MORNINGSTAR

China Artificial Intelligence: 2026 Q4

Chinese chipmakers are capturing AI profits today, but internet firms stand to benefit over the long term.

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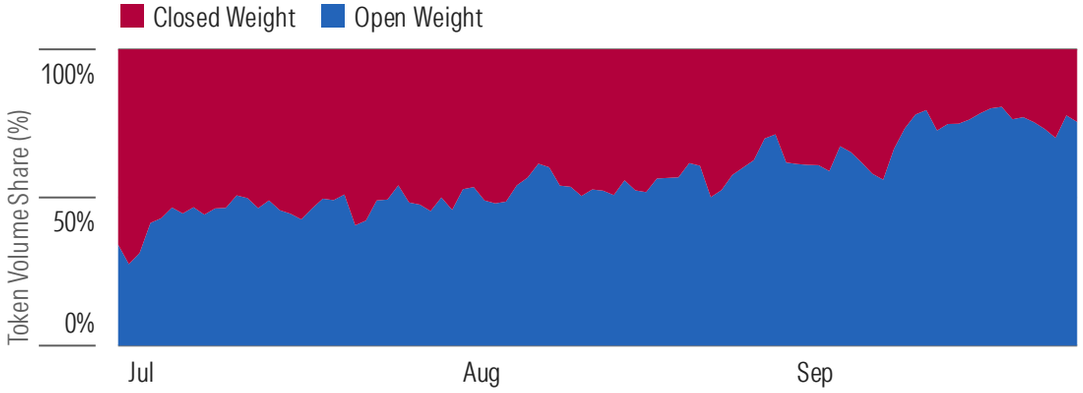
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Executive Summary

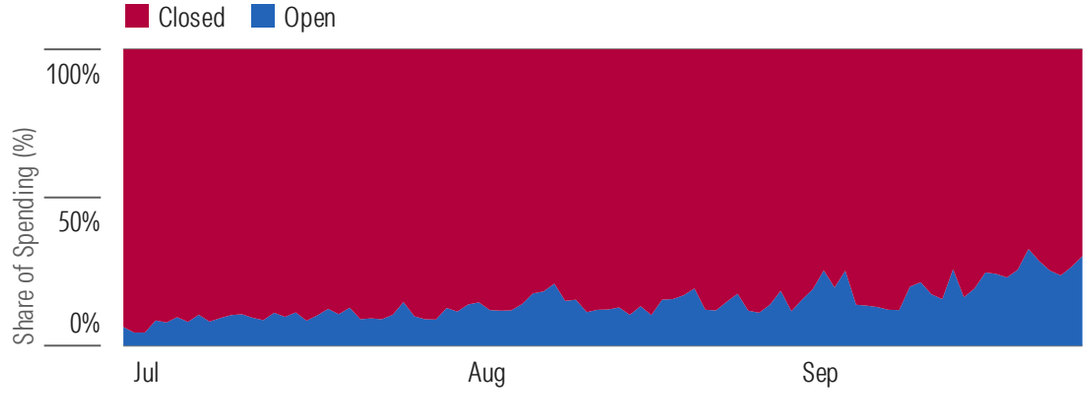
We favor resilient internet firms for longer-term AI returns.

Open-Weight Large Language Models, Mostly Developed by Chinese Firms, Are Gaining Share

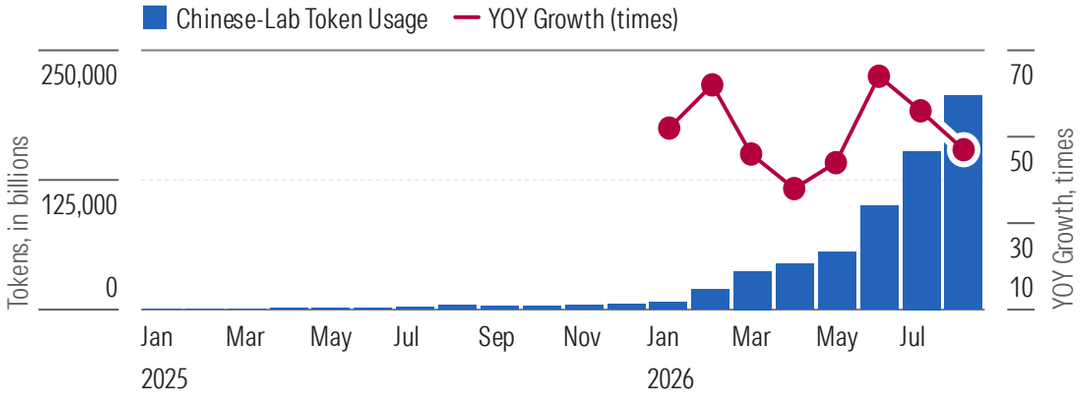
Open-Weight Models Gain Token Share on AI Gateway



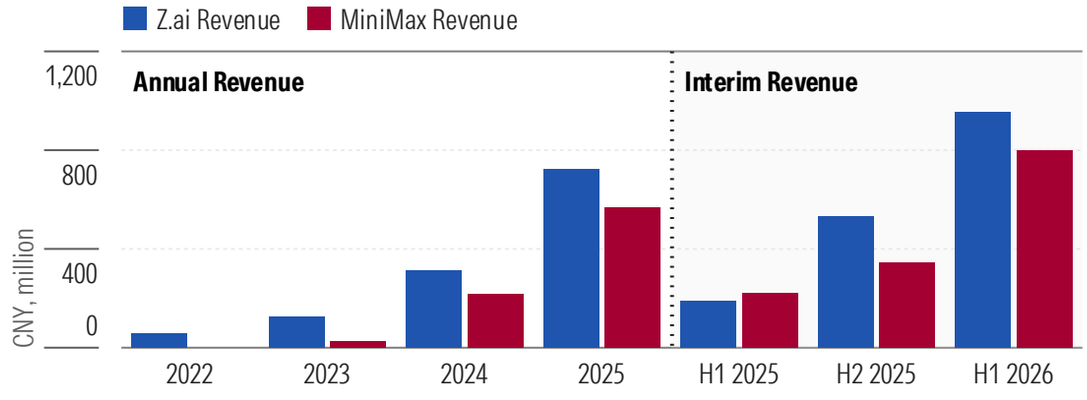
Open-Weight Models Gain Spending Share 2 Times as Fast as Token Share



Monthly Token Consumption at Chinese Model Firms Is Scaling Rapidly



Accelerating Token Growth Supports Revenue Growth at Listed Model Firms



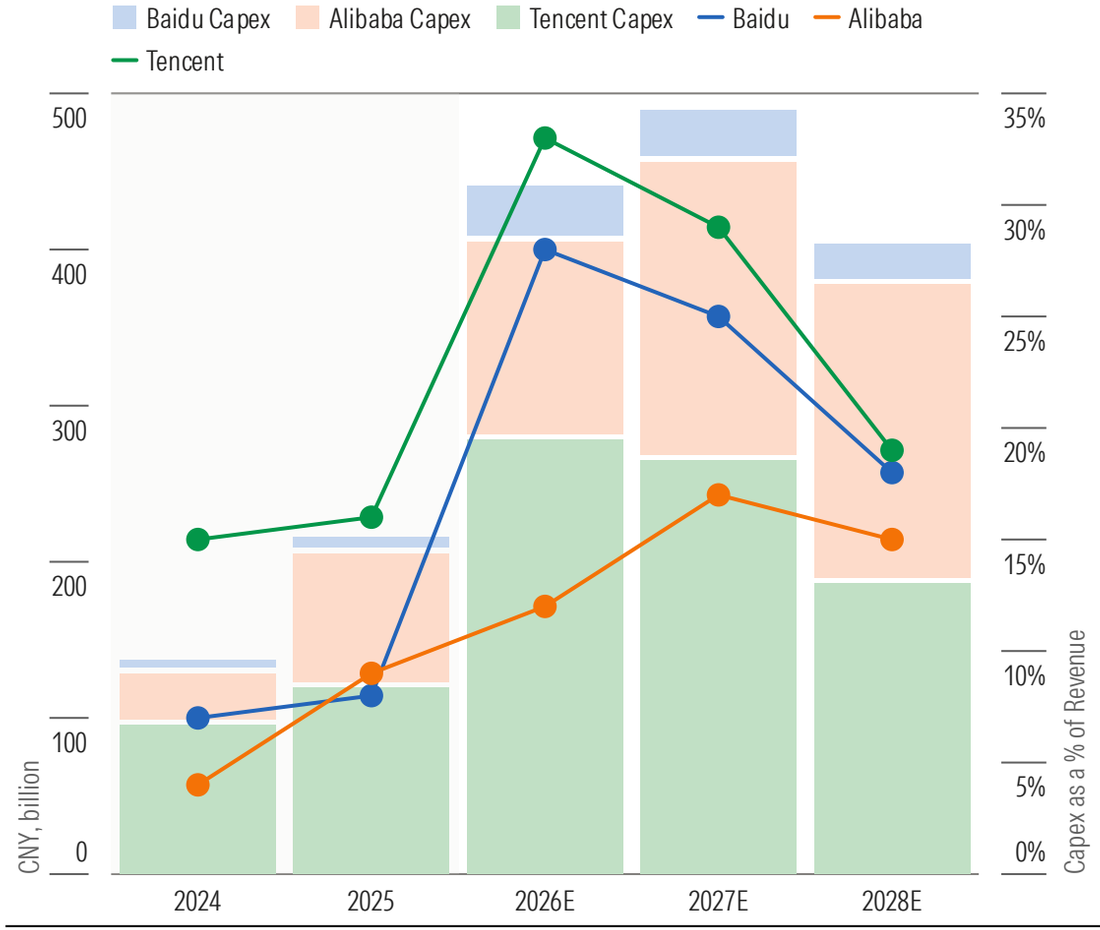
Source: AI Gateway. Data as of Sept. 27, 2026 (top left and top right). OpenRouter. Data as of Sept. 9, 2026. Chinese LLM firms include Alibaba, Baidu, Tencent, DeepSeek, Moonshot, Z.ai, MiniMax, and Mimo (bottom left). Company data. Data as of Sept. 11, 2026. MiniMax reported zero revenue in 2022 (bottom right).

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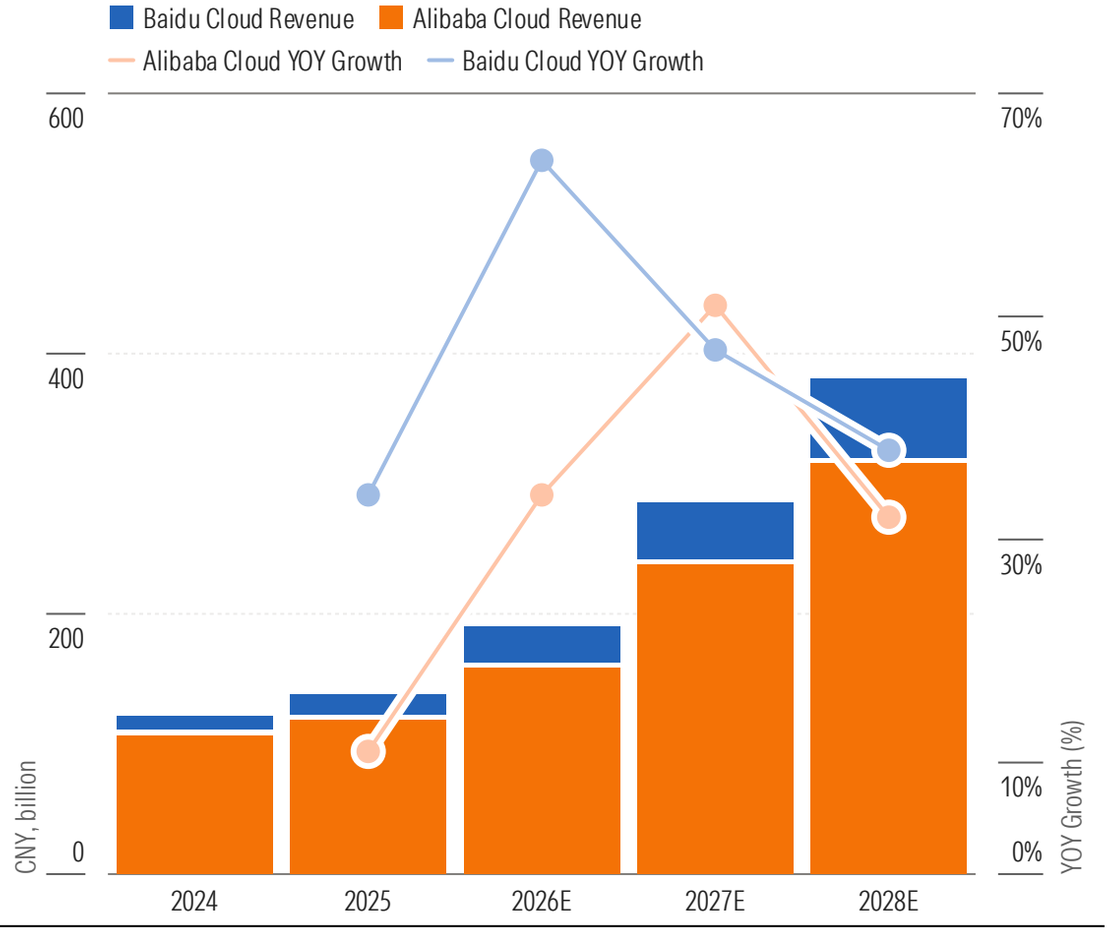
Higher Capital Expenditure/Revenue Ratio Is Necessary to Support AI-Induced Cloud Revenue Growth

Strong AI Demand Drives Substantially Higher AI and Cloud Capex Through 2028 ...

Capex/revenue ratio will fall in 2027 as chip supply increases.



Which Will Propel Robust Cloud Revenue Growth

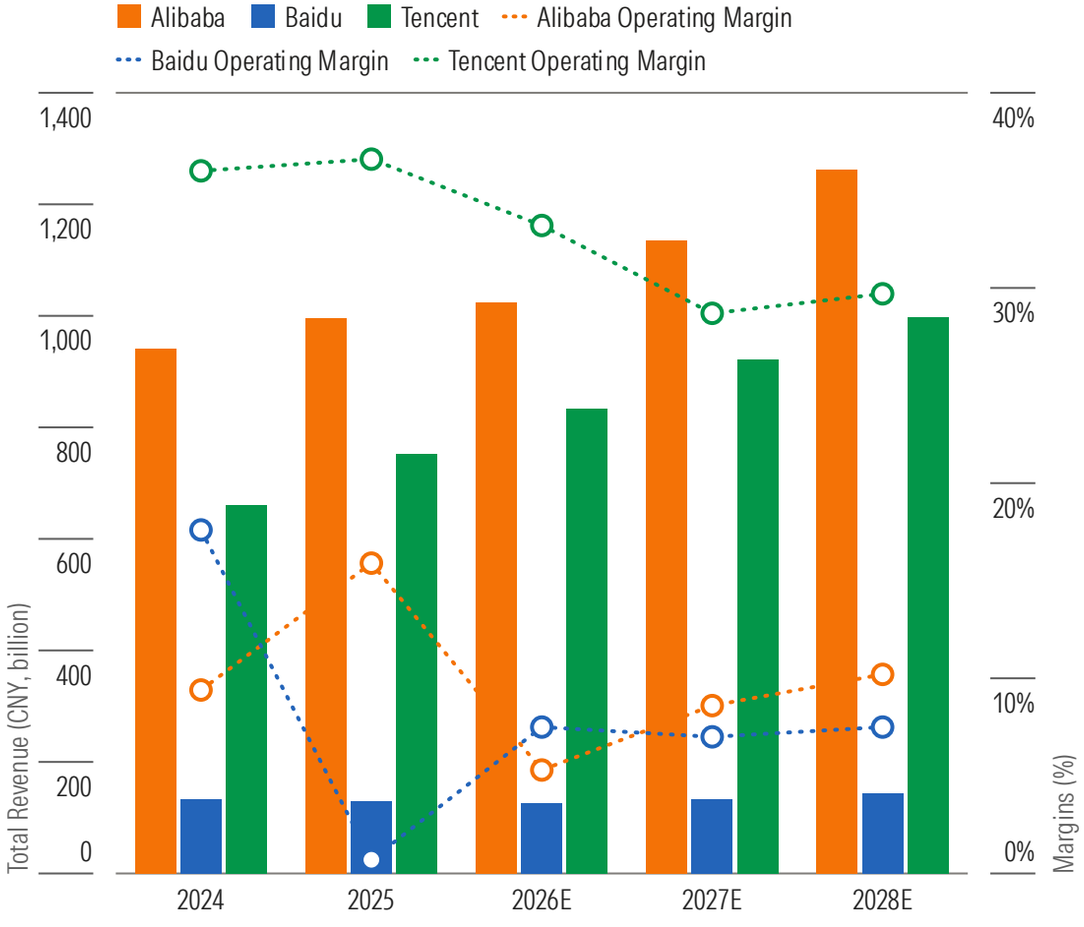


Source: Company data, Morningstar estimates. Data as of Sept. 9, 2026. Alibaba, Baidu, and Tencent all have cloud businesses, but not for Kuaishou. Tencent does not report cloud revenue consistently.

