

Tencent (700 HK)

Strong gaming momentum; maintain BUY

- Resilient 3Q20 results with 29% YoY revenue growth and 32% YoY core profit growth, primarily driven by online gaming business
- Strong momentum in online gaming business to sustain in the near term on potential launch of key titles and overseas contributions; online advertising business should continue to improve
- Maintain **BUY** and raise TP to HK\$ 730 on resilient business momentum

3Q20 highlights. Tencent reported resilient results in 3Q20, with 29% YoY growth in revenue and 32% YoY growth in non-GAAP net profit. Overall, the resilient results were driven by the ongoing momentum in online gaming and recovering online advertising businesses, which partially mitigates the slowdown in cloud segment.

Online gaming is the bright spot. Online gaming revenue rose by 45% YoY vs. 40% YoY in 2Q20, indicating a sequential improvement in the post-pandemic era. Smartphone game revenue grew 62% in 3Q20 on key titles including Peacekeeper Elite and Honor of Kings, in addition to increasing contribution from overseas titles. Looking forward, potential launch of key titles, including DNF Mobile and League of Legends Mobile, would continue to drive the momentum in coming quarters.

Online advertising recovered. Online advertising started to bottom out with a 16% YoY revenue growth in 3Q20 vs. 13% YoY growth in 2Q20, indicating a recovering business environment. Within online advertising, social and other advertising continued to be the main growth driver with a 21% YoY growth. We expect the segment to improve further in coming quarters.

Maintain BUY. We maintain our **BUY** rating on the counter given the strong momentum of the online gaming business and the improving online advertising business, which will help mitigate impacts of the cloud segment amid delay in IT infrastructure projects. Based on revised assumptions, we value the counter at HK\$662-806 based on SOTP methodology and set our TP to HK\$ 730.

Results and Valuation

	2018A	2019A	2020E	2021E
Revenue (RMB mn)	312,694	377,289	478,462	617,538
Chg (% YoY)	60.8	20.7	26.8	29.1
Net profit (RMB mn)	78,719	93,310	108,466	151,026
Chg (% YoY)	10.1	18.5	16.2	39.2
Non-GAAP net profit (RMB mn)	77,469	94,351	124,216	166,776
Chg (% YoY)	19.0	21.8	31.7	34.3
EPS (RMB)	8.3	9.9	11.4	15.8
Chg (% YoY)	9.7	18.2	15.2	39.2
Non-GAAP EPS (RMB)	8.2	10.0	13.0	17.5
Chg (% YoY)	18.5	21.5	30.5	34.3
Core P/E (x)	62.0	51.1	39.1	29.2
P/B (x)	14.9	11.1	9.1	7.2
ROAE (%)	24.9	22.1	20.1	22.9
ROAA (%)	12.3	11.1	10.7	13.1
DPS(HK\$)	0.97	1.14	1.32	1.83
Dividend Yield (%)	0.2	0.2	0.2	0.3

Source(s): Bloomberg, ABCI Securities estimates

Company Report

Nov 13, 2020

Rating: **BUY**

TP: **HK\$730**

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Share price (HK\$)	595.5
Est. share price return	22.6%
Est. dividend yield	0.3%
Est. total return	22.9%
Previous Rating & TP	BUY/HK\$500
Previous Report Date	May 14, 2020

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L(HK\$)	633.0/318.0
Issued shares (mn)	9,585
Market cap (HK\$ mn)	5,707,868
Avg daily turnover (HK\$ mn)	5,271
Major shareholder(s)	
Naspers	31.0%
Huateng Ma	8.53%

Source(s): Bloomberg, ABCI Securities

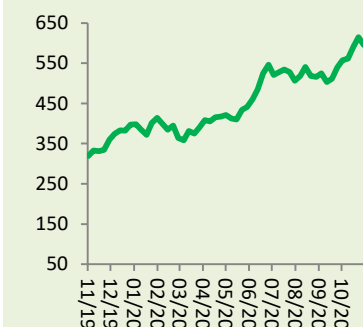
Share Performance (%)

	Absolute	Relative*
1-mth	6.7	1.1
3-mth	16.3	13.3
6-mth	38.4	30.7

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



3Q20 highlights

In 3Q20, revenue increased by 29% YoY to RMB 125.5bn, in-line with market expectation. In addition, non-GAAP net profit increased by 32% YoY to RMB 32.3bn, 2% above market expectation.

