

Tencent (700 HK)

Subdued near-term prospect

- 3Q19 presents a mixed picture of its business segments; further slowdown in online advertising and stabilizing online gaming business has been evident
- Online advertising is facing intensified competition from Douyin amid the softening macro environment,
- Maintain **HOLD** on still sluggish growth prospect in the near term

Mixed 3Q19 Results In 3Q19, revenue increased by 21% YoY to RMB 97.2bn, 2% below market expectation. Non-GAAP net profit was up 24% YoY to RMB 24.4bn, 2% below consensus. Overall, 3Q19 shows further slowdown in online advertising business, whose impact was partially mitigated by stabilizing online gaming business and still resilient FinTech/Business services.

Online advertising is facing intensified competition. Online advertising revenue growth slowed to 13% YoY in 1Q19 vs. 16% YoY in 2Q19. Media advertising revenues were down 28% YoY. In addition to softening macro environment, rising competition from Douyin, which has been ramping up its online advertising business in recent quarters, also poses threat to the segment's revenue.

Online gaming stabilizing. Online gaming revenue grew 11% YoY in 2Q19 vs. 8% YoY in 2Q19, driven by contributions from existing key titles and overseas. Overall, revenue from the segment has been stabilizing in recent quarters, thanks to the frequent launch of new games as well as the low-base effect. Nonetheless, specific headwinds are likely to linger, which include potential impacts from the government's recent measures to further limit playing times of youngsters and children, in addition to the escalating competition with other forms of online entertainment including short video apps.

FinTech/Business services are still resilient. On a positive note, FinTech/Business services/others businesses collectively reported a 39% YoY revenue growth in 3Q19; in particular, cloud revenue jumped 80% YoY.

Lack of positive catalyst. We maintain **HOLD** with an updated TP of HK\$328. We see limited positive catalyst given the subdued business outlook in the near term.

Results and Valuation

	2017A	2018A	2019E	2020E
Revenue (RMB mn)	237,760	312,694	370,866	456,693
Chg (% YoY)	56.5	31.5	18.6	23.1
Net profit (RMB mn)	71,510	79,206	82,102	91,510
Chg (% YoY)	74.0	10.8	3.7	11.5
Non-GAAP net profit (RMB mn)*	65,126	77,956	90,902	107,810
Chg (% YoY)	43.4	19.7	16.6	18.6
EPS (RMB)	7.6	8.3	8.6	9.6
Chg (% YoY)	73.4	9.7	3.7	11.5
Non-GAAP EPS (RMB)*	6.9	8.2	9.6	11.3
Chg (% YoY)	43.3	18.9	17.3	18.6
Core P/E (x)*	41.9	35.2	30.0	25.3
P/B (x)	10.7	8.4	6.8	5.6
ROAE (%)	30.9	25.0	20.8	19.3
ROAA (%)	15.0	12.4	10.8	10.7
DPS(HKD)	0.88	0.97	1.00	1.12
Dividend Yield (%)	0.3	0.3	0.3	0.3

*Excluding share based compensation, gain/loss from investee companies, amortization and impairment
 Source(s): Bloomberg, ABCI Securities estimates (*1 RMB= 1.11 HKD)

Company Report

Nov 14, 2019
 Rating: **HOLD**
 TP: **HK\$ 328**

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Share price (HK\$)	319.2
Est. share price return	2.8%
Est. dividend yield	0.3%
Est. total return	3.1%
Previous Rating & TP	HOLD/HK\$355
Previous Report Date	May 16, 2019

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	400.4/270.2
Issued shares (mn)	9,553
Market cap (HK\$ bn)	3,049
Avg daily turnover (HK\$ mn)	3,366
Major shareholder(s)	
Naspers	31.10%
Huateng Ma	8.63%

Source(s): Bloomberg, HKEx, ABCI Securities

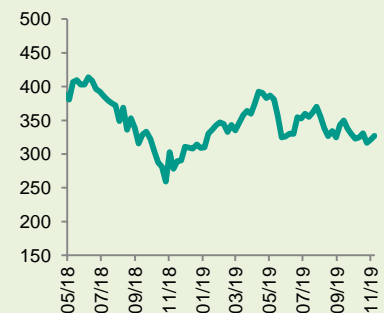
Share Performance (%)

	Absolute	Relative*
1-mth	(2.3)	(1.6)
3-mth	(5.7)	(9.8)
6-mth	(13.5)	(7.2)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



Valuation

We derive Tencent’s fair valuation range based on the SOTP approach. For Tencent’s core business, we apply 22x-25x P/E on its 2020E core net profit. Value of the Group’s investments is based on the latest book value as of Sep 2019 with holding discounts varying between 30-50%.

The SOTP approach results in a fair value range of HK\$ 304-352. We set our TP at HK\$ 328, approximating the mid-point of our fair value range.

Overall, we believe current valuation is being stretched on a PEG basis since growth outlook has dimmed significantly in our opinion. Maintain **HOLD**.

