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China Internet

2Q26 Wrap & 2H26 Outlook: AI vs. Non-AI Prospects & Debates

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CITI'S TAKE

The China Internet sector's 2Q26 results were generally softer than 1Q26 reflecting weaker macro activities and disruptions from AI-generated content, compounded by higher opex, a spike in capex, and negative FX impact. The sector continues to underperform with YTD returns -19.8% vs. Japan's +15.6%, India's +1.5%, the US's -6.5%, Korea's -9.9%, SEA's -23.2% vs. KOSPI at +62.2%, Nikkei +31.5%, S&P 500 +12.3%, HSI -1.2%, while Nifty -8.0%. Key highlights in 2Q26 were significant improvement in Chinese AI models, alongside a spike in capex and negative FCF from hyperscalers. For 2H26, we anticipate Chinese AI labs to work on larger models (3T+), which should further validate monetization through open platforms. However, continued macro softness is likely to dampen advertising, e-commerce and local services outlook. Sentiment will probably remain muted pending catalysts from agentic AI breakthrough. Our preferred picks are Tencent, BABA, Meituan, PDD, YMM, and Meitu.

Notable takeaways from 2Q26 print — The significant spike in capex that further weighed on negative FCF has concerned investors, despite companies attributing it to procurement timing fluctuations. While internal AI tools are boosting operational efficiency, the corresponding rise in token consumption is dragging OpM, particularly for smaller/mid-size companies that are rapidly applying AI to their operations. A significant leap in model intelligence from Chinese open-weight models like Qwen3.8 Max and Kimi K3 is making them increasingly attractive to foreign enterprises. AI-generated content is further disrupting the video and music ecosystem, though it helps validate the monetization of video models like Hailuo 3 and Kling. While intense, subsidy-driven food delivery competition continues to rationalize, the incremental improvement in UE is narrowing on a sequential basis. Continued soft macro and shift in ad budgets towards more interactive formats are forcing companies to invest in AI-empowered ad tools to stay competitive.

3Q/4Q26 trends: spending in AI vs. non-AI — 1) We anticipate Chinese AI labs to advance towards 3-5T models, narrowing the performance gap with US frontier labs and shift focus from benchmarks to practical applications, user adoption, and revenue. 2) While compute power will likely remain constrained, wider enterprise adoption and a greater mix of domestic hardware will help lower AI token costs for the industry. 3) With the macro environment expected to be muted, the next competitive battleground for ecommerce is emerging in supply-chain capabilities. 4) A larger batch of approved new game licenses could support a resilient gaming outlook, offsetting AI's disruptive impact on video and music. 5) cost optimization through AI adoption is expected to drive headcount and opex savings by year-end.

2Q/1H26 wrap & 3Q/2H26 outlook — Of the 57 internet companies that have reported 2Q/1H26 results, 24/30 delivered revs/earnings beats, 17/12 reported in-line revs/earnings and 16/15 missed revs/earnings. In terms of 3Q26 guidance, 2/2/2 companies beat/flat-lined/missed on rev; on profit, 1/1 guided profit beat/missed.

Investment risks — Soft China macro, geopolitical conditions, tightened regulations, capex investments and negative FCF and source of fund risk rotation.



See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliation

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