

NetEase, Inc.
Form 20-F
April 20, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 20-F

(Mark One)

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2017

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report

For the transition period from to

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)

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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:

3,283,217,456 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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post such files).

Yes No

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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

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

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INTRODUCTION

This annual report on Form 20-F includes our audited consolidated financial statements as of December 31, 2016 and 2017 and for the years ended December 31, 2015, 2016 and 2017.

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- and fee-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 causes 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.

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Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

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, 2015, 2016 and 2017 and as of December 31, 2016 and 2017 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, 2013 and 2014 and as of December 31, 2013, 2014 and 2015 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.

| | 2013 RMB | 2014 RMB | For the year ended December 31, 2015 RMB | | 2016 RMB | 2017 RMB | 2017 US\$ (Note 1) |
|---|-------------|-------------|--|--------------|--------------|-------------|-----------------------|
| | | | (in thousands, except per share/ADS data) | | | | |
| Statement of Operations and Comprehensive Income Data: | | | | | | | |
| Total net revenues | 9,196,175 | 11,712,834 | 22,802,895 | 38,178,844 | 54,102,019 | 8,315,328 | |
| Cost of revenues | (2,478,516) | (3,261,544) | (9,399,260) | (16,515,032) | (28,189,326) | (4,332,620) | |
| Gross profit | 6,717,659 | 8,451,290 | 13,403,635 | 21,663,812 | 25,912,693 | 3,982,708 | |
| Operating expenses: | | | | | | | |
| Selling and marketing expenses | (1,093,612) | (1,894,998) | (2,958,229) | (4,481,815) | (6,957,596) | (1,069,362) | |

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| | | | | | | |
|--|-------------|-------------|-------------|-------------|--------------|-------------|
| General and administrative expenses | (349,832) | (467,669) | (1,014,395) | (1,506,154) | (2,429,858) | (373,462) |
| Research and development expenses | (921,618) | (1,323,498) | (2,158,888) | (3,046,979) | (4,371,428) | (671,876) |
| Total operating expenses | (2,365,062) | (3,686,165) | (6,131,512) | (9,034,948) | (13,758,882) | (2,114,700) |
| Operating profit | 4,352,597 | 4,765,125 | 7,272,123 | 12,628,864 | 12,153,811 | 1,868,008 |
| Other income (expenses): | | | | | | |
| Investment income | 37,255 | 27,373 | 62,341 | 200,333 | 362,113 | 55,656 |
| Interest income | 506,181 | 601,502 | 596,930 | 541,969 | 667,323 | 102,566 |
| Exchange (losses)/gains | (15,348) | (17,998) | 133,776 | 146,510 | (448,827) | (68,983) |
| Other, net | 95,136 | 82,438 | 45,138 | 377,685 | 277,080 | 42,586 |
| Income before tax | 4,975,821 | 5,458,440 | 8,110,308 | 13,895,361 | 13,011,500 | 1,999,833 |
| Income tax | (530,603) | (662,735) | (1,273,408) | (2,102,498) | (2,162,363) | (332,349) |
| Net income | 4,445,218 | 4,795,705 | 6,836,900 | 11,792,863 | 10,849,137 | 1,667,484 |
| Add: Net income attributable to noncontrolling interests and redeemable noncontrolling interests | (1,308) | (39,082) | (101,792) | (188,343) | (141,198) | (21,702) |
| Net income attributable to NetEase, Inc.'s shareholders | 4,443,910 | 4,756,623 | 6,735,108 | 11,604,520 | 10,707,939 | 1,645,782 |
| Net income | 4,445,218 | 4,795,705 | 6,836,900 | 11,792,863 | 10,849,137 | 1,667,484 |
| Other comprehensive income | | | 27,452 | 34,027 | (24,894) | (3,826) |
| Total comprehensive income | 4,445,218 | 4,795,705 | 6,864,352 | 11,826,890 | 10,824,243 | 1,663,658 |
| Add: Comprehensive income attributable to noncontrolling interests and redeemable noncontrolling interests | (1,308) | (39,082) | (101,792) | (188,343) | (141,198) | (21,702) |
| Comprehensive income attributable to NetEase, Inc.'s shareholders | 4,443,910 | 4,756,623 | 6,762,560 | 11,638,547 | 10,683,045 | 1,641,956 |

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| | | | | | | |
|--|-------------|-------------|-------------|--------------|--------------|-------------|
| Net income attributable to NetEase, Inc.'s shareholders per share, basic | 1.37 | 1.46 | 2.05 | 3.54 | 3.25 | 0.50 |
| Net income attributable to NetEase, Inc.'s shareholders per share, diluted | 1.36 | 1.45 | 2.04 | 3.51 | 3.23 | 0.50 |
| Net income attributable to NetEase, Inc.'s shareholders per ADS, basic | 34.21 | 36.43 | 51.27 | 88.40 | 81.36 | 12.50 |
| Net income attributable to NetEase, Inc.'s shareholders per ADS, diluted | 34.12 | 36.29 | 50.94 | 87.72 | 80.74 | 12.41 |
| Weighted average number of ordinary shares outstanding, basic | 3,247,874 | 3,264,450 | 3,284,382 | 3,281,729 | 3,290,312 | 3,290,312 |
| Weighted average number of ADS outstanding, basic | 129,915 | 130,578 | 131,375 | 131,269 | 131,612 | 131,612 |
| Weighted average number of ordinary shares outstanding, diluted | 3,256,297 | 3,277,049 | 3,305,213 | 3,307,109 | 3,315,478 | 3,315,478 |
| Weighted average number of ADS outstanding, diluted | 130,252 | 131,082 | 132,209 | 132,284 | 132,619 | 132,619 |
| Share-based compensation cost included in: | | | | | | |
| Cost of revenues | 165,708 | 169,621 | 328,480 | 444,187 | 820,281 | 126,075 |
| Selling and marketing expenses | 17,967 | 23,253 | 36,023 | 52,689 | 95,382 | 14,660 |
| General and administrative expenses | 48,350 | 51,475 | 120,925 | 238,750 | 581,337 | 89,350 |
| Research and development expenses | 74,283 | 104,928 | 199,039 | 254,505 | 507,263 | 77,965 |
| | 306,308 | 349,277 | 684,467 | 990,131 | 2,004,263 | 308,050 |
| Other Financial Data: | | | | | | |
| Capital expenditures | 218,936 | 537,376 | 866,314 | 1,135,533 | 1,842,933 | 283,254 |
| Net cash provided by/(used in): | | | | | | |
| Operating activities | 5,235,890 | 5,873,023 | 8,076,920 | 15,488,266 | 11,889,238 | 1,827,346 |
| Investing activities | (5,453,279) | (4,520,166) | (2,536,524) | (14,001,814) | (13,249,291) | (2,036,382) |
| Financing activities | 86,848 | (778,442) | (1,632,736) | (2,250,507) | (1,302,728) | (200,226) |

