Tencent (700 HK)

Balanced revenue growth

- Resilient 4Q20 results with 26% YoY revenue growth and 30% YoY core profit growth, driven by resilient online gaming and recovering online advertising and Fintech/cloud businesses.
- Expect to see a more balanced revenue growth among major business segments in coming quarters.
- Maintain **BUY** and raise TP to HK$ 800 on resilient business momentum

4Q20 highlights. Tencent reported resilient results in 4Q20, with 26% YoY growth in revenue and 30% YoY growth in non-GAAP net profit. Overall, online gaming has been normalizing in the post-pandemic era, mitigated by recovering online advertising, Fintech, and cloud businesses.

Online gaming normalizing. Online gaming revenue rose by 29% YoY during the quarter driven by 43% YoY revenue growth of international games revenues and existing key titles. Having said that, the 6% QoQ segment revenue decline indicates a normalizing business environment in the post-pandemic era. Looking forward, the potential launches of Dungeon & Fighter (DnF) Mobile and League of Legends Mobile could potentially become the major drivers in 2021.

Non-gaming segments recovering. Online advertising and Fintech/business services continued to see sequential improvement with 22% YoY (16% QoQ) and 29% YoY (16% QoQ) revenue growth during the quarter. We expect the current momentum to continue in coming quarters driven by improving economic environment.

Balanced revenue growth. Tencent's business segments are at different stages of their respective cyclical cycles. In contrast with recent quarters where online gaming significantly outperforming online advertising and Fintech/business services, we expect to see a more balanced revenue growth among these segments in coming quarters.

Maintain BUY. We maintain **BUY** on the counter given its leading position in online gaming and online entertainment segment. Our revised SOTP-based TP is HK$ 800.

Results and Valuation

	2019A	2020A	2021E	2022E
Revenue (RMB mn)	377,289	482,052	604,905	737,676
Chg (%,YoY)	*20.7*	*27.8*	*25.5*	*21.9*
Net profit (RMB mn)	93,310	159,835	148,546	182,690
Chg (%,YoY)	*18.5*	*71.3*	*(7.1)*	*23.0*
Non-GAAP net profit (RMB mn)	94,351	122,730	164,296	198,440
Chg (%,YoY)	*21.8*	*30.1*	*33.9*	*20.8*
EPS (RMB)	9.9	16.8	15.7	19.3
Chg (%,YoY)	*18.2*	*70.9*	*(7.1)*	*23.0*
Non-GAAP EPS (RMB)	10.0	12.9	17.3	20.9
Chg (%,YoY)	*21.5*	*29.8*	*33.9*	*20.8*
Core P/E (x)	53.1	40.9	30.6	25.3
P/B (x)	11.6	7.1	6.0	5.0
ROAE (%)	22.1	25.2	17.5	18.3
ROAA (%)	11.1	14.0	10.5	11.5
DPS(HK$)	1.14	1.95	1.81	2.23
Dividend Yield (%)	0.2	0.3	0.3	0.4

Source(s): Bloomberg, ABCI Securities estimates

Company Report

Mar 25, 2021
Rating: BUY
TP: HK$800

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Share price (HK$)	605.5
Est. share price return	32.1%
Est. dividend yield	0.3%
Est. total return	32.4%
Previous Rating &TP	BUY/HK$730
Previous Report Date	Nov 13, 2020

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L(HK$)	775.5/369.6
Issued shares (mn)	9,595
Market cap (HK$ mn)	5,809,773
Avg daily turnover (HK$ mn)	16,629
Major shareholder(s)	
Naspers	31.0%
Huateng Ma	8.53%

Source(s): Bloomberg, ABCI Securities

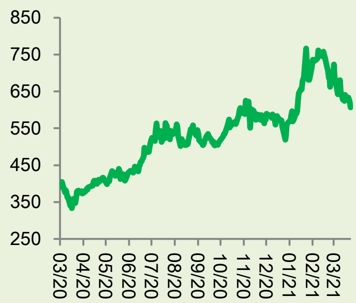
Share Performance (%)

	Absolute	Relative*
1-mth	-12.1	-4.9
3-mth	9.4	3.6
6-mth	20.8	0.7

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK$)



Source(s): Bloomberg, ABCI Securities

4Q20 highlights

In 4Q20, revenue increased by 26% YoY to RMB 133.7bn, in-line with market expectation. In addition, non-GAAP net profit increased by 30% YoY to RMB 33.2bn, 2% above market expectation.

