

# Tencent (700 HK)

## Dimmed growth prospect

- Both revenue and non-GAAP profit growths were in mid-teens levels in 1Q19; broad-based slowdown across major segments
- Online advertising is facing intensified competition from Douyu, while FinTech is impacted by tightened regulatory requirement
- Maintain **HOLD** on dimmed growth prospect

**Broad-based slowdown.** In 1Q19, revenue increased by 16% YoY to RMB 88.5bn, 4% below market expectation. Non-GAAP net profit was up 14% YoY to RMB 20.9bn, 6% above consensus, mainly driven by cost control. In our view, the revenue slowdown is worrisome as it occurred in all major segments.

**Online gaming: not out of the woods yet.** Online gaming revenue fell 2% YoY in 1Q19. The segment is facing challenges from alternative online entertainment, including short video apps, which might mitigate potential benefits from a more supportive regulatory environment recently as well as the new PUBG-styled game "Peacekeeper Elite".

**Online advertising facing intensified competition.** Online advertising revenue growth slowed to 25% YoY in 1Q19 vs. 38% YoY in 4Q18, in which long video advertising revenues were flat YoY. This supports our view that online advertising segment is facing rising competition from Douyin.

**FinTech/Business services also slowing.** FinTech/Business services/others businesses collectively reported a 45% YoY revenue growth in 1Q19, significantly lower than 72% YoY growth in 4Q18, as the FinTech business was impacted by the regulatory requirement of transferring its custodian cash to PBOC.

**Maintain HOLD.** In light of flaccid near-term growth prospect. We maintain **HOLD** with an updated TP of HK\$355.

### 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)*	46.4	39.0	33.2	28.0
P/B (x)	11.8	9.3	7.6	6.2
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 (%)	0.2	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= 1.15 HKD)

## Company Report

May 16, 2019  
 Rating: **HOLD**  
 TP: **HK\$ 355**

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Share price (HK\$)	365.6
Est. share price return	-2.9%
Est. dividend yield	0.3%
Est. total return	-2.6%
Previous Rating & TP	HOLD/HK\$360
Previous Report Date	Mar 22, 2019

Source(s): Bloomberg, ABCI Securities

### Key Data

52Wk H/L(HK\$)	458.9/251.4
Issued shares (mn)	9,520
Market cap (HK\$ bn)	3,480
Avg daily turnover (HK\$ mn)	3,785
Major shareholder(s)	
Naspers	31.10%
Huateng Ma	8.63%

Source(s): Bloomberg, HKEX, ABCI Securities

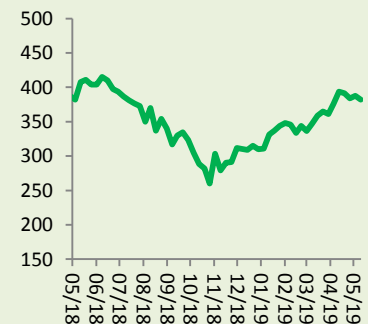
### Share Performance (%)

	Absolute	Relative*
1-mth	-6.5	-0.5
3-mth	2.7	1.3
6-mth	15.7	7.5

\*Relative to HSI

Source(s): Bloomberg, ABCI Securities

### Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



### 1Q19 results highlight

Overall, 1Q19 results were overall sluggish with broad-based slowdown evident in all major business segments.

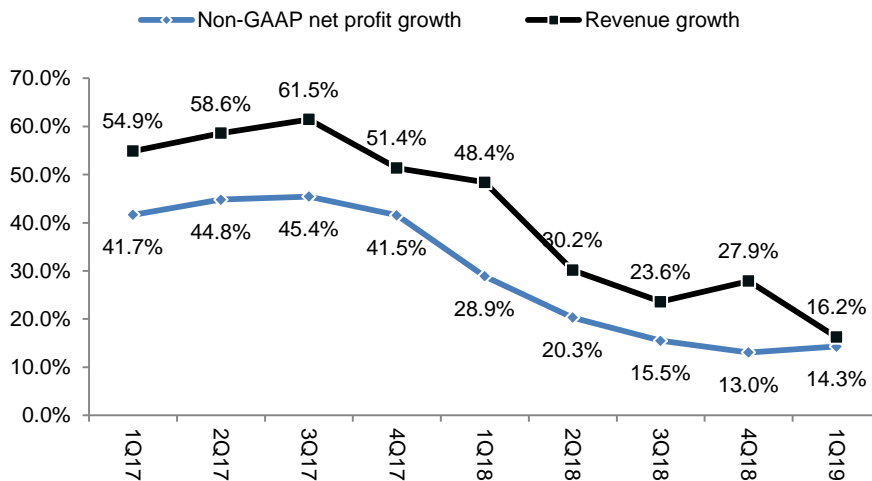
In 1Q19, revenue increased by 16% YoY to RMB 88.5bn, 4% below market expectation. Non-GAAP net profit was up 14% YoY to RMB 20.9bn, 6% above consensus, mainly driven by cost control. Reported net profit increased by 17% YoY to RMB 27.2bn, 40% above market expectation due to valuation gains from investee companies.

