



October 15, 2013  
Company Report  
Rating: BUY  
TP: HK\$ 479.0

H-Share price (HK\$)	419.0
Est. share price return	14.32%
Est. dividend yield	0.36%
Est. total return	14.68%
Previous Rating & TP	Initiate BUY
Previous Report Date	N/A

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**Key Data**

52Wk H/L(HK\$)	427.4/237.0
Issued shares (mn)	1,859.4
Market cap (HK\$ mn)	779,101
3-mth avg daily turnover (HK\$ mn)	1454
Major shareholder(s) (%):	
Naspers Limited	33.9
Ma Huateng	10.2

Source(s): Company, Bloomberg, ABCI Securities

**1H13 Revenue breakdown (%)**

VAS	76.68
Online advertising	7.69
e-Commerce transactions	14.72
Others	0.91
Total	100.00

Source(s): Company, ABCI Securities

**Share performance (%)**

	Absolute	Relative*
1-mth	2.0	0.7
3-mth	27.0	18.3
6-mth	71.3	64.2

\*Relative to HSI

Source(s): Bloomberg, ABCI Securities

**1-Year stock performance (HK\$)**



Source(s): Bloomberg

# Tencent (700 HK)-Initiation

## Chatting its way to the top; initiate with BUY

Tencent is the top player in China's internet & media market. Its instant messaging (IM) software, QQ, dominates China's IM market with 818 mn of monthly active users (MAU). We expect its mobile IM apps, Weixin/ WeChat will further enhance the size and coverage of its virtual community and facilitate development of other businesses such as e-commerce and online advertising, which we expect to be significant growth drivers of the company's profit in the future. We initiate coverage on Tencent with a BUY rating based on its strong fundamentals, including its dominance in China's IM market, and the high potential of its e-commerce and online financial services businesses. Our 12-month TP of HK479 is based a PEG ratio of 0.8, reflecting a valuation of 32.4x FY14E P/E and implies 9.8x FY14E P/B.

**Largest online community in China.** Tencent has the largest instant messaging (IM) community in China. MAU of its IM software, QQ, reached 818mn at the end-2Q13. Since MSN's exit from the IM market in ex-China regions, Tencent has been able to absorb higher-end users who previously used MSN messenger. With a diversified user base and free (basic) internet services (such as email account, blog account etc), Tencent has erected high entry barriers to other competitors in the internet and media industry.

**Expanding mobile community via Weixin/WeChat.** At the end of 2Q13, the combined MAU of Weixin and WeChat reached 236 mn, up 177% YoY. Thanks to its innovative features and compelling user experience, Weixin continued to enjoy rapid user growth, and extended its position to be the leading smartphone-only community in China.

**Accelerated monetization and diversified business lines.** Tencent's value-added services (VAS) in both online and mobile platforms have increased rapidly. Revenue from online VAS grew at 57.52% CAGR in 2003-12, and revenue from mobile VAS grew at 57.38% CAGR in 2008-12. Nonetheless, we expect the growth to slow in the future due to the already high internet penetration in China (42% by end-2012). The Group is expected to further diversify its business lines to help maintain a high GPM over 55%.

**Near-future positive catalysts include:** 1) Chinese government's initiatives to increase broadband speed and penetration; 2) China's mobile internet business expands rapidly, reshaping existing business models & the industry value chain. Tencent, with its existing platforms, is well positioned to gain on these changes; 3) With e-commerce and online payment gaining popularity in China, Tencent's huge client base will help accelerate monetization.

**Initiate BUY with TP at HK\$479:** Our 12-month TP of HK\$ 479 is based on a PEG ratio of 0.8 and reflects a valuation of 32.4x FY14E P/E and 9.8x FY14E P/B. Our TP of HK\$479 takes into account an EPS growth of 44% CAGR in 2013E-15E.

**Risk factors:** 1) Regulatory risks concerning e-commerce; 2) Disappointing monetization from WeChat and increasing marketing cost; 3) Intensifying competition with domestic e-commerce companies; (4) Slowdown in PC gaming sector; (5) Declines in 2H13 profit growth on HoH basis..

**Results and Valuation**

FY ended Dec 31	2011A	2012A	2013E	2014E	2015E
Turnover (RMB mn)	28,496	43,894	63,856	99,410	142,686
Chg (%.yoy)	45.05	54.03	45.48	55.68	43.53
Net Income (RMB mn)	10,203	12,732	15,481	21,891	32,437
Chg (%.YoY)	26.69	24.78	21.59	41.40	48.18
EPS (RMB)	5.49	6.83	8.28	11.64	17.17
Chg (%.YoY)	26.85	24.46	21.24	40.53	47.50
BVPS (RMB)	15.32	22.16	28.83	38.73	53.10
Chg (%.yoy)	29.22	44.72	30.07	34.34	37.12
DPS	0.75	1.00	1.17	1.68	2.45
P/E (x)	-	48.28	39.83	28.34	19.21
P/B (x)	-	14.89	11.44	8.52	6.21
Yield (%)	-	0.30	0.36	0.51	0.74
ROE (%)	40.63	36.50	32.53	34.56	37.47
ROA (%)	17.96	16.92	17.10	18.87	21.83
Net debt/total equity (%)	Net Cash	Net Cash	Net Cash	Net Cash	Net Cash

Source(s):Bloomberg, ABCI estimates



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*NOTE: For definition of terms, please refer to Key Glossary on P.27 of this report*

## Investment highlights

### Positive Drivers

#### 1. Sizable user base provides high entry barriers

Tencent has the largest online/mobile community in China. The exit of MSN Messenger in ex-China regions further enhanced Tencent's dominance in IM (instant messaging) market. In 2Q13, Tencent's key product, QQ, registered 818 mn active user accounts, covering China's internet users of multiple age and income levels. **Since internet/mobile users are inclined to consume or play within the same communities, its broad user coverage has laid a solid foundation for Tencent's various business lines and erected high entry barriers to potential competitors.**

#### 2. Strong growth in PC/mobile gaming

Tencent's online gaming business has been enjoying robust growth. Its average revenue per user (ARPU) range for Advanced Casual Games (ACG) rose from RMB 30~55 in 2Q09 to RMB 65-155 in 2Q13, while its combined average concurrent users (ACU) also rose from 1mn in 2Q09 to 5.8mn in 2Q13 (2Q09-2Q13 CAGR:55.19%).

The ARPU range of Massively Multi-player Online Games (MMOG) increased from RMB 60-90 in 2Q09 to RMB 185-240 in 2Q13, while the combined ACU grew at 8.78% CAGR for the same period. We expect Tencent's online gaming business will continue to outperform the market in the next two to three years.

Tencent launched several mobile games on Weixin/WeChat platforms. These games have successfully attracted a large number of players and have been well received by smartphone users. The games connect users within the Weixin/WeChat communities, amplifying the impact of the networking circle.

#### 3. WeChat/Weixin to accelerate monetization

Weixin is the leading smartphone-only community in China. WeChat, the overseas version of Weixin, targets at overseas markets and shares the same technology with China's Weixin.

Tencent launched the latest WeChat V5.0 for both iOS and Android systems that integrate powerful functions in e-commerce, online payment and online games. Weixin/WeChat are social networking apps with many more functions than WhatsApp and Line. (For details of product comparison, please refer to P21.)

Through aggressive marketing and promotional campaigns, Tencent has successfully expanded its Weixin/WeChat subscriber base in both domestic and overseas markets. By the end of 2Q13, the combined monthly active users (MAU) of Weixin and WeChat reached 236 mn, up 177% YoY.

We believe that Weixin/WeChat would continue to help Tencent broaden its service offering to users and explore new business opportunities, esp. in online gaming, e-commerce and online financial services. The platform will provide strong support for its mobile value-added services (MVAS)

#### 4. E-commerce segment presents huge opportunities

Tencent has built a comprehensive platform for its e-commerce business that includes the following products/services:

- B2C Open Platform
- C2C Marketplace
- Lifestyle Services
- O2O (Offline-to-Online) Services
- Online Payment



Revenue of Tencent's e-commerce segment reached RMB2,199.45mn in 2Q13, up 157% YoY and 15% QoQ, mostly driven by the expanded user base and increased average order value of principal business (business operated by Tencent without involvement of any third party agents). We expect the e-commerce segment to be the driver of the Group's future growth.

## Negative factors

### 1. Marketing expenditure for WeChat may be large

Tencent seeks to expand its overseas market by promoting its WeChat platform. The strategy has enjoyed early success. Its overseas subscribers grew from about 40 mn in April 2013 to over 100mn in July 2013, thanks to intensive marketing efforts by the Group. Consequently, the Group's sales and marketing expenses increased from RMB 962mn in 1Q13 (7.1% of total revenue) to RMB 1,234mn in 2Q13 (8.6% of total revenue), up 28% QoQ. We expect its marketing sales and expenses will continue to weigh on margins in 2H13 and affect its FY13 net profit. Subsequently, we predict to see flat HoH profit growth in 2H13.

### 2. E-commerce business affects margins

Tencent's e-commerce business is still at its early development stage where large investments in marketing and framework establishment are required. Price competition in China's B2C market is intensive and the future development of Tencent's e-commerce business is one of the investors' concerns.

In 2Q13, Tencent's principal e-commerce transactions business continued to experience strong YoY revenue growth, driven by enhanced user experience, broadened product range and expanded geographic coverage. Tencent's marketplace also registered significant revenue growth YoY as product selection and customer services improved. Gross profit margin (GPM), however, dropped from 6.88% in 1Q13 to 5.74% in 2Q13, higher than 2Q12's GPM at 2.51%. Since e-commerce business is still in its early days and only accounted for ~ 10% of the Group's FY12 revenue, it is unlikely to become a significant drag to the Group's overall GP in the near term. We believe the GPM of the e-commerce segment will improve in the next two to three years.

