

## Chinese LLM will be a verticalized sovereign market

- We believe Chinese LLM (Large Language Model) will be a sovereign market, which will benefit a range of supply chain companies from semiconductor, hardware, cloud computing and application developers. Adopt of LLM will follow the pattern of cloud, with players also falling into similar categories;
- Game development seems to be the immediate beneficiary, we raise NTES TP by 29% to US\$135 and make it our TOP ST PICK. Our TOP LT PICK is SMIC. We, however, caution on unrealistic expectations in the ST.

### LLM is a sovereign market and thus worth to invest in

A key investable theme in China Internet has been its being a sovereign market, which creates barriers to entry. We encourage investors to view LLM/AIGC as such. We believe a good reference to the competitive outcome of LLM is key word search. Like search, data security will play a big role in shaping the landscape.

### SMIC as the only local, advanced-node, logic IC player has value

We have noted the difference between an 100%, non-US semiconductor supply chain, which will likely take a decade to realize, and a localized, advanced-node, logic IC supply chain, which can volume produce chips like *Kirin 9000s* today, without sanction. We believe the former only has symbolic or deterrence value. Domestic substitution of Nvidia's AIGC chip will enjoy solid demand support, due to Nvidia AIGC chips being so expensive. There are many investment choices along China's semiconductor supply chain, we continue to recommend SMIC based on its uniqueness in advanced-node, silicon-based, logic IC.

### Short-term LLM commercial value is highly platform-dependent

From a technology perspective, Baidu bears the most resemblance to OpenAI but it is unlikely to reap the ST commercial benefits, for three reasons: (1) China Internet has been highly platform-dominant with poor interconnectivity of users, data and workflows, (2) Skilled developers are scanty and congregated in large platforms, (3) vertical industry knowhows are localized and opaque. These differences already accounted for differences in SaaS and cloud adoptions, it will be the same for LLM adoptions, in our opinion. We see large over small, 2B over 2C, platform over corporate sequence of LLM adoption. Exhibit 16 shows the AIGC functions under development by major applications.

### Key financial of stock mentioned

(RMB mn)	Revenues			Non-GAAP/IFRS Operating Profit			Non-GAAP/IFRS Net Income		
	2022A	2023E	2024E	2022A	2023E	2024E	2022A	2023E	2024E
Tencent	554,552	630,273	685,396	147,570	200,352	211,723	115,649	144,156	168,938
NetEase	96,496	106,030	119,369	22,724	31,370	37,771	22,808	32,224	36,348
Alibaba	868,687	960,150	1,119,267	147,400	173,858	210,136	147,804	177,683	205,121
Baidu	123,675	135,353	147,263	23,186	24,034	23,829	20,680	23,425	22,927
SMIC (US\$)	7,273	6,388	8,983	1,500	102	801	1,836	743	1,064

Source: Tencent Holdings, Alibaba Group Holdings, NetEase Inc, Baidu Inc, Semiconductor Manufacturing Int'l; Blue Lotus (as of October 18, 2023)

BUY

HOLD

SELL

### Top picks

	Ticker	Rating	Target
Tencent Holdings	700 HK	BUY	HK\$417
Alibaba Group Holdings	BABA US	BUY	US\$127
NetEase, Inc.	NTES US	BUY	HK\$135
Baidu, Inc	BIDU US	BUY	US\$162
Semiconductor Mfg. Int'l	981 HK	BUY	HK\$27

Source: Blue Lotus (as of October 18, 2023)

### Stocks mentioned

Name	BBG Ticker	Rating	Target Price	Last Price	FY24 PE
Tencent	700 HK	BUY	HK\$417	HK\$302	17.5x
Alibaba	BABA US	BUY	US\$127	US\$84	7.6x
NetEase	NTES US	BUY	US\$135	US\$103	15.2x
Baidu	BIDU US	BUY	US\$162	US\$119	13.8x
SMIC	981 HK	BUY	HK\$27	HK\$20.6	22.6x

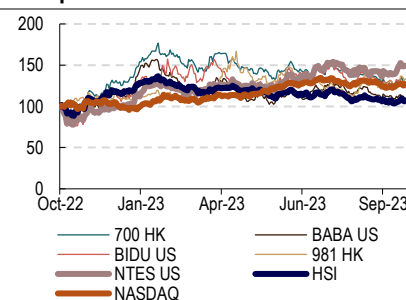
Source: Bloomberg, Blue Lotus (as of October 18, 2023); \* non-GAAP, HKD/RMB = 0.917; USD/RMB = 7.179

### What changed

Name	BBG Ticker	New Rating	Old Rating	New TP	Old TP	Diff
NetEase	NTES US	BUY	BUY	US\$135	US\$105	29%

Source: Blue Lotus (as of October 18, 2023)

### Price performance



Source: Bloomberg, Blue Lotus (as of October 18, 2023)

### Research team



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Blue Lotus Capital Advisors Limited

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Bloomberg, Blue Lotus Capital Advisors Limited and subject companies. Consensus forward estimates are used in analysis. Past performance is not indicative of future results. Investors should consider this report as only a single factor in making their investment decision.

