



Tencent (700 HK)

Resilient amid pandemic; longer-term outlook unaffected. Upgrade to BUY

- In-line 4Q19 results with 29% YoY core profit growth, driven by online gaming
- Positive impacts from extended CNY break likely to be short-lived as normalcy starts to resume; divergent near-term outlook among business segments, with solid online game momentum mitigating softer outlook for online advertising and FinTech/Business services
- Given the current undemanding valuation and the positive medium-to-long-term outlook, we upgrade to BUY

4Q19 highlights. In 4Q19, Tencent's revenue increased by 25% YoY to RMB 105.7bn, while non-GAAP net profit increased by 29% YoY to RMB 25.5bn, mainly driven by key mobile games including Peacekeeper Elite, PUBG Mobile, and consolidation of Supercell.

Near-term outlook. The extended CNY break amid coronavirus break has led to increased traffics and time spent on various types of apps under Tencent's ecosystem; however, the impact is likely short-lived as the outbreak slowly comes under control and normalcy starts to resume. Looking forward, online gaming business should be supported by key titles such as HOK, Peacekeeper Elite, etc. and international revenue. Online advertising could be impacted by lower advertising spending amid a weak economic environment and the delay of international sports events including NBA, European Nations Cup, etc. Payment business could be impacted by lower offline transaction volume amid consumer spending slowdown.

Upgrade to BUY. On a positive note, we believe current valuation is undemanding after recent corrections in share price. After going through the earnings cycle in 2018-2019, we believe investors have become more aware of the Group's pattern. Current valuation has partially priced in the higher degree of earnings cyclicity and lower visibility in the near term. While share price volatility may persist amid the COVID-19 pandemic, we believe its longer-term outlook remains unaffected. In our view, investors with a longer investment horizon may consider accumulating at dips in coming months. Upgrade to **BUY** with a SOTP-based TP of HK\$395.

Results and Valuation

	2018A	2019A	2020E	2021E
Revenue (RMB mn)	312,694	377,289	447,828	538,708
Chg (% YoY)	60.8	20.7	18.7	20.3
Net profit (RMB mn)	78,719	93,310	95,303	117,025
Chg (% YoY)	10.1	18.5	2.1	22.8
Non-GAAP net profit (RMB mn)	77,469	94,351	111,053	132,775
Chg (% YoY)	19.0	21.8	17.7	19.6
EPS (RMB)	8.3	9.9	10.0	12.2
Chg (% YoY)	9.7	16.9	2.1	22.8
Non-GAAP EPS (RMB)	8.2	10.0	11.6	13.9
Chg (% YoY)	18.5	20.1	17.7	19.6
Core P/E (x)	37.8	31.4	26.7	22.3
P/B (x)	9.0	6.9	5.7	4.7
ROAE (%)	24.9	22.1	17.9	18.5
ROAA (%)	12.3	11.1	9.5	10.5
DPS(HKD)	0.97	1.13	1.15	1.42
Dividend Yield (%)	0.3	0.3	0.3	0.4

Source(s): Bloomberg, ABCI Securities estimates (*1 RMB= 1.10 HKD)

Company Report

Mar 19, 2020

Rating: BUY

TP: HK\$395

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Share price (HK\$)	343.0
Est. share price return	15.2%
Est. dividend yield	0.4%
Est. total return	15.6%
Previous Rating & TP	HOLD/HK\$328
Previous Report Date	Nov 14, 2019

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	420.0/312.2
Issued shares (mn)	9,553
Market cap (HK\$ mn)	3,276,679
Avg daily turnover (HK\$ mn)	9,588
Major shareholder(s)	
Naspers	31.0%
Huateng Ma	8.53%

Source(s): Bloomberg, ABCI Securities

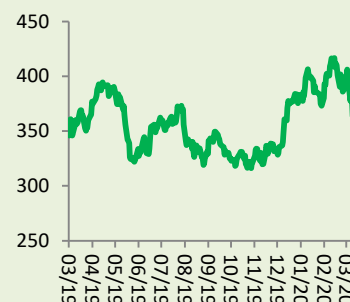
Share Performance (%)

	Absolute	Relative*
1-mth	-15.8	4.9
3-mth	-8.7	12.5
6-mth	1.4	18.6

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



農銀國際

ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

Tencent (700 HK)
Internet Media and Consumer Commerce Sector
Mar 19, 2020

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4Q19 highlights

In 4Q19, Tencent's revenue increased by 25% YoY to RMB 105.7bn, in line with market expectation. In addition, non-GAAP net profit increased by 29% YoY to RMB25.5bn, in line with consensus. Reported net profit increased by 52% YoY to RMB 21.6bn, 5% below market expectation.

Online gaming revenue increased by 25% YoY driven by key titles including Peacekeeper Elite (和平精英), PUBG Mobile, Call of Duty Mobile, as well as consolidation of Supercell since Nov 2019. This has prompted a 37% YoY growth in smartphone game revenue, offsetting the 7% YoY decline in PC game revenue. In addition, revenue from international games more than doubled YoY and contributed to 23% of online gaming revenue in 4Q19.

Online advertising reported 19% YoY revenue growth in 4Q19. Within online advertising, social and other advertising continued to be the main growth driver with 37% YoY growth during the quarter, thanks to advertising growth in Weixin Moments and its mobile advertising network. This has offset the 24% YoY revenue decline of media advertising dragged by uncertain broadcasting schedules and fewer telecasts of sports events in Tencent Video.

FinTech and business service revenue increased by 39% YoY on increased contribution from commercial payment and higher penetration of its cloud services.

Exhibit 1: 4Q19 highlight

(RMB m)	4Q18	4Q19	% YoY	Remarks
Online game	24,199	30,286	25%	Driven by Peacekeeper Elite, PUBG Mobile, Call of Duty Mobile, Supercell consolidation
Social network	19,452	22,022	13%	
Online advertising	17,033	20,225	19%	Driven by Weixin Moments
FinTech and business service	21,597	29,920	39%	
Others	2,615	3,314	27%	
Revenue	84,896	105,767	25%	In line with expectation
Gross profit	35,152	46,108	31%	
Operating profit	17,288	28,604	65%	
Net profit	14,229	21,582	52%	
Core profit (non-GAAP)	19,730	25,484	29%	In line with expectation
<u>Profitability (%):</u>				
Gross margin	41.4	43.6	2.2	
Operating margin	20.4	27.0	6.7	
Net margin	16.8	20.4	3.6	
Core net margin (non-GAAP)	23.2	24.1	0.9	

Source(s): The Company, ABCI Securities



High traffic amid COVID-19 outbreak

The extended CNY break amid coronavirus break has led to increased traffics and time spent on various types of apps under Tencent's ecosystem, including online games, online video, and more. We attribute such increase to 1) customers spending more time at home seeking for online entertainments; 2) users spending more time on epidemic-related information.

According to Questmobile, Tencent's major mobile games have experienced significantly growth in terms of users' average time spent during the 2020 CNY holiday compared with 2019 CNY holiday. E.g., average daily time spent per user for Honor of King (王者榮耀) increased by 74.8% to 194 minutes during the 2020 CNY break compared with the holiday last year.

Exhibit 2: Daily time spent per user –mobile games (minutes)

	Daily time spent per user (2019 CNY holiday)	Daily time spent per user (2020 CNY holiday)	Growth
Honor of King (王者榮耀)	111	194	74.80%
Peacekeeper Elite (和平精英)	99	124	25.30%
Crossfire (穿越火线)	94	127	35.10%

Remarks: 2019 CNY holiday: Feb 4-10, 2019;

2020 CNY holiday: Jan 24-Feb 2, 2020

Source(s): Questmobile

Similarly, growth occurred in other apps in Tencent's ecosystem such as WeChat, Tencent News, Tencent Video, etc. Average daily time spent per user for Tencent Video increased by 26.8% to 68 minutes during the 2020 CNY holiday compared to the break last year.