Mobile gaming revenue growth dropped 2% YoY in 1Q19 versus 12% growth in 4Q18 despite "Honour of Kings" content update and the launch of "Perfect World Mobile" and other games. PC gaming revenue declined by 2% YoY in 1Q19 despite the new skin introduction of "League of Legends" and DnF content update. We continue to believe the online gaming segment is facing challenges from increasing preference for alternative online entertainment, including short video apps.

Online advertising revenue growth slowed to 25% YoY in 1Q19 vs. 38% YoY in 4Q18 due to challenging macro environment and the high base last year. In particular, long video advertising revenues were flat YoY, which supports our view that competition from Douyin is escalating, especially when the latter has been ramping up its online advertising business in recent quarters.

FinTech/Cloud and other revenue grew 45% YoY in 1Q19, significantly lower than the 72% YoY growth in 4Q18. The business was impacted by the absence of interest income from its custodian cash since regulation requires custodian cash to be transferred to PBOC.

Exhibit 1: Both revenue and non-GAAP net profit\* growth have fallen to mid-teens level



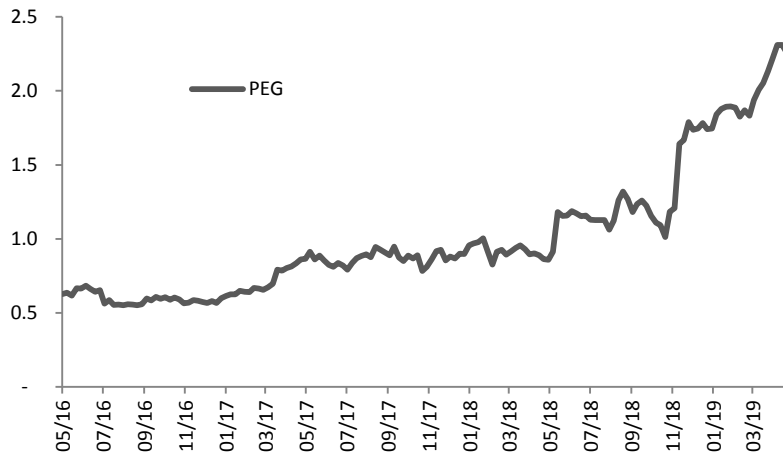
Source(s): Company, ABCI Securities

\*Excluding share based compensation, gain/loss from investee companies, amortization and impairment.



Despite decelerating growth, the counter has been trading at decent valuation, on a PEG basis, over the past few months. In our view, investors might be more focus on its longer term business transformation strategy towards business internet such as cloud and FinTech. This is despite the fact that Tencent’s business transformation could potentially take several years to materialize, in our view.

Exhibit 2: PEG trend



Source(s): Bloomberg

\*PEG = Forward P/E divided by estimated long term growth rate

### Valuation

We derive Tencent’s fair valuation range based on the SOTP approach. For Tencent’s core business, we apply 26x-31x on its 2019E core net profit. Value of the Group’s investments is based on the latest book value as of Mar 2019 with holding discounts varying between 0-30%.

The SOTP approach results in a fair value range of HK\$ 319.8- 389.3. We set our TP at HK\$ 355, approximating the mid-point of our fair value range. Maintain **HOLD**.

Exhibit 3: SOTP valuation

	Valuation – midpoint (HKD per share)	Valuation – high end	Valuation – low end	Remarks
Core business	313.5	341.0	286.0	26x -31x 2019E core PE
Investments:	41.1	48.4	33.9	Book value as of Mar 2019 with 0-30% holding discounts
<b>Total</b>	<b>354.6</b>	<b>389.3</b>	<b>319.8</b>	

