

Tencent (700 HK)

Lack of near-term catalysts

- 2Q18 revenue and net profit missed due to sluggish online gaming revenue
- Slowing of online gaming could due to rise of short video apps, delayed monetization of PUBG games, and high base. We believe more new game launches recently would only partly mitigate the situation as the shift of users' time spent towards alternative online entertainment is less likely to reverse in the near-term
- Recommend HOLD due to the lack of near-term catalysts

2Q18 highlight. In 2Q18, Tencent's revenue increased by 30% YoY to RMB 73.7bn, 5% below expectation due to 19%/8% QoQ drop in mobile/PC gaming revenue. Net profit dropped 2% YoY to RMB 17.9bn, 7% below expectation. On a positive note, non-GAAP net profit increased by 20% YoY to RMB19.7bn, in line with consensus.

Online gaming would take time to recover. We believe slowdown in online gaming over the past few months was caused by various factors including high base last year, delayed monetization of PUBG games, and rise of short video apps. Tencent has accelerated game launches recently. In our view, these initiatives could only partly mitigate the situation as the shift of user' time spent towards alternative online entertainment is less likely to reverse in the near term.

Strategic implication on ecosystem. In our view, rising popularity of alternative online entertainment formats could potentially lower Tencent's overall user stickiness. We remain watchful on the growth trend of online advertising segment in coming quarters.

Valuation. Our SOTP approach results in a fair valuation range of HK\$ 295.8-HK\$383.3. We set our TP at HK\$ 340, approximating the mid-point of our fair valuation range and implies 28.9x 2019E core P/E. Recommend HOLD due to the lack of near-term catalysts.

Risk factors: 1) Weaken users stickiness impacting other business segment in addition to online gaming; 2) Tighten regulatory environment in online gaming and internet finance; 3) Intensified competition from alternative online entertainment; 4) Potential entry of Google and Facebook into China;

Results and Valuation

	2016A	2017A	2018E	2019E
Revenue (RMB mn)	151,938	237,760	314,786	413,459
Chg (% YoY)	47.7	56.5	32.4	31.3
Net profit (RMB mn)	41,095	71,510	80,726	97,182
Chg (% YoY)	42.7	74.0	12.9	20.4
Non-GAAP net profit (RMB mn)	45,420	65,126	80,326	97,982
Chg (% YoY)	40.1	43.4	23.3	22.0
EPS (RMB)	4.4	7.6	8.5	10.2
Chg (% YoY)	41.5	73.4	11.8	20.4
Non-GAAP EPS (RMB)	4.8	6.9	8.5	10.3
Chg (% YoY)	39.2	43.3	23.3	22.0
Core P/E (x)	59.7	41.7	33.8	27.7
P/B (x)	15.3	10.6	8.2	6.5
ROAE (%)	26.7	30.9	25.7	24.5
ROAA (%)	11.7	15.0	13.7	14.4
DPS(HKD)	0.61	0.88	0.98	1.18
Dividend Yield (%)	0.2	0.3	0.3	0.4

Source(s): Bloomberg, ABCI Securities estimates (*1 RMB= 1.14 HKD)

Company Report

Aug 16, 2018
 Rating: HOLD
 TP: HK\$ 340

Analyst : Steve Chow
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 stevechow@abci.com.hk

Share price (HK\$)	326.2
Est. share price return	4.2%
Est. dividend yield	0.3%
Est. total return	4.5%
Previous Rating & TP	SELL/HK\$345
Previous Report Date	June 25, 2018

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	476.6/314.6
Issued shares (mn)	9,504
Market cap (HK\$ bn)	3,095
Avg daily turnover (HK\$ mn)	2,361
Major shareholder(s)	
Naspers	31.10%
Huateng Ma	8.61%

Source(s): Bloomberg, ABCI Securities

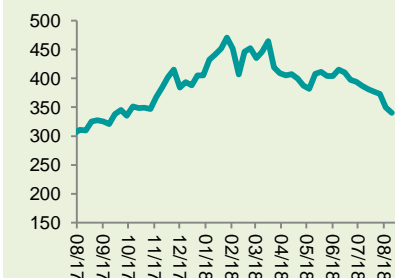
Share Performance (%)

	Absolute	Relative*
1-mth	-8.5	-5.8
3-mth	-14.8	-3.9
6-mth	-24.2	-13.4

*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
Aug 16, 2018

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Investment summary

2Q18 highlight

In 2Q18, Tencent's revenue increased by 30% YoY to RMB 73.7bn, 5% below market expectation. Non-GAAP net profit, on the other hand, increased by 20% YoY to RMB19.7bn, in line with consensus, driven by lower effective tax rate and better associates/JV profits. Reported net profit dropped 2% YoY to RMB 17.9bn, 7% below market expectation, due to lower gains on disposals of investee companies.

The weaker-than-expected results were mainly due to reduced online gaming revenue where mobile and PC gaming fell 19% and 8% QoQ caused by a multitude of issues such as delay in game monetization and rise in alternative online entertainment. Overall, this QoQ decline outcome is consistent with the MIIT's statistics in recent months and we have warned this factor in our previous report issued in June 2018.

Online advertising, on the other hand, remained largely resilient with a 39% YoY revenue growth in 2Q18. Within online advertising, social and other advertising continued to be the main growth driver, as evidenced by the 55% YoY growth driven by Weixin Moments and Mini Programs. Meanwhile, media advertising revenue increased by 16% YoY.

Payment/related financial service and cloud revenue continued to show robust growth of 81% YoY in 2Q18 despite PBOC's move to increase centralized deposit ratio requirement for third-party payment platforms.

