



## HONG KONG



700 HK Outperform

Price (at 07:59, 20 Mar 2015 GMT) HK\$142.60

<b>Valuation</b>	<b>HK\$</b>	<b>189.00</b>
- Sum of Parts		
<b>12-month target</b>	<b>HK\$</b>	<b>189.00</b>
<b>Upside/Downside</b>	<b>%</b>	<b>+32.5</b>
<b>12-month TSR</b>	<b>%</b>	<b>+33.0</b>
<b>Volatility Index</b>		<b>Medium</b>
<b>GICS sector</b>	<b>Software &amp; Services</b>	
<b>Market cap</b>	<b>HK\$bn</b>	<b>1,337</b>
<b>Market cap</b>	<b>US\$m</b>	<b>172,262</b>
<b>Free float</b>	<b>%</b>	<b>56.1</b>
<b>30-day avg turnover</b>	<b>US\$m</b>	<b>377.8</b>
<b>Number shares on issue</b>	<b>m</b>	<b>9,373</b>

## Investment fundamentals

Year end 31 Dec		2014A	2015E	2016E	2017E
Revenue	bn	78.9	98.8	125.6	157.7
EBIT	bn	31.0	40.4	50.6	63.0
EBIT growth	%	49.6	30.4	25.3	24.6
Reported profit	bn	23.8	28.5	37.0	47.3
Adjusted profit	bn	24.2	32.5	42.1	53.9
EPS rep	Rmb	2.54	3.04	3.93	5.01
EPS rep growth	%	53.3	19.3	29.4	27.4
EPS adj	Rmb	2.59	3.46	4.47	5.70
EPS adj growth	%	42.2	33.7	29.1	27.6
PER rep	x	44.8	37.6	29.0	22.8
PER adj	x	44.1	33.0	25.5	20.0
Total DPS	Rmb	0.36	0.48	0.62	0.79
Total div yield	%	0.3	0.4	0.5	0.7
ROA	%	22.2	20.9	21.3	21.8
ROE	%	34.5	34.1	33.6	33.0
EV/EBITDA	x	28.2	24.3	19.7	16.1
Net debt/equity	%	48.6	47.8	37.3	29.9
P/BV	x	13.0	9.9	7.6	5.8

Source: FactSet, Macquarie Research, March 2015  
(all figures in Rmb unless noted, TP in HKD)

## Analyst(s)

<b>Wendy Huang, CFA</b>	
+852 3922 3378	wendy.huang@macquarie.com
<b>Hillman Chan, CFA</b>	
+852 3922 3716	hillman.chan@macquarie.com
<b>Alice Yang</b>	
+852 3922 1266	alice.yang@macquarie.com
<b>Zhongyi Jin</b>	
+86 21 2412 9024	zhongyi.jin@macquarie.com

23 March 2015

Macquarie Capital Securities Limited

## Tencent

## A new start from 700

The stock crossed a milestone of HK\$140 (HK\$700 pre-share split level) post its 4Q14 earnings. With the gaming business remaining a cash cow, advertising is taking off to become the next growth engine. Tencent is also expanding its reach to users' daily lives by providing O2O services in 11 industries such as dining, parking and ticketing. We upgrade Tencent from Neutral to Outperform and raise our TP from HK\$138 to HK\$189. Our earnings-based SOTP value includes US\$67bn for gaming, US\$31bn for ads and US\$48bn for O2O and payment. We transfer coverage to Wendy Huang from Hillman Chan.

## Advertising: three-horse-led carriage is galloping ahead

With take-off in social ads, heavy investment in video ads and partnership with Sogou in search, Tencent's ad revenue is set to grow at a 65% CAGR over the next three years and finally become meaningful with a revenue contribution reaching 23% in FY17E. This should also support Tencent to narrow the gap with Baidu on the advertising front, with its revenue share of the latter rising from 20% in 2014 to 38% in 2017. Notably, in the US, the combined revenue of Facebook and twitter already accounted for 28% of Google's revenue in 2014 and will increase further to 50% in 2017E on Macquarie estimates. We expect China to follow the US suit to close the gap between social advertising revenue and search revenue.

## Well prepared for explosive O2O market in China

The mobile internet has enabled an upsurge in O2O transactions across industry verticals such as dining, transportation and household services. We forecast China's O2O market to expand from Rmb799bn in 2015 to Rmb2,921bn in 2017. With the largest and most trafficked mobile platform in China, Tencent is cultivating its O2O business by connecting its users with Weixin Pay and leveraging its partnerships with vertical leaders. We estimate Tencent will take 40% of China's O2O market by 2021 and generate RMB4.4bn net profit.

## First in, first out

Tencent was the first major internet company to enter into mobile internet investment mode three years ago. With an established position in China's mobile internet space and a footprint across 13 internet verticals, we expect Tencent to be the first to step out of the margin downturn and estimate its non-GAAP op margin to expand from 39% in 2014 to 41% in 2015 and 44% in the long term.

## Best long term investment in Chinese internet universe

We increase our non-GAAP EPS estimates by 5% for FY15E and 9% for FY16E on strong mobile game revenue and take-off of social ads. Our price target upgrade also reflects greater value assigned to the O2O business. We recommend Tencent as the best long-term investment in the Chinese internet universe, as its advertising business is hitting an inflection point and the O2O business offers a real option to valuation in the long term.

## Inside

Gaming anchors near-term earnings	4
Unlocking social ads potential via Mobile	
Qzone and Weixin	9
Weixin best positioned for O2O model	13
First in, first out	31
4Q14 results review	35
Earnings revision	36
Valuation and financials	37
Macquarie Quant View	42

## Executive summary

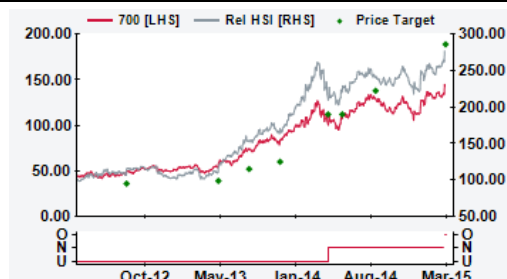
- Over the past ten years, Tencent has been able to leverage its massive QQ user base to establish a dominant and profitable gaming business, with the contribution to total revenue rising from 8% to 57%. While gaming should remain a cash cow for Tencent, advertising revenue is also set to take off with social ads, video ads and search ads. We estimate Tencent's ad revenue to grow at a 65% CAGR over the next three years and contribute 23% of total revenue in FY17E.
- In the longer term, the explosive growth in China's O2O market presents Tencent with the opportunity to penetrate into users' daily lives and evolve into an internet utility provider. We forecast China's O2O market to expand from Rmb799bn in 2015 to Rmb2,921bn in 2017, to account for 9% of total retail sales in China. Leveraging Weixin Pay and its partnerships with key vertical leaders, Tencent is well positioned to take 20% of this explosive market by 2017 and 40% by 2021 on our estimates. That being said, the O2O business offers a real option to Tencent's valuation in the long term.
- We upgrade Tencent from Neutral to Outperform and raise our TP from HK\$138 to HK\$189. Our earnings-based SOTP value of US\$226bn includes 1) US\$63bn for social networking; 2) US\$67bn for gaming; 3) US\$31bn for ads and; 4) US\$48bn for O2O and payment. We also conduct a sensitivity analysis on key metrics such as mobile game revenue growth, social ad revenue as well as O2O valuation. Our bear case value is HK\$94 per share vs a bull case value of HK\$265 per share. We also use a traditional DCF valuation for a sanity check and derive a fair value of HK\$216. Tencent is currently trading at 33x FY15 PE based on our estimates, in the middle of its historical range of 25x-39x.

**Fig 1 Expanding O2O uses to boost adoption of Tencent's payment system**



Source: Company data, Macquarie Research, March 2015

**Fig 2 700 HK rel HSI performance, & rec history**



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, March 2015

(all figures in Rmb unless noted, TP in HKD)

**Fig 3 Key assumptions and drivers**

	2012A	2013A	2014A	2015E	2016E	2017E
<b>Revenue (RMB mn)</b>	<b>43,894</b>	<b>60,437</b>	<b>78,932</b>	<b>98,791</b>	<b>125,587</b>	<b>157,691</b>
Social Networking	11,803	13,020	18,554	24,776	30,456	36,955
Online games	23,915	31,965	44,756	56,584	67,494	78,390
Online ads	3,382	5,034	8,308	12,790	22,727	37,009
e-Commerce	4,428	9,796	4,753	1,572	1,280	1,043
Others	365	622	2,561	3,069	3,630	4,294
<b>% of total revenue</b>						
Social Networking	27%	22%	24%	25%	24%	23%
Online games	54%	53%	57%	57%	54%	50%
Online ads	8%	8%	11%	13%	18%	23%
e-Commerce	10%	16%	6%	2%	1%	1%
<b>YoY growth</b>						
<b>Net revenue</b>	<b>54%</b>	<b>38%</b>	<b>31%</b>	<b>25%</b>	<b>27%</b>	<b>26%</b>
Social Networking	25%	10%	43%	34%	23%	21%
Online games	42%	34%	40%	26%	19%	16%
Online ads	70%	49%	65%	54%	78%	63%
e-Commerce		121%	-51%	-67%	-19%	-19%
Others	92%	70%	312%	20%	18%	18%
<b>Key assumptions</b>						
QQ active user account (m)	779	817	828	802	780	755
QQ paying account (m)	109	95	87	84	85	85
VAS ARPU (RMB/month)	27	40	61	80	96	113
Weixin/WeChat MAU (m)	na	280	451	580	697	796

Source: company data, Macquarie Research, March 2015

## Gaming anchors near-term earnings

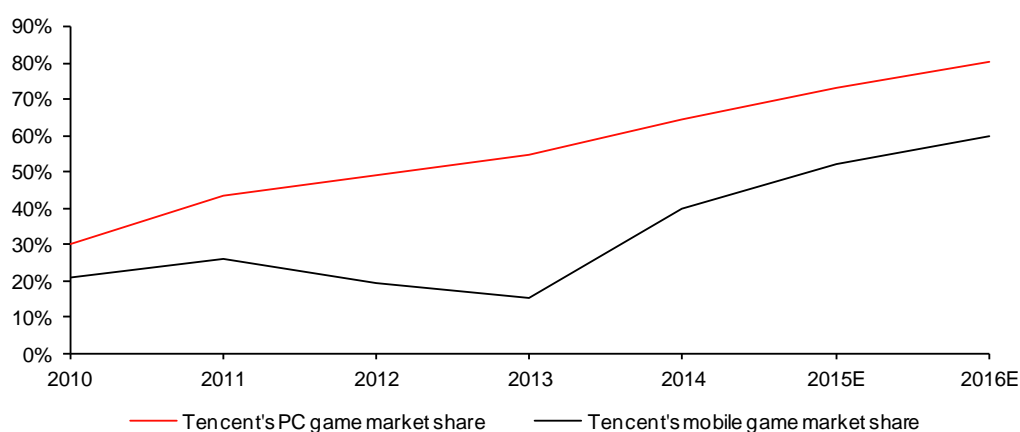
Tencent established a clear No.1 position in China's PC and mobile game markets with revenue shares of 64% and 40% respectively in 2014. While Tencent has never been the first PC game or mobile game operator, it has always led by opening up the mass market for different types of games. Continuing innovation in game genres should help Tencent's PC and mobile games to grow 17% and 82% respectively in 2015. We estimate gaming to contribute 57% and 54% of Tencent's total revenue in 2015 and 2016, respectively.

**Fig 4 Tencent's game revenue breakdown**

(RMB mn)	2010	2011	2012	2013	2014	2015E	2016E	2017E
Mobile game revenue	692	1,071	1,065	2,142	11,772	21,443	31,280	43,158
YoY		55%	-1%	101%	450%	82%	46%	38%
PC game revenue	9,509	15,822	22,849	30,063	37,458	43,671	48,707	52,487
YoY		66%	44%	32%	25%	17%	12%	8%

Source: company data, Macquarie Research, March 2015

**Fig 5 Tencent's gaming market share**



Source: company data, Enfodesk, Macquarie Research, March 2015

### Mobile game launches recovered in 4Q14 but have remained flat in 1Q15

Weixin experienced delays in game upgrades in 3Q14 due to compliance with iOS requirements for guest login. The number of top 100 games from Tencent remained flat in the low 20s between Jun and Sep 2014. Also, the portion of licensed mobile games (among Tencent's top 10 titles) increased from 10% in 1H14 to 30% in 3Q14. Thus 3Q14 marked the first quarter of QoQ decline (-13%) in Tencent's mobile game revenue.

