

Tencent (700 HK)

A better 2H23 for online gaming

- Online games could see a better 2H23 driven by more new game launches
- Online advertising remains the bright spot driven by Video Accounts and technological improvement
- Recent launch of Model-as-a-Service (MaaS) indicates ongoing development of AI initiatives
- Maintain **BUY** on Tencent for its dominant market position in the online entertainment industry and potential in AI development

Strong online advertising mitigates temporary slowdown in online gaming.

Domestic gaming revenue was flat YoY vs. 11% YoY in the previous quarter due to reduced release of highly commercial content during the quarter. Management expects the segment to resume growth in 3Q23 driven by more new game launches. Online advertising is a bright spot with revenue growth accelerating to 34% YoY during the quarter vs. 17% YoY growth in the previous quarter, thanks to Video Accounts and ongoing technological improvements via machine learning.

Launch of Model-as-a-Service (MaaS). Recent launch of MaaS solutions indicates ongoing development of AI initiatives. In our view, leading platforms such as Tencent and Alibaba (9988 HK) are focusing on enterprise AI market instead of consumer AI market at present to minimize regulatory risk.

Ongoing improvement in profitability. Margin improves in 2Q23 driven by cost control and improving business mix. Core net margin climbed from 21.0% in 2Q22 to 25.2% in 2Q23, resulting in a 33% YoY core net profit growth in 2Q23.

Maintain BUY on Tencent for its dominant market position in the online entertainment industry and long-term potential in AI development. Although online gaming slowed in 2Q23, the segment will likely recover in 2H23. Our SOTP-based TP is HK\$ 450, implying 23.7x 2024E core P/E. The counter is currently trading at about 17.6x 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	613,323	677,918
Chg (% YoY)	16.2	(1.0)	10.6	10.5
Net profit (RMB mn)	224,822	188,243	99,583	122,443
Chg (% YoY)	40.6	(16.3)	(47.1)	23.0
Non-GAAP net profit (RMB mn)	123,788	115,649	142,316	167,728
Chg (% YoY)	0.9	(6.6)	23.1	17.9
EPS (RMB)	23.6	19.8	10.5	12.9
Chg (% YoY)	40.1	(16.3)	(47.1)	23.0
Non-GAAP EPS (RMB)	13.0	12.1	14.9	17.6
Chg (% YoY)	0.4	(6.6)	23.1	17.9
Core P/E (x)	23.8	25.5	20.7	17.6
P/B (x)	3.7	4.1	3.6	3.2
ROAE (%)	27.2	22.7	12.0	13.1
ROAA (%)	15.3	11.8	6.3	7.4
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

Company Report

Aug 17, 2023

Rating: BUY

TP: HK\$ 450

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Share price (HK\$)	332.8
Est. share price return	35.2%
Est. cash dividend yield	0.7%
Est. total return	35.9%
Previous Rating & TP	BUY, HK\$450
Previous Report Date	May 22, 2023

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L(HK\$)	416.6/180.5
Issued shares (mn)	9,556
Market cap (HK\$ mn)	3,180,237
Avg daily turnover (HK\$ mn)	6,321
Major shareholder(s)	
Naspers	25.9%
Huateng Ma	8.4%

Source(s): Bloomberg, ABCI Securities

Share Performance (%)

	Absolute	Relative*
1-mth	-5.3	0.3
3-mth	-2.6	3.7
6-mth	-10.6	0.8

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities

Advertising as the bright spot

In 2Q23, revenue increased by 11% YoY to RMB 149bn, 2% below market expectation. In addition, non-GAAP net profit increased by 33% YoY to RMB 37.5bn, 4% above market expectation on better-than-expected margin improvement. Online advertising is a bright spot during the quarter, mitigating the moderation of online gaming.

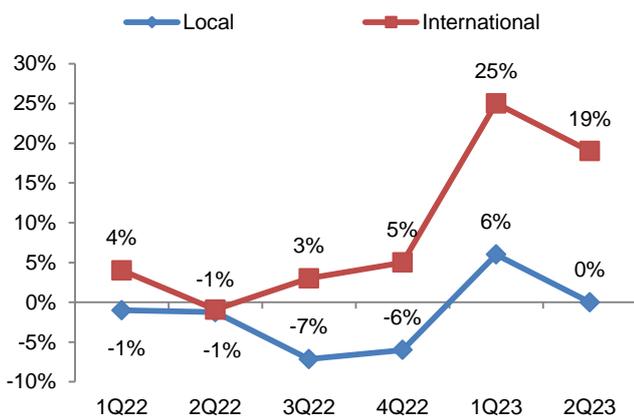
Online gaming revenue increased moderately by 5% YoY during the quarter vs. 11% YoY in the previous quarter. In particular, domestic gaming revenue was flat YoY vs. 11% YoY in the previous quarter due to reduced release of highly commercial content during the quarter. Management, however, expects the segment to resume growth in 3Q23 driven by more new gaming launches.

