

Tencent (700 HK)

Broad-based recovery

- Broad-based recovery seen in major segments
- Improving online gaming business with more new games in coming quarters, while online advertising and Fintech are driven by recovery of advertising spending and commercial payment activities, respectively
- Ongoing development of generative AI initiatives

Ongoing improvement in profitability. Tencent's core profit growth has seen sequential improvement in recent quarters (2%/19%/27% YoY in 3Q22/4Q22/1Q23), indicating an improving operating environment. Core net margin improved from 18.9% in 1Q22 to 21.7% in 1Q23, showing ongoing cost optimization.

Broad-based recovery. In contrast with 4Q22 where recovery was mainly in online advertising, we see broad-based recovery in 1Q23. Online games turned around in 1Q23 with a 11% YoY revenue growth vs. the 2% YoY drop in the previous quarter. In the coming months, we estimate 5-6 new games will be launched, raising visibility in growth outlook. The 17% YoY revenue growth in 1Q23 online advertising despite the high base driven by recovery in advertising spending across categories and continuous ramp-up in Video Accounts. Revenue of FinTech and business service went up 14% YoY during the quarter compared to the 1% drop in 4Q22, thanks to recovery of commercial payment. Impact of recent price cut in the cloud segment is manageable, in our view.

Maintain BUY on Tencent's leading position in online entertainment market and long-term potential in AI development. Our SOTP-based TP is HK\$ 450. The counter is currently trading at about 17x 2024E P/E, representing a reasonable entry-point for long-term investors, in our view.

Results and Valuation

FY ended Dec 31	2021A	2022A	2023E	2024E
Revenue (RMB mn)	560,118	554,552	610,523	690,782
Chg (% YoY)	16.2	(1.0)	10.1	13.1
Net profit (RMB mn)	224,822	188,243	160,777	186,374
Chg (% YoY)	40.6	(16.3)	(14.6)	15.9
Non-GAAP net profit (RMB mn)	123,788	115,649	142,356	167,367
Chg (% YoY)	0.9	(6.6)	23.1	17.6
EPS (RMB)	23.6	19.8	16.9	19.6
Chg (% YoY)	40.1	(16.3)	(14.6)	15.9
Non-GAAP EPS (RMB)	13.0	12.1	14.9	17.6
Chg (% YoY)	0.4	(6.6)	23.1	17.6
Core P/E (x)	23.1	24.7	20.1	17.1
P/B (x)	3.5	4.0	3.2	2.6
ROAE (%)	27.2	22.7	18.4	17.5
ROAA (%)	15.3	11.8	9.9	10.4
Cash DPS(HKD)	1.60	2.40	2.40	2.40
Cash dividend Yield (%)	0.5	0.7	0.7	0.7

Source(s): Bloomberg, ABCI Securities estimates

CNY/HKD=1.11

Company Report

May 22, 2023

Rating: BUY

TP: HK\$ 450

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Share price (HK\$)	341.4
Est. share price return	31.8%
Est. cash dividend yield	0.7%
Est. total return	32.5%
Previous Rating & TP	BUY, HK\$450
Previous Report Date	Mar 24, 2023

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L(HK\$)	416.6/180.5
Issued shares (mn)	9,561
Market cap (HK\$ mn)	3,264,125
Avg daily turnover (HK\$ mn)	8,304
Major shareholder(s)	
Naspers	25.9%
Huateng Ma	8.4%

Source(s): Bloomberg, ABCI Securities

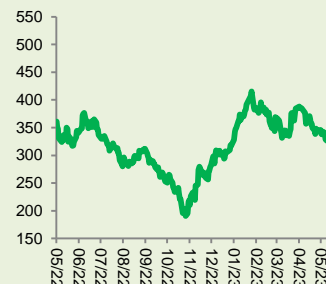
Share Performance (%)

