

16 August 2018

Technology | Software & Services

Tencent

Buy (Maintained)

Short-Term Headwinds But Key Strengths Remain

Maintain BUY with lower TP of HKD450 from HKD527, 34% upside, based on 35x 2019F P/E. Though market may be disappointed with Tencent's 2Q18 results, particularly on the slowdown in revenue growth, we continue to believe that its key strengths – social traffic, online game development, and distribution capabilities – are intact. We also expect temporary headwinds from the policy side on online games to motivate Tencent to further diversify its growth drivers, and deepen the monetisation of Weixin (eg through mini-programmes).

Short-term headwinds. Tencent's online gaming business is expected to remain under pressure over the next couple of quarters, mainly as players have been shifting their time to its two key *PUBG* games that have not yet obtained monetisation approvals. In addition, China's regulators recently froze approvals for online game licences amid a government reorganisation, though there is a green approval process that can grant eligible games a 1-month monetisation testing period.

We believe this will have a short-term negative impact on China's online gaming industry and Tencent's online gaming revenue, as Tencent is the largest distributor of games in China. Tencent also indicated that it is not sure when its *PUBG* mobile games would obtain monetisation approvals but believes that it is just a matter of time.

Competitive advantages remains:

- Social traffic is quite sticky on Tencent's *Weixin* platform. User time spent on *Weixin* actually increased during 2Q18. With such a strong user base and very low monetisation level, the potential for monetisation can be huge and would guarantee solid growth for the next couple of years;
- Tencent continues to solidify its leading position in online games. It is still the most powerful online game distribution platform in China, underpinned by its know-how in player preference and in-game monetisation.

Diversifying growth drivers for online games. Tencent plans to focus more on the overseas market and launch more games with higher ARPU to offset the impact from *PUBG* games, which cannot be monetised for the time being. Since 2017, Tencent has put in a lot of effort in building the mini-programme ecosystem within *Weixin*, which we believe has the potential to become the next big thing for Tencent, as a platform facilitating discovery and consumption of goods and services.

Financial outlook. We cut our non-GAAP earnings forecasts by 6%, 7%, and 9% for 2018F-2020F mainly on lower online gaming revenue and profit. Overall, we project a 27% (from 31%) non-GAAP earnings CAGR for 2017-2020F.

Maintain BUY with lower HKD450 TP based on 35x P/E. We change our valuation methodology from SOP to P/E, as the market has shifted the focus to growth figures.

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYm)	151,938	237,760	317,834	425,262	563,923
Reported net profit (CNYm)	41,095	71,510	86,687	103,369	132,922
Recurring net profit (CNYm)	45,420	65,126	79,657	105,445	134,030
Recurring net profit growth (%)	40.1	43.4	22.3	32.4	27.1
Recurring EPS (CNY)	4.8	6.8	8.4	11.1	14.1
DPS (CNY)	0.12	0.18	0.22	0.26	0.33
Recurring P/E (x)	61.9	43.3	35.4	26.8	21.1
P/B (x)	15.8	10.9	10.4	8.8	7.4
P/CF (x)	110	21	24	17	23
Dividend Yield (%)	0.0	0.1	0.1	0.1	0.1
EV/EBITDA (x)	1.86	(2.12)	(3.50)	(1.60)	(0.61)
Return on average equity (%)	27.4	32.7	32.7	34.8	37.8
Net debt to equity (%)	net cash	net cash	11.6	4.9	net cash
Our vs consensus EPS (adjusted) (%)			(6.4)	(5.8)	(0.5)

Source: Company data, RHB

Target Price:	HKD450
Price:	HKD336
Market Cap:	USD407,581m
Bloomberg Ticker:	700 HK

Share Data

Avg Daily Turnover (HKD/USD)	8,589m/1,094m
52-wk Price low/high (HKD)	320 - 475
Free Float (%)	50
Shares outstanding (m)	9,429
Estimated Return	34%

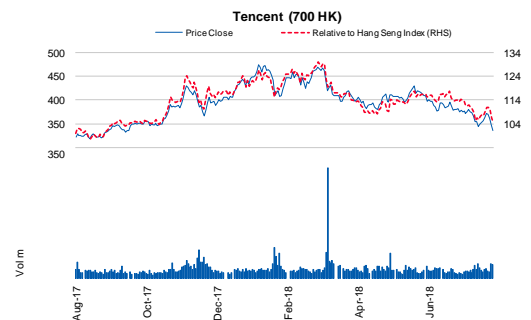
Shareholders (%)

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

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(17.3)	(11.8)	(15.6)	(24.8)	5.4
Relative	(8.6)	(7.6)	(3.3)	(12.6)	4.9

Source: Bloomberg



Source: Bloomberg

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Financial Exhibits

Financial model updated on : 2018-08-16.

