

Time to be patient

Tencent (700.HK)

Technology	
Stock Rating	Buy
Industry View	Overweight
Price target	HKD396.4
Up/downside	+13%
Close price	HKD350.6
52-Week	HKD314.6-476.6
18EPS	RMB8.98
18EPS growth	19.2%
18PE	39X
Market cap	HKD3,338.5bn

Source: Bloomberg, CASH

Relative performance chart



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Time to be patient: Recent headwinds, due to delay in game monetization approval and loss of interest income, are overshadowing the core competency of Tencent's strong platforms. Though we believe Tencent's share price will experience short term pressure, we still like Tencent's long term outlook, wait for a better time and accumulate on lower.

Lackluster 2Q18 overall results: Tencent reported 2Q18 results with revenue growing 30% YoY to Rmb73.7bn, 5% below street. Non-GAAP net income grew 20% YoY to Rmb19.7 bn, 2.8% slightly ahead of consensus.

Weak VAS: VAS revenue was +14% YoY and -10% QoQ to Rmb42.07bn, with online gaming revenue +6% YoY, -12.4% QoQ to Rmb25.20bn (PC -8.5% QoQ, mobile -19% QoQ) and community and platform revenue was +30% YoY, -7% QoQ to Rmb16.87bn. Gross margin for VAS was 59.0%, -1.6 % YoY,-4.3% QoQ driven by greater content costs for digital content activities.

Softness in smartphone games under VAS: Smartphone games revenue grew 19% YoY, -19% QoQ to Rmb17.6bn. DAU for Tencent's mobile games in China grew at a double-digit rate YoY, but monetization per user declined. (1) The delayed approval process of the tactical tournament game (PUBG Mobile) due to a restructuring of the regulatory bodies, (2) 5 out of 7 new games launched after mid-May, (3) Tencent prioritization of game play and user engagement over monetization resulted in a sharp sequential decline in overall online games revenue in 2Q.

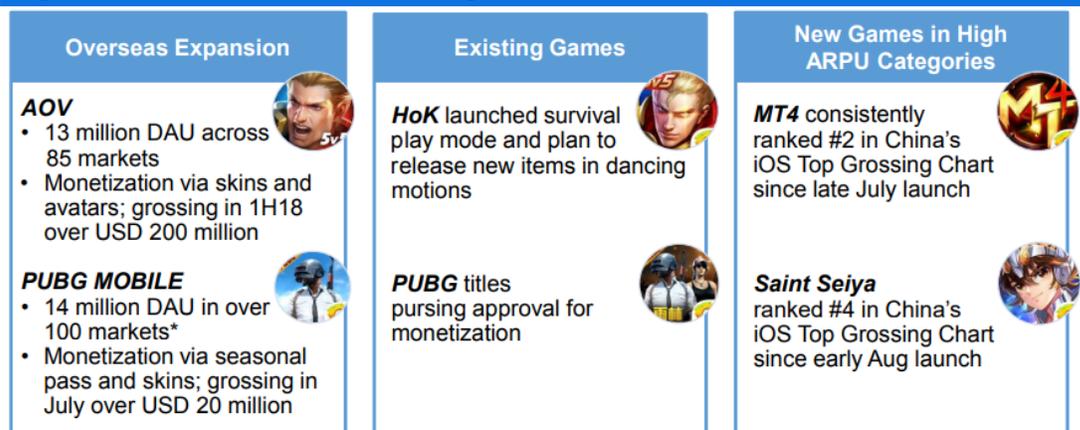
Promising new launches with long term driver intact: Deferred revenue -9.5% QoQ, overall gaming revenue may again experience a weak 3Q. But among new game launches in 3Q18, Free Fantasy Online Mobile, MT4 (launched in July, high-ARPU MMORPG genre), and Saint Seiya (launched in August) have performed well at top 10 grossing rank. Looking forward, **the company highlighted daily active users and time spent for smartphone games to maintain upward trend, reflecting the solid foundation of its mobile games business.** Currently, Tencent has about 15 games in the pipeline with approval obtained on monetization. We think **(1) overseas expansion** (Arena of Valor with >13mn DAUs and >USD30mn monthly grossing in

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1H18 outside China, mobile PUBG with >14mn DAUs and generated >USD20mn grossing in July), **(2) strengthening monetisation of existing games**, as well as **(3) release of new titles with higher ARPU**, are the future growth engines to drive smartphone games.

