

Tencent (700 HK)

Improving operating environment

- Online advertising is turning around driven by Video Accounts and improved demand from some industries
- Improving online gaming business with more new games in coming quarters
- Solid foundation of AI initiatives supported by high R&D spending

Ongoing operational improvement. Online advertising had a turnaround in 4Q22 with a 15% YoY revenue growth vs. 5% YoY decline in 3Q22, driven by Video Accounts and improved demand from a few industries. Online gaming revenue dropped 2% YoY in 4Q22 vs. 4% YoY decline in 3Q22, indicating a stabilizing operating environment. We expect a gradually improving operating environment in coming quarters driven by low base and potential new game launches. In addition, commercial payment volume has resumed a double-digit YoY growth QTD in 1Q23 amid consumption recovery, which bodes well for the FinTech business going forward.

Solid foundation for AI initiatives. In our view, R&D resource is the key determinant of long-term success in AI development. Tencent's R&D spending has been among the highest among peers thanks to its strong financial resources. It has been researching AI technologies, including computer vision, speech recognition, natural language processing. Going forward, it plans to roll out AI applications across its platform, potentially including generative AI features in WeChat and QQ.

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. In our view, a gradually improving operating environment supported by new game launches and rising video account monetization. Potential development of AI generative products will support future share performance.

Results and Valuation

	2021A	2022A	2023E	2024E
Revenue (RMB mn)	560,118	554,552	601,520	673,764
Chg (% YoY)	16.2	(1.0)	8.5	12.0
Net profit (RMB mn)	224,822	188,243	158,084	182,213
Chg (% YoY)	40.6	(16.3)	(16.0)	15.3
Non-GAAP net profit (RMB mn)	123,788	115,649	139,168	162,270
Chg (% YoY)	0.9	(6.6)	20.3	16.6
EPS (RMB)	23.6	19.8	16.6	19.1
Chg (% YoY)	40.1	(16.3)	(16.0)	15.3
Non-GAAP EPS (RMB)	13.0	12.1	14.6	17.0
Chg (% YoY)	0.4	(6.6)	20.3	16.6
Core P/E (x)	25.4	27.2	22.6	19.4
P/B (x)	3.9	4.4	3.5	2.9
ROAE (%)	27.2	22.7	18.1	17.1
ROAA (%)	15.3	11.8	9.8	10.2
Cash DPS(HKD)	1.60	2.40	2.40	2.40
Cash dividend Yield (%)	0.4	0.6	0.6	0.6

Source(s): Bloomberg, ABCI Securities estimates

CNY/HKD=1.14

Company Report

Mar 24, 2023

Rating: BUY

TP: HK\$ 450

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Share price (HK\$)	376.8
Est. share price return	19.4%
Est. cash dividend yield	0.6%
Est. total return	20.0%
Previous Rating & TP	BUY, HK\$390
Previous Report Date	Dec 29, 2022

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L(HK\$)	416.6/180.5
Issued shares (mn)	9,568
Market cap (HK\$ mn)	3,605,222
Avg daily turnover (HK\$ mn)	8,056
Major shareholder(s)	
Naspers	26.9%
Huateng Ma	8.4%

Source(s): Bloomberg, ABCI Securities

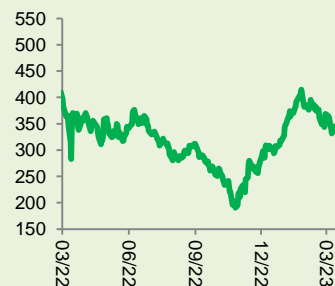
Share Performance (%)

	Absolute	Relative*
1-mth	8.4	8.7
3-mth	24.5	22.7
6-mth	45.0	33.8

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance(HK\$)



Source(s): Bloomberg, ABCI Securities

Ongoing operational improvement

In 4Q22, revenue increased 1% YoY to RMB 145bn. In addition, non-GAAP net profit increased 19% YoY to RMB 29.7bn.

Online gaming revenue dropped 2% YoY during the quarter vs. the 4% YoY decline in 3Q22, indicating a stabilizing operating environment. Domestic gaming revenue dropped 6% YoY vs. 7% YoY drop in 3Q22 due to lower user spending and minor protection measures. International gaming revenue increased 5% YoY vs. 3% YoY in the previous quarter, thanks to VALORANT and League of Legends, in addition to more new game launches. We expect improving operating environment in coming quarters for both domestic and international gaming segments due to the low base, a better operating environment, as well as more new game launches backed by the increasing no. of approvals.