Online gaming revenue increasing by 29% YoY during the quarter driven by key titles including Peacekeeper Elite and Honor of Kings, and the newly launched game Moonlight Blade Mobile. In addition, international gaming revenues, which accounted for about 25% of total online gaming revenue, experienced 43% YoY growth. Domestic online gaming revenue reported 25% YoY growth, 4ppt lower than the segment growth rate. On the flip side, segment revenue experienced 6% QoQ decline during the quarter, indicating a gradual normalizing business environment in the post-pandemic era.

Social network reported 27% YoY revenue growth driven by digital content services and consolidation of HUYA's live broadcast services. For example, its fee-based VAS subscriptions grew 22% YoY to 220m in 4Q20.

Online advertising reported a 22% YoY revenue growth vs. 16% YoY growth in the previous quarter, 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 25% YoY growth driven by higher demand for Weixin Moments, while media advertising saw 8% YoY revenue growth. By industry, advertising spending on ecommerce platforms, fast-moving consumer goods, and online education reported strong growth.

Revenue of FinTech and business service grew 29% YoY vs. 24% YoY in the previous quarter driven by increased transaction volume and improved market position in the cloud segment.

Exhibit 1: 4Q20 highlight

(RMB m)	4Q19	4Q20	*YoY*	Remarks
Online game	30,286	39,100	29%	43% growth of international games revenues
Social network	22,022	27,900	27%	
Online advertising	20,225	24,655	22%	Driven by Weixin Moments
FinTech and Business service	29,920	38,494	29%	
Others	3,314	3,541	7%	
Revenue	**105,767**	**133,690**	***26%***	In line with market expectation
Gross profit	**46,108**	**58,902**	***28%***	
Operating profit	**28,604**	**63,734**	***123%***	
Net profit	**21,582**	**59,323**	***175%***	
Core profit (non-GAAP)	**25,484**	**33,228**	***30%***	2% above market expectation
Profitability (%):	**4Q19**	**4Q20**	***ppt***	
Gross margin	43.6	44.1	*0.5*	
Operating margin	27.0	47.7	*20.6*	
Net margin	20.4	44.4	*24.0*	
Core net margin (non-GAAP)	24.1	24.9	*0.8*	

Source(s): The Company, ABCI Securities

Balanced revenue growth

Tencent's three major business segments are at different stages of their respective cyclical business cycles. During the pandemic, online gaming performed exceptionally well driven by lock-downs, while online advertising, FinTech and cloud were impacted by weak offline economic activities. The situation has now started to reverse with online gaming market normalizing and online advertising, FinTech, and cloud market recovering. As a result, we expect to see a more balanced revenue growth among these business segments in coming quarters.

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 in recent months. In addition, the newly launched game Moonlight Blade (天涯明月刀) received initial good reception and achieved the top 5 position in China's gaming league table in Jan/Feb 2021, according to App Annie.

Looking forward, Dungeon & Fighter (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 form 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, will also benefit as corporates gradually increase its advertising budgets in the post-pandemic era.

For FinTech and business services, the ongoing recovery in offline payment volume supported by a reviving retail market should benefit the segment. In addition, the cloud business are likely see gradual recovery of IT corporate spending.

Financial outlook

We expect revenue to grow at 24% CAGR in 2020-2022E.

Online gaming: We expect online gaming revenue to expand at 24% CAGR in 2020-22E. Overall, the online gaming market is expected to normalize in 2021 after achieving exceptional growth in 2020. Having said that, the potential launch of DnF Mobile and LoL Mobile and increasing contribution of overseas gaming revenue could mitigate the potential impact and lead to resilient segment growth ahead.

Social network: We expect social network revenue to increase at 19% CAGR in 2020-22E 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 in 2020. 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 25% CAGR in 2020-22E, mainly driven by social media advertising.

FinTech and business service: We expect segment revenue to increase at 27% CAGR in 2020-22E. The third-party payment business is influenced by retail consumption, which has been experiencing a gradual recovery in recent months. The cloud business is also set to recover in 2021 as corporates resume IT projects after a slowdown in 2020.

