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## RISK FACTORS

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You should carefully consider all of the information set out in this document before making an investment in the Shares, including the risks and uncertainties described below in respect of our business and our industry and the Global Offering. You should pay particular attention to the fact that we are a company incorporated in the Cayman Islands and that our principal operations are conducted in China and are governed by a legal and regulatory environment that in some respects differs from what prevails in other countries. Our business could be affected materially and adversely by any of these risks.

### RISKS RELATED TO OUR COMPANY AND OUR INDUSTRY

#### Risks related to our online games business

*If we fail to develop and introduce popular, high-quality online games in a timely and successful manner, 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 player preferences for online games are difficult to predict. Our future success depends not only on the popularity of our existing online games but also on our ability to develop new high-quality online games and expand our game portfolio with games in a variety of genres that are in line with market trends and to successfully monetize such games. The development of successful new online games can be challenging and requires high levels of innovation, a deep understanding of the online game industry in China and the other markets where our games are published (including with respect to evolving business models), and an ability to anticipate and effectively respond to changing interests and preferences of game players in a timely manner. Moreover, each of our new games requires long periods of time for research and development and testing and also typically experiences a long ramp-up period as players become familiar with the game. If we are unsuccessful at developing and introducing new online games that are appealing to players with acceptable pricing and terms, our business, financial condition and results of operations will be negatively impacted because we would not be able to compete effectively and our ability to generate revenues would suffer.

In addition, new technologies in online game programming or operations could render our current online titles or games in development obsolete or unattractive to our players, 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 in-house developed and licensed mobile games as of December 31, 2019 including the *Fantasy Westward Journey* mobile game, *Westward Journey Online* mobile game, *Onmyoji*, the mobile version of *New Ghost*, *Invincible*, *Knives Out*, *All About Jianghu*, *Identity V*, *Ancient Nocturne*, *Xuan Yuan Sword: Dragon Upon the Cloud* and *Fantasy Westward Journey 3D*. As the market for mobile games is rapidly evolving, with games in an expanding range of genres being introduced by us and our competitors, we cannot guarantee that we will be able to effectively compete in the mobile game market. We will also need to continue investing in the development of new technologies and bring new features and functionalities to our games, as well as enhance the user experience on our various platforms.

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We are not able to predict if or when we will commercially launch additional new games and the pace at which our new games will penetrate the online game market in China or elsewhere, if at all. A number of factors, including technical difficulties, lack of sufficient game development capabilities, personnel and other resources and failure to obtain or delays in obtaining relevant governmental authorities' approvals could result in delayed launching of our new games or the cancelation of the development of our pipeline games. Any delays in product releases or problems arising following the commercial release of one or more new online games such as programming errors, or "bugs," could negatively impact our business and reputation and could cause our results of operations to be materially different from expectations. We believe that expectations of players regarding the quality, performance and integrity of our online games and services are high, and if any of these issues occurs, players may stop playing our online games and may be less likely to return to such games as often in the future, which may negatively impact our business.

***If we are unable to continue to extend the life of existing online games that will encourage continued engagement with the games through the addition of new features or functionalities, our business may be negatively impacted.***

To prolong the lifespan of our online games, we need to continually improve and update them on a timely basis with new features and functionalities that appeal to existing game players, attract new game players and improve overall player loyalty to such games. As a result, 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. Developing successful updates and expansion packs for our existing games depends on our ability to anticipate market trends in the online game industry. We must also collect and analyze player behavior data and feedback from our online community in a timely manner and utilize this information to effectively incorporate features into our updates and expansion packs to improve the variety and attractiveness of our gameplay and any virtual items sold within the games.

In the course of 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.

We are unable to predict whether these activities will be successful or adversely affect our profitability given the significant resources required. Moreover, because of the rapidly evolving nature of the online games market in China and elsewhere, we cannot estimate the total life cycle of any of our games, particularly our more recently launched mobile or PC games, and changes in players' tastes or in the overall market for online games in China and elsewhere could alter the life cycle of each version or upgrade or even cause our players to stop playing our games altogether.

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***Any difficulties or delays in receiving approval from the relevant government authorities for our new games, or new expansion packs for or material changes to our existing games, could adversely affect our games' popularity and profitability.***

All games we release in China require government approvals. Moreover, even after certain games have received government approvals, any expansion packs for or material changes to the content of those games may require further government approvals. We cannot be certain of the duration of any necessary approval processes, and any delay in receiving such government approvals may adversely affect the profitability and popularity of such games. In particular, game approvals in 2018 experienced certain delays, although the approvals resumed starting from the end of 2018. Since then, China's game regulatory authority has officially published a few lists of newly approved game titles, including a number of our online games, and the approval processes for game titles appears to have returned to normal in 2019. There was, however, a decline in the number of games which received approvals in 2019 compared to previous years. We are not certain of the cause of the delays in 2018 or reduced number of approvals in 2019. In addition, no laws, regulations or official clarifications had been promulgated or published in relation to such delay and resumption of the assessment and approval procedures, and it is unclear whether there will be any similar delays in the future. We cannot predict the effect any future delay in approvals may have on our results of operations. We received our most recent regulatory approval for a new online game in May 2020.

According to several news reports in December 2018, PRC regulators established the Online Games Ethics Committee for the purpose of reviewing online games, and based on the assessment conducted by the Online Games Ethics Committee, PRC regulators reviewed and rejected nine of an initial batch of 20 games. As of the date of this document, no official laws and regulations had been promulgated or published in relation to the assessment criteria and procedures of the Online Games Ethics Committee. However, the formation of the Online Games Ethics Committee and its assessment criteria and procedures could impact our ability to launch and publish new games going forward, and require us to spend more time and costs in preparing and receiving the approvals necessary to launch our games. In addition, our games that have already received the relevant approval may also be subject to further review by the Online Games Ethics Committee, and we may be required to modify the content of our games, which will further add to our regulatory compliance costs and expenses.

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

The media in China has reported incidents of violent crimes allegedly inspired by online games and theft of virtual items between users in online games. While we believe that such events were not related to our online games, it is possible that our reputation, as one of the leading online game providers in China, could be adversely affected by such behavior. In response to the media reports, in August 2005 the Chinese government enacted 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. 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 doing business 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.” If the Chinese government determines 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.

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

***Because our long-term growth strategy involves further expansion of our online game services to players outside of China, our business will be susceptible to risks associated with international operations.***

An important component of our growth strategy involves the further expansion of our online game services and game player base internationally. In particular, we have launched our popular games *Knives Out* and *Identity V* in Japan, North America and other markets across the globe, and *MARVEL Super War* in several Southeast Asia markets. In the future, we may launch our online games in other international markets. The expansion of our online game services to markets outside of China will involve a variety of risks, including:

- difficulties in anticipating the preferences of game players in markets outside of China;
- challenges in formulating effective local sales and marketing strategies targeting users from various jurisdictions and cultures;
- challenges in identifying appropriate local business partners, including local game operators, and establishing and maintaining good working relationships with them;
- changes in a specific country's or region's political or economic conditions;
- unexpected changes in regulatory requirements, taxes or trade laws;
- difficulties in managing a business in new markets with diverse cultures, languages, customs, legal systems, alternative dispute systems and regulatory systems;
- more stringent regulations relating to data security and the unauthorized use of, or access to, commercial and personal information;
- currency exchange rate fluctuations and the resulting effect on our revenue and expenses, and the cost and risk of entering into hedging transactions if we choose to do so in the future;
- laws and business practices favoring local competitors or general preferences for local vendors;
- limited or insufficient intellectual property protection; and

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- adverse tax burdens and foreign exchange controls that could make it difficult to repatriate earnings and cash.

Our limited experience in operating our business outside of China increases the risk that any potential future expansion efforts that we may undertake will not be successful. If we invest substantial time and resources to expand our international operations and are unable to do so successfully and in a timely manner, our business and operating results will suffer.

***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 our revenue-sharing arrangements with these platforms change to our detriment, our mobile games business may be adversely affected.***

In addition to our proprietary distribution channels, we publish our mobile games through the Apple iOS app store and other mobile application stores or platforms owned and operated by third parties. We rely on these third parties to promote and distribute 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. Further, we believe that our games benefit from the strong brand recognition, large user base and the stickiness of these mobile platforms.

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

Furthermore, a few of these third-party platforms dominate the mobile application distribution channels. Any changes in the revenue-sharing arrangements that we have with any of the major third-party application distribution platforms may materially impact our revenue and profitability. In addition, changes in the credit period or the settlement cycle terms of these third-party platforms may materially and adversely affect our cash flow. 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.

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***Our business, financial condition and results of operations depend in part on the overall growth of the online game industry in China and the other markets where our games are operated, the growth of which is subject to a number of factors that are beyond our control.***

Our business, financial condition and results of operations depend in part on continued growth of the online game industry in China and other markets where our games are published, particularly the Asia-Pacific region and North America. The online game industry is affected by a number of factors that are beyond our control, including:

- general economic conditions and the level of discretionary spending devoted by players to non-essentials such as acquiring in-game virtual items;
- the availability and popularity of other forms of interactive entertainment, particularly games on console systems which are more popular in North America, Europe and Japan, and other leisure activities;
- the availability of reliable telecommunication and internet infrastructure and sufficient server bandwidth in the markets where we operate;
- evolving PC, smartphone and tablet technologies;
- changes in game player demographics and public tastes and preferences;
- any government restrictions on the playing of online games; and
- the availability and popularity of alternative gameplay models such as cloud-gaming services.

There is no assurance that the online game industry will continue to grow in future periods at any particular rate or at all.

***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 games.***

We generate a large portion of revenue in our online games segment from our mobile games. 70.8%, 71.0%, 71.4% and 70.3% of our total net game revenues were generated from mobile games for the years ended December 31, 2017, 2018 and 2019 and the three months ended March 31, 2020, respectively. In addition, 57.8%, 55.8%, 56.0% and 55.7% of our total net revenues were generated from mobile games for the years ended December 31, 2017, 2018 and 2019 and the three months ended March 31, 2020, respectively, and 23.9%, 22.8%, 22.4% and 23.5% of our total net revenues were generated from our PC games for the same periods, respectively. Our profits from our mobile games, even if the games are successful, are generally lower than our profits generated from PC games, because, in order to gain access to our games on mobile application stores, which are the primary distribution channel for our mobile games, we must enter into revenue-sharing arrangements that result in lower profit margins compared with those of our PC games. In addition, our mobile games tend to cover a wider variety of genres, some of which have historically had relatively lower profitability than that of our PC games. Furthermore, we are releasing more of our mobile games overseas, which may involve additional marketing and distribution costs and further impact the profitability of our mobile games.

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

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***A significant portion of our revenue from online game services is generated from the sale of virtual items within the games, and if we do not develop desirable virtual items and properly price them or if this revenue model ceases to be successful, our business, financial condition and results of operations may be materially and adversely affected.***

All of our mobile games and many of our PC games currently utilize the item-based revenue model. Under this revenue model, our game players are able to play the games for free, but are charged for the purchase of virtual items in the games. We believe that this attracts a wider audience of players and increases the number of potential paying users. However, the success of this business model largely depends on whether we can attract game players to play our games and whether we can successfully encourage more players to purchase virtual items. Game players will only pay for virtual items if they are perceived to provide value and enhance their playing experience, and we must closely monitor and analyze in-game consumption patterns and player preferences to understand what items will be appealing and the appropriate price for them. Moreover, we must offer sufficient in-game purchasing opportunities to make our games profitable, while ensuring that the games are fun to play including for players who purchase no virtual items. We might fail to accurately identify and introduce new and popular virtual items or price them properly or may not be able to market our virtual items effectively. In addition, the item-based revenue model may not continue to be commercially successful and in the future we may need to change our revenue model to a time-based or other revenue model. Any change in revenue model could result in disruption of our game operations and a decrease in the number of our game players and thereby materially and adversely affect our business, financial condition and results of operations.