	Absolute	Relative*
1-mth	-6.4	-2.3
3-mth	-10.6	-4.8
6-mth	22.3	13.8

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities

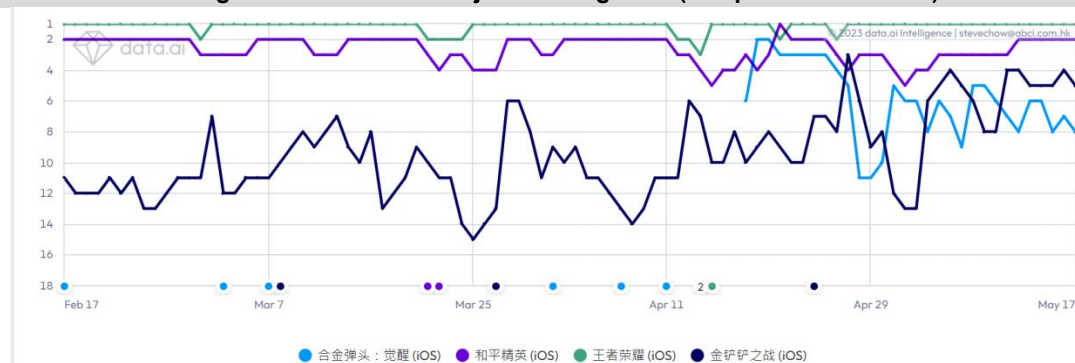
Broad-based recovery

In 1Q23, revenue increased 11% YoY to RMB 150bn. GAAP-based net profit increased 10% YoY to RMB25.8bn. In addition, non-GAAP net profit increased 27% YoY to RMB 32.5bn. Core profit growth has seen sequential improvement in recent quarters (2%/19%/27% in 3Q22/4Q22/1Q23), suggesting a more favorable operating environment. More importantly, in 1Q23, there was a broad-based recovery in major segments, unlike in 4Q22 most recovery came from online advertising.

Online gaming revenue increased 11% YoY during the quarter vs. the 2% YoY drop in 4Q22. Domestic gaming revenue increased 6% YoY compared to the 6% YoY drop in the previous quarter as a result of diminishing incremental effects of minor protection measures and persistent performance of established games. With the popular game VALORANT and other new game releases, international gaming revenue increased 25% YoY vs. 2% YoY in the previous quarter.

Tencent's major mobile games such as *Honor of King* (王者荣耀), *Peacekeeper Elite* (和平精英) and *Fight of the Golden Spatula* (金铲铲之战) have maintained their market position in recent months, as shown in Exhibit 1. In particular, the newly launched title, *Metal Slug: Awakening* (合金弹头: 觉醒), has achieved good initial response and has been ranked among the top 10 mobile games in recent weeks.

Exhibit 1: Grossing rank of Tencent's major mobile games (iOS platform in China)



Source(s): Data.ai, ABCI Securities

We expect continuous improvement in the operating environment on a normalizing impact of minor protection measures and new game launches.

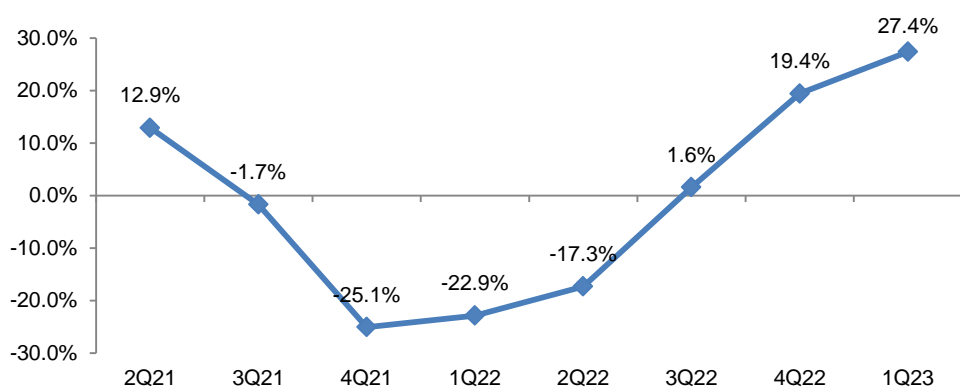
Social network revenue increased 6% YoY during the quarter versus 2% drop in the previous quarter driven by in-game item sales and music subscription.

Online advertising revenue growth was 17% YoY during the quarter vs. 15% YoY growth in the previous quarter despite a high base inflated by the Winter Olympics in 1Q22. Advertising spending saw growth across most categories amid consumption recovery and Video Accounts revenue continued to climb.

