both of which are located in Hangzhou's popular commercial and business centers. These two stores have, since their respective openings, generated strong interests and attracted tourists and local residents of Hangzhou, proving to be an effective marketing tool as we seek to further scale our e-commerce offerings. We also offer our customers special pricing discounts in connection with promotion activities and strive to expand our products selection to attract more visitors. We aim to continue to attract customers by delivering a satisfying customer experience and increasing our marketing and brand promotion efforts.

*Advertising Services*

We believe the growing number of Internet users in China represents an attractive demographic target for advertisers because it represents an affluent, educated and technically sophisticated market. To capitalize on this advertising opportunity, we maintain a dedicated advertising services sales force, which had 659 sales professionals located in Beijing, Shanghai and Guangzhou as of December 31, 2018.

In addition, online advertising on our mobile applications and the NetEase websites is also sold through online advertising sales networks and advertising agencies. We believe that our focus on providing widely used services that are designed to appeal to a broad base of Internet users attracts a variety of blue chip advertisers, ranging from technology products to consumer brands. We intend to continue to attract online advertisers by promoting the NetEase brand name to potential advertisers. We also engage in providing cooperative promotional advertising solutions in which we act as the official sponsor or co-sponsor of special events or online content, such as websites that feature movies or television series, athletic events, conferences, music awards, charity concerts and industry exhibitions.

*Innovative Businesses and Others*

For our innovative businesses and other online services, content and services are generally provided through mobile applications or their respective websites. Users purchase our services either at a pre-determined package rate or on an item-based basis, and payments are made using third-party online payment platforms or NetEase Pay.

For a discussion of the seasonality of our revenue, see Item 5 Operating and Financial Review and Prospects Revenue Seasonality of Revenues.

Table of Contents

**Marketing**

We employ a variety of traditional and online marketing programs and promotional activities to build our brand as part of our overall marketing strategy. We focus on building brand awareness through proactive public relations and traditional and online advertising. We invest in a series of marketing activities to further strengthen our brand image and continue to grow our user base, including partnering with TV, movie and stage production companies as well as book and comic publishers to extend our brand to a broader potential user group. Our marketing campaigns consist of corporate branding and announcements about our services through outdoor, print and online advertisements.

We also conduct in-game marketing campaigns, visible to users playing our online games, in connection with holiday seasons or the commercial launches of new games or expansion packs throughout the year. We have also entered into a number of agreements with third-party promoters of our online game titles. For our e-commerce business, we have participated in various promotional activities throughout the year. For example, we offered discounts and bonus coupons to our customers during the online shopping festivals on June 18, 2018, November 11, 2018 and December 12, 2018, all of which are major online shopping events widely recognized by Chinese consumers.

We plan to continue investing in various forms of marketing to further build awareness of our brand and game titles.

**RESEARCH AND DEVELOPMENT**

We believe that the ability to develop and enhance our services is an integral part of our future success. Our product development efforts and strategies consist of incorporating new technologies from third parties as well as continuing to develop our own proprietary technology in order to produce user-friendly Internet and e-commerce applications, services and technologies for the Chinese market.

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet, e-commerce and other online services to our users. We also have utilized and will continue to utilize third-party advertisement serving technologies in conjunction with our own proprietary software. In addition, we plan to continue to expand our technologies, services and registered user base through diverse online services developed internally. We will seek to continually improve and enhance our existing services to respond to rapidly evolving competitive and technological conditions. As of December 31, 2018, we had approximately 10,000 programmers, network engineers and graphic designers dedicated to our research and development activities.

Our major area of focus is the development of our proprietary online games (including introducing new types of games) and localizing licensed games, and we plan to continue this focus in the future. We have multiple studios of game developers established to research and develop new games and expansion packs. In developing a new game or expansion pack, game developers create proposals for the game theme and design, and then construct prototypes for management to review and approve. Subsequently, our quality control staff, as well as volunteer players, conduct limited beta testing for the new game designs and expansion packs. Based on analysis of the feedback provided by the quality control staff and volunteer players, our game developers refine the game designs and expansion packs and then initiate unlimited beta testing, by which time the game becomes available to the public. For games using the time-based revenue model, no revenue is collected from users during unlimited beta testing until commercial launch of the game. However, for games using the item-based revenue model, users in the unlimited beta testing can purchase in-game items, which allow those games to start generating revenue from the unlimited beta testing phase onwards. Accordingly, for item-based games, the beginning of unlimited beta testing is sometimes considered to be the commercial launch of the game. Our game developers further improve the new game designs and expansion packs as necessary based on user statistics and feedback gathered from unlimited beta testing. User statistics gathered from limited beta and unlimited beta testing results are compared with existing games,

which enables us to assess the potential for success of the new games and expansion packs and to plan the network infrastructure and marketing efforts required to support each new game or expansion pack.

In connection with our game development activities, we occasionally license specific game technologies which we incorporate into our internally developed games.

Table of Contents

**INFRASTRUCTURE AND TECHNOLOGY**

Our infrastructure and technology have been designed for reliability, scalability and flexibility and are administered by our technical staff. The NetEase websites and other online and mobile platforms are made available primarily through network servers co-located in the facilities of China Unicom's Beijing affiliate and China Telecom's Beijing affiliates. As of December 31, 2018, there were approximately 106,000 of such co-located servers, including servers supporting the operation of the games licensed to Shanghai EaseNet by Blizzard, operating with Web server software from Apache and Netscape and using leased dedicated lines from China Net Center and various affiliates of China Unicom and China Telecom.

In addition, we also develop our own systems to facilitate sales planning, targeting, trafficking, inventory management and reporting tools, as well as advertisement and search tracking systems for our advertising and search services.

We use Oracle's database systems to manage our registered user database. NetEase has established a comprehensive user profile system, and we analyze user information on a weekly basis. We also deploy a single sign-on system that allows users to easily access our services within the NetEase websites. We intend to continue to use a combination of internally developed software products as well as third-party products to enhance our Internet media services in the future.

**COMPETITION**

A number of companies offer competitive products or services in China, our main operating market. Specifically, we are encountering competition from companies offering various online games that target the China market, such as Tencent, Changyou.com Limited, Giant Interactive Group Inc., Shanda Games Limited, and Perfect World Company Limited. We also face competition from other websites that offer online content and online community services, including Tencent, Baidu, Alibaba, Sina, Sohu, Qihoo, iFeng.com, and other vertical Internet media. In addition, we face competition for our e-commerce businesses from other companies such as Alibaba, JD.com, Mijia Youpin and Vipshop Holdings Limited. Some of our existing and potential competitors in these areas have significantly greater financial and marketing resources than we do. In addition, we believe that many of our competitors have become more active in both licensing foreign-developed games and developing games in-house.

We also believe that competition in the online advertising industry in China is intense with numerous competitors such as Baidu, Sina, Sohu, Tencent, Alibaba, Qihoo, iFeng.com and ByteDance, as well as other vertical Internet media. In addition, we face competition from Internet media operated by multinational Internet companies such as Yahoo! Inc., Microsoft Corporation and Google Inc. which provide Chinese language service offerings. Many of these Internet companies have longer operating histories in the Internet market, greater name and brand recognition, larger customer bases and databases and significantly greater financial, technical and marketing resources than we have. The entry of additional, highly competitive Internet companies into the Chinese market would further heighten competition. We also compete with traditional forms of media for advertising-related revenue.

There can be no assurance that we will be able to compete successfully against our current or future competitors or that competition will not have a material adverse effect on our business, results of operations and financial condition.

## GOVERNMENT REGULATIONS

### Overview

The Chinese government has enacted an extensive regulatory scheme governing the operation of Internet-related businesses, such as telecommunications, Internet information services, and international connection to computer information networks, information security and censorship. In addition to MII, the various services of the PRC Internet industry are regulated by various governmental authorities, such as the SAIC, the State Council Information Office, or SCIO, the Ministry of Education, or MOE, the Ministry of Health, or MOH, the State Food and Drug Administration, or SFDA, the MOCT, the SART, the Ministry of Commerce, the Ministry of Public Security and the CAC.

Table of Contents

In September 2000, China's State Council promulgated the Telecommunications Regulations of the People's Republic of China, or the Telecom Regulations, which was revised in February 2016. The Telecom Regulations categorized all telecommunications businesses in China as either basic telecommunications businesses or value-added telecommunications businesses, with ICP services and e-mail services classified as value-added telecommunications businesses. According to the Telecom Regulations, the commercial operator of such services must obtain an operating license. The Telecom Regulations also set forth extensive guidelines with respect to different aspects of telecommunications operations in China.

In December 2001, in order to comply with China's commitments with respect to its entry into the WTO, the State Council promulgated the Regulation for the Administration of Foreign-invested Telecommunications Enterprises, or the FITE Regulations, which was revised in February 2016. The FITE Regulations set forth detailed requirements with respect to capitalization, investor qualifications and application procedures in connection with the establishment of a foreign invested telecom enterprise. Pursuant to the FITE Regulations, foreign investors may hold an aggregate of no more than 50% of the total equity in any value-added telecommunications business in China, with the one exception set forth in the Notice of the Ministry of Industry and Information Technology on Removing the Restrictions on Foreign Equity Ratios in Online Data Processing and Transaction Processing (Operating E-commerce) Business issued by MII in June 2015, pursuant to which, foreign investors may hold up to 100% of the total equity in online data processing and transaction processing businesses. However, the FITE Regulations do not define the online data processing and transaction processing business, and its interpretation and enforcement involve significant uncertainties. Therefore, we cannot assure you whether our online retail business and distribution of online information falls into the online data processing and transaction processing business category and whether we are permitted to conduct such value-added telecommunications services in the PRC through our subsidiaries in which foreign investors own more than 50% of the equity interests.

The Circular of the MII on Intensifying the Administration of Foreign Investment in Value-Added Telecommunication Services, or the 2006 MII Circular, was promulgated by MII on July 13, 2006. The 2006 MII Circular provides that (i) any domain name used by a value-added telecom service provider must be legally owned by the service provider or its shareholder(s); (ii) any trademark used by a value-added telecom service provider must be legally owned by the service provider or its shareholder(s); (iii) the operation site and facilities of a value-added telecom service provider must be installed within the scope as prescribed by the operating licenses obtained by the service provider and must correspond to the value-added telecom services that the service provider has been approved to provide; and (iv) a value-added telecom service provider must establish or improve the measures of ensuring information security. Companies which have obtained operating licenses for value-added telecom services are required to conduct a self-examination and self-correction according to the foregoing requirements and report the results of such self-examination and self-correction to MII. To comply with these requirements, Guangzhou NetEase submitted its self-correction report to MII in 2007.

**Classified Regulations**

*Internet Information Services*

The Measures for the Administration of Internet Information Services, or the ICP Measures, issued by the State Council went into effect on September 25, 2000 and was revised on January 8, 2011. Under the ICP Measures, any entity that provides information to Internet users must obtain an operating license from MII or its local branch at the provincial level in accordance with the Telecom Regulations described above. To provide these services in compliance with all the relevant ICP-related Chinese regulations, Guangzhou NetEase successfully obtained an ICP license issued by the Guangdong Provincial Telecommunications Bureau. Subsequently, Guangzhou NetEase obtained a Value-Added Telecom Business Operating License from the Guangdong Provincial Telecommunications Bureau, which replaced its ICP license and authorizes Guangzhou NetEase to provide Internet information services. Guangzhou NetEase obtained an Inter-Provincial Value-Added Telecommunications Business Operating License from MII, which specifically authorizes it to provide value-added telecommunications services (excluding fixed line phone call information services and Internet information services). Also, Shanghai EaseNet, Youdao Computer, Hangzhou Leihuo, Zhejiang Yixin Science & Technology Co., Ltd, Wangyibao, Ujia E-commerce Co., Ltd., or Ujia, Zhoushan Bole Technology Co., Ltd.,

Edgar Filing: NetEase, Inc. - Form 20-F

or Zhoushan Bole, NetEase Advertising, Hangzhou Bobo Technology Co., Ltd., or Hangzhou Bobo and certain other affiliated entities have each obtained a Value-Added Telecommunications Business Operating License issued by a relevant Provincial Telecommunications Bureau.



Table of Contents

The Provisional Regulations for the Administration of Website Operation of News Publications, which were jointly issued by SCIO and MII on November 17, 2000, stipulate that websites of non-news organizations shall not publish news items produced by themselves and require the websites of non-news organizations to be approved by SCIO after securing permission from SCIO at the provincial level. On September 25, 2005, the Regulations for the Administration of Internet News Information Services were promulgated jointly by SCIO and MII. The regulations require that any ICP operator that is a non-news organization but engaged in Internet news information services must obtain approval for those services from SCIO. NetEase Advertising has obtained an Internet News Information Service License from SCIO.

In December 2016, the MOC (later superseded by the MOCT) issued the Circular on the Administrative Measures for Business Activities Relating to Online Performance, pursuant to which an Internet platform operator who creates access for online performers shall (i) apply for a Network Culture Operation License with the relevant provincial-level authority; (ii) notify the MOC of any access or performance channels created for domestic performers within ten days; and (iii) submit an application to the MOC before creating any access or performance channels for foreign performers. As of the date of this annual report, Guangzhou NetEase and our certain other affiliated entities have each obtained the Network Culture Operation Licenses. In addition, the SART (formerly known as the State Administration of Radio, Film and Television, or the SARFT, and the SAPPRFT) issued a Notice on Strengthening the Management of Live-Streaming Service for the Network Audio-visual Programs in September 2016, pursuant to which an Internet live-streaming service provider shall (i) provide necessary censorship on the content of such live-stream; (ii) establish a mechanism to timely identify unlawful contents, prevent them from being distributed and replace them with backup programs; and (iii) record the live-streaming program and keep such records for at least 60 days. Shortly after this notice, the State Internet Information Office promulgated the Administrative Provisions on Internet Live-Streaming Services in November 2016, pursuant to which an Internet live-streaming service provider shall (i) establish a live-streaming content review platform; (ii) require authentication for the registration of live-streaming content providers; and (iii) enter into a service agreement with live-streaming content providers to specify each of the live-streaming service provider's and the content provider's rights and obligations. If an ICP who provides information services through mobile applications violates these regulations, mobile application stores through which the ICP distributes its applications may issue warnings, suspend the release of its applications, terminate the sale of its applications, and/or report the violations to governmental authorities.

In 2017, the CAC promulgated the Provisions for Internet-based News Information Services 2017 and its implementing rules, both of which became effective on June 1, 2017. The Provisions for Internet-based News Information Services 2017 require any party that provides Internet-based news information services to the public through online live streaming to obtain a permit for such news information services and restricts any party from carrying out such activities without a permit or beyond the scope indicated on the permit. In addition, the Provisions for Internet-based News Information Services 2017 prohibit organizations from establishing foreign, partially or wholly, entities from investing or operating Internet-based news information services. The CAC and the local cyberspace administrative offices are responsible for the supervision, management and inspection of such Internet-based news information services. We believe we are in compliance with such provisions and implementing rules because our news information services are conducted by one of our VIE companies through contractual arrangements.

In November 2018, the CAC published the Provisions on the Safety Assessment for Internet Information Services Capable of Creating Public Opinions or Social Mobilization. These provisions require certain Internet information service providers to conduct safety assessment in relation to the (i) the legal compliance status of their information services, new technologies and new applications, (ii) effectiveness of their implementation of safety measures as required by applicable laws and regulations, and (iii) effectiveness of their safety and risk control measures. We have submitted the assessment report accordingly as of the date of this annual report.

On June 27, 2002, MII and GAPP (later superseded by the SART) jointly promulgated the Provisional Measures for the Administration of Internet Publishing, which was replaced by the Rules for the Administration of Online Publishing Service jointly issued by SAPPRFT (later superseded by the SART) and MII that became effective on March 10, 2016. These provisional measures require Internet publishers to secure approval from the SAPPRFT (later superseded by the SART) for their operations. The term "Internet publishing" is defined as an act of online dissemination whereby Internet information service providers select, edit and process contents created by themselves or others (including contents from books, newspapers, periodicals, audio and video products, electronic publications that have already been formally published or

## Edgar Filing: NetEase, Inc. - Form 20-F

works that have been made public in other media format) and subsequently post the same on the Internet or transmit the same to users via the Internet. Guangzhou NetEase has obtained a license from the SAPPRFT (later superseded by the SART) to engage in Internet publishing.

Table of Contents

On July 8, 2004, SFDA issued the Measures for the Administration of Internet Drug Information Services, which stipulate that websites publishing drug-related information must obtain a license from local food and drug administrations. Guangzhou NetEase has obtained a license for publishing drug-related information from the Guangdong Food and Drug Administration.

Pursuant to the Measures for the Administration of Internet E-mail Services, or the Internet E-mail Measures, which were issued by MII on February 20, 2006, e-mail service providers must obtain value-added telecommunications business operating licenses or file for recordation as nonprofit Internet service providers. In addition, each e-mail service provider must keep a record of the timing, sender's or recipient's e-mail address and IP address of each e-mail transmitted through its servers for 60 days. The Internet E-mail Measures also state that an Internet e-mail service provider is obligated to keep confidential the users' personal registered information and Internet e-mail addresses. An Internet e-mail service provider and its employees may not illegally use any user's personal registered information or Internet e-mail address and may not, without consent of the user, divulge the user's personal registered information or Internet e-mail address, unless otherwise prescribed by another law or administrative regulation. Guangzhou NetEase has obtained an Inter-Provincial Value-Added Telecommunications Business Operating License.

The SARFT (later superseded by the SART) and MII jointly issued the Regulations for the Administration of Internet Audiovisual Program Services, or the Audiovisual Regulations, on December 20, 2007, which was revised on August 28, 2015, require that online audio and video service providers must obtain a permit from SAPPRFT (later superseded by the SART) in accordance with the Audiovisual Regulations. Guangzhou NetEase has obtained the Permit for the Network Transmission of Audiovisual Programs issued by the SAPPRFT (later superseded by the SART).

On September 3, 2009, the MOC (later superseded by the MOCT) issued its Notice on Strengthening and Improving the Content Censorship of Online Music Content. According to this notice, only entities approved by the MOC (later superseded by the MOCT) for an Internet Culture Operating License may engage in the production, release, dissemination (including providing direct links to music products) and importation of online music products. In addition, the notice also requires all domestic music products to be filed with the MOC (later superseded by the MOCT) within 30 days after being publicly available online. Imported music products must be approved by the MOC (later superseded by the MOCT) before being made available online. On October 23, 2015, the MOC (later superseded by the MOCT) issued its Notice on Further Strengthening and Improving the Management of Online Music Content. According to this notice, the entities should examine and verify the content of online music by themselves, while the culture management administration should supervise in the act and afterwards. Guangzhou NetEase, Shanghai EaseNet, Hangzhou Leihuo, Zhoushan Bole, Ujia, Hangzhou Bobo and certain other affiliated entities have each obtained an Internet Culture Operating License.

On May 4, 2008, the China Banking Regulatory Commission, or CBRC, and PBOC jointly issued the Guiding Opinions of China Banking Regulatory Commission and the People's Bank of China on the Pilot Operation of Small Loan Companies, or the Guiding Opinions. According to the Guiding Opinions, to apply for setting up a small loan company, the applicant is required to file a formal official application with the competent department of the provincial government, and, upon approval, it shall apply to the local administrative department for industry and commerce for handling the registration formalities and to receive the business license. It is also required to file the relevant materials with the local public security organ, the dispatch office of the CBRC and the branch institution of the PBOC within five working days after approval. The major sources of funds of a small loan company shall be the capital paid by shareholders, donated capital and the capital borrowed from a maximum of two banking financial institutions. The balance of the capital borrowed from banking financial institutions shall not exceed 50% of the net capital within the scope as prescribed by laws and regulations. In addition, the balance of loans granted by a small loan company to a single borrower shall not exceed 5% of the net capital of the company.

Table of Contents

In addition, on June 14, 2010, the PBOC issued the Measures for the Administration of Non-financial Institutions Engaging in Payment and Settlement Services, or the PBOC Measures, which became effective as of September 1, 2010 and require that non-financial institutions engaging in the business of effecting payments and settlements before June 14, 2010 obtain a permit, Payment Service Permit, from the PBOC by August 31, 2011 to continue such business. On December 1, 2010, the PBOC issued the Implementation Rules for the Measures for the Administration of Non-financial Institutions Engaging in Payment and Settlement Services, or the Implementation Rules for the PBOC Measures, which contains further elaboration with respect to the application qualification, material and procedure for the Payment Service Permit and further measures aiming at protecting the rights and interests of clients, including prominent disclosure of service rates, prior notice to clients before any modification can be made to the service rates or payment service agreement between a payment service provider and its clients. We have obtained the Payment Service Permit from the PBOC. On December 28, 2015, the PBOC issued the Administrative Measures for Internet Payment Services of Non-banking Payment Institutions, which will take effect on July 1, 2016, which require that non-banking payment institutions shall implement the real-name verification system for payment accounts and take effective measures to verify the personal information of clients. The measures also require that if non-banking payment institutions engage in transferring money between payment accounts and bank accounts, all such accounts shall be owned by the same client. On January 13, 2017, the PBOC issued the Notice of the PBOC on Matters concerning Implementing the Centralized Deposit of the Funds of Pending Payments of Clients of Payment Institutions, which requires that, beginning on April 17, 2017, a payment institution to deposit a certain percentage of the funds from its clients, pending payment from such clients, in a special deposit account with a designated financial institution where no interest on such percentage of funds shall accrue. This means that beginning on April 17, 2017, we were not able to collect interest on a certain portion of funds that our users have with us through our NetEase Pay payment platform. For other details, see Item 3.D. Risk Factors Risks Related to the Telecommunications and Internet Industries in China Regulatory restrictions on financial transactions may adversely affect the operation and profitability of our business.

On December 29, 2011, MII issued Several Provisions on Regulating the Market Order for Internet Information Services, or the Market Order Provisions. According to such provisions, Internet information service providers, or IISPs, are prohibited from a wide range of activities that would infringe upon rights and interests of users or other IISPs, including but not limited to maliciously forcing incompatibility on services and products provided by other IISPs, deceiving, misleading or forcing users to use or not to use services and products provided by other IISPs, changing user's browser configurations or other configurations without notifying and obtaining permission from the users, and bundling their terminal software with other software without providing clear notice to the users. Also, IISPs are prohibited from collecting information that is related to the users and can serve to identify the users' identities solely or in conjunction with other information without the users' consent or providing other people with such information, unless otherwise permitted or required under laws or administrative regulations. We believe our current operation is in compliance with the Market Order Provisions.

On June 7, 2013, the PBOC issued the Measures for the Custody of Clients' Reserves of Payment Institutions, or the Clients' Reserves Measures, which defines Clients' Reserves as funds actually received by payment institutions when processing payments for clients and payable upon clients' order, and requires payment institutions to fully deposit the Clients' Reserves into a dedicated deposit account held in the custody of banking institutions. On June 29, 2018, the PBOC issued a further notice that required payment institutions to cause up to 100% of the customer reserve funds to be transferred to the above-mentioned account. As of the date of the annual report, NetEase Pay has completed such transfer and is in compliance with the foregoing PBOC measures.

On July 18, 2015, PBOC, MII, Ministry of Public Security, MOF, SAIC, Legislative Affairs Office of the State Council, CBRC, CSRC, China Insurance Regulatory Commission and China Internet Information Technology Office jointly issued the Guiding Opinions on Promoting the Healthy Development of Internet Finance, which was imperative to encourage innovation, and support the steady development of Internet finance. According to the above-mentioned Guiding Opinions, Internet enterprises would be supported to set up Internet payment institutions, online lending platforms, equity crowd-funding platforms and online financial product sales platforms in compliance with the law, and a multi-level financial services system that serves the real economy would be established to better meet the investment and financing needs of medium, small and micro-sized enterprises and individuals, and further expand the breadth, and increase the depth, of inclusive finance. According to the above-mentioned Guiding Opinions, e-commerce enterprises would be encouraged to build and improve their own online financial services systems under the premise of compliance with financial laws and regulations, and effectively expand the supply chain operations of e-commerce enterprises.



Table of Contents

On August 7, 2014, SCIO issued the Interim Provisions on Managing the Development of Public Information Services on Instant Messaging Tools, or the Instant Messaging Interim Provisions, which stipulate that instant messaging tool service providers must enter into an agreement with their users during account registration to require them to abide by Seven Principles, including, without limitation, laws and regulations, socialist system principles and social ethics. We believe we have taken the necessary measures to comply with the Instant Messaging Interim Provisions.

On December 28, 2015, MIIT issued the Telecommunication Services Classification Catalogue (2015), replacing the old Telecommunication Services Classification Catalogue (2003), which took effect on March 1, 2016. The 2015 catalogue divides the information services business into five more detailed sub-categories and reclassifies the online data processing and transaction processing services business as a value-added telecom business from basic telecom business category in the 2003 Catalogue. In 2017, MIIT issued the new version of Measures for the Administration of Telecom Business Licensing, or MIIT Measures 2017, which became effective on September 1, 2017. Same as the previous 2009 version, the MIIT Measures 2017 require the companies who are engaged in the telecommunications businesses to have a Telecom Business License. However, the MIIT Measures 2017 removed the previous requirement of record-filing and the trans-regional value-added telecommunications business permit for the operation of such business.

On April 17, 2015, the National Copyright Administration issued the Circular on Regulating the Order of Internet Reproduction of Copyrighted Works. Under this circular, in order to reproduce the work of others, Internet media must comply with relevant provisions of the copyright laws and regulations and, unless otherwise provided by law or regulation, must obtain permission from and pay remuneration to the owner of the copyrighted work, and must indicate the name of the author as well as the title and the source of the work, and may not infringe any other rights or interests of the copyright owner. Moreover, when reproducing the works of others, Internet media must not make material alterations to the content of the works.

On June 28, 2016, the CAC published the first regulation of mobile applications in the PRC, the Administrative Provisions on Information Services for Mobile Internet Applications, or the App Administrative Provisions. These provisions expressly require mobile application providers to obtain the relevant operation licenses and hold the mobile application providers strictly responsible for the implementation of information security management regarding the applications they distribute or operate. The App Administrative Provisions also require mobile application providers to (i) verify the identity and contact information of their registered users, (ii) establish an appropriate mechanism to protect its users' personal data, (iii) develop an adequate censorship mechanism for any information published through their applications, (iv) protect their users' rights to be informed if their applications need to gain access to the users' personal details and refrain from accessing the functions unrelated to the relevant applications without the users' consent, (v) protect their users' intellectual property rights, and (vi) maintain internal records of users' activities.

*Information Security and Censorship*

Regulations governing information security and censorship include:

- The Law of the People's Republic of China on the Preservation of State Secrets (2010) and its Implementation Rules (2014);
- The Counter-espionage Law of the People's Republic of China (2014);

- The Rules of the People's Republic of China for Protecting the Security of Computer Information Systems (1994, revised in 2011);
- The Administrative Regulations for the Protection of Secrecy on Computer Information System Connected to International Networks (1997, revised in 2011);
- The Regulations for the Protection of State Secrets for Computer Information Systems on the Internet (2000);

Table of Contents

- The Notice issued by the Ministry of Public Security of the People's Republic of China Regarding Issues Relating to the Implementation of the Administrative Measure for the Security Protection of International Connections to Computer Information Networks (2000);
- The Administrative Measures of the Commercial Website Filings for the Record (2004);
- The Decision of the Standing Committee of the National People's Congress Regarding the Safeguarding of Internet Security (2002);
- The Provisions on the Technical Measures for the Protection of the Security of the Internet (2006);
- The Administrative Regulations for the Classified Protection of Information Security (2007);
- The Decision of the Standing Committee of the National People's Congress on Strengthening Network Information Protection (2012);
- Provisions on Protection of Personal Information of Telecommunication and Internet Users (2013);
- Internet User Account Name Management Regulations (2015); and
- Cyber Security Law of the People's Republic of China (2017).

Under the Administrative Regulations for the Protection of Secrecy on Computer Information System Connected to International Networks and various other laws and regulations, ICP operators and Internet publishers are prohibited from posting or displaying any content that:

- opposes the fundamental principles set forth in China's Constitution;



- compromises state security, divulges state secrets, subverts state power or damages national unity;
- harms the dignity or interests of the state;
- incites ethnic hatred or racial discrimination or damages inter-ethnic unity;
- sabotages China's religious policy or propagates heretical teachings or feudal superstitions;
- disseminates rumors, disturbs social order or disrupts social stability;
- propagates obscenity, pornography, gambling, violence, murder or fear or incites the commission of crimes;
- insults or slanders a third party or infringes upon the lawful rights and interests of a third party; or
- includes other content prohibited by laws or administrative regulations.

Failure to comply with these content censorship requirements may result in the revocation of licenses and the closing down of the concerned websites or other online and mobile platforms. To ensure compliance with these regulatory requirements, Guangzhou NetEase has taken all reasonable steps to avoid displaying any of the prohibited content on the NetEase websites and other online and mobile platforms. In addition, it is mandatory for Internet companies in the PRC to complete security-filing procedures and regularly update information security and censorship systems for their websites and other online and mobile platforms with the local public security bureau. Guangzhou NetEase has obtained a Filing and Registration Certificate for Computer Information System Connected to International Networks issued by Guangzhou Public Security Bureau.

On June 22, 2007, the Ministry of Public Security, the State Secrecy Bureau, the State Cryptography Administration Bureau and the State Council Information Office jointly issued the Administrative Regulations for the Classified Protection of Information Security, according to which websites should determine the protection classification of their information systems pursuant to a classification guideline and file such classification with the Ministry of Public Security and its bureaus at provincial level. Guangzhou NetEase has followed the requirements and filed its classification with the Guangzhou Public Security Bureau.

Table of Contents

On December 28, 2012, the Standing Committee of the National People's Congress issued the Decision on Strengthening Network Information Protection, or the Information Protection Decision, which provides that electronic information through which a citizen's identity can be identified or in which a citizen's privacy is involved, or Personal Information, is protected and no person shall steal, illegally obtain, sell or illegally provide to others any Personal Information. Also, according to the Information Protection Decision, where the network service providers provide website access service, or handle network access formalities for fixed-line telephones or mobile phones, or provide information publication service for their users, they shall require the users to provide authentic identity information when concluding agreement or confirming provision of such service with the users.

On July 16, 2013, MII issued the Provisions on Protection of Personal Information of Telecommunication and Internet Users, which defines Personal Information as information that can identify the user either on its own or in combination with other information that is collected in the course of provision of services by the telecommunication business operators and Internet information service providers, and sets out detailed provisions concerning the collection and utilization of such Personal Information.

On February 4, 2015, the SCIO issued the Internet User Account Name Management Regulations, which defines Internet User Account Name as an account name registered or used in Internet information services, including, without limitation, blogs, micro-blogs, instant communication tools, forums and thread comments. Also, according to the Internet User Account Name Management Regulations, Internet information service providers must prohibit their users from using any illegal or harmful information in their account name, avatar, profile or other registration information. We believe we have taken the necessary measures to comply with the Internet User Account Name Management Regulations.

On November 7, 2016, the Standing Committee of the National People's Congress promulgated the Cyber Security Law, which became effective on June 1, 2017. In accordance with the Cyber Security Law, network operators must comply with applicable laws and regulations and fulfill their obligations to safeguard network security in conducting business and providing services. Network service providers must take technical and other necessary measures as required by laws, regulations and mandatory requirements to safeguard the operation of networks, respond to network security effectively, prevent illegal and criminal activities, and maintain the integrity, confidentiality and usability of network data. In addition, network operators must not collect personal information irrelevant to their services. In the event of any unauthorized disclosure, damage or loss of collected personal information, network operators must take immediate remedial measures, notify the affected users and report the incidents to the relevant authorities in a timely manner. We collect and use our users' personal information only if our users give their informed consent, and we believe we have taken appropriate measures to protect the security of our users' personal information.

On April 11, 2017, the CAC released the Draft Measures on Security Assessment of the Cross-Border Transfer of Personal Information and Important Data, or the Draft Cross-Border Transfer Measures, which require personal information and important data collected or produced by network operators during their operations in China to be stored within China. According to the Draft Cross-Border Transfer Measures, assessment by relevant regulatory authority or the national cyberspace authority under certain circumstances must be completed before transferring such data overseas. Furthermore, such data may not be transferred overseas without consent from the concerned individual(s), or if the transfer endangers the interests of individuals or public security. The CAC completed the solicitation of comments on the Draft Cross-Border Transfer Measures in May 2017, but there remains substantial uncertainties with respect to its final content and enactment timetable.

The Administrative Provisions on the Information Services Provided through Official Accounts of Internet Users, the Administrative Provisions on the Administration of Information Services Provided through Chat Groups on the Internet, the Administrative Provisions on Internet Follow-up Comment Services, and the Administrative Provisions on Internet Forum and Community Services each requires that providers of the aforesaid services shall, under the principle of requiring mandatory registration of legal name of users and encouraged voluntary use of real name as screen name, authenticate the identity of each of their registered users and take necessary measures to protect their users' personal identity. To comply with such requirement, we require our users to register with legal names and have implemented certain data security measures to ensure that our users' personal identities are protected.



Table of Contents

*Online Games*

Effective as of April 10, 2009, the Measures for the Administration of Software Products, originally issued by MII on October 27, 2000, were amended and replaced by a new version issued by the MII in April 2009. According to these regulations, software products developed in the PRC could be registered with the local provincial government authorities in charge of the information industry and filed with the MII. Subsequently, on February 24, 2015, the Decision of the State Council on a Group of Administrative Approval Items Cancelled or Adjusted and Other Matters was issued which eliminated such registration procedures. Prior to February 24, 2015, all of our online games were registered with MII and its offices at the provincial level in accordance with the prior regulation.

Pursuant to the Provisional Regulations for the Administration of Online Culture promulgated by the MOC (later superseded by the MOCT) in May 2003, which were revised in July 2004, February 2011 and December 2017, online game operators are required to obtain an Internet Culture Operating License from the MOC (later superseded by the MOCT), which Guangzhou NetEase, Shanghai EaseNet and Hangzhou Leihuo and Shanghai NetEase MineWorld Network Technology Co., Ltd., or Shanghai MineWorld, have received. In 2004, the MOC (later superseded by the MOCT) promulgated the Notice Regarding the Strengthening of Online Games Censorship, which provides that imported online games must be reviewed and approved by the MOC (later superseded by the MOCT) before they can be put into public testing or operation. Shanghai EaseNet has obtained MOC (later superseded by the MOCT) approval for Blizzard's World of Warcraft, including its expansion packs, The Burning Crusade®, Wrath of the Lich King®, Cataclysm®, Mists of Pandaria®, Warlords of Draenor®, Legion®, Battle for Azeroth™, and the StarCraft II series, including Wings of Liberty®, Heart of the Swarm® and Legacy of the Void®, as well as Hearthstone, Heroes of the Storm, Diablo III, Overwatch and StarCraft: Remastered. Shanghai MineWorld has obtained MOC (later superseded by the MOCT) approval for Minecraft. In accordance with such regulation, we are also required to register domestic online games with the MOC (later superseded by the MOCT) after their release. We have accordingly made such registrations with the MOC (later superseded by the MOCT) for our domestic online games, including, for example, Fairy Tales, the New Westward Journey Online II mobile game and the Fantasy Westward Journey mobile game.

On April 24, 2009, the MOC (later superseded by the MOCT) issued a Circular Concerning the Examination and Declaration of Imported Online Game Products. According to this circular, in the event of a change of the operator of an imported online game, the game's existing import approval will be automatically revoked and the new operator must apply to the MOC (later superseded by the MOCT) for a new approval for the same game.

On June 4, 2009, the MOC (later superseded by the MOCT) and the Ministry of Commerce jointly issued the Notice on Strengthening Administration on Online Game Virtual Currency, or the Online Game Virtual Currency Notice. According to the Online Game Virtual Currency Notice, online game virtual currency should only be used to exchange virtual services provided by the issuing enterprise for a designated extent and time, and is strictly prohibited from being used to pay for or purchase tangible products or any service or product of another enterprise. Also, the Online Game Virtual Currency Notice obligates the issuing enterprise to give users 60 days prior notice and refund in the form of legal tender or other forms acceptable to users in case it plans to terminate the provision of its products or services. We have implemented measures which we believe are necessary to ensure our compliance of the Online Game Virtual Currency Notice.

In addition, for imported online games, the relevant license agreements for such games are required to be registered with the State Copyright Bureau. Shanghai EaseNet has registered the license agreement for World of Warcraft, the StarCraft II series, Hearthstone, Heroes of the Storm, Diablo III, Overwatch and StarCraft: Remastered with the State Copyright Bureau.



Table of Contents

The publication of online games also requires approval from SAPPRFT (later superseded by the SART) in accordance with the Rules for the Administration of Online Publishing Service jointly issued by SAPPRFT (later superseded by the SART) and MII, effective on March 10, 2016, replacing Provisional Rules for the Administration of Internet Publishing jointly promulgated by GAPP (later superseded by the SART) and MII on June 27, 2002. Starting from March 2018, the SART at the national level temporarily suspended its approval of online games, which was later resumed in December 2018. In the first quarter of 2019, the SART published on its website the Online Games Approval Lists. As of the date of this annual report, no government authority has issued or promulgated any further explanation in respect of the game approval procedures at the national SART level or any guidelines relating to the filing with the MOC before commercially launching an online game.

The Online Publishing Service Rules also forbids foreign investments in the online publishing sector. In addition, in April 2007, GAPP (later superseded by the SART) and several other government authorities jointly promulgated the Notice Concerning the Protection of Minors' Physical and Mental Well-being and Implementation of Anti-addiction System on Online Games (the Anti-Addiction Notice), which confirms the real-name verification scheme and anti-addiction system standard made by GAPP (later superseded by the SART) in previous years and requires online game operators to develop and test their anti-addiction systems from April 2007 to July 2007, after which no online games can be registered or operated without an anti-addiction system in accordance with the Anti-Addiction Notice. On July 1, 2011, GAPP (later superseded by the SART) and several other government authorities jointly issued the Notice Regarding the Initiation of Work on the Online Games Real-Name Verification System to Prevent Online Gaming Addiction, which requires that online game operators be responsible for the data registration and identification of online game users, and that online game operators shall duly file unverified user identification information with the Ministry of Public Security's National Citizen Identity Information Center, or NCIIC, which will be in charge of real-name verification for the national anti-addiction system. In addition, online game operators shall ensure that via the NCIIC real-name verification, users with fraudulent identification data shall be enrolled in the operators' anti-addiction systems. On July 25, 2014, the SARFT (later superseded by the SART) issued the Notice Regarding the Implementation of the Anti-Addiction and Real-Name Verification System in Online Games, which requires online game operators to submit their real-name verification procedure for online games when applying for publication of online games. We have implemented our anti-addiction system and taken necessary measures to comply with these measures. Since their implementation, we have not experienced a significant negative impact from these measures on our business.

On September 7, 2009, the Office of the Central Institutional Organization Commission issued the Notice on Interpretation of the Office of the Central Institutional Organization Commission on Several Provisions relating to Animation, Online Games and Comprehensive Law Enforcement in the Culture Market in the Three Provisions jointly promulgated by the MOC, the SARFT and GAPP (the SARFT and GAPP were later superseded by the SART and the MOC was superseded by the MOCT). According to this notice, SAPPRFT (later superseded by the SART) shall be responsible for the examination and approval of those online games made available on the Internet, and once an online game is available on the Internet, it shall be solely and completely administered by the MOC (later superseded by the MOCT). The notice further clarifies that the SAPPRFT (later superseded by the SART) shall be responsible for the examination and approval of the game publications which are authorized by overseas copyright owners to be made available on the Internet, and all other imported online games shall be examined and approved by the MOC (later superseded by the MOCT).

On September 28, 2009, GAPP (later superseded by the SART), the National Copyright Administration and the National Office of Combating Pornography and Illegal Publications jointly published the Notice on Further Strengthening Pre-examination and Pre-approval of Online Games and Administration of Imported Online Games Approval, or Circular 13. According to Circular 13, no entity should engage in the operation of online games without receiving an Internet Publishing License and the pre-approval from SAPPRFT (later superseded by the SART). Circular 13 expressly prohibits foreign investors from participating in online game operating business via wholly owned, equity joint venture or cooperative joint venture investments in China, and from controlling and participating in such businesses directly or indirectly through contractual or technical support arrangements. Moreover, for online games which have been approved by SAPPRFT (later superseded by the SART), when the operational entity changes, or when new versions, expansion packs or new content is implemented, the operation entity shall once again undertake the same procedures for the examination and approval by SAPPRFT (later superseded by the SART) of such changed operation entity, new versions, expansion packs or new content. Shanghai EaseNet has obtained SAPPRFT (later superseded by the SART) approval for Blizzard's World of Warcraft, including its expansion packs, The Burning Crusade, Wrath of the Lich King, Cataclysm, Mists of Pandaria, Warlords of Draenor and Legion, and StarCraft II series, including Wings of Liberty, Heart of the Swarm and Legacy of the Void, as well as Hearthstone, Heroes of the Storm, Diablo III and Overwatch. On May 24, 2016, SAPPRFT (later superseded by the SART) issued the

## Edgar Filing: NetEase, Inc. - Form 20-F

Circular on the Administration over Mobile Game Publishing Services, or Circular 44, which came into effect on July 1, 2016 and provides that no mobile game shall be published and operated online without the approval of the SAPPRFT (later superseded by the SART). We have taken necessary measures to comply with Circular 44.

Table of Contents

On June 3, 2010, the MOC (later superseded by the MOCT) issued a decree on Interim Measures for the Administration of Online Games, or the Online Games Measures, which became effective as of August 1, 2010 and were revised as of December 15, 2017. The Online Games Measures set forth certain requirements regarding online games, including requirements that game operators follow new registration procedures, publicize information about the content and suitability of their games, prevent access by minors to inappropriate games, avoid certain types of content in games targeted to minors, avoid game content that compels players to kill other players, manage virtual currency in certain ways and register users with their real identities. Although many of these requirements reflect previously issued government regulations with which we already comply, certain new requirements may cause us to change the way we launch and operate our online games. For other details, see Item 3.D.

**Risk Factors Risks Related to the Telecommunications and Internet Industries in China** The Chinese government has taken steps to limit online game playing time for all minors and to otherwise control the content and operation of online games. These and any other new restrictions on online games may materially and adversely impact our business and results of operations. On July 30, 2010, the MOC (later superseded by the MOCT) promulgated the Notice on the Implementation of the Interim Measures for the Administration of Online Games, which provides details concerning the scope of online games, the review of online games content by the MOC (later superseded by the MOCT), the administration of material changes in the content of online games and the implementation of real-name registration of online game users. In addition, the notice brings in the definition of joint operation of domestic online games and lays out the specific regulations for such joint operation.

On January 15, 2011, the MOC (later superseded by the MOCT) and several other government authorities jointly issued the Notice on Implementation Program of Online Game Monitoring System of the Guardians of Minors, or the Monitoring System Notice, which requires online game operators to adopt various measures to maintain an interactive system for the protection of minors, through communication with the online game operators, to monitor and restrict online game activities by minors, including restriction of playtime or total suspension of the relevant gaming account. We have taken necessary measures in compliance of the Monitoring System Notice.

On August 12, 2013, the MOC (later superseded by the MOCT) issued the Administrative Measures for Content Self-review of Internet Culture Operators, which requires Internet culture operators to carry out prior self-review upon the products and services to be provided. In particular, such self-review should be conducted by staff who has obtained the Certificate for Content Review Personnel issued by the local branch of the MOC (later superseded by the MOCT) at the provincial level. Our content review personnel have already obtained such certification.

On February 18, 1994, the State Council promulgated the Rules of the People's Republic of China for Protecting the Security of Computer Information Systems, which define Security Products for Computer Information Systems as software and hardware products designed for the protection of computer information security and stipulate that a license must be obtained before selling Security Products for Computer Information Systems. The Ministry of Public Security issued the Measures for the Administration of Security Products for Computer Information Systems Examination and Sales License on June 28, 1997 confirming that a license for the sale of security products for computer information systems must be obtained as a precondition for sales of such products. Guangzhou NetEase has developed a technology which is designed to protect the passwords of online game players and falls into the scope of security products for computer information systems which is subject to this license requirement. Guangzhou NetEase has obtained the above-mentioned license from the Ministry of Public Security.

According to the Guidelines for the Filing for Recordation of Domestic Online Games issued by the MOC (later superseded by the MOCT) in 2005, domestic online games operating in China must be filed for recordation with the MOC (later superseded by the MOCT) within 30 days after they are put into operation. Our internally developed online games, including New Westward Journey Online II, Fantasy Westward Journey II, New Legend of Westward Journey, New Westward Journey Online III, Tianxia III, Heroes of Tang Dynasty II, New Fly For Fun, Legend of Fairy, New Ghost, DREAM, Soul of the Fighter, Kung Fu Master II, Heroes of the Three Kingdoms, Dragon Sword, Onmyoji and other causal games, have successfully finished the recordation process.



Table of Contents

The Regulations for the Administration of Audio and Video Products, which was released by the State Council on December 25, 2001 and further amended in March 2011, require that the publication, production, duplication, importation, wholesale, retail and renting of the audio and video products are subject to a license issued by competent authorities. Guangzhou NetEase has obtained such license from Guangzhou Municipal Administration of Culture, Radio, Film, TV, Press and Publication.

On January 6, 2016, the MOC (later superseded by the MOCT) issued the Tentative Rules for the Management of Cultural Market Blacklist, according to which those cultural products and entities in serious violation of relevant laws and regulations will be put on the blacklist and thus subject to more strict regulations. We have taken necessary measures to ensure that none of our products or entities will be placed on such blacklist.

On December 1, 2016, the MOC (later superseded by the MOCT) issued the Notice 32, which became effective on May 1, 2017. The Notice 32 sets forth several requirements regarding the operation of online games, among which, it provides that virtual items distributed by online game operators shall be regulated as virtual currency, so long as such items are purchased by users directly with currencies or virtual currencies, or exchanged in proportion with virtual currencies, and such items enable users to directly exchange for other virtual items or value-added services in relation to online games. In addition, Notice 32 prohibits online game operators from distributing for free virtual items and value-added services by randomly selecting potential gamers as recipients to attract gamers to play, and requires such game operators to disclose to their potential gamers the details of its random selection process for the distribution of non-free items such that the gamers may make informed decisions on whether to participate or not. We have taken all necessary measures to ensure that our online games comply with Notice 32.

*E-commerce*

The E-Commerce Law, which was promulgated on August 31, 2018 and took effect on January 1, 2019, set forth detailed obligations of operators of e-commerce business and e-commerce platforms and guidelines in terms of contract performance and dispute resolutions in relation to e-commerce. Pursuant to this law, e-commerce operators shall, for example, (i) present unbiased search results and general product recommendations that are not based on a potential customer's particular purchase history and personal profile in addition to tailored product recommendations and services; and (ii) not cite any provision of a form contract or boiler plate provision to invalidate an agreement with a customer after it has received payment from such customer. In addition, an e-commerce platform operators shall (i) report information such as identity and tax information of third-party vendors to relevant authorities; (ii) make platform service agreement or web-links thereto prominently displayed and accessible on its homepage; (iii) be jointly liable in the event that such platform operator fails to take necessary measures when it has or should have the knowledge that any vendor using its platform infringes consumers' rights; and (iv) be jointly liable for any damage or threat to a customer's personal health and wellbeing caused by the products sold on its platform if a platform operator fails to examine the qualifications of its vendor using its Platform or fails to protect its consumers' safety in respect of goods or services that may affect a consumers' health. We are subject to this new law as both e-commerce business operator and e-commerce platform operator. Failure to comply with the E-Commerce Law could subject us to civil liabilities or administrative penalties.