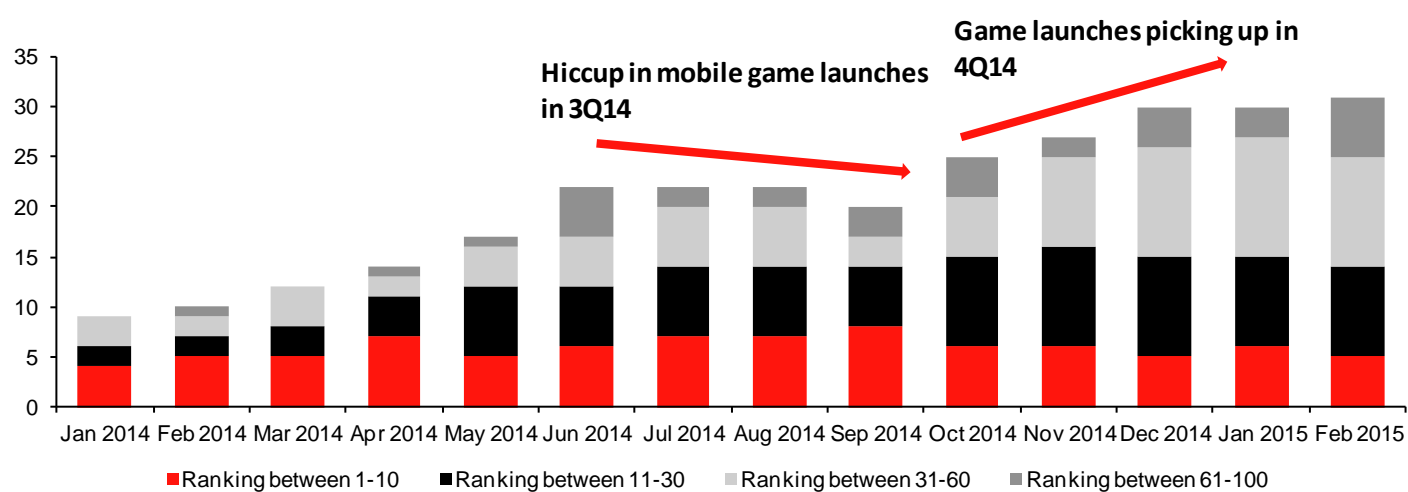
In 4Q14, Weixin resumed growth with 13 new games (12 mid-core) including the launch of hit titles such as Blade of the Three Kingdoms and the Legend of Sword and Fairy. Tencent's mobile game net revenue increased 12% QoQ to RMB2.9bn in 4Q14 (or RMB3.8bn gross mobile game revenue).

Going into 1Q15, Tencent's first 3D FPS mobile game, We Fire (全民突击), has been well received by gamers and topped the iOS gross rankings. Blade of the Three Kingdoms and My Name is MT 2 stayed among the top 5 by gross rankings on iOS. CNY also added to stronger seasonality. We thus project 15% QoQ growth in 1Q15 and 82% YoY growth in Tencent's 2015 mobile game revenue.

**Fig 6 Tencent's smartphone game revenue**

(RMB bn)	1Q14	2Q14	3Q14	4Q14	2014
Gross revenue	2	3.5	3	3.8	12.3
QoQ		75%	-14%	27%	
Net revenue	1.8	3	2.6	2.9	10.3
QoQ		67%	-13%	12%	
Diff between gross and net revenue	0.2	0.5	0.4	0.9	
Diff as % of gross revenue	10%	14%	13%	24%	

Source: company data, Macquarie Research, March 2015

**Fig 7 No. of Tencent mobile games (among top 100 by grossing)**

Source: AppAnnie, Macquarie Research, March 2015

**Fig 8 Top 20 mobile games in China by gross billings**

Chinese name	English name	Game publisher
全民奇迹-MU	MU	KingNet
神武	Shen Wu	Hero Network
全民突击	We Fire	Tencent
我叫MT2	My Name is MT 2	Tencent
三国之刃	San Guo Zhi Ren	Tencent
Boom Beach	Boom Beach	Supercell
刀塔传奇	Dota Heroes	Longtu
少年三国志	Shao Nian San Guo Zhi	Youzu
太极熊猫	Taichi Panda	Suzhou Snail
天天爱消除	Timi Match Every Day	Tencent
Clash of Clans	Clash of Clans	Supercell
开心消消乐	Happy Clearing	Happy Elements
乱斗西游	Battle to the West	Netease
天天酷跑	Timi Run Every Day	Tencent
全民飞机大战	We Fly	Tencent
放开那三国	Let Go of the Three Kingdoms	Babeltime
雷霆战机	Thunder Fighter	Tencent
仙剑奇侠传	Xian Jian Qi Xia Chuan	Tencent
航海王启航	One Piece	DeNA
暗黑黎明	Dawn after Dark	Perfect World

Source: AppAnnie (ranking on Mar 12, 2015), Macquarie Research, March 2015

### Moving towards mid-/hard-core titles on Weixin

Casual games play an important role in Tencent's mobile game portfolio as Weixin and Mobile QQ are social-based platforms and users are not necessarily gamers. Casual games are critical in the early stage to convert users into gamers and help users to connect with others. 8 of the top 10 Tencent mobile games were casual games in 1Q14.

After more than a year of mobile game launches on Weixin and when most Weixin users have tried their hand at one game or another, Tencent's mobile game portfolio is shifting from casual games (e.g. We Poker, We Fly) towards harder core games (e.g. Blade of the Three Kingdoms, My Name is MT 2). Out of the 13 mobile games launched in 4Q14, 12 were mid-core. Out of the top 10 Tencent mobile games by grossing, 4-5 were mid-/hard-core games in 4Q14 and 1Q15. Migration to harder-core titles leads to upside in the paying rate and ARPU.

**Fig 9 Quarterly ARPU of Tencent's online and smartphone games on an uptrend**

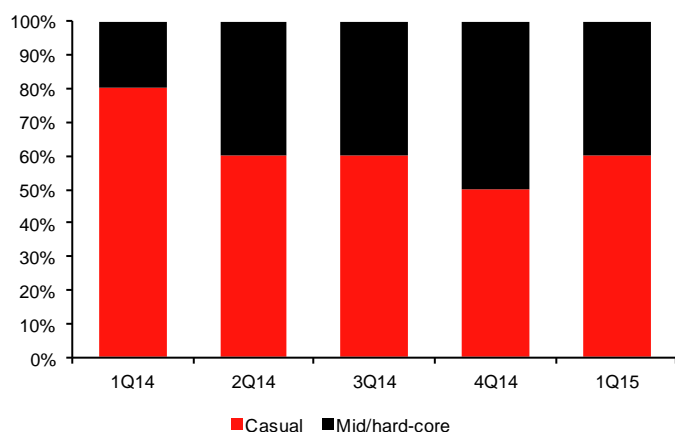
Qtly ARPU (CNY)	4Q13	1Q14	2Q14	3Q14	4Q14
Advanced casual games	80-190	85-220	85-220	100-220	95-235
MMO games	140-300	220-300	240-320	270-390	295-395
Smartphone game	60-70	80-90	100-110	100-110	155-165

Source: Macquarie Research, March 2015

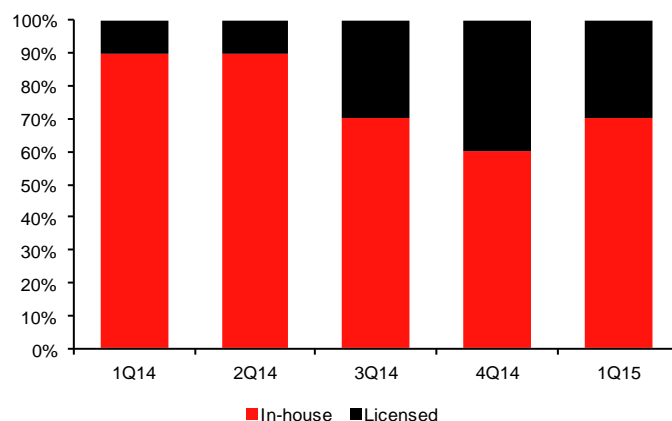
### Licensed games maintain 30-40% going forward

Since mid 2014, Weixin has been including more licensed titles, the revenue of which is recognized on a net basis after revenue sharing with game developers. Given the reduced revenue share of the gross game revenue, the top line growth of a portfolio with more licensed titles is naturally lower than a wholly self-developed portfolio. This was one reason for the company's conservative guidance on mobile game revenue growth in 2H14 and QoQ decline in mobile game revenue in 3Q14.

The portion of licensed games peaked in 4Q14 and has remained stable. 3 or 4 out of the top 10 Tencent mobile games are now licensed from third-party developers, compared to 1 out of the top 10 in 1H14.

**Fig 10 Tencent's top 10 mobile games by game genre**

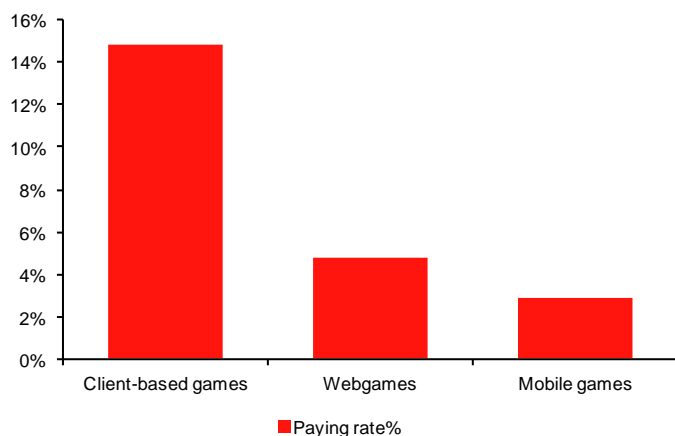
Source: company data, Macquarie Research, March 2015

**Fig 11 Tencent's top 10 mobile games by developer**

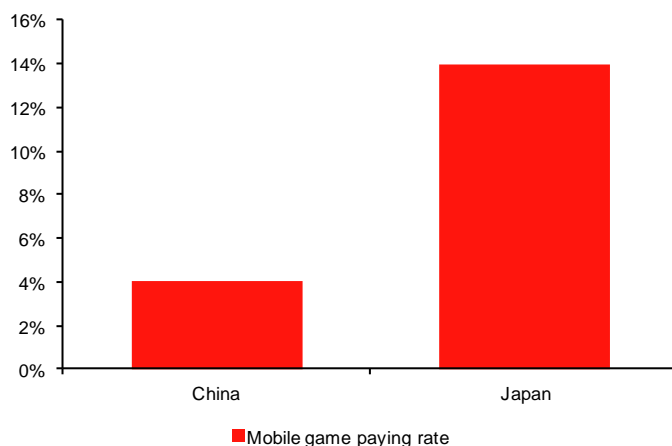
Source: company data, Macquarie Research, March 2015

**Upside to paying rate as the market grows more mature**

The paying rate among mobile games in China was low to mid single digit % in 2013. MTA QQ (an analytical product of Tencent) quoted about 3% conversion for 1Q14; and 91 Wireless indicated >5% in Oct 2013 in China. The Chinese mobile game conversion rate is far behind the low teens % in Japan in 2013.

