

# Tencent Holdings Ltd.

## Assessing Moments ad opportunity

We maintain our OW rating and raise our price target to HK\$158 (from HK\$142) as we adjust our estimates to incorporate the WeChat Moments ad opportunity. We maintain our positive view on Tencent's overall mobile strategy and believe it remains well-positioned to capture the emerging mobile monetization opportunities, leveraging WeChat and Mobile QQ's dominant position with a diversified exposure to entertainment (games), local services (fee income or traffic lead on transaction-based O2O initiatives) and targeted social advertising (Moments ads). Our new price target of HK\$158 is based on 28x (from 32x) rolling forward to 2016E non-GAAP EPS of HK\$5.63 (from HK\$5.23). Tencent is one of our best ideas.

**Assessing Moments ads** – We expect ad revenue ramp for WeChat Moments to be gradual and we estimate promoted feeds ads to contribute Rmb1.89bn in revenues for 2015 and grow to Rmb10.2bn (or 9% of total revenues) in 2016 based on 343mn DAU with a two ad exposure daily at CPM of Rmb40 (more detail later in this report).

**4Q14 preview** - Tencent is due to report 4Q14 results after market close on 18 March. We estimate total revenue of RMB20.04bn (+18% y/y and +1.2% q/q) and GAAP net profit of RMB5.77bn (28.8% margin) vs. Bloomberg consensus of RMB20.45bn and RMB6.03bn (29.5% margin). We expect a relatively in-line result driven by: 1) rebound of DNF and CF as a result of successful major content update; 2) continued strength of LOL; 3) sequential rebound and solid y/y growth of WeChat games revenues and 4) continued growth of Mobile Qzone ad revenues partially offset by sequential softness of brand ad growth following a strong Voice China III contribution in 3Q14.

**Estimates revision** – We have adjusted our 2015E and 2016E revenues by 2.4% and 8.2% and earnings estimates by -2.5% and +7.9% respectively to reflect incremental assumption from Moments ad revenues as well as other cost assumptions.

### 0700.HK: Quarterly and Annual EPS (CNY)

	2013		2014		2015		Change y/y		
FY Dec	Actual	Old	New	Cons	Old	New	Cons	2014	2015
Q1	0.43A	0.55A	0.55A	0.69A	0.78E	0.75E	0.80E	28%	36%
Q2	0.45A	0.63A	0.63A	0.62A	0.83E	0.80E	0.84E	40%	27%
Q3	0.47A	0.69A	0.69A	0.61A	0.96E	0.94E	0.91E	47%	36%
Q4	0.47A	0.70E	0.69E	0.70E	1.00E	0.99E	0.93E	47%	43%
Year	1.82A	2.57E	2.56E	2.57E	3.57E	3.48E	3.42E	41%	36%
P/E	58.1		41.4			30.4			

Source: Barclays Research.  
Bloomberg consensus estimate

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Stock Rating **OVERWEIGHT**  
Unchanged

Industry View **POSITIVE**  
Unchanged

Price Target **HKD 158.00**  
raised 11% from HKD 142.00

Price (10-Mar-2015) HKD 131.10  
Potential Upside/Downside +21%  
Tickers 700 HK / 0700.HK

Market Cap (USD mn)	158360
Shares Outstanding (mn)	9373.22
Free Float (%)	52.64
52 Wk Avg Daily Volume (mn)	22.8
52 Wk Avg Daily Value (USD mn)	0.00
Dividend Yield (%)	0.2
Return on Equity TTM (%)	34.25
Current BVPS (CNY)	8.00

Source: Thomson Reuters

Price Performance Exchange-HKG  
52 Week range HKD 138.00-93.00



[Link to Barclays Live for interactive charting](#)

### Asia ex-Japan Internet & Media

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Asia ex-Japan Internet & Media Industry View: POSITIVE**Tencent Holdings Ltd. (0700.HK)****Stock Rating: OVERWEIGHT**

Income statement (CNYmn)	2013A	2014E	2015E	2016E	CAGR
Net revenue	60,437	77,998	93,177	114,333	23.7%
EBITDA	22,784	34,751	40,708	52,502	32.1%
EBIT	19,194	30,493	37,121	49,027	36.7%
Pre-tax income	19,281	29,185	35,813	47,787	35.3%
Net income	15,502	23,720	29,470	39,344	36.4%
EPS (adj) (CNY)	1.82	2.56	3.48	4.53	35.5%
EPS (reported) (CNY)	1.66	2.54	3.15	4.20	36.3%
Net cash per share (CNY)	4.15	4.03	6.98	10.59	36.7%
Diluted shares (mn)	9,340.0	9,356.9	9,359.0	9,367.0	0.1%
DPS (CNY)	0.24	0.32	0.40	0.53	30.2%

Price (10-Mar-2015) **HKD 131.10**  
 Price Target **HKD 158.00**

**Why Overweight?** We are positive on Tencent's overall strategic direction of its mobile open platform initiatives and believe it is well positioned to capture the emerging opportunities of mobile Internet growth in the next few years, leveraging its sticky, integrated mobile user platform on WeChat.

**Upside case** **HKD 197.00**

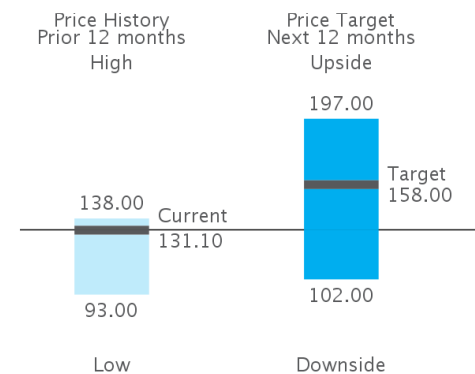
This assumes WeChat monetization is tracking faster than our base-case scenario, translating into higher revenue and earnings growth with our target multiple expanding to 35x.

**Downside case** **HKD 102.00**

This assumes WeChat monetization is tracking slower than our base-case scenario, translating into slower revenue and earnings growth and our target multiple de-rating to 18x.

Margin and return data	Average				
Gross margin (%)	54.0	62.3	66.4	67.5	62.6
Operating profit margin (%)	31.8	39.1	39.8	42.9	38.4
EBITDA margin (%)	37.7	44.6	43.7	45.9	43.0
Net margin (%)	25.6	30.4	31.6	34.4	30.5
ROIC (%)	83.4	58.1	77.7	114.5	83.4
ROA (%)	15.3	16.4	16.2	18.0	16.5
ROE (%)	29.3	29.1	30.7	31.3	30.1

Balance sheet and cash flow (CNYmn)	CAGR				
Tangible fixed assets	8,693	9,377	9,741	9,770	4.0%
Intangible fixed assets	4,103	4,161	4,219	4,277	1.4%
Cash and equivalents	55,402	72,619	108,775	142,009	36.9%
Total assets	107,235	159,586	198,261	234,729	29.8%
Short and long-term debt	16,653	34,894	43,458	42,845	37.0%
Other long-term liabilities	1,441	5,588	5,588	5,588	57.1%
Total liabilities	48,772	76,748	91,532	98,548	26.4%
Net debt/(funds)	-38,749	-37,725	-65,317	-99,164	N/A
Shareholders' equity	57,945	82,290	106,151	135,572	32.8%
Change in working capital	5,915	3,683	4,613	4,972	-5.6%
Cash flow from operations	27,492	36,156	42,901	55,165	26.1%
Capital expenditure	-4,846	-5,518	-4,717	-4,631	N/A
Free cash flow	22,646	30,638	38,184	50,534	30.7%

**Upside/Downside scenarios**

Valuation and leverage metrics	Average				
P/E (adj) (x)	58.1	41.4	30.4	23.3	38.3
P/E (reported) (x)	63.8	41.8	33.6	25.2	41.1
EV/EBITDA (x)	41.7	27.4	22.7	17.0	27.2
FCF yield (%)	2.3	3.1	3.9	5.1	3.6
P/Sales (x)	16.4	12.7	10.6	8.7	12.1
P/BV (x)	17.1	12.0	9.3	7.3	11.4
Dividend yield (%)	0.2	0.3	0.4	0.5	0.4
Total debt/capital (%)	84.5	77.3	104.9	115.7	95.6

Selected operating metrics (CNYmn)	CAGR				
VAS revenue	44,985	62,617	75,694	85,451	23.8%
Online ads revenue	5,034	8,081	12,828	24,029	68.4%
Other revenue	10,418	7,300	4,655	4,852	-22.5%

Source: Company data, Barclays Research

Note: FY End Dec

## Accessing advertising potential for WeChat platform

### 1) Official account ads showed initial contribution in 3Q14

In 2Q14, Tencent started beta-testing the Official Account advertising on its WeChat platform. According to Tencent's 2Q14 earnings call, a total of 100 pilot Official Accounts were involved in the testing with major advertising categories being O2O merchants and e-commerce players.

According to our research as well as news report (China Internet Watch, 16 September 2014), the advertising format introduced in WeChat official accounts is in the format of a display banner placed at the bottom of the article published by official accounts with a fixed width of 582px and height of 166px, no bigger than 50k, and allows links to external website. In order to become a WeChat Official Accounts Advertising Platform publisher that shares advertising revenues, Tencent requires the official account to have a minimum of 50,000 followers (fans). Separately, according to a news report (199IT, 21 January 2015) citing presentation material from Tencent introducing the WeChat advertising system, key formats for WeChat's Official Account are to include picture plus text, full picture, text link, subscription card and download card.

The pricing models for official account ads could be either 1) **cost per click** (CPC price starts at Rmb0.5/click) or 2) **cost per thousand impressions** (CPM price starts at Rmb15/thousand exposures).

In 3Q14, Tencent noted on its earnings call that it started to see revenue contribution from the Official Account advertising, together with the strong growth of Mobile Qzone advertising, both helping to contribute to the 32% q/q and 93% y/y growth of performance-based advertising during the quarter. Revenues from mobile ads accounted for 45% of total performance based ads. We noted from our research and usage that key advertiser categories for the Official Account advertising include apparels, accessories, home decoration, and consumer electronics.

