

Cloud Music (9899 HK)

1H23 preview: solid improvement in profitability

Cloud Music gradually shifts its focus from revenue growth to sustainable earnings growth. We forecast total revenue to decline by 9% YoY to RMB3.9bn in 1H23, as the Company reduced in-app exposure of live streaming functions and lowered revenue sharing ratio to drive quality growth of social entertainment business. Despite the revenue decline, we expect Cloud Music to achieve breakeven and generate adjusted net income of RMB42mn in 1H23 (1H22: net loss of RMB217mn), mainly due to the enhanced GPM (+10pcts YoY). We trim our FY23-25E total revenue forecast on softer social entertainment business outlook, but raise FY23-25E adjusted net income estimate by 3-8% due to improved margin profile. Our DCF-derived target price is HK\$103.5 (previous: HK\$110.0), which translates to 2.6/2.3x FY23/24E PS. Maintain BUY.

- **Solid core online music business.** We forecast online music revenue to grow by 12% YoY to RMB2.0bn in 1H23 (51% of total revenue), mainly driven by solid growth of membership subscription revenue (+17% YoY). Cloud Music continues to drive balanced growth of subscribers (+11% YoY) and ARPPU (+5% YoY) via: 1) increasing percentage of music tracks behind paywall (currently c.10-15%); 2) collaborating with popular NetEase games like Eggy Party; 3) reducing subscription discount. We expect 2H23E online music revenue growth will accelerate to 19% YoY, primarily driven by recovery of advertising business.
- **Social entertainment business to focus on sustainability.** Cloud Music reduced the in-app exposure of certain live streaming functions to enhance experience of dedicated music users and improve risk controls. The Company also lowered the revenue sharing ratio of live streaming business to drive more quality growth. As a result, we forecast social entertainment revenue to decline by 23% YoY to RMB1.9bn in 1H23 (49% of total revenue). Looking ahead in 2H23E, we expect recovery of social entertainment revenue HoH, as Cloud Music actively cooperates with its independent musicians to drive better engagement of social entertainment users.
- **Expect profitability improvement amid top-line growth softness.** We forecast GPM to improve by 10pct YoY to 22.6% in 1H23, supported by the enhanced social entertainment GPM and optimized music content costs. Despite revenue decline, we estimate gross profit to increase by 64% YoY to RMB881mn in 1H23. We expect S&M expenses as % total revenue to rise from 7.7% in 1H22 to 8.9% in 1H23 due to user acquisition investment and more offline marketing activities. Overall, we expect adjusted net income of RMB42mn in 1H23, versus adjusted net loss of RMB217mn in 1H22.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	6,998	8,992	8,523	9,340	10,150
YoY growth (%)	42.9	28.5	(5.2)	9.6	8.7
Gross margin (%)	2.0	14.4	23.0	26.7	29.8
Operating profit (RMB mn)	(1,347)	(385)	36	518	1,023
YoY growth (%)	na	na	na	1,353.4	97.6
Adjusted net profit (RMB mn)	(1,043.7)	(114.6)	194.3	618.2	1,064.6
EPS (Adjusted) (RMB cents)	(502.37)	(54.82)	92.97	295.82	509.42
Consensus EPS (RMB cents)	(502.37)	(54.82)	53.71	352.35	480.30
P/S (x)	2.2	1.7	1.8	1.6	1.5
P/E (x)	na	na	138.2	28.7	15.6

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price **HK\$103.50**

(Previous TP) **HK\$110.00**

Up/Downside **32.7%**

Current Price **HK\$78.00**

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Stock Data

Mkt Cap (HK\$ mn)	16,300.9
Avg 3 mths t/o (HK\$ mn)	8.7
52w High/Low (HK\$)	110.70/53.15
Total Issued Shares (mn)	209.0