**Fig 12 Mobile's paying rate the lowest (1Q14)**

Source: QQ MTA, Macquarie Research, March 2015

**Fig 13 China's paying rate % behind Japan's (2013)**

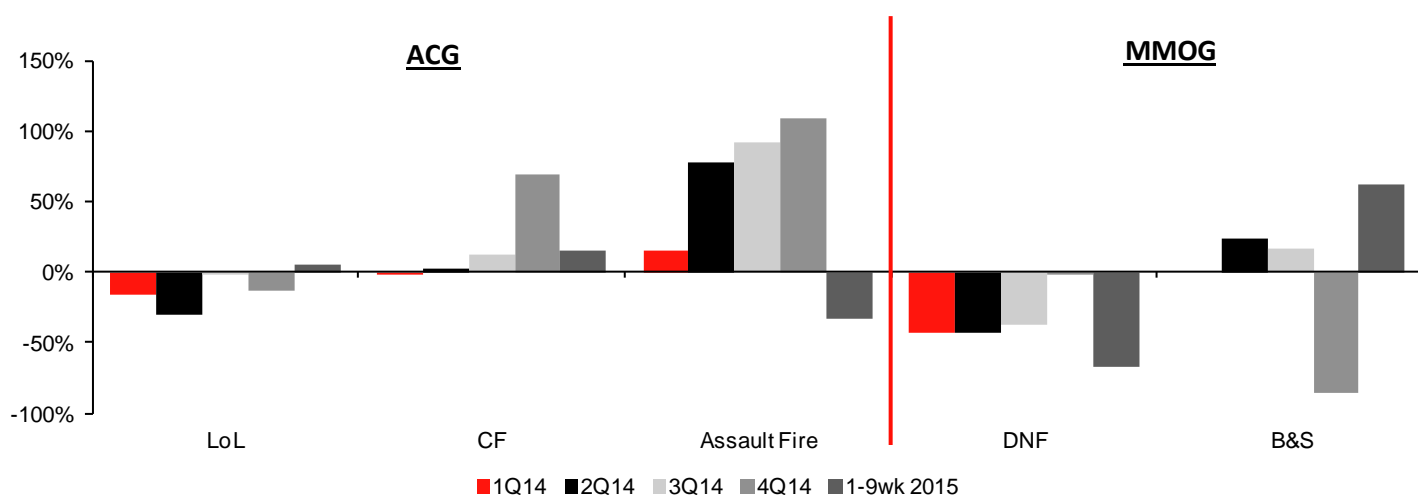
Source: MTA QQ, 91 Wireless, Macquarie Research, March 2015

**Tencent's PC game titles to stay stable**

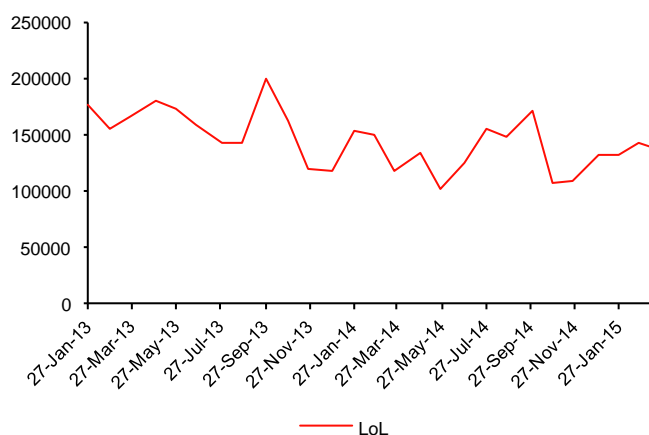
Tencent's Advanced Casual Games (ACG) saw gradual YoY pickup in popularity as measured by Baidu Index across 2014. LoL revenue continued to grow mildly YoY on increased monetization, while the other two titles, Cross Fire and Assault Fire, saw faster growth in 2H14. In contrast, MMOG titles such as DNF and B&S experienced decline through the same period.

Tencent also noted that MMOG users were moving to ACG due to greater innovation. The ACU (average concurrent user) of ACG saw 22% YoY growth to 7.3mn, whereas the ACU of MMOG experienced 36% YoY decline to 1.6mn in 4Q14.

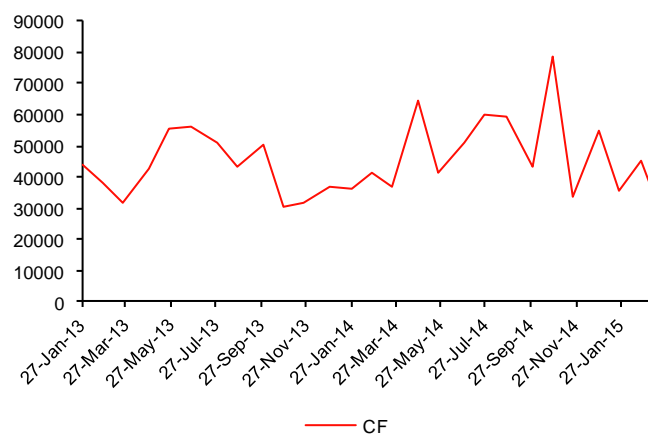
According to our check of 1Q15, ACG remains stable (flattish Baidu Index reading) and performance of MMOG is more divided (DNF down, B&S up in terms of Baidu Index).

**Fig 14 Change in popularity of Tencent's top PC game titles (as measured by change in Baidu Index)**

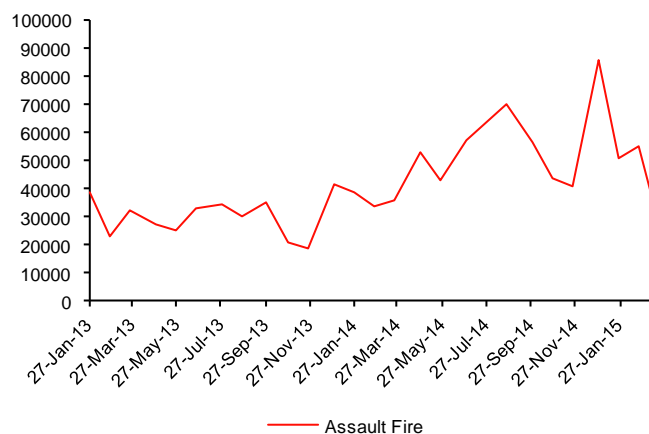
Source: Baidu Index, Macquarie Research, March 2015

**Fig 15 Popularity of LoL**

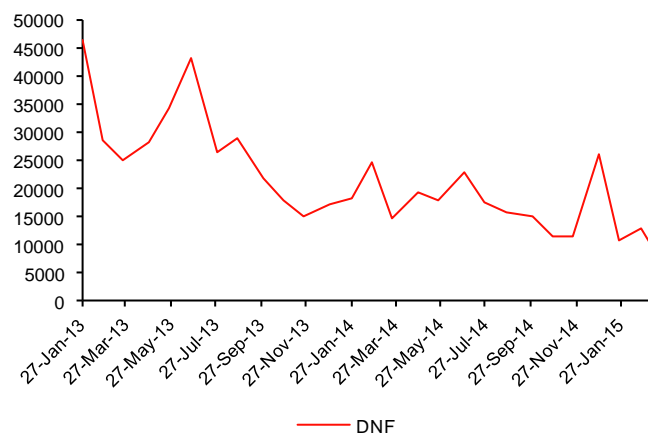
Source: Baidu Index, Macquarie Research, March 2015

**Fig 16 Popularity of Cross Fire**

Source: Baidu Index, Macquarie Research, March 2015

**Fig 17 Popularity of Assault Fire**

Source: Baidu Index, Macquarie Research, March 2015

**Fig 18 Popularity of DNF**

Source: Baidu Index, Macquarie Research, March 2015

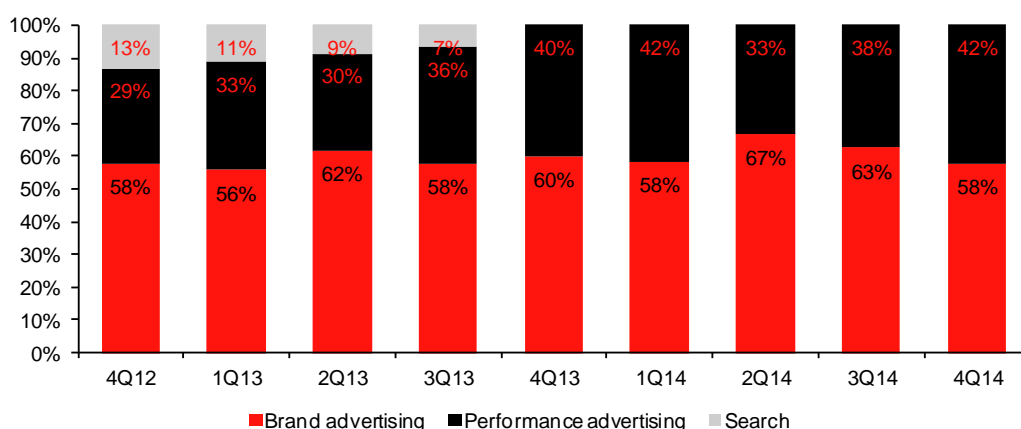


# Unlocking social ads potential via Mobile Qzone and Weixin

In the past three years, Tencent's advertising revenue enjoyed a 61% CAGR, thanks to enriched content, improved ad system (GDT) as well as unlocked social ad inventories. As shown in the chart below, brand ad revenue build on portal traffic and video traffic grew 89% in 2014. Performance ads accounted for 42% of ad revenue in 4Q14, compared to 40% in 4Q13. Besides its own mobile properties, Tencent focuses on third-party network and puts GDT ads on mobile apps on its open platform. In 2014, performance advertising revenue grew 68% on the back of increased news feed ad inventory on Mobile Qzone, and to a lesser extent, on Weixin Official Accounts.

Mobile has been a critical driver of the super growth of two ad segments and leaves room for future monetisation. Notably, mobile traffic reached 50% of total video traffic in 2Q14 but accounted for only low-teens % of video revenue, implying upside monetization potential to mobile traffic. Tencent also noted that video ad revenue doubled YoY in every quarter in 2014. Mobile contribution to total performance advertising revenue reached 45% in 3Q14, up from 30% in 2Q14.

**Fig 19 Breakdown of advertising**



Source: company data, Macquarie Research, March 2015; performance-based ads mainly social ads

## Social ads taking off

Tencent is leveraging the social elements of its platforms (vast user base along with their demographics and preference) to develop targeted advertising. In 4Q14, monthly active users (MAU) of three key mobile products, Weixin, Mobile QQ and Mobile QZone, all witnessed strong yoy growth at 30-41%. Weixin's MAU also crossed 500m for the first time.

On mobile QQ, there are limited mobile inventories and these are mostly used for promoting apps. Our channel checks suggest that CPC of mobile QQ ads is around Rmb0.5-1.

In contrast, mobile Qzone emerged as the first social ads platform with massive ad inventories since the beginning of 2014. Our channel checks suggest that the ad load of mobile Qzone is one out of seven feeds. The pricing model of news feed ads is either CPC at Rmb0.1-0.6 or cost per download at Rmb1.0-3.5.

With success in mobile QZone, Tencent opened up the ad inventory in Weixin Official accounts in 2H14. For now, Tencent offers text link ads and graphic ads on 15k Weixin official accounts, up from 10k in 3Q14. This not only allows Tencent to share ad revenue with official accounts with more than 50k followers, but also incentivises these official accounts to continue delivering high quality content. The revenue model is also built on a keyword bidding system with CPC at Rmb0.5.

**Fig 20 Developments of Tencent's mobile advertising**

Mobile properties	Brand ad	Performance ad
Weixin	4Q13: experimenting banner ads in Weixin news plug-in	4Q13: text link ads at the bottom of the page on Weixin official accounts  1Q14: experimenting GDT ads with a few thousands Weixin official accounts; moving at a measured pace  2Q14: beta testing text link ads with 100 pilot Weixin Official Accounts  3Q14: testing graphical ads (besides text link ads) on Weixin official accounts  1Q15: testing Weixin Moments ads with selected advertisers including Coca Cola, BMW, Vivo
Mobile QQ		1Q14: shifting some QQ IM inventory from brand to performance ad
Mobile Qzone		1Q14: Introduced news feeds ads (much higher CTR than banner ads on PC Qzone)  2Q14: Increased flows due to the news feeds on Mobile Qzone
Video platform	4Q13: experimenting pre-roll ads and logo on Tencent video app	3Q13: extending performance ad from Qzone to video platform
News app	3Q13: Testing splash screens and sponsored news feeds  4Q13: experimenting banner ads (brand ads) at the bottom of the content page in Tencent news apps  1Q14: mobile news services attracted 100+ advertisers	
Third-party apps mobile apps on open platform		1H14: More focused on third-party network for putting GDT ads on independent mobile apps , then on Weixin official accounts (experiment underway)
YingYongBao app store (MyApp)		4Q14: testing CPA-based ads in search and list rankings since Nov 2014

Source: company data, Macquarie Research, March 2015

**The long-awaited Weixin Moments ads finally come**

Tencent rolled out ads on Weixin Moments in late Jan 2015. The commercials are targeted ads that rely on user demographics and interests rather than mass display ads – user experience is still the top priority for Weixin, as Tencent has always reiterated, and is also the key reason why the company had held out for so long before putting ads on Moments.

Weixin has over 1.1bn registered accounts globally and 500m monthly active accounts. There are 8.53m public accounts on Weixin, with daily addition of 25k and 3bn sharing every day. Weixin ads click-through-rate is 2%. At this stage, Tencent has rolled out its Weixin ads to a selected 10 big advertisers.