Revenue of FinTech and business service increased 14% YoY during the quarter vs. the 1% drop in 4Q22 on rising commercial payment. Looking forward, we expect manageable impact from industry price cuts in the cloud segment as the business only had mid-single-digit contribution in Tencent's revenue at present; we believe the price cut mainly cover more basic services within the cloud business.

On the cost front, the sales and marketing expenses/revenue ratio dropped from 5.9% in 1Q22 to 4.7% in 1Q23 thanks to cost control; general and admin expenses/revenue ratio also dropped from 19.7% in 1Q22 to 16.4% in 1Q23. Hence, core net margin improved from 18.9% in 1Q22 to 21.7% in 1Q23.

Exhibit 2: Core net profit growth trend (YoY)



Source(s): Company, ABCI Securities

Financial Outlook

We expect revenue to grow at 12% CAGR in 2022-24E.

Online gaming: We expect revenue to expand at 14% CAGR in 2022-24E on new game launch and diminishing incremental impact from minor protection measures. In our view, the resumption of new game approval signals a stabilizing regulatory environment. In terms of new games, we see a comprehensive pipeline supporting growth in coming quarters.

Exhibit 3: Major new games at a glance

Name	Genre	Remark
New games ready to launch		
白夜极光	Strategy RPG	Target launch: June 2023
重生边缘	FPS	Target launch: summer 2023
命运方舟	MMORPG	Target launch: summer 2023
冒险岛：枫之传说	Adventure	Target launch: autumn 2023
战地无疆	Strategy	Target launch: 3Q23
新天龙八部	RPG	Target launch: 2023
New games in testing stage		
劲乐幻想	Causal game	
白荆回廊	RPG	
七人传奇：光与暗之交战	Card RPG	
冲呀！饼干人：王国	Simulation	
二之国：交错世界	Adventure	
塔瑞斯世界	MMORPG	
创造吧！我们的星球	Causal game	
无畏契约	FPS	
大航海时代：海上霸主	Strategy	
代号：破晓	MMORPG	
全境封锁 2	Survival	

Source(s): Company, ABCI Securities

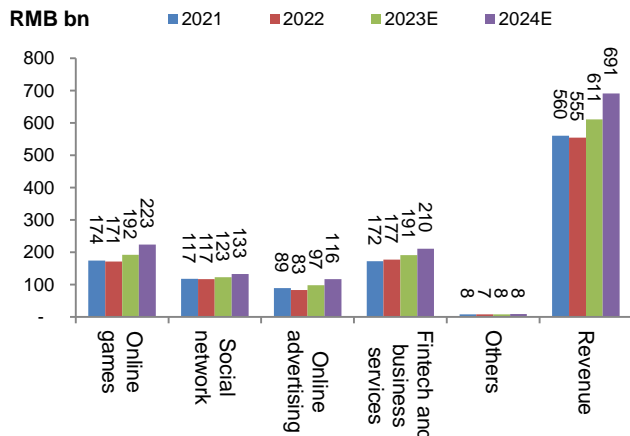
Social network: We expect social network revenue to increase at 6% CAGR in 2022-24E driven by ongoing content enhancement and short-video initiatives.

Online advertising: We expect the segment revenue growth to recover to 19% CAGR in 2022-24E, driven by ongoing industry recovery and ramp-up of in-feed advertising in Video Accounts.

FinTech and business service: We expect segment revenue to increase 9% in 2022-24E on recovery of retail commercial activities in the post-COVID era, which helps offset the price cut in the cloud business. Cloud has a mid-single-digit contribution in Tencent's revenue currently.