Exhibit 1: 2Q18 highlight

(RMB m)	2Q17	2Q18	% YoY	Remarks
Online game	23,861	25,202	6%	19% QoQ drop in mobile gaming revenue and 8% QoQ drop in PC gaming revenue
Social network	12,943	16,867	30%	
Online advertising	10,148	14,110	39%	Remained largely resilient
Others	9,654	17,496	81%	
Revenue	56,606	73,675	30%	5% below consensus
Gross profit	28,306	34,446	22%	
Operating profit	22,560	21,807	-3%	
Net profit	18,231	17,867	-2%	7% below consensus
Core profit (non-GAAP)	16,391	19,716	20%	In line with consensus
<u>Profitability (%):</u>	2Q17	2Q18	ppt YoY	
Gross margin	50.0	46.8	(3.3)	
Operating margin	39.9	29.6	(10.3)	
Net margin	32.2	24.3	(8.0)	
Core net margin (non-GAAP)	29.0	26.8	(2.2)	

Source(s): Company, ABCI Securities

Weakened momentum in online gaming

Recent industry statistics and company figures show that revenue from online gaming has been slowing in recent months. According to MIIT, internet gaming revenue growth was 23.3% YoY in 1H18 vs. 33.2% YoY in 1Q18, which implies a significant growth decline in 2Q18. More specifically, growth momentum in internet gaming has weakened since Apr, with revenue growth (YoY) falling from 33.2% YoY in 1Q18 to 27.9% in 4M18, 24.5% YoY in 5M18, and 23.3% YoY in 1H18. In our view, such slowdown could be driven by various factors

Rise of alternative online entertainment. We view online gaming as a sub-segment of the broader online entertainment market. Users' time spent on online gaming could be influenced by the availability and attractiveness of other forms of online entertainment including online video, online music, online literature, etc. In particular, we believe such substitution effect would be more pronounced among casual gamers than hardcore online gamers.

We notice that popularity of short video sharing platforms such as Douyin (抖音) has been increasing rapidly. In June 2018, Douyin announced that its China Monthly Active Users (MAU) and China Daily Active Users (DAU) had reached 300mn and 150mn. In July 2018, its global MAU had exceeded 500mn. According to App Annie, Douyin was ranked no. 1 in terms of downloads among all application apps on the iOS platform globally every month between Feb-June 2018, exceeding the downloads for YouTube and Facebook.

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Exhibit 2: Top 10 application apps downloaded globally (iOS platform)

	1/2018	2/2018	3/2018	4/2018	5/2018	6/2018
1	Baidu	Douyin (抖音)	Douyin (抖音)	Douyin (抖音)	Douyin (抖音)	Douyin (抖音)
2	Douyin (抖音)	YouTube	YouTube	YouTube	YouTube	YouTube
3	YouTube	WeChat	Facebook Messenger	Instagram	WhatsApp	Instagram
4	WeChat	Facebook Messenger	WeChat	WhatsApp	Instagram	Pinduoduo (拼多多)
5	Facebook	Facebook	Instagram	Facebook	Facebook	WhatsApp
6	Facebook Messenger	Instagram	Facebook	Facebook Messenger	Facebook Messenger	Facebook
7	Instagram	WhatsApp	WhatsApp	Google Maps	Google Maps	Facebook Messenger
8	WhatsApp	Taobao	Google Maps	Pinduoduo (拼多多)	Gmail	Google Maps
9	Google Arts & Culture	AliPay	Gmal	Gmal	Netflix	Gmal
10	Alipay	Bitmoji	Snapchat	Snapchat	Snapchat	Netflix

Source(s): App Annie

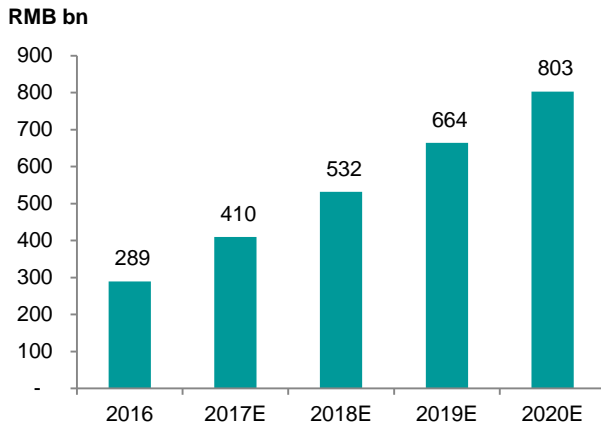
In our view, this could potentially reduce users' time on online gaming and consequently, the segmental revenue. We believe the rise of emerging forms of online entertainment could potentially steal shares from online gaming in the online entertainment market.

Our concern is echoed by Kingsoft, which issued a profit alert recently stating that other entertainment formats such as short video apps might have attracted some online game users and pressured the growth of China's online gaming market.

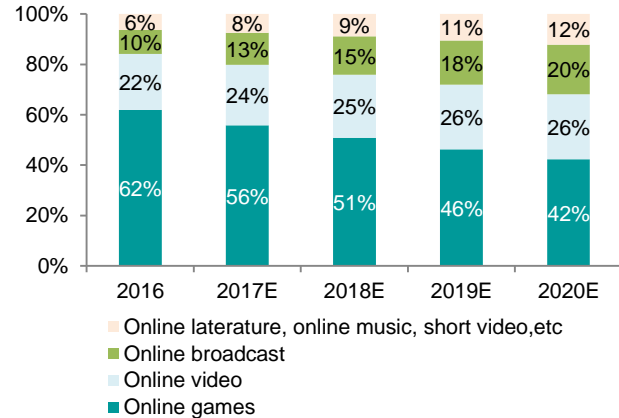
According to iResearch, China's online entertainment market is expected to reach RMB 803bn in 2020E vs. RMB 289bn in 2016, representing a CAGR of 29% over the

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period. Within the online entertainment market, however, the share of online games is expected to fall from 62% in 2016 to 42% in 2020E while shares of online video and online broadcast is estimated to increase from 22% and 10% in 2016 to 26% and 20% in 2020E. In our view, this indicates a structural shift in the industry where online gaming would compete with more causal forms of online entertainment such as online video and online broadcast.