**Business model**

- Moments ads come with a tag “Promoted (推廣)” at the top right corner for users to distinguish from other user feeds. The first batch of rollouts includes 10 brands with an advertising budget of over RMB10mn, according to the media.
- Moments ads are charged by CPM (RMB40-140 per 1000 views). It is reported that a Moments ad will be taken off if there is no user interaction for 6 hours. The ad will last for 7 days and push once to each user every 48 hours. Assuming Rmb40 CPM and over 200mn target audience, daily ad spending per advertiser could be as high as Rmb9mn.

Fig 21 Advertising on Weixin Moments (Coca Cola, BMW, Vivo)



Source: Company data, Macquarie Research, March 2015

Fig 22 Advertising on Weixin Public account



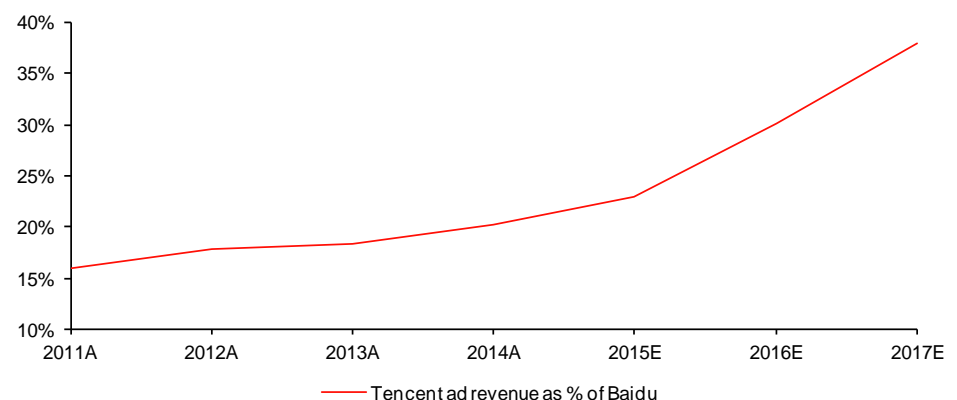
Source: company data, Macquarie Research, March 2015

Fig 23 Advertising on Weixin Public account



Source: company data, Macquarie Research, March 2015

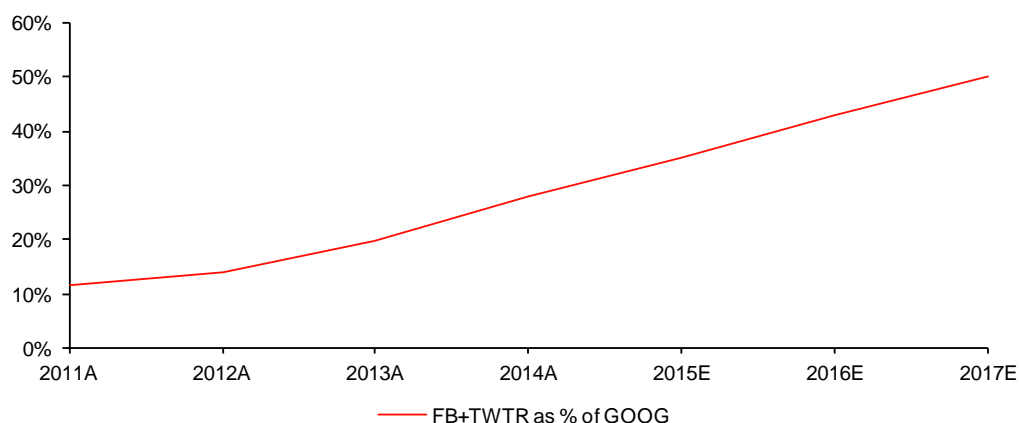
Fig 24 Tencent's ad revenue as % of Baidu's



Source: Company data, Macquarie Research, March 2015

With take-off in social ads, heavy investment in video ads and partnership with Sogou in search, we forecast ad revenue to grow at a 65% CAGR over the next three years to become a meaningful revenue contributor at 23% in FY17E. As such, Tencent should also narrow its gap with Baidu on the advertising front, with its revenue share of the latter rising from 20% in 2014 to 38% in 2017E. Notably, in the US, the combined revenue of Facebook and Twitter already accounted for 28% of Google's revenue in 2014. We expect China to follow the US suit to close the gap between social advertising revenue and search revenue.

**Fig 25 Combined ad revenue of Facebook and Twitter as % of Google's ad revenue**



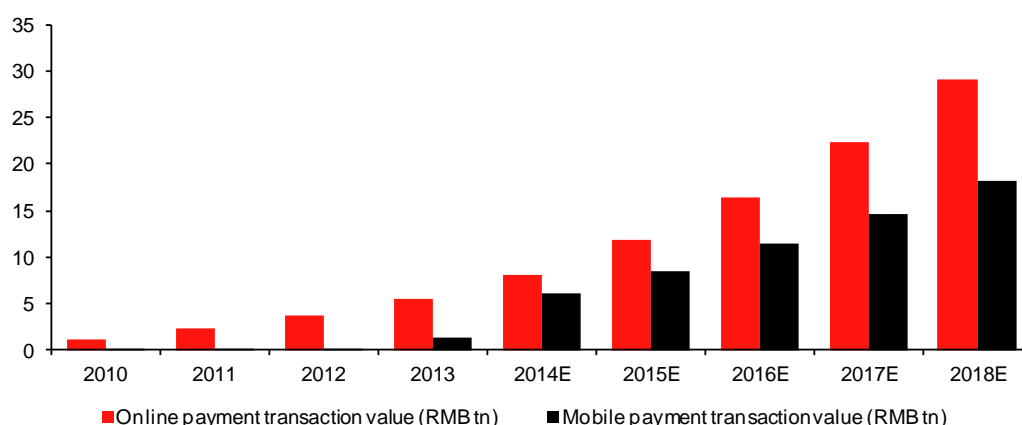
Source: Company data, Macquarie Research, March 2015

# Weixin best positioned for O2O model

## China's fast-growing online payment market at 38% CAGR

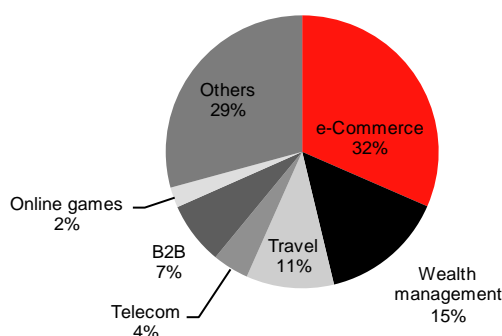
According to iResearch, China's online payment will grow from RMB8.1tn in 2014 to RMB29.2tn in 2018 at a CAGR of 38%. China's mobile payment will increase from RMB6tn in 2014 to RMB18.3tn in 2018 at a CAGR of 32%. e-Commerce, wealth management (e.g. subscription to money market funds) and travel (flight tickets, hotel rooms) are the top three categories for online payment.

**Fig 26 China's online and mobile payment market**



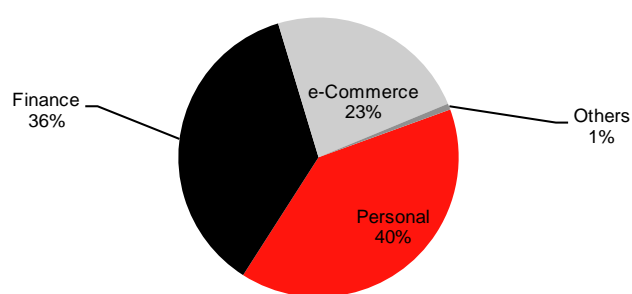
Source: iResearch, Macquarie Research, March 2015

**Fig 27 Online payment breakdown by category (4Q14)**



Source: iResearch, Macquarie Research, March 2015

**Fig 28 Mobile payment breakdown by category (4Q14)**

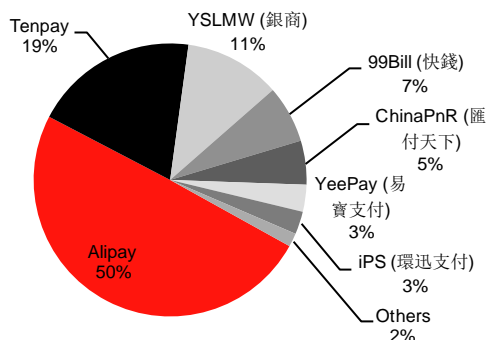


Source: iResearch, Macquarie Research, March 2015; \*Personal - money transfer, loan repayment; finance - subscription to wealth management products; e-Commerce - e-Commerce, Groupbuy, travel, online lottery, games

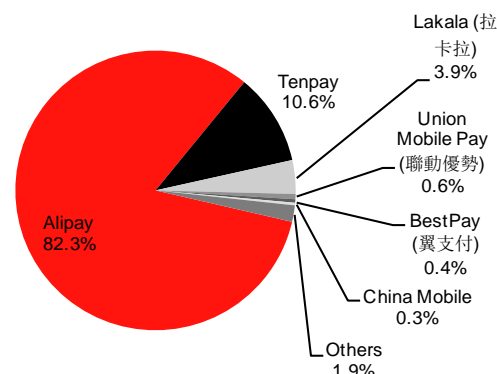
## Alibaba still dominates online payment

On the back of China's largest online marketplaces, i.e. Alibaba's Taobao and Tmall marketplaces, Alipay naturally dominates China's online and mobile payment markets with 50% and 82% market shares respectively in 2014.

On the other hand, TenPay is a latecomer to online payment with a strong social element but less relevance to transactions. TenPay is the underlying infrastructure to Tencent's payment solutions. Weixin Payment and QQ Wallet are consumer-facing mobile payment solutions. TenPay is the second largest online payment solution in China with 19% and 11% market shares in the online and mobile payment markets in 2014.

**Fig 29 Market share of third-party online payment solutions by transaction value (2014)**

Source: iResearch, Macquarie Research, March 2015; Tenpay includes Weixin Payment

**Fig 30 Market share of third-party mobile payment solutions by transaction value (2014)**

Source: iResearch, Macquarie Research, March 2015; Tenpay includes Weixin Payment

**Fig 31 Fast-growing number of Weixin Payment users driven by increasing O2O use on Weixin**

Source: iResearch, Macquarie Research, March 2015

### Tencent: expanding uses to boost adoption of its payment system

Tencent has been expanding into more O2O scenarios including taxi hailing with Didi, e-Commerce with JD.com, and F&B with Dianping in order to boost user adoption of its payment systems. The number of Weixin Payment users grew four-fold from 27mn in 4Q13 to 119mn in 4Q14 according to iResearch. Tencent indicated on its 4Q results call that over 100mn mobile accounts were already bundled with bank cards as of Dec 2014. Following Chinese New Year, this appears to have doubled to 200m accounts.

**Fig 32 Expanding uses to boost adoption of Tencent's payment system**

Source: company data, Macquarie Research, March 2015

### Phenomenal exchange of red envelopes on Weixin during CNY in 2015

To promote Weixin users' adoption of Weixin Payment and bundling of banking accounts to Weixin, Tencent organized several promotional events (e.g. ads on CCTV show and red envelopes) during CNY which turned out to be a great success.

Tencent partnered with CCTV and invited Weixin users to "shake" for red envelopes ("微信摇一摇"). Weixin also teamed up with brand advertisers (e.g. JD.com, China Merchants Bank, Huawei, Pingan Insurance) who sponsored red envelopes including RMB500mn cash (biggest prize: RMB4999 per envelope) and coupons worth RMB3bn.

Weixin reported the total number of red envelopes grew to 1bn on Weixin and 637mn on Mobile QQ on New Year's Eve, up from 20mn a year ago. Between midnight and 7pm on New Year's Eve, about 20mn Weixin users shook their handsets for red envelopes, up from 4.8mn users a year ago.

On the other hand, 240mn virtual red envelopes were sent among Alipay users worth RMB4bn on New Year's Eve. The number of clicks on Alipay homepage reached the peak of 883mn times per min. Between New Year's Eve and the 3rd day of CNY, more than 100mn Alipay users (excluding duplicate count) participated in Alipay's red envelopes.

