Tencent Holdings (700 HK)

3Q26: Higher AI Costs Result In Operating Profit Miss and Weigh on FCF

Highlights

- Tencent's 3Q26 results came in slightly below expectations. Revenue rose 7.5% yoy to Rmb207.3b, 1.6% below both our estimate and consensus. Higher AI-related costs weighed on profitability, with gross profit missing both estimates and non-IFRS operating profit coming in 6.8% below our estimate. Non-IFRS net profit fell 5.7% yoy to Rmb66.5b, broadly in line with expectations. Higher capex and compute prepayments widened the free cash outflow, with Tencent shifting to net debt.
- Maintain BUY with a lower target price of HK$500.00.

3Q26 Results

Year to 31 Dec (Rmbm)	3Q25A	2Q26A	3Q26A	UOBKHE	QoQ	YoY	Variance	Cons	Variance
Revenue	192,869	204,785	207,336	210,773	1.2%	7.5%	-1.6%	210,530	-1.5%
Social networking	32,260	32,514	31,826	33,779	-2.1%	-1.3%	-5.8%		
Online games	63,600	65,900	66,500	67,830	0.9%	4.6%	-2.0%		
Marketing Services	36,242	43,565	43,049	42,669	-1.2%	18.8%	0.9%		
Fintech and Cloud	58,174	60,286	63,655	63,383	5.6%	9.4%	0.4%		
Gross profit	108,798	118,433	115,911	120,491	-2.1%	6.5%	-3.8%	119,887	-3.3%
Non-IFRS Operating profit	72,570	75,636	68,073	73,064	-10.0%	-6.2%	-6.8%		
Non-IFRS net income	70,551	68,415	66,519	66,987	-2.8%	-5.7%	-0.7%	66,501	0.0%
Non-IFRS diluted EPS (RMB)	7.58	7.43	7.23	7.35	-2.8%	-4.6%	-1.7%	7.30	-1.0%
GPM	56.4%	57.8%	55.9%	57.2%	-1.9 ppts	-0.5 ppts	-1.3 ppts	56.9%	-1.0 ppts
Non-IFRS OPM	37.6%	36.9%	32.8%	34.7%	-4.1 ppts	-4.8 ppts	-1.8 ppts		
Non-IFRS NPM	36.6%	33.4%	32.1%	31.8%	-1.3 ppts	-4.5 ppts	0.3 ppts	31.6%	0.5 ppts

Source: Tencent, UOB Kay Hian

Analysis

- **International weakness weighed on gaming growth**. Online games revenue grew 4.6% yoy to Rmb66.5b, 2% below our estimate as international weakness partly offset solid domestic growth. Domestic games revenue rose 11% yoy to Rmb47.6b, led by evergreen titles including Honour of Kings, Delta Force and VALORANT MOBILE. International games revenue fell 9% yoy to Rmb18.9b, or 4% in constant currency, against a high base in 3Q25. Tencent expects a more normal cadence of premium game releases in 2027.
- **Advertising growth remained strong as margins narrowed.** Marketing services revenue rose 18.8% yoy to Rmb43.0b, broadly in line with our estimate. Growth was supported by improved AI-driven ad recommendations and wider use of Weixin's closed-loop marketing tools. Segment gross margin fell to 52% from 57% in 3Q25, reflecting higher AI-related operating costs and Mini Dramas content costs.

Key Financials

Year to 31 Dec (Rmbm)	2024	2025	2026F	2027F	2028F
Net turnover	660,257	751,766	821,926	902,999	987,416
EBITDA	221,456	258,027	271,745	289,648	324,321
Operating profit	208,099	241,562	253,629	270,932	305,005
Net profit (rep./act.)	194,073	224,842	209,302	227,735	251,373
Net profit (adj.)	222,703	259,626	242,948	266,184	293,198
EPS	2,350.7	2,790.9	2,653.9	2,901.9	3,190.0
PE	13.5	11.3	11.9	10.9	9.9
P/B	3.0	2.5	2.4	2.0	1.8
EV/EBITDA	13.1	11.2	10.6	10.0	8.9
Dividend yield	1.4	1.6	1.6	1.7	1.9
Net margin	29.4	29.9	25.5	25.2	25.5
Net debt/(cash) to equity	(13.3)	(11.6)	(6.3)	21.4	24.6
ROE	21.8	21.1	17.7	17.5	16.8
Consensus net profit	-	-	262,862.3	273,392.7	299,014.0
UOBKH/Consensus (x)	-	-	0.92	0.97	0.98

