

# Tencent Holdings Ltd. (700 HK)

N: Uneventful quarter with WeChat ads ramping in 2H15

## Neutral

Target price (HKD)	145.00
Share price (HKD)	135.90
Forecast dividend yield (%)	0.3
Potential return (%)	7

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

Dec	2014 a	2015 e	2016 e
HSBC EPS	2.59	3.49	4.55
HSBC PE	42.2	31.4	24.1
<b>Performance</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>
Absolute (%)	4.6	21.4	17.6
Relative <sup>A</sup> (%)	7.7	15.0	5.2

Note: (V) = volatile (please see disclosure appendix)

19 March 2015

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

- ▶ **Solid results helped by lower costs and taxes**
- ▶ **Steady growth in adoption and monetization of WeChat**
- ▶ **Maintain Neutral and Sum-of-parts TP of HKD145**

**Solid quarter with lower spending and EPS helped by taxes.** Total revenue grew 24% y-o-y to RMB20.978bn, 3% ahead of expectations. Management changed the way it recognises revenue from smart phone games from a net basis to a gross basis, increasing revenue by RMB907m and cost by the same amount. When we adjust for this change, total revenue missed our estimate by 2%. Key financial highlights include: 1) online gaming revenue grew 41% y-o-y to RMB11.9bn, with PC down q-o-q but up c10% y-o-y. 2) online advertising revenue increased 75% y-o-y to RMB2.6bn, with WeChat official accounts contributing roughly RMB183m or 17% of performance revenue. 3) S&M costs only grew 1% y-o-y reflecting easy comps due to its now exited e-commerce business in 4Q13. 4) Non-GAAP EPS was RMB0.72, 8% ahead of our estimate. We note that the effective tax rate was lower than expected at 13% (versus 19-20% in the past few quarters). This helped EPS by roughly RMB0.04.

**Steady execution of “Connection” strategy.** WeChat users totalled 500m in December (versus our 510m estimate), up 41% y-o-y. Smart phone gaming revenue amounted to RMB2.8bn, up 12% q-o-q on a net basis (RMB3.8bn on a gross basis), versus our RMB3.0bn estimate. WeChat will add c50games this year, shifting to mid-core games with higher ARPU. Over 100m user accounts have integrated bank cards with Mobile QQ Wallet and Weixin payment, helped by the Red Envelope campaign during Chinese New Year. Management is testing WeChat advertising on Moments with 10 brand advertisers and the initial response from users is positive while advertisers are extremely positive. We expect this to ramp gradually this year, and mostly back-end loaded as management continues monitor data to optimize user and advertiser experience.

**Estimate changes.** The new accounting treatment leads us to increase gaming revenue but lower gaming gross profits by the same level. We now expect smartphone gaming to be RMB18bn in 2015 (on a gross basis), versus RMB15bn on a net basis previously. We continue to expect WeChat moments to contribute RMB1.7bn this year and RMB4.2bn in 2016, representing 2%/3% of revenue, respectively. Specifically, for 2015/2016, we raise our revenue estimate by 4/4% but leave non-GAAP EPS unchanged.

**We maintain Neutral rating and SOTP-based TP of HKD145.** The stock now is trading at 31x/24x 2015/2016e non-GAAP EPS. Our target price implies 33x/25x 2015/16e non-GAAP EPS, which we think is reasonable given its adjusted EPS expected to grow at a CAGR of 24% from 2015-2018.

Index <sup>A</sup>	HANG SENG INDEX
Index level	24,120
RIC	0700.HK
Bloomberg	700 HK

Source: HSBC

Enterprise value (CNYm)	973166
Free float (%)	52
Market cap (USDm)	164,060
Market cap (HKDm)	1,273,820

Source: HSBC

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	78,932	102,327	129,757	155,314
EBITDA	32,710	42,674	54,928	66,525
Depreciation & amortisation	-4,801	-4,764	-5,896	-7,252
Operating profit/EBIT	30,542	38,270	50,702	62,499
Net interest	907	1,481	2,791	4,347
PBT	29,426	36,200	48,631	60,428
HSBC PBT	29,426	36,200	48,631	60,428
Taxation	-5,125	-7,240	-9,726	-12,086
Net profit	24,223	28,902	38,827	48,246
HSBC net profit	23,810	28,902	38,827	48,246

### Cash flow summary (CNYm)

Cash flow from operations	25,910	33,600	41,077	45,910
Capex	-4,718	-6,940	-8,585	-10,119
Cash flow from investment	-28,388	-6,940	-8,585	-10,119
Dividends	-1,761	-2,624	-3,992	-5,363
Change in net debt	6,871	-33,728	-41,988	-47,832
FCF equity	36,007	38,686	49,624	58,394