### Fig 33 Shake for red envelopes on Weixin during Chinese New Year



Source: Company data, Macquarie Research, March 2015



**Fig 34 Comparison of red envelopes on 2015 Chinese New Year's Eve**

	Tencent	Alibaba
No. of red envelopes sent	1010mn (Weixin); 637mn (QQ)	240mn (Alipay)
Peak no. of red envelopes exchanged (mn per min)	810	883
No. of users participating in red envelopes	About 20mn Weixin users (between midnight and 7pm on New Year's Eve)	>100mn Alipay users (between New Year's Eve and the 3 <sup>rd</sup> day of CNY)
Additional information	Weixin "Shake" feature (微信摇一摇) 11bn times	Total red envelopes worth RMB4bn

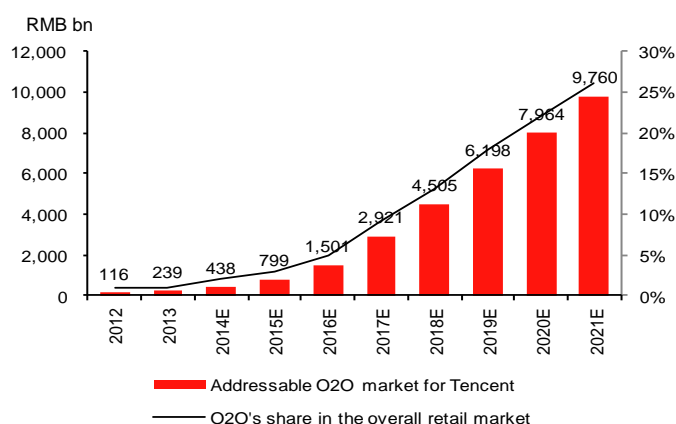
Source: company data, Macquarie Research, March 2015

### Latest roll-out of Weixin solutions for 11 industries

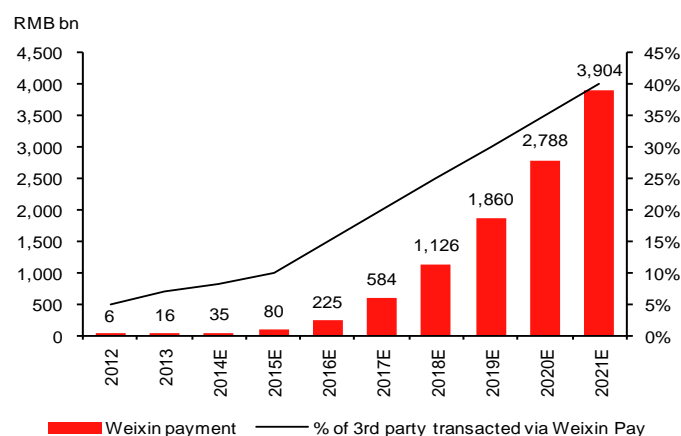
In Mar 2015, Weixin announced Weixin solutions for 11 industries ([“微信行业解决方案”](#)). It introduced standardized modules and explores in-depth how Weixin can be integrated with these industries from order placement to transaction payment. This is one step further from the rollout of Weixin's Smart Life Solutions ([“微信智慧生活”](#)) in Aug 2014.

With the big data of users on the QQ and Weixin platform, Tencent is best positioned among all the Chinese internet companies to expand its reach into users' daily lives via its social platform and become a real internet utility provider.

The overall addressable O2O market is expected to experience a boost in growth with the deepened penetration of O2O into the retail market. As Figure 29 suggests, the CAGR for the O2O market in the next six years would reach 52%. Meanwhile, as Weixin begins to gain market share in 3rd party transactions, according to our own estimates, by 2021, the total transaction volume of Weixin payments could reach RMB4,500 bn with a 40% share in the overall 3rd party transaction market, up from RMB 16bn in 2013 with a market share of less than one-tenth.

**Fig 35 O2O market transaction value is expected to soar**

Source: Company data, Macquarie Research, March 2015

**Fig 36 Weixin's payment potential going forward**

Source: Company data, Macquarie Research, March 2015

Among all the major sectors of the O2O market, catering, ticketing, luxury goods group buy and beauty would be the four dominant sub-segments.

### The 11 industries are as follow:

- Logistics
- Vending machines
- Department stores
- Restaurants
- Convenience stores
- Supermarkets
- Ticketing
- Hotels
- Travel
- Healthcare
- Car parking



**Logistics:** Users select a logistics company and use its public account for service > Users can then use WeChat payment for convenience

Logistics

Issues in traditional service	Weixin's benefit
Time consuming to manually fill out the documents	Public account can automatically record the receiver's and sender's information
Information lag for delivery process	Public account can inform clients of each steps through timely communication
Difficult to make changes	WeChat payment
No differentiation advantages for express companies	Through big data accumulation, companies can increase clients' loyalty

Source: Company data, Macquarie Research, March 2015

Fig 37 Express companies' public account



Source: Company data, Macquarie Research, March 2015

Fig 38 WeChat payment to provide convenience



Source: Company data, Macquarie Research, March 2015

**Vending machines:** Each good has a QR Code for purchase > Customers can scan and use WeChat payment to proceed

Vending machines

Issues in traditional service	Weixin's benefit
Difficult to make changes	No need for physical currency and use online payment to reduce operation costs
Difficulties in collecting customers' information	Able to know the customers well and can communicate with customers effectively

Source: Company data, Macquarie Research, March 2015

Fig 39 LBS service to allocate customer traffic



Source: Company data, Macquarie Research, March 2015

Fig 40 WeChat Lucky Draw to increase loyalty



Source: Company data, Macquarie Research, March 2015

**Department store:** Customers are attracted to official accounts of merchants through marketing campaigns and discount coupons > Customers use WeChat payment > Department stores can create online membership card for operations

Department stores	
Issues in traditional service	Weixin's benefit
Lack of e-commerce channels	Online department store with various public accounts
Long queues	WeChat payment to increase efficiency
Lack of marketing channels	Public account for communication
Little knowledge about customer information	Accumulate customer data through payment
Source: Company data, Macquarie Research, March 2015	

Fig 41 Virtual show rooms to increase SKU sales



Source: Company data, Macquarie Research, March 2015

Fig 42 Free Internet access as additional marketing channels



Source: Company data, Macquarie Research, March 2015

**Restaurants** : Customers can queue in advance > order through WeChat system > after scanning the QR code, they can proceed to pay through WeChat payment

## Restaurants

### Issues in traditional service

High operation costs  
Low communication efficiency

Source: Company data, Macquarie Research, March 2015

### Weixin's benefit

Customers can order and pay through WeChat  
WeChat acts as a better way to communicate

**Fig 43 Issue coupons through public accounts**

**Fig 44 Virtual saving cards**



Source: Company data, Macquarie Research, March 2015

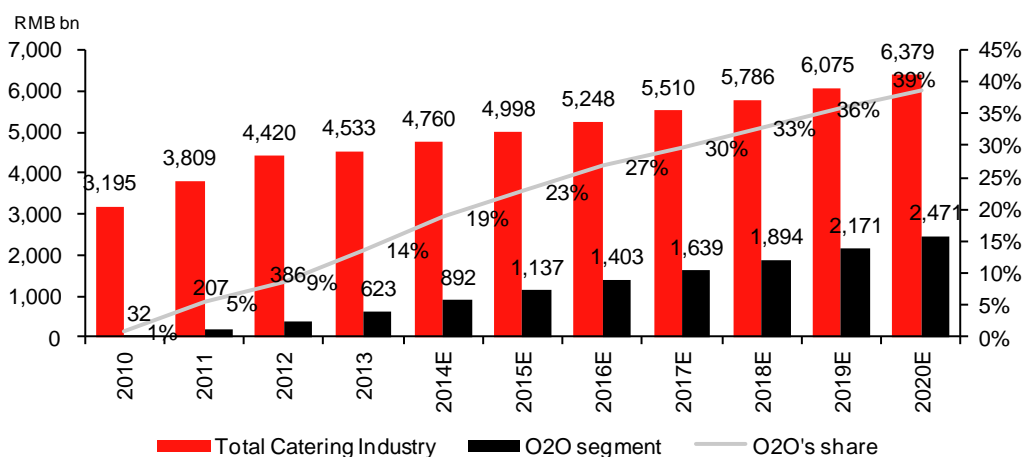


Source: Company data, Macquarie Research, March 2015

Catering, by its nature, has always taken the largest share since the O2O market was first born. Undoubtedly, catering is the most relevant industry to daily life, and with the increasing popularity of the Internet, more users begin to try the new services, such as online reservations (including takeaway) and group buy, or downloading coupons online before going to the restaurants.

In 2011, the total GMV of the O2O catering industry was only RMB21bn, which is estimated to have jumped to around RMB90bn in 2014, implying a CAGR of over 60% in the past three years. We estimate GMV of the O2O catering industry could reach RMB2,471bn by 2020.

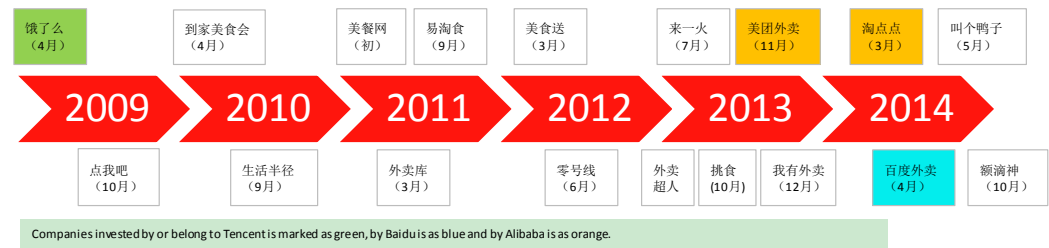
**Fig 45 China's catering O2O market size**



Source: Wind, Macquarie Research, March 2015

Therefore, given the explosive growth of catering O2O industry, the related emerging companies have grown at an accelerated pace since 2009 and capital markets are beginning to put their focus on this sub-industries as well.

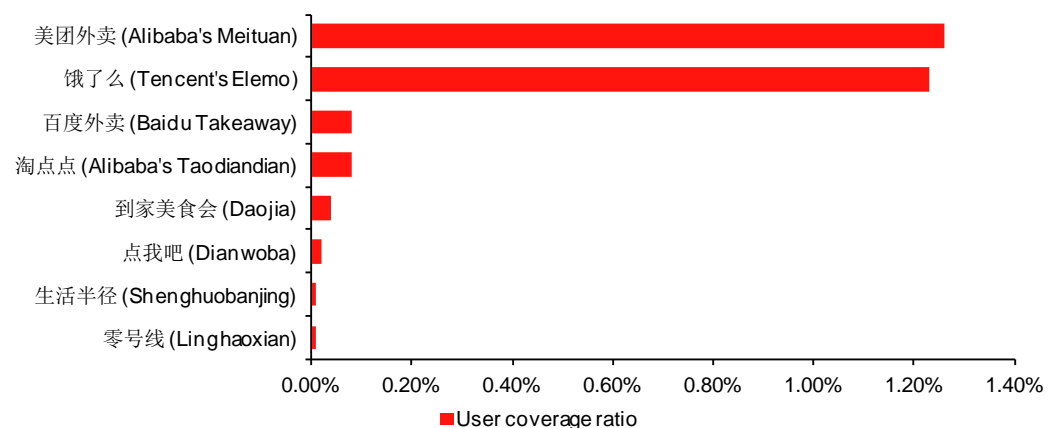
**Fig 46 The launch date of various online take-away service providers**



Source: Pingtu Website, Macquarie Research, March 2015

Meanwhile, to capture the rapid growth of the O2O catering industry, the emerging O2O service providers are actively investing at the mobile end. According to TalkingData, Meituan Takeaway, which Alibaba is invested in, had the highest user coverage (1.26%) by the end of 2014, followed by Eleme (the coverage ratio is 1.23%), which Tencent is invested in. Baidu Takeaway lags far behind with its 0.08% user coverage. User coverage ratio is defined as the number of devices installed with the particular app divided by the number of devices in the sample in the month.

**Fig 47 The coverage ratio ranking for the takeaway service providers' websites**



Source: TalkingData, Macquarie Research, March 2015; user coverage ratio = no. of devices installed with the particular app divided by no. of devices in the sample \* 100%; data sample as of Nov 2014

**Convenience stores:** At convenience stores, customers can scan the QR code to complete the transaction through WeChat payment.

