

Tencent (700 HK)

From strength to strength

- Robust 2Q17 results with revenue and non-GAAP net profit growing 59% and 45% YoY, beating consensus by 7% and 12% respectively
- Online gaming remained strong in 2Q17 and good receptions of recent new games imply still good momentum in 3Q17
- Online advertising surprised on the upside thanks to higher adv inventories and ongoing product improvements
- Maintain BUY with a new TP of HK\$364

Robust 2Q17. 2Q17 revenue and non-GAAP net profit grew by 59% to 45% YoY to RMB56.6bn and RMB16.4bn, beating consensus by 7% and 12% respectively, thanks to strong momentum in online games and online advertising business.

Online games' strong momentum likely carries into 3Q17. Online gaming revenue growth accelerated to 39% in 2Q17 from 34% in 1Q17. Overall, Tencent's mobile games have been gaining traction in recent months, occupying 5 positions among top 10 mobile games in China's iOS platform in June-July 2017, compared with 3 positions during April-May 2017. In addition, the general good receptions of recently launched new games including "Contra Return" and "Legacy TLBB" imply that the current strong momentum of gaming business is likely to carry into 2H17, in our view.

Online advertising accelerating. Growth in online advertising revenue edged up from to 55% YoY in 2Q17 from 47% YoY in 1Q17, driven by increasing adv inventories, ongoing product improvements of Weixin Moments and Weixin Official Accounts.

Cloud and payment a rising star. Revenue from payment-related and cloud services grew 114% YoY in 2Q17, and accounted for 17% of total revenue. Overall, Weixin Pay 's market share has increased from 21% in 2015 to 40% in 1Q17, narrowing its gap from AliPay's 54%.

Maintain BUY with new TP of HK\$364: The robust 2Q17 results support our long-term positive view on the counter. We maintain BUY on the counter with a new TP of HK\$364, based on 34x 2018E core PE.

Risk factors: 1) Tightening regulation on mobile game/online payment; 2) Entry of foreign competitors such as Facebook; 3) Slowdown in E-commerce; 4) Lifecycle of mobile games

Results and Valuation

FY ended Dec 31	2015A	2016A	2017E	2018E
Revenue (RMB mn)	102,863	151,938	228,596	316,563
Chg (% YoY)	30.3	47.7	50.5	38.5
Net profit (RMB mn)	28,806	41,095	65,178	88,561
Chg (% YoY)	21.0	42.7	58.6	35.9
Non-GAAP net profit (RMB mn)	32,410	45,420	64,178	87,561
Chg (% YoY)	33.8	40.1	41.3	36.4
Underlying EPS (RMB)	3.1	4.4	6.9	9.3
Chg (% YoY)	19.2	41.5	56.6	35.9
BVPS (RMB)	12.9	18.6	24.6	33.0
Chg (% YoY)	47.8	44.3	32.1	34.3
Core P/E (x)	81.1	58.2	41.2	30.2
P/B (x)	21.6	15.0	11.3	8.4
ROAE (%)	28.2	26.7	30.2	31.0
ROAA (%)	12.1	11.7	15.3	17.6
DPS(HKD)	0.36	0.47	0.61	0.96
Dividend Yield (%)	0.1	0.1	0.2	0.3

Source(s): Bloomberg, ABCI Securities estimates

Company Report

Aug 17, 2017
 Rating: BUY
 TP: HK\$364

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Share price (HK\$)	323.2
Est. share price return	12.5%
Est. dividend yield	0.4%
Est. total return	12.9%
Previous Rating & TP	BUY/HK\$299
Previous Report Date	May 23, 2017

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	333.0/179.6
Issued shares (mn)	9,498
Market cap (HK\$ bn)	3,069
Avg daily turnover (HK\$ mn)	5,128
Major shareholder(s)	
Naspers	33.25%
Huateng Ma	8.73%

Source(s): Company, ABCI Securities

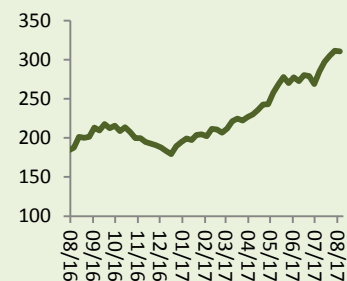
Share Performance (%)