### 3. Fierce competition from IM and e-commerce peers

On Sep 24, 2013, Alibaba (1688 HK) launched its own IM product, Laiwang V4.0 (来往). Laiwang is considered by market to be a major competitor of QQ because Alibaba has the largest e-commerce platform and non-bank online payment platform, Alipay (支付宝), in China. Laiwang will help users to interact with each other within its virtual community. Since Tencent's e-commerce business is still in its early days, Laiwang may attract frequent users of online/mobile e-commerce services, esp. those that are offered by Alibaba.

However, we do not consider Laiwang a major threat to QQ and Tencent's dominance in the IM market. Existing QQ users have already established their own social circles around various QQ products, and they would not be motivated to switch to Laiwang just because of Alibaba's reputation in the e-commerce domain. While QQ is seen as a social networking portal, Alibaba is mostly considered an e-commerce service provider and may fail to attract QQ users. In our view, Laiwang is more of a defensive tool for Alibaba to counter against Tencent's developing e-commerce platform.

## Business Analysis

### 1. Top player in China's online community market

In China, over 84% of internet surfers use IM frequently, making IM the most popular online application genre in China. Search engine is the second most popular form of application in China in which 80% of internet surfers were frequent users.

Tencent is the top player in China's online community. The Group has the largest share in the IM services market with over 818mn of monthly active users (MAU) in 2Q13.

#### Exhibit 1: China's main IM applications and respective coverage (as of Aug. 2013)

Rank	Software	No. of daily coverage, mn	Daily avg arrival rate* %
1	Tencent QQ	209.82	70.0
2	AliWangwang (阿里旺旺)	4.57	15.2
3	Fetion (飞信)	15.05	5.0
4	YY IM (歪歪)	8.16	2.7
5	MSN	4.92	1.6

\*Daily avg arrival rate = Daily avg coverage / Total avg coverage in China

Source(s): iResearch, iUserTracker

#### Exhibit 2: China's main IM applications and coverage (as of Aug. 2013)

Rank	Software	Monthly effective use time, mn hours	Monthly effective use time / Aggregate effective monthly use time for IM apps, %
1	Tencent QQ	3199.48	86.6
2	AliWangwang (阿里旺旺)	228.20	6.2
3	YY IM (歪歪)	97.00	2.6
4	Fetion (飞信)	51.87	1.4
5	Tencent TM	36.22	1.0

Source(s): iResearch, iUserTracker

Tencent's revenue and earnings have grown significantly in the past decade. Its diversified business portfolio that focuses on building user platforms and creating healthy industry value chains have enabled the Group to remain resilient amid rapid and unpredictable value migration in the Internet industry.

#### Exhibit 3: Business model of Tencent

Value-Added Services (75% of 2Q13 revenue)	Online Advertising (9% of 2Q13 revenue)	E-commerce (15% of 2Q13 revenue)
Social Networks (22% of 2Q13 revenue)	Brand Display	Principal
Online Games (53% of 2Q13 revenue)	Performance Display	Agent
Fee-based Revenue	Traffic-based Revenue	1.GMV 2.Fee / Commission 3.Traffic-based revenue

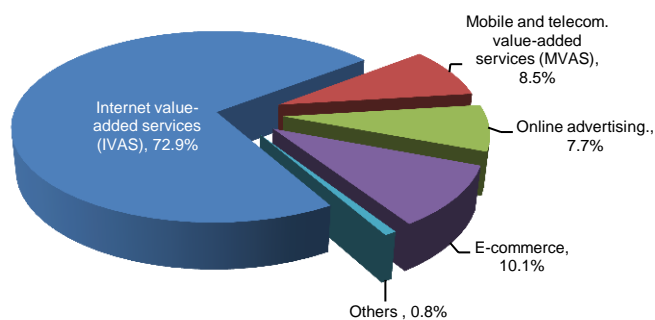
**QQ IM, Qzone, QQ.com, QQ Game**

**Free services to attract new users & enhance interaction within community**

Source(s): Company, ABCI Securities

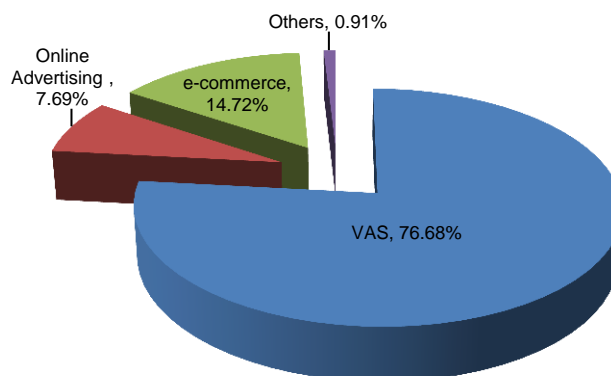
Tencent's revenue in 2012 mainly came from value-added services (VAS) (81.4%), online advertising (7.7%), and e-commerce transactions (10.1%). In 1H13, Tencent's e-commerce business grew quickly and its contribution increased from 10.1% in FY12 to 14.72% in 1H13.

**Exhibit 4: Revenue contribution of Tencent's different business lines in 2012**

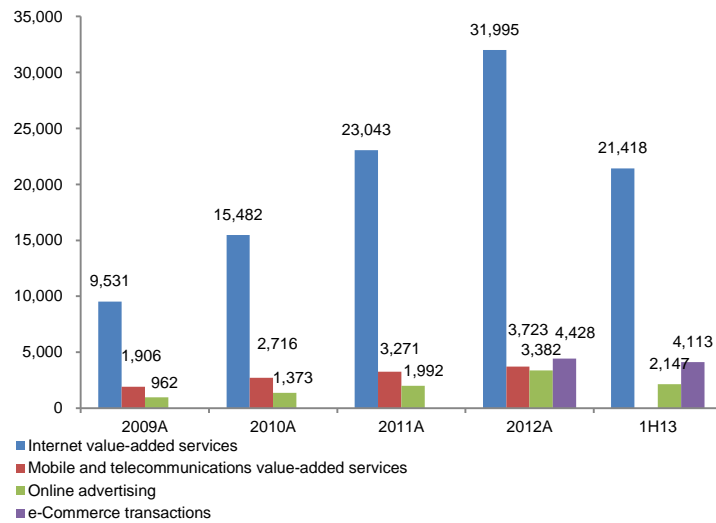


Source(s): Company, ABCI Securities

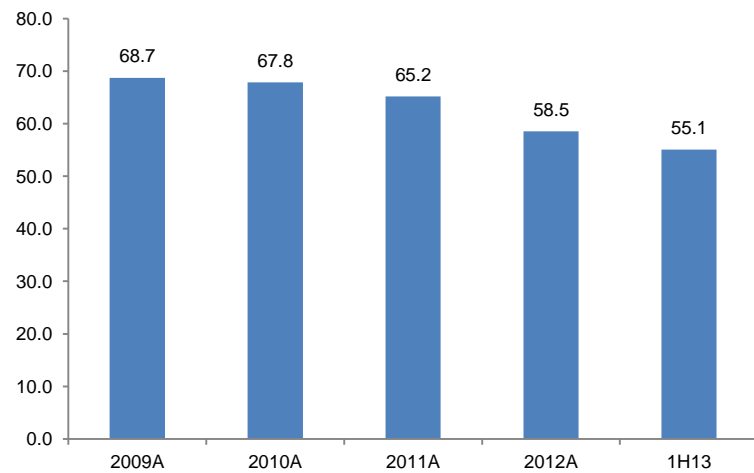
**Exhibit 5: Tencent's revenue mix in 1H13**



Source(s): Company, ABCI Securities

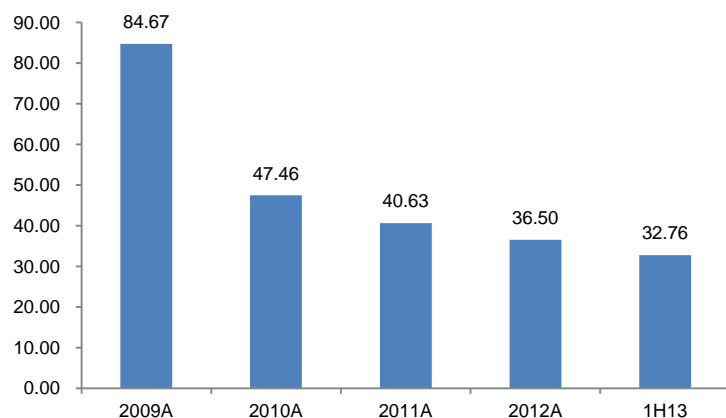
**Exhibit 6: Revenue of Tencent's major business lines in 2009-1H13 (RMB mn)**


Source(s): Company, ABCI Securities

**Exhibit 7: GPM trend in 2009-1H13 (%)**


Source(s): Company, ABCI Securities

Tencent's GPM margins slowed as revenue contribution from e-commerce and online advertising increased. We expect GPM to trend down more moderately and stabilize when its e-commerce business matures in 2017/18

**Exhibit 8: ROE trend in 2009-1H13 (%)**


Source(s): Company, ABCI Securities

Tencent's ROE diminished in recent years although the rate of decline has slowed. We expect its ROE to stabilize starting from 2014



## 2. VAS business – the bread and butter

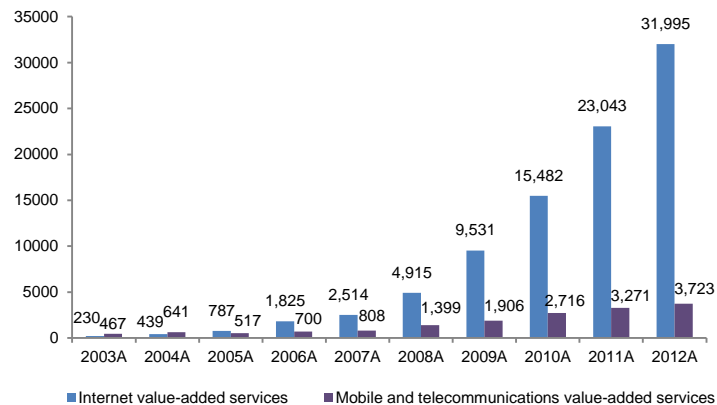
The company generated 81.4% of its revenue from value-added services (VAS), including IVAS (internet value-added services) and MVAS (Mobile and telecommunications value-added services) in 2012.

