

TME (TME US)

Improving profitability despite pressure on social entertainment business

TME announced 2Q23 financial results on 15 Aug. Total revenue grew by 5.5% YoY and 4.0% QoQ to RMB7.3bn in 2Q23, in line with CMBI/consensus estimate of RMB7.2/7.3bn. Non-IFRS net income was up 48.6% YoY to RMB1.5bn in 2Q23, also in line with CMBI/consensus estimate. Its online music revenue growth was ahead of consensus expectations by 8% due to solid music subscription growth and ad business recovery; but its social entertainment revenue was 12% below consensus due to TME's risk control measures implemented in 2Q23. In view of softer-than-expected social entertainment business, management now expects total revenue to decrease by low-to-mid single-digit percent YoY in FY23 (previously expect mid-single digit YoY growth in FY23), and accordingly we lower FY23-25 total revenue forecast by 5-6%. Our DCF-derived TP is revised down by 8% to US\$9.20. Maintain BUY on resilient earnings growth (FY23: +24% YoY) versus attractive valuation (FY23: 12x PE).

■ **Solid online music business beats expectation.** In 2Q23, online music business became the largest revenue contributor of TME (58% of total revenue), with revenue up by 48% YoY to RMB4.2bn. Total paying user reached 99.4mn out of 594mn MAU. Music subscription revenue grew by 37% YoY to RMB2.9bn in 2Q23, driven by balanced growth of ARPPU/subscribers (+14/20%). Non-subs music revenue grew by 76% YoY to RMB1.4bn in 2Q23, fuelled by strong YoY growth in revenue from ad-supported mode and other innovative ad formats. Looking ahead, we expect online music revenue to deliver solid growth of 30% YoY in 3Q23E. And TME's valuation will depend on consistent revenue growth and profitability improvement from its online music business.

■ **Social entertainment business under pressure due to proactive adjustment.** Social entertainment and others revenue dropped by 25% YoY to RMB3.0bn in 2Q23 (42% of total revenue), primarily due to the risk control measures implemented in the latter part of 2Q23. The management expects the impact will last into 2H23 and the monthly revenue will stabilize in 4Q23E. We estimate social entertainment revenue to decline by 55% YoY to RMB1.8bn in 3Q23E. To offset the impact, TME will introduce more interactive features and actively explore overseas opportunities.

■ **Continuous improvement in profitability.** Overall GPM expanded by 4.4ppt YoY and 1.2ppt QoQ to 34.3% in 2Q23, supported by the enhanced margin of online music business. Management expects GPM to further rise QoQ in 3Q23E. S&M expenses declined by 30% YoY in 2Q23 as TME focused on paying subscriber conversion instead of total user growth. Non-IFRS net margin was up 6.1ppt YoY and 0.8ppt QoQ to 21.0% in 2Q23. Despite the decline in social entertainment revenue, we expect non-IFRS net income to be stable YoY at RMB1.4bn in 3Q23E, supported by enhanced margin of online music business.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	31,244	28,339	26,986	28,848	30,606
YoY growth (%)	7.2	(9.3)	(4.8)	6.9	6.1
Gross margin (%)	30.1	31.0	35.1	36.9	37.2
Adjusted net profit (RMB mn)	4,144.6	4,743.7	5,893.4	6,689.7	7,256.5
EPS (Adjusted) (RMB)	2.50	2.96	3.72	4.22	4.58
Consensus EPS (RMB)	2.50	2.96	3.91	4.11	4.48
P/E (x)	48.9	14.2	14.4	12.7	11.7

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price US\$9.20

(Previous TP US\$10.00)

Up/Downside 49.6%

Current Price US\$6.15

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Stock Data

Mkt Cap (US\$ mn)	9,617.4
Avg 3 mths t/o (US\$ mn)	43.3
52w High/Low (US\$)	9.18/3.61
Total Issued Shares (mn)	1563.8