| | 2013 RMB | 2014 RMB | As of December 31, | | 2017 RMB | 2017 US\$ (Note 1) |
|---------------------------------------|-------------|-------------|--------------------|-------------|-------------|-----------------------|
| | | | 2015 RMB | 2016 RMB | | |
| (in thousands) | | | | | | |
| Balance Sheet Data: | | | | | | |
| Cash and cash equivalents | 1,458,298 | 2,021,453 | 6,071,487 | 5,439,499 | 2,764,140 | 424,841 |
| Time deposits-current | 16,625,468 | 18,496,574 | 14,593,291 | 19,361,098 | 30,603,369 | 4,703,652 |
| Property, equipment and software, net | 872,113 | 1,281,225 | 2,092,046 | 2,419,510 | 3,769,326 | 579,335 |
| Total assets | 24,546,330 | 30,354,671 | 41,157,430 | 58,031,860 | 71,031,415 | 10,917,330 |
| Short-term loan | 975,504 | 2,049,865 | 2,272,760 | 3,815,691 | 6,623,502 | 1,018,014 |
| Total liabilities | 4,378,067 | 6,862,877 | 11,833,831 | 19,568,919 | 23,981,579 | 3,685,902 |
| Redeemable noncontrolling interests | | 133,634 | | | 614,696 | 94,477 |
| Total shareholders' equity | 20,168,263 | 23,358,160 | 29,323,599 | 38,462,941 | 46,435,140 | 7,136,951 |

Note 1: See the section titled "Exchange Rate Information" below.

Exchange Rate Information

We have published our financial statements in Renminbi, or RMB. Our business is currently conducted in and from China in Renminbi. In this annual report, all references to Renminbi and RMB are to the legal currency of China and all references to U.S. dollars, dollars, \$ and US\$ are to the legal currency of the United States. 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: RMB6.5063 on the last trading day of 2017 (December 29, 2017) as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. The prevailing rate on April 13, 2018 was US\$1.00: RMB6.2725. We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated above, or at all, on December 29, 2017 or on any other date. The Chinese government imposes control over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign exchange and through restrictions on foreign trade.

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The following table sets forth the average buying rate for Renminbi expressed as per one U.S. dollar for the years 2013, 2014, 2015, 2016 and 2017.

| Year | Renminbi Average(1) |
|-------------|----------------------------|
| 2013 | 6.1412 |
| 2014 | 6.1704 |
| 2015 | 6.2869 |
| 2016 | 6.6549 |
| 2017 | 6.7350 |

(1) Determined by averaging the rates on the last business day of each month during the relevant period.

The following table sets forth the high and low exchange rates for Renminbi expressed as per one U.S. dollar during the past six months.

| Month Ended | High | Low |
|--------------------|-------------|------------|
| October 31, 2017 | 6.5712 | 6.6533 |
| November 30, 2017 | 6.5967 | 6.6385 |
| December 31, 2017 | 6.5063 | 6.6210 |
| January 31, 2018 | 6.2841 | 6.5263 |
| February 28, 2018 | 6.2649 | 6.3471 |
| March 31, 2018 | 6.2685 | 6.3565 |

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

RISKS RELATED TO OUR COMPANY

Our business depends to a significant extent on certain online games, which accounted for 42.2%, 49.6% and 46.9% of our total net revenues in 2015, 2016 and 2017, respectively. We may not be able to maintain the popularity of these games for a variety of reasons.

Certain of our mobile games, including the Fantasy Westward Journey mobile game, Westward Journey Online mobile game, Onmyoji and the mobile version of New Ghost, certain of our internally developed massively multi-player online role-playing PC-client games, known as PC-client MMORPGs, including Fantasy Westward Journey Online (previously known as Fantasy Westward Journey II), and certain games licensed from Blizzard Entertainment, Inc. (together with its affiliated companies, referred to as Blizzard in this annual report) such as Hearthstone®, contributed 42.2%, 49.6% and 46.9% of our total net revenues in 2015, 2016 and 2017, 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, 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 next 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 and game tournaments. For example, in 2017, we released several new games, including Demon Seals mobile, Land of Glory, Forever 7, Rules of Survival, Terminator 2: Judgment Day and Knives Out, and introduced new expansion packs for Fantasy Westward Journey Online, New Westward Journey Online II and New Ghost.

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. 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. The development of new online games can be very difficult and requires high levels of innovation.

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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 subscribers, 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, 2017, including the Fantasy Westward Journey mobile game, Westward Journey Online mobile game, Onmyoji, the mobile version of New Ghost, Invincible, Demon Seals mobile and Land of Glory. 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. 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 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 app 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.

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, or if the platforms lose popularity among users, 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 app 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.

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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.

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.

We may not be able to maintain a stable relationship with Blizzard, and we may experience difficulties in the operation of the online games licensed from it or its affiliates.

In August 2008 and April 2009, Blizzard agreed to license certain online games developed by it to Shanghai EaseNet Network Technology Co., Ltd., or Shanghai EaseNet, for operation in the PRC, including StarCraft® II: Wings of Liberty® and World of Warcraft. 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. Since the establishment of this joint venture, Blizzard has agreed to license StarCraft® II: Heart of the Swarm®, Heroes of the Storm®, Hearthstone, Diablo III®, StarCraft® II: Legacy of the Void® and Overwatch to Shanghai EaseNet for operation in the PRC, all of which have been commercially launched. In September 2016, 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 2020. For further details, see Item 4.B. Business Overview Our Services Game Licensing and Joint Venture with Blizzard. If we are unable to maintain a stable relationship with Blizzard, or if Blizzard 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 Blizzard could terminate or fail to renew the license and joint venture agreements with us, which in either case could harm our operating results and business. Moreover, the success of our arrangements with Blizzard depends on the popularity of the games licensed to us by it 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 Blizzard over which we have no control. In addition, certain events may limit Blizzard's ability to develop or license online games, such as claims by third parties that Blizzard's online games infringe such third parties' intellectual property rights or Blizzard's inability to acquire or maintain licenses to use another party's intellectual property in its online games. In the case of such events, Blizzard 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 Blizzard.

The licenses between Shanghai EaseNet and Blizzard require Shanghai EaseNet, as licensee of the games, to pay to Blizzard royalties for the games over the terms of the licenses, make minimum marketing expenditure commitments and provide funds for hardware to operate the games. We have guaranteed the payment of the foregoing amounts if and to the extent Shanghai EaseNet has insufficient funds to make such payments. We will be entitled to reimbursement of any amounts paid under the guarantee for marketing the licensed games and for hardware

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support to operate the games from any net profits subsequently generated by Shanghai EaseNet, after the deduction of, among others, various fees and expenses payable to Blizzard, us and our joint venture with Blizzard which will provide technical services to Shanghai EaseNet. See Item 4.B. Business Overview Our Services Game Licensing and Joint Venture with Blizzard. 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 Blizzard could be terminated.