We Expect AI to Boost Internet Firms' Growth, While Legacy Businesses Provide Safety Net if AI Initiatives Falter

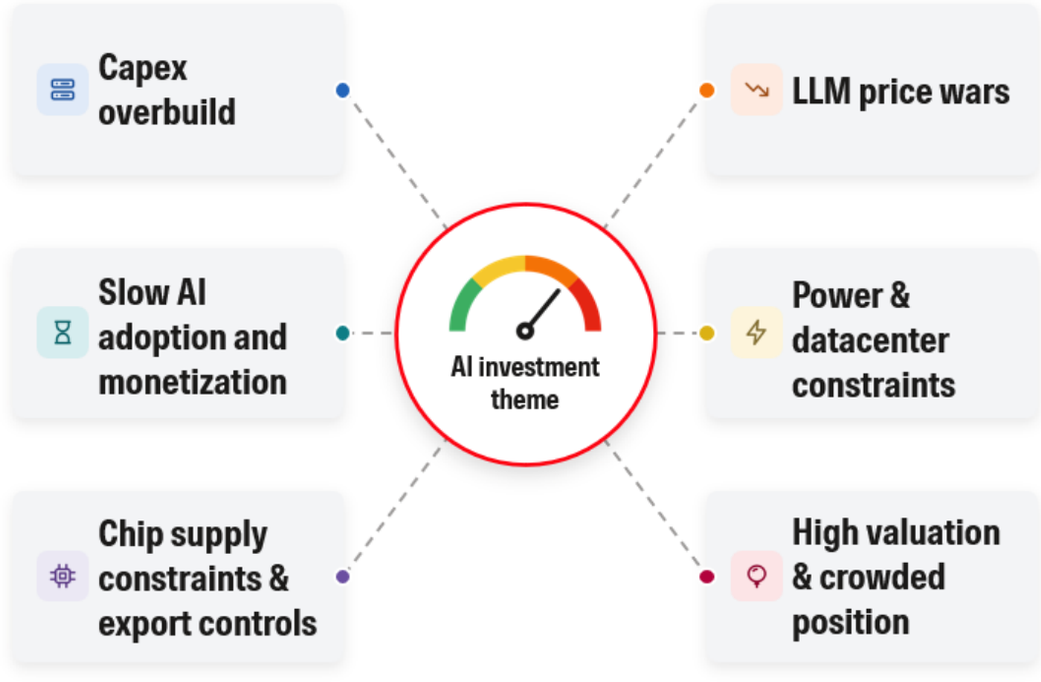
Chinese Cloud Providers Will See Revenue Growth as AI Revenue Increases

Reduced capex and higher utilization will help stabilize margins.



AI Growth Risks Exist, but Selected Internet Firms' Undervaluations Mitigate Them

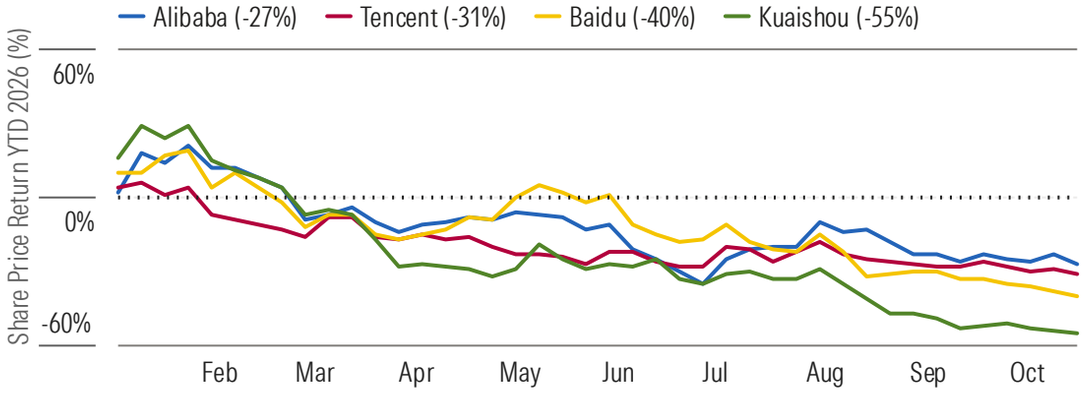
If AI fails, Tencent and, to a lesser extent, Alibaba can fall back on the legacy operations.



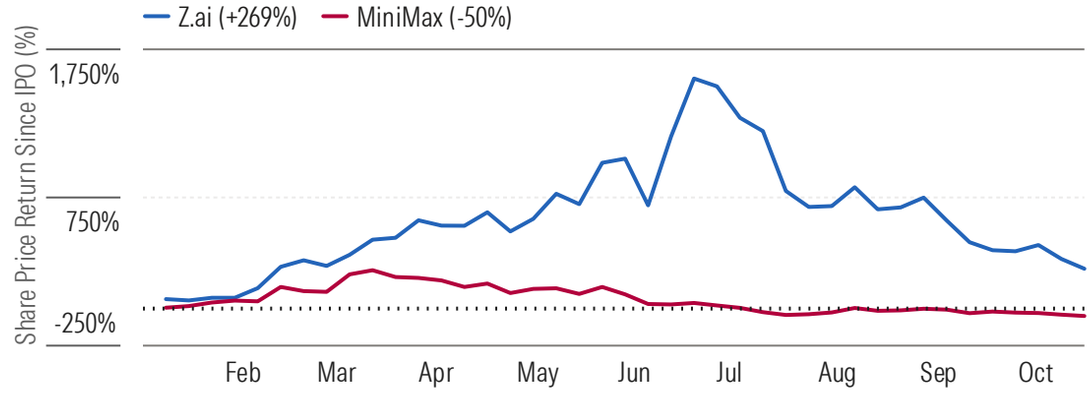
Source: Company data, Morningstar estimates. Data as of Sept. 9, 2026.

Z.ai's Rally Mirrors Anthropic's Strategy; GPU Names Drive China Semi Volatility

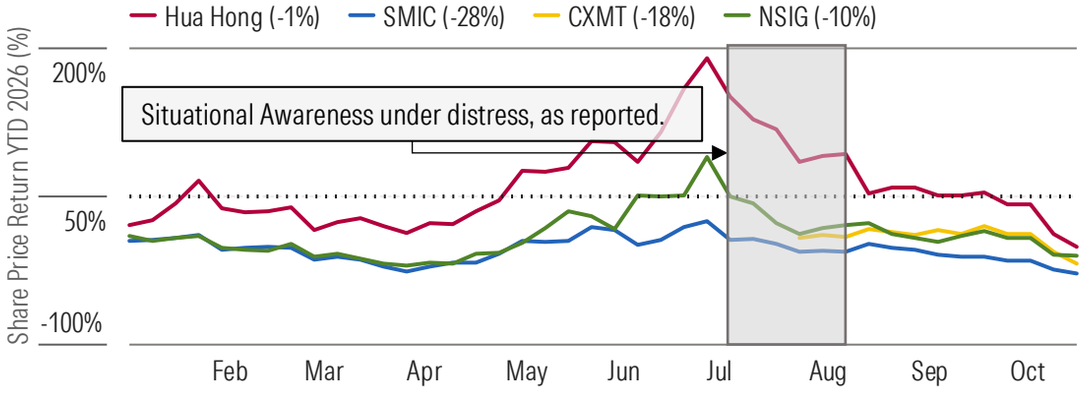
Chinese Internet Names Sold Off Year to Date Partly Due to Concerns on AI Return



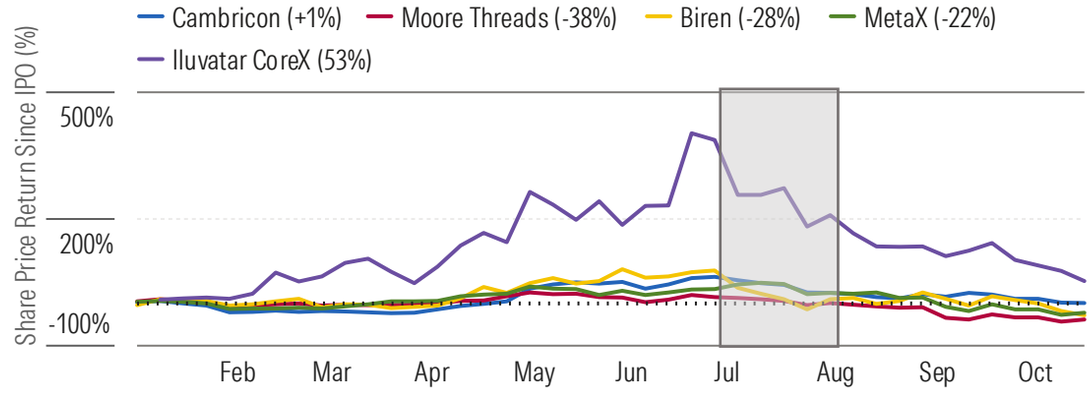
Z.ai Soared While MiniMax Underperformed



China Semiconductor Names Did Not Recover to June Highs



GPU Shares Are More Volatile and Sit Below Peaks



Source: PitchBook. Data as of Oct. 21, 2026. Z.ai and MiniMax were listed on Jan. 8 and Jan. 9, 2026, respectively. Biren, Iluvatar CoreX, and CXMT were listed on Jan. 2, Jan. 8, and July 27, 2026, respectively.

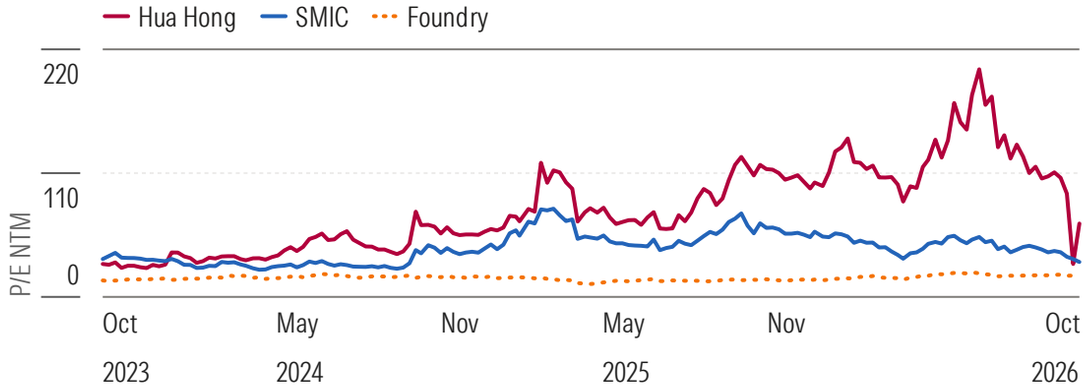
Chinese Chipmaker Valuations Rose on Self-Sufficiency Hopes but Remain Stretched Relative to Fundamentals

Chinese Chip Stocks Remain Overvalued Even as Price/FVE Declines

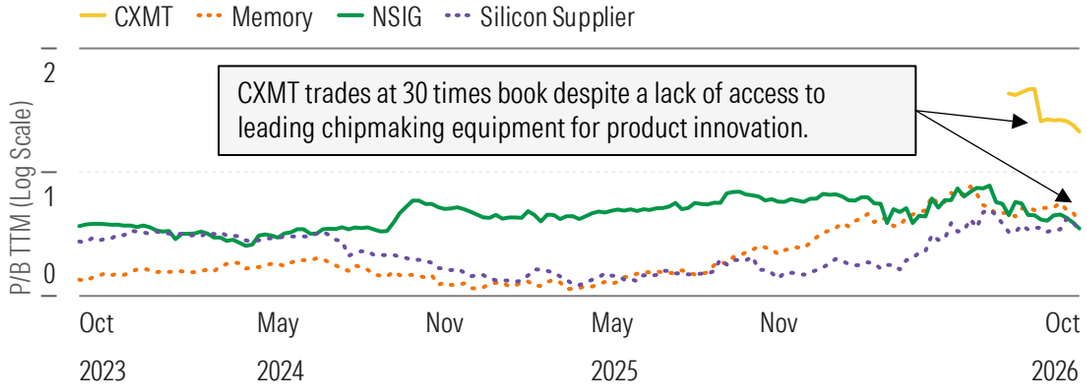
They all have high capex/revenue ratios that strain free cash flow generation.



Hua Hong Is the Most Expensive Amid Full Utilization and Heavy Capex



CXMT's Price/Book Is 3 Times Memory Leaders' Despite Lacking Advanced Tools

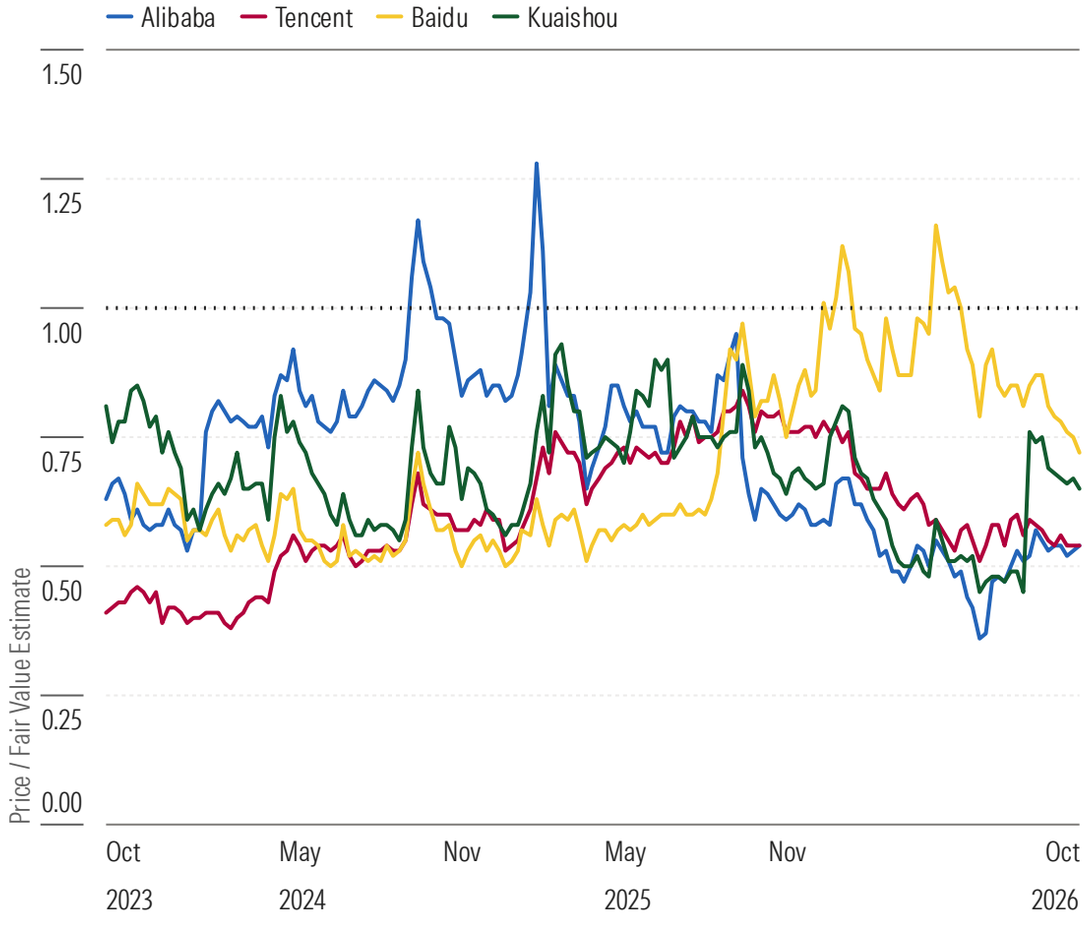


Source: PitchBook. Data as of Oct. 21, 2026. CXMT was listed on July 27, 2026. NSIG = National Silicon Industry Group. Market-cap-weighted averages for foundry, memory, and silicon suppliers comprise Taiwan Semiconductor Manufacturing, United Microelectronics, GlobalFoundries, and Win Semiconductors; Samsung Electronics, SK Hynix, Micron Technology, and Kioxia Holdings; and Sumco, Sino-American Silicon Products, and GlobalWafers, respectively (left chart).