Asia	Financial summary	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Hong Kong	Recurring EPS (CNY)	4.8	6.8	8.4	11.1	14.1
Technology	EPS (CNY)	4.3	7.5	9.1	10.8	13.9
Tencent	DPS (CNY)	0.12	0.18	0.22	0.26	0.33
Bloomberg 700 HK	BVPS (CNY)	18.7	27.3	28.4	33.8	39.9
Buy	Weighted avg adjusted shares (m)	9,494	9,536	9,536	9,536	9,536
Valuation basis	Valuation metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
35x P/E	Recurring P/E (x)	61.9	43.3	35.4	26.8	21.1
Key drivers	P/E (x)	68.4	39.5	32.6	27.3	21.2
i. Social advertising;	P/B (x)	15.8	10.9	10.4	8.8	7.4
ii. Mobile games;	FCF Yield (%)	0.6	4.5	3.9	5.8	4.2
iii. Further monetisation from Weixin.	Dividend Yield (%)	0.0	0.1	0.1	0.1	0.1
Key risks	EV/EBITDA (x)	1.86	(2.12)	(3.50)	(1.60)	(0.61)
i. Weaker-than-expected advertising demand due to economic conditions;	EV/EBIT (x)	2.27	(2.81)	(4.36)	(1.97)	(0.74)
ii. Competition in online video and online games;	Income statement (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
iii. Regulatory risks in China's internet sector such as content control.	Total turnover	151,938	237,760	317,834	425,262	563,923
Company Profile	Gross profit	84,499	116,925	153,328	204,278	265,359
Tencent is a leading internet conglomerate in China, with operations in online games, social networks, advertising and e-commerce. Its diversified services include:	EBITDA	61,029	87,830	110,963	144,386	183,871
i. QQ, Weixin and WeChat for communications;	Depreciation and amortisation	(11,125)	(21,608)	(21,881)	(27,147)	(32,872)
ii. Qzone for social networking;	Operating profit	49,904	66,222	89,082	117,239	150,999
iii. QQ game platform for online games;	Net interest	664	1,032	174	314	3,057
iv. QQ.com and various mobile apps for information.	Income from associates & JVs	(2,522)	821	435	(1,590)	(1,590)
Tencent has also made strategic investments in the fields of e-commerce, retail and online travel, among others.	Pre-tax profit	51,640	88,215	108,983	132,524	169,327
	Taxation	(10,193)	(15,744)	(19,301)	(26,505)	(33,865)
	Minority interests	(352)	(961)	(2,996)	(2,650)	(2,540)
	Recurring net profit	45,420	65,126	79,657	105,445	134,030
	Cash flow (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Change in working capital	(37,028)	25,531	(15,666)	6,256	9,279
	Cash flow from operations	25,480	135,538	115,353	165,927	124,865
	Capex	(7,796)	(8,069)	(5,542)	(2,300)	(5,374)
	Cash flow from investing activities	(96,254)	(141,304)	(63,973)	(68,487)	(80,248)
	Proceeds from issue of shares	3,838	4,046	3,970	0	0
	Cash flow from financing activities	58,697	25,637	(97,929)	(80,448)	(24,176)
	Cash at beginning of period	136,698	124,621	144,492	97,942	114,935
	Net change in cash	(12,077)	19,871	(46,550)	16,993	20,441
	Ending balance cash	124,621	144,492	97,942	114,935	135,376
	Balance sheet (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Total cash and equivalents	124,621	144,492	97,942	114,935	135,376
	Tangible fixed assets	23,748	31,871	37,413	39,713	45,087
	Intangible assets	36,467	40,266	41,238	40,603	38,170
	Total investments	170,374	277,964	313,388	353,062	397,498
	Total other assets	16,156	26,125	21,318	23,876	26,741
	Total assets	395,899	554,672	527,412	590,237	663,135
	Short-term debt	15,744	20,448	20,448	20,448	20,448
	Total long-term debt	93,753	111,457	111,457	111,457	111,457
	Other liabilities	7,511	6,016	3,945	4,333	4,454
	Total liabilities	206,516	273,609	235,514	246,828	262,032
	Shareholders' equity	177,760	260,044	270,879	322,390	380,083
	Minority interests	11,623	21,019	21,019	21,019	21,019
	Total equity	189,383	281,063	291,898	343,409	401,102
	Net debt	(15,124)	(12,587)	33,963	16,970	(3,471)
	Total liabilities & equity	395,899	554,672	527,412	590,237	663,135
	Key metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Revenue growth (%)	47.7	56.5	33.7	33.8	32.6
	Recurrent EPS growth (%)	39.2	42.8	22.3	32.4	27.1
	Gross margin (%)	55.6	49.2	48.2	48.0	47.1
	Operating EBITDA margin (%)	40.2	36.9	34.9	34.0	32.6
	Net profit margin (%)	27.0	30.1	27.3	24.3	23.6
	Dividend payout ratio (%)	13.9	12.0	12.0	12.0	12.0
	Capex/sales (%)	5.1	3.4	1.7	0.5	1.0
	Interest cover (x)	25.5	22.8	21.7	41.6	51.6