Exhibit 3: China's online entertainment market outlook (by revenue)


Source(s): iResearch, ABCI Securities

Exhibit 4: Market share (by revenue) of sub-segments in China's online entertainment market


Source(s): iResearch, ABCI Securities

Tightened regulatory environment: According to the management, regulators have recently suspended granting approvals on new games (including monetization of existing games). As a result, Tencent's two extreme survival mobile games, Playerunknown's Battlegrounds (PUBG) Mobile (绝地求生:刺激战场) and PUBG by Timi (绝地求生 全军出击), despite their popularities, have not been able to monetize yet. In June 2018, both PUBG games were ranked among the top 10 in terms of downloads but not revenue on iOS platform (China), according to App Annie.

Exhibit 5: China's top 10 online games in June 2018 (iOS platform)

	Download ranking	Revenue ranking
1	PUBG Mobile (绝地求生:刺激战场)	Honour of Kings (王者荣耀)
2	Hole.io	Fantasy Westward Journey (梦幻西游)
3	My Own Swordsman (武林外传)	Cross Gate (魔力宝贝)
4	PUBG by Timi (绝地求生 全军出击)	My Own Swordsman (武林外传)
5	Cross Gate (魔力宝贝)	QQ Speed (QQ 飞车)
6	Inhuman Academy (非人学园)	King Of Chaos (乱世王者)
7	FIFA Soccer	Westward Journey Online (大话西游)
8	Identity V (第五人格)	FIFA Soccer
9	Honour of Kings (王者荣耀)	QQ Dancer (QQ 炫舞)
10	Rise Up - Be Your Shelter	Chu Liuxiang (楚留香)

Source(s): App Annie

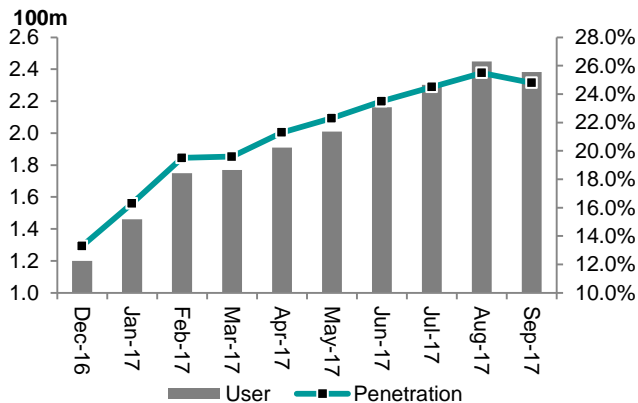
In our view, Tencent's PUBG mobile games, which are not monetizing at present but have taken up significant amount of users' time, may have reduced users' time spent on other online games with monetization capabilities. Hence, revenue growth in the online gaming business has been negatively affected.

In addition, the PUBG Corp (the Korean developer of PUBG game) has been testing various monetization strategies in PUBG global version (ex-China version), which

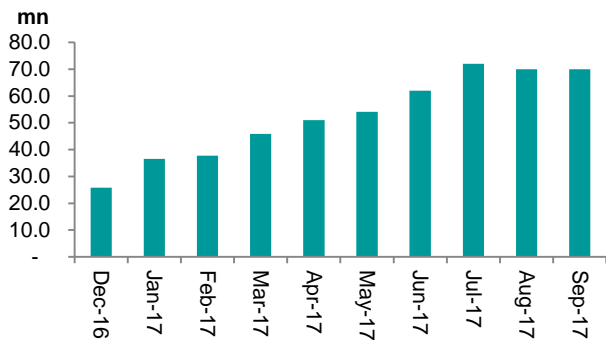
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may have affected user experiences. On the whole, monetization in PUBG games is still in the nascent stage.

High base in 2017. The popularity of Honor of Kings (HOK) in 2017 has created a high comparison base for Tencent's online gaming business. According to JiGuang, a big data service provider in China, the no. of HOK's players have grown substantially in 1H17, reaching ~250mn in late-Aug 2017 vs. ~1.2mn in early 2017; penetration also rose from 16.3% to 25.5% over the same period.

Exhibit 6: HOK- user base and penetration


Source(s): JIGUANG, ABCI Securities

Exhibit 7: HOK- DAU


Source(s): JIGUANG, ABCI Securities

The following initiatives might potentially lead to better online gaming revenue in coming quarters. However, we believe these initiatives could only mitigate the game-specific challenges (PUBG's delayed monetization) but not the structural challenges (rise of alternative online entertainment). Overall, we believe the shift of user' time spent towards alternative online entertainment is less likely to reverse in the near term.

More game launches in 3Q18. To mitigate the negative impact from delayed monetization of PUBG Mobile, Tencent has accelerated game launches recently, which included MT4 (我叫MT4), Saint Seiya Mobile (圣斗士星矢), Free Fantasy(自由幻想), etc. These games were ranked among the top 15 positions in China's online game downloaded (iOS platform, in terms of revenue) between July 7-Aug 11 based on our sample checks. In addition, Tencent has launched a new survival play mode in HOK.