Source: FactSet

Shareholding Structure

NetEase	61.4%
Alibaba	9.9%

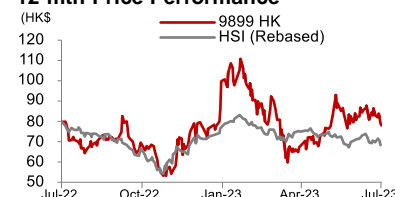
Source: Company data

Share Performance

	Absolute	Relative
1-mth	-6.9%	-2.4%
3-mth	16.8%	29.3%
6-mth	-22.0%	-10.8%

Source: FactSet

12-mth Price Performance



Source: FactSet

Figure 1: Cloud Music: forecast revision

RMB mn	Current			Previous			Change (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	8,523	9,340	10,150	10,647	12,264	13,614	-19.9%	-23.8%	-25.4%
Gross Profit	1,962	2,490	3,023	1,928	2,599	3,153	1.8%	-4.2%	-4.1%
Operating Profit	36	518	1,023	(84)	376	794	NA	37.6%	28.8%
Adjusted net profit	194	618	1,065	187	603	989	3.9%	2.5%	7.6%
Adjusted EPS (RMB)	0.9	3.0	5.1	0.9	2.9	4.7	3.3%	2.0%	8.4%
Gross Margin	23.0%	26.7%	29.8%	18.1%	21.2%	23.2%	4.9 ppt	5.5 ppt	6.6 ppt
Operating Margin	0.4%	5.5%	10.1%	-0.8%	3.1%	5.8%	1.2 ppt	2.4 ppt	4.3 ppt
Adjusted net margin	2.3%	6.6%	10.5%	1.8%	4.9%	7.3%	0.5 ppt	1.7 ppt	3.2 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	8,523	9,340	10,150	9,907	11,537	13,053	-14.0%	-19.0%	-22.2%
Gross Profit	1,962	2,490	3,023	2,029	2,824	3,488	-3.3%	-11.8%	-13.3%
Adjusted net profit	194	618	1,065	180	736	1,057	NA	-16.0%	0.7%
Adjusted EPS (RMB)	0.9	3.0	5.1	0.5	3.5	4.8	NA	-16.0%	6.1%
Gross Margin	23.0%	26.7%	29.8%	20.5%	24.5%	26.7%	2.5 ppt	2.2 ppt	3.1 ppt
Adjusted net margin	2.3%	6.6%	10.5%	1.8%	6.4%	8.1%	0.5 ppt	0.2 ppt	2.4 ppt

Source: Company data, CMBIGM estimates

Figure 3: Cloud Music: financial summary

(RMB mn)	2021	2022	2023E	2024E	2025E	1H23E
Online music segment						
Online music MAUs (mn)	182.6	189.4	195.1	200.9	207.0	195.8
YoY	1.2%	3.7%	3.0%	3.0%	3.0%	7.6%
Online music paying users (mn)	28.9	38.3	42.9	48.2	53.8	41.6
YoY	81.1%	32.4%	12.2%	12.4%	11.6%	10.6%
Paying ratio	15.8%	20.2%	22.0%	24.0%	26.0%	21.3%
Online music revenue	3,290	3,699	4,265	4,867	5,464	1,994
YoY	25.4%	12.4%	15.3%	14.1%	12.3%	11.8%
Subscription revenue	2,324	3,031	3,535	4,091	4,657	1,706.2
YoY	44.9%	30.4%	16.6%	15.7%	13.8%	16.5%
Non-subscription revenue	966	668	730	776	808	287
YoY	-5.1%	-30.9%	9.2%	6.3%	4.1%	-10.0%
Social entertainment segment						
Social entertainment paying users (mn)	0.7	1.3	1.3	1.4	1.6	1.4
YoY	108.9%	95.0%	-1.9%	10.6%	10.3%	14.5%
Social entertainment revenue	3,708	5,293	4,258	4,473	4,686	1,900.1
YoY	63.1%	42.8%	-19.6%	5.0%	4.8%	-23.2%
Overall						
Total revenue	6,998	8,992	8,523	9,340	10,150	3,894
YoY	42.9%	28.5%	-5.2%	9.6%	8.7%	-8.6%
Gross profit margin	2.0%	14.4%	23.0%	26.7%	29.8%	22.6%
S&M expense ratio	6.2%	7.1%	8.2%	7.6%	7.1%	8.9%
R&D expense ratio	12.4%	11.2%	13.0%	12.2%	11.4%	13.6%
Adjusted net profit margin	-14.9%	-1.3%	2.3%	6.6%	10.5%	1.1%
Adjusted net profit	-1,044	-115	194	618	1,065	42

Source: Company data, CMBIGM estimates

Based on DCF valuation (WACC of 14.7% and terminal growth of 2.5%), our target price of Cloud Music is HK\$103.5, which implies 2.6/2.3x FY23/24E PS.

Figure 4: Cloud Music: DCF valuation

(RMB mn)	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Adjusted EBITDA	96	565	1,085	1,532	1,977	2,468	2,838	3,226
Free cash flow	371	566	950	1,275	1,614	1,979	2,303	2,630
NPV of FCF	6,390							
Discounted terminal value	8,518							
Enterprise value	14,908							
Net cash	6,849							
Equity value	21,757							
Number of shares (diluted, mn)	209							
Exchange rate (HKD/RMB)	0.92							
Valuation per share (HK\$)	103.5							
Risk free rate	2.8%							
Beta	121.0%							
Equity risk premium	9.8%							
Cost of equity	14.7%							
Cost of debt	5.0%							
Tax rate	15.0%							
Debt/capital	Net Cash							
WACC	14.7%							
Terminal FCF growth (%)	2.5%							