Source: Company data, RHB

Figure 1: Actual results

CNYm FYE Dec 31	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	2Q18	2Q18	2Q18	
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	QoQ	YoY	Consensus	Diff
Revenue														
VAS	24,964	25,680	27,975	29,191	35,108	36,804	42,124	39,947	46,877	42,069	(10.3%)	14.3%		
Online advertising	4,701	6,532	7,449	8,288	6,888	10,148	11,042	12,361	10,689	14,110	32.0%	39.0%		
Others	2,330	3,479	4,964	6,385	7,556	9,654	12,044	14,084	15,962	17,496	9.6%	81.2%		
Total revenue	31,995	35,691	40,388	43,864	49,552	56,606	65,210	66,392	73,528	73,675	0.2%	30.2%	77,661	(5.1%)
YoY change	42.8%	52.3%	51.9%	44.1%	54.9%	58.6%	61.5%	51.4%	48.4%	30.2%			56.7%	
Cost of revenue	(13,406)	(15,235)	(18,560)	(20,238)	(24,109)	(28,300)	(33,529)	(34,897)	(36,486)	(39,229)	7.5%	38.6%		
Gross profit	18,589	20,456	21,828	23,626	25,443	28,306	31,681	31,495	37,042	34,446	(7.0%)	21.7%	36,546	(5.7%)
GPM	58.1%	57.3%	54.0%	53.9%	51.3%	50.0%	48.6%	47.4%	50.4%	46.8%			47.1%	
YoY change	38.4%	41.7%	40.1%	32.9%	36.9%	38.4%	45.1%	33.3%	45.6%	21.7%			29.1%	
Marketing expenses	(2,032)	(2,365)	(3,277)	(4,462)	(3,158)	(3,660)	(4,812)	(6,022)	(5,570)	(6,360)	14.2%	73.8%		
G&A expenses	(4,368)	(5,299)	(5,883)	(6,909)	(7,012)	(8,170)	(9,058)	(8,811)	(9,430)	(9,857)	4.5%	20.6%		
Operating profit	12,189	12,792	12,668	12,255	15,273	16,476	17,811	16,662	22,042	18,229	(17.3%)	10.6%		
OPM	38.1%	35.8%	31.4%	27.9%	30.8%	29.1%	27.3%	25.1%	30.0%	24.7%				
YoY change	44.4%	44.9%	38.3%	22.7%	25.3%	28.8%	40.6%	36.0%	44.3%	10.6%				
Other gains, net	506	911	1,155	1,022	3,191	5,125	3,918	7,906	7,585	2,506				
Interest income	703	626	637	653	808	959	1,017	1,156	1,065	1,072				
Finance cost	(491)	(377)	(604)	(483)	(691)	(834)	(524)	(859)	(654)	(1,151)				
Associates	(1,089)	(292)	(619)	(522)	(375)	498	818	(120)	(319)	1,526				
JC entity	-	-	-	-	-	-	-	-	-	-				
PBT	11,818	13,660	13,237	12,925	18,206	22,224	23,040	24,745	29,719	22,182	(25.4%)	(0.2%)	25,035	(11.4%)
Income tax	(2,550)	(2,780)	(2,461)	(2,402)	(3,658)	(3,970)	(4,993)	(3,123)	(5,746)	(3,602)				
Effective tax rate	21.6%	20.4%	18.6%	18.6%	20.1%	17.9%	21.7%	12.6%	19.3%	16.2%				
MI	(85)	(143)	(130)	6	(72)	(23)	(41)	(825)	(683)	(713)				
Net profit-GAAP	9,183	10,737	10,646	10,529	14,476	18,231	18,006	20,797	23,290	17,867	(23.3%)	(2.0%)	18,923	(5.6%)
NPM - GAAP	28.7%	30.1%	26.4%	24.0%	29.2%	32.2%	27.6%	31.3%	31.7%	24.3%			24.4%	
YoY change	33.4%	46.8%	43.0%	47.0%	57.6%	69.8%	69.1%	97.5%	60.9%	-2.0%			3.8%	
Net profit-Non GAAP	10,032	11,319	11,737	12,332	14,211	16,391	17,070	17,454	18,313	19,716	7.7%	20.3%	19,181	2.8%
NPM - non-GAAP	31.4%	31.7%	29.1%	28.1%	28.7%	29.0%	26.2%	26.3%	24.9%	26.8%			24.7%	
YoY change	39.3%	41.9%	41.8%	37.7%	41.7%	44.8%	45.4%	41.5%	28.9%	20.3%			17.0%	