Exhibit 1: SOTP valuation

	Valuation – midpoint (HKD per share)	Valuation – high end	Valuation – low end	Remarks
Core business	297	316	278	22x -25x 2020E core PE
Investments:	31	36	26	Book value as of Sep 2019 with holding discounts varying between 30-50%
Total	328	352	304	

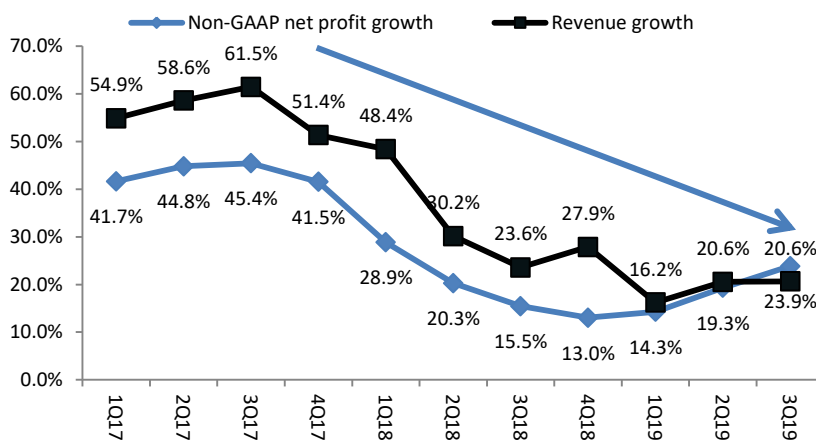
Source(s): Companies, Bloomberg, ABCI Securities

Exhibit 2: Changes in TP

Old	New	Comment
HK\$ 355	HK\$ 328	Roll over to 2020E vs. 2019E previously Lower P/E multiple of 22-25x vs. 26-31x

Source(s): ABCI Securities

Exhibit 3: Growth slowing down significantly



Source(s): Company, ABCI Securities

*Non-GAAP: Excluding share based compensation, gain/loss from investee companies, amortization and impairment



Exhibit 4: 3Q19 highlights

	3Q18	3Q19	YoY	Comments
MAU of QQ (m)	803	803	0%	
Combined MAU of Weixin & WeChat (m)	1,083	1,151	6%	
Financials (RMB m)				
Online game	25,813	28,604	11%	Contribution from existing key titles
Social network	18,236	22,025	21%	
Online advertising	16,247	18,366	13%	Competition from Douyin and weakened macro environment
FinTech/Business service/Others	20,299	28,241	39%	
Revenue	80,595	97,236	21%	2% below consensus
Cost of sales	(45,115)	(54,757)	21%	
Gross profit	35,480	42,479	20%	
Interest income	1,082	1,674	55%	
Other gains, net	8,762	932	-89%	
Selling & marketing expenses	(6,573)	(5,722)	-13%	
General & admin expenses	(10,890)	(13,536)	24%	
Operating profit	27,861	25,827	-7%	
Finance costs, net	(1,492)	(1,747)	17%	
Share of profit/(losses) of associates & JVs	264	234	-11%	
Profit before tax	26,633	24,314	-9%	
Income tax expenses	(3,228)	(3,338)	3%	
Non-controlling interests	(72)	(594)	725%	
Net profit	23,333	20,382	-13%	
Share based compensation	3,458	3,475	0%	
Gain/losses from investee companies	(20,819)	(2,444)	-88%	
Amortization and impairment	13,738	3,462	-75%	
Others	6	(463)		
Core profit (non-GAAP)	19,716	24,412	24%	2% below consensus
Profitability (%):				
	3Q18	3Q19	ppt	
			y-o-y	
Gross margin	44.0	43.7	(0.3)	
Operating margin	34.6	26.6	(8.0)	
Net margin	29.0	21.0	(8.0)	
Core net margin (non-GAAP)	24.5	25.1	0.6	

Source(s): Company, ABCI Securities

Notes: Individual items may not sum up to total due to rounding differences

Individual items may vary from reported figures due to rounding differences/definition differences

Source(s): the Company, ABCI Securities



Risk factors

Market competition

We believe the emergence of alternative online entertainment such as short video apps could steal shares from online gaming in the online entertainment market.

We expect competition to intensify if major overseas online platforms, such as Google and Facebook, are allowed to enter the China market. In our view, competition would be particularly fierce in the online advertising realm, which could potentially impact Tencent's online advertising revenue.

Tightening regulation on online gaming

Regulators have recently suspended approvals for new games (including monetization of existing games). It is uncertain when the regulator will resume the approval process. As such, competition from newcomers is limited. Declining revenue of existing games, we believe, has not been caused by the tightening of regulatory control; instead, product lifecycle has been the primary factor determining revenue growth of a game.

Tightening regulation on internet finance

As the Group is exposed to the internet finance market via its payment business; further regulatory measures in the internet finance market may affect business performance.

Slowing of ecommerce consumption

As the Group is exposed to consumer spending on online entertainment, any significant slowdown of consumption in China would impact business. In the long term, we believe domestic market value growth would converge with nominal income growth, which is usually in line with nominal GDP growth.