Exhibit 3: Daily time spent per user (minutes)

	Daily time spent per user (2019 CNY holiday)	Daily time spent per user (2020 CNY holiday)	Growth
WeChat	75	86	15.10%
QQ	57	66	15.50%
Tencent Video	54	68	26.80%
Tencent News	55	65	17.50%

Remarks: 2019 CNY holiday: Feb 4-10, 2019;

2020 CNY holiday: Jan 24-Feb 2, 2020

Source(s): Questmobile, ABCI Securities

We believe these exceptionally strong figures have been driven by the unusual circumstances. As the outbreak has started to alleviate in recent weeks and normalcy resumes, we expect these figures to normalize to lower levels in coming months.



Online gaming: Positive momentum

Online gaming revenue up 10%YoY in 2019 and accounted for 57.4% of VAS revenue or 30.4% of total revenue. In 2019, VAS segment enjoyed 52.9% gross margin and contributed to 63.2% of total gross profit, despite the fact that segment gross margin was down in 2019 versus 2018.

Overall, Tencent's two blockbuster games, Peacekeeper Elite (和平精英) and Honour of Kings (王者荣耀), have seen strong momentum in recent months, occupying the top two positions in China's best grossing mobile gaming league table every month since June 2019.

According to JiGuang, Honour of Kings (王者荣耀) achieved 69mn Daily Average User (DAU) in Dec 2019, up 28.3% YoY. In addition, DAU of Peacekeeper Elite (和平精英) increased from 26mn in June 2019 to 33.5mn DAU in Dec 2019.

In addition, other mobile gaming including QQ Speed (QQ飞车), CrossFire (穿越火线), CrazyRacing KartRider (跑跑卡丁车官方竞速版), Perfect World (完美世界), etc. also achieved good rankings in recent months. In particular, two older games, QQ Speed (QQ飞车) and CrossFire (穿越火线), have returned to the top 10 positions in Jan-Feb 2020, possibly driven by recent CNY promotion, in our view.

Exhibit 4: Best-selling mobile games in China's iOS platform (1/2019-7/2019)

	01/19	02/19	03/19	04/19	05/19	06/19	07/19
1	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)
2	Fantasy Westward Journey (梦幻西游)	Fantasy Westward Journey (梦幻西游)	Perfect World (完美世界)	Perfect World (完美世界)	Perfect World (完美世界)	Peacekeeper Elite (和平精英)	Peacekeeper Elite (和平精英)
3	Westward Journey Online (大话西游)	QQ Speed (QQ飞车)	Fantasy Westward Journey (梦幻西游)	Fantasy Westward Journey (梦幻西游)	Peacekeeper Elite (和平精英)	Fantasy Westward Journey (梦幻西游)	CrazyRacing KartRider (跑跑卡丁车官方竞速版)
4	QQ Speed (QQ飞车)	Onmyoji (阴阳师)	Westward Journey Online (大话西游)	Westward Journey Online (大话西游)	Fantasy Westward Journey (梦幻西游)	Perfect World (完美世界)	Fantasy Westward Journey (梦幻西游)
5	LifeAfter (明日之后)	Lord of the City (一刀传世)	LifeAfter (明日之后)	All Within The Boundaries (率土之滨)	Arknights (明日方舟)	Arknights (明日方舟)	Perfect World (完美世界)
6	King Of Chaos (乱世王者)	Fate/Grand Order	QQ Speed (QQ飞车)	QQ Speed (QQ飞车)	Onmyoji (阴阳师)	Onmyoji (阴阳师)	Dragon Raja (龙族幻想)
7	QQ Dancer (QQ炫舞)	QQ Dancer (QQ炫舞)	All Within The Boundaries (率土之滨)	Onmyoji (阴阳师)	Westward Journey Online (大话西游)	QQ Speed (QQ飞车)	Arknights (明日方舟)
8	Red Alert OL (红警 OL)	LifeAfter (明日之后)	Onmyoji (阴阳师)	Let's Hunt Monsters (一起来捉妖)	Let's Hunt Monsters (一起来捉妖)	Westward Journey Online (大话西游)	Westward Journey Online (大话西游)
9	Onmyoji (阴阳师)	Westward Journey Online (大话西游)	Kingdom Craft (乱世王者)	Anipop (开心消消乐)	QQ Speed (QQ飞车)	Fairy Tail: Magic Guide (妖精的尾巴: 魔导少年)	Authorization of Mu (精灵盛典)
10	Ghost (倩女幽魂)	King Of Chaos (乱世王者)	Lord of the City (一刀传世)	Red Alert OL (红警 OL)	Kingdom Craft (乱世王者)	All Within The Boundaries (率土之滨)	QQ Dancer (QQ炫舞)

Source(s): App Annie (Tencent's games are highlighted), ABCI Securities



Exhibit 5: Best-selling mobile games in China's iOS platform (7/2019-2/2020)

	08/19	09/19	10/19	11/19	12/19	01/20	02/20
1	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Honour of Kings (王者荣耀)	Peacekeeper Elite (和平精英)
2	Peacekeeper Elite (和平精英)	Peacekeeper Elite (和平精英)	Peacekeeper Elite (和平精英)	Peacekeeper Elite (和平精英)	Peacekeeper Elite (和平精英)	Peacekeeper Elite (和平精英)	Honour of Kings (王者荣耀)
3	Fantasy Westward Journey (梦幻西游)	Fantasy Westward Journey (梦幻西游)	Westward Journey Online (大话西游)	Fantasy Westward Journey 3D	Fantasy Westward Journey (梦幻西游)	AFK Arena	AFK Arena
4	CrazyRacing KartRider (跑跑卡丁车官方竞速版)	CrazyRacing KartRider (跑跑卡丁车官方竞速版)	Sangokushi Strategy (三国志·战略版)	Sangokushi Strategy (三国志·战略版)	Sangokushi Strategy (三国志·战略版)	Fantasy Westward Journey (梦幻西游)	Sangokushi Strategy (三国志·战略版)
5	Dragon Raja (龙族幻想)	Authorization of Mu (精灵盛典)	Authorization of Mu (精灵盛典)	Onmyoji (阴阳师)	Fantasy Westward Journey 3D	Sangokushi Strategy (三国志·战略版)	Fantasy Westward Journey (梦幻西游)
6	Authorization of Mu (精灵盛典)	Fate/Grand Order	CrazyRacing KartRider (跑跑卡丁车官方竞速版)	Westward Journey Online (大话西游)	Onmyoji (阴阳师)	CrossFire (穿越火线)	QQ Speed (QQ飞车)
7	Return of the Condor Heroes 2 (神雕侠侣 2)	Onmyoji (阴阳师)	Westward Journey Online (大话西游)	All Within The Boundaries (率土之滨)	New Swordsman (新笑傲江湖)	Onmyoji (阴阳师)	New Swordsman (新笑傲江湖)
8	Westward Journey Online (大话西游)	Dragon Raja (龙族幻想)	Honkai Impact 3 (崩坏 3)	Perfect World (完美世界)	Junior Three Kingdoms 2 (少年三国志 2)	QQ Speed (QQ飞车)	CrossFire (穿越火线)
9	Onmyoji (阴阳师)	Westward Journey Online (大话西游)	Onmyoji (阴阳师)	Shining Nikki (闪耀暖暖)	All Within The Boundaries (率土之滨)	Naruto Mobile (火影忍者)	Shenwu 4 (神武 4)
10	Shining Nikki (闪耀暖暖)	Perfect World (完美世界)	All Within The Boundaries (率土之滨)	Arknights (明日方舟)	Punishing: Gray Raven (战双帕弥什)	New Swordsman (新笑傲江湖)	Onmyoji (阴阳师)

Source(s): App Annie (Tencent's games are highlighted), ABCI Securities

Tencent's new games pipe remained solid in recent quarters. It has launched 10, 6, and five new games in 2Q19, 3Q19, and 4Q19 in China, including the blockbuster hit Peacekeeper Elite (和平精英) launched in 2Q19.