Source(s): Company, Bloomberg, ABCI Securities



Exhibit 4: 1Q19 highlights

	1Q18	1Q19	YoY	Comments
MAU of QQ (m)	806	823	2%	
Combined MAU of Weixin & WeChat (m)	1,040	1,112	7%	
<b>Financials (RMB m)</b>				
Online game	28,778	28,513	-1%	2% YoY drop in mobile gaming revenue
Social network	18,099	20,461	13%	
Online advertising	10,689	13,377	25%	Competition from Douyin and weakened macro environment
FinTech/Business service/Others	15,962	23,114	45%	Absence of interest income from custodian cash
<b>Revenue</b>	<b>73,528</b>	<b>85,465</b>	<b>16%</b>	4% below consensus
Cost of sales	(36,486)	(45,645)	25%	
<b>Gross profit</b>	<b>37,042</b>	<b>39,820</b>	<b>7%</b>	
Interest income	1,065	1,408	32%	
Other gains, net	7,585	11,089	46%	
Selling & marketing expenses	(5,570)	(4,244)	-24%	
General & admin expenses	(9,430)	(11,331)	20%	
<b>Operating profit</b>	<b>30,692</b>	<b>36,742</b>	<b>20%</b>	
Finance costs, net	(654)	(1,117)	71%	
Share of profit/(losses) of associates & JVs	(319)	(2,957)	827%	
<b>Profit before tax</b>	<b>29,719</b>	<b>32,668</b>	<b>10%</b>	
Income tax expenses	(5,746)	(4,812)	-16%	
Non-controlling interests	(683)	(646)	-5%	
<b>Net profit</b>	<b>23,290</b>	<b>27,210</b>	<b>17%</b>	
Share based compensation	1,585	2,477	56%	
Gain/losses from investee companies	(7,766)	(10,366)	33%	
Amortization and impairment	1,204	1,609	34%	
<b>Core profit (non-GAAP)</b>	<b>18,313</b>	<b>20,930</b>	<b>14%</b>	6% above consensus
<b>Profitability (%):</b>				
	<b>1Q18</b>	<b>1Q19</b>	<b>ppt y-o-y</b>	
Gross margin	50.4	46.6	(3.8)	
Operating margin	41.7	43.0	1.2	
Net margin	31.7	31.8	0.2	
Core net margin (non-GAAP)	24.9	24.5	(0.4)	

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



## Risk factors

### Market competition

We believe the emergence of alternative online entertainment 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 granting approvals on new games (including monetization of existing games). It is still uncertain when the regulator will resume the approval process. As such, competition from newcomers is limited as well. 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 to determine 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.

### 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)**

<b>FY Ended Dec 31 (RMB mn)</b>	<b>2017A</b>	<b>2018A</b>	<b>2019E</b>	<b>2020E</b>
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
<b>Total revenue</b>	<b>237,760</b>	<b>312,694</b>	<b>370,866</b>	<b>456,693</b>
Cost of sales	(120,835)	(170,574)	(210,887)	(260,784)
<b>Gross profit</b>	<b>116,925</b>	<b>142,120</b>	<b>159,979</b>	<b>195,909</b>
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)
<b>Operating Profits</b>	<b>90,302</b>	<b>97,129</b>	<b>104,110</b>	<b>113,937</b>
Finance cost	(2,908)	(4,669)	(5,050)	(5,140)
Share of profit of investments in associates	821	1,487	(1,000)	500
<b>Profit before tax</b>	<b>88,215</b>	<b>93,947</b>	<b>98,060</b>	<b>109,297</b>
Tax	(15,744)	(14,482)	(15,690)	(17,487)
<b>Profit after tax</b>	<b>72,471</b>	<b>79,465</b>	<b>82,371</b>	<b>91,809</b>
Minority interests	961	259	269	300
<b>Net profit</b>	<b>71,510</b>	<b>79,206</b>	<b>82,102</b>	<b>91,510</b>
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	-	-	-	-
<b>Non-GAAP (core) net profit</b>	<b>65,126</b>	<b>77,956</b>	<b>90,902</b>	<b>107,810</b>
<b>Growth</b>				
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
<b>Operating performance</b>				
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

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

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
<b>Total non-current assets</b>	<b>376,226</b>	<b>506,441</b>	<b>580,441</b>	<b>653,941</b>
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
<b>Total current assets</b>	<b>178,446</b>	<b>217,080</b>	<b>222,073</b>	<b>251,600</b>
<b>Total assets</b>	<b>554,672</b>	<b>723,521</b>	<b>802,514</b>	<b>905,541</b>
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
<b>Total current liabilities</b>	<b>151,740</b>	<b>202,435</b>	<b>205,242</b>	<b>223,352</b>
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
<b>Total non-current liabilities</b>	<b>125,839</b>	<b>164,879</b>	<b>164,879</b>	<b>164,879</b>
<b>Total liabilities</b>	<b>277,579</b>	<b>367,314</b>	<b>370,121</b>	<b>388,231</b>
<b>Net current assets</b>	<b>26,706</b>	<b>14,645</b>	<b>16,831</b>	<b>28,248</b>
Equity attributable to shareholders	256,074	323,510	399,427	484,044
Non-controlling interests	21,019	32,697	32,966	33,266
<b>Total equity</b>	<b>277,093</b>	<b>356,207</b>	<b>432,393</b>	<b>517,310</b>

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

Source(s): Company, ABCI Securities estimates

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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 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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