

17 May 2018

Technology | Software & Services

Tencent

Buy (Maintained)

Good Start To a Solid Year

Maintain BUY with new SOP-based TP of HKD529 from HKD540, offering 34% upside. Our TP implies FY18F-19F P/Es of 50x and 37x respectively. Tencent delivered another set of solid results for 1Q18, with revenue beating consensus by 4% and non-GAAP net profit in line with expectations. We see social advertising as a key driver for its 2018 earnings, as advertising inventories increase on Weixin and its other platforms with high traffic growth, which would also boost advertising loads. We also see large potential in its mobile game revenue as its high DAU games have not been monetised. Its ecosystem is getting stronger with mini programmes being rolled out.

Clear leader in tactical tournament games. Tencent has established its leadership in tournament games with four successful games – two in-house *PlayerUnknown's Battlegrounds (PUBG)* mobile games, one licensed *PUBG PC* game in China, and *Fortnite*, which is developed by its investee, Epic. Tencent believes that revenue potential from tactical tournament games can be very significant.

The combined daily active user (DAU) for the two *PUBG* mobile games is around 50m. Monetisation is however, pending regulatory approval and timing would therefore be uncertain. Tencent believes that *Fortnite* has set a good example as to how the monetisation of this type of game can be done – through seasonal passes and in-store item purchases.

Social advertising to take off. Advertisement loads on *Weixin Moment* increased to two per user daily from one last year. As we are expecting strong demand for this service, it would imply a potential near doubling of *Weixin Moment* advertising revenue this year.

Competitive landscape. There have been concerns that Tencent is losing user time spent to some emerging newsfeed and mini video platforms. Tencent believes that its key strength in social traffic remains intact. Meanwhile, it is escalating investment into mini-video and newsfeed. One advantage of Tencent's mini-video site is that it would be able to leverage on Tencent's large library of music, video and other content.

Financial outlook. We tweaked our earnings forecasts for FY18F-20F to factor in higher advertising revenue, lower PC revenue, and slightly lower margins. We expect mobile game, social advertising and payments to be the major revenue growth engines going forward. Overall, we are still projecting non-GAAP earnings to register a CAGR of 31% during FY17-20F.

Maintain BUY, with slightly lower TP of HKD529. Our SOP-based TP (Figure 4) implies FY18F-19F P/Es of 50x and 37x respectively. Key risks include regulatory risks in China's internet sector such as content control, and competition in the mobile payment and online video space.

Target Price: HKD529
Price: HKD396
Market Cap: USD479,670m
Bloomberg Ticker: 700 HK

Share Data

Avg Daily Turnover (HKD/USD) 11,872m/1,513m
52-wk Price low/high (HKD) 260 - 475
Free Float (%) 50
Shares outstanding (m) 9,429
Estimated Return 34%

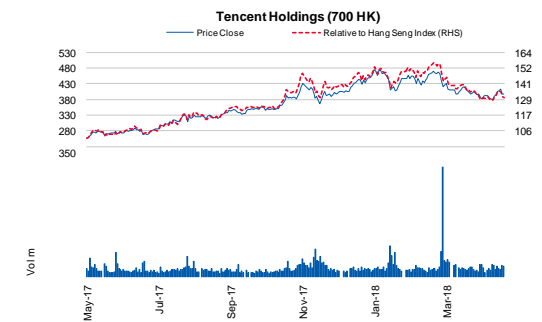
Shareholders (%)

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

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(2.4)	(1.7)	(11.4)	1.1	53.1
Relative	(6.4)	(4.3)	(11.4)	(6.1)	30.3

Source: Bloomberg



Source: Bloomberg

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYm)	151,938	237,760	344,723	470,981	621,708
Reported net profit (CNYm)	41,095	71,510	94,227	117,321	148,851
Recurring net profit (CNYm)	45,420	65,126	84,749	113,340	147,352
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)	67.3	47.1	36.2	27.1	20.8
P/B (x)	17.2	11.8	11.3	9.5	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)	2.02	(2.31)	(3.51)	(1.56)	(0.60)
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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Financial Exhibits

Financial model updated on : 2018-05-16.