### VAS platform: IVAS + MVAS

#### VAS content: Online Games + Social Networks

While the platform of IVAS is PC-based, MVAS is mobile-based. Tencent's IVAS and MVAS provide two main services to users: **i) online Games**; and **ii) social networking** (including online communities and open platforms)

**Exhibit 9: Revenue of Tencent's IVAS and MVAS segments in 2003-12**

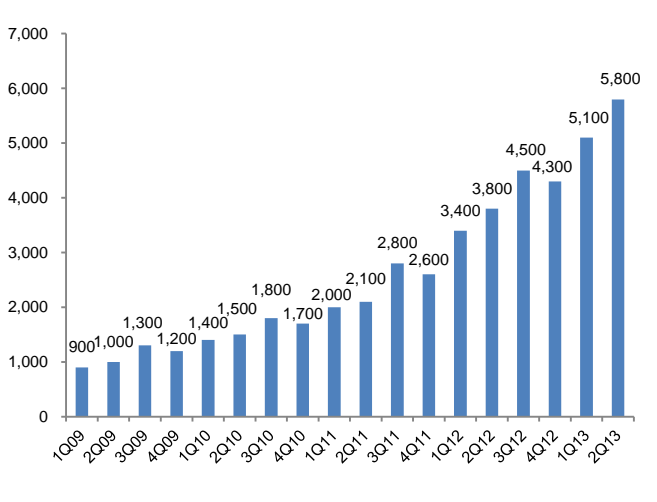


Source(s): Company, ABCI Securities

In 2012, Tencent's online game business extended its domestic leadership, supported by growth in major titles and contribution from self-developed new titles launched during the year, including *Legend of Yulong* and *Legend of Xuanyuan*. Tencent also achieved significant growth in international markets, riding on the success of its online game *League of Legends*. Its QQ game platform benefited from increased user activity with 8.4mn peak concurrent users (PCU) in 2Q13.

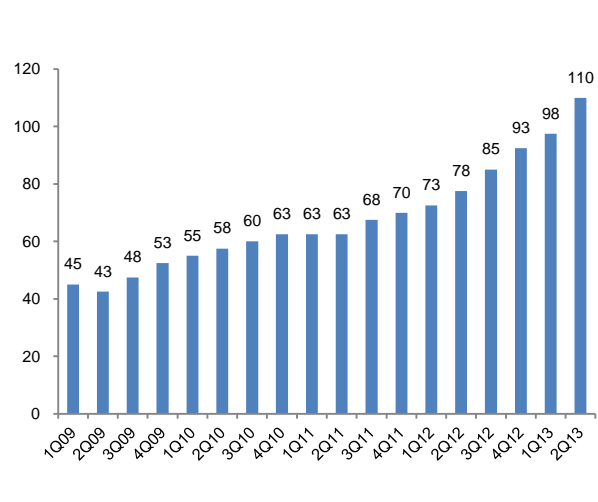
We expect Tencent to focus on strengthening its market leadership by broadening its game portfolio and increasing its penetration into the web and mobile game sectors. Its expansion efforts in the international markets will also yield profit for the group in the future.

**Exhibit 10: Combined ACU of ACG platform grew steadily in 1Q09-2Q13 (Unit '000)**

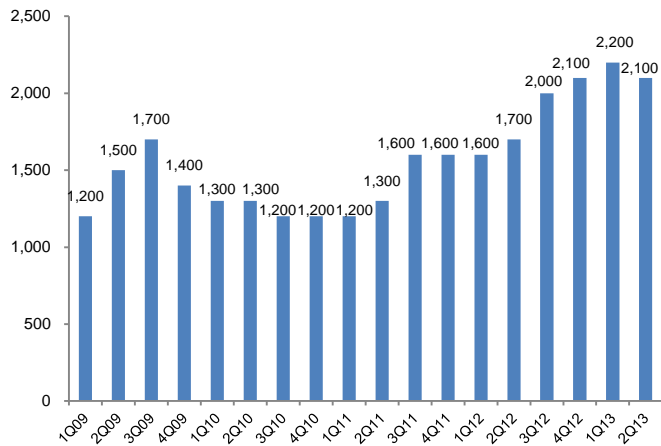


Source(s): Company, ABCI Securities

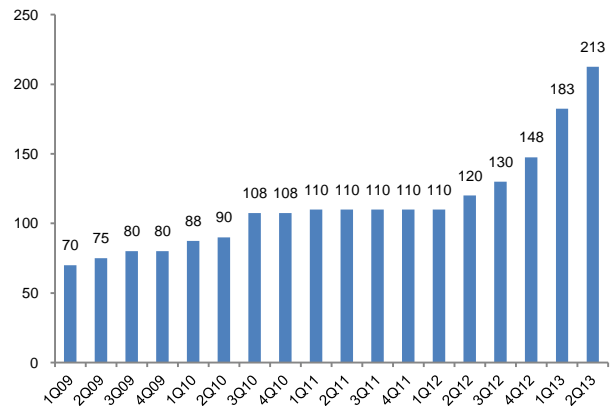
**Exhibit 11: ACG ARPU median trend in 1Q09-2Q03 (RMB)**



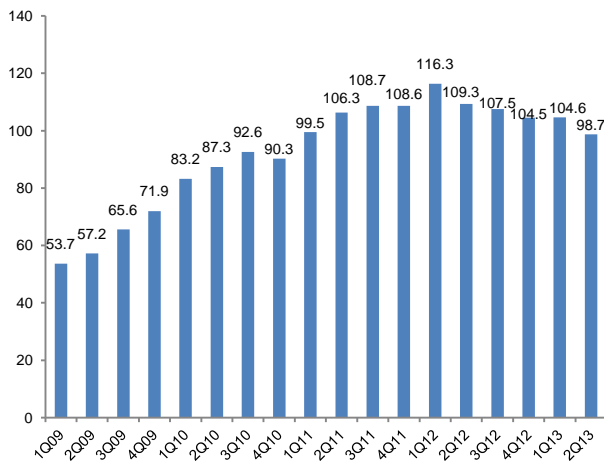
Source(s): Company, ABCI Securities

**Exhibit 12: Combined ACU of massively multiplayer online game (MMOG) platform in 1Q09- 2Q13 (Unit '000)**


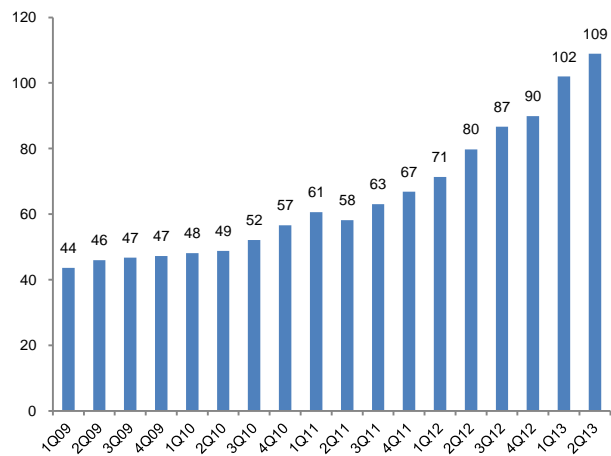
Source(s): Company, ABCI Securities

**Exhibit 13: Median of MMOG ARPU in 1Q09-2Q03 (RMB)**


Source(s) Company, ABCI Securities

**Exhibit 14: Fee-based VAS subscriptions in 1Q09-2Q13 (mn)**


Source(s): Company, ABCI Securities

**Exhibit 15: Fee-based VAS ARPU trend in 1Q09-2Q03 (RMB)**


Source(s) Company, ABCI Securities

**Exhibit 16: Value-Added Services (VAS)- Fee-based VAS**

Services/products	Monetization	User Base
<b>a) Social Networks:</b>		
QQ Membership	RMB10/month	N/A
Super QQ Membership	RMB20/month	N/A
Qzone	Free; monthly subscription fee for VIP privileges (RMB10); and items sales from apps on open platform	626 mn monthly active user accounts; 357 mn smart phone MAU for Qzone (2Q13)
Tencent Microblog	Free; monthly subscription fee for VIP privileges (RMB10);	85mn DAU (2Q13)
QQ Show (Avatars)	Free; Monthly subscription fee for VIP privileges (RMB10); or item sales	N/A
QQ Music	Free; Monthly subscription fee for VIP privileges (RMB10); or item sales	N/A
QQ Mail	Free	274 mn monthly ACU (2Q13)
Mobile VAS	Monthly subscription fee for VIP privileges (RMB5-15); or item sales (RMB1- 2 /item)	N/A
<b>b) Online Games:</b>		
QQ Game Platform	Monthly subscription fee for VIP privileges (RMB10-15) or item sales	Combined PCU of 8.4 mn and ACU of 4.1 mn (2Q13).
ACGs	Monthly subscription fee for VIP privileges (RMB10-30) or item sales	Combined PCU of 16.8 mn and ACU of 5.8 mn (2Q13).
MMOGs	Monthly subscription fee for VIP privileges (RMB20) or item sales; Time-based	Combined PCU of 5.8 mn and ACU of 2.1 mn (2Q13).
Mobile Games	Monthly subscription fee for VIP privileges (RMB10) or item sales	N/A

Source(s): Company

Note: (1) Smart phone MAU of Qzone denote the total number of Qzone MAU that logged in the social network via Mobile Qzone applications on iOS or Android phones at least once during the last calendar month of the quarter. Qzone MAU is the total number of user accounts that logged in Qzone at least twice during the last month of the quarter.

(2) Tencent Microblog DAU is the daily average number of user accounts that logged in Microblog to read or write message during the last month of the quarter.

