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China Internet

Social entertainment 3Q22 preview: remains under pressure

For 3Q22E, social entertainment platforms still face intensifying competition and macro challenges that can weigh on their revenue growth and margin expansion. Social entertainment platforms need to innovate their monetization methods and enhance operating efficiency in order to fend off competition and macro headwind, in our view. Platforms with concentrated revenue exposure to ad business like Weibo and loss-making platforms like BiliBili (Bili) might be more sensitive to the competition and macro environment. In comparison, we see more positive signs for Tencent/NetEase/TME in 3Q22E. We forecast 1) NetEase/TME's adjusted net income to grow 29/18% YoY in 3Q22E, due to their resilient core businesses and opex optimization; 2) Tencent's adjusted net income to drop by 9% YoY in 3Q22E but with narrowing decline rate (2Q22: -17.3% YoY) thanks to its control in headcount and opex.

- **Top-line growth remains under pressure due to weak consumer-related businesses.** Cloud Music > Bili > NetEase > Tencent > TME > Weibo in terms of our 3Q22E revenue growth forecast. Soft ad demand continued in 3Q22E, and we forecast Weibo's total revenue to drop 23% YoY in 3Q22E. The lack of new games and the tightening regulatory environment in the gaming sector further dragged down Bili's/NetEase's total revenue growth to +11%/+10% YoY in 3Q22E (1H22: +19%/14% YoY), based on our estimate. We forecast Tencent's total revenue to drop by 1% YoY in 3Q22E due to its soft advertising (-11% YoY) and gaming revenue growth (-4% YoY). In the online music sector, we expect Cloud Music revenue to grow 24.8% YoY in 3Q22E, with faster growth than TME (-9.5% YoY), as Cloud Music's social entertainment business remains at early development stage.
- **Opex control supports resilient earning performance.** NetEase > TME > Tencent > Weibo in terms of our 3Q22E earnings growth forecast, while Bili and Cloud Music remains loss-making. We forecast the YoY decline of Tencent's adjusted net income will narrow to 9.1% YoY in 3Q22E (2Q22: -17.3% YoY), driven by its strong operating leverage and stabilizing of its consumer-related business. Also, we forecast TME's/NetEase's adjusted net income to grow 18%/29% YoY in 3Q22E, mainly attributable to their resilient core music/gaming businesses and opex optimization. Bili and Weibo will still face bottom-line pressure in 3Q22E. We forecast Bili's adjusted net loss to further expand YoY in 3Q22E, due to soft performance of higher-margin mobile games and advertising businesses. We estimate Weibo's non-GAAP net income will decline by 34% YoY in 3Q22E, as its core ad business remains weak amid macro challenges.
- **Cash flow generation capability to assess business robustness amid near-term uncertainties**. We expect free cash flow of Tencent, NetEase and TME to improve in 2023E, mainly supported by their well-established business models and steady earnings growth. However, Bili's free cash flow will remain negative in 2023E due to its heavy investment in user acquisition and content. We expect its share price will remain choppy under current market sentiment, until it develops a self-sustained business model with more efficient operation and monetization.

China Internet Sector

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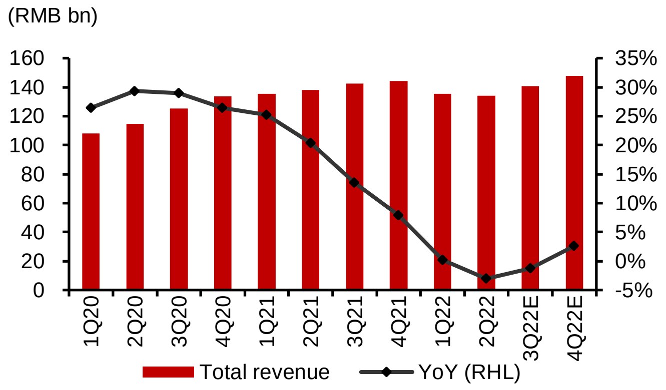
Tencent (700 HK, BUY, TP HK$398.0)

Tencent is deploying its WeChat ecosystem, which we expect will disrupt consumer internet industry competition and partially offset slowing macro impact. Infrastructure to support real economy industries, such as enterprise and fintech services, overseas markets development will be Tencent's growth drivers for the long run. Due to revenue exposure to high ROE consumer internet business, revenue recovery coupled with Opex optimization will stabilize earnings from 2023 onwards. BUY.