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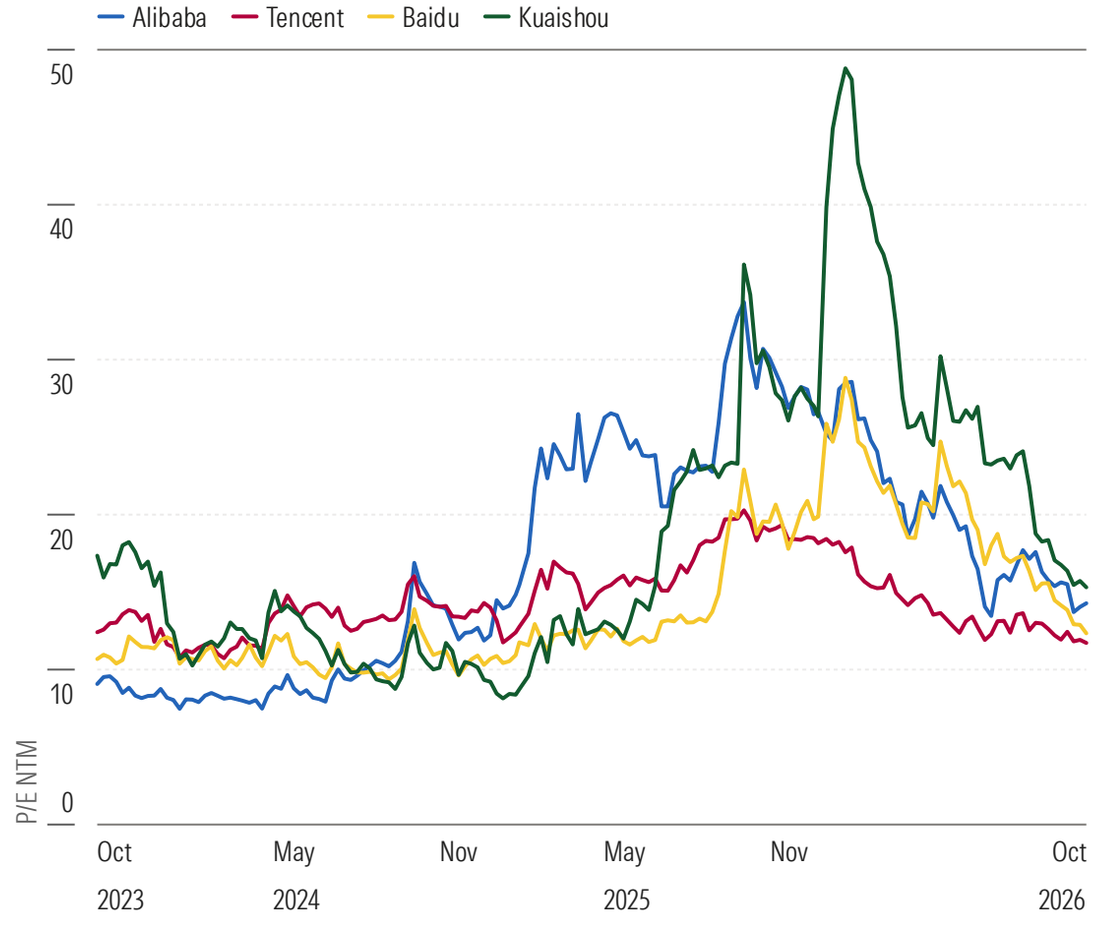
We Like Chinese Internet Names, as Falling Capex/Revenue Ratios Will Boost Free Cash Flow

Chinese Internet Stocks Trade Below Our Fair Value Estimates



Forward P/E Multiples Have Fallen From Recent Peaks to Attractive Levels

Chinese model firms are not expected to be profitable in the next 12 months.



Source: PitchBook. Data as of Oct. 21, 2026.

Chinese AI Adoption

Chinese models gain ground at home and abroad.

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Senior Equity Analyst

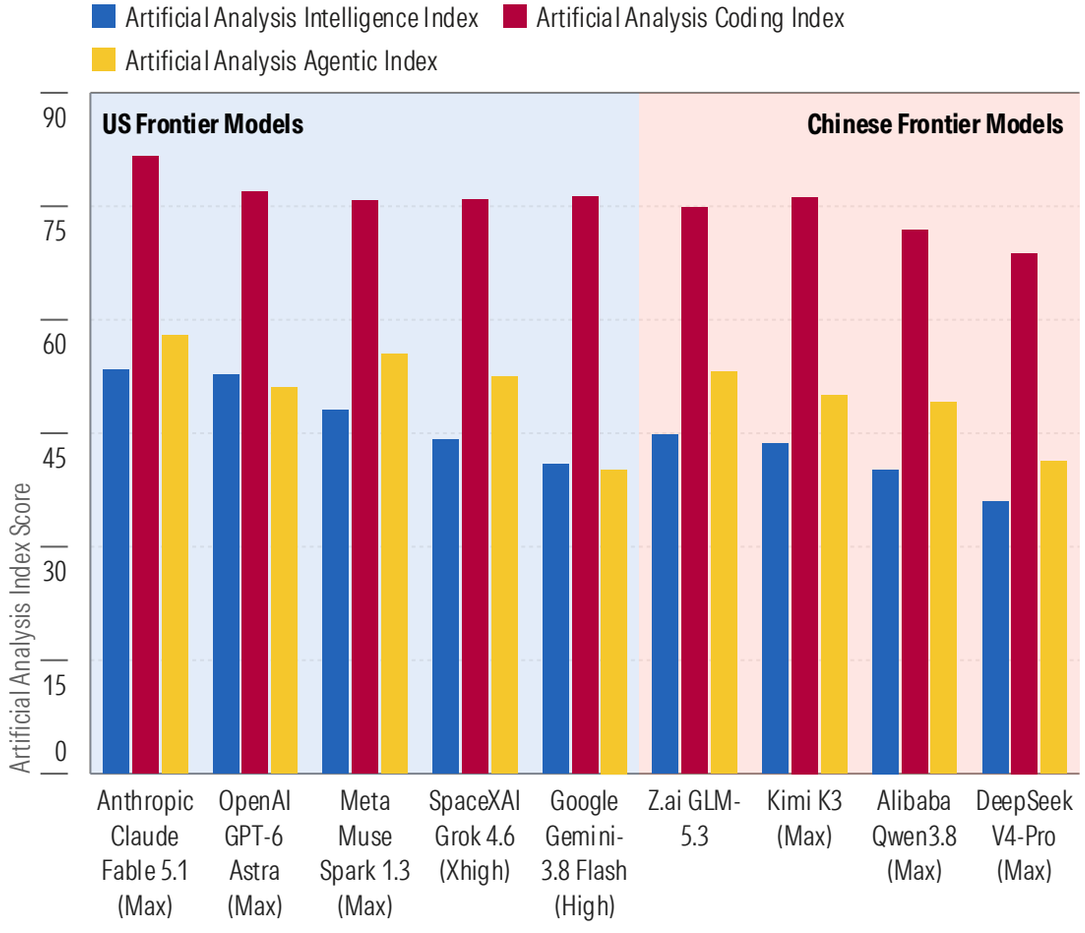
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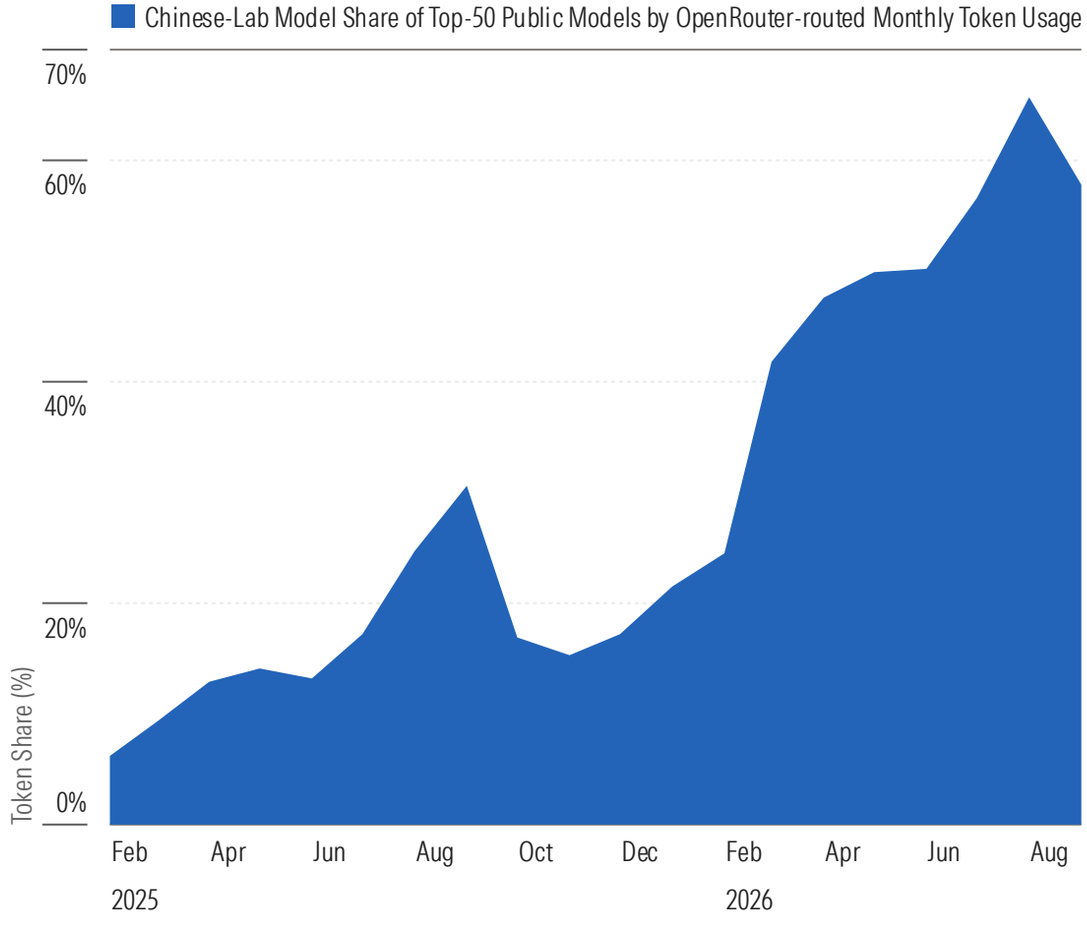
US Frontier Models' Lead in Intelligence Doesn't Prevent Chinese Models From Gaining Adoption

Top US Models Score Higher on Intelligence Benchmarks

Each firm's top model ranked by the Artificial Analysis Intelligence Index.



Chinese Models' Token Share Surges

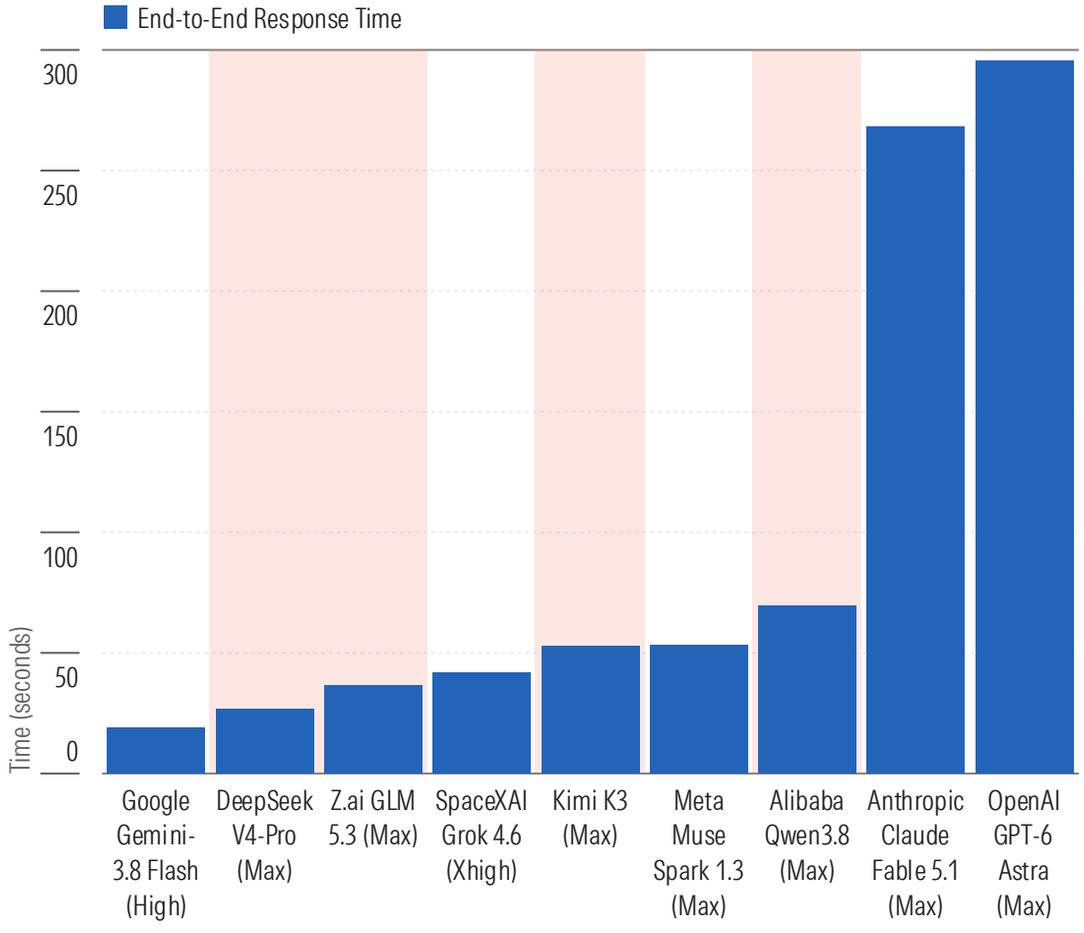


Source: Artificial Analysis. Data as of Oct. 6, 2026 (left). OpenRouter. Data as of Sept. 9, 2026 (right). Benchmark is Artificial Analysis Intelligence Index v4.3.2.

Chinese AI Models Gain Share by Being Fast and Cheap

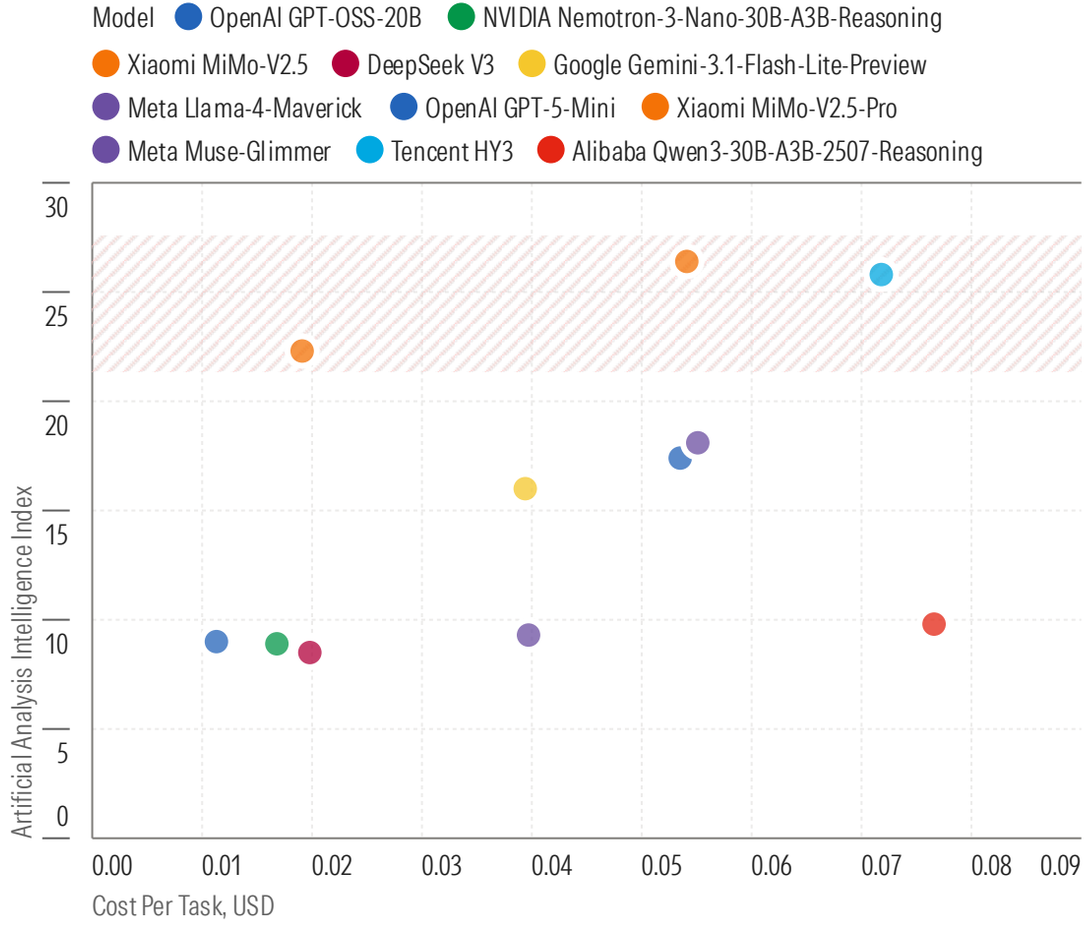
China's Most Intelligent Models Complete Tasks Quickly

End-to-end response time in seconds. Chinese models are shaded.



Xiaomi and Tencent Models Deliver Leading Price Performance

Top left indicates higher intelligence at lower cost.