In addition, Tencent, jointly with Activision, released Call of Duty: Mobile (CODM), a popular FPS game, in Oct 2019 globally.

New game launch has slowed down in 1Q20 - no major games have been introduced so far. This is in line its historical trend of fewer launches in 1Q (e.g. one game in 1Q19) due to the CNY holiday. The extended CNY break in 2020 amid coronavirus outbreak provide additional reasons to defer promoting new games, in our view.



Exhibit 6: Tencent's recent new mobile games launched in China

	Name	Chines name	Type	Remark
1Q19	Perfect World Mobile	完美世界手游	RPG	Licensed
2Q19	Catchya	一起来捉妖	Causal	In-house
2Q19	Peacekeeper Elite	和平精英	Action	In-house
2Q19	Happy Fish	欢乐捕鱼大战	Causal	In-house
2Q19	Ever Adventure	无尽远征	RPG	Licensed
2Q19	Legend of Blue Moon	蓝月传奇	RPG	Licensed
2Q19	Once Upon a Time	三生三世十里桃花	RPG	Licensed
2Q19	The Rhythm Of The Clouds And Dreams	云梦四时歌	RPG	Licensed
2Q19	Fairy Tail	妖精的尾巴	RPG	Licensed
2Q19	Eastward Legend: The Empyrean	剑网 3 指尖江湖	RPG	Licensed
2Q19	Raziel	拉结尔		
3Q19	KartRider Rush	跑跑卡丁车	Action	Licensed
3Q19	Game of Thrones	权力的游戏	SLG	Licensed
3Q19	Dragon Raja	龙族幻想	RPG	Licensed
3Q19	LEGO Cube	乐高无限	RPG	In-house
3Q19	Ace Force Legion	王牌战士	Action	In-house
3Q19	The Tale of Food	食物语	RPG	Licensed
4Q19	Auto Chess:Origin	多多自走棋	SLG	Licensed
4Q19	Fox Spirit Matchmaker	狐妖小红娘	RPG	In-house
4Q19	HUNTERxHUNTER	全职猎人	RPG	Licensed
4Q19	Lord Xueying Mobile	雪鹰领主	RPG	In-house
4Q19	DBM	龙珠最强之战	Action	Licensed

Source(s): The Company, ABCI Securities

Among Tencent's current new game pipeline, 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. We notice that DnF Mobile has completed a closed beta testing in Dec 2019 and will conduct another round of testing in Mar 2020; the expected launch date is 1H20.



Exhibit 7: Tencent's new mobile game pipe

Name	Chines Name	Remark
Stone Age	石器时代	Licensed
DnF Mobile	地下城与勇士	Licensed
Lineage II Revolution	天堂 II: 革命	Licensed
Need for Speed Online	极品飞车 OL 手机	
Mobile	版	Licensed
JX Mobile 2	剑侠情缘 2	Licensed
The Outcast	一人之下	In-house
Legend of Honour	光明勇士	Licensed
The Legend Of Qin	秦时明月手游	In-house
ReEvolve	我的起源	Licensed
Street Fighter Online	街霸 OL	In-house
Moonlight Blade Mobile	天涯明月刀手游	In-house
World of Love	恋世界	Licensed
CODM	使命召唤手游	In-house
Brawl Star	荒野乱斗	In-house
Angry Bird	愤怒的小鸟梦幻岛	Licensed
Dragon Nest Mobile 2	龙之谷 2	Licensed
My Hero Academia	我的英雄学院	Licensed
Chess Rush	魔方自走棋	In-house

Source(s): The Company, ABCI Securities

Stabilizing regulatory environment

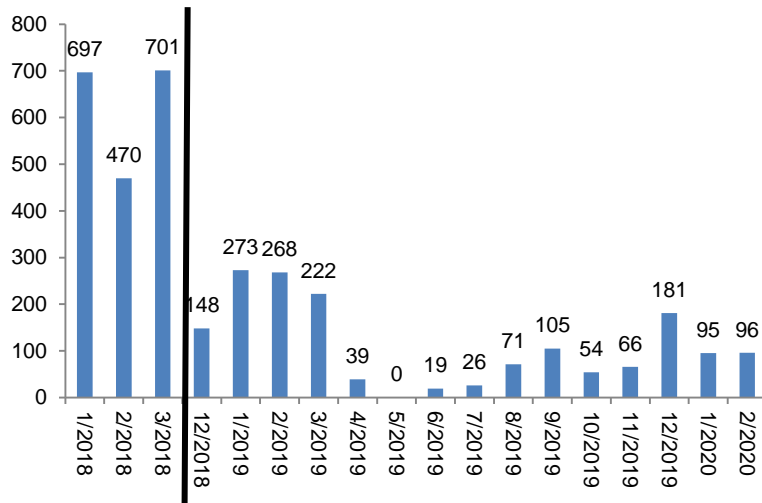
The number of new mobile game approvals has been recovering in recent months, averaging 110 per month in 2019. The figure was similar for the first two months in 2020, although it is still significantly lower than average of 622 approvals per month in 1Q18, which was prior to the regulatory tightening.

For Tencent, it has received 43 new game approvals since 2019, including its recent blockbuster hit Peacekeeper Elite (和平精英), an extreme survival game “replacing” its earlier PUBG Mobile which gained significant popularity but lack of monetization due to regulatory hurdle. Overall, Peacekeeper Elite (和平精英) was able to inherit PUBG Mobile’s popularity since launched.

In our view, the tightened approval process since 2018 has benefited larger players, including Tencent and NetEast, which have more financial resources to manage a longer product development cycle. In addition, fewer new games can imply a longer product life cycle for existing mobile games, which benefits these large players.



Exhibit 8: Number of mobile game approvals



Source(s): SAPPRFT, ABCI Securities

Online advertising: Ongoing headwinds

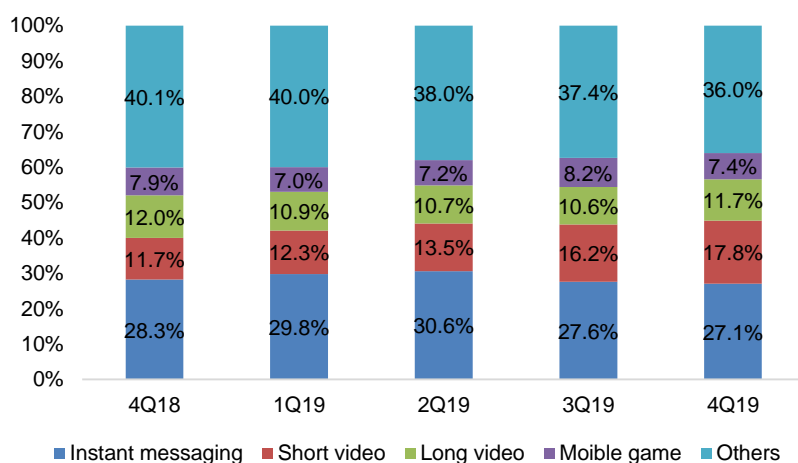
Online advertising revenue was up 17.7% YoY in 2019, contributing 18% of total revenue and 20% of total gross profit. Gross margin of online advertising segment was up to 49.0% in 2019 from 44.4% in 2018.

Compared with the ongoing gaming business, we are less bullish on the online advertising segment. Although the virus outbreak might have led more users to go online; structurally, we are seeing an ongoing shift of users spending more time on short videos, an area where Douyin (抖音) has a leading market position.