### 2) Launch of WeChat Moments promotional feeds advertising in Jan 2015

As we noted in our takeaway note from NDR meetings: *Tencent Holdings Ltd: NDR reaffirms 3Q14 issue as one-off*, we highlighted that Tencent management sounded confident on overall performance-based advertising and was exploring the ad opportunity on WeChat's Moments page, citing some global peers having four to five ads per news feed which are generating good revenues on mobile. We had expected Tencent would likely start testing the Moments news feed ad starting in 1H15 and believe it could potentially be a big driver for mobile advertising.

According to a news report (NetEase, 21 January 2015), WeChat indeed rolled out testing of its Moments promotional advertising feeds on 21 January. While we had expected testing timing in 1H15; the roll-out in January was earlier than we expected.

The ad format of the promotional feeds looks like the shared Moments posted by the friends circle. The post could consist of 1) pictures by brand, 2) a "Check the details" web page link, 3) a "promoted ad" indication wording on the upper right corner, and 4) a button to add comments to the ad at the bottom right corner (for more details, please refer to our previous report *Tencent (700 HK; OW; PT HK\$142) - WeChat Moments promotional feeds ad and version 6.1*).

According to the Tencent PPT cited by 199IT, Tencent plans to select only 50 brand advertisers for the first round of testing on WeChat Moments ads with a minimal budget of each at over Rmb10mn. The advertisement will be placed at the fifth feed in the Moments page below four new Moments posted by WeChat user's friends. If there is no action such

*Ads from Official accounts started revenue contribution in 3Q14*

*Moments ads - selected advertiser accounts and testing of user accounts started in January*

as clicking, sharing or commenting within six hours after the posting of the advertisement, it will disappear from the Moments page. Each advertisement will be valid for seven days and each WeChat user will only receive the same advertisement within 48 hours. In terms of pricing, the pricing of the promotional feeds ad is set at CPM of Rmb40/thousand exposures for the basic plan, Rmb140/ thousand exposures for targeted cities such as Beijing and Shanghai only, and Rmb90/thousand exposures for 17 key targeted cities. Gender target will be charged at an additional 10% of the original CPM price. In addition, Tencent will offer advertisers who joined the first round of testing two free additional targeting choices such as user age group, education level, network environment and operating system. Tencent agrees to provide a result analysis report generated by the system to each of the brand advertisers after each promotion. According to the PPT material, it seems like Tencent expects the Shanghai and Beijing targeted advertising to have a total exposure of around 20mn times, and the other 17 targeted key cities to have a total exposure of around 90mn and nationwide advertising will have a total exposure of 300 times. Based on the estimated exposure, the expected spending per ad placement is calculated as below (Figure 1).

FIGURE 1

**WeChat Moments promotional feeds advertising pricing**

	CPM	CPM with targeted gender	Expected total exposure	Expected spending per ad placement	Expected spending per ad placement with targeted gender
	(Rmb/'000 exposure)	(Rmb/'000 exposure)	(mn times)	(Rmb mn)	(Rmb mn)
No target region	40	44	300	12.0	13.2
Beijing and Shanghai only	140	154	20	2.8	3.1
Key cities only (17 cities)	90	99	90	8.1	8.9

Source: 199IT, Barclays Research estimates

After the announcement of launching Moments promotional feeds ads, on 25 January 2015 three global and domestic brands including Coca Cola, BMW, and Vivo first tried out the new ad format. According to a news report (199IT, 27 January 2015), WeChat officially announced the testing result for Vivo's advertisement, with total exposure reaching 155mn during the first one and half days (Jan 25 20:45 to Jan 27 9:00). During the period, WeChat recorded 7.2mn clicks, like or comment activities on the advertisement, and Vivo's official WeChat account fans increased by 220,000 during this period. According to another news report (NetEase, 27 January 2015), a survey website (wenjuan.com) did a survey on the first round of WeChat advertising. The result suggests only 21.5% of users displayed a negative view on Moments ads while 31.94% of users feel quite good about the Moments ads and 15.29% like the ads very much; the remaining 31.26% did not receive any ads. Also the survey suggests the click-through rate reached 48.71% for the first group of ads on WeChat Moments ads. According to a news report (source: IT home and date 1<sup>st</sup> February) a second round of Moments ads testing appears to have taken place with ChangAn Ford, Oppo, and Cadillac also tested on a WeChat Moments ad following the initial three brands.

**3) Comparing WeChat ads with Weibo, Facebook and Twitter**

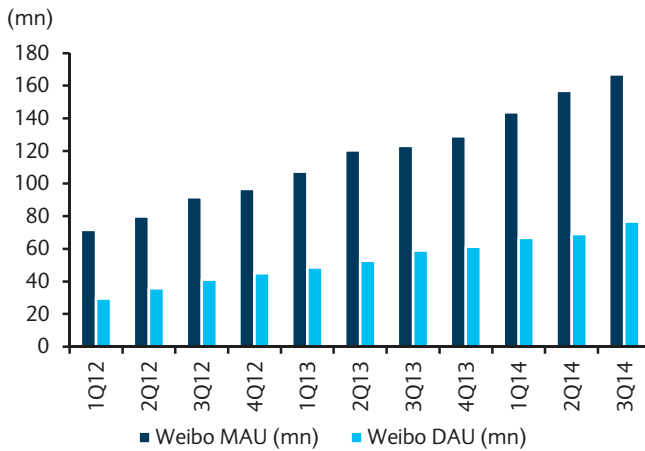
While the Moments promotional feeds ad is still in the initial testing stage for Tencent WeChat, the ad format has been widely adopted on other domestic and international social networking platforms such as Sina Weibo, Facebook and Twitter. In order to help us assess the revenue opportunity for Tencent WeChat Moments ads and growth trajectory, we analyze and compare the revenue ramp for Weibo, Facebook and Twitter.

**Weibo – early adopter of performance-based ads in China**

Sina started the testing of the promoted feed advertising on its Weibo platform in late 2012 and officially launched the product in 2Q13. The platform allows advertisers, especially small and mid size enterprise (SME) advertisers, to reach targeted users with a small but effective budget. Advertisers can target users by their social relationship, demographics, geography, interest group and device type. Also advertisers can choose from two bidding pricing schemes – cost per thousand impression (CPM - currently priced at a minimum of Rmb5/thousand exposures) or cost per engagement (CPE- currently priced at minimum of Rmb0.5/engagement).

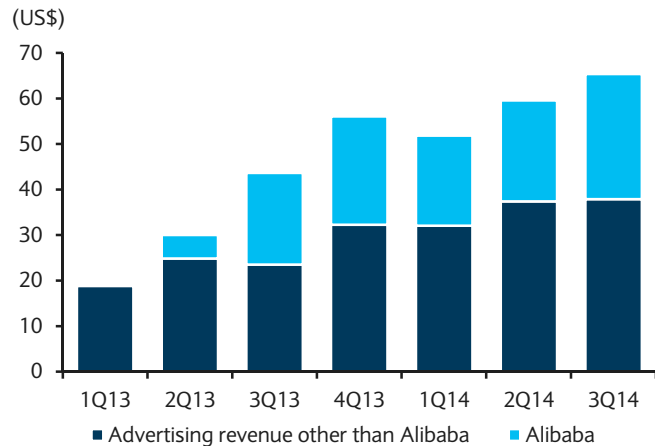
In 2Q14, Weibo started to open the promoted feed advertising to its key brand advertiser accounts. Management mentioned during its 2Q14 conference call that over 100 of its 190 key accounts tried out the function during the quarter. The brand advertiser promoted feed is priced at CPM (Rmb50/CPM currently). In 3Q14, Sina reported that Weibo recorded US\$22.8bn advertising revenue from promoted feeds during the quarter, up 438% yoy.

FIGURE 2  
Weibo – MAU and DAU



Source: Companies data, iResearch and Barclays Research estimates

FIGURE 3  
Weibo – advertising revenue breakdown

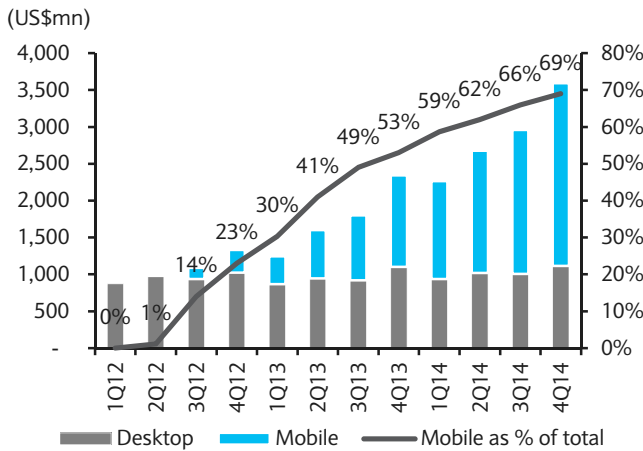


Source: Companies data, Barclays Research

**Facebook – the success in mobile ads validates the potential traction for WeChat Moments ads**

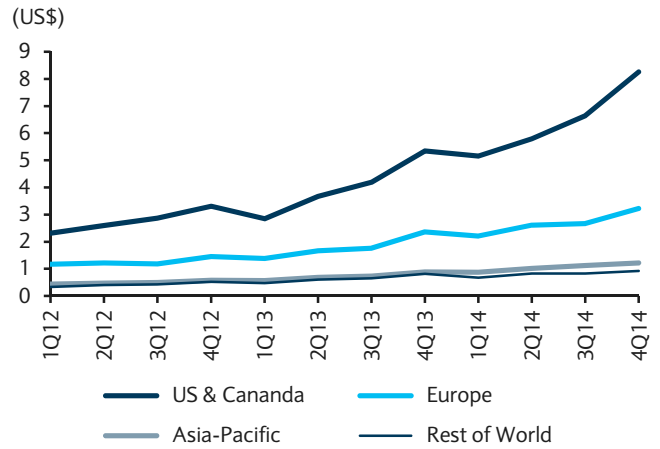
Facebook (covered by Paul Vogel, OW, PT of US\$88), reported US\$12.47bn in total revenues in 2014, with advertising revenues accounting for 92.2% or US\$11.49bn, of which mobile advertising contributed 59.5% and desktop advertising contributed 32.7% of total revenues in 2014. Specifically, mobile advertising reached 64.4% of total revenues or 69% of total advertising in 4Q14 (or US\$2.48bn), up 99.6% y/y compared to 1.1% y/y growth in desktop revenues. When Facebook first started mobile advertising in 2Q12, it only generated US\$10.8mn in that quarter and mobile revenues only accounted for 9.2% for the full year 2012. It has since grown to US\$3.16bn in 2013, representing 40% of total revenues, and grew another 135% y/y to US\$7.4bn in 2014.

