

Tencent (700 HK)

Accelerating monetization

- Robust 3Q17 results with revenue and non-GAAP net profit growing by 61% and 45% YoY, beating consensus by 7% and 4%
- New survival shooter mobile game "Glorious Mission" could potentially become the next blockbuster after "Honor of King"
- Monetization in online advertising would accelerate in the medium term despite a moderating growth in 3Q17 due to high base last year
- Maintain **BUY** with a revised TP of HK\$ 441

Robust 3Q17. 3Q17 revenue and non-GAAP net profit grew 61% to 45% YoY to RMB 65.2bn and RMB 17.0bn, beating consensus by 7% and 4%, thanks to strong momentum in online games and cloud/payment.

The next blockbuster game is in the pipeline. Growth in online gaming revenue remained robust at 48% in 3Q17 vs. 39% in 2Q17 due to strong momentum of "Honor of King" (HOK, "王者荣耀") and other titles. The upcoming new game, "Glorious Mission" ("光荣使命"), could potentially be the next blockbuster game after HOK given the rising popularity of extreme survival shooter game genre in recent months. In our view, this may mitigate potential growth-moderating impact resulted from the high base in 4Q16 when HOK turned hugely popular.

Accelerating monetization in advertising. Growth in online advertising revenue moderated to 48% in 3Q17 vs. 55% in 2Q17, mainly due to high base from the 2016 Olympics, although social advertising growth remained solid at 63% due to the still-intact growth from Weixin advertising. Tencent has recently announced a "Three 10 Billion" strategy that includes various forms of support for content providers to enrich content quality and increase traffic, supporting further monetization of advertising opportunities in years to come.

Cloud and payment - a rising star. Revenue from payment-related and cloud services jumped 143% YoY in 3Q17, accounting for 18% of total revenue. AUM of Tencent's wealth management platform has exceeded RMB 200bn with over 100mn users.

Maintain BUY with new TP of HK\$ 441. The robust 3Q17 results support our long-term positive view for the counter. We maintain **BUY** with a new SOTP-based TP of HK\$ 441.

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

Results and Valuation

FY ended Dec 31	2015A	2016A	2017E	2018E
Revenue (RMB mn)	102,863	151,938	239,675	332,340
Chg (% YoY)	30.3	47.7	57.7	38.7
Net profit (RMB mn)	28,806	41,095	68,163	84,835
Chg (% YoY)	21.0	42.7	65.9	24.5
Non-GAAP net profit (RMB mn)	32,410	45,420	64,929	87,835
Chg (% YoY)	33.8	40.1	43.0	35.3
Underlying EPS (RMB)	3.1	4.4	7.2	8.9
Chg (% YoY)	19.2	41.5	63.7	24.5
BVPS (RMB)	12.9	18.6	24.9	33.0
Chg (% YoY)	47.8	44.3	33.8	32.6
Core P/E (x)	98.1	70.5	49.3	36.4
P/B (x)	26.1	18.1	13.5	10.2
ROAE (%)	28.2	26.7	31.4	29.5
ROAA (%)	12.1	11.7	15.9	16.8
DPS(HKD)	0.36	0.47	0.61	1.05
Dividend Yield (%)	0.1	0.1	0.2	0.3

Source(s): Bloomberg, ABCI Securities estimates

Company Report

Nov 16, 2017
 Rating: BUY
 TP: HK\$441

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Share price (HK\$)	391.8
Est. share price return	12.6%
Est. dividend yield	0.3%
Est. total return	12.9%
Previous Rating & TP	BUY/HK\$364
Previous Report Date	Aug 17, 2017

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	398.6/179.6
Issued shares (mn)	9,499
Market cap (HK\$ bn)	3,731
Avg daily turnover (HK\$ mn)	488
Major shareholder(s)	
Naspers	33.25%
Huateng Ma	8.73%

Source(s): Company, ABCI Securities

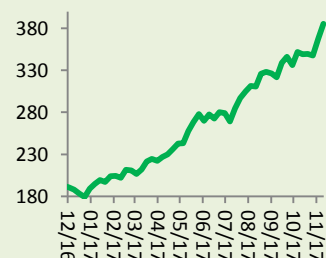
Share Performance (%)

	Absolute	Relative*
1-mth	7.7	7.2
3-mth	19.9	14.7
6-mth	49.8	35.9

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



3Q17 highlights

Tencent delivered another strong set of results for 3Q17, with revenue and non-GAAP net profit rising by 61% to RMB 65.2bn and 45% YoY to RMB17bn, beating consensus by 7% and 4%.

