



Tencent (700 HK) Transitioning to low-growth phase

- Growth continued to decelerate with non-GAAP profit growth falling to 13% YoY in 4Q18, significantly lower than the 29-45% YoY growth rate between 1Q17-1Q18
- We believe online gaming is still facing challenges while online advertising may see intensified competition from Douyin
- Valuation getting stretched after recent share price rebounds. Maintain **HOLD** on dimmed growth prospect

Growth continued to decelerate in 4Q18. In 4Q18, revenue increased by 28% YoY to RMB 84.9bn, in line with market expectation. Non-GAAP net profit was up 13% YoY to RMB 19.7bn, 5% above consensus. Overall, Tencent has experienced two consecutive quarters of slowdown in which non-GAAP net profit growth fell to teens level (16% YoY in 3Q18 and 13% YoY in 4Q18), significantly lower than the 29-45% YoY growth during 1Q17-1Q18. We believe the Group might have entered a low-growth phase.

Online gaming still facing challenges. Online gaming revenue fell 1% YoY in 4Q18 despite the launch of nine new titles during the quarter. Aside from regulatory reasons, we believe the slowdown could be partly caused by growing preference for alternative online entertainment including short video apps.

Online advertising may see intensified competition. Online advertising revenue gained 38% YoY in 4Q18 vs. 47% YoY in 3Q18. In our view, the slowdown of online advertising revenue could be caused by rising competition from Douyin, who has been actively ramping up its online advertising business in recent quarters.

Valuation is stretched. In our view, current valuation is getting stretched after the share price rebound in recent months especially since growth outlook has dimmed. In light of flaccid near-term growth prospect, we maintain **HOLD** with an updated TP of HK\$360.

Risk factors: 1) Tightened regulatory environment in online gaming and internet finance; 2) Intensified competition from alternative online entertainment; 3) Potential entry of Google and Facebook into China

Results and Valuation

	2017A	2018A	2019E	2020E
Revenue (RMB mn)	237,760	312,694	389,477	476,488
Chg (% YoY)	56.5	31.5	24.6	22.3
Net profit (RMB mn)	71,510	79,206	78,855	90,721
Chg (% YoY)	74.0	10.8	(0.4)	15.0
Non-GAAP net profit (RMB mn)*	65,126	77,956	92,655	107,021
Chg (% YoY)	43.4	19.7	18.9	15.5
EPS (RMB)	7.6	8.3	8.3	9.5
Chg (% YoY)	73.4	9.7	(0.4)	15.0
Non-GAAP EPS (RMB)*	6.9	8.2	9.7	11.3
Chg (% YoY)	43.3	18.9	19.6	15.5
Core P/E (x)*	45.5	38.3	32.0	27.7
P/B (x)	11.6	9.2	7.5	6.2
ROAE (%)	30.9	25.0	20.1	19.2
ROAA (%)	15.0	12.4	10.3	10.6
DPS(HKD)	0.88	0.97	0.96	1.11
Dividend Yield (%)	0.2	0.3	0.3	0.3

*Excluding share based compensation, gain/loss from investee companies, amortization and impairment

Source(s): Bloomberg, ABCI Securities estimates (*1 RMB= 1.17 HKD)

Company Report

Mar 22, 2019
Rating: **HOLD**
TP: HK\$ 360

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Share price (HK\$)	365
Est. share price return	-1.4%
Est. dividend yield	0.3%
Est. total return	-1.1%
Previous Rating & TP	HOLD/HK\$340
Previous Report Date	Aug 16, 2018

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	458.9/251.4
Issued shares (mn)	9,520
Market cap (HK\$ bn)	3,475
Avg daily turnover (HK\$ mn)	3,346
Major shareholder(s)	
Naspers	31.10%
Huateng Ma	8.63%

Source(s): Bloomberg, HKEX, ABCI Securities

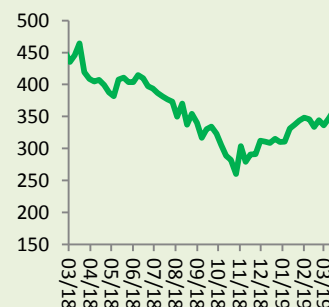
Share Performance (%)