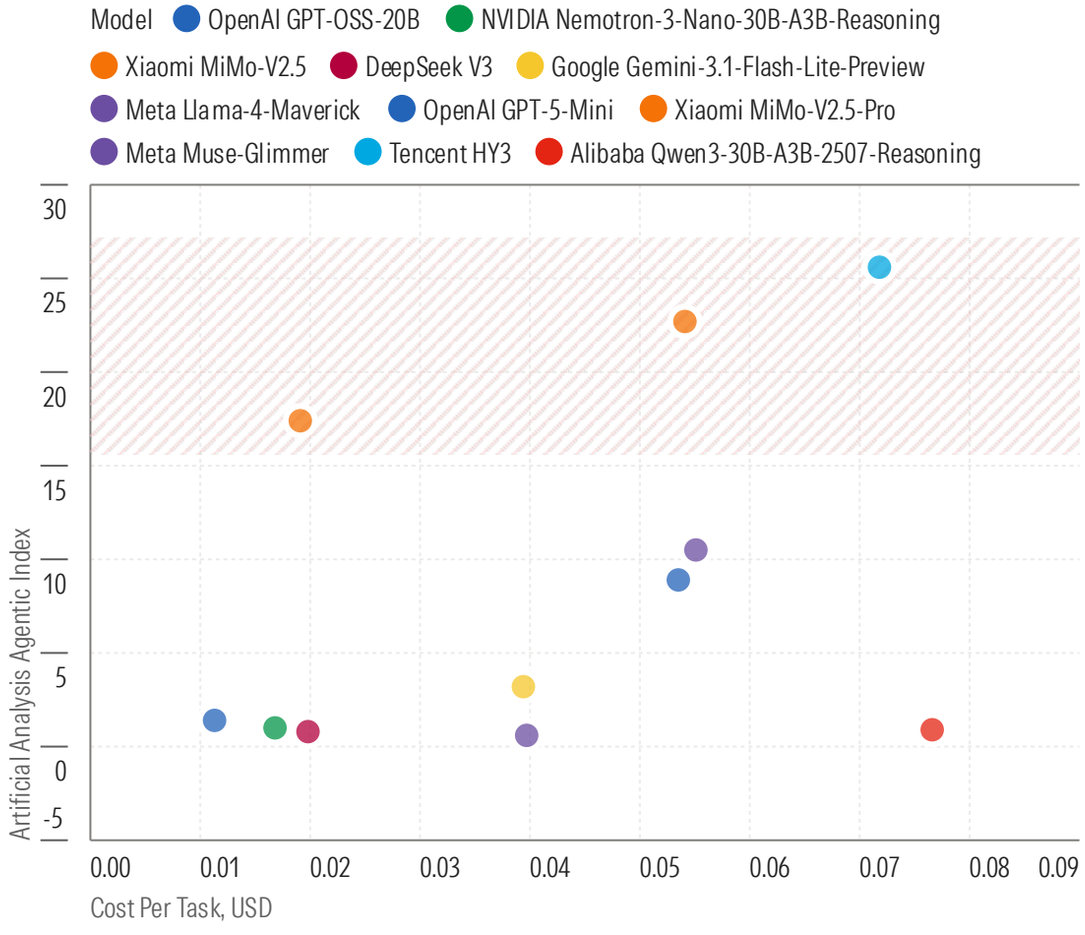


Source: Artificial Analysis. Data as of Oct. 6, 2026 (left) and Sept. 9, 2026 (right).

Xiaomi and Tencent Lead on Agentic and Coding Performance Among Low-Cost Models

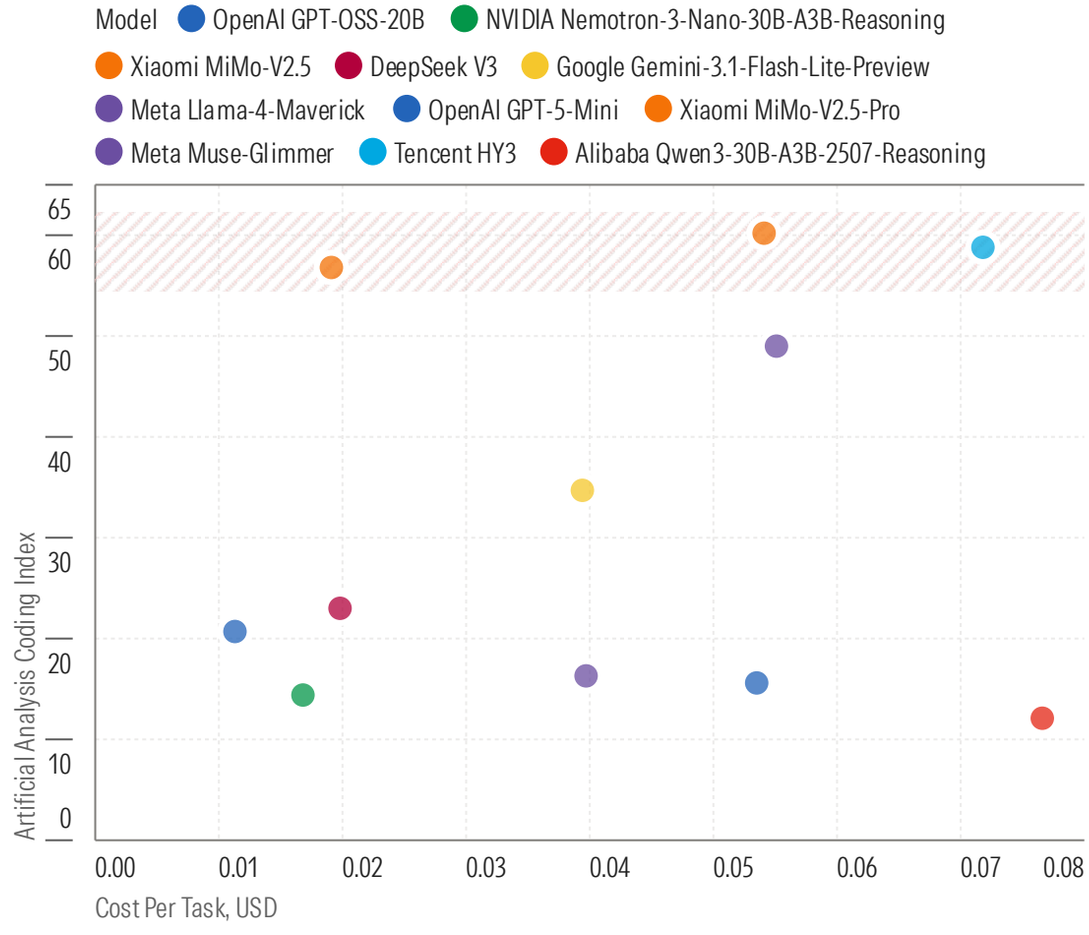
AI Agents' High Token Consumption Makes Cost-Efficiency Critical

Top left represents the highest agentic performance at the lowest cost.



Low-Cost Models Make Token-Intensive AI Coding Economically Viable

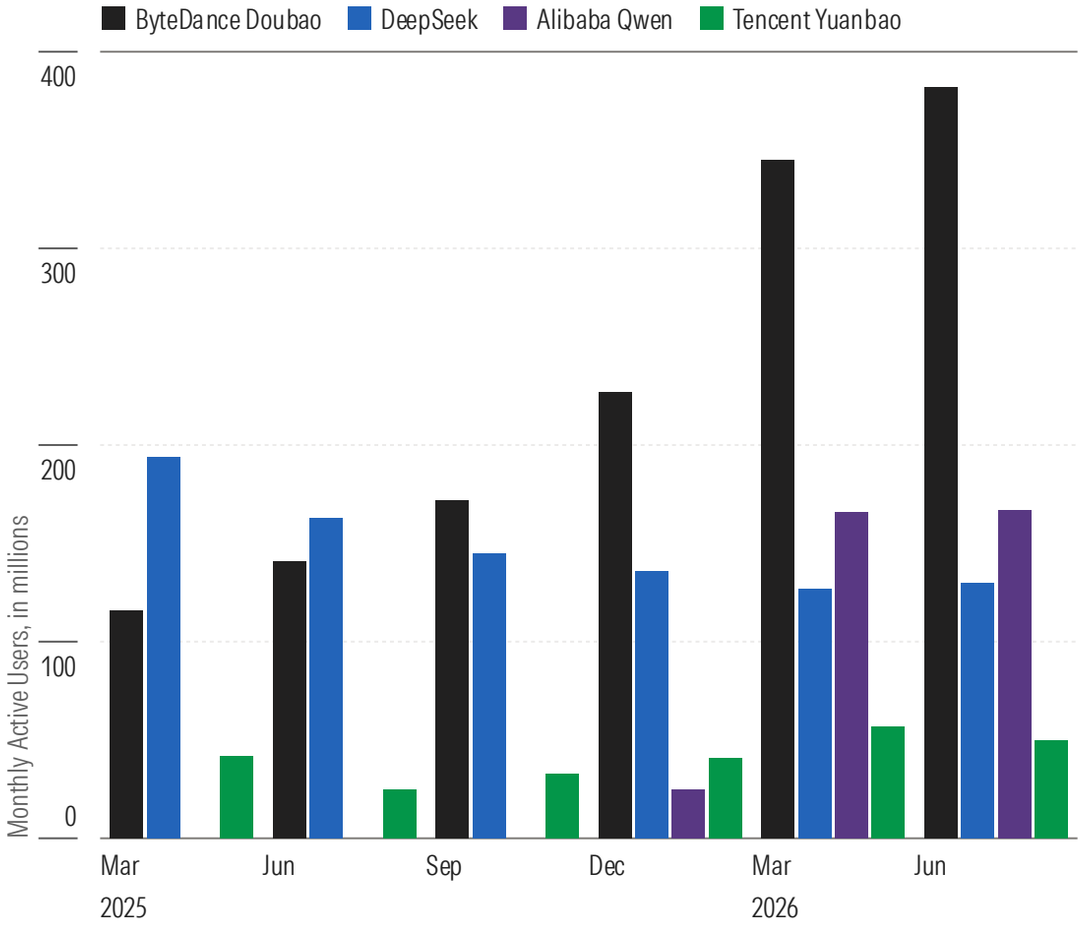
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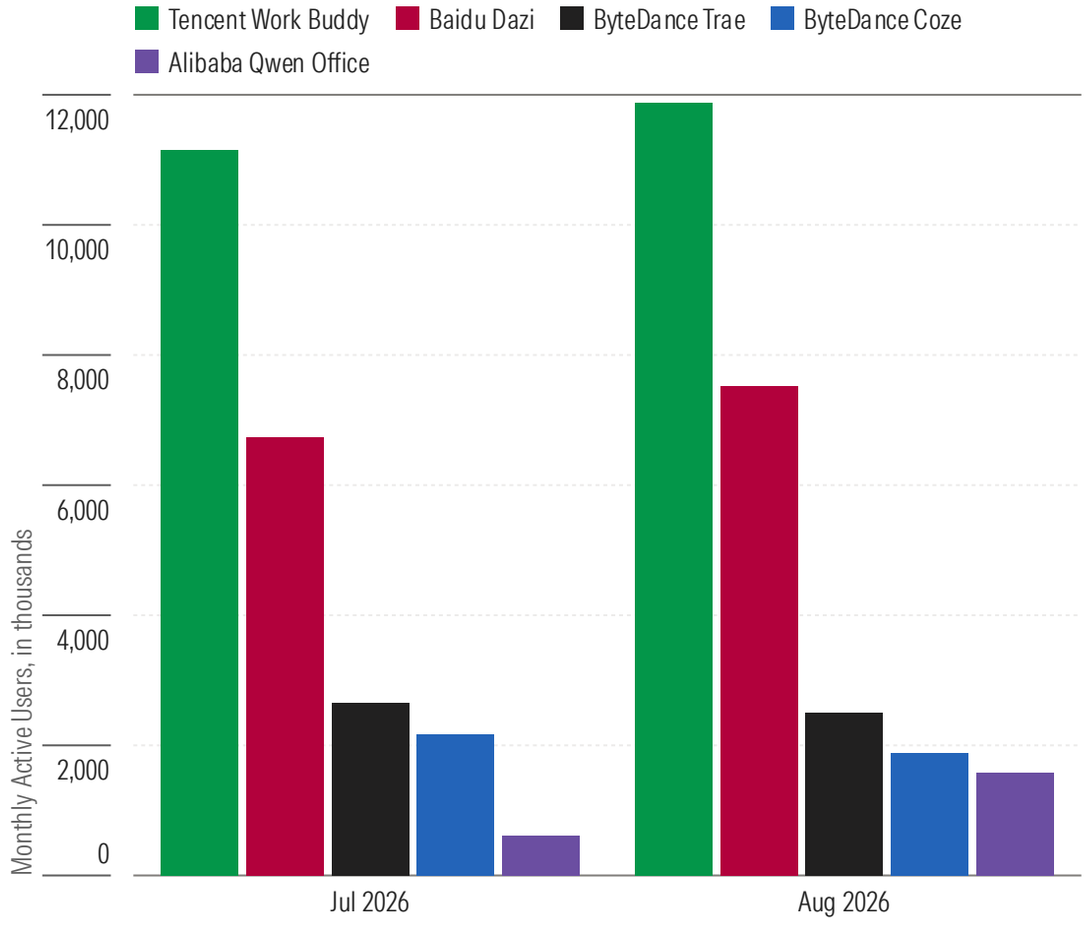
Source: Artificial Analysis. Data as of Sept. 9, 2026.

Consumer and Office AI Apps Gain Users in China

Doubao Widens Its Lead Among Consumer AI Apps



Tencent WorkBuddy Leads Office AI Apps



Source: QuestMobile. Data as of Sept. 9, 2026 (left). AICPB. Data as of Sept. 22, 2026 (right).

AI's Impact on Revenue

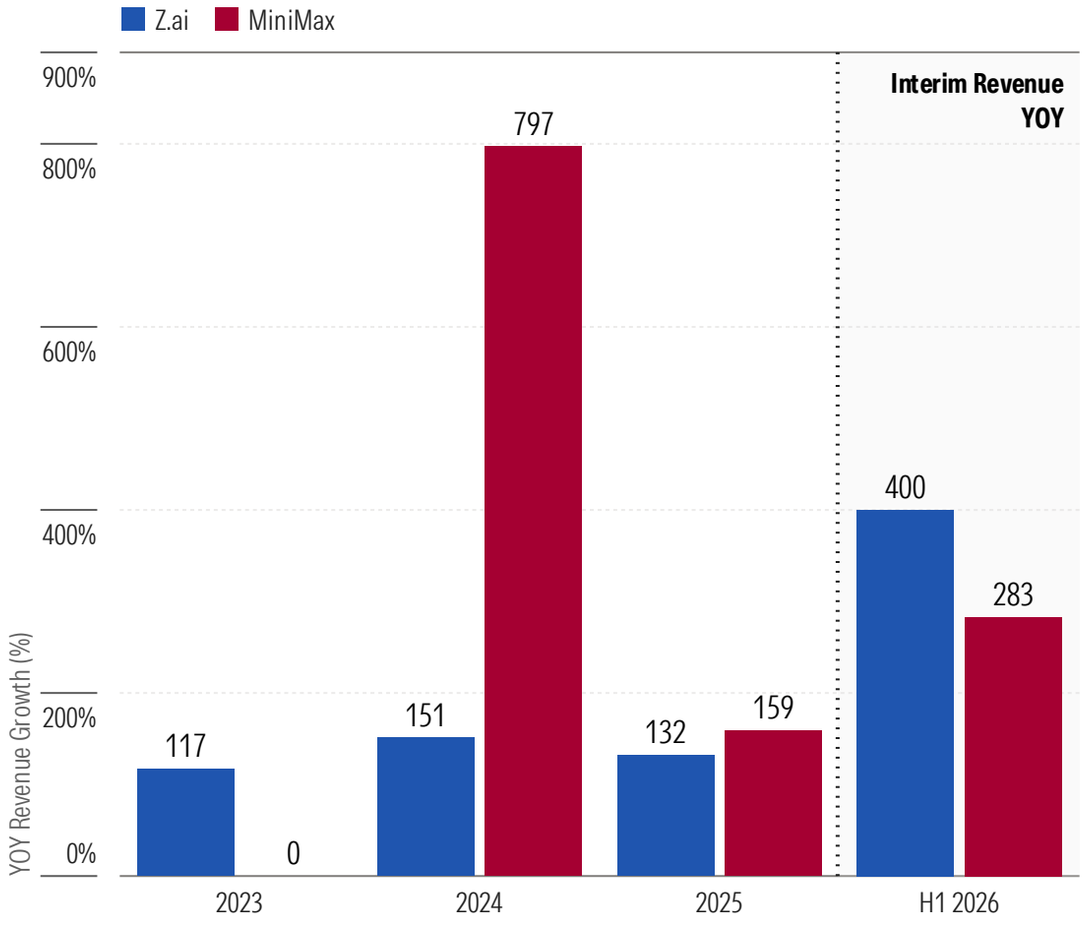
AI is lifting revenue for model firms, cloud, and selected internet services.