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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.

Any difficulties or delays in receiving approval from the relevant government authorities for the operation of games we license from game developers outside of China or any expansion packs for or material changes to such games could adversely affect such games popularity and profitability.

Games we license from game developers outside of China require government approvals before operation of such games within China. Moreover, even after licensed games have received government approvals, any expansion packs for or material changes of content to 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 licensed games.

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. For example, starting in August 2008, Blizzard agreed to license certain online games developed by it to Shanghai EaseNet for operation in the PRC. We have also formed a joint venture with Blizzard to provide technical services to Shanghai EaseNet. 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 the operation of Minecraft in the PRC to us. 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.

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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.

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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.

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.

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

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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. 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.

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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.com, or Kaola, and You.163.com, or 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. 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 revenue 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. 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 our e-commerce business, and additional licenses and permits may be required. For example, in March 2016, relevant PRC regulatory authorities introduced new rules, which took effect on April 8, 2016, governing taxation of cross-border e-commerce retail imports that caps the value of goods that may be imported at a reduced tax rate, which may adversely impact transaction volumes of certain high-end commodities on cross-border e-commerce platforms like Kaola. Although such cap has not had a material impact on Kaola's transaction values since being introduced, there can be no assurance that any revision to such cap or any other future regulations on cross-border e-commerce will not have a negative impact. Substantial uncertainties 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.

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

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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 recommendations to customers based on their past purchases or on products that they viewed but did not purchase, 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. 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.

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If we fail to manage 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. In addition, 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.

Our net inventories have increased significantly in 2017, from RMB1,578.1 million as of December 31, 2016 to RMB5,474.9 million (US\$841.5 million) as of December 31, 2017. As we plan to continue expanding our product offerings, we expect to include more products in our inventory, which will make it more challenging for us to manage our inventory effectively and will put more pressure on our warehousing system.

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. 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 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.

We expect that a portion of our future revenues will continue to come from our advertising services, which represented approximately 4.5% of our total net revenues for 2017, but we may not be able to compete effectively in this market because it is relatively new 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:

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- 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. No standards have been widely accepted for the measurement of the effectiveness of online advertising. 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, Jinri TouTiao.com, 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 particular, we increased our sales staff to support more direct contacts with advertisers. 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 NetEase Attitude Awards, an awards ceremony for individuals excelling in music, film and sports hosted by us to promote our brand name. 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, 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.

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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.

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. 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 in China.

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 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. 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.

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. 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.

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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.

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.

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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 e-mail 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.

A natural disaster or widespread public health problem or outbreaks could adversely affect our business and results of operations.

Our business could be adversely affected by natural disasters, widespread public health or other outbreaks and epidemics, such as earthquakes, fires or floods, SARS, and H5N1 influenza. 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 H5N6 or H7N9, 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.

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, e-mail and other fee-based premium services, Wangyibao Co., Ltd., or Wangyibao, the operator of our 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, and 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, which is not directly subject to those laws and regulations, 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.

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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 variable interest entities, or 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 and Youdao Computer and the entire share capital of Shanghai EaseNet is 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 and Youdao Computer. 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.

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One of our shareholders has significant influence over our company.

Our founder, Chief Executive Officer and director, William Lei Ding, beneficially owned, as of December 31, 2017, approximately 44.3% 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.

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.

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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.

Effective as of January 1, 2008, the Chinese government adopted the Enterprise Income Tax Law, as further clarified by subsequent tax regulations implementing the new income tax law, which unified the enterprise income tax, or EIT, rates payable by domestic and foreign-invested enterprises at 25.0%. Preferential tax treatments continue to be 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.

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 2015, 2016 and 2017. In addition, Boguan, NetEase Hangzhou and Media Beijing were each qualified as a Key Software Enterprise in 2016 and 2017 and enjoyed a further reduced preferential tax rate of 10% for 2015 and 2016. See Item 5.A. Operating Results Income Taxes.

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 is 25.0%. 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

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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.

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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, 2017. 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, 2017. 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.

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.

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Our operations are vulnerable to natural disasters 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.

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
- 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.

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.

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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.

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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.

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.

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.

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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.

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We do not believe that we were a PFIC for a taxable year 2017. 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 2017 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.

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 the enactment timetable, interpretation and implementation of a draft PRC Foreign Investment Law and how it may impact the viability of our current corporate structure, corporate governance and business operations.

The PRC Ministry of Commerce published a discussion draft of a proposed Foreign Investment Law in January 2015 aiming to, upon its enactment, replace 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. The Ministry of Commerce completed the solicitation of comments on this draft in February 2015 and indicated in March 2017 that it had revised the draft Foreign Investment Law based on public comments and was cooperating with the Legislative Affairs Office of the State Council and the Law Committee of National People's Congress for the legislative deliberation of the revised draft Foreign Investment Law. However, the revised draft Foreign Investment Law has not been made available to the public and there are still substantial uncertainties with respect to the enactment timetable and the final content of the Foreign Investment Law.

Among other things, the draft Foreign Investment Law proposes to expand the definition of foreign investment and to introduce the principle of actual control in determining whether a company is considered a foreign-invested enterprise. The draft Foreign Investment Law specifically proposes that entities established in China but controlled by foreign investors will be treated as foreign-invested enterprises, whereas an entity established in China by an investor from a foreign jurisdiction but controlled by PRC entities and/or citizens would be treated as a permitted PRC domestic investor in a restricted industry. In this connection, control is broadly defined in the draft law to cover the following summarized categories: (i) holding 50% or more of the shares, voting rights or other similar rights of the subject entity; (ii) holding less than 50% of the shares, voting rights or other similar rights of the subject entity but having the power to secure at least 50% of the seats on the board or other equivalent decision making bodies, or having the voting power to exert material influence on the board, the shareholders meeting or other equivalent decision making bodies; or (iii) having the power to exert decisive influence, via contractual or trust arrangements, over the subject entity's operations, financial matters or other key aspects of business operations. Once an entity is determined to be a foreign-invested enterprise, it will be subject to the foreign investment restrictions or prohibitions set forth in a negative list, to be separately issued by the State Council at a later date. If the underlying business of the foreign-invested enterprise falls within the negative list, market entry clearance by the Ministry of Commerce would be required for the establishment of such foreign-invested enterprise.

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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. Under the draft Foreign Investment Law, VIEs that are controlled via contractual arrangements would also be deemed foreign-invested enterprises if they are ultimately controlled by foreign investors. Therefore, for any company with a VIE structure in a restricted industry category that is included on the negative list, the VIE structure may be permissible only if the ultimate controlling person(s) is/are of PRC nationality (either PRC companies or PRC citizens) or if such foreign investment has obtained market entry clearance from the Ministry of Commerce. Conversely, if the actual controlling person(s) is/are of foreign nationalities, then the VIEs will be treated as foreign-invested enterprises and any operations in a restricted industry category without prior market entry clearance may be considered illegal.