- **3Q22 preview: expect gradual recovery of non-IFRS net income**

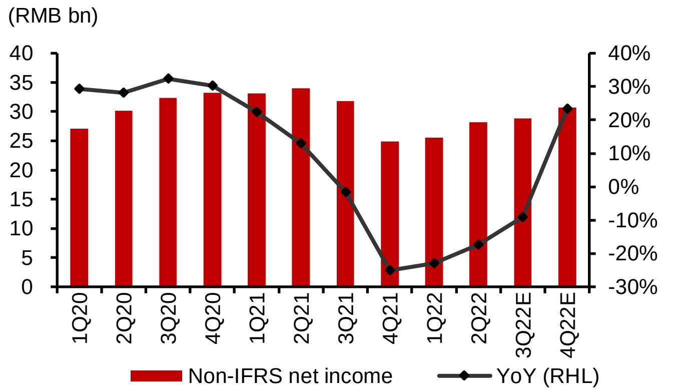
In 1H22, Tencent's total revenue and non-IFRS net income was down 1.5% YoY and 20.1% YoY, in the backdrop of macro challenges and resurgence of COVID-19. Looking into 2H22E, we forecast total revenue growth of +0.9% YoY, supported by 1) incremental contribution from deploying video account and WeChat ecosystem; 2) steady growth in FBS revenue; 3) while other segments will still be under negative impacts from softening macro conditions. However, Tencent has already started to optimize its opex since 2Q22. We expect operating leverage will help to stabilise net profit margins and non-IFRS net profit will return to growth by 5.1% YoY in 2H22E.

Figure 1: Tencent: total revenue



Source: Company data, CMBIGM estimates

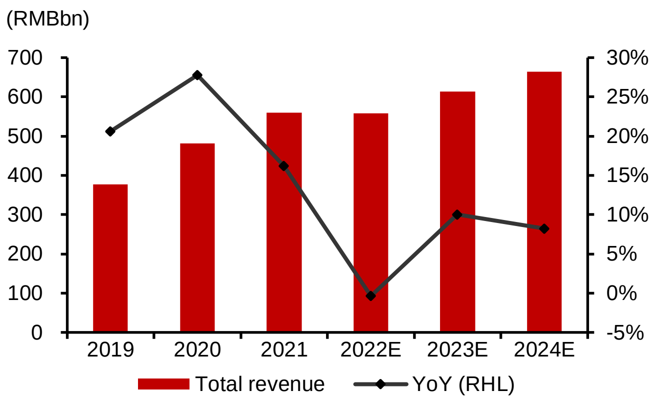
Figure 2: Tencent: non-IFRS net income



Source: Company data, CMBIGM estimates

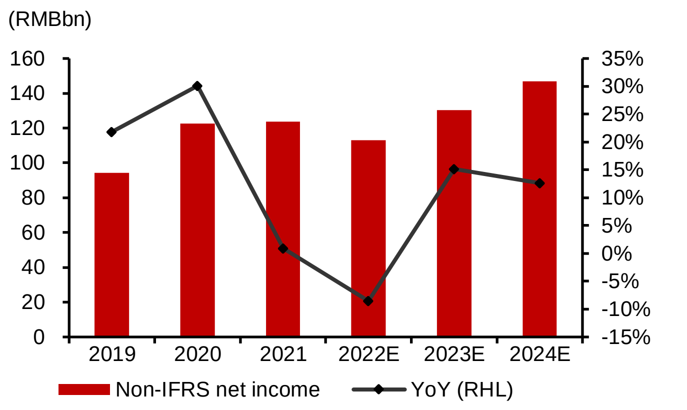
We forecast Tencent's total revenue to decline by 0.4% YoY to RMB558.0bn in 2022E, before rebounding by 10.0/8.2% YoY to RMB614.1/664.7bn in 2023/2024E, as advertising and FBS revenue growth reaccelerate with the recovery of consumption in 2023E. Besides, the operating leverage improvement and opex control will support non-IFRS net income to grow by 15.2/12.7% YoY to RMB130.4/146.9bn in 2023E/2024E, based on our estimates.

Figure 3: Tencent: total revenue



Source: Company data, CMBIGM estimates

Figure 4: Tencent: non-IFRS net income



Source: Company data, CMBIGM estimates

NetEase (NTES US, BUY, TP US$114.8)

NetEase delivered sturdy revenue growth of 13.8% YoY in 1H22, driven by resilient performance of its legacy titles and the launch of several key titles in 2H21. We forecast total revenue growth of 7.3/6.3% YoY in 2023/2024E, but the growth could be accelerated by several highly-anticipated titles in the pipeline and enhanced overseas games market expansion strategy. Supported by its game business' steady profit margin and cash flow generation capability, NetEase is well-positioned to invest for long-term quality growth, expanding into international markets, focusing on quality games development, and cultivating tenacious user community. Our SOTP valuation methodology derived target price is US$114.8. BUY.