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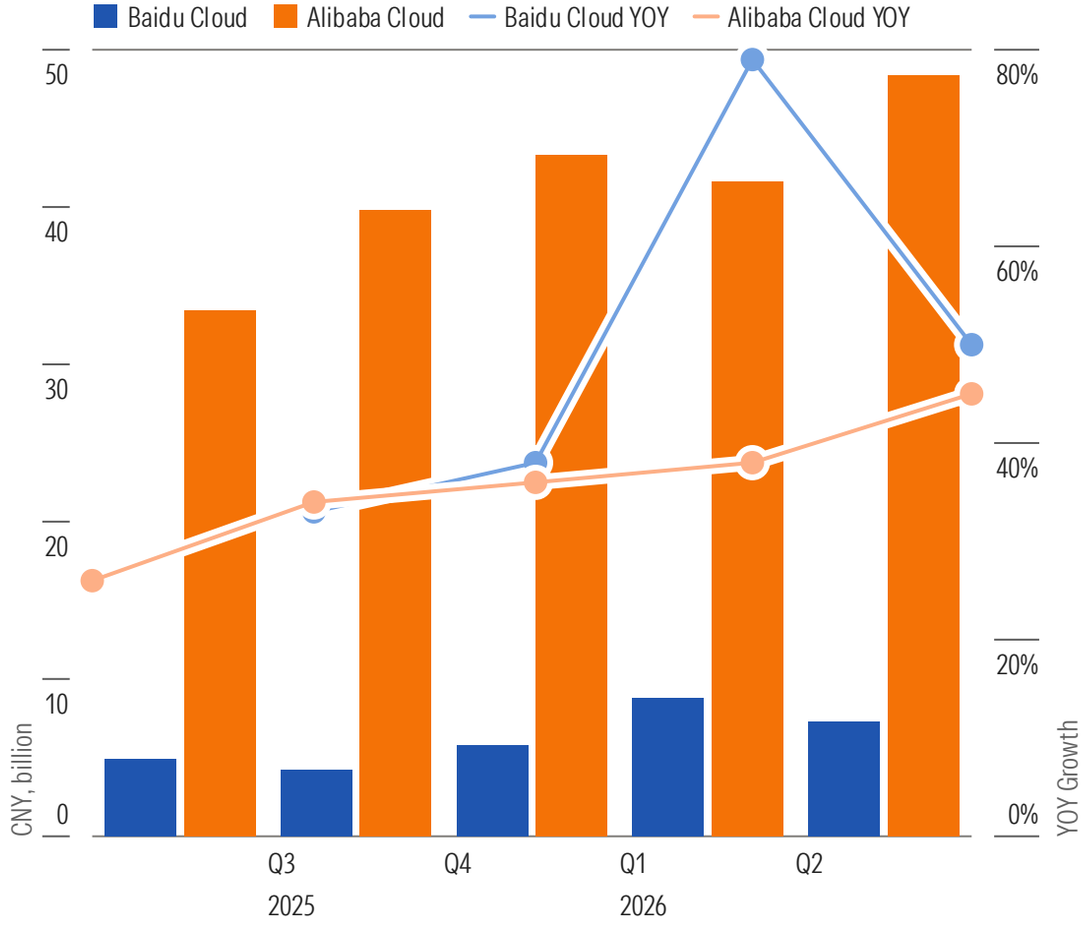
Surging Demand for Chinese Models Lifts Revenue of Listed Model Firms and Cloud Providers

Listed Chinese Model Firms Registered Robust Year-Over-Year Revenue Growth



Cloud Revenue Growth Is Driven by Token Usage and Model Firms' Cloud Usage

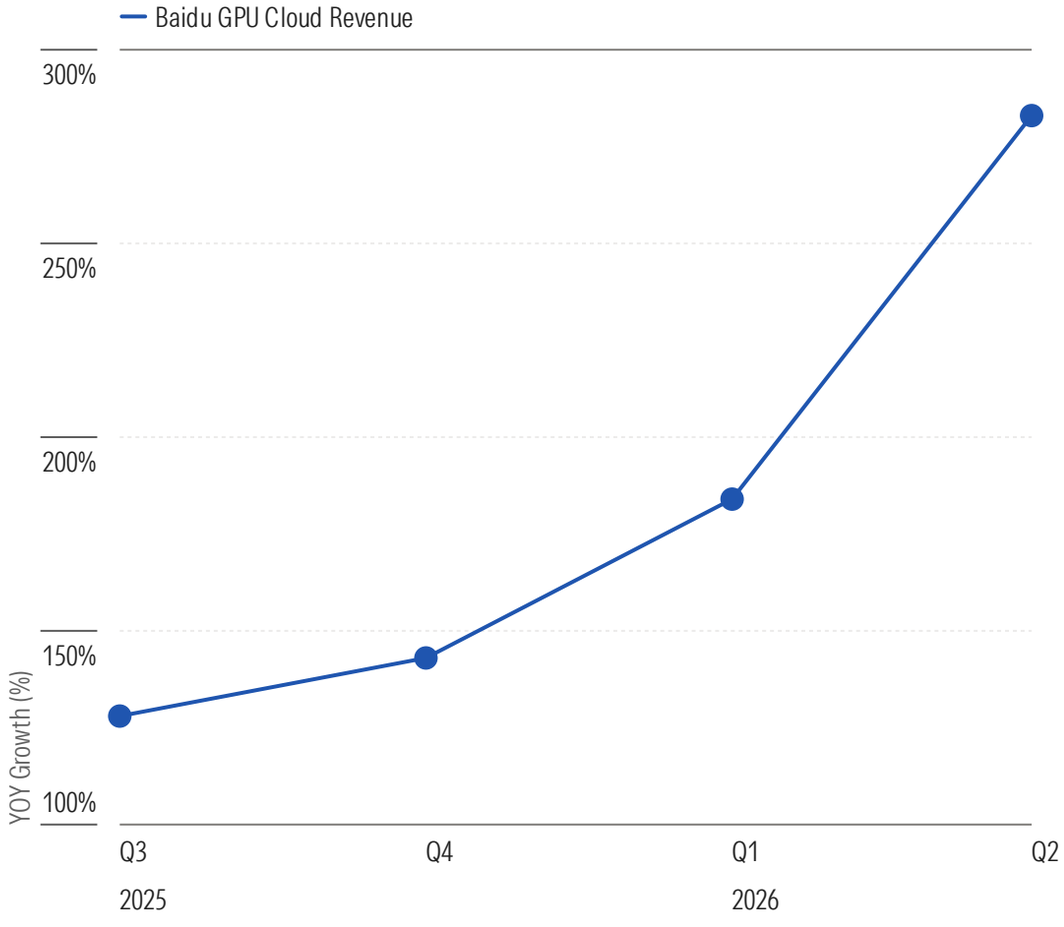
Chinese model firms mull open-source model revenue-sharing with platforms and users.



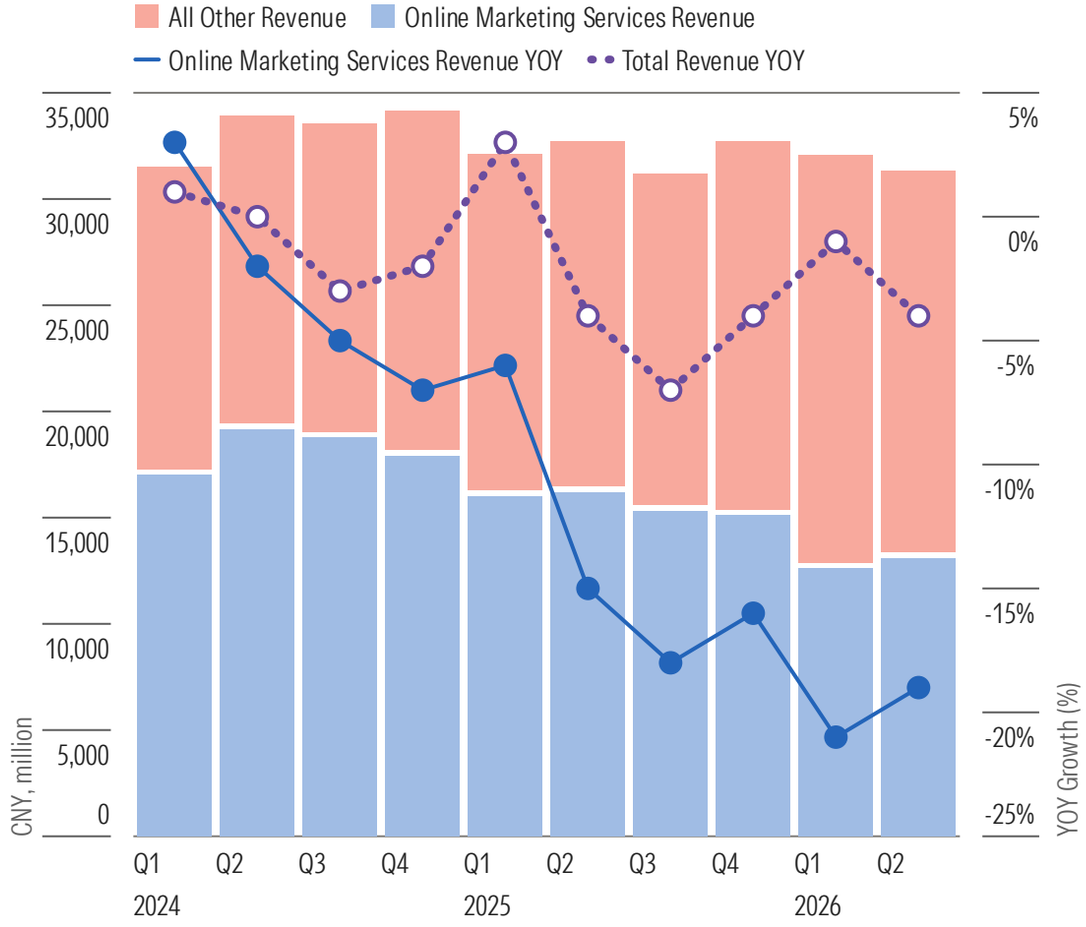
Source: Company data. Data as of Sept. 9, 2026. MiniMax reported zero revenue in 2022 (left).

AI Cloud Growth Partially Offsets Baidu's Ongoing Search Weakness

Baidu's GPU Cloud Revenue Skyrocketed Amid Surging AI Demand ...



Partially Offsetting Revenue Pressure From AI-Driven Search Disruption



Source: Company data. Data as of Sept. 21, 2026. Baidu GPU cloud revenue is part of total cloud revenue.

AI's Payoff Is Also Showing Up in Traditional Businesses Like Ads and Games

A few internet companies now tie AI directly to advertising revenue growth. No one isolates the contribution cleanly, but the picture is getting clearer.

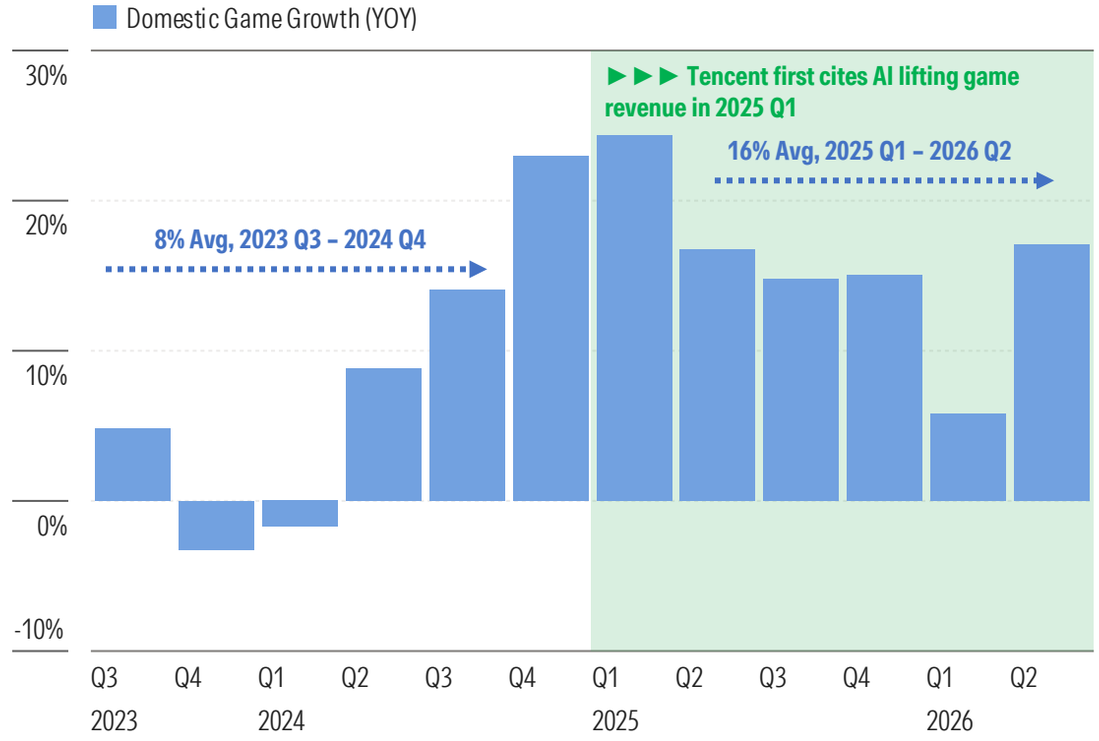
Since embedding AI in gaming content production and live ops, Tencent's domestic games growth has accelerated and held in consistent double digits, excluding Lunar New Year timing impact.

AI's Advertising Lift Is Showing Up in Both Performance Metrics and Revenue

Quarter	Company	Disclosure Summary	Evidence Type
2025 Q3	Bilibili	AI content and ad recommendations improved distribution efficiency by >10%.	Supporting operating indicator
	Kuaishou	Large AI models added 4%–5% to domestic ad revenue growth.	Supporting operating indicator
2025 Q4	Kuaishou	Large AI models added 5% to domestic ad revenue growth.	Supporting operating indicator
	Tencent	AI ad model, creative tools and automated campaigns drove much of the 19% ad revenue growth.	Direct revenue linkage
	Bilibili	Deep-conversion ad spend rose 40%; AI-advertiser budgets rose ~180%.	Direct revenue linkage
2026 Q1	Kuaishou	AI added 4pp to domestic ad revenue growth.	Direct revenue linkage
	Bilibili	AI targeting lifted CTCVR 25% YOY.	Direct revenue linkage
	Tencent	30% of advertiser spend now runs through the AI automated campaign tool.	Direct revenue linkage
2026 Q2	Tencent	Ad revenue +22% on higher ad prices and impressions, plus wider recommendation-model use.	Supporting operating indicator
	Kuaishou	AI ad technology added 1%–2% to incremental ad revenue growth.	Supporting operating indicator
	Bilibili	AI ad matching lifted CTCVR 19% YOY.	Supporting operating indicator

Direct revenue linkage Supporting operating indicator

Tencent's Domestic Games Growth Accelerated as It Began Using AI



Source: Company filings, Morningstar. Data as of September 2026. CTCVR = click-through and conversion rate, representing the probability that a user will both click on an ad or item and complete a conversion (like a purchase) after seeing an impression.

AI Spending and Returns

Heavy AI spending weighs on near-term returns.

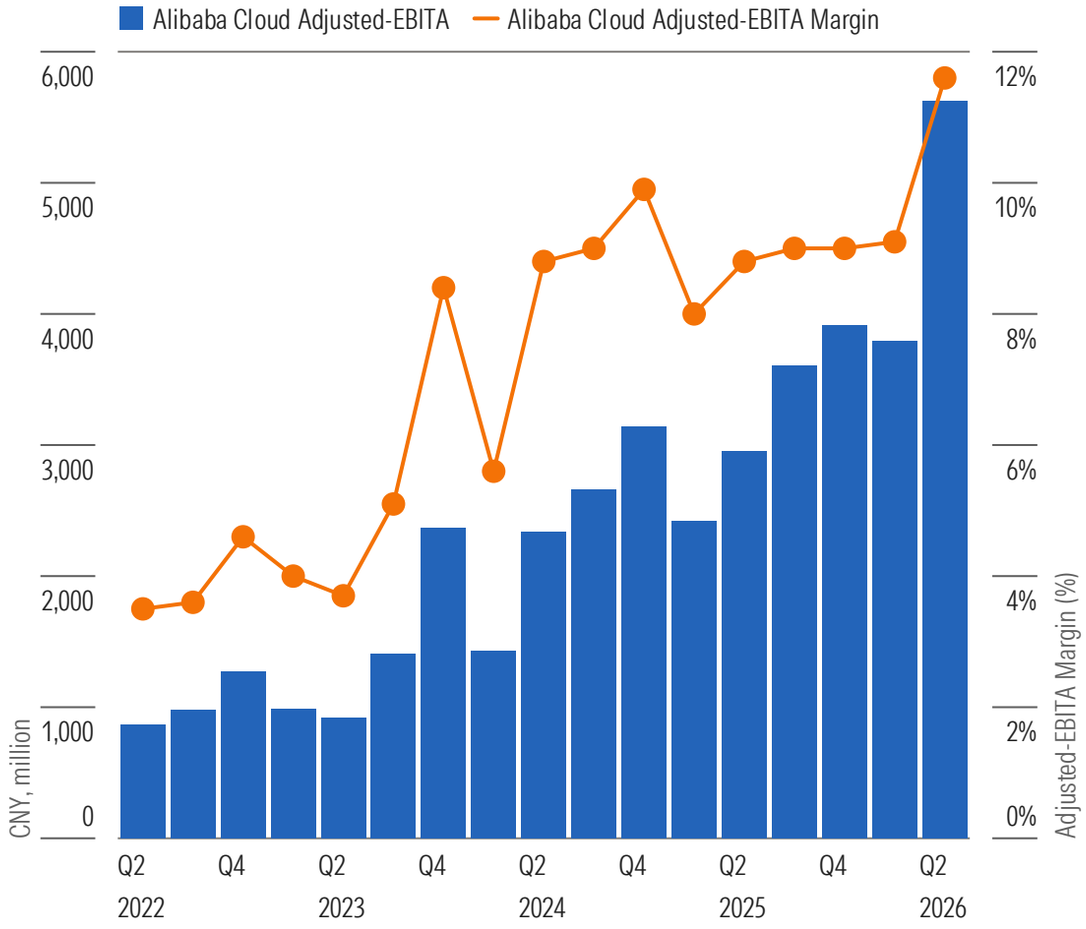
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Cloud Profits Rise, but AI-Related Losses Remain Large

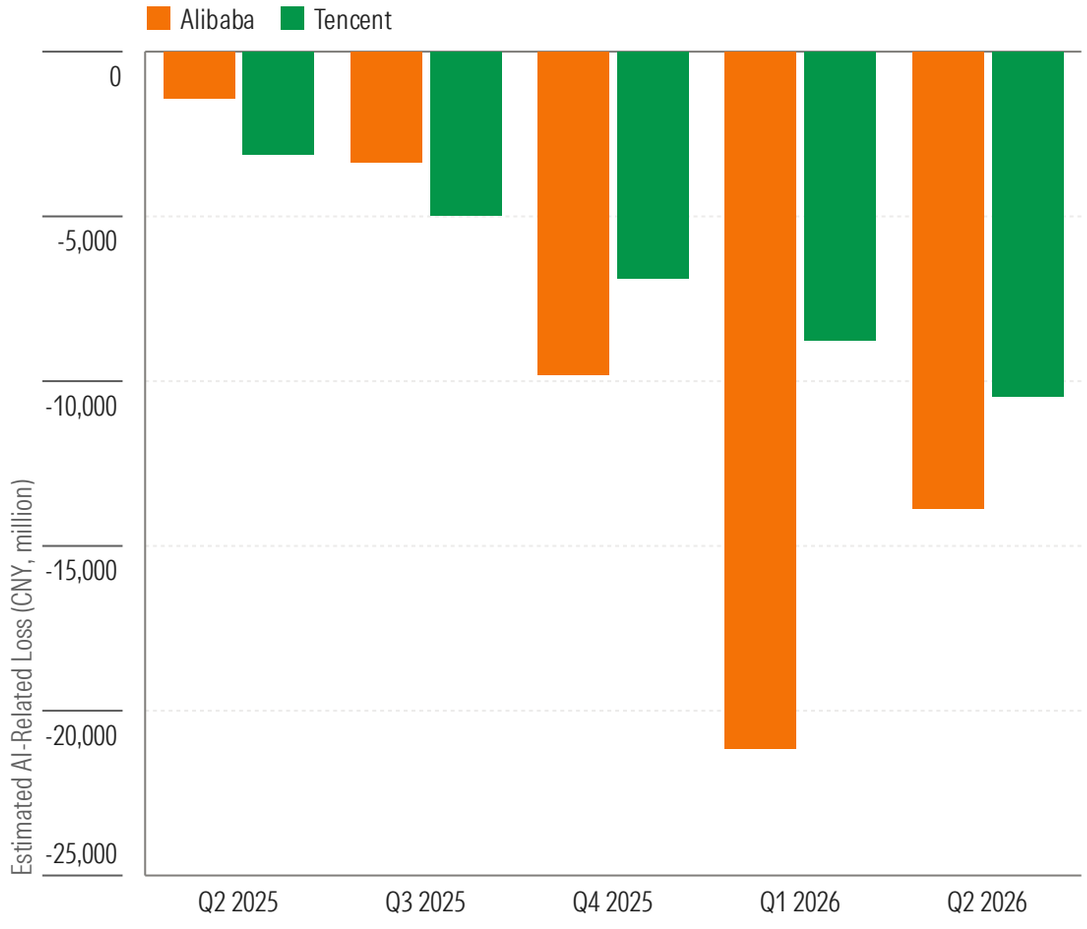
Alibaba Cloud Margin Increases Due to Higher Mix of AI Businesses and Efficiency

Alibaba believes cloud margin can reach 20% in a few years, thanks to AI businesses.



