

TME (TME US)

Subs intact despite soft ads and social

We expect TME's rev/ adj. net profit +1%/-46% YoY in 3Q21E, 2%/13% below consensus. Music subs remains intact (forecasting 4.5mn quarterly net adds), despite regulations against exclusive music copyright. Soft app-open ads, digital albums, and social entertainment are mostly priced in, in our view. Competition shifts to indie musicians in the post exclusive copyright era, and we anticipate further Tencent synergies in content creation and distribution. We cut its earnings by 0%/3%/3% in FY21/22/23E to reflect lower ads rev mix, increasing content investment, and intensified competition, and lowered DCF-based TP to US\$10.

- Expecting mixed 3Q21E.** We forecast 3Q21E topline +1% YoY (2% below consensus), as ads and digital album face short-term pressure and social entertainment continues to trend soft. By segment, we expect music/social +25%/-10% YoY in 3Q21E, with music sub/other music +31%/+16% YoY. Adj. net income is expected to -46% YoY in 3Q21E, 13% below consensus on lower ads rev mix, heightened content investment, and intensified competition.
- Solid sub net adds despite non-exclusive copyright regulations.** We expect music sub rev +31% YoY, mainly on subs which +37% YoY albeit soft music ARPPU (-4% YoY). 3Q21E music sub paying ratio was estimated at 11.2% (vs. 10.6% in 2Q21 and 8.0% in 3Q20). Despite regulations against exclusive music copyright, we expect minimal operating impact with MAU and total time spent (stabilizing QoQ). TME launched Incentive Project 4.0 in Sep 2021 to attract indie musicians, with 100% first-year rev sharing for three-year exclusive deal. As competition shifts to self-production, we expect further Tencent synergies to reflect in content creation (e.g., variety shows) and distribution (video account).
- Short-term pressure on ads and digital albums.** We cut our estimate on other music rev to +16% YoY in 3Q21E, as app-open ads and digital album sales face short-term headwinds from ads and fandom regulations. Social entertainment would continue to trend moderate with intensified competition and uncertainty in virtual gifting regulations, and we forecast flattish social rev in 2021-22E.
- Maintain BUY.** We cut TME earnings by 0%/3%/3% in FY21/22/23E to reflect short-term headwinds and margin dilution. Lowered DCF-based TP to US\$10, with long-term growth trajectory intact.

Earnings Summary

(YE 31 Dec)	FY19A	FY20A	FY21E	FY22E	FY23E
Revenue (RMB mn)	25,434	29,153	31,887	35,330	38,512
YoY growth (%)	34.0	14.6	9.4	10.8	9.0
Adj. net income (RMB mn)	4,903	4,971	3,777	3,925	4,401
Adj. EPS (RMB)	2.9	3.0	2.2	2.3	2.6
YoY growth (%)	11.3	1.0	-24.7	3.9	12.1
Consensus EPS	NA	NA	2.5	3.1	4.1
P/E (x)	15.6	15.4	20.5	19.7	17.6
P/B (x)	3.0	2.6	2.4	2.2	2.0
Yield (%)	0.0	0.0	0.0	0.0	0.0
ROE (%)	11.2	9.4	6.5	6.4	6.7
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIS estimates

BUY (Maintain)

Target Price	US\$10
(Previous TP)	US\$12.0
Up/Downside	+44.9%
Current Price	US\$6.9

China Internet Sector

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Stock Data

Mkt Cap (US\$ mn)	12,068
Avg 3 mths t/o (US\$ mn)	176.01
52w High/Low (US\$)	32.2/ 6.8
Total Issued Shares (mn)	835

Source: Bloomberg

Shareholding Structure

Pacific Alliance	6.01%
Baillie Gifford	5.46%
Invesco	4.13%

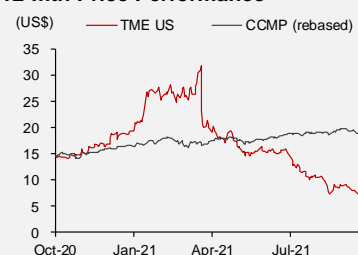
Source: Bloomberg

Share Performance

	Absolute	Relative
1-mth	-20.2%	-15.8%
3-mth	-52.9%	-52.6%
6-mth	-64.5%	-67.2%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