Weak momentum of PC game under VAS: PC game revenue declined 5% YoY and 8% QoQ to Rmb12.9bn. We believe the YoY decline was mainly due to user time shift to mobile games and tough comparison for LoL and DnF, whereas sequential decline due to slower seasonality. DnF saw YoY growth in paying users and ARPU on 10th anniversary in-game marketing activities in Jun and release of popular items during Labor Day holidays. On the other hand, LoL saw QoQ growth in DAU for popular mid-season invitational event. **This demonstrates the attractiveness of DnF and LoL remains solid. We are still looking forward for the monetarization of PC Fortnite (in the process of applying for the Green Channel but already received approval from the Ministry of Culture and Tourism).**

Figure1. Initiatives to drive future growth



Source: Tencent, CASH

Good growth in social networks revenue: Community and platform revenue +30% YoY, -7% QoQ to Rmb16.87bn with fast growth in subscribers (2Q18 30% YoY, 5% QoQ to 154mn), in part due to variety shows' increasing ability to attract subscribers (video subscriptions increased from 63 mn in 1Q18 to 74 mn in 2Q18 with revenue growing substantially faster than the industry). Apart from exclusive content in key verticals (drama, variety show and Chinese anime), Tencent's creative promotional initiatives like (1) social referral users (gift subscription cards or trial services via red envelopes to Weixin and QQ friends) and (2) cross promotion (bundling

subscriptions with partners' membership packages, including China Literature content) will drive subscriptions revenue. **We believe social networks revenue should accelerate slightly YoY going forward due to easier comparisons and fast growth in subscribers with exclusive content. Weishi , QQ Kandian and creative promotional initiatives are the long term drivers.**

Figure2. Exclusive content in key verticals (drama, variety show, Chinese anime)



Source: Tencent, CASH

Advertising remains strong: Total ad revenue was +39% YoY, +32% QoQ to Rmb14.11bn, with (a) media ad +16% YoY, 43% QoQ to Rmb4.73bn and (b) social ad +55%, +27% QoQ to Rmb9.38bn. GPM for online ads was 37.4%, -0.5 % YoY or +6.2 % QoQ due to increased video content investment. YoY decrease was mainly due to greater content costs, traffic acquisition costs, bandwidth and server custody fees;

Media advertising under advertising segment: Online video ad grew YoY due to sponsorship ad from variety shows such as Produce 101, also popular programs like Legend of Fuyao, while news ad revenue declined single digit YoY on high base last year. **We think the future catalysts include: (1) sequels of Produce 101 will generate more future revenue after proven success in 2Q; (2) IP-based original content in drama, variety show and Chinese anime can continue to drive this segment; (3) reducing discounts to agencies aims to improve margin, and (4) news feed inventory sequentially increased after a completion of ad system revamp. In the long run, Mobile QQ Browser and QQKanDian continues to modify the algorithm and enhanced content offering, enabling Tencent to increase hit rates of recommended feeds stream, boosting user time spent and advertising revenue.**