Source: Tencent, Bloomberg, UOB Kay Hian

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BUY (Maintained)

Share Price	HK$372.80
Target Price	HK$500.00
Upside	34.1%
Previous TP	HK$537.00

Stock Data

Sector	Communication Services
Bloomberg ticker	700 HK
Shares issued (m)	9,092.6
Market cap (US$m)	3,389,737.9
Market cap (US$m)	432,028.4
3-mth avg daily t'over (US$m)	1,156.3

Price Performance (%)

52-week high/low				HK$641.00/HK$370.00
1mth	3mth	6mth	1yr	YTD
(10.8)	(15.7)	(17.0)	(41.4)	(37.8)

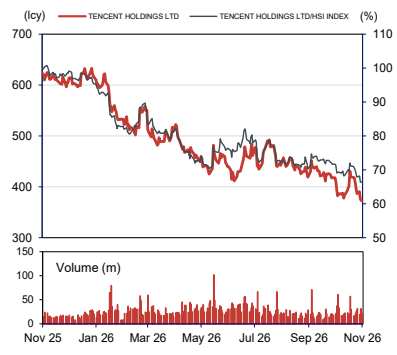
Major Shareholders (%)

Naspers	23.26

Balance Sheet Metrics

FY26 NAV/Share (Rmb)	134.66
FY26 Net Cash/ Share (Rmb)	8.44

Price Chart



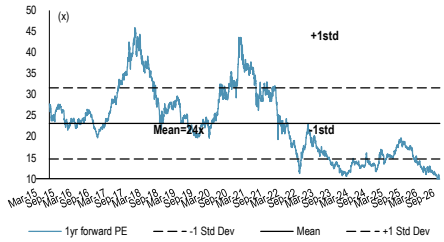
Source: Bloomberg

Company Description

The company is one of the largest comprehensive internet service providers.

- **FinTech and business services revenue grew 9% yoy to Rmb63.7b,** broadly in line with our Rmb63.4b estimate. Cloud revenue growth accelerated to 35% yoy, driven by growing demand for WorkBuddy, increased compute allocation to model-as-a-service (MaaS) and GPU rental, and continued international expansion. FinTech growth was supported by higher revenue from consumer lending and wealth management.
- **AI product investment ramps up.** Losses from new AI products widened to about Rmb15b (vs Rmb10.5b in 2Q), reflecting investments in Hy, Yuanbao, CodeBuddy, WorkBuddy and Xiaowei. Encouragingly, Hy4 ranked first among Chinese models on Agent Arena at launch, while WorkBuddy exceeded 10mn DAU and 100t daily tokens, highlighting improving AI adoption. Tencent expanded Xiaowei's integration with Weixin Mini Programs and Mini Shops to enable transactions. Management expects efficient inference and domestic chips to support cloud growth. Tighter access to advanced chips may extend the near-term model development cycle.
- **Higher AI costs weighed on margins.** Gross margin fell 0.5ppt yoy to 55.9%. VAS gross margin rose to 64% from 61% on a higher contribution from internally developed games, while marketing services gross margin fell to 52% from 57% due to higher AI operating costs and Mini Dramas content costs. Non-IFRS operating profit declined 6.2% yoy to Rmb68.1b. Excluding new AI products, it rose 8% yoy to Rmb83.3b. G&A expenses rose 29% yoy to Rmb44.1b, mainly due to higher R&D spending on Hy models, Weixin AI and other AI initiatives. Selling and marketing expenses rose 6% yoy to Rmb12.1b, mainly due to increased promotion of AI-native products.
- **Record AI investment pressures FCF, pushing the company into a net debt position.** Capex increased to Rmb81.4b in 3Q26 (vs Rmb52.8b in 2Q26), while FCF outflow widened to Rmb69.1b (vs Rmb13.8b), driven by higher capex and Rmb86b in compute prepayments. Excluding prepayments, FCF remained positive at Rmb16.9b. Tencent shifted to Rmb13.7b net debt from a Rmb58.2b net cash position in 2Q26.

