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China Internet & New Media

Global Markets Research
7 August 2026

EQUITY: INTERNET & NEW MEDIA

Our thoughts ahead of 2Q results

Top picks: BABA, Tencent, Meituan and J&T

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China's LLM Landscape: Market consolidation, big tech strategies and application challenges

China's large language model (LLM) market is highly competitive, with independent AI labs DeepSeek (unlisted) and Moonshot (unlisted) currently holding the lead, in our view. Alibaba's (BABA US, Buy) Qwen LLM is also a top-tier model, while Tencent (700 HK, Buy) and ByteDance (unlisted) are trying to catch-up. We believe the foundation model market will eventually consolidate into three to four highly capable leaders.

We believe the LLM strategies of major platforms like Alibaba, Tencent, and ByteDance will likely shift based on competitive market dynamics. These companies possess AI cloud services that act both as internal competitors for limited compute resources and as monetization partners for their LLMs through Model-as-a-Service (MaaS) offerings. While it is premature to determine the final standing of these large platforms relative to independent AI labs once the market stabilizes, we believe they are preparing for a worst-case scenario. Even if their proprietary models lag those from independent labs, these platforms are working to ensure the capability gap remains as narrow as possible, allowing them a fallback option to integrate open-weight models from independent labs into their cloud ecosystems. To cement these partnerships, platforms like Alibaba and Tencent have invested in leading AI labs. For instance, Alibaba has invested extensively across the Chinese AI value chain, from hardware [e.g., ChangXin Memory (688825 CH, Buy, covered by Donnie Teng] to LLM labs (e.g., Moonshot AI), as illustrated in *Fig 1*.

We believe the open-weight culture in China's LLM space poses a significant challenge for AI applications, most of which are closed-source and rely on subscription revenues. Text-to-video is the most competitive vertical, currently dominated by leaders like ByteDance's Seedance and Kuaishou's (1024 HK, Neutral) Kling. In July, MiniMax (100 HK, Not rated) launched an open-weight video generation model, MiniMax H3, which appears to be gaining strong attraction. While the superior Seedance 2.5 could remain unaffected, other close-source players like Kling will likely face mounting pressure, in our view.

Cooling competition among AI chatbots likely slows marketing spend

Ongoing AI investments by major platforms are having wide-ranging impacts across the broader internet sector. We believe these heavy AI investments have driven platforms to scrutinize profitability more closely in other new business lines, helping to temper competition in areas like quick commerce and local services. As major players including Alibaba and ByteDance have shifted resources from consumer-facing AI chatbots to business-oriented AI agents since 2Q26, our channel checks indicate that the marketing spend to promote AI chatbots has cooled considerably. This reduction will likely blunt the growth momentum for ad publishers such as Bilibili (BILI US, Neutral) and Weibo (WB US, Neutral), which had previously benefited from surging AI chatbot ad spend between 2H25 and 1Q26.

Ecommerce remains weak as expected

In 1H26, the ecommerce sector surprised the market on the downside, showing tepid growth as macroeconomic headwinds and a high base effect exerted a greater impact than anticipated. China's National Bureau of Statistics (NBS) reported a steadily slowing ecommerce market growth in 1H26, up merely 2.3% in 2Q26 vs. 7.5% growth in 1Q26. We expect e-commerce growth to remain subdued in 2H26, given persistently soft consumer sentiment.

For Alibaba, Customer Management Revenue (CMR) may remain soft in the upcoming

September quarter. However, we believe this is largely priced in, given the muted ecommerce growth observed in recent quarters. Instead, the market is increasingly focused on the profitability of BABA's ecommerce operations, which are now viewed primarily as cash-flow engines to fund the company's AI investments. BABA is placing greater emphasis on profitability across its non-AI segments, with quick commerce, international commerce, and cloud computing all demonstrating improving margins. The China ecommerce business (excluding quick commerce) may have also improved its EBITA margin by 1.8 pp y-y in the June quarter, based on our estimate.