The robust performance was mainly driven by accelerating growth in online games and persistence of strong momentum in cloud/payment businesses, which mitigated a moderating growth in online advertising business caused by the high base last year attributable to the 2016 Olympics.

Exhibit 1: 3Q17 highlights

Results review:				
(RMB m)	3Q16	3Q17	% y-o-y	Remark
Online game	18,166	26,844	48%	Mainly driven by mobile games
Social network	9,809	15,280	56%	Virtual item sales including video, music, and literature
Online advertising	7,449	11,042	48%	High base from the 2016 Olympics
Others	4,964	12,044	143%	Payment and cloud services
Revenue	40,388	65,210	61%	7% above consensus
Gross profit	21,828	31,681	45%	
Interest income	637	1,017	60%	
Other gains, net	1,155	3,918	239%	ZhongAn Insurance IPO
Selling & marketing expenses	(3,277)	(4,812)	47%	
General & admin expenses	(5,883)	(9,058)	54%	
Operating profit	14,460	22,746	57%	
Finance costs, net	(604)	(524)	-13%	
Share of profit/(losses) of associates & JVs	(619)	818	-232%	
Profit before tax	13,237	23,040	74%	
Income tax expenses	(2,461)	(4,993)	103%	
Non-controlling interests	(130)	(41)	-68%	
Net profit	10,646	18,006	69%	
Core profit (non-GAAP)			45%	4% above consensus
	11,737	17,070		
Profitability (%):	3Q16	3Q17	ppt y-o-y	
Gross margin	54.0	48.6	(5.5)	
Operating margin	35.8	34.9	(0.9)	
Net margin	26.4	27.6	1.3	
Core net margin (non-GAAP)	29.1	26.2	(2.9)	

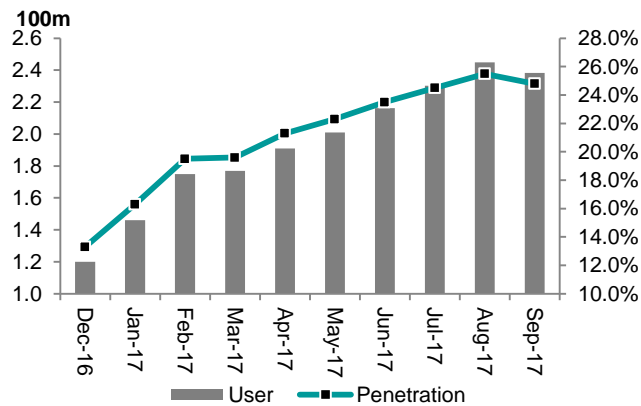
Source(s): Company, ABCI Securities

Online games are going strong

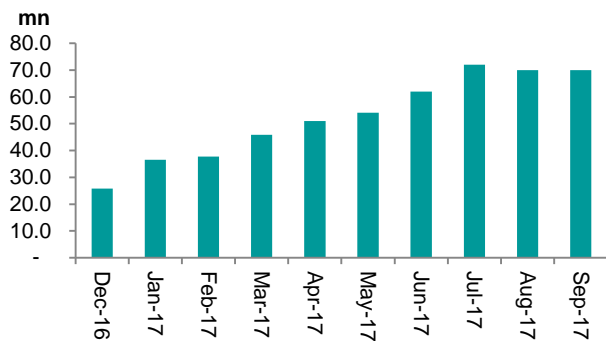
Growth in online gaming revenue accelerated to 48% in 3Q17 vs. 39% in 2Q17, thanks to strong performance of the flagship game, "Honor of King" (HOK), as well as new games including "Contra: Return" and "Legacy TLBB".

"Honor of King" (HOK): Momentum of HOK remained robust in recent months with ongoing improvement in daily active user (DAU) and user base.

According to data from JiGuang, a mobile big data platform in China, HOK's players reached c. 250mn in late-Aug versus c. 200mn in May 2017, with penetration rising from 22.3% to 25.5% over the same period. In addition, DAU remained at c. 70mn in 3Q17 vs. c. 55mn in 2Q17.

Exhibit 2: HOK- user base and penetration


Source(s): JIGUANG, ABCI Securities

Exhibit 3: HOK- DAU


Source(s): JIGUANG, ABCI Securities

In recent months, the Company has been enhancing the in-game experience through the introduction of new characters, fine-tuning the design of existing characters, etc. Various offline e-sport events have also been conducted for HOK to enhance its popularity.