***Providing a high level of customer service for our players is crucial to maintaining and growing the popularity of our online games, and any failure to do so could harm our reputation and our business.***

We devote significant resources to provide high quality customer services to our game players 24 hours a day, seven days a week, through telephone and online support. We also maintain a team of highly trained “Game Masters” which supervise the activities within our games to provide assistance to players as needed and stop any cheating or unfair behavior to ensure the game has an atmosphere of fun and fair play. These activities are crucial to retaining our existing game players and attracting new players who expect a high quality playing experience from our online games. In addition, our license agreements with third-party developers may also require us to provide specified minimum levels of customer support, and any breach of such obligations could result in the developer terminating our license agreement with them and other damages.

We have recently experienced increased complaints with regards to server capacity due to the larger than average number of game players during the COVID-19 outbreak in China. If we fail to maintain effective player support which meets the expectations of players, it could harm our reputation and the popularity of our online games, which may materially and adversely affect our business, financial condition and results of operations.

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

In addition to our internally-developed games, we also offer several mobile and PC games licensed from third-party developers, which accounted for 8.8%, 7.5%, 7.5% and 9.6% of our total net revenues in 2017, 2018, 2019 and the three months ended March 31, 2020, respectively. For example, starting in August 2008, Blizzard Entertainment, Inc. (together with its affiliated companies, “**Blizzard**”) agreed to license certain online games developed by it to Shanghai EaseNet Network Technology Co., Ltd. (the “**Shanghai EaseNet**”) for operation in

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the PRC. Shanghai EaseNet is a PRC company owned by William Lei Ding, our founder, director and chief executive officer, and has contractual arrangements with us and with the joint venture established between Blizzard and us. In January 2019, Shanghai EaseNet and Blizzard extended the term of the existing game licenses by Blizzard to Shanghai EaseNet to January 2023. These games include *World of Warcraft*<sup>®</sup>, *StarCraft*<sup>® II</sup>, *Diablo*<sup>® III</sup>, *Hearthstone*<sup>®</sup>, *Heroes of the Storm*<sup>®</sup> and *Overwatch*<sup>®</sup>, all of which have been commercially launched. We are also currently co-developing *Diablo Immortal*<sup>™</sup>, a mobile MMO action-RPG, with Blizzard. In addition to our relationship with Blizzard, in May 2016, we entered into a five-year exclusive agreement with Mojang AB, a subsidiary of Microsoft, pursuant to which Microsoft and Mojang agreed to license the operation of Minecraft in the PRC to us until 2022. In May 2019, we extended the term of the Minecraft license for an additional year to August 2023. If we are unable to maintain stable relationships with our existing game licensors, or if any of our licensors establishes similar or more favorable relationships with our competitors in violation of its contractual arrangements with us or otherwise, we may not be able to ensure the smooth operation of these licensed online games, and our licensors could terminate or fail to renew the license agreements with us, which could harm our operating results and business.

Moreover, the success of our arrangements with our game licensors depends on the popularity of the games licensed to us by them in the Chinese market, which is affected by, among other things, the frequency and success of updates and expansion packs to those games developed by them over which we have no control. Any failure of such licensors to provide game updates, enhancements and new versions in a timely manner and that are appealing to game players, provide assistance that enables us to effectively promote the games, or otherwise fulfill their obligations under our license agreements could adversely affect the game-playing experience of our game players, damage our reputation, or shorten the life-spans of those games, any of which could result in the loss of game players, acceleration of our amortization of the license fees we have paid for those games, or a decrease in or elimination of our revenues from those games.

In addition, certain events may limit our licensors' ability to develop or license online games, such as claims by third parties that their online games infringe such third parties' intellectual property rights or their inability to acquire or maintain licenses to use another party's intellectual property in their online games. In the case of such events, our licensors may be unable to continue licensing online games to us or to continue participating in any joint venture with us, regardless of the stability of our relationship with them.

We also 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 business, financial condition and results of operations.

***We receive relatively lower profits from the operation of online games that we license from third-party developers, and we are subject to certain financial obligations in connection with such licenses.***

Our revenue sharing arrangements for games that we license from third-party developers provide us with relatively less profit than games that we develop in-house. Moreover, to secure the rights to games from such developers, we are required, as licensee of the games, to pay them royalties for the games over the terms of the licenses, to make minimum marketing expenditure commitments, or to provide funds for hardware to operate the games. See “Our Business — Our Services — Online game services — Our games — Our game library — Licensed games” for details about these arrangements. In some cases, we may not be able to



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recoup our investments in such games. We often must make such commitments and investments without knowing whether the games we are licensing will be successful and generate sufficient revenues to enable us to recoup our costs or for the games to be profitable.

***Future alliances may expose us to potential risks, including those associated with the assimilation of new operation technologies and personnel, unforeseen or hidden liabilities, and potential business disputes with our partners, among others.***

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. In some cases, such alliances may involve our investment into strategic partners, as we have done with a number of game development studios in various countries. However, our ability to grow through future alliances, including through joint ventures and direct investments, 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 investments, 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.

***Termination of our material intellectual property licenses could have a material adverse effect on our business.***

Certain of our online games rely on intellectual property license agreements which give us the right to use certain names, characters, logos or storylines in connection with online games developed by us. For example, we have a partnership with Marvel Entertainment to create mobile games based on Marvel characters and storylines. If we were to breach any material term of these license agreements, the licensor could terminate the agreement. If the licensor were to terminate our rights to use any such intellectual property for this reason or any other reason, or if a licensor decides not to renew a license agreement upon the expiration of the license term, the loss of such rights could have a material adverse effect on our business. In addition, it can be difficult to identify a suitable intellectual property that can be adapted for use in online games and is recognizable to players in China and elsewhere, and we face significant competition for the rights to such intellectual property from other online game companies. Obtaining license rights, and particularly exclusive license rights, to use third-party intellectual property for use in online games can involve significant expense. In addition, we have previously obtained, and intend to continue to seek to obtain, license rights for works from certain intellectual property owners based outside of China, and our ability to utilize their intellectual property in China may be adversely affected by the scrutiny of such arrangements by the relevant Chinese authorities.

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Even if we obtain license rights for such intellectual property, we cannot assure you that games that we develop utilizing it will be popular and commercially successful and that we will be able to recoup the amounts we pay for the license rights. Moreover, after the expiration of the terms of our license agreements with the relevant copyright holders, we may not be able to renew the agreements with commercial terms that are favorable to us, if at all. Our inability to renew such agreements could force us to discontinue the related online games and have a significant adverse impact on our online game operations and revenues.

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

Our new online games, including mobile games and PC 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.

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

Several of our competitors have reported in past years 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 players 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. While 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 business, financial condition and results of operations may be materially and adversely affected as a result.

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*Our online games will be less likely to be successful if we cannot adopt and implement innovative and effective marketing strategies to attract attention to our games from game players in our targeted demographic groups.*

A relatively large number of mobile and PC games are typically available at any given time in the markets in which we launch and operate our online games, and such games compete for attention from the same game player population that we target. Our ability to successfully promote and monetize our online games will depend on our ability to adopt and effectively implement innovative marketing strategies, and particularly marketing through online media such as our 163.com website, social media sites, game live streaming sites and other online game forums, and our ability to cross-market new games to players of our current online games. We also engage in a wide range of other promotional activities such as hosting game tournaments and a forum that provides an online community for elite game players, key opinion leaders and masters of the online game industry to interact. If we fail to adopt and implement such marketing and cross-marketing strategies, or if the marketing strategies of our competitors are more innovative and effective than ours, our online games will be less likely to be successful and as a result we may not be able to achieve an acceptable level of revenue from those games.

*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 unauthorized third-party auction websites in exchange for real money, which we do not and are unable to track or monitor. 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, financial condition and results of operations.

In addition, such trading activities could run afoul of PRC regulations on virtual currency and subject traders and us to potential liability. See “— Risks related to doing business in China — Restrictions on virtual currency may adversely affect our online game revenues.”

### **Risks related to our other businesses**

*The success and future growth of our Youdao business will be affected by the user acceptance and market trend of integration of technology and learning.*

We offer online courses and a number of other learning services and products via our majority-controlled subsidiary, Youdao. Youdao operates in the intelligent learning industry, and its business model features integrating technology closely with learning to provide a more efficient and engaging learning experience. Intelligent learning remains a relatively new concept in China, and there are limited proven methods to project user demand or preference or available industry standards. For example, even with the proliferation of internet and mobile devices in China, we believe that some of Youdao's target students may still be inclined to choose traditional face-to-face courses over online courses as they find the former more intimate and reliable. We cannot assure you that Youdao's services and products will continue to be attractive to its users in the future. If Youdao's offering of learning services and products become less appealing to its users, the financial condition and results of operations of our Youdao business could be materially and adversely affected.

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***If we fail to develop and apply our technologies to support and expand Youdao’s product and service offerings or if we fail to timely respond to the rapid changes in industry trends and user preferences, our Youdao business may be materially and adversely affected.***

Over the years, we have developed a number of core technologies to support Youdao’s comprehensive suite of services and products. We also rely on technologies to build and maintain Youdao’s information technology infrastructure. The intelligent learning industry is subject to rapid technological changes and innovations and is affected by unpredictable product lifecycles and user preferences. Our technologies may become obsolete or insufficient, and we may have difficulties in following and adapting to technological changes in the intelligent learning industry in a timely and cost-effective manner. New technologies and solutions developed and introduced by Youdao’s competitors could render its offerings less attractive or obsolete thus materially affecting Youdao’s business and prospects. In addition, our substantial investments in Youdao’s technology may not produce expected results. If we fail to continue to develop, innovate and utilize our technologies to support and expand Youdao’s product and service offerings or if our competitors develop or apply more advanced technologies, the financial condition and results of operations of our Youdao business could be materially and adversely affected.

***Our intelligent learning, music streaming, e-commerce and other innovative businesses are subject to a broad range of laws and regulations. Any lack of requisite approvals, licenses or permits applicable to these businesses or any failure to comply with applicable laws or regulations may have a material and adverse impact on our business, financial condition and results of operations.***

Our intelligent learning, music streaming, e-commerce and other innovative businesses are subject to a broad range of laws and regulations, and future laws and regulations may impose additional requirements and other obligations.

For example, the private education industry in the PRC is subject to various regulations, and certain aspects of Youdao’s business operations may be deemed not to be in full compliance with them. Among other things, a “private school” is required to obtain approval or a permit from the relevant government authorities in China. However, it remains unclear in practice as to whether and how an online education service providers, in particular those that provide, among other things, after-school training services to primary and secondary school students, need to comply with the operating permit requirement under applicable PRC law. In addition, various PRC regulations require that Youdao make certain filings with the relevant provincial regulatory authorities for education and to comply with certain regulatory requirements for its intelligent learning business. As of the date of this document, we have not received any written notice of warning from, or been subject to penalties imposed by the relevant authorities for alleged failure by Youdao to comply with any applicable regulations and have completed or submitted applications for the filings required by such applicable regulations for most of the mobile apps Youdao operates. We are also preparing the required filings for Youdao’s newly launched and other learning apps. We cannot assure you, however, that we will complete all such filings and comply with other regulatory requirements in a timely manner, or at all.

Our e-commerce business is also subject to numerous PRC laws and regulations that regulate retailers generally or govern online retailers specifically. See below “— Risks related to doing business in China — We are subject to consumer protection laws that could require us to modify our current business practices and incur increased costs.” We may also be required to obtain licenses and permits from different regulatory authorities in order to sell certain categories of products on our e-commerce platform. In addition, the online activities of all of these businesses are subject to PRC regulations governing foreign ownership of companies in the internet industry and the licensing requirements pertaining to them, as well as internet

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access and the distribution of online content including music, music videos, online educational content and other forms of content over the internet. See below “— Risks Related to Our Corporate Structure” and “— Risks related to doing business in China.”

If the PRC governmental authorities determine that we are not in compliance with all the requirements under applicable laws and regulations, we may be subject to fines and/or other sanctions, and our operations could be disrupted. As these industries are evolving rapidly in China, it is also uncertain whether and how the PRC government would promulgate additional laws and regulations regarding our intelligent learning, music streaming, e-commerce and other innovative businesses. If the PRC government requires additional licenses or permits or provides more strict supervision requirements in the future in order for us to conduct these businesses, there is no guarantee that we would be able to obtain such licenses or permits or meet all the supervision requirements in a timely manner, or at all. Failure to maintain or regain compliance may materially and adversely affect our business, financial condition and results of operations.