### Balance sheet summary (CNYm)

Intangible fixed assets	10,055	10,055	10,055	10,055
Tangible fixed assets	88,257	92,201	96,774	101,471
Current assets	74,223	110,606	155,702	206,223
Cash & others	53,511	87,239	129,227	177,059
Total assets	172,534	212,861	262,531	317,750
Operating liabilities	47,478	59,911	74,489	88,071
Gross debt	35,584	35,584	35,584	35,584
Net debt	-17,927	-51,655	-93,643	-141,475
Shareholders funds	87,361	115,255	150,348	191,984
Invested capital	71,545	65,711	58,816	52,620

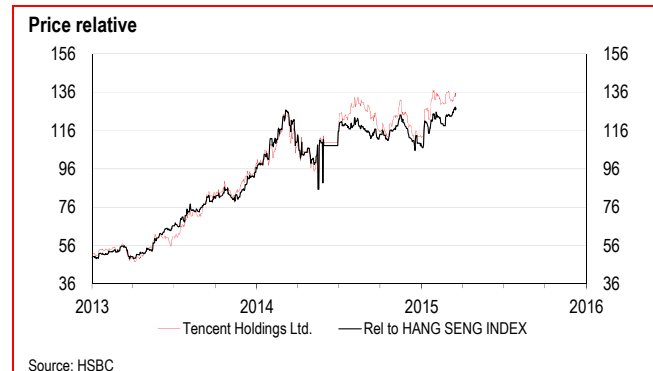
### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	30.6	29.6	26.8	19.7
EBITDA	50.5	30.5	28.7	21.1
Operating profit	59.1	25.3	32.5	23.3
PBT	52.6	23.0	34.3	24.3
HSBC EPS	41.7	34.6	30.4	22.1
<b>Ratios (%)</b>				
Revenue/IC (x)	1.5	1.5	2.1	2.8
ROIC	46.7	45.5	64.4	86.7
ROE	32.8	28.5	29.2	28.2
ROA	17.8	15.4	16.7	16.9
EBITDA margin	41.4	41.7	42.3	42.8
Operating profit margin	38.7	37.4	39.1	40.2
EBITDA/net interest (x)				
Net debt/equity	-20.0	-44.0	-61.4	-72.9
Net debt/EBITDA (x)	-0.5	-1.2	-1.7	-2.1
CF from operations/net debt				
<b>Per share data (CNY)</b>				
EPS reported (fully diluted)	2.59	3.09	4.15	5.16
HSBC EPS (fully diluted)	2.59	3.49	4.55	5.55
DPS	0.19	0.28	0.43	0.58
Book value	9.34	12.32	16.07	20.52

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	12.8	9.5	7.2	5.7
EV/EBITDA	30.8	22.8	17.0	13.3
EV/IC	14.1	14.8	15.8	16.8
PE*	42.2	31.4	24.1	19.7
P/Book value	11.7	8.9	6.8	5.3
FCF yield (%)	3.5	3.8	4.8	5.7
Dividend yield (%)	0.2	0.3	0.4	0.5

Note: \* = Based on HSBC EPS (fully diluted)



Note: price at close of 18 Mar 2015

# 4Q14 results recap

## 4Q14 results

RMB millions except HKD EPS	4Q14			Delta	
	Actual	HSBC	Consensus	HSBC	Consensus
Total online game revenue	11,964	10,935		9%	
Total VAS	17,137	15,982		7%	
Online Advertising	2,627	2,913		-10%	
E-Commerce	446	332		34%	
Other	768	1,164		-34%	
<b>Total Revenues</b>	<b>20,978</b>	<b>20,392</b>	<b>20,430</b>	<b>3%</b>	<b>3%</b>
memo: QoQ growth	5.9%	2.9%			
memo: YoY growth	23.6%	20.2%			
Gross profits	12,646	13,272	12,963	-5%	-2%
memo: QoQ growth	0.0%	5.0%			
memo: YoY growth	44.2%	51.3%			
<b>Gross Margins (bps)</b>	<b>60.3%</b>	<b>65.1%</b>	<b>63.5%</b>	<b>-480</b>	<b>-317</b>
Selling and marketing	(2,063)	(2,643)		-22%	
memo: QoQ growth	8.2%	38.7%			
memo: YoY growth	1.5%	30.0%			
memo: % of revenue	9.8%	13.0%			
G&A	(3,975)	(4,017)		-1%	
memo: QoQ growth	4.9%	6.0%			
memo: YoY growth	43.5%	45.0%			
memo: % of revenue	18.9%	19.7%			
<b>Non-GAAP Operating profit</b>	<b>8,068</b>	<b>7,879</b>		<b>2%</b>	
Non-GAAP Operating Margins	38.5%	38.6%		-18	
<b>Non-GAAP net income</b>	<b>6,723</b>	<b>6,217</b>		<b>8%</b>	
<b>Adjusted EPS CNY</b>	<b>CNY 0.72</b>	<b>CNY 0.66</b>			
memo: QoQ growth	4.2%	-3.4%			
memo: YoY growth	49.0%	38.2%			
<b>Adjusted EPS HKD</b>	<b>HKD 0.91</b>	<b>HKD 0.84</b>	<b>HKD 0.86</b>	<b>8%</b>	<b>5%</b>

