

INITIATE COVERAGE

Sea (SE US)

Testing Times For Key Segments

Share price has recovered about 50% after a narrower net loss in 3Q22, but we are doubtful that huge profitability could be attained with slower growth from the digital entertainment and e-commerce segments. We are also cautious on the risks of potential divestment by major shareholder Tencent and the huge amount of convertible notes in 2025-26. However, Shopee's dominant market share in ASEAN could allow it to leverage on higher growth opportunities. Initiate coverage with HOLD. Target price: US\$58.77.

INITIATE COVERAGE

- **Headwinds for the only profitable segment – Digital entertainment.** Sea Limited (Sea) has lowered its 2022 booking guidance by 10% to US\$2.6b-2.8b (US\$2.9b-3.1b previously). It has faced headwinds recently, such as India banning Free Fire and Riot Games taking back distributionship from Garena, Sea's digital entertainment arm. We foresee further deterioration in the segment's revenue and profitability as users spend less time and resources on gaming and the segment focuses more on internally-developed games. Also, heavy reliance on a single game, Free Fire, is a risk to be noted. For 2022 and 2023, we foresee a respective 28% and 13% decline in the segment's operating profit.
- **Cautious on e-commerce segment's profitability.** Sea expects its e-commerce arm, Shopee, to reach EBITDA breakeven by end-23. However, we are cautious on the slower sales growth, weaker consumer spending power and potential loss of market share. Interestingly, Shopee's sales and marketing expenses per new order surged from US\$1.40 in 1Q20 to US\$6.70 in 2Q22, indicating higher customer acquisition costs. We attribute the huge jump mainly to the new peripheral market expansion in Latin America.
- **Risk of divestment by major shareholder Tencent.** We think that the risk of potential divestment of Sea's stake by its second largest shareholder Tencent, which has 18.6% shareholding, should not be taken lightly. Garena's earnings may also be affected if Tencent decides to distribute their games by themselves. Out of the current 15 games published by Garena, six were developed by Tencent.
- **Huge amount of convertible notes due in 2025-26 puts Sea's financial strength at risk.** By end-25, Sea would have US\$1.1b worth of convertible notes due (at a convertible price of US\$90.46/share). In the following year, another US\$2.9b would be due (convertible price of US\$477.01/share). With these two convertible notes totalling US\$4.0b being way out of the money, Sea's adjusted net cash position as of 3Q22 is only around US\$3.1b, after deducting US\$4.2b from its total cash position of US\$7.3b. To recap, Sea's net cash outflow for 9M22 alone already reached US\$3.2b. Even at a reduced burn rate from 2023 onwards, Sea's financial strength is weaker than it appears.

Click [here](#) for Blue Top dated 12 Dec 22

KEY FINANCIALS

Year to 31 Dec (US\$m)	2020	2021	2022F	2023F	2024F
Net turnover	4,376	9,955	11,419	14,629	16,892
EBITDA	(1,303)	(1,583)	(2,419)	(1,120)	365
Operating profit	(1,303)	(1,583)	(2,419)	(1,120)	365
Net profit (rep./act.)	(1,618)	(2,047)	(2,914)	(1,567)	(220)
Net profit (adj.)	(1,618)	(2,047)	(2,914)	(1,567)	(220)
EPS (US\$ cent)	(316.1)	(383.8)	(525.1)	(270.2)	(35.1)
PE (x)	n.m.	n.m.	n.m.	n.m.	n.m.
P/B (x)	9.2	4.4	6.7	8.6	6.8
EV/EBITDA (x)	n.m.	n.m.	n.m.	n.m.	79.3
Dividend yield (n.a.)	n.a.	n.a.	n.a.	n.a.	n.a.
Net margin (%)	(37.0)	(20.6)	(25.5)	(10.7)	(1.3)
Net debt/(cash) to equity (%)	(154.1)	(98.2)	(103.8)	(71.8)	(56.6)
Interest cover (x)	(10.6)	(15.4)	(21.6)	(9.1)	2.9
ROE (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Consensus net profit	-	-	(2,599)	(1,576)	(220)
UOBKH/Consensus (x)	-	-	1.12	1.17	0.98

Source: Sea Limited, Bloomberg, UOB Kay Hian

n.m. : not meaningful; negative P/E, EV/EBITDA reflected as "n.m."