Asia	Financial summary	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Hong Kong	Recurring EPS (CNY)	4.8	6.8	8.9	11.9	15.5
Technology	EPS (CNY)	4.3	7.5	9.9	12.3	15.6
Tencent	DPS (CNY)	0.12	0.18	0.24	0.30	0.37
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
We use SOTP to value Tencent as we believe Weixin, which currently does not contribute much revenue, has significant value.	Recurring P/E (x)	67.3	47.1	36.2	27.1	20.8
	P/E (x)	74.4	42.9	32.6	26.2	20.6
	P/B (x)	17.2	11.8	11.3	9.5	8.1
	FCF Yield (%)	0.6	4.2	4.0	5.9	3.9
	Dividend Yield (%)	0.0	0.1	0.1	0.1	0.1
	EV/EBITDA (x)	2.02	(2.31)	(3.51)	(1.56)	(0.60)
	EV/EBIT (x)	2.47	(3.07)	(4.29)	(1.88)	(0.72)
Key drivers	Income statement (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
i. Social advertising;	Total turnover	151,938	237,760	344,723	470,981	621,708
ii. Mobile games;	Gross profit	84,499	116,925	169,781	231,509	297,350
iii. Further monetisation of Weixin	EBITDA	61,029	87,830	121,404	162,270	204,154
	Depreciation and amortisation	(11,125)	(21,608)	(21,881)	(27,147)	(32,872)
	Operating profit	49,904	66,222	99,523	135,122	171,282
	Net interest	664	1,032	1,644	319	3,065
	Income from associates & JVs	(2,522)	821	(1,441)	(1,590)	(1,590)
	Pre-tax profit	51,640	88,215	121,013	150,412	189,619
	Taxation	(10,193)	(15,744)	(24,005)	(30,082)	(37,924)
	Minority interests	(352)	(961)	(2,781)	(3,008)	(2,844)
	Recurring net profit	45,420	65,126	84,749	113,340	147,352
Key risks	Cash flow (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
i. Weaker-than-expected advertising demand due to economic conditions;	Change in working capital	(37,028)	25,531	(15,666)	6,256	9,279
ii. Competition in online video and online games;	Cash flow from operations	25,480	135,538	127,382	183,815	124,865
iii. Regulatory risks in China's internet sector such as content control	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	(110,015)	(98,364)	(24,217)
	Cash at beginning of period	136,698	124,621	144,492	97,886	114,850
	Net change in cash	(12,077)	19,871	(46,606)	16,965	20,400
	Ending balance cash	124,621	144,492	97,886	114,850	135,250
Company Profile	Balance sheet (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Tencent is a leading internet conglomerate in China, with operations in online games, social networks, advertising and e-commerce. Its diversified services include:	Total cash and equivalents	124,621	144,492	97,886	114,850	135,250
i. QQ, Weixin and WeChat for communications;	Tangible fixed assets	23,748	31,871	37,413	39,713	45,087
ii. Qzone for social networking;	Intangible assets	36,467	40,266	41,238	40,603	38,170
iii. QQ game platform for online games;	Total investments	170,374	277,964	313,388	353,062	397,498
iv. QQ.com and various mobile apps for information.	Total other assets	16,156	26,125	21,318	23,876	26,741
Tencent has also made strategic investments in the fields of e-commerce, retail and online travel, among others.	Total assets	395,899	554,672	527,355	590,153	663,009
	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	3,888	4,249	4,328
	Total liabilities	206,516	273,609	235,458	246,744	261,906
	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)	34,019	17,055	(3,345)
	Total liabilities & equity	395,899	554,672	527,355	590,153	663,009
	Key metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
	Revenue growth (%)	47.7	56.5	45.0	36.6	32.0
	Recurrent EPS growth (%)	39.2	42.8	30.1	33.7	30.0
	Gross margin (%)	55.6	49.2	49.3	49.2	47.8
	Operating EBITDA margin (%)	40.2	36.9	35.2	34.5	32.8
	Net profit margin (%)	27.0	30.1	27.3	24.9	23.9
	Dividend payout ratio (%)	13.9	12.0	12.0	12.0	12.0
	Capex/sales (%)	5.1	3.4	1.6	0.5	0.9
	Interest cover (x)	25.5	22.8	38.0	48.0	58.7