Ecosystem may need to improve further in face of competition

Popularity of short-video sharing platforms such as Douyin (抖音) has been increasing rapidly. According to Trustdata, Douyin's Monthly Active Users (MAU) has reached 300m in Feb 2019. This shows that Tencent's ecosystem may need to improve to increase competitiveness.

Non-GAAP financial measures

The Group has disclosed non-GAAP financial metrics such as non-GAAP net profit to supplement its GAAP financial measures. In our view, these non-GAAP financial measures are not standardized and should only be used as reference.



Consolidated income statement (2017A-2020E)

FY Ended Dec 31 (RMB mn)	2017A	2018A	2019E	2020E
Online gaming	97,883	103,992	109,192	123,387
Social network	56,100	72,654	79,919	87,911
Online advertising	40,439	58,079	72,599	87,119
FinTech/Business service/Others	43,338	77,969	109,157	158,277
Total revenue	237,760	312,694	370,866	456,693
Cost of sales	(120,835)	(170,574)	(210,887)	(260,784)
Gross profit	116,925	142,120	159,979	195,909
Interest income	3,940	4,050	4,250	4,450
Other gains/losses	20,140	16,714	12,200	7,200
Selling & marketing expenses	(17,652)	(24,233)	(22,252)	(31,969)
General & admin expenses	(33,051)	(41,522)	(50,067)	(61,654)
Operating Profits	90,302	97,129	104,110	113,937
Finance cost	(2,908)	(4,669)	(5,050)	(5,140)
Share of profit of investments in associates	821	1,487	(1,000)	500
Profit before tax	88,215	93,947	98,060	109,297
Tax	(15,744)	(14,482)	(15,690)	(17,487)
Profit after tax	72,471	79,465	82,371	91,809
Minority interests	961	259	269	300
Net profit	71,510	79,206	82,102	91,510
Share based compensation	6,875	10,325	11,000	13,000
Gain/losses from investee companies	(18,051)	(32,696)	(9,000)	(4,000)
Amortization and impairment	4,792	21,121	6,800	7,300
Other non-core items	-	-	-	-
Non-GAAP (core) net profit	65,126	77,956	90,902	107,810
Growth				
Total revenue (%)	56.5	31.5	18.6	23.1
Gross Profits (%)	38.4	21.5	12.6	22.5
Operating Profits (%)	60.9	7.6	7.2	9.4
Net Profits (%)	74.0	10.8	3.7	11.5
Non-GAAP net profit (%)	43.4	19.7	16.6	18.6
Operating performance				
Gross margin (%)	49.2	45.5	43.1	42.9
Operating margin (%)	38.0	31.1	28.1	24.9
Net margin (%)	30.1	25.3	22.1	20.0
Non-GAAP net margin (%)	27.4	24.9	24.5	23.6
ROAE (%)	30.9	25.0	20.8	19.3
ROAA (%)	15.0	12.4	10.8	10.7

Notes: Individual items may not sum to total due to rounding differences

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Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2017A-2020E)

As of Dec 31 (RMB mn)	2017A	2018A	2019E	2020E
Fixed assets	32,671	47,801	68,801	89,801
Intangible assets	40,266	56,650	59,650	62,150
Investment in associates and JV	144,581	227,790	267,790	307,790
Financial assets	132,377	136,914	146,914	156,914
Term deposit	5,365	-	-	-
Other non-current assets	20,966	37,286	37,286	37,286
Total non-current assets	376,226	506,441	580,441	653,941
Cash & equivalents	105,697	97,814	103,546	125,414
Restricted cash	1,606	2,590	2,590	2,590
Term deposit	36,724	62,918	62,918	62,918
Account receivables	16,549	28,427	27,688	35,346
Deposit, prepayments and other assets	17,110	18,493	18,493	18,493
Inventories	295	324	324	324
Other current assets	465	6,514	6,514	6,514
Total current assets	178,446	217,080	222,073	251,600
Total assets	554,672	723,521	802,514	905,541
Accounts payable	50,085	73,735	76,542	94,652
Other payables & accruals	29,433	33,312	33,312	33,312
Borrowings and notes	20,448	40,554	40,554	40,554
Deferred revenue	42,132	42,375	42,375	42,375
Other current liabilities	9,642	12,459	12,459	12,459
Total current liabilities	151,740	202,435	205,242	223,352
Loans and bonds payables	111,457	138,735	138,735	138,735
Deferred revenue	2,391	7,077	7,077	7,077
Other non-current liabilities	11,991	19,067	19,067	19,067
Total non-current liabilities	125,839	164,879	164,879	164,879
Total liabilities	277,579	367,314	370,121	388,231
Net current assets	26,706	14,645	16,831	28,248
Equity attributable to shareholders	256,074	323,510	399,427	484,044
Non-controlling interests	21,019	32,697	32,966	33,266
Total equity	277,093	356,207	432,393	517,310

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Source(s): Company, ABCI Securities estimates

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Definition of equity rating

Rating	Definition
Buy	Stock return rate \geq Market return rate (10%)
Hold	- Market return rate (-10%) \leq Stock return rate $<$ Market return rate (+10%)
Sell	Stock return $<$ - Market return (-10%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2005 (HSI total return index 2005-17 CAGR at 10%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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