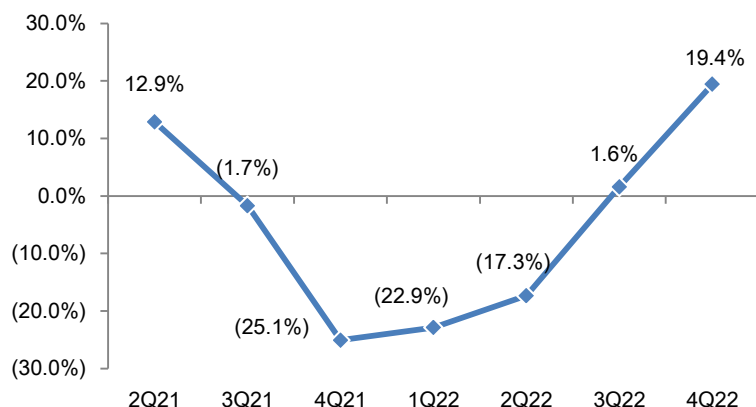
Social network revenue dropped by 2% YoY in during the quarter due to lower revenue from music and games related live streaming services.

Online advertising turned around with 15% YoY revenue growth vs. 5% YoY decline in 3Q22, driven by ecommerce platforms, FMCG, and game advertisers. Within online advertising, social and other advertising jumped 17% YoY in revenue on gains in Video Accounts and Mini Programs advertising. On the other hand, media advertising revenue showed a 4% YoY growth vs. the 26% YoY decline in 3Q22 on increased monetisation for ad-supported music content.

Revenue of FinTech and business service dropped 1% YoY during the quarter vs. 4% growth in 3Q22 due to pandemic reasons and rationalization of loss-making IT projects. On a positive note, commercial payment volume resumed a double-digit YoY growth QTD in 1Q23 amid consumption recovery.

On the cost front, sales and marketing expenses/revenue ratio dropped from 8.1% from 4Q21 to 4.2% in 4Q22, which mitigates the rise in general and admin expenses/revenue ratio that rose from 16.9% to 18.8% during the same period on increased R&D effort. Core net margin was 20.5% during the quarter vs. 17.3% in 4Q21 and 23.0% in 3Q22.

Exhibit 1: Core net profit growth trend



Source(s): Company, ABCI Securities

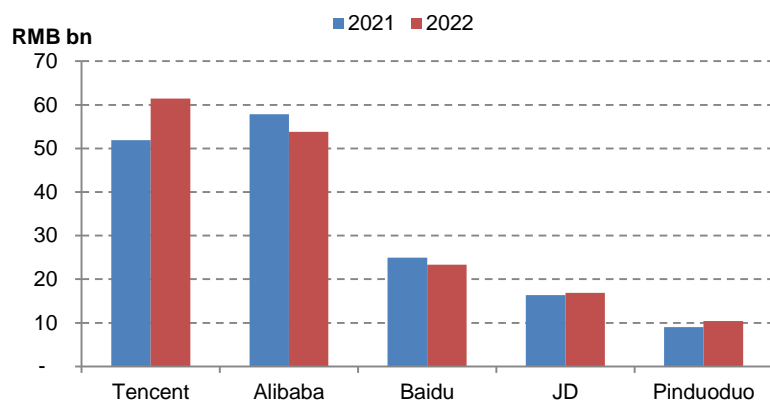


R&D spending key to AI development

In our view, R&D resources and capabilities will be the key in determining long-term competitiveness of AI products on any platforms.

Among the major online platforms in China, Alibaba and Tencent have been the leaders in R&D spending. Their larger operational scale and stronger financial position have enabled them to continue investing in new technologies, including AI, to increase long-term competitiveness.

Exhibit 2: R&D expense



Source(s): Companies, ABCI Securities

Tencent's AI Lab has been researching in various domains of AI technologies such as computer vision, speech recognition, natural language processing, machine learning, and reinforcement learning. Its major application categories include content, games, social networking, and platform-based tools. E.g., it has applied AI-based audio compression (AI codec) to selected games for better user experience. It has also developed a training environment for its flagship game "Honor of Kings Arena" using AI technology.

Going forward, it plans to roll out its AI applications across its ecosystem. For example, the Company might integrate generative AI into WeChat and QQ. In our view, these technologies could potentially enhance product innovation, monetization, operating efficiency, overall user experience, and stickiness.

Exhibit 3: Tencent AI Lab: Research application area

Application area	Details
Social AI	Intelligent assistants, customer service robots in WeChat and QQ.
Game AI	Weiqi AI superb and Tencent games
Content AI	Search, personalized recommendation, content generation
Platform AI	Machine translation, chat robots, voice recognition, sensitivity analysis;

Source(s): Company, ABCI Securities

Financial Outlook

We expect revenue to grow at 10% CAGR in 2022-24E.