**FIGURE 4**  
Facebook – advertising revenue split between desktop and mobile



Source: Company data, Barclays Research

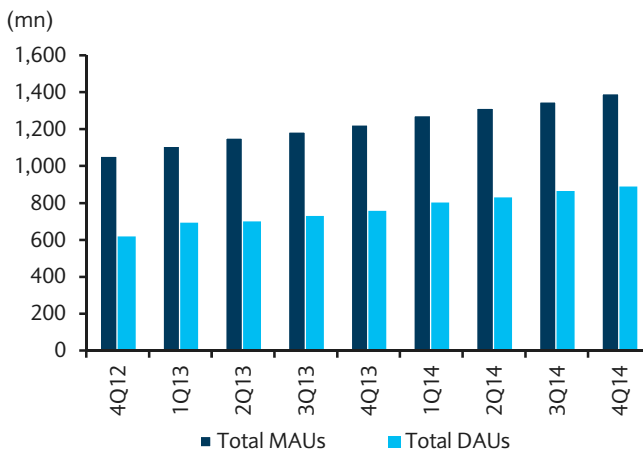
**FIGURE 5**  
Facebook – ARPU by region



Source: Companies data, Barclays Research

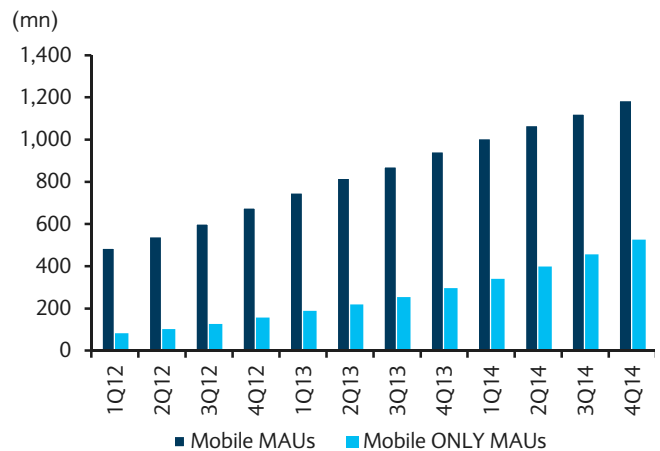
In the mean time, Facebook mobile MAU grew from 488mn in 1Q12 to 1.394bn (or 85% of total MAUs) in 4Q14 with mobile-only MAU growing from 83mn to 526mn over the same period. The DAU and MAU ratio for Facebook reached 64% in 4Q14.

**FIGURE 6**  
Facebook – MAU and DAU



Source: Companies data, Barclays Research

**FIGURE 7**  
Facebook – Mobile MAU



Source: Companies data, Barclays Research

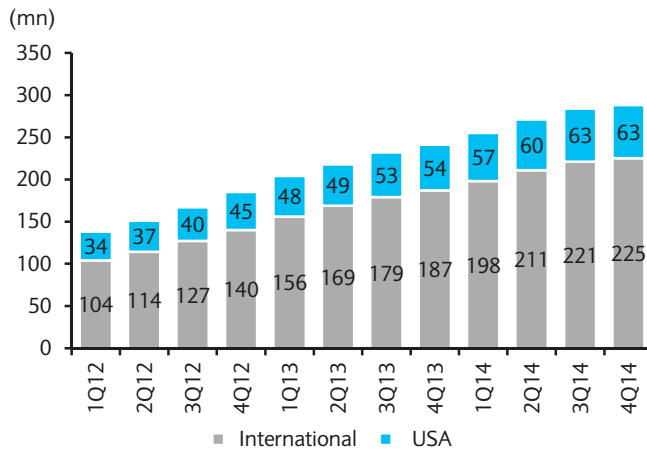
According to the reported metrics, in 4Q14, Facebook advertising revenue ARPU per MAU reached US\$8.77 per year for 2014, up 43.3% y/y from US\$6.12 in 2013. Being the more established and mature market, FB US and Canada advertising revenues ARPU per MAU was US\$25.84 for 2014, vs. US\$10.74 for Europe, US\$4.26 for Asia.

**Twitter - another successful case study of promoted tweet ads**

In addition to Facebook, Twitter (covered by Paul Vogel, OW, PT US\$60) also showed successful traction of its promoted tweet ads. According to the latest 4Q14 results, Twitter generated total revenues of US\$479mn in 4Q14 with advertising revenues accounting for US\$432mn and data licensing revenues contributing to 9.8% or US\$47mn. Twitter reported total timeline views of 181.95bn in 4Q14 implying 632 timeline views per MAU and US\$2.37 per thousand views. Blended ARPU per MAU (288mn) was US\$1.50, with US ARPU per MAU coming in at US\$4.41 while ARPU per MAU for international markets stood at US\$0.69

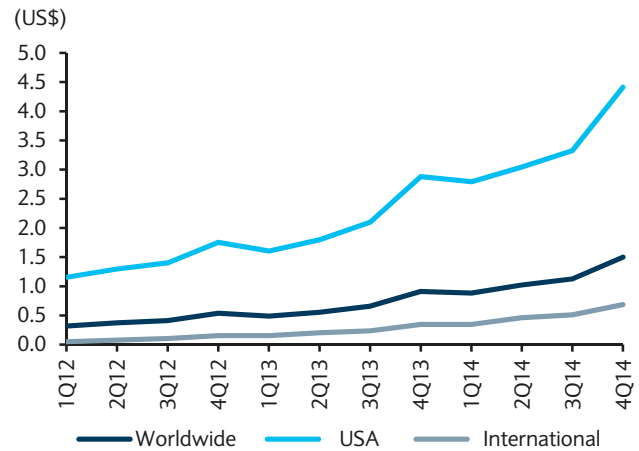
for 4Q14. Mobile advertising accounted for 88% of total advertising revenues or US\$380mn in 4Q14, up from 76% a year ago and 55% in 4Q12.

**FIGURE 8**  
Twitter – MAU by region



Source: Companies data, Barclays Research

**FIGURE 9**  
Twitter – ARPU by region

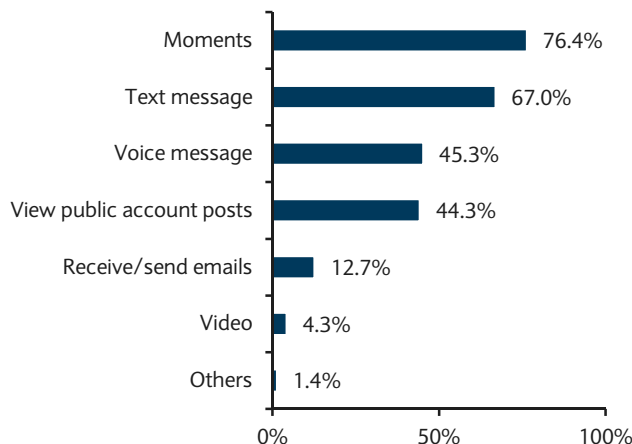


Source: Companies data, Barclays Research

#### 4. Our assessment for WeChat Moments ads revenues potential

According to the PPT from Tencent on the introduction of the WeChat advertising system cited by 199IT, the total registered users for Tencent WeChat has reached 1.12bn globally (as of January), with over 440mn monthly active users. During 3Q14 results, Tencent reported that WeChat MAU reached 468.1mn in 3Q14. As disclosed by the PPT material citing Moments as the highest frequency used service on WeChat platform (76.4% penetration), we believe the introduction of promotional feeds ads in the Moments page could serve as a catalyst for 2015. That said, we believe Tencent will likely retain its conservative approach and aim to maintain a balance between user experience and short term monetization. Hence, while we believe it could have upside risks to our estimates if the Moments ads indeed prove to be successful and effective, we do expect a gradual pick-up of the mobile advertising revenue from the promotional feeds in the early phase of its launch and expect Moments ad revenues to become more meaningful starting in 2H15.

**FIGURE 10**  
Tencent - service penetration among WeChat users



Source: 199IT, Barclays Research

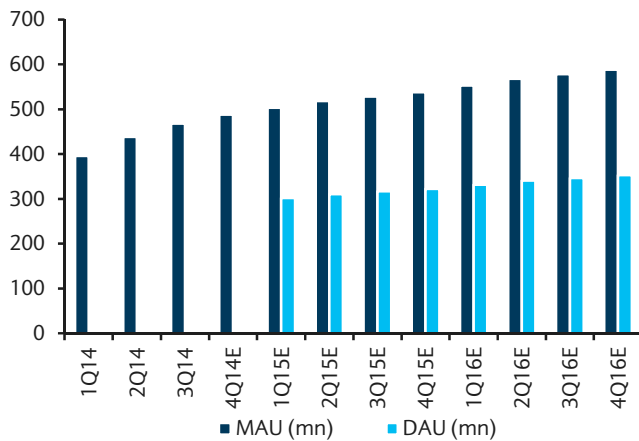
**FIGURE 11**  
Tencent – Moments ads assumption and revenues (quarterly)

	1Q15E	2Q15E	3Q15E	4Q15E
WeChat MAU (mn)	503	518	528	538
WeChat DAU (mn)	302	311	317	323
DAU reach %	5%	10%	50%	100%
CPM (Rmb/'000 exposure)	40.0	40.0	40.0	40.0
# of ads per DAU per day	1.0	1.0	1.0	1.0
WeChat Moment ad rev (Rmb mn)	42	112	570	1,162

Source: Barclays Research estimate

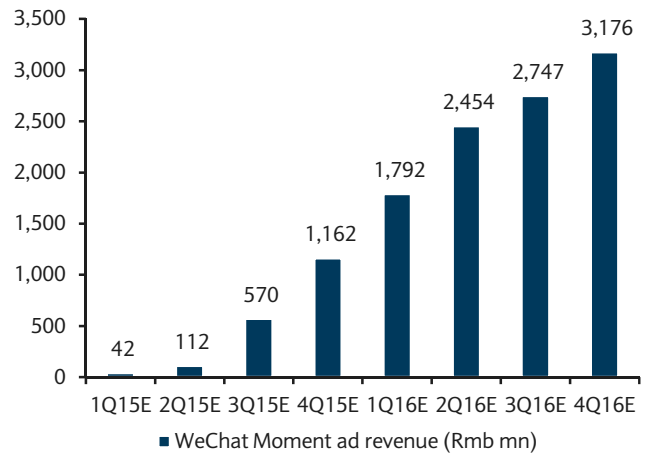
We estimate Moments ads to generate about Rmb42mn in 1Q15, based on 5% out of an estimated 302mn DAU under the testing universe with only one ad feed per day at CPM of Rmb40. We then estimate the testing universe to expand to 10% of the user base in 2Q15 with ad feeds remaining at one per day, with CPM stable at Rmb40. This would suggest Moments Ads revenues of Rmb112mn in 2Q15. We then estimate the testing universe to expand to 50% of WeChat’s user base in 3Q15 with ad load remaining at one ad per day. In 4Q15, we estimate the coverage universe to expand to the entire user base with a steady one ad load per day per user. As a result we forecast full year 2015 Moments ads to generate about Rmb1.89bn in revenues and grow to Rmb10.2bn in 2016; this implies 42% of total ad revenues and 9% of total revenues for 2016.