***Our controlling interest in Youdao may be diluted if Youdao raises additional capital with the issuance and sale of additional equity in the future.***

Youdao, our majority-controlled subsidiary listed on the New York Stock Exchange, may need additional capital in the future to fund its continued operations and support its business growth. As Youdao will continue to invest heavily in sales, marketing and branding efforts and in improving technologies, hiring qualified faculty and R&D personnel and offering additional products, services and content, Youdao may not generate sufficient revenue to offset such expenses. In the future, should Youdao require additional liquidity and capital resources to fund its business and operations, Youdao may need to obtain additional financing, including issuing and selling additional equity or equity-linked securities, or issuing additional equity awards to incentivize its employees, which would dilute our interest in Youdao.

***We may be unable to obtain licenses for 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, NetEase Cloud Music, depends upon maintaining commercially viable licenses or arrangements with copyright owners for music content which is popular in China. The majority of our agreements with copyright owners are usually non-exclusive, while some of our competitors have been entering into exclusive arrangements for music distribution rights in China. Therefore, our competitors offer certain music content that we do not have and we may lose users if those music content caters to their preferences. 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.

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.

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***If we fail to anticipate user preferences to provide online music streaming content catering to user demands, or maintain the activeness of our user community, our ability to attract and retain users may be materially and adversely affected.***

The success of our music streaming business relies on our ability to anticipate changes in user preferences and industry dynamics, and respond to such changes in a timely, appropriate and cost-effective manner. Music that was once popular with our users may become less attractive if user preferences evolve. If we fail to cater to the tastes and preferences of our users, or fail to deliver superior user experiences, we may suffer from reduced user traffic and engagement, and the financial condition and results of operations of this business may be materially and adversely affected.

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

Although we anticipate that the revenues generated by our online games 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. Our ability to generate and maintain significant advertising revenue will depend on a number of factors, many of which are beyond our control, including:

- macroeconomic conditions and the general level of advertiser spending;
- the development of a large base of users possessing demographic characteristics attractive to advertisers;
- competition with other major and emerging online advertising platforms;
- 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.

***Our e-commerce business is subject to challenges and risks, which may have a negative impact on our financial performance.***

We established our e-commerce platform, Yanxuan, in April 2016. Yanxuan primarily sells our private label products, including electronic products, food, apparel, homeware, kitchenware and other general merchandise which we primarily source directly from original design manufacturers in China. This business exposes us to challenges and risks that could negatively impact our financial performance. We have incurred significant expenses on a variety of different marketing and brand promotion efforts designed to enhance the recognition of our Yanxuan platform and increase sales of our products on such platform. 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.

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We face intense competition from other e-commerce players, private label manufacturers and retailers. The e-commerce industry in China is subject to rapid market change, the introduction of new business models, and the entry of new and well-funded competitors. If we are unable to compete effectively, our e-commerce business's financial condition and results of operations would be materially and adversely affected. 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, revenues from our e-commerce business will be adversely affected. In addition, our e-commerce business requires us to manage a large volume of inventory effectively and requires a large amount of working capital. 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, which may materially and adversely affect our e-commerce business and financial position.

Moreover, 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. 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.

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 certain of our other businesses, such as our online game business and advertising business. If we cannot successfully address 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.

### **Risks related to our operations overall**

*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. Our competition primarily comes from global online game developers and operators, such as Tencent, established online and offline education service providers in China, as well as leading digital media and entertainment providers. 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 us. We mainly compete to:

- attract, engage and retain users based on the design, quality, popularity and efficacy of our content offerings, the overall user experience of our products and services, as well as the effectiveness of our marketing activities;
- attract and retain motivated and capable talent, including engineers, game designers, product developers and creative professionals to build compelling content, tools and functions; and

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- win collaboration relationships with game studios and content owners based on our level of expertise in systematically developing original games, delivering a compelling user experience through operational know-how and customizing established game titles for rapid expansion into overseas markets.

Our ability to compete depends on a number of other factors as well, some of which may be beyond our control, including alliances, acquisitions or consolidations within our industries that may result in stronger competitors, and changes in the regulatory environment in the markets we operate. Existing and new competitors may leverage their established platforms or market positions, or introduce innovative business models, to launch highly-engaging content, products or services that may attract a large user base and achieve rapid growth, which may materially and adversely affect our business expansion and results of operations. We increasingly face competition from domestic and international players operating in our markets. 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 or that competition will not have a material and adverse effect on our business, financial condition and results of operations.

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

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

Furthermore, our competitors are constantly developing innovations, on both mobile devices and personal computers, to enhance users' online experience in areas that we currently operate or areas that we wish to expand our operations into. As a result, our efforts to continually



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innovate and explore new growth strategies and introduce new products and services to attract more customers to our services, may not be successful, and we cannot guarantee that our innovation efforts could bring positive financial impact to us.

***Our gross profit margin and profitability may be affected by changes in our mix of revenues.***

Our gross profit may fluctuate from period to period due to a shifting mix of services and products we sell due to changes in the relative demand for them in the marketplace. Shifts in the mix of our revenue contributed by our different business lines (or by shifts in the sales of individual services or products within such businesses) can impact our gross profit because they generally produce a different level of gross margin. For example, in general our Youdao and innovative businesses and others segments have had lower gross profit margins compared to our online game services segment. These individual gross margins in turn can be impacted in any given period by factors such as competition, the implementation of new regulatory requirements and other factors. If the mix of services and products sold shifts from higher margin business lines to lower margin lines as a result of differing growth rates among such lines (or to lower margin services and products within business lines), our overall gross profit margin and profitability may be adversely affected.

***We are exposed to credit risk on our accounts receivable, which may be heightened during periods of uncertain economic conditions.***

Our outstanding accounts receivable are not covered by collateral or credit insurance. While we have procedures to monitor and limit exposure to credit risk on our accounts receivable, which risk is heightened during periods of uncertain economic conditions, there can be no assurance such procedures will effectively limit our credit risk and enable us to avoid losses, which could have a material adverse effect on our financial condition and operating results.

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

We derive a substantial portion 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 slowdown, and China's GDP decreased by 6.8% in the first quarter of 2020 compared to the same period in 2019, primarily as a result of the COVID-19 pandemic. In addition, any future escalation of the ongoing trade war between the United States and China or ongoing impact of the coronavirus may negatively impact the growth in both the Chinese economy and the global economy as a whole. Although the PRC government has implemented a number of measures to address the slowdown, we cannot be certain that these measures will 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.

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*We are subject to a variety of laws and other obligations regarding data protection, and our failure to comply with any of them could result in proceedings against us by governmental entities or others and harm our public image and reputation, which could have a material adverse effect on our business, results of operations and financial condition.*

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 PRC* (the “**Cyber Security Law**”) which was promulgated by the National People’s Congress Standing Committee on November 7, 2016, and took effect on June 1, 2017, we, as a network operator, are obligated to provide technical assistance and support to public security and national security authorities in order to protect national security or assist with criminal investigations. In addition, the Cyber Security Law provides that personal information and important data collected and generated by an operator of critical information infrastructure in the course of its operations in the PRC must be stored in the PRC. We have undertaken significant measures in an effort to ensure compliance with the Cyber Security Law.

In addition, the General Administration of Quality Supervision, Inspection and Quarantine and Standardization Administration issued the *Standard of Information Security Technology — Personal Information Security Specification (2017 edition)*, which took effect in May 2018, and the *Standard of Information Security Technology — Personal Information Security Specification (2020 edition)*, which will take effect in October 2020. Pursuant to these standards, any entity or person who has the authority or right to determine the purposes for and methods of using or processing personal information are seen as a personal data controller. Such personal data controller is required to collect information in accordance with applicable laws, and prior to collecting such data, the information provider’s consent is required. Furthermore, the Cyberspace Administration of China (the “CAC”) issued the *Provisions on the Cyber Protection of Children’s Personal Information* (the “**Children’s Provisions**”) which took effect on October 1, 2019. According to the Children’s Provisions, no organization or individual is allowed to produce, release or disseminate information that infringes upon the personal information security of children under 14. Network operators collecting, storing, using, transferring or disclosing children’s personal information are required to enact special protections for such information. We generally comply with industry standards and have established privacy policies to ensure such compliance. However, compliance with any additional laws could be expensive, and may place restrictions on the conduct of our business and the manner in which we interact with our customers. Any failure to comply with applicable regulations could also result in regulatory enforcement actions against us.

Recently, there has been an increased focus on ensuring that mobile apps comply with privacy regulations. The *Announcement of Launching Special Crackdown Against Illegal Collection and Use of Personal Information by Apps* was issued with effect on January 23, 2019 and commenced a coordinated effort among the CAC, the MIIT, the Ministry of Public Security and the SAMR to combat the illegal collection and use of personal information by mobile apps throughout the PRC. On October 31, 2019, the MIIT issued the *Notice on the Special Rectification of Apps Infringing Users’ Rights and Interests*, pursuant to which app providers were required to promptly rectify issues the MIIT designated as infringing app users’ rights such as collecting personal information in violation of PRC regulations and setting obstacles for user account deactivation. If any of our mobile apps are not in compliance with these regulations, we could be subject to potentially serious penalties, including revocation of our business licenses and permits.

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Furthermore, we may be subject to similar data protection laws and other obligations in jurisdictions outside of China where we operate, including the *General Data Protection Regulation* (the “GDPR”). 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 for example, penalties calculated as a percentage of global revenue under the GDPR.

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, financial condition and results of operations. In addition, any negative publicity on our website or platform’s safety or privacy protection mechanism and policy could harm our public image and reputation and have a material and adverse effect on our business, results of operations and financial condition.

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

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

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 are subject to attempts of improper access or creating false or undesirable user accounts for purposes of spreading misinformation.

Although we believe that we have not experienced any hacking activity or security breach that allowed unauthorized access to any information stored on our information technology systems or caused any loss or corruption of personal information and other data, software or other computer equipment, we have been subject to denial of service attacks that have caused

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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 on 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 and other personal information of our users such as users of our intelligent education and e-commerce products may be compromised. 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 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.

***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

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interruptions in the availability of our services or increases the response time of our services could reduce user satisfaction and traffic, which would reduce the NetEase websites and other online and mobile platforms' appeal to users and advertisers. As the number of NetEase websites, mobile applications and traffic increase, we cannot assure you that we will be able to scale our systems proportionately. Any system failures and electrical outages could materially and adversely impact our business.

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

We have limited backup systems and have experienced system failures and electrical outages from time to time in the past, which have disrupted our operations. Most of our servers and routers are currently located at several different locations in China. Our disaster recovery plan may not 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.

***Our business could be adversely affected by widespread public health or other outbreaks and epidemics.***

COVID-19, a novel strain of coronavirus, has spread worldwide. This outbreak has caused, and may continue to cause us and certain of our business partners, including game licensors, suppliers, customers, advertisers and manufacturers, to implement temporary adjustments of work schemes allowing employees to work from home. We have taken measures to reduce the impact of this outbreak, including monitoring our employees' health and optimizing our technology system to support potential growth in game player traffic. However, we and certain of our business partners might still experience lower work efficiency and productivity, which may adversely affect our service quality. This outbreak has also caused restrictions on our employees' and our business partners' ability to travel. In addition, the deterioration in economic conditions in connection with the outbreak globally has caused, and may continue to cause, decreases or delays in advertising and marketing service spending and budgets of customers across our platforms. As a result of any of the above developments, our business, financial condition and results of operations could be materially and adversely affected.

The extent to which COVID-19 impacts our results will depend on future developments, which are highly uncertain and cannot be predicted, including new information which may emerge concerning the severity of COVID-19 and the actions to contain the coronavirus or treat its impact, among others. There have also been other outbreaks of epidemics in China and globally in recent years. Our operations could be disrupted if any future outbreak occurs in China, where substantially all of our revenue is derived, or in Beijing, Shanghai, Guangzhou and Hangzhou, where most of our employees are located. 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.

