

15 November 2018

Technology | Software & Services

Tencent

Buy (Maintained)

Strong Ads But Outlook For Online Games Clouded

Maintain BUY with unchanged HKD390 TP, 43% upside, based on 32x FY19F P/E. Market should be relieved over Tencent's 3Q18 non-GAAP profit, which beat consensus by 6%. We expect its move towards industrial internet and uncertain outlook for online games to cloud its short-to-medium term margins and financial performance, but we see upside potential at its online advertising business, given Weixin's low monetisation level and rising ad inventory.

15 games in the pipeline with monetisation approvals. Tencent has 15 games in the pipeline that have obtained monetisation licences. We believe these new games should support some growth at its online gaming segment. Our key question is still over the timing for the monetisation approval process to restart, and when Tencent's PUBG game will obtain approvals. Without any progress in this regard, we remain cautious over revenue growth at Tencent's online gaming segment.

We are also concerned over the online gaming industry overall, in addition to regulatory risks. The online gaming industry is now facing challenges over user time spent, switching to other forms of entertainment such as short videos, as well as being able to develop new IPs given the many existing IPs that have monetised to a greater extent. We therefore expect overall growth in the sector to slowdown, but we believe Tencent will outperform its peers given its deep pockets, industry knowhow, global online game partnerships, and strong distribution network.

Online advertising reaccelerating on rising ad inventory. Despite macroeconomic weaknesses and competition in the market, we expect advertising to continue to deliver strong growth for Tencent. Firstly, as we mentioned in our last report, our industry contact had indicated that Weixin Moment is testing three ads/user/day on average (two currently, and moving to four eventually). Secondly, its mini-programme ecosystem is making progress in terms of monetisation via online advertising.

Industrial Internet a long-term move. On the earnings call, management talked about industrial internet as part of their strategic highlights and elaborated on smart healthcare and smart transportation solutions. We believe it will take a long time for these initiatives to contribute meaningful revenue. Tencent could face many new competitors in these areas, such as Ping An Technology and other IT solutions companies.

Financial outlook. We maintain our forecasts and expect non-GAAP earnings CAGR of 25%. We also point out that Tencent's near-term margins will be under pressure given the higher mix of lower-margin businesses. However, if Tencent's online gaming growth resumes and online advertising keeps up, its overall margin may stabilise or recover slowly.

Maintain BUY, with same HKD390 TP, based on 32x FY19F P/E. This implies PEG of 1.3x, which is justified by Tencent's strong, yet far from fully-monetised Weixin ecosystem.

Target Price: HKD390
 Price: HKD272
 Market Cap: USD360,413m
 Bloomberg Ticker: 700 HK

Share Data

Avg Daily Turnover (HKD/USD) 8,913m/1,138m
 52-wk Price low/high (HKD) 251 - 477
 Free Float (%) 50
 Shares outstanding (m) 9,429
 Estimated Return 43%

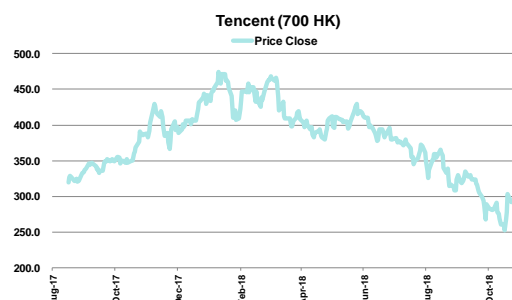
Shareholders (%)

MIH China (Naspers) 33.9
 Ma Huateng 10.2
 Zhang Zhidong 6.2

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(32.9)	(5.5)	(21.9)	(33.9)	(29.8)
Relative	(18.6)	(4.9)	(14.2)	(15.1)	(17.7)

Source: Bloomberg



Source: Bloomberg

Forecasts and Valuations	Dec-16	Dec-17	Dec 18F	Dec 19F	Dec 20F
Total turnover (CNYm)	151,938	237,760	310,360	400,195	533,366
Reported net profit (CNYm)	41,095	71,510	77,067	94,979	124,461
Recurring net profit (CNYm)	45,420	65,126	77,519	97,088	125,776
Recurring net profit growth (%)	40.1	43.4	19.0	25.2	29.5
Recurring EPS (CNY)	4.78	6.83	8.13	10.18	13.19
DPS (CNY)	0.54	0.71	0.98	1.21	1.58
Recurring P/E (x)	49.48	34.66	29.12	23.25	17.95
P/B (x)	12.71	8.70	8.24	6.92	5.87
Dividend Yield (%)	0.23	0.30	0.41	0.51	0.67
Return on average equity (%)	23.5	27.9	28.5	29.5	32.7
Net debt to equity (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, RHB