The Consumer Protection Law of the People's Republic of China, as amended on October 25, 2013, sets out the obligations of business operators and the rights and interests of the consumers. Pursuant to this law, business operators must guarantee that the commodities they sell satisfy the requirements for personal or property safety, provide consumers with authentic information about the commodities, and guarantee the quality, function, usage and term of validity of the commodities. The amendment in 2013 further strengthens the protection of consumers and imposes more stringent requirements and obligations on business operators, especially on the businesses operating through the Internet. For example, consumers are entitled to return the goods (except for certain specified goods) within seven days upon receipt without any reasons when they purchase the goods from business operators via the Internet. When a consumer purchases products (including cosmetics and food) or accepts services via an online trading platform and his or her interests are prejudiced, if the online trading platform provider fails to provide the name, address and valid contact information of the seller, the manufacturer or the service provider, the consumer is entitled to demand compensation from the online trading platform provider. Failure to comply with the Consumer Protection Law may subject business operators to civil

liabilities such as refunding purchase prices, replacement of commodities, repairing or ceasing damages, compensation, and restoring reputation, and could subject the business operators or the responsible individuals to criminal penalties when personal damages are involved or if the circumstances are severe.

Table of Contents

On January 26, 2014, SAIC issued the Administrative Measures for Online Trading, or the Online Trading Measures, which replaced its previous Interim Measures for the Administration of Online Commodities Transaction and Relevant Services. The Online Trading Measures aim to regulate online commodity trading and relevant services, setting standards for online commodity trading operators and relevant services providers, including third-party trading platform operators, concerning qualifications, after-sale services, terms of use, user privacy protection, data preservation, compliance with applicable laws in respect of intellectual property rights protection and unfair competition. On January 5, 2015, SAIC issued the Measures for the Punishment of Conduct Infringing the Rights and Interests of Consumers, or the Consumer Conduct Measures, which became effective on March 15, 2015. According to these measures, business operators are prohibited from a wide range of activities that would infringe upon the rights and interests of consumers, including but not limited to collecting and using information related to consumers without their consent, illegally providing third parties with such information in any form, or sending promotional message to consumers despite their express refusal. We believe we have taken the necessary measures to comply with the Consumer Conduct Measures. On September 2, 2015, SAIC issued the Interim Provisions on the Administration of Centralized Online Promotional Activities for Goods and Services, which require the organizer of centralized online promotion activities to publish the methods, terms and rules of the activities in advance in an obvious position on its website. On January 6, 2017, SAIC issued the Interim Measures for Return of Online Purchases within seven Days without Reason, or the Online Return Measures, which became effective on March 15, 2017. According to these measures, any consumer goods purchased online could be returned without any reason, if in good condition and are returned within seven days of receipt with signature from the consumers, except for customized products, fresh or live products, perishable goods, digital products, newspapers, periodicals and the goods confirmed to be exception of Online Return Measures by the consumers at the time of purchase.

The General Administration of Customs has promulgated the Announcement on the Regulatory Issues concerning the Inbound and Outbound Retail Commodities under E-Commerce, or Customs Circular No. 26, which took effect on April 8, 2016. Under the Customs Circular No. 26, e-commerce enterprises, e-commerce trade platform enterprises, payment enterprises and logistics enterprises shall, before the declaration of import retail commodities through cross border e-commerce, respectively submit to the customs bureau the information on trade, payment and logistics, among others. E-commerce enterprises shall verify the identity information of purchaser (subscriber) of cross-border e-commerce retail imports and provide the customs bureau with the effective identity information authenticated by respective competent authorities. In December 2018, the General Administration of Customs further promulgated the Announcement on Regulatory Matters concerning Cross-Border E-Commerce Retail Imports and Exports, which became effective on January 1, 2019, providing detailed rules and guidance on the administration of cross-border products, customs clearance, tax collection and administration, sites, quarantine, inspection procedures and logistics, and the process relating to the return of imported goods.

The Food Safety Law of the People's Republic of China, promulgated on February 28, 2009 and effective on June 1, 2009, as amended on December 29, 2018 with effect from the same date. This amendment set out a new and stricter regulation framework for the production and circulation of food. However, it currently remains unclear if food distributed through the recently established cross-border e-commerce industry is required to comply with all the requirements set forth in the new Food Safety Law. For more details, see Item 3.D. Risk Factors Risks Related to Our Company Our e-commerce business may expose us to new challenges and risks and may lower our profit margin.

On March 24, 2016, the MOF, General Administration of Customs and the State Administration of Taxation issued the Notice on Import Tax Policies for E-Commerce Retailers (Cai Guan Shui (2016) No. 18), with effect on April 8, 2016. On November 29, 2018, the foregoing authorities issued the new Circular on Improving Tax Policies for Cross-border E-Commerce Retail Imports, which took effect on January 1, 2019. According to such notice, which are applicable to the imported goods listed in the E-Commerce Retail Import Commodities List that was issued by the MOF and twelve other relevant PRC regulatory authorities on November 20, 2018, customs duties, import VAT and consumption tax will be charged on cross-border e-commerce retail imports calculated based on the goods imported, with individual purchasers of cross-border e-commerce retail imports defined as the taxpayers, the actual transaction price (including retail price, freight and insurance premium) regarded as the dutiable value, and e-commerce companies and trading platforms or logistics companies bearing the obligations of tax collection and withholding. The value of single transactions of retail products imported through cross-border e-commerce is capped at RMB5,000, and the total value of transactions carried out by an individual is capped at RMB26,000 per year. For cross-border e-commerce retail imports with a value within the above-mentioned limits, a zero tariff rate is applicable but, at the same time, import VAT and consumption tax exemptions will be abolished and import VAT and consumption tax will be charged temporarily at 70% of the statutory taxable amount. The relevant taxes will be charged in full on any transactions exceeding the single-transaction limit or the cumulative annual limit, and single indivisible goods whose dutiable value exceeds RMB5,000.



Table of Contents

On November 28, 2018, the Ministry of Commerce, National Development and Reform Commission, MOF, General Administration of Customs and State Administration for Market Regulation promulgated the Circular on Improving the Regulation of Cross-border E-Commerce Retail Imports, which took effect on January 1, 2019. Pursuant to this circular, cross-border e-commerce operator shall (i) engage a PRC-incorporated company as its domestic agent, (ii) be responsible for product quality and safety and its consumers' rights and interests, (iii) provide adequate disclosures to consumers, (iv) establish a risk prevention and control system and a quality assurance system for products that are subject to bonded import procedure, and (v) transmit real-time electronic transaction data to the customs. Cross-border e-commerce platforms are also subject to this circular and they shall, for example, be incorporated in PRC, transmit real-time electronic transaction data to the customs, establish disputes resolution and consumer rights protection system as well as adequate procedures in terms of quality control and risk management relating to the products sold on their platform. The domestic agents engaged by the cross-border e-commerce operator are required to make accurate and adequate disclosure to the relevant authorities. For our cross-border e-commerce platform Kaola, we have certain affiliated entities within our group to act as its domestic agent for purposes of complying with this circular.

*Online Advertising*

The Regulations for the Administration of Advertising and its Detailed Implementation Rules were both promulgated by the State Council and SAIC, which took effect on December 1, 1987 and January 1, 2005, respectively. According to these regulations, websites engaged in advertising must apply for a business license to conduct such business. In compliance with such regulations, NetEase Advertising, which operates our online advertising business through a series of agreements with Guangzhou NetEase, and Guangzhou NetEase have obtained a business license to carry out the design, production, agency and release of advertisements.

On February 9, 2012, SAIC and several other government authorities jointly issued the Rules on Review of Advertisement Release by Public Media, or the Advertisement Review Rule, which, among other things, states that public media (including Internet information service providers) shall have advertisement reviewers, who shall participate in trainings in relation to advertisement laws, regulations and business, and after passing the training should perform works including reviewing of advertisements to be released and management of advertisement review archives. In compliance with the Advertisement Review Rule, several employees of Guangzhou NetEase have obtained the Certificate for Advertisement Reviewer.

On April 24, 2015, the Standing Committee of the National People's Congress enacted the Advertising Law of the People's Republic of China, or the New Advertising Law. The New Advertising Law, which was a major overhaul of an advertising law enacted in 1994, increases the potential legal liability of providers of advertising services, and includes provisions intended to strengthen identification of false advertising and the power of regulatory authorities. The New Advertising Law forbids the usage of certain words or phrases in advertisement, such as "national, supreme or best" and provides a more detailed definition of false advertisement. The New Advertising Law also forbids sending advertisements to residences, vehicles, fixed or mobile telephones or personal email addresses if such advertisement is not invited or the receiver of the advertisement has rejected such advertising. We have taken necessary measures, including more stringent examination and monitoring of our advertisers and the content of their advertisements, in compliance with the New Advertising Law.

On July 4, 2016, SAIC promulgated the Provisional Measures of Internet Advertising Management, or the Internet Advertising Management Measures, which took effect on September 1, 2016. According to these measures, (i) an Internet advertisement shall be identifiable and clearly labeled as "advertisement"; (ii) paid search advertisements shall be clearly distinguished from natural search results; (iii) advertisements published in the form of pop-up or other forms shall be clearly marked with a "Close" sign to ensure "Single Click to Close"; and (iv) no entity or individual may induce users to click on the contents of an advertisement through deception, or attach advertisements in any form to an e-mail without user's permission. We have taken necessary measures to ensure that our current advertising publication and distribution process are in compliance with the Internet Advertising Management Measures.



Table of Contents

**INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS**

We rely on a combination of copyright, trademark, patent and trade secrecy laws and contractual restrictions on disclosure to protect our intellectual property rights. We require our employees to enter into agreements requiring them to keep confidential all information relating to our customers, methods, business and trade secrets during and after their employment with us. Our employees are required to acknowledge and recognize that all inventions, trade secrets, works of authorship, developments and other processes, whether or not patentable or copyrightable, made by them during their employment are our property. They also sign all necessary documents to substantiate our sole and exclusive right to those works and to transfer any ownership that they may claim in those works to us.

We have registered a number of domain names, including:

- [www.netease.com](http://www.netease.com);
  
- [www.163.com](http://www.163.com);
  
- [www.yeah.net](http://www.yeah.net);
  
- [www.126.com](http://www.126.com);
  
- [www.lofter.com](http://www.lofter.com);
  
- [www.youdao.com](http://www.youdao.com);
  
- [www.nease.net](http://www.nease.net);
  
- [www.188.com](http://www.188.com);
  
- [www.126.net](http://www.126.net);

- [www.kaola.com](http://www.kaola.com);
- [www.bobo.com](http://www.bobo.com);
- [www.netease.com](http://www.netease.com);
- [www.miaode.com](http://www.miaode.com);
- [www.163yun.com](http://www.163yun.com);
- [www.tryfun.com](http://www.tryfun.com);
- [www.onmyojigame.jp](http://www.onmyojigame.jp); and
- [www.immortalconquest.eu](http://www.immortalconquest.eu).

We have successfully registered numerous trademarks with China's Trademark Office, including marks incorporating the words "NetEase" and "Yeah" in English and for marks for "NetEase" as written in Chinese in traditional and simplified Chinese characters. In addition, we have registered trademarks involving Chinese characters and phrases that have meanings relating to our Web pages, products and services, including our dating and friends matching services, chat services, online gaming, interactive online video, e-commerce, our Internet finance services and certain other online services. We have also registered a number of trademarks in Hong Kong incorporating the words "NetEase" in English and the marks for "NetEase" as written in Chinese in traditional and simplified Chinese characters. In addition, we have also filed and registered the marks for "NetEase" in English and the marks for "NetEase" as written in Chinese in traditional and/or simplified Chinese characters in the United States, the European Union, the Republic of Korea, Japan, Macau, Taiwan, Thailand, and other jurisdictions. In addition, we have also registered the trademark "163" in China, Hong Kong, United States and European Union.



Table of Contents

In addition, we have registered our various self-developed games and other online products with the National Copyright Administration of the People's Republic of China. Moreover, we have filed certain patent applications with the National Intellectual Property Administration, U.S. Patent and Trademark Office, European Patent Office and Japan Patent Office, and have obtained Certificates of Design Patent, Utility Model Patent and/or Invention Patent for technologies related to our games, live video, news, blog, educational products, reading products, YiChat, e-commerce and finance, Cloud Music, hardware products, agricultural products, cloud technology, augmented reality technology, computer technology and e-mail from the National Intellectual Property Administration, as well as Certificates of Utility Patent for games in the United States.

While we actively take steps to protect our proprietary rights, such steps may not be adequate to prevent the infringement or misappropriation of our intellectual property. Infringement or misappropriation of our intellectual property could materially harm our business. We own the intellectual property (other than the content) relating to the NetEase websites and other online and mobile platforms, and the technology that enables online community, personalization, online games, e-commerce, news sharing, instant messaging, video streaming, Cloud Music, and other services on those platforms. We license content from various freelance providers and other content providers.

Many parties are actively developing community, online game, e-commerce, search and web-related technologies. We expect these parties to continue to take steps to protect these technologies, including seeking patent protection. There may be patents issued or pending that are held by others and that cover significant parts of our technology, business methods or services. For example, we are aware that a number of patents have been issued in areas of e-commerce, web-based information indexing and retrieval, online direct marketing, online game, instant message, music streaming and intelligent hardware. Disputes over rights to these technologies are likely to arise in the future. We cannot be certain that our products do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others.

**C. Organizational Structure**

Our organizational structure is set forth above under Our Organizational Structure.

**D. Property, Plants and Equipment**

Our principal executive offices are currently located at Building No. 7, West Zone, Zhongguancun Software Park (Phase II), No. 10 Xibeiwang East Road, Haidian District, Beijing, People's Republic of China 100193. In addition, as of December 31, 2018, we leased office, warehouse and store facilities with a total effective annual rent of RMB471.3 million (US\$68.5 million), including management fees, and an aggregate of approximately 1.5 million square meters of space at properties mainly in Beijing, Shanghai, Guangzhou, Hangzhou, Tianjin, Zhengzhou and Ningbo.

We own and occupy a research and development center in Hangzhou, China with a total floor area of 110,500 square meters, where our e-commerce, innovative businesses and other services and their related sales, marketing, technology, management and administrative functions

## Edgar Filing: NetEase, Inc. - Form 20-F

are located and an office building in Beijing with a total floor area of 95,000 square meters, where our advertising services are located. We also own and occupy a building in Guangzhou with a total floor area of 20,000 square meters, in which our online game developers, sales and marketing, technology and certain management as well as administrative support functions relating to game development are currently located. In addition, we also acquired a warehouse with a total floor area of 26,000 square meters in Ningbo for the operation of our e-commerce businesses.

We are in the process of constructing several new office buildings and warehouses, primarily located in Hangzhou, Guangzhou, Ningbo and Shanghai. As of December 31, 2018, we had incurred construction in progress costs of RMB2,154.0 million (US\$313.3 million) for these new office buildings and warehouses, which primarily comprise costs for building construction.

Table of Contents

We continue to assess our needs with respect to office space and may, in the future, vacate or add additional facilities. We believe that our current facilities and those under construction will be adequate for our needs in the immediate and foreseeable future.

As of December 31, 2018, we owned approximately 106,000 network servers co-located in the facilities of China Unicom's Beijing affiliate and China Telecom's Beijing affiliates for which we paid server custody fees, and we leased dedicated lines from affiliates of China Net Center and various affiliates of China Unicom and China Telecom pursuant to short term contracts. Our server custody and lease fees were approximately RMB1,556.6 million (US\$226.4 million) for the year ended December 31, 2018.

**Item 4A. Unresolved Staff Comments**

Not applicable.

**Item 5. Operating and Financial Review and Prospects**

*The following discussion of our financial condition and results of operations is based upon and should be read in conjunction with our consolidated financial statements and their related notes included in this annual report. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words "expect," "anticipate," "intend," "believe," or similar language. All forward-looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In evaluating our business, you should carefully consider the information provided under Item 3.D. Risk Factors. Actual results could differ materially from those projected in the forward-looking statements. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties.*

**A. OPERATING RESULTS**

**Overview**

NetEase is a leading Internet technology company in China. Our innovative online games, e-commerce services, communities and personalized premium services, which allow registered users to interact with other community members, have established a large and stable user base for the NetEase websites and other online and mobile platforms.

We achieved a net income attributable to our shareholders of RMB6,152.4 million (US\$894.8 million) for 2018 and generated positive operating cash flows of RMB13,415.9 million (US\$1,951.3 million) during the year. We recorded retained

earnings of RMB35,328.8 million, RMB42,733.1 million and RMB43,997.4 million (US\$6,399.2 million) as of December 31, 2016, 2017 and 2018, respectively.

### **Our Corporate Structure**

Our company was incorporated in the Cayman Islands on July 6, 1999 as an Internet technology company in China.

NetEase, Inc. conducts its business in China through its subsidiaries and VIEs. Under current Chinese regulations, there are restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of Internet content, online games and e-commerce services. In addition, the operation by foreign or foreign-invested companies of advertising businesses in China is subject to government approval. In order to comply with these restrictions and other Chinese rules and regulations, NetEase, Inc. and certain of its subsidiaries have entered into a series of contractual arrangements for the provision of such services with certain affiliated companies, including Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Shanghai EaseNet, Youdao Computer and certain other affiliated companies. These affiliated companies are considered variable interest entities for accounting purposes, and are referred to collectively in this annual report as VIEs. The revenue earned by the VIEs largely flows through to NetEase, Inc. and its subsidiaries pursuant to such contractual arrangements. Based on these agreements, Media Beijing, NetEase Hangzhou, Boguan, Hangzhou Langhe and certain other affiliated companies provide technical consulting and related services to the VIEs. In addition, Guangzhou NetEase has a wholly-owned subsidiary, Wangyibao (the operator of our NetEase Pay online payment platform). Please also see Item 4.B. Business Overview Our Organizational Structure.

Table of Contents

As of December 31, 2018, the total assets of all the consolidated VIEs of our company were RMB10.5 billion (US\$1.5 billion), mainly comprising cash and cash equivalents, time deposits, accounts receivable, prepayments and other current assets and fixed assets. As of December 31, 2018, the total liabilities of the consolidated VIEs were RMB9.9 billion (US\$1.4 billion), mainly comprising accounts payable, deferred revenue, accrued liabilities and other payables. As of December 31, 2018, the total assets of our company and all of our consolidated subsidiaries were RMB76.5 billion (US\$11.1 billion), mainly comprising cash and cash equivalents, time deposits, restricted cash, accounts receivable, short-term investments, inventories, prepayments and other current assets, fixed assets, land use rights, long-term investments and other long-term assets. As of December 31, 2018, the total liabilities of our company and all of our consolidated subsidiaries were RMB25.7 billion (US\$3.8 billion), mainly comprising accounts payable, salary and welfare payables, tax payable, short-term loan, deferred revenue, accrued liabilities and other payables.

We believe that our present operations are structured to comply with the relevant Chinese laws. However, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions. We cannot be certain that the Chinese government will not take action to prohibit or restrict our business activities.

Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services, online advertising and online payment services, may impose additional regulatory requirements on us or our service providers or otherwise harm our business.

## **Revenues**

We generate our revenues from the provision of online games services, e-commerce, advertising services and innovative businesses and other services. No customer individually accounted for greater than 10% of our total revenues for the years ended December 31, 2016, 2017 and 2018.

### *Online Games Services*

We generate our mobile game revenues primarily from the sale of in-game virtual items, including avatars, skills, privileges or other in-game consumables, features or functionality, within the games. We distribute our mobile games through partnerships with major Android- and iOS-based app stores in China as well as proprietary distribution channels, such as our website. Users have a variety of payment options for in-game virtual items, including our prepaid cards, online payments through app stores and other online payment channels. We derive our PC-client game revenues mainly from sales of our prepaid point cards.

Customers can purchase virtual prepaid cards online by debit card, credit card or bank transfer, and receive the prepaid point card information as soon as payment is confirmed. Customers can also purchase physical prepaid point cards in different locations in China, including Internet cafés, software stores, convenience stores and bookstores, or from vendors who register the points in our system. Customers can use the points to play our online games, either to pay for playing time or to purchase virtual items within the games, and use our other fee-based services.

We also generate revenues from certain games licensed to us by international game developers, including games licensed by Blizzard and Microsoft.

Table of Contents

We expect that we will face increasing competition as online game providers in China and abroad expand their presence in the Chinese market or enter it for the first time.

*E-commerce*

We established our two e-commerce platforms, Kaola and Yanxuan, in January 2015 and April 2016, respectively.

Kaola sells mainly imported goods that we source from overseas suppliers, including maternity and baby products, skincare and cosmetics and other general merchandise, and Yanxuan sells our private label products, including apparel, homeware, kitchenware and other general merchandise, which we primarily source directly from original design manufacturers in China. We generate revenues from both these platforms through merchandise sales and recognize revenue on a gross basis as we carry our own inventory and have discretion in setting prices. We also provide discount coupons to our customers for use in purchases on Kaola and Yanxuan, which are treated as a reduction of revenue when the relevant transactions are recognized. We also act as the marketplace service provider for third-party vendors to sell their products on the Kaola platform and recognize revenue when services are rendered based on a pre-determined service fee rate.

*Advertising Services*

We derive most of our advertising services revenue from fees we earn from brand advertising offered on the mobile applications and websites of our Internet media business and our advertising revenue was primarily derived from brand advertising services.

We expect that the online advertising market in China will continue to grow as Internet usage in China increases and as more companies, in particular China-based companies in a variety of industries, accept the Internet as an effective advertising medium. Moreover, we expect that as the e-commerce industry further develops in China, there will be more small- to medium-sized online businesses using our online advertising services to advertise or market their businesses and products. We also believe that the growth rate of mobile Internet advertising in China may increase at a faster rate than that of traditional PC-client advertising. Competition in this area is, and we expect it to remain, intense.

*Innovative Businesses and Others*

We derive our innovative businesses and others revenues primarily from video streaming, music streaming, online payment platform, online education and premium e-mail and other value-added services.

Our video streaming platform CC streams gameplay shows (where viewers watch people compete in online games) and game-related shows, and we generate revenue from the sale of virtual items to viewers which we share with broadcasters who provide commentary for the shows.

## Edgar Filing: NetEase, Inc. - Form 20-F

For our Cloud Music streaming business, users can choose time-based subscriptions to access a range of music content or make item-based purchases of particular music content. We recognize revenue from such subscription fees and item-based purchases.

Our Youdao Education platforms provide their respective users with online courses, reading materials and premium educational solutions, as applicable, in exchange for pre-determined package fees.

Our NetEase Pay online payment platform enables registered users to deposit money in their accounts and use the accounts to pay for game point cards and other fee-based services and products offered by us and third-party vendors. The third-party vendors are charged a service fee when they receive a payment through NetEase Pay at fixed rates based on their service agreements with us. We recognize revenue upon services rendered.

Our other online fee-based premium services, supplied to registered users of the NetEase websites, also include premium e-mail and other value-added services.



Table of Contents

*Seasonality of Revenues*

Historically, revenues from advertising and innovative businesses and other online services have followed the same general seasonal trend throughout each year, with the first quarter of the year being the weakest quarter due to the Chinese New Year holiday and the traditional close of customers' annual budgets, and the fourth quarter as the strongest. Usage of our online games has generally increased around the Chinese holidays, particularly the winter and summer school holidays. Generally, our e-commerce revenues are relatively lower during the public holidays in China, particularly during the Chinese New Year holiday season in the first quarter of each year, while sales in the fourth quarter are higher than each of the preceding three quarters due to a variety of promotional activities conducted by retail and e-commerce businesses in China.

**Cost of Revenues**

*Online Games Services*

Cost of revenues for our online games services consist primarily of staff costs (in particular remuneration to employees who maintain game software and employees known as the Game Masters who are responsible for the daily co-ordination and regulation of the activities inside our games' virtual worlds), service fees paid to Internet data centers, or IDC, for the rental of servers, and printing costs for our prepaid point cards. For our mobile games, cost of revenues also includes fees paid to game developers, distribution channels (app stores) and payment channels.

In addition, cost of revenues for our online games services include that portion of bandwidth and server custody fees (fees paid to telecommunications companies to host and maintain our servers) and depreciation and amortization of computers and software which are attributable to our online games business. Our subsidiaries and VIEs have network servers co-located in facilities owned by China Telecom's and China Unicom's affiliates, for which we pay server custody fees to China Telecom and China Unicom.

The cost of revenues for our licensed games also includes royalties, and in some cases license and consulting fees, paid to the licensors.

*E-commerce*

Cost of revenues related to our e-commerce business consists primarily of costs of merchandise sold, inbound shipping costs and inventory write-downs relating to merchandise sold, service fees related to online payments, the relevant portion of bandwidth and server custody fees and depreciation and amortization of computers and software which are attributable to the provision of e-commerce services.

*Advertising Services*

## Edgar Filing: NetEase, Inc. - Form 20-F

Cost of revenues related to our advertising services consists primarily of staff costs for editors of the various content channels of our Internet media business and content fees paid to such content providers as well as that portion of bandwidth and server custody fees, depreciation and amortization of computers and software which are attributable to the provision of advertising services.

### *Innovative Businesses and Others*

Cost of revenues related to our innovative businesses and others consists primarily of staff costs, service fees related to online payments, as well as that portion of bandwidth and server custody fees, depreciation and amortization of computers and software which are attributable to the provision of the services in this segment. We pay content fees to third-party partners for the right to use proprietary content developed by them, such as copyrights of books and music. We also pay content fees to newspaper and magazine publishers for the right to use their proprietary content, such as headline news and articles.

### **Operating Expenses**

Operating expenses include selling and marketing expenses, general and administrative expenses and research and development expenses.

Table of Contents

*Selling and Marketing Expenses*

Selling and marketing expenses consist primarily of salary and welfare expenses, shipping and handling costs, compensation costs for our sales and marketing staff, and marketing and advertising expenses payable to third-party vendors, Internet companies and agents.

Shipping and handling costs for our e-commerce platforms, which primarily include third-party delivery costs relating to the delivery of products from our distribution centers to customers, fulfillment expenses incurred in our various distribution facilities and packing material expenses, each of which is classified as selling and marketing expenses. The shipping and handling costs, which are included in selling and marketing expenses, were approximately RMB503.0 million, RMB1,182.7 million and RMB1,670.4 million (US\$242.9 million) for the years ended December 31, 2016, 2017 and 2018, respectively.

*General and Administrative Expenses*

General and administrative expenses consist primarily of salary and welfare expenses, compensation costs for our general administrative and management staff, office rental, legal, professional and consultancy fees, bad debt expenses, recruiting expenses, travel expenses and depreciation charges.

*Research and Development Expenses*

Research and development expenses consist principally of salary and welfare expenses and compensation costs for our research and development professionals.

**Share-Based Compensation Cost**

*NetEase 2009 Restricted Share Unit Plan*

In November 2009, we adopted our 2009 Restricted Share Unit Plan, or the RSU Plan, for our employees, directors and consultants. We have reserved 323,694,050 ordinary shares for issuance under this plan. The RSU Plan was adopted by a resolution of the board of directors on November 17, 2009 and became effective for a term of ten years unless sooner terminated.

## Edgar Filing: NetEase, Inc. - Form 20-F

For the years ended December 31, 2016, 2017 and 2018, we recorded share-based compensation cost of approximately RMB990.1 million, RMB1,911.2 million and RMB2,491.0 million (US\$362.3 million), respectively, for awards granted under the RSU Plan. This cost has been allocated to (i) cost of revenues, (ii) selling and marketing expenses, (iii) general and administrative expenses, and (iv) research and development expenses, depending on the responsibilities of the relevant employees.

As of December 31, 2018, total unrecognized compensation cost related to unvested awards granted under the RSU Plan, adjusted for estimated forfeitures, was RMB4,112.5 million (US\$598.1 million), which is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2018, the weighted average remaining vesting period was 2.44 years.

### *Other Share Incentive Plans*

Beginning in 2014, certain of our subsidiaries granted options exercisable for ordinary shares to certain of our employees. The options expire five to seven years from the date of grant and either vest or have a vesting commencement date upon certain conditions being met. The awards can become 100% vested on the vesting commencement date, or vest in two, four or five substantially equal annual installments with the first installment vesting on the vesting commencement date. We adopt the binomial option pricing model to determine the fair value of stock options and accounts for share-based compensation cost using an estimated forfeiture rate. For the years ended December 31, 2017 and 2018, we recorded RMB93.1 million and RMB38.7 million (US\$5.6 million) in compensation expenses for the share options granted under these plans.

While certain share options which have been granted will become vested or would commence vesting upon their applicable vesting commencement date, the occurrence of the applicable vesting conditions is not within our control and is not deemed probable to occur for accounting purposes until the vesting commencement date. For such share options, no compensation expenses were recorded. As of December 31, 2018, there were RMB352.6 million (US\$51.3 million) in unrecognized share based compensation expenses related to such share options which are expected to be recognized when the relevant vesting conditions are met.

Table of Contents

**Income Taxes**

*Cayman Islands*

Under the current laws of the Cayman Islands, we and our intermediate holding companies which are incorporated in the Cayman Islands, are not subject to tax on income or capital gain. Additionally, upon payments of dividends by us to our shareholders or by our intermediate holding companies in the Cayman Islands to us, no Cayman Islands withholding tax will be imposed.

*British Virgin Islands ( BVI )*

Our subsidiaries in the BVI are exempted from income tax on its foreign-derived income in the BVI. There are no withholding taxes in the BVI.

*Hong Kong*

Our subsidiaries in Hong Kong are subject to 16.5% income tax on their taxable income generated from operations in Hong Kong. No significant taxable income was generated by these companies in 2016, 2017 and 2018. The payments of dividends by these companies to us are not subject to any Hong Kong withholding tax.

*China*

The PRC Enterprise Income Tax Law subjects Foreign Invested Enterprises ( FIEs ) and domestic companies to EIT at a uniform rate of 25%, and preferential tax treatments may be granted to FIEs or domestic companies which conduct businesses in certain encouraged sectors and to entities otherwise classified as High and New Technology Enterprises, or HNTEs, Software Enterprises or Key Software Enterprises.

NetEase Beijing, Boguan, NetEase Hangzhou, Media Beijing and Hangzhou Langhe were qualified as HNTEs and enjoyed a preferential tax rate of 15% for 2016, 2017 and 2018. In 2016, 2017 and 2018, Boguan, Netease Hangzhou and Media Beijing were each also qualified as a Key Software Enterprise and enjoyed a further reduced preferential tax rate of 10% for 2015, 2016 and 2017. The related tax benefit was recorded in 2016, 2017 and 2018, respectively.

Lede Technology was recognized as a Software Enterprise in 2014. It was exempt from EIT for 2014 and 2015 and subject to a 50% reduction in its EIT rate from 2016 to 2018.

## Edgar Filing: NetEase, Inc. - Form 20-F

Tianjin Technology was recognized by the tax bureau as a Software Enterprise, and it was exempt from EIT for 2015 and 2016, and subject to a 50% reduction in its EIT rate from 2017 to 2019. The related tax benefit for 2015 was recorded in 2016.

The foregoing preferential income tax rates, however, are subject to periodic review and renewal by PRC authorities.

### **Sales Tax**

Pursuant to the Provisional Regulation of the PRC on Value Added Tax, or VAT, and its implementation rules, or Provisional VAT Regulation, our PRC subsidiaries and VIEs are generally subject to VAT at a rate of 6% for revenues earned from rendering services to our customers in the PRC.

Gross proceeds from sales of general goods in China are generally subject to a VAT of 17%, with certain exceptions pursuant to the Provisional VAT Regulation. Creditable VAT already paid can be deducted from the calculation of such VAT. In accordance with recent reforms which became effective on May 1, 2018 and April 1, 2019, respectively, the 17% rate was adjusted to 13%.

Table of Contents

We are also subject to cultural development fees on the provision of advertising services in China. The applicable tax rate is 3% of our advertising services revenues.

**Uncertain Tax Positions**

In order to assess uncertain tax positions, we apply a more likely than not threshold and a two-step approach for tax position measurement and financial statement recognition. For the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon settlement. We did not have any significant unrecognized uncertain tax positions as of December 31, 2017 and 2018.

**Critical Accounting Policies and Estimates**

The preparation of financial statements often requires the selection of specific accounting methods and policies from several acceptable alternatives. Further, significant estimates and judgments may be required in selecting and applying those methods and policies in the recognition of the assets and liabilities in our consolidated balance sheet, the revenues and expenses in our consolidated statement of operations and the information that is contained in our significant accounting policies and notes to the consolidated financial statements. We make our estimates and judgments on historical experience and various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates and judgments under different assumptions or conditions.

We believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operation. We do not have significant change in accounting estimates during the year.

**Change in Segment Reporting**

Effective in the fourth quarter of 2017, we changed our segment disclosure by reporting the financial results of our e-commerce business separately in light of the significant growth of the revenue contribution from our e-commerce business to our total consolidated net revenues in 2017. This segment primarily reflects the results of our two e-commerce platforms, Kaola and Yanxuan, which were established in January 2015 and April 2016, respectively. On December 31, 2018, we renamed our e-mail and others segment to innovative businesses and others to better articulate the businesses included in this segment; there was no change to the mix of business included in this segment. We now report four reporting segments: (1) online game services, (2) e-commerce, (3) advertising services, and (4) innovative businesses and others. This change in segment reporting aligns with the manner in which our chief operating decision maker, or CODM, currently receives and uses financial information to allocate resources and evaluate the performance of reporting segments. This change in segment presentation does not affect our consolidated balance sheets, consolidated statements of income or consolidated statements of cash flows. We have retrospectively revised segment information from the previous period to conform to the requisite presentation for the current period.

**Critical Accounting Policies and Estimates Regarding Revenue Recognition**

*Revenue Recognition*

On January 1, 2018, we adopted Topic 606 using the modified retrospective method applied to all contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Under Topic 606, revenues from contracts with customers are recognized when control of the promised goods or services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those goods or services, reduced by estimates for return allowances, promotional discounts, rebates and VAT. The recognition of revenues involves certain management judgments, including estimated lives of virtual items purchased by game players, estimated breakage of game points, return allowance for goods sold, the estimation of the fair value of an advertising-for-advertising barter transaction, and the volume of sales rebates. The amount and timing of our revenues can be different if management made different judgments or utilized different estimates.



Table of Contents

Our service sales represent revenues from online game services, advertising services and other innovative businesses. Product sales represent revenue from the sale of products through our e-commerce platforms where we record revenue on a gross basis.

*Online Games Services*

We operate mobile games and PC-client games. We are the principal of all games we operate, including both self-developed games and licensed games. As all these games are hosted on our servers, we have the pricing discretion, and are responsible for the sale and marketing of the games as well as any related customer services. Fees paid to game developers, distribution channels (for example, app stores) and payment channels are recorded as cost of revenues.

*Mobile games*

We generate mobile game revenues from the sale of in-game virtual items, including avatars, skills, privileges or other in-game consumables, features or functionality, within the games. The performance obligation is to provide on-going game services to the game players who have purchased such virtual items and is satisfied over the average playing period of the paying players. Accordingly, we recognize the revenues ratably over the estimated average playing period of these paying players.

We consider the average period that players typically play the games and other game player behavior patterns, as well as various other factors to arrive at the best estimates for the estimated playing period of the paying players for each game. If a new game is launched and only a limited period of paying player data is available, then we consider other qualitative factors, such as the playing patterns for paying users for other games with similar characteristics and playing patterns of paying players, such as targeted players and purchasing frequency. While we believe our estimates to be reasonable based on available game player information, we may revise such estimates based on new information indicating a change in the game player behavior patterns and any adjustments are applied prospectively.

*PC-client games*

We sell prepaid point cards to players of our PC-client games. Players can purchase physical prepaid point cards in different locations in China, including Internet cafés, software stores, convenience stores and bookstores. They can also purchase virtual prepaid points from vendors who register the points in our system and virtual prepaid cards online via debit and credit cards or bank transfers via online payment services platforms, and receive the prepaid point information over the Internet. Our game players can use the points to play our PC-client games, pay for in-game items and use other fee-based services. Proceeds received from the sales of prepaid point cards and online points to players are recorded as deferred revenues.

We earn revenue through providing PC-client game services to players under two types of revenue models: time-based revenue model and item-based revenue model. For PC-client games using the time-based model, players are charged based on the time they spend playing games. Revenues are recognized ratably over the game playing period as the performance obligations are satisfied.

## Edgar Filing: NetEase, Inc. - Form 20-F

Under the item-based model, the basic game play functions are free of charge, and players are charged for purchases of in-game items. In-game items have different life patterns: one-time use, limited life and permanent life. Revenues from the sales of one-time use in-game items are recognized upon consumption. Limited life items are either limited by the number of uses (for example, 10 times) or limited by time (for example, three months). Revenues from the sales of limited life in-game items are recognized ratably based on the extent of time passed or expired or when the items are fully used. Players are allowed to use permanent life in-game items without any use or time limits. Revenues from the sales of permanent life in-game items are recognized ratably over the estimated average playing period of the paying players.

Table of Contents

We consider the average period that players typically play the games and other game player behavior patterns, as well as various other factors, including the acceptance and popularity of expansion packs, promotional events launched and market conditions to arrive at the best estimates of the playing period of paying players for the permanent in-game items of PC-client games. This estimate is re-assessed on a quarterly basis. Adjustments arising from changes in the estimated playing period of paying players are applied prospectively as such changes result from new information indicating a change in the game player behavior patterns.

*Breakage of unused PC-client game points*

We recognize expected breakage associated with our unused online points with expiry dates in a personal game account as revenue, using a game player's historical consumption pattern as reference and subject to certain other variable considerations. For game points that do not expire, we recognize the expected breakage amount as revenue when the likelihood of the player exercising the remaining points becomes remote.

*E-commerce*

We are the principal for our online direct sales because we control the inventory before it is transferred to customers. We also have the primary responsibility for fulfilling the contracts and bearing the inventory risk, and the sole discretion in establishing prices. E-commerce revenues from these online direct sales are recognized when control of the goods is transferred to the customer, which generally occurs upon our delivery to the customer.

For our online marketplace business, third-party sellers offer products to customers through our e-commerce platform and we act as the marketplace service provider. We are not the seller of the third-parties' goods in these transactions and recognize revenue when services are rendered based on a pre-determined service fee rate.

We also provide discount coupons to our customers for use in purchases on our e-commerce platforms, Kaola and Yanxuan, which are treated as a reduction of revenue when the related transaction is recognized.

*Return allowance*

We estimate return allowances, which reduce revenue and cost of sales, using relevant historical data. Liabilities for return allowances and rights to recover products from customers associated with our liabilities are recorded as Accrue liabilities and other payables and Inventories, net, respectively, on our consolidated balance sheets. Neither of such balances were material as of December 31, 2017 and 2018.

*Advertising Services*

We derive advertising fees principally from short-term advertising contracts. Advertising service contracts consist of multiple performance obligations with a typical term of less than three months. Each performance obligation generally represents a different form of advertisement, including but not limited to banners, text-links, videos, logos and rich media. In arrangements where we have multiple performance obligations, the transaction price is allocated to each performance obligation using the relative standalone price for each obligation. We generally determine standalone prices based on the historical prices charged to customers. If the performance obligation has not been sold separately, we estimate the standalone price by taking into consideration the pricing for advertising areas on our platform with similar levels of popularity and advertisements with similar formats and quoted prices from competitors as well as other general market conditions. Consideration allocated to each performance obligation is recognized as revenue over the advertisement display period, which is usually within three months.

We also enter into performance-based advertising arrangements with customers based on cost per thousand impressions, under which we recognize revenues based on the number of times that the advertisement has been displayed. We also enters into cost per action advertising arrangements with customers, under which revenues are recognized based on the number of actions completed resulting from our advertisements, including but not limited to when end-users click on links to our customers products.

Table of Contents

Certain customers may receive volume rebates, which are accounted for as a variable consideration. We estimate annual expected revenue volume with reference to such customers' historical results and reduce the relevant revenues recognized.

*Innovative Businesses and Others*

Revenue from innovative businesses and others is predominantly derived from fee-based premium services, online payment platform services and other online services. Fee-based premium services revenues, mostly operated on either consumption-basis or a monthly subscription basis, are derived principally from providing premium live-streaming services, online music services, online reading, e-mail and other innovative businesses. Prepaid subscription fees collected from customers are deferred and are recognized as revenue on a straight-line basis by us over the subscription period, during which customers can access the premium online services provided by us. Fees collected from customers to purchase online services are recognized as revenue when the related services are rendered.

*Practical Expedients*

We have used the following practical expedients as allowed under ASC 606:

- (i) The effects of a significant financing component are not taken into account for contracts if we expect, at contract inception, that the period between when we transfer a promised good or service to the customer and when the customer pays for that good or service will be one year or less.
  
- (ii) We apply the portfolio approach in determining the commencement date of consumption of permanent virtual items and the estimated average playing period of paying players for our PC-client games and mobile games for the recognition of online game revenue given that the effect of applying a portfolio approach to a group game players' behaviors does not differ materially from considering each one of them individually.
  
- (iii) We elect to expense the costs to obtain a contract as incurred when the expected amortization period is one year or less.

*Contract Balances*

Timing of revenue recognition may differ from the timing of invoicing to customers. Accounts receivables represent amounts invoiced and revenue recognized prior to invoicing, when we have satisfied our performance obligations and have the unconditional right to payment. We closely monitor the collection of our accounts receivables and record a reserve for doubtful accounts against aged accounts and for specifically identified non-recoverable amounts. If the economic situation and the financial condition of the customer deteriorates resulting in an impairment of the customer's ability to make payments, additional allowances might be required. Accounts receivables balances are written off when they are determined to be uncollectible.

**Other Critical Accounting Policies and Estimates**

*Research and Development Costs*

Research and development costs mainly consist of personnel-related expenses and technology service costs incurred for the development of online games prior to the establishment of technological feasibility and costs associated with new product development. We did not capitalize costs incurred for the development of online game products for the years ended December 31, 2016, 2017 and 2018 because the period after the date technical feasibility is reached and the time when the game is marketed have been short historically and the development costs incurred in the period are insignificant.

*Depreciation*

We depreciate our building, computer equipment, software and other assets (other than leasehold improvements) on a straight-line basis over their estimated useful lives, which range from three years to twenty years. We depreciate leasehold improvements, which are included in our operating expenses, on a straight-line basis over the lesser of the relevant lease term or their estimated useful lives.

Table of Contents

Management's judgment is required in the assessment of the useful lives of long-lived assets, and is required in the measurement of impairment. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. The estimation of future cash flows requires significant management judgment based on our historical results and anticipated results and is subject to many factors. Measurement of any impairment loss for long-lived assets is based on the amount by which the carrying value exceeds the fair value of the asset.

*Inventories, net*

Inventories, which mainly represent products for our e-commerce business, are stated at the lower of cost or net realizable value in our consolidated balance sheets. Cost of inventory is determined using the weighted average cost method.

Adjustments are recorded to write down the cost of inventory to the estimated net realizable value due to slow-moving merchandise and damaged goods, which is dependent upon factors such as historical and forecasted consumer demand and promotional environment. We take ownership, risks and rewards of the products purchased. Write downs are recorded in cost of revenues in our consolidated statements of operations and comprehensive income. Certain costs attributable to buying and receiving products, such as purchase freights, are also included in inventories.

*Investments*

*Short-term investments*

Short-term investments include investments in financial instruments with a variable interest rate indexed to performance of underlying assets and investments that we intend, and have the ability, to hold to maturity.

In accordance with ASC 825, for investments in financial instruments with a variable interest rate indexed to performance of underlying assets, we elected the fair value method at the date of initial recognition and carried these investments at fair value. Changes in the fair value are reflected in the consolidated statements of operations and comprehensive income as other income/(expense). Fair value is estimated based on quoted prices of similar products provided by banks at the end of each period. We classify the valuation techniques that use these inputs as Level 2 of fair value measurements.

*Long-term investments*

Long-term investments are comprised of equity investments in publicly traded companies and privately-held companies.

Equity investments in publicly traded companies are reported at fair value. Prior to January 1, 2018, they were classified as available-for-sale equity securities under long-term investments, with unrealized gains or losses, if any, recorded in accumulated other comprehensive income/(loss) in shareholders' equity. The treatment of a decline in the fair value of an individual security is based on whether the decline is other-than-temporary. We assess available-for-sale equity securities for other-than-temporary impairment by considering factors including, but not limited to, our ability and intent to hold the individual security, severity of the impairment, expected duration of the impairment and forecasted recovery of fair value. If we determine a decline in fair value is other-than-temporary, the cost basis of the individual security is then written down to fair value as a new cost basis and the amount of the write-down is accounted for as a realized loss charged to the consolidated statements of comprehensive income. The fair value of the investment would then become the new cost basis of the investment and is not adjusted for subsequent recoveries in fair value. Starting January 1, 2018, upon the adoption of ASU 2016-01, unrealized gains and losses during the year of 2018 are recognized in other income/(expense).

Prior to January 1, 2018, for investments in common stock or in-substance common stocks issued by privately-held companies over which we did not have significant influence, and investments in privately-held companies' equity securities that are not common stock or in-substance common stocks, as these securities do not have readily determinable fair value, we carried such investments at cost and only adjusted for other-than-temporary declines in fair value and distributions of earnings that exceeded our share of earnings since our investment. Starting January 1, 2018, upon the adoption of ASU 2016-01, we have elected to measure these investments in equity securities without readily determinable fair value at cost, less impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the same or a similar investment in the same issuer (referred to as the measurement alternative). All gains and losses on these equity securities, realized and unrealized, are recognized in other income (expense), net.



Table of Contents

Management regularly evaluates the impairment of its investments in privately-held companies based on performance and financial position of the investee as well as other evidence of market value. Such evaluation includes, but is not limited to, reviewing the investee's cash position, recent financing, projected and historical financial performance, cash flow forecasts and financing needs. An impairment loss is recognized in earnings equal to the excess of the investment's cost over its fair value at the balance sheet date of the reporting period for which the assessment is made. The fair value would then become the new cost basis of investment.

*Investments in equity method investees*

Investments in common stock or in-substance common stock of investees and investments in limited partnerships in which we are in a position to exercise significant influence by participating in, but not controlling or jointly controlling, the financial and operating policies are accounted for using the equity method and are reported under long-term investment in the consolidated balance sheets.

*Share-Based Compensation Expense*

Under our RSU Plan, we issue restricted share units, or RSUs, to our employees, directors and consultants with performance conditions and service vesting periods ranging from one year to five years. Some of the RSUs issued are to be settled, at our discretion, in shares or cash upon vesting based on the share price at grant date. At each reporting period, we evaluate the likelihood of performance conditions being met. Share-based compensation costs are then recorded for the number of RSUs expected to vest on a graded-vesting basis, net of estimated forfeitures, over the requisite service period. The compensation cost of the RSUs to be settled in shares only is measured based on the fair value of shares when all conditions to establish the grant date have been met. The compensation cost of RSUs to be settled either in shares or cash at our discretion is remeasured until the date when settlement in shares or cash is determined by us.

We record share-based compensation on our consolidated statements of operations and comprehensive income with the corresponding credit to the additional paid-in-capital for share options and RSUs to the extent that such awards are to be settled only in shares.

Certain of our subsidiaries granted options exercisable for ordinary shares to certain of our employees. The options expire five to seven years from the date of grant and either vest or have a vesting commencement date upon certain conditions being met. We adopt the binomial option pricing model to determine the fair value of stock options and account for share-based compensation cost using an estimated forfeiture rate.

Forfeitures were estimated based on our weighted average historical forfeiture rate of the past five years. Differences between actual and estimated forfeitures are expensed in the period that the differences occur.

