

Tencent (700 HK)

Not immune to headwinds

- Market sentiment of internet/technology stocks may further weaken in the near term amid ongoing friction between the US and China
- Online gaming revenue growth would slow down in our view
- The counter has retracted from ~ 40x rolling 12-mth P/E to the current 32x; further de-rating is possible should market sentiment deteriorate further. Current holders could consider taking profit in the near term

Sentiment may weaken further in the near term. Ongoing dispute between the US and China on trade, "Made in China 2025", and other geopolitical issues have prompted us to adopt a more cautious stance on the sector as we believe market sentiment may deteriorate further. In particular, the US's recent actions on ZTE have evoked concerns that more punitive regulatory measures could be taken against the Chinese internet/technology companies. In our view, this could lead to higher share price volatility and sector de-rating in the near term.

Online gaming revenue growth sets to slow. Tencent's online gaming revenue growth has slowed from 48% in 3Q17 to 26% in 1Q18 due to the high base of Honor of King's (HOK). In addition, according to MIIT, China's online gaming revenue growth was 27.9% in 4M18, down from 33.2% in 1Q18, implying a 7.6% YoY drop in online gaming revenue in April.

De-rating has started. The counter has once reached c. 40x rolling 12-month P/E in Jan 2018 before retracting to the current level at ~32x, slightly above the historical average of 30.5x.

Assessing further downside. Should de-rating continues, we believe the counter's valuation may fall to 26x rolling 12-mth P/E, which is around 1 SD below the historical average P/E of 30.5x. Since 2014, the counter has tested such level several times.

Recommendation. The counter's share price at present still entails a 110% return since 2017. Amid mounting uncertainties, we believe downside is escalating and investors should consider taking profit in the near term, in our view. Our revised SOTP-based TP is HK\$ 345, which warrants a **SELL** rating. We will revisit our overall stance on the Group after the interim results in Aug 2018.

Results and Valuation

	2016A	2017A	2018E	2019E
Revenue (RMB mn)	151,938	237,760	329,600	435,864
Chg (% YoY)	47.7	56.5	38.6	32.2
Net profit (RMB mn)	41,095	71,510	82,659	99,771
Chg (% YoY)	42.7	74.0	15.6	20.7
Non-GAAP net profit (RMB mn)	45,420	65,126	87,159	105,271
Chg (% YoY)	40.1	43.4	33.8	20.8
Underlying EPS (RMB)	4.4	7.6	8.7	10.5
Chg (% YoY)	41.5	73.4	14.5	20.7
BVPS (RMB)	18.6	27.0	35.0	44.7
Chg (% YoY)	44.3	44.8	29.8	27.7
Core P/E (x)	67.7	47.3	35.3	29.3
P/B (x)	17.4	12.0	9.3	7.2
ROAE (%)	26.7	30.9	26.2	24.9
ROAA (%)	11.7	15.0	14.0	14.7
DPS(HKD)	0.61	0.88	1.01	1.22
Dividend Yield (%)	0.2	0.2	0.3	0.3

Source(s): Bloomberg, ABCI Securities estimates (*1 RMB= 1.20 HKD)

Company Report

June 25, 2018

Rating: SELL

TP: HK\$ 345

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Share price (HK\$)	388.8
Est. share price return	-11.3%
Est. dividend yield	0.3%
Est. total return	-11.0%
Previous Rating & TP	BUY/HK\$520
Previous Report Date	Mar 22, 2018

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	476.6/218.2
Issued shares (mn)	9,504
Market cap (HK\$ bn)	3,695
Avg daily turnover (HK\$ mn)	5,126
Major shareholder(s)	
Naspers	33.25%
Huateng Ma	8.73%

Source(s): Bloomberg, ABCI Securities

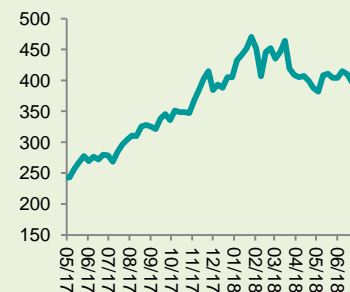
Share Performance (%)