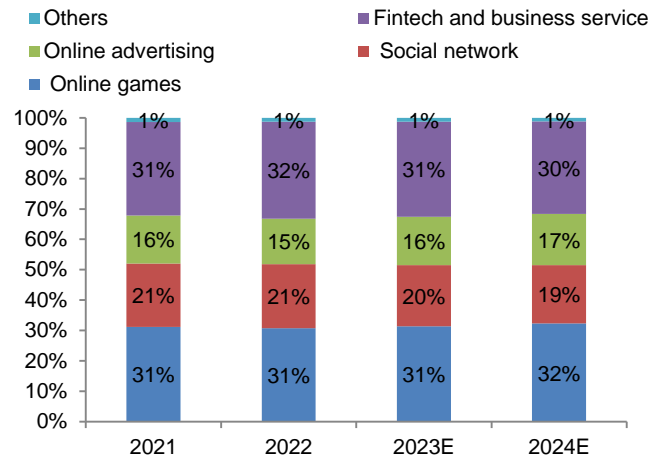


Exhibit 4: Revenue outlook



Source(s): Company, ABCI Securities estimates

Exhibit 5: Revenue mix outlook

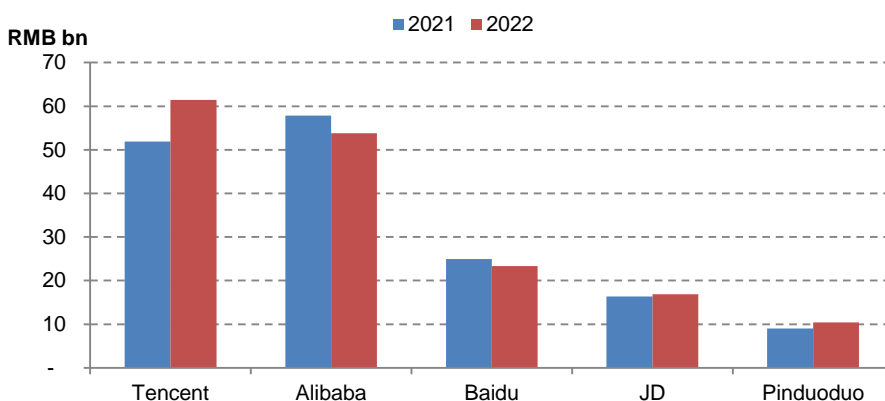


Source(s): Company, ABCI Securities estimates

Tencent has implemented various cost-control measures, including closure of non-core businesses and rationalizing underperforming businesses. We expect such effort to continue and SG&A cost-to-revenue ratio to fall from 24.5% in 2022 to 20.6% in 2024E.

Despite ongoing cost optimization measures, Tencent maintains its industry lead in R&D spending, illustrating the Company's priority in new technology investment, including that in AI, to increase long-term competitiveness. Tencent plans to roll out its AI applications across its ecosystem though the schedule is not confirmed. We believe that these technologies have the potential to improve product innovation, increase monetization opportunities, boost operational efficiency, enhance user experience, and increase user engagement and retention.

Exhibit 6: R&D expense

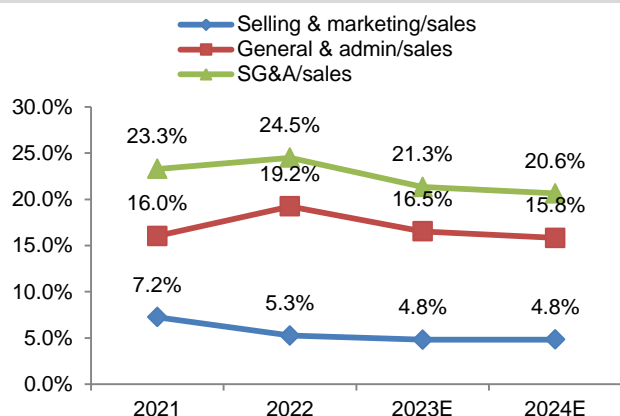


Source(s): Companies, ABCI Securities

Core net margin (excl. impacts of share-based compensation and other non-operating items) would improve from 20.9% in 2022 to 24.2% in 2024E.