Online advertising is a bright spot with revenue growth accelerating to 34% YoY during the quarter vs. 17% YoY growth in the previous quarter, driven by Video Accounts and ongoing operational improvements in machine learning, raising the ROI for advertisers. In terms of industries, the Company saw a double-digit growth in advertising spending in every major advertiser category except transportation.

Revenue of FinTech and Business Service increased by 15% YoY during the quarter, driven by recovery of commercial payment activities. The low-single-digit growth in Business services revenue was due to ongoing business adjustments in the cloud segment. The Company launched MaaS solutions that enable enterprises to develop customized AI models. In our view, leading platforms such as Tencent and Alibaba are focusing on enterprise AI market instead of consumer AI market currently to minimize regulatory risk.

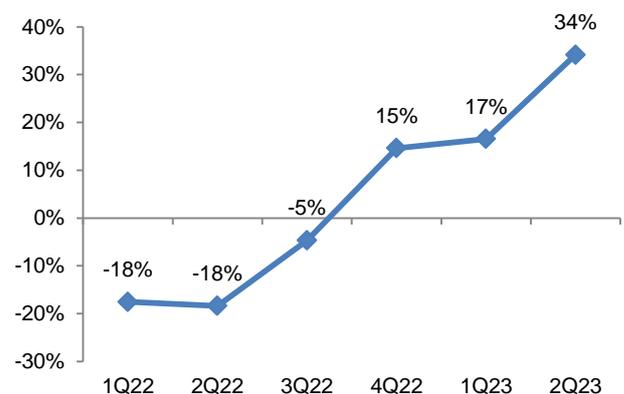
On the cost front, sales and marketing expenses/revenue ratio dropped from 5.9% in 2Q22 to 5.6% in 2Q23, while general and admin expenses/revenue ratio dropped from 19.6% in 2Q22 to 17.0% in 2Q23. Core net margin improved from 21.0% in 2Q22 to 25.2% in 2Q23 driven by cost control and improving business mix.

Exhibit 1: Online gaming revenue growth trend



Source(s): Company, ABCI Securities estimates

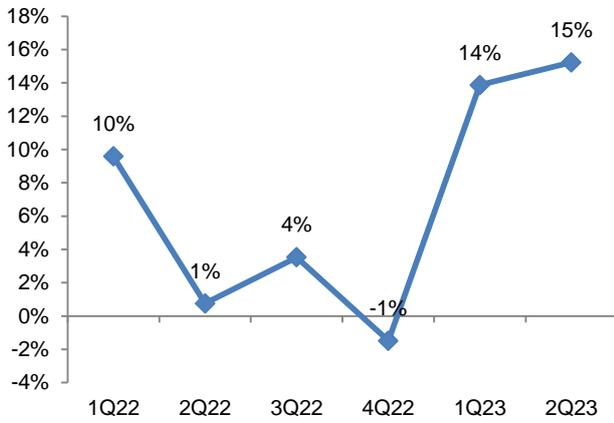
Exhibit 2: Online advertising revenue growth trend



Source(s): Company, ABCI Securities estimates

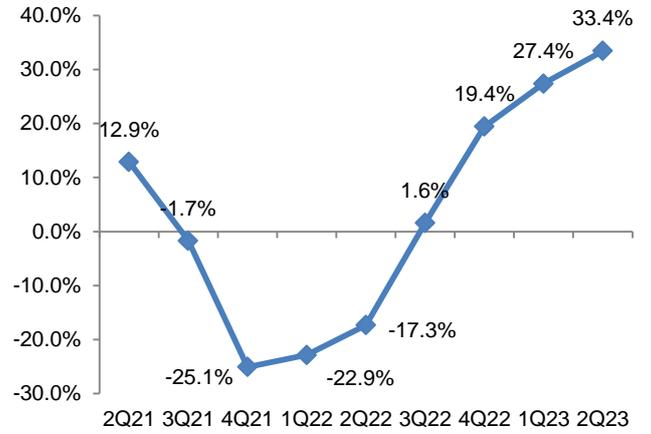


Exhibit 3: FinTech and business service revenue growth trend



Source(s): Company, ABCI Securities estimates

Exhibit 4: Core net profit growth trend



Source(s): Company, ABCI Securities estimates

Financial Outlook

We expect revenue to grow at 11% CAGR in 2022-24E.