Overall, HOK's quarterly ARPU is currently below the average level of Tencent's other massively multiplayer online game (MMOG) / multiplayer online battle arena (MOBA) games, which implies further monetization potential in our view. Separately, management also said impact from its anti-addiction measures on HOK has been minimal since many young players are non-paying.

In overseas market, the Company has recently soft launched HOK in Europe and Southeast Asian markets (using the alternative name "Arena of Valor"). Overall, it received better reception in Southeast Asia than Europe due to differences in preference. E.g. European games generally prefer: (1) shorter battle time (5-10min/battle vs. the typical 15-20min/battle for the Chinese games); (2) more strategy-based games vs. MOBA games; (3) simpler in-game rules. Currently, Arena of Valor was generally outside of the top 50 ranking in various European markets (iOS platform), implying more localization is still needed.

"Glorious Mission" (光荣使命) – another potential blockbuster: Looking forward, we believe Tencent's new game, "Glorious Mission", which started open testing in early Nov, could become its next blockbuster after HOK. An extreme survival shooter game that resembles the format of a highly successfully PC game, PlayerUnknown's Battlegrounds (PUBG), "Glorious Mission" had over 20mn of user pre-registrations within the first week of availability.

In addition, Tencent's game, "Cross Fire", has launched a PUBG-style update called "Deserted Island" ("荒岛特训"), attracting over 20mn of user registrations within the first week of availability.

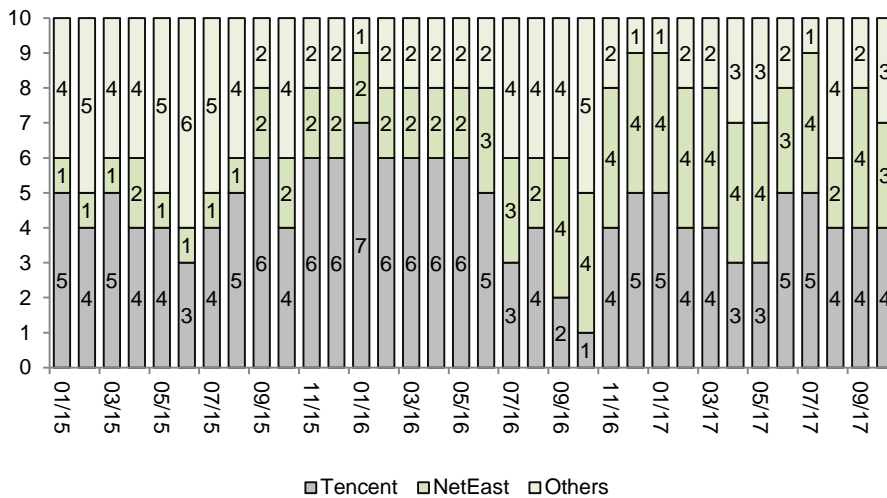
Overall, PUBG, developed by the Korean publisher, Bluehole, has become a huge success in recent months with over 12mn copies sold worldwide, popularizing the extreme survival shooter game genre.

Other new games: Tencent's recently-launched games, including "King of Chaos" ("乱世王者"), "Legacy TLBB" ("天龙八部手游"), and "Contra: Return" ("魂斗罗:归来"), achieved good receptions, occupying the top 10 positions on China's iOS platform in recent months.

Mobile version of “Dungeon & Fighter” (DNF): The Company is currently working with its Korea partner on game development, especially in the area of localization. In our view, DNF mobile could be another major hit after HOK given its strong track record on the PC platform. The game is likely to be launched in 2018 based on its current development progress.

High base for 4Q17: Overall, the still-robust momentum of HOK and impressive performance of various new games have contributed to the strong results in 3Q17. We believe the Company’s growth in 4Q17 would be moderated by the high base in 4Q16 when HOK became hugely popular.

Exhibit 4: Distribution by company- top 10 grossing games in China (iOS platform)



Source(s): App Annie, ABCI Securities

Online advertising: Speeding up monetization

Growth in online advertising revenue moderated to 48% YoY in 3Q17 vs. 55% YoY in 2Q17 mainly due to slowing media advertising revenue growth (29% YoY in 3Q17 vs. 48% YoY in 2Q17) given the high base in 2016 resulted from the Olympics. Having said that, social advertising revenue growth remained solid at 63% in 3Q17, reflecting a still-intact growth from Weixin advertising such as Moments and Public Accounts.

During the recent Tencent Global Partner Conference, Tencent announced its “Three 10 Billion” plan for its content creation partners, including 1) RMB 10bn investment in revenue sharing, platform support, and project investments for content creators; 2) Content providers can publish contents to Tencent’s various platforms with 10bn daily user traffic; 3) RMB 10bn worth of industry infrastructures such as shared workspace for content startups. The purpose of “Three 10 Billion” strategy is to further enhance its content ecosystem from content production, distribution, and monetization.