## Financial Summary – Tencent Holdings Limited

Fiscal year ends-31-Dec

### Exhibit 1. Income statement

RMB mn	2022A	2023E	2024E
Revenues	554,552	630,273	685,396
Cost of revenues	(315,806)	(335,789)	(365,156)
Gross profit	238,746	294,485	320,240
G&A cost	(106,696)	(105,309)	(116,575)
Marketing cost	(29,229)	(29,551)	(33,506)
Operating profit IFRS	235,706	173,165	183,699
Share based compensation	(25,888)	(22,647)	(24,628)
Operating profit non-IFRS	147,570	200,352	211,723
Finance cost/income	(9,352)	(11,549)	(6,452)
Other income/cost	132,885	13,541	13,541
Share of profits of asso. and JVs	(16,129)	2,748	2,885
Pre-tax profit, IFRS	210,225	164,364	180,132
Income tax	(21,516)	(48,404)	(53,048)
Net income, IFRS	188,709	115,960	127,084
Non-controlling interests	466	3,471	3,588
Net income, non-IFRS	115,649	144,156	168,938
EPS, IFRS (RMB)	19.3	11.5	12.7
EPS, non-IFRS(RMB)	11.9	14.8	17.3
Gross margin	43.1%	46.7%	46.7%
Operating margin, non-IFRS	26.6%	31.8%	30.9%

Source: Tencent Holdings Limited, Blue Lotus (as of October 18, 2023)

### Exhibit 2. Balance sheet

RMB mn	2022A	2023E	2024E
Cash and cash equivalent	156,739	267,964	352,486
Restricted cash and ST investment	3,629	4,355	5,225
Term deposits over three months	98,621	118,346	142,015
Accounts receivable	42,534	69,041	49,540
Prepayments and others	42,436	40,361	49,677
Inventory	1,235	617	309
Total current asset	565,989	500,684	599,252
Property and equipment	28,231	31,169	33,618
Construction in progress	1,235	617	309
Invest. in a jointly controlled entity	328,114	344,520	361,746
Intangibles, goodwill, and others	21,747	21,231	22,130
Available-for-sale financial assets	488,439	563,968	620,365
Total non-current assets	1,012,142	1,079,052	1,167,277
Total assets	1,578,131	1,579,736	1,766,529
Account payables	100,274	127,326	126,182
Accrued expense and others	72,650	86,325	88,057
Deferred revenues	84,158	116,148	90,409
Short-term debt	15,702	16,487	17,311
Total current liabilities	434,204	346,286	321,960
Long-term debt	112,145	112,145	112,145
Other long-term liability	35,513	35,513	35,513
Total non-current liability	361,067	147,658	147,658
Total equity	721,391	1,021,669	1,230,056
Total liabilities and equity	1,578,131	1,579,736	1,766,529

Source: Tencent Holdings Limited, Blue Lotus (as of October 18, 2023)

### Company Description

Tencent is China's 2nd largest internet company by revenue and profits and the largest by traffic measures. Founded in 1998, Tencent dominates China's online game industry with more than 50% market share in 2022. Apart from online games, the company also has online advertising, fintech, and company services, and other revenue streams.

### Industry View

China's entertainment market has continued to grow in recent years. The online game market remains one of the most promising subsectors in the entertainment market. By 2022, total China mobile game market reached RMB 190bn with players over 650mn. In 2023, the total China mobile game market is expected to reach RMB 220bn.