- **3Q22 preview: preparing for next phase of strong product cycle**

We forecast 3Q22 total revenue growth to slow down to 10.0% YoY, mainly due to the high-base effect, as both *Harry Potter: Magic Awakened* and *Naraka: Bladepoint* were launched in 3Q21. We estimate non-GAAP net income to increase by 30% YoY to RMB5.0bn in 3Q22, driven by the resilient growth of gaming revenue and the favourable foreign exchange gain.

Figure 5: NetEase: key financial data forecasts

(RMB mn)	2022E	2023E	2024E	3Q22E	4Q22E
Online games revenue	72,774	75,936	78,875	17,613	18,379
YoY%	11.7%	4.3%	3.9%	10.8%	5.6%
As % of total revenue	74.9%	72.8%	71.2%	72.2%	70.7%
Youdao revenue	4,591	5,496	6,344	1,194	1,241
YoY%	-14.2%	19.7%	15.4%	-13.9%	-7.0%
As % of total revenue	4.7%	5.3%	5.7%	4.9%	4.8%
Cloud Music revenue	9,092	11,595	14,006	2,400	2,433
YoY%	29.9%	27.5%	20.8%	24.7%	28.8%
As % of total revenue	9.4%	11.1%	12.6%	9.8%	9.4%
Revenue from innovative businesses and others	10,680	11,214	11,551	3,204	3,958
YoY%	6.0%	5.0%	3.0%	7.5%	5.5%
As % of total revenue	11.0%	10.8%	10.4%	13.1%	15.2%
Total revenue	**97,137**	**104,243**	**110,776**	**24,411**	**26,012**
YoY%	10.9%	7.3%	6.3%	10.0%	6.7%

(RMB mn)	2022E	2023E	2024E	3Q22E	4Q22E
Gross profit margin (%)	54.2%	54.1%	54.3%	55.1%	51.6%
S&M expenses ratio (%)	13.7%	13.5%	13.0%	14.4%	13.8%
R&D expenses ratio (%)	15.5%	15.5%	15.5%	16.1%	16.0%
Non-GAAP net profit margin (%)	20.9%	21.0%	21.6%	20.5%	18.4%
Non-GAAP net profit	**20,279**	**21,862**	**23,925**	**4,993**	**4,782**
YoY%	3.5%	7.8%	9.4%	29.8%	-25.2%

Source: Company data, CMBIGM estimates

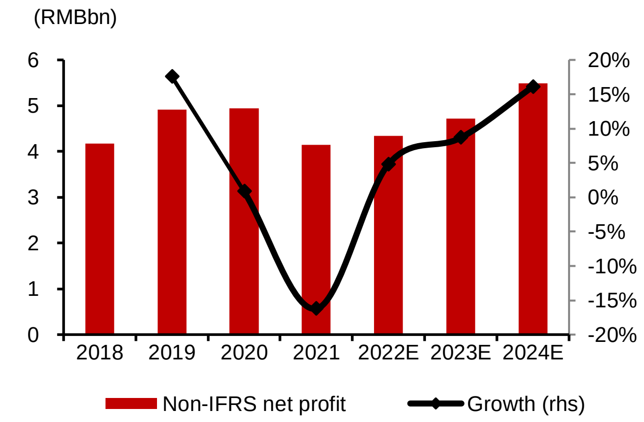
TME (TME US, BUY, TP US$6.60)

TME will continue to focus on improving operating efficiency in 2H22 to combat macro uncertainty and intensifying competition in social entertainment sector. We forecast total revenue to drop by 11.2% YoY to RMB27.7bn in 2022E, due to the soft performance of social entertainment and ad businesses, before recovering by 7.1/6.5% YoY to RMB29.7/31.7bn in 2023/2024E. Although non-IFRS net profit was down by 16.1% YoY to RMB1.9bn in 1H22, we expect non-IFRS net profit to recover to 30.9% YoY to RMB2.4bn in 2H22E, driven by effective cost control initiatives and recovery of core music business. We remain positive on its long-term monetization potential, and forecast non-IFRS net income CAGR of 9.8% over 2021-2024E. Our DCF-derived target price is US$6.60, which translates into 16/15x 2022/2023E non-IFRS PE. BUY.