Exhibit 8: Revenue ranking among Tencent's new games in China (iOS platform)

Name	Launch	Revenue ranking in China's iOS platform					
		07/07	07/14	07/21	07/28	08/04	08/11
Cross Gate (魔力宝贝)	06/11	9	9	21	40	35	52
Free Fantasy (自由幻想)	07/03		3	4	5	9	11
妖神记	07/19			12	31	31	67
MT4 (我叫 MT4)	07/25				2	2	2
Saint Seiya Mobile (圣斗士星矢)	08/01					5	3
电击文库：零境交错	08/08						13

Source(s): App Annie

Launch of “Fortnite” in China. Fortnite is an extreme survival game similar to PUBG. It is developed by Epic Games in which Tencent is holding a stake of ~40%. Since its release in late 2017, the game has gained strong reception among gamers. The table below shows that the no. of Fortnite players have been rising since early-2018, overtaking PUBG almost every month since Apr 2018 (except June), according to Newzoo, a market intelligence provider covering the global games, esports, and mobile markets, In addition, Tencent has started beta-testing of the PC version of Fortnite in China in July 2018. In our view, the Group may launch the mobile version in coming months. The launch of Fortnite may be able to make up for the limited monetization of PUBG given the similarity between the two.

Exhibit 9: Most popular PC games (no. of unique players) globally

	01/18	02/18	03/18	04/18	05/18	06/18	07/18
1	League of Legends	League of Legends	League of Legends	League of Legends	League of Legends	League of Legends	League of Legends
2	PUBG	PUBG	PUBG	Hearthstone: Heroes of Warcraft	Fortnite	Hearthstone: Heroes of Warcraft	Fortnite
3	Hearthstone: Heroes of Warcraft	Hearthstone: Heroes of Warcraft	Fortnite	Fortnite	PUBG	PUBG	Hearthstone: Heroes of Warcraft
4	Counter-Strike: Global Offensive	Fortnite	Hearthstone: Heroes of Warcraft	PUBG	Hearthstone: Heroes of Warcraft	Fortnite	PUBG
5	Minecraft	Counter-Strike: Global Offensive	Counter-Strike: Global Offensive	Counter-Strike: Global Offensive	Counter-Strike: Global Offensive	Counter-Strike: Global Offensive	Counter-Strike: Global Offensive
6	Fortnite	Minecraft	Minecraft	Overwatch	Overwatch	Minecraft	Minecraft
7	Overwatch	Overwatch	Overwatch	Minecraft	Minecraft	Overwatch	Overwatch
8	World of Warcraft	World of Warcraft	Tom Clancy's Rainbow Six: Siege	World of Warcraft	Tom Clancy's Rainbow Six: Siege	Tom Clancy's Rainbow Six: Siege	World of Warcraft
9	Tom Clancy's Rainbow Six: Siege	Tom Clancy's Rainbow Six: Siege	World of Warcraft	Tom Clancy's Rainbow Six: Siege	World of Warcraft	World of Warcraft	Tom Clancy's Rainbow Six: Siege
10	Grand Theft Auto V	Grand Theft Auto V	Grand Theft Auto V	Grand Theft Auto V	Dota2	Grand Theft Auto V	Grand Theft Auto V

Source(s): Newzoo

PUBG global version launches new subscription service. Recently, the PUBG global version developed by Korean developer Blue Hole (not the PUBG China version developed and distributed by Tencent) has launched a new type of subscription service, Event Pass, which is a four-week time-limited add-on to encourage players to log in daily, complete challenges on a daily and weekly timescale, and unlock exclusive rewards. In our view, this new monetization approach, which differs from traditional monetization strategies such as in-game purchase of skins and items, could be transferred to PUBG China as well to expedite monetization.



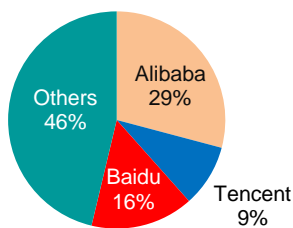
Strategic implication on ecosystem

In our view, the rising popularity of alternative online entertainment formats such as short video apps, which have impacted China’s online gaming market (as suggested by Kingsoft’s profit alert statement), could potentially lower Tencent’s overall user stickiness, as users’ might spend less time on Tencent’s ecosystem.

In our view, this might potentially lead to some adverse impact to Tencent’s online advertising in the future, although the 39% YoY growth in online advertising revenue in 2Q18 suggests that segment growth momentum remains largely resilient at the moment.

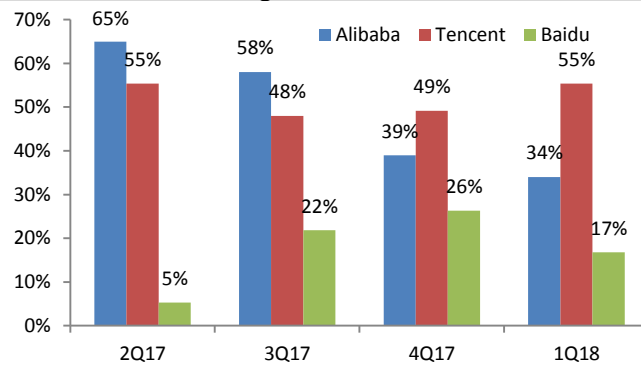
Overall, growth in online advertising revenue has remained robust in recent quarters. Collectively, we believe Tencent and Alibaba have been stealing online advertising market shares from Baidu, as evidenced by the higher growth in online advertising revenue over the past quarters.

Exhibit 10: Online advertising market share – 4Q17



Source(s): iResearch, companies, ABCI Securities

Exhibit 11: Online advertising revenue growth among the three ecommerce giants



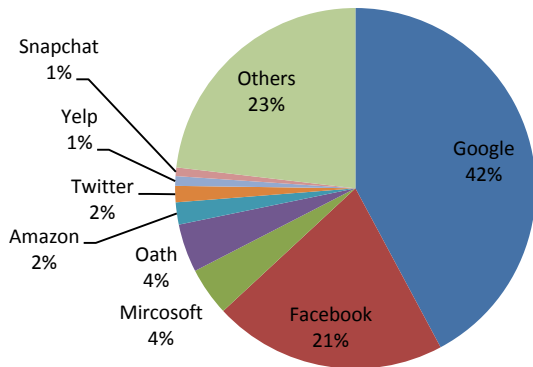
Source(s): Companies, ABCI Securities

In our view, such trend could be disrupted should competition intensified from uprising alternative online entertainment platforms including Douyin (抖音) and Toutiao (今日头条).