### Exhibit 3. Cash flow statement

RMB mn	2022A	2023E	2024E
Net income	188,709	115,960	127,084
Adjusted for:			
Depreciation & amortization	50,303	60,594	66,700
Taxation	19,691	23,159	26,378
Net Interest	(937)	(1,338)	(1,763)
Changes in			
Account receivable	15,823	(26,507)	19,501
Inventory	2,470	1,235	617
Account payables	(8,316)	27,052	(1,144)
Short term deposit	(17,042)	(20,450)	(24,540)
Other assets	0	0	0
Accrued liabilities and deferred revenues	(7,341)	45,666	(24,007)
Cash from operations	167,811	267,809	230,716
Capex, PPE	(15,049)	(17,104)	(18,600)
Capex, land and bldg.	0	0	0
Purchase of intangibles	(39,117)	(45,913)	(51,447)
(Increase) /decrease in term deposits	(7,603)	(9,124)	(10,949)
Cash paid for equity investment	(44,404)	(75,529)	(56,397)
Payment for business combinations	0	0	0
Cash from investing	(104,871)	(157,369)	(147,018)
Cash from financing	(59,953)	785	824
Change in cash	(18,733)	111,225	84,522
Cash at beginning	171,055	156,739	267,964
Cash at end	156,739	267,964	352,486

Source: Tencent Holdings Limited, Blue Lotus (as of October 18, 2023)

See the last page of the report for important disclosures

## Financial Summary – NetEase, Inc.

Fiscal year ends 31-Dec

### Exhibit 4. Income statement

RMB mn	F2022A	F2023E	F2024E
Revenues	96,496	106,030	119,369
Cost of revenues	(43,730)	(42,912)	(45,306)
Gross profit	52,766	63,119	74,063
Selling and marketing expenses	(13,403)	(14,145)	(16,002)
G&A expenses	(4,696)	(4,734)	(5,563)
Share based compensation	(3,096)	(3,159)	(3,318)
Operating profit non-GAAP	22,724	31,370	37,771
Interest income	2,150	3,312	3,378
Profit before taxation, GAAP	24,250	34,598	39,364
Income tax	(5,032)	(5,818)	(6,620)
NI GAAP from continuing operations	19,218	28,780	32,744
NI GAAP from discontinued operations	-	-	-
NI GAAP	19,218	28,780	32,744
Non-controlling interests	497.3	307.3	307.3
NI attributable to NetEase, GAAP	22,808	32,243	36,369
Number of ADS, diluted (mn)	671	671	672
EPADS, GAAP (RMB)	29.4	43.3	49.2
Gross margin	54.7%	59.5%	62.0%
Operating margin, non-GAAP	23.5%	29.6%	31.6%
NI non-GAAP	22,808	32,224	36,348

Source: NetEase Inc., Blue Lotus (as of October 18, 2023)

### Exhibit 5. Balance sheet

RMB mn	F2022A	F2023E	F2024E
Cash and equivalents	24,889	36,977	58,004
Restricted Cash	2,699	10,603	11,937
Accounts receivable, net	5,003	6,681	7,522
Inventories, net	994	4,703	4,965
Prepayments & other curr. assets	5,448	7,422	8,356
Short-term investments	7,623	31,809	35,811
Assets held for sale	0	0	0
Net PP&E	6,342	13,381	15,311
Long-term Investments	0	7,422	8,356
Other long-term assets	26,239	4,241	4,775
Total assets	172,761	188,340	226,553
Accounts payable	1,507	2,351	2,483
Salary and welfare payables	4,733	2,939	3,103
Taxes payable	2,813	4,892	5,165
Short-term loans	23,876	15,905	17,905
Deferred revenue	12,519	15,396	17,333
Total current liabilities	56,829	50,496	56,136
Non-current liabilities	5,781	636	716
Total liabilities	63,888	51,132	56,852
Total equity	108,737	137,378	170,179
Total liabilities and equity	172,761	188,340	226,553

Source: NetEase Inc., Blue Lotus (as of October 18, 2023)

### Company Description

NetEase, Inc., through its subsidiaries, operates an interactive online community in China. The company operates in three segments: online game services; advertising services; and e-mail, e-commerce, and others, with online games contributing ~70% of total revenue. NetEase currently has more than a 15% share of the gaming market of China.

### Industry View

China's entertainment market has continued to grow in recent years. The online game market remains one of the most promising subsectors in the entertainment market. By 2022, total China mobile game market reached RMB 190bn with players over 650mn. In 2023, the total China mobile game market is expected to reach RMB 220bn.