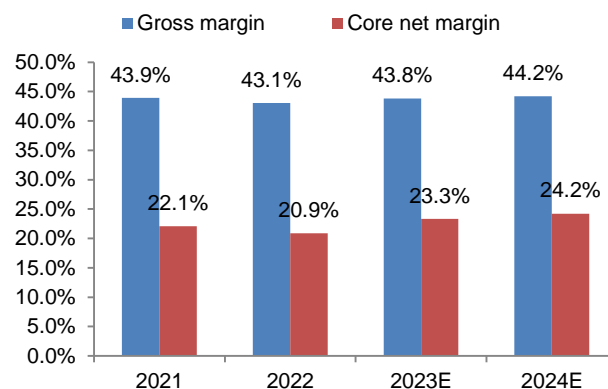


Exhibit 7: Cost trend (% of revenue)



Source(s): Company, ABCI Securities estimates

Exhibit 8: Margin outlook



Source(s): Company, ABCI Securities estimates

Exhibit 9: Forecast changes for 2023E

(RMB mn)	Old	New	Diff.	Comment
Revenue	601,520	610,523	1%	
Core profit	139,168	142,356	2%	Cost optimization

Source(s): ABCI Securities estimates

Exhibit 10: Forecast changes for 2024E

(RMB mn)	Old	New	Diff.	Comment
Revenue	673,764	690,782	3%	More new game launches
Core profit	162,270	167,367	3%	Cost optimization

Source(s): ABCI Securities estimates

Valuation and recommendation

In our view, a gradually improving operating environment supported by new game launches, recovery in corporate online advertising spending, rising video account monetization, as well as the development of AI product will help support future share performance.

We maintain **BUY** on Tencent for its dominant market position in the online entertainment industry and potential for long-term potential growth in AI development. Our SOTP-based TP is HK\$ 450, implying 27.1/22.7x 2023/24E core P/E.

Exhibit 11: SOTP valuation sensitivity (HK\$ per share)

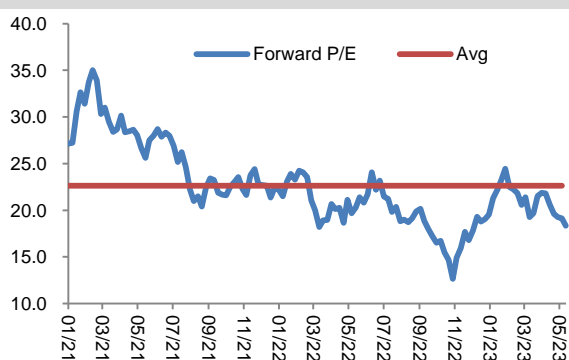
	High	Low	Remarks
Core business	398	299	18x -24x 2023E core P/E
Investments	83	83	Book value
Total	481	382	

Source(s): ABCI Securities estimates

In terms of relative value, its current valuation is less appealing than Alibaba (9988 HK), as shown in the chart below. In our view, Tencent's premium valuation over Alibaba can be explained by the more favorable macro environment of online gaming as opposed to e-commerce, which is experiencing intense competition with increased customer subsidies.

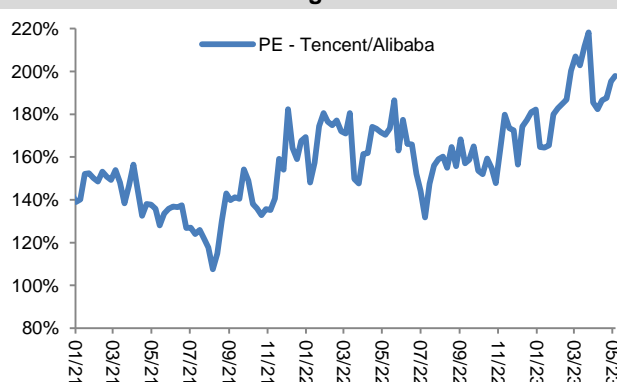
On a standalone basis, the counter is currently trading at about 17x 2024E P/E, representing a reasonable entry-point for long-term investors, in our view.