Source: RHB, Company, Bloomberg

Figure 2: Changes to our earnings

(CNYm)	FY18F			FY19F			FY20F		
	Original	New	Change	Original	New	Change	Original	New	Change
VAS	201,565	181,025	(10.2%)	247,535	212,848	(14.0%)	288,490	247,365	(14.3%)
Online advertising	63,240	61,067	(3.4%)	96,146	93,118	(3.1%)	136,796	132,488	(3.1%)
Others	79,919	75,742	(5.2%)	127,300	119,296	(6.3%)	196,421	184,071	(6.3%)
Total revenue	344,723	317,834	(7.8%)	470,981	425,262	(9.7%)	621,708	563,923	(9.3%)
Cost of sales	-174,942	-164,506	(6.0%)	-239,472	-220,984	(7.7%)	-324,357	-298,564	(8.0%)
Gross profit	169,781	153,328	(9.7%)	231,509	204,278	(11.8%)	297,350	265,359	(10.8%)
<i>Gross profit margin</i>	<i>49.3%</i>	<i>48.2%</i>		<i>49.2%</i>	<i>48.0%</i>		<i>47.8%</i>	<i>47.1%</i>	
Selling & Marketing expenses	-26,870	-25,035	(6.8%)	-34,662	-31,306	(9.7%)	-45,768	-41,525	(9.3%)
G&A costs	-43,388	-39,211	(9.6%)	-61,725	-55,733	(9.7%)	-80,300	-72,835	(9.3%)
Operating profit	99,523	89,082	(10.5%)	135,122	117,239	(13.2%)	171,282	150,999	(11.8%)
<i>Operating profit margin</i>	<i>28.9%</i>	<i>28.0%</i>		<i>28.7%</i>	<i>27.6%</i>		<i>27.6%</i>	<i>26.8%</i>	
Other gains, net	21,287	19,293		16,561	16,561		16,861	16,861	
Interest income	4,260	4,281		3,135	3,135		5,985	5,985	
Finance cost	-2,616	-4,107		-2,816	-2,820		-2,920	-2,927	
Associates & JCE	-1,441	435		-1,590	-1,590		-1,590	-1,590	
PBT	121,013	108,983	(9.9%)	150,412	132,524	(11.9%)	189,619	169,327	(10.7%)
Income tax	-24,005	-19,301		-30,082	-26,505		-37,924	-33,865	
Effective tax rate	20%	18%		20%	20%		20%	20%	
MI	(2,781)	(2,996)		(3,008)	(2,650)		(2,844)	(2,540)	
Net profit - GAAP	94,227	86,687	(8.0%)	117,321	103,369	(11.9%)	148,851	132,922	(10.7%)
<i>NPM - GAAP</i>	<i>27.3%</i>	<i>27.3%</i>		<i>24.9%</i>	<i>24.3%</i>		<i>23.9%</i>	<i>23.6%</i>	
Net profit - non GAAP	84,749	79,657	(6.0%)	113,340	105,445	(7.0%)	147,352	134,030	(9.0%)
<i>NPM - non GAAP</i>	<i>24.6%</i>	<i>25.1%</i>		<i>24.1%</i>	<i>24.8%</i>		<i>23.7%</i>	<i>23.8%</i>	
EPS - GAAP (CNY)	9.881	9.090	(8.0%)	12.303	10.840	(11.9%)	15.609	13.939	(10.7%)
EPS - Non GAAP (CNY)	8.887	8.353	(6.0%)	11.885	11.058	(7.0%)	15.452	14.055	(9.0%)

