UOBKayHian

Sector – Update | Greater China

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# Internet

## AI Capex: Returns Remain Attractive, Funding Risk Diverging


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**MARKET WEIGHT (Maintained)**

### Segmental Rating

| Segment | Rating |
|---|---|
| E-commerce | MARKET WEIGHT (Maintained) |
| Online Game | OVERWEIGHT (Maintained) |
| OTA | OVERWEIGHT (Maintained) |
| AI | OVERWEIGHT (Maintained) |
| Online Property Vertical | MARKET WEIGHT (Maintained) |
| Local Life Service | UNDERWEIGHT (Maintained) |
| E-commerce | MARKET WEIGHT (Maintained) |

*Source: UOB Kay Hian*

### Sector Picks

| Company | Ticker | Rec | Share Price (HK$) | Target Price (HK$) |
|---|---|---|---|---|
| Alibaba | 9988 HK | BUY | 110.00 | 188.00 |

*Source: Bloomberg, UOB Kay Hian*

### Highlights

- AI/AI cloud remained the bright spot in 2Q26, with Alibaba and Baidu delivering 45%/50% yoy revenue growths in AI cloud respectively and Tencent reporting healthy cloud growth on AI demand. However, the surge in capex and Alibaba's HK$80b (US$10.3b) placement shifts the AI debate from project returns to funding duration and capital structure. The investment cycle is pressuring near-term FCF, but stronger utilisation, proprietary chips and higher-margin AI services should improve compute economics over time.
- Maintain MARKET WEIGHT. Top BUY: Alibaba.

### Analysis

- **Funding risk is increasingly differentiated across CSPs.** Due to the step-up in capex, we expect Alibaba to have the largest structural funding gap among Chinese hyperscale peers, and it is the most likely to rely on debt, selective equity and potentially cloud-level financing. We do not expect Alibaba to have any solvency risk, as it is: a) sustaining >50% external cloud growth, b) keeping mature infrastructure ROIC in the mid-teens or above, c) containing non-infrastructure AI losses, and d) funding the multi-year build without repeated parent-level equity issuance. Alibaba also has sizeable investment portfolios in AI/LLM companies including CXMT, Z.ai and MiniMax totalling around Rmb330b in listed assets. Underlying compute economics remain attractive, with an estimated 20% IRR and payback period of 2-3 years, but the recent capital raising suggests the capex cycle will stay elevated for longer.
- **Tencent largely self-funding despite front-loaded AI spending.** Tencent remains largely self-funded, with limited parent-equity risk. Its annualised 1H26 operating cash flow of roughly Rmb310b should comfortably cover our Rmb200b capex assumption, dividends and most buybacks. The decline in net cash to around Rmb58b mainly reflects the timing of the Rmb41.6b dividend and approximately Rmb50b of compute prepayments, rather than a structural funding gap. Tencent has also diversified funding through long-dated USD/RMB notes, short-term borrowings, and sizeable investment portfolios of Rmb480b listed and Rmb350b unlisted assets. We therefore see limited parent-equity issuance risk; the main economic costs are instead interest expense, potential tax leakage and the opportunity cost of monetising investment assets.
- **Baidu has weak internal cash generation, but parent dilution remains unattractive.** Baidu's weaker cash generation is offset by its reluctance to dilute at a low parent valuation, making Kunlunxin the more likely external funding vehicle. Baidu's 2Q26 operating cash flow of only Rmb3.4b fell short of Rmb11.4b of capex, with the gap increasingly funded through bank borrowing and leasing. Nevertheless, roughly Rmb100b of adjusted liquidity can cover the base-case deficit for several years. The key constraint is not near-term liquidity, but Baidu's low parent valuation and management's limited economic incentive to issue parent equity. We therefore see Kunlunxin, rather than Baidu parent equity, as the more logical external equity-financing vehicle. This avoids direct parent share-count dilution, but transfers part of the AI asset's economics to outside investors.

### Peer Comparison

| Company | Ticker | Rec* | Price 2 Sep 26 (S$) | Target Price (S$) | Upside To TP (%) | Last Year End | PE 2025 (x) | PE 2026F (x) | PE 2027F (x) | Yield 2026F (%) | ROE 2026F (%) | Market Cap. (HK$m) | Price/ NAV ps (x) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Alibaba | 9988 HK | BUY | 109.70 | 188.00 | 71 | Mar-26 | 19.3 | 18.4 | 13.1 | 0.96 | 8.0 | 2,177,406 | 1.6 |
| Tencent | 700 HK | BUY | 438.20 | 608.00 | 39 | Dec-25 | 13.7 | 12.8 | 12.1 | 1.39 | 18.7 | 3,985,360 | 2.5 |
| Baidu | 9888 HK | BUY | 94.90 | 145.00 | 53 | Dec-25 | 12.6 | 16.3 | 13.4 | 0.00 | 4.2 | 480,143 | 0.8 |