	Absolute	Relative*
1-mth	4.7	4.2
3-mth	14.3	1.8
6-mth	7.7	4.1

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities



4Q18 results highlight

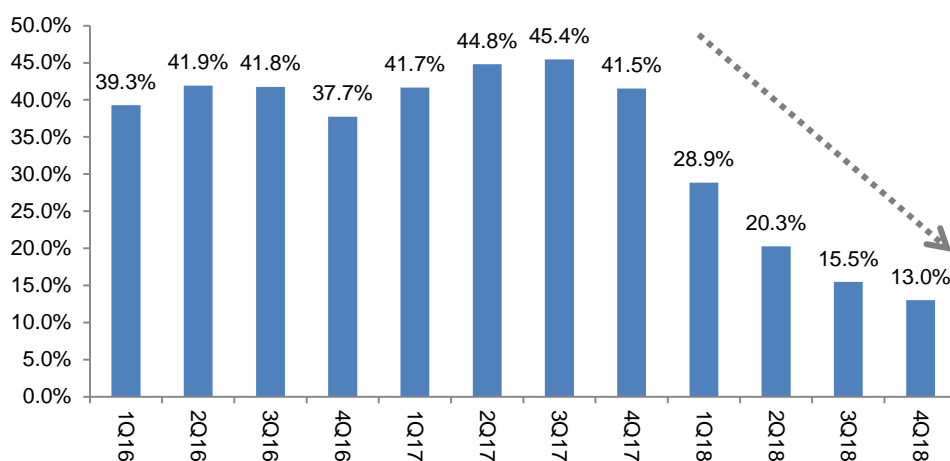
In 4Q18, revenue increased by 28% YoY to RMB 84.9bn, in line with market expectation. Non-GAAP net profit was up 13% YoY to RMB 19.7bn, 5% above consensus. Reported net profit dropped by 32% YoY to RMB 14.2bn, 19% below market expectation due to impairment provisions on investee companies.

Mobile gaming revenue growth improved to 12% YoY in 4Q18 vs. 7% YoY in 3Q18, still lower than 19% YoY in 2Q18 and 68% YoY in 1Q18. The Group launched nine new mobile games in 4Q18 (3Q18: 10 new titles). PC gaming revenue declined by 12% YoY in 4Q18 vs. 15% YoY drop in 3Q18. On a QoQ basis, mobile game revenue dropped by 3% in 4Q18, attributable to return of school season and tightened regulatory approvals; also, increasing preference for alternative online entertainment, including short video apps, may have suppressed growth.

Online advertising revenue gained 38% YoY in 4Q18 vs. 47% YoY in 3Q18, of which social and other advertising continued to be the main growth driver, up 44% YoY, driven by Weixin Moments and Mini Programs; media advertising revenue increased by 26% YoY. In our view, the slowdown in online advertising revenue could be due to rising competition from Douyin, which has been ramping up its online advertising business in recent quarters.

Payment/related financial services and cloud revenue continued to show robust growth of 72% YoY in 4Q18. However, its low segment margin could lead to thinner overall margin for the Group, in our view.

Exhibit 1: Non-GAAP net profit* growth has been trending down



Source(s): Company, ABCI Securities

*Excluding share based compensation, gain/loss from investee companies, amortization and impairment



Exhibit 2: 4Q18 highlights

	4Q17	4Q18	YoY	Comments
MAU of QQ (m)	783	807	3%	
Combined MAU of Weixin & WeChat (m)	989	1,098	11%	
Financials (RMB m)				
Online game	24,367	24,199	-1%	12% YoY increase in mobile gaming revenue and 12% YoY drop in PC gaming revenue
Social network	15,580	19,452	25%	
Online advertising	12,361	17,033	38%	Rising competition from Douyin
Others	14,084	24,212	72%	
Revenue	66,392	84,896	28%	In-line with consensus
Gross profit	31,495	35,152	12%	
Interest income	1,156	1,350	17%	
Other gains, net	7,906	(2,139)	-127%	
Selling & marketing expenses	(6,022)	(5,730)	-5%	
General & admin expenses	(8,811)	(11,345)	29%	
Operating profit	25,724	17,288	-33%	
Finance costs, net	(859)	(1,372)	60%	
Share of profit/(losses) of associates & JVs	(120)	16	-113%	
Profit before tax	24,745	15,932	-36%	
Income tax expenses	(3,123)	(1,906)	-39%	
Non-controlling interests	(825)	203	-125%	
Net profit	20,797	14,229	-32%	
Share based compensation	2,084	2,804	35%	
Gain/losses from investee companies	(6,189)	(125)	-98%	
Amortization and impairment	762	2,822	270%	
Core profit (non-GAAP)	17,454	19,730	13%	5% above consensus
Profitability (%):				
	4Q17	4Q18	ppt y-o-y	
Gross margin	47.4	41.4	(6.0)	
Operating margin	38.7	20.4	(18.4)	
Net margin	31.3	16.8	(14.6)	
Core net margin (non-GAAP)	26.3	23.2	(3.0)	

