

Tencent (700 HK)

Valuation starts to get rich

- Recent solid 1Q17 results support our long-term positive view on Tencent ,but we believe near-term stock volatility could increase as valuation is getting rich after recent share price rally
- 1Q17 results review: 55% and 42% growth in revenue and core profit
- Mobile games was the key driver, and the trend is likely to sustain in coming quarters, while cloud and payment business become an emerging driver

Valuation starts to get rich. Overall, the recent solid 1Q17 result supports our long-term positive view on the company. Our new TP is HK\$ 299, based on 34x rolling 12-mth fwd core P/E. After the recent share rally, however, valuation starts to get rich, trading at ~32x rolling 12-mth fwd core P/E vs. the historical average at 30x, which could lead to higher stock volatility should overall market sentiment reverse.

Historical PE range: 25-35x. Tencent's historically PE range was 25-35x, which translates to HK\$220-308, based on our current earnings forecast. In our view, this PE range could be viewed as technical floor/ceiling in the near term.

1Q17 review. Tencent recently delivered solid 1Q17 results with revenue and core profit rising by 55% to 42% to RMB49.6bn and RMB14.2bn. As a result of strong revenue and improved profitability of investments (such as JD.com), core net margin improved from 28.1% in 4Q16 to 28.7% in 1Q17.

Mobile games as the main driver. Revenue from online games was up 34% YoY in 1Q17 compared to 27% YoY in 4Q16 driven by key mobiles games such as "Honor of Kings" and "Dragon Next Mobile". We believe such momentum is likely to sustain in coming quarters.

Online advertising is gaining traction. Growth in online advertising revenue edged up from to 47% YoY in 1Q17 from 45% YoY in 4Q16, driven by Tencent Video, Tencent News, and Weixin advertising.

Cloud and payment starts to bear fruit. Revenue from payment-related and cloud services grew 224% YoY in 1Q17. Its contribution to total revenue increased to 15% YoY in 1Q17 from 7% YoY in 1Q16. We believe this segment would be an emerging growth driver for the Group.

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	222,962	314,650
Chg (% ,YoY)	30.3	47.7	46.7	41.1
Net profit (RMB mn)	28,806	41,095	59,469	77,581
Chg (% ,YoY)	21	42.7	44.7	30.5
Non-GAAP net profit (RMB mn)	32,410	45,420	63,469	81,581
Chg (% ,YoY)	33.8	40.1	39.7	28.5
Underlying EPS (RMB)	3.1	4.4	6.3	8.3
Chg (% ,YoY)	19.2	41.5	44.7	30.5
BVPS (RMB)	12.9	18.6	24.4	31.9
Chg (% ,YoY)	47.8	44.3	30.8	30.7
Core P/E (x)	69.7	49.7	35.6	27.7
P/B (x)	18.8	13.0	10.0	7.6
ROAE (%)	28.2	26.7	27.9	28.2
ROAA (%)	12.1	11.7	14.1	15.8
DPS(HKD)	0.36	0.47	0.61	0.88
Dividend Yield (%)	0.1	0.2	0.2	0.3

Source(s): Bloomberg, ABCI Securities estimates

Company Report

May 23, 2017

Rating: BUY

TP: HK\$ 299

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Share price (HK\$)	275.2
Est. share price return	5.5%
Est. dividend yield	0.4%
Est. total return	5.9%
Previous Rating &TP	BUY/HK\$230
Previous Report Date	Dec 1, 2016

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	280.6/158.8
Issued shares (mn)	9,478
Market cap (HK\$ bn)	2,649
Avg daily turnover (HK\$ mn)	605
Major shareholder(s)	
Naspers	33.25%
Huateng Ma	8.73%

Source(s): Company, ABCI Securities

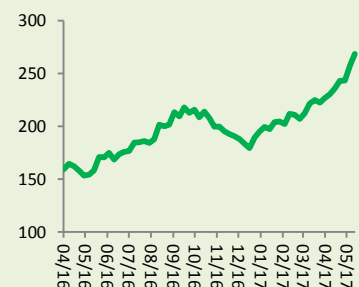
Share Performance (%)