According to JiGuang, users' time spent on instant messaging, where Tencent has a leading market position via its WeChat app, has dropped from 40.1% in 4Q18 to 36.0% in 4Q19. In addition, users' time spent on long videos (Tencent Video is the second largest player with 114m DAUs in Dec 2019 vs. 124m for iQiyi) also dropped slightly from 12.0% in 4Q18 to 11.7% in 4Q19. On the other hand, users' time spent on short videos has increased from 11.7% in 4Q18 to 17.8% in 4Q19.

As users' time spent continued to shift to short videos, advertisers are more inclined to place advertisements on leading short video platforms such as Douyin.

Exhibit 9: Share of users' time spent among mobile applications

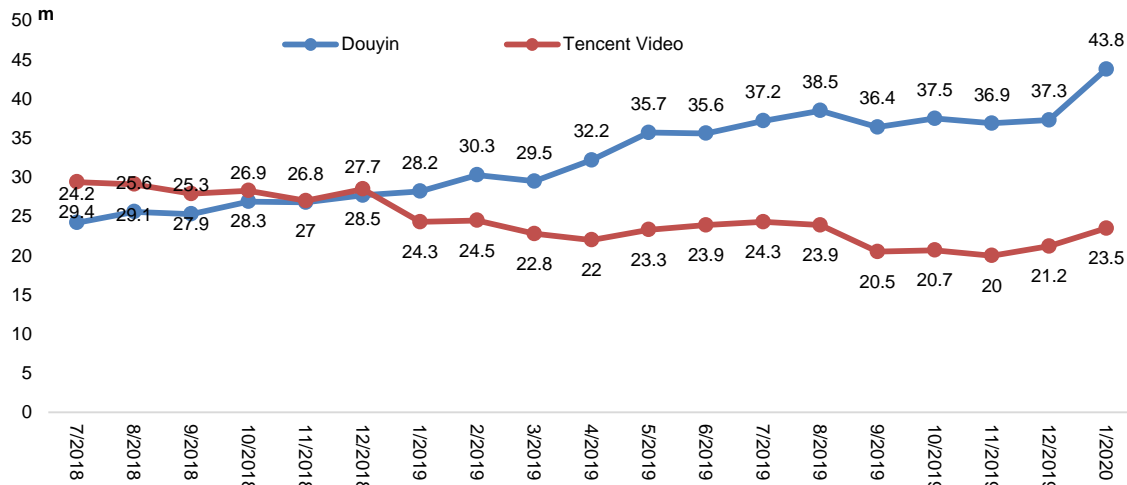


Source(s): JiGuang, ABCI Securities

Douyin's MAUs exceed that of Tencent Video since 4Q18 and the gap continues to widen. According to Trustdata, Douyin's MAUs reached 43.8m in Jan 2020 vs. 23.5mn for Tencent Video. In our view, this divergent trend would inevitably affect their respective online advertising businesses.



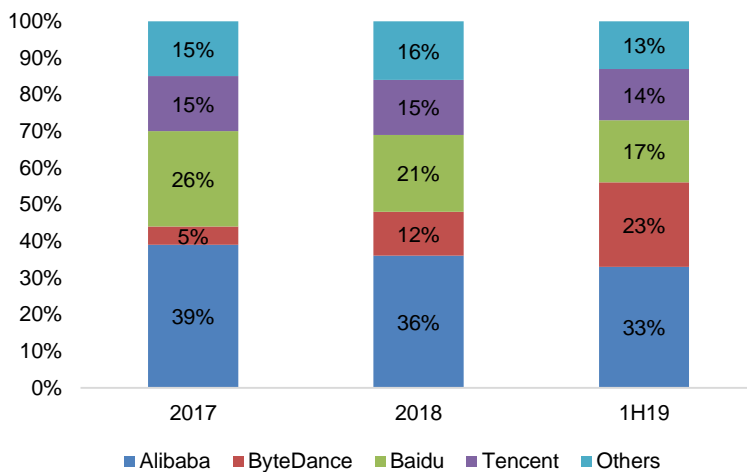
Exhibit 10: Monthly Average Users (MAU) comparison



Source(s): Trustdata, ABCI Securities

Overall, rising MAU and time spent of Douyin have helped its parent group, ByteDance, to grow its online advertising business in recent years. According to R3, ByteDance's online advertising market increased markedly from 5% in 2017 to 23% in 1H19, and has become the second largest player in China's online advertising market in 1H19 with 113% YoY revenue growth during the period. Tencent, on the other hand, has maintained a stable market share in recent years, ranking fourth with a 14% market share in 1H19.

Exhibit 11: Online advertising market share trend



Source(s): R3, ABCI Securities

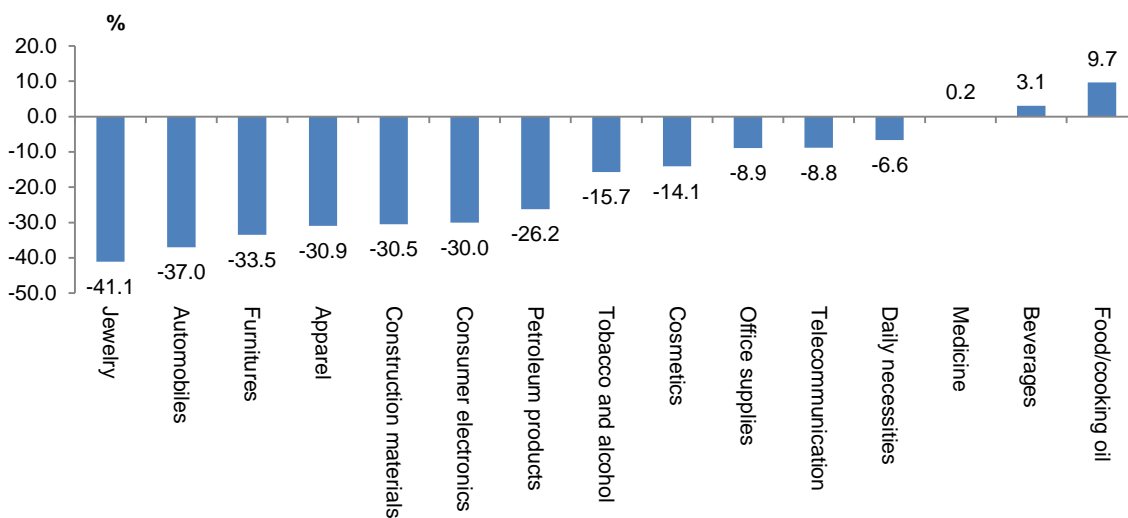


In addition to the above structural challenges, the current weak economic environment would prompt advertisers to turn more conservative on advertising budgets going forward.

China's retail sales have dropped by 20.5% YoY in 2M20, according to National Bureau of Statistics (NBS). Among the product categories, jewelry, automobiles, furniture, apparel, construction materials, and consumer electronics were the hardest hits. These industries are more likely to reduce its overall advertising expenses in coming months.

In addition, the delay of international sports events, including NBA, European Nations Cup, The Premier League, amid the epidemic could impact traffics in Tencent Video and Tencent News in the near term.

Exhibit 12: 2M20 retail sales growth of product categories



Source(s): NBS, ABCI Securities

Exploring a new business model

On a positive note, Tencent has been exploring new features and monetization models within its WeChat ecosystem. Tencent plans to focus on short-form content in its WeChat ecosystem in 2020.

The Group have stepped up investment in the short video. In 4Q19, its short video app Weishi increased its DAU 80% QoQ and daily uploads 70% QoQ. In addition, it has recently started to test out the WeChat video account, which allows users to create short videos. In our view, these initiatives would allow it to compete more effectively with Douyin.

In addition, it has recently launched a trial test to charge users for premium contents in their WeChat subscription channels. This is similar to Youtube's channel membership feature where users can enjoy premium contents and support the favorite content creators by subscribing to paid membership. In our view, this business model, if successful, could enhance the overall ecosystem. Content creators are more motivated to create quality works, which will in turn attract more traffic and paid members in the ecosystem.