Analyst

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Figure 1: Actual results analysis

CNYm FYE Dec 31	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	3Q18	3Q18	3Q18	3Q18	3Q18	
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	QoQ	YoY	RHB	Diff	Consensus	Diff
Revenue													
VAS	35,108	36,804	42,124	39,947	46,877	42,069	44,049	4.7%	4.6%	42,325	4.1%		
Online advertising	6,888	10,148	11,042	12,361	10,689	14,110	16,247	15.1%	47.1%	16,480	(1.4%)		
Others	7,556	9,654	12,044	14,084	15,962	17,496	20,299	16.0%	68.5%	19,945	1.8%		
Total revenue	49,552	56,606	65,210	66,392	73,528	73,675	80,595	9.4%	23.6%	78,751	2.3%	80,411	0.2%
YoY change	54.9%	58.6%	61.5%	51.4%	48.4%	30.2%	23.6%			20.8%		23.3%	
Cost of revenue	(24,109)	(28,300)	(33,529)	(34,897)	(36,486)	(39,229)	(45,115)	15.0%	34.6%	(43,765)			
Gross profit	25,443	28,306	31,681	31,495	37,042	34,446	35,480	3.0%	12.0%	34,986	1.4%	36,780	(3.5%)
GPM	51.3%	50.0%	48.6%	47.4%	50.4%	46.8%	44.0%			44.4%		45.7%	
YoY change	36.9%	38.4%	45.1%	33.3%	45.6%	21.7%	12.0%			10.4%		16.1%	
Marketing expenses	(3,158)	(3,660)	(4,812)	(6,022)	(5,570)	(6,360)	(6,573)	3.3%	36.6%	(6,773)	(2.9%)		
G&A expenses	(7,012)	(8,170)	(9,058)	(8,811)	(9,430)	(9,857)	(10,890)	10.5%	20.2%	(10,316)	5.6%		
Operating profit	15,273	16,476	17,811	16,662	22,042	18,229	18,017	(1.2%)	1.2%	17,897	0.7%		
OPM	30.8%	29.1%	27.3%	25.1%	30.0%	24.7%	22.4%			22.7%			
YoY change	25.3%	28.8%	40.6%	36.0%	44.3%	10.6%	1.2%			0.5%			
Other gains, net	3,191	5,125	3,918	7,906	7,585	2,506	8,762			4,500			
Interest income	808	959	1,017	1,156	1,065	1,072	1,082			1,072			
Finance cost	(691)	(834)	(524)	(859)	(654)	(1,151)	(1,492)			(1,151)			
Associates	(375)	498	818	(120)	(319)	1,526	264			(350)			
JC entity	-	-	-	-	-	-	-			-			
PBT	18,206	22,224	23,040	24,745	29,719	22,182	26,633	20.1%	15.6%	21,968	21.2%	23,781	12.0%
Income tax	(3,658)	(3,970)	(4,993)	(3,123)	(5,746)	(3,602)	(3,228)			(4,394)			
Effective tax rate	20.1%	17.9%	21.7%	12.6%	19.3%	16.2%	20.0%			20.0%			
MI	(72)	(23)	(41)	(825)	(683)	(713)	(72)			(706)			
Net profit-GAAP	14,476	18,231	18,006	20,797	23,290	17,867	23,333	30.6%	29.6%	18,390	26.9%	18,923	23.3%
NPM - GAAP	29.2%	32.2%	27.6%	31.3%	31.7%	24.3%	29.0%			21.4%		23.5%	
YoY change	57.6%	69.8%	69.1%	97.5%	60.9%	-2.0%	29.6%			-6.3%		5.1%	
Net profit-Non GAAP	14,211	16,391	17,070	17,454	18,313	19,716	19,710	(0.0%)	15.5%	18,743	5.2%	18,569	6.1%
NPM - non-GAAP	28.7%	29.0%	26.2%	26.3%	24.9%	26.8%	24.5%			23.8%		23.1%	
YoY change	41.7%	44.8%	45.4%	41.5%	28.9%	20.3%	15.5%			9.8%		8.8%	