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*From time to time we may evaluate and consummate strategic investments or acquisitions, which could require significant management attention, disrupt our business and adversely affect our financial results.*

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.

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If we use our equity securities to pay for acquisitions, we may dilute the value of our ADSs and the underlying 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.

***We face risks associated with our long-term and short-term investments.***

We currently invest a portion of our capital in long-term and short-term investments. As of March 31, 2020, our long-term investments mainly consisted of investment in equity method investees, equity investments with readily determinable fair values and equity investments without readily determinable fair values, and our short-term investments mainly consisted of financial products issued by commercial banks in China with a variable interest rate indexed to the performance of underlying assets and a maturity date within one year when purchased. These investments may earn yields substantially lower than anticipated, and any failure to realize the benefits we expected from these investments may materially and adversely affect our business and financial results.

We had investment income of RMB362.1 million, investment losses of RMB22.4 million, investment income of RMB1,306.3 million and investment losses of RMB109.7 million (US\$15.5 million) for the years ended December 31, 2017, 2018 and 2019 and for the three months ended March 31, 2020, respectively. We also had unrealized losses on available-for-sale securities recorded in “other comprehensive income,” net of tax of RMB23.3 million for the year ended December 31, 2017, and zero for the years ended December 31, 2018 and 2019 and the three months ended March 31, 2020, respectively.

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

We rely on affiliates of China Telecom, China Unicom, and China Mobile to provide us with server and bandwidth service for internet users to access the NetEase websites and other online and mobile platforms. If China Telecom, China Unicom, and China Mobile 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 also rely on cloud servers maintained by third-party cloud service providers particularly for our overseas games. We do not control the operation of these providers or their facilities, and the facilities are vulnerable to damage, interruption or misconduct. Unanticipated problems at these facilities could result in lengthy interruptions in our services. Problems with our cloud service providers or the telecommunications network providers with whom they contract could adversely affect the experience of our users. Any change in service levels at our cloud servers or any errors, defects, disruptions, or other performance problems with our platform could harm our business or reputation or we could be required to retain the services of replacement providers, which could increase our operating costs.

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***We may be held liable for information or content displayed on, retrieved from or linked to the NetEase websites and other NetEase's 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 intellectual property infringement claims or actions from time to time and are occasionally subject to defamation claims or infringement claims related to individual's publicity rights. 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 copyright, defamation and other 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 or uploaded by users on message boards, online communities, social media platforms, voting systems, chat rooms or our other online and mobile platforms including NetEase Cloud Music, NetEase CC live streaming platform and the NetEase News App. 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 services.

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

***Divestitures of businesses and assets may have a material and adverse effect on our business and financial condition.***

We have undertaken, and may undertake in the future, partial or complete divestitures or other disposal transactions in connection with certain of our businesses and assets, particularly ones that are not closely related to our core focus areas or might require excessive resources or financial capital, to help our company meet its objectives. For example, in September 2019, we sold our e-commerce platform Kaola. These decisions are largely based on our management's assessment of the business models and likelihood of success of these businesses. However, our judgment could be inaccurate, and we may not achieve the desired strategic and financial benefits from these transactions. Our financial results could be adversely affected by the impact from the loss of earnings and corporate overhead contribution/allocation associated with divested businesses. In addition, as our net (loss)/income from discontinued operations are non-recurrent, it may be difficult for investors and analysts to predict our future earnings potential based on our historical financial performance.

Dispositions may also involve continued financial involvement in the divested business, such as through guarantees, indemnities or other financial obligations. Under these arrangements, performance by the divested businesses or other conditions outside of our control could affect our future financial results. We may also be exposed to negative publicity as a result of the potential misconception that the divested business is still part of our consolidated group. On



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the other hand, we cannot assure you that the divesting business would not pursue opportunities to provide services to our competitors or other opportunities that would conflict with our interests. If any conflicts of interest that may arise between the divesting business and us cannot be resolved in our favor, our business, financial condition, results of operations could be materially and adversely affected.

Furthermore, reducing or eliminating our ownership interests in these businesses might negatively affect our operations, prospects, or long-term value. We may lose access to resources or know-how that would have been useful in the development of our own business. Our ability to diversify or expand our existing businesses or to move into new areas of business may be reduced, and we may have to modify our business strategy to focus more exclusively on areas of business where we already possess the necessary expertise. We may sell our interests too early, and thus forego gains that we otherwise would have received had we not sold. Selecting businesses to dispose of or spin off, finding buyers for them (or the equity interests in them to be sold) and negotiating prices for what may be relatively illiquid ownership interests with no easily ascertainable fair market value will also require significant attention from our management and may divert resources from our existing business, which in turn could have an adverse effect on our business operations.

We have applied for, and the Hong Kong Stock Exchange has granted, a waiver from strict compliance with the requirements in Paragraph 3(b) of Practice Note 15 to the Hong Kong Listing Rules such that we are able to list a subsidiary entity (other than one involving our online game business) on the Hong Kong Stock Exchange within three years of the Listing. While we currently do not have any plan with respect to any spin-off listing on the Hong Kong Stock Exchange, we may consider a spin-off listing on the Hong Kong Stock Exchange for one or more of our businesses (other than our online game business) within the three year period subsequent to the Listing. The waiver granted by the Hong Kong Stock Exchange is conditional upon us confirming to the Hong Kong Stock Exchange in advance of any spin-off that it would not render our Company incapable of fulfilling the eligibility requirements under Rule 19C.05 of the Hong Kong Listing Rules based on the financial information of the entity or entities to be spun-off at the time of the Company's Listing (calculated cumulatively if more than one entity is spun-off). For additional information, see "Waivers and Exemptions — Three-year Restriction on Spin-offs."

### **Risks related to our corporate structure**

***If the PRC government finds that the contractual arrangements with our VIEs do not comply with applicable PRC laws and regulations, or if these regulations or their interpretations change in the future, we may be subject to penalties or be forced to relinquish our interests in those operations.***

Due to legal restrictions on foreign investment in Chinese companies providing value-added telecommunications services and holding ICP licenses and other regulated licenses, we operate all of our business segments through contractual arrangements with the VIEs and their equity holders. The contractual arrangements enable us to: (i) hold effective control over the VIEs; (ii) receive substantially all of the economic benefits of our VIEs; and (iii) have an exclusive option to purchase all or part of the equity interests in the VIEs when and to the extent permitted by PRC law or request any existing shareholders of the VIEs to transfer any or part of the equity interest in the relevant VIE to another PRC person or entity designated by us at any time at our discretion. Because of the contractual arrangements, we are the primary beneficiary of the VIEs and their respective subsidiaries and consolidate the results of operations of the VIEs into ours. Our VIEs and their respective subsidiaries hold the licenses, approvals and key assets that are essential for our business operations.

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If the PRC government finds that our contractual arrangements do not comply with the existing or future restrictions on foreign investment, or if the PRC government otherwise finds that we, the VIEs or any of their subsidiaries are in violation of the existing or future PRC laws or regulations or lack the necessary permits or licenses to operate our business, the relevant PRC regulatory authorities would have broad discretion in dealing with such violations or failures, including, without limitation:

- revoking our business and operating licenses;
- discontinuing or restricting our operations;
- imposing fines or confiscating any of our income that they deem to have been obtained through illegal operations;
- imposing conditions or requirements with which we may not be able to comply;
- requiring us to restructure the relevant ownership structure or operations;
- restricting our financing activities to finance the business and operations of our VIEs; or
- taking other regulatory or enforcement actions that could be harmful to our business.

Any of these actions could cause significant disruption to our business operations, and may materially and adversely affect our business, financial condition and results of operations. In addition, it is unclear what impact the PRC government actions would have on us and on our ability to consolidate the financial results of any of the VIEs in our consolidated financial statements, if the PRC governmental authorities find our legal structure and contractual arrangements to be in violation of PRC laws, rules and regulations. If any of these penalties results in our inability to direct the activities of VIEs that most significantly impact their economic performance and/or our failure to receive the economic benefits from the VIEs, we may not be able to consolidate the VIEs and their respective subsidiaries into our consolidated financial statements. Please also see the below risk factors “— Substantial uncertainties exist with respect to how the 2019 PRC Foreign Investment Law may impact the viability of our current corporate structure, corporate governance and business operations” and “— Risks related to doing business in China — The Chinese government restricts the ability for foreign investors to invest in and operate in certain types of telecommunications and internet businesses.”

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

On March 15, 2019, the Standing Committee of National People’s Congress promulgated the 2019 PRC Foreign Investment Law, which became effective on January 1, 2020. The 2019 PRC Foreign Investment Law replaces the trio of existing laws regulating foreign investment in China, namely, the *Wholly Foreign-owned Enterprises Law*, the *Sino-foreign Equity Joint Ventures Law*, and the *Sino-foreign Cooperative Joint Ventures Law*, together with their implementation rules and ancillary regulations, and embodies an expected PRC regulatory trend to rationalize its foreign investment regulatory regime in line with prevailing international practice and the legislative efforts to unify the corporate legal requirements for both foreign and domestic investments. However, uncertainties still exist in relation to interpretation and implementation of the 2019 PRC Foreign Investment Law, especially in

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regard to, including, among other things, the nature of VIE structure, the promulgation schedule of both the “negative list” under the 2019 PRC Foreign Investment Law and specific rules regulating the organization form of foreign-invested enterprises within the five-year transition period.

The 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 “History — Corporate Structure — Variable interest entity structure.” While the 2019 PRC Foreign Investment Law and its implementation regulations which took effect on January 1, 2020 do not define contractual arrangements as a form of foreign investment explicitly, we cannot assure you that future laws and regulations will not provide for contractual arrangements as a form of foreign investment. Therefore, there can be no assurance that our control over our VIEs through contractual arrangements will not be deemed as foreign investment in the future.

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

***Our contractual arrangements with our VIEs may not be as effective in providing operational control as direct ownership. If our VIEs 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.***

Our VIEs 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. 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 founder, director and chief executive officer, 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. Many 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

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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.

***Because our contractual arrangements with certain of our 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 certain affiliated entities, including Guangzhou NetEase, Hangzhou Leihuo, Youdao Computer, Shanghai EaseNet, and their ultimate shareholders is based on a number of contracts, and these affiliated companies are considered our VIEs for accounting purposes. The terms of these agreements are often statements of general intent and do not detail the rights and obligations of the parties. Some of these contracts provide that the parties will enter into further agreements on the details of the services to be provided. Others contain price and payment terms that are subject to monthly adjustment. These provisions may be subject to differing interpretations, particularly on the details of the services to be provided and on price and payment terms. It may be difficult for us to obtain remedies or damages from these 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.

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

Our founder, director and chief executive officer, William Lei Ding, beneficially owned, as at the Latest Practicable Date, approximately 44.7% of our total issued share capital 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.

***A majority of the share capital of certain of our affiliated entities are held by our major shareholder, who may cause these agreements to be amended in a manner that is adverse to us.***

William Lei Ding, directly or indirectly holds the majority interest in certain of our VIEs. 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 of directors 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.

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***We may not be able to conduct our operations without the services provided by certain of our affiliated entities.***

Our operations are currently dependent upon our commercial relationships with our VIEs, 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, our VIEs 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.

***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 “History — Corporate Structure — Our corporate 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 our VIEs 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 “— Risks related to doing business in China — We may be treated as a resident enterprise for PRC tax purposes under the PRC Enterprise Income Tax Law, which may subject us to PRC income tax on 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” 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.

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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.

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 certain of our 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 our VIEs 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. In addition, the PRC tax authorities may also impose late payment interest.

***A transfer of shares of certain of our affiliated entities may trigger tax liability.***

If we need to cause the transfer of shareholdings of our VIEs 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.

***We may lose the ability to use and enjoy assets held by any of our principal VIEs that are important to the operation of our business if such VIE declares bankruptcy or becomes subject to a dissolution or liquidation proceeding.***

Our principal VIEs hold assets that are material to our business operations, such as our certain intellectual property and core licenses and permits. Although the VIE contracts between our subsidiaries and VIEs and the shareholders of our VIEs contain terms that prohibit the shareholders of our VIEs from adversely affecting the existence of the VIEs, in the event the shareholders breach this obligation and voluntarily liquidate our VIEs, or if any of our VIEs declare bankruptcy and all or part of its assets become subject to liens or rights of third-party creditors, we might be unable to continue some or all of our business operations. Furthermore, if any of our VIEs were to undergo a voluntary or involuntary liquidation proceeding, its shareholders or unrelated third-party creditors might claim rights to some or all of such VIE's assets and their rights could be senior to our rights under the VIE contracts, thereby hindering our ability to operate our business.