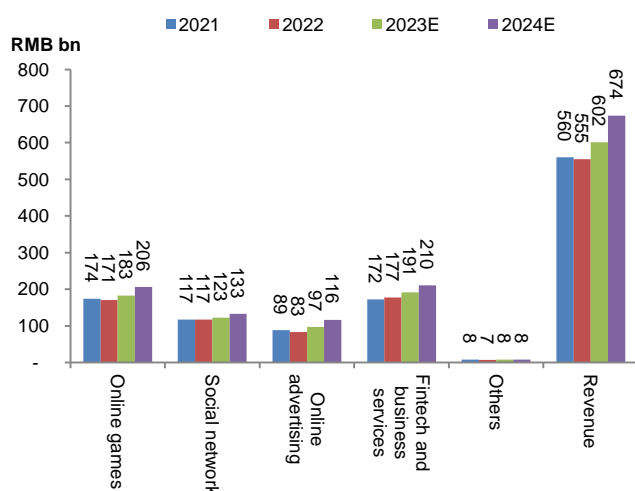
Online gaming: We expect revenue to expand at 10% CAGR in 2022-24E on new game launch and easier base. In our view, the resumption of new game approval signals a stabilizing regulatory environment. The Company has received several new game approvals such as “Pokemon Unite” and “Lost Ark” in recent months, meaning that more new games would start generating revenue in coming quarters. In our view, both the domestic and international gaming market would rebound in 2023, especially with the low base in 2022.

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.

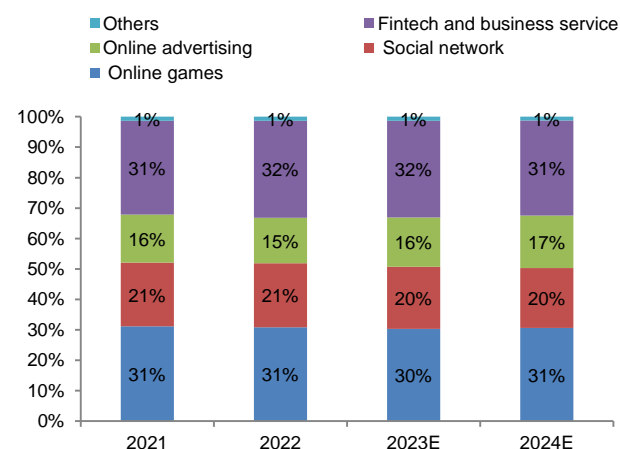
FinTech and business service: We expect segment revenue to increase 9% in 2022-24E on recovery of retail commercial activities in the post-COVID era, which mitigates the near-term impact of rationalizing cloud business (reducing low-margin projects).

Exhibit 4: Revenue outlook



Source(s): Company, ABCI Securities estimates

Exhibit 5: Revenue mix outlook



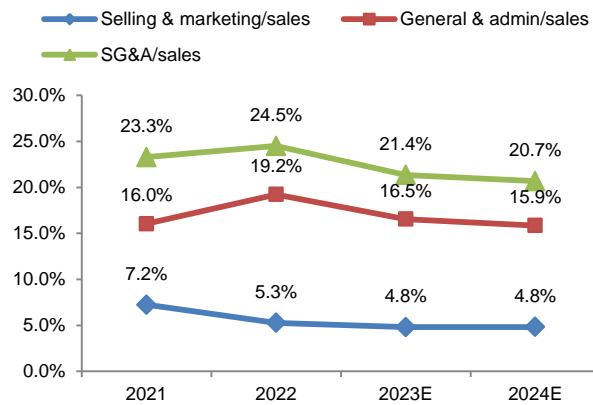
Source(s): Company, ABCI Securities estimates

Tencent has implemented various cost-control measures, including closing down non-core businesses and rationalizing underperforming businesses. We expect such effort to continue and SG&A cost-to-revenue ratio would fall from 24.5% in 2022 to 20.7% in 2024E.

Core net margin (excl. impacts of share-based compensation and other non-operating items) would improve from 20.9% in 2022 to 24.1% in 2024E.