Our assumptions are based on our historical experience and expectation of future development. The assumptions used in calculating the fair value of stock options and related share-based compensation expenses represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change or different assumptions are used, particularly with respect to the volatility of our shares, our share-based compensation expense could be materially different for any period.

**Consolidated Results of Operations**

The following table sets forth a summary of our audited consolidated statements of operations for the periods indicated both in Renminbi and as a percentage of total revenues:

Table of Contents

	2016		For the year ended December 31, 2017		2018	
	RMB 000	%	RMB 000	%	RMB 000	%
<b>Statement of Operations and Comprehensive Income Data:</b>						
Net revenues:						
Services	33,748,455	88.4	42,654,982	78.8	48,518,932	72.2
Product	4,430,389	11.6	11,447,037	21.2	18,637,521	27.8
Total net revenues	38,178,844	100.0	54,102,019	100.0	67,156,453	100.0
Cost of revenues:						
Services	(12,602,876)	(33.0)	(17,741,107)	(32.8)	(21,089,648)	(31.4)
Product	(3,912,156)	(10.3)	(10,448,219)	(19.3)	(17,663,309)	(26.3)
Total cost of revenues	(16,515,032)	(43.3)	(28,189,326)	(52.1)	(38,752,957)	(57.7)
Gross profit	21,663,812	56.7	25,912,693	47.9	28,403,496	42.3
Operating expenses:						
Selling and marketing expenses	(4,481,815)	(11.7)	(6,957,596)	(12.9)	(9,526,470)	(14.2)
General and administrative expenses	(1,506,154)	(3.9)	(2,429,858)	(4.5)	(3,191,537)	(4.7)
Research and development expenses	(3,046,979)	(8.0)	(4,371,428)	(8.1)	(7,792,550)	(11.6)
Total operating expenses	(9,034,948)	(23.6)	(13,758,882)	(25.5)	(20,510,557)	(30.5)
Operating profit	12,628,864	33.1	12,153,811	22.4	7,892,939	11.8
Other income (expenses):						
Investment income	200,333	0.5	362,113	0.7	(22,266)	(0.0)
Interest income	541,969	1.4	667,323	1.2	587,518	0.9
Exchange (losses) / gains	146,510	0.4	(448,827)	(0.8)	(113,323)	(0.2)
Other, net	377,685	1.0	277,080	0.5	599,230	0.9
Income before tax	13,895,361	36.4	13,011,500	24.0	8,944,098	13.4
Income tax	(2,102,498)	(5.5)	(2,162,363)	(4.0)	(2,466,681)	(3.7)
Net income	11,792,863	30.9	10,849,137	20.0	6,477,417	9.7
Accretion and deemed dividends in connection with repurchase of redeemable noncontrolling interests						
					(248,098)	(0.4)
Net income attributable to noncontrolling interests and redeemable noncontrolling interests						
	(188,343)	(0.5)	(141,198)	(0.2)	(76,912)	(0.1)
Net income attributable to NetEase, Inc.'s shareholders						
	11,604,520	30.4	10,707,939	19.8	6,152,407	9.2
Net income						
	11,792,863	30.9	10,849,137	20.0	6,477,417	9.7
Other comprehensive income:						
Unrealized gains/(losses) on available-for-sale securities, net of tax						
	(232,633)	(0.6)	(23,321)	(0.0)		
Reclassification adjustment for losses/(gains) on available-for-sale securities recorded in net income, nil of tax						
	266,660	0.7				
Foreign currency translation adjustment						
			(1,573)	(0.0)	18,624	0.0
Total other comprehensive income						
	34,027	0.1	(24,894)	(0.0)	18,624	(0.0)
Total comprehensive income:						
	11,826,890	31.0	10,824,243	20.0	6,496,041	9.7
Add: Comprehensive income attributable to noncontrolling interests and redeemable noncontrolling interests						
	(188,343)	(0.5)	(141,198)	(0.3)	(76,912)	(0.1)
Comprehensive income attributable to NetEase, Inc.'s shareholders						
	11,638,547	30.5	10,683,045	19.7	6,419,129	9.6
Share-based compensation cost included in:						

Edgar Filing: NetEase, Inc. - Form 20-F

Cost of revenues	444,187	1.2	820,281	1.5	764,972	1.1
Selling and marketing expenses	52,689	0.1	95,382	0.2	116,611	0.2
General and administrative expenses	238,750	0.6	581,337	1.1	804,565	1.2
Research and development expenses	254,505	0.7	507,263	0.9	843,502	1.3

**Year Ended December 31, 2018 Compared to Year Ended December 31, 2017**

We generate net revenues from service and product sales. Net service revenues are derived from online games services, e-commerce, advertising services, innovative businesses and other services. Net product revenues represent revenue from the sale of products through our e-commerce platforms where we record revenue on a gross basis. Net revenue from service and product sales represented 72.2% and 27.8% of our total net revenues in 2018, compared with 78.8% and 21.2% in 2017, respectively.

Table of Contents

We have organized our operations into four segments: online games services, e-commerce, advertising services and innovative businesses and other services. These segments reflect the way we evaluate, view and run our business operations. The following table sets forth the net revenues and cost of revenues by segments for the period presented as derived from our audited financial statements. See Item 18 of Part III, Financial Statements Note 24 Segment Information.

	For the year ended December 31,		
	2017 RMB	2018 RMB	2018 US\$
<b>Net revenues:</b>			
Online games services	36,281,642	40,190,057	5,845,402
E-commerce	11,670,416	19,235,476	2,797,684
Advertising services	2,408,823	2,500,833	363,731
Innovative businesses and others	3,741,138	5,230,087	760,684
Total net revenues	54,102,019	67,156,453	9,767,501
<b>Cost of revenues:</b>			
Online games services	(13,473,339)	(14,617,656)	(2,126,050)
E-commerce	(10,464,714)	(17,688,717)	(2,572,717)
Advertising services	(797,892)	(889,677)	(129,398)
Innovative businesses and others	(3,453,381)	(5,556,907)	(808,219)
Total cost of revenues	(28,189,326)	(38,752,957)	(5,636,384)

**Net revenues**

Total net revenues increased by 24.1% to RMB67,156.5 million (US\$9,767.5 million) in 2018 from RMB54,102.0 million in 2017. Net revenues from online games services, e-commerce services, advertising services and innovative businesses and other services constituted 59.9%, 28.6%, 3.7% and 7.8%, respectively, of our total net revenues in 2018, compared with 67.0%, 21.6%, 4.5% and 6.9%, respectively, in 2017. Net revenues generated from licensed games represented 5.7% and 7.2% of our total net revenues in 2018 and 2017, respectively.

*Online Games Services*

Net revenues from online games services increased by 10.8% to RMB40,190.1 million (US\$5,845.4 million) in 2018 from RMB36,281.6 million in 2017. The increase was principally attributable to higher net revenues from our mobile games which totaled RMB28,536.9 million (US\$4,150.5 million) in 2018 compared to RMB25,678.6 million in 2017. The growth in net revenues from mobile games mainly resulted from mobile games such as Knives Out, which gained popularity over the course of 2018 and the newly released game Chu Liu Xiang. Our mobile game portfolio now consists of over 100 diverse games, and we expect to continue introducing new mobile games each year for the foreseeable future, which we believe will contribute to future revenue growth in this segment. Our new PC-client game, Justice, which was released in June 2018, also achieved a high revenue performance in 2018.

## Edgar Filing: NetEase, Inc. - Form 20-F

Net revenues from licensed games decreased slightly by 2.1% to RMB3,826.5 million (US\$556.5 million) in 2018 from RMB3,910.2 million in 2017, which was mainly attributable to the decrease in net revenues from games licensed from Blizzard.

Net revenues from mobile games and PC-client games represented 71.0% and 28.9% of total net revenues from online games services in 2018, respectively, compared to 70.8% and 29.2% in 2017, respectively.

### *E-commerce*

Net revenues from our e-commerce segment increased by 64.8% to RMB19,235.5 million (US\$2,797.7 million) in 2018 from RMB11,670.4 million in 2017. The increase was mainly attributable to growth in the popularity of our e-commerce platforms, Kaola and Yanxuan, among consumers in China, offset in part by increased promotions and sales discounts in 2018 compared to 2017. The aggregate number of active users, meaning users who have registered accounts and have completed at least one purchase in a given period, of Kaola and Yanxuan in the aggregate increased from 23.0 million in 2017 to 41.0 million in 2018, and the number of orders we fulfilled on these two platforms increased from 81.1 million in 2017 to 139.4 million in 2018.

Table of Contents

*Advertising Services*

Net revenues from advertising services increased by 3.8% to RMB2,500.8 million (US\$363.7 million) in 2018 from RMB2,408.8 million in 2017. The top performing advertising revenue contributors in 2018 were automobile, real estate and internet services sectors.

Average net revenues per traditional advertiser (i.e., customers which do not advertise through our search services), which provide the substantial portion of our advertising revenue, were approximately RMB1.5 million (US\$0.2 million) in 2018, which represented a 3.1% decrease as compared with 2017. The number of traditional advertisers using the NetEase websites increased to 1,603 in 2018 from 1,489 in 2017, with revenues from our top ten advertisers comprising 38.9% of our total advertising services revenues in 2018, as compared to 39.6% in 2017.

*Innovative Businesses and Others*

Net revenues from the innovative businesses and others segment increased by 39.8% to RMB5,230.1 million (US\$760.7 million) in 2018 from RMB3,741.1 million in 2017. This increase mainly resulted from increases in revenue contribution by our music streaming, e-reading and online education businesses.

**Cost of Revenues**

Our cost of revenues increased by 37.5% to RMB38,753.0 million (US\$5,636.4 million) in 2018 from RMB28,189.3 million in 2017. The year-over-year increase was mainly due to an increase in the volume of the merchandise sold by our e-commerce platforms as well as an increase in both the cost of revenue sharing with distributors, developers and other third parties and related information costs. In 2018, costs relating to online games services, e-commerce, advertising services and innovative businesses and others represented 37.7%, 45.7%, 2.3% and 14.3% of total cost of revenues, respectively, as compared with 47.8%, 37.1%, 2.8% and 12.3% of the total cost of revenues, respectively, in 2017.

*Online Games Services*

Cost of revenues from our online games services increased by 8.5% to RMB14,617.7 million (US\$2,126.1 million) in 2018 from RMB13,473.3 million in 2017. The increase in cost of revenues in 2018 was primarily due to an increase in revenue sharing costs with distributors, developers and other third parties related to mobile games. The revenue sharing costs increased by RMB981.7 million (US\$142.8 million) to RMB9,027.4 million (US\$1,313.0 million) in 2018 from RMB8,045.7 million in 2017 primarily due to the launch of various self-developed and licensed mobile games in 2018.

*E-commerce*

Cost of revenues from our e-commerce services increased by 69.0% to RMB17,688.7 million (US\$2,572.7 million) in 2018 from RMB10,464.7 million in 2017, which was primarily attributable to an increase in the costs of merchandise sold.

*Advertising Services*

Cost of revenues from our advertising services increased by 11.5% to RMB889.7 million (US\$129.4 million) in 2018 from RMB797.9 million in 2017. The increase in cost of revenues in 2018 was primarily due to an increase in information sourcing costs and higher staff-related costs. The information sourcing costs increased by RMB71.1 million (US\$10.3 million) to RMB210.6 million (US\$30.6 million) in 2018 from RMB139.5 million in 2017, mainly due to increase in content cost incurred in relation to an expansion of our advertising business.



Table of Contents*Innovative Businesses and Others*

Cost of revenues from our innovative businesses and other services increased by 60.9% to RMB5,556.9 million (US\$808.2 million) in 2018 from RMB3,453.4 million in 2017. The increase in cost of revenues in 2018 was primarily due to a combination of the following factors:

- Content cost increased by RMB1,061.1 million (US\$154.3 million) to RMB1,962.0 million (US\$285.4 million) in 2018 from RMB900.9 million in 2017, primarily due to the amortization of license fees related to our music content.
- Revenue sharing-related costs increased by RMB585.5 million (US\$85.2 million) to RMB1,765.9 million (US\$256.8 million) in 2018 from RMB1,180.4 million in 2017, primarily due to increased revenue sharing costs from our online education, e-reading, and live video streaming services.

**Gross Profit**

Our gross profit increased by 9.6% to RMB28,403.5 million (US\$4,131.1 million) in 2018 from RMB25,912.7 million in 2017.

The following table sets forth the consolidated gross profits and gross profit margins of our business activities for the periods indicated as derived from our audited financial statements. The gross profit margins in 2017 and 2018 were calculated by dividing our gross profits over our net revenues for the corresponding type of services.

	For the Year Ended December 31,		
	2017 RMB 000	2018 RMB 000	2018 US\$ 000
<b>Gross profit:</b>			
Online games services	22,808,303	25,572,401	3,719,352
E-commerce	1,205,702	1,546,759	224,967
Advertising services	1,610,931	1,611,156	234,333
Innovative businesses and others	287,757	(326,820)	(47,535)
Total gross profit	25,912,693	28,403,496	4,131,117
<b>Gross profit margin:</b>			
Online games services	62.9%	63.6%	63.6%
E-commerce	10.3%	8.0%	8.0%
Advertising services	66.9%	64.4%	64.4%
Innovative businesses and others	7.7%	(6.2)%	(6.2)%
Total gross profit margin	47.9%	42.3%	42.3%

The increase of gross profit margin for online games services was mainly due to the increased revenues contribution from our self-developed mobile games, which have relatively higher gross profit margin, as a percentage of our total online game revenues. The decrease of gross profit margin for e-commerce services was mainly due to the increased level of promotions and sales discounts offered in 2018 compared to 2017. The decrease in gross profit margin for advertising services was mainly due to an increase in information sourcing costs and higher staff-related costs. The decrease in gross profit margin for innovative businesses and others was mainly due to higher costs related to licensed music content.

### **Operating Expenses**

Total operating expenses increased by 49.1% to RMB20,510.6 million (US\$2,983.1 million) in 2018 from RMB13,758.9 million in 2017 as a result of an increase in selling and marketing expenses, general and administrative expenses and research and development expenses.

Selling and marketing expenses increased by 36.9% to RMB9,526.5 million (US\$1,385.6 million) in 2018 from RMB6,957.6 million in 2017, primarily due to a combination of the following factors:

Table of Contents

- An increase in marketing costs of approximately RMB1,726.3 million (US\$251.1 million) in 2018 resulting from increased marketing spending on our various online games, as well as media and outdoor branding promotion for our e-commerce services, advertising services and innovative businesses and other services.
- An increase in shipping and handling costs of approximately RMB487.7 million (US\$70.9 million) in 2018 resulting from the expansion of our e-commerce business.
- An increase in staff-related costs of our sales team of approximately RMB304.3 million (US\$44.3 million) in 2018, primarily driven by increased headcount and higher compensation levels and performance-related bonus accruals.

General and administrative expenses increased by 31.3% to RMB3,191.5 million (US\$464.2 million) in 2018 from RMB2,429.9 million in 2017, primarily due to an increase in staff-related costs of approximately RMB662.7 million (US\$96.4 million) in 2018 driven by increased headcount and higher compensation levels.

Research and development expenses increased by 78.3% to RMB7,792.6 million (US\$1,133.4 million) in 2018 from RMB4,371.4 million in 2017, primarily due to a combination of the following factors:

- An increase in staff-related costs of approximately RMB2,237.4 million (US\$325.4 million) in 2018, mainly as a result of increased headcount for our online games services, e-commerce services and innovative businesses and other services and higher salaries, bonuses and other benefits paid to our research and development teams during 2018, including share based compensation.
- An increase in technology costs of approximately RMB677.3 million (US\$98.5 million), mainly for game content design.
- An increase in other miscellaneous cost of approximately RMB392.9 million (US\$57.1 million) such as depreciation and amortization costs, rental and utilities expenses.

**Allowances for Doubtful Accounts**

## Edgar Filing: NetEase, Inc. - Form 20-F

As of December 31, 2018, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB4,419.1 million (US\$642.7 million). After providing for doubtful accounts in the amount of RMB130.6 million (US\$19.0 million), the net balance of accounts receivable was RMB4,288.5 million (US\$623.7 million) as of December 31, 2018. The allowances for doubtful accounts represented the provisions of RMB130.6 million (US\$19.0 million) as of December 31, 2018, as compared to the provision of RMB84.9 million as of December 31, 2017.

We periodically review our provisioning policy for doubtful accounts. In assessing the adequacy and reasonableness of the policy, we consider the aging analysis of accounts receivable balances, historical bad debt rates, repayment patterns and credit worthiness of customers and industry trend analysis.

No significant allowance for bad and doubtful accounts was provided in 2018. As of December 31, 2018, we had one distribution channel with a receivable balance exceeding 10% of our total accounts receivable balance.

### **Other Income (Expenses)**

Other income in 2018 mainly consisted of interest income, investment income related to short-term investments, foreign exchange gain and government incentives, offset in part by foreign exchange losses, impairment provisions related to certain equity investments, net investment losses in equity method investees and fair value change related to our equity investments with readily determinable fair value and other financial instruments.

Interest income decreased to RMB587.5 million (US\$85.5 million) in 2018 from RMB667.3 million in 2017, primarily due to a decrease of RMB3.2 billion (US\$468.7 million) in our net cash balance, which includes total cash and cash equivalents, time deposits and restricted cash balance minus short-term loans. We incurred interest expense of RMB318.1 million (US\$46.3 million) in 2018 related to our short-term loans.

Table of Contents

Investment loss was RMB22.3 million (US\$3.2 million) in 2018 compared to investment income of RMB362.1 million in 2017, consisting primarily of (i) investment income related to short-term investments of RMB463.6 million (US\$67.4 million) in 2018, compared to RMB389.5 million in 2017, and (ii) cash dividend of RMB17.1 million (US\$2.5 million) from equity investments in 2018, compared to RMB29.6 million in 2017, which was offset in part by (i) impairment provisions related to certain investments and a net investment loss in equity method investees totalling RMB258.0 million (US\$37.5 million) in 2018, compared to RMB70.7 million in 2017, and (ii) a fair value change of RMB248.2 million (US\$36.1 million) related to the equity investments with readily determinable fair value and other financial instruments in 2018 compared to nil in 2017.

In 2018, we received and recognized unconditional government incentives of approximately RMB329.2 million (US\$47.9 million), compared to RMB252.0 million in 2017.

We also incurred net foreign exchange losses of RMB113.3 million (US\$16.5 million) in 2018, compared to net foreign exchange losses of RMB448.8 million in 2017, both of which are primarily due to the translation gains and losses arising from our U.S. dollar-denominated bank deposit and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over these periods.

#### **Income Tax**

Income tax increased to RMB2,466.7 million (US\$358.8 million) in 2018 from RMB2,162.4 million in 2017. Our effective tax rate in 2018 was 27.6% compared with 16.6% in 2017. The change in the effective tax rate was mainly due to the fact that certain of our subsidiaries experienced higher operating losses in 2018.

#### **Net Income**

As a result of the foregoing, net income attributable to our shareholders decreased by 42.5% to RMB6,152.4 million (US\$894.8 million) in 2018 from RMB10,707.9 million in 2017.

#### **Year Ended December 31, 2017 Compared to Year Ended December 31, 2016**

Net revenue from service and product sales represented 78.8% and 21.2% of our total net revenues in 2017, compared with 88.4% and 11.6% in 2016, respectively. The following table sets forth the net revenues and cost of revenues by segments for the period presented as derived from our audited financial statements.

**For the year ended December 31,**

Edgar Filing: NetEase, Inc. - Form 20-F

	2016 RMB	2017 RMB
<b>Net revenues:</b>		
Online games services	27,980,491	36,281,642
E-commerce	4,541,744	11,670,416
Advertising services	2,152,379	2,408,823
Innovative businesses and others	3,504,230	3,741,138
Total net revenues	38,178,844	54,102,019
<b>Cost of revenues:</b>		
Online games services	(9,974,146)	(13,473,339)
E-commerce	(3,986,871)	(10,464,714)
Advertising services	(749,652)	(797,892)
Innovative businesses and others	(1,804,363)	(3,453,381)
Total cost of revenues	(16,515,032)	(28,189,326)

**Net revenues**

Total net revenues increased by 41.7% to RMB54,102.0 million in 2017 from RMB38,178.8 million in 2016. Net revenues from online games services, e-commerce services, advertising services and innovative businesses and others constituted 67.0%, 21.6%, 4.5% and 6.9%, respectively, of our total net revenues in 2017, compared with 73.3%, 11.9%, 5.6% and 9.2%, respectively, in 2016. Net revenues generated from licensed games represented 7.2% and 12.5% of our total net revenues in 2017 and 2016, respectively.

Table of Contents

*Online Games Services*

Net revenues from online games services increased by 29.7% to RMB36,281.6 million in 2017 from RMB27,980.5 million in 2016. The increase was principally attributable to higher net revenues from our mobile games which totaled RMB25,421.6 million in 2017 compared to RMB16,898.6 million in 2016, excluding mobile games licensed from Blizzard which are discussed below. The growth in net revenues from mobile games mainly resulted from mobile games such as Onmyoji and the mobile version of New Ghost, both of which gained popularity over the course of 2017 as well as revenue contribution from newly released games such as Demon Seals mobile and Land of Glory.

Net revenues from games licensed by Blizzard decreased by 17.4% to RMB3,467.7 million in 2017 from RMB4,196.4 million in 2016, which was mainly attributable a lighter release slate in 2017 and increased competition in the market.

Net revenues from mobile games (excluding the mobile games licensed from Blizzard), self-developed PC-client games and Blizzard licensed games represented 70.1%, 20.3% and 9.6% of total net revenues from online games services in 2017, respectively, compared to 60.4%, 24.6% and 15.0% in 2016, respectively.

*E-commerce*

Net revenues from our e-commerce segment increased by 157.0% to RMB11,670.4 million in 2017 from RMB4,541.7 million in 2016. The increase was mainly attributable to rapid growth in the popularity of our e-commerce platforms, Kaola and Yanxuan, among consumers in China. The aggregate number of active users of Kaola and Yanxuan in the aggregate increased from 6.8 million in 2016 to 23.0 million in 2017, and the number of orders we fulfilled on these two platforms increased from 27.0 million in 2016 to 81.1 million in 2017. Net revenue from e-commerce represented 21.6% of our total net revenues in 2017, compared to 11.9% in 2016.

*Advertising Services*

Net revenues from advertising services increased by 11.9% to RMB2,408.8 million in 2017 from RMB2,152.4 million in 2016. The increase in advertising services revenue in 2017 was driven by increased market demand, mainly as a result of continued efforts to introduce new online content and the increase in our general brand awareness, both of which increased our site traffic and in turn increased the attractiveness of our advertising services.

Average net revenues per traditional advertiser was approximately RMB1.6 million in 2017, which remained stable as compared with 2016. The number of traditional advertisers using the NetEase websites increased to 1,489 in 2017 from 1,335 in 2016, with revenues from our top ten advertisers comprising 39.6% of our total advertising services revenues in 2017 as compared to 29.4% in 2016.

*Innovative Businesses and Others*

Net revenues from the innovative businesses and others segment increased by 6.8% to RMB3,741.1 million in 2017 from RMB3,504.2 million in 2016. This increase mainly resulted from the increase in popularity of our live video streaming platform CC.

**Cost of Revenues**

Our cost of revenues increased by 70.7% to RMB28,189.3 million in 2017 from RMB16,515.0 million in 2016. The year-over-year increase was mainly due to an increase in each of the cost of merchandise sold by our e-commerce platforms, information costs, costs of revenue sharing with distributors, developers and other third parties, staff-related costs and technology costs. In 2017, costs relating to online games services, e-commerce, advertising services and innovative businesses and others represented 47.8%, 37.1%, 2.8% and 12.3% of total cost of revenues, respectively, as compared with 60.4%, 24.2%, 4.5% and 10.9% of the cost of revenues, respectively, in 2016.



Table of Contents

*Online Games Services*

Cost of revenues from our online games services increased by 35.1% to RMB13,473.3 million in 2017 from RMB9,974.1 million in 2016. The increase in cost of revenues in 2017 was primarily due to a combination of the following factors:

- Revenue sharing costs with distributors, developers and other third parties related to mobile games increased by RMB2,877.1 million to RMB8,045.7 million in 2017 from RMB5,168.6 million in 2016 primarily due to the launch of various self-developed and licensed mobile games in 2017.
- Staff-related costs increased by RMB884.1 million to RMB2,825.1 million in 2017 from RMB1,941.0 million in 2016, mainly as a result of an increase in the level of salaries and other compensation and an increase in the number of our employees. The number of full time employees in our online games business increased to 8,193 as of December 31, 2017 from 7,702 as of December 31, 2016.
- The above increase was offset in part by a decrease in technology costs of RMB417.6 million to RMB2,017.7 million in 2017 from RMB2,435.3 million in 2016, mainly due to a decrease in royalty fee payments of RMB569.8 million in line with the decreased revenue contribution from games that we license from Blizzard.

*E-commerce*

Cost of revenues from our e-commerce services increased by 162.5% to RMB10,464.7 million in 2017 from RMB3,986.9 million in 2016, which was primarily attributable to the increase in the costs of merchandise sold.

*Advertising Services*

Cost of revenues from our advertising services increased by 6.4% to RMB797.9 million in 2017 from RMB749.7 million in 2016. The increase in cost of revenues in 2017 was primarily due to a combination of the following factors:

- Information sourcing costs increased by RMB32.9 million to RMB139.5 million in 2017 from RMB106.6 million in 2016, mainly due to the increase in content costs incurred in relation to an expansion of the advertising business.

- Revenue sharing costs related to our performance-based advertising business increased by RMB18.6 million to RMB122.0 million in 2017 from RMB103.4 million in 2016, also primarily due to an expansion of the business.

*Innovative Businesses and Others*

Cost of revenues from our innovative businesses and other services increased by 91.4% to RMB3,453.4 million in 2017 from RMB1,804.4 million in 2016. The increase in cost of revenues in 2017 was primarily due to a combination of the following factors:

- Revenue sharing-related costs increased by RMB1,062.2 million to RMB1,180.4 million in 2017 from RMB118.2 million, primarily due to the increased revenue contribution from our live video streaming services.
- Content cost increased by RMB634.5 million to RMB900.9 million in 2017 from RMB266.4 million in 2016, primarily due to the amortization of license fees related to our music content.
- Technology service cost such as bandwidth and server custody fees increased by RMB212.7 million to RMB415.4 million in 2017 from RMB202.7 million in 2016, mainly as a result of an increase in the bandwidth usage by our innovative businesses and other value added services in 2017.

Table of Contents

- Staff-related cost increased by RMB106.2 million to RMB627.4 million in 2017 from RMB521.2 million in 2016, mainly as a result of an increase in salaries and bonuses paid and an increase in the number of our employees.
- The above increase was offset in part by the decrease in cost of merchandise sold of RMB443.1 million from RMB557.6 million in 2016, which was mainly due to the discontinuation of one of our online service platforms.

**Gross Profit**

Our gross profit increased by 19.6% to RMB25,912.7 million in 2017 from RMB21,663.8 million in 2016.

The following table sets forth the consolidated gross profits and gross profit margins of our business activities for the periods indicated as derived from our audited financial statements. The gross profit margins in 2016 and 2017 were calculated by dividing our gross profits over our net revenues for the corresponding type of services.

	For the Year Ended December 31,	
	2016 RMB 000	2017 RMB 000
<b>Gross profit:</b>		
Online games services	18,006,345	22,808,303
E-commerce	554,873	1,205,702
Advertising services	1,402,727	1,610,931
Innovative businesses and others	1,699,867	287,757
Total gross profit	21,663,812	25,912,693
<b>Gross profit margin:</b>		
Online games services	64.4%	62.9%
E-commerce	12.2%	10.3%
Advertising services	65.2%	66.9%
Innovative businesses and others	48.5%	7.7%
Total gross profit margin	56.7%	47.9%

The decrease of gross profit margin for online games services was mainly due to the increased revenues contribution from mobile games, which have relatively lower gross profit margin, as a percentage of NetEase's total online game revenues. The decrease of gross profit margin for e-commerce services was mainly due to the increased level of promotions and sales discounts offered in 2017. The decrease in gross profit margin for innovative businesses and others business was mainly due to the discontinuation of revenue contribution from one of our online service platforms, which had relatively higher gross profit margins. The increase in gross profit margin for advertising services was mainly due to our enhanced monetization efforts and improved economies of scale.

**Operating Expenses**

## Edgar Filing: NetEase, Inc. - Form 20-F

Total operating expenses increased by 52.3% to RMB13,758.9 million in 2017 from RMB9,034.9 million in 2016 as a result of an increase in selling and marketing expenses, research and development expenses and general and administrative expenses.

Selling and marketing expenses increased by 55.2% to RMB6,957.6 million in 2017 from RMB4,481.8 million in 2016, primarily due to a combination of the following factors:

- An increase in marketing costs of approximately RMB1,439.4 million in 2017 resulting from increased marketing spending on our various online games, including our self-developed mobile games, PC-client games and games licensed from Blizzard, as well as media and outdoor branding promotion for our e-commerce services, advertising services and innovative businesses and other services.

Table of Contents

- An increase in shipping and handling costs of approximately RMB679.7 million in 2017 resulting from the expansion of our e-commerce business.
- An increase in staff-related costs of our sales team of approximately RMB332.4 million in 2017, primarily driven by increased headcount and higher compensation levels and performance-related bonus accruals, particularly for our online game promotion teams.

General and administrative expenses increased by 61.3% to RMB2,429.9 million in 2017 from RMB1,506.2 million in 2016, primarily due to an increase in staff-related costs of approximately RMB798.8 million in 2017 driven by increased headcount, higher compensation levels and an increase in other miscellaneous costs of approximately RMB57.9 million such as facility costs due to increased business expansion.

Research and development expenses increased by 43.5% to RMB4,371.4 million in 2017 from RMB3,047.0 million in 2016, primarily due to a combination of the following factors:

- An increase in staff-related costs of approximately RMB1,067.5 million in 2017, mainly as a result of increased headcount for our online games services, e-commerce services and innovative businesses and other services and higher salaries, bonuses and other benefits paid to our research and development team during 2017, including share based compensation.
- An increase in technology costs of approximately RMB70.1 million, mainly for game content design.
- An increase in other miscellaneous cost of approximately RMB137.1 million such as depreciation and amortization costs, rental and utilities expenses.

**Allowances for Doubtful Accounts**

As of December 31, 2017, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB3,704.6 million. After providing for doubtful accounts in the amount of RMB84.9 million, the net balance of accounts receivable was RMB3,619.7 million as of December 31, 2017. The allowances for doubtful accounts represented the provisions of RMB84.9 million as of December 31, 2017, as compared to the provision of RMB24.1 million as of December 31, 2016.

No significant allowance for bad and doubtful accounts was provided in 2017. As of December 31, 2017, we had one distribution channel with a receivable balance exceeding 10% of our total accounts receivable balance.

**Other Income (Expenses)**

Other income in 2017 mainly consisted of interest income, investment income related to short-term investments, foreign exchange gain and government incentives, offset in part by foreign exchange losses and impairment provisions related to certain equity investments.

Interest income increased to RMB667.3 million in 2017 from RMB542.0 million in 2016, primarily due to an increase in our total cash and cash equivalents and time deposit balance, which increased by 32.0% to RMB33.5 billion as of December 31, 2017 from RMB25.4 billion as of December 31, 2016. We incurred interest expense of RMB92.1 million in 2017 related to our short-term borrowings.

Investment income increased to RMB362.1 million in 2017 from RMB200.3 million in 2016, consisting primarily of (i) investment income related to short-term investments of RMB389.5 million in 2017, compared to RMB303.4 million in 2016, (ii) cash dividend of RMB29.6 million from available-for-sale investments in 2017, compared to RMB21.4 million in 2016, and (iii) net investment income of RMB9.6 million from a partial disposal of an equity investee in 2017, compared to RMB234.1 million in 2016, offset in part by impairment provisions related to certain investments and a net investment loss in associated companies which totaled RMB70.7 million in 2017 compared to RMB364.7 million in 2016.

In 2017, we received and recognized unconditional government incentives of approximately RMB252.0 million, compared to RMB346.4 million in 2016.

Table of Contents

We also reported net foreign exchange losses of RMB448.8 million in 2017, compared to a net foreign exchange gain of RMB146.5 million in 2016, both of which are primarily due to the translation gains and losses arising from our U.S. dollar-denominated bank deposit and short-term loan balances as the exchange rate of the U.S. dollar against the RMB fluctuated over these periods.

**Income Tax**

Income tax increased to RMB2,162.4 million in 2017 from RMB2,102.5 million in 2016. Our effective tax rate in 2017 was 16.6% compared with 15.1% in 2016. The change in the effective tax rate was mainly due to the higher withholding tax recorded in 2017.

**Net Income**

As a result of the foregoing, net income attributable to our shareholders decreased by 7.7% to RMB10,707.9 million in 2017 from RMB11,604.5 million in 2016.

**B. LIQUIDITY AND CAPITAL RESOURCES**

To date, we have financed our operations primarily through operating cash flows and existing capital resources. As of December 31, 2018, we had RMB5,389.2 million (US\$783.8 million) in cash and cash equivalents, RMB33,000.3 million (US\$4,799.7 million) in time deposits and RMB11,674.8 million (US\$ 1,698.0 million) in short-term investments. We had short-term borrowings of RMB13,658.6 million (US\$1,986.6 million) as of December 31, 2018. On August 9, 2018, we entered into a three year US\$500.0 million revolving loan facility agreement with a group of four arrangers. The facility was priced at 95 basis points over LIBOR and has a commitment fee of 0.20% on the undrawn portion. As of December 31, 2018, we had an undrawn balance of US\$100.0 million under this credit facility.

We believe that our current levels of cash and cash equivalents, cash flows from operations and short-term investments will be sufficient to meet our anticipated cash needs for at least the next 12 months. However, we may need additional cash resources if we experience changed business conditions or other developments. We may also need additional cash resources if we find and wish to pursue opportunities for investment, acquisition, strategic cooperation or other similar action. If we determine that our cash requirements exceed our amounts of cash and cash equivalents on hand, we may seek to issue debt or equity securities or obtain a credit facility. Any issuance of equity securities could cause dilution for our shareholders. Any incurrence of indebtedness could increase our debt service obligations and cause us to be subject to restrictive operating and finance covenants. It is possible that, when we need additional cash resources, financing will only be available to us in amounts or on terms that would not be acceptable to us or financing will not be available at all.

**Cash Flows**

*Operating Activities*

Cash provided by operating activities was RMB13,415.9 million (US\$1,951.3 million), RMB11,889.2 million and RMB15,488.3 million for the years ended December 31, 2018, 2017 and 2016, respectively.

For the year ended December 31, 2018, cash provided by operating activities consisted primarily of (i) our net income of RMB6,477.4 million (US\$942.1 million), (ii) share-based compensation cost of RMB2,529.7 million (US\$367.9 million), (iii) depreciation and amortization charges of RMB2,083.5 million (US\$303.0 million), (iv) an increase in deferred revenue of RMB1,804.6 million (US\$262.5 million), (v) an increase in accounts payable and other liabilities of RMB955.4 million (US\$139.0 million), including content fees, bandwidth cost, bonuses, marketing expenses and sales of game cards, (vi) an increase in taxes payable of RMB693.6 million (US\$100.9 million), (vii) a decrease in inventories of RMB457.1 million (US\$66.5 million), (viii) impairment loss for investment of RMB159.7 million (US\$23.2 million), and (ix) fair value change of equity security investments and other financial instruments of RMB248.2 million (US\$36.1 million), partially offset by (A) an increase in accounts receivable, prepayments and other current assets of RMB1,433.6 million (US\$208.5 million), and (B) fair value changes of short-term investments of RMB463.6 million (US\$67.4 million).



Table of Contents

For the year ended December 31, 2017, cash provided by operating activities consisted primarily of (i) our net income of RMB10,849.1 million, (ii) an increase in accounts payable and other liabilities of RMB3,392.5 million, including content fees, bandwidth cost, bonuses, marketing expenses and sales of game cards, (iii) share-based compensation cost of RMB2,004.3 million, (iv) depreciation and amortization charges of RMB801.8 million, (v) a decrease in accounts receivable, prepayments and other current assets of RMB449.0 million, (vi) unrealized exchange losses of RMB437.9 million, and (vii) allowance for provision for doubtful debts of RMB60.8 million, partially offset by (A) an increase in inventories of RMB3,896.8 million, (B) a decrease in deferred revenue of RMB1,291.9 million, (C) deferred income taxes of RMB438.0 million, (D) fair value changes of short-term investments of RMB389.8 million, and (E) a decrease in taxes payable of RMB155.9 million.

For the year ended December 31, 2016, cash provided by operating activities consisted primarily of (i) our net income of RMB11,792.9 million, (ii) an increase in deferred revenue of RMB2,879.5 million, (iii) an increase in accounts payable and other liabilities of RMB2,245.8 million, such as content fees, bandwidth cost, bonuses, marketing expenses and sales of game cards, (iv) share-based compensation cost of RMB990.1 million, (v) an increase in tax payable of RMB986.4 million, (vi) depreciation and amortization charges of RMB327.5 million, and (vii) impairment loss for investment of RMB278.9 million, partially offset by (A) an increase in accounts receivable, prepayments and other current assets of RMB2,710.9 million, (B) an increase in inventories of RMB760.4 million, (C) fair value changes in short-term investments of RMB304.6 million, (D) gain on disposal of long-term investment of RMB234.1 million and (E) unrealized exchange gains of RMB166.6 million.

*Investing Activities*

Cash used in investing activities was RMB13,569.5 million (US\$1,973.6 million), RMB12,855.3 million and RMB11,861.4 million for the years ended December 31, 2018, 2017 and 2016, respectively.

For the year ended December 31, 2018, cash used in investing activities mainly consisted of (i) placement/rollover of matured time deposits of RMB41,553.4 million (US\$6,043.7 million), (ii) purchase of short-term investments of RMB13,423.0 million (US\$1,952.3 million), (iii) purchase of property, equipment, software and land use rights of RMB5,536.1 million (US\$805.2 million), (iv) acquisitions of other long-term investments of RMB2,751.0 million (US\$400.1 million), (v) purchase of intangible assets and licensed copyrights of video content of RMB1,349.9 million (US\$196.3 million), (vi) net change in short-term investments with terms of three months or less of RMB1,172.3 million (US\$170.5 million), (vii) change in other assets of RMB543.9 million (US\$79.1 million), and (viii) investment in equity investees of RMB272.5 million (US\$39.6 million), partially offset by (A) proceeds from maturity of time deposits of RMB39,924.5 million (US\$5,806.8 million), and (B) proceeds from maturity of short-term investments of RMB13,101.5 million (US\$1,905.5 million).

For the year ended December 31, 2017, cash used in investing activities mainly consisted of (i) placement/rollover of matured time deposits of RMB33,984.1 million, (ii) purchase of short-term investments of RMB12,491.0 million, (iii) purchase of property, equipment, software and land use rights of RMB1,849.4 million, (iv) acquisitions of other long-term investments of RMB900.7 million, (v) net change in short-term investments with terms of three months or less of RMB895.3 million, (vi) purchase of intangible assets and licensed copyrights of video content of RMB674.8 million, (vii) investment in associated companies of RMB235.8 million, and (viii) change in other assets of RMB224.1 million, partially offset by (A) proceeds from maturity of time deposits of RMB22,429.6 million, (B) proceeds from maturity of short-term investments of RMB15,615.5 million, and (C) proceeds from disposal of equity investment of RMB350.4 million.

For the year ended December 31, 2016, cash used in investing activities mainly consisted of (i) placement/rollover of matured time deposits of RMB20,367.4 million, (ii) purchase of short-term investments of RMB12,439.0 million, (iii) net change in short-term investments with terms of three months or less of RMB3,704.3 million, (iv) purchase of property, equipment, software and land use rights of RMB1,140.0 million, (v) investment in associated companies of RMB364.5 million, (vi) acquisitions of other long-term investments of RMB181.1 million, and

(vii) change in other assets of RMB173.4 million, partially offset by (A) proceeds from maturity of time deposits of RMB16,377.4 million, (B) proceeds from maturity of short-term investments of RMB9,879.3 million, and (C) proceeds from disposal of long-term investments of RMB249.6 million.

Table of Contents

*Financing Activities*

Cash provided by financing activities was RMB1,587.4 million (US\$230.9 million) for the year ended December 31, 2018, and cash used in financing activities was RMB1,302.7 and RMB2,250.5 million for the years ended December 31, 2018, 2017 and 2016, respectively.

For the year ended December 31, 2018, cash provided by financing activities resulted from (i) net proceeds in short-term loan of RMB6,209.6 million (US\$903.2 million) and (ii) proceeds from issuance of redeemable noncontrolling shareholder interests, net of issuance cost of RMB5,294.2 million (US\$770.0 million), partially offset by repurchase of shares of RMB7,516.7 million (US\$1,093.3 million), dividends paid in the amount of RMB1,440.2 million (US\$209.5 million), and repurchase of noncontrolling interest and redeemable noncontrolling interests of RMB975.0 million (US\$141.8 million).

For the year ended December 31, 2017, cash used in financing activities resulted from dividends paid in the amount of RMB3,257.6 million and repurchase of shares of RMB2,061.6 million, partially offset by net proceeds of short-term bank loan of RMB3,105.0 million.

For the year ended December 31, 2016, cash used in financing activities resulted from dividends paid in the amount of RMB2,546.2 million and repurchase of shares of RMB1,199.1 million, partially offset by proceeds from net proceeds from short-term bank loan of RMB1,494.8 million.

**Management of Capital Resources**

In managing our capital, we seek to maintain a reasonable amount of liquidity to support new business growth and maximize returns on our capital resources, while at the same time focusing on the preservation of capital and complying with applicable legal requirements. Our capital resources include primarily cash on hand, demand deposits and time deposits mainly placed with banks in Hong Kong and China and short-term investments. Although we consolidate the results of our subsidiaries and VIEs in our consolidated financial statements, we do not have direct access to the cash and cash equivalents or future earnings of our subsidiaries and VIEs. As of December 31, 2018, these subsidiaries and VIEs had RMB38.4 billion (US\$5.6 billion) in cash and cash equivalents, demand deposits and short-term and long-term time deposits. Our cash and cash equivalents, demand deposits, time deposits and short-term investments held outside of China are mainly denominated in U.S. dollars, Renminbi and Euro.

To fund any cash requirements we may have, we may need to rely on dividends and other distributions on equity paid by our subsidiaries. Since substantially all of our operations are conducted through our PRC subsidiaries and VIEs, our subsidiaries may need to rely on dividends, loans or advances made by another PRC subsidiary or VIE. Certain of these payments are subject to PRC taxes, including sales taxes, which effectively reduce the received amount. In addition, the PRC government could impose restrictions on such payments or change the tax rates applicable to such payments. In 2016 and 2017, we accrued RMB404.8 million and RMB707.1 million withholding tax liabilities, respectively, associated with our quarterly dividends and cash expected to be distributed from our PRC subsidiaries to companies in our corporate group outside of China for general corporate purposes. In 2018, we accrued RMB679.4 million (US\$98.8 million) for withholding tax liabilities. We repatriated a portion of these earnings and paid related withholding income tax in 2018. For the foreseeable future, we intend to reinvest all remaining undistributed earnings as at December 31, 2018 in our PRC subsidiaries, and accordingly no other withholding tax is expected to be incurred.

In addition, the payment of dividends by entities established in the PRC is subject to limitations. Regulations in the PRC currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in the PRC. Each of our PRC subsidiaries that is a domestic company is also required to set aside at least 10.0% of its after-tax profit based on PRC accounting standards each year to its general reserves or statutory capital reserve fund until the accumulative amount of such reserves reach 50.0% of its respective registered capital. These restricted reserves are not distributable as cash dividends. As a result of these and other restrictions under PRC laws and regulations, our PRC subsidiaries and VIEs are restricted in their ability to transfer a portion of their net assets to us either in the form of dividends, loans or advances, which restricted portion amounted to approximately RMB6.7 billion, or 15% of our total consolidated net assets, as of December 31, 2018. In addition, if any of our PRC subsidiaries incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us.

Table of Contents

Furthermore, any transfer of funds from us to any of our PRC subsidiaries or VIEs, either as a shareholder loan or as an increase in registered capital, is subject to certain statutory limit requirements and registration or approval of the relevant PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Our PRC subsidiaries and VIEs are not permitted under PRC law to directly lend money to one another. Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our PRC subsidiaries or VIEs. These limitations on the free flow of funds between us and our PRC subsidiaries and VIEs could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.

For additional information, see Item 3.D. Risk Factors Risks Related to Our Company Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and VIEs, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner. and Risk Factors Risks Related to Doing Business in China Restrictions on currency exchange may limit our ability to utilize our revenues effectively. and Item 10D. Exchange Controls.

**Capital Expenditures**

Our capital requirements relate primarily to financing:

- our working capital requirements, such as bandwidth and server custody fees, inventory purchase costs, staff costs, sales and marketing expenses and research and development costs; and
- costs incurred for the construction of our new office buildings and warehouses in Zhoushan, Guangzhou, Hangzhou and Ningbo in China, acquisition of new servers in connection with the operation of our self-developed and licensed games, investment in the expansion packages of the aforementioned games, and upgrades of our online service infrastructure.

**C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES, ETC.**

We believe that an integral part of our future success will depend on our ability to develop and enhance our services. Our product development efforts and strategies consist of incorporating new technologies from third parties as well as continuing to develop our own proprietary technology.

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet and e-commerce services to our users. In addition, we plan to continue to expand our technologies, products and services and registered user base through diverse online community products and services developed internally, particularly with respect to our online games services. We will seek to continually improve and enhance our existing services to respond to rapidly evolving competitive and technological conditions. For the years 2018, 2017 and 2016, we spent RMB7,792.6 million (US\$1,133.4 million), RMB4,371.4 million and RMB3,047.0 million, respectively, on research and development activities.

**D. TREND INFORMATION**

Other than as described elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events that are reasonably likely to have a material adverse effect on our revenue, income from continuing operations, profitability, liquidity or capital resources, or that would cause our reported financial information not necessarily to be indicative of future operation results or financial condition.

**E. OFF-BALANCE SHEET ARRANGEMENTS**

We do not have any outstanding derivative financial instruments, off-balance sheet guarantees, interest rate swap transactions or foreign currency forward contracts. We do not engage in trading activities involving non-exchange traded contracts.

Table of Contents**F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS**

We have entered into leasing arrangements relating to our office premises. We also have contractual obligations in respect of the construction of new office buildings and warehouse facilities in Beijing, Hangzhou, Guangzhou, Zhoushan and Ningbo, office rental and capital expenditures related to computer equipment and server custody fees. In addition, we have contractual obligations in connection with the licensing of World of Warcraft, StarCraft II series, Heroes of the Storm, Hearthstone, Diablo III and Overwatch from Blizzard. The following sets forth our contractual obligations for operating leases, server custody fees, long-term payables, capital expenditures and office machine and other obligations related to content and services purchases, including the royalties and minimum marketing expenditure commitment for the games licensed to us by Blizzard, as of December 31, 2018:

	<b>Rental Commitments RMB</b>	<b>Server Custody Fee Commitments RMB</b>	<b>Capital Commitments RMB</b>	<b>Royalties and Expenditure for Licensed Content Commitments RMB</b>	<b>Office Machines and Other Commitments RMB</b>	<b>Total RMB</b>
2019	384,395	134,683	788,755	2,747,243	79,164	4,134,240
2020	270,552	43,290	719,101	1,545,167	60,838	2,638,948
2021	204,218	39,168	392,574	2,128,540	20,858	2,785,358
2022	89,263	11,592		1,566,765	17,529	1,685,149
Beyond 2022	64,981			2,277,465	113	2,342,559
	1,013,409	228,733	1,900,430	10,265,180	178,502	13,586,254

Other than the obligations set forth above, we do not have any long-term commitments.