### Exhibit 6. Cash flow statement

RMB mn	F2022A	F2023E	F2024E
Net income	19,218	28,780	32,744
Depreciation & Amort.	1,613	1,929	2,248
Share based compensation cost	3,096	3,159	3,318
Deferred income taxes	0	0	0
Change in acc. receivable	505	(1,678)	(841)
Change in inventory	(29)	(3,709)	(262)
Change in prepayments	788	(1,974)	(934)
Change in acc. payable	522	844	131
Change in salary and welfare payments	600	(1,794)	164
Change in taxes payable	(1,724)	2,079	273
Change in deferred revenue	386	2,877	1,937
Change in accrued liabilities	5,277	(5,917)	1,147
Net cash from operating activities	27,709	22,784	39,779
Purchase of PPE	(3,377)	(3,711)	(4,178)
Proceeds from sale of PPE	0	0	0
Purchase of short-term investments	4,659	(24,186)	(4,002)
Net cash from investing activities	(7,370)	5,179	(19,419)
Net cash from financing activities	(10,238)	(7,971)	2,001
Net increase in cash and cash equivalents	10,212	19,992	22,362
Balance b/f	17,376	27,588	47,580
Balance c/f	27,588	47,580	69,941

Source: NetEase Inc., Blue Lotus (as of October 18, 2023)

See the last page of the report for important disclosures

## Financial Summary – Baidu, Inc.

Fiscal year ends-31-Dec

### Exhibit 7. Income statement

(RMB mn)	2022A	2023E	2024E
Net revenues	123,675	135,353	147,263
Online marketing	74,711	81,236	89,154
Others	48,964	54,117	58,109
Cost of revenues	(63,935)	(67,465)	(72,504)
Gross profit	59,740	67,888	74,759
R&D cost	(23,315)	(27,289)	(31,752)
SG&A	(20,514)	(24,088)	(27,179)
Share based compensation	(6,788)	(7,221)	(7,709)
Operating profit, GAAP	15,911	16,511	15,828
Operating profit, non-GAAP	23,186	24,034	23,829
Finance income/(expenses), net	3,332	4,489	3,317
Pre-tax profit, GAAP	10,112	23,182	16,206
Taxation	1,796	4,170	2,915
Net income, GAAP	8,316	27,352	19,121
Net income to Baidu, GAAP	7,559	21,185	20,686
Net income, non-GAAP	20,680	23,425	22,927
Number of shares diluted	350	355	355
EPADS, non-GAAP (RMB)	59.1	66.0	64.6

Source: Baidu Inc., Blue Lotus (as of August 23, 2023)

### Exhibit 8. Balance sheet

(RMB mn)	2022A	2023E	2024E
Cash and cash equivalent	65,236	96,645	122,837
Short term investment	108,759	110,934	113,153
Accounts receivable	11,733	12,841	13,971
Total current assets	212,850	247,542	277,082
Equity investment	55,297	55,297	55,297
Property and equipment	23,973	34,042	36,856
Intangible assets	8,095	4,518	3,481
Non-current assets	178,123	184,516	186,472
Total assets	390,973	432,058	463,554
Other current liabilities	23,085	23,085	23,085
Total current liabilities	79,630	81,991	86,909
Deferred income	159.0	159.0	159.0
Long term loan	13,722	13,722	13,722
Other non-current liabilities	59,657	59,657	59,657
Non-current liabilities	73,538	73,538	73,538
Total equity	229,412	267,451	293,700
Total liabilities and equity	390,973	432,058	463,554

Source: Baidu Inc., Blue Lotus (as of August 23, 2023)

### Company Description

Baidu is the largest search engine company and online advertising media with the highest advertising revenue in China. In addition to the search business, Baidu offers users a series of knowledge-oriented products, such as Baidu Tieba and Baidu Encyclopedia. Information searching is the major service of Baidu, with market share over 80%. The revenue of Baidu's core business online marketing services in 2022 was RMB 74.7bn accounting for 60% of total revenue.

### Industry View

China's total internet advertising revenue in 2022 is approximately RMB 1,071 billion and we estimate it will reach RMB 1,170 billion in 2023. As the most efficient advertising model, search ads will remain favorable for advertisers.

### Exhibit 9. Cash flow statement

(RMB mn)	2022A	2023E	2024E
Net income to Baidu, GAAP	7,559	21,185	20,686
Depreciation	4,851	5,512	6,233
Amortization	3,704	4,190	4,720
Share based compensation	6,788	7,221	7,709
Change in working capital	(8,836)	1,352	3,609
Increase in accounts receivable	(1,752)	(1,108)	(1,130)
(Increase)/decrease in accrued expense	(3,370)	1,116	3,647
Cash from operations	26,170	45,627	41,392
Purchase of fixed assets	(7,421)	(8,121)	(8,836)
Purchase of intangibles	(3,384)	(3,682)	(3,906)
Cash from investing	(3,944)	(14,218)	(15,200)
Cash from financing	(6,390)	-	-
Increase in cash and cash equivalent	17,565	31,409	26,192
Cash at beginning	47,671	65,236	96,645
Cash at end	65,236	96,645	122,837

Source: Baidu Inc., Blue Lotus (as of August 23, 2023)

See the last page of the report for important disclosures

## Financial Summary – Semiconductor Manufacturing Int'l

Fiscal year end 31-Dec.