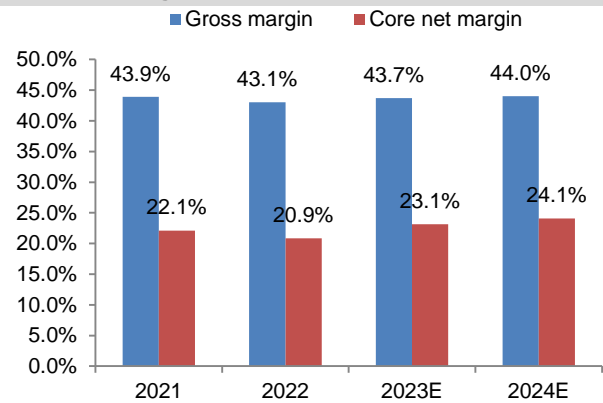


Exhibit 6: Cost trend (% of revenue)



Source(s): Company, ABCI Securities estimates

Exhibit 7: Margin outlook



Source(s): Company, ABCI Securities estimates

Exhibit 8: Forecast changes for 2023E

(RMB mn)	Old	New	Diff.	Comment
Revenue	594,116	601,520	1%	Online advertising recovery
Core profit	133,054	139,168	5%	Cost optimization

Source(s): ABCI Securities estimates

Valuation and recommendation

Maintain **BUY** on Tencent given its leading market position in the online entertainment industry and its long-term potential on AI development. Our SOTP-based TP is HK\$ 450.

Exhibit 9: SOTP valuation sensitivity (HK\$ per share)

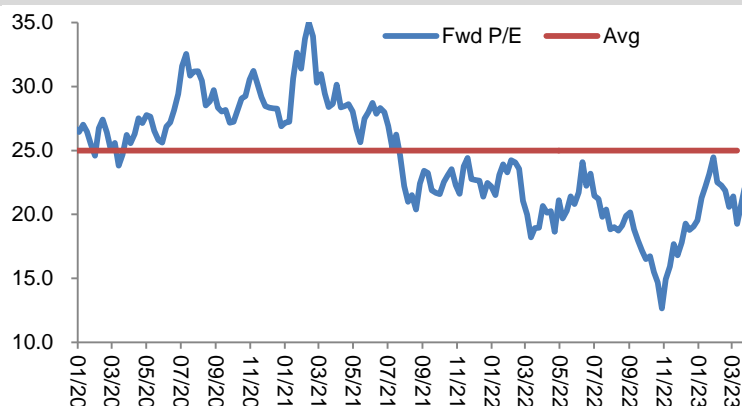
	High	Low	Remarks
Core business	400	300	18x -24x 2023E core P/E
Investments*	80	80	Book value
Total	480	380	

Source(s): ABCI Securities estimates

*Excluding investment on Meituan

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.

Exhibit 10: Forward P/E



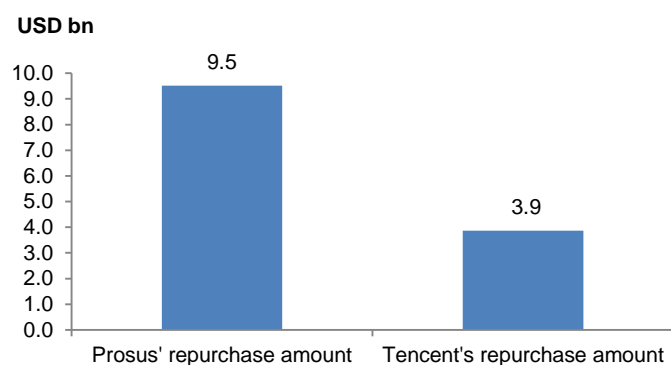
Source(s): Bloomberg, ABCI Securities

Regarding Naspers' orderly divestment of Tencent's share, we estimate the net selling pressure to be equivalent to ~2.5% of the Group's average trading volume since the beginning of the program in June 2022, which is largely in line with the market expectation.

To recap, Tencent's strategic shareholders, Naspers/Prosus (Prosus is majority owned by Naspers), announced in late June 2022 to dispose of Tencent's stakes orderly in the open market to fund its own share repurchase program. Between June 28, 2022 and Mar 10, 2023, Prosus spent ~US\$ 9.5bn in share repurchase. Tencent has allocated ~US\$ 3.9bn on share repurchase over the same period, offsetting some of the selling pressure from Prosus. If we assume Prosus' repurchase is fully funded by disposal of Tencent's shares, the corresponding net selling pressure of Tencent would be equivalent to ~ 2.5% of Tencent's average trading volume during the same period.



Exhibit 11: Repurchase amount –Prosus vs. Tencent



Source(s): Companies, Bloomberg, ABCI Securities

Note: Dated between June 28, 2022 and 10 Mar, 2023

Exhibit 12: TP changes (HK\$ per share)

Old	New	Remarks
390	450	SOTP based; TP implies 23.2x 2024E core P/E vs. 20.1x previously

Source(s): ABCI Securities estimates



農銀國際

ABC INTERNATIONAL

ABC SECURITIES COMPANY LIMITED

Tencent (700 HK, BUY)

China Internet Sector

Mar 24, 2023

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.