Auditor: Ernst & Young

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Figure 1: 3Q21E financial preview

RMB mn, Dec-YE	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21E	QoQ	YoY	Consensus	Diff %
Revenue	6,932	7,575	8,335	7,824	8,008	7,636	-4.6%	0.8%	7,801	-2%
Operating Profit	1,107	1,026	1,018	911	1,035	530	-48.7%	-48.3%	653	-19%
Net profit	939	1,132	1,197	926	827	439	-46.9%	-61.2%	551	-20%
Adj. net profit	1,155	1,349	1,364	1,235	1,161	728	-37.3%	-46.1%	833	-13%
Adj. EPS (RMB)	0.69	0.80	0.81	0.69	0.66	0.43	-34.8%	-46.3%	0.49	-12%
Margin (%)										
Gross margin	31.3%	32.4%	32.4%	31.5%	30.4%	25.4%			28.6%	
Operating margin	16.0%	13.5%	12.2%	11.6%	12.9%	6.9%			8.4%	
Adj. net margin	16.7%	17.8%	16.4%	15.8%	14.5%	9.5%			10.7%	
Growth (%)										
Revenue (YoY)	17.5%	16.4%	14.3%	24.0%	15.5%	0.8%			3.0%	
Revenue (QoQ)	9.8%	9.3%	10.0%	-6.1%	2.4%	-4.6%			-2.6%	
Operating Profit	24.2%	5.3%	-4.9%	11.8%	-6.5%	-48.3%			-36.3%	
Adj. net profit	2.3%	9.3%	1.8%	12.0%	0.5%	-46.1%			-38.2%	

Source: Company data, Bloomberg

Figure 2: 3Q21E revenue breakdown

RMB mn, Dec-YE	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21E	QoQ	YoY
Total revenue	5,898	6,507	7,293	6,311	6,932	7,575	8,335	7,824	8,008	7,636	-5%	1%
Online music service	1,562	1,846	2,139	2,044	2,221	2,324	2,760	2,749	2,950	2,910	-1%	25%
Subscription	798	942	1,110	1,207	1,314	1,460	1,580	1,690	1,790	1,909	7%	31%
Others	764	904	1,029	837	907	864	1,180	1,059	1,160	1,001	-14%	16%
Social entertainment / others	4,336	4,661	5,154	4,267	4,711	5,251	5,575	5,075	5,058	4,726	-7%	-10%

Source: Company data

Figure 3: CMBIS estimates vs consensus

RMB mn, Dec-YE	CMBIS			Consensus			Diff (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Revenue	31,887	35,330	38,512	31,969	34,987	39,525	-0.3%	1.0%	-2.6%
Gross Profit	9,012	9,835	10,789	9,472	10,411	11,755	-4.9%	-5.5%	-8.2%
Operating Profit	2,232	2,239	2,547	3,310	3,541	4,270	-32.6%	-36.8%	-40.4%
Adj. net profit	3,777	3,925	4,401	3,944	4,084	4,929	-4.2%	-3.9%	-10.7%
EPS (RMB)	2.23	2.32	2.60	2.09	2.25	2.81	6.6%	3.2%	-7.5%
Gross Margin	28.3%	27.8%	28.0%	29.6%	29.8%	29.7%	-1.4ppts	-1.9ppts	-1.7ppts
Operating Margin	7.0%	6.3%	6.6%	10.4%	10.1%	10.8%	-3.4ppts	-3.8ppts	-4.2ppts
Net Margin	11.8%	11.1%	11.4%	12.3%	11.7%	12.5%	-0.5ppts	-0.6ppts	-1.0ppts