FinTech and business services: A mixed bag

FinTech and business services recorded 39% YoY revenue growth in 2019, contributing 27% of total revenue and 16.4% of total gross profit. Gross margin improved from 25.4% in 2018 to 27.2% in 2019.

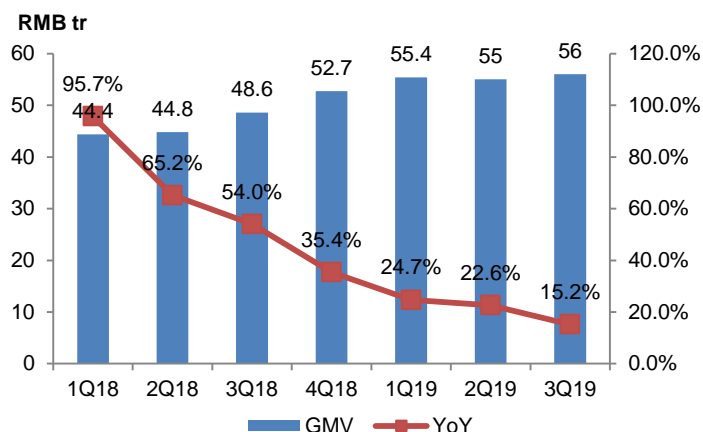
On the third-party payment market, we expect the current competitive landscape to remain stable as price competition has eased in recent quarters, which should bode well for profitability.

The third-party mobile payment market size reached RMB 56tr in 3Q19, with growth normalizing to the mid-teens levels after years of development. Tencent had a 39% market share in 3Q19, vs. Alibaba's 55%.

On the regulatory front, various local media have recently reported that PBOC had allowed third-party payment platforms to enjoy a 0.35% annual interest (10% of the interest income will be transferred into a protection fund for the non-bank payments industry) from PBOC on their customer balance, effective for three years between Aug 2019 and July 2022. This indicates a policy reversal of its previous "no interest" policy on third-party payment platforms.

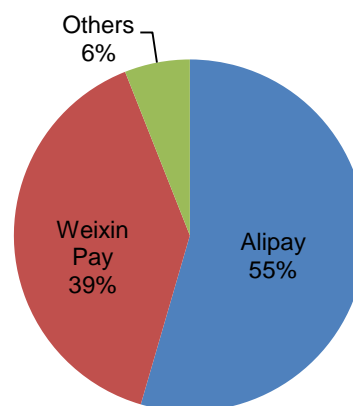
On the flip side, the weakened consumer market could inevitably impact third-party payment volume in the near term, as the majority of payment volume is related to offline merchants like restaurants, retail stores, and more.

Exhibit 13: Third-party mobile payment market size



Source(s): iResearch, ABCI Securities

Exhibit 14: Third-party mobile payment market share (3Q19)



Source(s): iResearch, ABCI Securities

Tencent is China's second largest cloud service provider with 19% market share in 3Q19, lower than Alibaba's 45% but higher than Amazon's 8%, and Baidu's 8%, according to Canalys.

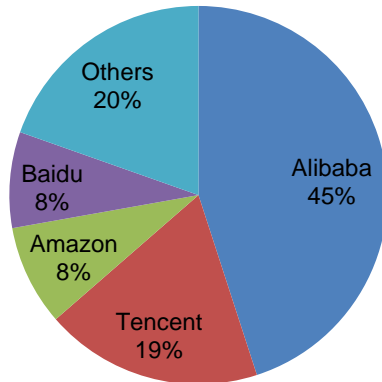
In our view, China's cloud market is driven by increasing need from corporates to embark on digital transformation projects and building platforms and application to develop new services.

We believe Alibaba has a competitive edge in terms of developing deep understanding, via A.I. system. Based on the large number of local merchants from its operation of online platform accumulated in the past decades, Alibaba is more



able to assess the need of SMEs in China. In comparison, Tencent, may need more time to develop similar capabilities as its core business is consumer-focused with less connection to SMEs in China.

Exhibit 15: China's cloud market –market share (3Q19)



Source(s): Canalys, ABCI Securities

Financial outlook

We expect revenue to grow at 19% CAGR in 2019-2021E.

Online gaming: Online gaming revenue was up 10% YoY in 2019. We expect online gaming revenue to expand at 17% CAGR in 2019-2021E. The recent coronavirus outbreak has increased consumers' time spent on online gaming, which bodes well for this segment especially in 1H20. In addition, full -year contribution of Peacekeeper Elite, which was launched in May 2019, will start in 2020E. The potential launch of DnF Mobile in 1H20 could be another potential income driver since the franchise has accumulated a sizable user base.

In addition, segment revenue is also supported by the consolidation of Supercell starting in Nov 2019 after Tencent raised its stakes to 51.2%. Overall, Supercell reported USD 1.56bn in revenue and USD 577mn in profit before tax (PBT) in 2019, equivalent to 2.9% and 0.5% of Tencent's revenue and PBT in 2019.

Online advertising: Unlike online gaming, we expect a weaker outlook for online advertising given the languid economy impacting the whole advertising industry. In addition, ongoing competition from Douyin, which has been actively ramping up its advertising business in recent quarters, will bring challenges. We expect a 21% revenue CAGR in 2019-2021E, given that segment revenue was up 17.7% YoY in 2019.

Fintech and business service: Segment revenue was up 38.6% YoY in 2019. We expect segment revenue to increase at 27% CAGR in 2019-21E. The third-party payment business will be affected by a multitude of positive and negative factors: positive ones from improving regulatory environment that allows interest income on customers' outstanding balance from PBOC, and negative ones from reduced offline transactions amid the diminishing consumption appetite.

Exhibit 16: Revenue forecasts (RMB mn)

	2018	2019	2020E	2021E
Value added services (VAS)	176,646	199,991	234,759	261,441
<i>Online games</i>	103,992	114,700	140,905	157,445
<i>Social network</i>	72,654	85,281	93,853	103,996
Online advertising	58,079	68,377	76,918	100,744
Fintech and business services	73,138	101,355	126,694	100,744
Others	4,831	7,566	9,458	11,822
Total revenue	312,694	377,289	447,828	538,708

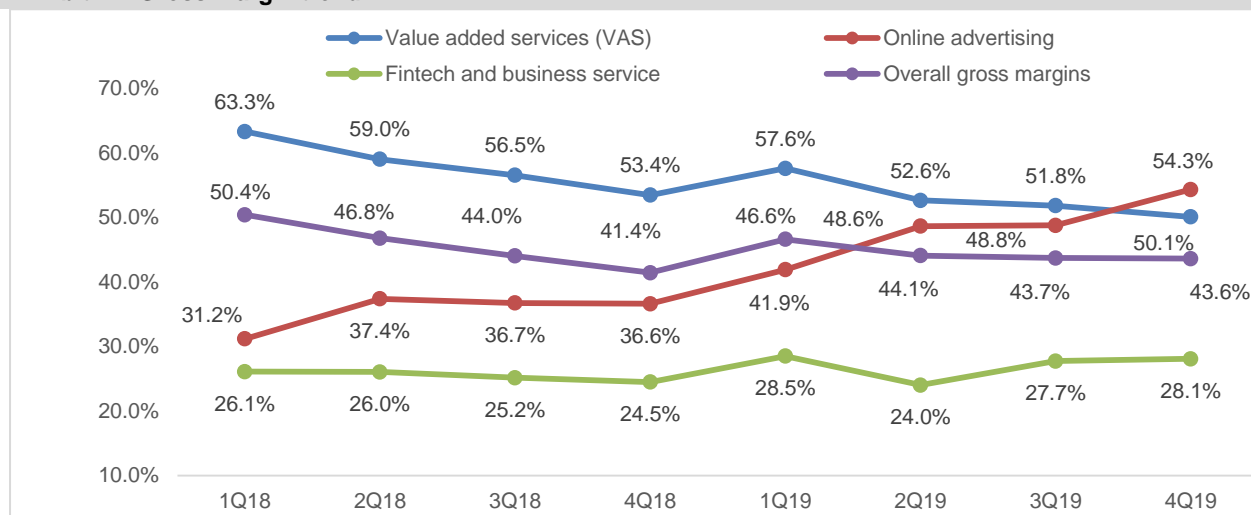
Source(s): The Company, ABCI Securities estimates



Tencent's gross margin has been declining in recent quarters, mainly dragged by falling profitability of VAS business (online gaming and social network). On a positive note, online advertising gross margin has been on an uptrend as Tencent continued to innovative value-added advertising services. Fintech and business services gross margin remained largely stable in recent quarters.