FIGURE 12  
Tencent – MAU and estimated DAU



Source: Company data, Barclays Research estimates

FIGURE 13  
Tencent – WeChat Moments ad revenue estimates



Source: Barclays Research estimates

In addition to Moments ads, we also estimate that ad revenues from official accounts could reach Rmb700mn in 2015 and Rmb1.26bn in 2016. Together with our existing estimates for WeChat gaming revenues and very small and conservative estimates for WeChat O2O and sticker revenues, we estimate total WeChat revenues to be Rmb19.3bn in 2015 or 21% of total revenues. For 2016, we estimate total WeChat revenues will grow 70% y/y to Rmb32.9bn or 29% of total revenues.

FIGURE 14  
Tencent WeChat revenues breakdown – FY2014-17E (Rmb mn)

	2014E	2015E	2016E	2017E
WeChat sticker	30	80	120	120
WeChat O2O	300	1,550	2,480	3,968
WeChat gaming	10,416	15,117	18,906	22,687
WeChat advertising	120	2,587	11,429	19,451
- WeChat Moments ads	-	1,887	10,169	17,801
- WeChat official account ads	120	700	1,260	1,650
<b>Total WeChat revenue</b>	<b>10,866</b>	<b>19,334</b>	<b>32,935</b>	<b>46,226</b>

Source: Barclays Research estimates

**How would WeChat monetization compare to other social platforms?**

In this section, we will compare our estimated WeChat revenues for 2015 and 2016 with global peers such as Facebook, Twitter and Line as well as China peer Weibo.



We notice the following:

- **Total revenues** – Comparing WeChat total revenues of US\$3.1bn for 2015 and US\$5.3bn for 2016, WeChat is at about 19% and 24% of Facebook’s revenues.
- **Ad only revenues** – however, by comparing WeChat advertising revenues only with Facebook revenues, WeChat is only at 3% of Facebook’s total ad revenues in 2015 and 9% in 2016.
- **Revenues per MAU** – Using total revenues, WeChat’s revenues per MAU of US\$5.80 for 2015 and US\$9.43 for 2016 are still slightly lower than Twitter while about 25-45% smaller than Facebook. However, if only using advertising revenues per MAU, WeChat is smaller than Line and Weibo in 2015 but is expected to exceed both of them in 2016.

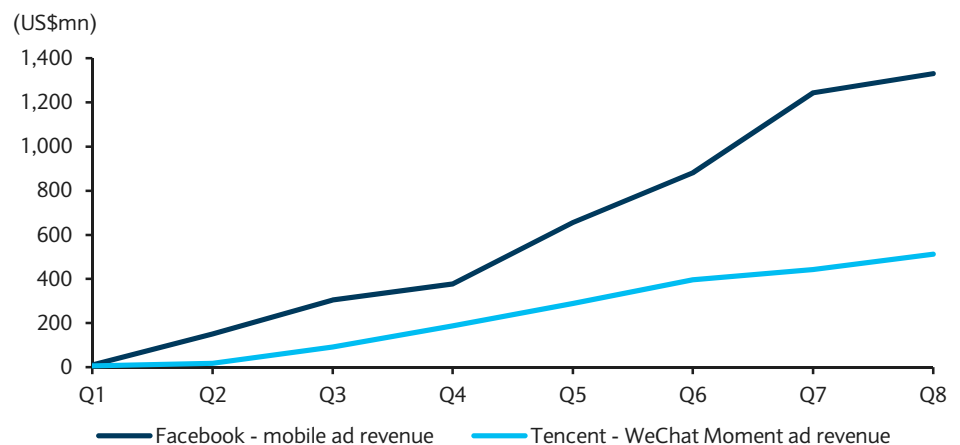
FIGURE 15  
Comparison of monetization among key social platforms (US\$m)

	Market cap (US\$m)	MAU (2015)	MAU (2016)	Market Cap per MAU (2015)	Total Revs (2015)	Total Revs (2016)	Ad Revs (2015)	Ad Revs (2016)	Revs per MAU (2015)	Revs per MAU (2016)	Ad Revs per MAU (2015)	Ad Revs per MAU (2016)
WeChat	NA	538	563	NA	3,118	5,312	417	1,843	5.80	9.43	0.78	3.27
Facebook	224,730	1,558	1,732	144	16,808	22,362	15,704	21,108	10.79	12.91	10.08	12.19
- Asia only	NA	533	623	NA	2,684	4,033	2,579	3,910	5.04	6.47	4.84	6.27
Twitter	30,286	334	370	91	2,461	3,918	2,185	3,472	7.37	10.59	6.54	9.38
Line	NA	225	250	NA	1,475	1,795	224	291	6.55	7.18	1.00	1.17
Weibo	2,926	200	220	15	460	625	382	521	2.30	2.84	1.91	2.37

Source: Companies data, Barclays Research estimates

One of the takeaways from the table above suggests to us that if WeChat Moments ads prove to be successful, there is potential for Ad revenues per MAU to further increase and grow. That said, Facebook and Twitter are both global players and have revenues from different regions, and US-based ARPU and revenues are still much higher than rest of the regions. On the other hand, as WeChat currently only monetize in China, we see our current revenue assumptions and revenues per MAU estimate as reasonable, and have room to improve.

FIGURE 16  
Facebook vs. WeChat – mobile ad revenue ramp up



Source: Companies data, Barclays Research estimates

On Figure 16, we compare the timeline and growth trajectory of our estimated Moments ads revenues with Facebook's mobile revenues trend. FB started to monetize mobile promoted news ads in 2Q12 (quarter 1) and generated US\$10.8mn mobile revs that quarter. By quarter 7 (which is 4Q13), FB's mobile revenues surpassed PC ad revenues for the first time to reach US\$1.24bn or 53% of total ad revenues. By quarter 8 (which is 1Q14), FB mobile revenues reached 59% of total ad revenues or 53% of total revenues at US\$1.33bn. We estimate WeChat Moments ad to grow from Rmb42.3mn (or US\$6.8mn) in quarter 1 (in this case 1Q15) to Rmb3.17bn (US\$512mn) by quarter 8 (4Q16E).

## Earnings revision and adjusting price target to HK\$158

Following our new assumptions for WeChat Moments ads and tweaking our other estimates for gaming, brand advertising and community revenues, we have adjusted our revenues and earnings as follows:

FIGURE 17

### Tencent – revisions to Barclays Research estimates

	Revenues (Rmb mn)			Non-GAAP EPS (HK\$)			Net Profit (Rmb mn)		
	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
2014E	77,998	77,998	0.0%	3.19	3.18	-0.3%	23,803	23,720	-0.3%
2015E	91,022	93,177	2.4%	4.44	4.33	-2.5%	30,336	29,470	-2.9%
2016E	105,702	114,333	8.2%	5.23	5.64	7.9%	36,057	39,344	9.1%

Source: Barclays Research estimates

We maintain our Overweight rating on Tencent and raise our price target to HK\$158 (from HK\$142), based on 28x (from 32x previously) rolling forward to 2016E non-GAAP EPS of HK\$5.64 (from HK\$5.23). Our 28x target multiple is in-line with two-year earnings (2015E-17E) CAGR of 28%, which we believe is reasonable.

We remain positive on Tencent's overall strategic direction for its mobile open platform initiatives and believe it remains well positioned to capture the emerging opportunities in mobile Internet growth over the next few years, leveraging its sticky, integrated mobile user platform on WeChat. Tencent remains one of our best ideas.

**Risks:** 1) The WeChat monetization ramp up could disappoint if new games to be released fail to attract a similar level of user traction, and Moments ads fail to take off and user experience is materially affected; 2) PC games growth slows down as legacy games slow faster-than-expected and new PC games such as Call of Duty fail to take off; 3) margin pressure as a result of stepped up investment in O2O initiatives, marketing spend and coupon subsidies on WeChat payment.

### Sensitivity for Moments ads analysis for 2016

Given that Tencent just started testing the Moments ads at the end of January, we have yet to hear any formal feedback or comments from Tencent management regarding the traction and adoption rate. We believe there is still uncertainty on our revenue assumptions and growth trend estimates. We have done some sensitivity analysis relating to CPM and ad load assumptions. As noted earlier, in our base case scenario, we estimate total Moments ad revenues of Rmb10.17bn for 2016 which we assume CPM of Rmb40 on average of two ads per DAU per day. If the ad feedback ramps up faster than expected, on our bull case scenario, we estimate CPM grows to Rmb45 with four ads per DAU per day, this would result in Moments ad revenues of Rmb22.37bn for 2016. However, on the other hand, if the ramp is more gradual and ad loads never increase and actually drop to only 0.5 ads per DAU per day, we estimate Moments ad revenues would only reach Rmb2.47bn for 2016.