### Exhibit 10. Income statement

(US\$ mn)	2022A	2023E	2024E
Revenue	7,273	6,388	8,983
Cost of sales	(4,512)	(5,091)	(6,836)
Gross profit	2,762	1,296	2,146
Gross margin over net revenues	38.0%	20.3%	23.9%
Selling and marketing expenses	(733)	(715)	(808)
Administrative expenses	(494)	(442)	(494)
R&D	(34)	(36)	(42)
Operating profit, IFRS	1,836	381	1,196
Operating margin	25.2%	6.0%	13.3%
Operating profit, non-IFRS	1,500	102	801
Operating margin, non-IFRS	20.6%	1.6%	8.9%
Other income (expense), net	378	1,001	750
(Loss)/Profit before income tax	2,214	1,382	1,946
Income tax expense	(16)	(53)	(58)
Effective tax rate	(0.72%)	(3.80%)	(3.00%)
Profit for the year, IFRS	2,198	1,330	1,888
Profit for the year, non-IFRS	1,836	743	1,064
EBITDA	4,611	4,252	5,460

Source: Semiconductor Manufacturing Int'l, Blue Lotus (as of October 18, 2023)

### Exhibit 11. Balance sheet

(US\$ mn)	2022A	2023E	2024E
Non-current assets	27,792	33,574	41,571
Property, plant, and equipment	19,382	21,892	26,125
Land use right	654	754	854
Intangible assets	68	55	50
Investments in associates	1,859	2,045	2,250
Investments in joint ventures	20	23	27
Current assets	18,341	20,375	24,103
Inventories	1,181	1,464	2,042
Trade and other receivables	1,447	891	2,397
Cash and bank balances	11,078	12,987	14,397
Total assets	46,134	53,950	65,675
Current liabilities	3,932	3,383	5,681
Trade and other payables	58	51	72
Borrowings	1,447	891	2,397
Short-term notes	78	78	78
Non-current liabilities	9,479	12,399	16,039
Total liabilities	13,411	15,782	21,720
Total equity	32,723	38,167	43,955
Total liabilities and shareholders' equity	46,134	53,950	65,675

Source: Semiconductor Manufacturing Int'l, Blue Lotus (as of October 18, 2023)

### Company Description

SMIC is Mainland China's most advanced and largest foundry. It provides integrated circuit (IC) foundry and technology services on process nodes from 0.35 micron to 7 nanometer. SMIC has five 300mm wafer fabrication facilities (fab) and two 200mm fabs, with 714K wafer/month capacity in 4Q22. SMIC is the world's 5th largest foundry by revenue, by our est., capturing 5% market share in 2022.

### Industry View

We estimate that the global foundry industry will decline by 14% YoY to US\$ 105bn in 2023, of which we estimate SMIC's share will be 6%~. In 2022 the top five foundries, including SMIC, generated 92%~ of foundry revenues. Samsung and TSMC together generated 75%~ of global foundry revenues, per TrendForce.

### Exhibit 12. Cash flow statement

(US\$ mn)	2022A	2023E	2024E
Profit for the year, IFRS	2,198	1,330	1,888
Adjustment	-	-	-
Depreciation	1,634	2,638	3,334
Amortization	34	36	38
Interest income	(349)	(775)	(310)
Finance costs	126	194	141
Other adjustments	(15)	7	(21)
Share based compensation	-	-	-
Working capital change	(1,613)	(441)	(444)
Net cash from operating	2,810	3,466	4,678
Capital expenditures	(5,862)	(5,211)	(7,666)
Change in investment	(189)	(208)	(228)
Change in LT investment	(192)	(202)	(212)
Net cash used in investing	(6,395)	(5,643)	(8,140)
Proceeds from borrowings	3,081	3,086	3,371
Net cash from financing	6,081	4,086	4,871
Net increase in cash	2,496	1,909	1,410
Cash and equiv. At the beginning of the year	8,582	11,078	12,987
Cash and equiv. At the end of the year	11,078	12,987	14,397

Source: Semiconductor Manufacturing Int'l, Blue Lotus (as of October 18, 2023)

