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Technology | Software & Services

Tencent

Buy (Maintained)

Target Price: HKD529.00

Price: HKD375.00

Market Cap: USD454,042m

Bloomberg Ticker: 700 HK

2Q Preview: Short-term Pressure From Online Games

Maintain BUY, HKD529.00 TP offers 41% upside. We remain upbeat, mainly as key strengths are intact. Its game distribution and monetisation capabilities in China's online games market is unparalleled, as is its large, sticky user base generated on social networks. For 2Q, we estimate 16% YoY and 4% QoQ growth of its non-GAAP earnings to CNY19bn, slightly lower than consensus' CNY19.5bn; and 38% YoY and 6% QoQ growth of its revenue (at CNY78.2bn, a tad lower than consensus' CNY78.7bn). The lower profitability is mainly due to soft growth of its high-margin online games businesses, as PUBG games are not monetised yet. We expect advertising revenue to be strong, on its popular self-produced show *Produce 101* on Tencent Video and higher pricing from Weixin advertising. Key spots to watch: when *PUBG* can be approved by the Government to start monetisation; monetisation progress of the game *Fortnite* which was just launched in China; as well as how Weixin deepens monetisation across Weixin Moment, mini-programmes and public accounts.

Soft online game revenue. We expect Tencent's mobile games unit to record CNY12.5bn in revenue in 2Q (-15%QoQ, +22% YoY). We have imputed three factors into our forecasts:

- QQ *Speed's* revenue may decline QoQ, as 1Q18 was the key promotion period for this game;
- Honor of Kings* may also see a slight sequential revenue decline, after it peaked in March on promotional activities. However, we do not think the decline will be very substantial in 2Q18. It added in-game items for purchase such as FIFA World Cup-themed skins that should have attracted spending;
- New key titles – the two *PlayerUnknown's Battlegrounds (PUBG)* games have not yet obtained approval to start monetisation yet despite the continuous increase in monthly active users.

We expect the PC game segment to post revenue of CNY12.9bn (-8% QoQ, -5% YoY). There should be a stable performance from key PC games such as *Dungeon and Fighter* and *League of Legends*, while other tier-2 titles in general should see obvious YoY and sequential declines in revenues, as users shift their time to the mobile platform.

We expect the total game revenue to be at CNY25.4bn (+7% YoY, -12% QoQ) and social network revenue to be at CNY18.6bn (+44% YoY, +3% QoQ). In total, we expect value-added service (VAS) revenue to be CNY34.0bn (+20% YoY, -6% QoQ).

Strong online advertising revenue. We expect online revenue to be CNY15.3bn (+51% YoY) due to hefty advertising revenue from its self-produced variety show *Produce 101* (which also helps to improve the margin of the video business, with lower content costs as it is done in-house); advertising inventory increasing on Weixin Moment; higher pricing from Weixin Moment and public accounts advertisements. We believe the FIFA World Cup had a very limited impact on Tencent Video's advertising revenue. The football matches were mainly aired late at night, and therefore had only a very small impact on other content. Also, Youku only secured the streaming rights of the FIFA World Cup two weeks before the event began – so the actual advertising revenue was far from the maximum potential, as there was limited time to recruit advertisers.

Other segments still growing well. We expect revenue from other segments to grow 95% YoY, driven by payment and cloud.

2Q18 earnings growth mainly dragged by online game segment. For 2Q, we estimate 16% YoY and 4% QoQ growth of its non-GAAP earnings to CNY19bn, vs consensus' CNY19.5bn; and 38% YoY and 6% QoQ growth of its revenue (at CNY78.2bn, vs consensus' CNY78.7bn). The decline in profitability is mainly due to the slower growth of its high-margin online game businesses.

Maintain BUY, with a HKD529.00 SOP-based TP implying FY18F-19F P/E of 50x and 37x. Key risks: regulatory risks affecting China's internet sector such as content control, and competition in mobile payment and online video.

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYb)	152	238	345	471	622
Reported net profit (CNYb)	41	72	94	117	149
Recurring net profit (CNYb)	45	65	85	113	147
Recurring net profit growth (%)	40.1	43.4	30.1	33.7	30.0
Recurring EPS (CNY)	4.8	6.8	8.9	11.9	15.5
DPS (CNY)	0.12	0.18	0.24	0.30	0.37
Recurring P/E (x)	67.5	47.3	36.4	27.2	20.9
P/B (x)	17.3	11.8	11.4	9.6	8.1
P/CF (x)	120	23	24	17	25
Dividend Yield (%)	0.0	0.1	0.1	0.1	0.1
EV/EBITDA (x)	2.22	(2.18)	(3.41)	(1.49)	(0.54)
Return on average equity (%)	27.4	32.7	35.5	39.6	42.4
Net debt to equity (%)	netcash	netcash	11.7	5.0	netcash
Our vs consensus EPS (adjusted) (%)			(0.7)	0.6	4.0

Source: Company data, RHB

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