Online gaming continued to experience robust growth in 3Q20 with revenue increasing by 45% YoY (8% QoQ) vs. 40% YoY in 2Q20, thanks to key titles including Peacekeeper Elite and Honor of Kings, as well as increasing contribution from overseas titles including PUBG Mobile. Smartphone game revenue grew 62% in 3Q20, much higher than the 1% YoY growth in PC game revenue.

Social network reported 29% YoY revenue growth in 3Q20 driven by video and music content subscriptions. For example, its video and music subscriptions grew by 20% YoY and 46% YoY to 120 million and 52 million respectively in 3Q20.

Online advertising reported a 16% YoY (15% QoQ) revenue growth in 3Q20 vs. 13% YoY growth in 2Q20, indicating a gradual recovery from the trough brought on by the pandemic. Within online advertising, social and other advertising continued to be the main driver with a 21% YoY growth driven by higher impressions and eCPM; nonetheless, media advertising still saw a 1% YoY revenue decline. By industry, advertising spending on ecommerce platforms, internet services, and online education reported strong growth; meanwhile, advertising spending on real estates, financial services, consumer staples, and automobile are stabilizing.

Revenue of FinTech and business service grew 24% YoY in 3Q20 vs. 30% YoY in 2Q20 due to delay in cloud projects during the outbreak. On a positive note, its Total Payment Volume (TPV) increased over 30% YoY in 3Q20, driven by deeper penetration in offline transactions and expansions in retail categories, such as grocery and apparel.

Exhibit 1: 3Q20 highlight

(RMB m)	3Q19	3Q20	YoY	Remarks
Online game	28,604	41,422	45%	Driven by Peacekeeper Elite, HOK, PUBG Mobile, etc
Social network	22,025	28,380	29%	
Online advertising	18,366	21,351	16%	Driven by social network advertising
FinTech and business service	26,758	33,255	24%	Delay of cloud projects
Others	1,483	1,039	-30%	
Revenue	97,236	125,447	29%	In-line with market expectation
Gross profit	42,479	56,647	33%	
Operating profit	25,827	43,953	70%	
Net profit	20,382	38,542	89%	
Core profit (non-GAAP)	24,412	32,303	32%	2% above market expectation
<u>Profitability (%)</u>	3Q19	3Q20	ppt	
			change	
Gross margin	43.7	45.2	1.5	
Operating margin	26.6	35.0	8.5	
Net margin	21.0	30.7	9.8	
Core net margin (non-GAAP)	25.1	25.8	0.6	

Source(s): The Company, ABCI Securities



Near-term business outlook

Tencent's two blockbuster games, Peacekeeper Elite (和平精英) and Honor of Kings (王者荣耀), have continued to top the chart in China's best grossing mobile gaming league table every month since June 2019. Overall, the pandemic-induced boost in online gaming traffic has started to normalize in the domestic market; however, gaming traffic in overseas markets is still elevated.

Looking forward, based on Tencent's new game pipeline, DnF Mobile (地下城与勇士) could be another potential blockbuster. To recap, DnF PC version has been Tencent's long-standing blockbuster game with a long history since 2008; the game has accumulated a large and loyal user base over the years. Another potential blockbuster would be the upcoming launch of League of Legends (LoL) mobile version in overseas market. Similar to DnF, LoL has amassed a sizable loyal user base over the years.