In addition, recent media reports suggested that major overseas online platform such as Google and Facebook might see a higher chance to enter the China market, which could potentially lead to intensified competition in the online advertising market in China. According to eMarketer, market shares of Google and Facebook were 42% and 21% in US’s online advertising market.



Exhibit 12: US online advertising market – market share (2017)



Source(s): eMarketer, ABCI Securities



Initiatives to enable retailers in digital transformation

On a positive note, Tencent has been a pioneer in implementing new business initiatives, such as the “smart retail” strategy announced recently.

- In Dec 2017, Tencent acquired a 5% stake in YongHui, a major hypermarket chain in China.
- In Jan 2018, Tencent, JD.com, Sunning, and Sunac collectively purchased a 14% stake in Wanda Commercial, in which Tencent will hold a 4.12% stake. In addition, there are media reports suggesting Tencent may invest in Carrefour China as well.
- In Feb 2018, Tencent acquired a 5.31% stake in Heilan Home, a major menswear brand in China.
- In Feb 2018, Tencent and JD.com collectively purchased an 11% stake in Better Life, a supermarket and department store chain in China.

Traditional retailers lack the necessary technological know-how to implement the O2O/new retail concept. As a result, we believe major online platforms like Tencent are well positioned to establish strategic relationship with major offline retailers to develop new retail concept.

One of its investees, Yonghui Superstores (601933 CH), has piloted a new retail concept store “Super Species (超级物种)”, which offers a one-stop experience of “supermarket + restaurant + O2O” for consumers. In the restaurant section, customers can order food via an app. The supermarket section does not accept cash and customers can check out via the self-service cashiers. It also provides food delivery services to cover 3km areas within 30 minutes. In 1H18, YongHui has opened 19 “Super Species” stores with a full-year target of 100 new stores in 2018.

More often than not, traditional retailers lack the necessary technological know-how to implement the O2O/new retail concept, which presents enormous opportunities for Tencent, which has been focusing on infrastructure such as cloud computing, A.I., big data, and financial services related to new retail business model to enable offline retailers to explore the digital transformation in of the retail industry.

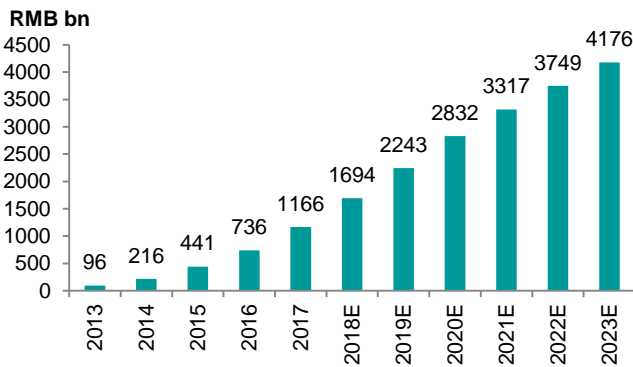
Within various market segments in the O2O/new retail area, we view food ecommerce consumption/online food delivery as a high-growth area where Tencent, via its investments in YongHui, Better Life, and a leading online food delivery platform in China, is well positioned to tap on the emerging trend.

Indeed, offline restaurant chain operators are eyeing on the delivery market, considering it as one of the revenue growth drivers. E.g. takeaway sales of KFC China in 2Q18 was up 33% YoY, accounting for 13% of sales. To keep up with competitors, we believe restaurant-chain operators would need to cooperate with major online food delivery platforms to extend into the online food delivery domain. In our view, strategic alliance between restaurant chains and online food delivery platforms would only increase in the future.

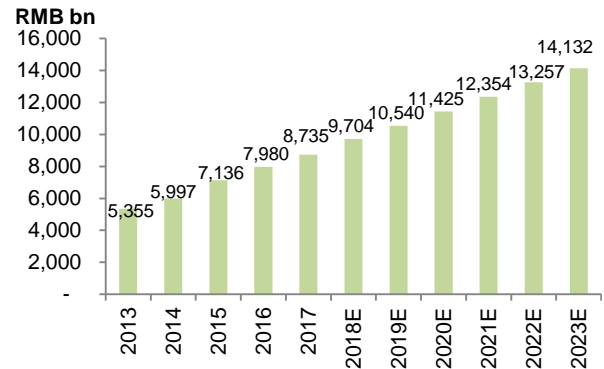
In our view, food consumption through service ecommerce is on a structural uptrend. In our view, consumers are spending more on food delivery, in-store dining, and food retail as living standard improves. Meanwhile, ongoing improvement in delivery service is driving more consumers to order food online and while receiving delivery offline.

According to iResearch, food consumption in China (both online and offline, based on gross transaction volume) is expected to grow from RMB 8.7tr in 2017

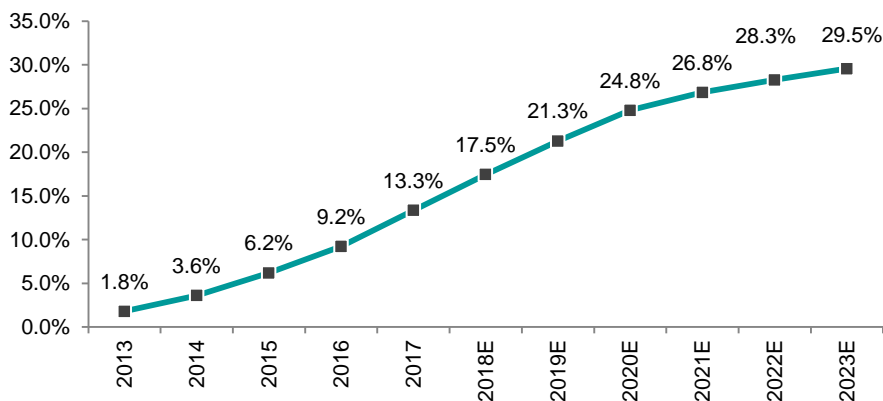
to RMB14.1tr in 2023, representing a CAGR of 8.3% during the period. In addition, food consumption through service ecommerce platforms in China (based on gross transaction volume) is expected to grow from RMB 1.2tr in 2017 to RMB 4.2tr in 2023E, representing a CAGR of 23.7% during the period. This translates to an online penetration rate of 29.5% in 2023E vs. 13.3% in 2017.