But Cloud Profit Is Outweighed by AI Training, Inference, and Marketing Costs

Tencent's AI-related losses are widening as it invests more in models and AI agents.

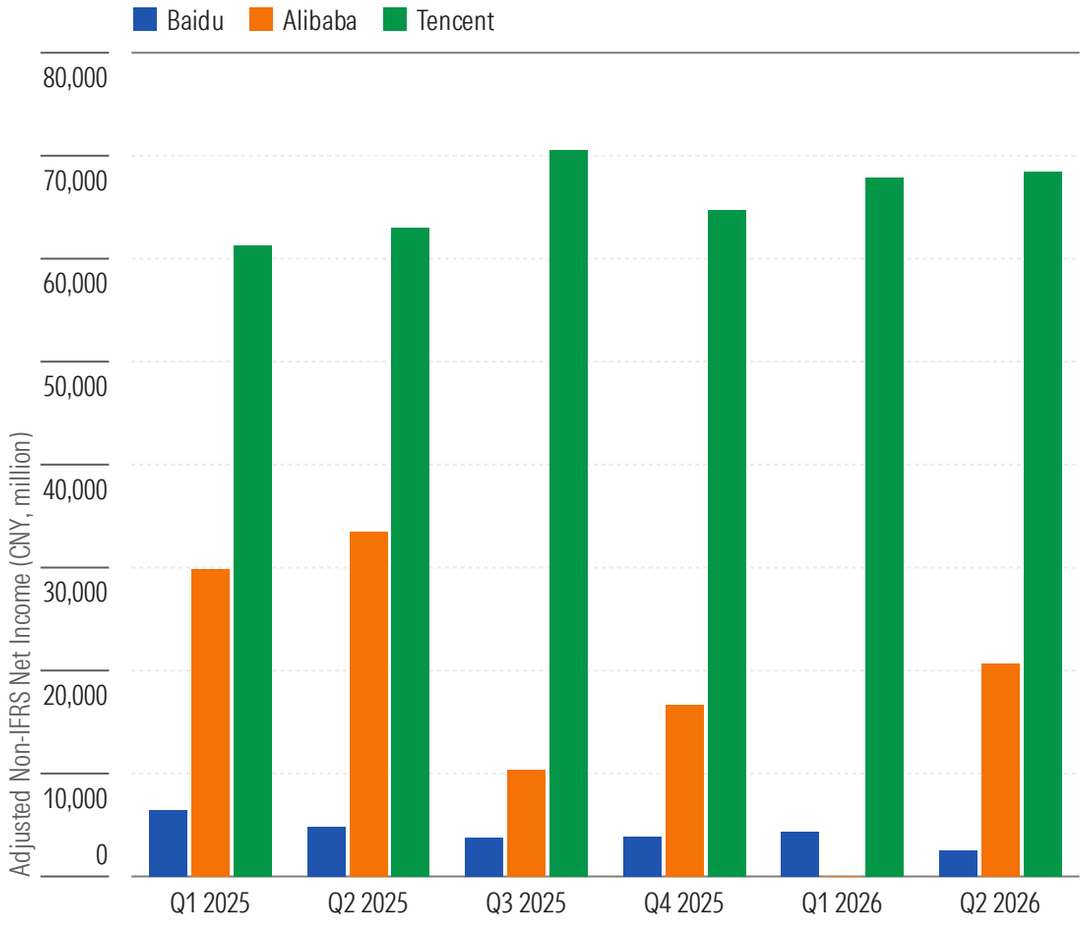


Source: Company data. Data as of Sept. 21, 2026. Alibaba cloud adjusted EBITDA = AI cloud and compute services since June quarter 2026 and cloud intelligence group before June quarter. Alibaba's AI-related losses = all others losses before June quarter and LLM firms and applications loss since June quarter. Tencent separately reports non-IFRS EBIT losses from new AI products, including Hunyuan, Yuanbao, CodeBuddy, WorkBuddy, and QClaw/Xiaowei.

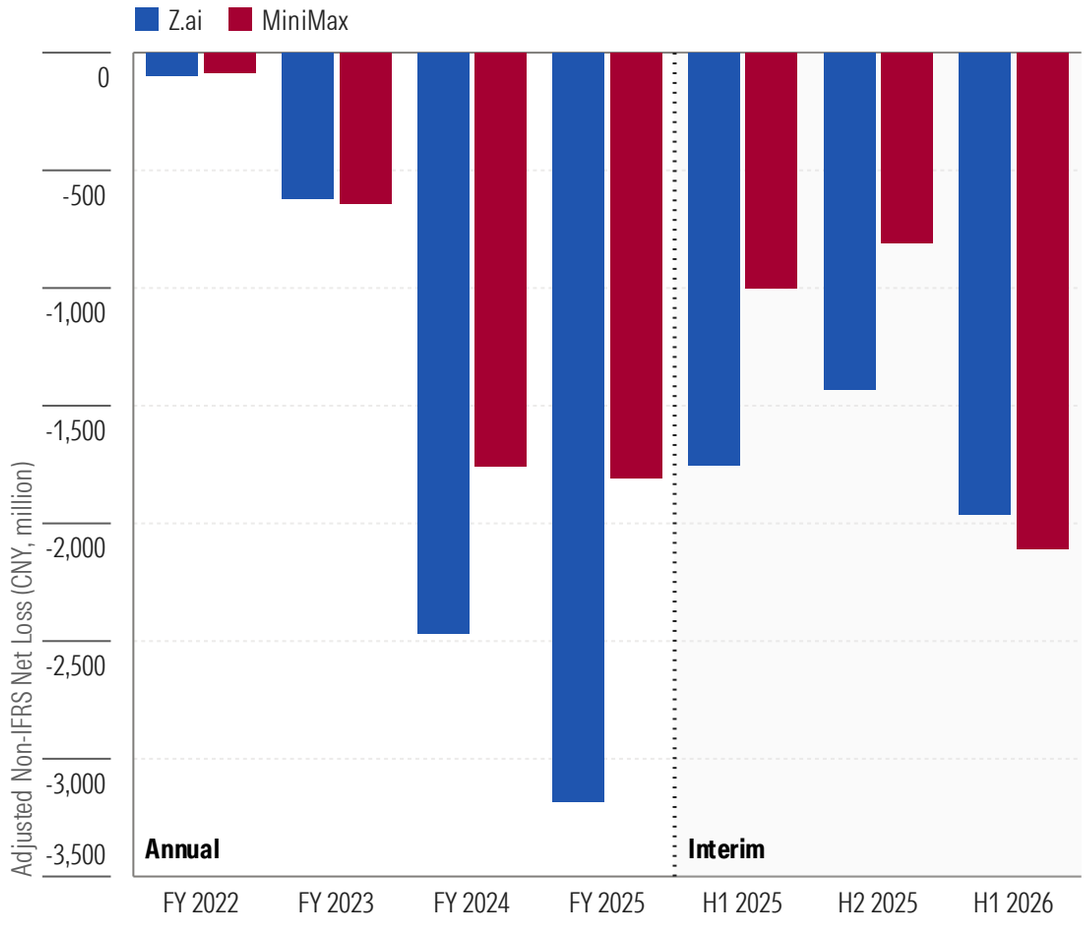
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Internet Firms Stay Profitable While Independent Model Firms Post Losses

Core Businesses Keep Internet Firms Profitable Despite AI Investments



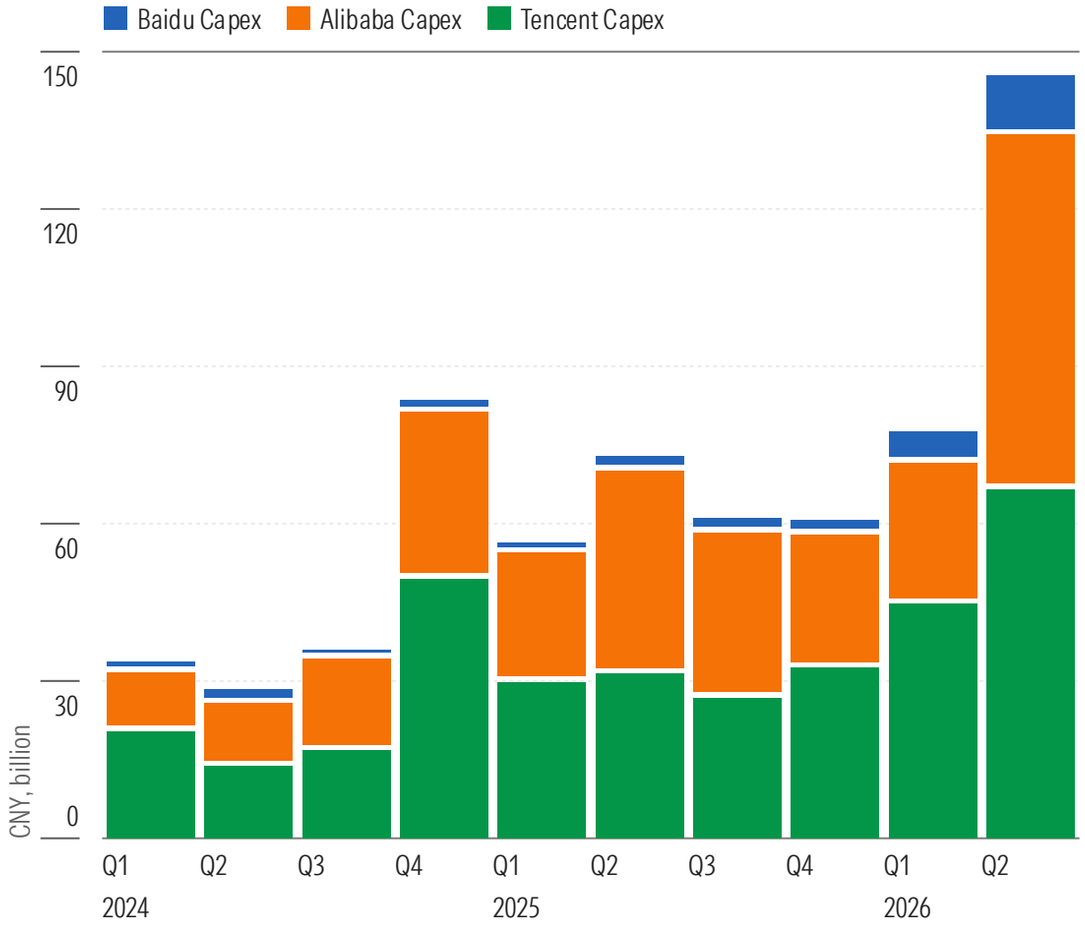
Model Firms Z.ai and MiniMax Don't Have the Same Advantage; Net Loss Expanded



Source: Company data. Data as of Sept. 11, 2026. Alibaba's reported figures have been calendarized for comparability (left).

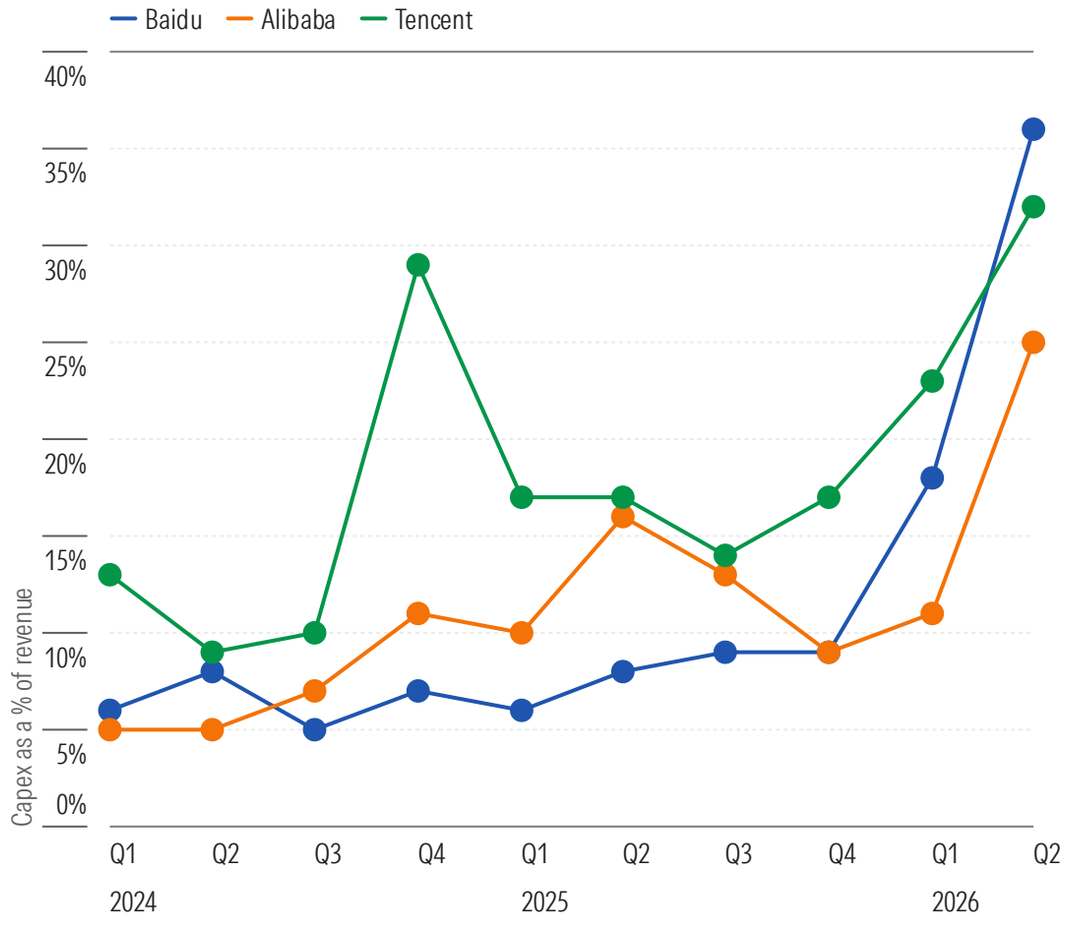
AI Capex Rises Now, but Capital Intensity Should Ease Later

Chinese Cloud Providers' Capex Surges



Capex Intensity Hits New Highs at All Three Firms

Near-term capex intensity is abnormally high as advanced chips are in short supply.



Source: Company data. Data as of Sept. 11, 2026. Alibaba's reported figures have been calendarized for comparability.

China AI Semiconductors

AI spending news pushes share prices beyond our fair value estimates.