Convenience stores

Issues in traditional service	Weixin's benefit
Limited space for displaying goods Long queues Lack of marketing channels No customer relationship management	Virtual goods shelves in WeChat Store WeChat payment to increase efficiency Public account for precise delivery Establish WeChat membership card system to increase loyalty and accumulate data

Source: Company data, Macquarie Research, March 2015

Fig 48 Virtual goods shelves



Source: Company data, Macquarie Research, March 2015

Fig 49 Virtual QR code wall to save space and arrange inventories



Source: Company data, Macquarie Research, March 2015

**Supermarkets:** Customers are attracted to virtual goods shelves and promotion activities > using WeChat payment can increase conversion rate > customers can be reached through virtual memberships and lucky draw promotional activities

Supermarkets	
Issues in traditional service	Weixin's benefit
High costs for traditional promotional activities	WeChat promotion is almost zero cost
Long queues	WeChat payment to increase efficiency
Hard to capture the high traffic and realize precise marketing	WeChat public account can potentially promote sales volume with low costs
High communication costs with customers	WeChat public account can bring about value-added service
Source: Company data, Macquarie Research, March 2015	

Fig 50 WeChat promotion activities



Source: Company data, Macquarie Research, March 2015

Fig 51 WeChat stores (official accounts)



Source: Company data, Macquarie Research, March 2015

**Ticketing:** Customers purchase tickets directly by scanning the QR Code > customers can proceed to WeChat payment and save in WeChat pocket > WeChat will remind the customers of the show. Customers can avoid a long ticket-checking queue by simply scanning through WeChat.

Ticketing

Issues in traditional service	Weixin's benefit
Long queues Few selling channels Low loyalty	WeChat tickets can be checked by QR Code and no need for queue Virtual ticketing office WeChat can provide overall solution through WeChat subscription, lucky draw and Wifi

Source: Company data, Macquarie Research, March 2015

Fig 52 WeChat shows subscription



Source: Company data, Macquarie Research, March 2015

Fig 53 SNS sharing among friends on WeChat



Source: Company data, Macquarie Research, March 2015

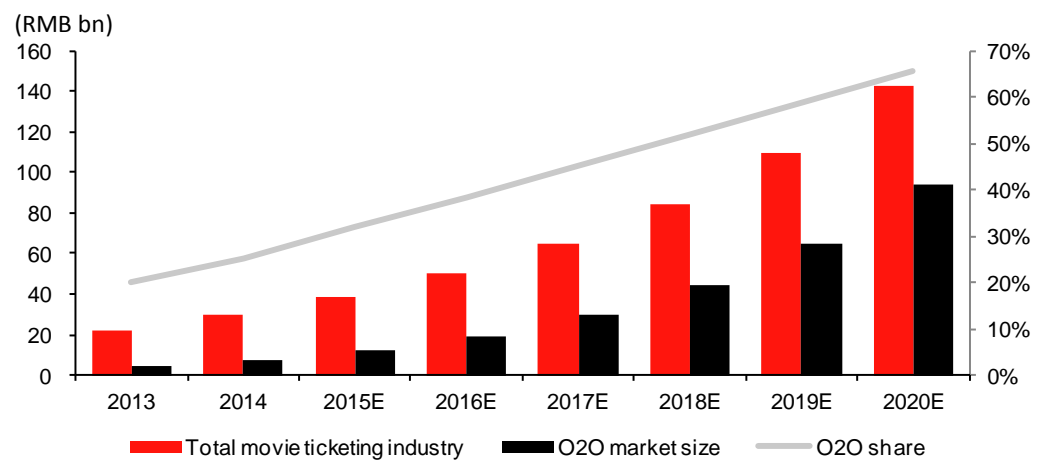
**Ticketing:**

For the ticketing industry, take movie ticketing as an example. This O2O market has grown from almost zero in 2012 to RMB3-4bn in 2013, and representing around 15%-20% of the total movie ticketing industry market share.

In 2013 alone, Maoyan Movie alone sold 60mn movie tickets and accounted for 10% of the total ticketing volume.

According to our estimates, the O2O market could grow to near RMB100bn by the end of 2020 with a CAGR of over 50% for the next five years.



**Fig 54 Movie ticketing O2O market size projection**

Source: Wind, Macquarie Research, March 2015

**Hotels:** Customers can check in and check out through WeChat > Hotels can provide better CRM through virtual membership card and public accounts.

Hotels

Issues in traditional service	Weixin's benefit
Tedious check in and out procedures Inefficient CRM system	WeChat can realize self-check in/out WeChat can provide virtual cards and better CRM
Source: Company data, Macquarie Research, March 2015	

Fig 55 WeChat Virtual Card



Source: Company data, Macquarie Research, March 2015

Fig 56 Precise and in-time CRM



Source: Company data, Macquarie Research, March 2015

**Travel:** Customers can purchase tickets through WeChat public accounts > scan the QR Code when entering the sites > Tourist site can recommend routes and real time guidance

Travel	
Issues in traditional service	Weixin's benefit
Long queue High promotional costs for traditional channels  No visitor's information	WeChat online purchase Attractions can build their own operation channels through WeChat Collect visitor's information and achieve effective communication channel
Source: Company data, Macquarie Research, March 2015	

Fig 57 WeChat Map



Source: Company data, Macquarie Research, March 2015

Fig 58 WeChat Verbal Guidance



Source: Company data, Macquarie Research, March 2015

**Healthcare:** Customers can perform initial diagnosis through instructions on WeChat > Customers can then make appointment through the system to avoid the long queue > After the official diagnosis, e-reports are available through WeChat

Healthcare	
Issues in traditional service	Weixin's benefit
Long queue	WeChat can provide appointment in advance
Lack effective guidance through the process	WeChat real time guidance
Can not inform the patients of the doctor's information	WeChat can send information in time
Source: Company data, Macquarie Research, March 2015	

Fig 59 WeChat Intelligent Diagnosis



Source: Company data, Macquarie Research, March 2015

Fig 60 WeChat e-report



Source: Company data, Macquarie Research, March 2015

**Car parking:** Customers can proceed to payment through the public account of a car park on WeChat > the system can also provide real-time information on spare parking lots.

Car parking

Issues in traditional service	Weixin's benefit
Long queue for collecting fees High management fees Unable to collect users' information	WeChat can proceed with the payment Users can locate their cars with WeChat WeChat can provide more connection for the company and the users
Source: Company data, Macquarie Research, March 2015	

Fig 61 WeChat Intelligent Parking



Source: Company data, Macquarie Research, March 2015

Fig 62 Spare Slots information



Source: Company data, Macquarie Research, March 2015

### **Taxi booking**

Besides the 11 industries mentioned above, the taxi industry has caught the public's eye in the past year and is also growing at a rapid pace. It is estimated that the total taxi orders per day are around 50-60m, while Didi alone could have reached 5.3m orders in 2014. By total GMV-wise, the total GMV for the taxi market is around RMB 300-400bn, while the O2O car rental service providers have achieved a GMV of RMB8bn within one or two years.

Since Didi Private Car's launch in August 2014, this business has also witnessed explosive growth, with the total orders per day reaching 50,000 at the beginning of Sep, 200,000 in November and over 300,000 by the end of December 2014. Now, Didi alone provides private car services in 19 cities nationwide and the number of drivers who have registered the Didi app has reached over 900,000.

With the merger of Didi and Kuaidi, the largest two O2O taxi and car rental service providers in China, this O2O market is likely to continue to grow at a rapid pace with less competition and much more resources available, both financially and in terms of the user base.

## First in, first out

Tencent was the first major internet company to enter into mobile internet investment mode three years ago. As shown in the chart on the next page, Tencent has the strongest cash generating capabilities among the three internet giants (TAB – Tencent, Alibaba and Baidu). In 2014, Tencent generated Rmb41bn operating cash flow, compared to Rmb21bn for Alibaba and Rmb18bn for Baidu.

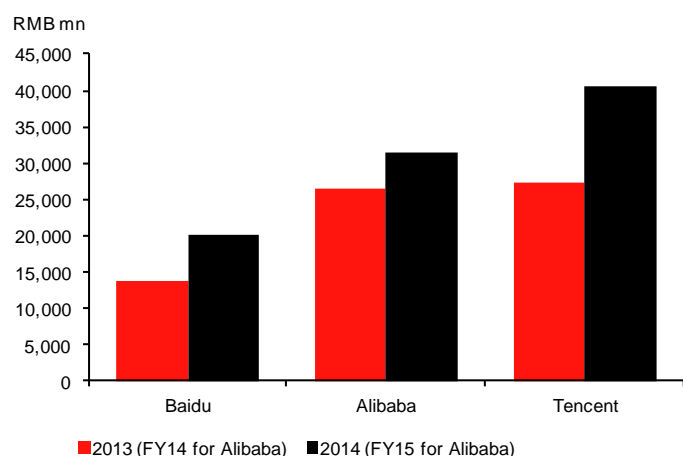
From an investment perspective, Tencent and Alibaba have been competing aggressively for the best resources and partnerships in 13 important verticals (Please refer to M&A mapping on page 33-34). Tencent has been smarter in spending dollars. In 2014, Tencent's investment cash outflow was Rmb41bn, compared to Rmb59bn for Alibaba. Notably, Baidu is well-known for being conservative on M&A, incurring only Rmb8.5bn in investment cash outflow.

The rise of operating expense for Tencent has mainly been driven by content cost, S&M cost as well as R&D cost. In 2013, Tencent spent most among TAB on this front. But the operating expense growth moderated in 2014 as Tencent started to step out from the investment cycle and benefited from its first-mover advantage.

With its established position in China's mobile internet space and footprint across 13 internet verticals, we expect Tencent to be the first to step out of the margin downturn and estimate its non-GAAP op margin to expand from 39% in 2014 to 41% in 2015 and 44% in the long term.

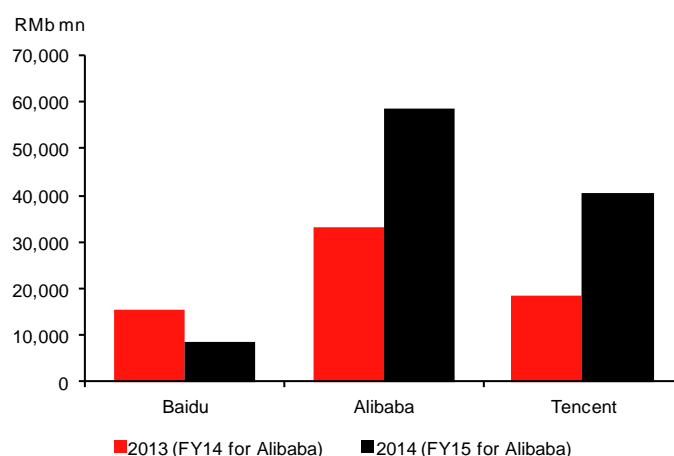
Notably, all three companies have tried to strengthen their balance sheets by issuing debt or IPOs. As of 2014, the three internet giants are sitting on similar levels of gross cash around Rmb58-63bn.

**Fig 63 Comparison of operating cash flow**

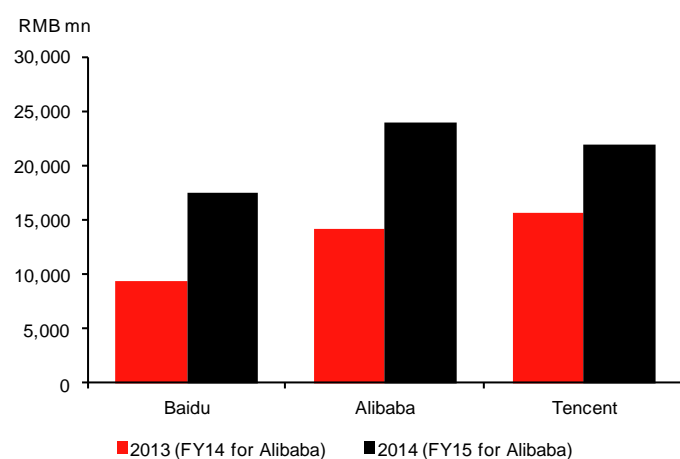


Source: company data, Macquarie Research, March 2015

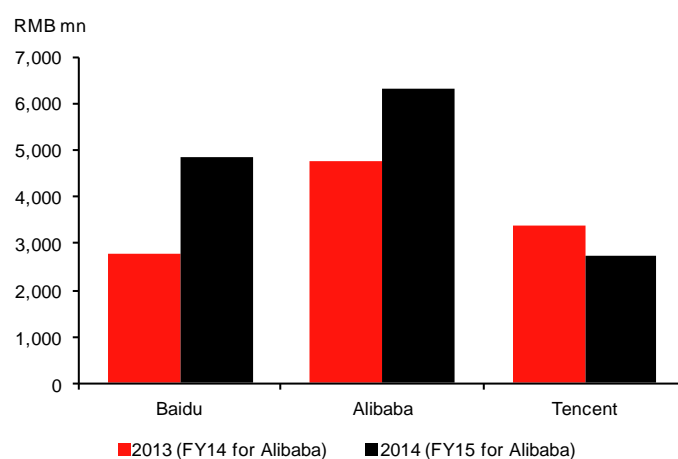
**Fig 64 Comparison of investing cash outflow**