Social network business has reported steady revenue growth in recent quarters driven by video and music subscriptions and we expect the trend to continue in the near term.

For online advertising business, we believe it is gradually emerging from trough thanks to the recovering economy in China, and we expect the improvement to continue in coming quarters. By segment, we believe social network advertising will continue to benefit from increase in advertising inventories and traffic. Media advertising, however, will continue to be under pressure due to budget cuts, especially from international brands.

For FinTech and business services, the ongoing recovery in offline payment volume supported by a reviving retail market should benefit the segment. Near-term headwinds in the cloud market, however, will persist due to delay in IT infrastructure projects.



Financial outlook

We expect revenue to grow at 28% CAGR in 2019-2021E.

Online gaming: We expect online gaming revenue to expand at 28% CAGR in 2019-21E. The coronavirus outbreak has increased consumers' time spent on online gaming, which bodes well for this segment especially in 2020. In addition, the potential launch of DnF Mobile could be another income driver since the franchise has accumulated a sizable user base.

Segment revenue is also supported by the consolidation of Supercell in Nov 2019 after Tencent had raised its stakes to 51.2%. Supercell reported US\$ 1.56bn in revenue and US\$ 577mn in profit before tax (PBT) in 2019, equivalent to 2.9% and 0.5% of Tencent's revenue and PBT in 2019.

Social network: We expect social network revenue to increase at 24% CAGR in 2019-21E driven by further penetration of Tencent Video and Tencent Music and ongoing monetization of user base.

Online advertising: Overall, the weak economic environment has led to a slowdown in revenue growth. Having said that, we believe the situation will improve gradually over the next few quarters, driven by economic recovery in the post-pandemic era. We expect online advertising revenue to expand at 23% CAGR in 2019-21E, mainly driven by social media advertising.

FinTech and business service: We expect segment revenue to increase at 34% CAGR in 2019-21E. The third-party payment business is influenced by retail consumption, which has been experiencing a gradual recovery in recent months.

Exhibit 2: Revenue forecasts (RMB mn)

	2018	2019	2020E	2021E
Value added services (VAS)	176,646	199,991	262,125	318,433
<i>Online games</i>	<i>103,992</i>	<i>114,700</i>	<i>156,225</i>	<i>187,896</i>
<i>Social network</i>	<i>72,654</i>	<i>85,281</i>	<i>105,900</i>	<i>130,537</i>
Online advertising	58,079	68,377	76,918	103,918
FinTech and business services	73,138	101,355	129,734	181,628
Others	4,831	7,566	9,684	13,558
Total revenue	312,694	377,289	478,462	617,538
Gross margin	45.5%	44.4%	45.1%	43.9%

Source(s): The Company, ABCI Securities estimates



Tencent's gross margin has been declining in recent years, mainly dragged by falling profitability of VAS business (online gaming and social network). Gross margin of online advertising gross margin has been trending up as Tencent continues to innovative value-added advertising services; meanwhile, gross margin of FinTech and business services has been rising.

We expect gross margin to fall from 44.4% in 2019 to 43.9% in 2021E, affected by ongoing changes in business mix shifting to lower-margin online advertising and FinTech/business services segments.

In terms of operating cost, we expect ongoing improvement in cost efficiency to mitigate partially the negative impacts of lower gross margin. We estimate SG&A cost-to-revenue ratio to fall from 19.8% in 2019 to 15.3% in 2021E

Expenses on selling, marketing, general, and admin: Thanks to the higher economies of scale, we expect selling and marketing cost-to-revenue ratio to drop from 5.7% in 2019 to 4.3% in 2021E, and general and admin cost-to-revenue ratio to drop from 14.2% in 2019 to 11.0% in 2021E.