Exhibit 12: Forward P/E



Source(s): Bloomberg, ABCI Securities

Exhibit 13: Relative value against Alibaba

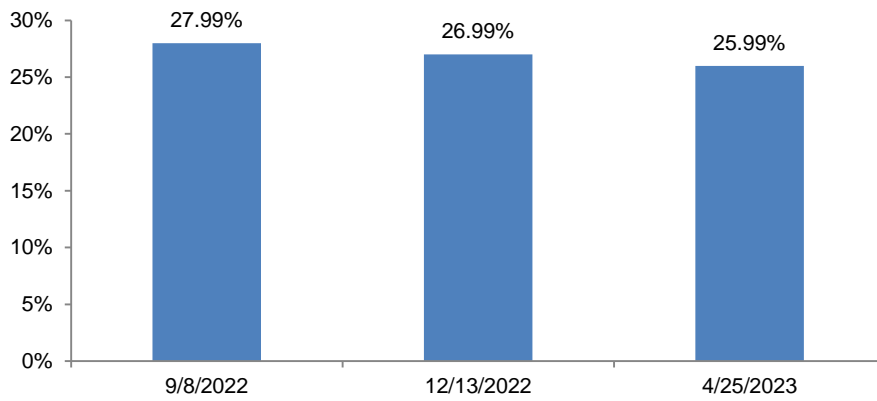


Source(s): Bloomberg, ABCI Securities

Regarding Naspers' divestment of Tencent's share, its stake in Tencent has been gradually reduced from 27.99% in Sep 8, 2022 to 25.99% in Apr 25, 2023, implying a disposal pace of about 1ppt per 3-4 months. In our view, such disposal pace is orderly and within market expectation.



Exhibit 14: Naspers' stakes in Tencent



Source(s): HKEX, ABCI Securities



Risk factors

Market competition

The rise of emerging forms of online entertainment such as short video apps could steal shares from online long video in the online entertainment market.

Tightening regulation on online gaming

Mobile gaming revenue could be impacted should the regulatory further tighten or fail to relax new game approval. Other measures, such as increased curfew on online gaming for minors, may also affect revenue.

Strict regulation on internet finance

As the Company is exposed to the internet finance market via its commercial payment business and wealth management, further regulatory measures may affect business performance

Non-GAAP financials

The Company has disclosed the non-GAAP financial metric, such as the non-GAAP net profit, to supplement its GAAP financial measures. Historically, there were differences between its GAAP net profit and non-GAAP net profit due to inclusion of items such as share-based compensation, impairment, fair valuation changes of investment, and disposal gains of asset in the former.

While investors tend to exclude these items when performing analysis given their non-cash nature, we believe these non-GAAP financial measures should only serve as reference.



Financial forecast

Consolidated income statement (2021A-2024E)

FY Ended Dec 31 (RMB mn)	2021A	2022A	2023E	2024E
VAS	291,572	287,565	314,259	355,567
Online advertising	88,666	82,729	97,265	116,472
FinTech and business service	172,195	177,064	191,229	210,352
Others	7,685	7,194	7,770	8,391
Total revenue	560,118	554,552	610,523	690,782
Cost of sales	(314,174)	(315,806)	(342,948)	(385,297)
Gross profit	245,944	238,746	267,575	305,485
Interest income	6,650	8,592	8,050	8,050
Other gains/losses	149,467	124,293	68,000	73,000
Selling & marketing expenses	(40,594)	(29,229)	(29,357)	(33,315)
General & admin expenses	(89,847)	(106,696)	(100,916)	(109,315)
Operating Profits	271,620	235,706	213,352	243,905
Finance cost	(7,114)	(9,352)	(9,500)	(9,800)
Share of profit of investments in associates	(16,444)	(16,129)	(5,000)	(3,000)
Profit before tax	248,062	210,225	198,852	231,105
Tax	(20,252)	(21,516)	(36,086)	(42,420)
Profit after tax	227,810	188,709	162,766	188,685
Minority interests	2,988	466	1,989	2,311
Net profit	224,822	188,243	160,777	186,374
Share based compensation	30,070	32,651	33,579	37,993
Gain/losses from investee companies	(166,661)	(164,840)	(72,000)	(77,000)
Amortization and impairment	36,382	57,206	20,000	20,000
Other non-core items	(825)	2,389	(0)	(0)
Non-GAAP net profit (core profit)	123,788	115,649	142,356	167,367
Growth				
Total revenue (%)	16.2	(1.0)	10.1	13.1
Gross Profits (%)	11.0	(2.9)	12.1	14.2
Operating Profits (%)	47.4	(13.2)	(9.5)	14.3
Net Profits (%)	40.6	(16.3)	(14.6)	15.9
Non-GAAP net profit (%)	0.9	(6.6)	23.1	17.6
Operating performance				
Gross margin (%)	43.9	43.1	43.8	44.2
Operating margin (%)	48.5	42.5	34.9	35.3
Net margin (%)	40.1	33.9	26.3	27.0
Non-GAAP net margin (%)	22.1	20.9	23.3	24.2
ROAE (%)	27.2	22.7	18.4	17.4
ROAA (%)	15.3	11.8	9.9	10.4