See the last page of the report for important disclosures



## Financial Summary – Alibaba Group Holdings Limited

Fiscal year ends-31-Mar

### Exhibit 13. Income statement

(RMB bn)	FY2023A	FY2024E	FY2025E
China retail marketplace GMV	7,338	8,051	8,561
Net revenues	868.7	960.2	1,119.3
Cost of revenues	(549.7)	(602.4)	(697.7)
Gross profit	319.0	357.8	421.6
Operating expenses, GAAP	(218.6)	(219.2)	(256.2)
R&D cost	(56.7)	(51.3)	(58.4)
Sales marketing cost	(103.5)	(109.7)	(126.9)
General administrative	(42.2)	(45.9)	(53.0)
Operating profit, GAAP	100.4	138.5	165.4
Share based compensation	30.8	23.1	26.9
Operating profit, non-GAAP	147.4	173.9	210.1
Interest income and investment income, net	(17.0)	2.0	4.2
Pre-tax profit, GAAP	89.2	147.4	176.5
Income tax	(15.5)	(27.1)	(37.8)
Net income, GAAP	65.6	120.2	138.7
Net income, Non-GAAP	147.8	177.7	205.1
Number of ADS, diluted	2.6	2.5	2.6
EPADS, GAAP, diluted (RMB)	27.5	49.8	57.0
EPADS, non-GAAP, diluted (RMB)	56.0	70.2	80.4
Gross margin	36.7%	37.3%	37.7%
Operating margin, non-GAAP	17.0%	18.1%	18.8%
Net margin, GAAP	7.5%	12.5%	12.4%
Net margin, non-GAAP	17.0%	18.5%	18.3%

Source: Alibaba Group Holdings Limited, Blue Lotus (as of October 18, 2023)

### Exhibit 14. Balance sheet

(RMB bn)	FY2023A	FY2024E	FY2025E
Cash and restricted cash	229.5	83.5	487.2
Short-term invest. And inv in sec.	331.4	391.1	99.0
Prepayments and others	137.1	137.1	137.1
Total current asset	698.0	611.6	723.3
Property and equipment	176.0	195.9	208.5
Investment in securities, non-current	453.1	488.6	523.0
Intangibles, goodwill and others	315.0	364.3	366.7
Prepayments, non-current	110.9	162.5	178.3
Total assets	1,753.0	1,822.9	1,999.7
Bank borrowings	7.5	7.5	7.5
Income tax payable	12.5	29.9	32.2
Accrued expense	276.0	310.6	330.3
Deferred revenue	71.3	92.9	101.9
Merchant deposits	13.3	29.4	34.7
Total current liabilities	380.6	470.3	506.5
Long term debt	52.0	38.3	38.3
Deferred tax liabilities	95.7	133.1	142.6
Total non-current liabilities	147.7	171.4	181.0
Additional paid in capital	416.9	416.9	416.9
Retained earnings	599.0	719.3	865.7
Total equity	989.7	1,110.0	1,256.4
Total liabilities and equity	1,753.0	1,822.9	1,999.7

Source: Alibaba Group Holdings Limited, Blue Lotus (as of October 18, 2023)

### Company Description

Since 2013, Alibaba Group has become the largest online mobile e-business company by GMV in the world. Alibaba operates several subsidiaries. The GMV of Taobao and Tmall accounts for ~49% of China's market share in 2022. AliCloud Computing, the largest public cloud computing company in China, occupied 34% of China's market share in 2022, and owns one-third of Ant Finance, including Alipay, which is the largest online payment platform in the world occupying over 50% of China's market share in 2022.

### Industry View

We estimate China's e-commerce market to grow by 11%~ in 2023, after growing 7%~ in 2022. Between 2022 and 2024, we estimate the total online ecommerce market to grow at CAGR of 13%, and traditional e-commerce and social e-commerce sub-sectors to grow at CAGR of 9% and 36%, respectively.

### Exhibit 15. Cash flow statement

(RMB bn)	FY2023A	FY2024E	FY2025E
Net income	65.6	120.2	138.7
Adjusted for	-	-	-
Depreciation & amortization	49.7	61.1	69.1
Share based compensation	30.8	23.1	26.9
Amortization of intangible assets	18.4	20.6	17.9
Changes in	-	-	-
Prepayments and others	(32.9)	(38.3)	(33.8)
Income tax payables	3.3	2.7	2.3
Merchant deposits	5.0	5.1	5.3
Accrued liabilities and deferred rev.	37.3	27.3	28.7
Cash from operations	176.9	222.4	255.6
Capex, PPE	(53.3)	(66.5)	(74.0)
Purchase of intangibles	(8.8)	17.2	14.7
Cash paid for equity investment	(40.0)	(48.0)	(57.6)
Acquisitions of AFS and HTM investment securities	(22.1)	8.5	-
Other cash paid in investing	(4.1)	(78.1)	265.0
Cash from Investing activities	(128.4)	(166.9)	148.0
Cash from financing activities	(59.9)	0.1	0.1
Change in cash	(6.4)	55.6	403.8
Cash at beginning	34.3	229.5	83.5
Cash at end	229.5	83.5	487.2