FIGURE 18  
WeChat Moments ad revenue sensitivity analysis for 2016

	Bear	Base	Bull
MAU (mn)	572	572	572
DAU (mn)	343	343	343
CPM (Rmb/'000 impression)	40	40	45
# of ads per DAU per day	0.5	2.0	4.0
Wechat Moments ad revenue (Rmb mn)	2,470	10,169	22,373
Total advertising revenue (Rmb mn)	16,330	24,029	36,233
Total revenues (Rmb mn)	106,634	114,333	126,537
Operating profit (Rmb mn)	46,200	49,027	53,537
<i>Op margin</i>	43.3%	42.9%	42.3%
Non-operating profit(Rmb mn)	48,791	51,774	56,531
<i>Non-GAAP Op margin</i>	45.8%	45.3%	44.7%
GAAP net profit (Rmb mn)	37,012	39,344	43,065
<i>Net margin</i>	34.7%	34.4%	34.0%
Non-GAAP net profit (Rmb mn)	39,983	42,471	46,439
<i>Non-GAAP net margin</i>	37.5%	37.1%	36.7%
GAAP EPS (Rmb)	3.95	4.20	4.60
Non-GAAP EPS (Rmb)	4.27	4.53	4.96
Non-GAAP EPS (HK\$)	5.31	5.64	6.17
P/E multiple	28	28	28
<b>Target price (HK\$)</b>	<b>149</b>	<b>158</b>	<b>173</b>

Source: Barclays Research estimates

## Recent business developments and new initiatives update

### 1) Successful red packet and other promotional events on WeChat/Mobile QQ during Chinese New Year

With the enhanced WeChat red packet function added to the attachment bar in the WeChat 6.1 version, WeChat's red packet again attracted strong user attention and engagement during the Lunar New Year period (18-25 February). According to a news report (TechWeb, 20 February 2015), a total over 1.01bn personal red packets was sent/received during New Year's Eve (18 Feb), which is over 200 times last year's record. This is on back of the high usage of WeChat during the holiday. According to the same news report, total messages sent by WeChat users reached 14.3bn and the total number of posts on WeChat Moments page reached 260mn during New Year's Eve. According to another news report (Sina, 26 February 2015), a total 3.27bn red packets were sent / received during 18-23 February, which increased significantly from over 40mn red packets recorded during the CNY holiday last year (30 Jan – 7 Feb 2014).

In addition to the personal red packets among WeChat friends, WeChat also cooperated with TV programs such as the CCTV Spring Festival Gala and partnered with companies such as JD and Huawei to send red packets in its "Shake" function under "Discover" tab. According to the same TechWeb news, WeChat recorded over 11bn total shakes during the CCTV Spring Festival Gala program which was broadcasted in 185 countries globally, and

during the peak period of 22:32-22:42 New Year Eve, 120mn red packets were distributed through the Shake function with a total worth of Rmb500mn.

In addition to the red packet, WeChat also cooperated with merchants to distribute coupons during the Chinese New Year period through the “Shake” function. According to a news report (Sohu, 24 February 2015), on 19 February, a total of 378mn coupons were distributed to 75mn WeChat users through the “Shake” function. Participating merchants include 25,000 retail stores in over 300 cities from a variety of industries such as catering, hotel, airline, finance, ecommerce, retail, entertainment, etc. The same Sohu news report also mentioned that home electronics giant Gome distributed 10mn coupons during the day with a total value of Rmb100mn. Driven by the coupon program, Gome saw its WAP traffic and GMV triple during the CNY period and the number of orders was nearly five times of normal level, reaching a similar level to its Singles Day promotion. As the coupons can also be used in Gome’s offline stores, its Guangdong stores saw total revenue doubling during the holiday, according to the Sohu news report.

On the QQ side, according to a news report (CCtime, 22 February 2015), mobile QQ recorded a total of 637mn red packets sent/received during New Year’s Eve and Sina news (26 February) mentioned that about 1.16bn red packets were sent/received during 18-23 February. In addition, QQ also cooperated with other partners such as JD, Dianping and Vdian to distribute red packets to users, and 154mn users joined the event to grab these red packets. QQ users could also win an additional chance to grab the red packets by voting for the performance during the broadcasting of the CCTV Spring Festival Gala; a total of 670mn votes were sent by QQ users during the broadcasting period. Mobile QQ only added the red packet function in its latest 5.4 version about one month ago.

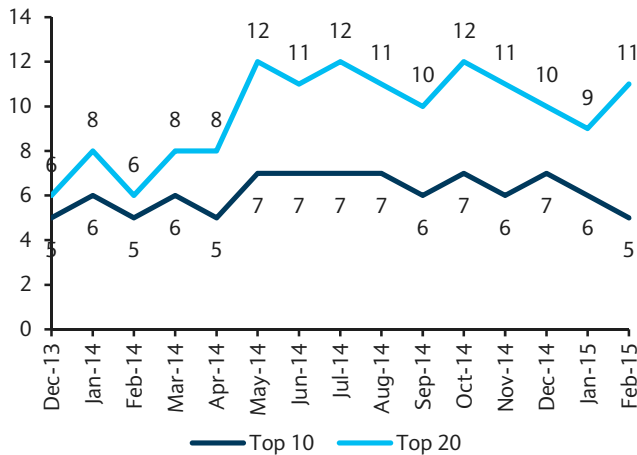
***Our view:***

We believe the widely used red packet function will help further drive user engagement on WeChat/mobile QQ and drive higher adoption of the Tenpay and WeChat payment function. In addition, the corporation with TV programs such as the CCTV Spring Festival Gala will help Tencent to broaden its user base and further expand its user penetration. On the other hand, the distribution of merchant coupons and strong user traction of these coupons will also help drive online shopping activities on the WeChat/mobile QQ platform, in our view. Besides, when users get the coupons for services such as hotel bookings, taxi/car hire and movie tickets, it will likely help to drive the faster adoption of O2O services provided by Tencent, in our view.

**2) Update on WeChat games performance**

Since the beginning of 3Q13, Tencent has launched 49 games on its WeChat platform (as of 13 Feb 2015), including 28 in-house and 21 third-party games. Overall, Tencent games continues to take 5-7th position out of the top 10 and 9-12th position out of top 20 based on gross billings on the iOS platform, according to App Annie statistics.

FIGURE 19  
Tencent – number of games ranked within Top 10 & 20



Note: Data collected for the last Sunday of each month.  
Source: App Annie, Barclays Research

FIGURE 20  
China's top 10 mobile games measured by daily gross revenues (iOS)

Ranking	22-Feb-15	Publisher
1	We Fire	Tencent
2	Shen Wu	Hero Network
3	Timi Match Everyday	Tencent
4	Blade of Three Kingdoms	Tencent
5	I'm MT2	Tencent
6	Boom Beach	Supercell
7	Kai Xin Xiao Xiao Le	Happy Elements
8	Shao Nian Shan Guo Zhi	Youzu
9	Timi Run Everyday	Tencent
10	Timi Drive Everyday	Tencent

Source: Company data, App Annie (8 March 2015), Barclays Research

Most of these games are ranked highly on the iOS and Android appstore download volume rankings. Among them, Timi Match Everyday and Tim Run Everyday launched in 3Q13 have continued their strong performance and have ranked within the top ten on the iOS appstore (measured by daily gross revenue) from time to time. We also notice the two third-party hard-core games – Blade of Three Kingdoms and I'm MT2 which were launched in 4Q14 are both showing encouraging results and should help contribute to the growth in 4Q14. More importantly, a recently launched FPS (first person shooting) game We Fire (launched on 6 January 2015) was consistently ranked No.1 on the iOS appstore, measured by daily gross revenue for the past few weeks, according to App Annie statistics. Given the game was only launched in January 2015, we believe this could serve as a positive driver for 1Q15 mobile games revenues.

FIGURE 21

## Tencent – smartphone games launch and ranking summary (iOS)

Game name	Chinese name	Launch date	In-house / third-party	Current rank on iOS (daily downloads)	Current rank on iOS (daily gross revenues)
Timi Match Everyday	天天爱消除	05-Aug-13	In-house	11	3
Timi Link Everyday	天天连萌	20-Aug-13	In-house	Out of top 100	Out of top 100
Rhythm Master	节奏大师	02-Sep-13	In-house	31	88
Timi Run Everyday	天天酷跑	13-Sep-13	In-house	9	11
Trump the Landlord	欢乐斗地主	15-Oct-13	In-house	37	9
Plants vs Zombies 2	植物大战僵尸 2	30-Oct-13 (Android only)	third-party	NA	NA
Qhero	全民英雄	02-Dec-13	In-house	Out of top 100	Out of top 100
Timi Drive Everyday	天天飞车	17-Dec-13	In-house	85	10
National Aircraft War	全民飞机大战	03-Jan-14	In-house	29	11
QQ Majiang	欢乐麻将	10-Jan-14	In-house	12	23
Timi Texas Holdem	天天德州	25-Feb-14	In-house	48	31
Tower of Saviors	神魔之塔	01-Mar-14	third-party	Out of top 100	Out of top 100
Thunder Fighter	雷霆战机	20-Mar-14	In-house	47	14
National Dance	全民炫舞	10-Apr-14	In-house	Out of top 100	Out of top 100
National Pengpengpeng	全民砰砰砰	18-Apr-14	third-party	Out of top 100	Out of top 100
Qtown	全民小镇	21-Apr-14	In-house	Out of top 100	Out of top 100
Timi Fighting Everyday	天天炫斗	28-Apr-14	third-party	Out of top 100	26
Taming Monster	全民打怪兽	29-Apr-14	third-party	Out of top 100	Out of top 100
Castle Clash	城堡争霸	11-May-14	third-party	Out of top 100	Out of top 100
Water Margin	全民水浒	16-Jun-14	In-house	Out of top 100	Out of top 100
National Elt	全民精灵	13-Jul-14	In-house	Out of top 100	Out of top 100
Huan Le Xi You	欢乐西游	15-Jul-14	In-house	Out of top 100	34
National Farm	全民农场	26-Jul-14	In-house	Out of top 100	Out of top 100
Everybody's Marble	天天富翁	02-Aug-14	third-party	66	39
Candy Crush Saga	糖果传奇	05-Aug-14 (Android) 21-Aug-14 (iOS)	third-party	17	22
Fruit Ninja	全民切水果	10-Sep-14	third-party	Out of top 100	Out of top 100
Long Qi Di Guo	龙骑帝国	29-Sep-14	third-party	Out of top 100	Out of top 100
Heng Sao Xi You	横扫西游	10-Oct-14	third-party	Out of top 100	37
Blade of Three Kingdom	三国之刃	19-Oct-14	third-party	58	4
Quan Min Zhan Xian	全民斩仙	22-Oct-14	third-party	Out of top 100	85
Wind Travel	天天风之旅	31-Oct-14	In-house	79	69
Tribal guard battle	新部落守卫战	10-Nov-14	In-house	Out of top 100	Out of top 100
Qi Xiong Zheng Ba	七雄争霸	11-Nov-14	In-house	Out of top 100	Out of top 100
Chinese Paladin	仙剑奇侠传	20-Nov-14	In-house	Out of top 100	16
Tian Tian Lai Zhan	天天来战	26-Nov-14	3rd-party	Out of top 100	51
Seven Knights	七骑士	27-Nov-14	3rd-party	Out of top 100	Out of top 100
Xian Xia Dao	仙侠道	01-Dec-14	3rd-party	Out of top 100	Out of top 100
You Long Ying Xiong	游龙英雄	03-Dec-14	3rd-party	Out of top 100	53
Monster Strike	怪物弹珠	11-Dec-14	3rd-party	Out of top 100	Out of top 100
I'm MT 2	我叫MT2	16-Dec-14	3rd-party	44	5
Huan Le Dou Niu	欢乐斗牛	17-Dec-14	3rd-party	4	20
Quan Min Po Huai Shen	全民破坏神	29-Dec-14	In-house	Out of top 100	54
We Fire	全民突击	06-Jan-15	In-house	2	1
Tian Tian Dou San Guo	天天斗三国	16-Jan-15	In-house	Out of top 100	Out of top 100
Quan Min Chuang Tian Xia	全民闯天下	21-Jan-15	3rd-party	Out of top 100	Out of top 100
TD Everyday	天天来塔防	27-Jan-15	In-house	Out of top 100	25
Quan Min Pao Pao Da Zhan	全民泡泡大战	02-Feb-15	In-house	9	19
Long Jie Qi Shi Lu	龙界启示录	06-Feb-15	3rd-party	Out of top 100	Out of top 100
Da Nao San Guo	大闹三国	13-Feb-15	In-house	27	38