Source(s): The Company, ABCI Securities estimates

Notes: VAS includes online games and social network

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 (2021A-2024E)

As of Dec 31 (RMB mn)	2021A	2022A	2023E	2024E
Fixed assets	106,550	104,336	109,336	117,336
Intangible assets	171,376	161,802	143,802	129,802
Investment in associates and JV	324,449	259,702	254,702	251,702
Financial assets	442,441	391,332	421,332	451,332
Term deposit	19,491	28,336	36,837	47,888
Other non-current assets	63,245	66,634	68,472	70,401
Total non-current assets	1,127,552	1,012,142	1,034,480	1,068,461
Cash & equivalents	167,966	156,739	172,277	203,238
Restricted cash	2,476	2,783	2,922	3,068
Term deposit	83,813	104,776	157,164	204,313
Account receivables	49,331	45,467	55,198	62,454
Deposit, prepayments and other assets	65,390	76,685	80,519	84,545
Inventories	1,063	2,333	2,450	2,572
Other current assets	114,773	177,206	29,241	29,241
Total current assets	484,812	565,989	499,771	589,432
Total assets	1,612,364	1,578,131	1,534,252	1,657,893
Accounts payable	109,470	92,381	109,599	123,134
Other payables & accruals	60,582	61,139	64,196	67,406
Borrowings and notes	19,003	22,026	22,026	22,026
Deferred revenue	93,292	88,570	92,999	97,648
Other current liabilities	120,751	170,088	22,123	22,123
Total current liabilities	403,098	434,204	310,943	332,337
Loans and bonds payables	282,526	312,337	312,337	312,337
Deferred revenue	4,526	3,503	3,678	3,862
Other non-current liabilities	45,521	45,227	45,835	46,474
Total non-current liabilities	332,573	361,067	361,850	362,673
Total liabilities	735,671	795,271	672,793	695,009
Net current assets	81,714	131,785	188,828	257,095
Equity attributable to shareholders	806,299	721,391	798,001	897,115
Non-controlling interests	70,394	61,469	63,458	65,769
Total equity	876,693	782,860	861,458	962,883

Source(s): The Company, ABCI Securities estimates

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

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

Consolidated cash flows statement (2021A-2024E)

As of Dec 31 (RMB mn)	2021A	2022A	2023E	2024E
PBT	248,062	210,225	198,852	231,105
Depreciation and amortization	57,670	61,216	63,000	66,000
Other non-cash adjustments	(131,437)	(106,878)	(69,507)	(78,427)
Change in working capital	891	(18,472)	(51,060)	(49,464)
Operating cash flow	175,186	146,091	141,284	169,214
Acquisition of fixed asset	(29,302)	(22,679)	(35,000)	(40,000)
Net purchase of investments	(81,250)	(39,247)	(15,000)	(20,000)
Other investment cash flow	(67,997)	(42,945)	(30,000)	(30,000)
Investing cash flow	(178,549)	(104,871)	(80,000)	(90,000)
Financing cash flow	21,620	(59,953)	(45,746)	(48,253)
Fx effect	(3,089)	7,506	-	-
Net cash flow	15,168	(11,227)	15,538	30,961

Source(s): The Company, ABCI Securities estimates

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

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

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ABCI Securities Company Limited and/or its affiliates, within the past 12 months, have investment banking relationship with Tencent (700 HK) and Alibaba (9988 HK).

Definition of equity rating

Rating	Definition
Buy	Stock return rate \geq Market return rate (9%)
Hold	- Market return rate (-9%) \leq Stock return rate < Market return rate (+9%)
Sell	Stock return < - Market return (-9%)

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 2006 (HSI total return index 2006-22 averaged at 8.4%)

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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