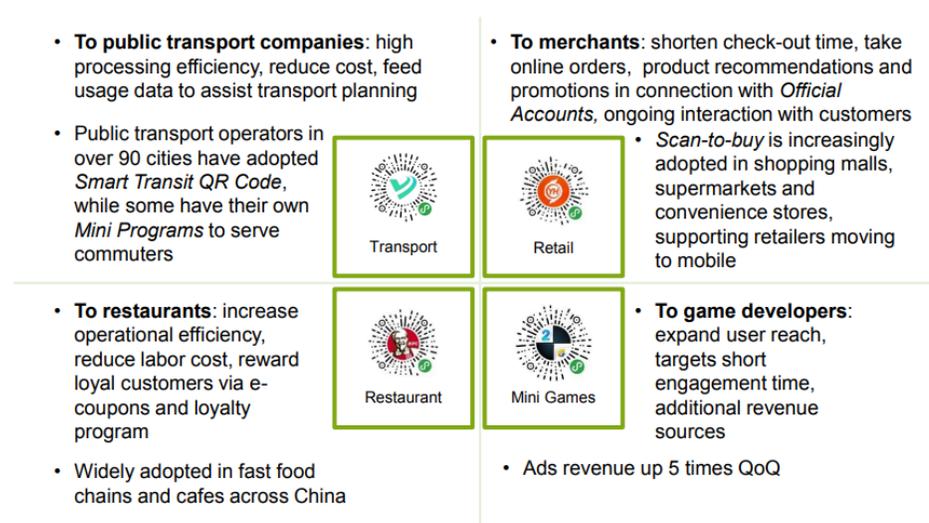
Social advertising under advertising segment: We expect Moments ad takes time to ramp up revenue post increasing ad inventories. On mini-programs, number of DAU reached 200 mn with penetration across different usages like public transport,

restaurants, shopping malls and online games. **Moments/mini Games in Weixin drove up time spent per user per day, a good move for future monetarization. Also, Mini Programs is an innovative and fast-growing developer platform within Weixin with powerful features and easy programming that can help connect offline services to online engagement. In the long run, it can help payment, cloud, advertising business (synergy between different business segments).**

Figure3. Weixin Mini Programs

Weixin Mini Programs

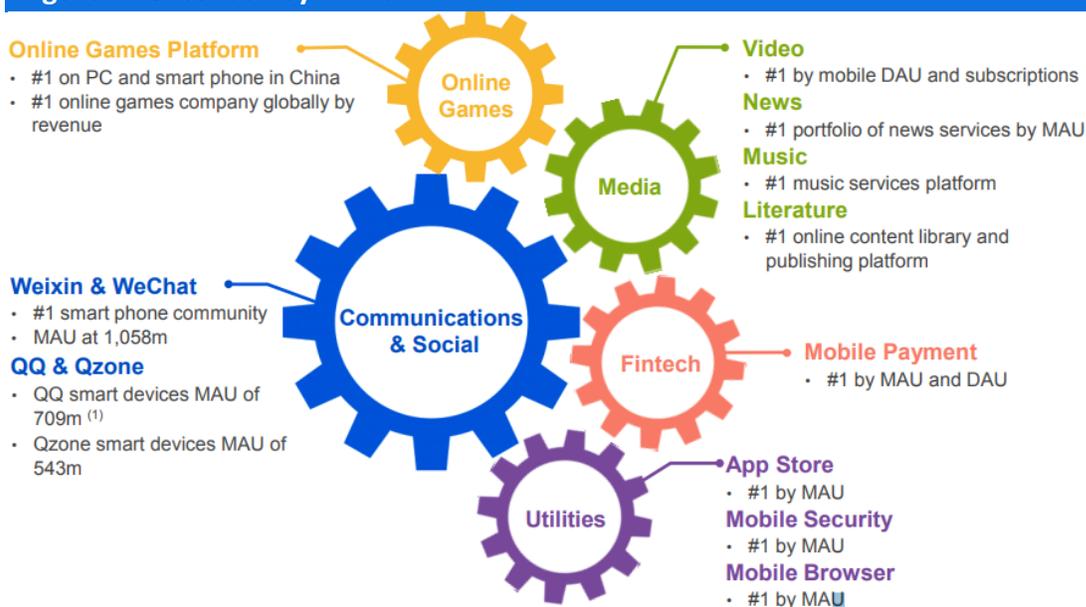
Expanding Penetration Across Multiple Use Cases