**Quantitative and Qualitative Disclosures About Market Risk***Interest Rate Risk*

Our exposure to market rate risk for changes in interest rates relates primarily to the interest income generated by excess cash invested in fixed-rate corporate bonds of well-known Chinese companies and financial products issued by commercial banks in China, as well as interest expenses payable on our short-term bank borrowings. All of our short-term bank borrowings as of December 31, 2018 were at fixed rates. From time to time, we use derivatives, such as interest rate swaps, to manage our interest rate exposure. Interest instruments carry a degree of interest rate risk. We have not been exposed nor do we anticipate being exposed to material risks due to changes in interest rates. However, our future net interest income may fall short of expectations due to changes in interest rates. Based on our interest instruments as of December 31, 2018, a 10% change in the interest rate would result in an increase or decrease of RMB58.8 million (US\$8.5 million) of our total amount of net interest income or of RMB46.4 million (US\$6.7 million) of our total amount of investment income from short-term investments in 2018.

*Foreign Currency Risk*

## Edgar Filing: NetEase, Inc. - Form 20-F

A significant majority of our revenues and expenses are denominated in Renminbi, but as noted above, a certain portion of our cash is kept in U.S. dollars and Euro. Although we believe that, in general, our exposure to foreign exchange risks should be limited, the value of our ADSs will be affected by the foreign exchange rate between U.S. dollars, Euro and Renminbi. For example, to the extent that we need to convert U.S. dollars or Euro into Renminbi for our operational needs and the Renminbi appreciates against the U.S. dollars or Euro at that time, our financial position and the price of our ADSs may be adversely affected. Conversely, if we decide to convert our Renminbi into U.S. dollars for the purpose of declaring dividends on our ADSs or otherwise and the U.S. dollar or Euro appreciates against the Renminbi, the U.S. dollar equivalent of our earnings from our subsidiaries and controlled entities in China would be reduced.

In July 2005, the Chinese government announced that it is pegging the exchange rate of the Chinese Renminbi against a number of currencies, rather than just the US dollar. This change in policy resulted in an overall appreciation in the value of the Renminbi against the US dollar, although more recently the Renminbi has depreciated against the US dollar. We translate our monetary assets and liabilities which are denominated in currencies other than Renminbi into Renminbi as of each accounting period end, in accordance with applicable accounting standards. As a result of this foreign currency translation, we reported net foreign exchange losses of RMB113.3 million (US\$16.5 million) in 2018, compared to net foreign exchange losses of RMB448.8 million in 2017. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure. Accordingly, we may incur economic losses in the future due to foreign exchange rate fluctuations, which could have a negative impact on our financial condition and results of operations.



Table of Contents

As of December 31, 2018, we had U.S. dollar-denominated debt outstanding of US\$1,871.0 million. If the U.S. dollar had appreciated/depreciated by 10% against the Renminbi, our interest payments on this debt in Renminbi terms would have increased/decreased by RMB40.8 million (US\$5.9 million).

As of December 31, 2018, we had U.S. dollar-denominated cash and cash equivalents and time deposits of US\$2,726.2 million. If the U.S. dollar had appreciated/depreciated by 10% against the Renminbi, our U.S. dollar-denominated cash and cash equivalents and time deposits as of December 31, 2018 would have increased/decreased by RMB1,874.4 million in Renminbi terms.

**Recently Adopted Accounting Pronouncements**

*Revenue from Contracts with Customers*

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 (Topic 606) Revenue from Contracts with Customers. Topic 606 supersedes the revenue recognition requirements in Topic 605 Revenue Recognition, and requires entities to recognize revenue when control of the promised goods or services is transferred to customers at an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. We adopted Topic 606 on January 1, 2018 using the modified retrospective method and elected to apply this new revenue accounting standard only to contracts not completed as of the adoption date. We recognized the cumulative effect of initially applying the new revenue accounting standard as an adjustment to the opening balance of retained earnings for the year ended December 31, 2018. The comparative financial statements have not been restated and continue to be reported under the accounting standards in effect for those periods.

The adoption of Topic 606 primarily impacts the accounting of the recognition of breakage associated with our unused online game points in a personal game account as a result of recording revenue based upon estimates of breakage under the new revenue standard. Under Topic 605, revenue for unused points was not recorded until the points expired. Thus, for unused points, revenue is recorded earlier under the new standard. The cumulative effect adjustment upon adoption includes a reduction of our deferred revenue of approximately RMB81.7 million and a net increase to our retained earnings of approximately RMB27.4 million (net of tax). Revenues of related game points would have been recorded in the consolidated statement of operations and comprehensive income for the year ended December 31, 2018 under Topic 605 based on their actual expiry date. Therefore, the adoption of Topic 606 impacted our consolidated statement of operations and comprehensive income for the year ended December 31, 2018 by reducing revenues by RMB81.7 million (US\$11.9 million). The adoption of Topic 606 does not have significant impact on used game points as of December 31, 2018.

*Financial Instruments - Recognition and Measurement*

In January 2016, the FASB issued Accounting Standards Update No. 2016-01 (ASU No. 2016-01) Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. We adopted this guidance on January 1, 2018 and RMB38.2 million of accumulated other comprehensive income for our available-for-sale equity securities that existed as of December 31, 2017 was reclassified into retained earnings upon the adoption thereof. For equity investments without readily determinable fair value, we elected to measure them at their costs minus impairment (if any), plus or minus changes resulting from observable price changes as evidenced by the same or similar investments in the same issuer. We did not record any changes to the carrying value of equity investments without readily determinable fair value for the year ended December 31, 2018.

*Statement of Cash Flows*

In November 2016, the FASB issued ASU 2016-18 Statement of Cash Flows (Topic 230): Restricted Cash. The guidance requires that a statement of cash flows explain the change during a period in the aggregate amount of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents are to be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period aggregate amounts shown in the statement of cash flows. The standard should be applied using a retrospective transition method to each period presented. We adopted this guidance on January 1, 2018 with a retrospective transition method. Pursuant to this new guidance, the net change of cash, cash equivalents and restricted cash increased by RMB2,140.6 million and decreased by RMB393.8 million for the years ended December 31, 2016 and 2017, respectively, compared to the amounts presented under previous guidance.

Table of Contents**Recent Accounting Pronouncements**

In February 2016, the FASB issued ASU 2016-02 *Leases* as amended, which generally requires lessees to recognize operating and financing lease liabilities and the corresponding right-of-use assets on the balance sheet and to provide enhanced disclosures surrounding the amount, timing and uncertainty of cash flows arising from leasing arrangements. We will adopt the new standard effective January 1, 2019 on a modified retrospective basis and will not restate comparative periods. We estimate approximately RMB861.5 million may be recognized as total right-of-use assets and total lease liabilities on our consolidated balance sheet as of January 1, 2019. Other than this, we do not expect the new standard to have a material impact on our consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13 *Financial Instruments-Credit Losses (Topic 326)*, which requires entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the impact this standard will have on our consolidated financial statements and related disclosures.

In June 2018, the FASB issued ASU No. 2018-07, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The guidance simplifies the accounting for share-based payments made to non-employees so the accounting for such payments is substantially the same as those made to employees. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We do not expect the adoption of this guidance to have a material impact on our consolidated financial statements.

**Item 6. Directors, Senior Management and Employees****A. Directors and Senior Management**

The names of our directors and executive officers, their ages as of April 1, 2019 and the principal positions with NetEase held by them are as follows:

<b>Name</b>	<b>Age</b>	<b>Position</b>
William Lei Ding	47	Director and Chief Executive Officer
Charles Zhaoxuan Yang	36	Chief Financial Officer
Alice Cheng (1)	57	Director
Denny Lee	51	Director
Joseph Tong (1)	56	Director
Lun Feng	59	Director
Michael Leung (1)	65	Director
Michael Tong	47	Director

---

(1) Member of the audit, compensation and nominating committees.

Table of Contents

**Biographical Information**

*William Lei Ding*, our founder, has served as a director since July 1999 and as our Chief Executive Officer since November 2005. From March 2001 until November 2005, Mr. Ding served as our Chief Architect, and, from June 2001 until September 2001, he served as our Acting Chief Executive Officer and Acting Chief Operating Officer. From July 1999 until March 2001, Mr. Ding served as Co-Chief Technology Officer, and from July 1999 until April 2000, he also served as our interim Chief Executive Officer. Mr. Ding established Guangzhou NetEase and Shanghai EaseNet, our affiliates, in May 1997 and January 2008. Mr. Ding holds a Bachelor of Science degree in Communication Technology from the University of Electronic Science and Technology of China.

*Charles Zhaoxuan Yang* has served as our Chief Financial Officer since June 30, 2017. Prior to joining us, Mr. Yang was an executive director of the China technology, media and telecommunications, and corporate finance team at J.P. Morgan Securities (Asia Pacific) Limited based in Hong Kong for almost a decade. Mr. Yang holds a master's degree in Business Administration from the University of Hong Kong and a bachelor's degree from Wesleyan University with majors in Economics and Mathematics. Mr. Yang is a Certified Public Accountant licensed in the State of Michigan.

*Alice Cheng* has served as a director since June 2007. Ms. Cheng has been the Chief Financial Officer of BBK Electronics Corp., Ltd., a PRC-based manufacturer of audio/visual equipment, since May 2005. From October 2010 to April 2013, she served as a supervisor of Wistron Information Technology Corporation in Taiwan, an information technology company with operations in Taiwan, China and Japan. From January 2002 to April 2005, she served as Financial Controller of Wistron Corporation, a Taiwanese original design manufacturer of notebook computers and other electronics. Prior to that, she held various positions with Acer Inc., a Taiwanese computer manufacturer, culminating in the position of Financial Controller. Ms. Cheng received a Bachelor of Accounting from the Chinese Culture University in Taiwan in 1983 and a Masters of Business Administration from the Thunderbird School of Global Management in Arizona in 2003. She is licensed as a certified public accountant in Taiwan and the PRC.

*Denny Lee* has served as a director since April 2002. Mr. Lee previously served as our Chief Financial Officer from April 2002 until June 2007 and as our Financial Controller from November 2001 until April 2002. Prior to joining our company, Mr. Lee worked in the Hong Kong office of KPMG for more than ten years. Mr. Lee graduated from the Hong Kong Polytechnic University and is a member of the Hong Kong Institute of Certified Public Accountants and the Association of Chartered Certified Accountants. Mr. Lee currently serves as the chairman of the audit committees and an independent non-executive director on the boards of New Oriental Education & Technology Group Inc., Concord Medical Services Holdings Limited, NIO Inc. and Jianpu Technology Inc., which are listed on the New York Stock Exchange, as well as China Metal Resources Utilization Ltd., which is listed on The Stock Exchange of Hong Kong Limited.

*Joseph Tong* has been a director of Parworld Investment Management Limited, which provides financial and investment advisory services, since April 2004. From December 2002 until April 2004, Mr. Tong was engaged in establishing

offices and operations in Hong Kong and China, setting up accounting and internal control policies and overseeing the overall operations for TLM Apparel Co., Ltd., a garment trading company operating in Hong Kong and China which he co-founded. Prior to that, from September 2000 to September 2002, he was the e-Commerce Director of the Asia Region for Universal Music Limited where he was responsible for forming e-business development strategies and overseeing new promotional opportunities. Mr. Tong currently serves as the chairman of the audit committee and an independent director on the board of Crosby Capital Limited, which is listed on The Stock Exchange of Hong Kong Limited. Mr. Tong received a Bachelor of Social Science degree with honors in Accounting and Statistics from the University of Southampton, England. He is a member of the American Institute of Certified Public Accountants, an associate member of the Hong Kong Institute of Certified Public Accountants, and has served as a director since March 2003.

*Lun Feng* has served as a director since July 2005. He has been the Chairman of Vantone Holdings Co., Ltd., a private real estate investment company in China, since 1993. Mr. Feng has a Juris Doctor from the Chinese Academy of Social Sciences, a Masters of Law degree from the Party School of the Chinese Communist Party and a Bachelor of Arts in Economics from Northwest University.

Table of Contents

*Michael Leung* has served as a director since July 2002. Mr. Leung held senior positions with Peregrine Capital (China) Limited, SG Securities (HK) Limited (previously known as Crosby Securities (Hong Kong) Limited), Swiss Bank Corporation, Hong Kong Branch, and Optima Capital Limited (previously known as Ke Capital (Hong Kong) Limited) where he provided financial advisory services. Mr. Leung was also a director at Emerging Markets Partnership (Hong Kong) Limited, which was the principal advisor to the AIG Asian Infrastructure Fund L.P, and an independent non-executive director of Anhui Expressway Company Limited, Junefield Department Store Group Limited and China Huiyuan Juice Group Limited, all of which are companies listed on The Stock Exchange of Hong Kong Limited. Mr. Leung currently serves as an independent non-executive director for China Ting Group Holdings Limited, Orange Sky Golden Harvest Entertainment (Holdings) Limited, Optics Valley Union Holding Company Limited and Luye Pharma Group Ltd., all of which are companies listed on The Stock Exchange of Hong Kong Limited. Mr. Leung received a Bachelor's Degree in Social Sciences from the University of Hong Kong with a major in Accounting, Management and Statistics.

*Michael Tong* has served as a director of our company since December 1999. He joined our company as an executive in May 2003 and later served as our Co-Chief Operating Officer from July 2004 to March 2009. Before joining our company as an executive, Mr. Tong had approximately seven years of experience in the investment industry working in several venture capital and private equity firms, including Techpacific Venture Capital Limited, Softbank China Venture Investments Limited and Nomura China Venture Investment Limited. Mr. Tong is an independent non-executive director on the board of Beijing New Oriental Online Technology Co., Ltd. Mr. Tong graduated with a Bachelor of Business Administration from the University of Wisconsin, Madison with a major in Accounting and an extra concentration in Computer Science in 1993.

**Relationships Among Directors or Executive Officers; Right to Nominate Directors**

There are no family relationships among any of the directors or executive officers of our company. None of our directors were nominated pursuant to a contractual or other right.

**B. Compensation**

**Director Compensation**

In 2018, we paid an aggregate amount of RMB1.7 million (US\$244,410) in compensation for the services of our independent non-executive directors. On February 13, 2018, we also granted restricted share unit awards under our RSU Plan (described below) to each of our independent non-executive directors which vested on March 1, 2019. ADRs, representing less than 1% of our total outstanding ordinary shares, were given to the directors in settlement of such awards upon vesting.

## Edgar Filing: NetEase, Inc. - Form 20-F

All of our current directors have entered into indemnification agreements in which we agree to indemnify, to the fullest extent allowed by Cayman Islands law, our charter documents or other applicable law, those directors from any liability or expenses, unless the liability or expense arises from the director's own willful negligence or willful default. The indemnification agreements also specify the procedures to be followed with respect to indemnification.

We do not have service contracts with any of our directors which provide for benefits upon termination.

### **Executive Officer Compensation**

In 2018, we paid our executive officers aggregate cash compensation of RMB5.5 million (US\$0.8 million). We also granted restricted share unit awards under our RSU Plan to our Chief Financial Officer, which will represent less than 1% of our total outstanding ordinary shares upon vesting.

### **Employment Agreements**

We have entered into employment and related agreements with each of our executive officers. These agreements include: (i) a covenant that prohibits the executive officer from engaging in any activities that compete with our business during and for one to two years after their employment with us, (ii) a requirement that executive officers assign all rights in company-related inventions to us and to keep our proprietary information confidential, and (iii) provisions for severance payments in the event the executive officer is terminated without cause or resigns for good reason.



Table of Contents

**2009 Restricted Share Unit Plan**

**General**

Our board approved our 2009 Restricted Share Unit Plan, or the RSU Plan, in November 2009. The RSU Plan was adopted by our board as a replacement for our Amended and Restated 2000 Stock Incentive Plan, which expired in February 2010 under its terms.

The purpose of the RSU Plan is to attract and retain the best available personnel, to provide additional incentive to employees, directors and consultants and to promote the success of our business. The RSU Plan provides for the granting of incentive awards of restricted share units, which may or may not be granted with dividend equivalent rights. Participants under the RSU Plan will not receive any account status reports.

The RSU Plan is not subject to the Employee Retirement Income Security Act of 1974, as amended, nor is the RSU Plan a qualified plan within the meaning of Section 401(a) of the Internal Revenue Code of 1986, as amended.

**Plan Administration**

Our board has designated our compensation committee to administer the RSU Plan, and it may designate one or more of our officers to exercise its authority thereunder from time to time.

**Securities Subject to the RSU Plan**

The maximum aggregate number of our ordinary shares which may be issued pursuant to all awards under the RSU Plan is 323,694,050 ordinary shares. Such ordinary shares may, in whole or in part, be authorized but unissued shares or shares that will have been or may be reacquired by us. It is anticipated that all future awards to our employees, directors and consultants will be granted pursuant to the RSU Plan or any other future plan adopted by our board and, if appropriate, our shareholders.

The RSU Plan provides that in the event of certain corporate transactions, including specified types of mergers and acquisition transactions, each outstanding award granted under the RSU Plan shall automatically become fully vested and be released from any restrictions on transfer and repurchase or forfeiture rights, immediately prior to the specified effective date of such corporate transaction, unless the award is assumed by the successor company or its parent company in connection with the corporate transaction. Upon consummation of such corporate transactions, each outstanding award shall be terminated unless the award is assumed by the successor company or its parent company in connection with the applicable corporate transaction. Our board will determine whether an award was assumed in the manner contemplated by the RSU Plan.

**Eligibility**

Under the RSU Plan, awards can be issued to participants in the RSU Plan, which include employees, directors or consultants of us, our subsidiaries or our VIEs.

**Awards under the RSU Plan**

Awards under the RSU Plan are evidenced by an award agreement which contains, among other things, such provisions concerning how the restricted share unit may be settled upon vesting and forfeiture upon termination of employment or the consulting arrangement (by reason of death, disability, retirement or otherwise) as have been determined by our board.

Restricted share units do not represent any actual ownership interest in us. The units granted correspond in number and value to a specified number of our ordinary shares. No actual shares are issued. Instead, the units are tracked in a bookkeeping account. The units may be subject to forfeiture provisions to replicate the treatment of restricted shares. The purchase price, if any, for an award shall be determined by our board. The units can ultimately be paid in cash or ordinary shares, as our board determines. Dividend equivalents may be paid on the restricted share units. A dividend equivalent right entitles the participant to receive cash compensation measured by the dividends paid with respect to our ordinary shares. The dividend equivalents may be paid out at the time of the dividend or may be credited to the participant's account and converted to additional units.

Table of Contents

**Conditions of Awards**

Our board, either acting directly or through our compensation committee or one or more of our officers, is authorized to determine the provisions, terms and conditions of each award, including, without limitation, the award vesting schedule, repurchase provisions, rights of first refusal, forfeiture provisions, settlement of the award, payment contingencies and satisfaction of any performance criteria established by our board. Partial achievement of the specified criteria may result in a payment or vesting corresponding to the degree of achievement as specified in the award agreement.

**Termination of Service**

In the event of the termination of the participant's employment or service with us for any reason prior to the vesting of any restricted share units, such unvested units held by the participant shall be automatically forfeited as of the date of termination. Neither the participant nor any of the participant's successors, heirs, assigns or personal representatives shall have any rights or interests in any restricted share units that are so forfeited.

**Amendment; Termination**

Under the RSU Plan, our board may at any time terminate, suspend, or amend the RSU Plan in any respect, except that no termination, suspension or amendment will be effective without shareholder approval if such approval is required to comply with any law, regulation or stock exchange rule and no such change may adversely affect any award previously granted without the written consent of the recipient. The RSU Plan will expire in November 2019.

**Non-Transferability of Awards**

Under the RSU Plan, awards may not be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of, except by will or by the laws of descent and distribution and during the lifetime of the participants, to the extent and in the manner provided in the award agreement. The RSU Plan permits the designation of beneficiaries by holders of awards in the event of the participant's death. After any such transfer, the original recipient shall continue to remain subject to the withholding tax requirements described below.

**Payment of Taxes**

No ordinary shares shall be delivered under the RSU Plan to any participant or other person until such participant or other person has made arrangements acceptable to us regarding payment of Chinese, Cayman Islands, U.S. and any other federal, state, provincial, local or other taxes required by law. Alternatively, we will withhold or collect from the participant an amount sufficient to satisfy such tax obligations.

### **Other Equity Incentive Plans**

Certain of our subsidiaries have adopted their own equity incentive plans, which allow the relevant subsidiaries to grant options or other awards to certain of our employees. The options expire in five to seven years from the date of grant and either vest or have a vesting commencement date upon certain conditions being met. The awards can become 100% vested on the vesting commencement date, or vest in two, four or five substantially equal annual installments with the first installment vesting on the vesting commencement date.

### **C. Board Practices**

At each annual general meeting of our shareholders, our shareholders are asked to elect the directors nominated to serve for the ensuing year or until their successors are elected and duly qualified or until such director's earlier death, bankruptcy, insanity, resignation or removal. For information regarding the period during which our officers and directors have served in their respective positions, please refer to Item 6.A.

Directors and Senior Management. We have no specific policy with respect to director attendance at our annual general meetings of shareholders, and no director attended the annual general meeting of shareholders held on September 7, 2018.

Table of Contents

Our board has three committees, the audit committee, the compensation committee and the nominating committee. Alice Cheng, Joseph Tong and Michael Leung are currently the members of each of these committees.

The board of directors has determined that Mr. Joseph Tong is an audit committee financial expert as defined by Item 16A of Form 20-F. The board of directors has adopted a written audit committee charter pursuant to which the audit committee is responsible for overseeing the accounting and financial reporting processes of our company, including the appointment, compensation and oversight of the work of our independent auditors, monitoring compliance with our accounting and financial policies and evaluating management's procedures and policies relative to the adequacy of our internal accounting controls.

The board of directors has adopted a written compensation committee charter pursuant to which the compensation committee is responsible for, among other things, annually reviewing and approving our company's corporate goals and objectives relevant to the compensation of our chief executive officer, evaluating such officer's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by our board), determining and approving the chief executive officer's compensation level based on this evaluation. The committee also annually reviews and makes recommendations to the board with respect to non-chief executive officer compensation, incentive compensation plans and equity based plans, administers our incentive compensation plans and equity-based plans as in effect and as adopted from time to time by our board (the board retains, however, the authority to interpret such plans), and approves any new equity compensation plan or any material change to an existing plan where shareholders' approval has not been obtained.

The board of directors has adopted a written nominating committee charter pursuant to which the nominating committee is responsible for monitoring the size and composition of our board and considering and making recommendations to our board with respect to the nominations or elections of directors of our company.

The audit, compensation and nominating committees are composed solely of non-employee directors, as such term is defined in Rule 16b-3 under the Exchange Act and the board of directors has determined that all such members are independent as that term is defined in NASDAQ Marketplace Rule 5605(a)(2).

**Compensation Committee Interlocks**

No interlocking relationships have existed between our board of directors or compensation committee and the board of directors or compensation committee of any other company.

**D. Employees**

As of December 31, 2016, 2017 and 2018, we had 15,748, 18,129 and 22,726 full-time employees, respectively.

## Edgar Filing: NetEase, Inc. - Form 20-F

The following table sets forth information regarding our staff as of December 31, 2018:

Online game	8,197
Online Game Customer service	1,653
E-commerce	3,251
Advertising services	2,754
Product development	2,453
E-mail	239
Marketing	786
Others	3,393
Total	22,726

In addition, as of December 31, 2018, we had approximately 1,922 part-time employees.

Table of Contents

None of our employees are represented by a labor union.

All employees of our company and of our affiliated companies are employed under employment contracts which specify, among other things, the employee's responsibilities, remuneration and grounds for termination of employment. Each employee signs a confidentiality agreement in respect of our intellectual property rights.

**E. Share Ownership**

The table in this section sets forth certain information known to us with respect to the beneficial ownership as of December 31, 2018 (unless otherwise indicated) by:

- all persons who are beneficial owners of 5% or more of our ordinary shares,
- each of our directors,
- our Chief Executive Officer and Chief Financial Officer, and
- all current directors and executive officers as a group.

As of December 31, 2018, 3,199,018,406 of our ordinary shares were outstanding. The amounts and percentages of ordinary shares beneficially owned are reported on the basis of regulations of the SEC governing the determination of beneficial ownership of securities. Under the rules of the SEC, a person is deemed to be a beneficial owner of a security if that person has or shares voting power, which includes the power to vote or to direct the voting of such security, or investment power, which includes the power to dispose of or to direct the disposition of such security. A person is also deemed to be a beneficial owner of any securities of which that person has a right to acquire beneficial ownership within 60 days. Under these rules, more than one person may be deemed a beneficial owner of securities as to which such person has no economic interest. The shareholders listed below do not have different voting rights.

<b>5% Shareholder</b>	<b>Number of Shares Beneficially Owned</b>	
	<b>Number</b>	<b>Percentage</b>
Shining Globe International Limited/William Lei Ding(1) c/o NetEase, Inc., Building No. 7, West Zone, Zhongguancun Software Park (Phase II), No. 10 Xibeiwang East Road, Haidian District, Beijing, People's	1,456,000,000	45.5%

Edgar Filing: NetEase, Inc. - Form 20-F

Republic of China 100193.

Orbis Investment Management Limited and Orbis Asset Management Limited c/o Orbis House, 25 Front Street, Hamilton HM 11, Bermuda	250,714,200(2)	7.8%(2)
--	----------------	---------

	Number of Shares Beneficially Owned	
	Number	Percentage
<b>Executive Officers and Directors(3)</b>		
Charles Zhaoxuan Yang	*	*
Alice Cheng	*	*
Denny Lee	*	*
Joseph Tong	*	*
Lun Feng	*	*
Michael Leung	*	*
Michael Tong	*	*
All current directors and executive officers as a group (8 persons)(4)	1,456,826,575	45.5%

---

\* less than 1%

(1) Shining Globe International Limited is the record owner of 1,456,000,000 ordinary shares, consisting of 1,406,000,000 ordinary shares and 2,000,000 ADSs. Shining Globe International Limited is wholly owned by Shining Globe Holding Limited, which is in turn wholly owned by Shining Globe Trust, or the Trust, for which TMF (Cayman) Ltd. acts as the trustee. William Lei Ding, our founder, Chief Executive Officer and a director, is the sole director of Shining Globe International Limited and the settlor of the Trust, retaining the investment and dispositive powers with respect to the assets of the Trust. The beneficiaries of the Trust are William Lei Ding and his family.



Table of Contents

(2) Based on information included in Form 13-F dated October 31, 2018, filed by Orbis Investment Management Limited and Orbis Asset Management Limited.

(3) The address of our current executive officers and directors are c/o Building No. 7, West Zone, Zhongguancun Software Park (Phase II), No. 10 Xibeiwang East Road, Haidian District, Beijing, People's Republic of China 100193 and c/o NetEase Building, No. 599 Wangshang Road, Binjiang District, Hangzhou, People's Republic of China 310052.

(4) Shares owned by all of our current directors and executive officers as a group includes shares beneficially owned by William Lei Ding. Such amount includes ordinary shares and ordinary shares issuable upon vesting of RSUs held by our directors and executive officers as a group.

As of December 31, 2018, based on public filings with the SEC, there are no major shareholders holding 5% or more of our ordinary shares or ADSs representing ordinary shares, except as described above.

As of December 31, 2018, there were five ordinary shareholders of record with an address in the United States, including The Bank of New York Mellon, depository of our ADS program, which held 1,793,357,765 ordinary shares as of that date.

To our knowledge, except as disclosed above, we are not owned or controlled, directly or indirectly, by another corporation, by any foreign government or by any other natural or legal person or persons, severally or jointly.

To our knowledge, there are no arrangements the operation of which may at a subsequent date result in us undergoing a change in control.

Our major shareholders do not have different voting rights than any of our other shareholders.

## **Item 7. Major Shareholders and Related Party Transactions**

### **A. Major Shareholders**

Please refer to Item 6.E. Directors, Senior Management and Employees Share Ownership.

**B. Related Party Transactions**

NetEase, Inc. and certain of its wholly owned subsidiaries have entered into a series of agreements with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Youdao Computer and certain other affiliated entities and the shareholders of these entities, under which we provide our Internet and e-commerce applications, services and technologies and advertising services to Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo Youdao Computer and certain other affiliated entities, and they in turn provide certain of our online games and operate the NetEase websites, our e-commerce platforms, our online advertising business, and e-mail and certain of our other fee-based premium services. We believe that the terms of each agreement are no less favorable than the terms that we could obtain from disinterested third parties and that the shareholders of Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo, Youdao Computer and certain other affiliated entities will not receive material benefits from these agreements except as shareholders of NetEase. The agreements with Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo and Youdao Computer are described below.

Table of Contents

*Agreements relating to Guangzhou NetEase*

William Lei Ding, our Chief Executive Officer, and Xiaojun Hui, our vice president of game development, own 99.0% and 1.0% of the equity interest in Guangzhou NetEase, respectively.

- *Domain Name License Agreement between NetEase and Guangzhou NetEase.* NetEase granted Guangzhou NetEase the right to use the domain names netease.com, 163.com, 126.com, yeah.net and nease.net on the NetEase websites in China for license fees of RMB10,000 per year. NetEase may waive this fee at any time.
- *Copyright License Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing granted Guangzhou NetEase the right to use NetEase Beijing's web page layout in China for a royalty of RMB10,000 per year. NetEase Beijing may waive this fee at any time.
- *Trademark License Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing granted Guangzhou NetEase a license to use NetEase Beijing's registered trademarks on the NetEase websites in China for license fees of RMB10,000 per year. NetEase Beijing may waive this fee at any time.
- *Cooperative Agreements.* Guangzhou NetEase has entered into cooperative agreements with each of NetEase Beijing, Boguan and NetEase Hangzhou pursuant to which such subsidiaries have agreed to provide the following services:
  - research and development of computer software (including, but not limited to, online games software) and technical support and maintenance for the operation of computer software;
  - technical service for Internet media, including, but not limited to, server maintenance and development, update and upgrade of relevant application software; and
  - research and development of electronic publishing technology and relevant technical assistance and support.

Guangzhou NetEase has agreed to pay a monthly service fee to each such subsidiary in accordance with a formula based on their respective expenses incurred. The cooperative agreements with each of NetEase Beijing, Boguan and NetEase Hangzhou were effective from September 1, November 1, and December 1, 2012, respectively, and each will continue to be effective unless any one of the two respective parties terminates

such agreement by written notice.

- *Online Advertising Agreement between Guangzhou NetEase and NetEase Advertising.* Guangzhou NetEase sells all of the banner space on the NetEase websites to NetEase Advertising and publishes the advertisements provided by NetEase Advertising on the banner space purchased by NetEase Advertising. NetEase Advertising pays Guangzhou NetEase RMB10,000 per year. Guangzhou NetEase may waive this fee at any time.

The term of the foregoing agreement is automatically renewable for successive one year term.

- *Trademark Transfer Agreement between Guangzhou NetEase and NetEase Beijing.* Under this agreement, Guangzhou NetEase transferred its registered trademarks to NetEase Beijing.
- *Supplemental Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing may not grant the license to use its domain name, copyright and trademark to any third party without Guangzhou NetEase's consent and may not provide technical service to any third party.
- *Shareholder Voting Rights Trust Agreement among NetEase Beijing and the Individual Shareholders of Guangzhou NetEase.* William Lei Ding and Xiaojun Hui agreed to irrevocably appoint NetEase Beijing to represent him to exercise all voting rights to which he is entitled as a shareholder of Guangzhou NetEase. The term of this agreement is 20 years from May 12, 2010. This agreement was amended and novated on May 1, 2014 in connection with Mr. Hui's acquisition of his equity interest in Guangzhou NetEase from a prior shareholder and further amended and restated on November 30, 2015 in connection with the equity transfer of NetEase Advertising to William Lei Ding and Li Li.

Table of Contents

- *Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing agrees to pay the operating costs of Guangzhou NetEase.
- *Letter of Agreement.* Each of William Lei Ding and Xiaojun Hui have agreed that any amendments to be made to the Shareholder Voting Rights Trust Agreement, the Equity Pledge Agreement (described below) and the Loan Agreement (described below), as well as all other agreements to which our company, NetEase Beijing and/or their respective affiliates is a party, on the one hand, and any of their VIEs and/or the shareholders of such entities, on the other hand, shall be subject to the approval by the vote of a majority of our board, excluding the vote of William Lei Ding. Messrs. Ding and Hui have also agreed that, if any amendments to the above mentioned agreements require a vote of the shareholders of our company or Guangzhou NetEase, as applicable, both of them will vote in their capacity as direct or indirect shareholders of these companies to act based upon the instructions of our board. The term of this agreement is 20 years from May 12, 2010, and this agreement was amended and novated on May 1, 2014 in connection with Mr. Hui's acquisition of his equity interest in Guangzhou NetEase from a prior shareholder and further amended and restated on November 30, 2015 in connection with the equity transfer of NetEase Advertising to William Lei Ding and Li Li.
- *Loan Agreement and Equity Pledge Agreement.* Concurrent with Mr. Hui's acquisition of his equity interest in Guangzhou NetEase from a prior shareholder, Mr. Hui entered into a Loan Agreement and Equity Pledge Agreement with NetEase Beijing, each dated May 1, 2014. Under the Loan Agreement, NetEase Beijing provided Mr. Hui with an interest-free loan in the principal amount of RMB0.2 million (US\$32,000) to Mr. Hui, which funds were used by Mr. Hui to pay the consideration to acquire such 1.0% equity interest. The loan can be repaid by transferring such 1.0% equity interest to NetEase Beijing or its designee or through such other method as NetEase Beijing shall determine. The term of the loan is 10 years from the date of the agreement and can be extended upon the mutual consent of both parties. Under the Equity Pledge Agreement, Mr. Hui pledges his 1.0% equity interest in Guangzhou NetEase to NetEase Beijing to secure his respective obligations under the Loan Agreement and Shareholder Voting Rights Trust Agreement. Mr. Hui agrees he shall not transfer, pledge or encumber his 1.0% equity interest without the prior written consent of NetEase Beijing. During the term of this agreement, NetEase Beijing is entitled to all dividends and other distributions made by Guangzhou NetEase. The Equity Pledge Agreement will remain binding until Mr. Hui discharges all his obligations under the above-mentioned agreements.

*Agreements relating to NetEase Advertising*

William Lei Ding and Li Li, the chief executive officer of our Internet media business, own 99.0% and 1.0% of the equity interest in NetEase Advertising, respectively.

- *Loan Agreements and Equity Pledge Agreements between Media Beijing and each of the ultimate shareholders of NetEase Advertising.* Each of Mr. Ding and Ms. Li has entered into a Loan Agreement and an Equity Pledge Agreement with Media Beijing, each dated November 30, 2015. Under the Loan Agreements, Media Beijing provided each of Mr. Ding and Ms. Li with an interest-free loan in the principal amount of approximately RMB7.7

million (US\$1.1 million) and RMB98,000 (US\$14,254), which funds were used by each of Mr. Ding and Ms. Li to pay the consideration to acquire their 79.0% and 1.0% of the equity interests in NetEase Advertising, respectively. Each loan can be repaid by transferring the ultimate shareholder's equity interest in NetEase Advertising to Media Beijing or its designee or through such other method as Media Beijing shall determine. The term of each Loan Agreement is 10 years from the date of the agreement and will be automatically extended for further 10 year terms unless otherwise decided by Media Beijing. Under the Equity Pledge Agreements, each of Mr. Ding and Ms. Li pledges his/her equity interest in NetEase Advertising to Media Beijing to secure his/her respective obligations under the Loan Agreement as well as the Exclusive Purchase Option Agreement, the Shareholder Voting Rights Trust Agreement and the Operating Agreement. Each of Mr. Ding and Ms. Li agrees he/she shall not transfer, assign or pledge his/her equity interest in NetEase Advertising without the prior written consent of Media Beijing. The Equity Pledge Agreements will remain binding until the pledgor discharges all his/her obligations under the above-mentioned agreements.

Table of Contents

- *Exclusive Purchase Option Agreements among Media Beijing, NetEase Advertising and each of the ultimate shareholders of NetEase Advertising.* Under the Exclusive Purchase Option Agreements, each dated November 30, 2015, each of Mr. Ding and Ms. Li has granted Media Beijing an option to purchase all or a portion of his/her equity interest in NetEase Advertising at a price equal to the original paid-in capital paid by the ultimate shareholder. In addition, NetEase Advertising has granted Media Beijing an option under the Exclusive Purchase Option Agreements to purchase all or a portion of the assets held by NetEase Advertising or its subsidiaries at a price equal to the net book value of such assets. Each of NetEase Advertising and the ultimate shareholders of NetEase Advertising agrees not to transfer, mortgage or permit any security interest to be created on any equity interest in or assets of NetEase Advertising without the prior written consent of Media Beijing. Each Exclusive Purchase Option Agreement shall remain in effect until all of the equity interests in or assets of NetEase Advertising have been acquired by Media Beijing or its designee or until Media Beijing unilaterally terminates the agreement by written notice.
- *Shareholder Voting Rights Trust Agreement between Media Beijing and each of the Individual Shareholders of NetEase Advertising.* Each of Mr. Ding and Ms. Li agreed to irrevocably entrust a person designated by Media Beijing to represent him or her to exercise all the voting rights and other shareholders' rights to which he/she is entitled as a shareholder of NetEase Advertising. Each agreement shall remain effective for as long as Mr. Ding or Ms. Li remains a shareholder of NetEase Advertising unless Media Beijing unilaterally terminates the agreement by written notice.
- *Operating Agreement among Media Beijing, NetEase Advertising and the ultimate shareholders of NetEase Advertising.* To ensure the successful performance of the various agreements between the parties, NetEase Advertising and its ultimate shareholders have agreed that, except for transactions in the ordinary course of business, NetEase Advertising will not enter into any transaction that would materially affect the assets, liabilities, rights or operations of NetEase Advertising without the prior written consent of Media Beijing. Media Beijing has also agreed that it will provide performance guarantees and, at Media Beijing's discretion, guarantee loans for working capital purposes to the extent required by NetEase Advertising for its operations. Furthermore, the ultimate shareholders of NetEase Advertising have agreed that, upon instruction from Media Beijing, they will appoint NetEase Advertising's board members, president, chief financial officer and other senior executive officers. The term of this agreement is 20 years from November 30, 2015 and can be extended with the written consent of Media Beijing.
- *Cooperative Agreement between Media Beijing and NetEase Advertising.* Under this cooperative agreement, Media Beijing has agreed to provide the following services:
  - research and development of computer software (including, but not limited to, the production, distribution, monitoring and management software of online advertisement) and technical support and maintenance for the operation of computer software;
  - design, development, update and upgrade of advertisement distribution platform;

- technical service for Internet media, including, but not limited to, server maintenance and development, update and upgrade of relevant application software; and
- research and development of electronic publishing technology and relevant technical assistance and support.

NetEase Advertising has agreed to pay a monthly service fee to Media Beijing in accordance with a formula based on its expenses incurred. This agreement was effective from October 1, 2013 and will continue to be effective unless any one of the two parties terminates such agreement by written notice.



Table of Contents*Agreements relating to Hangzhou Leihuo*

Zhipeng Hu and Tianlei Hu, two of our employees, each owned 50.0% of the equity interest in Hangzhou Leihuo. On April 18, 2019, pursuant to a supplementary agreement of assignment, the equity interest in Hangzhou Leihuo owned by Tianlei Hu and the contractual obligations described below were assigned to Long Cheng, another employee of ours. As of the date of this annual report, each of Zhipeng Hu and Long Cheng owns 50.0% of the equity interest in Hangzhou Leihuo.

- *Loan Agreements and Equity Pledge Agreements between NetEase Hangzhou and each of the ultimate shareholders of Hangzhou Leihuo.* Each of the ultimate shareholders of Hangzhou Leihuo has entered into a Loan Agreement and an Equity Pledge Agreement with NetEase Hangzhou, each dated December 1, 2015. Under the Loan Agreements, NetEase Hangzhou provided each of the ultimate shareholders of Hangzhou Leihuo with an interest-free loan in the principal amount of RMB5.0 million (US\$0.7 million), which funds were used by each of the ultimate shareholders of Hangzhou Leihuo to pay the consideration to acquire their 50.0% equity interests in Hangzhou Leihuo. Each loan can be repaid by transferring the ultimate shareholder's equity interest in Hangzhou Leihuo to NetEase Hangzhou or its designee or through such other method as NetEase Hangzhou shall determine. The term of each Loan Agreement is 10 years from the date of the agreement and will be automatically extended for further 10 year terms unless otherwise decided by NetEase Hangzhou. Under the Equity Pledge Agreements, each of the ultimate shareholders of Hangzhou Leihuo pledges his 50.0% equity interest in Hangzhou Leihuo to NetEase Hangzhou to secure his respective obligations under the Loan Agreement as well as the Exclusive Purchase Option Agreement, the Shareholder Voting Rights Trust Agreement and the Operating Agreement. Each of the ultimate shareholders of Hangzhou Leihuo agrees he shall not transfer, assign or pledge his equity interest in Hangzhou Leihuo without the prior written consent of NetEase Hangzhou. The Equity Pledge Agreements will remain binding until the pledgor discharges all his obligations under the above-mentioned agreements.

- *Exclusive Purchase Option Agreements among NetEase Hangzhou, Hangzhou Leihuo and each of the ultimate shareholders of Hangzhou Leihuo.* Under the Exclusive Purchase Option Agreements, each dated December 1, 2015, each of the ultimate shareholders of Hangzhou Leihuo has granted NetEase Hangzhou an option to purchase all or a portion of his equity interest in Hangzhou Leihuo at a price equal to the original paid-in capital paid by the ultimate shareholder. In addition, Hangzhou Leihuo has granted NetEase Hangzhou an option under the Exclusive Purchase Option Agreements to purchase all or a portion of the assets held by Hangzhou Leihuo or its subsidiaries at a price equal to the net book value of such assets. Each of Hangzhou Leihuo and the ultimate shareholders of Hangzhou Leihuo agrees not to transfer, mortgage or permit any security interest to be created on any equity interest in or assets of Hangzhou Leihuo without the prior written consent of NetEase Hangzhou. Each Exclusive Purchase Option Agreement shall remain in effect until all of the equity interests in or assets of Hangzhou Leihuo have been acquired by NetEase Hangzhou or its designee or until NetEase Hangzhou unilaterally terminates the agreement by written notice.

- *Shareholder Voting Rights Trust Agreement between NetEase Hangzhou and each of the ultimate shareholders of Hangzhou Leihuo.* Under these agreements, each dated December 1, 2015, each of the ultimate shareholders of Hangzhou Leihuo has agreed to irrevocably entrust a person designated by NetEase Hangzhou to represent him to exercise all the voting rights and other shareholders' rights to which he is entitled as a shareholder of

Hangzhou Leihuo. Each agreement shall remain effective for as long as such shareholder remains a shareholder of Hangzhou Leihuo unless NetEase Hangzhou unilaterally terminates the agreement by written notice.

- *Operating Agreement among NetEase Hangzhou, Hangzhou Leihuo and the ultimate shareholders of Hangzhou Leihuo.* To ensure the successful performance of the various agreements between the parties, Hangzhou Leihuo and its ultimate shareholders have agreed that, except for transactions in the ordinary course of business, Hangzhou Leihuo will not enter into any transaction that would materially affect the assets, liabilities, rights or operations of Hangzhou Leihuo without the prior written consent of NetEase Hangzhou. NetEase Hangzhou has also agreed that it will provide performance guarantees and, at NetEase Hangzhou's discretion, guarantee loans for working capital purposes to the extent required by Hangzhou Leihuo for its operations. Furthermore, the ultimate shareholders of Hangzhou Leihuo have agreed that, upon instruction from NetEase Hangzhou, they will appoint Hangzhou Leihuo's board members, president, chief financial officer and other senior executive officers. The term of this agreement is 20 years from December 1, 2015 and can be extended with the written consent of NetEase Hangzhou.

Table of Contents

- *Cooperation Agreement between NetEase Hangzhou and Hangzhou Leihuo.* Under this Cooperation Agreement, NetEase Hangzhou has agreed to provide the following services:
  - the development of computer software (including, but not limited to, online games) and technical support and maintenance for computer software operation;
  - the provision of broadband Internet access and other operational support; and
  - jointly with Hangzhou Leihuo, the provision of value-added telecommunication and other services to users of the Leihuo website and relevant products.

Hangzhou Leihuo has agreed to pay a monthly service fee to NetEase Hangzhou in accordance with a formula based on its expenses incurred. This agreement was effective from January 1, 2010 and will continue to be effective unless it is terminated by written notice of NetEase Hangzhou or, in case of a material breach of the agreement, it is terminated by written notice of the non-breaching party.

*Agreements relating to Youdao Computer*

Prior to November 20, 2017, William Lei Ding and certain employees or former employees of Youdao Computer owned 71.1% and 28.9% of the equity interest in Youdao Computer, respectively. As a result of an internal reorganization completed on November 20, 2017, Zhou Feng, one of our employees, became the holder of the 28.9% equity interest in Youdao Computer, with William Lei Ding continuing to hold 71.1% of the equity interest in Youdao Computer.

- *Loan Agreements between Youdao Information and each of William Lei Ding and Zhou Feng.* Each of William Lei Ding and Zhou Feng entered into a Loan Agreement with Youdao Information, dated September 26, 2016 and November 20, 2017, respectively. Under these Loan Agreements, Youdao Information provided each of William Lei Ding and Zhou Feng with an interest-free loan in the principal amount of approximately RMB3.6 million (US\$0.5 million) and RMB1.4 million (US\$0.2 million), respectively. These funds were used by each of William Lei Ding and Zhou Feng to pay the consideration to acquire his respective equity interest in Youdao Computer. Such loans can be repaid by transferring each of William Lei Ding and Zhou Feng's respective equity interest in Youdao Computer to Youdao Information or its designee or through such other method as Youdao Information shall determine. The term of each of the Loan Agreements is 10 years from the date of such agreement and will be automatically extended for a further 10-year term unless otherwise decided by Youdao Information.

- *Equity Pledge Agreements between Youdao Information and each of William Lei Ding and Zhou Feng.* Each of William Lei Ding and Zhou Feng entered into an Equity Pledge Agreement with Youdao Information, dated September 26, 2016 and November 20, 2017, respectively. Under such Equity Pledge Agreements, each of William Lei Ding and Zhou Feng pledged his respective equity interest in Youdao Computer to Youdao Information to secure his obligations under the applicable Loan Agreement, Exclusive Purchase Option Agreement, Shareholder Voting Rights Trust Agreement, and Operating Agreement. Each of William Lei Ding and Zhou Feng further agreed to not transfer or pledge his respective equity interest in Youdao Computer without the prior written consent of Youdao Information. Each of the Equity Pledge Agreement will remain binding until the respective pledger, William Lei Ding or Zhou Feng, as the case may be, discharges all his obligations under the above-mentioned agreements.