12-Month Forward PE Band



Source: Bloomberg UOB Kay Hian

Valuation/Recommendation

- **Maintain BUY with a lower target price of HK$500.00,** based on our 2027 SOTP valuation. We adopt lower multiples to reflect elevated AI infrastructure capex, near-term FCF pressure and higher-than-expected marketing spend. Our target price implies 16x 2027F PE, while Tencent currently trades at 13x 2026F and 12x 2027F PE, around 1SD below its historical mean of 24x.

Earnings Revision/Risk

- We leave our 2026 revenue estimate largely unchanged and lower our non-IFRS net profit forecast for 2026/2027 by 4%/3% respectively. This implies yoy revenue growth of 9.3%/9.9% and earnings growth of -6.4%/10% in 2026/27 respectively, with net margins of 30%/29%.
- **Key risks:** a) Increasing disruption from AI-generated content; b) intensifying competition; c) regulatory risks; d) slowing game revenue growth; e) and elevated capex requirements.

Share Price Catalyst

- a) AI-driven revenue and efficiency gains, b) stronger WeChat Video Accounts advertising, c) game licence approvals, and d) Hunyuan ecosystem expansion.

SOTP-Based Valuation

(Rmb m)	2027F revenue	2027F non-GAAP earnings	Valuation 2027 (x)	Value (LC bn)	Tencent holding (%)	Est. fair value to Tencent (RMB bn)	Fair value to Tencent (US$ b)	Fair value/ share (HK$)
Online game (PC + Mobile game)	284,342	100,717	15x PE	1,511	100	1,511	224	179
Social networking (QQ + Wexin VAS)	132,762	47,026	12x PE	564	100	564	84	67
Online ads	199,099	56,758	18x PE	1,022	100	1,022	151	121
Payment	193,628	30,981	12x PE	372	100	372	55	44
Cloud	93,168		5x PS	466	100	466	69	55
Total EV	902,999	235,481	13x PE	3,097	100	3,097	290	466
Investees	**% owned**		**Rmb/sh.**			**Valuatio**		
Total (15% discount)						523	79	64
2027F Net cash per share (HK$)								30
Target price (HK$)								**500**

Source: UOB Kay Hian

Profit & Loss

Year to 31 Dec (Rmbm)	2025	2026F	2027F	2028F
Net turnover	751,766.0	821,925.6	902,998.7	987,415.6
EBITDA	258,027.0	271,745.1	289,648.1	324,321.0
Deprec. & amort.	16,465.0	18,116.0	18,716.0	19,316.0
EBIT	241,562.0	253,629.1	270,932.1	305,005.0
Total other non-operating income	27,077.0	17,003.0	18,703.3	20,573.6
Associate contributions	23,740.0	2,309.0	6,917.0	6,917.0
Net interest income/(expense)	(15,130.0)	(12,303.4)	(12,303.4)	(12,303.4)
Pre-tax profit	277,249.0	260,637.7	284,249.0	320,192.3
Tax	(47,448.0)	(46,554.6)	(51,733.3)	(64,038.5)
Minorities	(4,959.0)	(4,781.0)	(4,781.0)	(4,781.0)
Net profit	224,842.0	209,302.1	227,734.7	251,372.8
Net profit (adj.)	259,626.0	242,947.9	266,183.6	293,198.4