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### **Risks related to doing business in China**

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

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

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

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

*The Chinese government restricts the ability for foreign investors to invest in and operate in certain types of telecommunications and internet businesses.*

Foreign ownership of certain types of telecommunications and internet businesses which we operate, including value-added telecommunications services, internet cultural services and internet publication services, is subject to restrictions under applicable PRC laws. For example, on September 28, 2009, General Administration of Press and Publication (the “GAPP”) together with the National Copyright Administration and National Office of Combating Pornography and Illegal Publications issued a *Notice Regarding the Consistent Implementation of the “Regulation on Three Provisions” of the State Council and the Relevant Interpretations of the State Commission Office for Public Sector Reform and the Further Strengthening of the Administration of Examination and Approval of Online Games and the Examination and Approval of Imported Online Games* (the “Circular 13”). According to Circular 13, 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 it 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

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contractual or technical arrangements. In addition, the *Rules for the Administration of Online Publishing Service* jointly issued by the SAPPRFT and MIIT, effective on March 10, 2016, forbids foreign investments in the online publishing business.

With respect to our internet media business, the CAC's *Provisions for the Administration of Internet 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)* issued by the MOC (later superseded by the MOCT) on July 6, 2005, foreign investors (excluding Hong Kong and Macau) are prohibited from establishing or operating internet-based cultural institutions. It is unclear what activities count as "operating internet-based cultural institutions," however certain services we provide in our innovative businesses and others segment are likely to be deemed as such. We believe we are also in compliance with this requirement because we operate our other innovative businesses and other services through our contractually controlled VIEs.

It is unclear whether the authorities will deem our VIE structure as a kind of "indirect way" for 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. Please also see "— Risks related to our corporate structure" above for a discussion of the risks associated with our VIE structure.

In recent years, the PRC government has been promoting foreign investment reform in some sectors and purported to loosen the foreign investment restrictions in those sectors. For example, 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* promulgated by the MIIT on June 19, 2015, allows foreign investors hold up to 100% of the equity interests in an online data processing and transaction processing business (operational e-commerce) in China. In addition, the NDRC and the MOFCOM jointly published the Negative List, which came into effect on July 30, 2019. The Negative List removes some of the previous restrictions on value-added telecommunications providers by allowing foreign investors to hold up to 100% of the equity interests in e-commerce, domestic multi-party communication, e-storage and forwarding and call center businesses in China. It is unclear how these new policies 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 telecommunications and internet business, which may adversely impact our financial statements, operations and cash flows.

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

As part of its anti-addiction online game policy, the Chinese government has taken several steps to discourage minors under the age of 18 from continuously playing online games once they exceed a set number of hours of continuous play. For example, in July 2005, the MOC (later superseded by the MOCT) and the MII (later superseded by the MIIT) jointly issued an



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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 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 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 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 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.

To identify that a game player is a minor and is thus subject to the online game anti-addiction system, a real-name registration system must be adopted to require players to register their real identity information before playing online games. Pursuant to the *Notice Regarding the Initiation of Work on the Online Games Real-Name Verification System to Prevent Online Gaming Addiction* (the “**Commencement of Real-Name Authentication Notice**”) issued by eight government authorities on July 1, 2011, online game (excluding mobile game) operators must submit the identity information of game players which needs to be further verified to the National Citizen Identity Information Center, a subordinate public institution of the Ministry of Public Security, for verification since October 1, 2011, in an effort to prevent minors from using an adult’s ID to play online games. Violation of the Anti-Addiction Notice and the Commencement of Real-Name Authentication Notice could result in the termination of the operation of online games. On August 30, 2018, the *Implementation Scheme on Comprehensive Prevention and Control of Adolescent Myopia* (the “**Implementation Scheme**”) was issued jointly by eight PRC regulatory authorities at the national level, including the National Press and Publication Administration (the “**NPPA**”) and the National Radio and Television Administration (the “**NRTA**”). The Implementation Scheme provides that as a part of the plan to prevent myopia among children, the NPPA will control the number of new online games and take steps to restrict the amount of time children spend on playing online games. On October 25, 2019, the NPPA promulgated the *Notice on Preventing Minors from Indulging in Online Games*, according to which the length of minors’ use of online games should be strictly controlled. It requires all online game users to register their identification information. The total length of time for minors to access online games must be limited on a daily basis. Every day from 22:00 to 8:00 the next day, online game companies are not permitted to provide game services to minors in any form. Game services provided to minors must not exceed 3 hours per day on public holidays and 1.5 hours on other days. In addition, online transactions are capped monthly at RMB200 or RMB400, depending on a minor’s age. We have updated our anti-addiction systems accordingly to comply with the above-mentioned requirements. We do not believe that the Implementation Scheme has any material impact on our gaming operations, but we cannot assure you that any future regulations or restrictive rules will not adversely affect our operations.

On July 10, 2019, the MOCT announced the abolishment of the *Interim Measures for the Administration of Online Games* (the “**Online Games Measures**”) which had previously regulated activities related to the online game industry, 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

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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. As of the date of this document, no laws and regulations had been promulgated or published to replace the Online Games Measures. We cannot be sure if or when any future regulations or restrictive rules in this regard will be promulgated and whether they would negatively impact our operations, including by increasing our compliance costs and negatively impacting our ability to launch and operate new games.

***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 and mobile MMORPG which helps to build a large user base and maintain loyalty is that users can accumulate virtual tools, powers and rankings as they play the games. We believe that these virtual assets are highly valued by our users, particularly long-term users, and are traded among users. However, on occasion, such assets can be lost if, for example, a user's identity is stolen by another user or we experience a system error or crash. Other than the *General Rules on the Civil Law of the PRC*, 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 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.***

A large part of our online game revenues are collected through the sale of prepaid points, as described elsewhere on this document.

On February 15, 2007, the MOC (later superseded by the MOCT), the PBOC, and 12 other PRC regulatory authorities jointly issued the *Notice on the Reinforcement of the Administration of Internet Cafés and Online Games* (the "**Internet Cafés Notice**") which strengthens 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 MOFCOM jointly issued the *Notice on Strengthening Administration on Online Game Virtual Currency* (the "**Online Game 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 Online Game 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 Online Game Virtual Currency Notice's objective is to limit the circulation of virtual currency and thereby reduce concerns that it may impact real world inflation. To accomplish this, the Online Game Virtual Currency Notice requires online game operators to report the total amount of their issued virtual currencies on a quarterly basis and

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to refrain from issuing disproportionate amounts of virtual currencies in order to generate revenues. In addition, the Online Game 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 Online Game 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 Online Game 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.

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

Internet companies in China are subject to a variety of existing and new rules, regulations, policies, and license and permit requirements on the distribution of information over the mobile and internet. Under these rules and regulations, content service providers are prohibited from posting or displaying over the mobile or internet content that, among others, violates PRC laws and regulations, impairs the national security of China, is obscene, superstitious, defamatory, or may be deemed by relevant government authorities as “socially destabilizing” or leaking “state secrets” of China. 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.

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 a particular political ideology, and the CAC, which has been given the responsibility to protect, supervise and administer cyber security issues in China. In addition, the MIIT has published implementing regulations that subject online information providers to potential liability for content included in their media and the actions of subscribers and others using their systems, including liability for violation of PRC laws prohibiting the distribution of content deemed to be socially destabilizing. The Ministry of Public Security has also from time to time prohibited the distribution over the internet of information which it believes to be socially destabilizing.

The Ministry of Public Security has the authority to require any local internet service provider to block any website maintained outside China at its sole discretion. The State Secrecy Bureau, which is directly responsible for the protection of state secrets of all PRC government and Chinese Communist Party organizations, is authorized to block any website it deems to be leaking state secrets or failing to meet the relevant regulations relating to the protection of state secrets in the distribution of online information. The term “state secrets” has been broadly interpreted by Chinese governmental authorities in the past. We may be liable under any of these pronouncements for content and materials posted, uploaded or transmitted by users on our platform. User-generated content is accessible on the NetEase websites and our other online and mobile platforms including NetEase News App and NetEase Cloud Music, such as content and materials posted or uploaded by users on message boards, online communities and social media platforms. We have implemented an efficient and thorough content screening and monitoring mechanism for NetEase Cloud Music and our other platforms which involve both

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automated filtering and manual review, to timely remove any inappropriate or illegal content, including interactive content on our platform. However, such procedures may not prevent all illegal or inappropriate content or comments from being posted, and our editorial staff may fail to review and screen such content or comments effectively. Failure to identify and prevent illegal or inappropriate content from being distributed on our platform may subject us to liability. To the extent that PRC regulatory authorities find any content on our platform objectionable, they may require us to limit or eliminate the dissemination of such content on our platform in the form of takedown orders or otherwise. In addition, PRC laws and regulations are subject to interpretation by the relevant authorities, and it may not be possible to determine in all cases the types of content that could result in our liability as a platform operator.

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 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.

***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 or imitating our name, private label merchandise or other intellectual property. Monitoring unauthorized use of our intellectual property is difficult and costly, and we cannot be certain that the steps we take will effectively prevent misappropriation of our technology or other intellectual property.

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, our current and future business activities, including our portal service and private label merchandise, may infringe upon the proprietary rights of others, and third parties may assert infringement claims against us, including claims alleging, among other things, copyright, trademark or patent infringement. 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 “Our Business — Intellectual Property.”

***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 *PRC 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 platform and hurt our business and results of operations. For example, the amended *PRC Consumer Protection Law*, which became effective in March 2014, strengthens the protection of consumers and imposes more stringent requirements and obligations on

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business operators, with a particular focus on businesses that operate via the Internet. Pursuant to the *PRC Consumer Protection Law*, consumers are generally entitled to return goods purchased within seven days upon receipt without giving any reasons if the purchases 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.

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* (the “**PBOC Measures**”) which became effective on September 1, 2010 and require that non-financial institutions engaging in the business of effecting payments and settlements before September 1, 2010 obtain a permit from the PBOC by August 31, 2011 to continue operating their business. We currently operate an online payment platform used by both distributors of our prepaid points and end-users of our online services, which requires a permit under the PBOC Measures. In addition, on December 28, 2015, the PBOC issued a notice regarding the *Administrative Measures for Internet Payment Services of Non-banking Payment Institutions* (the “**PBOC Notice 43**”) which took effect on July 1, 2016. According to the PBOC Notice 43, 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 43, a payment institution shall not engage in, including in a disguised form, such businesses as securities, insurance, credit loans, financing, wealth management, guarantee, trust, currency exchange, cash deposit and withdrawal services. In addition, a payment institution is required to, based on client identity, conduct affiliated management of all the payment accounts opened by the same client. On January 13, 2017, the PBOC issued the *Notice of the PBOC on Matters concerning Implementing the Centralized Deposit of the Funds of Pending Payments of Clients of Payment Institutions*, which requires that from April 17, 2017, payment institutions transfer a portion of customer reserve funds to a specifically designated bank account upon the request of the PBOC and that no interest be allowed to accrue upon the transferred customer reserve funds. On June 29, 2018, the PBOC issued a further notice that requires payment institutions to cause up to 100% of the customer reserve funds to be transferred to the above-mentioned account.

We are in compliance with the PBOC Notice 43 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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***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 less 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, many of 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.

***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, certain contracts governed by PRC law may contain less detail and may not be as comprehensive in defining contracting parties' rights and obligations in some instances. As a result, those contracts are more vulnerable to disputes and legal challenges. In addition, contract interpretation and enforcement by the court in China is not as developed as in the United States, and the result of contract dispute in certain cases 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 in plaintiff's regard, may materially and adversely affect our reputation and our business operations, and may cause the price of our ADSs to decline.

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

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

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

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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.