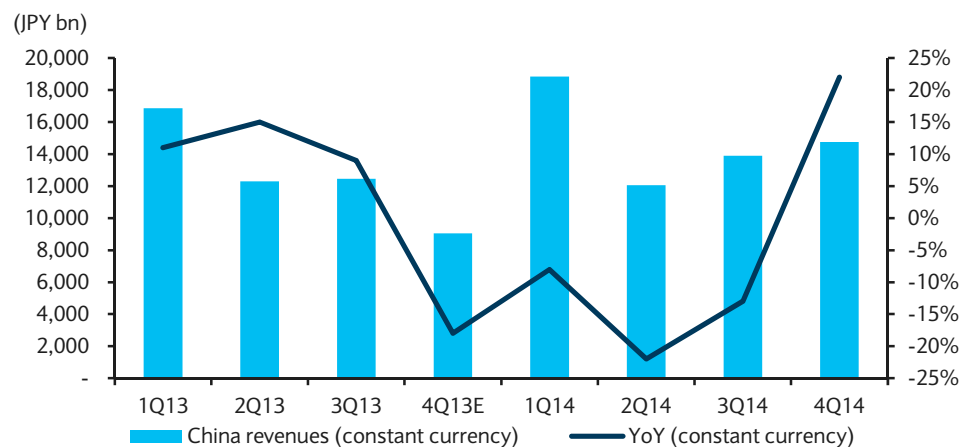
Source: Company data, App Annie (8 March 2015), Barclays Research

### 3) Update on PC games

#### *Nexon's 4Q14 result suggest positive and solid growth for DNF*

According to Nexon's 4Q14 results reported on 12 February, 2015, revenues from China grew 36% y/y to JPY16.4bn or 22% y/y on constant currency to JPY14.76bn, citing a strong performance of DNF as a result of well-received content updates and item sales during November and December. Nexon noted the Tier 1 content update "Kunoichi" was introduced during 4Q14. This was the first quarter of y/y growth shown for China revenues on a constant currency basis after four consecutive y/y decline quarters since 4Q13. Looking into 1Q15, Nexon guided that it expects China revenues to see high single-digit y/y decline on an as-reported basis. Another tier content update was also introduced on 10<sup>th</sup> February for the Lunar New Year update.

FIGURE 22  
Nexon China revenue and growth



Source: Company data, Barclays Research

We see Nexon's comments on the China result on 4Q14 as a positive read-through for DNF performance in 4Q14 for Tencent. That said, due to the deferred revenue recognition, we believe while DNF will help contribute to growth of PC games in 4Q14, it will also benefit growth in 1Q15 and next few quarters.

#### **Other major games updates**

In addition to DNF, below we provide several updates on Tencent's major PC games: 1) CF launched its 2.0 version Innovation Era on 17 December 2014; 2) Blade & Soul's new expansion pack was launched on 22 January 2015; 3) Call of Duty Online started its public open beta in China on 12 January 2015.

- **League of Legends (LOL):** According to iResearch statistics, LOL continues to show strong daily unique visitor (DUV) and monthly unique visitor (MUV) momentum over the past few months. For the week of 2 February 2015, the game recorded DUV and MUV of 9.2mn and 17.6mn respectively, and continued to rank as the number one client-based game in China based on traffic recorded by iResearch. **We expect the solid growth of LOL to continue into the next few quarters, which should help to offset any weaker revenue from some other PC games.**
- **Crossfire (CF):** The game launched a new 2.0 version update "Innovation Era" on 17 December 2014 to provide more attractive and realistic game battle experience to its players. According to the game's official site, this update is considered to be one of the biggest updates since the game was launched in 2008. The 2.0 version has enhanced graphical user interface and better visuals, with screen optimization; it also introduced

brand new modes, maps, roles and more GP weapons. We expect this major upgrade is likely to help the game retain its user base and user engagement which might lead to the rebound of traffic and monetization for 2015.

- Blade and Soul (B&S):** After the launch of the expansion pack, White Blue Mountain Range, on 8 August 2014, the user base of the game showed a stable trend until the end of 2014. On 22 January, 2015, B&S launched another new expansion pack with a new character followed by one more new version for Chinese New Year was launched on 5 February with some adjustment to the game play and a series of promotions for the holiday period. According to a news report (PCgame, 3 February 2015), the new character has been well received and players using the new character reached 2.23mn in the first week after its launch. We believe, with the continued enhancement of the game updates, it might help to attract more gamers' interest and potentially translate into stronger revenue ramp in 2015.
- Call of Duty Online (COD):** ATVI management commented during its 4Q14 conference call that Call of Duty Online which just started its public open beta in China on 12 January 2015 saw "positive initial consumer momentum". However, ATVI only expects modest contributions from Call of Duty Online in 2015 and believes the game will focus on building and growing the audience during the year as it noticed that for most of the free-to-play game, it may take some time for the game to ramp its monetization, but given the micro-transaction model is familiar to Chinese gamers, ATVI is optimistic on the long term monetization and expects meaningful contribution to grow over time. ATVI also believes Call of Duty Online will help it become better positioned in the fast-growing Asia market where free-to-play is the dominant business model. We remain cautiously optimistic on the potential success of COD online, given that: 1) While Baidu index did show strong momentum during the first couple weeks of launch, the trend seems to taper off a bit starting from end-January. 2) As we noted before, we do caution on the potential cannibalization of elements of Tencent's existing FPS game portfolio, including Cross Fire and Assault Fire. 3) ATVI's comment of "taking time to ramp" and "modest contributions" suggest to us that it might still be too early to determine and conclude the ultimate success and traction of COD online in China.

## Tencent 4Q14 results preview

Scheduled to report 4Q results after market close on 18 March. Conference call at 8 p.m. HK or 8 a.m. EST.  
Dial-in numbers:  
+852-3018-6770 (HK)  
or +1-866-331-9014 (US)  
Password: 63655586

**4Q14 preview:** We estimate 4Q14 total revenue of RMB20.04bn (+18% y/y and +1.2% q/q) and GAAP net profit of RMB5.77bn (28.8% margin) compared with Bloomberg consensus of RMB20.45bn and RMB6.03bn (29.5% margin), respectively. We expect Tencent to deliver a relatively in-line result, meeting consensus expectations for its top-line growth, driven by: 1) rebound of DNF and CF as a result of successful major content update; 2) continued strength of LOL; 3) sequential rebound and solid y/y growth of WeChat games revenues and 4) continued improvement of performance-based revenues, especially from Mobile Qzone partially offset by sequential softness of brand ad growth following a strong 3Q14 Voice China III contribution. All these will be partially offset by the continued steep decline of ecommerce transaction revenues.

FIGURE 23

### Tencent – Barclays Research estimates vs. consensus forecasts

CNY mn	4Q14E			1Q15E			2014E			2015E		
	Barclays	Cons.	Diff.	Barclays	Cons.	Diff.	Barclays	Cons.	Diff.	Barclays	Cons.	Diff.
Total revenue	20,044	20,452	-2.0%	20,833	21,936	-5.0%	77,998	78,498	-0.6%	93,177	96,408	-3.4%
Non-GAAP net income	6,422	6,477	-0.8%	6,970	7,511	-7.2%	23,923	24,147	-0.9%	32,565	31,585	3.1%
Non-GAAP EPADS (CNY)	0.69	0.70	-1.5%	0.75	0.80	-7.1%	2.56	2.57	-0.6%	3.48	3.42	1.8%

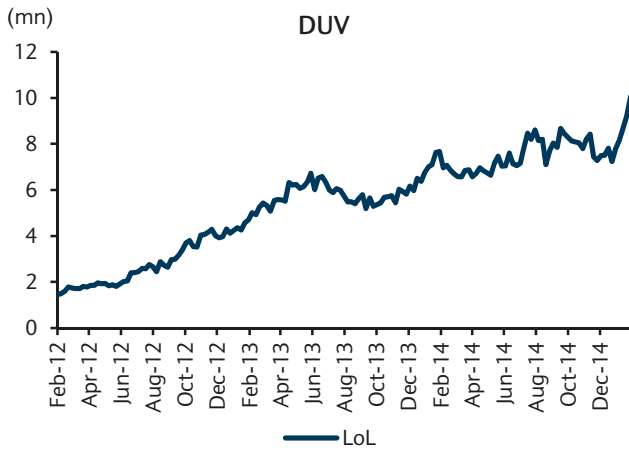
Source: Bloomberg consensus estimates, Barclays Research estimates