It is uncertain whether we would be considered to be ultimately controlled by Chinese parties. Mr. William Lei Ding, our director and chief executive officer and a PRC citizen, was the largest shareholder of NetEase as of the close of the period covered by the annual report, but shares owned by him constituted less than 50% of NetEase's then total outstanding ordinary shares. It is uncertain whether Mr. Ding would be deemed to have control over NetEase under the draft Foreign Investment Law. Moreover, the draft Foreign Investment Law has not taken a position on what actions would be taken with respect to the existing companies with a VIE structure, whether or not these companies are controlled by Chinese parties. In addition, it is uncertain whether the industries of online games, online advertising, e-commerce and other services in which our VIEs operate will be subject to the foreign investment restrictions or prohibitions set forth in the negative list that is to be issued by the State Council. If the enacted version of the Foreign Investment Law and the final negative list mandate further actions, such as market entry clearance or restructuring of corporate structure and operations, to be completed by companies with existing VIE structure like us, there may be substantial uncertainties as to whether we can complete these actions in a timely manner, or at all, and our business and financial condition may be materially and adversely affected.

The draft Foreign Investment Law, if enacted as proposed, may also materially impact our corporate governance practice and increase our compliance costs. For instance, the draft Foreign Investment Law proposes to impose stringent ad hoc and periodic information reporting requirements on foreign investors and the applicable foreign-invested enterprises. Aside from an investment implementation report and an investment amendment report that are required for each investment and alteration of investment specifics, an annual report is mandatory, and large foreign-invested enterprises meeting certain criteria are required to report on a quarterly basis. Also, the Ministry of Commerce may supervise and examine the foreign investors and the foreign-invested enterprises on a regular and irregular basis on their compliance with the Foreign Investment Law. Any company found to be non-compliant with these information reporting obligations may potentially be subject to fines and/or administrative or criminal liabilities, and the persons directly responsible may be subject to criminal liabilities.

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.

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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:

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- 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 2017, the RMB depreciated against the U.S. dollar by approximately 8.5%. 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.

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.

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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 offshore investment activities by Chinese residents. 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.

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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 prospectus, 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 required by the laws of the United States to undergo regular inspections by the PCAOB to assess its compliance with the laws of the United States and applicable professional standards. Our auditor is located in China, and the PCAOB is currently unable to conduct inspections on auditors in China without the approval of the PRC 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. As a result, our auditor, like other independent registered public accounting firms operating in China, is currently not inspected by the PCAOB.

Inspections of other firms that the PCAOB has conducted outside of China have identified deficiencies in those firms' audit procedures and quality control procedures, and such deficiencies may be addressed as part of the inspection process to improve future audit quality. The inability of the PCAOB to conduct inspections of independent registered public accounting firms operating in China makes it more difficult to evaluate the effectiveness of our auditor's audit procedures or quality control procedures and, to the extent that such inspections might have facilitated improvements in our auditor's audit procedures and quality control procedures, investors may be deprived of such benefits.

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. If future document productions fail to meet specified criteria, the SEC retains the authority to impose a variety of additional remedial measures on the firms depending on the nature of the failure. While we cannot predict if the SEC will further review the Big Four PRC-based accounting firms' compliance with specified criteria or if the results of such a review would result in the SEC imposing penalties such as suspensions or restarting the administrative proceedings, if the accounting firms are subject to additional remedial measures, we may not be able to continue to meet our reporting obligations under 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.

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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 Internet content provider, or 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 e-mail and other 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 and Shanghai EaseNet 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 e-mail and other 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.

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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 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, 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.

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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 email 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 email 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.

An ongoing government suspension has adversely affected our online services related to third-party lottery products and we may be required to obtain governmental authorizations and approvals for providing such services, which, if unattainable, may adversely affect our business.

We have provided certain online services related to third-party lottery products. Under the Tentative Administrative Measures on Internet Lottery Sale promulgated by the MOF on September 26, 2010, an approval from the MOF is required for conducting an online lottery sales business. On January 18, 2012, the Implementation Rules of the Lottery Administration Regulations, or the Lottery Implementation Rules, were jointly issued by the MOF, the PRC Ministry of Civil Affairs and the State General Administration of Sport. The Lottery Implementation Rules became effective as of March 1, 2012 and explicitly stipulate that the welfare lotteries and sports lotteries sold without the approval of the MOF and the Lottery Issuing Authority's and Lottery Sales Office's commission may be categorized as illegal lotteries. In December 2012, the MOF issued the Lottery Distribution and Sale Administration Measures, which became effective on January 1, 2013, and the Tentative Administrative Measures on Telephone Lottery Sale, which became effective on April 1, 2014. Such measures expressly allow lottery sales online or via telephone after obtaining an approval from the MOF. However, there are no associated implementation rules. Under these issued rules or regulations, it is currently unclear if we need to obtain approval from the MOF with respect to our provision of services related to third-party lottery products.

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On January 15, 2015, the Notice on Issues Related to Self-Inspection and Self-Remedy of Unauthorized Online Lottery Sales, or the Lottery Self-Inspection Notice, was jointly issued by the MOF, the PRC Ministry of Civil Affairs and the State General Administration of Sport. In addition, on April 3, 2015, the MOF, the PRC Ministry of Public Security, the State Administration of Industry and Commerce, or SAIC, the MII, the PRC Ministry of Civil Affairs, the People's Bank of China, or the PBOC, the State General Administration of Sport and the China Banking Regulatory Commission jointly issued a public announcement (Announcement No. 18 of 2015) with regard to online lottery sales in China, or Announcement No. 18, which reaffirmed that any entities or individuals engaged in online sales of lottery tickets which have not been approved by the MOF should immediately cease such activities and that lottery vendors shall be required to obtain written approval from the MOF before engaging in sales of lottery products online in the future. After the issuance of the Lottery Self-Inspection Notice, we were informed by provincial sports lottery administration centers that, as part of their self-inspection process, they would temporarily suspend accepting online purchase orders for lottery products. The suspension began in late February 2015 and remained in effect after the issuance of Announcement No. 18 and as of the date of this annual report. As a result, our online services related to third-party lottery products were affected, and we have not been able to process online purchase orders for the suspended lottery products. On April 28, 2016, the MOF, the Ministry of Public Security, the SAIC, the Ministry of Civil Affairs and the State General Administration of Sport jointly promulgated the Notice on Seriously Investigating and Severely Sanctioning the Unauthorized Online Lottery Sale (Cai Zong [2016] No. 22), or Notice No. 22. In addition to reaffirming that using the Internet to sell lottery products requires government authorization, Notice No. 22 announces the government's plan to set up the procedures and application process for such authorization. We intend to submit an application to the relevant government agency for such authorization to provide online lottery services. However, we do not know when, or if at all, such application procedure will be in place. We also cannot guarantee you if our application will be approved. A prolonged or permanent suspension has had and will continue to have a material adverse impact on our revenues, and our results of operations and prospects may be adversely affected.

