

JPM-pp1

Asia Pacific Equity Research

17 March 2015

Tencent (700 HK)

Overweight

Price: HK\$135.60

16 Mar 2015

Price Target: HK\$160.00

PT End Date: 31 Dec 2015

4Q preview: expecting a recovery of mobile game and stable PC game revenue; mobile ads is the key focal point

Tencent will report 4Q14 results on March 18 after the HK market closes with a conference call scheduled at 8:00pm HKT. We expect Tencent to report non-GAAP EPS of RMB0.71, slightly above consensus estimates of RMB0.69. We believe core business lines remain solid in 4Q, with recovery of mobile game, continued momentum of online ads, as well as steady growth of PC game driving growth. We are keen on the development strategy and outlook of mobile ads, which in our view is the focal point and key stock driver for Tencent in 2015.

- **Key financial forecasts.** We expect total revenue to come in at RMB20.1bn (+1% QoQ, +18% YoY) vs consensus of RMB20.5bn. We model mobile game revenue of RMB2.8bn in 4Q14. We expect gross margin to improve 2.7ppt sequentially to reach 66.6% in 4Q14, with non-GAAP operating margin at 42.2%, edging up from 41.7% in 3Q.
- **Core business lines remain solid across the board.** We expect robust growth of Tencent's core PC gaming business in 4Q, driven primarily by content updates. Particularly, we note that Nexon's 4Q China revenue grew 22% YoY (constant currency basis) after YoY declines over the past four quarters, indicating a solid performance of DnF in 4Q. For mobile games, we expect a moderate recovery given the resolution of iOS guest log-in issue in Oct and an acceleration of new game launches in the quarter. We estimate mobile game revenue of RMB2.8bn, up 8.4% QoQ from RMB2.6bn in 3Q. In addition, we expect Tencent's ads revenue to continue its momentum in 4Q (JPMe +71% YoY), driven by online video and performance-based ads on mobile QZone.
- **Development of mobile ads the focal point.** We view the launch of Weixin news feed ads in Jan as an important step of Tencent to unlock the monetization capability of its core mobile social platform through ads. Our channel checks indicate that initial feedback from Weixin moment ads is encouraging. While we expect insignificant financial contribution in 1Q15 as Tencent is still fine tuning the ads system, we expect the business to gradually ramp up in coming quarters. We are keen on management's comments on the development plans and outlook for mobile ads.
- **Key things to watch.**

- 1) Mobile ads development plan and outlook
- 2) Mobile game outlook
- 3) Updates on O2O strategy
- 4) Development of internet banking

Reiterate OW.

Investment Thesis

We expect Tencent to start expanding its monetization cylinder from gaming to ads in 2015, which should drive earnings growth in a non-cannibalistic fashion. Tencent has generated the majority of its earnings growth from gaming and gaming-related activities over the past five years, while Facebook monetized mostly through ad services (JPMe: Internet value-added services to account for 80% of Tencent's total revenue in 2014 vs. Facebook to generate 92% of revenue from ads). We expect Tencent's ad revenue to increase from 11% of total revenue in 2014 to 25% in 2017, driven largely by the monetization of performance ads on mobile.

Valuation

Our Dec-15 PT of HK\$160 is based on 2016E EPS of HK\$6.33, an FY16E-18E non-GAAP EPS CAGR of 22.0% and a PEG of 1.15x. We adopt PEG as our primary valuation methodology, as it balances valuation multiple and growth prospects. Our PT implies a 34x 2015E P/E and a 25x 2016E P/E.

We cross-check our PT with a 10-year DCF valuation, which yields a price target of HK\$152. Key assumptions of our DCF valuation include: (1) a risk-free rate of 4%; (2) an equity risk premium of 7% in the China market; (3) a beta of 1.2; (4) a discount rate of 12.6%; and (5) a terminal growth rate of 3%.

Risks to Rating and Price Target

Downside risks to our view include:

- Core PC games aging faster than expected
- Inability to launch successful mobile game titles continuously
- Slower-than-expected ramp-up of mobile ads revenue
- Video content spend

Internet

AC

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
10-Nov-11	OW	32.98	46.00
15-Mar-12	OW	41.76	48.00
08-May-12	OW	46.16	55.00
17-May-12	OW	43.92	55.20
10-Nov-12	OW	53.40	61.20
21-Mar-13	OW	51.84	60.00
30-Aug-13	OW	72.36	86.60
27-Oct-13	OW	85.24	101.20
07-Jan-14	OW	99.12	116.00
20-Mar-14	OW	115.60	128.00
15-May-14	OW	101.50	130.00
25-Jun-14	OW	114.20	138.00
14-Aug-14	N	130.10	144.00
18-Sep-14	N	124.00	137.00
13-Nov-14	N	127.60	142.00
06-Jan-15	OW	113.50	160.00

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