*Source: Bloomberg, UOB Kay Hian*

## AI Investment Commitment, Internal Funding and Liquidity Dynamics

| Section | Metric (Rmb b, unless stated) | Alibaba | Tencent | Baidu |
|---|---|---|---|---|
| 1. Quarterly AI cash commitment | Reported capex | 68 | 53 | 11 |
| | + AI-related prepayments in quarter | 69 | 53 | 9 |
| | - Increase in supplier payables | (53) | (27) | (1) |
| | **Adjusted AI cash commitment** | **190** | **133** | **21** |
| | As multiple of OCF | 3.5x | 1.5x | 5.5x |
| 2. Annual internal funding position | Operating cash flow, WC normalized | 135 | 310 | 15 |
| | Capex, base case | 225 | 200 | 55 |
| | Dividend+Buyback | 35 | 85 | 5 |
| 3. Liquidity & funding capacity | **Surplus** | **(125)** | **25** | **(45)** |
| | Net cash | 208 | 58 | 179 |
| | Less minimum operating cash | (60) | (50) | (80) |
| | **Liquidity available for the AI investment** | **23** | **33** | **54** |
| | Placement proceeds | 70 | | |
| | Investment portfolio, listed FV + unlisted book | 333 | 875 | |
| | Additional debt capacity at 1x EBITDA | 170 | 300 | 25 |

*Source: Respective companies, UOB Kay Hian*

- **Alibaba's June quarter materially improved visibility on AI infrastructure economics.** Alibaba AI cloud & compute revenue grew 45% yoy in the June quarter, with external cloud also up 45% and management expecting a >50% growth in the September quarter. Baidu AI cloud infrastructure revenue increased 50% yoy to Rmb7.3b and GPU public-cloud revenue surged 283% yoy; management expects AI cloud infrastructure growth to re-accelerate above 60% in 3Q26. Tencent does not separately disclose cloud revenue, but said cloud growth remained healthy on AI demand, international expansion and pricing. Alibaba's/Tencent's/Baidu's 2Q26 capex reached Rmb67.7b/Rmb59.3b/Rmb11.5b respectively. The investment cycle is pressuring near-term FCF, but stronger utilisation, proprietary chips and higher-margin AI services should improve compute economics over time.
- **Alibaba's AI investment remains well funded,** supported by around US$25b of annual core e-commerce profit, cloud scaling and improving working-capital efficiency. Management cautioned against annualising the June quarter's capex given compute-supply volatility, and instead highlighted a three-year payback on AI infrastructure as Alibaba leverages its 40% share of China AI cloud and full-stack IaaS/PaaS/MaaS offering. Cloud remains the key monetisation engine, with targets of Rmb30b MaaS ARR in FY27, US$100b external cloud revenue by 2030, overseas cloud at 10-20% of revenue, and a 20% medium-term cloud margin. AI commercialisation remains enterprise-first, while Alibaba continues to invest across large-parameter, coding, world and video models; consumer products such as Qwen are strategically important but unlikely to be profitable in the near term.

## Alibaba AI Capex Expansion Precedes Cloud Revenue Growth

| Period | 1QFY25 | 2QFY25 | 3QFY25 | 4QFY25 | FY2025 | 1QFY26 | 2QFY26 | 3QFY26 | 4QFY26 | FY2026 | 1QFY27 | 2QFY27F | 3QFY27F | 4QFY27F | FY2027F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Capex** | **11,939** | **16,977** | **31,369** | **23,993** | **84,278** | **38,629** | **31,428** | **25,376** | **26,588** | **122,021** | **67,660** | **54,128** | **51,963** | **51,728** | **225,479** |
| **yoy** | **99%** | **313%** | **331%** | **136%** | **206%** | **224%** | **85%** | **-19%** | **11%** | **45%** | **75%** | **72%** | **105%** | **95%** | **85%** |
| As % of total revenue | 5% | 7% | 11% | 10% | 8% | 16% | 13% | 9% | 11% | 12% | 25% | 20% | 19% | 17% | 20% |
| **AI Cloud and Compute Service** | **26,549** | **29,610** | **31,742** | **30,127** | **118,028** | **33,418** | **39,824** | **43,284** | **41,626** | **158,152** | **48,437** | **59,736** | **66,225** | **65,769** | **240,167** |
| **yoy** | **6%** | **7%** | **13%** | **18%** | **11%** | **26%** | **34%** | **36%** | **38%** | **34%** | **45%** | **50%** | **53%** | **58%** | **52%** |
| As % of total revenue | 11% | 13% | 11% | 13% | 12% | 13% | 16% | 15% | 17% | 15% | 18% | 22% | 21% | 24% | 21% |
| Adjusted EBITA | 2,337 | 2,661 | 3,138 | 2,420 | 10,559 | 2,954 | 3,604 | 3,911 | 3,796 | 14,266 | 5,628 | 8,227 | 8,596 | 8,911 | 31,363 |
| Adjusted EBITA margin | 9% | 9% | 10% | 8% | 9% | 9% | 9% | 9% | 9% | 9% | 12% | 14% | 13% | 14% | 13% |
| as of Group total EBITA | 5% | 6% | 6% | 7% | 7% | 8% | 23% | 17% | 74% | 23% | 21% | 38% | 25% | 36% | 33% |