Exhibit 2: Revenue forecasts (RMB mn)

	2019	2020	2021E	2022E
Value added services (VAS)	**199,991**	**264,212**	**325,679**	**392,684**
Online games	*114,710*	*156,100*	*195,585*	*240,404*
Social network	*85,281*	*108,100*	*130,093*	*152,279*
Online advertising	**68,377**	**82,271**	**104,845**	**128,590**
FinTech and business services	**101,355**	**128,086**	**166,512**	**208,140**
Others	**7,566**	**7,495**	**7,870**	**8,263**
Total revenue	**377,289**	**482,064**	**604,905**	**737,676**

Source(s): The Company, ABCI Securities estimates

We expect gross margin to fall from 46.0% in 2020 to 44.7% in 2022E, 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 21.0% in 2020 to 16.3% in 2022E

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 7.0% in 2020 to 5.8% in 2022E, and general and admin cost-to-revenue ratio to drop from 14.0% in 2020 to 10.5% in 2022E.

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

	2019	2020	2021E	2022E
Selling & marketing expenses	(21,396)	(33,758)	(36,424)	(43,062)
General & admin expenses	(53,446)	(67,625)	(65,563)	(77,512)
Total SG&A	**(74,842)**	**(101,383)**	**(101,987)**	**(120,575)**
% of revenue				
Selling & marketing expenses	5.7%	7.0%	6.0%	5.8%
General & admin expenses	14.2%	14.0%	10.8%	10.5%
Total SG&A	**19.8%**	**21.0%**	**16.9%**	**16.3%**

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 25.5% in 2020 to 26.9% in 2022E. This would result in a 27% CAGR in core net profit for 2020-22E.

Earnings sensitivity

In terms of earning sensitivity, we estimate that a 100bp improvement in core net margin would increase its 2021E and 2022E core net profits by 3.7% and 3.7% respectively.

Exhibit 4: Earnings sensitivity

Changes in core net margin (bps)	Changes in 2021E core net profit	Changes in 2022E core net profit
100	3.7%	3.7%
75	2.8%	2.8%
50	1.8%	1.9%
25	0.9%	0.9%
-	0.0%	0.0%
(25)	-0.9%	-0.9%
(50)	-1.8%	-1.9%
(75)	-2.8%	-2.8%
(100)	-3.7%	-3.7%

Source(s): ABCI Securities estimates

Exhibit 5: Forecast changes (2021E)

(RMB m)	**old**	**new**	**Diff**	**Comment**
Revenues	617,538	604,905	-2%	Lower growth assumptions
Net income	151,026	148,546	-2%	
Core profit	166,776	164,296	-1%	

Source(s): ABCI Securities estimates

Valuation

We maintain **BUY** on Tencent given the leading position on online gaming/entertainment business and balanced business portfolio. 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$ 708-858 and set our TP at HK$800.

To valuate Tencent's core business, we apply a 26x-31x targeted core 2022E P/E. Tencent's investment value is based on their latest book value at end-2020 with a 0-30% holding discount.

Exhibit 6: SOTP valuation (HK$ per share)

	Valuation – high end	Valuation – low end	Remarks
Core business	771	647	26x -31x 2022E core P/E
Investments	87	61	End-2020 book value (RMB 691bn) with 0%-30% holding discount
Total	**858**	**708**	

Source(s): ABCI Securities estimates

Exhibit 7: TP changes (HK$ per share)

Segment	Old	New	Methodology-old	Methodology-new
Core business	670	726	33x 2021E core P/E	29x 2022E core P/E
Investments	60	74	Book value with a 15% holding discount	Book value with a 15% holding discount
Overall	**730**	**800**		

Source(s): ABCI Securities estimates

Risk factors

Market competition

The rise of emerging forms of online entertainment such as short video apps could steal shares from online long video in the online entertainment market.

In addition, 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.

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 commercial payment business and wealth management, 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 16.3bn in 2020.

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.