Source: Company data, RHB

Figure 1: Tencent's 1Q18 results

CNYm FYE Dec 31	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	1Q18	1Q18	1Q18	1Q18	1Q18	1Q18
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	RHB	QoQ	YoY	RHB	Diff	Consensus	Diff
Revenue															
VAS	24,964	25,680	27,975	29,191	35,108	36,804	42,124	39,947	46,877	17.3%	33.5%	45,398	3.3%		
Online advertising	4,701	6,532	7,449	8,288	6,888	10,148	11,042	12,361	10,689	(13.5%)	55.2%	10,878	(1.7%)		
Others	2,330	3,479	4,964	6,385	7,556	9,654	12,044	14,084	15,962	13.3%	111.2%	15,774	1.2%		
Total revenue	31,995	35,691	40,388	43,864	49,552	56,606	65,210	66,392	73,528	10.7%	48.4%	72,050	2.1%	70,785	3.9%
YoY change	42.8%	52.3%	51.9%	44.1%	54.9%	58.6%	61.5%	51.4%	48.4%			45.4%		42.8%	
Cost of revenue	(13,406)	(15,235)	(18,560)	(20,238)	(24,109)	(28,300)	(33,529)	(34,897)	(36,486)	4.6%	51.3%	(35,069)			
Gross profit	18,589	20,456	21,828	23,626	25,443	28,306	31,681	31,495	37,042	17.6%	45.6%	36,981	0.2%	33,243	11.4%
GPM	58.1%	57.3%	54.0%	53.9%	51.3%	50.0%	48.6%	47.4%	50.4%			51.3%		47.0%	
YoY change	38.4%	41.7%	40.1%	32.9%	36.9%	38.4%	45.1%	33.3%	45.6%			45.3%		30.7%	
Marketing expenses	(2,032)	(2,365)	(3,277)	(4,462)	(3,158)	(3,660)	(4,812)	(6,022)	(5,570)	(7.5%)	76.4%	(4,539)	22.7%		
G&A expenses	(4,368)	(5,299)	(5,883)	(6,909)	(7,012)	(8,170)	(9,058)	(8,811)	(9,430)	7.0%	34.5%	(10,303)	(8.5%)		
Operating profit	12,189	12,792	12,668	12,255	15,273	16,476	17,811	16,662	22,042	32.3%	44.3%	22,139	(0.4%)		
OPM	38.1%	35.8%	31.4%	27.9%	30.8%	29.1%	27.3%	25.1%	30.0%			30.7%			
YoY change	44.4%	44.9%	38.3%	22.7%	25.3%	28.8%	40.6%	36.0%	44.3%			45.0%			
Other gains, net	506	911	1,155	1,022	3,191	5,125	3,918	7,906	7,585			15			
Interest income	703	626	637	653	808	959	1,017	1,156	1,065			668			
Finance cost	(491)	(377)	(604)	(483)	(691)	(834)	(524)	(859)	(654)			(700)			
Associates	(1,089)	(292)	(619)	(522)	(375)	498	818	(120)	(319)			(350)			
JC entity	-	-	-	-	-	-	-	-	-			-			
PBT	11,818	13,660	13,237	12,925	18,206	22,224	23,040	24,745	29,719	20.1%	63.2%	21,772	36.5%	21,038	41.3%
Income tax	(2,550)	(2,780)	(2,461)	(2,402)	(3,658)	(3,970)	(4,993)	(3,123)	(5,746)			(4,354)			
Effective tax rate	21.6%	20.4%	18.6%	18.6%	20.1%	17.9%	21.7%	12.6%	19.3%			20.0%			
MI	(85)	(143)	(130)	6	(72)	(23)	(41)	(825)	(683)			(87)			
Net profit-GAAP	9,183	10,737	10,646	10,529	14,476	18,231	18,006	20,797	23,290	12.0%	60.9%	17,330	34.4%	16,863	38.1%
NPM - GAAP	28.7%	30.1%	26.4%	24.0%	29.2%	32.2%	27.6%	31.3%	31.7%			24.1%		23.8%	
YoY change	33.4%	46.8%	43.0%	47.0%	57.6%	69.8%	69.1%	97.5%	60.9%			19.7%		16.5%	
Net profit-Non GAAP	10,032	11,319	11,737	12,332	14,211	16,391	17,070	17,454	18,313	4.9%	28.9%	19,226	(4.7%)	18,374	(0.3%)
NPM - non-GAAP	31.4%	31.7%	29.1%	28.1%	28.7%	29.0%	26.2%	26.3%	24.9%			26.7%		26.0%	
YoY change	39.3%	41.9%	41.8%	37.7%	41.7%	44.8%	45.4%	41.5%	28.9%			35.3%		29.3%	