HOLD

Share Price	US\$60.65
Target Price	US\$58.77
Upside	-3.1%

COMPANY DESCRIPTION

Sea has developed an integrated platform consisting of digital entertainment, e-commerce and digital financial services, each localised to meet the unique characteristics of its markets.

STOCK DATA

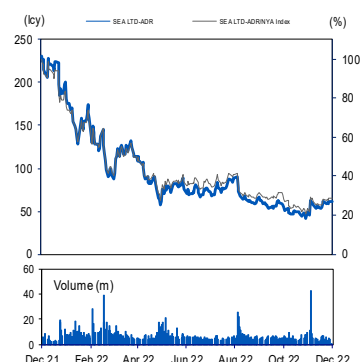
GICS sector	Communication Services
Bloomberg ticker:	SE US
Shares issued (m):	516.2
Market cap (US\$m):	34,069.4
Market cap (US\$m):	34,069.4
3-mth avg daily t'over (US\$m):	338.0
Price Performance (%)	

52-week high/low US\$231.04/US\$40.92

1mth	3mth	6mth	1yr	YTD
22.7	(8.7)	(20.5)	(74.5)	(72.9)

Major Shareholders	%
Forrest Li	25.2
Tencent	18.6
-	-
FY22 NAV/Share (US\$)	9.03
FY22 Net Cash/Share (US\$)	9.38

PRICE CHART



Source: Bloomberg

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- **Initiate coverage with HOLD.** Share price has recovered after the 3Q22 results announcement with a narrower net loss. However, we remain doubtful that the company's cost rationalising exercise could continue to improve profitability with slower growth from the digital entertainment and e-commerce segments. We value the company at US\$58.77 per share, based on SOTP valuation where we pegged the digital entertainment segment (Garena) at 8.0x 2023F PE, the e-commerce segment (Shopee) at 1.8x 2023F PS and the digital financial services segment (SeaMoney) at 3.5x 2023F PS.

STOCK IMPACT

- **Lower bookings.** Sea lowered its 2022 booking guidance by 10% to US\$2.6b-2.8b (US\$2.9b-\$3.1b previously), implying a further decline of 26% qoq in 4Q22. Moving forward, we believe post-COVID-peak normalisation will accelerate as global economies reopen at a quicker pace. Hence, we expect further deterioration in revenue and profitability for Sea's digital entertainment segment as the time and resources that users will be spending on gaming fall. For 2022 and 2023, we expect its digital entertainment segment's operating profit to decline 28% and 13% respectively.
- **Heavy reliance on a single game.** Free Fire is also an inherent risk to be noted. Garena recently faced some headwinds such as India banning Free Fire, and Riot Games taking back League of Legends (LoL) and Teamfight Tactics' (TFT) distributionship from Garena. With management's focus on re-accelerating Garena's growth and stabilising the user base, operating margin may be hit by higher costs in the near term as we expect Garena to focus more on internally-developed games.
- **Slower growth for e-commerce segment.** Sea's e-commerce segment delivered a commendable set of results in 3Q22, where its adjusted EBITDA loss narrowed significantly to US\$496m (-28% yoy/-24% qoq). Sea expects this to continue narrowing to reach EBITDA breakeven by end-23. However, we are cautious on the slower sales growth, weaker consumer spending power and the potential loss of market share, especially in ASEAN given Sea's leading market position.
- **Higher sales & marketing expenses.** In the competitive e-commerce industry, Sea could lose market share if it reduces marketing and promotion activities too drastically. Interestingly, Shopee's sales & marketing expenses for every new order increased significantly from US\$1.40 in 1Q20 to US\$6.70 in 2Q22, indicating higher customer acquisition costs. We are worried that its lower marketing expenses may not translate into meaningful profits in the future, especially as larger competitors like Lazada have access to stronger financial backing to engage in prolonged warfare.
- **Digital financial services.** We expect SeaMoney to continue to play an important role as an e-commerce enabler through innovative service offerings. We are optimistic about its growth prospects due to its large monetisation base, leveraging on its Shopee platform as well as the potential strong growth from the launching of its digital banks in Singapore and Malaysia. We anticipate significant growth in total payment value from US\$17b in 2021 to US\$126b in 2025, increasing at 60% CAGR.