(3) QQ Mail MAU is the total number of user accounts that logged in QQ Mail at least two days during the last month of the quarter.

**What do we expect from the MVAS and IVAS business?**

Tencent's IVAS and MVAS revenues grew at the respective CAGR of 50% and 25% in 2009-12. The Group launched the latest Weixin/WeChat in July 2013 and the apps were well received by the users in China. We expect that users will be willing to pay for privileges offered for smartphone and PC. We believe revenue contribution from MVAS will increase in the coming years.

Besides, Tencent launched its open platform in mid-2011 to support developers to distribute and market their apps to Tencent users through various product channels, including QQ IM, and social networking service (SNS) such as Qzone and Weibo. Tencent announced that it had shared RMB 3bn of revenue with external developers in July 3, 2013, at its Application Developer Conference.

Tencent charges small developers in its open platform on a multi-tier revenue sharing ratio ranging from 0%- 50%. By encouraging more external developers to join the platform, Tencent would be able to provide more apps at lower R&D and marketing costs, enhancing both the competitiveness and profitability of its VAS business.

We believe that Tencent can utilize fully its large client base and smoothly integrate its various PC channels and platforms with the mobile ones, boosting efficiency of its Games and SNS businesses in both the PC and mobile systems.

### 3. Online Advertisement: a fast-growing business

Tencent's online advertising revenue constituted 7.7% of the total in 2012. From 2009-12, the contribution was similar at ~7%. However, revenue of this business line (in absolute terms) grew quickly at a CAGR of 37% in 2009-12.

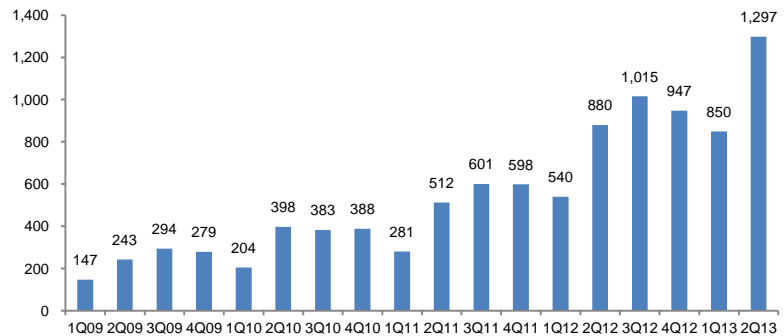
Tencent's online advertising business consists of **brand display**, **performance display**, and **Search**. The main contents are as follows:

**Exhibit 17: Online advertising categories**

Services/products	Monetization	User Base
Brand display	Inventories on QQ.com and verticals; online video platform; QQ IM, Mobile Browser etc.; Pricing mainly by CPT or CPD	About 1,000 brand display advertisers as of 2Q13
Performance display	Inventories on social networks Qzone and Microblog; contextual advertising and mobile advertising; Pricing is determined mainly by CPC or CPA through bidding system, or by CPM	NA
Search	Inventories on SOSO and Paipai search results; keyword-based bidding system Pricing mainly by CPC	NA

Source(s): Company

**Exhibit 18: Revenue of online advertising in 1Q09-2Q13 (RMB mn)**



Source(s): Company

Tencent's revenue from online advertising business increased by 53% QoQ to RMB 1,297mn in 2Q13 on seasonality as well as continuous growth in performance-based social and video advertising.

We expect revenue from the business to increase in the coming years. In particular, we expect the performance-based social and video advertising will continue to grow strongly. However, the segment's contribution to total revenue would remain stable at ~12% due to the fast-growing e-commerce sector.

#### Investment in Sogou benefits Tencent's online advertising business

On Sep 16, Tencent announced its strategic investment in Sogou (a search engine with a 10.8% market share in China). Tencent purchased a 36.5% stake in Sohu and has the option to increase the investment to 40% in the near future.

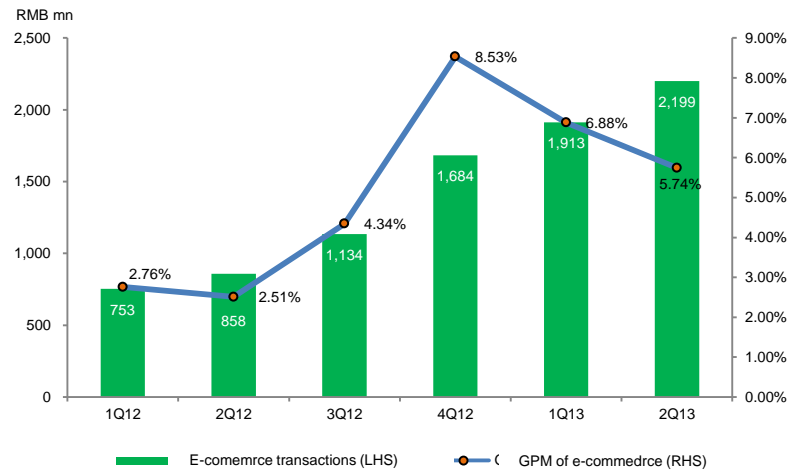
We believe by combining Sogou with Tencent's present search engine, Soso (with a 4.3% market share in China), the Group's position in China's internet search market is likely to strengthen. The transaction would enhance Tencent's crossing-selling channels and benefit Tencent's online advertisement.

#### 4. E-commerce business: A long-term growth driver

Tencent launched its own e-commerce business only recently and has been disclosing the segment's financial results since 1Q12. In 2012, Tencent expanded its B2C e-commerce transactions business. The segment achieved significant growth in transaction volume and revenue throughout the year despite stiff competition in the e-commerce sector.

**Exhibit 19: Tencent's e-commerce revenue in 1Q09~2Q13**

Tencent's e-commerce is still at its infant stage and its GMP is still volatile. However, we predict that the business will keep growing and the GPM will be improved gradually.



Source(s): Company, ABCI Securities

Revenue from Tencent's e-commerce transactions business increased by 156% YoY to RMB 2,199mn in 2Q13, driven by growth in volume of principal e-commerce transactions and revenue per transaction. Fees generated from transactions at Tencent's marketplace also increased.

We forecast that Tencent would invest to promote its e-commerce business to attract more users, meaning that its GPM will not improve significantly in the coming quarters. The e-commerce will build a solid foundation for Tencent's long-term growth, however, and we expect that the segment's profitability will grow steadily in the long run.

#### Why are we optimistic about Tencent's e-commerce business?

China's e-commerce market will be led by social commerce (electronic commerce that involves the use of social/online media that supports social interactions and user contributions to assist in the online buying and selling of products and services) and the online-to-offline (O2O) business model is gaining traction. We believe social commerce will develop rapidly and become a cash-generating engine for Tencent based on its largest virtual community in China.

#### #1 Emergence of social commerce

China's B2C and C2C markets have developed quickly in the past few years. With the intensifying competition, however, profitability declined. Unlike traditional e-commerce, social commerce focuses on the integration of commercial activities with online/mobile communities. Social commerce is essential to O2O business. The key to O2O business is to find consumers online and lead them to the real-world stores. It is a combination of payment model and foot traffic generator for merchants (as well as a "discovery" mechanism for consumers) that creates offline purchases.

Unlike B2C and C2C e-commerce, O2O provides consumers with real world, physical shopping experiences instead of the virtual ones. According to I-Research, about 84.7% consumers are willing to continue to use social commerce and among them, about 72.9% claim that they will use O2O more frequently in the future. We believe O2O will revolutionize consumption in the coming years.

With Tencent's existing online payment platform, Tenpay, the technical barrier to build an online payment platform for its O2O business is limited. **By launching Weixin/WeChat V5.0, Tencent has successfully connected its mobile community with potential O2O businesses.** By cross selling products/services to users, monetizing power of these apps will be greatly enhanced.

## #2 What are our concerns?

By entering the e-commerce market, Tencent encounters fierce competition from Alibaba, the largest e-commerce internet company that owns: (1) China's largest B2C website Tmall (天貓); (2) China's largest C2C website, Taobao (淘寶); (3) China's most popular online payment platform, Alipay (支付寶).

In Aug 2013, Alibaba announced it would disconnect the use of Weixin/WeChat for its sellers and encouraged them to login with a Sina microblog account to compete against Tencent and its developing e-commerce platform.

Despite intense market competition, we believe Tencent's e-commerce has the following strengths:

### i) Largest virtual community in China

Tencent's competitive advantages, which include its largest IM community in China (with massive logged-in user base), existing billing and payment relationships with consumers, its insight into users' interests, and its network's ability to enhance "word-of-mouth" effect by users would offer appealing business opportunities.

### ii) Multiple payment channels

Tencent actively expands its payment channels to help accelerate revenue collection and attract more e-commerce consumers.

Besides Tenpay, Tencent's payment channels also include credit card sales, prepaid point cards etc. All these provide convenient payment mechanisms for its clients and minimize collection risks. Also, with its massive user base, Tencent can negotiate for more benefits and discounts from banks and sellers.

We predict Tencent's overall GPM would trend down in FY13E-15E due to higher revenue contribution from e-commerce segment and increased marketing activities. The Group will gain larger market shares in the e-commerce market at the expense of profit margin. In the long run, the Group should be able to stabilize its e-commerce's GPM after the platform matures. Moreover, a thriving e-commerce business will lend support to its online advertising business.

### iii) A banking license will further enhance Tencent's competitiveness against Alipay

Tencent announced on Oct. 3, 2013 that the company is now a minority shareholder of a consortium (not disclosed) formed for the purpose of seeking a PRC banking license in connection with the provision of banking services and certain financial services online, where Tencent will supplement with its online platforms and user interface.