Online healthcare: tightened oversight on sales of GLP-1

China has issued two new regulations so far this year to regulate prescription drug marketing, information display, prescription reviews, pharmacist staffing, and platform risk controls. Following these regulations, our channel checks show that major online healthcare platforms like JDH (6618 HK, Buy) have started downplaying the weight-loss effects of the related GLP-1 drugs, while also implementing stricter eligibility checks on customers purchasing these drugs. The lower product visibility and higher transaction friction could both serve to slow the online sales growth of these products which are one of the most popular categories for the online healthcare channels. Further, Chinese pharmacy watchdog now requires prescription reviews to be conducted by licensed pharmacists, prohibits AI from replacing pharmacists in the review process, and caps daily review volumes per human pharmacist at reasonable levels. This tightened oversight will likely limit highly automated practices for online pharmacy sales, potentially increasing compliance costs and transaction friction, in our view.

JDH's sales will likely see potential downside risks. For JDH, we expect a limited impact on its upcoming 2Q print from the aforementioned tightened regulations, which were implemented in mid-to-late May. We still maintain our forecast for JDH's online pharmaceutical sales to register ~25% y-y in 2Q26, supporting our ~16% y-y total revenue growth estimate for the quarter.

However, we see potential downside risk to JDH's FY26E revenue guidance of high-teens-20% growth provided by management in early-March which we believe have yet to factor in the tightened regulatory oversights on nutritions since April and on prescription drug since late May. According to management, its FY26 guidance was based on assumptions of ~25%, 15%, and 10% growth in its pharmaceuticals, nutrition products, and medical devices, respectively. Given the new regulatory environment, achieving the desired pharmaceutical and nutrition growth targets may prove challenging, in our view.

Tightening tax levies likely mean increased difficulty to receive tax rebates

China authorities have tightened tax levies across the board, affecting both individuals and corporate entities. While we do not expect new taxes targeting the internet sector, cash-strapped local authorities may reduce, delay, or suspend certain tax rebates for high-tech industries. We believe this will likely lead to an inflation of the effective tax rate for companies in the sector. Though we have not come across any comments from any of the companies we cover about potential tax rate change, we think this is a potential risk that the market should be aware of in view of the current tightening tax scenario in China.

Our top picks: Alibaba, Tencent, Meituan and J&T

We continue to believe that Alibaba is the best proxy in the Chinese internet space to capitalize on the AI trend. BABA's strength lies in its robust full-stack AI capabilities, with a strong positioning across key segments of the AI value chain, including chips, cloud infrastructure, and LLMs.

For BABA's upcoming June quarter print, we are primarily focused on the following: 1) Whether Alibaba will raise guidance for its MaaS service. We believe the segment has maintained robust momentum, potentially making the earlier guidance of exceeding CNY30bn in ARR by March 2027 appear overly conservative. 2) Whether BABA will provide updated guidance for AliCloud's margin trajectory. Management previously guided for AliCloud's EBITA margin to improve to 11-12% in the June and September quarters, up from 8-9% in previous quarters. We believe AliCloud's margin could expand further from current levels through the rest of the year, driven by higher-margin MaaS services and pricing strength. 3) Whether further details will be provided regarding the *IPO* timeline for T-Head, BABA's chip business. Industry channels indicate that T-Head will begin selling chips directly to customers rather than solely through AliCloud, which we view as a sign of growing independence. Finally, BABA will host its flagship annual cloud event on 22-24 Sept, where it typically showcases its latest technological advancements and AI capabilities, potentially driving positive market sentiment. Our TP for Alibaba remains at USD178, implying 22x CY27F(FY28F) P/E, vs. the current valuation of 16x.

Tencent remains a highly potent player in the AI field, despite currently trailing some of the peers. The company is heavily investing in three key strategic AI products: the Hunyuan LLM, the desktop agent WorkBuddy, and a yet-to-be-officially-launched WeChat agent. We are particularly positive on the prospects of the WeChat agent, which could serve as an intelligent connector between WeChat's 1bn+ users and its vast network of service providers. Long-term, we believe the WeChat agent is well-positioned to charge a commission for directing customer traffic to these providers. Tencent's WorkBuddy is gaining strong traction among white-collar professionals and students, aided by robust marketing campaigns. Competition is intensifying in this arena, as industry majors like Alibaba and ByteDance have all entered the space. While WorkBuddy enjoys a first-mover advantage, competitors possess the capability to make inroads, given that the desktop agent business remains in its early stages, in our view.