Source: Company data, HSBC estimates

# Estimates changes

HSBC estimate changes		
RMBm except HKD EPS	2015e	2016e
<b>Current</b>		
Revenue	102,327	129,757
Operating profit	38,270	50,702
OPM	37.4%	39.1%
<b>Non-GAAP EPS</b>	<b>HKD 4.41</b>	<b>HKD 5.76</b>
<b>Previous</b>		
Revenue	98,604	124,978
Operating profit	39,027	51,097
OPM	39.6%	40.9%
<b>Non-GAAP EPS</b>	<b>HKD 4.44</b>	<b>HKD 5.74</b>
<b>Delta</b>		
Revenue	4%	4%
GM bps	(254)	(266)
Operating profits	-2%	-1%
OPM bps	(218)	(181)
<b>Non-GAAP EPS</b>	<b>-1%</b>	<b>0%</b>

Source: HSBC estimates

# Valuation and risks

- ▶ Sum-of-the-parts approach yields range of HKD132 to HKD145
- ▶ Value Weixin at HKD46 using DCF
- ▶ The risks to our rating include Weixin usage growth and monetization ramp, and with its core PC gaming business

## SOTP-based target price of HKD145

Range is HKD132 to HKD145

We continue to use a sum-of-the parts approach to value Tencent, using same multiples, believing it is the best way to capture the full value of the company. Our target price implies 33x/25x 2015/16e non-GAAP EPS.

Based on 2015 estimates, we value the value-added services (ex-Weixin) business at 25-30x NOPAT. This amounts to HKD46 to HKD56/share.

We continue to use a DCF to value Weixin, with our key assumptions and valuation details summarized in our DCF valuation tables 1&2. This approach yields a fair value of HKD46/share.

Weixin DCF valuation table 1

RMBm	2015e	2016e	2017e	2018e	2019e	2020e
Terminal value						477,22
Cash flows	2,011	5,568	8,987	11,044	13,042	14,788

Source: HSBC estimates

**Weixin DCF valuation table 2**

<b>Beta</b>	<b>1.07</b>
Risk free rate	2.5%
Equity risk premium	7%
Terminal growth rate	5%
<b>WACC</b>	<b>8.1%</b>
Cost of equity	9.59%
Cost of debt (after tax)	1%
Debt/ total capital	17%
Equity/total capital	83%
NPV (RMB million)	339,017
Minority discount	0%
Adjusted NPV (RMBm)	339,017
Add net cash	-
<b>Equity value (RMBm)</b>	<b>339,017</b>

Source: Corporate data, Bloomberg, HSBC estimates

The e-commerce business continues to be valued at a range of 2.0-2.5x 2015e revenue. Using this approach, we value the e-commerce business at HKD0.2 to HKD0.3/share.

We value online advertising at 40-45x NOPAT. This amounts to HKD28 to HKD32/share.

We include Tencent's total investments and associates in available-for-sale securities, with a total value of RMB64bn, translating into HKD9/share.

This totals HKD130 to HKD144/per share, to which we add HKD1 of net cash per share (December 2015). This results in a total value per share of HKD132 to HKD145.

We believe investors will continue to reward strong operating momentum at Weixin and shrewd investments and alliances by management. Thus, instead of setting our target price at the mid-point of the range, we set it at the high end of HKD145.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppt above and below the hurdle rate for Chinese stocks of 9.0%. Our target price of HKD145 implies a potential return of 7.0% (including a 0.3% prospective dividend yield), within the Neutral band; therefore, we keep our Neutral rating on the stock. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

## Risks

Our Neutral rating is subject to upside and downside risks. These include:

- ▶ Tencent's ability or failure to continue to offer expansion packs and features that lead to higher monetisation of games.
- ▶ If new licensed games – in particular Blade & Soul and Call of Duty – exceed or miss expectations, Tencent's performance could be affected.
- ▶ Tencent's ability to generate revenue from Weixin that is above or below our forecast.
- ▶ Online advertising ahead or below expectations.