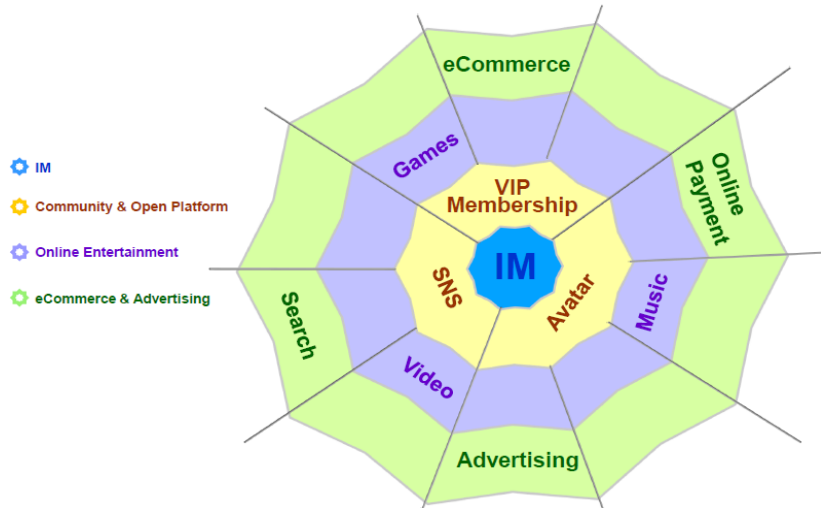
According to the Chinese media, the undisclosed consortium has applied for a private banking license and the application is currently being assessed by the China Banking Regulatory Commission (CBRC).

Tencent's currently operates the online payment system, Tenpay that allows digital transactions from WeChat and its other products. With a private banking license, Tencent will be able to provide an end-to-end payment system for its users, as well as an internet banking platform that offers loans to small business or money management products to all users. This will significantly broaden its revenue sources and help the Group to compete against Alipay.

**5. QQ IM and Weixin/WeChat amplify the synergy of different platforms**

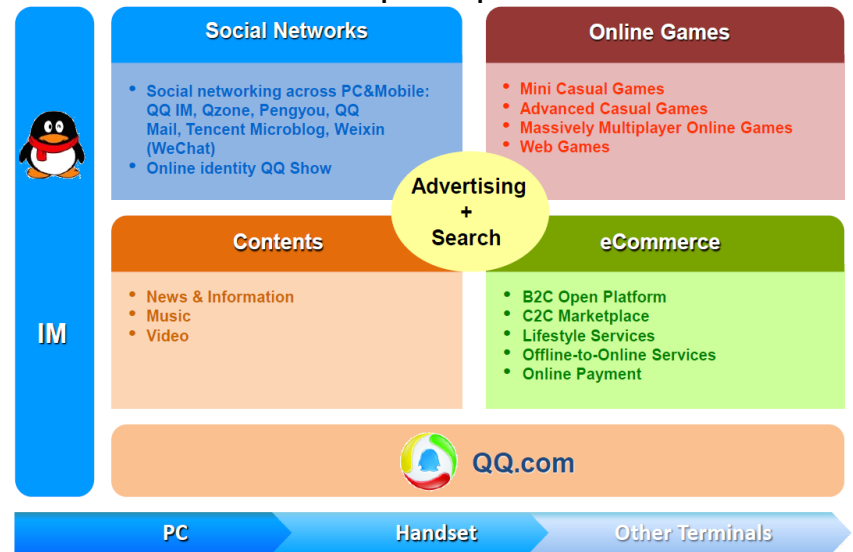
Based on its huge user base in QQ IM and Weixin/WeChat, Tencent successfully integrates its product portfolios and amplifies the synergy across multiple platforms over PC and mobile users.

**Exhibit 20: Tencent’s strategy for sustainable growth**



Source(s): Company

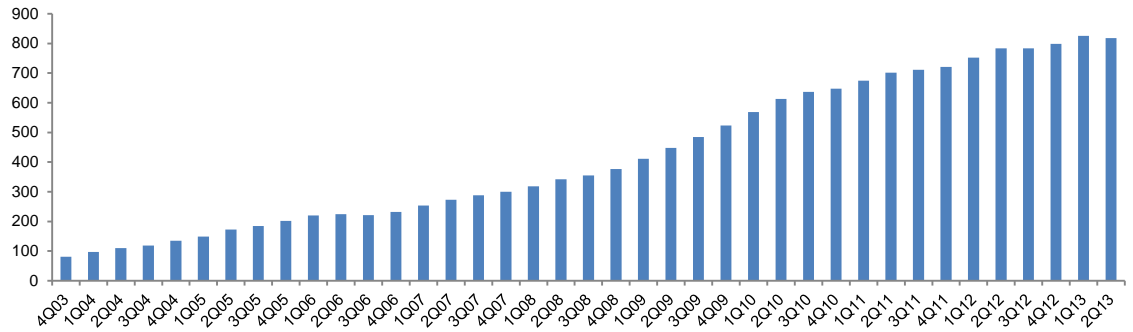
**Exhibit 21: Tencent’s diversified product portfolio and connections**



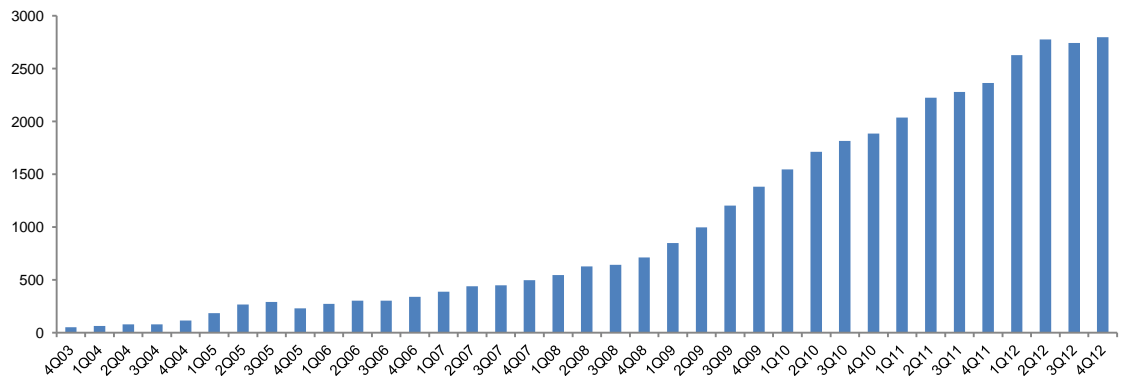
Source(s): Company

**QQ IM: No.1 IM community in China**

By the end of 2Q13, MAU of QQ IM reached 818.5mn, 1.38 times the internet users in China (~591mn), according to CNNIC. The figure reflects the high market penetration of QQ IM, with some users having more than one QQ account.

**Exhibit 22: MAU of QQ IM in 4Q03-2Q13 (mn users)**


Source(s): Company, ABCI Securities

**Exhibit 23: Average daily QQ IM user hours in 4Q03~2Q13 (mn hours)**


Source(s): Company, ABCI Securities

**What makes QQ IM so powerful?**

In our view, QQ IM significantly raises the entry barriers for other IM competitors due to the following reasons:

- **Free basic IM services:** which make it difficult for any rivals to compete with QQ on price;
- **High-speed and large-file transfer.** QQ provides free “resume broken download” function that enables speedy transfer of large files among users. Fee-based users can have access to more efficient high-speed and large-file transfer functions that enable them to transfer mega-sized file within minutes (e.g. Movies in DVD).
- **Large IM community tends to be sticky.** The larger the QQ IM community, the stickier the IM tool is for its users. QQ users can easily contact their friends within a single online community, saving time and effort, and is more efficient than joining a different IM community.
- **Large community helps Tencent reduce its content costs.** QQ IM’s users often share their contents for free across different QQ communities such as QQ.com, Qzone, QQ Game Platform and QQ microblog etc.



Traditionally, QQ IM is considered a leisure community for young people. However, after MSN has exited from non-China regions, QQ IM starts to attract more high-end users that were previously MSN Messenger users. Though we do not expect the AMU to rise rapidly (because QQ IM's penetration is relatively high), we expect the fee-based VAS registered subscriptions will continue to grow steadily.

### Weixin/WeChat: Why promising?

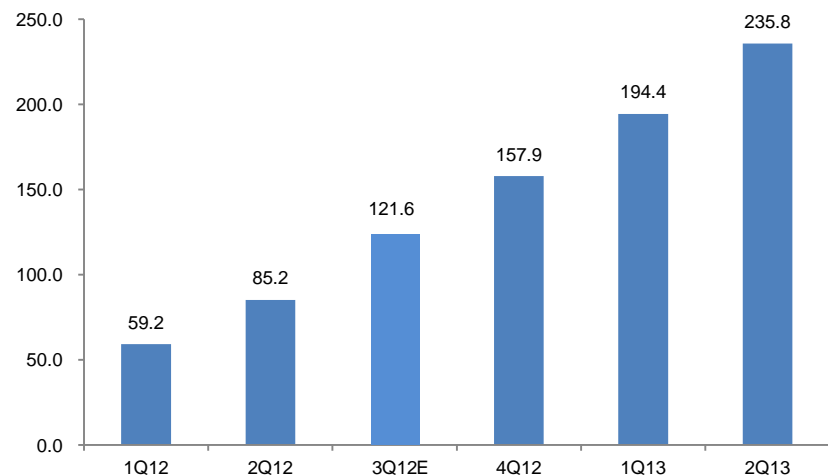
#### #1 Fast-growing mobile IM

WeChat and Weixin share the same IM technology for smartphones. Domestically, Tencent brands this service as Weixin. Overseas, Tencent promotes the service as WeChat. Tencent's management commented during the 2Q13 conference call that WeChat's overseas user accounts had reached 100mn, thanks to aggressive marketing and promotional campaigns.

Besides, the WeChat user base is diversified and is rapidly expanding in both developing and developed markets. Its market coverage includes Hong Kong, Taiwan, Macau, Thailand, India, Indonesia, Malaysia, Singapore, the Philippines, Latin America, South Africa, and the Middle East.