Tencent's Hunyuan LLM delivered a positive surprise with its recent 3.0 iteration exceeding low market expectations. However, the benchmark for Chinese LLMs has since been raised further by independent labs like DeepSeek and Moonshot. Among large platforms, Alibaba's latest LLM iteration, Qwen 3.8 Max, has also secured a tier-1 ranking in our view. Hunyuan's next iteration, which we believe will be launched by October, faces a high bar; it will need to demonstrate further narrowing of the gap with state-of-the-art models to change the market's cautious view on its weak standing in the China LLM market. Tencent's AI spending continues to be a focal point for investors. Correspondingly, many investors believe Tencent's net profit growth in FY26 may decelerate to flat or low-single-digit percentages, vs latest Bloomberg consensus of 5.9% growth. We maintain our Buy rating with a TP of HKD727, implying 20x FY27F P/E, vs. the current 13x.

Meituan's (3690 HK, Buy) food delivery (FD) segment will likely record higher-than-expected improvement in profitability, driven by an increasingly rational competitive environment. Bloomberg consensus expects the unit economics (UE) of the FD segment to swing into a loss in 3Q26 due to increased summer subsidies. However, based on Alibaba's resolute tone regarding loss-cutting in its quick commerce division, we believe Meituan's FD segment could maintain positive UE in 3Q26. Concurrently, we are cautiously optimistic about the outlook for the in-store segment, as its major competitor, Douyin (unlisted) is likely shifting its focus to balance scale with profitability, as per a *Douyin local service expert* . Our TP of HKD109 implies 33x FY27F P/E, vs current valuation of 28x.

J&T (1519 HK, Buy) reported a solid 25% y-y parcel volume growth in 1H26, backed by robust volume expansion in Southeast Asia (SEA) and other markets (excluding China and SEA), as well as the resumption of market share gains in China. Beyond strong volumes, we expect SEA unit economics will likely remain resilient, supported by ongoing cost optimization and platform-led pricing support, which should help offset higher fuel costs. In China, a more rational competitive environment, driven by continued "anti-involution" efforts, should support an earnings recovery. As the actual volume growth in 1H across SEA and other markets, 71% and 120% y-y, respectively, came in well ahead of the company's prior FY26E guidance of 50% and 90% volume growth for these two market, we believe J&T may lift the FY26E volume guidance for these two strategic markets, which could serve as a positive catalyst for the stock. Our TP of HKD14 implies 15x FY27F P/E, vs currently 11x.

Sum of our recent published expert insights across the internet economy

1. *Douyin's local services business aims to break-even at some point in 2H26E, according to an expert*
2. *Moonshot AI expert: closed source LLM is the way to go for LLM monetization at scale*
3. *LLM expert: open source is not an open playbook*
4. *Douyin ecommerce is balancing scale growth and profitability*
5. *TikTok shop logistics expert: positive cross-read for J&T*
6. *China's LLM evolution: scaling, agent integration and cost optimization*

Fig. 1: Part of BABA's investments in the China AI space

Category	Invested company name	Listed/unlisted	Alibaba's Stake	Note
AI memory	ChangXin Memory	Listed	4.5%	
LLM	Moonshot AI	Unlisted	36.0%	Stake info was as of May 2024. No latest stake info. can be found
LLM	BaiChuan AI	Unlisted	NA	
LLM	01.AI	Unlisted	NA	
AI video generation	Kling AI	Unlisted	1.1%	
Embodied AI	Unitree Robotics	Unlisted	NA	
Embodied AI	X Square	Unlisted	NA	
Edge computing chip	Aojie Technology (688220.SH)	Listed	NA	
AI accelerator chip	Vastai Technologies	Unlisted	4.4%	

Source: Company data, Nomura research

Appendix A-1

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