Exhibit 3: SG&A cost trend (RMB mn)

	2018	2019	2020E	2021E
Selling & marketing expenses	(24,233)	(21,396)	(26,039)	(26,458)
General & admin expenses	(41,522)	(53,446)	(62,730)	(68,034)
Total SG&A	(65,755)	(74,842)	(88,769)	(94,492)
% of revenue				
Selling & marketing expenses	7.7%	5.7%	5.4%	4.3%
General & admin expenses	13.3%	14.2%	13.1%	11.0%
Total SG&A	21.0%	19.8%	18.6%	15.3%

Source(s): The Company, ABCI Securities estimates

Based on the gross margin and cost trends, we expect core net margin (excl. impacts of share-based compensation and other non-operating items) to improve from 25.0% in 2019 to 27.0% in 2021E. This would result in a 32% CAGR in core net profit for 2019-21E.



Earnings sensitivity

In terms of earning sensitivity, we estimate that a 100bp improvement in core net margin would increase its 2020E and 2021E core net profits by 3.9% and 3.7% respectively.

Exhibit 4: Earnings sensitivity

Changes in core net margin (bps)	Changes in 2020E core net profit	Changes in 2021E core net profit
100	3.9%	3.7%
75	2.9%	2.8%
50	1.9%	1.9%
25	1.0%	0.9%
-	0.0%	0.0%
(25)	-1.0%	-0.9%
(50)	-1.9%	-1.9%
(75)	-2.9%	-2.8%
(100)	-3.9%	-3.7%

Source(s): ABCI Securities estimates

Exhibit 5: Forecast changes (2020E)

(RMB m)	2020E		Diff	Comment
	old	new		
Revenues	459,189	478,462	4%	Higher growth assumptions
Net income	102,944	108,466	5%	
Core profit	118,694	124,216	5%	

Source(s): ABCI Securities estimates

Exhibit 6: Forecast changes (2021E)

(RMB m)	2021E		Diff	Comment
	old	new		
Revenues	581,230	617,538	6%	Higher growth assumptions
Net income	132,489	151,026	14%	Lower cost assumptions
Core profit	148,239	166,776	13%	

Source(s): ABCI Securities estimates

Valuation

We maintain **BUY** on Tencent given the strong momentum of online gaming/entertainment business. In addition, we expect the impetus in the overseas market to persist in the near term.

Based on the SOTP approach, we derive a fair valuation range of HK\$ 662-806 and set our TP at HK\$730.

To value Tencent's core business, we apply a 30x-36x targeted 2021E P/E. Tencent's investment value is based on their latest book value at end-Sep 2020 with a 0-30% holding discount.

Exhibit 7: SOTP valuation (HK\$ per share)

	Valuation – high end	Valuation – low end	Remarks
Core business	735	613	30x -36x 2021E core P/E
Investments	70	49	End-Sep 2020 book value (RMB 574bn) with 0%-30% holding discount
Total	806	662	

Source(s): ABCI Securities estimates

Peer valuation analysis

Among the HK-listed internet platforms, including Tencent, Alibaba (9988 HK/BABA US), and Meituan (3690 HK), Tencent is trading at a higher P/E than Alibaba. On the other hand, Meituan is trading at significant higher P/E than Tencent and Alibaba; however, P/E might not be the best valuation metric for Meituan as the company is still in the early stage of profitability. Instead, P/Sales is a more suitable measure.



Exhibit 8: Peer valuation

		Market cap (Lcy)	Price (Lcy)	P/sales			P/E		
				2019	2020E	2021E	2019	2020E	2021E
HK-listed major online platforms									
700 HK Equity	TENCENT	5,707,868	595.5	12.8	10.2	7.9	51.1	39.1	29.2
9988 HK Equity	ALIBABA	5,597,421	258.6	9.6	7.0	5.4	45.4	26.9	22.0
3690 HK Equity	MEITUAN	1,721,407	292.6	15.4	13.4	9.0	453.4	280.7	89.1

Source(s): Bloomberg, ABCI Securities estimates

Exhibit 9: TP changes (HK\$ per share)

Segment	Old	New	Methodology- old	Methodology -new
Core business	453	670	26.5x 2021E core P/E	33x 2021E core P/E
Investments	47	60	Book value with a 15% holding discount	Book value with a 15% holding discount
Overall	500	730		

Source(s): ABCI Securities estimates



Risk factors

Market competition

We believe the rise of emerging forms of 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 in turn could impact Tencent's online advertising revenue that accounted for 18% of total revenue in 2019.