For Weixin/WeChat, the total users have exceeded 400mn by Aug 2013. Tencent reported that the MAU of Weixin/WeChat, as of 2Q13, had reached 235.8mn, 1.76 times higher than the number of users in 2Q12. Considering that it has taken more than 3 years for QQ IM's MAU to rise from ~80mn to 230mn in 4Q03-4Q06, the growing rate of Weixin/WeChat is impressive.

**Exhibit 24: MAU of Weixin/WeChat in 1Q12-2Q13 (mn)**



Source(s): Company, ABCI Securities

Note: Tencent will release the official 3Q12 data in Nov. 2013.

#### #2 Free services help enhance stickiness

Core IM services of WeChat/Weixin, including the community and gaming VAS, are free. WeChat/Weixin can be subscribed without charges, attracting users from all over the world.

Besides, the free games help retain Weixin/WeChat users. Users spending more time within the Tencent's community would help promote Tencent's online advertising and O2O businesses.

#### New functions of WeChat V5.0. :

- Two mobile games provided in the Tencent mobile game centre, the Classic Aircraft War (经典飞机大战) and Timi Match Everyday (天天爱消除), were gaining popularity among mobile users. Timi Match Everyday is currently the most frequently downloaded game in Apple's app store;

- Mobile payment, supported by Tenpay that provides three payment methods:
  - A. Pay by web scanning;
  - B. Pay by using app.
  - C. Pay by public account (such as McDonald's);

The mobile payment system supports credit and debit cards of seven Chinese banks (CMB, CCB, ABC, China Everbright Bank, China Guangfa Bank, China Industrial Bank, CITIC), and credit cards of five other Chinese banks (ICBC, BOC, Ping An, Shenzhen Development Bank, Bank of Ningbo);

- grouping of multiple official accounts;
- enhanced scanning functions of QR code, barcode, CDs/ books' cover, movie ad., and even some street or building views;
- translation by scanning (English words);
- other user-friendly features such as voice input and rearrangement of function buttons.

We expect Tencent to introduce more games (in-house and third party production) via the WeChat's platform.

The launch of new payment system and more commercialized function changes (such as QR and barcode scanning) would help Tencent expand its O2O business.

With the powerful WeChat V5.0, Tencent would attract more users and commercial partners, enabling the Group to monetize its mobile traffic with its newly launched products.

#### **What are the concerns?**

On Sep 24, 2013, Alibaba launched its IM product, Laiwang (来往), to compete with Tencent's QQ IM and Weixin in China's IM market. Alibaba owns the largest e-commerce platform and non-bank online payment platform, Alipay (支付宝), in China. By combining Laiwang and Alipay, Alibaba would be able to extend its strength in e-commerce to social commerce.

Alipay connects over 170 financial companies (both bank and non-bank financial service firms) and provides both PC-based and mobile-based online payment service in 14 major currencies. It is the largest competitor of Tencent's online payment platform, Tenpay.

Laiwang will help users communicate with contacts within the Laiwang community. Since Tencent's e-commerce business is still in its early stage of development, Laiwang may attract frequent users of online/mobile e-commerce.

We do not consider Laiwang a major threat to QQ. Tencent's IM markets QQ/Weixin/WeChat users have formed their own social circles around various QQ products (i.e. online games or microblog) and these users would not be motivated to switch to Laiwang simply because of Alibaba's reputation in e-commerce.

Besides, Alibaba is traditionally considered an e-commerce company based on a B2C or C2C instead of an O2O model. Tencent's leading position in online/mobile community services would help facilitate development of its O2O business. We believe the launch of Weixin/WeChat V5.0 will help extend its edges in VAS to the e-commerce market.

## 6. Industrial perspective: Optimistic

### #1 Internet user base is large and keeps growing

Internet users in China grew rapidly at a CAGR of 57.17% from 0.67mn to 591mn in 1997-2013. According to China Internet Network Information Centre (CIIIC), China's internet penetration reached 44.1% by June 30, 2013.

The relatively high penetration may indicate a low single-digit CAGR growth in the coming years. However, engagement per user is increasing further as the internet becomes more closely entwined with people's daily activities and the value chains of different business sectors in China. Rapid economic expansion would also enhance use or consumption of e-commerce and other services. According to documents released in the 18th National Congress of the Communist Party of China (CPC) in Nov 2012, China will seek to double its gross domestic product (GDP) and urban/rural residents' per capita annual income by the year 2020 (compared to 2010).

We expect Tencent will benefit as business opportunities on the internet continued to expand.

### #2 Fast-growing mobile internet users to benefit WeChat

Thanks to the rapid increase in smartphone penetration, China's mobile internet activities have been soaring in the past few years. In 2012, about 70.0% of the new internet users access the internet through smartphones, significantly higher than any other internet equipment.

China's mobile internet expands rapidly, reshaping the existing business models and the value chains of the internet and media industry. According to CNNIC, around 84.1% of internet users are IM users, among which ~ 79.88% are mobile internet users, and the utilization rate of the mobile IM reaches 85.7%.

By June 2013, 244mn of internet users use online payment services, up 10.8% since Dec 2012. In addition, mobile users grew 43% in the same period. We believe the e-commerce business of Tencent, with the support of its largest mobile IM community in China and various e-commerce/ mobile payment platforms, will benefit from such fast growth in internet use.

### #3 Chinese government supports development of internet infrastructure

China announced the "Broadband China" Project in Aug 2013, putting forward a slew of favourable policies and goals to ensure the long-term growth of internet in China. The main goals (until end-2015) are:

- 1) Wide deployment of FTTH (fibre-to-the-home) in urban areas, and broadband-to-village in rural areas;
- 2) Fixed broadband household penetration to reach 50%;
- 3) The third generation mobile communication and Long Term Evolution (3G / LTE ) user penetration rate to reach 32.5%;
- 4) Broadband (wired or wireless access, the same below) penetration ratio to reach 95% in China's administrative villages;
- 5) Almost all schools, libraries, hospitals and other public institutions have basic broadband access;
- 6) Urban and rural households' basic broadband access speed to improve to 20 megabits per second (Mbps) and 4Mbps; basic broadband access speed of certain developed cities to reach 100Mbps;
- 7) Significantly enhance the level of broadband applications and penetration of mobile internet;
- 8) Significantly enhance network and information security capabilities

We believe the government's ambitious goals will generate higher e-commerce consumption or VAS demand for Tencent going forward.

## Peer comparison

Tencent's business is unique in the sense that it has successfully expanded its community service to other internet platforms and integrated the IM, virtual community, VAS, online advertising and e-commerce smoothly over the past years. It is hard to locate another comparable competitor in China or overseas market.

Though Tencent is not the original app developer in business sectors such as IM, social networking or e-commerce, the Group has made rapid and significant progress in relevant technologies, and has been able to combine those technologies with its existing online communities and VAS markets.

### Exhibit 25: Comparison of different social networking apps (Weixin/WeChat, WhatsApp and Line)



\*Overseas market refers to global regions excluding China  
 Source(s): ABCI Securities

**Exhibit 26: Comparison of different internet/ online social media companies (as of Oct. 11, 2013)**

Ticker	Company	Mkt_Cap	P/E FY13E	P/E FY14E	PEG FY13E	PEG FY14E	EV/Shr	EPS FY13E	EPS FY14E
<b>HK Internet, HK\$</b>									
700HK Equity	<b>Tencent-ABCI Estimates</b>	779,101	39.83	28.34	2.14	0.80	----	8.28	11.64
700HK Equity	Tencent	779,101	37.05	29.38	1.54	1.22	191.86	8.91	11.24
3888HK Equity	Kingsoft	24,425	30.83	24.67	1.10	0.88	2.82	0.53	0.66
777HK Equity	Netdragon	12,600	16.31	21.14	3.08	3.99	6.66	1.20	0.92
484HK Equity	Forgame	8,686	----	----	----	----	----	----	----
<b>CN Internet @US, US\$</b>									
SINA US Equity	Sina	5,735	108.95	47.34	2.03	0.88	39.65	0.79	1.82
SOHU US Equity	Sohu	3,160	34.46	24.69	0.95	0.68	34.27	2.40	3.34
NTES US Equity	NetEase	9,090	12.21	11.11	0.88	0.80	23.07	5.70	6.26
BIDU US Equity	BaiDu	53,502	30.00	24.05	1.29	1.03	91.40	31.15	38.86
QIHU US Equity	Qihoo 360	10,199	68.54	40.19	1.16	0.68	26.59	1.21	2.07
CTRP US Equity	Ctrip	7,293	41.37	32.44	1.94	1.52	18.74	1.36	1.74
JOBS US Equity	51job	2,115	24.93	21.61	1.25	1.08	32.69	2.94	3.39
PWRD US Equity	Perfect World	956	12.31	9.90	1.10	0.88	9.66	9.74	12.11
YY US Equity	YY Inc.	2,723	44.12	28.58	0.96	0.62	----	1.14	1.75
<b>Global Internet, US\$</b>									
GOOG US Equity	Google	291,938	20.16	17.10	1.22	1.03	573.98	43.45	51.24
FB US Equity	Facebook	120,573	68.57	50.52	2.32	1.71	23.55	0.72	0.98
YHOO US Equity	Yahoo	34,691	23.11	20.32	2.01	1.77	14.58	1.47	1.67
Amzn US Equity	Amazon	141,954	121.75	62.18	4.06	2.07	235.31	2.55	5.00
EbayUS Equity	EBay	70,902	20.20	17.11	1.37	1.16	47.22	2.71	3.20
AOL US Equity	American Online	2,574	16.71	14.85	1.88	1.67	25.07	2.01	2.26
LNKD US Equity	LinkedIn	26,984	147.99	104.10	2.97	2.09	107.99	1.54	2.20
GRPN US Equity	GROUPON	7,328	92.52	39.46	4.46	1.90	3.02	0.12	0.28
YNDX US Equity	Yandex N.V.	12,621	34.02	26.73	1.06	0.83	19.30	36.42	46.36
<b>Global Internet, JPY</b>									
4689 JP Equity	Yahoo Japan	2,881,672	21.01	19.90	1.77	1.65	384.88	23.84	25.18
<b>Global Internet, KRW</b>									
035720 KS Equity	Daum Communications	1,260,953	15.49	12.73	1.13	0.93	71.69	1110.00	1110.00

Source(s): Bloomberg, ABCI Securities estimates

## Valuation and Recommendation

Our projections of Tencent's financial performance are based on:

- A unique business model, with high entry barriers based on scale benefits, community stickiness and networking effects.
- The company's strengths in developing its virtual community (#1 in China and expanding fast in overseas markets), leading position in VAS (both PC- and mobile -based), brand building (QQ has become one of the most widely recognized internet brands in China), e-commerce market (the scale and stickiness of community imply a fast-growing O2O model in social commerce), and its low content costs (the majority of Tencent's contents is provided by users).