- **PC games:** We model PC online gaming revenue to grow 23% y/y and 2.5% q/q to RMB9.69bn in 4Q14. We believe the continued strength of LOL and solid rebound of DNF and Crossfire (as highlighted from Nexon 4Q14 read-through and major content update 2.0 for CF) will help contribute to solid growth in PC games.
- **Mobile games:** We model the mobile game revenue line to grow by 255% y/y and 13.8% q/q to RMB2.13bn, while for WeChat games we estimate revenue to be Rmb3.016bn, up 16% q/q from Rmb2.6bn recorded in 3Q14 and compared to Rmb600mn reported in 4Q14. (We note that about 60% of the WeChat games revenue is recognized on the mobile gaming revenue line and the rest on the community and open platform line). While the one-off disruption of iOS guess login ended in end October, there is still one month impact for 4Q14. In addition, most of the new games launched in the past few months are mostly third party games which Tencent will book as net revenues after sharing with game developers. That said, we remain positive on the growth outlook for WeChat games for 2015 and model it to grow to Rmb15.1bn (+45% y/y from our estimate of Rmb10.4bn for 2014).
- **Community and open platform:** We estimate PC community and open platform revenue growth of 5% y/y to RMB2.68bn in 4Q14, mainly contributed by the steady trend of its web games' performance and some improvement of QQ super VIP and Qzone user subscription base. For the mobile open platform, we estimate RMB1.94bn revenue for 4Q14, up from Rmb1.75bn in 3Q14 mainly due to the sequential rebound of WeChat games revenues (as mentioned above). However, we believe there is likely some upside to this mobile platform revenue line due to continued traction of Tencent app store YingYongBao as an app distribution channel.
- **Online advertising:** We estimate online advertising revenue growth of 60% y/y and -1.6% q/q to RMB2.4bn, driven by continued traction of performance based advertising, especially with growth in Mobile Qzone and some revenues from WeChat official accounts, partially offset by sequential softness of brand advertising following a strong 3Q14 of Voice of China III contribution. We believe there is potential upside risk to advertising revenues if traction from Mobile Qzone and WeChat official accounts actually come in stronger than we expect.
- **E-commerce:** We model e-commerce revenue to decline by 90% y/y and 28% q/q to RMB332mn as Tencent continues to transition out its Yixun business to JD and marketplace. We estimate other revenues to be relatively flat at Rmb868mn driven by lottery commission fee contribution.
- **Margins:** We model total gross margin of 65.8%, improving from 63.8% thanks to lower contribution from the lower-margin Yixun e-commerce business, increased contribution from higher-margin smartphone games, and higher margins from performance based advertising revenues. For operating expense, we model sales and marketing expense to be around Rmb2.2bn or 11% of total revenues, up 8% y/y. However, we model G&A (including R&D) to grow 41% y/y to Rmb3.9bn. Our overall GAAP and non-GAAP operating margin estimates are 36.6% and 39.7%, a slight decline from 37.9% and 41.7% achieved in 3Q14. We model 4Q14 GAAP and non-GAAP net margins to be 28.8% and 32% compared with 28.6% and 32.5% for 3Q14.

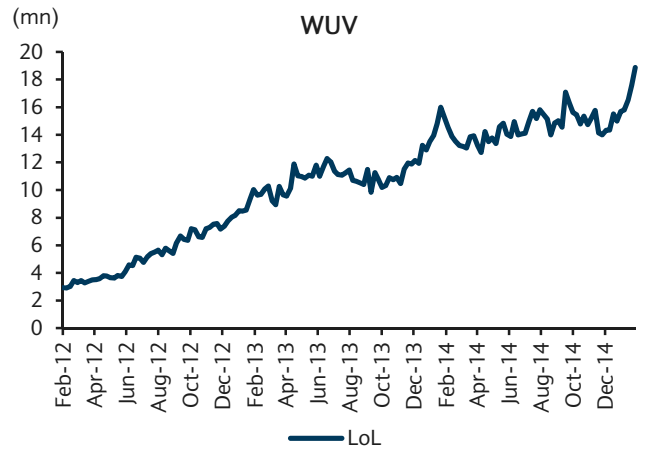
**1Q15 outlook:** Tencent does not provide financial guidance, but we expect key focus on the earnings call to relate to the progress of WeChat Moments advertising feedback and ramp-up and update on WeChat payment monetization progress. In addition, we believe comment and update on WeChat games and PC games is also important as games revenues remain key revenue and profit contributions. Besides that, we also expect some questions on the impact of lottery regulation as well as an update on the Yixun winding down progress. Lastly, we believe margins, spending on O2O and other new initiatives such as financing and private banking could also be a focus. We forecast 1Q15 total revenue of RMB20.8bn and non-GAAP EPS of RMB0.745 vs. consensus of RMB21.9bn and RMB0.80, respectively.

FIGURE 24  
LOL – DUV trend



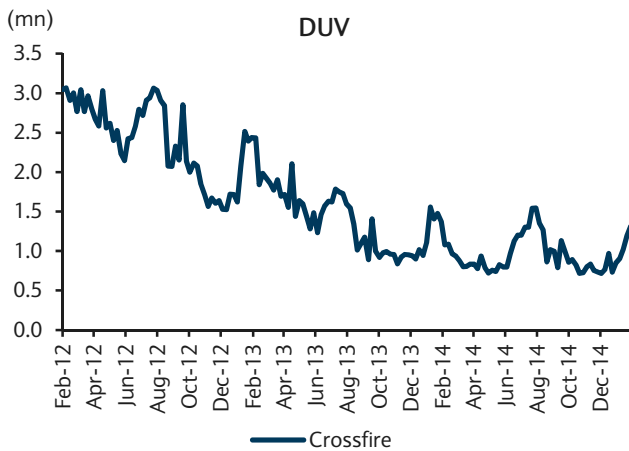
Source: iResearch

FIGURE 25  
LOL – WUV trend



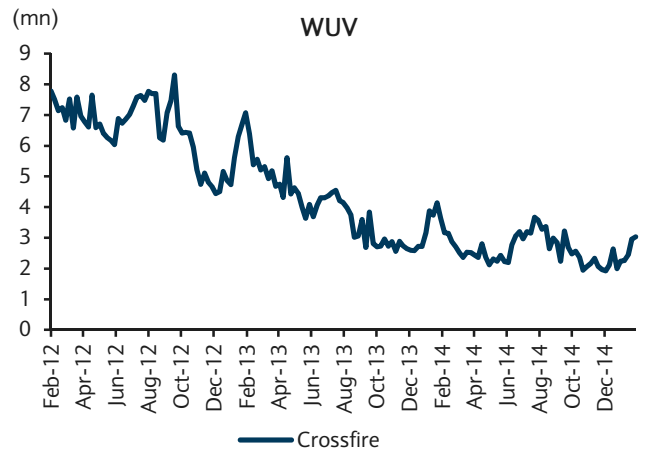
Source: iResearch

FIGURE 26  
CF – DUV trend



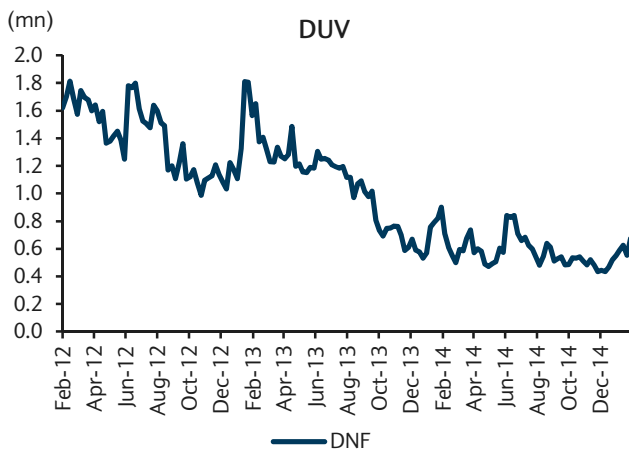
Source: iResearch

FIGURE 27  
CF – WUV trend



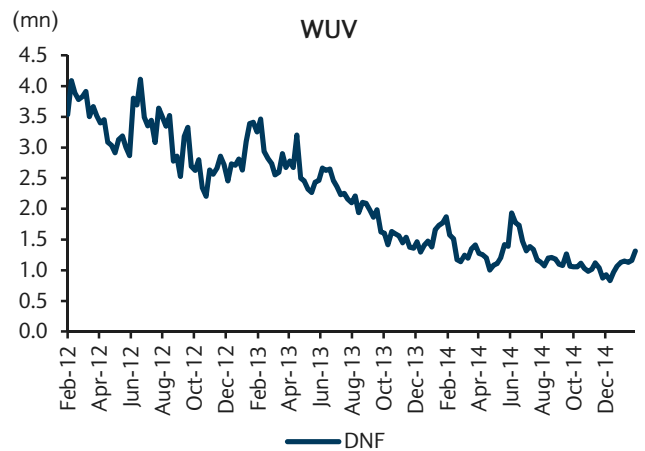
Source: iResearch

FIGURE 28  
DNF – DUV trend



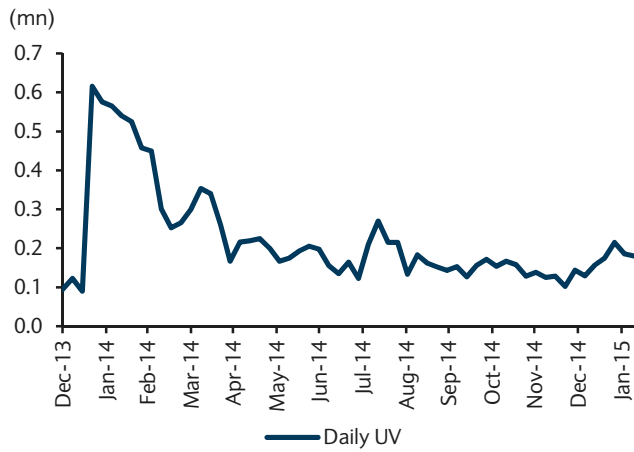
Source: iResearch

FIGURE 29  
DNF – WUV trend



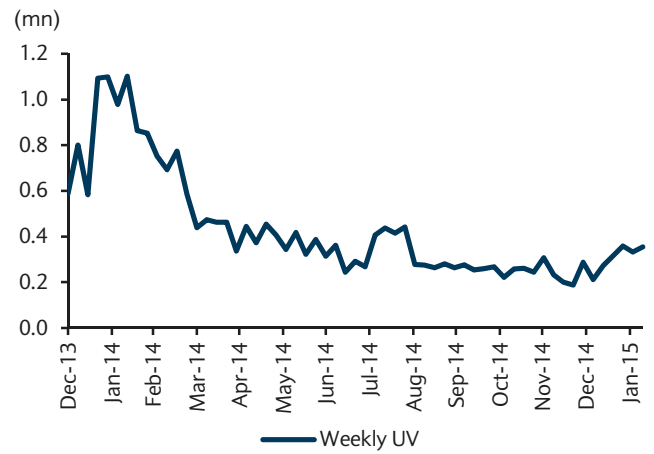
Source: iResearch

FIGURE 30  
B&S – DUV trend



Source: iResearch

FIGURE 31  
B&S – WUV trend



Source: iResearch

## Income statement

FIGURE 32

Tencent – consolidated income statement (Rmb million, except per share data)