■ **3Q22 preview: earnings stabilize despite revenue drop**

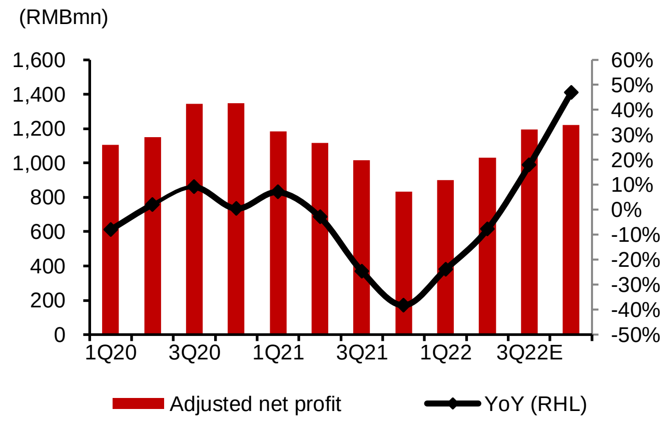
We forecast total revenue to decline by 9.5% YoY to RMB7.1bn in 3Q22E, mainly due to the decline in social entertainment revenue (-21.5% YoY) but partially offset by steady growth of online music revenue (+11.1% YoY). Music subscription revenue is expected to grow by 18.9% YoY to RMB2.3bn in 3Q22E based on our estimates, driven by net addition of c.3mn paying users. Supported by the rationalizing of music licensing costs and more prudent investment in audio content, overall GPM will expand from 29.6/29.9% in 3Q21/2Q22 to 31.0% in 3Q22E. With improving GPM and optimization in selling and marketing expense, we forecast non-IFRS net income would return to growth by 17.8% YoY to RMB1.2bn in 3Q22E.

Figure 6: TME: non-IFRS net income



Source: Company data, CMBIGM estimates

Figure 7: TME: non-IFRS net income (quarter)



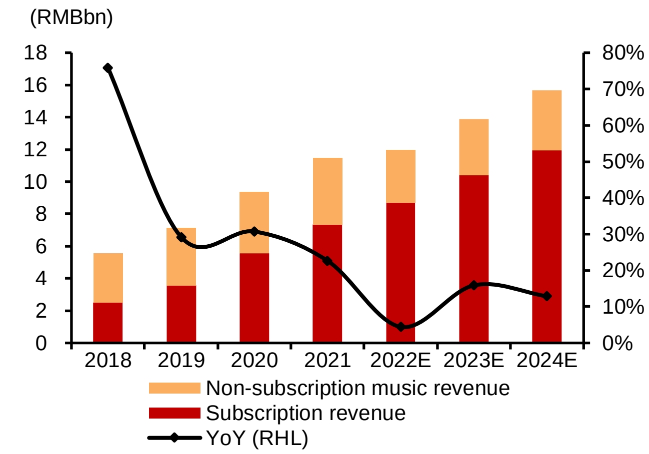
Source: Company data, CMBIGM estimates

We forecast total revenue to drop by 11.2% YoY to RMB27.7bn in 2022E, due to the soft performance of social entertainment and ad businesses, before recovering by 7.1/6.5%

YoY to RMB29.7/31.7bn in 2023/2024E. Although non-IFRS net profit was down by 16.1% YoY to RMB1.9bn in 1H22, we expect non-IFRS net profit to recover to 30.9% YoY to RMB2.4bn in 2H22E, driven by effective cost control initiatives and recovery of core music business. We remain positive on its long-term monetization potential, and forecast non-IFRS net income CAGR of 9.8% over 2021-2024E.

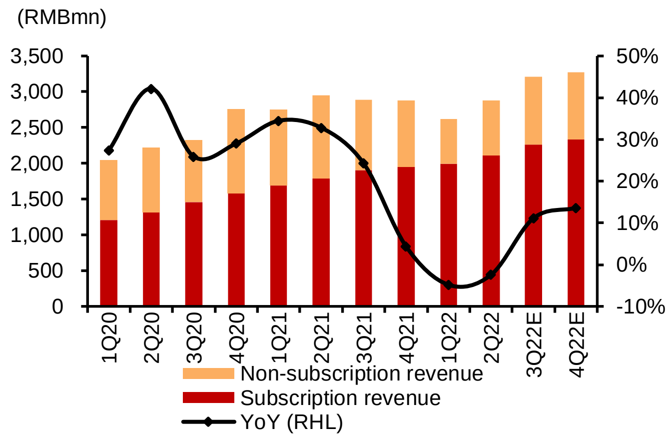
Online music revenue growth slows down to +4.4% YoY in 2022E based on our estimate, primarily due to the weak performance of advertising and sublicensing businesses in the backdrop of macro headwind and tightening regulations. Nonetheless, subscription business remains resilient and we forecast music subscription revenue to increase by 18.6% YoY to RMB8.7bn in 2022E, driven by balanced growth of paying users and ARPPU. Looking forward, we expect online music revenue growth will reaccelerate to 15.9/12.9% YoY in 2023/2024E, driven by the solid growth of subscription business and recovery of advertising business.