Exhibit 13: Food consumption through service ecommerce platforms in China (based on gross transaction volume)


Source(s): iResearch, ABCI Securities

Exhibit 14: Food consumption in China (based on gross transaction volume)


Source(s): iResearch, ABCI Securities

Exhibit 15: Online penetration of food consumption in China


Source(s): iResearch, ABCI Securities



In our view, this structural uptrend is supported by the following societal trends that are unlikely to reverse.

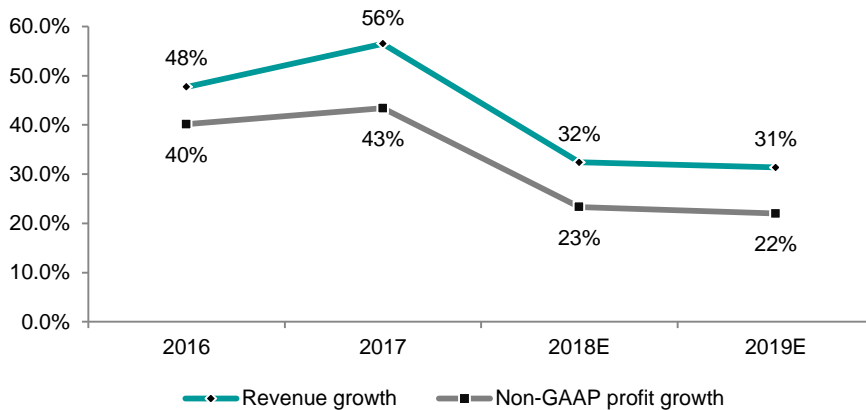
- **Urbanization.** China's ongoing urbanization has led to the emergence of a large number of cities, accelerating the growth of consumer service industry. As of end-2016, China had 156 cities with a population of over 1mn, as compared to 10 cities with over 1mn of population in the US. In addition, population density in urban cities in China was 2,426 people per sqkm in 2017, which is seven times that of the US, according to iResearch.
- **Consumer upgrade.** The improvement in Chinese consumers' standard of living has led to ongoing consumer upgrade from basic needs to discretionary spending, and from physical goods to services and experiences.
- **Labor supply for the consumer service industry.** There is a shift in the labor supply from the traditional agricultural and manufacturing sectors to the service sector. In our view, this accelerates the emergence of new business models such as on-demand delivery.
- **Growing mobile internet population and high penetration of online payment infrastructure in China.** In China, the massive mobile internet user base enables Chinese consumers to discover and enjoy more services. China's mobile internet population reached 753mn by 2017, and is expected to grow to 1,012mn by 2023, representing a CAGR of 5% over the period. In China, mobile internet user base makes up the majority of the active online population, with a penetration rate of 97.5% as of 2017, according to iResearch. In addition, mobile payment penetration of mobile internet users in China was 70% in 2017.



Financial outlook

We expect Tencent's non-GAAP profit to grow by 23% and 22% in 2018-19E, representing a CAGR of 22% during the period. This implies a slowdown compared with the 43% growth in non-GAAP profit in 2017, mainly because of the high base in 2017 and slowing mobile gaming revenue in 2018.

Exhibit 16: Revenue and profit growth outlook



Source(s): Company, ABCI Securities estimates

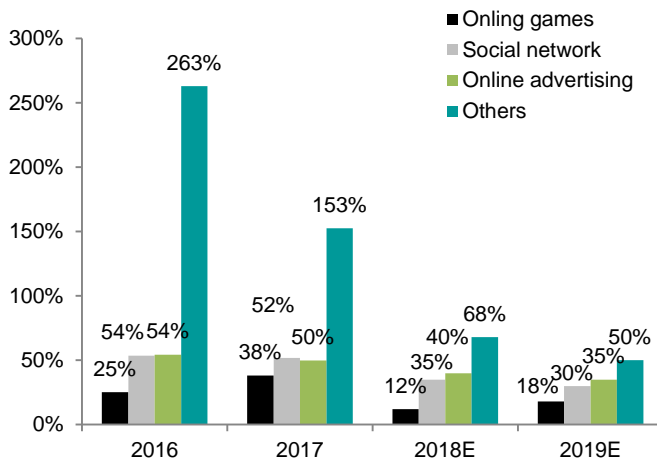
We expect revenue to grow by 32% and 31% in 2018-19E.

For online gaming, after a weak 2Q18, we expect some mild recovery in 2H18 driven by more game launches, leading to an 12% YoY growth in segmental revenue in 2018E. For 2019E, we expect online gaming revenue to generate 18% growth. This implies that Tencent's online gaming market share would be 42% in 2019E based on our estimate.

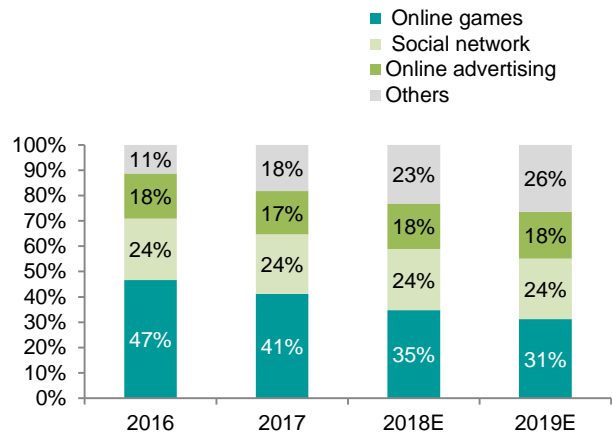
For online advertising, we expect revenue to grow by 35% YoY and 30% YoY in 2018E-19E, driven by ongoing shift from search engine ad. to news feed ad. Overall, our forecast implies that Tencent's online advertising market share to increase to 12% in 2019E from 11% in 2017.