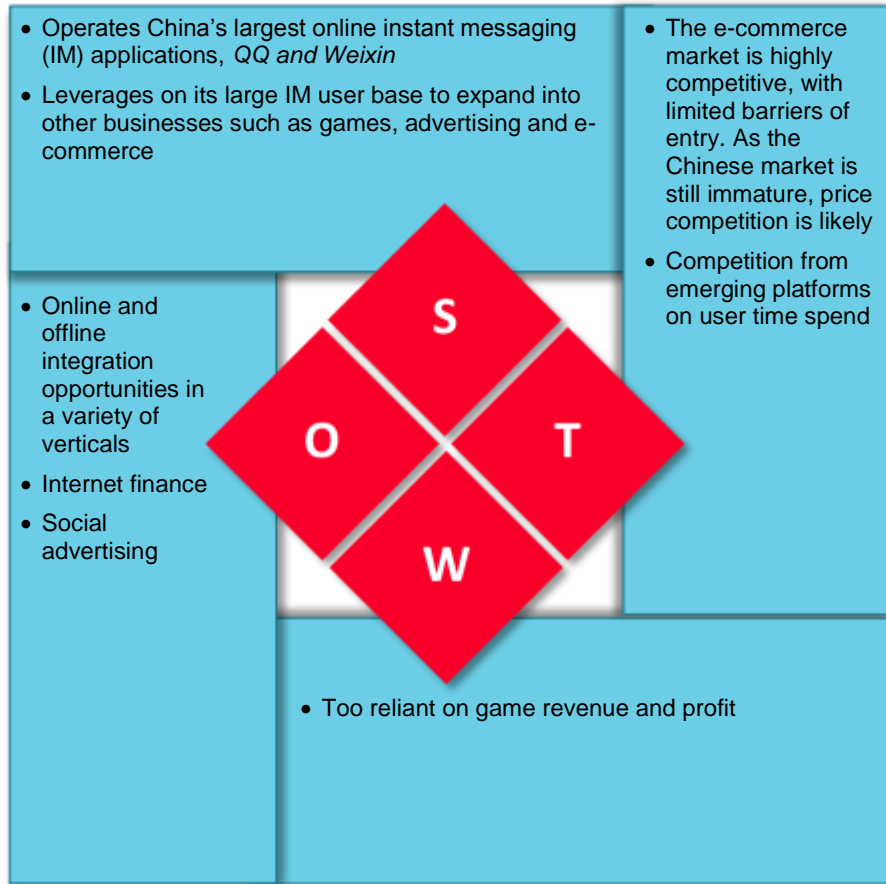
Source: RHB

Figure 3: Annual profit and loss

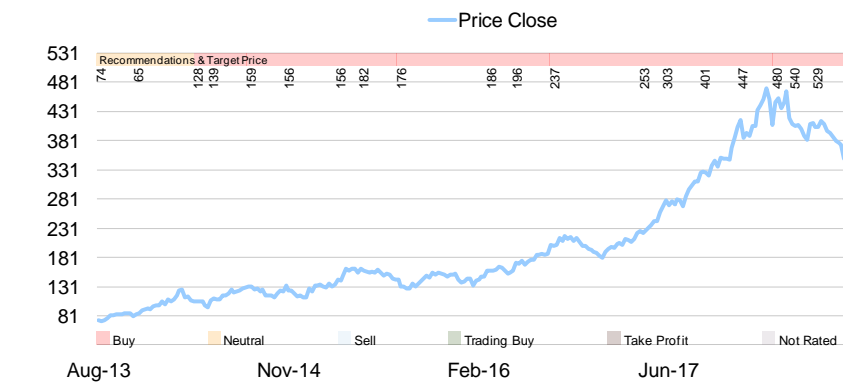
FYE Dec 31 (CNYm)	FY12	FY13	FY14	FY15	FY16	FY17	FY18F	FY19F	FY20F
Revenue									
VAS	35,718	44,985	63,310	80,669	107,810	153,983	181,025	212,848	247,365
YoY change	43.0%	36.6%	40.7%	27.4%	33.6%	42.8%	17.6%	17.6%	16.2%
Online advertising	3,382	5,034	8,308	17,468	26,970	40,439	61,067	93,118	132,488
YoY change	69.8%	48.8%	65.0%	110.3%	54.4%	49.9%	51.0%	52.5%	42.3%
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	317,834	425,262	563,923
YoY change	54.0%	37.7%	30.6%	30.3%	47.7%	56.5%	33.7%	33.8%	32.6%
Cost of revenue	(18,207)	(27,778)	(30,873)	(41,631)	(67,439)	(120,835)	(164,506)	(220,984)	(298,564)
Gross profit	25,687	32,659	48,059	61,232	84,499	116,925	153,328	204,278	265,359
GPM	58.5%	54.0%	60.9%	59.5%	55.6%	49.2%	48.2%	48.0%	47.1%
YoY change	38.3%	27.1%	47.2%	27.4%	38.0%	38.4%	31.1%	33.2%	29.9%
Marketing expenses	(2,993)	(5,695)	(7,797)	(7,993)	(12,136)	(17,652)	(25,035)	(31,306)	(41,525)
G&A expenses	(7,765)	(9,988)	(14,155)	(16,825)	(22,459)	(33,051)	(39,211)	(55,733)	(72,835)
Operating profit	14,928	16,975	26,107	36,414	49,904	66,222	89,082	117,239	150,999