Figure 8: TME: online music revenue



Source: Company data, CMBIGM estimates

Figure 9: TME: online music revenue (quarter)



Source: Company data, CMBIGM estimates

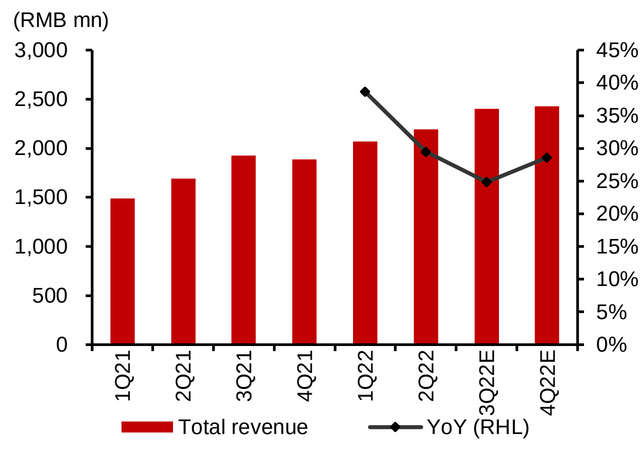
Cloud Music (9899 HK, BUY, TP HK$110.0)

Cloud Music is the second largest online music platform in China in terms of both revenue and MAU, taking up 19% market share of China's online music revenue per iResearch and our estimate in 2021. Compared to the market leader TME, Cloud Music remains at early stage of monetization, with ample room for revenue growth and margin improvement. We expect Cloud Music to benefit from the secular trend of rising paying ratio, growing ARPPU and rationalizing music licensing costs in the China online music sector. We forecast total revenue CAGR of 26.0% over 2021-2024E, and adjusted net income of RMB75/535mn in 2023/2024E (vs. adjusted net loss of RMB1,044/346mn in 2021/2022E). Our DCF-derived target price is HK$110.0, which translates into 2.2x/1.8x 2022/2023E PS. BUY.

■ **3Q22 preview: solid margin improvement**

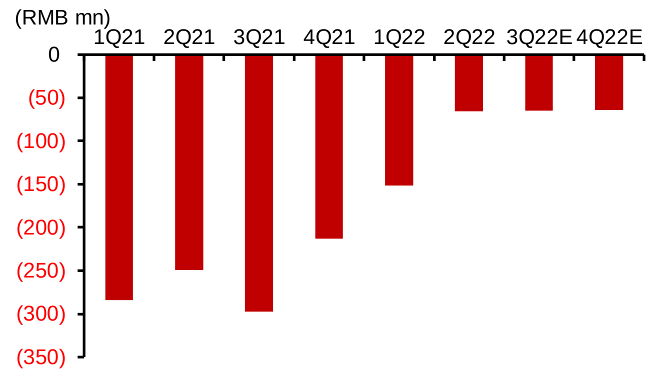
We forecast Cloud Music revenue to increase by 24.8% YoY to RMB2.4bn in 3Q22, driven by robust growth of music subscription revenue (+31.2% YoY) and social entertainment revenue (+35.4% YoY). Due to favourable revenue mix shift to higher-margin social entertainment business and rationalizing music content costs, we estimate adjusted net loss to narrow from RMB298mn in 3Q21 to RMB65mn in 3Q22E.

Figure 10: Cloud Music: total revenue



Source: Company data, CMBIGM estimates

Figure 11: Cloud Music: adjusted net income

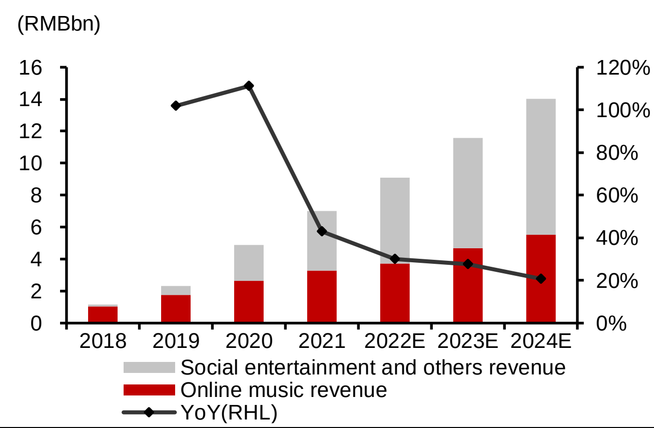


Source: Company data, CMBIGM estimates

We forecast total revenue to increase by 29.9/27.5/20.8% YoY to RMB9.1/11.6/14.0bn in 2022/2023/2024E, primarily driven by the solid growth of the music subscription and social entertainment businesses. Online music/social entertainment business will deliver a revenue CAGR of 19.0/31.7% over 2021-2024E, as their paying user base ramped up at a CAGR of 25.3/46.2% during the same period, based on our estimates. Online music/social entertainment businesses will account for 39.6/60.4% of total revenue in 2024E, versus 47.0/53.0% of total revenue in 2021.