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

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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.

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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 MMORPGs 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 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.

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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.

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. Most recently, 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.

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.

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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, Chinese language-based web search, 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 21.6% of our total revenue for 2017, 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, TouTiao.com, Youku 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.

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.

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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 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 self-developed and licensed games and investment in the expansion packages of such games, and upgrades of our online service infrastructure, for a total of approximately RMB1,842.9 million (US\$283.3 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. Our principal capital expenditures for 2015 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 in connection with the operation of our self-developed and licensed games, and investment in the expansion and upgrade of our mailbox infrastructure for a total of approximately RMB866.3 million.

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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, 2017, we had capital expenditure commitments of RMB970.4 million (US\$149.1 million) for 2018 onwards, which primarily consist of commitments made in connection with the construction of new office buildings and warehouses in Guangzhou, Hangzhou and Ningbo. Our capital expenditures in 2017 have been, and future capital expenditures are expected to continue to be, funded by operating cash flows and our existing capital resources.

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, e-mail and other 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 e-mail 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.

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 (RPGs), MMORPGs, battle arena games, simulation games (SLGs), collectible card games (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, starting in August 2008, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC, as discussed below under Our Services Game Licensing and Joint Venture with Blizzard.

We had offered over 100 self-developed and licensed mobile games of various genres as of December 31, 2017, such as the Fantasy Westward Journey mobile game, Westward Journey Online mobile game, Onmyoji, Invincible, the mobile version of New Ghost, Demon Seals mobile, Land of Glory, Forever 7, Rules of Survival, Terminator 2: Judgment Day and Knives Out. 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 items, 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), Revelation, Demon Seals 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 and Fantasy Westward Journey Online, as well as licensed games such as World of Warcraft. We plan to launch other new games using the item-based revenue model in the future.

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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, 2017, we had launched and promoted our self-developed games such as Onmyoji, Crusaders of Light, Rules of Survival and Knives Out globally. 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. In addition, we have established game development centers in California and Korea as part of our international expansion.

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. Yanxuan 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, 2017, we made available to our e-commerce platform customers imported products from over 40 countries and regions, covering more than 2,700 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, including Hangzhou, Ningbo, Tianjin, Zhengzhou and Shenzhen. We also have developed a logistical system comprising fulfillment centers located in Hong Kong, the Republic of Korea, Australia, Japan, France and the United States.

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 and growing 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.

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E-mail and Others

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. We also offer a wide range of other online services, which primarily include CC, our live video streaming platform, Cloud Music, our music streaming platform, Wangyibao, our payment platform, EaseRead, our e-reading platform, NetEase Cloud Classroom, our online education platform and Youdao Dictionary, our e-dictionary services platform. 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 e-mail and other 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, as well as certain other affiliated entities. Under the contracts, we provide our mobile applications, services and technologies and advertising services to Guangzhou NetEase, NetEase Advertising, Hangzhou Leihuo and certain other affiliated entities and they operate the NetEase online games, websites, e-commerce platforms, the online advertising business as well the e-mail and other online businesses. Guangzhou NetEase also has a wholly-owned subsidiary, Wangyibao, the operator of our Wangyibao online payment platform. For more information on these agreements, see Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions.

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, and with us. The joint venture was established concurrently with the licensing of games from Blizzard in August 2008 and provides technical services to Shanghai EaseNet.

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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.

Lede Inc. (previously named Ujia.com, Inc.), Lede (Hong Kong) Limited (previously named Ujia (Hong Kong) Limited), or Lede Hong Kong, and Lede Technology, were established by us in the second half of 2011. Lede Technology now operates our online services business related to third-party insurance and other products.

HQG Inc., HQG Limited and Hangzhou Youmai Technology Co., Ltd., or 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 affiliated companies as of April 19, 2018, other than our joint venture arrangements with Blizzard, which are described separately in this section.

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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, 2017, 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, Demon Seals mobile, Knives Out, Terminator 2: Judgment Day and Rules of 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 subsequently have 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, Revelation and Tianxia III. These games are PC-client MMORPGs set in classical Chinese-themed fantasy worlds.

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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, such as New Westward Journey Online II, Fantasy Westward Journey Online and New Westward Journey Online III, pay RMB0.60 (US\$0.10) per hour of game playing time. For our item-based games, such as Tianxia III, New Ghost, Revelation and Demon Seals, 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.

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

| Game | Type | Genre | Revenue Model | Date of Initial Commercial Launch |
|--|----------------|--|--------------------------|--|
| Tianxia III | PC-client Game | 3D MMORPG, classical Chinese setting | Item-based | October 2011 |
| New Westward Journey Online III (a comprehensive upgrade of Westward Journey Online III) | PC-client Game | 2D MMORPG, classical Chinese setting | Item-based | May 2013 |
| Fantasy Westward Journey Online (previously known as Fantasy Westward Journey II) | PC-client Game | 2D MMORPG, classical Chinese setting | Item-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 MMOPRG | Item-based | May 2016 |
| Tianxia Mobile | Mobile Game | MMORPG | Item-based | June 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 |
| Terminator 2: Judgment Day | Mobile Game | Battle Arena | Item-based | November 2017 |
| Knives Out | Mobile Game | Battle Arena | Item-based | November 2017 |
| Rules of Survival | Mobile Game | Battle Arena | Item-based | November 2017 |
| Forever 7 | Mobile Game | RPG | Item-based | November 2017 |

In connection with the introduction of our online games, we developed a prepaid point card 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, primarily playing time for online games. We also utilize our pre-paid point cards for the payment of virtual items as we launch item-based games for which playing time is free and players may purchase various virtual items to enhance their game playing experience.

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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, 2017, 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, of which more than 500 personnel provided customer service support for games licensed from Blizzard.

Game Licensing and Joint Venture with Blizzard

Commencing in August 2008, Blizzard has entered in various license agreements to license to Shanghai EaseNet on an exclusive basis in China the following PC-client and mobile games:

| Game | Genre | Date of Initial License | Date of Initial Commercial Launch |
|---------------------|---------------------------------------|--------------------------------|--|
| StarCraft II series | Space-themed strategy game | August 2008 | April 2011 |
| World of Warcraft | Fantasy-themed role playing game | April 2009 | September 2009 |
| Heroes of the Storm | Multi-player online battle arena game | November 2012 | June 2015 |
| Hearthstone | CCG | July 2013 | January 2014 |
| Diablo III | Action role-playing game | June 2014 | May 2015 |
| Overwatch | Team-based first-person shooter game | May 2015 | May 2016 |

In September 2016, Blizzard and Shanghai EaseNet agreed to extend the licenses to operate all of the foregoing games to January 2020. 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.