Source: FactSet

Shareholding Structure

Tencent	53.2%
Spotify	8.2%

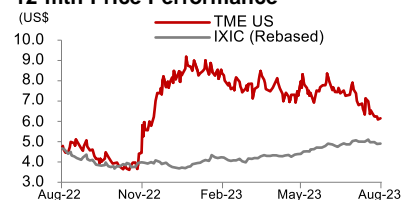
Source: Company data

Share Performance

	Absolute	Relative
1-mth	-19.0%	-17.1%
3-mth	-22.7%	-30.7%
6-mth	-27.2%	-36.3%

Source: FactSet

12-mth Price Performance



Source: FactSet

Business forecasts update and valuation

Figure 1: TME: forecast revision

RMB mn	Current			Previous			Change (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	26,986	28,848	30,606	28,613	30,557	32,411	-5.7%	-5.6%	-5.6%
Gross Profit	9,478	10,659	11,391	9,704	10,619	11,472	-2.3%	0.4%	-0.7%
Operating Profit	5,634	6,547	7,126	5,548	6,198	6,867	1.6%	5.6%	3.8%
Non-IFRS net profit	5,893	6,690	7,256	5,903	6,528	7,178	-0.2%	2.5%	1.1%
Non-IFRS EPS (RMB)	3.7	4.2	4.6	3.6	4.0	4.4	1.9%	4.6%	3.2%
Gross Margin	35.1%	36.9%	37.2%	33.9%	34.8%	35.4%	1.2 ppt	2.2 ppt	1.8 ppt
Operating Margin	20.9%	22.7%	23.3%	19.4%	20.3%	21.2%	1.5 ppt	2.4 ppt	2.1 ppt
Non-IFRS net margin	21.8%	23.2%	23.7%	20.6%	21.4%	22.1%	1.2 ppt	1.8 ppt	1.6 ppt

Source: CMBIGM estimates

Figure 2: CMBIGM estimates vs consensus

RMB mn	CMBIGM			Consensus			Diff (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	26,986	28,848	30,606	29,408	31,469	33,590	-8.2%	-8.3%	-8.9%
Gross Profit	9,478	10,659	11,391	9,859	10,736	11,777	-3.9%	-0.7%	-3.3%
Operating Profit	5,634	6,547	7,126	5,697	6,167	6,898	-1.1%	6.2%	3.3%
Non-IFRS net profit	5,893	6,690	7,256	6,115	6,430	7,013	-3.6%	4.0%	3.5%
Non-IFRS EPS (RMB)	3.7	4.2	4.6	3.9	4.1	4.5	-4.9%	2.7%	2.1%
Gross Margin	35.1%	36.9%	37.2%	33.5%	34.1%	35.1%	1.6 ppt	2.8 ppt	2.2 ppt
Operating Margin	20.9%	22.7%	23.3%	19.4%	19.6%	20.5%	1.5 ppt	3.1 ppt	2.7 ppt
Non-IFRS net margin	21.8%	23.2%	23.7%	20.8%	20.4%	20.9%	1.0 ppt	2.8 ppt	2.8 ppt

Source: Bloomberg, CMBIGM estimates

Figure 3: TME: quarterly financial

(RMB mn)	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	Cons.	Diff%	CMBI	Diff%
Online music	2,880	2,616	2,878	3,430	3,559	3,501	4,249	3,923	8.3%	3,906	8.8%
YoY change (%)	4.3%	-4.8%	-2.4%	18.8%	23.6%	33.8%	47.6%				
Subscription revenue	1,950	1,993	2,107	2,249	2,352	2,599	2,890	2,784	3.8%	2,752	5.0%
YoY change (%)	23.5%	17.8%	17.6%	18.3%	20.6%	30.4%	37.2%				
Other revenue	930	623	771	1,181	1,207	902	1,359	1,140	19.2%	1,154	17.7%
YoY change (%)	-21.3%	-41.1%	-33.4%	19.7%	29.8%	44.8%	76.1%				
Social entertainment	4,727	4,028	4,027	3,935	3,866	3,503	3,037	3,434	-11.6%	3,254	-6.7%
YoY change (%)	-15.2%	-20.6%	-20.4%	-20.0%	-18.2%	-13.0%	-24.6%				
Total revenue	7,607	6,644	6,905	7,365	7,425	7,004	7,286	7,305	-0.3%	7,161	1.8%
YoY change (%)	-8.7%	-15.1%	-13.8%	-5.6%	-2.4%	5.4%	5.5%				
GPM (%)	28.8%	28.0%	29.9%	32.6%	33.0%	33.1%	34.3%				
Adjusted NPM (%)	10.9%	13.5%	14.9%	18.7%	19.4%	20.1%	21.0%				
Adjusted net profit	831	899	1,029	1,379	1,438	1,411	1,529	1,553	-1.5%	1,543	-0.9%
YoY change (%)	-38.4%	-23.9%	-7.9%	35.9%	73.1%	57.0%	48.6%				