Source: Tencent, CASH

Other businesses: Other business revenue reached Rmb 17.50mn, up 81.2% YoY and 9.6% QoQ, primarily benefited from payment related services and doubled YoY revenue of cloud services. Gross margin for others was 24.9%, +2% YoY and -0.5 % QoQ. GPM YoY improvement was mainly driven by the increased scale of payment related and cloud services. **The monthly active users on payment surpassed 800 mn by end of June, with average daily transaction volume increased by over 40% YoY, with offline commercial transactions grew 280% YoY in 2Q18 and commercial payment volume accounting for over half of the total transaction volume for the first time. Expanding the monetisation scenarios is on the way to offset the loss in interest income on new rules on third-party payment, we believe.**

Figure 4. Tencent's Key Platforms



Source: Tencent

Key risks: 1) Faster-than-expected PC game slowdown; 2) delay in new game launch; 3) regulatory policy risks; 4) slowdown in China's economy, which might negatively affect advertising demand.

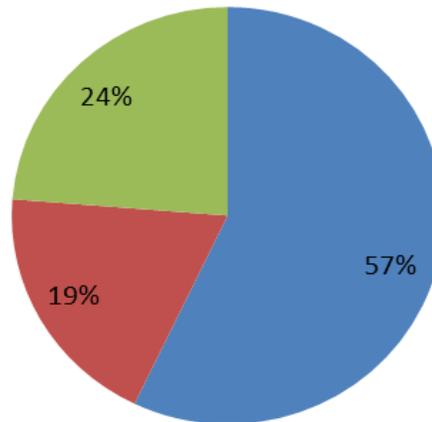
Retain Buy with target price down to HK\$396.4: We revised 2018/19 earnings growth by -21.4%/+12.5% to 19.3%/29.8% based on slowdown of monetarization of gaming business and loss of interest income from the payment business. We reiterate buy with TP down 27% to HK\$396.4 based on target P/E of 29.6x, implying a 13% upside.

Background

Founded in 1998, Tencent has the largest instant messaging and social network platform in China, with the highest monthly active-users, MAU (Weixin: 889.3m; Mobile QQ: 652.5m in 4Q16). Tencent mainly monetises through PC games, Mobile games, social networks (including monthly subscription fee for VIP privileges in QQ Music, Video, Reading, and Anime & Manga), brand ads and performance ads, and others (like payment and cloud services). Pony Ma (馬化騰), Chief Executive Officer, is one of the core founders.