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

Under the *PRC Enterprise Income Tax Law*, the EIT rate payable by domestic and foreign-invested enterprises is 25.0%. Preferential tax treatments are granted to entities that conduct business in encouraged sectors and to entities that are classified as 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, Boguan, NetEase Hangzhou and certain other PRC subsidiaries were qualified as HNTEs and enjoyed a preferential tax rate of 15% for 2017, 2018 and 2019. In addition, Boguan, NetEase Hangzhou and certain other subsidiaries were each qualified as a Key Software Enterprise in 2017, 2018 and 2019 and enjoyed tax benefits in 2017, 2018 and 2019 relating to a further reduced preferential tax rate of 10%. See “Financial Information — Components of Results of Operations — 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” or “Key Software Enterprise” status are subject to an annual assessment by the relevant government authorities in China. Without any preferential tax status, the standard EIT rate of 25.0% will apply. Moreover, if there are further changes to the relevant income tax laws and their implementation, our subsidiaries and VIEs may need to pay additional taxes, which could have a material adverse effect on our results of operations.

***We may be treated as a resident enterprise for PRC tax purposes under the PRC Enterprise Income Tax Law, which may subject us to PRC income tax on 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 *PRC 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 *PRC Enterprise Income Tax Law*, “de facto management body” is defined as the body that has material and overall management control over the business, personnel, accounts and properties of the enterprise. In April 2009, the PRC tax authority promulgated a circular to clarify the criteria for determining whether the “de facto management bodies” are located within the PRC for enterprises established outside of the PRC that are controlled by entities established within the PRC. However, the relevant laws and regulations remain unclear regarding treatment of an enterprise established outside the PRC that is not controlled by entities established within the PRC.

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

Under the implementation rules of the *PRC 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 *Announcement on Issues Concerning “Beneficial Owners” in Tax Treaties* (the “**SAT Circular 9**”) which was issued on February 3, 2018 by the SAT and effective on April 1, 2018, provides that a “non-resident enterprise” which does not engage in substantive business activities may not be deemed to be a beneficial owner that is entitled to the above-mentioned reduced income tax rate of 5%. It is unclear at this stage whether SAT Circular 9 applies to dividends from our PRC subsidiaries paid to us through our Hong Kong subsidiaries. It is possible that under SAT Circular 9 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 investors which are considered “non-resident enterprises” and individual shareholders who are non-PRC residents may be subject to withholding income tax, and gains realized on the transfer of our ordinary shares or ADSs by such investors may be subject to PRC income tax if such dividends or gains are deemed to be from PRC sources, which may adversely and materially affect the value of the investment in our shares or ADSs. The tax rate for gains and dividends is 10% for “non-resident enterprise” shareholders and 20% for non-PRC individual shareholders, subject to any reduction or exemption set forth in applicable tax treaties. However, it is unclear whether in practice non-PRC shareholders would be able to obtain the benefits of income tax treaties entered into between PRC and their countries or areas.

***We and our shareholders face uncertainties with respect to indirect transfers of equity interests in PRC resident enterprises by a non-PRC company.***

On February 3, 2015, the SAT issued the *Bulletin on Issues of Enterprise Income Tax on Indirect Transfers of Assets by Non-PRC Resident Enterprises* (the “**Bulletin 7**”) which has been further amended by the *Announcement on Issues Concerning the Withholding of Enterprise Income Tax at Source on Non-PRC Resident Enterprises* (the “**Bulletin 37**”) issued by the State Administration of Taxation on October 17, 2017 and amended on June 15, 2018. Pursuant to these bulletins, subject to a safe harbor for purchase and sale of equity securities through a public securities market, an “indirect transfer” of assets, including equity interests in a PRC resident enterprise, by non-PRC resident enterprises may be re-characterized and treated as a direct transfer of PRC taxable assets, if the arrangement does not have a reasonable commercial purpose and was established for the purpose of avoiding payment of PRC enterprise income tax. As a result, gains derived from this indirect transfer may be subject to PRC enterprise income tax.



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***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. Then, the RMB 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 2019, the RMB depreciated against the U.S. dollar by approximately 15%. 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 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

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by loans or capital contributions. We cannot assure you that we can obtain these governmental registrations or approvals on a timely basis, if at all. Any future restrictions imposed by SAFE or tightened foreign exchange control by SAFE as a matter of practice may adversely affect our ability to utilize our revenues effectively and pay dividends to our shareholders.

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

On 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* (the “**Stock Incentive Plan 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. If we or such PRC participants fail to comply with these regulations, we or such PRC participants may be subject to fines and other legal or administrative sanctions.

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

The SAFE has adopted certain regulations that require registration with, and approval from, Chinese government authorities in connection with direct or indirect control of an offshore entity by Chinese residents. The term “control” under SAFE regulation is broadly defined as the operation rights, beneficiary rights or decision-making rights acquired by PRC residents in the offshore special purpose vehicles or PRC companies by means of acquisition, trust, proxy, voting rights, repurchase, convertible bonds or other arrangements. The SAFE regulations retroactively require registration of investments in non-Chinese companies previously made by Chinese residents. In particular, the SAFE regulations require Chinese residents to register with SAFE information about offshore companies in which they have directly or indirectly invested and to make follow-up registrations in connection with certain material transactions involving such offshore companies, such as mergers or division, capital increases and decreases, equity transfer or exchange. 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, registrations and amendments as required under these regulations. We intend to take all necessary measures to ensure that all required applications and registrations 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

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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.

### **Risks related to our Shares, the ADSs, the Listing and the Global Offering**

*As a company applying for listing under Chapter 19C, we adopt different practices as to certain matters as compared with many other companies listed on the Hong Kong Stock Exchange.*

As we are applying for listing under Chapter 19C of the Hong Kong Listing Rules, we will not be subject to certain provisions of the Hong Kong Listing Rules pursuant to Rule 19C.11, including, among others, rules on notifiable transactions, connected transactions, share option schemes, content of financial statements as well as certain other continuing obligations. In addition, in connection with the Listing, we have applied for a number of waivers and/or exemptions from strict compliance with the Hong Kong Listing Rules, the Companies (WUMP) Ordinance, the Takeovers Codes and the SFO. As a result, we will adopt different practices as to those matters as compared with other companies listed on the Hong Kong Stock Exchange that do not enjoy those exemptions or waivers. For additional information, see “Waivers and Exemptions.”

Furthermore, if 55% or more of the total worldwide trading volume, by dollar value, of our Shares and ADSs over our most recent fiscal year takes place on the Hong Kong Stock Exchange, the Hong Kong Stock Exchange will regard us as having a dual primary listing in Hong Kong and we will no longer enjoy certain exemptions or waivers from strict compliance with the requirements under the Hong Kong Listing Rules, the Companies (WUMP) Ordinance, the Takeovers Codes and the SFO, which could result in our incurring of incremental compliance costs.

*The trading price of ADSs has been and is likely to continue to be, and the trading price of our Shares can be, volatile, which could result in substantial losses to holders of our Shares and/or the ADSs.*

The trading price of ADSs has been and is likely to continue to be volatile and could fluctuate widely in response to a variety of factors, many of which are beyond our control. The trading price of our Shares, likewise, can be volatile for similar or different reasons. For example, the trading prices of ADSs ranged from US\$209.01 to US\$325.00 per ADS in 2019. In addition, the performance and fluctuation of the market prices of other companies with business operations located mainly in China, especially internet and technology companies, that have listed their securities in Hong Kong and/or the United States may affect the overall investor attitude towards Chinese public companies. The securities of some of these companies have experienced and may continue to experience significant volatility, resulting from, among other things, underperformance and deteriorating financial results, negative news or perceptions

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about inadequate corporate governance practices, and fraudulent behaviors of such companies. Consequently, the trading performance of our Shares and/or the ADSs may be adversely and materially affected, regardless of our actual operation performance.

In addition to market and industry factors, the price and trading volume for our Shares and/or the ADSs may be highly volatile for factors specific to our operation, including the followings:

- variations in our results of operations that are not in line with market or research analyst expectations or changes in financial estimates by securities research analysts;
- announcements of studies and reports relating to the quality of our product and service offerings or those of our competitors;
- changes in the economic performance or market valuations of other market players in our industries;
- announcements made by us or our competitors of new features or functionalities or other product and service offerings, investments, acquisitions, strategic relationships, joint ventures or capital commitments;
- press and other reports, whether or not true, about our business, including negative reports published by short sellers, regardless of their veracity or materiality to us;
- litigation and regulatory allegations or proceedings that involve us and our directors;
- additions to or departures of our management;
- political or market instability or disruptions, and actual or perceived social unrest in the markets where we operate;
- fluctuations of exchange rates among the Renminbi, the Hong Kong dollar and the U.S. dollar;
- sales or perceived potential sales or other dispositions of existing or additional Shares and/or ADSs or other equity or equity-linked securities;
- any actual or alleged illegal acts of our senior management or other key employees;
- any share repurchase program; and
- regulatory developments affecting us or our industry, customers, licensors and other suppliers.

In particular, our revenues and results of operations have varied significantly in the past and may continue to fluctuate in the future, which may adversely impact the trading price of our ADSs and Shares. Historically, usage of our online games has generally increased around the Chinese holidays, particularly the winter and summer school holidays. Our Youdao platform tends to have larger student enrollments in the second and fourth quarters when it offers more courses including, for example, test preparation courses for school exams in the spring and fall semesters and China's national college entrance exams, national postgraduate entrance exams and college English tests, compared to the rest of the year. Revenues from innovative

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businesses and others, including advertising 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. Our e-commerce business revenues are relatively lower 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. 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.

Furthermore, the stock market in general experiences price and volume fluctuations that are often unrelated or disproportionate to the operating performance of companies like us, such as the large decline in share prices in the United States in early 2020. These market and industry fluctuations may significantly affect the trading price of our Shares and/or ADSs. In the past, following periods of instability in the market price of a company's securities, shareholders have often instituted securities class action suits against that company.

Furthermore, our directors and employees may face additional exposure to claims and lawsuits as a result of their position in other public companies. For example, one of our directors, Mr. Denny Lee, was named as a defendant in ongoing securities class action lawsuits filed in the U.S. against NIO Inc., a company listed on the New York Stock Exchange (ticker: NIO), together with certain current, former directors and/or senior officers of NIO Inc., regarding an alleged misrepresentation in the registration statement and the prospectus filed in connection with the company's initial public offering. Mr. Lee's appointment as the independent director of NIO Inc. was effective immediately after the SEC's declaration of effectiveness of NIO Inc.'s registration statement on Form F-1, of which its prospectus is a part. Mr. Lee has also been named as a defendant in a putative class action lawsuit against another U.S.-listed company. All of these cases concern Mr. Lee in his capacity as an independent director of such U.S.-listed companies. The existence of litigation, claims, investigations and proceedings against our directors and employees, even if they do not involve our company, may harm our reputation and adversely affect the trading price of our Shares and/or ADSs.

***Substantial future sales or perceived potential sales of our Shares, ADSs, or other equity or equity-linked securities in the public market could cause the price of our Shares and/or ADSs to decline.***

Sales of our Shares, ADSs, or other equity or equity-linked securities in the public market, or the perception that these sales could occur, could cause the market price of our Shares and/or ADSs to decline significantly. All of our Shares represented by ADSs were freely transferable by persons other than our affiliates without restriction or additional registration under the U.S. Securities Act. The Shares held by our affiliates are also available for sale, subject to volume and other restrictions as applicable under Rule 144 of the U.S. Securities Act, under trading plans adopted pursuant to Rule 10b5-1 or otherwise.

Divestiture in the future of our Shares and/or ADSs by shareholders, the announcement of any plan to divest our Shares and/or ADS, or hedging activity by third-party financial institutions in connection with similar derivative or other financing arrangements entered into by shareholders, could cause the price of our Shares and/or ADSs to decline.

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Furthermore, although all of our directors and executive officers have agreed to a lock-up of their Shares, any major disposal of our Shares and/or ADSs by any of them upon expiration of the relevant lock-up periods (or the perception that these disposals may occur upon the expiration of the lock-up period) may cause the prevailing market price of our Shares and/or ADSs to fall which could negatively impact our ability to raise equity capital in the future.