	Absolute	Relative*
1-mth	16.5	10.9
3-mth	30.2	5.3
6-mth	43.9	12.0

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

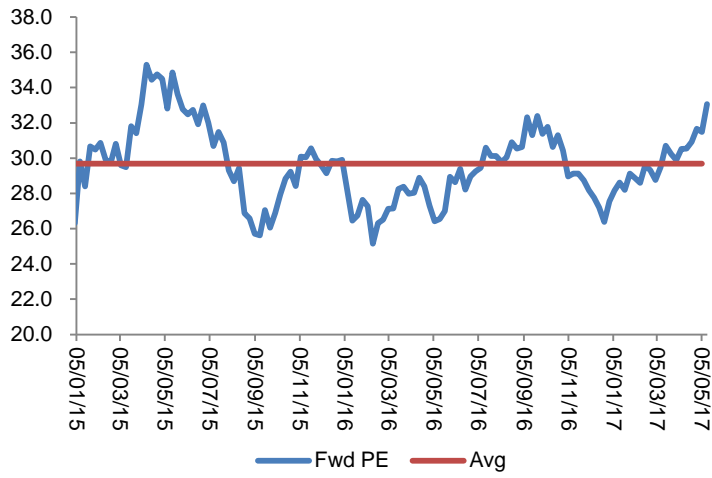
Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



Exhibit 1: Historical valuation



Source(s): Bloomberg, ABCI Securities



Exhibit 2: 1Q17 results highlight

(RMB m)	1Q16	1Q17	% YoY	Remark
Online game	17,085	22,811	34%	34% growth in mobile games
Social network	7,879	12,297	56%	Virtual item sales including video, music, and literature
Online advertising	4,701	6,888	47%	
Others	2,330	7,556	224%	Payment and cloud services
Revenue	31,995	49,552	55%	7% above consensus
Gross profit	18,589	25,443	37%	
Interest income	703	808	15%	
Other gains, net	506	3,191	531%	
Selling & marketing expenses	-2,032	-3,158	55%	
General & admin expenses	-4,368	-7,012	61%	
Operating profit	13,398	19,272	44%	
Finance costs, net	-491	-691	41%	
Share of profit/(losses) of associates & JVs	-1,089	-375	-66%	
Profit before tax	11,818	18,206	54%	
Income tax expenses	-2,550	-3,658	43%	
Noncontrolling interests	-85	-72	-15%	
Net profit	9,183	14,476	58%	
One-off items	849	-265	n.a.	
Core profit (non-GAAP)	10,032	14,211	42%	5% above consensus
Profitability (%):	1Q16	1Q17	ppt YoY	
Gross margin	58.1	51.3	-6.8	
Operating margin	41.9	38.9	-3	
Net margin	28.7	29.2	0.5	
Core net margin (non-GAAP)	31.4	28.7	-2.7	

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	142,309	177,887
Online advertising	17,468	26,970	37,758	50,973
Others	4,726	17,158	42,895	85,790
Total revenue	102,863	151,938	222,962	314,650
Cost of sales	41,631	67,439	104,891	158,928
Gross profit	61,232	84,499	118,071	155,722
Interest income	2,327	2,619	3,600	4,500
Other gains/losses	1,886	3,594	4,000	4,000
Selling & marketing expenses	7,993	12,136	17,837	25,172
General & admin expenses	16,825	22,459	31,215	40,904
Operating Profits	40,627	56,117	76,619	98,146
Finance cost	1,618	1,955	2,800	2,800
Share of profit of investments in associates	-2,793	-2,522	-1,500	-1,000
Profit before tax	36,216	51,640	72,319	94,346
Tax	7,108	10,193	12,656	16,511
Profit after tax	29,108	41,447	59,664	77,835
Minority interests	302	352	195	254
Profits attributable to shareholders	28,806	41,095	59,469	77,581
Non-GAAP profits attributable to shareholders	32,410	45,420	63,469	81,581
Growth				
Total revenue (%)	30.3	47.7	46.7	41.1
Gross Profits (%)	27.4	38	39.7	31.9
Operating Profits (%)	33	38.1	36.5	28.1
Net profit (%)	21	42.7	44.7	30.5
Non-GAAP net profit (%)	33.8	40.1	39.7	28.5
Operating performance				
Operating margin (%)	66.3	66.4	64.9	63.0
Net margin (%)	28.0	27.0	26.7	24.7
Core net margin (%)	31.5	29.9	28.5	25.9
ROAE (%)	28.2	26.7	27.9	28.2
ROAA (%)	12.1	11.7	14.1	15.8

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	109,263	174,172
Restricted cash	54,731	750	750	750
Term deposit	37,331	50,320	50,320	50,320
Account receivables	7,061	10,152	12,486	18,483
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	188,849	259,755
Total assets	306,818	395,899	448,594	532,500
Accounts payable	15,700	27,413	26,098	39,543
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	99,882	113,327
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	208,337	221,782
Net current assets	30,972	47,957	88,968	146,428
Equity attributable to shareholders	120,035	174,624	228,440	298,646
Non-controlling interests	2,065	11,623	11,818	12,072
Total equity	122,100	186,247	240,258	310,718

Source(s): Company, ABCI Securities estimates



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ABCI Securities Company Limited and/or its affiliates may pursue financial interests to the companies mentioned in the report.

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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