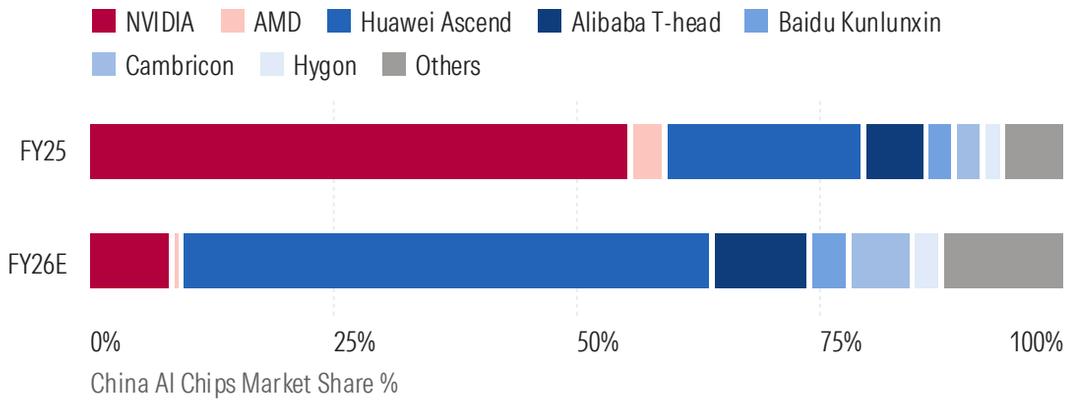
Phelix Lee
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Jing Jie Yu
Equity Analyst

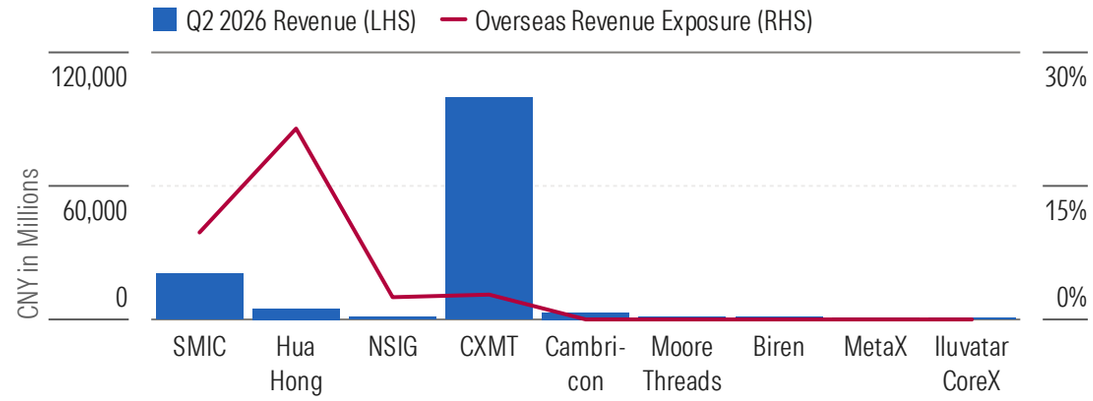
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Chinese AI Chip Suppliers Use Large Domestic Market to Insulate From US Policy Curbs and Fund Catch-Up

Domestic AI Chip Adoption Continues to Accelerate in China

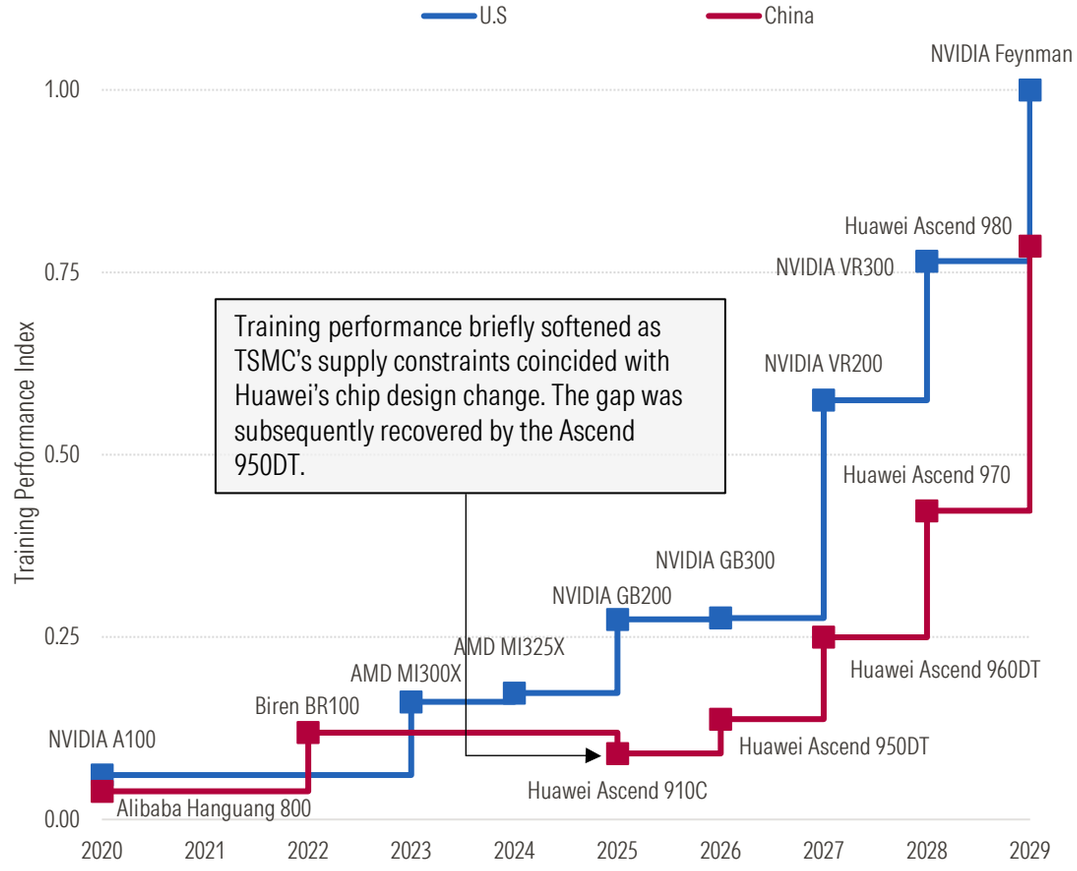


Near-Zero Overseas Exposure Insulates China From Reciprocal Curbs



Technology Parity With Leading US AI Chips Remains Elusive

Huawei narrows the generation gap with Nvidia, but a performance deficit persists.



Source: IDC (top left). Company filings, Morningstar estimates (bottom left, right). Data as of September 2026. SMIC = Semiconductor Manufacturing International Corp., NSIG = National Silicon Industry Group, CXMT = ChangXin Memory Technologies.

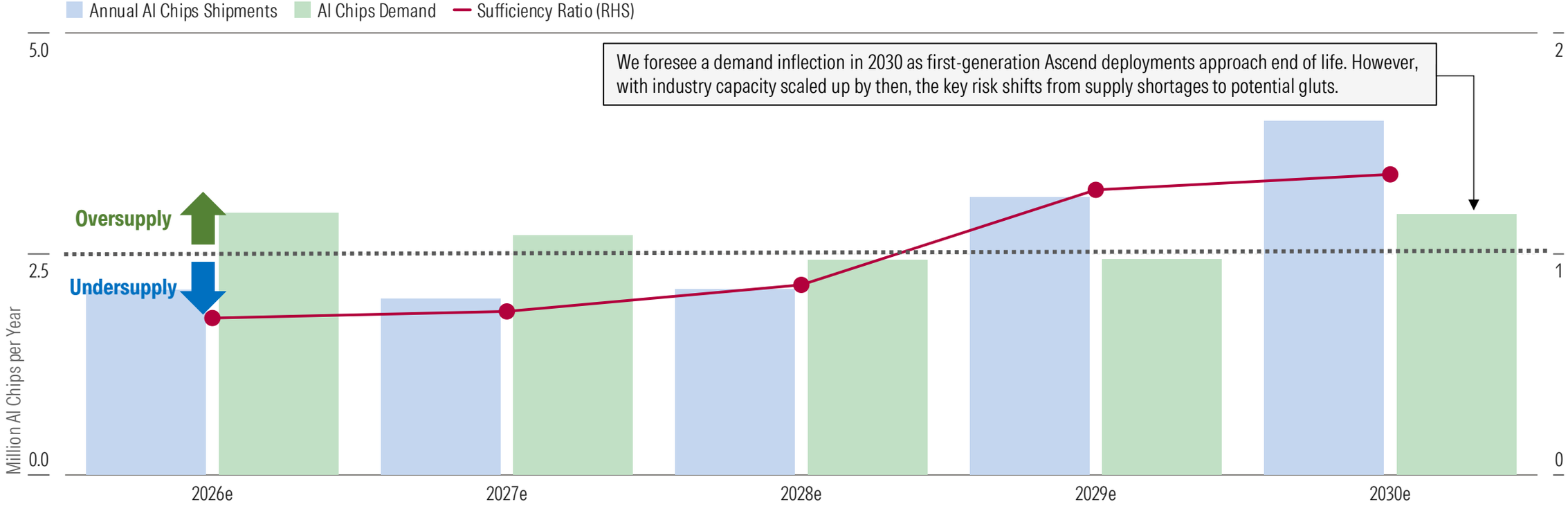
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China AI Chip Shortage Set to Ease, With Oversupply Risk Emerging After 2028

We expect domestic AI chip supply to remain below demand through 2028, with the gap narrowing as SMIC improves advanced-node yields, expands capacity, and allocates a greater share to AI chip production. The inflection comes in 2029 as these supply drivers compound. On demand, China's data center capacity grows from 40 gigawatts in 2026 to 60 GW by 2030 with AI/high-performance computing's share rising from 39% to 48%, but growth of number of chips moderates through 2027-29 as capacity additions slow from the 2026 peak.

AI Chip Demand From Data Center Buildout Outpaces Domestic Shipments Until 2029, Before Supply Growth Takes Over

SMIC yield improvement at advanced nodes is the key swing factor to unlock meaningful incremental output without additional wafer capacity.



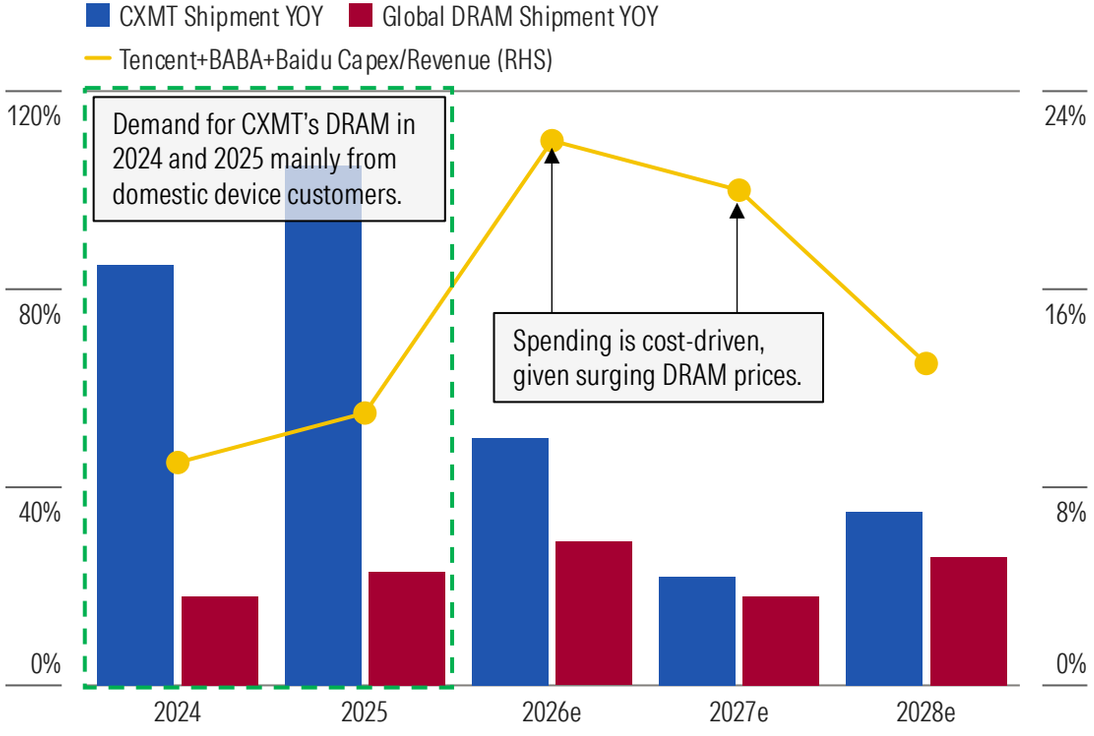
Source: Rystad Energy, Morningstar estimates, Semi, Gartner, IDC. Data as of September 2026.

Chinese Memory Players Benefit From Domestic AI Investments, but We Stay Sidelined by Aggressive Expansion

While Chinese memory chips have seen surging adoption by global device players in the past two quarters, we see incremental demand driven mainly by domestic internet leaders, as AI memory investments reaccelerate alongside an improvement in Chinese-made logic chips. We expect CXMT and YMTC to benefit from strong shipment growth into 2028. That said, rich valuations imply lofty earnings outlook through the decade. We stay conservative, given cyclicality risks longer-term from aggressive supply growth over the next five years.

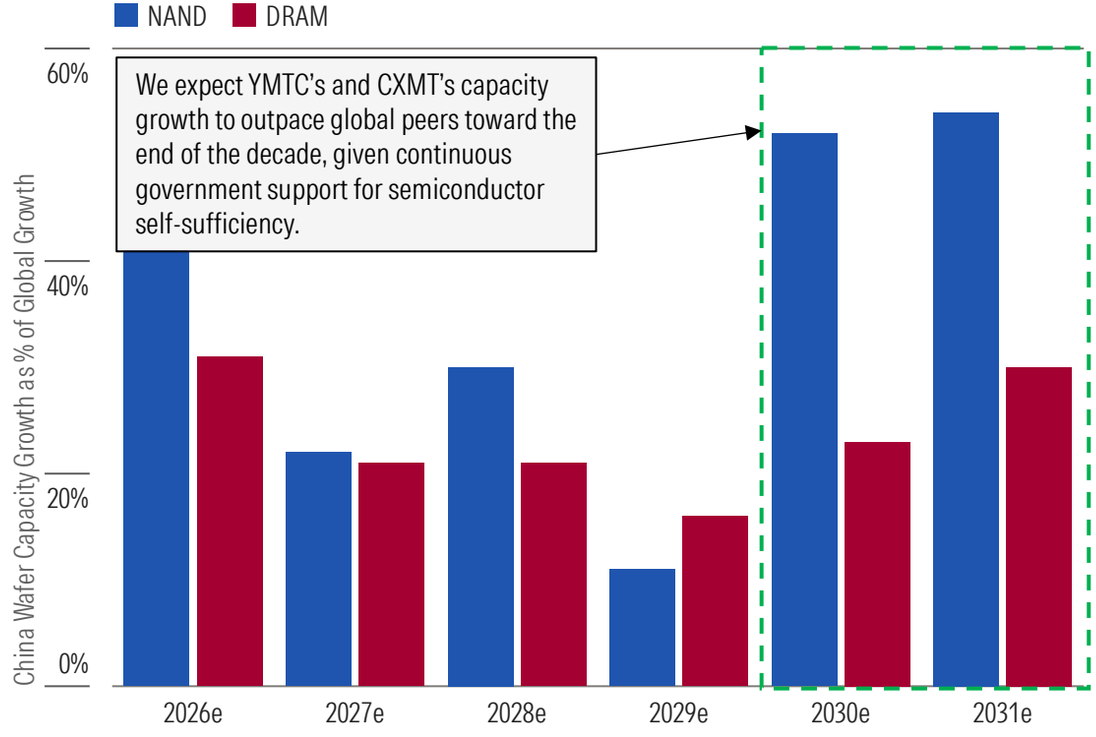
We Expect CXMT to Benefit as Enterprise Domestic Demand for AI Accelerates

CXMT's improving DRAM capabilities drive adoption by Chinese internet players.



Aggressive Domestic Capacity Expansion Keeps Us Wary of Cyclicality in Memory

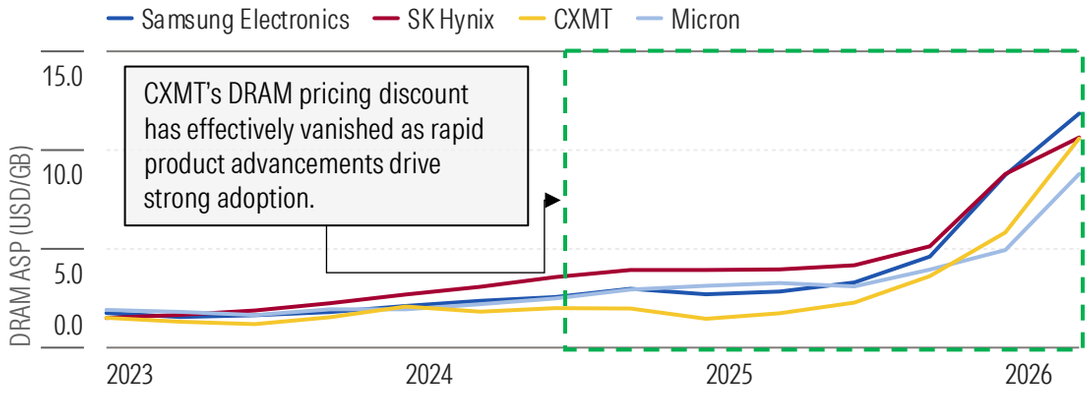
We do not expect domestic memory capacity growth to slow even in the long run.