In addition, the changing business mix that shifts from higher-margin VAS to lower-margin online advertising and Fintech/business services also contributed to the decline. For example, VAS accounted for 56.8% of gross profit in 4Q19, down from 66.3% in 4Q18.

Exhibit 17: Gross margin trend



Source(s): The Company, ABCI Securities

Looking forward, we expect gross margin to fall from 44.4% in 2019 to 43.1% in 2021E given ongoing changes in business mix shifting towards lower-margin online advertising and Fintech/business services segments.

In terms of operating cost, we expect ongoing improvement going forward, mitigating some negative impacts from gross margin erosion. Overall, we expect SG&A cost-to-revenue ratio to drop from 19.8% in 2019 to 17.8% in 2021E

Selling and marketing expenses: Overall, we expect selling and marketing cost-to-revenue ratio to drop from 5.7% in 2019 to 5.4% in 2021E, driven by increasing economies of scale

General and admin expenses: We expect general and admin cost-to-revenue ratio to drop from 14.2% in 2019 to 12.4% in 2021E, driven by increasing economies of scale.



Exhibit 18: SG&A cost trend (RMB mn)

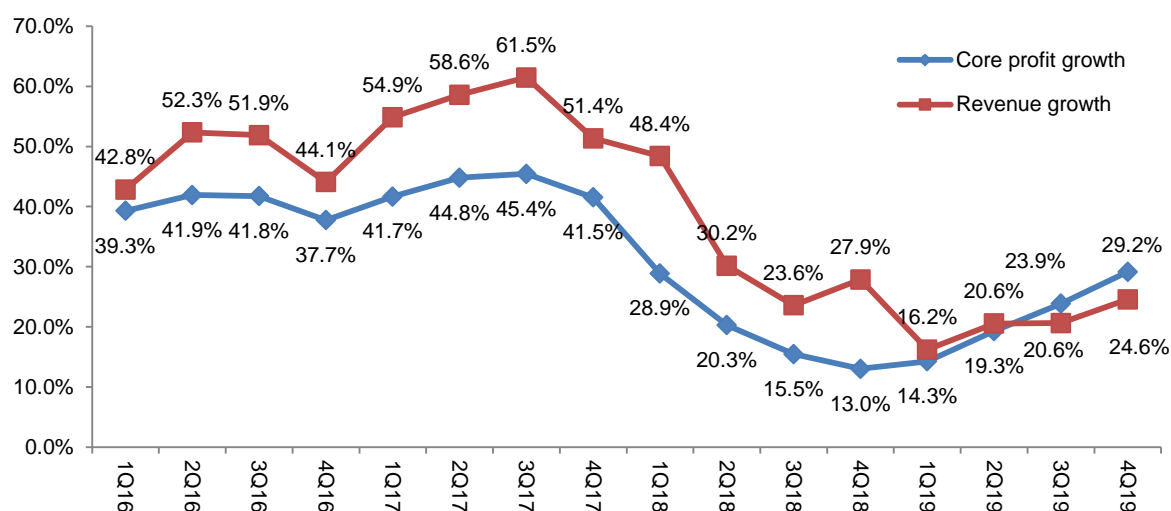
	2018	2019	2020E	2021E
Selling & marketing expenses	(24,233)	(21,396)	(24,691)	(28,917)
General & admin expenses	(41,522)	(53,446)	(59,483)	(67,035)
Total SG&A	(65,755)	(74,842)	(84,174)	(95,951)
% of revenue				
Selling & marketing expenses	7.7%	5.7%	5.5%	5.4%
General & admin expenses	13.3%	14.2%	13.3%	12.4%
Total SG&A	21.0%	19.8%	18.8%	17.8%

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 drop slightly to 24.6% by 2021E from 25.0 in 2019. This would result in a 19% CAGR in core net profit for 2019-2021E.

Overall, Tencent's core profit growth has slowed down significantly since 2Q18 due to tightened regulatory environment on mobile gaming and increasing competition for user time from emerging online entertainments. The situation has improved since 3Q19 because of the stabilizing regulatory environment on mobile gaming, contribution from new mobile games, and an easier comparison base.

Exhibit 19: Revenue and profit growth trend



Source(s): The Company, ABCI Securities



In terms of earning sensitivity, we estimate that a 100bp improvement in core net margin would increase its 2020E and 2021E core net profits by 4.0% and 4.1% respectively, as shown in Exhibit 20.

Exhibit 20: Earnings sensitivity

Changes in core net margin (bps)	Changes in 2020E core net profit	Changes in 2021E core net profit
100	4.0%	4.1%
75	3.0%	3.0%
50	2.0%	2.0%
25	1.0%	1.0%
-	0.0%	0.0%
(25)	-1.0%	-1.0%
(50)	-2.0%	-2.0%
(75)	-3.0%	-3.0%
(100)	-4.0%	-4.1%

Source(s): ABCI Securities estimates

Exhibit 21: Forecast changes

(RMB m)	2020E			Comment
	old	new	Diff	
Revenues	456,693	447,828	-2%	
Net income	113,937	125,428	10%	
Core profit	91,510	95,303	4%	Lower cost assumptions

Source(s): ABCI Securities estimates



Exhibit 22: Quarterly financials (RMB mn)

	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Value added services (VAS)	46,877	42,069	44,049	43,651	48,974	48,080	50,629	52,308
Online games	28,778	25,202	25,813	24,199	28,513	27,307	28,604	30,286
Social network	18,099	16,867	18,236	19,452	20,461	20,773	22,025	22,022
Online advertising	10,689	14,110	16,247	17,033	13,377	16,409	18,366	20,225
Fintech and business services	15,182	16,666	19,693	21,597	21,789	22,888	26,758	29,920
Others	780	830	606	2,615	1,325	1,444	1,483	3,314
Revenue	73,528	73,675	80,595	84,896	85,465	88,821	97,236	105,767
Cost of revenue	-36,486	-39,229	-45,115	-49,744	-45,645	-49,695	-54,757	-59,659
Gross profit	37,042	34,446	35,480	35,152	39,820	39,126	42,479	46,108
Interest income	1,065	1,072	1,082	1,350	1,408	1,652	1,674	1,580
Other gains/(losses), net	7,585	2,506	8,762	-2,139	11,089	4,038	932	3,630
Selling & marketing expenses	-5,570	-6,360	-6,573	-5,730	-4,244	-4,718	-5,722	-6,712
General & admin expenses	-9,430	-9,857	-10,890	-11,345	-11,331	-12,577	-13,536	-16,002
Profit from operations	30,692	21,807	27,861	17,288	36,742	27,521	25,827	28,604
Net finance cost	-654	-1,151	-1,492	-1,372	-1,117	-1,982	-1,747	-2,767
Shares of profit of associates/JV	-319	1,526	264	16	-2,957	2,370	234	-1,328
PBT	29,719	22,182	26,633	15,932	32,668	27,909	24,314	24,509
Income tax expenses	-5,746	-3,602	-3,228	-1,906	-4,812	-3,225	-3,338	-2,137
Minority interest	-683	-713	-72	203	-646	-548	-594	-790
Net income	23,290	17,867	23,333	14,229	27,210	24,136	20,382	21,582
Non-GAAP net profit	18,313	19,716	19,710	19,730	20,930	23,525	24,412	25,484
YoY								
Revenue growth (%)	48.4%	30.2%	23.6%	27.9%	16.2%	20.6%	20.6%	24.6%
EBIT growth (%)	59.3%	-3.3%	22.5%	-32.8%	19.7%	26.2%	-7.3%	65.5%
Net profit growth (%)	60.9%	-2.0%	29.6%	-31.6%	16.8%	35.1%	-12.6%	51.7%
Core profit growth (%)	28.9%	20.3%	15.5%	13.0%	14.3%	19.3%	23.9%	29.2%
Margin								
Gross profit margin (%)	50.4%	46.8%	44.0%	41.4%	46.6%	44.1%	43.7%	43.6%
Operating margin (%)	41.7%	29.6%	34.6%	20.4%	43.0%	31.0%	26.6%	27.0%
Net margin (%)	31.7%	24.3%	29.0%	16.8%	31.8%	27.2%	21.0%	20.4%
Core net margin (%)	24.9%	26.8%	24.5%	23.2%	24.5%	26.5%	25.1%	24.1%