Shanghai EaseNet is required to pay royalties for these games to Blizzard and, until September 2016, was also required to pay license and consultancy fees to Blizzard for the StarCraft II series, World of Warcraft, and Overwatch games. The license agreements also include minimum marketing expenditure commitments. In sum, the total commitments amount to approximately RMB7.4 billion (US\$1.1 billion) over the terms of the agreements. As of December 31, 2017, our outstanding commitments under the license agreements with respect to the StarCraft II series, World of Warcraft, Hearthstone, Heroes of the Storm, Diablo III and Overwatch totaled RMB2,944.5 million (US\$452.6 million). We have guaranteed the payment of the foregoing amounts if and to the extent Shanghai EaseNet has insufficient funds to make such payments. We will be entitled to reimbursement of any amounts paid for the marketing of the games and hardware support to operate the games under the guarantee from any net profits subsequently generated by Shanghai EaseNet, after the deduction of, among others, various fees and expenses payable to Blizzard, us and our joint venture with Blizzard which will provide technical services to Shanghai EaseNet.

Blizzard has the right to terminate the license of the foregoing games 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.

Other Game Licensing

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.

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Revenues from our online games accounted for 76.0%, 73.3% and 67.0% of our total net revenues in 2015, 2016 and 2017, respectively.

E-commerce Business

We operate two major e-commerce platforms for consumers in China. The first e-commerce platform, Kaola, was established in January 2015. Through Kaola, we source goods from mainly overseas suppliers, maintain our own inventory and sell such imported goods, including maternity and baby products, skincare and cosmetics and other general merchandise, to Chinese consumers. We have also recently started to allow pre-screened third-party vendors to use Kaola to sell their products, but sales made directly by such third-party vendors on Kaola remain a small portion of Kaola's overall transaction value. The second e-commerce platform, Yanxuan, was established in April 2016. Through Yanxuan, we sell 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, Wangyibao, 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.

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.

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.

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 5.1%, 11.9% and 21.6% of our total net revenues in 2015, 2016, and 2017, respectively.

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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 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.

In order to stay abreast of the developments in mobile and wearable devices, we have cooperated with leading global companies, such as Huawei, to make our NetEase News App available on their latest products. Content display 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 and on the *Dislike* button to voice their disagreement with comments posted by others. Comments receiving the most support are placed more prominently in the commentary sections.

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- *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 annual NetEase Attitude Awards.

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.

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 7.8%, 5.6% and 4.5% of our total net revenues in 2015, 2016, and 2017, respectively.

E-mail and Others

E-mail

We provide registered users with free and fee-based premium e-mail services which support both the Chinese and English languages. Registered users can access and send e-mails through their web browsers, mobile application or through the POP3 and the SMTP standards, which allow users to handle e-mails on their own e-mail applications without opening their browsers. The free email service includes free SPAM filters and anti-virus protection as well as the convenience of an address book to maintain user contact lists online. As of December 31, 2017, we had approximately 980 million registered free e-mail users. We also offer value-added e-mail services for individuals, known as VIP, which provide fee-paying subscribers with the latest anti-virus and anti-SPAM filtering capabilities. The VIP e-mail service also includes enhanced security features as well as several convenient online and offline payment methods and 24-hour customer support. As of December 31, 2017, we had approximately 470,000 active VIP e-mail subscribers. In addition, we also offer fee-based premium e-mail services to corporate users, who could use their corporate name as e-mail address and enjoy our custom-made functions, such as group instant message, push mail service and Internet disk services. As of December 31, 2017, we had approximately 650,000 corporate e-mail customers.

Other Services

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 payment services through Wangyibao, e-books and reading materials through EaseRead, online education through NetEase Cloud Classroom, NetEase Open Courses and Youdao Classes, and online dictionary through Youdao Dictionary.

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- 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.
- Wangyibao is our online payment system where we act as the payment intermediary to facilitate transactions. We help third-party vendors to collect payments and generate revenues from service fees paid by these third-party vendors based on a pre-determined service fee rate and the amount of processed orders.
- EaseRead offers users certain free reading materials and other premium content for item-based fees.
- Our online education websites and mobile applications provide various courses to their users, primarily relating to test preparations, educational channels and talkshows such as TedTalk, and open courses from world-renowned universities.
- Youdao Dictionary offers users online dictionary services and has become one of the most popular online translation tools among Chinese Internet users, achieving over 703 million installations as of December 31, 2017.

Revenues from e-mail and others accounted for 11.1%, 9.2% and 6.9% of total net revenues in 2015, 2016 and 2017, respectively.

SALES AND MARKETING

Sales

Online Games

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For our mobile games, the Apple app store for iOS and third-party Android app stores such as Qihoo 360 Mobile, Xiaomi, Huawei, 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 ranges from 30% to 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 2.0% to 4.0% 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. 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 522 sales professionals located in Beijing, Shanghai and Guangzhou as of December 31, 2017.

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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.

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

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. 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. Pursuant to these agreements, promoters market our game titles to potential customers in specific locations, principally Internet cafés and university campuses, in return for a commission for new users they recruit. 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 November 11, 2017 and December 12, 2017, both 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.

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. As of December 31, 2017, we had approximately 7,000 programmers, network engineers and graphic designers dedicated to online game research and development.

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.

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

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, 2017, there were approximately 77,000 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, Youku, 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, Jumei International Holding Limited 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, TouTiao.com and Youku, 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.

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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, 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.

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

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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. Guangzhou NetEase has obtained an Internet News Information Service License from SCIO.

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.

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 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.

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.

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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, Ledu and 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.

On April 16, 2009, the PBOC issued a notice, or the PBOC Notice, regarding the regulation of non-financial institutions engaged in the business of effecting payments and settlements. The PBOC Notice requires non-financial institutions established before April 16, 2009 which are engaged in the payment and settlement business to register with the PBOC before July 31, 2009. According to the PBOC Notice, such registration is interpreted as a basis for future policy making rather than a permit. Guangzhou NetEase has finished the requisite registration with the PBOC. 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 will not be able to collect interest on a certain portion of funds that our users have with us through our Wangyibao 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.

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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. We have taken necessary measures to comply with the Clients' Reserves 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.

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 Principals, including, without limitation, laws and regulations, socialist system principals 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.

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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);

- 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);
- Cyber Security Law of the People's Republic of China (2016);
- 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);
- Cyber Security Law of the People's Republic of China (2017).

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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.

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.

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On December 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.

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. (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 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.

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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.