- *Exclusive Purchase Option Agreements.* Under the Exclusive Purchase Option Agreements entered into by Youdao Information, Youdao Computer and each of William Lei Ding and Zhou Feng, dated September 26, 2016 and November 20, 2017, respectively, each of William Lei Ding and Zhou Feng granted Youdao Information an option to purchase all or a portion of his respective equity interest in Youdao Computer at a price equal to the original and any additional paid-in capital paid by him. In addition, under each Exclusive Purchase Option Agreement, Youdao Computer has granted Youdao Information an option to purchase all or a portion of the assets held by Youdao Computer or its subsidiaries at a price equal to the net book value of such assets. Each of Youdao Computer, William Lei Ding and Zhou Feng agreed not to transfer, mortgage or permit any security interest to be created on any equity interest in or assets of Youdao Computer without the prior written consent of Youdao Information. Each Exclusive Purchase Option Agreement shall remain in effect until all of the equity interests in or assets of Youdao Computer have been acquired by Youdao Information or its designee or until Youdao Information unilaterally terminates the agreement by written notice.

Table of Contents

- *Shareholder Voting Rights Trust Agreements between Youdao Information and each of William Lei Ding and Zhou Feng.* Under the Shareholder Voting Rights Trust Agreements between Youdao Information and each of William Lei Ding and Zhou Feng, dated September 26, 2016 and November 20, 2017, respectively, each of William Lei Ding and Zhou Feng, agreed to irrevocably entrust a person designated by Youdao Information to represent him to exercise all the voting rights and other shareholders' rights to which he is entitled as a shareholder of Youdao Computer. Each Shareholder Voting Rights Trust Agreement shall remain effective for as long as William Lei Ding or Zhou Feng, as applicable, remains a shareholder of Youdao Computer unless Youdao Information unilaterally terminates the agreement by written notice.

- *Operating Agreements among Youdao Computer, Youdao Information and each of William Lei Ding and Zhou Feng.* To ensure the successful performance of the various agreements between the parties, each of Youdao Computer, William Lei Ding and Zhou Feng agreed that, except for transactions in the ordinary course of business, Youdao Computer will not enter into any transaction that would materially affect the assets, liabilities, rights or operations of Youdao Computer without the prior written consent of Youdao Information. Youdao Information also agreed that it would provide performance guarantees and, at Youdao Information's discretion, guarantee loans for working capital purposes to the extent required by Youdao Computer for its operations. Furthermore, each of William Lei Ding and Zhou Feng agreed that, upon instruction from Youdao Information, he would appoint Youdao Computer's board members, president, chief financial officer and other senior executive officers. The term of each Operating Agreement is 20 years from the date of execution and can be extended with the written consent of Youdao Information.

- *Cooperation Agreement between Youdao Information and Youdao Computer.* Under this Cooperation Agreement, Youdao Information has agreed to provide the following services:

- the development of computer software (including, but not limited to, generating online advertisement and distribution and maintenance of related software) and technical support and maintenance for computer software operation;

- the development of computer software related to generating online advertisement, establishment of platforms for online advertisement and related updates and operational support; and

- the provision of technology support, including, but not limited to, server maintenance, development of server software and related maintenance and updates.

Youdao Computer has agreed to share its monthly income (after tax and expenses) with Youdao Information in accordance with certain formulas as specified in the Cooperation Agreement. This agreement was effective from July 1, 2015 and will continue to be effective unless it is terminated by written notice of Youdao Information or, in case of a material breach of the agreement, it is terminated by written notice of the

non-breaching party.

In addition, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC starting in August 2008, there are certain contractual arrangements among Shanghai EaseNet, the joint venture established between Blizzard and us, and us. As a result of these arrangements, Shanghai EaseNet is a controlled VIE, and William Lei Ding, our Chief Executive Officer, director and major shareholder, does not receive any benefits in his capacity as the shareholder of Shanghai EaseNet or exercise any personal control over it. We have consolidated Shanghai EaseNet into our financial statements as of and for the years ended December 31, 2016, 2017 and 2018. Mr. Ding's role as the shareholder of Shanghai EaseNet is designed to address Chinese regulations which place restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of online games. See Item 5.A Operating Results Our Corporate Structure.

Table of Contents

In the year ended December 31, 2018, we also entered into several guarantee agreements in the aggregate amount of US\$785.0 million in respect of certain credit facilities taken by our subsidiaries. As of December 31, 2018, US\$177.6 million of such credit facilities had not been utilized.

**C. Interests of Experts and Counsel**

Not applicable.

**Item 8. Financial Information**

**A. Consolidated Statements and Other Financial Information**

See Item 18. Financial Statements for our audited consolidated financial statements filed as part of this annual report.

**A.7 Legal Proceedings**

From time to time, we become subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights, and a variety of claims arising in connection with our e-mail, message boards and other communications and community features, such as claims alleging defamation or invasion of privacy. However, such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and management resources.

In April 2018, PUBG Corporation and PUBG Santa Monica, Inc., or PUBG, filed suit against defendants NetEase, Inc., NetEase Information Technology Corp. and NetEase (Hong Kong) Limited in the U.S. District Court for the Northern District of California. The complaint generally alleges that two of our mobile games, Rules of Survival and Knives out, infringe the plaintiffs' copyrights and trademarks and that we have engaged in unfair business competition under California law. As of March 31, 2019, we reached a settlement with PUBG with respect to this matter.

We are not currently a party to, nor are we aware of, any other legal proceeding, investigation or claim which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition or results of operations.

**A.8 Dividend Policy**

## Edgar Filing: NetEase, Inc. - Form 20-F

In May 2014, our board of directors approved a quarterly dividend policy commencing in 2016. Under this policy, quarterly dividends are set at an amount equivalent to approximately 25% of our anticipated net income after tax in each fiscal quarter. The determination to make dividend distributions and the amount of such distributions in any particular quarter will be made at the discretion of our board of directors and will be based upon our operations and earnings, cash flow, financial condition and other relevant factors. Our board of directors declared dividends of US\$0.23, US\$0.61, US\$0.45 and US\$0.48 per ADS for the first, second, third and fourth quarters of 2018, respectively.

We are a holding company incorporated in the Cayman Islands, and our ability to pay dividends to our shareholders depends upon dividends, loans or advances that we receive from our subsidiaries and VIEs. Please refer to Item 3.D. Risk Factors Risks Related to Our Company Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and VIEs, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.

Holders of our ADSs will be entitled to receive dividends, if any, subject to the terms of the deposit agreement (including the fees and expenses payable thereunder), to the same extent as the holders of our ordinary shares. Cash dividends will be paid to the depositary in U.S. dollars, which will distribute them to the holders of ADSs according to the terms of the deposit agreement. Other distributions, if any, will be paid by the depositary to the holders of ADSs in any means it deems legal, fair and practical.



Table of Contents

**B. Significant Changes**

We have not experienced any significant changes since the date of our audited consolidated financial statements included in this annual report.

**Item 9. The Offer and Listing**

Not applicable except for Item 9.A.4. and Item 9.C. Our ADSs have been listed on the NASDAQ Global Select Market (formerly the NASDAQ National Market) since June 30, 2000. Our ADSs trade under the symbol NTES.

**Item 10. Additional Information**

**A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

The following presents a description of the terms and provisions of our restated memorandum and articles of association.

*General*

We were incorporated in the Cayman Islands on July 6, 1999 and operate under the Cayman Islands Companies Law (2018 Revision), as revised and amended from time to time, or the Companies Law. Our corporate objectives and purpose are unrestricted.

*Directors*

## Edgar Filing: NetEase, Inc. - Form 20-F

A director may vote in respect of any contract or transaction in which he is interested, provided however, that the nature of the interest of any director in any such contract or transaction shall be disclosed by him at or prior to its consideration and any vote on that matter. A general notice or disclosure to the directors or otherwise contained in the minutes of a meeting or a written resolution of the directors or any committee thereof that a director is a shareholder of any specified firm or company and is to be regarded as interested in any transaction with such firm or company shall be sufficient disclosure and after such general notice it shall not be necessary to give special notice relating to any particular transaction.

The directors may determine remuneration to be paid to the directors. The directors may exercise all the powers of our company to borrow money and to mortgage or charge its undertaking, property and uncalled capital or any part thereof, to issue debentures, debenture stock and other securities whenever money is borrowed or as security for any of our debts, liabilities, or obligations or those of any third party.

A shareholding qualification for directors may be fixed by the Company in a general meeting, but unless and until so fixed, there are no shareholding qualifications. Further, there are no age limitations or retirement requirements and no share ownership qualifications for directors unless so fixed by shareholders in a general meeting.

### *Rights, Preferences and Restrictions of Ordinary Shares*

*General.* All of our outstanding shares are fully paid and non-assessable. Certificates representing the shares are issued in registered form. Our shareholders who are non-residents of the Cayman Islands may freely hold and vote their shares.

Table of Contents

*Dividends.* The holders of shares are entitled to such dividends as may be declared by our board of directors. Under Cayman Islands law, dividends may be declared and paid only out of funds legally available therefor, namely out of either profit or our share premium account, and provided further that a dividend may not be paid if this would result in our company being, immediately following such payment, unable to pay its debts as they fall due in the ordinary course of business.

*Voting Rights.* Each share is entitled to one vote on all matters upon which the shares are entitled to vote, including the election of directors. Voting at any meeting of shareholders is by show of hands unless a poll is demanded. A poll may be demanded by the Chairman or any other shareholder present in person or by proxy. A quorum required for a meeting of shareholders consists of at least two shareholders present in person or by proxy.

Any ordinary resolution to be made by the shareholders requires the affirmative vote of a simple majority of the votes attaching to the shares cast in a general meeting, while a special resolution requires the affirmative vote of no less than two-thirds of the votes cast attaching to the shares. A special resolution is required for matters such as a change of our name. Holders of the shares may by ordinary resolution, among other things, elect directors, appoint auditors, and increase our share capital. Both ordinary resolutions and special resolutions may also be passed by a unanimous written resolution signed by all the shareholders of our company.

*Liquidation.* On a return of capital on winding up or otherwise (other than on conversion, redemption or purchase of shares) assets available for distribution among the holders of shares shall be distributed among the holders of the shares pro rata. If the assets available for distribution are insufficient to repay all of the paid-up capital, the assets will be distributed so that the losses are borne by our shareholders proportionately.

*Calls on Shares and Forfeiture of Shares.* Our board of directors may from time to time make calls upon shareholders for any amounts unpaid on their shares in a notice served to such shareholders at least 14 days prior to the specified time or times of payment. The shares that have been called upon and remain unpaid are subject to forfeiture.

*Redemption, Repurchase and Surrender of Shares.* Subject to the provisions of the Companies Law and the memorandum and articles of association, we may issue shares on the terms that they are, or at our option or at the option of the holders are, subject to redemption on such terms and in such manner as we may determine by special resolution. Subject to the provisions of the Companies Law and the memorandum and articles of association, we may also repurchase any of our shares provided that the manner of such purchase has first been approved by ordinary resolution of our shareholders. Under the Companies Law, the redemption or repurchase of any share may be paid out of our profits or out of the proceeds of a fresh issue of shares made for the purpose of such redemption or repurchase, or out of capital (including share premium account and capital redemption reserve) if we can, immediately following such payment, pay our debts as they fall due in the ordinary course of business. In addition, under the Companies Law no such share may be redeemed or repurchased (a) unless it is fully paid up, (b) if such redemption or repurchase would result in there being no shares outstanding, or (c) if we have commenced liquidation. In addition, we may accept the surrender of any fully paid share for no consideration.

*Variations of Rights of Shares*

The rights attached to any class of shares (unless otherwise provided by the terms of issue of the shares of that class) may, subject to the provisions of the Companies Law, be varied either with the consent in writing of the holders of three-fourths of the issued shares of that class or with the sanction of a special resolution passed at a general meeting of the holders of the shares of that class.

*General Meetings of Shareholders*

The directors may whenever they think fit, and they shall on the requisition of our shareholders holding not less than one-tenth of our paid-up capital as at the date of the deposit of the requisition carries the right of voting at general meetings of our company, proceed to convene a general meeting of our company. If the directors do not within 21 days from the date of the deposit of the requisition duly proceed to convene a general meeting, the requisitionists, or any of them representing more than one-half of the total voting rights of all of them, may themselves convene a general meeting, but any meeting so convened shall not be held after the expiration of three months after the expiration of such 21 days. Advanced notice of at least five days is required for the convening of the annual general meeting and other shareholders meetings.

Table of Contents

*Limitations on the Right to Own Shares*

There are no limitations on the right to own our shares.

*Limitations on Transfer of Shares*

There are no provisions in our restated memorandum or articles of association that would have an effect of delaying, deferring or preventing a change in control and that would operate only with respect to a merger, acquisition or corporate restructuring.

*Disclosure of Shareholder Ownership*

There are no provisions in our restated memorandum or articles of association governing the ownership threshold above which shareholder ownership must be disclosed.

*Changes in Capital*

We may from time to time by ordinary resolution increase the share capital by such sum, to be divided into shares of such amount, as the resolution shall prescribe. The new shares shall be subject to the same provisions with reference to the payment of calls, lien, transfer, transmission, forfeiture and otherwise as the shares in the original share capital. We may by ordinary resolution:

- (a) consolidate and divide all or any of our share capital into shares of larger amount than our existing shares;
- (b) sub-divide our existing shares, or any of them into shares of smaller amount than is fixed by our restated memorandum of association or into shares without nominal or par value; and
- (c) cancel any shares which, at the date of the passing of the resolution, have not been taken or agreed to be taken by any person.

We may by special resolution reduce our share capital and any capital redemption reserve fund in any manner authorized by the Companies Law.

*Differences in Corporate Law*

The Companies Law is modeled after that of the United Kingdom but does not follow recent United Kingdom statutory enactments and differs from laws applicable to U.S. corporations and their shareholders. Set forth below is a summary of the significant differences between the provisions of the Companies Law applicable to us and the laws applicable to companies incorporated in the United States and their shareholders.

*Mergers and Similar Arrangements.* The Companies Law permits mergers and consolidations between Cayman Islands companies and between Cayman Islands companies and non-Cayman Islands companies. For these purposes, (a) *merger* means the merging of two or more constituent companies and the vesting of their undertaking, property and liabilities in one of such companies as the surviving company and (b) a *consolidation* means the combination of two or more constituent companies into a consolidated company and the vesting of the undertaking, property and liabilities of such companies to the consolidated company. In order to effect such a merger or consolidation, the directors of each constituent company must approve a written plan of merger or consolidation (a *Plan*), which must then be authorized by each constituent company by way of (a) a special resolution of the shareholders of each such constituent company; and (b) such other authorization, if any, as may be specified in such constituent company's articles of association. The consent of each holder of a fixed or floating security interest of a Cayman Islands constituent company must be obtained, unless the Grand Court of the Cayman Islands waives such requirement. The Plan must be filed with the Registrar of Companies together with, among other documents, a director's declaration as to the solvency of the constituent company and of the consolidated or surviving company, a director's declaration of the assets and liabilities of each constituent company and an undertaking that a copy of the certificate of merger or consolidation will be given to the members and creditors of each constituent company and that notification of the merger or consolidation will be published in the Cayman Islands Gazette. Dissenting shareholders have the right to be paid the fair value of their shares (which, if not agreed between the parties, will be determined by the Grand Court of the Cayman Islands) if they follow the required procedures set out in the Companies Law, subject to certain exceptions. Court approval is not required for a merger or consolidation which is effected in compliance with these statutory procedures.

Table of Contents

In addition, there are statutory provisions that facilitate the reconstruction and amalgamation of companies by way of schemes of arrangement, provided that the arrangement in question is approved by a majority in number of each class of shareholders or creditors with whom the arrangement is to be made, and who must in addition represent three-fourths in value of each such class of shareholders or creditors, as the case may be, that are present and voting either in person or by proxy at a meeting, or meetings convened for that purpose. The convening of the meetings and subsequently the arrangement must be sanctioned by the Grand Court of the Cayman Islands. While a dissenting shareholder would have the right to express to the court the view that the transaction ought not to be approved, the court can be expected to approve the arrangement if it satisfies itself that:

- the statutory provisions as to majority vote have been complied with;
- the shareholders have been fairly represented at the meeting in question and the statutory majority are acting bona fide without coercion of the minority to promote interests adverse to those of the class;
- the arrangement is such that may be reasonably approved by an intelligent and honest man of that class acting in respect of his interest; and
- the arrangement is not one that would more properly be sanctioned under some other provision of the Companies Law.

The Companies Law contains a statutory power of compulsory acquisition which may facilitate the squeeze out of dissentient minority shareholders upon a take-over offer. When a take-over offer is made and accepted by holders of 90% of the affected shares within four months, the offeror may, within a two-month period after expiry of such four-month period, require the holders of the remaining shares to transfer such shares on the terms of the offer. An objection can be made to the Grand Court of the Cayman Islands but this is unlikely to succeed unless there is evidence of fraud, bad faith or collusion.

If the arrangement and reconstruction is thus approved, or if a take-over offer is made and accepted, the dissenting shareholder would have no rights comparable to appraisal rights, which would otherwise ordinarily be available to dissenting shareholders of United States corporations, providing rights to receive payment in cash for the judicially determined value of the shares.

*Shareholders Suits.* In principle, we will normally be the proper plaintiff and as a general rule a derivative action may not be brought by a minority shareholder. However, based on English authorities, which would in all likelihood be of persuasive authority in the Cayman Islands, there are exceptions to the foregoing principle, including when: (a) a company acts or proposes to act illegally or ultra vires; (b) the act complained of, although not ultra vires, could only be effected duly if authorized by more than a simple majority vote that has not been obtained; and (c) those who control the company are perpetrating a fraud on the minority.

*Indemnification.* Cayman Islands law does not (other than as set forth hereafter) limit the extent to which a company's organizational documents may provide for indemnification of officers and directors, except to the extent any such provision may be held by the Cayman Islands courts to be contrary to public policy, such as to provide indemnification against civil fraud or the consequences of committing a crime. Our articles of association provide for indemnification of officers and directors for losses, damages, costs and expenses incurred in their capacities as such, except through their own willful neglect or default.

Insofar as indemnification or liability arising under the Securities Act of 1933 may be permitted to directors, officers or persons controlling the registrant pursuant to the foregoing provisions, we have been informed that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act of 1933 and is therefore unenforceable.



Table of Contents

**C. Material Contracts**

We have not entered into any material contracts other than in the ordinary course of business and other than those described in Item 4. Information on the Company or elsewhere in this annual report.

**D. Exchange Controls**

Foreign currency exchange in the PRC is primarily governed by the Foreign Exchange Administration Rules issued by the State Council on January 29, 1996 and effective as of April 1, 1996 (and amended on January 14, 1997 and August 1, 2008) and the Regulations of Settlement, Sale and Payment of Foreign Exchange which came into effect on July 1, 1996.

Under the Foreign Exchange Administration Rules, Renminbi is freely convertible for current account items, including the distribution of dividends payments, interest payments, trade and service-related foreign exchange transactions. Conversion of Renminbi for capital account items, such as direct investment, loans, securities investment and repatriation of investment, however, is still generally subject to the approval or verification of SAFE.

In March 2015, SAFE released the Circular on Reforming the Management Approach regarding the Foreign Exchange Capital Settlement of Foreign-Invested Enterprises, or FIEs, or the Foreign Exchange Capital Settlement Circular, which became effective from June 1, 2015. This circular replaced SAFE's previous related circulars, including the Circular on Issues Relating to the Improvement of Business Operation with Respect to the Administration of Foreign Exchange Capital Payment and Settlement of Foreign Invested Enterprises. The Foreign Exchange Capital Settlement Circular clarifies that FIEs may settle a specified proportion of their foreign exchange capital in banks at their discretion, and may choose the timing for such settlement. The proportion of foreign exchange capital to be settled at FIEs' discretion for the time being is 100% and the SAFE may adjust the proportion in due time based on the situation of international balance of payments. The circular also stipulates that FIEs' usage of capital and settled foreign exchange capital shall comply with relevant provisions concerning foreign exchange control and be subject to the management of a negative list. The FIEs' capital and Renminbi capital gained from the settlement of foreign exchange capital may not be directly or indirectly used for expenditure beyond the business scope of the FIEs or as prohibited by laws and regulations of the PRC. Such capital also may not be directly or indirectly used for issuing Renminbi entrusted loans except as permitted by the business scope of the FIE, for repaying inter-enterprise borrowings including any third-party advance, or for repaying the bank loans denominated in RMB that have been sub-lent to a third party. On June 9, 2016, SAFE issued the Circular on Reform and Regulating of the Administrative Policy of the Settlement under Capital Accounts, or SAFE Circular 16, which became effective on the same date. Pursuant to SAFE Circular 16, FIEs may either continue to follow the current payment-based foreign currency settlement system or choose to follow the conversion-at-will system for foreign currency settlement. Where a foreign-invested enterprise elects the conversion-at-will system for foreign currency settlement, it may convert, in part or in whole, the amount of the foreign currency in its capital account into Renminbi at any time. The converted Renminbi will be kept in a designated account labeled as settled but pending payment, and if such FIE needs to make payment from such designated account, it does not need to go through a lengthy approval process, but instead is only required to declare its intended use for such converted Renminbi. Although SAFE Circular 16 effectively simplifies the administrative process for converting foreign currencies into Renminbi for settlement of capital account items, the Notice on Further Promoting the Reform of Foreign Exchange Administration and Improving Authenticity and Compliance Review (Hui Fa [2017] No. 3), or Notice No. 3, released by SAFE on January 26, 2017, requires a domestic company to provide explanations to the banks through which it seeks to exchange currency of the sources of funds for investment and the intended use of such funds. Under Notice No. 3, submission of relevant corporate documents, including board resolutions and relevant contracts is also required to support a domestic company's claim of intended use. In 2018, SAFE adopted a number of additional regulations, but none have had a material impact on our operations. However, we closely monitor any changes and new regulatory releases, especially given the recently increased frequency of SAFE enforcement actions, to ensure that our operations remain in compliance.

In addition, the payment of dividends by entities established in the PRC is subject to limitations. Regulations in the PRC currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in the PRC. Each of our PRC subsidiaries that is a domestic company is also required to set aside at least 10.0% of its after-tax profit based on PRC accounting standards each year to its general reserves or statutory capital reserve fund until the accumulative amount of such reserves reach 50.0% of its respective registered capital. These restricted reserves are not distributable as cash dividends. In addition, if any of our PRC subsidiaries incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us.

Table of Contents

Furthermore, pursuant to regulations promulgated by SAFE, PRC subsidiaries of offshore parent companies may be prohibited from making distributions of profits to such offshore parent companies and from paying the offshore parent companies proceeds from any reduction in capital, share transfer or liquidation in respect of such PRC subsidiaries, if PRC shareholders with a direct or indirect stake in the offshore parent company fail to make the requisite SAFE registrations.

These regulations require PRC residents to file with the competent SAFE offices information about offshore companies in which they have directly or indirectly invested (including with respect to investments already made as of the inception of the new regulation) and to make follow-up filings in connection with certain material transaction involving such offshore companies, such as mergers or acquisitions, capital increases or decreases, and external equity investments or equity transfers.

Moreover, to discourage the outflow of capital from China, the overall current regulatory environment relating to foreign exchange controls in China suggests that, as a matter of practice, SAFE has been making it increasingly difficult to exchange Renmibi into foreign currencies for offshore dividend payments or capital account settlement. For additional information on the SAFE regulations and the related risks to our company, see Item 3.D. Risk Factors Risks Related to Doing Business in China The Chinese government has strengthened the regulation of investments made by Chinese residents in offshore companies and reinvestments in China made by these offshore companies. Our business may be adversely affected by these restrictions.

For more information about foreign exchange control, see Item 3.D. Risk Factors Risks Related to Our Company Our corporate structure may restrict our ability to receive dividends, loans or advances from, and transfer funds to, our PRC subsidiaries and VIEs, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner. and Risk Factors Risks Related to Doing Business in China Restrictions on currency exchange may limit our ability to utilize our revenues effectively.

## **E. Taxation**

The following summary of the material Cayman Islands and United States federal income tax consequences relevant to the purchase, ownership or sale of our ordinary shares or ADSs is based upon laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change. To the extent that the discussion relates to matters of Cayman Islands tax law, it represents the opinion of Maples and Calder (Hong Kong) LLP, or Maples and Calder, our Cayman Islands counsel.

### **Cayman Islands Taxation**

The Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty. There are no other taxes likely to be material to us levied by the government of the Cayman Islands except for stamp duties which may be applicable on instruments executed in, or after execution brought within, the jurisdiction of the Cayman Islands. The Cayman Islands is not party to any double tax treaties that are applicable to any payments made by or to our company. There are no exchange control regulations or currency restrictions in the Cayman Islands.

### **United States Federal Income Taxation**

The following discussion is a summary of certain United States federal income tax considerations applicable to the purchase, ownership and disposition of shares or ADSs by a U.S. Holder (as defined below) who holds such shares or ADSs as capital assets within the meaning of Section 1221 of the Internal Revenue Code of 1986, as amended (the Code ). This summary does not purport to be a complete analysis of all potential United States federal income tax effects. This summary is based on the Code, United States Treasury regulations promulgated thereunder, Internal Revenue Service ( IRS ) rulings and judicial decisions and the income tax treaty between the United States and the PRC, or the U.S.-PRC Tax Treaty, all as in effect on the date hereof. All of these are subject to change, possibly with retroactive effect, or to different interpretations. Such change could materially and adversely affect the tax consequences described below. No assurance can be given that the IRS would not assert, or that a court would not sustain, a position contrary to any of the tax consequences described below.

Table of Contents

This summary does not address all aspects of United States federal income taxation that may be relevant to particular U.S. Holders in light of their specific circumstances (for example, U.S. Holders subject to the alternative minimum tax provisions of the Code) or to holders that may be subject to special rules under United States federal income tax law, including:

- broker dealers in stocks, securities, commodities or currencies;
- persons (including securities traders) that use a mark-to-market accounting method;
- banks and financial institutions;
- insurance companies;
- regulated investment companies;
- real estate investment trusts;
- tax-exempt entities;
- persons holding shares or ADSs as part of a hedging or conversion transaction or a straddle;
- persons deemed to sell shares or ADSs under the constructive sale provisions of the Code;
- certain former citizens or residents of the United States;
- persons whose functional currency is not the U.S. dollar; and

- direct, indirect or constructive owners of 10% or more of the total combined vote or value of all classes of our equity.

This summary also does not discuss any aspect of state, local or non-U.S. tax law, or United States federal estate or gift tax law as applicable to U.S. Holders. Prospective purchasers are urged to consult their tax advisors about the United States federal, state and local and non-U.S. tax consequences to them of the purchase, ownership and disposition of shares or ADSs.

For purposes of this summary, U.S. Holder means a beneficial holder of shares or ADSs who or that for United States federal income tax purposes is:

- an individual citizen or resident of the United States;
- a corporation (or other entity classified as a corporation for United States federal income tax purposes) created or organized in or under the laws of the United States, any state thereof or the District of Columbia;
- an estate, the income of which is subject to United States federal income taxation regardless of its source; or
- a trust, if a court within the United States is able to exercise primary supervision over the administration of such trust and one or more U.S. persons (within the meaning of the Code) have the authority to control all substantial decisions of the trust, or if a valid election is in effect to be treated as a domestic trust.

If a partnership or other entity or arrangement classified as a partnership for United States federal income tax purposes holds shares or ADSs, the United States federal income tax treatment of a partner generally will depend on the status of the partner and the activities of the partnership. This summary does not address the tax consequences of any such partner. If you are a partner of a partnership holding shares or ADSs, you should consult your own tax advisor regarding the U.S. federal income tax consequences of acquiring, owning or disposing of our shares or ADSs.

Table of Contents

**ADSs**

The discussion below is written on the basis that the representations contained in the deposit agreement are true and that the obligations in the deposit agreement and any related agreement will be performed in accordance with the terms. If you hold ADSs, you generally will be treated as the owner of the underlying shares represented by those ADSs for United States federal income tax purposes. Accordingly, deposits or withdrawal of shares for ADSs will not be subject to United States federal income tax.

The U.S. Treasury has expressed concern that parties to whom ADSs are released before shares are delivered to the depository or intermediaries in the chain of ownership between holders and the issuer of the security underlying the ADSs, may be taking actions that are inconsistent with the claiming of foreign tax credits by U.S. Holders of ADSs. These actions would also be inconsistent with the claiming of the reduced rate of tax, described below, applicable to dividends received by certain non-corporate U.S. Holders. Accordingly, the creditability of non-U.S. withholding taxes (if any), and the availability of the reduced tax rate for dividends received by certain non-corporate U.S. Holders, each described below, could be affected by actions taken by such parties or intermediaries. For purposes of the discussion below, we assume that intermediaries in the chain of ownership between the holder of an ADS and us are acting consistently with the claim of U.S. foreign tax credits by U.S. Holders.

**Taxation of Dividends and Other Distributions on the Shares or ADSs**

Subject to the passive foreign investment company, or PFIC, rules discussed below, the gross amount of any distributions (including withheld taxes, if any) paid by our company out of current or accumulated earnings and profits (as determined for United States federal income tax purposes) generally will be taxable to a U.S. Holder as foreign source dividend income on the date such distribution is actually or constructively received, and will not be eligible for the dividends received deduction generally allowed to corporations. Distributions in excess of current and accumulated earnings and profits will be treated as a non-taxable return of capital to the extent of the U.S. Holder's adjusted tax basis in the shares or ADSs and thereafter as capital gain. However, we do not maintain calculations of our earnings and profits in accordance with United States federal income tax accounting principles. U.S. Holders should therefore assume that any distribution by our company with respect to the shares or ADSs will constitute dividend income. U.S. Holders should consult their own tax advisors with respect to the appropriate United States federal income tax treatment of any distribution received from our company. This discussion assumes that distributions, if any, will be made in U.S. dollars.

Certain dividends received by non-corporate U.S. Holders, including individuals, may be eligible for the special reduced rates normally applicable to long-term capital gains, provided that certain conditions are satisfied. A U.S. Holder is not able to claim the reduced rate for any year in which we are treated as a PFIC. See *Passive Foreign Investment Company Considerations*, below. Dividends may be taxed at the lower applicable capital gains rate provided that (1) our shares or ADSs, as applicable, are readily tradable on an established securities market in the United States, (2) our company is not a PFIC (as discussed below) for either our taxable year in which the dividends were paid or the preceding taxable year, and (3) certain holding period and other requirements are met. Because our ADSs are listed on the NASDAQ Global Select Market, they are considered for purposes of clause (1) above to be readily tradable on an established securities market in the United States. However, because our ordinary shares are not listed on an established securities market, we do not believe that dividends paid on our ordinary shares that are not represented by ADSs currently meet the conditions required for these reduced tax rates. There can be no assurance that our ADSs will be considered readily tradable on an established securities market in subsequent years.

In the event that dividends from our company are subject to withholding by the PRC, a U.S. Holder may be eligible, subject to a number of complex limitations, to claim a foreign tax credit in respect of foreign withholding taxes imposed on dividends received on the shares or ADSs. For purposes of calculating the U.S. foreign tax credit, dividends paid on our shares or ADSs will be treated as income from sources outside the

United States, and will generally constitute passive category income. A U.S. Holder who does not elect to claim a foreign tax credit for foreign income tax withheld, may instead claim a deduction, for United States federal income tax purposes, in respect of such withholdings, but only for a year in which such holder elects to do so for all creditable foreign income taxes. The U.S. foreign tax credit rules are complex. U.S. Holders should consult their own tax advisors regarding the foreign tax credit rules in light of their particular circumstances.



Table of Contents

**Taxation of Disposition of Shares or ADSs**

Subject to the PFIC rules discussed below, you will generally recognize taxable gain or loss on any sale or exchange or other taxable disposition of a share or ADS in an amount equal to the difference between the amount realized (determined in the case of a sale or exchange in a currency other than U.S. dollars by reference to the spot exchange rate in effect on the date of the sale or exchange or, if sold or exchanged on an established securities market and the U.S. Holder is a cash basis taxpayer or an electing accrual basis taxpayer, the spot exchange rate in effect on the settlement date) for the share or ADS and your adjusted tax basis (in U.S. dollars) in the share or ADS. A U.S. Holder's initial tax basis will be the U.S. Holder's U.S. dollar purchase price for such share or ADS. The gain or loss will generally be capital gain or loss and will be long-term capital gain or loss if you have held the share or ADS for more than one year. Long-term capital gains of non-corporate U.S. Holders are eligible for reduced rates of taxation. The deductibility of a capital loss may be subject to limitations. Any gain or loss that you recognize generally will be treated as United States source gain or loss for United States foreign tax credit purposes. In the event PRC tax were to be imposed on any gain from the disposition of shares or ADSs, such gain may be treated as PRC source gain under the U.S.-PRC Tax Treaty, in which case a U.S. Holder eligible for treaty benefits may be able to claim a foreign tax credit, subject to applicable limitations. Because the determination of treaty benefit eligibility is fact intensive and depends upon a holder's particular circumstances, U.S. Holders should consult their tax advisors regarding U.S.-PRC Tax Treaty benefit eligibility. U.S. Holders are also encouraged to consult their own tax advisors regarding the tax consequences in the event PRC tax were to be imposed on a disposition of shares or ADSs, including the availability of the U.S. foreign tax credit and the ability and whether to treat any gain as PRC source gain for the purposes of the U.S. foreign tax credit in consideration of their particular circumstances.

**Tax on Net Investment Income**

A 3.8% tax is imposed on the net investment income (as defined in section 1411 of the Code) of individuals whose income exceeds certain threshold amounts, and of certain trusts and estates under similar rules. U.S. Holders should consult their tax advisors regarding the applicability of this net investment income tax in respect of an investment in our company in light of their particular circumstances.

**Passive Foreign Investment Companies**

A non-U.S. corporation will be classified as a PFIC for any taxable year in which, after taking into account the income and assets of the corporation and certain subsidiaries pursuant to applicable look-through rules, either (i) at least 75% of its gross income is passive income or (ii) at least 50% of the average value (determined on a quarterly basis) of its assets is attributable to assets which produce passive income or are held for the production of passive income. Passive income generally includes dividends, interest, rents and royalties (other than certain rents and royalties derived in the active conduct of a trade or business), annuities and gains from assets that produce passive income.

We will be treated as owning our proportionate share of the assets and earning our proportionate share of the income of any other corporation in which we own, directly or indirectly, more than 25% (by value) of the stock.

Additionally, if we are classified as a PFIC in any taxable year with respect to which a U.S. Holder owns shares or ADSs, we generally will continue to be treated as a PFIC with respect to such U.S. Holder in all succeeding taxable years, regardless of whether we continue to meet the tests described above, unless the U.S. Holder makes the deemed sale election described below. Furthermore, if we are treated as a PFIC then one or more of our subsidiaries may also be treated as PFICs.

Based on certain estimates of our gross income and gross assets (which estimates are inherently imprecise), we do not believe that we were a PFIC for taxable year 2018 for United States federal income tax purposes. The determination of whether we will be classified as a PFIC is made annually and depends on particular facts and circumstances. In particular, the fair market value of some of our company's assets may be determined in large part by the market price of the ADSs, which is likely to fluctuate. In addition, the composition of our company's income and assets will be affected by how, and how quickly, our company spends any cash that is raised. Thus, no assurance can be provided that our company would not be classified as a PFIC for any future taxable year. Furthermore, while we believe our valuation approach is reasonable, it is possible that the IRS could challenge our determination concerning our PFIC status. For these reasons, there can be no assurance that we were not a PFIC in 2018 or that we will not be a PFIC for any future taxable year.

Table of Contents

***U.S. Federal Income Tax Treatment of a Shareholder of a PFIC***

If our company is classified as a PFIC for any taxable year during which a U.S. Holder owns shares or ADSs, the U.S. Holder, absent certain elections (including a mark-to-market election and a QEF election as described below), will generally be subject to adverse rules (regardless of whether our company continues to be classified as a PFIC) with respect to (i) any excess distributions (generally, any distributions received by the U.S. Holder on the shares or ADSs in a taxable year that are greater than 125% of the average annual distributions received by the U.S. Holder in the three preceding taxable years or, if shorter, the U.S. Holder's holding period for the shares or ADSs) and (ii) any gain realized on the sale or other disposition of shares or ADSs.

Under these rules (a) the excess distribution or gain will be allocated ratably over the U.S. Holder's holding period, (b) the amount allocated to the current taxable year and any taxable year prior to the first taxable year in which our company is classified as a PFIC will be taxed as ordinary income, and (c) the amount allocated to each of the other taxable years during which our company was classified as a PFIC will be subject to tax at the highest rate of tax in effect for the applicable category of taxpayer for that year and an interest charge will be imposed with respect to the resulting tax attributable to each such other taxable year.

If we are a PFIC in any year with respect to a U.S. Holder, and any of our subsidiaries are also PFICs, such U.S. Holder will be treated as owning a proportionate share (by value) of the shares of the lower-tier PFICs for purposes of these rules. Non-corporate U.S. Holders will not be eligible for the reduced tax rate on any dividends received from us if we are a PFIC in the taxable year in which such dividends are paid or in the preceding taxable year.

If we are classified as a PFIC and then cease to be so classified, a U.S. Holder may make an election (a deemed sale election) to be treated for U.S. federal income tax purposes as having sold such U.S. Holder's ordinary shares or ADSs on the last day of our taxable year during which we were a PFIC. A U.S. Holder that makes a deemed sale election would then cease to be treated as owning stock in a PFIC. However, gain recognized as a result of making the deemed sale election would be subject to the adverse rules described above and loss would not be recognized.

***Mark-to-Market Election***

In certain circumstances, a U.S. Holder may be eligible to make a mark-to-market election with respect to its shares or ADSs if such shares or ADSs qualify as marketable stock under applicable U.S. federal income tax rules. For purposes of these rules, marketable stock is stock which is regularly traded (traded in greater than de minimis quantities on at least 15 days during each calendar quarter) on a qualified exchange or other market within the meaning of applicable U.S. Treasury regulations. A qualified exchange includes a national securities exchange that is registered with the SEC.

A U.S. Holder that makes an effective mark-to-market election must include in gross income, as ordinary income, rather than capital gain, for each taxable year an amount equal to the excess, if any, of the fair market value of the shares or ADSs, as applicable, at the close of the taxable year over the U.S. Holder's adjusted basis in the shares or ADSs.

## Edgar Filing: NetEase, Inc. - Form 20-F

An electing U.S. Holder may also claim an ordinary loss deduction for the excess, if any, of the U.S. Holder's adjusted tax basis in such shares or ADSs over their fair market value at the close of the taxable year, but this deduction is allowable only to the extent of any net mark-to-market gains previously included in income pursuant to the mark-to-market election. The adjusted tax basis of a U.S. Holder's shares or ADSs with respect to which the mark-to-market election applies would be adjusted to reflect amounts included in gross income or allowed as a deduction because of such election. If a U.S. Holder makes an effective mark-to-market election with respect to our shares or ADSs, gains from an actual sale or other disposition of such shares or ADSs in a year in which we are a PFIC would be treated as ordinary income, and any losses incurred on such sale or other disposition would be treated as ordinary losses to the extent of any net mark-to-market gains previously included in income.

Table of Contents

If we are classified as a PFIC for any taxable year in which a U.S. Holder owns shares or ADSs but before a mark-to-market election is made, the adverse PFIC rules described above will apply to any mark-to-market gain recognized in the year the election is made. Otherwise, a mark-to-market election will be effective for the taxable year for which the election is made and all subsequent taxable years unless the shares or ADSs are no longer regularly traded on a qualified exchange or the IRS consents to the revocation of the election. Our ADSs are listed on the NASDAQ Global Select Market, which is a qualified exchange or other market for purposes of the mark-to-market election. Consequently, if the ADSs continue to be so listed, and are regularly traded for purposes of these rules (for which no assurance can be given) we expect that the mark-to-market election would be available to a U.S. Holder with respect to our ADSs.

A mark-to-market election is not permitted for the shares of any of our subsidiaries that are also classified as PFICs. Prospective investors should consult their own tax advisors regarding the availability of, and the procedure for, and the effect of making, a mark-to-market election, and whether making the election would be advisable, including in light of their particular circumstances.

***QEF Election***

The PFIC rules permit a holder of PFIC stock in certain circumstances to avoid some of the disadvantageous tax treatment described above by making a qualified electing fund, or QEF, election to be taxed currently on its share of the PFIC's undistributed income. We do not, however, intend to provide the information regarding our income that the U.S. Investor would need to make a QEF election if we are classified as a PFIC.

If we are a PFIC in any year with respect to a U.S. Holder, and any of our subsidiaries are also PFICs, such U.S. Holder will be treated as owning a proportionate share (by value) of the shares of the lower-tier PFICs for purposes of these rules. Non-corporate U.S. Holders will not be eligible for the reduced tax rate on any dividends received from us if we are a PFIC in the taxable year in which such dividends are paid or in the preceding taxable year.

If we are a PFIC in any year with respect to a U.S. Holder, such U.S. Holder will be required to file an annual information return on IRS Form 8621 regarding distributions received on our shares or ADSs and any gain realized on the disposition of our shares or ADSs, and certain U.S. Holders will be required to file an annual information return (also on IRS Form 8621) relating to their ownership of our shares or ADSs.

U.S. Holders should consult their tax advisors regarding the potential application of the PFIC regime, including eligibility for and the manner and advisability of making a mark-to-market election and related reporting requirements.

**Information Reporting and Backup Withholding; Specified Foreign Financial Assets**

The proceeds of a sale or other disposition, as well as dividends paid with respect to shares or ADSs by a United States payor (including any payments received from a U.S. financial intermediary), generally will be reported to the IRS and to the U.S. Holder as required under applicable regulations. Backup withholding tax may apply to these payments if the U.S. Holder fails to timely provide an accurate taxpayer identification number or otherwise fails to comply with, or establish an exemption from, such backup withholding tax requirements. Certain U.S. Holders (including, among others, certain corporations) are not subject to the information reporting or backup withholding tax requirements described herein. U.S. Holders should consult their tax advisors as to their qualification for exemption from backup withholding tax and the procedure for

establishing an exemption.

Certain U.S. Holders of specified foreign financial assets with an aggregate value in excess of the applicable dollar threshold are required to report information relating to their holding of stock or securities issued by a non-U.S. person (such as our company), subject to certain exceptions (including an exception for shares held in accounts maintained by certain financial institutions) with their tax return for each year in which they hold such stock or securities. U.S. Holders should consult their own tax advisors regarding the information reporting obligations that may arise from their acquisition, ownership or disposition of our shares or ADSs.

Table of Contents

THE ABOVE DISCUSSION DOES NOT COVER ALL TAX MATTERS THAT MAY BE OF IMPORTANCE TO A PARTICULAR INVESTOR. PROSPECTIVE INVESTORS ARE STRONGLY URGED TO CONSULT THEIR OWN TAX ADVISORS ABOUT THE TAX CONSEQUENCES OF AN INVESTMENT IN OUR ORDINARY SHARES OR ADSs.

**Enforcement of Civil Liabilities**

We are an exempted company incorporated in the Cayman Islands because of the following benefits found there:

- political and economic stability;
- an effective judicial system;
- a favorable tax system;
- the absence of exchange control or currency restrictions; and
- the availability of professional and support services.

However, certain disadvantages accompany incorporation in the Cayman Islands. These disadvantages include, but are not limited to, the following:

- the Cayman Islands has a less developed body of securities laws as compared to the United States and provides significantly less protection to investors; and
- Cayman Islands companies may not have standing to sue before the federal courts of the United States.

Our constituent documents do not contain provisions requiring that disputes, including those arising under the securities laws of the United States, between us, our officers, directors and shareholders be arbitrated.

A substantial portion of our current operations is conducted in China through our wholly-owned subsidiaries which are incorporated in China, Hong Kong, the British Virgin Islands or the Cayman Islands. All or most of our assets are located in China. A majority of our directors and officers are nationals or residents of jurisdictions other than the United States and a substantial portion of their assets are located outside the United States. As a result, it may be difficult for a shareholder to effect service of process within the United States upon these persons, or to enforce against us or them judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States.

Maples and Calder (Hong Kong) LLP, our counsel as to Cayman Islands law, and Jun He Lawyers, our counsel as to Chinese law, have advised us, respectively, that there is uncertainty as to whether the courts of the Cayman Islands or China would:

(1) recognize or enforce judgments of United States courts obtained against us or our directors or officers predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States; or

(2) entertain original actions brought in the Cayman Islands or China against us or our directors or officers predicated upon the securities laws of the United States or any state in the United States.

Maples and Calder (Hong Kong) LLP has further advised us that there is uncertainty under Cayman Islands law with regard to whether a judgment obtained from the United States courts under the civil liability provisions of the securities laws will be determined by the courts of the Cayman Islands as penal or punitive in nature. If such a determination is made, the courts of the Cayman Islands will not recognize or enforce the judgment against a Cayman company. Because the courts of the Cayman Islands have yet to rule on whether such judgments are penal or punitive in nature, it is uncertain whether they would be enforceable in the Cayman Islands. Maples and Calder (Hong Kong) LLP has advised us that although there is no statutory enforcement in the Cayman Islands of judgments obtained in the federal or state courts of the United States, a judgment obtained in a foreign court of competent jurisdiction will be recognized and enforced in the courts of the Cayman Islands at common law, without any re-examination of the merits of the underlying dispute, by an action commenced on the foreign judgment debt in the Grand Court of the Cayman Islands, provided that such judgment: (a) is given by a foreign court of competent jurisdiction; (b) imposes on the judgment debtor a liability to pay a liquidated sum for which the judgment has been given; (c) is final; (d) is not in respect of taxes, a fine or a penalty; and (e) was not obtained in a manner and is not of a kind the enforcement of which is contrary to natural justice or the public policy of the Cayman Islands.



Table of Contents

Jun He Lawyers has advised us further that the recognition and enforcement of foreign judgments are provided for under Chinese Civil Procedures Law. Chinese courts may recognize and enforce foreign judgments in accordance with the requirements of Chinese Civil Procedures Law based either on treaties between China and the country where the judgment is made or on reciprocity between jurisdictions.

**F. Dividends and Paying Agents**

Not applicable.

**G. Statement by Experts**

Not applicable.

**H. Documents on Display**

We have previously filed with the SEC our registration statement on Form F-1 and prospectus under the Securities Act of 1933, as amended, with respect to our ADSs.

We are subject to the periodic reporting and other informational requirements of the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the SEC. Specifically, we are required to file annually a Form 20-F within four months after the end of each fiscal year. Copies of reports and other information, when so filed, may be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the SEC at 100 F Street, N.E., Washington, D.C. 20549. You can request copies of these documents upon payment of a duplicating fee, by writing to the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act.

Our financial statements have been prepared in accordance with U.S. GAAP.

## Edgar Filing: NetEase, Inc. - Form 20-F

In accordance with NASDAQ Marketplace Rule 5250(d)(1), we will post this annual report on Form 20-F on our website at <http://ir.netease.com> under the heading Annual Reports. In addition, we will provide hardcopies of our annual report free of charge to shareholders and ADS holders upon request.

### **I. Subsidiary Information**

Not applicable.

### **Item 11. Quantitative and Qualitative Disclosures About Market Risk**

Please refer to Item 5.F. Operating and Financial Review and Prospects Quantitative and Qualitative Disclosures About Market Risk.

Table of Contents

**Item 12. Description of Securities Other than Equity Securities**

**A. Debt Securities**

Not applicable.

**B. Warrants and Rights**

Not applicable.

**C. Other Securities**

Not applicable.

**D. American Depositary Shares**

**Fees and charges our ADS holders may have to pay**

The Bank of New York Mellon, the depository of our ADS program, collects its fees for delivery and surrender of ADSs directly from investors depositing ordinary shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depository collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depository may refuse to provide fee-attracting services until its fees for those services are paid.