EARNINGS REVISION/RISK

- **Huge amount of convertible notes due in 2025 and 2026 place Sea's financial strength at risk.** By end-25, Sea would have US\$1.1b worth of convertible notes due at a convertible price of US\$90.46/share. In the following year, another US\$2.9b will be due at a convertible price of US\$477.01/share.
- **Risk of divestment by major shareholder Tencent; we observed a correction in JD.com's valuation with the announcement of Tencent's divestment in Dec 21.** We think that the risk of potential divestment of Sea's stake by its second largest shareholder Tencent, which has 18.7% shareholding, should not be taken lightly. The P/S of JD.com dropped by around 13% before its share price stabilised.

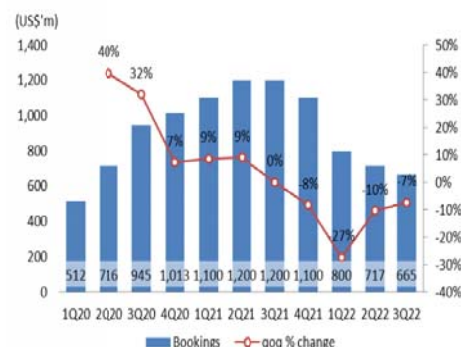
VALUATION/RECOMMENDATION

- **Initiate coverage with HOLD.** We initiate coverage on Sea with a HOLD recommendation and target price of US\$58.77 where we derived our target price based on SOTP valuation. We value the digital entertainment segment at 8x 2023F PE, around 50% discount to the sector average due to high dependency on one game, Free Fire. For the e-commerce segment, we forecast total GMV to hit above US\$110b in 2023. However, we expect the e-commerce business only to achieve EBITDA breakeven in 2023, and we use the price to sales (PS) multiple. We are applying a 1.8x PS 2023F for the e-commerce business, which is pegged to the global ecommerce peers' average. We apply 3.5x PS 2023F for the digital finance service segment, similar to the global peers' average.

SHARE PRICE CATALYST

- The group achieving positive EBITDA sooner than expected.
- Its e-commerce segment achieving EBITDA breakeven.

DROP IN DIGITAL ENTERTAINMENT BOOKINGS



Source: Sea, UOB Kay Hian

MORE EFFORTS TO CAPTURE MARKET SHARE



Source: Sea, UOB Kay Hian

CONVERTIBLE NOTES AMOUNT, DUE DATE AND CONVERSION PRICE AS OF 5 APR 22

Issuance Date	Maturity Date	Interest rate (%)	Amount outstanding as of 5 Apr 22 (US\$m)	Convertible price per share (US\$)
Jun-18	Jul-23	2.25	31.3	19.8
Nov-19	Dec-24	1.00	152	50.13
May-20	Dec-25	2.38	1,100	90.46
Sep-21	Sep-26	0.25	2,875	477.01

Source: UOB Kay Hian

SOTP VALUATION SUMMARY

	2023F net profit /sales (US\$m)	Valuation Method	Valuation (x)	Fair Value (US\$)
Digital Entertainment	1,500 (net profit)	PE	8.0	20.11
E-Commerce	9,428 (sales)	PS	1.8	30.45
Digital Financial Services	1,308 (sales)	PS	3.5	8.21
Total				58.77

