

China / Hong Kong Flash Note

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DBS Group Research . Equity

15 Aug 2019

Tencent (700 HK) : **BUY**

Mkt. Cap: US\$414,102m | **3m Avg. Daily Val:** US\$691.9m

Last Traded Price (14 Aug 2019): HK\$340.00

Price Target 12-mth: HK\$466.0 (37.1% upside)

Analyst

Tsz-Wang TAM, CFA +852 36684195; tszwangtam@db.com
Susanna Chui, CFA +852 36684194; susanna_chui@db.com

Company Guide



Summary of our point of view, and highlights the relevant data points, which are actively tracked

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2Q19 topline missed on advertising growth, but games growing fast

- 2Q19 bottomline in line; but topline missed on lower than expected online advertising growth
- Mobile games revenue back on a growth track from -2% y-o-y in 1Q19 to 25% in 2Q19; expect growth to accelerate in 2H19, driven by Peacekeeper Elite
- Online ad revenue growth moderated from 25% y-o-y in 1Q19 to 16% in 2Q19; but ad loads on Mini Program to ramp up in 2H19
- Reiterate BUY and TP of HK\$466

Forecasts and Valuation

FY Dec (RMB m)	2017A	2018A	2019F	2020F
Turnover	237,760	312,694	402,485	519,902
EBITDA	110,685	128,605	160,368	206,355
Pre-tax Profit	88,215	94,466	116,541	151,810
Net Profit	71,510	78,719	97,180	126,676
Net Pft (Pre Ex) (core profit)	65,126	77,469	100,777	130,824
Net Profit Gth (Pre-ex) (%)	74.0	10.1	23.5	30.4
EPS (RMB)	7.60	8.34	10.29	13.41
EPS (HK\$)	8.49	9.31	11.49	14.98
Core EPS (HK\$)	7.73	9.16	11.92	15.47
Core EPS (RMB)	6.92	8.20	10.67	13.85
EPS Gth (%)	73.4	9.7	23.5	30.4
Core EPS Gth (%)	42.9	18.5	30.1	29.8
Diluted EPS (HK\$)	8.38	9.19	11.34	14.79
DPS (HK\$)	0.97	0.97	1.20	1.56
BV Per Share (HK\$)	30.11	37.90	47.86	60.78
PE (X)	40.2	36.6	29.7	22.8
Core PE (X)	44.1	37.2	28.6	22.0
P/Cash Flow (X)	22.2	20.7	17.6	14.0
P/Free CF (X)	25.0	24.1	20.8	16.6
EV/EBITDA (X)	26.0	22.8	18.2	13.9
Net Div Yield (%)	0.3	0.3	0.4	0.5
P/Book Value (X)	11.3	9.0	7.1	5.6
Net Debt/Equity (X)	CASH	0.0	CASH	CASH
ROAE (%)	33.2	27.2	26.6	27.3
Earnings Rev (%):			Nil	Nil
Consensus EPS (RMB)			9.85	11.99
Other Broker Recs:		B:42	S:0	H:6

Source: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

What's New

2Q19 bottomline in line; but topline missed on online advertising growth. Revenue rose 20.6% y-o-y to Rmb88,821m in 2Q19, lower than market expectations, due to moderate growth of online advertising amid macro headwinds and ad market inventory oversupply. Gross profit margin (GPM) was 44.1% in 2Q19, versus 46.6% in 1Q19 and 46.8% in 2Q18, because of rising content spending of value-added services (i.e. digital content subscription), and fast growing lower-margin FinTech, Business and Other Services. Non-GAAP net profit increased by 19.3% y-o-y to Rmb23,525.m, in line than market expectations.

Mobile games resumed revenue growth from -2% in 1Q19 to 25% in 2Q19; expect growth to accelerate in 2H19, driven by Peacekeeper Elite. Value-added services (57.1% of 2Q19 revenue) grew by 14.3% y-o-y to Rmb48,080m (PC games -9.3%, mobile games +25.0%, social networks +24.3%). The acceleration in mobile game revenue growth was attributed to launch of survival game, Peacekeeper Elite, in May 2019, which was top 2 in China's mobile game market after Honour of Kings in terms of gross billings. Management expressed that only a small portion of cash flow generated from Peacekeeper Elite in 2Q19 was captured by mobile game revenue in 2Q19, and hence it was not even among the top 10 games in terms of reported revenue in 2Q19. A significantly larger portion has been deferred to subsequent quarters. Deferred revenue grew by 2.7% q-o-q in 2Q19, which was a weak season, which implies that mobile game revenue growth will accelerate in 2H19.