For payment/financial/could businesses, we expect revenue growth to remain robust at 59% CAGR between 2017-19E.

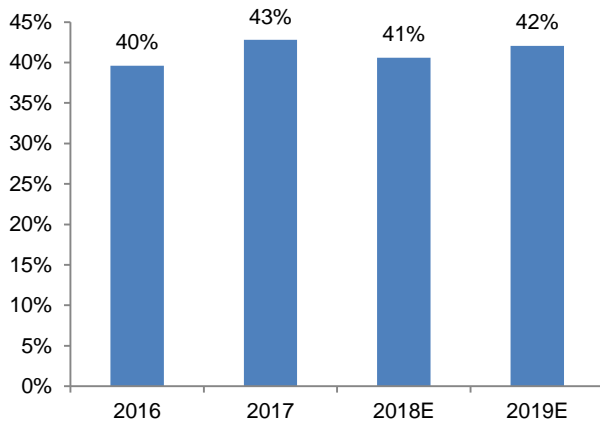
As a result, we expect Tencent's revenue mix to become more balanced by 2019E, with online gaming, social network, online advertising, and others accounting for 31%/24%/18%/26% of total revenue vs. the 41%/24%/17%/18% in 2017.

Exhibit 17: Revenue growth by segment


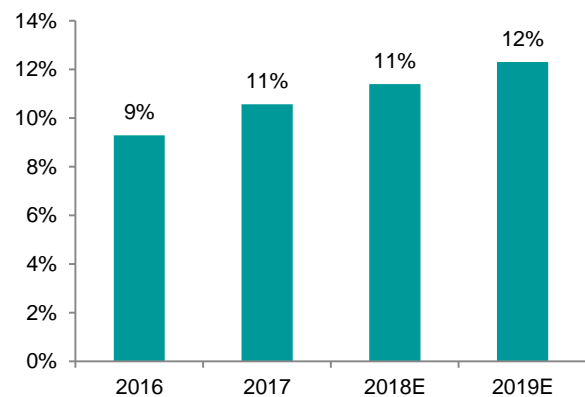
Source(s): Company, ABCI Securities estimates

Exhibit 18: Revenue mix trend


Source(s): Company, ABCI Securities estimates

Exhibit 19: Tencent's estimated market share trend-online gaming


Source(s): iResearch, Company, ABCI Securities estimates

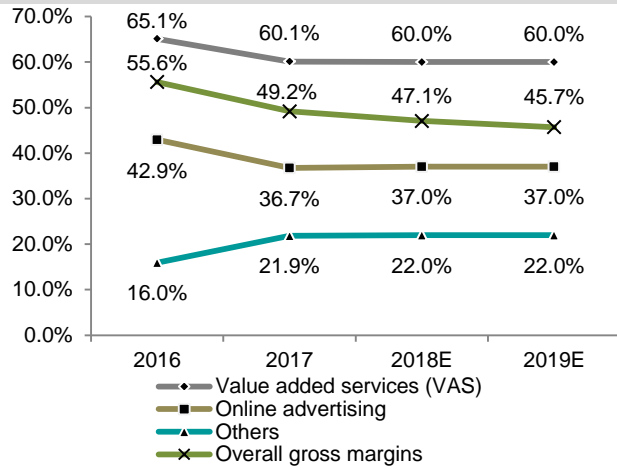
Exhibit 20: Tencent's estimated market share trend-online advertising


Source(s): iResearch, Company, ABCI Securities estimates

We expect gross margin to fall from 49.2% in 2017 to 45.7% in 2019E, reflecting changes in business mix in which online advertising and cloud/financial services, with lower gross margins than online gaming, would increase profit contribution in 2018-19E. Operating cost ratios would improve slightly in 2018-19E, thanks to better economies of scale. Overall, we expect SG&A cost-to-revenue ratio to drop from 21.3% in 2017 to 21.0% in 2019E, mitigating some negative impact from gross margin erosion. As a result, core net margin would drop modestly to 23.7% in 2019E from 27.4% in 2017, based on our estimates.

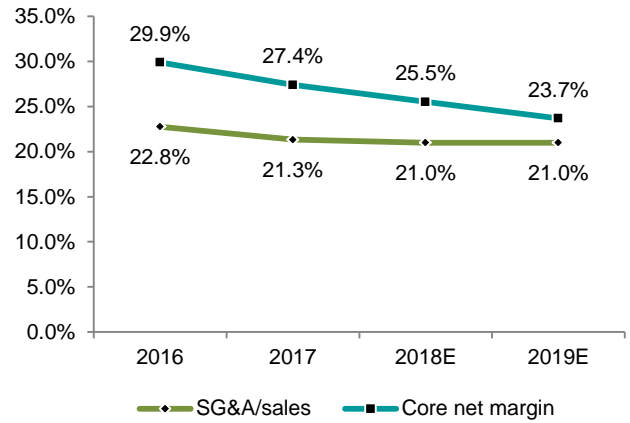


Exhibit 21: Gross margin trend by segment



Source(s): Company, ABCI Securities

Exhibit 22: Operating cost and core net margin trend



Source(s): Company, ABCI Securities

Valuation

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

In valuing Tencent's core business, we roll over to 2019E and apply 23x-29x (vs. 26x previously) on its 2019E core net profit to reflect that Tencent's core profit growth is likely to slow down to 23% YoY and 22% YoY in 2018 and 2019, respectively. This implies 1.05x-1.32x PEG for 2019E.