**Persons depositing or withdrawing shares must pay:**

Up to US\$0.05 per ADS

**For:**

- Issuance of ADSs, including issuances resulting from a distribution of ordinary shares or rights or other property
- Cancellation or withdrawals of ADSs

- Distribution of ADSs pursuant to stock dividends, free stock distributions or exercise of rights
- Distributions of securities other than ADSs or rights to purchase additional ADSs
- Distributions of cash dividends or other cash distributions
- Transfer of American depositary receipts, or ADRs
- As necessary

Up to US\$0.01 per ADS

US\$1.5 per certificate presented for transfer

Taxes and other governmental charges the depositary or the custodian have to pay on any ADS or ordinary shares underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes

**Fees and other payments made by the depositary to us**

We did not receive any direct or indirect payment from the depositary in 2018, except that the depositary has agreed to waive certain fees for standard costs associated with the administration of the ADS program and waived such costs in an aggregate amount of US\$26,339 for the year ended December 31, 2018.

Table of Contents

**PART II**

**Item 13. Defaults, Dividend Arrearages and Delinquencies**

None.

**Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds**

Not applicable.

**Item 15. Controls and Procedures**

**Disclosure Controls and Procedures**

Our management, with the participation of William Lei Ding, our Chief Executive Officer, and Charles Zhaoxuan Yang, our Chief Financial Officer, have conducted an evaluation pursuant to Rule 13a-15 promulgated under the Exchange Act, as amended, of the effectiveness of our disclosure controls and procedures as of December 31, 2018. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that such disclosure controls and procedures were effective as of December 31, 2018.

**Management's Annual Report on Internal Control over Financial Reporting**

Our management's annual report on internal control over financial reporting is included in this annual report on pages F-1. PricewaterhouseCoopers Zhong Tian LLP, our independent registered public accounting firm, audited the effectiveness of our company's internal control over the financial reporting period of December 31, 2018 as stated in this annual report on pages F-2.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal controls over financial reporting identified in connection with the evaluation required by Rules 13a-15 or 15d-15 that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Item 16A.                      Audit Committee Financial Expert**

Our board of directors has determined that Mr. Joseph Tong qualifies as an audit committee financial expert as defined by the applicable rules of the SEC and that Mr. Tong is independent as that term is defined in NASDAQ Marketplace Rule 5605(a)(2).

**Item 16B.                      Code of Ethics**

We have adopted a Code of Business Conduct which applies to our employees, officers and non-employee directors, including our principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions. This code is intended to qualify as a code of ethics within the meaning of the applicable rules of the SEC.

Table of Contents**Item 16C. Principal Accountant Fees and Services****Disclosure of Fees Charged by Independent Accountants**

The following table summarizes the fees charged by PricewaterhouseCoopers Zhong Tian LLP and its affiliates for certain services rendered to our company during 2017 and 2018.

	For the year ended December 31,	
	2017(1)	2018(1)
	RMB (in thousands)	
Audit fees (2)	11,400	15,250
Tax fees(3)	796	595
All other fees(4)	292	192
Total	12,488	16,037

(1) The fees disclosed are exclusive of out-of-pocket expenses on the amounts paid, which totaled approximately RMB771,000 and RMB1,033,000 in 2017 and 2018, respectively.

(2) Audit fees means the aggregate fees billed in each of the fiscal years for professional services rendered by our principal auditors for the audit of our annual financial statements and our internal controls over financial reporting.

(3) Tax fees means the aggregate fees billed in each of the fiscal years for professional services rendered by our principal auditors for tax compliance and tax advice.

(4) All other fees includes the aggregate fees billed in each of the fiscal years for non-audit services rendered which were not listed above.

**Audit Committee Pre-approval Policies and Procedures**

Our audit committee has adopted procedures which set forth the manner in which the committee will review and approve all audit and non-audit services to be provided by PricewaterhouseCoopers Zhong Tian LLP before that firm is retained for such services. The pre-approval procedures are as follows:

- Any audit or non-audit service to be provided to us by the independent accountant must be submitted to the audit committee for review and approval, with a description of the services to be performed and the fees to be charged.
- The audit committee in its sole discretion then approves or disapproves the proposed services and documents such approval, if given, through written resolutions or in the minutes of meetings, as the case may be.

**Item 16D. Exemptions from the Listing Standards for Audit Committees**

We have not sought an exemption from the applicable listing standards for the audit committee of our board of directors.



Table of Contents**Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

On November 15, 2017, we announced a share repurchase program authorized by our board of directors, pursuant to which we were authorized to purchase up to US\$1.0 billion worth of our issued and outstanding ADSs on the NASDAQ Global Select Market. On June 11, 2018, our board of directors approved an amendment to this share repurchase program, authorizing the repurchase of up to an additional US\$1.0 billion worth of our issued and outstanding ADSs. After such amendment, we were authorized to repurchase a total of US\$2.0 billion worth of our issued and outstanding ADSs on the NASDAQ Global Select Market. This share repurchase program expired on November 14, 2018. This table below shows the ADSs that we repurchased under this program as of November 14, 2018, the last day of such program.

<b>Period</b>	<b>Total Number of ADSs Purchased(1)</b>	<b>Average Price Paid Per ADS US\$</b>	<b>Total Number of ADSs Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Approximate Maximum Dollar Value of ADSs that May Yet Be Purchased Under the Plans or Programs US\$</b>
February 2018	441,771	306.08	441,771	864,782,094
March 2018	796,534	302.20	796,534	624,069,583
April 2018	559,130	270.17	559,130	473,010,396
May 2018	713,014	245.41	713,014	298,027,752
June 2018	847,809	247.67	847,809	1,088,047,058
July 2018	270,224	259.02	270,224	1,018,053,727
August 2018	678,189	206.41	678,189	878,069,043
September 2018	235,933	193.93	235,933	832,314,957
October 2018	53,322	201.14	53,322	821,589,544
November 2018 (through November 14, 2018)(2)	400	209.86	400	821,505,599
<b>Total</b>	<b>4,596,326</b>		<b>4,596,326</b>	

(1) Our ADS to ordinary share ratio is one ADS for every 25 ordinary shares.

(2) This repurchase program expired on November 14, 2018.

On November 14, 2018, we announced a new share repurchase program authorized by our board of directors, pursuant to which we were authorized to purchase up to US\$1.0 billion worth of our outstanding ADSs. This program will expire on November 15, 2019.

**Item 16F. Change in Registrant's Certifying Accountants**

Not applicable.

**Item 16G. Corporate Governance**

As permitted by NASDAQ, in lieu of the NASDAQ corporate governance rules, but subject to certain exceptions, we may follow the practices of our home country which for the purpose of such rules is the Cayman Islands. Specifically, our board of directors adopted our RSU Plan without seeking shareholder approval which is generally required under Rule 5635(c) of the NASDAQ Marketplace Rules. There is no specific requirement under Cayman Islands law for shareholder approval to be obtained with respect to the establishment or amendment of equity compensation arrangements.

**Item 16H. Mine Safety Disclosure**

Not applicable.

**PART III**

**Item 17. Financial Statements**

We have elected to provide financial statements pursuant to Item 18.

**Item 18. Financial Statements**

The consolidated financial statements for NetEase, Inc. and its subsidiaries are included at the end of this annual report.

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

#### Item 19. Exhibits

<b>Exhibit Number</b>	<b>Document</b>
1.1	Amended and Restated Memorandum of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
1.2	Amended and Restated Articles of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.2 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
1.3	<u>Amendment to Amended and Restated Articles of Association of NetEase.com, Inc. dated as of June 6, 2003 (incorporated by reference to Exhibit 1.3 to the company's Annual Report on Form 20-F for the year ended December 31, 2002 filed with the SEC on June 27, 2003)</u>
2.1	Specimen American Depositary Receipt of NetEase.com, Inc. (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
2.2	Specimen Stock Certificate of NetEase.com, Inc. (incorporated by reference to Exhibit 4.2 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
3.1	<u>Proxy Agreement dated April 15, 2009 between NetEase (Hangzhou) Network Co., Ltd. and Zhipeng Hu (incorporated by reference to Exhibit 3.3 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
3.2	<u>Shareholder Voting Rights Trust Agreement dated December 1, 2015 between NetEase (Hangzhou) Network Co., Ltd. and Tianlei Hu (incorporated by reference to Exhibit 3.8 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
3.3	<u>Shareholder Voting Rights Trust Agreement dated December 1, 2015 between NetEase (Hangzhou) Network Co., Ltd. and Zhipeng Hu (incorporated by reference to Exhibit 3.9 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
3.4	<u>Shareholder Voting Rights Trust Agreement dated November 30, 2015 between NetEase Media Technology (Beijing) Co., Ltd. and Li Li (incorporated by reference to Exhibit 3.6 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
3.5	<u>Shareholder Voting Rights Trust Agreement dated November 30, 2015 between NetEase Media Technology (Beijing) Co., Ltd. and William Lei Ding (incorporated by reference to Exhibit 3.5 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
3.6	<u>Amended and Restated Shareholder Voting Right Trust Agreement dated November 30, 2015 among NetEase Information Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd. (now known as Beijing NetEase Media Co., Ltd.) William Lei Ding and Xiaojun Hui (incorporated by reference to Exhibit 3.7 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
3.7	<u>Shareholder Voting Rights Trust Agreement dated September 26, 2016 between NetEase Youdao Information Technology (Beijing) Co., Ltd. and William Lei Ding (incorporated by reference to Exhibit 3.6 to the company's Annual Report on Form 20-F for the year ended December 31, 2016 filed with the SEC on April 21, 2017)</u>
3.8	<u>Shareholder Voting Right Trust Agreement dated November 20, 2017 between NetEase Youdao Information Technology (Beijing) Co., Ltd. and Feng Zhou (incorporated by reference to Exhibit 3.8 to the company's Annual Report on Form 20-F for the year ended December 31, 2017 filed with the SEC on April 20, 2018)</u>
4.1	

Edgar Filing: NetEase, Inc. - Form 20-F

2009 Restricted Share Unit Plan (incorporated by reference to Exhibit 10.1 to the company's Registration Statement on Form S-8 (file no. 333-164249) filed with the SEC on January 8, 2010)

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

<b>Exhibit Number</b>	<b>Document</b>
4.2	<u>Form of Employment Agreement between NetEase.com, Inc. and its executive officers (incorporated by reference to Exhibit 4.3 to the company's Annual Report on Form 20-F for the year ended December 31, 2009 filed with the SEC on June 29, 2010)</u>
4.3	Domain Name License Agreement dated February 3, 2000 between NetEase.com, Inc. (now known as NetEase, Inc.) and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.7 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)
4.4	Copyright License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.8 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)
4.5	Trademark License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.9 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)
4.6	Supplemental Agreement (to Copyright License Agreement and Domain Name License Agreement) dated April 27, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.10 to Amendment No.1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
4.7	Notice of Renewal dated April 2, 2001 relating to the Copyright License Agreement and the Trademark License Agreement each dated February 3, 2000 and made between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 4.14 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001)
4.8	Online Advertising Agreement dated February 15, 2000 between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.15 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)
4.9	Notice of Renewal dated April 2, 2001 relating to the Online Advertising Agreement dated February 15, 2000 and made between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 4.21 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001)
4.10	Supplemental Agreement dated May 15, 2000 (amending the Domain Name License Agreement) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.37 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
4.11	Agreement dated May 12, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.41 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
4.12	Supplemental Agreement dated May 12, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000) between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.47 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

<b>Exhibit Number</b>	<b>Document</b>
4.13	Supplemental Agreement dated May 15, 2000 (supplementing the Domain Name License Agreement dated February 3, 2000) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.48 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)
4.14	Letter of Agreement, dated June 6, 2000, among William Lei Ding, Bo Ding and NetEase.com, Inc. (incorporated by reference to Exhibit 10.49 to Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on June 15, 2000)
4.15	Supplemental Agreement dated June 15, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000), between Beijing Guangyitong Advertising Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.50 to Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on June 15, 2000)
4.16	<u>Supplemental Letter of Agreement dated May 17, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.39 to the company's Annual Report on Form 20-F for the year ended December 31, 2004 filed with the SEC on June 27, 2005)</u>
4.17	<u>Second Supplemental Letter of Agreement dated July 15, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc., as supplemented by the Supplemental Letter of Agreement dated May 17, 2004 by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.40 to the company's Annual Report on Form 20-F for the year ended December 31, 2004 filed with the SEC on June 27, 2005)</u>
4.18	<u>No. 3 Supplemental Letter of Agreement dated July 20, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc., as supplemented by the Supplemental Letter of Agreement dated May 17, 2004 and the Second Supplemental Letter of Agreement dated July 15, 2004, each by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.41 to the company's Annual Report on Form 20-F for the year ended December 31, 2004 filed with the SEC on June 27, 2005)</u>
4.19	<u>Form of Cooperative Agreement (incorporated by reference to Exhibit 4.25 to the company's Annual Report on Form 20-F for the year ended December 31, 2012 filed with the SEC on April 22, 2013)</u>
4.20	<u>Loan Agreement dated March 23, 2009 between NetEase (Hangzhou) Network Co., Ltd. and Zhipeng Hu (incorporated by reference to Exhibit 4.25 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.21	<u>Loan Agreement dated March 23, 2009 between NetEase (Hangzhou) Network Co., Ltd. and Gang Chen (incorporated by reference to Exhibit 4.26 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.22	<u>Equity Pledge Agreement dated April 15, 2009 between NetEase (Hangzhou) Network Co., Ltd. and Zhipeng Hu (incorporated by reference to Exhibit 4.27 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

<b>Exhibit Number</b>	<b>Document</b>
4.23	<u>Equity Pledge Agreement dated April 15, 2009 between NetEase (Hangzhou) Network Co., Ltd. and Gang Chen (incorporated by reference to Exhibit 4.28 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.24	<u>Exclusive Purchase Option Agreement dated April 15, 2009 among NetEase (Hangzhou) Network Co., Ltd., Gang Chen and Hangzhou Leihuo Network Co., Ltd (incorporated by reference to Exhibit 4.29 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.25	<u>Exclusive Purchase Option Agreement dated April 15, 2009 among NetEase (Hangzhou) Network Co., Ltd., Zhipeng Hu and Hangzhou Leihuo Network Co., Ltd (incorporated by reference to Exhibit 4.30 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.26	<u>Operating Agreement dated April 15, 2009 among NetEase (Hangzhou) Network Co., Ltd., Zhipeng Hu, Gang Chen and Hangzhou Leihuo Network Co., Ltd (incorporated by reference to Exhibit 4.31 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.27	<u>Cooperation Agreement dated January 1, 2010 between NetEase (Hangzhou) Network Co., Ltd. and Hangzhou Leihuo Network Co., Ltd (incorporated by reference to Exhibit 4.32 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.28	<u>Amendment and Novation of Operating Agreement dated May 1, 2014 among NetEase Information Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd., Bo Ding and William Lei Ding (incorporated by reference to Exhibit 4.33 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.29	<u>Amendment and Novation of Letter of Agreement dated May 1, 2014 among NetEase Inc., William Lei Ding, Bo Ding and Xiaojun Hui (incorporated by reference to Exhibit 4.34 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.30	<u>Loan Agreement dated May 1, 2014 between NetEase Information Technology (Beijing) Co., Ltd. and Xiaojun Hui (incorporated by reference to Exhibit 4.35 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.31	<u>Equity Pledge Agreement dated May 1, 2014 between NetEase Information Technology (Beijing) Co., Ltd. and Xiaojun Hui (incorporated by reference to Exhibit 4.36 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)</u>
4.32	<u>Loan Agreement dated November 30, 2015 between NetEase Media Technology (Beijing) Co., Ltd. and William Lei Ding (incorporated by reference to Exhibit 4.37 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.33	<u>Loan Agreement dated November 30, 2015 between NetEase Media Technology (Beijing) Co., Ltd. and Li Li (incorporated by reference to Exhibit 4.38 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.34	<u>Equity Pledge Agreement dated November 30, 2015 between NetEase Media Technology (Beijing) Co., Ltd. and William Lei Ding (incorporated by reference to Exhibit 4.39 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.35	<u>Equity Pledge Agreement dated November 30, 2015 between NetEase Media Technology (Beijing) Co., Ltd. and Li Li (incorporated by reference to Exhibit 4.40 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>





## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

<b>Exhibit Number</b>	<b>Document</b>
4.36	<u>Exclusive Purchase Option Agreement dated November 30, 2015 among NetEase Media Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd. and William Lei Ding (incorporated by reference to Exhibit 4.41 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.37	<u>Exclusive Purchase Option Agreement dated November 30, 2015 among NetEase Media Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd. and Li Li (incorporated by reference to Exhibit 4.42 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.38	<u>Operating Agreement dated November 30, 2015 among NetEase Media Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd., William Lei Ding and Li Li (incorporated by reference to Exhibit 4.43 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.39	<u>Amended and Restated Letter of Agreement dated November 30, 2015 among NetEase, Inc., William Lei Ding and Xiaojun Hui (incorporated by reference to Exhibit 4.44 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.40	<u>Loan Agreement dated December 1, 2015 between NetEase (Hangzhou) Network Co., Ltd. and Tianlei Hu (incorporated by reference to Exhibit 4.45 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.41	<u>Loan Agreement dated December 1, 2015 between NetEase (Hangzhou) Network Co., Ltd. and Zhipeng Hu. (incorporated by reference to Exhibit 4.46 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.42	<u>Amended and Restated Equity Pledge Agreement dated December 1, 2015 between NetEase (Hangzhou) Network Co., Ltd. and Tianlei Hu (incorporated by reference to Exhibit 4.47 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.43	<u>Amended and Restated Equity Pledge Agreement dated December 1, 2015 between NetEase (Hangzhou) Network Co., Ltd. and Zhipeng Hu. (incorporated by reference to Exhibit 4.48 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.44	<u>Exclusive Purchase Option Agreement dated December 1, 2015 among NetEase (Hangzhou) Network Co., Ltd., Hangzhou NetEase Leihuo Network Co., Ltd. and Tianlei Hu (incorporated by reference to Exhibit 4.49 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.45	<u>Exclusive Purchase Option Agreement dated December 1, 2015 among NetEase (Hangzhou) Network Co., Ltd., Hangzhou NetEase Leihuo Network Co., Ltd. and Zhipeng Hu (incorporated by reference to Exhibit 4.50 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.46	<u>Operating Agreement dated December 1, 2015 among NetEase (Hangzhou) Network Co., Ltd., Hangzhou NetEase Leihuo Network Co., Ltd., Tianlei Hu and Zhipeng Hu (incorporated by reference to Exhibit 4.51 to the company's Annual Report on Form 20-F for the year ended December 31, 2015 filed with the SEC on April 22, 2016)</u>
4.47	<u>Loan Agreement dated September 26, 2016 between William Lei Ding and NetEase Youdao Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 4.51 to the company's Annual Report on Form 20-F for the year ended December 31, 2016 filed with the SEC on April 21, 2017)</u>

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

<b>Exhibit Number</b>	<b>Document</b>
4.48	<u>Equity Pledge Agreement dated September 26, 2016 between William Lei Ding and NetEase Youdao Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 4.52 to the company's Annual Report on Form 20-F for the year ended December 31, 2016 filed with the SEC on April 21, 2017)</u>
4.49	<u>Exclusive Purchase Option Agreement dated September 26, 2016 among William Lei Ding, NetEase Youdao Information Technology (Beijing) Co., Ltd. and Youdao Computer System Co., Ltd. (incorporated by reference to Exhibit 4.53 to the company's Annual Report on Form 20-F for the year ended December 31, 2016 filed with the SEC on April 21, 2017)</u>
4.50	<u>Operating Agreement dated September 26, 2016 among Youdao Computer System Co., Ltd., NetEase Youdao Information Technology (Beijing) Co., Ltd. and William Lei Ding. (incorporated by reference to Exhibit 4.54 to the company's Annual Report on Form 20-F for the year ended December 31, 2016 filed with the SEC on April 21, 2017)</u>
4.51	<u>Cooperation Agreement dated July 1, 2015 between NetEase Youdao Information Technology (Beijing) Co., Ltd. and Youdao Computer System Co., Ltd. (incorporated by reference to Exhibit 4.55 to the company's Annual Report on Form 20-F for the year ended December 31, 2016 filed with the SEC on April 21, 2017)</u>
4.52	<u>Loan Agreement dated November 20, 2017 between Feng Zhou and NetEase Youdao Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 4.52 to the company's Annual Report on Form 20-F for the year ended December 31, 2017 filed with the SEC on April 20, 2018)</u>
4.53	<u>Equity Pledge Agreement dated November 20, 2017 between Feng Zhou and NetEase Youdao Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 4.53 to the company's Annual Report on Form 20-F for the year ended December 31, 2017 filed with the SEC on April 20, 2018)</u>
4.54	<u>Exclusive Purchase Option Agreement dated November 20, 2017 among NetEase Youdao Information Technology (Beijing) Co., Ltd., Feng Zhou and Youdao Computer System Co., Ltd. (incorporated by reference to Exhibit 4.54 to the company's Annual Report on Form 20-F for the year ended December 31, 2017 filed with the SEC on April 20, 2018)</u>
4.55	<u>Operating Agreement dated November 20, 2017 among NetEase Youdao Information Technology (Beijing) Co., Ltd., Youdao Computer System Co., Ltd. and Feng Zhou (incorporated by reference to Exhibit 4.55 to the company's Annual Report on Form 20-F for the year ended December 31, 2017 filed with the SEC on April 20, 2018)</u>
4.56*	<u>US\$500,000,000 Syndicated Facility Agreement between the Registrant and the parties thereto dated August 9, 2018</u>
4.57*	<u>Letter of Amendment between the Registrant and the Agent (as defined therein) dated September 21, 2018 relating to the US\$500,000,000 Syndicated Facility Agreement dated August 9, 2018</u>
4.58*	<u>Supplementary Agreement of Assignment among NetEase (Hangzhou) Network Co., Ltd., Hangzhou NetEase Leihuo Network Co., Ltd., Zhipeng Hu, Tianlei Hu and Long Cheng dated April 18, 2019</u>
8.1*	<u>Subsidiaries and Variable Interest Entities of NetEase, Inc.</u>
11.1	<u>Code of Business Conduct (incorporated by reference to Exhibit 11.1 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the SEC on June 26, 2007)</u>
12.1*	<u>Certification of Chief Executive Officer Required by Rule 13a-14(a)</u>
12.2*	<u>Certification of Chief Financial Officer Required by Rule 13a-14(a)</u>
13.1**	<u>Certification of Chief Executive Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code</u>
13.2**	<u>Certification of Chief Financial Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code</u>
15.1	

Edgar Filing: NetEase, Inc. - Form 20-F

Charter of Audit Committee of the Board of Directors of the Registrant (incorporated by reference to Exhibit 15.1 to the company's Annual Report on Form 20-F for the year ended December 31, 2014 filed with the SEC on April 24, 2015)

Edgar Filing: NetEase, Inc. - Form 20-F

Table of Contents

<b>Exhibit Number</b>	<b>Document</b>
15.2*	<u>Consent of PricewaterhouseCoopers Zhong Tian LLP, Independent Registered Public Accounting Firm</u>
15.3*	<u>Consent of Maples and Calder (Hong Kong) LLP</u>
15.4*	<u>Consent of Jun He Law Offices</u>
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document

---

\*Filed with this annual report on Form 20-F

\*\*Furnished with this annual report on Form 20-F

Table of Contents

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

**NETEASE, INC.**

By: */s/ William Lei Ding*  
William Lei Ding  
Chief Executive Officer

Date: April 26, 2019

Table of Contents

**NETEASE, INC.**

<u>Management's report on internal control over financial reporting</u>	F-1
<u>Report of independent registered public accounting firm</u>	F-2
<u>Consolidated balance sheets at December 31, 2017 and 2018</u>	F-3
<u>Consolidated statements of operations and comprehensive income for the years ended December 31, 2016, 2017 and 2018</u>	F-4
<u>Consolidated statements of shareholders' equity for the years ended December 31, 2016, 2017 and 2018</u>	F-5
<u>Consolidated statements of cash flows for the years ended December 31, 2016, 2017 and 2018</u>	F-6
<u>Notes to the consolidated financial statements</u>	F-7

---

Table of Contents

**Management's Report on Internal Control over Financial Reporting**

The management of NetEase, Inc., or the Company, is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) and 15d-15(f) promulgated under the Securities Exchange Act of 1934, as amended.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management, with the participation of the Company's principal executive and principal financial officer, assessed the effectiveness of the Company's internal control over financial reporting as of the end of the most recent fiscal year, December 31, 2018. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework (2013)*. Based on its assessment, management concluded that, as of the end of the Company's most recent fiscal year, December 31, 2018, the Company's internal control over financial reporting is effective based on those criteria.

PricewaterhouseCoopers Zhong Tian LLP, the Company's independent registered public accounting firm, has audited the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, as stated in their report, which is included herein.

Table of Contents

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of NetEase, Inc.

***Opinions on the Financial Statements and Internal Control over Financial Reporting***

We have audited the accompanying consolidated balance sheets of NetEase, Inc. and its subsidiaries (the Company) as of December 31, 2018 and 2017, and the related consolidated statements of operations and comprehensive income, of shareholders' equity and of cash flows for each of the three years in the period ended December 31, 2018, including the related notes (collectively referred to as the consolidated financial statements). We also have audited the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

***Basis for Opinions***

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing on Page F-1 of this Annual Report on Form 20-F. Our responsibility is to express opinions on the Company's consolidated financial statements and on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating



effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

***Definition and Limitations of Internal Control over Financial Reporting***

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers Zhong Tian LLP

PricewaterhouseCoopers Zhong Tian LLP

Beijing, the People's Republic of China

April 26, 2019

We have served as the Company's auditor since 2002.

Table of Contents**NetEase, Inc.****Consolidated Balance Sheets****(in thousands except per share data)**

	<b>December 31, 2017 RMB</b>	<b>December 31, 2018 RMB</b>	<b>December 31, 2018 US\$ Note 2(n)</b>
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	2,764,140	5,389,198	783,827
Time deposits	30,603,369	32,900,287	4,785,148
Restricted cash	5,926,906	4,817,340	700,653
Accounts receivable, net	3,619,725	4,288,500	623,736
Inventories, net	5,474,929	5,017,823	729,812
Prepayments and other current assets	3,816,028	4,627,797	673,085
Short-term investments	9,742,663	11,674,775	1,698,026
Total current assets	61,947,760	68,715,720	9,994,287
Non-current assets:			
Property, equipment and software, net	3,769,326	5,378,560	782,280
Land use rights, net	593,279	3,502,569	509,428
Deferred tax assets	823,495	1,064,295	154,795
Time deposits	100,000	100,000	14,544
Restricted cash	200		
Long-term investments	2,684,776	5,246,108	763,015
Other long-term assets	1,112,579	2,960,676	430,612
Total non-current assets	9,083,655	18,252,208	2,654,674
Total assets	71,031,415	86,967,928	12,648,961
<b>Liabilities, Redeemable noncontrolling interests and Shareholders' Equity</b>			
Current liabilities:			
Accounts payable (including accounts payable of the consolidated VIEs without recourse to the primary beneficiaries of RMB941,358 and RMB1,022,340 as of December 31, 2017 and 2018, respectively)	2,442,531	2,384,818	346,857
Salary and welfare payables (including salary and welfare payables of the consolidated VIEs without recourse to the primary beneficiaries of RMB106,265 and RMB109,917 as of December 31, 2017 and 2018, respectively)	2,189,110	2,991,897	435,153
Taxes payable (including taxes payable of the consolidated VIEs without recourse to the primary beneficiaries of RMB22,058 and RMB84,118 as of December 31, 2017 and 2018, respectively)	1,564,692	2,272,023	330,452
Short-term loans (including short-term loans of the consolidated VIEs without recourse to the primary beneficiaries of nil and RMB129,900 as of December 31, 2017 and 2018, respectively)	6,623,502	13,658,554	1,986,554
Deferred revenue (including deferred revenue of the consolidated VIEs without recourse to the primary beneficiaries of RMB5,853,904 and RMB6,672,715 as of December 31, 2017 and 2018, respectively)	6,237,969	7,953,255	1,156,753
Accrued liabilities and other payables (including accrued liabilities and other payables of the consolidated VIEs without recourse to the primary beneficiaries of RMB1,966,436 and RMB1,866,234 as of December 31, 2017 and 2018, respectively)	4,692,310	5,848,463	850,624
Total current liabilities	23,750,114	35,109,010	5,106,393
Non-current liabilities:			
Deferred tax liabilities	213,215	393,681	57,259
Other long-term payable (including long-term payable of the consolidated VIEs without recourse to the primary beneficiaries of RMB7,500 and RMB7,500 as of December 31, 2017 and 2018, respectively)	18,250	53,656	7,804
Total liabilities	23,981,579	35,556,347	5,171,456
Commitments and contingencies (See Note 20)			

Edgar Filing: NetEase, Inc. - Form 20-F

Redeemable noncontrolling interests	614,696	5,385,736	783,323
Shareholders' equity:			
Ordinary shares, US\$0.0001 par value:			
1,000,300,000 shares authorized, 3,283,217 shares issued and outstanding as of December 31, 2017 and 3,199,018 shares issued and outstanding as of December 31, 2018	2,678	2,620	381
Additional paid-in capital	1,753,439		
Statutory reserves	1,206,224	1,214,578	176,653
Accumulated other comprehensive income	36,585	17,050	2,480
Retained earnings	42,733,081	43,997,388	6,399,155
NetEase, Inc.'s shareholders' equity	45,732,007	45,231,636	6,578,669
Noncontrolling interests	703,133	794,209	115,513
Total shareholders' equity	46,435,140	46,025,845	6,694,182
Total liabilities, redeemable noncontrolling interests and shareholders' equity	71,031,415	86,967,928	12,648,961

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

## NetEase, Inc.

**Consolidated Statements of Operations and Comprehensive Income**

(in thousands except per share data or per ADS data)

	2016 RMB	For the year ended December 31, 2017 RMB		2018 RMB	2018 US\$ Note 2(n)
<b>Net revenues:</b>					
Services	33,748,455	42,654,982	48,518,932	7,056,786	
Products	4,430,389	11,447,037	18,637,521	2,710,715	
Total net revenues	38,178,844	54,102,019	67,156,453	9,767,501	
<b>Cost of revenues</b>					
Services	(12,602,876)	(17,741,107)	(21,089,648)	(3,067,362)	
Products	(3,912,156)	(10,448,219)	(17,663,309)	(2,569,022)	
Total cost of revenues	(16,515,032)	(28,189,326)	(38,752,957)	(5,636,384)	
<b>Gross profit</b>	21,663,812	25,912,693	28,403,496	4,131,117	
<b>Operating expenses:</b>					
Selling and marketing expenses	(4,481,815)	(6,957,596)	(9,526,470)	(1,385,568)	
General and administrative expenses	(1,506,154)	(2,429,858)	(3,191,537)	(464,190)	
Research and development expenses	(3,046,979)	(4,371,428)	(7,792,550)	(1,133,379)	
Total operating expenses	(9,034,948)	(13,758,882)	(20,510,557)	(2,983,137)	
<b>Operating profit</b>	12,628,864	12,153,811	7,892,939	1,147,980	
<b>Other income/(expenses):</b>					
Investment income/(losses), net	200,333	362,113	(22,266)	(3,238)	
Interest income, net	541,969	667,323	587,518	85,451	
Exchange gains/(losses)	146,510	(448,827)	(113,323)	(16,482)	
Other, net	377,685	277,080	599,230	87,154	
<b>Income before tax</b>	13,895,361	13,011,500	8,944,098	1,300,865	
Income tax	(2,102,498)	(2,162,363)	(2,466,681)	(358,764)	
<b>Net income</b>	11,792,863	10,849,137	6,477,417	942,101	
Accretion and deemed dividends in connection with repurchase of redeemable noncontrolling interests			(248,098)	(36,084)	
Net income attributable to noncontrolling interests and redeemable noncontrolling interests	(188,343)	(141,198)	(76,912)	(11,186)	
<b>Net income attributable to the NetEase, Inc. s shareholders</b>	11,604,520	10,707,939	6,152,407	894,831	
<b>Net income</b>	11,792,863	10,849,137	6,477,417	942,101	
<b>Other comprehensive income</b>					
Unrealized losses on available-for-sale securities, net of tax	(232,633)	(23,321)			
Reclassification adjustment for losses on available-for-sale securities recorded in net income, nil of tax	266,660				
Foreign currency translation adjustment		(1,573)	18,624	2,709	
<b>Total other comprehensive income</b>	34,027	(24,894)	18,624	2,709	
<b>Total comprehensive income</b>	11,826,890	10,824,243	6,496,041	944,810	

Edgar Filing: NetEase, Inc. - Form 20-F

Comprehensive income attributable to noncontrolling interests and redeemable noncontrolling interests	(188,343)	(141,198)	(76,912)	(11,186)
<b>Comprehensive income attributable to the NetEase, Inc. s shareholders</b>	<b>11,638,547</b>	<b>10,683,045</b>	<b>6,419,129</b>	<b>933,624</b>
Net income per share, basic	3.54	3.25	1.90	0.28
Net income per ADS, basic	88.40	81.36	47.54	6.91
Net income per share, diluted	3.51	3.23	1.89	0.27
Net income per ADS, diluted	87.72	80.74	47.26	6.87
Weighted average number of ordinary shares outstanding, basic	3,281,729	3,290,312	3,235,324	3,235,324
Weighted average number of ADS outstanding, basic	131,269	131,612	129,413	129,413
Weighted average number of ordinary shares outstanding, diluted	3,307,109	3,315,478	3,254,689	3,254,689
Weighted average number of ADS outstanding, diluted	132,284	132,619	130,188	130,188

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

## NetEase, Inc.

## Consolidated Statements of Shareholders Equity

(Amounts and share numbers, in thousands)

	Ordinary shares Share	Amount RMB	Additional paid-in capital RMB	Treasury stock Share	Amount RMB	Statutory reserves RMB	Accumulated other comprehensive income RMB	Retained earnings RMB	Noncontrolling Interests RMB	Total shareholders equity RMB
Balance as of December 31, 2015	3,286,932	2,685	1,779,331			1,010,917	27,452	26,419,698	83,516	29,323,599
Ordinary shares issued upon settlement of restricted share units	27,664	18	(18)							
Share-based compensation			1,057,715							1,057,715
Appropriation to statutory reserves						149,244		(149,244)		
Net income attributable to NetEase, Inc. and noncontrolling interest shareholders								11,604,520	188,343	11,792,863
Repurchase of shares				(33,116)	(1,199,102)					(1,199,102)
Cancellation of treasury stock	(33,116)	(27)	(1,199,075)	33,116	1,199,102					
Net change in unrealized gains on available-for-sale securities							34,027			34,027
Capital injection in subsidiaries by noncontrolling interest shareholders								3	1	4
Dividends to shareholders								(2,546,165)		(2,546,165)
Balance as of December 31, 2016	3,281,480	2,676	1,637,953			1,160,161	61,479	35,328,812	271,860	38,462,941
Ordinary shares issued upon settlement of restricted share units	29,805	21	(21)							
Share-based compensation			2,177,079							2,177,079
Appropriation to statutory reserves						46,063		(46,063)		
Net income attributable to NetEase, Inc. and noncontrolling interest								10,707,939	126,502	10,834,441

Edgar Filing: NetEase, Inc. - Form 20-F

shareholders									
Repurchase of shares			(28,068)	(2,061,591)					(2,061,591)
Cancellation of treasury stock	(28,068)	(19)	(2,061,572)	28,068	2,061,591				
Net change in unrealized gains on available-for-sale securities						(23,321)			(23,321)
Capital injection in subsidiaries by noncontrolling interest shareholders								311,500	311,500
Dividends to shareholders						(3,257,607)			(3,257,607)
Foreign currency translation adjustment						(1,573)			(1,573)
Deconsolidation of a subsidiary								(6,729)	(6,729)
Balance as of December 31, 2017	3,283,217	2,678	1,753,439		1,206,224	36,585	42,733,081	703,133	46,435,140
Cumulative effect of changes in accounting principles related to revenue recognition and financial instruments						(38,159)	65,608	12,367	39,816
Ordinary shares issued upon settlement of restricted share units	30,709	19	(19)						
Share-based compensation			2,397,798					131,852	2,529,650
Appropriation to statutory reserves					8,354		(8,354)		
Net income attributable to NetEase, Inc. and noncontrolling interest shareholders							6,400,505	76,912	6,477,417
Repurchase of shares			(114,908)	(7,592,598)					(7,592,598)
Cancellation of treasury stock	(114,908)	(77)	(4,151,218)	114,908	7,592,598		(3,441,303)		
Repurchase of noncontrolling interest and redeemable noncontrolling interests							(223,243)	(131,143)	(354,386)
Capital injection in subsidiaries by noncontrolling interest shareholders								15,510	15,510
Dividends to shareholders							(1,440,194)		(1,440,194)
Foreign currency translation adjustment						18,624			18,624
Disposal of a subsidiary								(5,654)	(5,654)

Edgar Filing: NetEase, Inc. - Form 20-F

Accretion of redeemable noncontrolling interests					(88,712)	(8,768)	(97,480)
Balance as of December 31, 2018	3,199,018	2,620	1,214,578	17,050	43,997,388	794,209	46,025,845

The accompanying notes are an integral part of these consolidated financial statements.



Table of Contents

## NetEase, Inc.

## Consolidated Statements of Cash Flows (in thousands)

	2016 RMB	For the year ended December 31,		2018 US\$ Note 2(n)
		2017 RMB	2018 RMB	
<b>Cash flows from operating activities:</b>				
Net income	11,792,863	10,849,137	6,477,417	942,101
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	327,515	801,804	2,083,501	303,033
Fair value change of equity security investments and other financial instruments			248,169	36,095
Investment impairment	278,906	58,537	159,703	23,228
Share-based compensation cost	990,131	2,004,263	2,529,650	367,922
Allowance for doubtful accounts	9,952	60,826	50,954	7,411
Loss/(Gain) on disposal of property, equipment and software	1,276	5,072	(1,385)	(201)
Unrealized exchange (gains)/losses	(166,638)	437,868	39,427	5,735
Gain on disposal of long-term investments, business and subsidiaries	(234,050)	(9,595)	(213,339)	(31,029)
Deferred income taxes	66,676	(438,043)	(69,899)	(10,166)
Net equity share of losses from equity method investees	85,813	12,232	98,301	14,297
Fair value changes of short-term investments	(304,605)	(389,793)	(463,600)	(67,428)
Changes in operating assets and liabilities:				
Accounts receivable	(1,646,885)	565,228	(710,932)	(103,401)
Inventories	(760,365)	(3,896,799)	457,053	66,476
Prepayments and other current assets	(1,063,997)	(116,240)	(722,711)	(105,114)
Accounts payable	604,089	1,100,787	(85,195)	(12,391)
Salary and welfare payables	570,466	700,479	806,401	117,286
Taxes payable	986,390	(155,904)	693,639	100,886
Deferred revenue	2,879,489	(1,291,890)	1,804,579	262,465
Accrued liabilities and other payables	1,071,240	1,591,269	234,144	34,055
Net cash provided by operating activities	15,488,266	11,889,238	13,415,877	1,951,260
<b>Cash flows from investing activities:</b>				
Purchase of property, equipment and software	(1,135,533)	(1,842,933)	(2,528,149)	(367,704)
Proceeds from sale of property, equipment and software	2,064	4,425	6,691	973
Purchase of intangible assets and licensed copyrights of music content	(4,434)	(674,803)	(1,349,905)	(196,336)
Purchase of land use right	(60)	(6,488)	(3,007,959)	(437,489)
Net change of short-term investments with terms of three months or less	(3,704,332)	(895,298)	(1,172,326)	(170,508)
Purchase of short-term investments	(12,439,000)	(12,491,000)	(13,423,000)	(1,952,294)
Proceeds from maturities of short-term investments	9,879,319	15,615,544	13,101,476	1,905,531
Investment in equity method investees	(364,486)	(235,769)	(272,451)	(39,626)
Acquisitions of other equity investments	(181,117)	(900,712)	(2,751,040)	(400,123)
Proceeds from disposal of investment in equity method investees and other equity investments	249,569	350,418		
Placement/rollover of time deposits	(20,367,430)	(33,984,148)	(41,553,428)	(6,043,695)
Proceeds from maturity of time deposits	16,377,449	22,429,597	39,924,525	5,806,781
Change in other long-term assets	(173,402)	(224,103)	(543,949)	(79,114)
Net cash used in investing activities	(11,861,393)	(12,855,270)	(13,569,515)	(1,973,604)
<b>Cash flows from financing activities:</b>				
Net proceeds from short-term loan with terms of three months or less	1,494,756	3,095,465	6,194,113	900,896
Proceeds of short-term loan		9,505	34,256	4,982
Repayment of short-term loan			(18,761)	(2,728)
Dividends paid to shareholders	(2,546,165)	(3,257,607)	(1,440,194)	(209,468)

Edgar Filing: NetEase, Inc. - Form 20-F

Repurchase of redeemable noncontrolling interests			(780,000)	(113,446)
Proceeds from issuance of redeemable noncontrolling interest shareholders, net of issuance cost	600,000		5,294,174	770,006
Repurchase of noncontrolling interest			(195,000)	(28,362)
Capital injection from noncontrolling interest shareholders	4	311,500	15,510	2,256
Repurchase of shares	(1,199,102)	(2,061,591)	(7,516,679)	(1,093,256)
Net cash (used in)/provided by financing activities	(2,250,507)	(1,302,728)	1,587,419	230,880
<b>Effect of exchange rate changes on cash held in foreign currencies</b>	132,285	(12,766)	81,511	11,855
<b>Net increase/(decrease) in cash, cash equivalents and restricted cash</b>	1,508,651	(2,281,526)	1,515,292	220,391
<b>Cash, cash equivalents and restricted cash, beginning of the year</b>	9,464,121	10,972,772	8,691,246	1,264,089
<b>Cash, cash equivalents and restricted cash, end of the year</b>	10,972,772	8,691,246	10,206,538	1,484,480
<b>Supplemental disclosures of cash flow information:</b>				
Cash paid for income taxes, net of tax refund	1,097,178	2,712,875	2,006,657	291,856
Cash paid for interest expenses	31,171	84,708	301,761	43,889
<b>Supplemental schedule of non-cash investing and financing activities:</b>				
Fixed asset purchases financed by accounts payable	260,277	293,194	409,222	59,519

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**Notes to the Consolidated Financial Statements**

(Amounts expressed in Renminbi ( RMB ), unless otherwise stated)

**1. Organization and Nature of Operations****(a) The Group**

NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999 and changed its name to NetEase, Inc. ( the Company ) with effect from March 29, 2012. The Company has been listed on the Nasdaq National Market (now the Nasdaq Global Select Market) in the United States of America since July 2000. As of December 31, 2018, the Company has wholly-owned and majority-owned subsidiaries incorporated in countries and jurisdictions mainly in the People's Republic of China ( PRC ), Hong Kong, Cayman Islands and British Virgin Islands ( BVI ). The Company also effectively controls a number of variable interest entities ( VIEs ) for which the Company is the primary beneficiary. The Company, its subsidiaries and VIEs are hereinafter collectively referred to as the Group . The major subsidiaries and VIEs through which the Company conducts its business operations as of December 31, 2018 are described below:

<b>Major Subsidiaries</b>	<b>Place and year of Incorporation</b>
NetEase Information Technology (Beijing) Co., Ltd. ( NetEase Beijing )	Beijing, China 1999
Guangzhou Boguan Telecommunication Technology Co., Ltd. ( Boguan )	Guangzhou, China 2003
NetEase Youdao Information Technology (Beijing) Co., Ltd. ( Youdao Information )	Beijing, China 2006
NetEase (Hangzhou) Network Co., Ltd. ( NetEase Hangzhou )	Hangzhou, China 2006
Hangzhou Langhe Technology Co., Ltd. ( Hangzhou Langhe )	Hangzhou, China 2009
NetEase Media Technology (Beijing) Co., Ltd. ( Media Beijing )	Beijing, China 2012
HQG, Limited ( HQG )	Hong Kong, China 2014
Hangzhou Youmai Technology Co., Ltd. ( Hangzhou Youmai )	Hangzhou, China 2014
Tianjin Wang Zhi Yi Innovation and Technology Co., Ltd. ( Tianjin Technology )	Tianjin, China 2015
Hangzhou Netease Yanxuan Trading Co., Ltd. ( Hangzhou Yanxuan )	Hangzhou, China 2016
<b>Major VIEs and VIEs' subsidiaries</b>	<b>Place and year of Incorporation</b>
Guangzhou NetEase Computer System Co., Ltd. ( Guangzhou NetEase )	Guangzhou, China 1997
Beijing NetEase Media Co., Ltd. (previously named Beijing Guangyitong Advertising Co., Ltd. ) ( NetEase Advertising )	Beijing, China 1999
Shanghai EaseNet Network Technology Co., Ltd. ( Shanghai EaseNet )	Shanghai, China 2008
StormNet Information Technology (Hong Kong) Limited ( StormNet IT HK )	Hong Kong, China 2008
StormNet Information Technology (Shanghai) Co., Ltd. ( StormNet IT SH )	Shanghai, China 2008
Hangzhou NetEase Leihuo Network Co., Ltd. ( HZ Leihuo )	Hangzhou, China 2009
Wangyibao Co., Ltd. ( Wangyibao Company )	Hangzhou, China 2010

Guangzhou NetEase, a principal VIE of the Company, was incorporated in June 1997 in China and owned by William Lei Ding, or Mr. Ding, the Company's Chief Executive Officer, director and major shareholder, and another Chinese employee of the Group. It is responsible for providing online game, e-mail and other value-added telecommunication services.

## Edgar Filing: NetEase, Inc. - Form 20-F

NetEase Advertising, owned by Mr. Ding and another Chinese employee of the Group, was incorporated in November 1999 in China. NetEase Advertising operates the Company's portal business.

HZ Leihuo was incorporated in April 2009 in China by two Chinese employees of the Group and currently operates the Company's mobile game business.

Wangyibao Company was incorporated in July 2010 in China as a wholly-owned subsidiary of Guangzhou NetEase for the purpose of operating the NetEase Pay (formerly known as Wangyibao) online payment platform of the Company to facilitate e-payments by online game or other services customers to the Company.

Table of Contents

In addition, Shanghai EaseNet is a PRC company owned by Mr. Ding, and has contractual arrangements with the joint venture established between, and owned equally by, Blizzard Entertainment, Inc. ( Blizzard ) and the Company, and with the Company. The joint venture was established concurrently with the licensing of certain online games in August 2008 and provides technical services to Shanghai EaseNet. The joint venture currently consists of two companies, StormNet IT HK and its wholly-owned subsidiary StormNet IT SH.

The following combined financial information of the Group's VIEs was included in the accompanying consolidated financial statements of the Group as follows (in thousands):

		<b>December 31, 2017 RMB</b>	<b>December 31, 2018 RMB</b>
Total assets		9,729,718	10,491,261
Total liabilities		8,897,521	9,892,724
		<b>For the year ended December 31,</b>	
	<b>2016 RMB</b>	<b>2017 RMB</b>	<b>2018 RMB</b>
Net revenues	31,043,737	40,584,251	43,323,784
Net income	448,771	357,163	224,220
		<b>For the year ended December 31,</b>	
	<b>2016 RMB</b>	<b>2017 RMB</b>	<b>2018 RMB</b>
Net cash provided by/(used in) operating activities	1,736,702	(124,670)	402,754
Net cash (used in)/provided by investing activities	(270,733)	122,286	(720,675)
Net cash (used in)/provided by financing activities	(57,000)	4,000	229,862

In accordance with various contractual agreements, the Company has the power to direct the activities of the VIEs and can have assets transferred out of the VIEs. Therefore, the Company considers that there are no assets in the respective VIEs that can be used only to settle obligations of the respective VIEs, except for the registered capital of the VIEs amounting to approximately RMB536.2 million and RMB562.2 million, respectively, as of December 31, 2017 and 2018, as well as certain non-distributable statutory reserves amounting to approximately RMB27.2 million and RMB32.1 million, respectively, as of December 31, 2017 and 2018. As the respective VIEs are incorporated as limited liability companies under the PRC Company Law, creditors do not have recourse to the general credit of the Company for the liabilities of the respective VIEs.