Source: The Company, ABCI Securities



Valuation

We derive Tencent's fair valuation range based on SOTP approach.

In valuing Tencent's core business, we roll over our forecasts to 2021E and apply 21x-25x (vs.22-25x previously) targeted P/E ratio.

We value Tencent's investment based on their latest book value with a 0-30% holding discount.

The SOTP approach results in a fair valuation range of HKD 357.3-HKD 433.8. We set our TP at HKD395, approximating the mid-point of our fair valuation range and implies 25.8x 2021E core P/E. Our latest TP warrants a **BUY** rating.

Exhibit 23: SOTP valuation

	Valuation – Mid-point (HKD per share)	Valuation – high end	Valuation – low end	Remarks
Core business	352.4	383.1	321.8	21x -25x 2021E core PE
Investments:	43.1	50.7	35.5	Book value with 0%-30% holding discount
Total	395.6	433.8	357.3	

Source(s): ABCI Securities estimates

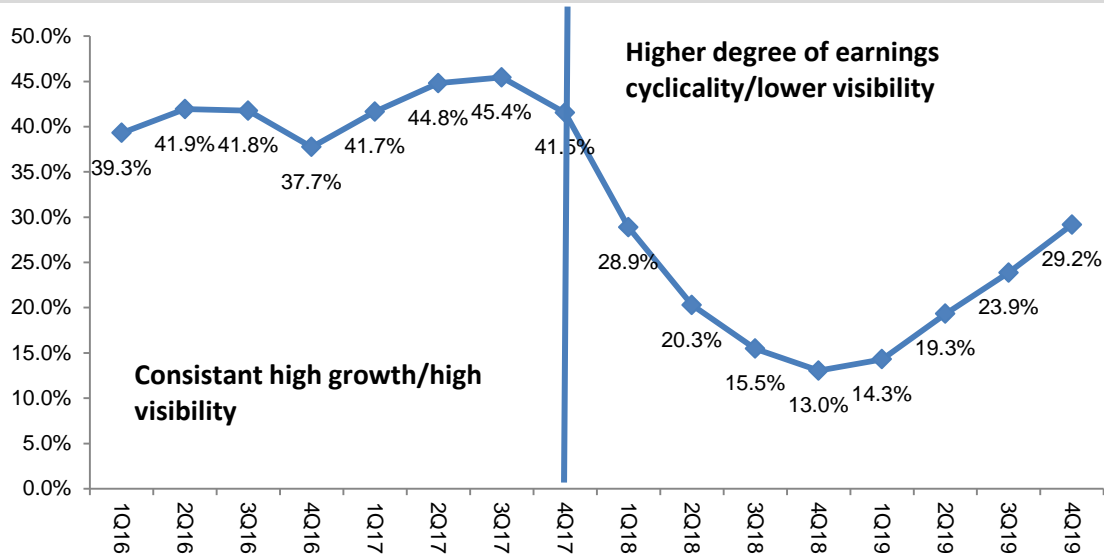
While Tencent's earnings trend have stabilized lately, the moderated earnings growth since early 2018 have allowed investors to become more aware of the Group's earnings cycles and the potential downside risks in downturn. This is in contrast with the period during 2016-2017 when investors perceived Tencent as a growth stock based on its robust earnings trend during the period.

As a result, we believe current valuation has partially priced in the higher degree of earnings cyclicity and lower earnings visibility compared to the past.

While share price volatility could persist in the near term amid ongoing coronavirus outbreak and growing pessimism in the global economy, we believe its current valuations have already priced the short-term negatives and the cyclicity inherent in its business. In our view, investors with a longer term investment horizon may consider accumulating at dips in coming months, in our view. Upgrade to **BUY**.

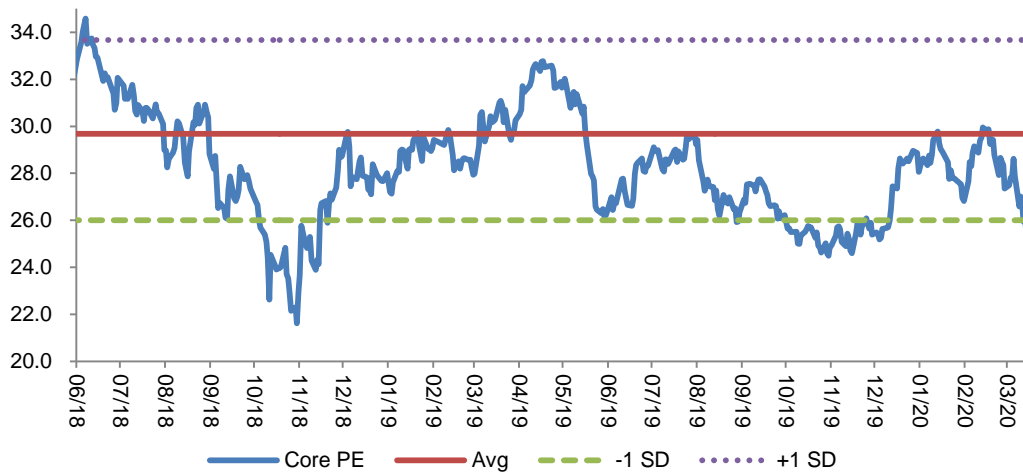


Exhibit 24: Tencent's core profit growth trend



Source(s): The Company, ABCI Securities

Exhibit 25: PE band



Source(s): Bloomberg, ABCI Securities



Peer valuation analysis

Among the HK-listed internet platforms including Tencent, Alibaba (9988 HK/BABA US) and Meituan (3690 HK), Tencent is trading at a higher P/E than Alibaba. In our view, this could be justified by higher defensiveness of the former amid the recent coronavirus outbreak that increases users' time spent on online platforms. On the other hand, Alibaba's ecommerce business is impacted by supply chain disruptions; after all, online sales growth of physical goods slowed markedly to only 3.0% YoY in 2M20.

Meituan is trading at significant higher P/E than Tencent and Alibaba; however, P/E might not be the best valuation metric for Meituan as the company is still in the early stage of profitability. Instead, P/Sales is a more suitable measure.

On the flip side, major HK-listed internet platforms are generally trading at higher P/E than major US-listed internet platforms such as Facebook and Alphabet, which could potentially affect their attractiveness in terms of relative value among global investors, in our view.