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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 regarded as technology import contracts and, accordingly, must be registered with the Ministry of Commerce. Shanghai EaseNet has registered the license agreements for StarCraft II series and World of Warcraft with the local office of the Ministry of Commerce. Such license agreements also need to be registered with the State Copyright Bureau, otherwise the licensee cannot remit licensing fees out of China to the foreign game licensor. Shanghai EaseNet has registered the license agreement for World of Warcraft, StarCraft II series, Hearthstone, Heroes of the Storm, Diablo III and Overwatch with the State Copyright Bureau.

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. Guangzhou NetEase has received such approval. 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 administrated 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).

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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 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 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.

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

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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.

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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.

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 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.

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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.

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 April 24, 2015 with effect from October 1, 2015. 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. According to the notice, which is applicable to the imported goods listed in the E-Commerce Retail Import Commodities List that was issued by the MOF and ten other relevant PRC regulatory authorities on April 6, 2016, 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 RMB2,000, and the total value of transactions carried out by an individual is capped at RMB20,000 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 RMB2,000.

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Online Lottery Services

The principal rules and regulations currently in effect and applicable to online lottery services include the Regulation on Administration of Lottery, promulgated by the State Council on May 4, 2009 and effective as of July 1, 2009, and the Tentative Administration Measures on Internet Lottery Sale, promulgated by the MOF on September 26, 2010, and effective upon its promulgation. On January 18, 2012, the MOF, the PRC Ministry of Civil Affairs and the State General Administration of Sports jointly promulgated the Lottery Implementation Rules, which became effective on March 1, 2012. In December 2012, the MOF issued the Lottery Distribution and Sale Administration Measures, which became effective on January 1, 2013, and the Tentative Administrative Measures on Telephone Lottery Sale, which became effective on April 1, 2014. On January 15, 2015, the Lottery Self-Inspection Notice was jointly issued by the MOF, the PRC Ministry of Civil Affairs and the State General Administration of Sport. In addition, on April 3, 2015, the MOF, the PRC Ministry of Public Security, the SAIC, the MII, the PRC Ministry of Civil Affairs, the PBOC, the State General Administration of Sport and the China Banking Regulatory Commission jointly issued Announcement No. 18, which affirmed that any entities or individuals engaged in online sales of lottery tickets which have not been approved by the MOF should immediately cease such activities and that lottery vendors shall be required to obtain written approval from the MOF before engaging in sales of lottery products online in the future. On April 28, 2016, the MOF, the Ministry of Public Security, the SAIC, the Ministry of Civil Affairs and the State General Administration of Sport jointly promulgated Notice No. 22, which reaffirms that using the Internet to sell lottery products requires government authorization and announces the government's plan to set up the procedures and application process for such authorization. We intend to submit an application to the relevant government agency for such authorization to provide online lottery services. However, it currently remains unclear when, or if at all, such application procedure will be in place and if any application we submit will be approved. For more details, see Item 3.D. Risk Factors Risks Related to the Telecommunications and Internet Industries in China An ongoing government suspension has adversely affected our e-commerce services related to third-party lottery products and we may be required to obtain governmental authorizations and approvals for providing such e-commerce services, which, if unattainable, may adversely affect our e-commerce business.

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.

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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.

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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;
- www.163.com;
- www.yeah.net;
- www.126.com;
- www.lofter.com;
- www.youdao.com;
- www.nease.net;
- www.188.com;

- www.lede.com;
- www.kaola.com;
- www.bobo.com;
- www.netease.com;
- www.neteasemedia.com;
- www.miaode.com;
- www.163yun.com;
- www.tryfun.com;
- www.onmyojigame.jp; and
- 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 and Hong Kong.

In addition, we have registered our various self-developed games and other online products with the State Copyright Bureau of China. Moreover, we have filed certain patent applications with the State Intellectual Property Office of China, U.S. Patent and Trademark Office and European Patent Office, and have obtained Certificate of Design Patent, Invention Patent for NetEase Cloud Music, Youdao Dictionary, YiChat, hardware products and certain other 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 State Intellectual Property Office, as well as Certificates of Utility Patent for games in the United States.

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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, 2017, we leased office and warehouse facilities with a total effective annual rent of RMB230.9 million (US\$35.5 million), including management fees, and an aggregate of approximately 813,298 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, email and other services and their related sales, marketing, technology, management and administrative functions 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 three new office buildings and warehouses in Hangzhou, Guangzhou and Ningbo on land with an area of approximately 76,000, 37,000 and 160,000 square meters, respectively. As of December 31, 2017, we had incurred construction in progress costs of RMB1,084.6 million (US\$166.7 million) for these new office buildings and warehouses, which primarily comprise costs for building construction.

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 are adequate for our needs in the immediate and foreseeable future.

As of December 31, 2017, we owned approximately 77,000 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 RMB905.8 million (US\$139.2 million) for the year ended December 31, 2017, of which approximately 16% was related to the operations of online games licensed from Blizzard.

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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 RMB10,707.9 million (US\$1,645.8 million) for 2017 and generated positive operating cash flows of RMB11,889.2 million (US\$1,827.3 million) during the year. We recorded retained earnings of RMB26,419.7 million, RMB35,328.8 million and RMB42,733.1 million (US\$6,568.0) as of December 31, 2015, 2016 and 2017, respectively.

Our Corporate Structure

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

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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 Lede Technology provide technical consulting and related services to the VIEs. In addition, Guangzhou NetEase has a wholly-owned subsidiary, Wangyibao (the operator of our Wangyibao online payment platform). Please also see Item 4.B. Business Overview Our Organizational Structure.

As of December 31, 2017, the total assets of all the consolidated VIEs of our company were RMB9.7 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, 2017, the total liabilities of the consolidated VIEs were RMB8.9 billion (US\$1.4 billion), mainly comprising accounts payable, deferred revenue, accrued liabilities and other payables. As of December 31, 2017, the total assets of our company and all of our consolidated subsidiaries were RMB61.3 billion (US\$9.4 billion), mainly comprising cash and cash equivalents, time deposits, restricted cash, accounts receivable, short-term investments, prepayments and other current assets, fixed assets and other long-term assets. As of December 31, 2017, the total liabilities of our company and all of our consolidated subsidiaries were RMB15.1 billion (US\$2.3 billion), mainly comprising accounts payable, salary and welfare payables, tax payable, short-term loan, deferred revenue, accrued liabilities and other payables.

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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 e-mail and other services. No customer individually accounted for greater than 10% of our total revenues for the years ended December 31, 2015, 2016 and 2017.

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.

Starting in August 2008, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC as discussed in Business Overview Our Services Game Licensing and Joint Venture with Blizzard. These games include World of Warcraft, StarCraft II series, Hearthstone, Heroes of the Storm, Diablo III, Overwatch, which were commercially launched in 2009, 2011, 2014, 2015, 2015 and 2016, respectively.