Tightening regulation over online gaming

Regulators have suspended granting approvals on new games (including monetization of existing games) between Apr 2018 and Nov 2018. Mobile gaming revenue could be impacted should the regulatory tighten new game approval again in the future. Other measures, such as curfew on online gaming for minors, may also affect revenue.

Tightening regulation on internet finance

As the Group is exposed to the internet finance market via its payment business, further regulatory measures 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 financial performance. In the long run, we believe domestic market growth would converge with income growth, which usually aligns with GDP growth.

Ecosystem may need to improve further amid competition

Popularity of short-video sharing platforms such as Douyin (抖音) has been increasing rapidly. In our view, this shows that Tencent's ecosystem has room to improve.

Non-GAAP financials

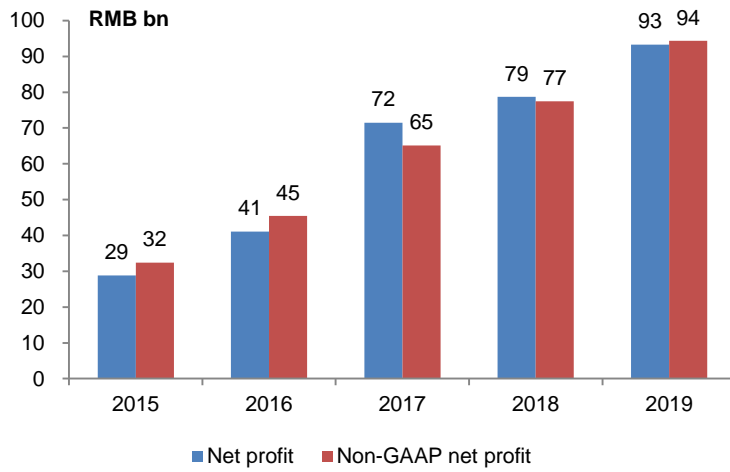
The Group has disclosed the non-GAAP financial metric, such as the non-GAAP net profit, to supplement its GAAP financial measures. Historically, there were differences between its GAAP net profit and non-GAAP net profit due to inclusion of items such as share-based compensation, impairment, fair valuation changes of investment, and disposal gains of asset in the former.

Among these items, share-based compensation expense is related to various factors including price movement of ordinary shares, expected volatility, risk-free interest rate, etc. Its share-based compensation expenses have been trending up over the past few years, rising from RMB 4.9bn in 2016 to RMB 12.3bn in 2019.

While investors tend to exclude these items when performing analysis given their non-cash nature, we believe these non-GAAP financial measures should only serve as reference.



Exhibit 10: Net profit vs. Non-GAAP core net profit (RMB m)



Source(s): The Company, ABCI Securities



Financial forecast

Consolidated income statement (2018A-2021E)