Source: RHB

Figure 2: Tencent's annual profit & loss breakdown

FYE Dec 31 (CNYm)	FY12	FY13	FY14	FY15	FY16	FY17	FY18F	FY19F	FY20F
Revenue									
VAS	35,718	44,985	63,310	80,669	107,810	153,983	174,385	191,265	222,038
YoY change	43.0%	36.6%	40.7%	27.4%	33.6%	42.8%	13.2%	9.7%	16.1%
Online advertising	3,382	5,034	8,308	17,468	26,970	40,439	60,232	89,635	127,257
YoY change	69.8%	48.8%	65.0%	110.3%	54.4%	49.9%	48.9%	48.8%	42.0%
Others	4,793	10,418	7,314	4,726	17,158	43,338	75,742	119,296	184,071
YoY change	2419.3%	117.4%	(29.8%)	(35.4%)	263.1%	152.6%	74.8%	57.5%	54.3%
Total revenue	43,895	60,437	78,932	102,863	151,938	237,760	310,360	400,195	533,366
YoY change	54.0%	37.7%	30.6%	30.3%	47.7%	56.5%	30.5%	28.9%	33.3%
Cost of revenue	(18,207)	(27,778)	(30,873)	(41,631)	(67,439)	(120,835)	(165,478)	(210,940)	(286,384)
Gross profit	25,687	32,659	48,059	61,232	84,499	116,925	144,881	189,255	246,982
GPM	58.5%	54.0%	60.9%	59.5%	55.6%	49.2%	46.7%	47.3%	46.3%
YoY change	38.3%	27.1%	47.2%	27.4%	38.0%	38.4%	23.9%	30.6%	30.5%
Marketing expenses	(2,993)	(5,695)	(7,797)	(7,993)	(12,136)	(17,652)	(26,215)	(30,324)	(38,538)
G&A expenses	(7,765)	(9,988)	(14,155)	(16,825)	(22,459)	(33,051)	(39,901)	(52,449)	(68,224)
Operating profit	14,928	16,975	26,107	36,414	49,904	66,222	78,766	106,483	140,220
OPM	34.0%	28.1%	33.1%	35.4%	32.8%	27.9%	25.4%	26.6%	26.3%
YoY change	31.4%	13.7%	53.8%	39.5%	37.0%	32.7%	18.9%	35.2%	31.7%
Other gains, net	(284)	905	2,759	1,886	3,594	20,140	19,293	16,561	16,861
Interest income	836	1,314	1,676	2,327	2,619	3,940	4,281	3,135	5,985
Finance cost	(348)	(84)	(1,182)	(1,618)	(1,955)	(2,908)	(4,107)	(2,820)	(2,927)
Associates	(54)	213	(346)	(2,793)	(2,522)	821	435	(1,590)	(1,590)
JC entity	(26)	(43)	(1)	-	-	-	-	-	-
PBT	15,052	19,280	29,013	36,216	51,640	88,215	98,667	121,768	158,549
Income tax	(2,266)	(3,718)	(5,125)	(7,108)	(10,193)	(15,744)	(18,701)	(24,354)	(31,710)
Effective tax rate	15.1%	19.3%	17.7%	19.6%	19.7%	17.8%	19.0%	20.0%	20.0%
MI	(53)	(61)	(78)	(302)	(352)	(961)	(2,899)	(2,435)	(2,378)
Net profit - GAAP	12,733	15,502	23,810	28,806	41,095	71,510	77,067	94,979	124,461
NPM - GAAP	29.0%	25.6%	30.2%	28.0%	27.0%	30.1%	24.8%	23.7%	23.3%
YoY change	24.8%	21.7%	53.6%	21.0%	42.7%	74.0%	7.8%	23.2%	31.0%
Net profit - Non GAAP	14,286	16,957	24,737	32,410	45,420	65,126	77,519	97,088	125,776
NPM - non-GAAP	32.5%	28.1%	31.3%	31.5%	29.9%	27.4%	25.0%	24.3%	23.6%
YoY change	30.7%	18.7%	45.9%	31.0%	40.1%	43.4%	19.0%	25.2%	29.5%

Source: RHB, Company data

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