Source: Company data, CMBIGM

DCF valuation

Our target price is US\$9.20, based on the DCF valuation methodology (WACC of 11.6% and terminal growth of 2.5%).

Figure 4: TME: DCF Valuation

(RMBmn)	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Free cash flow	4,324	6,493	6,994	7,600	8,289	9,123	9,843	9,890
NPV of free cash flow	41,547							
Discounted terminal value	51,847							
Net cash	7,284							
Total TME valuation	100,678							
Number of ADS (diluted, mn)	1,564							
Valuation per ADS (US\$)	9.20							

Source: Company data, CMBIGM estimates

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	29,153	31,244	28,339	26,986	28,848	30,606
Cost of goods sold	19,851	21,840	19,566	17,508	18,189	19,215
Gross profit	9,302	9,404	8,773	9,478	10,659	11,391
Operating expenses	4,592	5,604	4,330	3,844	4,112	4,265
Selling expense	2,475	2,678	1,144	831	879	933
Admin expense	3,101	4,009	4,413	3,979	4,182	4,437
Others	(984)	(1,083)	(1,227)	(966)	(949)	(1,105)
Operating profit	4,710	3,800	4,443	5,634	6,547	7,126
Share of (losses)/profits of associates/JV	19	(47)	38	80	0	0
Interest expense	(97)	(121)	(108)	(115)	(103)	(93)
Pre-tax profit	4,632	3,632	4,373	5,600	6,443	7,033
Income tax	(456)	(417)	(534)	(759)	(967)	(1,055)
After tax profit	4,176	3,215	3,839	4,841	5,477	5,978
Net profit	4,176	3,215	3,839	4,841	5,477	5,978
Adjusted net profit	4,949	4,145	4,744	5,893	6,690	7,256
BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	31,687	26,791	26,559	29,643	35,280	41,549
Cash & equivalents	11,128	6,591	9,589	12,820	17,979	23,744
Account receivables	2,800	3,610	2,670	2,842	2,880	2,888
Inventories	18	24	14	8	5	3
Prepayment	2,846	2,731	2,958	2,302	2,392	2,527
ST bank deposits	14,858	12,769	11,291	11,630	11,979	12,338
Other current assets	37	1,066	37	41	45	49
Non-current assets	36,586	40,463	40,450	40,846	41,280	41,738
PP&E	176	243	323	272	248	239
Right-of-use assets	311	283	398	398	398	398
Deferred income tax	303	346	347	364	383	402
Investment in JVs & assos	2,255	3,599	4,330	4,380	4,430	4,480
Intangibles	2,020	2,829	2,368	2,162	1,951	1,733
Goodwill	17,492	19,121	19,493	19,743	19,993	20,243
Financial assets at FVTPL	9,771	7,302	3,168	3,231	3,296	3,362
Other non-current assets	4,258	6,740	10,023	10,296	10,582	10,882
Total assets	68,273	67,254	67,009	70,489	76,560	83,287
Current liabilities	9,602	10,450	11,717	10,361	10,936	11,666
Account payables	3,565	4,329	4,998	4,221	4,435	4,738
Tax payable	445	363	404	385	411	436
Other current liabilities	5,489	5,666	6,192	5,628	5,959	6,358
Lease liabilities	103	92	123	127	130	134
Long-term borrowings	5,940	5,749	6,165	6,160	6,179	6,198
Bond payables	5,175	5,062	5,536	5,536	5,536	5,536
Obligations under finance leases	218	205	306	321	337	354
Other non-current liabilities	547	482	323	303	306	307
Total liabilities	15,542	16,199	17,882	16,521	17,115	17,864
Share capital	2	2	2	2	2	2
Capital surplus	34,910	32,395	29,905	29,905	29,905	29,905
Retained earnings	11,111	14,194	12,052	16,893	22,370	28,348
Other reserves	6,222	3,726	6,140	6,140	6,140	6,140
Total shareholders equity	52,245	50,317	48,099	52,940	58,417	64,395
Minority interest	486	738	1,028	1,028	1,028	1,028
Total equity and liabilities	68,273	67,254	67,009	70,489	76,560	83,287