Year to 31 Dec	2013	1Q14	2Q14	3Q14	4Q14E	2014E	2015E	2016E
<b>Revenues</b>								
VAS	44,985	14,413	15,713	16,047	16,444	62,617	75,694	85,451
Online gaming	30,223	9,443	8,975	9,452	9,692	37,124	43,897	48,952
Mobile game	1,743	1,394	2,106	1,872	2,131	7,491	10,475	12,598
Community and open platforms	10,178	2,638	2,718	2,973	2,685	11,014	11,446	11,760
Non-mobile game	2,842	1,388	1,914	1,750	1,936	6,988	9,877	12,142
Online advertising	5,034	1,177	2,064	2,440	2,400	8,081	12,828	24,029
E-commerce transactions	9,796	2,524	1,324	459	332	4,639	688	47
Others	622	286	645	862	868	2,661	3,967	4,805
<b>Total revenues</b>	<b>60,437</b>	<b>18,400</b>	<b>19,746</b>	<b>19,808</b>	<b>20,044</b>	<b>77,998</b>	<b>93,177</b>	<b>114,333</b>
<i>YoY change</i>	<i>37.7%</i>	<i>35.8%</i>	<i>37.3%</i>	<i>27.5%</i>	<i>18.1%</i>	<i>29.1%</i>	<i>19.5%</i>	<i>22.7%</i>
<b>Cost of revenues</b>								
VAS	15,384	4,371	4,755	5,325	5,098	19,549	23,324	26,149
Online advertising	2,777	766	1,140	1,177	1,152	4,235	5,908	9,010
E-commerce transactions	9,239	2,422	1,416	346	249	4,433	516	35
Others	378	241	263	319	347	1,170	1,575	1,909
Total cost of revenues	27,778	7,800	7,574	7,167	6,846	29,387	31,325	37,103
<b>Gross profit</b>	<b>32,659</b>	<b>10,600</b>	<b>12,172</b>	<b>12,641</b>	<b>13,198</b>	<b>48,611</b>	<b>61,853</b>	<b>77,230</b>
<i>Gross margin</i>	<i>54.0%</i>	<i>57.6%</i>	<i>61.6%</i>	<i>63.8%</i>	<i>65.8%</i>	<i>62.3%</i>	<i>66.4%</i>	<i>67.5%</i>
Other operating exp/(income)	(2,219)	(1,982)	(1,097)	(570)	(260)	(3,909)	(1,216)	(1,549)
Selling and marketing	5,695	1,855	1,973	1,906	2,205	7,939	9,042	9,833
General and administration	9,988	2,937	3,453	3,790	3,909	14,089	16,906	19,919
Total operating expenses	13,464	2,810	4,329	5,126	5,854	18,119	24,732	28,203
<b>Operating profit</b>	<b>19,194</b>	<b>7,790</b>	<b>7,843</b>	<b>7,515</b>	<b>7,345</b>	<b>30,493</b>	<b>37,121</b>	<b>49,027</b>
<i>Operating margin</i>	<i>31.8%</i>	<i>42.3%</i>	<i>39.7%</i>	<i>37.9%</i>	<i>36.6%</i>	<i>39.1%</i>	<i>39.8%</i>	<i>42.9%</i>
Finance income, net	(84)	(238)	(354)	(317)	(317)	(1,226)	(1,268)	(1,200)
Share of loss of jointly controlled entity	213	45	23	(139)	(10)	(81)	(40)	(40)
Share of losses of associates	(43)	(1)	-	-	-	(1)	-	-
Gain on disposal of assets	-	-	-	-	-	-	-	-
Profit before tax	19,281	7,596	7,512	7,059	7,018	29,185	35,813	47,787
Income tax expense	(3,718)	(1,164)	(1,686)	(1,383)	(1,228)	(5,461)	(6,267)	(8,363)
Minority interest	(61)	25	10	(19)	(19)	(3)	(76)	(80)
<b>Net income</b>	<b>15,502</b>	<b>6,457</b>	<b>5,836</b>	<b>5,657</b>	<b>5,770</b>	<b>23,720</b>	<b>29,470</b>	<b>39,344</b>
<i>Net margin</i>	<i>25.6%</i>	<i>35.1%</i>	<i>29.6%</i>	<i>28.6%</i>	<i>28.8%</i>	<i>30.4%</i>	<i>31.6%</i>	<i>34.4%</i>
Diluted EPS (RMB)	1.66	0.69	0.62	0.60	0.62	2.54	3.15	4.20
Diluted EPS (HKD)	2.09	0.86	0.78	0.75	0.77	3.15	3.92	5.23
<b>Non-GAAP net income</b>	<b>17,005</b>	<b>5,194</b>	<b>5,874</b>	<b>6,433</b>	<b>6,422</b>	<b>23,923</b>	<b>32,565</b>	<b>42,471</b>
<b>Non-GAAP diluted EPS (RMB)</b>	<b>1.82</b>	<b>0.55</b>	<b>0.63</b>	<b>0.69</b>	<b>0.69</b>	<b>2.56</b>	<b>3.48</b>	<b>4.53</b>
<b>Non-GAAP diluted EPS (HK\$)</b>	<b>2.30</b>	<b>0.69</b>	<b>0.78</b>	<b>0.86</b>	<b>0.85</b>	<b>3.18</b>	<b>4.33</b>	<b>5.64</b>
Diluted shares average (m)	9,340	9,361	9,361	9,352	9,354	9,357	9,359	9,367

Source: Company data, Barclays Research estimates

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Tencent Holdings Ltd. (0700.HK, 10-Mar-2015, HKD 131.10), Overweight/Positive, A/D/E/J/L

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China Mobile Games & Entertainment Group (CMGE)	CJ CGV (079160.KS)	CJ Hellovision (037560.KS)
Ctrip.com International Ltd. (CTRP)	Daum Kakao (035720.KQ)	E-Commerce China Dangdang Inc. (DANG)
Info Edge (India) Ltd. (INED.NS)	Interpark INT (108790.KQ)	JD.com (JD)
Just Dial Ltd. (JUST.NS)	KT Skylife (053210.KS)	MakeMyTrip (MMYT)
Naver Corp. (035420.KS)	NetEase, Inc. (NTES)	Perfect World Co., Ltd. (PWRD)
Qihoo 360 Technology Co., Ltd. (QIHU)	Qunar (QUNR)	Sina Corp. (SINA)
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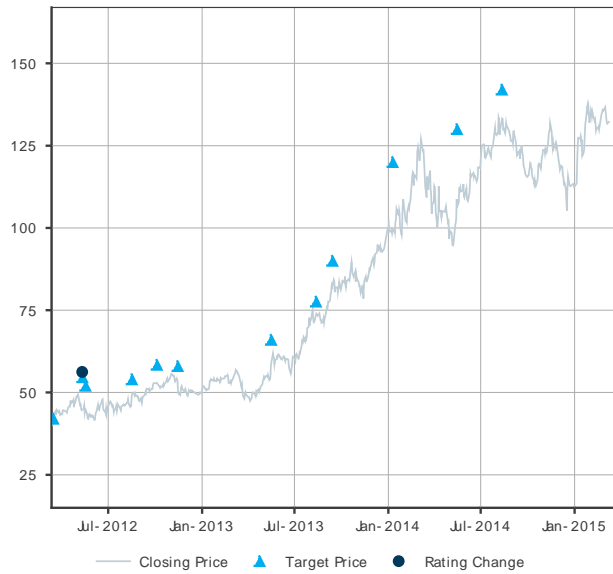
**Tencent Holdings Ltd. (700 HK / 0700.HK)**  
**HKD 131.10 (10-Mar-2015)**

Stock Rating  
**OVERWEIGHT**

Industry View  
**POSITIVE**

**Rating and Price Target Chart - HKD (as of 10-Mar-2015)**

Currency=HKD



Date	Closing Price	Rating	Adjusted Price Target
11-Aug-2014	132.30		142.00
15-May-2014	108.80		130.00
09-Jan-2014	98.60		120.00
13-Sep-2013	82.16		90.00
12-Aug-2013	73.48		77.60
16-May-2013	58.44		66.00
14-Nov-2012	53.56		58.00
04-Oct-2012	52.92		58.40
16-Aug-2012	48.92		54.00
17-May-2012	45.00		52.00
11-May-2012	44.72	Overweight	54.60
15-Mar-2012	41.76		42.00

Source: Thomson Reuters, Barclays Research

Historical stock prices and price targets may have been adjusted for stock splits and dividends.

Source: IDC, Barclays Research

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**Valuation Methodology:** Our price target of HK\$158 is based on 28x 2016E non-GAAP EPS of HK\$5.64. Our target multiple of 28x is in-line with two-year (2015-2017E) earnings CAGR of 28%, which we believe is reasonable.

**Risks which May Impede the Achievement of the Barclays Research Price Target:** The key downside risks to our investment thesis and price target include the following: 1) The WeChat monetization ramp up could disappoint if new games to be released fail to attract a similar level of user traction, and Moments ads fail to take off and user experience materially affected; 2) PC games growth slows down as legacy games slowing faster-than-expected and new PC games such as Call of Duty fail to take off; 3) margin pressure as a result of stepped up investment in O2O initiatives, marketing spend and coupon subsidies on WeChat payment.



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