Source: Alibaba Group Holdings Limited, Blue Lotus (as of October 18, 2023)

## Vertical and closed loop are key to China AIGC

- Closed loop and vertical are key towards AIGC adoption:** We see AIGC adoption in China closely follow the pattern of cloud computing and SaaS in that: (1) major Internet platforms with closed loop user, data and developer resources will fence in the 1<sup>st</sup> round of opportunities; (2) telecom carriers and their application partners, mainly Huawei, will capture the 2<sup>nd</sup> round, working with vertical leading enterprises to create “private AIGC clusters” to penetrate the 2B market via private clouds, (3) nimble startups will focus on specific opportunities, such as healthcare consultation, game engine and advertising technology to help platforms capturing 2C opportunities. To sum, due to the lack of potent IT departments in corporations and wide availability of IT talents from outsourcing countries like India, China’s adoption of computing technology will be heavily top down;
- The incentive of adopting AIGC is mainly cost:** Our channel check suggested that the key reason for adopting AIGC is cost and labour cost is the most important business driver in game development. We have heard AIGC cutting cost of development by 1/3 to 1/2 in some cases, mainly in graphic design, worldview and NPC programming tasks. NetEase has aggressively adopted AIGC in its game development. The automation can significantly improve game development for new projects. We adjusted our revenue forecasts for <Eggy Party> and <Justice Mobile> due to their outstanding performance and the overall recovery of the domestic gaming industry. We now estimated the two games to generate approximately \$8 bn and \$10 bn, in revenues in 2023. In conjunction with the cost-saving and efficiency-improving effects of AIGC within NetEase, we have revised our target price by 29%;
- AIGC benefits to advertising and e-commerce is peripheral at current stage:** Our channel check confirmed peripheral benefits of AIGC in generating creative contents in advertising and e-commerce but the benefits are not critical. We foresee the same for productivity tools. We see continuing iteration of AIGC to possibly generate new business models to bring about more change. Currently we see AIGC to further increase the dominance of leading platforms at the expense of SME content creators and merchants. We also see AIGC application in healthcare to be a material opportunity that is currently not explored by the listco’s.

*China’s adoption of cloud computing showed its characteristics of vertical domination, in both 2C and 2B.*

*A key reason SaaS didn’t take off in China is because Chinese business owners do not wish to make their business transparent to outsiders.*

*Investors might have overplayed the “toy” aspect of AIGC in its commercial values.*

**Exhibit 16. AIGC functions of leading apps in China.**

Ranking	APP	English name	Company	App category	LLM Brand	Functions
1	微信	WeChat	Tencent	Communication	Hunyuan (混元)	1. Image recognition (Objects and Text) 2. Chatbots
2	抖音	Douyin	Bytedance	Entertainment	Doubao (豆包)	1. Digital avatar Livestreaming 2. Text-to-Text/Text-to-Picture generation 3. Contents censorship review
3	支付宝	Alipay	Alibaba	Payment	Tongyi (通义千问)	1. Personal financial assistant offering investment advice 2. Expert business assistant providing industry-specific Q&A
4	淘宝	Taobao	Alibaba	E-Commerce	Tongyi	1. AI participation in store design, naming, decoration, product design, and marketing 2. AI shopping assistant, offering solutions to user queries and merchandise links 3. Customer service, order management, financial management
5	拼多多	Pinduoduo	PDD	E-Commerce	None	None
6	百度	Baidu Mobile	Baidu	Entertainment	Erine Bot (文心一言)	AI Search/ChatBots with text-to-text/text-to-picture generation
7	快手	Kuaishou	Kuaishou	Entertainment	KwaiYii (快意)	1. AI search 2. Ads generation 3. Quick image-to-text functionality for rapid content creation 4. AI content review
8	QQ	QQ	Tencent	Communication	Hunyuan	AI drawing and avatar QR Code generation
9	高德地图	Amap	Alibaba	Digital map	Tongyi	Connects with Mobile dash cams, able to give out break warnings
10	美团	Meituan	Meituan	E-Commerce	Zhipu (智谱)	Customer services
11	京东	JD	JD	E-Commerce	ChatRhino (言犀)	Expected to be released in 2H23
12	小红书	Red	Red	Entertainment	Unknown	Text-to-graph generation
13	番茄免费小说	TomatoFiction	Bytedance	Entertainment	Doubao	Audio book voice replacement
14	钉钉	Ding Talk	Alibaba	Productivity	Tongyi 通义千问)	1. DingTalk Co-pilot: generate tables, articles, PowerPoint presentations with prompts; automatically meeting summaries 2. AI Assistants: AI group purchase assistant, group chats and digital avatars for meetings
15	QQ 浏览器	QQ Browser	Tencent	Browser	Hunyuan	1. Intelligent summarization for quick information extraction 2. Smart Q&A for retrieving information by asking questions.