Figure5. Tencent's revenue breakdown in 2Q2018

■ VAS ■ Online advertising ■ Others



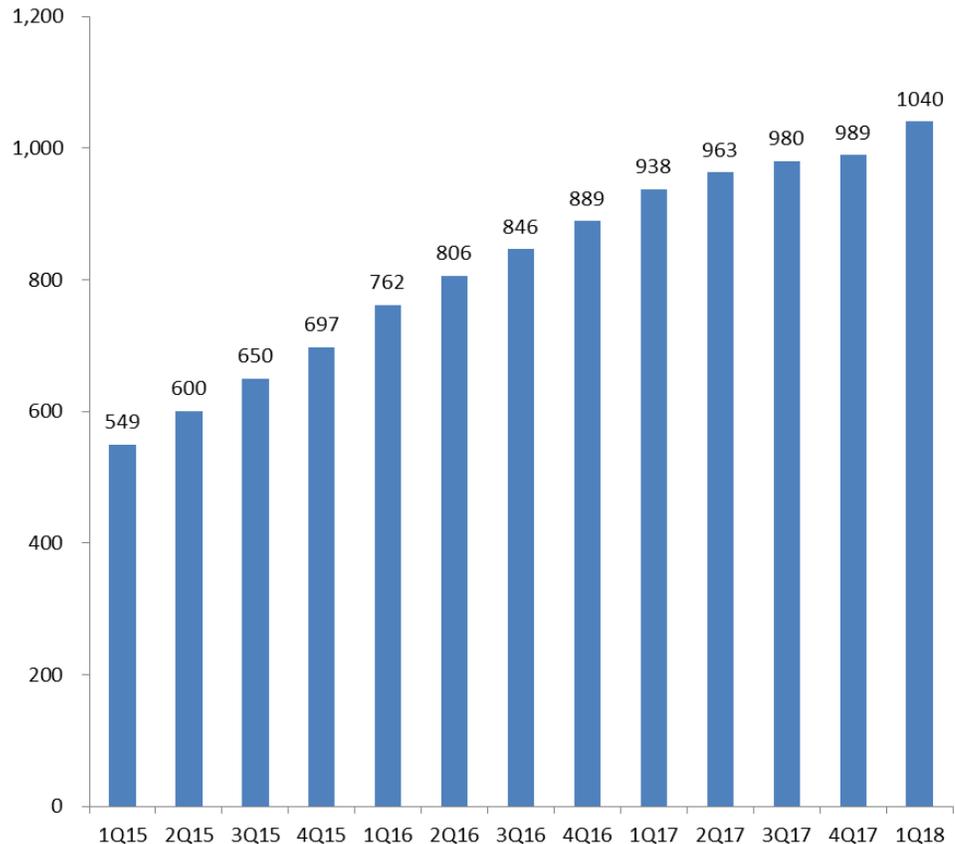
Source: CASH, Company data

Figure6. Top 10 iOS Mobile Games in China in Aug 2018

Ranking	Game Title	Publisher
1	Honor of Kings	Tencent
2	Fantasy Westward Journey	NetEase
3	The King of Fighters: Destiny	Tencent
4	King Of Chaos	Tencent
5	Westward Journey Online	NetEase
6	QQ Speed	Tencent
7	Ghost	NetEase
8	Onmyoji	NetEase
9	MU Awakening	Tencent
10	QQ Dancer	Tencent

Source: CASH, SensorTower

Figure7. Number of monthly active WeChat users (in millions)



Source: CASH, Company data

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Tencent

Income Statement (million RMB\$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Revenue	151,938	237,760	339,454	452,829	580,283
Cost of goods sold	-67,439	-120,835	-184,075	-244,962	-311,205
Gross profit	84,499	116,925	155,379	207,867	269,078
SG&A	-28,382	-26,623	-44,956	-62,093	-97,906
R&D	-11,845	-17,456	-25,437	-30,883	-37,312
Other expense	6,213	24,080	34,379	45,862	58,770
Operating profit	56,117	90,302	110,424	145,775	171,171
EBITDA	68,858	113,804	135,669	179,452	214,327
Depreciation	-3,716	-4,880	-9,364	-12,491	-16,007
Amortization	-9,025	-18,622	-15,882	-21,186	-27,149
EBIT	56,117	90,302	110,424	145,775	171,171
Net interest expense	-1,955	-2,908	-3,916	-5,034	-6,372
Associates & JCEs	-2,522	821	821	821	821
Other income	0	0	0	0	0
Earnings before tax	51,640	88,215	107,329	141,562	165,621
Income tax	-10,193	-15,744	-18,184	-26,997	-30,103
Net profit After tax	41,447	72,471	89,145	114,565	135,517
Minority interests	-352	-961	-3,856	-3,856	-3,856
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	41,095	71,510	85,288	110,709	131,661
Extraordinary items	0	0	0	0	0
Reported NPAT	41,095	71,510	85,288	110,709	131,661
Dividends	-3,699	-4,758	-5,675	-7,366	-8,760
Transfer to reserves	37,396	66,752	79,614	103,342	122,901
EPS	4.34	7.53	8.98	11.65	13.86
DPS	0.39	0.50	0.60	0.78	0.92