Online gaming: We expect revenue to expand at 8% CAGR in 2022-24E on new game launch and diminishing impact from minor protection measures. In particular, we expect online gaming revenue growth to improve to 6% and 8% in 3Q23 and 4Q23 respectively vs. 5% YoY in 2Q23 driven by more new game launches. For 2024E, we expect a 9% YoY segment revenue growth.

Social network: We expect social network revenue to increase at 4% CAGR in 2022-24E driven by ongoing content enhancement and short-video initiatives.

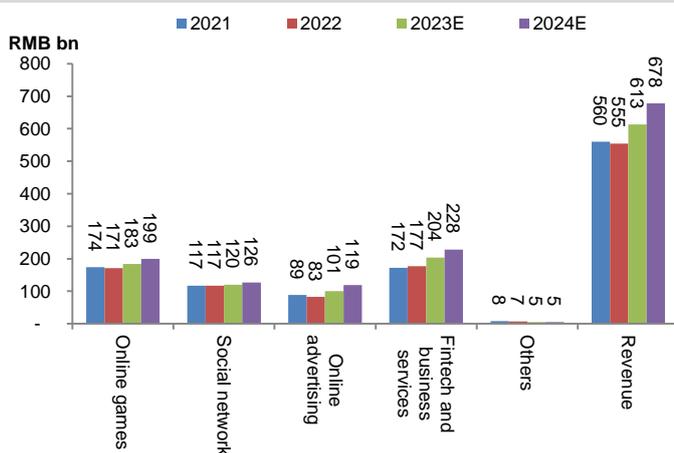
Online advertising: We expect the segment revenue growth to recover to 20% CAGR in 2022-24E, driven by ongoing industry recovery and ramp-up of in-feed advertising in Video Accounts.

FinTech and business service: We expect segment revenue to increase 12% in 2022-24E driven by retail commercial activities. In addition, the Company has recently launched the MaaS solutions for cloud business, which allow enterprises to develop customized AI models. We believe it could be a new growth driver for the cloud business in the medium term.

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 21.2% in 2024E.

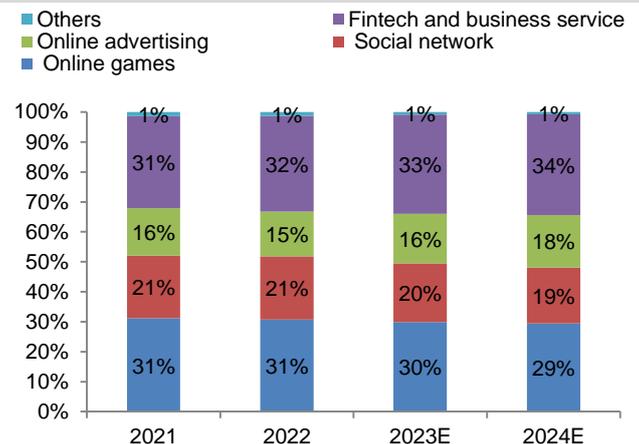
Core net margin (excl. impacts of share-based compensation and other non-operating items) would improve from 20.9% in 2022 to 24.7% in 2024E.