E.g., its Penguin Platform would allow content creators to publish content across Tencent’s various platforms such as Weixin, QQ, Q Zone, Tencent News, Tencent Video, etc.

In our view, this “Three 10 Billion” strategy would elevate both content quality and traffic, facilitating further monetization of advertising opportunities in years to come.



Payment: A rising star

Revenue growth in “Other and ecommerce” stayed solid at 143% in 3Q17, attributable to strong momentum in payment and cloud businesses. Its contribution to Tencent’s revenue further increased to 18% in 3Q17 vs. 17% in the last quarter.

In 3Q17, monthly offline payment volume increased 280% YoY. In addition, Tencent has recently piloted “Lingqian tong” (“零钱通”), a cash management product similar to Alipay’s flagship fund, “Yuebao” (“余额宝”). Overall, AUM of Tencent’s wealth management platform has exceeded RMB 200bn with over 100mn users.

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

Valuation

Overall, the robust 3Q17 results support our long-term positive view for the counter. We maintain **BUY** with a new SOTP-based TP of HK\$ 441, which includes HK\$ 415.3 for its core businesses and HK\$ 25.7 for major investments.

Exhibit 5: SOTP valuation

	Valuation (HKD per share)	Remark
Core business	415.3	39x 2018E core profit
Major investments:		
- JD	7.7	Market value with 10% holding discount
- China Literature	4.4	Market value with 10% holding discount
- Zhong An	1.1	Market value with 10% holding discount
- YiXi	1.0	Market value with 10% holding discount
- Others*	11.5	Market value with 10% holding discount
Total	441	

Source(s): Companies, Bloomberg, ABCI Securities

*58.com, Sogou, Telsla, Snap, Activision Blizzard, Sea, and Netmarble



Consolidated income statement (2015A-2018E)

FY Ended Dec 31 (RMB mn)	2015A	2016A	2017E	2018E
Value added services (VAS)	80,669	107,810	156,325	213,383
Online advertising	17,468	26,970	40,455	54,614
Others	4,726	17,158	42,895	64,343
Total revenue	102,863	151,938	239,675	332,340
Cost of sales	41,631	67,439	122,284	172,326
Gross profit	61,232	84,499	117,391	160,013
Interest income	2,327	2,619	3,600	4,000
Other gains/losses	1,886	3,594	14,234	8,000
Selling & marketing expenses	7,993	12,136	16,777	23,264
General & admin expenses	16,825	22,459	33,554	43,204
Operating Profits	40,627	56,117	84,893	105,545
Finance cost	1,618	1,955	3,500	4,000
Share of profit of investments in associates	-2,793	-2,522	1,000	1,000
Profit before tax	36,216	51,640	82,393	102,545
Tax	7,108	10,193	14,007	17,433
Profit after tax	29,108	41,447	68,386	85,113
Minority interests	302	352	223	278
Profits attributable to shareholders	28,806	41,095	68,163	84,835
Non-GAAP profits attributable to shareholders	32,410	45,420	64,929	87,835
Growth				
Total revenue (%)	30.3	47.7	57.7	38.7
Gross Profits (%)	27.4	38.0	38.9	36.3
Operating Profits (%)	33.0	38.1	51.3	24.3
Net profit (%)	21.0	42.7	65.9	24.5
Non-GAAP net profit (%)	33.8	40.1	43.0	35.3
Operating performance				
Operating margin (%)	39.5	36.9	35.4	31.8
Net margin (%)	28.0	27.0	28.4	25.5
Core net margin (%)	31.5	29.9	27.1	26.4
ROAE (%)	28.2	26.7	31.4	29.5
ROAA (%)	12.1	11.7	15.9	16.8

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	120,857	191,638
Restricted cash	54,731	750	750	750
Term deposit	37,331	50,320	50,320	50,320
Account receivables	7,061	10,152	13,422	19,522
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	201,379	278,260
Total assets	306,818	395,899	461,124	551,005
Accounts payable	15,700	27,413	30,425	42,876
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	104,209	116,660
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	212,664	225,115
Net current assets	30,972	47,957	97,170	161,599
Equity attributable to shareholders	120,035	174,624	236,614	313,765
Non-controlling interests	2,065	11,623	11,846	12,124
Total equity	122,100	186,247	248,460	325,889

Source(s): Company, ABCI Securities estimates

Disclosures

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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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