Source: RHB, Company data, Bloomberg

Figure 2: Changes to our earnings estimates

(CNYm)	FY18F			FY19F			FY20F		
	Original	New	Change	Original	New	Change	Original	New	Change
VAS	200,904	201,565	0.3%	247,418	247,535	0.0%	288,784	288,490	(0.1%)
Online advertising	57,998	63,240	9.0%	81,674	96,146	17.7%	112,457	136,796	21.6%
Others	75,296	79,919	6.1%	111,081	127,300	14.6%	162,633	196,421	20.8%
Total revenue	334,199	344,723	3.1%	440,173	470,981	7.0%	563,874	621,708	10.3%
Cost of sales	-164,032	-174,942	6.7%	-212,506	-239,472	12.7%	-275,683	-324,357	17.7%
Gross profit	170,167	169,781	(0.2%)	227,667	231,509	1.7%	288,191	297,350	3.2%
<i>Gross profit margin</i>	50.9%	49.3%		51.7%	49.2%		51.1%	47.8%	
Selling & Marketing expenses	-25,120	-26,870	7.0%	-32,469	-34,662	6.8%	-41,618	-45,768	10.0%
G&A costs	-48,366	-43,388	(10.3%)	-63,328	-61,725	(2.5%)	-81,129	-80,300	(1.0%)
Operating profit	96,680	99,523	2.9%	131,870	135,122	2.5%	165,444	171,282	3.5%
<i>Operating profit margin</i>	28.9%	28.9%		30.0%	28.7%		29.3%	27.6%	
Other gains, net	60	21,287		80	16,561		80	16,861	
Interest income	2,671	4,260		3,135	3,135		5,985	5,985	
Finance cost	-2,800	-2,616		-2,821	-2,816		-2,928	-2,920	
Associates & JCE	-1,472	-1,441		-1,590	-1,590		-1,590	-1,590	
PBT	95,139	121,013	27.2%	130,674	150,412	15.1%	166,990	189,619	13.6%
Income tax	-19,028	-24,005		-26,135	-30,082		-33,398	-37,924	
Effective tax rate	20%	20%		20%	20%		20%	20%	
MI	(381)	(2,781)		(523)	(3,008)		(668)	(2,844)	
Net profit - GAAP	75,731	94,227	24.4%	104,017	117,321	12.8%	132,924	148,851	12.0%
<i>NPM - GAAP</i>	22.7%	27.3%		23.6%	24.9%		23.6%	23.9%	
Net profit - non GAAP	88,102	84,749	(3.8%)	118,485	113,340	(4.3%)	150,812	147,352	(2.3%)
<i>NPM - non GAAP</i>	26.4%	24.6%		26.9%	24.1%		26.7%	23.7%	
EPS - GAAP (CNY)	7.942	9.881	24.4%	10.908	12.303	12.8%	13.939	15.609	12.0%
EPS - Non GAAP (CNY)	9.239	8.887	(3.8%)	12.425	11.885	(4.3%)	15.815	15.452	(2.3%)