Cashflow statement (million RMB\$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Net income	41,095	71,510	85,288	110,709	131,661
Depreciation	3,716	4,880	9,364	12,491	16,007
Amortization	9,025	18,622	15,882	21,186	27,149
Change in Net Working Capital	10,630	51,628	126,199	62,634	-1,272
Cashflow from operations	65,518	106,140	236,733	207,019	173,545
Capital expenditures	-12,100	-13,585	-26,237	-35,000	-44,851
Other non current assets	-68,350	-129,988	-14,003	-14,003	-14,003
Other non current liabilities	3,516	-7,161	0	0	0
CF from investing acts	-70,923	-96,392	-40,240	-49,003	-58,854
CF after investing acts	-5,405	9,748	196,493	158,017	114,691
Equity issue	27,416	24,907	-3,856	-3,856	-3,856
Debt issue	45,476	27,963	32,765	36,810	44,047
Convertible debt issue	0	0	0	0	0
Dividends	-3,699	-4,758	-5,675	-7,366	-8,760
CF from financial acts	31,443	26,598	23,234	25,588	31,430
Net cashflow	26,038	36,346	219,727	183,604	146,121
Beginning cash	43,438	71,902	105,697	325,424	509,028
Adjustments	2,426	-2,551	0	0	0
Ending cash	71,902	105,697	325,424	509,028	655,149
Ending net debt	-2,075	-7,907	-194,869	-341,663	-443,738

Source: Company data, CASH

700.HK, Buy, TargetPrice: 396.4

Balance Sheet (million RMB\$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Cash & equivalents	71,902	105,697	325,424	509,028	655,149
Marketable securities	750	1,606	1,606	1,606	1,606
Accounts receivable	10,152	16,549	22,987	30,665	39,120
Inventories	263	295	829	1,104	1,333
Other current assets	66,087	54,299	156,204	208,375	262,150
Total current assets	149,154	178,446	507,050	750,777	959,357
LT investments	10,702	9,074	9,074	9,074	9,074
Fixed assets	13,900	23,597	40,470	62,979	91,823
Other intangible assets/Goodw	36,467	40,266	38,387	31,205	18,059
Other LT assets	185,676	303,289	303,289	303,289	303,289
Total assets	395,899	554,672	898,271	1,157,324	1,381,603
ST debt	12,278	15,696	14,000	14,000	14,000
Accounts payable	27,413	50,085	72,121	95,977	123,455
Other current liabilities	61,506	85,959	298,999	397,900	431,610
Total current liabilities	101,197	151,740	385,121	507,878	569,065
LT debt	57,549	82,094	116,555	153,365	197,411
Convertible debt	0	0	0	0	0
Other LT liabilities	50,906	43,745	43,745	43,745	43,745
Total liabilities	209,652	277,579	545,420	704,987	810,221
Minority interest	11,623	21,019	17,163	13,307	9,450
Preferred interest	0	0	0	0	0
Common stock	0	0	0	0	0
Retained earnings	136,743	202,682	282,296	385,638	508,539
Proposed dividend	-3,699	-5,052	-5,675	-7,366	-8,760
Other equity and reserves	37,881	53,392	53,392	53,392	53,392
Total shareholders' equity	186,247	277,093	352,850	452,337	571,381
Total equity & liabilities	395,899	554,672	898,271	1,157,324	1,381,603

Key Ratios

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
EPS	41.6%	73.6%	19.3%	29.8%	18.9%
Revenue	47.7%	56.5%	42.8%	33.4%	28.1%
Profitability (%)					
Gross margin	55.6%	49.2%	45.8%	45.9%	46.4%
EBITDA margin	45.3%	47.9%	40.0%	39.6%	36.9%
EBIT margin	36.9%	38.0%	32.5%	32.2%	29.5%
Net Margin	27.3%	30.5%	26.3%	25.3%	23.4%
Effective tax rate	19.7%	17.8%	16.9%	19.1%	18.2%
Dividend payout	9.0%	6.7%	6.7%	6.7%	6.7%
ROE	23.7%	28.3%	26.6%	26.1%	24.1%
ROA	10.4%	12.9%	9.5%	9.6%	9.5%
Liquidity (x)					
Current ratio	1.47	1.18	1.32	1.48	1.69
Interest coverage	28.70	31.05	28.20	28.96	26.86
Leverage					
Net Debt/EBITDA (x)	net cash				
Net Debt/Equity (%)	net cash				
Activity (days)					
Days receivable	25.1	24.4	24.7	24.7	24.7
Days inventory	0.6	0.5	0.9	0.9	0.8
Days payable	65.9	76.9	77.5	77.4	77.7
Cash cycle	-40.2	-52.0	-51.9	-51.8	-52.1

Source: Company data, CASH