	Absolute	Relative*
1-mth	-2.8	2.0
3-mth	-6.5	-2.6
6-mth	-3.3	-1.7

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities

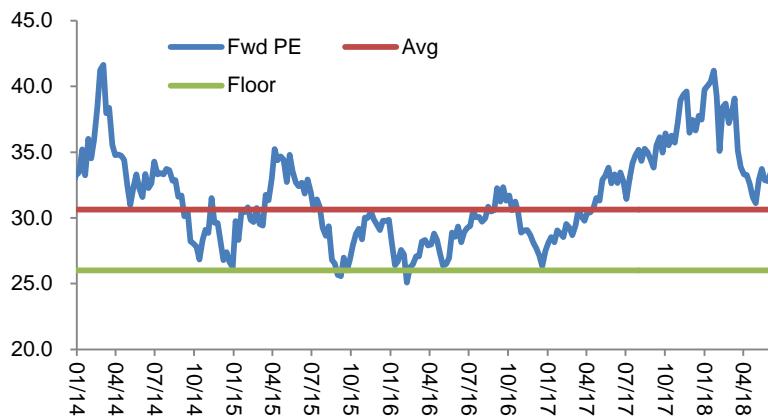
Risk factors: 1) Tightening regulation on mobile game/online payment; 2) Entry of foreign competitors such as Facebook; 3) Slowdown in ecommerce; 4) Lifecycle of mobile games; 5) Potential regulatory actions from US on China technology sectors.

Exhibit 1: SOTP valuation

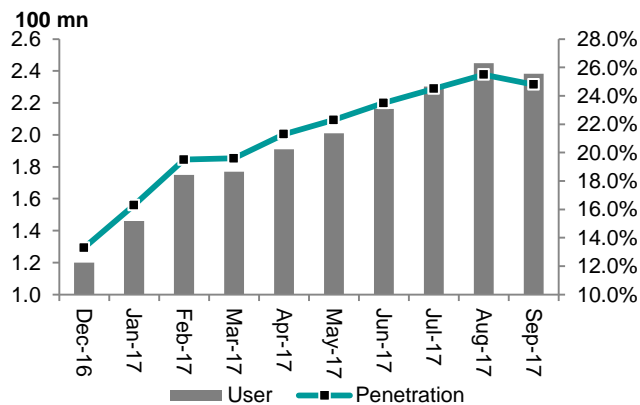
	Valuation (HKD per share)	Remark
Core business	316	26x 12mth-fwd core P/E [#]
Investments:	29	Mar-18 value; Assume 30% holding discount
Total	345	

Source(s): Companies, Bloomberg, ABCI Securities

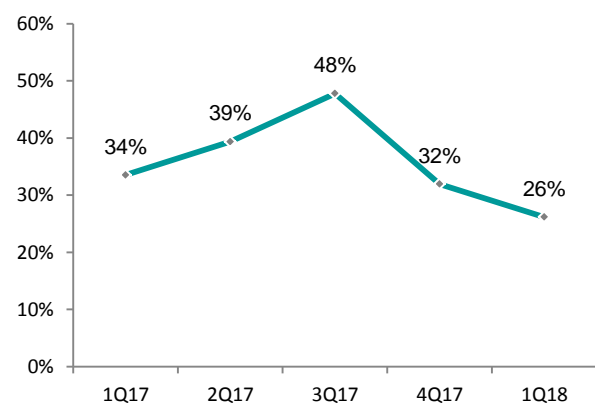
[#] 12 mth, till end-June 2019

Exhibit 2: Valuation –Rolling 12-month P/E


Source(s): Bloomberg, ABCI Securities

Exhibit 3: HOK- user base and penetration


Source(s): JIGUANG, ABCI Securities

Exhibit 4: Tencent's online gaming revenue growth


Source(s): the Company



Exhibit 5: Changes in financial forecasts

RMB mn	2018			2019		
	old	new	Diff	old	new	Diff
Revenues	333,832	329,600	-1%	445,074	435,864	-2%
EBIT	105,208	102,515	-3%	134,652	123,600	-8%
Net profit	85,135	82,659	-3%	109,576	99,771	-9%
Core profit	89,635	87,159	-3%	115,076	105,271	-9%
Core EPS (RMB)	9.44	9.17	-3%	12.11	11.08	-9%
Margin						
EBIT margin	31.5%	31.1%		30.3%	28.4%	
Net margin	25.5%	25.1%		24.6%	22.9%	
Core net margin	26.9%	26.4%		25.9%	24.2%	