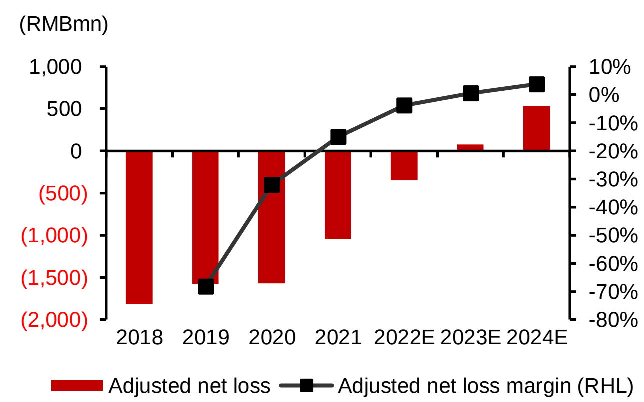
We expect significant margin improvement potential for Cloud Music going forward. Driven by favourable revenue mix shift to higher-margin social entertainment business and rationalizing content costs, we estimate overall GPM to rise from 2.0% in 2021 to 12.9/17.0/20.0% in 2022/2023/2024E. The expanding GPM in addition to operating efficiency improvement shall drive adjusted net margin to improve from -14.9% in 2021 to -3.8% in 2022E and 0.6/3.8% in 2023/2024E. We forecast adjusted net income of RMB75/535mn in 2023/2024E, versus adjusted net loss of RMB346mn in 2022E.

Figure 12: Cloud Music: total revenue trend



Source: Company data, CMBIGM estimates

Figure 13: Cloud Music: adjusted net loss



Source: Company data, CMBIGM estimates

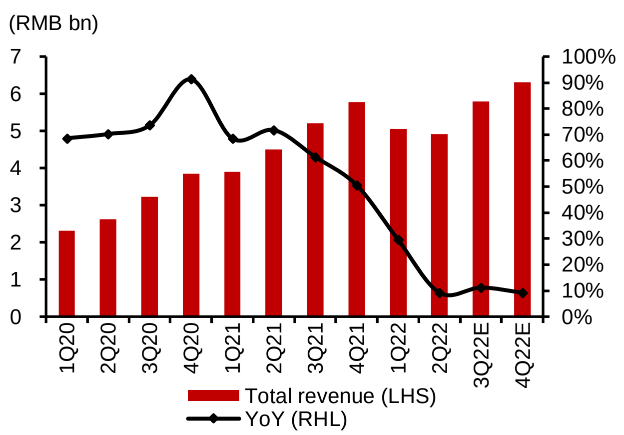
BiliBili (BILI US, BUY, TP US$20.0)

Due to unexpected macro events in 2Q22, Bili's revenue growth decelerated to +18.7% YoY in 1H22 (2021: 61.3% YoY) and adjusted net loss widened from RMB2.2bn in 1H21 to RMB3.6bn in 1H22. Its user community engagement remains healthy, with MAU/time spend up 29/10% YoY in 2Q22. At this stage, we view accelerating user base growth, cultivating user community and improving user engagement as crucial for Bili's long-term prospects, which will improve self-sustainability of its ecosystem, and balance profit-sharing with content contributors which may lead to better margins and cash flows. We forecast total revenue growth of +9.8% YoY in 2H22E. Bili will focus more on the monetization and operating efficiency improvement in 2H22E. We forecast total revenue will grow by 20.7/16.2% YoY to RMB26.6/30.9bn in 2023/2024E, and adjusted net loss will narrow from RMB7.7bn in 2022E to RMB5.2/2.6bn in 2023/2024E. Our SOTP derived target price is US$20.0 per ADS (2.1/1.8x 22E/23E PS). BUY.