Exhibit 5: Revenue outlook



Source(s): Company, ABCI Securities estimates

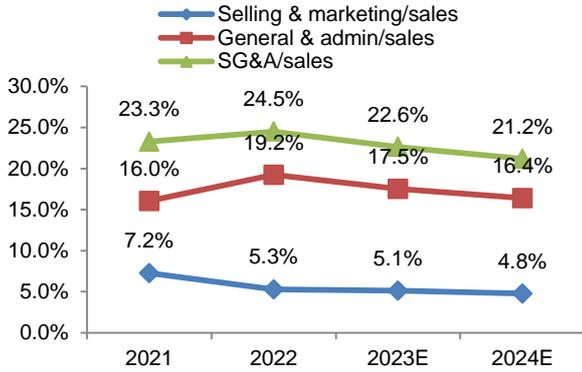
Exhibit 6: Revenue mix outlook



Source(s): Company, ABCI Securities estimates

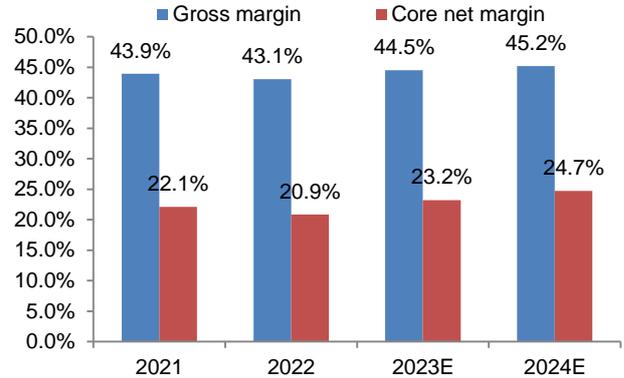


Exhibit 7: Cost trend (% of revenue)



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	610,523	613,323	0.5%	Fine-tuning segment growth assumptions
Core profit	142,356	142,316	0%	

Source(s): ABCI Securities estimates

Exhibit 10: Forecast changes for 2024E

(RMB mn)	Old	New	Diff.	Comment
Revenue	690,782	677,918	-2%	Revised down VAS and online advertising but revising up FinTech and Business Service
Core profit	167,367	167,728	0%	

Source(s): ABCI Securities estimates

Valuation and recommendation

We maintain **BUY** on Tencent for its dominant market position in the online entertainment industry and potential in AI development. Although online gaming saw a temporary slowdown in 2Q23, growth will likely rebound in 2H23. In addition, online advertising growth momentum remains strong with ongoing margin improvement.

Our SOTP-based TP is HK\$ 450, implying 23.7x 2024E core P/E.

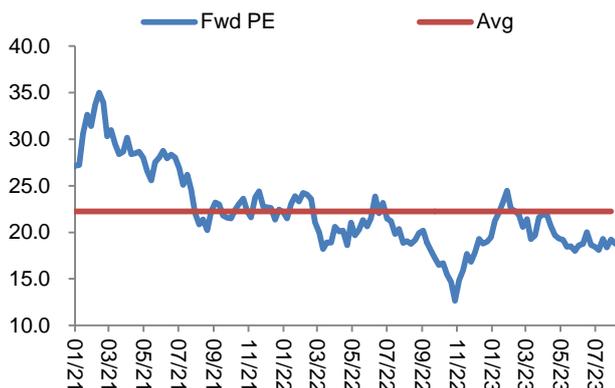
Exhibit 11: SOTP valuation sensitivity (HK\$ per share)

	High	Low	Remarks
Core business	437	304	16x -23x 2024E core P/E
Investments	81	81	Book value
Total	518	385	

Source(s): ABCI Securities estimates

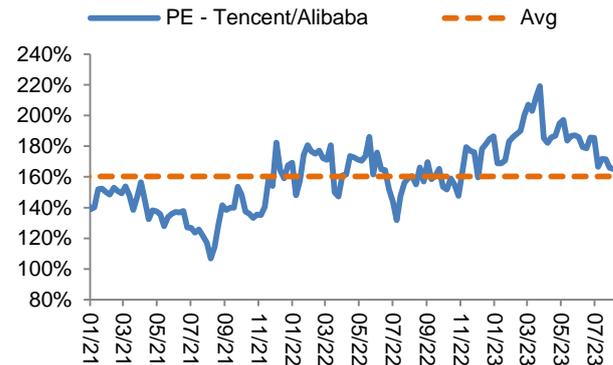
The counter is currently trading at about 17.6x 2024E P/E, representing a reasonable entry point for long-term investors, in our view. In addition, it is also trading at a reasonable relative value against Alibaba, as illustrated in the chart below.