	Absolute	Relative*
1-mth	13.5	9.7
3-mth	24.9	8.1
6-mth	52.5	13.6

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)

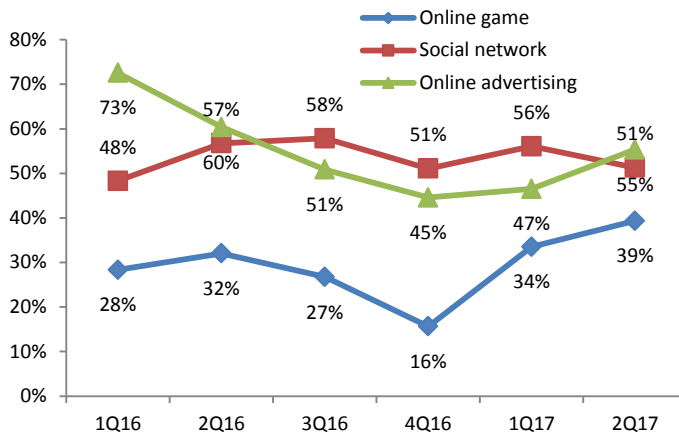


Source(s): Bloomberg, ABCI Securities

2Q17: From strength to strength

Tencent delivered a robust 2Q17 with revenue and non-GAAP net profit rising by 59% to 45% YoY to RMB56.6bn and RMB16.4bn, beating consensus by 7% and 12% respectively. The robust performance was mainly driven by online gaming and online advertising businesses.

Exhibit 1: Revenue growth by major segment



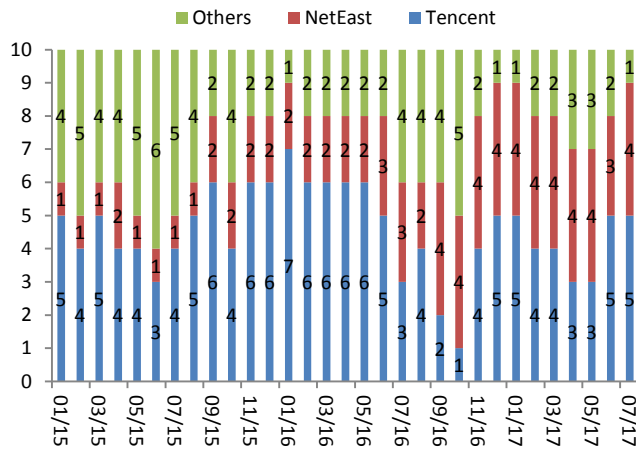
Source(s): Company, ABCI Securities

Online games: Online gaming revenue growth accelerated to 39% in 2Q17 from 34% in 1Q17.

Overall, Tencent's mobile games have been gaining traction in recent months, occupying five positions in the top 10 grossing games at China's iOS platform for June-July 2017, compared with three positions in Apr-May 2017. Its flagship game, "Honor of King" ("王者荣耀"), has maintained its no. 1 ranking in iOS mobile games in China over the past few months. Two new games, "Legacy TLBB" ("天龙八部手游") and "Contra: Return" ("魂斗罗:归来"), have also entered top five at China's iOS platform shortly after launching. "Journey to the Fairyland"("寻仙"), another game launched in Aug 2017, was well received and climbed to the top 10 at China's iOS platform.

In our view, good receptions of recently launched new games imply that the current strong momentum of gaming business is likely to carry into 2H17.

Exhibit 2: Distribution by company- Top 10 grossing games in China (iOS platform)



Source(s): App Annie, ABCI Securities

In addition, we estimate impacts of Tencent's control measures implemented for its flagship game, "Honor of King", will be limited amid addiction concerns. To recap, these control measures include: 1) players identified as below 12 years of age are limited to one hour of play time per day; those aged between 12-18 years are limited to two hours per day; 2) players below 12 years of age are banned from logging in after 9pm; 3) parental control functions are introduced; 4) tighten requirements for real-name registration of players

Online advertising: Online advertising revenue grew by 55% YoY to RMB10.1bn. Revenue from social advertising grew by 61%, higher than 48% growth in media advertising, thanks to the strong momentum of Weixin Moments amid the structural trend of increasing share of social advertising versus brand advertising.