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.

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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.

E-mail and Others

We derive our e-mail and others revenues primarily from premium e-mail services, video streaming services, music streaming services, online payment platform services, and e-reading materials and online education services.

Our online fee-based premium services, supplied to registered users of the NetEase websites, include 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.

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 Wangyibao 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 Wangyibao at fixed rates based on their service agreements with us. We recognize revenue upon services rendered.

Similar to Cloud Music, each of EaseRead and our online education platforms provides its respective users reading materials or online courses, as applicable, in exchange for item-based fees.

Seasonality of Revenues

Historically, revenues from advertising and e-mail 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 fee 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.

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The cost of revenues for certain games licensed from Blizzard also includes royalties, and in some cases license and consulting fees, paid to Blizzard.

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

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.

E-mail and Others

Cost of revenues related to our e-mail 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 e-mail and other services. 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.

Selling and Marketing Expenses

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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 RMB155.4 million, RMB503.0 million and RMB1,182.7 million (US\$181.8 million) for the years ended December 31, 2015, 2016 and 2017, 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.

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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.

For the years ended December 31, 2015, 2016 and 2017, we recorded share-based compensation cost of approximately RMB684.5 million, RMB990.1 million and RMB1,911.2 million (US\$293.8 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, 2017, total unrecognized compensation cost related to unvested awards granted under the RSU Plan, adjusted for estimated forfeitures, was RMB4,386.8 million (US\$674.2 million), which is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2017, the weighted average remaining vesting period was 3.06 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, 2016 and 2017, we recorded nil and RMB93.1 million (US\$14.3 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, 2017, there were RMB266.0 million (US\$40.9 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.

Income Taxes

Cayman Islands

Under the current laws of the Cayman Islands, we, Lede Inc., Media Cayman and HQG, Inc. are not subject to tax on income or capital gain. Additionally, upon payments of dividends by us to our shareholders or by Lede Inc., Media Cayman, or HQG, Inc. to us, no Cayman Islands withholding tax will be imposed.

British Virgin Islands (BVI)

NetEase Interactive Entertainment Limited is exempted from income tax on its foreign-derived income in the BVI. There are no withholding taxes in the BVI.

Hong Kong

Hong Kong NetEase Interactive, NetEase Hong Kong, Lede Hong Kong, Media Hong Kong, HQG Limited and StormNet IT HK 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 2015, 2016 and 2017. The payments of dividends by Hong Kong NetEase Interactive, NetEase Hong Kong, Lede Hong Kong, Media Hong Kong, HQG Limited, and StormNet IT HK 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.

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NetEase Beijing, Boguan, NetEase Hangzhou, Media Beijing and Hangzhou Langhe were qualified as HNTEs and enjoyed a preferential tax rate of 15% for 2015, 2016 and 2017. In 2016 and 2017, 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 and 2016. The related tax benefit was recorded in 2016 and 2017, respectively.

Wangyibao was recognized as a Software Enterprise in 2011. Accordingly, it was exempt from EIT for 2011 and 2012 and subject to a 50% reduction in its EIT rate from 2013 to 2015. In 2015, Wangyibao was also qualified as a HNTE and enjoyed a preferential tax rate of 15% from 2016 to 2017.

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 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 (VAT) and its implementation rules, 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 and importation of goods and provision of services are generally subject to a VAT rate of 17% with exceptions for certain categories of goods that are taxed at a VAT rate of 13%.

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.

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. We now report four reporting segments: (1) online game services, (2) e-commerce, (3) advertising services, and (4) email and others. This change in segment reporting aligns with the manner in which our chief operating decision maker (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.

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Critical Accounting Policies and Estimates Regarding Revenue Recognition

Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is reasonably assured.

Net revenues presented in the consolidated statements of operations and comprehensive income represent revenues from service and product sales net off sales discount and VAT. Service sales represent revenues from online games services, advertising services, and certain e-mail and other services. Service sales are recognized when service has been rendered. Product sales represent revenue from the sale of products through our e-commerce platform where we record revenue on a gross basis. Product sales are recorded when the products are shipped and title passes to customers.

Online Games Services

Mobile games

We primarily operate our mobile games, including both self-developed and licensed mobile games, through Hangzhou Leihuo and generate 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 our games.

We record revenue generated from mobile games on a gross basis as we are acting as the principal in fulfilling all obligations related to the operation of our mobile game. Fees paid to game developers, distribution channels such as app stores and payment channels are recorded as cost of revenues.

For the purposes of determining when the service has been provided to the end-users, we have determined that an implied obligation exists to provide on-going services to the end-users who have purchased virtual items to gain an enhanced game-playing experience over the average playing period of these paying players. Accordingly, we recognize revenues ratably over the estimated average playing period of these paying players, starting from the point in time when virtual items are delivered to the players' accounts and all other revenue recognition criteria are met.

We consider the average period of time that players typically play the games and other game playing behavior patterns, as well as various other factors, to arrive at a best estimate for the estimated playing period of the paying players. 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 the playing patterns of certain targeted players and purchasing frequency. While we believe our estimates to be

reasonable based on available game player information, we may revise such estimates and any adjustments are applied prospectively as such changes result from new information indicating a change in game player behavior patterns.

PC-client games

We provide PC-client MMORPG and certain other online games services through Guangzhou NetEase and Shanghai EaseNet. Regarding the revenue recognition for our online games, we sell prepaid point cards and online points to the end-users who may use the points on such cards for online games services provided by us. Proceeds received from the sales of prepaid point cards and online points are initially recorded as deferred revenue.

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We earn revenue through providing online games services to players under two types of revenue models: a time-based revenue model and an item-based revenue model. For the time-based model, revenue is recognized based upon the actual usage of game playing time by players. For the item-based model, the basic gameplay functions are free of charge, and players are charged for purchases of in-game items. Revenues from the sales of in-game items are recognized when the items are consumed by the customers or over the estimated lives of the 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 based on the estimated lives of the in-game items. 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 for the estimated lives of the permanent life in-game items. However, given the relatively short operating history of our item-based games, our estimate of the period that game players typically play our games may not accurately reflect the estimated lives of the permanent life in-game items. We have adopted a policy of assessing the estimated lives of the permanent life in-game items on a quarterly basis. All paying users' data collected since the launch of the games are used to perform the relevant assessments. Historical behavior patterns of these paying users during the period between their first log-on date and last log-on date are used to estimate the lives of the permanent life in-game items.

While we believe our estimates to be reasonable based on available game player information, we may revise such estimates in the future as we continue to gain more operating history and data of our item-based games. Any adjustments arising from changes in estimates of the lives of the permanent in-game items will be applied prospectively as such changes are resulted from new information indicating a change in the game player behavior patterns. Any changes in our estimate of lives of the permanent in-game items may result in our revenues being rec