*Source: Alibaba, industry data, UOB Kay Hian*

- **AI remains Tencent's top capital allocation priority,** with 3Q26 capex and compute prepayments expected to remain meaningful before moderating thereafter; we estimate Rmb200b for 2026, including Rmb32b in 1Q26 and

Rmb80b in 2Q26. The front-loaded spending is intended to secure better storage and compute economics while supporting Hunyuan development and Harness commercialisation. Importantly, management increasingly sees Hunyuan's differentiation as coming not only from parameter scaling, but also from data engineering, post-training, evaluation and proprietary usage feedback from WorkBuddy/CodeBuddy, complemented by Tencent's domain data in gaming, office productivity and financial services. This also strengthens the strategic value of WorkBuddy, which could serve as both a monetisation layer and model moat through scale effects, proprietary workflow feedback and full-stack optimisation across models, infrastructure and chips, helping lower serving costs and improve Hunyuan's performance.

- On the consumer side, Xiaowei is designed around scalable unit economics by combining cloud-based frontier models with lighter on-device models, while AI should also support advertising and gaming through better monetisation tools, faster content creation, improved virtual-item development and shorter development cycles, with potential upside to gaming margins.
- **Domestic AI infrastructure remains strategically important**. Alibaba has deployed Rmb190b of its Rmb380b three-year AI capex plan, while Tencent has raised its 2026 capex estimate to Rmb181b. Baidu frontloaded purchases of server, chip and raw materials in 2Q26 and expects 3Q-4Q26 reported capex to moderate, with more leasing and financing structures. We expect domestic chips such as T-Head and Kunlunxin to become more important as hyperscalers scale inference workloads and manage supply constraints and unit costs.

### AI Capex Intensity and Return Profile Across Chinese and Global Players

| Company | Annual Capex | Relevant revenue size | Capex / Revenue | Asset life | Payback period | Mature ROIC* | After-tax project IRR |
|---|---|---|---|---|---|---|---|
| Alibaba | **Rmb214b / ~US$30b** | **Rmb242b / ~US$34b** | **88%** | 5yr | **2-3yr** | **c20%** | **c20%** |
| Tencent | **Rmb200b / ~US$29b** | **Rmb58b / ~US$8b** | **~3.1x** | c5–6yr | N/M on cloud-only revenue | N/M | N/M |
| Meta | US$130–145b | US$50–60b | 2-3x | c5.5yr | 2.0–2.8yr | 30–45% | 26–33% |
| AWS | US$120–130b | AWS ~US$150bF | 80–85%[1] | 5–6yr | 2.5–3.2yr | 22–30% | 22–33% |
| Google | US$100–110b | Google Cloud ~US$70–80bF | >100%[2] | c6yr | 2.7–3.5yr | 20–28% | 19–30% |
| Oracle | US$50b+ | OCI ~US$25–30bE | >100% | c6yr | 3.2–5.0yr | 10–20% | 7–23% |
| GDS | US$1.3b | US$1.8b | 70% | 15–20yr+ | 7–9yr | 8–11% | 12–15% |
| VNET | US$1.4–1.7b | US$1.6b | 85–100% | 15–20yr+ | 8–11yr | 6–9% | 9–13% |

*Source: Industry data, UOB Kay Hian*

## Valuation/Recommendation

- **Alibaba (9988 HK).** Maintain BUY with a target price of HK$188.00 (US$192.00). Cloud acceleration is the key near-term catalyst, although elevated AI capex and FCF remain the main debate.
- **Tencent (700 HK).** Maintain BUY with a target price of HK$608.00. We remain constructive on resilient gaming, accelerating AI-driven advertising and cloud monetisation, while monitoring elevated capex.
- **Baidu (9888 HK).** Maintain BUY with a target price of HK$145.00 (US$148.00). We remain constructive on strong AI cloud and GPU cloud growth, while monitoring the continued weakness in legacy advertising and the sustainability and quality of AI-driven monetisation.

## Sector Catalyst/Risk

- **Catalysts:** a) Faster AI cloud monetisation and improving compute economics, b) a sequential recovery in e-commerce demand and lower local-commerce losses, c) sustained game engagement/new launches, and d) recovery of travel demand in 4Q26.
- **Risks** include: a) weaker-than-expected consumption, b) higher AI capex and prolonged FCF pressure, c) intensifying e-commerce/AI competition, d) game pipeline delays, and e) renewed geopolitical or fuel price pressure on travel.