■ **3Q22 preview: user base and engagement growth are crucial**

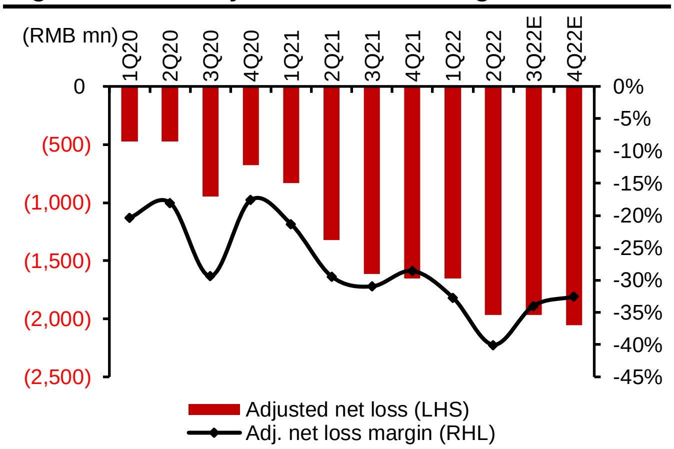
Bili's business operations were disrupted by the macro challenges and resurgence of the COVID-19 in 2Q22. Total revenue growth decelerated to +9.2% YoY in 2Q22 (the lowest since 2018) and adjusted net loss margin widened by 10.6pp YoY to -40.0% in 2Q22. At this stage of growth, we believe Bili needs to accelerate the growth of user base, in order to establish a large enough ecosystem which will create economic value that can keep the platform's development self-sustaining. It will involve growing user base, user time spend and engagement. For instance, larger user base would give Bili more room to adjust down revenue sharing ratio of its live-streaming business to industry norm-level (50-60%).

Figure 14: Bili: quarterly revenue trend



Source: Company data, CMBIGM estimates

Figure 15: Bili: adjusted net loss margin



Source: Company data, CMBIGM estimates

Figure 16: Bili: key financial forecasts

(RMB mn)	2021	2022E	2023E	2024E	3Q22E	4Q22E
Mobile games	5,091	5,126	5,614	5,900	1,436	1,286
YoY%	6.0%	0.7%	9.5%	5.1%	3.2%	-0.7%
VAS	6,935	8,764	10,956	13,081	2,233	2,375
YoY%	80.3%	26.4%	25.0%	19.4%	17.0%	25.3%
Advertising	4,523	5,218	6,760	8,329	1,383	1,636
YoY%	145.5%	15.4%	29.6%	23.2%	18.0%	3.0%
E-commerce and others	2,834	2,923	3,254	3,571	736	983
YoY%	88.1%	3.1%	11.3%	9.7%	0.3%	-2.1%

(RMB mn)	2021	2022E	2023E	2024E	3Q22E	4Q22E
Total revenue	**19,384**	**22,030**	**26,584**	**30,880**	**5,788**	**6,279**
YoY%	61.5%	13.7%	20.7%	16.2%	11.2%	8.6%
Average MAUs	**250**	**312**	**378**	**446**	**323**	**327**
YoY%	34.5%	25.0%	21.0%	18.0%	7.8%	5.1%
Gross profit margin (%)	20.9%	16.9%	22.5%	27.7%	17.4%	19.9%
S&M expense ratio (%)	29.9%	23.5%	19.5%	16.0%	23.0%	22.6%
R&D expense ratio (%)	14.7%	21.0%	18.0%	15.5%	21.0%	20.2%
Adjusted net loss margin (%)	-28.3%	-34.9%	-19.7%	-8.5%	-34.0%	-32.2%
Adjusted net loss	**(5,478)**	**(7,685)**	**(5,230)**	**(2,622)**	**(1,966)**	**(2,020)**

Source: Company data, CMBIGM estimates

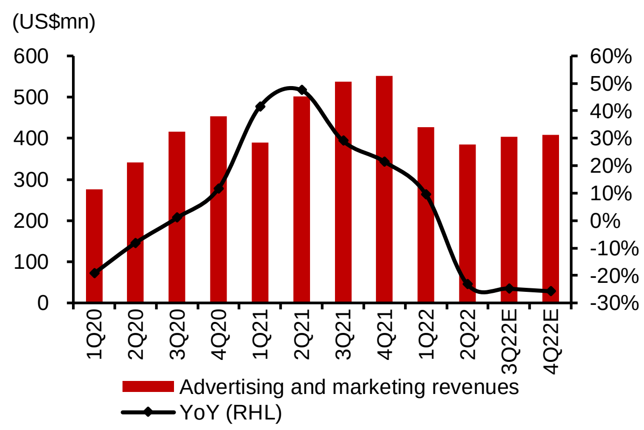
Weibo (WB US, BUY, TP US$21.8)

Weibo is the fourth largest social media platforms by MAUs in China (behind Tencent/Douyin/Kuaishou), with 582mn MAUs and 43% DAU/MAU ratio as of June 2022. Weibo has established unique proposition to advertisers with its large user base and vibrant KOL community. It provides advertisers with differentiated brand-plus-performance marketing solutions with relatively high ROI. We expect revenue/earnings deceleration to bottom-out from 2023E onwards, with total revenue/non-GAAP net income CAGR of 4.4/3.5% over 2022-2024E, as the macro environment gradually recovers. Its current valuation of 5x 2022E non-GAAP PE (70% discount to the sector average) offers attractive risk-reward. Our target price for Weibo is US$21.8, based on 9.0x 2022E non-GAAP EPS. BUY.