Currently, there are certain contractual arrangements between the Company and several of its VIEs which require the Company to provide additional financial support or guarantees to its VIEs, where necessary. Please see Note 1(b) for additional information.

There is no entity in the Company's group for which the Company has a variable interest but is not the primary beneficiary as of December 31, 2018.

**(b) Nature of operations**

The Group generates revenues from providing online game services, e-commerce, advertising services, and initiative businesses and others.

The industry in which the Group operates is subject to a number of industry-specific risk factors, including, but not limited to, rapidly changing technologies; government regulations of the Internet, online game and e-commerce industry in China; significant numbers of new entrants; dependence on key individuals; competition of similar services from larger companies; customer preferences; and the need for the continued successful development, marketing and selling of its services.

*VIE Arrangements with Guangzhou NetEase, NetEase Advertising, HZ Leihuo, and Shanghai EaseNet*

The Group conducts its business mainly in China. The Chinese government regulates Internet access, telecommunications services, the distribution of news and other information and the provision of commerce through strict business licensing requirements and other governmental regulations, which include, among others, those restricting foreign ownership in Chinese companies providing Internet advertising and other Internet or telecommunications value-added services. To comply with the existing Chinese laws and regulations, the Company and certain of its subsidiaries have entered into a series of contractual arrangements with its principal VIEs with respect to the operation of the NetEase websites, operation of self-developed and licensed PC-client and mobile games, Internet content and wireless value-added services, as well as the provision of advertising services. Our major VIEs include:

Table of Contents

- (1) Guangzhou NetEase (owned by Mr. Ding and a Chinese employee of the Group, (together referred as the VIE shareholders )),
- (2) NetEase Advertising (owned by Mr. Ding and another Chinese employee of the Group),
- (3) HZ Leihuo (owned by two employees of the Group), and
- (4) Shanghai EaseNet (owned by Mr. Ding).

Based on the agreements with these VIEs, the Company's subsidiaries NetEase Beijing, Media Beijing, Boguan and NetEase Hangzhou provided technical consulting and related services to these VIEs. The principal agreements that transfer economic benefits of Guangzhou NetEase, NetEase Advertising and HZ Leihuo to the Company and its subsidiaries are:

- *Cooperative agreements with Guangzhou NetEase* under these agreements, the Company's subsidiaries NetEase Beijing, Boguan and NetEase Hangzhou provide various technical consulting and related services to Guangzhou NetEase in exchange for substantially all of Guangzhou NetEase's net profits.
- *Cooperative agreements with NetEase Advertising* under these agreements, NetEase Beijing until October 2013, and Media Beijing from October 2013 onwards, provide various technical consulting and related services in exchange for substantially all of NetEase Advertising's profits.
- *Cooperative agreement with HZ Leihuo* under this agreement, the Company's subsidiary NetEase Hangzhou provides various technical consulting and related services to HZ Leihuo in exchange for substantially all of HZ Leihuo's net profits.

Each cooperative agreement will remain in effect indefinitely unless any one of the contract parties terminates such agreement by written notice or otherwise required by law.

The principal agreements that provide the Company and its subsidiaries effective control over Guangzhou NetEase are:

- *Shareholder Voting Rights Trust Agreement among the VIE shareholders and NetEase Beijing.* Each of the VIE shareholders irrevocably appoints NetEase Beijing to represent him to exercise all the voting rights to

which he is entitled as a shareholder of Guangzhou NetEase. The term of this agreement was 10 years from May 12, 2000, which was extended on June 10, 2011 with a term of 20 years from May 12, 2010.

- Letter of Agreement. Each of the VIE shareholders have agreed that any amendments to be made to the agreements to which the Company, NetEase Beijing and/or their respective affiliates is a party, on the one hand, and any of their variable interest entities and/or the shareholders of such entities, on the other hand, shall be subject to the approval by the vote of a majority of the Board of the Company, excluding the vote of Mr. Ding. The VIE shareholders have also agreed that, if any amendments to the above mentioned agreements require a vote of the shareholders of the Company or Guangzhou NetEase, as applicable, both of them will vote in their capacity as direct or indirect shareholders of these companies to act based upon the instructions of the Company's Board. The term of this agreement is 20 years from May 12, 2010.

- Other Governance Arrangements. The parties have agreed that upon the Company's determination and at any time when NetEase Beijing or its affiliates are able to obtain approval to invest in and operate all or any part of any business operated by Guangzhou NetEase, NetEase Beijing or its affiliates may acquire all or any part of the assets or equity interests of Guangzhou NetEase, to the extent permitted by Chinese law.



Table of Contents

The principal agreements that provide the Company and its subsidiaries effective control over NetEase Advertising are:

- Operating Agreement among Media Beijing, NetEase Advertising and the VIE shareholders of NetEase Advertising. To ensure the successful performance of the various agreements between the parties, NetEase Advertising and its VIE shareholders have agreed that, except for transactions in the ordinary course of business, NetEase Advertising will not enter into any transaction that would materially affect the assets, liabilities, rights or operations of NetEase Advertising without the prior written consent of Media Beijing. Media Beijing has also agreed that it will provide performance guarantees and, at Media Beijing's discretion, guarantee loans for working capital purposes to the extent required by NetEase Advertising for its operations. Furthermore, the VIE shareholders of NetEase Advertising have agreed that, upon instruction from Media Beijing, they will appoint NetEase Advertising's board members, president, chief financial officer and other senior executive officers. The term of this agreement is 20 years from November 30, 2015 and can be extended with the written consent of Media Beijing.
- Shareholder Voting Rights Trust Agreement among Media Beijing and the VIE Shareholders of NetEase Advertising. Under these agreements, each dated November 30, 2015, each of the VIE shareholders agreed to irrevocably entrust a person designated by Media Beijing to represent him to exercise all the voting rights and other shareholders' rights to which he is entitled as a shareholder of NetEase Advertising. Each agreement shall remain effective for as long as the VIE shareholder remains a shareholder of NetEase Advertising unless Media Beijing unilaterally terminates the agreement by written notice.
- Exclusive Purchase Option Agreements among Media Beijing, NetEase Advertising and the VIE shareholders of NetEase Advertising. Under the Exclusive Purchase Option Agreements, each dated November 30, 2015, each of the VIE shareholders has granted Media Beijing an option to purchase all or a portion of his equity interest in NetEase Advertising at a price equal to the original paid-in capital paid by the VIE shareholder. In addition, NetEase Advertising has granted Media Beijing an option under the Exclusive Purchase Option Agreements to purchase all or a portion of the assets held by NetEase Advertising or its subsidiaries at a price equal to the net book value of such assets. Each of NetEase Advertising and the VIE shareholders of NetEase Advertising agrees not to transfer, mortgage or permit any security interest to be created on any equity interest in or assets of NetEase Advertising without the prior written consent of Media Beijing. Each Exclusive Purchase Option Agreement shall remain in effect until all of the equity interests in or assets of NetEase Advertising have been acquired by Media Beijing or its designee or until Media Beijing unilaterally terminates the agreement by written notice.

The principal agreements that provide the Company and its subsidiaries effective control over HZ Leihuo are:

- Operating Agreement among NetEase Hangzhou, HZ Leihuo and the VIE shareholders of HZ Leihuo. To ensure the successful performance of the various agreements between the parties, HZ Leihuo and its VIE shareholders have agreed that, except for transactions in the ordinary course of business, HZ Leihuo will not enter into any transaction that would materially affect the assets, liabilities, rights or operations of HZ Leihuo without the prior

written consent of NetEase Hangzhou. NetEase Hangzhou has also agreed that it will provide performance guarantees and, at NetEase Hangzhou's discretion, guarantee loans for working capital purposes to the extent required by HZ Leihuo for its operations. Furthermore, the VIE shareholders of HZ Leihuo have agreed that, upon instruction from NetEase Hangzhou, they will appoint HZ Leihuo's board members, president, chief financial officer and other senior executive officers. The term of this agreement is 20 years from December 1, 2015 and can be extended with the written consent of NetEase Hangzhou.

- Shareholder Voting Rights Trust Agreement among NetEase Hangzhou and the VIE shareholders of HZ Leihuo. Under these agreements, each dated December 1, 2015, each of the VIE shareholders of HZ Leihuo has agreed to irrevocably entrust a person designated by NetEase Hangzhou to represent him to exercise all the voting rights and other shareholders' rights to which he is entitled as a shareholder of HZ Leihuo. Each agreement shall remain effective for as long as the VIE shareholder remains a shareholder of HZ Leihuo unless NetEase Hangzhou unilaterally terminates the agreement by written notice.
- Exclusive Purchase Option Agreements among NetEase Hangzhou, HZ Leihuo and the VIE shareholders of HZ Leihuo. Under the Exclusive Purchase Option Agreements, each dated December 1, 2015, each of VIE shareholders of HZ Leihuo has granted NetEase Hangzhou an option to purchase all or a portion of his equity interest in HZ Leihuo at a price equal to the original paid-in capital paid by the ultimate shareholder. In addition, HZ Leihuo has granted NetEase Hangzhou an option to purchase all or a portion of the assets held by HZ Leihuo or its subsidiaries at a price equal to the net book value of such assets. Each of HZ Leihuo and the VIE shareholders of HZ Leihuo agrees not to transfer, mortgage or permit any security interest to be created on any equity interest in or assets of HZ Leihuo without the prior written consent of NetEase Hangzhou. Each Exclusive Purchase Option Agreement shall remain in effect until all of the equity interests in or assets of HZ Leihuo have been acquired by NetEase Hangzhou or its designee or until NetEase Hangzhou unilaterally terminates the agreement by written notice.

Table of Contents

*The Joint Venture*

In addition to the foregoing, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC, there are certain contractual arrangements among Shanghai EaseNet, the joint venture established between Blizzard and the Company, and the Company.

StormNet IT HK, StormNet IT SH and Shanghai EaseNet (collectively referred to as the JV Group ) are variable interest entities as equity investment at risk is not sufficient to permit the JV Group to finance its activities without additional subordinated financial support provided by any parties. As Blizzard receives its interest as an indirect contribution from NetEase, Blizzard and the Company are considered related parties for purposes of identifying which party is the primary beneficiary under ASC 810. Since the aggregate variable interests held by Blizzard and NetEase would, if held by a single party, identify that party as the primary beneficiary, either Blizzard or the Company will be the primary beneficiary. Based on the assessment of all relevant facts and circumstances, the Company determined that the Company is most closely associated with the JV Group and therefore is the primary beneficiary. As a result, the JV Group's results of operations, assets and liabilities have been included in the Company's consolidated financial statements.

The Company conducts substantially all of its business through the various VIEs discussed above and their subsidiaries, and therefore these companies directly affect the Company's financial performance and cash flows. As discussed below, if the Chinese government determines the VIE agreements do not comply with applicable laws and regulations and requires the Company to restructure its operations entirely or discontinue all or any portion of its business, or if the uncertainties in the PRC legal system limit the Group's ability to enforce these contractual agreements, the Group's business operations will be significantly disrupted and the Group might be unable to consolidate these companies in the future. In the opinion of management, the likelihood of loss in respect of the Group's current ownership structure or the contractual arrangements with its VIEs is remote.

*Risks related to the VIE arrangements*

The Company believes that its contractual arrangements with the VIEs are in compliance with PRC law and are legally enforceable. Mr. Ding, who is the major shareholder of Guangzhou NetEase, and is in turn the major shareholder of Wangyibao Company, and of Shanghai EaseNet and NetEase Advertising, is the largest shareholder of the Company. He therefore has no current interest in seeking to act contrary to the contractual arrangements. However, uncertainties in the PRC legal system could limit the Company's ability to enforce these contractual arrangements and if Mr. Ding were to reduce his interest in the Company, his interests may diverge from that of the Company and that may potentially increase the risk that he would seek to act contrary to the contractual terms, for example by influencing the VIEs not to pay the service fees when required to do so. If the VIEs or their respective shareholder fail to perform their respective obligations under the current contractual arrangements, the Company may have to incur substantial costs and expend significant resources to enforce those arrangements and rely on legal remedies under Chinese laws. The Chinese laws, rules and regulations are relatively new, and because of the limited volume of published decisions and their non-binding nature, the interpretation and enforcement of these laws, rules and regulations involve substantial uncertainties. These uncertainties may impede the ability of the Company to enforce these contractual arrangements, or suffer significant delay or other obstacles in the process of enforcing these contractual arrangements and materially and adversely affect the results of operations and the financial position of the Company.

In addition, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions, and there are substantial uncertainties regarding the interpretation and application of current and future Chinese laws and regulations. Accordingly, the Company cannot be assured that Chinese regulatory authorities will not ultimately take a contrary view to its belief and will not take action to prohibit or restrict its business activities. The relevant regulatory authorities would have broad discretion in dealing with any deemed violations

which may adversely impact the financial statements, operations and cash flows of the Company (including the restriction on the Company to carry out the business). It is unclear, however, how such restructuring could impact the Company's business and operating results, as the Chinese government has not yet found any such contractual arrangements non-compliant. If the legal structure and contractual arrangements were found to be in violation of any existing PRC laws and regulations, the PRC government could potentially:

- revoke the Group's business and operating licenses;
  - require the Group to discontinue or restrict operations;
  - restrict the Group's right to collect revenues;
  - block the Group's websites;
  - require the Group to restructure the operations in such a way as to compel the Group to establish a new enterprise, re-apply for the necessary licenses or relocate the Group's businesses, staff and assets;
  - impose additional conditions or requirements with which the Group may not be able to comply;
- or
- take other regulatory or enforcement actions against the Group that could be harmful to the Group's business.

The imposition of any of these penalties may result in a material and adverse effect on the Group's ability to conduct the Group's business. In addition, if the imposition of any of these penalties causes the Group to lose the rights to direct the activities of the VIEs or the right to receive their economic benefits, the Group would no longer be able to consolidate the VIEs. The Group does not believe that any penalties imposed or actions taken by the PRC government would result in the liquidation of the Company, its subsidiaries or the VIEs.

Table of Contents

**2. Principal Accounting Policies**

**(a) Basis of consolidation**

The consolidated financial statements include the financial statements of the Company, its subsidiaries and VIEs for which the Company is the primary beneficiary with the ownership interests of minority shareholders reported as noncontrolling interests. All significant transactions and balances among the Company, its subsidiaries and VIEs have been eliminated upon consolidation. The Company consolidates a VIE if the Company has the power to direct matters that most significantly impact the activities of the VIE, and has the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

**(b) Basis of presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( US GAAP ). The consolidated financial statements are prepared based on the historical cost convention.

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses during the reporting periods. Actual results might differ from those estimates. These estimates and assumptions include, but are not limited to, assessing the following: average playing period of paying players of online games, realization of deferred tax assets and the determination of uncertain tax positions, lower of cost and market value of inventories, useful lives and impairment provision of property, equipment and software and intangibles, assumptions related to stock-based compensation and impairment of long-term investments.

**(c) Revenue recognition**

On January 1, 2018, the Group adopted Topic 606 using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with the Group's historic accounting under Topic 605. For the year ended December 31, 2018, net revenue recognized from sources other than contracts with customers under ASC 606 was immaterial.

Revenues from contracts with customers are recognized when control of the promised goods or services is transferred to the Group's customers, in an amount that reflects the consideration the Group expects to be entitled to in exchange for those goods or services, reduced by estimates for return allowances, promotional discounts, rebates and Value Added Tax ( VAT ). The recognition of revenues involves certain management judgments, including estimated lives of virtual items purchased by game players, estimated breakage of game points, return allowance for goods sold, the estimation of the fair value of an advertising-for-advertising barter transaction, volume sales rebates. The amount and timing of the Group's revenues could be different if management made different judgments or utilized different estimates.

The Group's service sales represent revenues from online game services, advertising services, other initiative businesses and others. Product sales represent revenue from the sale of products through its e-commerce platform where the Group records revenue on a gross basis. Refer to Note 24 Segment Information for disaggregation of revenue.

(i) Online game services

The Group operates mobile games and PC-client games. The Group is the principal of all games it operates, including both self-developed games and licensed games. As all these games are hosted on the Group's servers, the Group has the pricing discretion, and is responsible for the sale and marketing of the games as well as customer services. Fees paid to game developers, distribution channels (app stores) and payment channels are recorded as cost of revenues.

*Mobile games*

The Group generates mobile game revenues from the sale of in-game virtual items, including items, avatars, skills, privileges or other in-game consumables, features or functionality, within the games. The Group's performance obligation is to provide on-going game services to players who purchased virtual items to gain an enhanced game-playing experience. This performance obligation is satisfied over the playing period of the paying players. Accordingly, the Group recognizes the revenues ratably over the estimated average playing period of these paying players.

Table of Contents

The Group considers the average period that players typically play the games and other game player behavior patterns, as well as various other factors to arrive at the best estimates for the estimated playing period of the paying players for each game. If a new game is launched and only a limited period of paying player data is available, then the Group considers other qualitative factors, such as the playing patterns for paying users for other games with similar characteristics and playing patterns of paying players, such as targeted players and purchasing frequency. While the Group believes its estimates to be reasonable based on available game player information, the Group may revise such estimates based on new information indicating a change in the game player behavior patterns and any adjustments are applied prospectively.

*PC-client games*

The Group sells prepaid point cards to the end users. Customers can purchase physical prepaid point cards in different locations in China, including Internet cafés, software stores, convenience stores and bookstores. Customers can also purchase virtual prepaid points from vendors who register the points in the Group's system and virtual prepaid cards online via debit and credit cards or bank transfers via the online payment services platforms, and receive the prepaid point information over the Internet. Customers can use the points to play the Group's PC-client games, pay for in-game items and use other fee-based services. Proceeds received from the sales of prepaid point cards and online points to players are recorded as deferred revenues.

The Group earns revenue through providing PC-client game services to players under two types of revenue models: time-based revenue model and item-based revenue model. For PC-client games using the time-based model, players are charged based on the time they spend playing games. Revenues are recognized ratably over the game playing period as the performance obligations are satisfied.

Under the item-based model, the basic game play functions are free of charge, and players are charged for purchases of in-game items. In-game items have different life patterns: one-time use, limited life and permanent life. Revenues from the sales of one-time use in-game items are recognized upon consumption. Limited life items are either limited by the number of uses (for example, 10 times) or limited by time (for example, three months). Revenues from the sales of limited life in-game items are recognized ratably based on the extent of time passed or expired or when the items are fully used. Players are allowed to use permanent life in-game items without any use or time limits. Revenues from the sales of permanent life in-game items are recognized ratably over the estimated average playing period of the paying players.

The Group considers the average period that players typically play the games and other game player behavior patterns, as well as various other factors, including the acceptance and popularity of expansion packs, promotional events launched and market conditions to arrive at the best estimates for the playing period of the paying players for the permanent in-game items of PC-client games. This estimate is re-assessed on a quarterly basis. Adjustments arising from the changes of estimated playing period of the paying players are applied prospectively as such changes are resulted from new information indicating a change in the game player behavior patterns.

Breakage of unused PC-client game points

The Group recognizes expected breakage associated with the Group's unused online points with expiry dates in a personal game account as revenue in proportion to the pattern of points consumed by the customer, subject to the constrain for estimating variable consideration. For game points that do not expire, the Group recognizes the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

(ii) E-commerce

The Group's e-commerce businesses mainly include cross-border and domestic e-commerce business. The Group established its cross-border e-commerce platform Kaola, in January 2015 and primarily sells imported maternity and baby products, skincare and cosmetics and other general merchandise through online direct sales.

In addition, the Group established its domestic e-commerce platform Yanxuan, in April 2016 and sells its private label products, including apparel, homeware, kitchenware and other general merchandise which are sourced primarily directly from original design manufacturers in China.

The Group is the principal for the online direct sales, as it controls the inventory before they are transferred to customers. The Group has the primary responsibility for fulfilling the contracts, bears the inventory risk, and has sole discretion in establishing the prices. E-commerce revenues from online direct sales are recognized when control of the goods is transferred to the customer, which generally occurs upon our delivery to the customer.

The Group also act as the marketplace service provider for third-party vendors to sell their products on the Group's platform. In online marketplace business, third-party sellers offer products to customers on the Group's platform and the Group acts as the marketplace service provider. The Group is not the seller of the third-parties' goods in these transactions and recognize revenue when services are rendered based on a pre-determined service fee rate.

The Group also provides discount coupons to its customers for use in purchases on the Kaola and Yanxuan platform, which are treated as a reduction of revenue when the related transaction is recognized.



Table of Contents

*Return allowance*

Return allowances, which reduce revenue and cost of sales, are estimated using historical experience. Liabilities for return allowances and rights to recover products from customers associated with the Group's liabilities are recorded as Accrue liabilities and other payables and Inventories, net, respectively, on the Group's consolidated balance sheets. Both of the balances are not material as of December 31, 2017 and 2018.

(iii) Advertising services

The Group derives its advertising revenues principally from short-term online advertising contracts. Advertising service contracts may consist of multiple performance obligations with a typical term of less than three months. Each performance obligation generally represent different formats of advertisement, including but not limited to banners, text-links, videos, logos, buttons and rich media. In arrangements where the Group has multiple performance obligations, the transaction price is allocated to each performance obligation using the relative stand-alone selling price. The Group generally determines standalone selling prices based on the prices charged to customers. If the performance obligation has not been sold separately, the Group estimates the standalone selling price by taking into consideration of the pricing for advertising areas of the Group's platform with a similar popularities and advertisements with similar formats and quoted prices from competitors as well as other market conditions. Considerations allocated to each performance obligation is recognized as revenue over the advertisement display period, which is usually within three months.

The Group also enters into performance-based advertising arrangements with customers. The Group enters into cost per mille ( CPM ), or cost per thousand impressions, advertising arrangements with customers, under which the Group recognizes revenues based on the number of times that the advertisement has been displayed.

The Group also enters into cost per action ( CPA ) advertising arrangements with customers, under which the Group recognizes revenues based on the number of actions completed resulted from the advertisements, including but not limited to when users click on links.

Certain customers may receive volume rebates, which are accounted for as variable consideration. The Group estimates annual expected revenue volume with reference to their historical results and reduce revenues recognized.

The Group recognizes revenue from providing advertising service in exchange for non-cash consideration, usually advertising services, promotional benefits, content, consulting services and software provided by counterparties, at the fair value of the non-cash consideration measured as of contract inception date. If the Group is not able to reliably determine the fair value of noncash consideration in some situations, the value of the noncash consideration received is measured indirectly by reference to the standalone selling price of advertising services provided by the Group.

The Group has been engaged in certain advertising barter transactions, which primarily involved exchanges of advertising services rendered by the Group for advertising, promotional benefits, content, consulting services and software provided by the counterparties. For the years ended December 31, 2016 and 2017, no revenue from rendering advertising services in exchange for non-cash consideration was recognized as the fair value was not determinable. For the year ended December 31, 2018, revenue from rendering advertising services in exchange for non-cash

consideration is insignificant.

(iv) Innovative businesses and others

On December 31, 2018, the Group renamed its e-mail and others segment to innovative businesses and others to better articulate the businesses included in this segment. For details please see Note 24 Segment Information.

Revenue from innovative businesses and others is predominantly derived from fee-based premium services, online payment platform services and other online services. Fee-based premium services revenues, mostly operated on either consumption-basis or a monthly subscription basis, are derived principally from providing premium live-streaming services, online music services, online reading, e-mail and other innovative businesses. Prepaid subscription fees collected from customers are deferred and are recognized as revenue on a straight-line basis by the Group over the subscription period, during which customers can access the premium online services provided by the Group. Fees collected from customer to be consumed to purchase online services are recognized as revenue when related services are rendered.

The Group generates revenue from the operation of its live streaming platforms whereby users can enjoy live performances provided by the hosts and interact with the hosts. Most of the hosts host the performance on their own. The Group creates and sells virtual items to users so that the users present them simultaneously to hosts to show their support. The virtual items sold by the Group comprise of either (i) consumable items or (ii) time-based item, such as privilege titles etc. Under the arrangements with the hosts, the Group shares with them a portion of the revenues derived from the sales of virtual items. Revenues derived from the sale of virtual items are recorded on a gross basis as the Group acts as the principal to fulfill all obligations related to the sale of virtual items. Accordingly, revenue is recognized when the virtual item is delivered and consumed if the virtual item is a consumable item or, in the case of time-based virtual item, recognized ratably over the period each virtual item is made available to the user.

In February 2009, the Group launched its NetEase Pay payment platform, through which customers registered for NetEase Pay operations can deposit money in their accounts and use the accounts to pay for game point cards and other fee-based services and products. The Group recognizes revenue when services are rendered to account holders in accordance with service agreement.

Table of Contents

The Group offers online services related to third-party virtual products to facilitate the sale of products from third-party providers. The Group acts as an agent and do not buy, sell, manufacture, or design such products. Revenues are recognized when services are rendered to customers based on the pre-determined service fee rate. The Group also operated its Duobao platform, which provides services that allow users to purchase the virtual currency, Duobao Bi , and use them to exchange for products. For the services where the Group acts as an agent, products are provided by third-party suppliers and revenues are recognized on a net basis when services are rendered. The Group terminated the Duobao platform in early 2017.

*Practical Expedients*

The Group has used the following practical expedients as allowed under ASC 606:

(i) The effects of a significant financing component has not been adjusted for contracts which the Group expects, at contract inception, that the period between when the Group transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less.

(ii) The Group applied the portfolio approach in determining the commencement date of consumption and the estimated average playing period of paying players for PC-client games permanent virtual items and of mobile games for the recognition of online game revenue given that the effect of applying a portfolio approach to a group game players behaviors would not differ materially from considering each one of them individually.

(iii) The Group elects to expense the costs to obtain a contract as incurred when the expected amortization period is one year or less.

*Contract Balances*

Timing of revenue recognition may differ from the timing of invoicing to customers. Accounts receivable represent amounts invoiced and revenue recognized prior to invoicing, when the Group has satisfied its performance obligations and has the unconditional right to payment. The Group closely monitors the collection of its accounts receivables and records a reserve for doubtful accounts against aged accounts and for specifically identified non-recoverable amounts. If the economic situation and the financial condition of the customer deteriorate resulting in an impairment of the customer's ability to make payments, additional allowances might be required. Accounts receivables balances are written off when they are determined to be uncollectible.

The following table sets out the movements of the allowance for doubtful accounts for the years ended December 31, 2016, 2017 and 2018 (in thousands):

Edgar Filing: NetEase, Inc. - Form 20-F

	<b>Balance at January 1, RMB</b>	<b>Charged to/(Write-back against) cost and expenses RMB</b>	<b>Write-off of receivable balances and corresponding provisions RMB</b>	<b>Balance at December 31, RMB</b>
2016	14,185	9,952	(1)	24,136
2017	24,136	60,826	(53)	84,909
2018	84,909	50,954	(5,215)	130,648

The Group's right to consideration in exchange for goods or services that the Group has transferred to a customer is recognized as a contract asset. Contract assets as of January 1, 2018 and December 31, 2018 were not material.

A contract liability is the Group's obligation to transfer goods or services to a customer for which the Group has received consideration (or an amount of consideration is due) from the customer. Contract liabilities are presented as Deferred Revenue on the consolidated balance sheets of the Group. Refer to Note 14 - Deferred revenue for further information, including changes in deferred revenue during the year.

Table of Contents**(d) Cost of revenues**

Costs of revenues consist primarily of purchase price, inbound shipping costs and inventory write downs, staff costs, royalties and consultancy fees related to licensed games, revenue sharing cost related to mobile games, depreciation and amortization of computers and software, server custody fees, bandwidth, and other direct costs of providing these services. These costs are charged to the consolidated statements of operations and comprehensive income as incurred. Shipping and handling costs, which primarily include third-party delivery costs relating to the delivery of products from distribution centers to customers, fulfillment expenses occurred in the Group's various distribution facilities and packing material expenses, are classified as selling and marketing expenses. Shipping and handling costs included in selling and marketing expenses were approximately RMB503.0 million, RMB1,182.7 million and RMB1,670.4 million (US\$242.9 million) for the years ended December 31, 2016, 2017 and 2018, respectively.

**(e) Research and development costs**

Research and development costs mainly consist of personnel-related expenses and technology service costs incurred for the development of online games prior to the establishment of technological feasibility and costs associated with new products development. For the years ended December 31, 2016, 2017 and 2018, the costs incurred for development of online game products have not been capitalized because the period after the date technical feasibility is reached and the time when the game is marketed is short historically and the development cost incurred in the period are insignificant.

**(f) Cash, cash equivalents and time deposits**

Cash and cash equivalents mainly represent cash on hand, demand deposits placed with large reputable banks in Hong Kong or China, and highly liquid investments that are readily convertible to known amounts of cash and with original maturities from the date of purchase with terms of less than three months. As of December 31, 2017, there were cash at bank and demand deposits with terms of less than three months denominated in US dollars, HK dollars and Euro amounting to approximately US\$112.5 million, HK\$5.3 million and Euro1.6 million, respectively. As of December 31, 2018, there were cash at bank and demand deposits with terms of less than three months denominated in US dollars, HK dollars and Euro amounting to approximately US\$269.9 million, HK\$90.7 million and Euro1.0 million, respectively (equivalent to approximately RMB1,852.7 million, RMB79.5 million and RMB7.7 million, respectively).

Time deposits represent time deposits placed with banks with original maturities of three months or more. As of December 31, 2017, there were time deposits denominated in US dollars amounting to approximately US\$2,547.8 million. As of December 31, 2018, there were time deposits denominated in US dollars amounting to approximately US\$2,456.3 million (equivalent to approximately RMB16,857.9 million).

As of December 31, 2017 and 2018, the Group had approximately RMB15.1 billion and RMB12.7 billion cash and cash equivalents and time deposits held by its PRC subsidiaries and VIEs, representing 45.1% and 33.1% of total cash and cash equivalents and time deposits of the Group, respectively.

## Edgar Filing: NetEase, Inc. - Form 20-F

As of December 31, 2017 and 2018, the Group had a restricted cash balance approximately RMB5,927.1 million and RMB4,817.3 million, respectively, comprising as follows (in millions):

	December 31, 2017 RMB	December 31, 2018 RMB
Customer deposit of NetEase Pay accounts	1,554.8	1,364.4
Pledge deposits for short-term bank borrowings Current	4,091.0	2,695.0
Pledge deposits for Letter of Guarantee	271.0	748.5
Others	10.3	9.4
<b>Total</b>	<b>5,927.1</b>	<b>4,817.3</b>

The Group had no other lien arrangements during 2017 and 2018.

Table of Contents

**(g) Fair value of financial instruments**

Accounting guidance defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Group considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

Accounting guidance establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Accounting guidance establishes three levels of inputs that may be used to measure fair value:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets

Level 2 Include other inputs that are directly or indirectly observable in the marketplace

Level 3 Unobservable inputs which are supported by little or no market activity

The Group's financial instruments include cash and cash equivalents and time deposits, accounts receivable, prepayments and other current assets, short-term investments, accounts payable, short-term loan, deferred revenue and accrued liabilities and other payables, which the carrying values approximate their fair value. Please see Note 25 for additional information.

**(h) Inventories, net**

Inventories, net mainly represent products for the Group's e-commerce business, are stated at the lower of cost or net realizable value in the consolidated balance sheets. Cost of inventory is determined using the weighted average cost method. Adjustments are recorded to write down the cost of inventory to the estimated net realizable value due to slow-moving merchandise and damaged goods, which is dependent upon factors such as historical and forecasted consumer demand, and promotional environment. The Group takes ownership, risks and rewards of the products purchased. Write downs are recorded in cost of revenues in the consolidated statements of operations and comprehensive income. Certain costs attributable to buying and receiving products, such as purchase freights, are also included in inventories.

**(i) Investments**

Short-term investments

Short-term investments include investments in financial instruments with a variable interest rate indexed to performance of underlying assets, all of which are with an original maturities of less than 12 months.

In accordance with ASC 825, for investments in financial instruments with a variable interest rate indexed to performance of underlying assets, the Group elected the fair value method at the date of initial recognition and carried these investments at fair value. Changes in the fair value are reflected in the consolidated statements of operations and comprehensive income as other income/(expense), net. Fair value is estimated based on quoted prices of similar products provided by banks at the end of each period. The Group classifies the valuation techniques that use these inputs as Level 2 of fair value measurements. Please see Note 5 and Note 25 for additional information.

Long-term investments

Long-term investments are comprised of equity investments in publicly traded companies and privately-held companies.

Equity investments in publicly traded companies are reported at fair value as equity investment with readily determinable fair value. Prior to January 1, 2018, they were classified as available-for-sale equity securities under long-term investments, with unrealized gains or losses, if any, recorded in accumulated other comprehensive income/(loss) in shareholders' equity. The treatment of a decline in the fair value of an individual security was based on whether the decline was other-than-temporary. The Group assessed its available-for-sale equity securities for other-than-temporary impairment by considering factors including, but not limited to, its ability and intent to hold the individual security, severity of the impairment, expected duration of the impairment and forecasted recovery of fair value. If the Group determines a decline in fair value was other-than-temporary, the cost basis of the individual security was written down to fair value as a new cost basis and the amount of the write-down was accounted for as a realized loss charged to the consolidated statements of comprehensive income. The fair value of the investment would then become the new cost basis of the investment and were not adjusted for subsequent recoveries in fair value. Starting January 1, 2018, upon the adoption of ASU 2016-01, unrealized gains and losses during the year are recognized in other income/(expense), net.



Table of Contents

Prior to January 1, 2018, investments in common stock or in-substance common stock issued by privately-held companies on which the Group does not have significant influence, and investments in privately-held companies' shares that are not ordinary shares or in-substance ordinary shares, as these equity securities do not have readily determinable fair value, the Group carried these investment at cost and only adjusts for other-than-temporary declines in fair value and distributions of earnings that exceed the Group's share of earnings since its investment. Starting January 1, 2018, upon the adoption of ASU 2016-01, the Group elects to measure these equity securities investments without readily determinable fair value at cost, less impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer (referred to as the measurement alternative). All gains and losses on these equity securities, realized and unrealized, are recognized in other income/(expense), net.

Management regularly evaluates the impairment of the investments in privately-held companies based on performance and financial position of the investee as well as other evidence of market value. Such evaluation includes, but is not limited to, reviewing the investee's cash position, recent financing, projected and historical financial performance, cash flow forecasts and financing needs. An impairment loss is recognized in earnings equal to the excess of the investment's cost over its fair value at the balance sheet date of the reporting period for which the assessment is made. The fair value would then become the new cost basis of investment.

**(j) Investment in equity method investees**

Investments in common stock or in-substance common stock of investees and limited-partnership investments in which the Group is in a position to exercise significant influence by participating in, but not controlling or jointly controlling, the financial and operating policies are accounted for using the equity method and are reported under long-term investments in the consolidated balance sheets.

**(k) Property, equipment and software**

Property, equipment and software are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line basis over the following estimated useful lives, taking into account any estimated residual value:

Building	20 years
Decoration	5 years
Leasehold improvements	lesser of the term of the lease and the estimated useful lives of the assets
Furniture, fixtures, office and other equipment	3-10 years
Vehicles	5 years
Servers and computers	3 years
Software	3 years

Repairs and maintenance expenditures, which are not considered improvements and do not extend the useful life of the property and equipment, are expensed as incurred.

**(l) Intangible assets**

Finite-lived intangible assets are tested for impairment if impairment indicators arise. The Group amortizes its finite-lived intangible assets using the straight-line method:

Land use right	over the remaining term of the land use right period
License right	over the license period
Technology	10 years

The Group obtains music content for customers through licensing agreements. When the license fee for music title is determinable or reasonably estimable and the content is available for streaming, the Group recognizes an asset representing the fee and a corresponding liability for the amounts owed. The Group relieves the liability as payments are made and the Group amortizes the asset to Cost of revenues on a straight-line basis over the term of the respective licensing agreements.

**(m) Advertising expenses**

The Group expenses advertising costs as incurred and reports these costs under selling and marketing expense. Advertising expenses totaled approximately RMB1,116.9 million, RMB2,310.6 million and RMB2,933.8(US\$426.7 million) for the years ended December 31, 2016, 2017 and 2018, respectively.

Table of Contents

**(n) Foreign currency translation**

The Group's reporting currency is RMB. The Company and its subsidiaries and VIEs, with an exception of several subsidiaries incorporated in Cayman Islands, use RMB as their functional currency. In 2017, several of the Company's subsidiaries incorporated in Cayman Islands changed their functional currency from RMB to US\$. The determination of the respective functional currency is based on the criteria of ASC 830, Foreign Currency Matters and such change has not resulted in any material effect on the Group's financial statements.

Transactions in currencies other than the functional currency are measured and recorded in the functional currency using the exchange rate in effect at the date of the transaction. At the balance sheet date, monetary assets and liabilities that are denominated in currencies other than the functional currency are translated into the functional currency using the exchange rate at the balance sheet date. The resulting exchange differences are included in the consolidated statements of operations and comprehensive income.

Assets and liabilities of the Group companies are translated from their respective functional currencies to the reporting currency at the exchange rates at the balance sheet dates, equity accounts are translated at historical exchange rates and revenues and expenses are translated at the average exchange rates in effect during the reporting period. The exchange differences for the translation of group companies with non-RMB functional currency into the RMB functional currency are included in foreign currency translation adjustments, which is a separate component of shareholders' equity on the consolidated financial statements.

Translations of amounts from RMB into United States dollars for the convenience of the reader were calculated at the noon buying rate of US\$1.00 = RMB6.8755 on the last trading day of 2018 (December 31, 2018) as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at such rate.

**(o) Share-based compensation**

Under its 2009 Restricted Share Unit Plan (see Note 18(a)), the Company issues restricted share units (RSUs) to its employees, directors and consultants with performance conditions and service vesting periods ranging from one year to five years. Some of the RSUs issued are to be settled, at the Company's discretion, in stock or cash upon vesting based on the stock price at grant date. At each reporting period, the Company evaluates the likelihood of performance conditions being met. Share-based compensation costs are then recorded for the number of RSUs expected to vest on a graded-vesting basis, net of estimated forfeitures, over the requisite service period. The compensation cost of the RSUs to be settled in stock only is measured based on the fair value of stock when all conditions to establish the grant date have been met. The compensation cost of RSUs to be settled either in stock or cash at the Company's discretion is remeasured until the date when settlement in stock or cash is determined by the Company.

The Company records share-based compensation to the consolidated statements of operations and comprehensive income with the corresponding credit to the additional paid-in-capital for share options and RSUs to the extent that such awards are to be settled only in stock.

## Edgar Filing: NetEase, Inc. - Form 20-F

Certain subsidiaries of the Company granted options exercisable for ordinary shares to certain of the Group's employees. The options expire five to seven years from the date of grant and either vest or have a vesting commencement date upon certain conditions being met ( "Vesting Commencement Date" ). The Group adopts the binomial option pricing model to determine the fair value of stock options and accounts for share-based compensation cost using an estimated forfeiture rate.

Forfeitures were estimated based on the Group's weighted average historical forfeiture rate of the past five years. Differences between actual and estimated forfeitures are expensed in the period that the differences occur. See Note 18 for further information regarding share-based compensation assumptions and expense.

### (p) **Taxation**

Income tax expense is recognized in accordance with the laws of the relevant taxing authorities, with deferred taxes being provided for temporary differences between amounts of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws. Tax rate changes are reflected in income during the period the changes are enacted.

A deferred income tax asset or liability is computed for the expected future impact of differences between the financial reporting and tax bases of assets and liabilities as well as the expected future tax benefit to be derived from tax loss and tax credit carry forwards.

Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount more likely than not to be realized in future tax returns.

For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, all deferred tax assets and liabilities are offset and presented as a single amount. The Group does not offset deferred tax assets and liabilities attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

Table of Contents

The Group reports tax-related interest expense and penalty in Other, net in the consolidated statements of operations and comprehensive income, if there is any. The Group did not incur any material penalty or interest payments in connection with tax positions during the years ended December 31, 2016, 2017 and 2018.

The Group did not have any significant unrecognized uncertain tax positions as of December 31, 2017 and 2018.

In order to assess uncertain tax positions, the Group applies a more likely than not threshold and a two-step approach for the tax position measurement and financial statement recognition. Under the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement.

**(q) Net earnings per share ( EPS ) and per American Depositary Share ( ADS )**

Basic earnings per share is computed on the basis of the weighted-average number of ordinary shares outstanding during the period under measurement. Diluted earnings per share are based on the weighted-average number of ordinary shares outstanding and potential ordinary shares. Potential ordinary shares result from the assumed exercise of outstanding stock options, RSUs or other potentially dilutive equity instruments, when they are dilutive under the treasury stock method or the if-converted method.

**(r) Statutory reserves**

The Company's subsidiaries and VIEs incorporated in China are required to make appropriations to certain non-distributable statutory reserves. In accordance with the laws applicable to foreign invested enterprises in China, its subsidiaries have to make appropriations from its after-tax profit as reported in their PRC statutory accounts to non-distributable statutory reserves including (i) general reserve fund, (ii) enterprise expansion fund and (iii) staff bonus and welfare fund. The appropriation to the general reserve fund is at least 10% of the after-tax profits as reported in the PRC statutory accounts. Appropriation is not required if the reserve fund has reached 50% of the registered capital of the respective company. The appropriation to the other reserve funds is at the discretion of the board of directors of the respective company. At the same time, the Company's VIEs, in accordance with the China Company Laws, must make appropriations from their after-tax profit as reported in their PRC statutory accounts to non-distributable statutory reserves including (i) statutory surplus fund and (ii) discretionary surplus fund. The appropriation to the statutory surplus fund is at least 10% of the after-tax profits as reported in their PRC statutory accounts. Appropriation is not required if the statutory surplus fund has reached 50% of the registered capital of the respective company. Appropriation to the discretionary surplus fund is made at the discretion of the board of directors of the respective companies.

The general reserve fund and statutory surplus fund are restricted to set off against losses, expansion of production and operation or increase in the registered capital of the respective companies. The staff bonus and welfare fund is available to fund payments of special bonuses to staff and for collective welfare benefits. Upon approval by the board of directors, the discretionary surplus and enterprise expansion fund can be used to offset accumulated losses or to increase capital.

The staff bonus and welfare fund is a liability in nature. The other statutory reserves are not transferable to the Company in the form of cash dividends, loans or advances, and therefore are not available for distribution except in liquidation.

(s) **Noncontrolling interests and Redeemable noncontrolling interests**

Noncontrolling interests are recognized to reflect the portion of the equity of majority-owned subsidiaries and VIEs which is not attributable, directly or indirectly, to the controlling shareholder.

The noncontrolling interest will continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance.

Redeemable noncontrolling interests represent redeemable equity interests issued by the Group's subsidiaries to certain investors (see Note 15), and have been classified as mezzanine classified noncontrolling interests in the consolidated financial statements as these redeemable interests are contingently redeemable upon the occurrence of certain conditional events, which is not solely within the control of the Group. The Group accreted the redeemable equity interests to their redemption value, which is purchase price plus interest per year over the period since issuance to the earliest redemption date. The accretions were recorded against retained earnings, or in the absence of retained earnings, by charges against additional paid-in capital. Once additional paid-in capital had been exhausted, additional charges were recorded by increasing the accumulated deficit.

(t) **Related parties**

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or significant influence, such as a family member or relative, stockholder, or a related corporation.

Table of Contents

**(u) Comprehensive income**

Comprehensive income is defined as the change in equity of the Group during a period arising from transactions and other events and circumstances excluding transactions resulting from investments by shareholders and distributions to shareholders.

Comprehensive income for the years ended December 31, 2016 and 2017 includes net income, change in unrealized gains/(losses) on marketable securities classified as available-for-sale securities (net of tax) and foreign currency translation adjustment. Starting from January 1, 2018, upon adoption of ASU 2016-01, gain/(losses) on marketable securities are recognized in other income/(expense), net.

**(v) Segment reporting**

The Group's internal organizational structure as well as information about geographical areas, business segments and major customers in financial statements is set out in detail under Note 24.

**(w) Dividends**

Dividends of the Company are recognized when declared.

**(x) Recently adopted accounting pronouncements**

*Revenue from Contracts with Customers*

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 (Topic 606) Revenue from Contracts with Customers. Topic 606 supersedes the revenue recognition requirements in Topic 605 Revenue Recognition (Topic 605), and requires entities to recognize revenue when control of the promised goods or services is transferred to customers at an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The Group adopted Topic 606 on January 1, 2018 using the modified retrospective method. Additionally, the Group elected to apply the new revenue accounting standard only to contracts not completed as of the adoption date. The Group recognized the cumulative effect of initially applying the new revenue accounting standard as an adjustment to the opening balance of retained earnings. The comparative financial statements have not been restated and continue to be reported under the accounting standards in effect for those periods.

## Edgar Filing: NetEase, Inc. - Form 20-F

The adoption of Topic 606 primarily impacts the accounting of the recognition of breakage associated with the Group's unused online points in a personal game account as a result of recording revenue based upon estimates of breakage under the new revenue standard. Under Topic 605, revenue for unused points was not recorded until the points expired. Thus, for unused points, revenue is recorded earlier under the new standard. The cumulative-effect adjustment upon adoption includes a reduction of its deferred revenue of approximately RMB81.7 million and a net increase to its retained earnings of approximately RMB27.4 million (net of tax). Revenues of related game points would have been recorded in the consolidated statement of operations and comprehensive income for the year ended December 31, 2018 under Topic 605 based on its actual expiry date. Therefore, adoption of the new revenue accounting standard impacted the Company's consolidated statement of operations and comprehensive income for the year ended December 31, 2018 by reducing RMB81.7 million of revenues. The adoption of Topic 606 does not have significant impact to other used game points as of December 31, 2018.

### *Financial Instruments - Recognition and Measurement*

In January 2016, the FASB issued Accounting Standards Update No. 2016-01 (ASU No. 2016-01) Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The Group adopted this guidance on January 1, 2018, and RMB38.2 million of accumulated other comprehensive income for the Group's available-for-sale equity securities that existed as of December 31, 2017 was reclassified into retained earnings upon the adoption. For equity investments without readily determinable fair value, the Group elected to measure them at their costs minus impairment (if any), plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investments of the same issuer. The Group did not record any changes to the carrying value of equity investments without readily determinable fair value for the year ended December 31, 2018.

### *Statement of Cash Flows*

In November 2016, the FASB issued ASU 2016-18 Statement of Cash Flows (Topic 230): Restricted Cash. The guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown in the statement of cash flows. The standard should be applied using a retrospective transition method to each period presented. The Group adopted this guidance on January 1, 2018 on a retrospective transition method. Pursuant to the new guidance, the net change of cash, cash equivalents and restricted cash increased RMB2,140.6 million and decreased RMB393.8 million for the year ended 31 December, 2016 and 2017, respectively, compared to the amounts presented under previous guidance.



Table of Contents**(y) Recently issued accounting pronouncements not yet adopted**

In February 2016, the FASB issued ASU 2016-02 *Leases* as amended, which generally requires lessees to recognize operating and financing lease liabilities and corresponding right-of-use assets on the balance sheet and to provide enhanced disclosures surrounding the amount, timing and uncertainty of cash flows arising from leasing arrangements. The Group will adopt the new standard effective January 1, 2019 on a modified retrospective basis and will not restate comparative periods. The Group estimate approximately RMB861.5 million would be recognized as total right-of-use assets and total lease liabilities on its consolidated balance sheet as of January 1, 2019. Other than disclosed, the Group do not expect the new standard to have a material impact on the net assets of the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13 *Financial Instruments-Credit Losses (Topic 326)*, which requires entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Group is currently evaluating the impact that the standard will have on its consolidated financial statements and related disclosures.