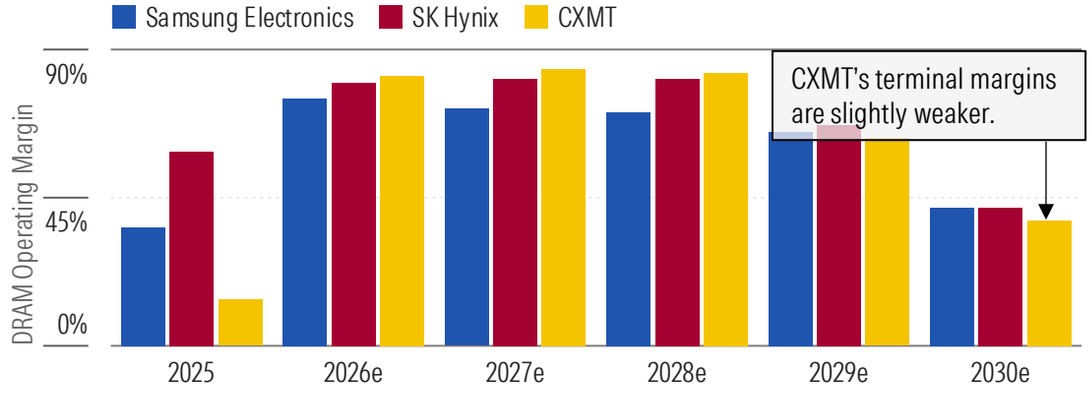
Source: Morningstar estimates, Gartner, IDC. Data as of September 2026. YMTC = Yangtze Memory Technologies Co.

Domestic AI Memory Demand Driven by Improving Chipmaking Capabilities; Impact of Tooling Restrictions Mixed

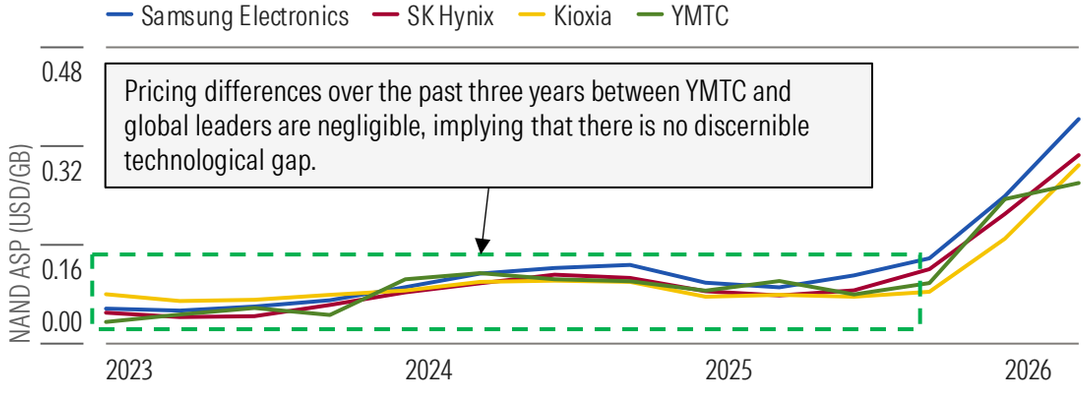
China's DRAM Proves Increasingly Competitive to Peers as Price Gap Closes ...



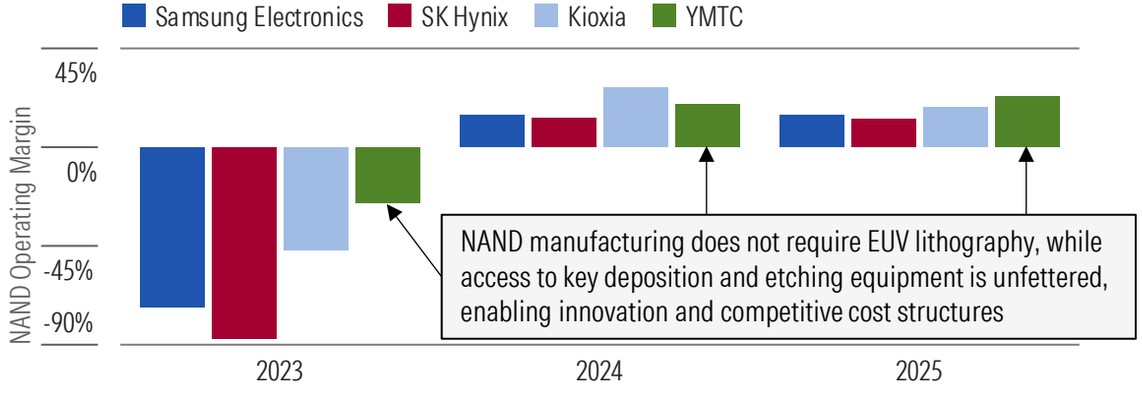
But Slight Technological Gaps Persist in DRAM From Equipment Restrictions



Chinese NAND Technology Has Been Neck-and-Neck With Global Peers ...



And We Do Not See NAND Facing Any Material Manufacturing Headwinds



Source: Company filings, Morningstar estimates, IDC. Data as of September 2026.

Powering China's AI Growth

Power transmission and storage are the bottlenecks.

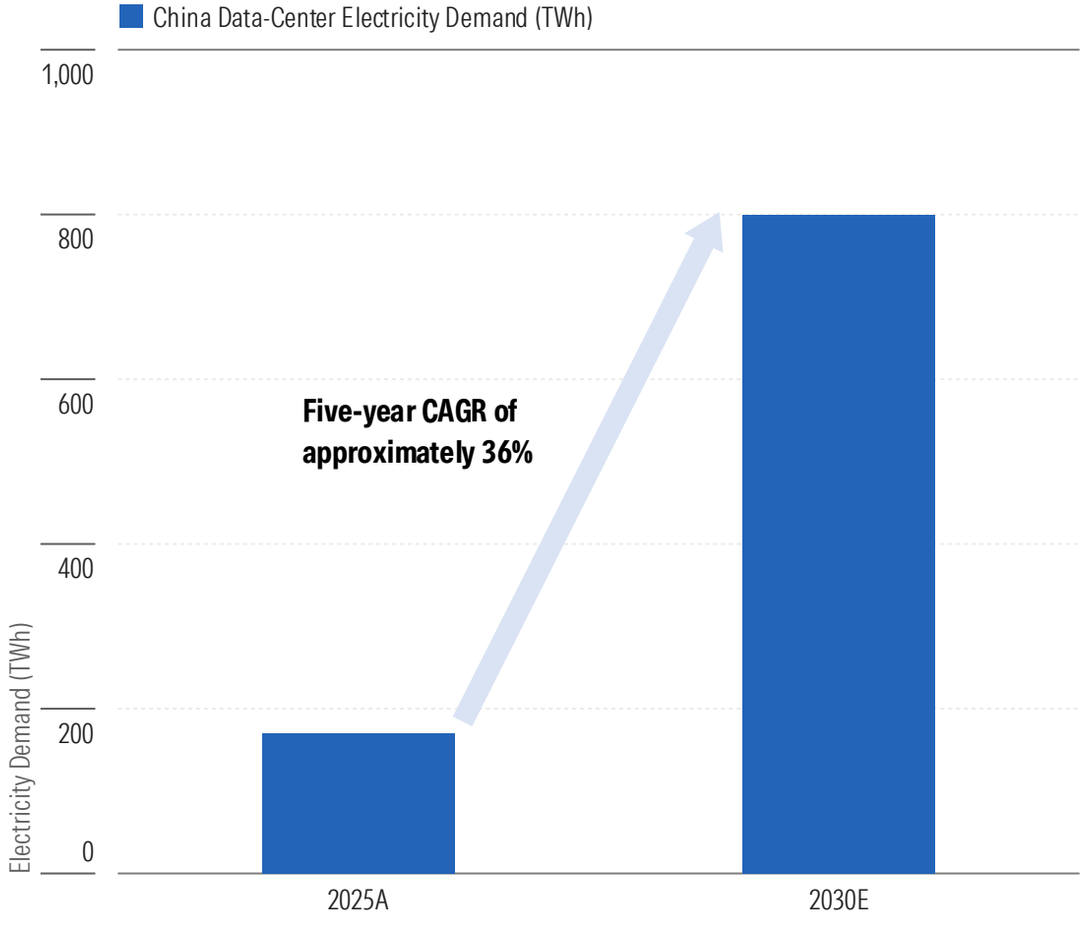
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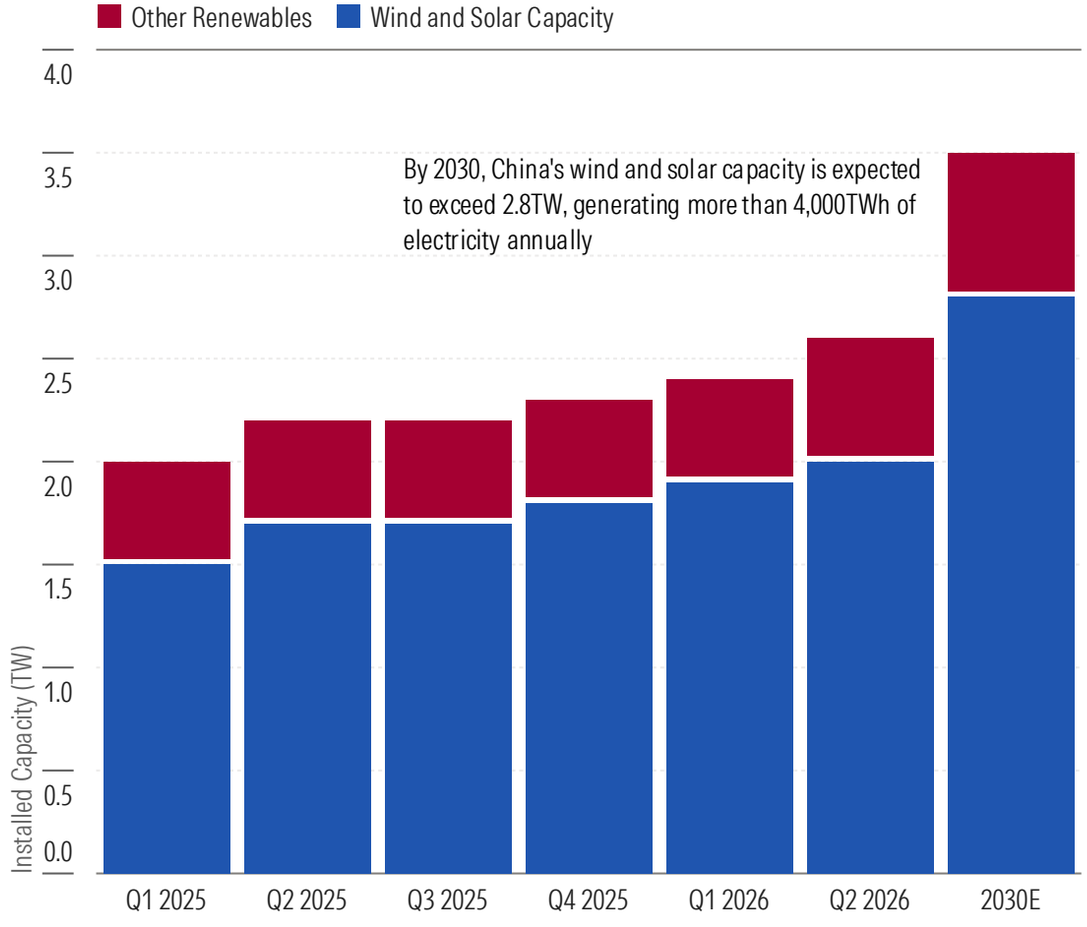
China's Electricity Supply Is Sufficient to Meet AI-Led Demand, but Transmission and Storage Are Not

China's Data Center Electricity Demand Is Set to Rise Rapidly



Renewable Energy Supply Expansion Should Outpace Incremental Demand

Transmission, storage, and grid integration are bottlenecks worth monitoring.



Source: China National Energy Administration, China Electricity Council, Morningstar estimates. Data as of Sept. 22, 2026.

Top Picks and Coverage

Our top picks are Tencent and Alibaba.

Tencent's User Scale Positions Its AI Agent for Success; Alibaba's Full-Stack AI Capabilities Drive Efficiency

Tencent Is Undervalued Even If AI Doesn't Deliver

Tencent Holdings (HKG:00700)



Market Cap	Moat Rating	Last Close	Fair Value Est.	Rating
451.86B USD	Wide	HKD 410	HKD 780	★★★★★

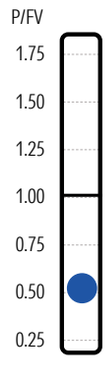
The market assumes Tencent's AI agent business has negative economic value because it requires heavy investment with uncertain returns. This view has contributed to a decline of approximately 30% in the shares this year. We disagree. We think Tencent will benefit from greater user stickiness once the AI agent is launched inside WeChat, which strengthens the ecosystem behind its existing revenue. We also see three potential paths to direct monetization: a cut of agent-facilitated transactions, higher ad revenue from better targeting, supported by richer user-intent signals gathered by Xiaowei, and a paid subscription tier for advanced AI features.

Most importantly, our valuation does not require the current AI spending to earn its cost of capital. We view much of the spending as discretionary, and we expect management to scale it back if returns fail to meet its targets. This limits the risk that heavy investment permanently erodes returns, so our valuation does not rely on the spending to create economic value.

Tencent's moat rests on WeChat and its games portfolio, and neither depends on AI. WeChat controls the social graph, payments, and the miniprogram ecosystem, and an outside agent would have to work through all three. The games are protected by established IP and player networks. People play where their friends play, and an AI entrant can't quickly copy either. We therefore don't expect AI entrants to erode either advantage. Our valuation holds without AI success, so any monetization is upside.

Alibaba Poised to Capture AI Upside Through Cloud and Model Leadership

Alibaba Group (HKG:09988)



Market Cap	Moat Rating	Last Close	Fair Value Est.	Rating
262.98B USD	Wide	HKD 104.90	HKD 201	★★★★★

In our view, the market is overly concerned about a near-term increase in the capex/revenue ratio while overlooking the long-term earnings growth from reducing AI hardware supply constraints and costs and monetization. We think return on the current AI capex will be generated after two to three years.

The strong position in cloud and the ability to continuously release state-of-the-art models in China put Alibaba in a strong position to capture enterprise spending in AI in Asia-Pacific. Alibaba is the largest public cloud provider in China with the highest share in AI cloud market and enterprise-level large model invocation. It is also Asia-Pacific's largest infrastructure-as-a-service provider with a market share of 22.5% in 2025.

We like Alibaba's full-stack AI capabilities, as this will allow cost savings in the AI value chain. Its capabilities range from proprietary AI training and inference processors to cloud, AI development platform, Qwen foundational models, and AI apps. Additionally, as one of the largest internet companies in China, its ecosystem spanning omnichannel retail, enterprise productivity, maps, and other businesses provides its AI businesses a rich amount of data, use cases, and monetization opportunities.

Source: PitchBook. Data as of Oct. 20, 2026.

We Prefer Tencent and Alibaba Across Our Coverage

We See More Buying Opportunities in Our China Internet Coverage

Company	Ticker	Industry	Market Cap (US$'b)	Moat Rating	Uncertainty Rating	Trading Currency	Last Close	Fair Value Estimate	Star Rating	P/FVE	2026 P/E	P/B	3M Return	1Y Return
Semiconductor Manufacturing International	HKG:00981	Semiconductors	83.69	None	Very High	HKD	57.65	35.00	★★	1.65	40.81	2.51	-27.6%	-25.7%
Hua Hong Grace Semiconductor	HKG:01347	Semiconductors	33.38	None	High	HKD	94.55	41.00	★	2.31	113.65	3.17	-49.0%	15.7%
Foundry Market-Cap-Weighted Average										1.84	61.58	2.69	-33.7%	-13.9%
Tencent Holdings	HKG:00700	Internet Content & Information	488.63	Wide	High	HKD	424.80	780.00	★★★★★	0.54	14.60	3.34	-7.7%	-34.0%
Alibaba Group	HKG:09988	Internet Retail	274.40	Wide	High	HKD	107.00	201.00	★★★★★	0.53	26.29	1.96	-2.9%	-34.7%
Alibaba Group	NYSE:BABA	Internet Retail	274.40	Wide	High	USD	110.78	207.00	★★★★★	0.54	22.99	1.72	-1.4%	-29.7%
Baidu	HKG:09888	Internet Content & Information	28.39	None	High	HKD	83.00	110.00	★★★★	0.75	17.37	0.83	-28.1%	-34.1%
Baidu	NASDAQ:BIDU	Internet Content & Information	28.39	None	High	USD	84.30	113.00	★★★★	0.75	14.78	0.72	-28.3%	-30.7%
Kuaishou	HKG:01024	Internet Content & Information	16.03	None	Very High	HKD	30.10	45.00	★★★★	0.67	21.22	1.58	-30.1%	-63.3%
Internet Retail Market-Cap-Weighted Average										0.55	18.80	2.75	-7.2%	-34.8%
CXMT	SHG:688825	Semiconductors	490.34	None	Very High	CNY	51.00	23.00	★	2.22	16.69	22.79		
Memory Market-Cap-Weighted Average										2.22	16.69	22.79		
National Silicon Industry Group	SHG:688126	Semiconductor Equipment & Materials	10.10	None	High	CNY	21.37	6.60	★	3.24	(76.32)	3.64	-41.3%	-17.6%
Silicon Suppliers Market-Cap-Weighted Average										3.24	(76.32)	3.64	-41.3%	-17.6%
Overall Market-Cap-Weighted Average										**1.25**	**20.91**	**9.65**	**-7.2%**	**-21.0%**

Source: PitchBook. Data as of Oct. 12, 2026. CXMT was listed on July 27, 2026.

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