Source: Tencent Holdings, Alibaba Group Holdings, NetEase Inc, Baidu Inc, Bytedance, Red, JD, Kuaishou; Blue Lotus (as of October 18, 2023)



**Exhibit 17. NetEase inc. FY2Q23 Earnings Preview Table**

Rmb mn	C3Q23E	C3Q23C	E vs. Cons	C2Q23A	QoQ	C3Q22A	YoY	C4Q23E	C4Q23C	E vs. Cons
<b>Net revenue</b>	<b>27,707</b>	<b>27,425</b>	<b>1.03%</b>	<b>24,403</b>	<b>13.54%</b>	<b>23,159</b>	<b>19.6%</b>	<b>26,520</b>	<b>28,713</b>	<b>(7.64%)</b>
Online game services and VAS	21,496			18,092	18.81%	18,140	18.5%	19,788		
Mobile Game	14,864			12,141	22.4%	11,127	33.59%	13,813		
PC Game	4,955			4,721	4.95%	5,707	(13.2%)	4,728		
Youdao	1,402			956	46.66%	956	47%	1,192		
Innovative business and others	4,808			5,355	(10.21%)	5,369	(10.4%)	5,539		
Cost of revenues (Cancellation)	(11,072)			(9,405)	17.72%	(10,218)	8.4%	(10,051)		
<b>Gross profit</b>	<b>16,634</b>	<b>16,296</b>	<b>2.08%</b>	<b>14,998</b>	<b>10.91%</b>	<b>12,941</b>	<b>28.5%</b>	<b>16,469</b>	<b>16,886</b>	<b>(2.47%)</b>
<b>Gross margin</b>	<b>60.0%</b>	<b>59.4%</b>	<b>0.6ppt</b>	<b>61.5%</b>	<b>(1.4ppt)</b>	<b>55.9%</b>	<b>4.2ppt</b>	<b>62.1%</b>	<b>58.8%</b>	<b>3.29ppt</b>
Selling and marketing expenses	(3,929)			(3,271)	20.11%	(3,301)	19.0%	(3,958)		
General and administrative expenses	(1,275)			(1,169)	9.12%	(1,113)	14.6%	(1,339)		
Research and development expenses	(4,123)			(3,801)	8.46%	(3,582)	15.11%	(4,228)		
<b>Profit from operations, GAAP</b>	<b>7,307</b>	<b>6,896</b>	<b>5.96%</b>	<b>6,757</b>	<b>8.1%</b>	<b>4,946</b>	<b>47.73%</b>	<b>6,944</b>	<b>7,245</b>	<b>(4.16%)</b>
Profit from operations, non GAAP	8,090			7,576	6.8%	5,690	42.18%	7,772		
<b>Operating margin, non GAAP</b>	<b>29.2%</b>	<b>25.1%</b>	<b>4.1ppt</b>	<b>31.0%</b>	<b>(1.8ppt)</b>	<b>24.6%</b>	<b>4.6ppt</b>	<b>29.3%</b>	<b>25.2%</b>	<b>4.07ppt</b>
Profit before taxation, GAAP	8,529			7,279	17.2%	5,731	48.8%	7,491		
Net income, GAAP	6,911			5,938	16.4%	4,667	48.1%	6,088		
<b>Net income, non GAAP</b>	<b>7,693</b>	<b>6,977</b>	<b>10.26%</b>	<b>6,758</b>	<b>13.8%</b>	<b>5,410</b>	<b>42.2%</b>	<b>6,916</b>	<b>7,178</b>	<b>(3.7%)</b>

Source: NetEase Inc., Blue Lotus (as of October 18, 2023)

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