Source(s): ABCI Securities

Notes: -We revise 2018E/19E revenue down by 1%/2%

-We revise 2018E/19E EBIT down by 3%/8% due to lower revenue and higher operating expenses

- As a result, our 2018E/19E net profit/core profit were down by 3%/9%



Consolidated income statement (2016A-2019E)

FY Ended Dec 31 (RMB mn)	2016A	2017A	2018E	2019E
Value added services (VAS)	107,810	153,983	200,178	250,222
Online advertising	26,970	40,439	56,615	76,430
Others	17,158	43,338	72,808	109,212
Total revenue	151,938	237,760	329,600	435,864
Cost of sales	-67,439	-120,835	-172,528	-233,425
Gross profit	84,499	116,925	157,072	202,439
Interest income	2,619	3,940	4,000	4,000
Other gains/losses	3,594	20,140	10,000	10,000
Selling & marketing expenses	-12,136	-17,652	-24,720	-33,997
General & admin expenses	-22,459	-33,051	-43,837	-58,842
Operating Profits	56,117	90,302	102,515	123,600
Finance cost	-1,955	-2,908	-3,500	-4,000
Share of profit of investments in associates	-2,522	821	900	1,000
Profit before tax	51,640	88,215	99,915	120,600
Tax	10,193	15,744	16,986	20,502
Profit after tax	41,447	72,471	82,929	100,098
Minority interests	352	961	271	327
Profits attributable to shareholders	41,095	71,510	82,659	99,771
Non-GAAP profits attributable to shareholders (Core profit)	45,420	65,126	87,159	105,271
Growth				
Total revenue (%)	47.7	56.5	38.6	32.2
Gross Profits (%)	38.0	38.4	34.3	28.9
Operating Profits (%)	38.1	60.9	13.5	20.6
Net profit (%)	42.7	74.0	15.6	20.7
Non-GAAP net profit (%)	40.1	43.4	33.8	20.8
Operating performance				
Operating margin (%)	36.9	38.0	31.1	28.4
Net margin (%)	27.0	30.1	25.1	22.9
Core net margin (%)	29.9	27.4	26.4	24.2
ROAE (%)	26.7	30.9	26.2	24.9
ROAA (%)	11.7	15.0	14.0	14.7

Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2016A-2019E)

As of Dec 31 (RMB mn)	2016A	2017A	2018E	2019E
Fixed assets	24,602	32,671	34,671	36,671
Intangible assets	36,467	40,266	43,766	47,266
Investment in associates and JV	80,299	144,581	164,581	204,581
Financial assets	85,566	132,377	142,377	152,377
Term deposit	5,415	5,365	5,365	5,365
Other non-current assets	14,396	20,966	20,966	20,966
Total non-current assets	246,745	376,226	411,726	467,226
Cash & equivalents	71,902	105,697	136,930	181,728
Restricted cash	750	1,606	1,606	1,606
Term deposit	50,320	36,724	36,724	36,724
Account receivables	10,152	16,549	19,361	26,797
Deposit, prepayments and other assets	14,118	17,110	17,110	17,110
Inventories	263	295	295	295
Other current assets	1,649	465	465	465
Total current assets	149,154	178,446	212,491	264,725
Total assets	395,899	554,672	624,217	731,951
Accounts payable	27,413	50,085	42,927	58,078
Other payables & accruals	20,873	29,433	29,433	29,433
Borrowings and notes	15,744	20,448	20,448	20,448
Deferred revenue	31,203	42,132	42,132	42,132
Other current liabilities	5,964	9,642	9,642	9,642
Total current liabilities	101,197	151,740	144,582	159,733
Loans and bonds payables	93,753	111,457	111,457	111,457
Deferred revenue	2,038	2,391	2,391	2,391
Other non-current liabilities	12,664	11,991	11,991	11,991
Total non-current liabilities	108,455	125,839	125,839	125,839
Total liabilities	209,652	277,579	270,421	285,572
Net current assets	47,957	26,706	67,909	104,992
Equity attributable to shareholders	174,624	256,074	332,506	424,762
Non-controlling interests	11,623	21,019	21,290	21,617
Total equity	186,247	277,093	353,796	446,379

Source(s): Company, ABCI Securities estimates

Disclosures

Analyst Certification

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Steve Chow holds H-shares of Tencent (700 HK).

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 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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