Source: Company data, Bloomberg, CMBIS estimates

Figure 4: Earnings revision

RMB mn, Dec-YE	New			Old			Diff (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Revenue	31,887	35,330	38,512	32,136	35,372	38,949	-0.8%	-0.1%	-1.1%
Gross Profit	9,012	9,835	10,789	9,149	10,017	11,015	-1.5%	-1.8%	-2.1%
Operating Profit	2,232	2,239	2,547	2,240	2,270	2,564	-0.4%	-1.4%	-0.7%
Adj. net profit	3,777	3,925	4,401	3,777	4,055	4,541	0.0%	-3.2%	-3.1%
EPS (RMB)	2.23	2.32	2.60	2.25	2.41	2.70	-0.8%	-3.8%	-3.7%
Gross Margin	28.3%	27.8%	28.0%	28.5%	28.3%	28.3%	-0.2ppts	-0.5ppts	-0.3ppts
Operating Margin	7.0%	6.3%	6.6%	7.0%	6.4%	6.6%	-0.0ppts	-0.1ppts	+0.0ppts
Net Margin	11.8%	11.1%	11.4%	11.8%	11.5%	11.7%	+0.0ppts	-0.4ppts	-0.3ppts

Source: Company data, CMBIS estimates

Figure 5: DCF valuation

DCF valuation (RMB mn)	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
EBIT	2,232	2,239	2,547	4,108	6,247	8,849	11,799	14,945	18,132	21,227
Tax	(361)	(510)	(582)	(703)	(1,069)	(1,514)	(2,019)	(2,557)	(3,102)	(3,631)
D&A	457	510	570	638	740	847	957	1,068	1,180	1,292
Working capital	(402)	(328)	(275)	(357)	(364)	(371)	(378)	(386)	(394)	(402)
CAPEX	(361)	(400)	(436)	(495)	(505)	(516)	(524)	(530)	(536)	(540)
FCF	1,565	1,511	1,824	3,191	5,049	7,296	9,835	12,540	15,281	17,945
FCF Growth		-3%	21%	75%	58%	44%	35%	28%	22%	17%
Terminal Value										184,836
PV (FCF+ Terminal Value)	1,565	1,337	1,429	2,212	3,097	3,960	4,724	5,330	5,748	67,503

Assumptions

WACC	13.0%
Tax rate	15.0%
Risk free rate	3.6%
Cost of debt	0.0%
Beta	1.00
Market risk return	13.0%
Cost of equity	13.0%
Debt/Assets	0.0%
Terminal growth rate	3.0%
Debt value	0

Equity Value

PV	96,904
minus: Net cash	(12,955)
minus: Minority Interest	486
Equity Value	109,373
FX	6.45
Valuation (US\$ mn) based on DCF	10.0

		WACC				
		11%	12%	13%	14%	15%
Growth	1.5%	11.6	10.3	9.2	8.3	7.6
	2.0%	12.0	10.6	9.5	8.5	7.7
	2.5%	12.5	11.0	9.7	8.7	7.9
	3.0%	13.0	11.4	10.0	9.0	8.1
	3.5%	13.6	11.8	10.4	9.2	8.3
	4.0%	14.3	12.3	10.7	9.5	8.5
	4.5%	15.1	12.8	11.1	9.8	8.7

Source: Company data, Bloomberg, CMBIS estimates

Financial Summary

Income statement

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net revenues	25,434	29,153	31,887	35,330	38,512
Online music service	7,152	9,349	12,026	15,188	17,487
Subscription	3,560	5,561	7,419	9,362	10,275
Others	3,592	3,788	4,607	5,827	7,212
Social entertainment	18,282	19,804	19,861	20,142	21,025
COGS	(16,761)	(19,851)	(22,876)	(25,495)	(27,723)
Gross profit	8,673	9,302	9,012	9,835	10,789
S&M	(2,041)	(2,475)	(2,867)	(3,568)	(3,928)
R&D	(1,370)	(1,859)	(2,073)	(2,261)	(2,388)
Admin.Exp.	(1,333)	(1,242)	(1,839)	(1,767)	(1,926)
Operating profit	3,929	3,726	2,232	2,239	2,547
Other income, net	611	906	823	1,161	1,335
Pre-tax Income	4,540	4,632	3,055	3,400	3,882
Income Tax	(563)	(456)	(361)	(510)	(582)
Net profit	3,977	4,176	2,694	2,890	3,300
Adj. net profit	4,903	4,971	3,777	3,925	4,401