FY Ended Dec 31 (RMB mn)	2018A	2019A	2020E	2021E
Online gaming	103,992	114,710	156,225	187,896
Social network	72,654	85,281	105,900	130,537
Online advertising	58,079	68,377	76,918	103,918
FinTech and business service	73,138	101,355	129,734	181,628
Others	4,831	7,566	9,684	13,558
Total revenue	312,694	377,289	478,462	617,538
Cost of sales	(170,574)	(209,756)	(262,843)	(346,414)
Gross profit	142,120	167,533	215,619	271,124
Interest income	4,569	6,314	7,050	8,050
Other gains/losses	16,714	19,689	7,250	7,550
Selling & marketing expenses	(24,233)	(21,396)	(26,039)	(26,458)
General & admin expenses	(41,522)	(53,446)	(62,730)	(68,034)
Operating Profits	97,648	118,694	141,150	192,232
Finance cost	(4,669)	(7,613)	(8,100)	(8,350)
Share of profit of investments in associates	1,487	(1,681)	(500)	(500)
Profit before tax	94,466	109,400	132,550	183,382
Tax	(14,482)	(13,512)	(23,728)	(31,861)
Profit after tax	79,984	95,888	108,822	151,521
Minority interests	1,265	2,578	355	495
Net profit	78,719	93,310	108,466	151,026
Share based compensation	11,025	12,309	12,500	12,800
Gain/losses from investee companies	(33,073)	(20,720)	(4,000)	(4,100)
Amortization and impairment	21,265	10,547	7,250	7,050
Other non-core items	(467)	(1,095)	-	-
Non-GAAP net profit (core profit)	77,469	94,351	124,216	166,776
Growth				
Total revenue (%)	60.8	20.7	26.8	29.1
Gross Profits (%)	21.5	17.9	28.7	25.7
Operating Profits (%)	8.1	21.6	18.9	36.2
Net Profits (%)	10.1	18.5	16.2	39.2
Non-GAAP net profit (%)	19.0	21.8	31.7	34.3
Operating performance				
Gross margin (%)	45.5	44.4	45.1	43.9
Operating margin (%)	31.2	31.5	29.5	31.1
Net margin (%)	25.2	24.7	22.7	24.5
Non-GAAP net margin (%)	24.8	25.0	26.0	27.0
ROAE (%)	24.9	22.1	20.1	22.9
ROAA (%)	12.3	11.1	10.7	13.1

Source(s): The Company, ABCI Securities estimates

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

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



Consolidated balance sheet (2018A-2021E)

As of Dec 31 (RMB mn)	2018A	2019A	2020E	2021E
Fixed assets	47,801	78,070	99,070	120,070
Intangible assets	56,650	128,860	131,360	133,860
Investment in associates and JV	227,790	221,894	261,894	301,894
Financial assets	136,914	210,543	220,543	230,543
Term deposit	-	19,000	19,000	19,000
Other non-current assets	37,286	41,651	41,651	41,651
Total non-current assets	506,441	700,018	773,518	847,018
Cash & equivalents	97,814	132,991	173,659	258,180
Restricted cash	2,590	2,180	2,180	2,180
Term deposit	62,918	46,911	46,911	46,911
Account receivables	28,427	35,839	37,031	49,487
Deposit, prepayments and other assets	18,493	27,840	27,840	27,840
Inventories	324	718	718	718
Other current assets	6,514	7,489	7,489	7,489
Total current assets	217,080	253,968	295,829	392,805
Total assets	723,521	953,986	1,069,347	1,239,823
Accounts payable	73,735	80,690	95,399	125,731
Other payables & accruals	33,312	45,174	45,174	45,174
Borrowings and notes	40,554	33,229	33,229	33,229
Deferred revenue	42,375	64,228	64,228	64,228
Other current liabilities	12,459	16,835	16,835	16,835
Total current liabilities	202,435	240,156	254,865	285,197
Loans and bonds payables	138,735	187,584	187,584	187,584
Deferred revenue	7,077	7,334	7,334	7,334
Other non-current liabilities	19,067	30,088	30,088	30,088
Total non-current liabilities	164,879	225,006	225,006	225,006
Total liabilities	367,314	465,162	479,871	510,203
Net current assets	14,645	13,812	40,963	107,608
Equity attributable to shareholders	323,510	432,706	533,002	672,652
Non-controlling interests	32,697	56,118	56,473	56,968
Total equity	356,207	488,824	589,475	729,620

Source(s): The Company, ABCI Securities estimates

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

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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 2008 (HSI total return index 2008-19 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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