Source: RHB

Figure 3: Tencent's 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	201,565	247,535	288,490
YoY change	43.0%	36.6%	40.7%	27.4%	33.6%	42.8%	30.9%	22.8%	16.5%
Online advertising	3,382	5,034	8,308	17,468	26,970	40,439	63,240	96,146	136,796
YoY change	69.8%	48.8%	65.0%	110.3%	54.4%	49.9%	56.4%	52.0%	42.3%
Others	4,793	10,418	7,314	4,726	17,158	43,338	79,919	127,300	196,421
YoY change	2419.3%	117.4%	(29.8%)	(35.4%)	263.1%	152.6%	84.4%	59.3%	54.3%
Total revenue	43,895	60,437	78,932	102,863	151,938	237,760	344,723	470,981	621,708
YoY change	54.0%	37.7%	30.6%	30.3%	47.7%	56.5%	45.0%	36.6%	32.0%
Cost of revenue									
	(18,207)	(27,778)	(30,873)	(41,631)	(67,439)	(120,835)	(174,942)	(239,472)	(324,357)
Gross profit	25,687	32,659	48,059	61,232	84,499	116,925	169,781	231,509	297,350
GPM	58.5%	54.0%	60.9%	59.5%	55.6%	49.2%	49.3%	49.2%	47.8%
YoY change	38.3%	27.1%	47.2%	27.4%	38.0%	38.4%	45.2%	36.4%	28.4%
Marketing expenses									
	(2,993)	(5,695)	(7,797)	(7,993)	(12,136)	(17,652)	(26,870)	(34,662)	(45,768)
G&A expenses									
	(7,765)	(9,988)	(14,155)	(16,825)	(22,459)	(33,051)	(43,388)	(61,725)	(80,300)
Operating profit	14,928	16,975	26,107	36,414	49,904	66,222	99,523	135,122	171,282
OPM	34.0%	28.1%	33.1%	35.4%	32.8%	27.9%	28.9%	28.7%	27.6%
YoY change	31.4%	13.7%	53.8%	39.5%	37.0%	32.7%	50.3%	35.8%	26.8%
Other gains, net									
	(284)	905	2,759	1,886	3,594	20,140	21,287	16,561	16,861
Interest income									
	836	1,314	1,676	2,327	2,619	3,940	4,260	3,135	5,985
Finance cost									
	(348)	(84)	(1,182)	(1,618)	(1,955)	(2,908)	(2,616)	(2,816)	(2,920)
Associates									
	(54)	213	(346)	(2,793)	(2,522)	821	(1,441)	(1,590)	(1,590)
JC entity									
	(26)	(43)	(1)	-	-	-	-	-	-
PBT	15,052	19,280	29,013	36,216	51,640	88,215	121,013	150,412	189,619
Income tax									
	(2,266)	(3,718)	(5,125)	(7,108)	(10,193)	(15,744)	(24,005)	(30,082)	(37,924)
Effective tax rate	15.1%	19.3%	17.7%	19.6%	19.7%	17.8%	19.8%	20.0%	20.0%
MI	(53)	(61)	(78)	(302)	(352)	(961)	(2,781)	(3,008)	(2,844)
Net profit - GAAP	12,733	15,502	23,810	28,806	41,095	71,510	94,227	117,321	148,851
NPM - GAAP	29.0%	25.6%	30.2%	28.0%	27.0%	30.1%	27.3%	24.9%	23.9%
YoY change	24.8%	21.7%	53.6%	21.0%	42.7%	74.0%	31.8%	24.5%	26.9%
Net profit - Non GAAP	14,286	16,957	24,737	32,410	45,420	65,126	84,749	113,340	147,352
NPM - non-GAAP	32.5%	28.1%	31.3%	31.5%	29.9%	27.4%	24.6%	24.1%	23.7%
YoY change	30.7%	18.7%	45.9%	31.0%	40.1%	43.4%	30.1%	33.7%	30.0%