***The different characteristics of the capital markets in Hong Kong and the U.S. may negatively affect the trading prices of our Shares and/or ADSs.***

Upon the Listing, we will be subject to Hong Kong and SEC requirements and Nasdaq rules concurrently. The Hong Kong Stock Exchange and Nasdaq have different trading hours, trading characteristics (including trading volume and liquidity), trading and listing rules, and investor bases (including different levels of retail and institutional participation). As a result of these differences, the trading prices of our Shares and our ADSs may not be the same, even allowing for currency differences. Fluctuations in the price of our ADSs due to circumstances peculiar to the U.S. capital markets could materially and adversely affect the price of the Shares, or vice versa. Certain events having significant negative impact specifically on the U.S. capital markets may result in a decline in the trading price of our Shares notwithstanding that such event may not impact the trading prices of securities listed in Hong Kong generally or to the same extent, or vice versa. Because of the different characteristics of the U.S. and Hong Kong capital markets, the historical market prices of our ADSs may not be indicative of the trading performance of the Shares after the Global Offering.

***Exchange between our Shares and our ADSs may adversely affect the liquidity and/or trading price of each other.***

Our ADSs are currently traded on Nasdaq. Subject to compliance with U.S. securities law and the terms of the Deposit Agreement, holders of our Shares may deposit Shares with the depository in exchange for the issuance of our ADSs. Any holder of ADSs may also withdraw the underlying Shares represented by the ADSs pursuant to the terms of the Deposit Agreement for trading on the Hong Kong Stock Exchange. In the event that a substantial number of Shares are deposited with the depository in exchange for ADSs or vice versa, the liquidity and trading price of our Shares on the Hong Kong Stock Exchange and our ADSs on Nasdaq may be adversely affected.

***The time required for the exchange between Shares and ADSs might be longer than expected and investors might not be able to settle or effect any sale of their securities during this period, and the exchange of Shares into ADSs involves costs.***

There is no direct trading or settlement between Nasdaq and the Hong Kong Stock Exchange on which our ADSs and the Shares are respectively traded. In addition, the time differences between Hong Kong and New York and unforeseen market circumstances or other factors may delay the deposit of Shares in exchange for ADSs or the withdrawal of Shares underlying the ADSs. Investors will be prevented from settling or effecting the sale of their securities during such periods of delay. In addition, there is no assurance that any exchange of Shares into ADSs (and vice versa) will be completed in accordance with the timelines investors may anticipate.

Furthermore, the depository for the ADSs is entitled to charge holders fees for various services including for the issuance of ADSs upon deposit of Shares, cancelation of ADSs, distributions of cash dividends or other cash distributions, distributions of ADSs pursuant to share dividends or other free share distributions, distributions of securities other than ADSs and annual service fees. As a result, shareholders who exchange Shares into ADSs, and vice versa, may not achieve the level of economic return the shareholders may anticipate.

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*As a company incorporated in the Cayman Islands, we are permitted to adopt certain home country practices in relation to corporate governance matters that differ significantly from Nasdaq rules.*

As a Cayman Islands exempted company listed on Nasdaq, we are subject to Nasdaq rules. However, Nasdaq rules permit a foreign private issuer like us to follow the corporate governance practices of its home country. Certain corporate governance practices in the Cayman Islands, which is our home country, may differ significantly from Nasdaq rules applicable to U.S. domestic issuers. For instance, we are not required to:

- have a majority of the board be independent (although all of the members of the audit committee must be independent under the U.S. Exchange Act);
- have a compensation committee or a nominating or corporate governance committee consisting entirely of independent directors;
- have regularly scheduled executive sessions for non-management directors; or
- have executive sessions of solely independent directors each year.

We have relied on and intend to continue to rely on some of these exemptions. Specifically, our board of directors adopted our 2009 RSU Plan and 2019 RSU Plan without seeking shareholder approval which is generally required under Rule 5635(c) of the Nasdaq Marketplace Rules. There is no specific requirement under Cayman Islands law for shareholder approval to be obtained with respect to the establishment or amendment of equity compensation arrangements. In situations where we choose to follow home country practices, our shareholders may be afforded less protection than they otherwise would under Nasdaq rules applicable to U.S. domestic issuers.

*We are a foreign private issuer within the meaning of the rules under the U.S. Exchange Act, and as such we are exempt from certain provisions applicable to U.S. domestic public companies.*

Because we qualify as a foreign private issuer under the U.S. Exchange Act, we are exempt from certain provisions of the securities rules and regulations in the United States that are applicable to U.S. domestic issuers, including:

- the rules under the U.S. Exchange Act requiring the filing with the SEC of quarterly reports on Form 10-Q or current reports on Form 8-K;
- the sections of the U.S. Exchange Act regulating the solicitation of proxies, consents, or authorizations in respect of a security registered under the U.S. Exchange Act;
- the sections of the U.S. Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and liability for insiders who profit from trades made in a short period of time; and
- the selective disclosure rules by issuers of material nonpublic information under Regulation FD.

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We are required to file an annual report on Form 20-F within four months of the end of each fiscal year. In addition, we intend to continue to publish our results on a quarterly basis as press releases, distributed pursuant to Nasdaq rules. Press releases relating to financial results and material events will also be furnished to the SEC on Form 6-K. However, the information we are required to file with or furnish to the SEC will be less extensive and less timely compared to that required to be filed with the SEC by U.S. domestic issuers. As a result, holders of our ADSs may be afforded less protection or information than they would under the U.S. Exchange Act rules applicable to U.S. domestic companies.

***The voting rights of holders of ADSs are limited by the terms of the Deposit Agreement.***

Holders of ADSs may exercise their voting rights with respect to the underlying Shares represented by their ADSs only in accordance with the provisions of the Deposit Agreement. Upon receipt of voting instructions from them in the manner set forth in the Deposit Agreement, the depositary will endeavor, in so far as practicable, to vote the underlying Shares represented by their ADSs in accordance with these instructions. However, the depositary and its agents may not be able to send voting instructions to holders of ADSs or carry out their voting instructions in a timely manner. We will make all reasonable efforts to cause the depositary to extend voting rights to holders of ADSs in a timely manner, but they may not receive the voting materials in time to ensure that they can instruct the depositary to vote the underlying Shares represented by their ADSs. Furthermore, the depositary and its agents will not be responsible for any failure to carry out any instructions to vote, for the manner in which any vote is cast or for the effect of any vote. As a result, holders of ADSs may not be able to exercise their rights to vote and they may lack recourse if the underlying Shares represented by their ADSs are not voted as they requested.

***Except in limited circumstances, the depositary will give us a discretionary proxy to vote our Shares underlying the ADSs if holders of these ADSs do not give voting instructions to the depositary, which could adversely affect the interests of holders of Shares and/or the ADSs.***

Under the Deposit Agreement, the depositary will give us a discretionary proxy to vote the Shares underlying the ADSs at shareholders' meetings if holders of these ADSs do not give voting instructions to the depositary, unless:

- we have instructed the depositary that we do not wish a discretionary proxy to be given;
- we have informed the depositary that there is substantial opposition as to a matter to be voted on at the meeting;
- a matter to be voted on at the meeting would have a material adverse impact on shareholders; or
- voting at the meeting is made on a show of hands.

The effect of this discretionary proxy is that, if holders of ADSs fail to give voting instructions to the depositary, they cannot prevent our Shares underlying their ADSs from being voted, except under the circumstances described above. This may make it more difficult for shareholders to influence our management. Holders of our Shares are not subject to this discretionary proxy.



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***Holders of ADSs may be subject to limitations on transfer of their ADSs.***

ADSs are transferable on the books of the depository. However, the depository may close its transfer books at any time or from time to time when it deems expedient in connection with the performance of its duties. In addition, the depository may refuse to deliver, transfer or register transfers of ADSs generally when our books or the books of the depository are closed, or at any time if we or the depository deems it advisable to do so because of any requirement of law or of any government or governmental body, or under any provision of the Deposit Agreement, or for any other reason.

***Holders of ADSs may not receive distributions on our Shares if the depository decides it is impractical or unlawful to make such distributions.***

The depository has agreed to pay cash to holders of ADSs to the extent that we decide to distribute cash dividends or other cash distributions on our Shares or other deposited securities. In the second quarter of 2019, our board of directors determined that quarterly dividends will be set at an amount equivalent to approximately 20%-30% of our anticipated net income after tax in each fiscal quarter. Our board of directors also approved an additional special dividend equivalent to US\$3.45 per ADS in the third quarter of 2019.

To the extent that there is a distribution in shares, rights or other securities and properties, the depository has agreed to distribute to holders of ADSs the shares, rights or other distributions it or the custodian receives on our Shares or other deposited securities after deducting its fees and expenses. ADS holders will receive these distributions in proportion to the number of Shares their ADSs represent. However, the depository may, at its discretion, decide that it is impractical to make a distribution available to holders of ADSs. For example, it would be unlawful to make a distribution to a holder of ADSs if it consists of securities that require registration under the U.S. Securities Act but that are not properly registered or distributed pursuant to an applicable exemption from registration. We have no obligation to take any other action to permit the distribution of shares, rights or anything else to holders of ADSs. This means that holders of ADSs may not receive the distributions we make on our Shares if it is impractical for us to make them available. These restrictions may materially reduce the value of the 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 Shares and/or the 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, 2018 and 2019. 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, 2018 and 2019. 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

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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 Shares and/or ADSs or otherwise harm our reputation. Furthermore, we may need to incur additional costs and use additional management and other resources to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and other requirements going forward.

***Our auditor of the consolidated financial statements included in our annual report on Form 20-F filed with the SEC, 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 of the consolidated financial statements included in our annual report on Form 20-F filed with the SEC, the independent registered public accounting firm, as an auditor of companies that are registered with the SEC and traded publicly in the United States and a firm registered with the PCAOB, is subject to the laws in the United States pursuant to which the PCAOB conducts regular inspections to assess its compliance with the applicable professional standards. It is located in, and organized under the laws of, the PRC, which is a jurisdiction where the PCAOB has been unable to conduct inspections without the approval of the Chinese authorities.

On May 24, 2013, the PCAOB announced that it had entered into a Memorandum of Understanding on Enforcement Cooperation (the “MOU”) with the CSRC and the MOF. The MOU establishes a cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in the U.S. and the PRC. The PCAOB continues to engage in discussions with the CSRC and the MOF to permit joint inspections in China of audit firms that are registered with the PCAOB and audit China-based companies that trade on U.S. exchanges. However, the implementation procedures of the MOU remain uncertain.

On December 7, 2018, the SEC and the PCAOB issued a joint statement highlighting continued challenges faced by the U.S. regulators in their oversight of financial statement audits of U.S.-listed companies with significant operations in China. On April 21, 2020, the SEC and the PCAOB issued another joint statement reiterating the greater risk that disclosures will be insufficient in many emerging markets, including China, compared to those made by U.S. domestic companies. In discussing the specific issues related to the greater risk, the statement again highlights the PCAOB’s inability to inspect audit work paper and practices of accounting firms in China, with respect to their audit work of U.S. reporting companies. However, it remains unclear what further actions, if any, the SEC and PCAOB will take to address the problem.

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

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As part of a continued regulatory focus in the United States on access to audit and other information currently protected by national law, in particular China's, in June 2019, a bipartisan group of lawmakers introduced bills in both houses of Congress that would require the SEC to maintain a list of issuers for which the PCAOB is not able to inspect or investigate an auditor report issued by a foreign public accounting firm. The Ensuring Quality Information and Transparency for Abroad-Based Listings on our Exchanges (EQUITABLE) Act prescribes increased disclosure requirements for such issuers and, beginning in 2025, the delisting from national securities exchanges such as Nasdaq of issuers included for three consecutive years on the SEC's list. On May 20, 2020, the U.S. Senate passed S. 945, the Holding Foreign Companies Accountable Act (the "**Kennedy Bill**"). If passed by the U.S. House of Representatives and signed by the U.S. President, the Kennedy Bill would amend the Sarbanes-Oxley Act of 2002 to direct the SEC to prohibit securities of any registrant from being listed on any of the U.S. securities exchanges or traded "over-the-counter" if the auditor of the registrant's financial statements is not subject to PCAOB inspection for three consecutive years. Enactment of any of such legislations or other efforts to increase U.S. regulatory access to audit information could cause investor uncertainty for affected issuers, including us, the market price of our ADSs could be adversely affected, and we could be delisted if we are unable to cure the situation to meet the PCAOB inspection requirement in time. It is unclear if and when any of such proposed legislations will be enacted. Furthermore, there have been recent media reports on deliberations within the U.S. government regarding potentially limiting or restricting China-based companies from accessing U.S. capital markets. If any such deliberations were to materialize, the resulting legislation may have material and adverse impact on the stock performance of China-based issuers listed in the United States.