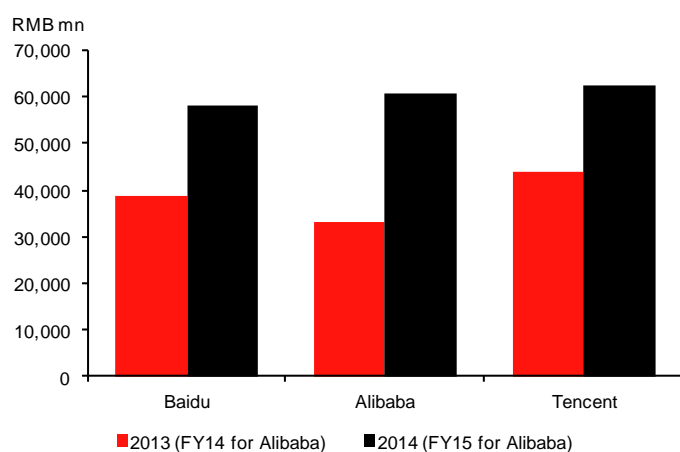
Source: company data, Macquarie Research, March 2015

**Fig 65 Comparison of operating expense**

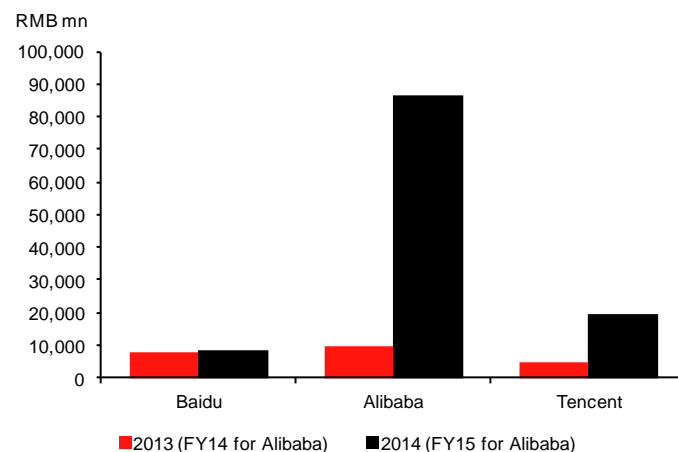
Source: company data, Macquarie Research, March 2015

**Fig 66 Comparison of Capex**

Source: company data, Macquarie Research, March 2015

**Fig 67 Comparison of gross cash position**

Source: company data, Macquarie Research, March 2015

**Fig 68 Comparison of cash raised**

Source: company data, Macquarie Research, March 2015



Fig 69 M&amp;A mapping

	Search		Security		Video / entertainment		App distribution		e-Com + O2O		Payment	
	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)
<b>Tencent</b> Net cash: US\$ 3.7bn (as of Dec 2014). Quarterly operating cash inflow: US\$ 1.7bn (4Q14).												
In-house	X		QQ guardian (mobile)		Tencent video		Yingyongbao		QQ mall		Tenpay, QQ Wallet, Weixin pay	
Investee	Sogou (Sohu)		Kingsoft (PC)		X		X		51Buy + Gaopeng+ Dianping + Beauty talks + JD.com + Didi Taxi +58.com		X	
Potential target	Easou	2,000	X		X		Wandoujia	1,000	Jumei	2,100	X	
					Xunlei	420						
<b>Baidu</b> Net cash: US\$ 5.5bn (as of Dec 2014). Quarterly operating cash inflow: US\$ 861mn (4Q14)												
In-house	Baidu search (PC +Mobile)		Baidu mobile guardian		X		Baidu mobile assistant		X		Baidu payment/Baidu Wallet	
Investee	X		X		iQiyi-PPS + Lecai+Pixellot (US\$ 3mn)		91 wireless		Nuomi + Uber (US\$600mn)		X	
Potential target	Easou	2,000	X		X		X		Dangdang (DANG US)	640	X	
									Ganji.com	2,000		
<b>Alibaba</b> Net cash: US\$ 9.9bn (as of Dec 2014). Quarterly operating cash inflow: US\$ 3.1bn (4Q14)												
In-house	Etao		X		X		Taobao		Taobao+Tmall+1688		Alipay (PC + mobile)	
Investee	X		X		Youku Tudou (YOKU US US\$ 4.0bn) +Huayi Brothers (Rmb3.6bn)+魔漫相机+芭乐传媒+Huxiu (虎嗅网)+Evergrande Football+ 21century media+V film+ Huashu+Vision China		UC Web		Meituan + SINA Weibo + Kuaidi Taxi+卡行天下+Intime+遛遛宠物+茵曼+一达通+新加坡邮政+1stdibs+全峰快递		Weibo pay	
Potential target	Easou	2,000	X		X		Wandoujia	1,000	Ganji.com	2,000	X	

Source: Company data, Macquarie Research, March 2015

Fig 70 M&amp;A mapping

	Map		Mobile + SNS		Online travel		Browser		Auto		Real-estate		Online games	
	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)	Co.	Est. Value (US\$ mn)
<b>Tencent</b>	Net cash: US\$ 3.7bn (as of Dec 2014). Quarterly operating cash inflow: US\$ 1.7bn (4Q14).													
In-house	Tencent map		Weixin/mobile QQ +Kaixin.com		QQ travel		QQ browser		X		X		Various game studios	
Investee	Naviinfo (002405 CN US\$ 1.9bn)		Kakao		eLong (US\$ 762mn) + 17u		Kingsoft		Bitauto (US\$ 2.2bn)		Leju (US\$ 1.2bn) + Anjuke (US\$ 1.5bn)		Rekoo + iDreamsky + Epic games + Riot Games + CJ Games + Miniclip + Activision Blizzard	
Potential target	X		X		Ctrip (CTRP US)	8,000	X		X		X		X	
<b>Baidu</b>	Net cash: US\$ 5.5bn (as of Dec 2014). Quarterly operating cash inflow: US\$ 861mn (4Q14)													
In-house	Baidu map		X		X		Baidu browser		X		X		X	
Investee	X		Indoor atlas (US\$10mn)		Qunar (QUNR US\$ 3.2bn)		X		X		X		Linekong (US\$ 20mn)	
Potential target	X		X		X		X		Autohome (ATHM US)	5,000	X		X	
<b>Alibaba</b>	Net cash: US\$ 9.9bn (as of Dec 2014). Quarterly operating cash inflow: US\$ 3.1bn (4Q14)													
In-house	X		Laiwang		Taobao travel		X		X		X		X	
Investee	AutoNavi + DDMap		Umeng + Momo + Super timetable+Tango		Yecity + Qyer.com +117go.com +Baicheng.com		UC web		X		Shiji information (Rmb 2.8bn)		Ktplay+Kabam (US\$120mn)	
Potential target	X		X		X		X		X		Soufun (SFUN US)	2,300	Shanda games	1,700

Source: Company data, Macquarie Research, March 2015

## 4Q14 results review

- **Solid 4Q14 results.** 4Q revenue grew 6% QoQ and 24% YoY to RMB21bn, 3-6% ahead of MQ/consensus. 4Q GPM declined to 60.3% from 63.8% in 3Q due to greater sharing and content cost. 4Q OPM of 35.2% declined from 37.9% in 3Q14 and was below consensus of 36.2%. S&M marketing expenses rose 8% QoQ due to online game promotions and advertising of Weixin Payment. Weixin MAU crossed 500mn for the first time. Non-GAAP net income of RMB6.7bn rose 5% QoQ and 51% YoY, 3% above consensus.
- **Mobile games resumed growth.** VAS grew 7% QoQ and 44% YoY to RMB17bn. Online game revenues grew 6% and 41% to RMB12bn due to strong mobile game performance as Tencent adopted gross revenue recognition, new titles and expansion pack launches.
- 4Q mobile game revenue was RMB3.8bn (gross), or RMB2.9bn (net), compared to net revenue of RMB2.6bn in 3Q and RMB3bn in 2Q. Slower seasonality impacted PC client-based games. VAS and online games would have grown 3% and 2% if gross revenue recognition was adopted for smartphone games in 3Q14.
- **Online advertising grew on the back of performance-based ad.** 4Q online advertising revenue rose 8% QoQ and 75% YoY to RMB2.6bn, driven by Mobile Qzone and Weixin Official Accounts. However, video ad revenue declined QoQ on a high base in 3Q due to Voice of China 3 and World Cup.

**Fig 71 4Q14 results review**

(Rmb mn)	4Q13	3Q14	4Q14	MQ estimates	QoQ	YoY	vs MQ	4Q14 consensus	vs consensus
<b>Revenue</b>	<b>16,970</b>	<b>19,808</b>	<b>20,978</b>	<b>19,751</b>	<b>6%</b>	<b>24%</b>	<b>6%</b>	<b>20,357</b>	<b>3%</b>
Social networking	3,457	4,723	5,173	4,840	10%	50%	7%		
Online games	8,475	11,324	11,964	11,865	6%	41%	1%		
Online ads	1,497	2,440	2,627	2,395	8%	75%	10%		
e-Commerce	3,324	459	446	0	-3%	-87%	n.a.		
Others	217	862	768	651	-11%	254%	18%		
Cost of sales	-8,198	-7,167	-8,332	-6,756	16%	2%	23%		
<b>Gross profit</b>	<b>8,772</b>	<b>12,641</b>	<b>12,646</b>	<b>12,995</b>	<b>0%</b>	<b>44%</b>	<b>-3%</b>		
<b>Operating expenses</b>	<b>-4,803</b>	<b>-5,696</b>	<b>-6,038</b>	<b>-5,827</b>	<b>6%</b>	<b>26%</b>	<b>4%</b>		
S&M	-2,033	-1,906	-2,063		8%	1%			
G&A	-1,469	-1,763	-1,814		3%	24%			
R&D	-1,301	-2,027	-2,161		7%	66%			
Operating profit	4,751	7,515	7,394	7,593	-2%	56%	-3%	7,377	0%
<b>Net income</b>	<b>3,911</b>	<b>5,657</b>	<b>5,860</b>	<b>6,019</b>	<b>4%</b>	<b>50%</b>	<b>-3%</b>	<b>5,992</b>	<b>-2%</b>
<b>Non-GAAP net income</b>	<b>4,440</b>	<b>6,433</b>	<b>6,723</b>	<b>6,787</b>	<b>5%</b>	<b>51%</b>	<b>-1%</b>	<b>6,517</b>	<b>3%</b>
Diluted EPS (RMB)	0.42	0.60	0.63	0.64	4%	50%	-3%	0.63	-1%
Non-GAAP diluted EPS (RM)	0.47	0.69	0.72	0.73	4%	52%	-1%	0.70	3%
<i>GPM</i>	51.7%	63.8%	60.3%	65.8%	(354 bps)	859 bps	(551 bps)		
<i>GAAP OPM</i>	28.0%	37.9%	35.2%	38.4%	(269 bps)	725 bps	(320 bps)		
<i>Non-GAAP OPM</i>	31.4%	41.9%	39.4%	42.3%	(250 bps)	798 bps	(297 bps)		
<b>Key assumptions</b>									
QQ active user account (mn)	808	820	815		-1%	1%			
QQ paying account (mn)	88.6	88.7	83.7		-6%	-6%			
QQ ARPU (RMB/month, incl)	12.1	13.9	14.5		4%	20%			
Weixin/WeChat MAU (mn)	355.0	468.1	500.0		7%	41%			

Source: company data, Bloomberg consensus Macquarie Research, March 2015

## Earnings revision

- We raise our revenue assumptions by 9% and 15% for FY15 and FY16 to reflect stronger social networking and higher monetization upside to online advertising (Mobile Qzone, Weixin Moments ads), and thus lift our non-GAAP net profit estimates by 5% and 9% for FY15 and FY16.