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	4,632	3,632	4,373	5,600	6,443	7,033
Depreciation & amortization	824	1,001	1,160	622	622	635
Tax paid	(637)	(589)	(733)	0	0	0
Change in working capital	(497)	579	2,211	(976)	358	486
Others	563	616	470	(759)	(967)	(1,055)
Net cash from operations	4,885	5,239	7,481	4,487	6,456	7,100
Investing						
Capital expenditure	(501)	(2,758)	(1,053)	(364)	(387)	(409)
Acquisition of subsidiaries/ investments	(540)	(2,078)	(165)	(250)	(250)	(250)
Net proceeds from disposal of short-term investments	6	(877)	1,055	0	0	0
Others	(13,171)	(286)	(1,283)	(658)	(676)	(694)
Net cash from investing	(14,206)	(5,999)	(1,446)	(1,272)	(1,313)	(1,352)
Financing						
Net borrowings	5,400	0	0	0	0	0
Proceeds from share issues	(134)	0	0	0	0	0
Others	26	(3,710)	(3,419)	15	16	17
Net cash from financing	5,292	(3,710)	(3,419)	15	16	17
Net change in cash						
Cash at the beginning of the year	15,426	11,128	6,591	9,589	12,820	17,979
Exchange difference	(269)	(67)	382	0	0	0
Cash at the end of the year	11,128	6,591	9,589	12,820	17,979	23,744
GROWTH	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Revenue	14.6%	7.2%	(9.3%)	(4.8%)	6.9%	6.1%
Gross profit	7.3%	1.1%	(6.7%)	8.0%	12.5%	6.9%
Operating profit	1.9%	(19.3%)	16.9%	26.8%	16.2%	8.9%
Net profit	5.0%	(23.0%)	19.4%	26.1%	13.1%	9.2%
Adj. net profit	0.8%	(16.3%)	14.5%	24.2%	13.5%	8.5%
PROFITABILITY	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Gross profit margin	31.9%	30.1%	31.0%	35.1%	36.9%	37.2%
Operating margin	16.2%	12.2%	15.7%	20.9%	22.7%	23.3%
Adj. net profit margin	17.0%	13.3%	16.7%	21.8%	23.2%	23.7%
Return on equity (ROE)	8.7%	6.3%	7.8%	9.6%	9.8%	9.7%
GEARING/LIQUIDITY/ACTIVITIES	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Net debt to equity (x)	(0.1)	(0.0)	(0.1)	(0.1)	(0.2)	(0.3)
Current ratio (x)	3.3	2.6	2.3	2.9	3.2	3.6
Receivable turnover days	31.3	37.4	40.4	37.3	36.2	34.4
Payable turnover days	56.3	66.0	87.0	96.1	86.8	87.1
VALUATION	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
P/E	38.1	48.9	14.2	14.4	12.7	11.7
P/E (diluted)	38.7	49.5	14.3	14.6	12.9	11.8
P/B	3.0	3.1	1.1	1.3	1.2	1.1

Source: Company data, CMBIGM estimates. Note: The calculation of net cash includes financial assets.

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