Exhibit 12: Forward P/E



Source(s): Bloomberg, ABCI Securities

Exhibit 13: Relative value against Alibaba

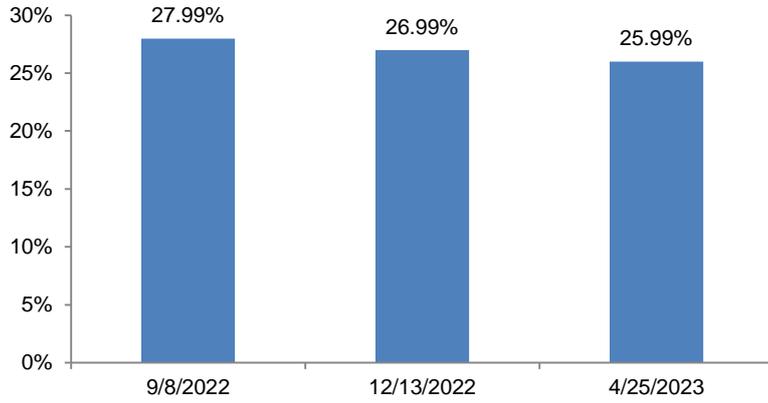


Source(s): Bloomberg, ABCI Securities

Regarding Naspers' divestment of Tencent's share, its stake in Tencent has 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 regulation tightens or more stringent requirements for new game approval are imposed. 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	303,799	325,803
Online advertising	88,666	82,729	100,865	119,021
FinTech and business service	172,195	177,064	203,624	228,058
Others	7,685	7,194	5,036	5,036
Total revenue	560,118	554,552	613,323	677,918
Cost of sales	(314,174)	(315,806)	(340,203)	(371,463)
Gross profit	245,944	238,746	273,121	306,455
Interest income	6,650	8,592	8,050	8,050
Other gains/losses	149,467	124,293	2,500	3,500
Selling & marketing expenses	(40,594)	(29,229)	(31,341)	(32,349)
General & admin expenses	(89,847)	(106,696)	(107,456)	(111,201)
Operating Profits	271,620	235,706	144,873	174,455
Finance cost	(7,114)	(9,352)	(9,500)	(9,800)
Share of profit of investments in associates	(16,444)	(16,129)	1,500	1,800
Profit before tax	248,062	210,225	136,873	166,455
Tax	(20,252)	(21,516)	(35,921)	(42,348)
Profit after tax	227,810	188,709	100,952	124,107
Minority interests	2,988	466	1,369	1,665
Net profit	224,822	188,243	99,583	122,443
Share based compensation	30,070	32,651	33,733	37,286
Gain/losses from investee companies	(166,661)	(164,840)	(1,000)	(2,000)
Amortization and impairment	36,382	57,206	10,000	10,000
Other non-core items	(825)	2,389	(0)	(0)
Non-GAAP net profit (core profit)	123,788	115,649	142,316	167,728
Growth				
Total revenue (%)	16.2	(1.0)	10.6	10.5
Gross Profits (%)	11.0	(2.9)	14.4	12.2
Operating Profits (%)	47.4	(13.2)	(38.5)	20.4
Net Profits (%)	40.6	(16.3)	(47.1)	23.0
Non-GAAP net profit (%)	0.9	(6.6)	23.1	17.9
Operating performance				
Gross margin (%)	43.9	43.1	44.5	45.2
Operating margin (%)	48.5	42.5	23.6	25.7
Net margin (%)	40.1	33.9	16.2	18.1
Non-GAAP net margin (%)	22.1	20.9	23.2	24.7
ROAE (%)	27.2	22.7	12.0	13.1
ROAA (%)	15.3	11.8	6.4	7.6

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	261,202	263,002
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	1,040,980	1,079,761
Cash & equivalents	167,966	156,739	219,709	259,385
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	55,451	61,291
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	547,456	644,416
Total assets	1,612,364	1,578,131	1,588,437	1,724,177
Accounts payable	109,470	92,381	108,722	118,712
Other payables & accruals	60,582	61,139	64,196	67,406
Borrowings and notes	19,003	22,026	72,026	72,026
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	360,066	377,916
Loans and bonds payables	282,526	312,337	302,337	302,337
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	351,850	352,673
Total liabilities	735,671	795,271	711,916	730,588
Net current assets	81,714	131,785	187,390	266,500
Equity attributable to shareholders	806,299	721,391	813,683	929,086
Non-controlling interests	70,394	61,469	62,838	64,502
Total equity	876,693	782,860	876,521	993,588

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	136,873	166,455
Depreciation and amortization	57,670	61,216	63,000	66,000
Other non-cash adjustments	(131,437)	(106,878)	(4,688)	(8,863)
Change in working capital	891	(18,472)	(52,191)	(51,592)
Operating cash flow	175,186	146,091	142,994	172,001
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)	(24)	(42,325)
Fx effect	(3,089)	7,506	-	-
Net cash flow	15,168	(11,227)	62,970	39,676

Source(s): The Company, ABCI Securities estimates

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

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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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