While forecasting revenue and earnings for high-growth companies in evolving markets is fraught with risks, and all valuation methodologies are subject to the industry development and general equity market conditions, we believe PEG ratio (price/earnings-to-growth) provides a more reasonable gauge regarding the Group's value. The main reason is that Tencent has enjoyed high earnings growth in the past years. In 2009-12, its EPS grew at 35% CAGR. Thus, Tencent's P/E has remained high and the counter has outperformed the market for the last 12 months.

We predict that the Group's EPS will attain a CAGR growth of 44% in 2013-2015. Thus, we believe a PEG of 1 is a reasonable value for the Group, while a 0.8 PEG should be a conservative valuation to verify the BUY action (the Chinese internet peers' average is 0.91 as shown in Exhibit 26).

Considering Tencent's high growth in revenue and net profit, we estimate its FY14E EPS growth to be 40.53%, and a 0.8 PEG would suggest a FY14E P/E of 32.4x. Based on our FY14E P/E, we set the 12-month TP at HK\$ 479, which is 14.42% higher than the current price of HK\$419. Tencent's strong fundamentals with the largest virtual community in China and high growth potential in VAS and e-commerce businesses prompt us to initiate coverage on the Group with a **BUY** rating.

## Financial projections

Sales and marketing costs has remained one of investors' concerns since the launch of Weixin/WeChat V5.0 and the Group's e-commerce business. In our view, Tencent's e-commerce business is still in its early days but the Group's solid community base will provide strong support and potential for its future growth. On the other hand, Weixin/WeChat would help the Group to expand its market coverage and user base while enhancing the synergy among different platforms. In the long run, a well-developed e-commerce and social networking platforms could become powerful earners for the Group.

### Exhibit 27: Key assumptions for revenue prediction and earnings outlook

Key Assumptions	2012A	2013E	2014E	2015E
MAU growth of QQ IM, %	11	8	8	7
MAU growth of Weixin/WeChat, %	--	160	60	20
Fee-based VAS acc. growth, %	14	15	15	15
ARPU growth of fee-based VAS acc., %	31	25	28	25
E-commerce revenue growth, %	--	80	90	70
Online advertisement growth, %	70	30	30	25
Other revenue growth (including online financial service), %	92	95	90	80
Cost of revenues/Revenue, %	41	45	45	45
S&M Expenses/Revenue, %	7	8	11	10
G&A Expenses/Revenue, %	18	19	18	18
GPM, %	59	55	55	55
Effective Tax Rate, %	15	15	15	15

Source(s): Company, ABCI Securities estimates

### Earnings expectations and sensitivity tests on performance and valuation

We forecast the 2013E/2014E net profit for Tencent to be RMB 15,481/21,891mn, representing a YoY growth of 21.59% and 41.40%. The forecast is based on the assumption that 2013E revenue will grow 45.48% YoY and 2014E revenue will grow 55.68% YoY. Below is the sensitivity analysis of Tencent's net profit to changes in various business performances:

### Exhibit 28: Sensitivity test on 2014E estimated net income (RMB mn)

Assuming the following variable change ONLY	5ppt lower than base case	Base case*	5ppt higher than base case
QQ MAU growth (%)	21,159	21,891	22,623
<i>Changes (vs. base-case) (%)</i>	<i>-3.34</i>	<i>0.00</i>	<i>+3.34</i>
ARPU growth of fee-based VAS account. (%)	21,274	21,891	22,508
<i>Changes (vs. base-case) (%)</i>	<i>-2.82</i>	<i>0.00</i>	<i>+2.82</i>
E-commerce revenue growth (%)	21,805	21,891	21,977
<i>Changes (vs. base-case) (%)</i>	<i>-0.39</i>	<i>0.00</i>	<i>+0.39</i>
Cost of revenue/ Revenue (%)	26,098	21,891	17,684
<i>Changes (vs. base-case) (%)</i>	<i>+19.22</i>	<i>0.00</i>	<i>-19.22</i>
Selling and marketing expenses/Revenue (%)	26,098	21,891	17,684
<i>Changes (vs. base-case) (%)</i>	<i>+19.22</i>	<i>0.00</i>	<i>-19.22</i>

\*Base case assumptions: (1) QQ MAU growth=8% YoY; (2) ARPU growth of fee-based VAS=28% YoY; (3) E-commerce revenue growth=90%YoY; (4) Cost of revenue/Revenue=45%; Selling and marketing expenses/Revenue=11%

Source(s): ABCI Securities estimates



Consolidated income statement (2011A-2015E)

FY Ended Dec 31 (RMB mn)	2011A	2012A	2013E	2014E	2015E
IVAS	23,043	31,995	49,254	72,953	97,574
MVAS	3,271	3,723	0	0	0
Online advertising	1,992	3,382	5,919	10,358	17,609
e-Commerce transactions	0	4,428	7,970	14,745	25,066
Others	190	365	713	1,354	2,437
<b>Revenues</b>	<b>28,496</b>	<b>43,894</b>	<b>63,856</b>	<b>99,410</b>	<b>142,686</b>
Cost of revenues	(9,928)	(18,207)	(28,735)	(44,734)	(64,209)
<b>Gross profit</b>	<b>18,568</b>	<b>25,686</b>	<b>35,121</b>	<b>54,675</b>	<b>78,478</b>
SG&A	(7,204)	(10,759)	(17,241)	(29,237)	(40,476)
Other income and gains	(735)	(123)	(409)	(423)	(318)
<b>Pre-tax profit</b>	<b>12,099</b>	<b>15,051</b>	<b>18,289</b>	<b>25,861</b>	<b>38,320</b>
Income tax	(1,874)	(2,266)	(2,743)	(3,879)	(5,748)
<b>Net profit</b>	<b>10,225</b>	<b>12,785</b>	<b>15,546</b>	<b>21,982</b>	<b>32,572</b>
<b>Profit attributable to:</b>					
Minority interests	22	53	64	91	135
<b>Equity holders of the Company</b>	<b>10,203</b>	<b>12,732</b>	<b>15,481</b>	<b>21,891</b>	<b>32,437</b>
<b>EPS (Basic), RMB</b>	<b>5.61</b>	<b>6.97</b>	<b>8.31</b>	<b>11.71</b>	<b>17.25</b>
<b>EPS, Diluted, RMB</b>	<b>5.49</b>	<b>6.83</b>	<b>8.28</b>	<b>11.64</b>	<b>17.17</b>
<b>DPS, RMB</b>	<b>0.75</b>	<b>1.00</b>	<b>1.17</b>	<b>1.68</b>	<b>2.45</b>

Source(s): Company, ABCI Securities estimates

Consolidated balance sheet (2011A-2015E)

As of Dec 31 (RMB mn)	2011A	2012A	2013E	2014E	2015E
Fixed assets	5,885	7,403	10,703	13,830	17,043
Intangible assets	3,780	4,719	5,548	6,397	7,235
Interests in associates	4,433	7,310	5,872	6,591	6,231
Other non-current assets	7,203	19,315	19,898	22,737	20,532
<b>Total non-current assets</b>	<b>21,301</b>	<b>38,747</b>	<b>42,020</b>	<b>49,555</b>	<b>51,042</b>
Inventories		568	1,116	2,212	3,760
Accounts receivable	2,021	2,354	3,193	5,965	9,988
Prepayments, deposits and other assets	2,212	3,878	3,045	3,461	3,253
Cash and cash equivalents	12,612	13,383	23,671	37,937	63,343
Other current assets	18,659	16,326	17,492	16,909	17,201
<b>Current Assets</b>	<b>35,503</b>	<b>36,509</b>	<b>48,517</b>	<b>66,484</b>	<b>97,545</b>
<b>Total assets</b>	<b>56,804</b>	<b>75,256</b>	<b>90,537</b>	<b>116,039</b>	<b>148,586</b>
Accounts payable	2,244	4,212	6,386	9,941	12,842
Other payables and accruals	5,014	6,301	9,578	12,923	17,122
Borrowings	7,999	1,077	3,595	2,336	2,966
Current income tax liabilities	709	420	564	492	528
Deferred revenue	5,016	8,115	6,566	7,340	6,953
Other short-term liabilities	200	540	381	471	426
<b>Total current liabilities</b>	<b>21,183</b>	<b>20,665</b>	<b>27,070</b>	<b>33,504</b>	<b>40,837</b>
Borrowings		2,106	2,011	1,917	1,341
Long-term notes payable	3,733	7,517	4,035	4,186	2,520
Deferred income tax liabilities	940	1,312	1,126	1,219	1,172
Long-term payables	1,860	1,509	1,684	1,596	1,640
<b>Total non-current liabilities</b>	<b>6,533</b>	<b>12,443</b>	<b>8,856</b>	<b>8,918</b>	<b>6,674</b>
<b>Total liabilities</b>	<b>27,716</b>	<b>33,108</b>	<b>35,926</b>	<b>42,421</b>	<b>47,510</b>
<b>Total equity</b>	<b>29,088</b>	<b>42,148</b>	<b>54,611</b>	<b>73,618</b>	<b>101,076</b>
Non-controlling interests	625	851	738	794	766
<b>Equity of the firm</b>	<b>28,464</b>	<b>41,298</b>	<b>53,873</b>	<b>72,823</b>	<b>100,310</b>
<b>BVPS, RMB</b>	<b>15.32</b>	<b>22.16</b>	<b>28.83</b>	<b>38.73</b>	<b>53.10</b>