Exhibit 26: Peer valuation

		Market cap (Lcy)	Price (Lcy)	P/sales			P/E		
				<u>2019E</u>	<u>2020E</u>	<u>2021E</u>	<u>2019E</u>	<u>2020E</u>	<u>2021E</u>
HK-listed major online platforms									
700 HK Equity	TENCENT	3,303,405	346.2	8.0	6.5	5.3	32.3	26.2	21.2
9988 HK Equity	ALIBABA	3,730,058	173.8	6.7	5.1	4.1	25.6	22.0	17.4
3690 HK Equity	MEITUAN	422,986	72.7	4.0	3.1	2.4	196.5	77.3	27.3
				7.4	5.8	4.7	28.9	24.1	19.3
US-listed major online platforms									
FB US Equity	FACEBOOK	418,902	147.0	5.9	4.9	4.1	22.7	14.4	12.2
GOOGL US Equity	ALPHABET	752,003	1,091.2	4.6	4.9	4.2	21.9	16.9	14.7
AMZN US Equity	AMAZON.COM	910,993	1,830.0	3.2	2.7	2.3	78.6	44.2	32.5
				5.5	4.7	3.9	67.5	33.2	18.4

Source(s): Bloomberg, ABCI Securities estimates



Risk factors

Market competition

We believe the rise of emerging forms of online entertainment such as short video apps 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 in turn could potentially impact Tencent's online advertising revenue accounting for 18% of total revenue in 2019.

Tightening regulation on 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.

Tightening regulation on internet finance

As the Group is exposed to the internet finance market via its payment business, 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 is usually in line with GDP growth.

Ecosystem may need to improve further in the face of competition

Popularity of short-video sharing platforms such as Douyin (抖音) has been increasing rapidly. According to Trustdata, Douyin's MAUs reached 43.8m in Jan 2020 vs. 23.5mn for Tencent Video. This shows that Tencent's ecosystem has room to improve.

Non-GAAP financials

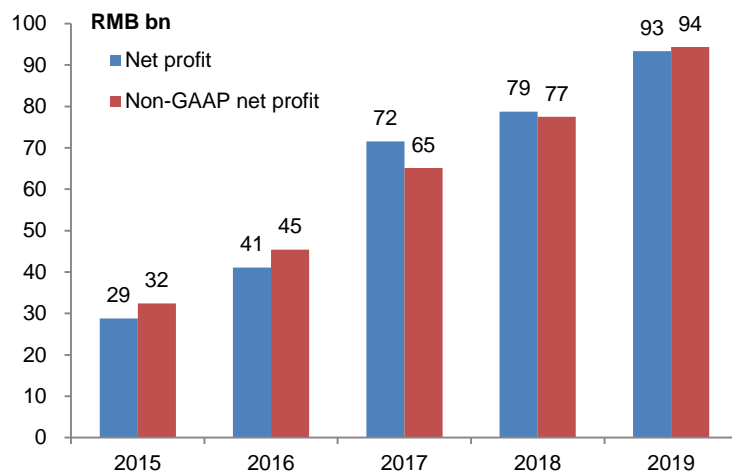
The Group has disclosed the non-GAAP financial metric, such as the non-GAAP net profit, to supplement its GAAP financial measures. Historically, there were differences between its GAAP net profit and non-GAAP net profit due to inclusion of items such as share-based compensation, impairment, fair valuation 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 RMB4.9bn in 2016 to RMB 12.3bn in 2019.

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.



Exhibit 27: Net profit vs. Non-GAAP core net profit (RMB m)



Source(s): The Company, ABCI Securities



Consolidated income statement (2018A-2021E)

FY Ended Dec 31 (RMB mn)	2018A	2019A	2020E	2021E
Online gaming	103,992	114,710	140,916	157,456
Social network	72,654	85,281	93,843	103,985
Online advertising	58,079	68,377	76,918	100,744
FinTech and business service	73,138	101,355	126,694	164,702
Others	4,831	7,566	9,458	11,822
Total revenue	312,694	377,289	447,828	538,708
Cost of sales	(170,574)	(209,756)	(252,526)	(306,735)
Gross profit	142,120	167,533	195,302	231,973
Interest income	4,569	6,314	7,050	8,050
Other gains/losses	16,714	19,689	7,250	7,550
Selling & marketing expenses	(24,233)	(21,396)	(24,691)	(28,917)
General & admin expenses	(41,522)	(53,446)	(59,483)	(67,035)
Operating Profits	97,648	118,694	125,428	151,621
Finance cost	(4,669)	(7,613)	(8,100)	(8,350)
Share of profit of investments in associates	1,487	(1,681)	(500)	(500)
Profit before tax	94,466	109,400	116,828	142,771
Tax	(14,482)	(13,512)	(21,212)	(25,363)
Profit after tax	79,984	95,888	95,615	117,408
Minority interests	1,265	2,578	312	383
Net profit	78,719	93,310	95,303	117,025
Share based compensation	11,025	12,309	12,500	12,800
Gain/losses from investee companies	(33,073)	(20,720)	(4,000)	(4,100)
Amortization and impairment	21,265	10,547	7,250	7,050
Other non-core items	(467)	(1,095)	-	-
Non-GAAP net profit (core profit)	77,469	94,351	111,053	132,775
Growth				
Total revenue (%)				
Gross Profits (%)	60.8	20.7	18.7	20.3
Operating Profits (%)	21.5	17.9	16.6	18.8
Net Profits (%)	8.1	21.6	5.7	20.9
Non-GAAP net profit (%)	10.1	18.5	2.1	22.8
	19.0	21.8	17.7	19.6
Operating performance				
Gross margin (%)	45.5	44.4	43.6	43.1
Operating margin (%)	31.2	31.5	28.0	28.1
Net margin (%)	25.2	24.7	21.3	21.7
Non-GAAP net margin (%)	24.8	25.0	24.8	24.6
ROAE (%)	24.9	22.1	17.9	18.5
ROAA (%)	12.3	11.1	9.5	10.5

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 (2018A-2021E)

As of Dec 31 (RMB mn)	2018A	2019A	2020E	2021E
Fixed assets	47,801	78,070	99,070	120,070
Intangible assets	56,650	128,860	131,360	133,860
Investment in associates and JV	227,790	221,894	261,894	301,894
Financial assets	136,914	210,543	220,543	230,543
Term deposit	-	19,000	19,000	19,000
Other non-current assets	37,286	41,651	41,651	41,651
Total non-current assets	506,441	700,018	773,518	847,018
Cash & equivalents	97,814	132,991	160,071	206,330
Restricted cash	2,590	2,180	2,180	2,180
Term deposit	62,918	46,911	46,911	46,911
Account receivables	28,427	35,839	34,660	43,170
Deposit, prepayments and other assets	18,493	27,840	27,840	27,840
Inventories	324	718	718	718
Other current assets	6,514	7,489	7,489	7,489
Total current assets	217,080	253,968	279,869	334,638
Total assets	723,521	953,986	1,053,387	1,181,656
Accounts payable	73,735	80,690	91,655	111,330
Other payables & accruals	33,312	45,174	45,174	45,174
Borrowings and notes	40,554	33,229	33,229	33,229
Deferred revenue	42,375	64,228	64,228	64,228
Other current liabilities	12,459	16,835	16,835	16,835
Total current liabilities	202,435	240,156	251,121	270,796
Loans and bonds payables	138,735	187,584	187,584	187,584
Deferred revenue	7,077	7,334	7,334	7,334
Other non-current liabilities	19,067	30,088	30,088	30,088
Total non-current liabilities	164,879	225,006	225,006	225,006
Total liabilities	367,314	465,162	476,127	495,802
Net current assets	14,645	13,812	28,749	63,842
Equity attributable to shareholders	323,510	432,706	520,831	629,040
Non-controlling interests	32,697	56,118	56,430	56,814
Total equity	356,207	488,824	577,261	685,854

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



Disclosures

Analyst Certification

I, Chow Sau Shing, Steve, 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 (except "Disclosures of Interests" below) 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.

Disclosures of Interests

ABCI Securities Company Limited and/or its affiliates, within the past 12 months, have investment banking relationship with one or more of the companies mentioned in the report.

Definition of equity rating

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 2008 (HSI total return index 2008-19 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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