Balance Sheet

Year to 31 Dec (Rmbm)	2025	2026F	2027F	2028F
Fixed assets	176,942.0	284,691.0	506,975.7	691,463.8
Other LT assets	1,266,584.0	1,353,882.0	1,472,478.5	1,603,542.5
Cash/ST investment	384,819.0	456,067.0	80,846.2	(13,419.6)
Other current assets	210,641.0	252,077.0	276,616.8	303,900.2
Total assets	2,038,986.0	2,346,717.0	2,336,917.1	2,585,486.8
ST debt	42,618.0	88,722.0	88,722.0	88,722.0
Other current liabilities	370,133.0	454,694.0	260,572.7	305,729.9
LT debt	208,369.0	291,379.0	291,379.0	291,379.0
Other LT liabilities	176,801.0	213,978.0	213,978.0	213,978.0
Shareholders' equity	1,154,152.0	1,211,581.0	1,395,902.4	1,599,314.7
Minority interest	86,913.0	86,363.0	86,363.0	86,363.0
Total liabilities & equity	2,038,986.0	2,346,717.0	2,336,917.1	2,585,486.6

Cash Flow

Year to 31 Dec (Rmbm)	2025	2026F	2027F	2028F
Operating	303,052.0	258,239.7	270,377.1	276,259.3
Profit fo the year	277,249.0	260,637.7	284,249.0	320,192.3
Tax	(47,448.0)	(46,554.6)	(51,733.3)	(64,038.5)
Deprec. & amort.	16,465.0	18,116.0	18,716.0	19,316.0
Associates	(23,740.0)	(2,309.0)	(6,917.0)	(6,917.0)
Working capital changes	(17,182.0)	43,125.0	36,229.9	17,873.9
Non-cash items	0.0	0.0	0.0	0.0
Other operating cashflows	97,708.0	(14,775.4)	(10,167.4)	(10,167.4)
Investing	(83,762.0)	(337,662.1)	(359,596.9)	(334,867.9)
Capex (growth)	(79,198.0)	(238,358.4)	(234,779.7)	(197,483.1)
Investment	0.0	0.0	0.0	0.0
Others	(4,564.0)	(99,303.7)	(124,817.2)	(137,384.8)
Financing	(136,165.0)	66,794.2	(31,306.8)	(35,657.2)
Dividend payments	(43,580.2)	(50,748.2)	(47,541.9)	(52,088.9)
Proceeds from borrowings	15,130.0	12,303.4	12,303.4	12,303.4
Loan repayment	0.0	0.0	0.0	0.0
Others/interest paid	(107,714.8)	105,239.0	3,931.7	4,128.3
Net cash inflow (outflow)	83,125.0	(12,628.2)	(120,526.6)	(94,265.8)
Beginning cash & cash equivalent	132,519.0	214,001.0	201,372.8	80,846.2
Changes due to forex impact	(1,643.0)	0.0	0.0	0.0
Ending cash & cash equivalent	214,001.0	201,372.8	80,846.2	(13,419.6)

Key Metrics

Year to 31 Dec (%)	2025	2026F	2027F	2028F
Profitability				
EBITDA margin	34.3	33.1	32.1	32.8
Pre-tax margin	36.9	31.7	31.5	32.4
Net margin	29.9	25.5	25.2	25.5
ROA	11.8	9.5	9.7	10.2
ROE	21.1	17.7	17.5	16.8
Growth				
Turnover	13.9	9.3	9.9	9.3
EBITDA	16.5	5.3	6.6	12.0
Pre-tax profit	14.8	(6.0)	9.1	12.6
Net profit	15.9	(6.9)	8.8	10.4
Net profit (adj.)	16.6	(6.4)	9.6	10.1
EPS	18.7	(4.9)	9.3	9.9
Leverage				
Debt to total capital	16.8	22.7	20.4	18.4
Debt to equity	21.7	31.4	27.2	23.8
Net debt/(cash) to equity	(11.6)	(6.3)	21.4	24.6

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