In June 2018, the FASB issued ASU No. 2018-07, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The guidance simplifies the accounting for share-based payments made to non-employees so the accounting for such payments is substantially the same as those made to employees. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Group does not expect the adoption of this guidance to have a material impact on the consolidated financial statements.

**3. Concentrations and Risks****(a) Bandwidth and server custody service provider**

The Group relied on telecommunications service providers and their affiliates for bandwidth and server custody service to support its operations during fiscal years 2016, 2017 and 2018 as follows:

	For the year ended December 31,		
	2016	2017	2018
Total number of telecommunications service providers	14	23	49
Number of service providers provided by 10% or more of the Group's bandwidth and server custody expenditure	3	3	3
Total % of the Group's bandwidth and server custody expenditure provided by 10% or greater service providers	79.5%	67.8%	57.8%

**(b) Credit risk**

Financial instruments that potentially subject the Group to significant concentrations of credit risk consist primarily of cash and cash equivalents, time deposits, restricted cash, accounts receivable and short-term investments. As of December 31, 2017 and 2018, substantially all of the Group's cash equivalents, time deposits and restricted cash were held in major financial institutions located in the PRC or Hong Kong, which management consider being of high credit quality. Accounts receivable are typically unsecured and are generally derived from revenue earned from mobile games services (mainly related to remittances from distribution channels) and advertising services. One distribution channel had a receivable balance exceeding 10% of the total accounts receivable balance for the year ended December 31, 2017 and 2018, as follows:

	December 31, 2017	December 31, 2018
Distribution channel A	34.6%	22.2%
Allowance for doubtful accounts	Not applicable	Not applicable

Short-term investments consist of financial products issued by commercial banks in China with a variable interest rate indexed to performance of underlying assets, which have a maturity date within one year as of the purchase date. The effective yields of the short-term investments range from 1.90% to 5.50% per annum. Any negative events or deterioration in financial well-being with respect to the counterparties of the above investments and the underlying collateral may cause a material loss to the Group and have a material effect on the Group's financial condition and results of operations.

**(c) Major Customers**

No single customer represented 10% or more of the Group's total net revenues for the years ended December 31, 2016, 2017 and 2018.

Table of Contents**(d) Online Games**

The Group derived 46.3%, 44.3% and 30.2% of its total net revenues from its top 5 online games for the years ended December 31, 2016, 2017 and 2018, respectively.

Additionally, 61.9%, 70.8% and 71.0% of the Group's total net game revenues were generated from mobile games for the years ended December 31, 2016, 2017 and 2018, respectively.

**4. Prepayments and Other Current Assets**

The following is a summary of prepayments and other current assets (in thousands):

	December 31, 2017 RMB	December 31, 2018 RMB
Guarantee payment made to Blizzard - royalty fees	42,697	97,642
Prepayment for royalties, revenue sharing cost	1,479,817	2,000,327
Interest and other operating income receivable	417,843	511,364
Prepayments of content and marketing cost and other operational expenses	381,213	729,376
Prepayment for sales tax and deductible value added tax	698,902	463,411
Bridge loans in connection with ongoing investments	30,575	19,679
Deposits	138,633	123,995
Employee advances	55,045	44,469
Advance to suppliers	337,938	330,903
Others	233,365	306,631
	3,816,028	4,627,797

In accordance with the license agreements of World of Warcraft®, StarCraft® II series, Hearthstone®, Heroes of the Storm®, Diablo® III and Overwatch®, the Group made certain guarantee payments to Blizzard on behalf of Shanghai EaseNet for the minimum guaranteed royalties as of December 31, 2017 and 2018. The guarantee amounts will be released to the Group when actual royalties are paid by Shanghai EaseNet to Blizzard.

As of December 31, 2017 and 2018, prepayments for royalties and revenue sharing cost representing prepaid royalties or revenue sharing cost related to operations of licensed PC and mobile games.

The amount of employee advances listed above included staff housing loan balances of RMB48.5 million and RMB43.1 million repayable within 12 months from December 31, 2017 and 2018, respectively (see Note 9). No advances were made directly or indirectly to the Group's executive officers for their personal benefit for the years ended December 31, 2017 and 2018.



Table of Contents**5. Short-term Investments**

As of December 31, 2017 and 2018, the Group's short-term investments mainly consisted of financial products issued by commercial banks in China with a variable interest rate indexed to the performance of underlying assets and a maturity date within one year when purchased. As of December 31, 2018, the effective yields of short-term investments ranged from 1.90% to 5.50% per annum (2017: 2.00% to 5.30% per annum).

The following is a summary of short-term investments (in thousands):

		<b>December 31, 2017</b>	<b>Estimated</b>
	<b>Cost</b>	<b>Unrealized</b>	<b>Fair Value</b>
	<b>RMB</b>	<b>Gains/(Losses)</b>	<b>RMB</b>
		<b>RMB</b>	
Short-term investments	9,597,381	145,282	9,742,663
	9,597,381	145,282	9,742,663
		<b>December 31, 2018</b>	<b>Estimated</b>
	<b>Cost</b>	<b>Unrealized</b>	<b>Fair Value</b>
	<b>RMB</b>	<b>Gains/(Losses)</b>	<b>RMB</b>
		<b>RMB</b>	
Short-term investments	11,528,300	146,475	11,674,775
	11,528,300	146,475	11,674,775

During the years ended December 31, 2016, 2017 and 2018, the Group recorded investment income related to short-term investments of RMB303.4 million, RMB389.5 million and RMB463.6 million in the consolidated statements of operations and comprehensive income, respectively.

**6. Property, Equipment and Software**

The following is a summary of property, equipment and software (in thousands):

	<b>December 31,</b>	<b>December 31,</b>
	<b>2017</b>	<b>2018</b>
	<b>RMB</b>	<b>RMB</b>
Building and decoration	1,496,971	1,499,947
Leasehold improvements	98,278	176,174
Furniture, fixtures and office equipment	124,201	141,697
Vehicles	68,414	76,913
Servers and computers	2,583,270	3,885,881
Software	86,650	96,850
Construction in progress	1,086,773	2,153,966
	5,544,557	8,031,428

Edgar Filing: NetEase, Inc. - Form 20-F

Less: accumulated depreciation	(1,775,231)	(2,652,868)
Net book value	3,769,326	5,378,560

Depreciation expense was RMB312.9 million, RMB522.2 million and RMB954.7 million for the years ended December 31, 2016, 2017 and 2018, respectively.

As of December 31, 2017 and 2018, the construction in progress balance were mainly comprised of construction of office buildings and warehouses in Hangzhou, Zhoushan, Guangzhou and Ningbo that have not yet been placed in service for our intended use. All the related cost is capitalized in construction in progress to the extent it is incurred for the purposes of bringing the construction development to a usable state.

Table of Contents**7. Land Use Rights**

Land use rights represent acquired right to use the land on which the Group's offices and warehouses are built. In 2018, the Group obtained the land use rights in Guangzhou, Shanghai and Tianjin from the local authorities. Amortization of the land use right is made over the remaining term of the land use right period from the date when the land was made available for use by the Group. The land use rights are summarized as follows (in thousands):

	December 31, 2017 RMB	December 31, 2018 RMB
Cost	637,057	3,581,508
Incentive payment from local government	(15,000)	(15,000)
Accumulated amortization	(28,778)	(63,939)
Land use right, net	593,279	3,502,569

The total amortization expense for each of the years ended December 31, 2016, 2017 and 2018 amounted to approximately RMB11.4 million, RMB12.5 million, and RMB35.2 million, respectively.

**8. Long-term Investments**

The following is a summary of long-term investments (in thousands):

	December 31, 2017 RMB	December 31, 2018 RMB
Investments in equity method investees	563,896	736,551
Equity investments with readily determinable fair values	828,260	612,465
Equity investments without readily determinable fair values	1,292,620	3,897,092
	2,684,776	5,246,108

**(a) Investments in equity method investees**

The Group recorded equity share of loss of RMB85.8 million, RMB12.2 million, and RMB98.3 million for the years ended December 31, 2016, 2017 and 2018, respectively, which was included in investment income, net in the consolidated statements of operations and comprehensive income. Significant equity method investments are summarized as follows.

- (1) In August 2013, the Group established a joint venture with China Telecom Corp. Ltd. (China

Telecom ), Hangzhou Yixin Technology Co., Ltd. ( Yixin ) to launch YiChat , a proprietary social instant messaging application for smart phones. The Group contributed RMB200.0 million cash in exchange for a 27.0% equity interest in Yixin. In July 2015, the Group increased its equity shares in Yixin to 35.0% with a cash consideration of approximately RMB127.5 million.

(2) In 2016, the Group acquired a 49.0% equity interest in MAXWIN (B.V.I) LIMITED ( MAXWIN ), which is engaged in the retail business of casual and sportswear apparel, for a consideration of approximately RMB344.6 million in cash. In 2017, the Group disposed the 49.0% equity interest in MAXWIN for a cash consideration of approximately RMB340.4 million.

(3) As of December 31, 2018, the Group contributed RMB228.6 million cash in a limited partnership as a limited partner. The objective of the limited partnership is to engage in investment in on-line game business. The Group accounted such investment under the equity method.

**(b) Equity investments with readily determinable fair values ( Available-for-sale securities prior to adoption of ASU 2016-01)**

As of December 31, 2018, equity investments with readily determinable fair values included RMB509.5 million invested in shares of Huatai Securities Company Limited ( Huatai ) and RMB102.9 million invested in shares of Caissa Touristic Group ( Caissa ). The Group recorded unrealized fair value loss of RMB215.8 million related to the equity investments with readily determinable fair value for the year ended December 31, 2018.

Prior to adoption of ASU 2016-01, these investments were classified as available-for-sale equity securities. For the year ended December 31, 2016 and 2017, RMB266.7 million and nil impairment provision for Huatai were recognized as investment income, net in the consolidated statements of comprehensive income, respectively.

The Group also received cash dividends of RMB21.4 million, RMB20.9 million and RMB12.7 million from Huatai for the years ended December 31, 2016, 2017 and 2018, respectively.



Table of Contents**(c) Equity investments without readily determinable fair value ( Equity investments prior to adoption of ASU 2016-01)**

Equity investments without determinable fair value represent investments in privately held companies with no readily determinable fair value. The Group does not have significant influence on these investees, or the investments are not common stock or in substance common stock. Prior to January 1, 2018, the Group accounted for investments in these equity securities at cost less impairment. On January 1, 2018, the Group adopted ASU 2016-01 prospectively. These investments are classified as equity investments without determinable fair value, and are carried at cost less impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. For the year ended December 31, 2018, there s no upward adjustments to the carrying value of equity securities without readily determinable fair value resulted from such transactions.

The Group did not sell any investments in equity securities without readily determinable fair value during the year ended December 31, 2018. The Group recognized a gain of RMB234.1 million and RMB9.6 million related to the partial disposal of one of the Group s investment in equity securities without readily determinable fair value as investment income, net in the consolidated statements of operations and comprehensive income for the years ended December 31, 2016 and 2017.

The Group recognized impairment provision of RMB12.2 million, RMB58.5 million and RMB133.6 million related to certain of the equity investments as investment income, net in the consolidated statements of operations and comprehensive income for the years ended December 31, 2016, 2017 and 2018, respectively.

**9. Other Long-term Assets**

The following is a summary of other long-term assets (in thousands):

	<b>December 31, 2017</b>	<b>December 31, 2018</b>
	<b>RMB</b>	
Copyrights, licenses and domain names	820,362	2,464,971
Staff housing loans	107,203	98,244
Non-current deposits	93,147	109,805
Others	91,867	287,656
	<b>1,112,579</b>	<b>2,960,676</b>

Balances of copyrights and licenses represents prepaid minimum royalties for exploitation of related intellectual properties, which was amortized over the term of the respective licensing agreements or estimated amortization periods.

The Group made housing loans to its employees (excluding executive officers) for house purchases via a third-party commercial bank in China. Each individual staff housing loan is collateralized either by the property for which the loan is extended or by approved personal guarantees for the loan amount granted. The repayment term is five years from the date of drawdown. The interest rate is fixed varying from 1.5% to 3.25% per

annum for the years ended December 31, 2017 and 2018, respectively. The outstanding portion of the staff housing loans repayable within 12 months as of December 31, 2017 and 2018 amounted to approximately RMB48.5 million and RMB43.1 million, respectively, and are reported under prepayments and other current assets in the consolidated balance sheets (see Note 4).

**10. Taxation**

**(a) Income taxes**

*Cayman Islands*

Under the current laws of the Cayman Islands, the Company, and its intermediate holding companies in the Cayman Islands are not subject to tax on income or capital gain. Additionally, upon payments of dividends by the Company or its subsidiaries in the Cayman Islands to their shareholders, no Cayman Islands withholding tax will be imposed.

*British Virgin Islands ( BVI )*

Subsidiaries in the BVI are exempted from income tax on its foreign-derived income in the BVI. There are no withholding taxes in the BVI.

*Hong Kong*

Subsidiaries in Hong Kong are subject to 16.5% income tax for 2016, 2017 and 2018 on their taxable income generated from operations in Hong Kong. The payments of dividends by these companies to their shareholders are not subject to any Hong Kong withholding tax.

Table of Contents

*China*

On March 16, 2007, the National People's Congress of PRC enacted the Enterprise Income Tax Law, under which Foreign Invested Enterprises ( FIEs ) and domestic companies would be subject to enterprise income tax ( EIT ) at a uniform rate of 25%. Preferential tax treatments will continue to be granted to FIEs or domestic companies which conduct businesses in certain encouraged sectors and to entities otherwise classified as Software Enterprises , Key Software Enterprises and/or High and New Technology Enterprises ( HNTEs ). The Enterprise Income Tax Law became effective on January 1, 2008.

NetEase Beijing, Boguan, NetEase Hangzhou, Media Beijing and Hangzhou Langhe were qualified as HNTEs and enjoyed a preferential tax rate of 15% for 2016, 2017 and 2018. In 2016, 2017 and 2018, Boguan, Netease Hangzhou and Media Beijing were qualified as a Key Software Enterprise and enjoyed a further reduced preferential tax rate of 10% for 2015, 2016 and 2017. The related tax benefit was recorded in 2016, 2017 and 2018, respectively.

Lede Technology was recognized as a Software Enterprise in 2014. It was exempt from EIT for 2014 and 2015 and subject to a 50% reduction in its EIT rate from 2016 to 2018.

Tianjin Technology was recognised as a Software Enterprise in 2016 to enjoy exemption from EIT for 2015 and 2016 and subject to a 50% reduction in its EIT rate from 2017 to 2019. Hence, the related tax benefit for 2015 was recorded in 2016.

The aforementioned preferential tax rates are subject to annual review by the relevant tax authorities in China.

The following table presents the combined effects of EIT exemptions and tax rate reductions enjoyed by the Group for the years ended December 31, 2016, 2017 and 2018 (in thousands except per share data):

	<b>For the year ended December 31,</b>		
	<b>2016</b>	<b>2017</b>	<b>2018</b>
	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
Aggregate amount of EIT exemptions and tax rate reductions	1,417,150	1,464,587	1,621,063
Earnings per share effect, basic	0.43	0.45	0.50
Earnings per share effect, diluted	0.43	0.44	0.50

The following table sets forth the component of income tax expenses of the Group for the years ended December 31, 2016, 2017 and 2018 (in thousands):

	<b>For the year ended December 31,</b>		
	<b>2016</b>	<b>2017</b>	<b>2018</b>

Edgar Filing: NetEase, Inc. - Form 20-F

	RMB	RMB	RMB
Current tax expense	2,035,822	2,600,406	2,536,580
Deferred tax expense/(benefit)	66,676	(438,043)	(69,899)
Income tax expenses	2,102,498	2,162,363	2,466,681

The following table presents a reconciliation of the differences between the statutory income tax rate and the Group's effective income tax rate for the years ended December 31, 2016, 2017 and 2018:

	For the year ended December 31,		
	2016	2017	2018
	%	%	%
Statutory income tax rate	25.0	25.0	25.0
Permanent differences	(0.8)	(0.5)	2.3
Effect due to different tax rates applicable to overseas entities	(0.1)	(0.5)	3.7
Effect of lower tax rate applicable to Software Enterprises, Key Software Enterprise and HNTes	(13.3)	(16.2)	(24.1)
Change in valuation allowance	1.4	3.4	13.1
Effect of withholding income tax	2.9	5.4	7.6
Effective income tax rate	15.1	16.6	27.6

Table of Contents

As of December 31, 2018, certain entities of the Group had net operating tax loss carry forwards as follows (in thousands):

	<b>RMB</b>
Loss expiring in 2019	3,582
Loss expiring in 2020	9,222
Loss expiring in 2021	191,412
Loss expiring in 2022	968,390
Loss expiring after 2022	4,083,469
	5,256,075

Full valuation allowance was provided on the related deferred tax assets as the Group's management does not believe that sufficient positive evidence exists to conclude that recoverability of such deferred tax assets is more likely than not to be realized.

**(b) Sales tax**

Pursuant to the provision regulation of the PRC on VAT and its implementation rules, the Company's subsidiaries and VIEs are generally subject to VAT at a rate of 6% from revenues earned from services provided.

All entities that engaged in the sale of general goods in China are generally required to pay VAT at a rate of 17% or other applicable value added tax rate implemented by the provision regulation of the gross sales proceeds received, less any creditable value added tax already paid or borne by the taxpayer. Pursuant to further VAT reform implemented from 1 May, 2018, all industries that were previously subject to VAT at a rate of 17% were adjusted to 16%.

The Group is also subject to cultural development fee on the provision of advertising services in China. The applicable tax rate is 3% of the advertising services revenue.

**(c) Deferred tax assets and liabilities**

The following table presents the tax impact of significant temporary differences that give rise to the deferred tax assets and liabilities as of December 31, 2017 and 2018 (in thousands):

	<b>December 31, 2017 RMB</b>	<b>December 31, 2018 RMB</b>
Deferred tax assets:		
Deferred revenue, primarily for advanced payments from online games customers	285,919	507,982
Accruals	510,522	616,453

Edgar Filing: NetEase, Inc. - Form 20-F

Depreciation of fixed assets	3,697	5,103
Amortization of Intangible assets	55,168	43,899
Net operating tax loss carry forward	742,512	1,653,496
	1, 597,818	2,826,933
Less: valuation allowance	(774,323)	(1,762,638)
Total	823,495	1,064,295

	December 31, 2017 RMB	December 31, 2018 RMB
Deferred tax liabilities:		
Withholding income tax(d)	183,642	392,945
Others	29,573	736
Total	213,215	393,681

Table of Contents

The Group does not believe that sufficient positive evidence exists to conclude that the recoverability of deferred tax assets of certain entities of the Group is more likely than not to be realized. Consequently, the Group has provided full valuation allowances for certain entities of the Group on the related deferred tax assets. The following table sets forth the movement of the aggregate valuation allowances for deferred tax assets for the periods presented (in thousands):

	Balance at January 1 RMB	Provision/(Write-off) for the year RMB	Balance at December 31 RMB
2016	223,644	143,784	367,428
2017	367,428	406,895	774,323
2018	774,323	988,315	1,762,638

**(d) Withholding income tax**

The Enterprise Income Tax Law also imposes a withholding income tax of 10% on dividends distributed by a FIE to its immediate holding company outside of China. A lower withholding income tax rate of 5% is applied if the FIE's immediate holding company is registered in Hong Kong or other jurisdictions that have a tax treaty arrangement with China. Such withholding income tax was exempted under the previous income tax law. On February 22, 2008, the Ministry of Finance and State Administration of Taxation jointly issued a circular which stated that for FIEs, all profits accumulated up to December 31, 2007 are exempted from withholding tax when they are distributed to foreign investors. Based on the interpretation of the current tax laws, management believes that the Company and all its non-PRC subsidiaries are not considered as a resident enterprise in China for corporate income tax purposes, but it cannot be certain that the relevant PRC tax authorities will agree with this determination. Except for the foregoing withholding taxes, the Company's non-PRC subsidiaries, which are currently all incorporated in Hong Kong, the British Virgin Islands or Cayman Islands are not subject to taxation on dividends they receive from the Company's PRC subsidiaries.

In 2016, the Group accrued RMB404.8 million withholding tax liabilities, associated with its quarterly dividend and cash expected to be distributed from its PRC subsidiaries to overseas for general corporate purposes.

In 2017, the Group altered its capital allocation strategy due to the change of business strategy. As a result, the Group recorded withholding tax liabilities of RMB707.1 million and RMB679.4 million (US\$98.8 million) in 2017 and 2018, respectively. The Group have repatriated a portion of these earnings and paid related withholding income tax in 2017 and 2018.

As of December 31, 2017 and 2018, there were approximately RMB1,079.5 million and RMB1,057.7 million (US\$153.8 million) unrecognized deferred tax liabilities related to undistributed earnings of the Group's PRC subsidiaries, respectively. And the Group still intends to indefinitely reinvest these remaining undistributed earnings in its PRC subsidiaries.

**11. Taxes Payable**

The following is a summary of taxes payable as of December 31, 2017 and 2018 (in thousands):

	December 31, 2017 RMB	December 31, 2018 RMB
Value Added Tax payable	103,182	231,167
Withholding individual income taxes for employees	161,814	191,367
Enterprise income taxes	1,248,518	1,778,029
Others	51,178	71,460
	1,564,692	2,272,023

## 12. Short-term Loan

As of December 31, 2017 and 2018, the short-term loan balances represent short-term loan arrangements with banks which were repayable within a maturity term ranging from one month to one year and charged at a fixed interest rates ranging from 0.78% to 2.42% and 0.74% to 4.57% per annum, respectively. As of December 31, 2017 and 2018, the weighted average interest rate for the outstanding short-term loans was approximately 2.13% and 3.14%, respectively. The short-term loan are denominated in US\$, EUR, HK\$, JPY or CNY.

As of December 31, 2017 and 2018, certain short-term loans were secured by RMB deposits of the Group in onshore branches of the banks in the amount of RMB4,091.0 million and RMB2,695.0 million (US\$392.0 million), which was recognized as restricted cash (see Note 2(f)).

On August 9, 2018, the Group entered into a three year US\$500 million syndicated facility agreement with a group of four mandated lead arrangers and bookrunners. The facility is priced at 95 basis points over London interbank offered rate ( LIBOR ) and has a commitment fee of 0.20% on the undrawn portion. There were US\$100 million of borrowings outstanding under the syndicated facility as of December 31, 2018. The Group was subject to certain covenants under the syndicated facility agreement and was in compliance with these covenants as of December 31, 2018.



Table of Contents

In 2018, the Group also entered into several uncommitted loan credit facility agreements provided by certain financial institution. As at December 31, 2018, US\$933.5 million of such credit facilities has not been utilized.

In the year ended December 31, 2018, the Company also entered into several guarantee agreements in the aggregate amount of US\$785.0 million in respect of certain credit facilities taken by its subsidiaries. As at December 31, 2018, US\$177.6 million of such credit facilities had not been utilized.

### 13. Accrued Liabilities and Other Payables

The following is a summary of accrued liabilities and other payables as of December 31, 2017 and 2018 (in thousands):

	December 31, 2017 RMB	December 31, 2018 RMB
Customer deposits on NetEase Pay accounts	1,554,789	1,369,672
Marketing expenses and promotion materials	1,434,596	2,102,970
Accrued fixed assets related payables	294,970	413,723
Server custody fees and telecommunication charges	232,395	260,280
Accrued revenue sharing	187,838	373,559
Other staff related cost	38,950	80,400
Content cost	406,890	299,837
Professional fees	65,404	246,425
Accrued freight and warehousing charge	257,877	455,561
Others	218,601	246,036
	4,692,310	5,848,463

### 14. Deferred Revenue

Deferred revenue represents sales proceeds from prepaid point cards, online points sold, unamortized mobile game in-game spending, prepaid products fees before delivery and prepaid subscription fees for Internet value-added services for which services are yet to be provided as of the balance sheet dates.

For the year ended December 31, 2018, the additions to the deferred revenue balance were primarily due to cash payments received or due in advance of satisfying our performance obligations, while the reductions to the deferred revenue balance were primarily due to the recognition of revenues upon fulfillment of our performance obligations, both of which were in the ordinary course of business. During the year ended December 31, 2018, RMB5,925.4 million of revenues recognized were included in the deferred revenue balance at the beginning of the year.

As of December 31, 2018, the aggregate amount of transaction price allocated to our unsatisfied performance obligations is RMB7,953.3 million, which includes our deferred revenues balances and amounts to be invoiced and recognized as revenue in future periods. We expect to

recognize a significant majority of this balance as revenue over the next 12 months, and the remainder thereafter. This balance does not include an estimate for variable consideration arising from sales rebates to advertising service customers and estimated breakage for online points.

## 15. Noncontrolling Interests and Redeemable Noncontrolling Interests

### NetEase Cloud Music

In the first quarter of 2017, pursuant to the agreements entered into by certain of the Group's subsidiaries and VIE (together referred as NetEase Cloud Music) and some investors, one of NetEase Cloud Music's PRC subsidiary (Hangzhou Cloud Music) issued equity interests with preferential rights to certain investors for a total cash consideration of RMB600.0 million. In addition, Hangzhou Cloud Music issued equity interest to one investor for a total cash consideration of RMB150.0 million. After the issuance of the equity interests, the investors together held approximately 12.59% equity interests in NetEase Cloud Music.

The Group determined that the equity interests with preferential rights of RMB600.0 million should be classified as redeemable noncontrolling interests since they are contingently redeemable upon the occurrence of a conditional event, which is not solely within the control of the Company. The redemption price equals initial investment plus annual interests. Equity interests issued of RMB150.0 million was classified as noncontrolling interests.

Table of Contents

In the first quarter of 2018, due to the changes of NetEase Cloud Music financing plan, the Group repurchased all of the redeemable noncontrolling interests and noncontrolling interest issued in China by Hangzhou Cloud Music at a cash consideration of RMB780.0 million and RMB195.0 million, respectively (the Onshore Repurchase ). The Group accounted for the Onshore Repurchase as an equity transaction, no gains or losses were recognized from the repurchase. The excess of the consideration transferred over the carrying amount of the noncontrolling interests surrendered, amounting to RMB63.9 million was recorded as a reduction to retained earnings. The excess of the consideration transferred over the carrying amount of the redeemable noncontrolling interests surrendered, amounting to RMB159.4 million was recognized as a deemed dividend to preferred shareholders, which also reduces the numerator for EPS calculation. The repurchased redeemable noncontrolling interest and noncontrolling interest of NetEase Cloud Music were then retired.

Following the Onshore Repurchase, during 2018, Cloud Village Inc., the Cayman holding company of NetEase Cloud Music issued Preferred Shares ( NetEase Cloud Music Preferred Shares ) to certain investors for an aggregated cash consideration of US\$716.3 million (the Offshore Issuance ). Immediately after the Offshore Issuance, the NetEase Cloud Music Preferred Shares investors together held approximately 24.13% issued and outstanding interests in NetEase Cloud Music. The Company still maintains control of NetEase Cloud Music.

The NetEase Cloud Music Preferred Shares were entitled to certain preferences and privileges with respect to redemption. The Group determined that the preferred shares should be classified as redeemable noncontrolling interests since they are contingently redeemable upon the occurrence of a conditional event or a deemed redemption event, which is not solely within the control of the Group. The redemption price equals to the net initial investment amount plus annual interests, if any.

Others

In April 2018, a subsidiary of the Group issued equity interests with preferential rights ( Other Preferred Shares ) to a group of investor for a total cash consideration of US\$70.0 million. The Group determined that the equity interests with preferential rights should be classified as redeemable noncontrolling interest since they are contingently redeemable upon the occurrence of a conditional event, which is not solely within the control of the Company. The redemption price equals to the net initial investment amount plus annual interests.

Each issuance of the preferred shares is recognized at the respective issue price at the date of issuance net of issuance costs. The Group records accretions on the redeemable noncontrolling interest to the redemption value from the issuance dates to the earliest redemption dates if redemption is probable. The accretions using the effective interest method, are recorded as deemed dividends to preferred shareholders, which reduces retained earnings and equity classified noncontrolling interests, and earnings available to common shareholders in calculating basic and diluted earnings per share.

## 16. Capital Structure

The holders of ordinary shares in the Company are entitled to one vote per share and to receive ratably such dividends, if any, as may be declared by the board of directors of the Company. In the event of liquidation, the holders of ordinary shares are entitled to share ratably in all assets remaining after payment of liabilities. The ordinary shares have no preemptive, conversion, or other subscription rights.

**17. Employee Benefits**

The Company's subsidiaries and VIEs incorporated in China participate in a government-mandated multi-employer defined contribution plan under which certain retirement, medical, housing and other welfare benefits are provided to employees. Chinese labor regulations require the Company's Chinese subsidiaries and VIEs to pay to the local labor bureau a monthly contribution at a stated contribution rate based on the monthly basic compensation of qualified employees. The relevant local labor bureau is responsible for meeting all retirement benefit obligations; hence, the Group has no further commitments beyond its monthly contribution. The following table presents the Group's employee welfare benefits expense for the years ended December 31, 2016, 2017 and 2018 (in millions):

	<b>For the year ended December 31,</b>		
	<b>2016</b>	<b>2017</b>	<b>2018</b>
	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
Contributions to medical and pension schemes	481.8	626.4	849.3
Other employee benefits	315.1	410.5	593.4
	796.9	1,036.9	1,442.7

**18. Share-based Compensation****(a) Restricted share units plan**

In November 2009, the Company adopted a restricted share units plan for the Company's employees, directors and consultants (the 2009 RSU Plan). The Company has reserved 323,694,050 ordinary shares for issuance under the plan. The 2009 RSU Plan was adopted by a resolution of the board of directors on November 17, 2009 and became effective for a term of ten years unless sooner terminated.

Table of Contents**(b) Share-based compensation expense**

The Group recognizes share-based compensation cost in the consolidated statements of operations and comprehensive income based on awards ultimately expected to vest, after considering estimated forfeitures. Forfeitures are estimated based on the Group's historical experience over the last five years and revised in subsequent periods if actual forfeitures differ from those estimates.

The table below presents a summary of the Group's share-based compensation cost for the years ended December 31, 2016, 2017 and 2018 (in thousands):

	2016 RMB	For the year ended December 31, 2017 RMB	2018 RMB
Cost of revenues	444,187	820,281	764,972
Selling and marketing expenses	52,689	95,382	116,611
General and administrative expenses	238,750	581,337	804,565
Research and development expenses	254,505	507,263	843,502
	990,131	2,004,263	2,529,650

As of December 31, 2018, total unrecognized compensation cost related to unvested awards under the 2009 RSU Plan, adjusted for estimated forfeitures, was US\$598.1 million (RMB4,112.5 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2018, the weighted average remaining vesting period was 2.44 years.

**(c) Restricted share units award activities**

The following table presents a summary of the Company's RSUs award activities for the years ended December 31, 2016, 2017 and 2018:

	Employees (in thousands)	Director and Consultants (in thousands)	Total (in thousands)
<b>Number of ordinary shares issuable upon vesting of restricted share units:</b>			
Outstanding at January 1, 2016	39,623	162	39,785
Granted	30,980	100	31,080
Vested	(27,545)	(119)	(27,664)
Forfeited	(1,633)		(1,633)
Outstanding at December 31, 2016	41,425	143	41,568
Outstanding at January 1, 2017	41,425	143	41,568
Granted	31,452	45	31,497
Vested	(29,705)	(100)	(29,805)

Edgar Filing: NetEase, Inc. - Form 20-F

Forfeited	(1,465)		(1,465)
Outstanding at December 31, 2017	41,707	88	41,795
Outstanding at January 1, 2018	41,707	88	41,795
Granted	33,807	46	33,853
Vested	(30,671)	(38)	(30,709)
Forfeited	(2,305)		(2,305)
Outstanding at December 31, 2018	42,538	96	42,634

The following table presents the total fair value of RSUs on vesting dates for the years ended December 31, 2016, 2017 and 2018, respectively:

		RSU	
		US\$ (in millions)	RMB (in millions)
Total fair value vested:	2016	177.2	1,230.4
	2017	343.6	2,235.9
	2018	324.4	2,230.7

Table of Contents

The following table presents the weighted average remaining contractual life for the RSUs outstanding as of December 31, 2018:

Exercise Price	Number Outstanding / Exercisable (in thousands)	Weighted Average Remaining Contractual Life Years	Weighted Average Exercise Price US\$
<b>Restricted Share Units</b>			
Performance-based settled in stock	36,687	3.66	n/a
Time-based-settled in stock/cash	44,564	2.20	n/a
Time-based-settled in stock	6,133	2.03	n/a
	87,384	2.80	n/a

The aggregate intrinsic value of RSUs outstanding as of December 31, 2018 was US\$822.7 million. The intrinsic value was calculated based on the Company's closing stock price of US\$235.37 per ADS, or US\$9.4148 per ordinary share as of December 31, 2018.

It is the Company's policy to issue new shares upon vesting of RSUs. The number of shares available for future grant under the Company's 2009 RSU Plan was 79,343,175 as of December 31, 2018.

#### (d) **Other Share Incentive Plan**

Certain of the Company's subsidiaries have adopted stock option plans, which allow the related subsidiaries to grant options to certain employees of the Group. The options expire in five to seven years from the date of grant and either vest or have a vesting commencement date upon certain conditions being met ( Vesting Commencement Date ). The award can become 100% vested on the Vesting Commencement Date, or vests in two, four or five substantially equal annual installments with the first installment vesting on the Vesting Commencement Date.

The Group has used the binomial model to estimate the fair value of the options granted. For the years ended December 31, 2016, 2017 and 2018, nil, RMB93.1 and RMB38.7 million compensation expenses were recorded for the share options granted.

While certain share options granted will become vested or commence vesting beginning on the Vesting Commencement Date, the effectiveness of the conditions is not within the control of the Group and is not deemed probable to occur for accounting purposes until the Vesting Commencement Date. For such share options, no compensation expenses were recorded. As of December 31, 2018, there were RMB352.6 million unrecognized share based compensation expenses are related to such share options for which the service condition had been met and are expected to be recognized when the conditions are achieved.

## 19. **Net Income Per Share**

The following table sets forth the computation of basic and diluted net income per share for the years ended December 31, 2016, 2017 and 2018:

Edgar Filing: NetEase, Inc. - Form 20-F

	For the year ended December 31,		
	2016	2017	2018
<b>Numerator (RMB in thousands):</b>			
Net income attributable to NetEase, Inc.'s shareholders for basic/dilutive net income per share calculation	11,604,520	10,707,939	6,152,407
<b>Denominator (No. of shares in thousands):</b>			
Weighted average number of ordinary shares outstanding, basic	3,281,729	3,290,312	3,235,324
Dilutive effect of employee stock options and restricted share units	25,380	25,166	19,365
Weighted average number of ordinary shares outstanding, diluted	3,307,109	3,315,478	3,254,689
Net income per share, basic (RMB)	3.54	3.25	1.90
Net income per share, diluted (RMB)	3.51	3.23	1.89

Basic net income per share is computed using the weighted average number of the ordinary shares outstanding during the year. Diluted net income per share is computed using the weighted average number of ordinary shares and potential ordinary shares outstanding during the year. For the years ended December 31, 2016, 2017 and 2018, options to purchase ordinary shares and RSUs that were anti-dilutive and excluded from the calculation of diluted net income per share totaled approximately 2.7 million shares, 3.8 million shares and 19.6 million shares, respectively.



Table of Contents**20. Commitments and Contingencies****(a) Commitments**

The Group leases office space, staff quarters and certain equipment under non-cancelable operating lease agreements, which expire at various dates through December 2022. As of December 31, 2018, future minimum lease under non-cancelable operating lease agreements, capital commitments, royalties and other expenditures commitments related to licensed contents, including the royalties and minimum marketing expenditure commitment for the games licensed by Blizzard, as well as other commitments related to office machines and services purchases, were as follows (in thousands):

	<b>Rental Commitments RMB</b>	<b>Server Custody Fee Commitments RMB</b>	<b>Capital Commitments RMB</b>	<b>Royalties and Expenditure for Licensed Content Commitments RMB</b>	<b>Office Machines and Other Commitments RMB</b>	<b>Total RMB</b>
2019	384,395	134,683	788,755	2,747,243	79,164	4,134,240
2020	270,552	43,290	719,101	1,545,167	60,838	2,638,948
2021	204,218	39,168	392,574	2,128,540	20,858	2,785,358
2022	89,263	11,592		1,566,765	17,529	1,685,149
Beyond 2022	64,981			2,277,465	113	2,342,559
	1,013,409	228,733	1,900,430	10,265,180	178,502	13,586,254

For the years ended December 31, 2016, 2017 and 2018, the Group incurred rental expenses in the amounts of approximately RMB146.3million, RMB231.9 million and RMB471.9 million, respectively.

**(b) Litigation****Overview**

From time to time, the Group is involved in claims and legal proceedings that arise in the ordinary course of business. Based on currently available information, management does not believe that the ultimate outcome of these unresolved matters, individually and in the aggregate, is reasonably possible to have a material adverse effect on the Group's financial position, results of operations or cash flows. However, litigation is subject to inherent uncertainties and the Group's view of these matters may change in the future. Were an unfavorable outcome to occur, there exists the possibility of a material adverse impact on the Group's financial position, results of operations or cash flows for the period in which the unfavorable outcome occurs, and potentially in future periods. The Group records a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The Group reviews the need for any such liability on a regular basis. The Group has not recorded any material liabilities in this regard as of December 31, 2017 and 2018.

## Litigation

In April 2018, PUBG Corporation and PUBG Santa Monica, Inc. filed suit against defendants NetEase, Inc., NetEase Information Technology Corp. and NetEase (Hong Kong) Limited in the U.S. District Court for the Northern District of California. The complaint generally alleges that two of the Company's mobile games, Rules of Survival and Knives Out, infringe the plaintiffs' copyrights and trademarks and that the Company has engaged in unfair business competition under California law. As of March 31, 2019, the Group has reached a settlement agreement with PUBG with respect to this matter.

## 21. Dividends

### Quarterly Dividend Policy

In May 2014, the Company's board of directors approved a new quarterly dividend policy. Under this policy, the Company intends to make quarterly cash dividend distributions at an amount equivalent to approximately 25% of the Group's anticipated net income after tax in each fiscal quarter. Dividends are recognized when declared. There is no dividend payable as of December 31, 2017 and 2018 respectively. The cash dividend declared related to the net profits of fiscal year 2017 and fiscal year 2018 was RMB2,656.0 million and RMB1,538.3 million (US\$223.7 million) in total, respectively.

The determination to make dividend distributions and the amount of such distributions in any particular quarter will be made at the discretion of the Company's board of directors and will be based upon its operations and earnings, cash flow, financial condition, capital and other reserve requirements and surplus, any applicable contractual restrictions, the ability of the Company's PRC subsidiaries to make distributions to their offshore parent companies, and any other conditions or factors which the board deems relevant and having regard to the directors' fiduciary duties.

Table of Contents

**22. Share Repurchase Programs**

The Company accounts for repurchased ordinary shares under the cost method and includes such treasury stock as a component of the common shareholders' equity. Cancellation of treasury stock is recorded as a reduction of ordinary shares, additional paid-in-capital and retained earnings, as applicable. An excess of purchase price over par value is allocated to additional paid-in-capital first with any remaining excess charged entirely to retained earnings.

In November 2016, the Company announced that its board of directors approved a new share repurchase program of up to US\$1.0 billion of the Company's outstanding ADSs for a period not to exceed 12 months. As of expiration date of the program, the Company has repurchased approximately 1.1 million ADSs (equivalent to 28.1 million ordinary shares) for approximately US\$306.1 million under this program.

In November 2017, the Company announced that its board of directors approved a new share repurchase program of up to US\$1.0 billion of the Company's outstanding ADSs for a period not to exceed 12 months. On June 11, 2018, the Company announced that its board of directors approved an amendment to its share repurchase program, authorizing the repurchase of up to an additional US\$1.0 billion of the Company's outstanding ADSs. This expands the US\$1.0 billion repurchase program that was approved on November 15, 2017 for a period not to exceed 12 months, bringing the total authorized repurchase amount to US\$2.0 billion. As of expiration date of the program, the Company has repurchased approximately 4.6 million ADSs (equivalent to 114.9 million ordinary shares) for approximately US\$1,178.5 million under this program.

In November 2018, the Company announced that its board of directors approved a new share repurchase program of up to US\$1.0 billion of the Company's outstanding ADSs for a period not to exceed 12 months. As of December 31, 2018, no ADSs were repurchased under this program.

**23. Related Party Transactions**

The Group had no material transactions with related parties for the year ended December 31, 2016, 2017 and 2018, and no material related parties' balances as of December 31, 2018.

**24. Segment Information**

**(a) Description of segments**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker ( CODM ), or decision making group, in deciding how to allocate resources and in assessing performance. The Group's CODM is the Chief Executive Officer.

The Group's organizational structure is based on a number of factors that the CODM uses to evaluate, view and run its business operations which include, but are not limited to, customer base, homogeneity of products and technology. The Group's operating segments are based on this organizational structure and information reviewed by the Group's CODM to evaluate the operating segment results.

Effective in the fourth quarter of 2017, the Group changed its segment disclosure to separately report the financial results of its e-commerce business in light of the significant growth of the revenue contribution from e-commerce to the Group's total consolidated net revenues in 2017. This segment primarily reflects the results of NetEase's two e-commerce platforms, Kaola and Yanxuan, which were established in January 2015 and April 2016, respectively. On December 31, 2018, the Group renamed its e-mail and others segment to innovative businesses and others to better articulate the businesses included in this segment, there is no change to the business mix included in this segment. The Group now reports four reporting segments: 1) Online game services, 2) E-commerce, 3) Advertising services, and 4) Innovative businesses and others. This change in segment reporting aligns with the manner in which the Group's CODM currently receives and uses financial information to allocate resources and evaluate the performance of reporting segments. This change in segment presentation does not affect consolidated balance sheets, consolidated statements of operations and comprehensive income or consolidated statements of cash flows. The Group retrospectively revised prior period segment information, to conform to current period presentation.

Table of Contents**(b) Segment data**

The table below provides a summary of the Group's operating segment results for the years ended December 31, 2016, 2017 and 2018. The Group does not allocate any operating costs or assets to its business segments as the Group's CODM does not use this information to measure the performance of the operating segments. There was no significant transaction between reportable segments for the years ended December 31, 2016, 2017 and 2018 (in thousands).

	For the year ended December 31,		
	2016 RMB	2017 RMB	2018 RMB
<b>Net revenues:</b>			
Online game services	27,980,491	36,281,642	40,190,057
E-commerce	4,541,744	11,670,416	19,235,476
Advertising services	2,152,379	2,408,823	2,500,833
Innovative businesses and others	3,504,230	3,741,138	5,230,087
<b>Total net revenues</b>	<b>38,178,844</b>	<b>54,102,019</b>	<b>67,156,453</b>
<b>Cost of revenues:</b>			
Online game services	(9,974,146)	(13,473,339)	(14,617,656)
E-commerce	(3,986,871)	(10,464,714)	(17,688,717)
Advertising services	(749,652)	(797,892)	(889,677)
Innovative businesses and others	(1,804,363)	(3,453,381)	(5,556,907)
<b>Total cost of revenues</b>	<b>(16,515,032)</b>	<b>(28,189,326)</b>	<b>(38,752,957)</b>
<b>Gross profit/(loss):</b>			
Online game services	18,006,345	22,808,303	25,572,401
E-commerce	554,873	1,205,702	1,546,759
Advertising services	1,402,727	1,610,931	1,611,156
Innovative businesses and others	1,699,867	287,757	(326,820)
<b>Total gross profit</b>	<b>21,663,812</b>	<b>25,912,693</b>	<b>28,403,496</b>

The following table set forth the breakdown of net revenues by type of good or service for the years ended December 31, 2016, 2017 and 2018:

	For the year ended December 31,		
	2016 RMB	2017 RMB	2018 RMB
Online games services	27,980,491	36,281,642	40,190,057
Online product sales from e-commerce platforms	4,430,389	11,447,037	18,637,521
Advertising services	2,152,379	2,408,823	2,500,833
Others	3,615,585	3,964,517	5,828,042
<b>Total Net revenue</b>	<b>38,178,844</b>	<b>54,102,019</b>	<b>67,156,453</b>

The following table presents the total depreciation and amortization expenses of property and equipment and land use rights by segment for the years ended December 31, 2016, 2017 and 2018:

	2016 RMB	For the year ended December 31, 2017 RMB	2018 RMB
Online game services	101,400	157,695	235,896
E-commerce	274	4,745	18,482
Advertising services	4,061	8,712	10,727
Innovative businesses and others	52,933	89,953	184,987
Total depreciation and amortization expenses of property and equipment and land use rights	158,668	261,105	450,092

As substantially all of the Group's long-lived assets are located in the PRC and substantially all of the Group's revenue of reportable segments are derived from China based on the geographical locations where services and products are provided to customers, no geographical information is presented.

Table of Contents**25. Financial Instruments**

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2017 (in thousands):

		Fair Value Measurements (RMB)	
		Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
	Total		
Time deposits-short term	30,603,369	30,603,369	
Time deposits-long term	100,000	100,000	
Equity investments with readily determinable fair values	828,260	828,260	
Short-term investments	9,742,663		9,742,663
Total	41,274,292	31,531,629	9,742,663

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2018 (in thousands):

		Fair Value Measurements (RMB)	
		Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
	Total		
Time deposits-short term	32,900,287	32,900,287	
Time deposits-long term	100,000	100,000	
Equity investments with readily determinable fair values	612,465	612,465	
Short-term investments	11,674,775		11,674,775
Total	45,287,527	33,612,752	11,674,775

The rates of interest under the loan agreements with the lending banks were determined based on the prevailing interest rates in the market. The Group classifies the valuation techniques that use these inputs as Level 2 of fair value measurements of short-term bank loans. For other financial assets and liabilities with carrying values that approximate fair value, if measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy. As of December 31, 2017 and 2018, certain equity investments without determinable fair value (Note 8) were measured using significant unobservable inputs (Level 3) and written down from their respective carrying value to fair value, with impairment charges of RMB58.5 million and RMB133.6 million incurred and recorded in earnings for the years then ended.

**26. Restricted Net Assets**

## Edgar Filing: NetEase, Inc. - Form 20-F

Relevant PRC laws and regulations permit PRC companies to pay dividends only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. Additionally, the Company's PRC subsidiaries and VIEs can only distribute dividends upon approval of the shareholders after they have met the PRC requirements for appropriation to the general reserve fund and the statutory surplus fund respectively. The general reserve fund and the statutory surplus fund require that annual appropriations of 10% of net after-tax income should be set aside prior to payment of any dividends. As a result of these and other restrictions under PRC laws and regulations, the PRC subsidiaries and VIEs are restricted in their ability to transfer a portion of their net assets to the Company either in the form of dividends, loans or advances, which restricted portion amounted to approximately RMB6.7 billion, or 15% of the Company's total consolidated net assets, as of December 31, 2018. Even though the Company currently does not require any such dividends, loans or advances from the PRC subsidiaries and VIEs for working capital and other funding purposes, the Company may in the future require additional cash resources from its PRC subsidiaries and VIEs due to changes in business conditions, to fund future acquisitions and developments, or merely declare and pay dividends to or distributions to the Company's shareholders.