Financial forecast

Consolidated income statement (2019A-2022E)

FY Ended Dec 31 (RMB mn)	2019A	2020A	2021E	2022E
Online gaming	114,710	156,100	195,585	240,404
Social network	85,281	108,100	130,093	152,279
Online advertising	68,377	82,271	104,845	128,590
FinTech and business service	101,355	128,086	166,512	208,140
Others	7,566	7,495	7,870	8,263
Total revenue	**377,289**	**482,052**	**604,905**	**737,676**
Cost of sales	(209,756)	(260,532)	(333,748)	(407,651)
Gross profit	**167,533**	**221,520**	**271,157**	**330,025**
Interest income	6,314	6,957	8,050	8,050
Other gains/losses	19,689	57,131	7,550	7,550
Selling & marketing expenses	(21,396)	(33,758)	(36,424)	(43,062)
General & admin expenses	(53,446)	(67,625)	(65,563)	(77,512)
Operating Profits	**118,694**	**184,225**	**184,770**	**225,050**
Finance cost	(7,613)	(7,887)	(8,350)	(8,350)
Share of profit of investments in associates	(1,681)	3,672	4,000	4,500
Profit before tax	**109,400**	**180,010**	**180,420**	**221,200**
Tax	(13,512)	(19,897)	(31,387)	(37,912)
Profit after tax	**95,888**	**160,113**	**149,033**	**183,288**
Minority interests	2,578	278	487	598
Net profit	**93,310**	**159,835**	**148,546**	**182,690**
Share based compensation	12,309	16,228	12,800	12,800
Gain/losses from investee companies	(20,720)	(69,473)	(4,100)	(4,100)
Amortization and impairment	10,547	17,060	7,050	7,050
Other non-core items	(1,095)	(920)	-	-
Non-GAAP net profit (core profit)	**94,351**	**122,730**	**164,296**	**198,440**
Growth				
Total revenue (%)	20.7	27.8	25.5	21.9
Gross Profits (%)	17.9	32.2	22.4	21.7
Operating Profits (%)	21.6	55.2	0.3	21.8
Net Profits (%)	18.5	71.3	(7.1)	23.0
Non-GAAP net profit (%)	21.8	30.1	33.9	20.8
Operating performance				
Gross margin (%)	44.4	46.0	44.8	44.7
Operating margin (%)	31.5	38.2	30.5	30.5
Net margin (%)	24.7	33.2	24.6	24.8
Non-GAAP net margin (%)	25.0	25.5	27.2	26.9
ROAE (%)	22.1	25.2	17.5	18.3
ROAA (%)	11.1	14.0	10.5	11.4

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 (2019A-2022E)

As of Dec 31 (RMB mn)	2019A	2020A	2021E	2022E
Fixed assets	78,070	94,385	115,385	136,385
Intangible assets	128,860	159,437	161,937	164,437
Investment in associates and JV	221,894	305,262	345,262	385,262
Financial assets	210,543	379,035	389,035	399,035
Term deposit	19,000	31,681	31,681	31,681
Other non-current assets	41,651	45,978	45,978	45,978
Total non-current assets	**700,018**	**1,015,778**	**1,089,278**	**1,162,778**
Cash & equivalents	132,991	152,798	240,752	350,941
Restricted cash	2,180	2,520	2,520	2,520
Term deposit	46,911	68,487	68,487	68,487
Account receivables	35,839	44,981	48,475	61,136
Deposit, prepayments and other assets	27,840	40,321	40,321	40,321
Inventories	718	814	814	814
Other current assets	7,489	7,726	7,726	7,726
Total current assets	**253,968**	**317,647**	**409,095**	**531,945**
Total assets	**953,986**	**1,333,425**	**1,498,373**	**1,694,723**
Accounts payable	80,690	94,030	121,134	147,958
Other payables & accruals	45,174	54,308	54,308	54,308
Borrowings and notes	33,229	14,242	14,242	14,242
Deferred revenue	64,228	86,649	86,649	86,649
Other current liabilities	16,835	19,850	19,850	19,850
Total current liabilities	**240,156**	**269,079**	**296,183**	**323,007**
Loans and bonds payables	187,584	234,202	234,202	234,202
Deferred revenue	7,334	6,678	6,678	6,678
Other non-current liabilities	30,088	45,423	45,423	45,423
Total non-current liabilities	**225,006**	**286,303**	**286,303**	**286,303**
Total liabilities	**465,162**	**555,382**	**582,486**	**609,310**
Net current assets	**13,812**	**48,568**	**112,912**	**208,939**
Equity attributable to shareholders	432,706	703,984	841,341	1,010,269
Non-controlling interests	56,118	74,059	74,546	75,144
Total equity	**488,824**	**778,043**	**915,887**	**1,085,414**

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

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Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (10%)
Hold	- Market return rate (-10%) ≤ 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 2008-20 CAGR at 9.2%)

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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