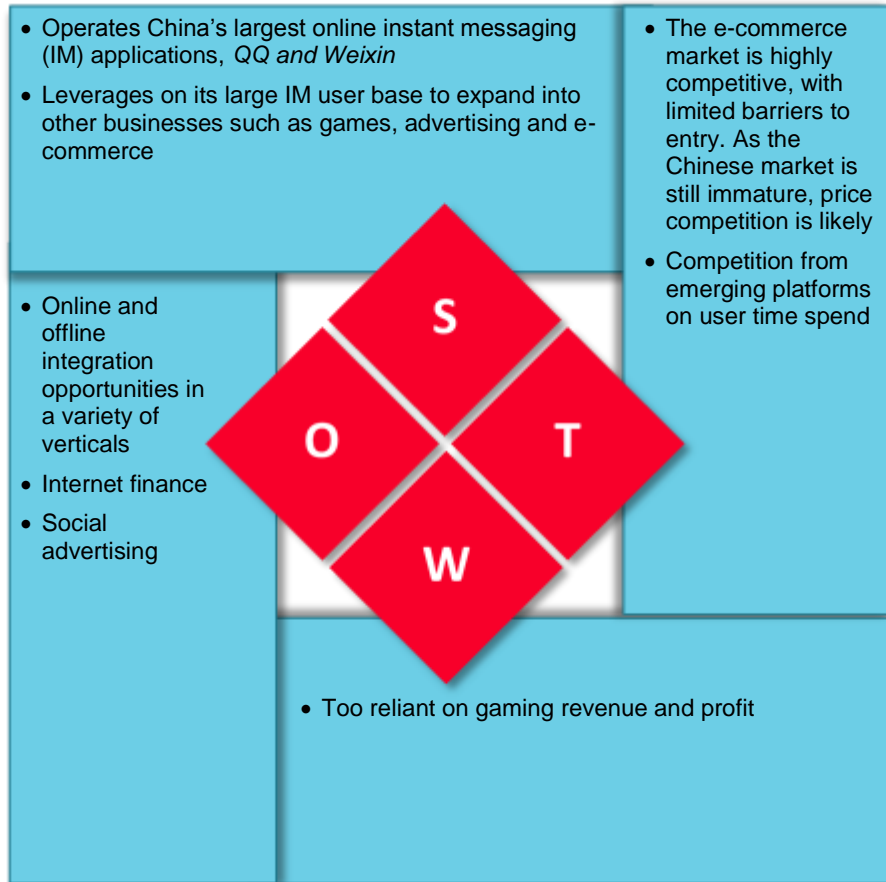
Source: RHB, Company

Figure 4: Tencent's valuation

		Value(CNY bn)	NAV (CNY) per share	NAV (HKD) per share		
Weixin payment		382	40	49		
	FY19F EPS (CNY)	FY19F target PEG (x)	Non GAAP Net Profit CAGR FY17-20F	FY18 P/E	NAV (CNY) per share	NAV (HKD) per share
The rest of its business	11.885	1.0	31%	31	368	454
Net cash (debt) per share - End-1Q18					NAV (CNY) per share (2)	NAV (HKD) per share (2)
Market Value of listed associates and available-for-sale financial assets*	NAV(CNYm)				NAV (CNY) per share	NAV (HKD) per share
	213,000				22	28
Total	FY19F EPS				NAV (CNY) per share	NAV (HKD) per share
	11.885				429	529

Source: RHB

SWOT Analysis



Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
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
2016-03-18	Buy	186	158

Source: RHB, Bloomberg

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