Source(s): Company, ABCI Securities estimates



**Consolidated cash flow statement (2011A-2015E)**

<b>FY ended Dec 31 (RMB mn)</b>	<b>2011A</b>	<b>2012A</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>
<b>Profit for the year</b>	<b>10,225</b>	<b>12,785</b>	<b>15,546</b>	<b>21,982</b>	<b>32,572</b>
Adjustments for:					
Income tax expense	1,874	2,266	2,743	3,879	5,748
Dividend income	–	(407)	(407)	(407)	(407)
Depreciation of fixed assets and investment properties	1,208	1,880	1,544	1,712	1,628
Amortization of intangible assets	726	733	729	731	730
Interest income	(469)	(836)	(520)	(608)	(655)
Equity-settled share-based compensation expenses	733	905	1,479	2,176	3,214
<b>Changes in working capital:</b>					
Accounts receivable	(251)	(267)	(839)	(2,772)	(4,023)
Inventories	–	(301)	(548)	(1,096)	(1,548)
Prepayments, deposits and other receivables	(2,630)	(2,255)	833	(416)	208
Accounts payable	828	1,689	2,174	3,555	2,901
Other adjusted items	2,951	5,461	5,153	6,120	6,525
<b>Net Cash generated from operating activities</b>	<b>15,194</b>	<b>21,654</b>	<b>27,887</b>	<b>34,857</b>	<b>46,893</b>
Income tax paid	(1,836)	(2,225)	(2,693)	(3,808)	(5,643)
<b>Net cash flows generated from operating activities</b>	<b>13,358</b>	<b>19,429</b>	<b>25,194</b>	<b>31,048</b>	<b>41,250</b>
<b>Cash flows from investing activities</b>					
Payments for business combinations, net of cash acquired	(1,444)	(435)	(940)	(687)	(813)
Purchase fixed assets, construction in progress & investment properties	(4,060)	(3,657)	(3,858)	(3,758)	(3,808)
Payments for interests in associates	(3,529)	(3,668)	(3,598)	(3,633)	(3,616)
Purchase/prepayment of intangible assets	(788)	(869)	(829)	(849)	(839)
Receipt from maturity of term deposits with initial term of over 3 months	5,989	18,532	12,261	15,396	13,828
Interest received	415	626	520	573	547
Dividends received	20	440	230	335	282
Other adjusted items	(11,958)	(27,239)	(19,598)	(23,419)	(21,509)
<b>Net cash flows used in investing activities</b>	<b>(15,355)</b>	<b>(16,270)</b>	<b>(15,812)</b>	<b>(16,041)</b>	<b>(15,927)</b>
<b>Cash flows from financing activities</b>					
Proceeds from short-term borrowings	6,683	983	3,833	2,408	3,120
Proceed from long-term borrowings	0	2,215	1,108	1,661	1,385
Net proceed from issuance of long-term notes	3,761	3,768	3,764	3,766	3,765
Proceeds from issuance of ordinary shares	160	238	199	219	209
Dividends paid to the Company's shareholders	(838)	(1,108)	(973)	(1,040)	(1,007)
Other adjusted items	(5,392)	(8,483)	(6,937)	(7,710)	(7,324)
<b>Net cash flows (used in)/generated from financing activities</b>	<b>4,373</b>	<b>(2,386)</b>	<b>994</b>	<b>(696)</b>	<b>149</b>
<b>Net increase in cash and cash equivalents</b>	<b>2,376</b>	<b>773</b>	<b>10,375</b>	<b>14,311</b>	<b>25,472</b>
<b>Cash and cash equivalents at beginning of the year</b>	<b>10,408</b>	<b>12,612</b>	<b>13,383</b>	<b>23,671</b>	<b>37,937</b>
<b>Exchange losses on cash and cash equivalents</b>	<b>(172)</b>	<b>(2)</b>	<b>(87)</b>	<b>(45)</b>	<b>(66)</b>
<b>Cash and cash equivalents at end of the year</b>	<b>12,612</b>	<b>13,383</b>	<b>23,671</b>	<b>37,937</b>	<b>63,343</b>

Source(s): Company, ABCI Securities estimates

**Financial ratio table (2011A-2015E)**

<b>FY Ended Dec 31</b>	<b>2011A</b>	<b>2012A</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>
Gross Profit Margin, %	58.52	55.00	55.00	55.00	55.00
Operating Margin, %	43.00	35.27	28.91	26.27	27.05
Net Margin, %	35.81	29.01	24.24	22.02	22.73
ROE, %	40.63	36.50	32.53	34.56	37.47
ROA, %	17.96	16.92	17.10	18.87	21.83
Total Equity/Total Debt, %	104.95	127.31	152.01	173.54	212.74

Source(s): Company, ABCI Securities estimates

## Risk factors

### 1. Peer competition

The downside risks to our valuation include competition from industry peers, such as Alibaba and Sina microblog, and the uncertainties in MVAS business.

In the mobile IM market, China Telecom has launched a mobile messaging app to rival with WeChat. Alibaba also launched its own PC-based and mobile internet IM product. Alibaba is the largest competitor of Tencent in the e-commerce market holding the largest online payment system.

Peer competition may reduce the ARPU of its fee-based users, or even reduce the number of users, esp. in the mobile VAS market.

### 2. High marketing expenses may pressure margins

It may take Tencent longer than expected to stabilize its overall GPM if marketing expenses of e-commerce business and WeChat continue to grow at rates higher than its core revenue.

### 3. Increased exposure to regulation of e-commerce (including mobile)

As Tencent seeks to expand its smartphone-based VAS and e-commerce businesses, its exposure to regulation of mobile commerce also increases. A tightening of rules in these domains may hurt Tencent's profits.

### 4. Slowdown in PC gaming

Tencent still generates over half its revenues from PC-based VAS, the majority of which is PC-based games. However, if PC game segment slow down and Tencent could not generate sufficient mobile VAS revenues to compensate for the decline, then its profitability could be lower than our estimates.

## Key Glossary

Abbreviation	Definitions and explanation (provided by Tencent)	定义
ACG	Advanced Casual Game	高级休闲游戏
ACU	Average Concurrent User accounts. Quarterly ACU is the average number of simultaneous online user accounts during the quarter.	平均同时在线用户数
ARPU	Average Revenue Per User. Quarterly ARPU is online game net revenues derived from ACG or MMOG during the quarterly period divided by the quarterly active paying user accounts of these ACGs or MMOGs during the quarterly period. Tencent's definition of ARPU may not be comparable to similarly titled measures presented by other online game companies.	平均每月用户收入
B2C	Business-to-consumer / Business-to-customer	商家（企业）至消费者销售
C2C	Consumer To Consumer / Customer to Customer	消费者至消费者的销售
Combined MAU of Weixin & WeChat:	Total number of user accounts that logged in Weixin or WeChat to send out messages at least once during the last month of the quarter.	微信 WeChat 合并月活跃账户数
CPA	Cost-per-Action	每次访问行动的费用
CPC	Cost-per-click	每次点击行动的费用
CPD	Cost per day	每天点击成本
CPM	Cost Per Mille	每千人成本网络广告费用
CPT	Cost Per Time	根据广告展示时间收取的费用
DAU	Daily Active User Accounts	日活跃用户数
DNF	Dungeon and Fighter	地下城与勇士
FPS	First Person Shooting	第一人称射击游戏
FTTH	fibres-to-the-home	光纤到户
GMV	Gross Merchandise Volume	（网站）成交金额
IVAS	Internet value-added services	互联网增值服务
LOL	League of Legends	英雄联盟
LTE	Long Term Evolution ( LTE )	4G LTE 技术
MAU	Monthly Active User accounts;	月活跃账户数
MAU--QQ IM	Total number of user accounts that logged in QQ at least once during the last month.	QQ 月活跃账户数
Mbps	megabits per second	兆位/秒
MCG	Mini Casual Game	小型休闲游戏
MM ORGS	Massive Multiplayer Online Role-Playing Game	大型多人在线角色扮演游戏
MMO Racing	Massive Multiplayer Online Racing	大型多人在线赛车游戏
MMOFPS	Massive Multiplayer Online First-Person Shoot	大型多人在线第一人称射击游戏
MMOG	Massive Multiplayer Online Game	大型多人在线音乐游戏
MMORTS	Massive Multiplayer Online Real-Time Strategy	大型多人在线实时战略游戏
MVAS	mobile & telecommunications value-added services	移动及电讯增值服务
O2O	Online To Offline	离线商务模式（线上营销线下消费）
PCU	Peak Concurrent User Accounts. Quarterly PCU is the highest number of simultaneous online user accounts during the quarter.	最高同时在线用户数
PCU	Peak Concurrent User accounts	最高同时在线户
PCU-- QQ IM PCU	The highest number of logged-in user accounts recorded on any time of a day during the quarter.	QQ 最高同时在线户
SNS	Social Network Site	社交网站
TAC	Traffic Acquisition Cost	流量获得成本
VAS	value-added services which contains IVAS and MVAS	增值服务
WeChat	A product of Tencent that leverages Weixin's technology to serve the international markets.	微信（海外版）
Weixin	An extension of Tencent's mobile IM service, whose functions have been developed and become a mobile community.	微信

Source(s): Company, ABCI Securities

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### Definition of equity rating

Rating	Definition
Buy	Stock return $\geq$ Market return rate
Hold	Market return – 6% $\leq$ Stock return < Market return rate
Sell	Stock return < Market return – 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate from 2008-2012

Time horizon of share price target: 12-month

### Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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