Source(s): Company, ABCI Securities

Notes: Individual items may not sum up to total due to rounding differences

Individual items may vary from reported figures due to rounding differences/definition differences



Valuation

We derive Tencent's fair valuation range based on the SOTP approach. For Tencent's core business, we apply 27x-30x on its 2019E core net profit. Value of the Group's investments is based on the latest book value as of Dec 2018 with holding discounts varying between 0-40%.

The SOTP approach results in a fair value range of HK\$ 335.3- 387.7. We set our TP at HK\$ 360, approximating the mid-point of our fair value range.

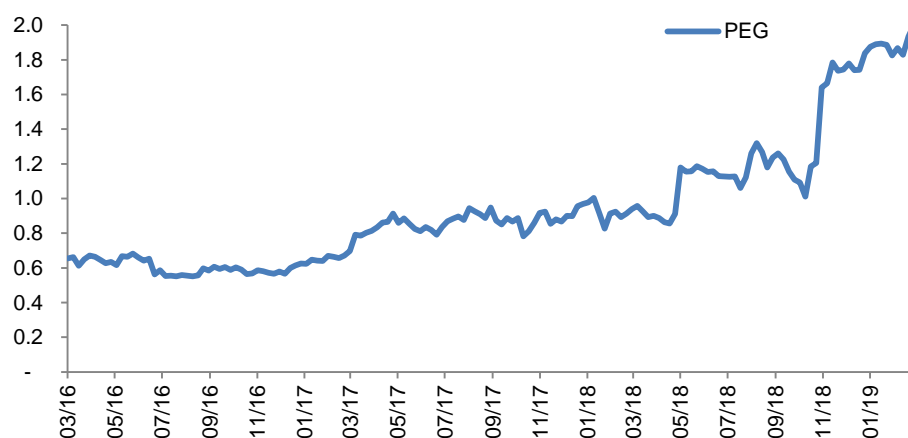
Overall, after the recent rebound amid improving market sentiment, we believe current valuation is getting stretched on a PEG basis since growth outlook has dimmed significantly in our opinion. Maintain **HOLD**.

Exhibit 3: SOTP valuation

	Valuation – midpoint (HKD per share)	Valuation – high end	Valuation – low end	Remarks
Core business	325.1	342.2	308.0	27x -30x 2019E core PE
Investments:	36.4	45.5	27.3	Book value as of Dec 2018 with 0-40% holding discounts
Total	361.5	387.7	335.3	

Source(s): Companies, Bloomberg, ABCI Securities

Exhibit 4: PEG trend



Source(s): Bloomberg, ABCI Securities

*PEG = Forward P/E divided by estimated long term growth rate



Risk factors

Market competition

We believe the emergence of alternative 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 could potentially impact Tencent's online advertising revenue.

Tightening regulation on online gaming

Regulators have recently suspended granting approvals on new games (including monetization of existing games). It is still uncertain when the regulator will resume the approval process. As such, competition from newcomers is limited as well. Declining revenue of existing games, we believe, has not been caused by the tightening of regulatory control; instead, product lifecycle has been the primary factor to determine revenue growth of a game.

Tightening regulation on internet finance

As the Group is exposed to the internet finance market via its payment business; further regulatory measures in the internet finance market 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 business. In the long term, we believe domestic market value growth would converge with nominal income growth, which is usually in line with nominal GDP growth.

Ecosystem may need to improve further in face of competition

Popularity of short-video sharing platforms such as Douyin (抖音) has been increasing rapidly. According to Trustdata, Douyin's Monthly Active Users (MAU) has reached 300m in Feb 2019. This shows that Tencent's ecosystem may need to improve to increase competitiveness.

Non-GAAP financial measures

The Group has disclosed non-GAAP financial metrics such as non-GAAP net profit to supplement its GAAP financial measures. In our view, these non-GAAP financial measures are not standardized and should only be used as reference.