Tencent has increased adv inventories in Weixin by lowering the traffic threshold for loading advertisements in Official Accounts. Tencent has also introduced various new features in Weixin Moments, including the card format ad that allows for larger sizes and more interactive functions. The Group is also testing new functions that allow users to interact directly with advertisers.

Cloud and payment: Revenue from payment-related and cloud services increased by 117% YoY to RMB9.7bn in 2Q17. Its contribution to total revenue jumped to 17% in 2Q17 from 7% in 1Q16.

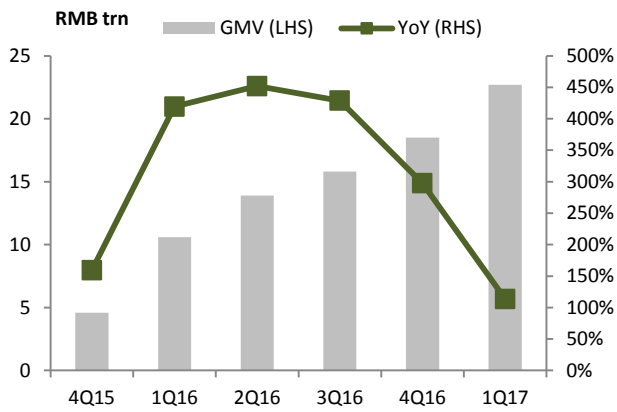
Overall, GMV of third-party mobile payment in China has achieved an over 100% growth in recent quarters, as illustrated in the chart below. Weixin Pay is now the second largest player in the industry – its market share increased from 21% in 2015 to 40% in 1Q17. Conversely, market share of AliPay fell from 68% in 2015 to 54% in 1Q17.

We believe this segment would become an increasingly significant growth driver of the Group in the medium term.

Nonetheless, regulations over the industry are strengthening. E.g., PBOC has recently announced a new measure that requires all third-party payment platforms to connect to a new central clearing platform (網聯) by Oct 15, 2017 and re-route all transactions to the new platform by June 30, 2018.

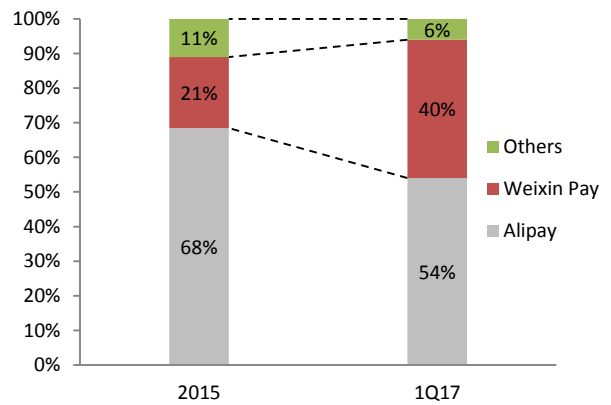


Exhibit 3: China third-party mobile payment GMV



Source(s): iResearch, ABCI Securities

Exhibit 4: Market share trend



Source(s): iResearch, ABCI Securities

Exhibit 5: 2Q17 results highlight

(RMB m)	2Q16	2Q17	% YoY	Remark
Online game	17,124	23,861	39%	Mainly driven by mobile games
Social network	8,556	12,943	51%	
Online advertising	6,532	10,148	55%	Increasing adv inventories and ongoing product improvements
Others	3,479	9,654	177%	Payment and cloud services
Revenue	35,691	56,606	59%	7% above consensus
Gross profit	20,456	28,306	38%	
Interest income	626	959	53%	
Other gains, net	911	5,125	463%	
Selling & marketing expenses	(2,365)	(3,660)	55%	
General & admin expenses	(5,299)	(8,170)	54%	
Operating profit	14,329	22,560	57%	
Finance costs, net	(377)	(834)	121%	
Share of profit/(losses) of associates & JVs	(292)	498	-271%	
Profit before tax	13,660	22,224	63%	
Income tax expenses	(2,780)	(3,970)	43%	
Noncontrolling interests	(143)	(23)	-84%	
Net profit	10,737	18,231	70%	
One-off items	582	(1,840)	n.a.	
Core profit (non-GAAP)	11,319	16,391	45%	12% above consensus
Profitability (%):	2Q16	2Q17	ppt YoY	
Gross margin	57.3	50.0	(7.3)	
Operating margin	40.1	39.9	(0.3)	
Net margin	30.1	32.2	2.1	
Core net margin (non-GAAP)	31.7	29.0	(2.8)	