OPM	34.0%	28.1%	33.1%	35.4%	32.8%	27.9%	28.0%	27.6%	26.8%
YoY change	31.4%	13.7%	53.8%	39.5%	37.0%	32.7%	34.5%	31.6%	28.8%
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	108,983	132,524	169,327
Income tax	(2,266)	(3,718)	(5,125)	(7,108)	(10,193)	(15,744)	(19,301)	(26,505)	(33,865)
Effective tax rate	15.1%	19.3%	17.7%	19.6%	19.7%	17.8%	17.7%	20.0%	20.0%
MI	(53)	(61)	(78)	(302)	(352)	(961)	(2,996)	(2,650)	(2,540)
Net profit - GAAP	12,733	15,502	23,810	28,806	41,095	71,510	86,687	103,369	132,922
NPM - GAAP	29.0%	25.6%	30.2%	28.0%	27.0%	30.1%	27.3%	24.3%	23.6%
YoY change	24.8%	21.7%	53.6%	21.0%	42.7%	74.0%	21.2%	19.2%	28.6%
Net profit - Non GAAP	14,286	16,957	24,737	32,410	45,420	65,126	79,657	105,445	134,030
NPM - non-GAAP	32.5%	28.1%	31.3%	31.5%	29.9%	27.4%	25.1%	24.8%	23.8%
YoY change	30.7%	18.7%	45.9%	31.0%	40.1%	43.4%	22.3%	32.4%	27.1%

Source: RHB, Company

SWOT Analysis



Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2018-05-17	Buy	529	411
2018-03-22	Buy	540	439
2018-02-07	Buy	480	415
2017-11-16	Buy	447	392
2017-08-17	Buy	401	329
2017-05-18	Buy	303	264
2017-03-23	Buy	253	223
2016-08-18	Buy	237	203
2016-06-22	Buy	196	177
2016-05-19	Buy	196	157

Source: RHB, Bloomberg

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