Sum of the parts valuation

2015															
RMBm	Revenue	Gross Profit	Adjusted Operating Profit*	NOPAT	Methodology	Range		Value		Per share		% total value		USD	USD
						Low	High	Low	High	Low	High	Low	High		
<b>VAS ex-WeChat</b> memo: margin	74,954	50,543 67.4%	16,943 41.5%	13,555	Multiple of NOPAT	25	30	338,863	406,635	46	56	35%	38%	54,655	65,586
<b>WeChat</b> memo: margin					DCF			339,017	339,017	46	46	35%	32%	55,577	55,577
<b>E-commerce</b> memo: margin	750	337 45.0%	-52 -7.0%	-42	Multiple of revenues	2	2.5	1,500	1,875	0.2	0.3	0%	0%	242	302
<b>Online Advertising</b> memo: margin	16,006	7,747 45.7%	6,402 31.7%	5,122	Multiple of NOPAT	40	45	204,875	230,484	28	32	21%	22%	33,044	37,175
<b>Others</b> Investments in associates Market value of listed securities & available for sale Total investments	2,561	1,414	768	615	Multiple of NOPAT	5	10	3,073 51,131 13,277 64,408	6,146 51,131 13,277 64,408	0.4	0.8	0%	1%	496 8,247 2,141	991 8,247 2,141
Investment portfolio								64,408	64,408	9	9	7%	6%		
					<b>Sub-Total</b>			<b>884,255</b>	<b>978,012</b>	<b>HKD 130</b>	<b>HKD 144</b>	<b>99%</b>	<b>99%</b>		
					Add net cash per share**					HKD 1	HKD 1	1%	1%		
					<b>Total value per share</b>					<b>HKD 132</b>	<b>HKD 145</b>	<b>100%</b>	<b>100%</b>		
					<b>HSBC target</b>										<b>HKD 145</b>

Notes: \*Estimate for Dec 2015  
Source: Corporate files, Bloomberg, Reuters, HSBC estimates

# Disclosure appendix

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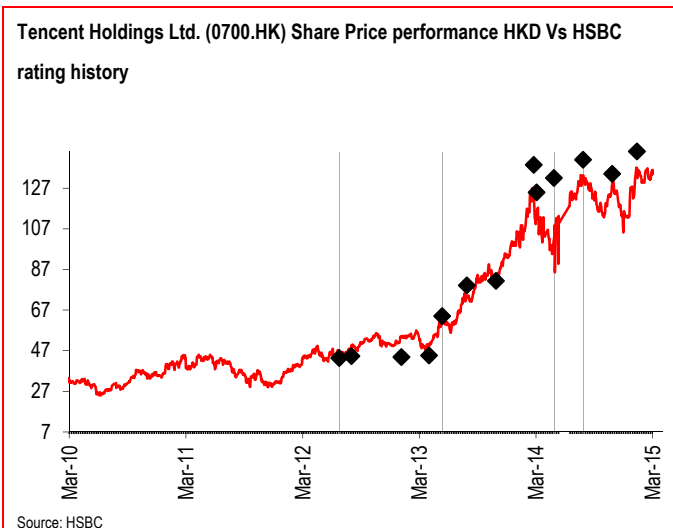
\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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As of 18 March 2015, the distribution of all ratings published is as follows:

<b>Overweight (Buy)</b>	41%	(30% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	39%	(28% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	20%	(20% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities



### Recommendation & price target history

From	To	Date
N/A	Underweight	10 July 2012
Underweight	Neutral	28 May 2013
Neutral	Overweight	14 May 2014
Overweight	Neutral	13 August 2014
Target Price	Value	Date
Price 1	43.34	10 July 2012
Price 2	44.14	17 August 2012
Price 3	43.74	21 January 2013
Price 4	44.54	17 April 2013
Price 5	63.91	28 May 2013
Price 6	79.09	14 August 2013
Price 7	81.29	13 November 2013
Price 8	138.41	11 March 2014
Price 9	124.83	20 March 2014
Price 10	132.02	14 May 2014
Price 11	141.00	13 August 2014
Price 12	134.00	12 November 2014
Price 13	145.00	28 January 2015

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
TENCENT HOLDINGS LTD.	0700.HK	135.90	18-Mar-2015	1, 4, 5, 6, 11

Source: HSBC

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