Source: UOB Kay Hian

PROFIT & LOSS

Year to 31 Dec (US\$m)	2021	2022F	2023F	2024F
Net turnover	9,955	11,419	14,629	16,892
EBITDA	(1,583)	(2,419)	(1,120)	365
Deprec. & amort.	0	0	0	0
EBIT	(1,583)	(2,419)	(1,120)	365
Associate contributions	5	0	0	0
Net interest income/(expense)	(103)	(112)	(124)	(126)
Pre-tax profit	(1,710)	(2,610)	(1,234)	249
Tax	(333)	(300)	(329)	(464)
Minorities	(4)	(3)	(4)	(4)
Net profit	(2,047)	(2,914)	(1,567)	(220)
Net profit (adj.)	(2,047)	(2,914)	(1,567)	(220)

BALANCE SHEET

Year to 31 Dec (US\$m)	2021	2022F	2023F	2024F
Fixed assets	1,030	1,649	1,684	1,688
Other LT assets	2,552	2,604	2,666	2,721
Cash/ST investment	10,838	9,352	7,070	7,321
Other current assets	4,336	3,396	4,117	4,613
Total assets	18,756	17,001	15,536	16,342
ST debt	100	0	0	0
Other current liabilities	7,076	7,131	6,606	5,871
LT debt	3,476	4,148	4,148	4,148
Other LT liabilities	679	679	679	679
Shareholders' equity	7,399	5,013	4,071	5,607
Minority interest	26	29	33	37
Total liabilities & equity	18,756	17,001	15,536	16,342

CASH FLOW

Year to 31 Dec (US\$m)	2021	2022F	2023F	2024F
Operating	209	(1,415)	(1,668)	773
Pre-tax profit	(1,715)	(2,610)	(1,234)	249
Tax	(333)	(300)	(329)	(464)
Deprec. & amort.	279	449	483	498
Associates	5	0	0	0
Working capital changes	1,276	418	(1,289)	(1,263)
Non-cash items	570	629	702	1,752
Other operating cashflows	126	n.a.	n.a.	n.a.
Investing	(3,767)	(574)	(538)	(525)
Capex (growth)	(772)	(539)	(495)	(471)
Investments	(3,726)	0	0	0
Proceeds from sale of assets	799	0	0	0
Others	(68)	(35)	(43)	(54)
Financing	7,402	503	(77)	4
Dividend payments	0	0	0	0
Issue of shares	4,050	480	527	557
Proceeds from borrowings	2,960	(100)	0	0
Loan repayment	391	0	0	0
Others/interest paid	n.a.	124	(604)	(553)
Net cash inflow (outflow)	3,843	(1,486)	(2,283)	251
Beginning cash & cash equivalent	7,053	10,838	9,352	7,070
Changes due to forex impact	(58)	n.a.	n.a.	n.a.
Ending cash & cash equivalent	10,838	9,352	7,070	7,321

KEY METRICS

Year to 31 Dec (%)	2021	2022F	2023F	2024F
Profitability				
EBITDA margin	(15.9)	(21.2)	(7.7)	2.2
Pre-tax margin	(17.2)	(22.9)	(8.4)	1.5
Net margin	(20.6)	(25.5)	(10.7)	(1.3)
ROA	n.a.	n.a.	n.a.	n.a.
ROE	n.a.	n.a.	n.a.	n.a.
Growth				
Turnover	127.5	14.7	28.1	15.5
EBITDA	n.a.	n.a.	n.a.	n.a.
Pre-tax profit	n.a.	n.a.	n.a.	n.a.
Net profit	n.a.	n.a.	n.a.	n.a.
Net profit (adj.)	n.a.	n.a.	n.a.	n.a.
EPS	n.a.	n.a.	n.a.	n.a.
Leverage				
Debt to total capital	32.5	45.1	50.3	42.4
Debt to equity	48.3	82.7	101.9	74.0
Net debt/(cash) to equity	(98.2)	(103.8)	(71.8)	(56.6)
Interest cover (x)	(15.4)	(21.6)	(9.1)	2.9

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