Source: CMBIGM estimates

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	4,896	6,998	8,992	8,523	9,340	10,150
Cost of goods sold	5,491	6,855	7,699	6,561	6,850	7,127
Gross profit	(595)	143	1,293	1,962	2,490	3,023
Operating expenses	929	1,490	1,678	1,926	1,973	2,000
Selling expense	327	431	635	699	710	717
Admin expense	97	264	172	179	187	193
R&D expense	576	869	1,011	1,108	1,141	1,153
Others	(71)	(75)	(140)	(60)	(65)	(64)
Operating profit	(1,525)	(1,347)	(385)	36	518	1,023
Investment gain/loss	(4)	2	(3)	(3)	(3)	(3)
Other gains/(losses)	(1,522)	(755)	0	0	0	0
Interest income	101	48	183	95	103	113
Interest expense	0	0	(0)	0	0	0
Pre-tax profit	(2,950)	(2,051)	(204)	128	617	1,133
Income tax	(2)	(5)	(17)	(19)	(93)	(170)
After tax profit	(2,951)	(2,056)	(221)	109	525	963
Net profit	(2,951)	(2,056)	(221)	109	525	963
Adjusted net profit	(1,568)	(1,044)	(115)	194	618	1,065
BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	6,863	8,769	8,909	9,017	9,739	10,872
Cash & equivalents	3,006	853	548	755	1,152	1,924
Account receivables	254	674	736	593	585	604
Prepayment	1,642	1,345	1,428	1,156	1,155	1,145
ST bank deposits	817	5,528	5,804	6,094	6,399	6,719
Financial assets at FVTPL	971	241	265	291	320	353
Other current assets	172	128	128	128	128	128
Non-current assets	1,195	619	637	519	487	487
PP&E	21	44	49	48	62	68
Right-of-use assets	0	11	11	11	11	11
Investment in JVs & assos	89	93	93	93	93	93
Other non-current assets	1,085	471	485	368	322	315
Total assets	8,057	9,388	9,546	9,536	10,227	11,359
Current liabilities	2,173	1,948	2,206	1,982	2,046	2,106
Account payables	1	0	0	0	0	0
Tax payable	1	0	0	0	0	0
Other current liabilities	146	56	56	56	56	56
Lease liabilities	0	3	3	3	3	3
Contract liabilities	385	605	777	767	841	913
Accrued expenses	1,640	1,284	1,370	1,156	1,146	1,133
Non-current liabilities	11,192	58	73	93	101	109
Convertible bonds	11,162	0	0	0	0	0
Other non-current liabilities	29	58	73	93	101	109
Total liabilities	13,364	2,006	2,279	2,075	2,147	2,215
Share capital	0	0	0	0	0	0
Retained earnings	(8,372)	(10,600)	(10,822)	(10,713)	(10,188)	(9,225)
Other reserves	3,066	17,982	18,089	18,174	18,267	18,369
Total shareholders equity	(5,307)	7,382	7,267	7,461	8,080	9,144
Total equity and liabilities	8,057	9,388	9,546	9,536	10,227	11,359

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	(2,950)	(2,051)	(204)	128	617	1,133
Depreciation & amortization	22	15	32	35	19	25
Tax paid	(2)	(6)	(17)	(19)	(93)	(170)
Change in working capital	531	177	114	328	127	66
Others	1,429	957	(76)	(10)	(9)	(12)
Net cash from operations	(969)	(908)	(151)	462	661	1,042
Investing						
Capital expenditure	(21)	(40)	(36)	(35)	(33)	(31)
Acquisition of subsidiaries/ investments	(6,534)	(11,544)	(300)	(317)	(334)	(352)
Net proceeds from disposal of short-term investments	10,045	7,681	0	0	0	0
Others	(85)	40	183	95	103	113
Net cash from investing	3,406	(3,862)	(154)	(256)	(264)	(270)
Financing						
Proceeds from share issues	0	2,679	0	0	0	0
Share repurchases	0	0	0	0	0	0
Others	(321)	(65)	(0)	0	0	0
Net cash from financing	(321)	2,614	(0)	0	0	0
Net change in cash						
Cash at the beginning of the year	911	3,006	853	548	755	1,152
Exchange difference	(21)	4	0	0	0	0
Cash at the end of the year	3,006	853	548	755	1,152	1,924
GROWTH	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Revenue	111.2%	42.9%	28.5%	(5.2%)	9.6%	8.7%
Gross profit	na	na	806.3%	51.7%	26.9%	21.4%
Operating profit	na	na	na	na	1,353.4%	97.6%
Net profit	na	na	na	na	381.2%	83.5%
Adj. net profit	na	na	na	na	218.2%	72.2%
PROFITABILITY	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Gross profit margin	(12.2%)	2.0%	14.4%	23.0%	26.7%	29.8%
Operating margin	(31.1%)	(19.2%)	(4.3%)	0.4%	5.5%	10.1%
Adj. net profit margin	(32.0%)	(14.9%)	(1.3%)	2.3%	6.6%	10.5%
Return on equity (ROE)	na	(198.2%)	(3.0%)	1.5%	6.8%	11.2%
GEARING/LIQUIDITY/ACTIVITIES	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Net debt to equity (x)	na	(0.9)	(0.9)	(0.9)	(0.9)	(0.9)
Current ratio (x)	3.2	4.5	4.0	4.5	4.8	5.2
Receivable turnover days	19.0	35.1	29.9	25.4	22.8	21.7
VALUATION	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
P/E	na	na	na	138.2	28.7	15.6
P/E (diluted)	na	na	na	138.2	28.7	15.6
P/B	na	3.8	2.0	2.0	1.9	1.6

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

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