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Online ad revenue growth moderated from 25% in 1Q19 to 16% in 2Q19; but ad loads on Mini Program will ramp up in 2H19. Online advertising revenue (19.2% of 2Q19 revenue) increased by 16.3% y-o-y to Rmb16,409m, of which social and other advertising rose 27.9%, while media advertising declined 7.0% y-o-y. Management attributed the moderation in online advertising growth (from 25.1% y-o-y in 1Q19 to 16.3% in 2Q19) to macro headwinds and ad market inventory oversupply (i.e. from Bytedance's Toutiao and Douyin), conditions which are expected to continue for the rest of the year. However, the company will improve user data analytic capabilities to target ads better in order to sustain healthy growth amid the current challenging environment. According to our channel checks with ad agencies, while Mini Program's ad monetisation is still minimal YTD, they expect more ad loads to come in 2H19.

Reiterate BUY and TP of HK\$466. We like Tencent's long term capability to broaden its game portfolio across genres to drive sustainable growth, and WeChat Moments' and Mini Program's ad monetisation potential. We reiterate our BUY call on Tencent on still solid earnings CAGR of 30% over FY18-20F, with TP of HK\$466. Our TP is based on SOTP methodology, with the following assumptions: (1) 35x (based on one standard deviation above historical average) FY19F net profit from core operations (HK\$430); and (2) market price or valuation implied by recent equity financing of other investments (HK\$36).

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Quarterly Income Statement (RMB m)

FY Dec	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19
Revenue						
Value-added services	46,877	42,069	44,049	43,651	48,974	48,080
Online advertising	10,689	14,110	16,247	17,033	13,377	16,409
Others	15,962	17,496	20,299	24,212	23,114	24,332
Total revenue	73,528	73,675	80,595	84,896	85,465	88,821
Total gross profit	37,042	34,446	35,480	35,152	39,820	39,126
Selling expenses	(5,570)	(6,360)	(6,573)	(5,730)	(4,244)	(4,718)
Administrative expenses	(9,430)	(9,857)	(10,890)	(11,345)	(11,331)	(12,577)
Interest income	1,065	1,072	1,082	1,350	1,408	1,652
Other income	7,585	2,506	8,762	0	11,089	4,038
Operating profit	30,692	21,807	27,861	19,427	36,742	27,521
Interest expenses	(654)	(1,151)	(1,492)	(1,372)	(1,117)	(1,982)
Associates	(319)	1,526	264	16	(2,957)	2,370
Pre-tax profit	29,719	22,182	26,633	18,071	32,668	27,909
Taxation	(5,746)	(3,602)	(3,228)	(1,906)	(4,812)	(3,225)
Minority Interests	(683)	(713)	(72)	203	(646)	(548)
Net profit	23,290	17,867	23,333	16,368	27,210	24,136
Non-GAAP net profit	18,313	19,716	19,710	19,730	20,930	23,525
Growth (q-o-q)						
Value-added services	17.3%	-10.3%	4.7%	-0.9%	12.2%	-1.8%
Online advertising	-13.5%	32.0%	15.1%	4.8%	-21.5%	22.7%
Others	13.3%	9.6%	16.0%	19.3%	-4.5%	5.3%
Total Revenue	10.7%	0.2%	9.4%	5.3%	0.7%	3.9%
Gross profit	17.6%	-7.0%	3.0%	-0.9%	13.3%	-1.7%
Operating profit	19.3%	-28.9%	27.8%	-30.3%	89.1%	-25.1%
Net profit	12.0%	-23.3%	30.6%	-29.9%	66.2%	-11.3%
Non-GAAP net profit	4.9%	7.7%	0.0%	0.1%	6.1%	12.4%
Growth (y-o-y)						
Value-added services	33.5%	14.3%	4.6%	9.3%	4.5%	14.3%
Online advertising	55.2%	39.0%	47.1%	37.8%	25.1%	16.3%
Others	111.2%	81.2%	68.5%	71.9%	44.8%	39.1%
Total Revenue	48.4%	30.2%	23.6%	27.9%	16.2%	20.6%
Gross profit	45.6%	21.7%	12.0%	11.6%	7.5%	13.6%
Operating profit	59.3%	-3.3%	22.5%	-24.5%	19.7%	26.2%
Net profit	60.9%	-2.0%	29.6%	-21.3%	16.8%	35.1%
Non-GAAP net profit	28.9%	20.3%	15.5%	13.0%	14.3%	19.3%
Margins						
Total revenue	63.3%	59.0%	56.5%	53.4%	57.6%	52.6%
Online advertising	31.2%	37.4%	36.7%	36.6%	41.9%	48.6%
Others	25.4%	24.9%	22.8%	23.1%	26.1%	24.1%
Total gross profit	50.4%	46.8%	44.0%	41.4%	46.6%	44.1%
Operating profit	41.7%	29.6%	34.6%	22.9%	43.0%	31.0%
Net profit	31.7%	24.3%	29.0%	19.3%	31.8%	27.2%
Non-GAAP net profit	24.9%	26.8%	24.5%	23.2%	24.5%	26.5%