Source(s): Company, ABCI Securities

Consolidated income statement (2015A-2018E)

FY Ended Dec 31 (RMB mn)	2015A	2016A	2017E	2018E
Value added services (VAS)	80,669	107,810	153,090	208,968
Online advertising	17,468	26,970	37,758	50,973
Others	4,726	17,158	37,748	56,621
Total revenue	102,863	151,938	228,596	316,563
Cost of sales	41,631	67,439	115,222	162,017
Gross profit	61,232	84,499	113,374	154,546
Interest income	2,327	2,619	3,600	5,000
Other gains/losses	1,886	3,594	12,316	11,316
Selling & marketing expenses	7,993	12,136	16,002	22,159
General & admin expenses	16,825	22,459	32,003	41,153
Operating Profits	40,627	56,117	81,285	107,549
Finance cost	1,618	1,955	3,500	3,500
Share of profit of investments in associates	-2,793	-2,522	1,000	3,000
Profit before tax	36,216	51,640	78,785	107,049
Tax	7,108	10,193	13,393	18,198
Profit after tax	29,108	41,447	65,391	88,851
Minority interests	302	352	214	290
Profits attributable to shareholders	28,806	41,095	65,178	88,561
Non-GAAP profits attributable to shareholders	32,410	45,420	64,178	87,561
Growth				
Total revenue (%)	30.3	47.7	50.5	38.5
Gross Profits (%)	27.4	38.0	34.2	36.3
Operating Profits (%)	33.0	38.1	44.8	32.3
Net profit (%)	21.0	42.7	58.6	35.9
Non-GAAP net profit (%)	33.8	40.1	41.3	36.4
Operating performance				
Operating margin (%)	39.5	36.9	35.6	34.0
Net margin (%)	28.0	27.0	28.5	28.0
Core net margin (%)	31.5	29.9	28.1	27.7
ROAE (%)	28.2	26.7	30.2	31.0
ROAA (%)	12.1	11.7	15.3	17.6

Source(s): Company, ABCI Securities estimates

Consolidated balance sheet (2015A-2018E)

As of Dec 31 (RMB mn)	2015A	2016A	2017E	2018E
Fixed assets	16,806	24,602	26,602	28,602
Intangible assets	13,439	36,467	39,967	43,467
Investment in associates and JV	66,945	80,299	87,799	95,299
AFS	44,339	85,566	85,566	85,566
Term deposit	3,674	5,415	5,415	5,415
Other non-current assets	6,237	14,396	14,396	14,396
Total non-current assets	151,440	246,745	259,745	272,745
Cash & equivalents	43,438	71,902	116,703	189,986
Restricted cash	54,731	750	750	750
Term deposit	37,331	50,320	50,320	50,320
Account receivables	7,061	10,152	12,802	18,595
Other receivables and prepayments	11,397	14,118	14,118	14,118
Inventories	222	263	263	263
Other current assets	1,198	1,649	1,649	1,649
Total current assets	155,378	149,154	196,605	275,681
Total assets	306,818	395,899	456,350	548,426
Accounts payable	15,700	27,413	28,668	40,311
Other payables & accruals	70,199	20,873	20,873	20,873
Borrowings and notes	15,315	15,744	15,744	15,744
Deferred revenue	21,122	31,203	31,203	31,203
Other current liabilities	2,070	5,964	5,964	5,964
Total current liabilities	124,406	101,197	102,452	114,095
Loans and bonds payables	50,014	93,753	93,753	93,753
Deferred revenue	3,004	2,038	2,038	2,038
Other non-current liabilities	7,294	12,664	12,664	12,664
Total non-current liabilities	60,312	108,455	108,455	108,455
Total liabilities	184,718	209,652	210,907	222,550
Net current assets	30,972	47,957	94,153	161,585
Equity attributable to shareholders	120,035	174,624	233,606	313,749
Non-controlling interests	2,065	11,623	11,837	12,127
Total equity	122,100	186,247	245,443	325,875

Source(s): Company, ABCI Securities estimates

Disclosures

Analyst Certification

I, Steve Chow, being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. I and/or my associates have no financial interests in relation to the listed company (ies) covered in this report, and I and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

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Steve Chow holds H-shares of Tencent (700 HK).

Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return - 6% \leq Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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