Consolidated income statement (2017A-2020E)

FY Ended Dec 31 (RMB mn)	2017A	2018A	2019E	2020E
Online gaming	97,883	103,992	116,471	128,118
Social network	56,100	72,654	87,185	102,878
Online advertising	40,439	58,079	76,664	98,130
Others	43,338	77,969	109,157	147,361
Total revenue	237,760	312,694	389,477	476,488
Cost of sales	(120,835)	(170,574)	(225,485)	(278,502)
Gross profit	116,925	142,120	163,992	197,986
Interest income	3,940	4,050	4,250	4,250
Other gains/losses	20,140	16,714	7,200	7,200
Selling & marketing expenses	(17,652)	(24,233)	(26,484)	(33,354)
General & admin expenses	(33,051)	(41,522)	(51,411)	(64,326)
Operating Profits	90,302	97,129	97,546	111,756
Finance cost	(2,908)	(4,669)	(5,000)	(5,200)
Share of profit of investments in associates	821	1,487	1,636	1,799
Profit before tax	88,215	93,947	94,182	108,355
Tax	(15,744)	(14,482)	(15,069)	(17,337)
Profit after tax	72,471	79,465	79,113	91,018
Minority interests	961	259	258	297
Net profit	71,510	79,206	78,855	90,721
Share based compensation	6,875	10,325	11,000	13,000
Gain/losses from investee companies	(18,051)	(32,696)	(4,000)	(4,000)
Amortization and impairment	4,792	21,121	6,800	7,300
Other non-core items	-	-	-	-
Non-GAAP (core) net profit	65,126	77,956	92,655	107,021
Growth				
Total revenue (%)	56.5	31.5	24.6	22.3
Gross Profits (%)	38.4	21.5	15.4	20.7
Operating Profits (%)	60.9	7.6	0.4	14.6
Net Profits (%)	74.0	10.8	(0.4)	15.0
Non-GAAP net profit (%)	43.4	19.7	18.9	15.5
Operating performance				
Gross margin (%)	49.2	45.5	42.1	41.6
Operating margin (%)	38.0	31.1	25.0	23.5
Net margin (%)	30.1	25.3	20.2	19.0
Non-GAAP net margin (%)	27.4	24.9	23.8	22.5
ROAE (%)	30.9	25.0	20.1	19.2
ROAA (%)	15.0	12.4	10.3	10.6

Notes: Individual items may not sum to total due to rounding differences

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Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2017A-2020E)

As of Dec 31 (RMB mn)	2017A	2018A	2019E	2020E
Fixed assets	32,671	47,801	68,801	89,801
Intangible assets	40,266	56,650	59,650	62,150
Investment in associates and JV	144,581	227,790	267,790	307,790
Financial assets	132,377	136,914	146,914	156,914
Term deposit	5,365	-	-	-
Other non-current assets	20,966	37,286	37,286	37,286
Total non-current assets	376,226	506,441	580,441	653,941
Cash & equivalents	105,697	97,814	104,442	126,568
Restricted cash	1,606	2,590	2,590	2,590
Term deposit	36,724	62,918	62,918	62,918
Account receivables	16,549	28,427	29,077	36,878
Deposit, prepayments and other assets	17,110	18,493	18,493	18,493
Inventories	295	324	324	324
Other current assets	465	6,514	6,514	6,514
Total current assets	178,446	217,080	224,358	254,286
Total assets	554,672	723,521	804,799	908,227
Accounts payable	50,085	73,735	81,840	101,083
Other payables & accruals	29,433	33,312	33,312	33,312
Borrowings and notes	20,448	40,554	40,554	40,554
Deferred revenue	42,132	42,375	42,375	42,375
Other current liabilities	9,642	12,459	12,459	12,459
Total current liabilities	151,740	202,435	210,540	229,783
Loans and bonds payables	111,457	138,735	138,735	138,735
Deferred revenue	2,391	7,077	7,077	7,077
Other non-current liabilities	11,991	19,067	19,067	19,067
Total non-current liabilities	125,839	164,879	164,879	164,879
Total liabilities	277,579	367,314	375,419	394,662
Net current assets	26,706	14,645	13,818	24,503
Equity attributable to shareholders	256,074	323,510	396,425	480,313
Non-controlling interests	21,019	32,697	32,955	33,253
Total equity	277,093	356,207	429,380	513,565

Notes: Individual items may not sum to total due to rounding differences

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Source(s): Company, ABCI Securities estimates



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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 2005 (HSI total return index 2005-17 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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