Kerrisdale Capital

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Tencent Music Entertainment (TME)

Forced Liquidation Provides Attractive Buying Opportunity

Tencent Music Entertainment ("TME") is the leading streaming music service in China with over 800m active users and household brand names like QQ Music and Kugou. According to a Sunday Bloomberg article, Archegos Capital liquidated 50m shares of TME last week, a colossal sum 4x the average daily volume, sending shares into a 40% tailspin as the market absorbed this supply. We believe this presents an opportunity to acquire a leading global asset undergoing a transformation away from its decelerating livestreaming business to a subscription-based music streaming model. If shares recover to their recent trading range of 10.5x – 12x EV/Revenue and management achieves their 2021 revenue targets, TME is worth $35-40/share, or 75-100% higher than current trading levels.

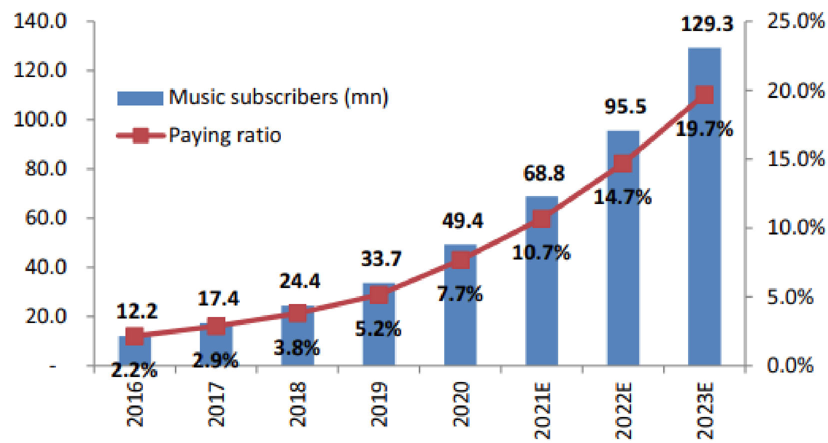
Capitalization	
Share Price	**$20.00**
Diluted Shares	1,678
Market Cap.	**$33,551**
Plus: Total debt	824
Less: Cash	(3,903)
Enterprise Value	**$30,472**

Trading Multiples	2021E	2022E
EV / Revenue	5.8x	4.8x
EV / Adj. EBITDA	34.9x	25.1x
EV / Adj. EBIT	37.6x	26.9x
P / E	40.2x	30.0x

TME shares began rapidly appreciating in January after Alibaba shut down its streaming music business (Xiami), leaving NetEase Music (~150m users) as the only competition. TME then acquired Lazy Audio, a leading long-form audio business, and announced its intention to grow in the budding podcasting and audio category. These events, along with the widely apparent success in its music business, sent TME shares to new highs before the recent correction. Looking ahead at the next three to five years, we see shares de-risked with several attractive growth drivers ahead for TME's business.

Unlike its best-known global analogue Spotify, the vast majority of TME's music listeners are unpaid. But that is rapidly changing – by moving more content behind its paywall, TME has successfully nudged users towards monthly subscriptions. TME's paying ratio (paid subscribers divided by total monthly active users) jumped from 6% to 9% over the past year. Compared to Spotify's paying ratio of 45%, TME's existing user base still offers many years of expansion. If TME's paying ratio reaches 20% by 2023, it would have nearly 130m paid subscribers. At that level, TME would generate RMB 15bn in subscription sales, up from 5.5bn in 2020.

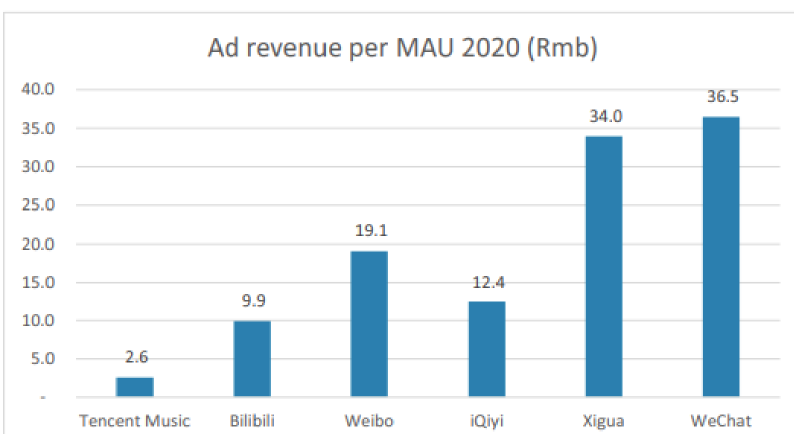
Exhibit 2: Music paying ratio could reach 20% in 2023E, on par with IQ today



Source: Company data, Morgan Stanley Research (E) estimates

TME has also developed a nascent advertising business into a meaningful contributor to revenue. Management has improved its ad stack, expanded its sales force, and grown CPMs, resulting in the doubling of revenue in Q4 2020. TME's advertising business remains under-monetized vs. peers: it earned just RMB 2.6 per user vs 10+ for many comparable platforms. As a result of its improvements, advertising revenue grew 100% y/y over the past two quarters and now accounts for a majority of online music's non-subscription revenue. Analysts estimate that advertising revenue could grow from RMB 1.5bn in 2020 to 7bn in 2023.

Exhibit 5: TME has the lowest ad revenue/MAU among peers under our coverage



Source: Company data, Morgan Stanley Research (E)

Long-form audio, or podcasts, offers a third driver for TME's music business. According to iResearch, China's long-form audio market should grow at a 40% CAGR over the next three years. This business offers higher margins than music, since long-form audio does not require hefty content fees charged by major music labels. The business is currently a drag on profitability as TME invests in its growth. But its early success is evident with penetration growing to 15% in Q4 2020 from 5% a year ago. Management expects long-form audio DAUs to double in 2021 to nearly 20m users.

Meanwhile, TME's legacy livestreaming and social business continue to weigh on consolidated growth: the music business is growing by 30-35% vs. 10% growth in social entertainment. Although TME's still-dominant platforms for karaoke and music-related content have lost mindshare to short-form audio and apps like TikTok, with this trend potentially persisting into the future, signs of a recovery are beginning to take shape. According to management on the most recent call, TME's WeSing MAUs bottomed and began growing in December and January. The Kugou Music live streaming business is rapidly scaling. And y/y comparisons become much easier in the coming quarters. The social business is rapidly learning to cope with the new competitive environment.

Revenue	FY 2019	FY 2020	FY 2021E	FY 2022E	FY 2023E
Subscription	3,560	5,557	7,768	10,899	14,549
Digital Music Sales	3,592	3,788	4,994	6,588	8,530
Total Music	**7,152**	**9,345**	**12,762**	**17,487**	**23,079**
Social Entert.	**18,282**	**19,803**	**22,354**	**25,338**	**28,302**
% Growth					
Subscription	42.4%	56.1%	39.8%	40.3%	33.5%
Digital Music Sales	53.0%	5.5%	31.8%	31.9%	29.5%
Total Music	**47.6%**	**30.7%**	**36.6%**	**37.0%**	**32.0%**
Social Entert.	**35.9%**	**8.3%**	**12.9%**	**13.3%**	**11.7%**

TME's combination of a grossly under-monetized music business and a recovering social entertainment business warrant a premium valuation. TME shares recently enjoyed a premium vs. SPOT by as much as 5 turns to revenue, but the gap significantly narrowed after last week's forced selling. As shares recover towards 10.5x – 12x EV/Revenue, TME offers 75-100% upside from current levels.