Source: Company, DBS HK

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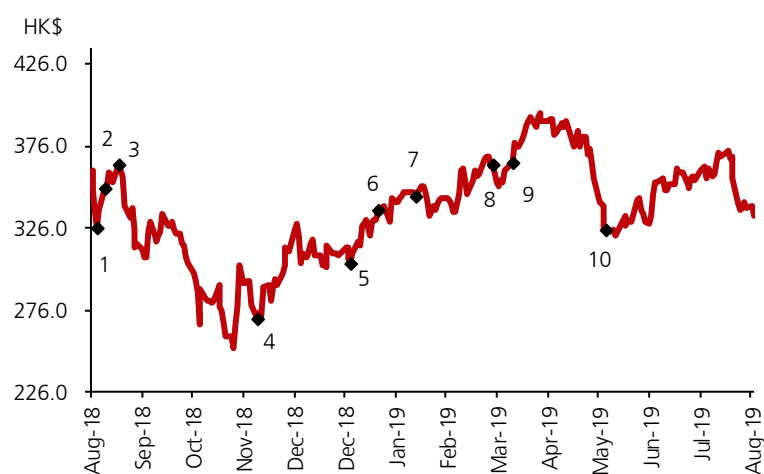
Tencent's sum-of-the-parts (SOTP) valuation

Business segment	FY19F Revenue (Rmb m)	Normalised NPM	Normalised net profit (Rmb m)	Stake	Valuation (HK\$ m)	Valuation per share (HK\$)	Valuation method
Core business	402,485	25.0%	100,777	100%	4,056,286	430	35x FY19F PE
Other investment					347,538	36	
Fair value of listed investee companies					273,700	29	Fair value
Didi				10%	41,357	4	Historical transaction value
Supersell				39%	32,481	3	Historical transaction value
Total valuation					4,329,986	466	

Source: Company, DBS HK

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Target Price & Ratings History



Source: DBS HK

Analyst: Tsz-Wang TAM, CFA

Susanna Chui, CFA

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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DBS Bank (Hong Kong) Limited13th Floor One Island East, 18 Westlands Road, Quarry Bay, Hong Kong

Tel: (852) 3668-4181, Fax: (852) 2521-1812

Flash Note

DBS Regional Research Offices

HONG KONG**DBS Bank (Hong Kong) Ltd****Contact: Carol Wu**

13th Floor One Island East,
18 Westlands Road,
Quarry Bay, Hong Kong
Tel: 852 3668 4181
Fax: 852 2521 1812
e-mail: dbsvhk@dbs.com

MALAYSIA**AllianceDBS Research Sdn Bhd****Contact: Wong Ming Tek (128540 U)**

19th Floor, Menara Multi-Purpose,
Capital Square,
8 Jalan Munshi Abdullah 50100
Kuala Lumpur, Malaysia.
Tel.: 603 2604 3333
Fax: 603 2604 3921
e-mail: general@alliancedbs.com

SINGAPORE**DBS Bank Ltd****Contact: Janice Chua**

12 Marina Boulevard,
Marina Bay Financial Centre Tower 3
Singapore 018982
Tel: 65 6878 8888
Fax: 65 65353 418
e-mail: equityresearch@dbs.com
Company Regn. No. 196800306E

INDONESIA**PT DBS Vickers Sekuritas (Indonesia)****Contact: Maynard Priajaya Arif**

DBS Bank Tower
Ciputra World 1, 32/F
Jl. Prof. Dr. Satrio Kav. 3-5
Jakarta 12940, Indonesia
Tel: 62 21 3003 4900
Fax: 6221 3003 4943
e-mail: research@id.dbsvickers.com

THAILAND**DBS Vickers Securities (Thailand) Co Ltd****Contact: Chanpen Sirithanarattanakul**

989 Siam Piwat Tower Building,
9th, 14th-15th Floor
Rama 1 Road, Pathumwan,
Bangkok Thailand 10330
Tel. 66 2 857 7831
Fax: 66 2 658 1269
e-mail: research@th.dbs.com
Company Regn. No 0105539127012
Securities and Exchange Commission, Thailand