We value Tencent's investment based on their latest book value as of June 2018 with a 0-40% holding discount.

The SOTP approach results in a fair valuation range of HK\$ 295.8-HK\$383.3. We set our TP at HK\$ 340, approximating the mid-point of our fair valuation range and implies 28.9x 2019E core P/E.

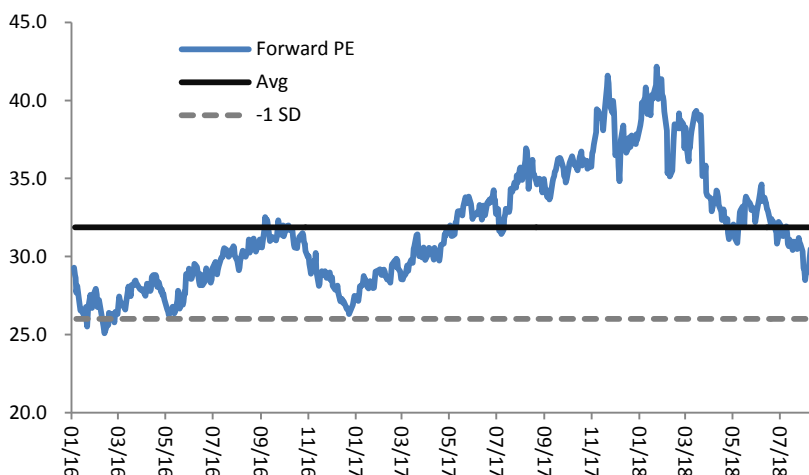
After recent share correction, the counter is trading at less demanding valuation. In our view, Tencent's current valuation is factoring soft near-term business outlook. However, we see limited near-term positive catalyst due to still soft online gaming business outlook. Recommend HOLD.

Exhibit 23: SOTP valuation

	Valuation – Mid point (HKD per share)	Valuation – high end	Valuation – low end	Remark
Core business	305.6	340.8	270.3	23x -29x 2019E core PE
Investments:	34.0	42.4	25.5	Book value as of June 2018 with 0%-40% holding discount
Total	339.5	383.3	295.8	

Source(s): Companies, Bloomberg, ABCI Securities

Exhibit 24: PE band



Source(s): Bloomberg, ABCI Securities



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 could potentially impact Tencent's online advertising revenue, which accounted for 17% of total in 2017.

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.

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 financial performance. In the long term, we believe domestic market growth would converge with income growth, which is usually in line with GDP growth. Currently, our economist expects China's GDP to expand by 6.6% YoY in 2018E and 6.4% YoY in 2019E.

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. In June 2018, Douyin announced that its China Monthly Active Users (MAU) and China Daily Active Users (DAU) have reached 300mn and 150mn. In July 2018, it announced that its global MAU had exceeded 500mn. This shows that Tencent's ecosystem has rooms to improve.



Consolidated income statement (2016A-2019E)

FY Ended Dec 31 (RMB mn)	2016A	2017A	2018E	2019E
Online gaming	70,844	97,883	109,629	129,362
Social network	36,966	56,100	75,735	98,456
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	314,786	413,459
Cost of sales	(67,439)	(120,835)	(166,603)	(224,463)
Gross profit	84,499	116,925	148,184	188,996
Interest income	2,619	3,940	4,050	4,250
Other gains/losses	3,594	20,140	13,200	12,700
Selling & marketing expenses	(12,136)	(17,652)	(23,609)	(31,009)
General & admin expenses	(22,459)	(33,051)	(42,496)	(55,817)
Operating Profits	56,117	90,302	99,328	119,120
Finance cost	(1,955)	(2,908)	(3,250)	(3,550)
Share of profit of investments in associates	(2,522)	821	1,500	1,900
Profit before tax	51,640	88,215	97,578	117,470
Tax	(10,193)	(15,744)	(16,588)	(19,970)
Profit after tax	41,447	72,471	80,990	97,500
Minority interests	352	961	264	318
Net profit	41,095	71,510	80,726	97,182
Share based compensation	4,982	6,875	4,800	5,000
Gain/losses from investee companies	(7,770)	(18,051)	(10,000)	(9,500)
Amortization and impairment	6,972	4,792	4,800	5,300
Other non-core items	141	-	-	-
Non-GAAP net profit	45,420	65,126	80,326	97,982
Growth				
Total revenue (%)	47.7	56.5	32.4	31.3
Gross Profits (%)	38.0	38.4	26.7	27.5
Operating Profits (%)	38.1	60.9	10.0	19.9
Net Profits (%)	42.7	74.0	12.9	20.4
Non-GAAP net profit (%)	40.1	43.4	23.3	22.0
Operating performance				
Gross margin (%)	55.6	49.2	47.1	45.7
Operating margin (%)	36.9	38.0	31.6	28.8
Net margin (%)	27.0	30.1	25.6	23.5
Non-GAAP net margin (%)	29.9	27.4	25.5	23.7
ROAE (%)	26.7	30.9	25.7	24.5
ROAA (%)	11.7	15.0	13.7	14.4

Source(s): 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 (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	45,266	49,766
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	413,226	469,726
Cash & equivalents	71,902	105,697	133,032	174,179
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	18,491	25,420
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	207,723	255,799
Total assets	395,899	554,672	620,949	725,525
Accounts payable	27,413	50,085	41,452	55,849
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	143,107	157,504
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	268,946	283,343
Net current assets	47,957	26,706	64,615	98,295
Equity attributable to shareholders	174,624	256,074	330,719	420,580
Non-controlling interests	11,623	21,019	21,283	21,602
Total equity	186,247	277,093	352,002	442,182

Source(s): 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



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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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