Cash flow summary

YE 31 Dec (RMB mn)	FY19A	FY20E	FY21E	FY22E	FY23E
Pre-tax Income	4,540	4,632	3,055	3,400	3,882
D&A	410	457	510	570	648
Change in WC	1,135	(314)	402	328	275
Others	(1,200)	(483)	504	656	3,242
Operating CF	4,885	4,292	4,470	4,954	8,047
Capex	(286)	(330)	(361)	(400)	(436)
Investments	37	6	0	0	0
Others	(7,853)	(13,882)	(2,105)	(1,844)	(1,781)
Investing CF	(8,102)	(14,206)	(2,465)	(2,243)	(2,217)
Equity raised	12	0	0	0	0
Change of debts	0	0	0	0	0
Others	(43)	5,292	0	0	0
Financing CF	(31)	5,292	0	0	0
Net change in cash	(1,933)	(4,029)	1,827	2,227	2,737
Cash (beg of yr)	17,356	15,426	11,128	12,955	15,182
FX	3	(269)	0	0	0
Cash (end of yr)	15,426	11,128	12,955	15,182	17,919

Balance sheet

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Non-current assets	25,764	36,586	40,640	42,484	44,234
Intangible assets, net	1,622	2,020	1,518	1,461	1,388
Goodwill	17,140	17,492	19,640	20,890	22,140
Financial assets	4,461	9,771	9,771	9,771	9,771
Others	2,541	7,303	9,712	10,363	10,934
Current assets	26,914	31,687	34,134	37,040	40,404
Cash, restricted cash	15,426	11,128	12,955	15,182	17,919
Accounts receivable	2,198	2,800	3,407	3,775	4,115
Other current assets	2,220	2,846	2,783	3,084	3,362
Term deposits	7,000	14,858	14,858	14,858	14,858
Others	70	55	131	142	151
Current liabilities	8,490	9,602	10,691	11,809	12,813
Accounts payables	2,559	3,565	3,447	3,842	4,177
Other payables	3,782	3,881	3,826	4,240	4,621
Deferred revenue	1,694	1,608	2,870	3,180	3,466
Others	455	548	548	548	548
Non-current liabilities	510	5,940	5,940	5,940	5,940
Notes payable	0	5,175	5,175	5,175	5,175
Deferred tax liability	297	265	265	265	265
Others	213	500	500	500	500
MI	88	486	486	486	486
Total Equity	43,678	52,731	58,143	61,776	65,885
Shareholders' equity	43,590	52,245	57,657	61,290	65,399

Key ratios

YE 31 Dec	FY19A	FY20A	FY21E	FY22E	FY23E
Sales mix (%)					
Online music service	28.1	32.1	37.7	43.0	45.4
Subscription	14.0	19.1	23.3	26.5	26.7
Others	14.1	13.0	14.4	16.5	18.7
Social entertainment	71.9	67.9	62.3	57.0	54.6
Total	100.0	100.0	100.0	100.0	100.0
Growth rate (%)					
Revenue	34.0	14.6	9.4	10.8	9.0
Gross profit	19.2	7.3	(3.1)	9.1	9.7
EBIT	18.9	(5.2)	(40.1)	0.3	13.8
Adj. net profit	17.8	1.4	(24.0)	3.9	12.1
P&L ratios (%)					
Operating margin	15.4	12.8	7.0	6.3	6.6
Pre-tax margin	17.9	15.9	9.6	9.6	10.1
Adj. net margin	19.3	17.1	11.8	11.1	11.4
Effective tax rate	(12.4)	(9.8)	(11.8)	(15.0)	(15.0)
Returns (%)					
ROE	11.2	9.4	6.5	6.4	6.7
ROA	9.3	7.3	5.1	4.9	5.2
Per share					
EPS (RMB)	2.9	3.0	2.2	2.3	2.6
DPS (RMB)	1.0	2.0	3.0	4.0	5.0
BVPS (RMB)	15.8	20.3	22.1	23.5	25.0

Source: Company data, CMBIS estimates

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