Tightening regulation on internet finance

As the Group 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 Group 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	305,256	338,549
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	601,520	673,764
Cost of sales	(314,174)	(315,806)	(338,608)	(377,129)
Gross profit	245,944	238,746	262,912	296,636
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)	(28,958)	(32,552)
General & admin expenses	(89,847)	(106,696)	(99,542)	(106,811)
Operating Profits	271,620	235,706	210,462	238,323
Finance cost	(7,114)	(9,352)	(9,500)	(9,800)
Share of profit of investments in associates	(16,444)	(16,129)	(10,000)	(8,000)
Profit before tax	248,062	210,225	190,962	220,523
Tax	(20,252)	(21,516)	(30,968)	(36,104)
Profit after tax	227,810	188,709	159,994	184,418
Minority interests	2,988	466	1,910	2,205
Net profit	224,822	188,243	158,084	182,213
Share based compensation	30,070	32,651	33,084	37,057
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	139,168	162,270
Growth				
Total revenue (%)	16.2	(1.0)	8.5	12.0
Gross Profits (%)	11.0	(2.9)	10.1	12.8
Operating Profits (%)	47.4	(13.2)	(10.7)	13.2
Net Profits (%)	40.6	(16.3)	(16.0)	15.3
Non-GAAP net profit (%)	0.9	(6.6)	20.3	16.6
Operating performance				
Gross margin (%)	43.9	43.1	43.7	44.0
Operating margin (%)	48.5	42.5	35.0	35.4
Net margin (%)	40.1	33.9	26.3	27.0
Non-GAAP net margin (%)	22.1	20.9	23.1	24.1
ROAE (%)	27.2	22.7	18.1	17.1
ROAA (%)	15.3	11.8	9.8	10.2

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 balance sheet (2021A-2024E)

As of Dec 31 (RMB mn)	2021A	2022A	2023E	2024E
Fixed assets	106,550	104,336	125,336	146,336
Intangible assets	171,376	161,802	214,802	267,802
Investment in associates and JV	324,449	259,702	249,702	241,702
Financial assets	442,441	391,332	451,332	511,332
Term deposit	19,491	28,336	29,753	31,240
Other non-current assets	63,245	66,634	68,472	70,401
Total non-current assets	1,127,552	1,012,142	1,139,396	1,268,814
Cash & equivalents	167,966	156,739	245,912	340,431
Restricted cash	2,476	2,783	2,922	3,068
Term deposit	83,813	104,776	110,015	115,516
Account receivables	49,331	45,467	51,499	59,531
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	522,558	634,904
Total assets	1,612,364	1,578,131	1,661,954	1,903,717
Accounts payable	109,470	92,381	122,898	136,879
Other payables & accruals	60,582	61,139	64,196	67,406
Borrowings and notes	19,003	22,026	27,026	32,026
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	329,242	356,082
Loans and bonds payables	282,526	312,337	322,337	332,337
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	371,850	382,673
Total liabilities	735,671	795,271	701,092	738,755
Net current assets	81,714	131,785	193,316	278,821
Equity attributable to shareholders	806,299	721,391	897,484	1,099,378
Non-controlling interests	70,394	61,469	63,379	65,584
Total equity	876,693	782,860	960,862	1,164,962

Source(s): The Company, ABCI Securities estimates

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

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Consolidated cash flows statement (2021A-2024E)

As of Dec 31 (RMB mn)	2021A	2022E	2023E	2024E
Net income	248,062	210,225	190,962	220,523
Depreciation and amortization	57,670	61,139	13,000	13,000
Other non-cash adjustments	(131,437)	(63,625)	12,115	8,953
Change in working capital	891	(61,648)	20,170	1,420
Operating cash flow	175,186	146,091	236,248	243,895
Acquisition of fixed asset	(29,302)	(18,014)	(24,000)	(24,000)
Net purchase of investments	(81,250)	(50,000)	(55,000)	(55,000)
Other investment cash flow	(67,997)	(36,857)	(68,000)	(68,000)
Investing cash flow	(178,549)	(104,871)	(147,000)	(147,000)
Financing cash flow	21,620	(59,953)	(75)	(2,376)
Fx effect	(3,089)	7,506	-	-
Net cash flow	15,168	(11,227)	89,173	94,519

Source(s): The Company, ABCI Securities estimates

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ABCI Securities Company Limited and/or its affiliates, within the past 12 months, have investment banking relationship with Tencent 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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