*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 Chinese affiliates of the "big four" accounting firms (the "**Big Four PRC-based Accounting Firms**"), 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.

In January 2014, the administrative law judge presiding over the matter reached an initial decision that the Big Four PRC-based Accounting 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.

In February 2015, the Big 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 Big Four PRC-based Accounting Firms to follow detailed procedures and to seek to provide the SEC with access to these firms' audit documents via the CSRC. Under the terms of the settlement, the underlying proceeding against the Big Four PRC-based Accounting Firms was deemed dismissed with prejudice four years after entry of the settlement. The four-year anniversary occurred on February 6, 2019. While we cannot predict if the SEC will further challenge the Big Four PRC-based Accounting Firms' compliance with U.S. law in connection with U.S. regulatory requests for audit work papers or if the results of such a challenge would result in the SEC imposing penalties such as suspensions, if the Big Four PRC-based Accounting Firms are subject to additional remedial measures, we may not be able to continue to meet our

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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 Shares and/or ADSs may be materially and adversely affected.

***Holders of our Shares and ADSs may have difficulty effecting service of process and enforcing judgments obtained against us, our directors and our management, the ability of U.S. authorities to bring actions in the PRC may also be limited, and our Articles of Association include certain provisions that may be different from common practices in Hong Kong.***

We are a Cayman Islands company, and the major portion of our assets are located outside the United States and Hong Kong. A substantial portion of our current operations are conducted in the PRC. In addition, some of our directors and executive officers are nationals and residents of countries or areas other than the United States and Hong Kong. A substantial portion of the assets of these persons are located outside the United States and Hong Kong. As a result, it may be difficult or impossible for holders of our Shares and ADSs to effect service of process within the United States or Hong Kong upon these persons, or to bring an action against us or against these individuals in the United States or Hong Kong in the event that they believe that their rights have been infringed under the U.S. federal securities laws, Hong Kong laws or otherwise. Even if shareholders are successful in bringing an action of this kind, the laws of the Cayman Islands and China may render them unable to enforce a judgment against our assets or the assets of our directors and officers. There is uncertainty as to whether the courts of the Cayman Islands or the PRC would recognize or enforce judgments. Furthermore, class action lawsuits, which are available in the United States for investors to seek remedies, are generally uncommon in the Cayman Islands and the PRC.

The SEC, the U.S. Department of Justice and other U.S. authorities may also have difficulties in bringing and enforcing actions against us or our directors or executive officers in the PRC. The SEC has stated that there are significant legal and other obstacles to obtaining information needed for investigations or litigation in China. China has recently adopted a revised securities law which provides, among other things, that without governmental approval in China, no entity or individual in China may provide documents and information relating to securities business activities to overseas regulators which could present significant legal and other obstacles to obtaining information needed for investigations and litigation conducted outside of China.

Furthermore, our Articles of Association are specific to us and include certain provisions that may be different from common practices in Hong Kong, such as the absence of requirements that the appointment, removal and remuneration of auditors must be approved by a majority of our shareholders. See “Information about This Document and the Global Offering” and “Waivers and Exemptions.”

As a result of the foregoing, our public shareholders may have more difficulty in protecting their interests through actions against us, our management, our directors or our major shareholders than they would as public shareholders of a company incorporated in the United States or Hong Kong.

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***It may be difficult for overseas regulators to conduct investigations or collect evidence within China.***

Shareholder claims or regulatory investigation that are common in the United States generally are difficult to pursue as a matter of law or practicality in China. For example, in China, there are significant legal and other obstacles to providing information needed for regulatory investigations or litigation initiated outside China. Although the authorities in China may establish a regulatory cooperation mechanism with the securities regulatory authorities of another country or region to implement cross-border supervision and administration, such cooperation with the securities regulatory authorities in the United States may not be efficient in the absence of mutual and practical cooperation mechanisms. Furthermore, according to Article 177 of the PRC Securities Law, or Article 177, which became effective in March 2020, no overseas securities regulator is allowed to directly conduct investigation or evidence collection activities within the territory of the PRC. While detailed interpretations of or implementation rules under Article 177 have yet to be promulgated, the inability for an overseas securities regulator to directly conduct investigation or evidence collection activities within China may further increase difficulties you may face in protecting your interests.

***If we are classified as a PFIC for United States federal income tax purposes, such classification could result in adverse U.S. federal income tax consequences to U.S. investors.***

We could be classified as a 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.

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

We do not believe that we were a PFIC for the taxable years 2017, 2018 and 2019. Based on certain estimates and assumptions, we do not expect to be a PFIC for taxable year 2020. The PFIC determination is highly fact intensive and made at the end of each taxable year. We hold and will continue to hold a substantial amount of cash and cash equivalents, and our PFIC status may depend in large part in the market price of our ADSs and Shares which is likely to fluctuate. For these reasons, there can be no assurance that we will not be a PFIC in taxable year 2020 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 or VIEs are treated as PFICs, U.S. investors would be subject to adverse U.S. federal income tax consequences, such as increased tax liability on capital gains and actual or deemed dividends, interest charges on certain taxes treated as deferred, and additional reporting requirements under U.S. federal

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income tax laws and regulations. Whether U.S. investors make (or are eligible to make) a timely mark-to-market election may affect the U.S. federal income tax consequences to U.S. investors with respect to the acquisition, ownership and disposition of our Shares and ADSs and any distributions such U.S. investors may receive. We do not expect to provide the information regarding our income that would be necessary in order for a U.S. investor to make a qualified electing fund (the “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. investor, the U.S. investor will be required to file an annual information return on IRS Form 8621 (or other then applicable IRS Form or statement) regarding distributions received on our Shares or ADSs and any gain realized on the disposition of our Shares or ADSs, and certain U.S. investors will be required to file an annual information return (also on IRS Form 8621 or other then applicable IRS Form or statement) relating to their ownership of our Shares or ADSs. U.S. investors should consult their tax advisors regarding the potential application of the PFIC regime and related reporting requirements.

***An active trading market for our Shares on the Hong Kong Stock Exchange might not develop or be sustained and trading prices of our Shares might fluctuate significantly.***

Following the completion of the Global Offering, we cannot assure you that an active trading market for our Shares on the Hong Kong Stock Exchange will develop or be sustained. The trading price or liquidity for our ADSs on Nasdaq might not be indicative of those of our Shares on the Hong Kong Stock Exchange following the completion of the Global Offering. If an active trading market of our Shares on the Hong Kong Stock Exchange does not develop or is not sustained after the Global Offering, the market price and liquidity of our Shares could be materially and adversely affected.

In 2014, the Hong Kong, Shanghai and Shenzhen Stock Exchanges collaborated to create an inter-exchange trading mechanism called Stock Connect that allows international and mainland Chinese investors to trade eligible equity securities listed in each other’s markets through the trading and clearing facilities of their home exchange. Stock Connect currently covers over 2,000 equity securities trading in the Hong Kong, Shanghai and Shenzhen markets. Stock Connect allows mainland Chinese investors to trade directly in eligible equity securities listed on the Hong Kong Stock Exchange, known as Southbound Trading. Without Stock Connect, mainland Chinese investors would not otherwise have a direct and established means of engaging in Southbound Trading. However, it is unclear whether and when the Shares of our Company with a secondary listing in Hong Kong upon the Listing, will be eligible to be traded through Stock Connect, if at all. The ineligibility or any delay of our Shares for trading through Stock Connect will affect mainland Chinese investors’ ability to trade our Shares and therefore may limit the liquidity of the trading of our Shares on the Hong Kong Stock Exchange.

***Since there will be a gap of several days between pricing and trading of our Shares, the price of our ADSs traded on Nasdaq may fall during this period and could result in a fall in the price of our Shares to be traded on the Hong Kong Stock Exchange.***

The pricing of the Offer Shares will be determined on the Price Determination Date. However, our Shares will not commence trading on the Hong Kong Stock Exchange until they are delivered, which is expected to be about four Hong Kong business days after the Price Determination Date. As a result, investors may not be able to sell or otherwise deal in our Shares during that period. Accordingly, holders of our Shares are subject to the risk that the trading price of our Shares could fall when trading commences as a result of adverse market

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conditions or other adverse developments that could occur between the Price Determination Date and the time trading begins. In particular, as our ADSs will continue to be traded on Nasdaq and their price can be volatile, any fall in the price of our ADSs may result in a fall in the price of our Shares to be traded on the Hong Kong Stock Exchange.

***There is uncertainty as to whether Hong Kong stamp duty will apply to deposits of our ordinary shares into or withdrawal of our ordinary shares from the ADS facility or trading of our ADSs following our initial public offering in Hong Kong and listing of our Shares on the Hong Kong Stock Exchange.***

In connection with our initial public offering of Shares in Hong Kong, we will establish a branch register of members in Hong Kong (the “**Hong Kong share register**”). Our Shares that are traded on the Hong Kong Stock Exchange, including those to be issued in the Global Offering and those represented by ADSs, will be registered on the Hong Kong share register, and the trading of these Shares on the Hong Kong Stock Exchange will be subject to the Hong Kong stamp duty. To facilitate conversion between ADSs and Shares and their respective trading on Nasdaq and the Hong Kong Stock Exchange, we also intend to move a portion of our issued Shares, including all of the ordinary shares deposited in our ADS program, from our Cayman share register to our Hong Kong share register.

Under the Hong Kong Stamp Duty Ordinance, any person who effects any sale or purchase of Hong Kong stock, defined as stock the transfer of which is required to be registered in Hong Kong, is required to pay Hong Kong stamp duty. The stamp duty is currently set at a total rate of 0.2% of the greater of the consideration for, or the value of, shares transferred, with 0.1% payable by each of the buyer and the seller. See “Information about This Document and the Global Offering — Dealings and Settlement of Ordinary Shares in Hong Kong.”

To the best of our knowledge, Hong Kong stamp duty has not been levied in practice on the trading of ADSs representing shares of companies that are listed in both the United States and Hong Kong and that have maintained all or a portion of their ordinary shares, including ordinary shares underlying ADSs, in their Hong Kong share registers, or on the deposit of shares in or withdrawal of shares from ADS facilities of that kind. However, it is unclear whether, as a matter of Hong Kong law, the trading of ADSs representing shares of these dual-listed companies or the deposit of shares in or withdrawal of shares from those ADS facilities constitutes a sale or purchase of the underlying Hong Kong-registered ordinary shares that is subject to Hong Kong stamp duty. We advise investors to consult their own tax advisors on this matter. If Hong Kong stamp duty is determined by the competent authority to apply to the trading of those ADSs or deposits of shares in or withdrawal of shares from those ADS facilities, the trading price and the value of your investment in our Shares and/or the ADSs may be affected.

***Purchasers of our Shares in the Global Offering will experience immediate dilution and may experience further dilution if we issue additional Shares in the future.***

The Public Offer Price of our Shares is higher than the net tangible assets per Share of the Shares issued to our existing shareholders immediately prior to the Global Offering. Therefore, purchasers of our Shares in the Global Offering will experience an immediate dilution in terms of the pro forma net tangible asset value. In addition, we may consider offering and issuing additional Shares, ADSs or equity-related securities in the future to raise additional funds, finance acquisitions or for other purposes. Purchasers of our Shares may experience further dilution in terms of the net tangible asset value per Share, ADS or equity-related security if we issue additional Shares in the future at a price that is lower than the net tangible asset value per Share.