- **3Q22 preview: navigate short-term headwind**

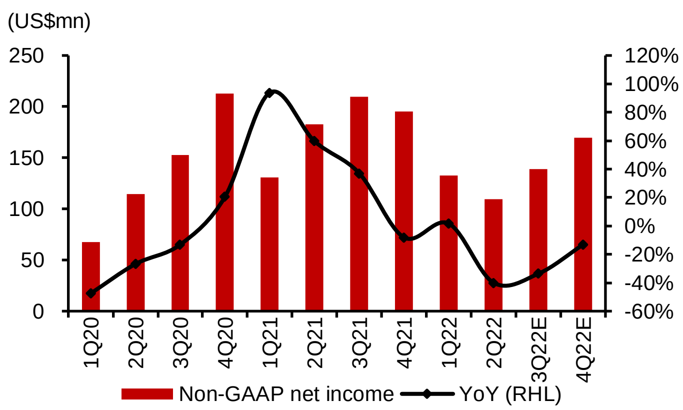
Macro challenges linger and the overall consumption sentiment remains weak in 3Q22. We forecast Weibo's advertising and marketing revenue to decline by 25% YoY to US$404mn in 3Q22. We expect non-GAAP net income to decline by 33.7% YoY to US$139mn in 3Q22E.

Figure 17: Weibo: advertising revenue trend



Source: Company data, CMBIGM estimates

Figure 18: Weibo: non-GAAP net income

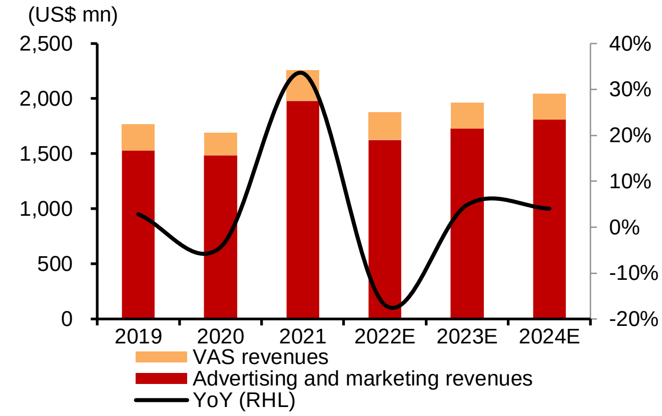


Source: Company data, CMBIGM estimates

We forecast Weibo's total revenue to decline by 16.9% YoY to US$1.87bn (2021: +33.6% YoY), primarily due to the resurgence of COVID-19, the high base in 2021 as well as the foreign exchange headwind. Looking ahead, we expect total revenue to rebound by 4.8/4.0% YoY to US$1.97/2.04bn in 2023/2024E driven by the recovery of macro environment and consumption sentiment. Based on our estimate, advertising and marketing/VAS business will account for 88.5/11.5% of total revenue in 2024E, versus 86.7/13.3% of total revenue in 2021.

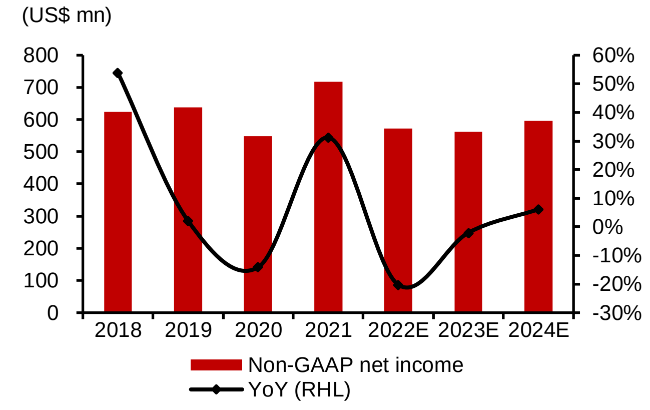
We forecast non-GAAP net income to drop by 20.2% YoY to US$573mn in 2022E, mainly attributable to the decline in revenue, charge of cultural business construction fees that was exempted in 2021, and increase in content investment. Due to the top-line pressure, Weibo will also exercise more prudent control in operating expenses and maintain a healthy margin profile. We estimate non-GAAP net income to grow by 1.2/5.8% to US$580/614mn, which imply non-GAAP net margin of 29.5/30.0% in 2023/2024E.

Figure 19: Weibo: total revenue trend



Source: Company data, CMBIGM estimates

Figure 20: Weibo: non-GAAP net income trend



Source: Company data, CMBIGM estimates

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