**Fig 72 Estimate revisions**

New estimates			
(RMB mn)	1Q15E	2015E	2016E
Revenue	22,804	98,791	125,587
Social networking	5,665	24,776	30,456
Online games	13,698	56,584	67,494
Online advertising	2,364	12,790	22,727
E-Commerce	424	1,572	1,280
Others	653	3,069	3,630
Operating profit	7,767	36,363	45,486
Net profit	5,947	28,467	36,988
Non-GAAP net profit	6,860	32,460	42,075
Non-GAAP EPS (RMB)	0.73	3.46	4.47

Old estimates			
(RMB mn)	1Q15E	2015E	2016E
Revenue	20,910	90,760	109,216
Social networking	4,952	20,566	21,896
Online games	13,503	55,990	68,581
Online advertising	1,883	11,300	15,255
E-Commerce	0	0	0
Others	572	2,903	3,484
Operating profit	7,655	33,294	42,364
Net profit	6,424	27,959	35,549
Non-GAAP net profit	7,178	31,016	38,582
Non-GAAP EPS (RMB)	0.77	3.31	4.11

Estimate revision			
	1Q15E	2015E	2016E
Revenue	9.1%	8.8%	15.0%
Social networking	14.4%	20.5%	39.1%
Online games	1.4%	1.1%	-1.6%
Online advertising	25.5%	13.2%	49.0%
E-Commerce	n.a.	n.a.	n.a.
Others	14.1%	5.7%	4.2%
Operating profit	1.5%	9.2%	7.4%
Net profit	-7.4%	1.8%	4.0%
Non-GAAP net profit	-4.4%	4.7%	9.1%
Non-GAAP EPS	-4.5%	4.6%	8.8%

Source: Macquarie Research, March 2015

## Valuation and financials

We assign a target FY16 PE multiple of 35x (or US\$63bn value) to Tencent's social networking business to reflect its long-term earnings potential and importance to its own model and platform. Tencent is currently trading at 33x FY15 PE based on our estimates compared to median of 32x.

In our view, social networking sets a foundation for Tencent's overall platform and the basis for the monetization of other products. Our target multiple is on par with Facebook's trading multiple of 33x FY16 PE according to Bloomberg consensus.

We benchmark our multiple for the online games segment against the Chinese online gaming industry (8-14x FY16 PE), and include a premium (thus 17x FY16PE) for Tencent's dominant market share, strong earnings visibility and comprehensive game portfolio. Its gaming segment is estimated to be worth US\$67bn.

We assign a 35x FY16 PE multiple to online advertising, reflecting 55% earnings CAGR between 2016 and 2019 on the back of strong brand ads (fast-growing video ads) and performance-based ads (mobile Qzone, Weixin Moments ads). The online advertising segment is estimated to be worth US\$31bn.

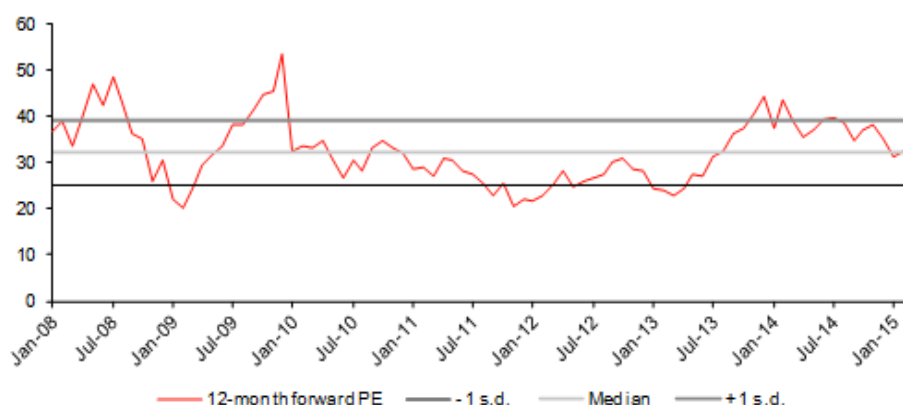
We assign a value of US\$48bn to TenPay (including Weixin Payment and QQ Wallet) as well as O2O. Tencent is rolling out aggressively more O2O scenarios (taxi hailing, restaurants, applications in 11 industries) for its Weixin users in order to gain a higher market share in mobile payment. We assume 1) TenPay will account for 40% of China's online payment market and O2O market by 2021; 2) an average take rate of 1%; 3) a net margin of 70%. We estimate FY21 net profit of TenPay will be US\$4.4bn, and thus arrive at a future value of US\$88bn at 20x PE. Using a discount rate of 13%, the payment and O2O segment is worth US\$48bn in 2016.

**Fig 73 Tencent's sum-of-parts valuation**

(RMB mn)	2016E revenue	2016E non-GAAP earnings	2016-19E non-GAAP earnings CAGR	Target 2016E PE	Est. fair value (RMB bn)	Fair value (US\$ bn)	Fair value/ share (HK\$)
Social networking (QQ + Weixin VAS)	30,456	11,094	23%	35x	388	63	53
Online game (PC + Mobile game)	67,494	24,585	16%	17x	418	67	57
Online ads (Portal + Video + Social ads)	22,727	5,550	55%	35x	194	31	26
Payment + O2O					296	48	40
<b>Total EV</b>	<b>120,677</b>	<b>41,228</b>	<b>24%</b>	<b>31x</b>	<b>1,296</b>	<b>209</b>	<b>175</b>
2016E cash per share (HK\$)						17	14
<b>Target price (HK\$)</b>							<b>189</b>

Source: Macquarie Research, March 2015

**Fig 74 Currently trading at 33x 1-year forward PE vs median PE of 32x**



Source: Bloomberg, Macquarie Research, March 2015

Fig 75 Scenario analysis

	Bear case	Base case	Bull case
<b>Assumptions</b>			
Social networking 2014-16 revenue CAGR	18%	28%	48%
Online game 2014-16 revenue CAGR	13%	23%	38%
Online ads 2014-16 revenue CAGR	35%	65%	105%
Fair value of payment + O2O (US\$bn)	20	48	60

Bear case	2016E revenue (RMB bn)	2016E non- GAAP earnings	Target 2016E PE	Est. fair value (RMB bn)	Fair value (US\$ bn)	Fair value/ share (HK\$)
Social networking (QQ + Weixin VAS)	25,887	9,429	20x	189	31	26
Online game (PC + Mobile game)	56,949	20,744	10x	207	34	28
Online ads (Portal + Video + Social ads)	15,230	3,719	20x	74	12	10
Payment + O2O + others				124	20	17
Total EV	98,067	33,893	18x	594	97	80
Target price (HK\$)						94

Base case	2016E revenue (RMB bn)	2016E non- GAAP earnings	Target 2016E PE	Est. fair value (RMB bn)	Fair value (US\$ bn)	Fair value/ share (HK\$)
Social networking (QQ + Weixin VAS)	30,456	11,094	35x	388	63	53
Online game (PC + Mobile game)	67,494	24,585	17x	418	67	57
Online ads (Portal + Video + Social ads)	22,727	5,550	35x	194	31	26
Payment + O2O + others				296	48	40
Total EV	120,677	41,228	31x	1,296	209	175
Target price (HK\$)						189

Bull case	2016E revenue (RMB bn)	2016E non- GAAP earnings	Target 2016E PE	Est. fair value (RMB bn)	Fair value (US\$ bn)	Fair value/ share (HK\$)
Social networking (QQ + Weixin VAS)	40,707	14,827	35x	519	85	70
Online game (PC + Mobile game)	84,990	30,958	20x	619	101	84
Online ads (Portal + Video + Social ads)	35,049	8,559	40x	342	56	46
Payment + O2O + others				372	60	50
Total EV	160,745	54,344	34x	1,852	302	251
Target price (HK\$)						265

Source: Macquarie Research, March 2015

We have performed a scenario analysis to evaluate Tencent's fair value based on different sets of growth rates for its key business.

- Base case - we assume 28/23/65% revenue CAGR between 2014-16 for Tencent's social networking, online game, online ads segments; and a fair value of US\$48bn for its payment and O2O. We then derive our TP of HK\$189.
- Bear case - we assume membership/subscription of its social platforms will stay stagnant and the overall game and advertising industry slow down faster than expected even for the leading players like Tencent i.e. 18/13/35% revenue CAGR between 2014-16 for Tencent's social networking, online game, online ads segments; and a fair value of US\$20bn for its payment and O2O. We then derive a fair value HK\$94 per share.
- Bull case - we assume Tencent's core business will grow faster than expected i.e. 48/38/105% revenue CAGR between 2014-16 for Tencent's social networking, online game, online ads segments; and a fair value of US\$60bn for its payment and O2O. We then derive a fair value of HK\$265 per share.

We have also performed a DCF valuation for sanity check and arrive at a TP of HK\$216 based on 20x terminal EBITDA multiple.

**Fig 76 DCF valuation**

YE 31 December (RMB mn)	2016E	2017E	2018E	2019E	2020E	2021E
Free cash flow	45,492	55,778	63,064	72,184	85,792	103,871
EBIT * (1-t)	38,256	47,862	58,223	69,537	84,460	103,313
+ D&A	5,997	6,597	7,197	7,797	8,397	8,997
+ Capex & investments	-11,789	-13,625	-15,516	-17,517	-19,841	-22,552
+ (Inc) / dec in NWC	13,028	14,944	13,161	12,367	12,776	14,113
Proportionate FCF	45,492	55,778	63,064	72,184	85,792	103,871
Year	1.79	2.79	3.79	4.79	5.79	6.79
WACC	13%	13%	13%	13%	13%	13%
Discount factor	1.25	1.41	1.59	1.80	2.04	2.30
NPV of FCF	36,523	39,600	39,593	40,076	42,121	45,098
Base case WACC calculation :						
Risk free rate	2.2%	DCF valuation (RMB mn):				
Equity risk premium	13.0%	Total NPV of forecast				197,914
Beta	1.02	Terminal EBITDA				131,834
Cost of common equity	15.4%	Terminal EBITDA multiple				20 x
After tax cost of debt	4.2%	Terminal value				2,636,686
Cost of Debt	5.0%	NPV of terminal value				1,294,529
Tax rate	-15.9%					
Debt/Total capital (steady state):		Enterprise value				1,492,442
% common equity	79%	TV : EV				86.7%
% debt	21%	Net (cash) debt (2016E)				-102,833
WACC calculated	13.1%	Hypothetical DCF-based fair value :				
Terminal FCFF =	103,871	Equity value (RMB mn)				1,595,275
Implied perpetual growth rate	9.1%	Equity value (HK\$ mn)				2,033,526
		Per share (HK\$)				215.97

**DCF MATRIX**

	Hypothetical DCF-based fair value (HK\$)						
Exit multiple	14x	16x	18x	20x	22x	24x	26x
WACC							
10%	187	207	228	248	269	289	310
11%	179	198	218	237	256	276	295
12%	171	189	208	226	245	263	281
13%	163	181	198	216	233	251	269
14%	156	173	190	206	223	240	256
15%	150	166	181	197	213	229	245
16%	144	159	174	189	204	219	234
	NPV of forecast FCF (RMB mn)						
	2016E	2017E	2018E	2019E	2020E	Total NPV	
FCF	45,492	55,778	63,064	72,184	85,792		
Year to discount	1.79	2.79	3.79	4.79	5.79		
WACC							
10%	38,320	42,681	43,837	45,581	49,212	219,629	
11%	37,706	41,619	42,361	43,650	46,703	212,038	
12%	37,107	40,592	40,948	41,817	44,343	204,806	
13%	36,523	39,600	39,593	40,076	42,121	197,914	
14%	35,953	38,640	38,295	38,423	40,029	191,340	
15%	35,397	37,712	37,051	36,851	38,058	185,068	
16%	34,854	36,814	35,856	35,356	36,200	179,079	
	Terminal value as EBITDA multiple (RMB mn)						
Exit multiple	14x	16x	18x	20x	22x	24x	26x
WACC							
10%	1,058,711	1,209,956	1,361,200	1,512,444	1,663,689	1,814,933	1,966,178
11%	1,004,737	1,148,271	1,291,805	1,435,339	1,578,873	1,722,406	1,865,940
12%	953,962	1,090,242	1,226,523	1,362,803	1,499,083	1,635,363	1,771,644
13%	906,170	1,035,623	1,165,076	1,294,529	1,423,982	1,553,434	1,682,887
14%	861,162	984,185	1,107,208	1,230,232	1,353,255	1,476,278	1,599,301
15%	818,754	935,718	1,052,683	1,169,648	1,286,613	1,403,578	1,520,542
16%	778,774	890,027	1,001,280	1,112,534	1,223,787	1,335,041	1,446,294
Implied non-GAAP PER (2016E)							
Exit multiple	14x	16x	18x	20x	22x	24x	26x
WACC							
10%	32.8x	36.4x	40.0x	43.6x	47.2x	50.8x	54.4x
11%	31.4x	34.8x	38.2x	41.6x	45.0x	48.4x	51.8x
12%	30.0x	33.2x	36.5x	39.7x	42.9x	46.2x	49.4x
13%	28.7x	31.8x	34.8x	37.9x	41.0x	44.1x	47.1x
14%	27.5x	30.4x	33.3x	36.2x	39.2x	42.1x	45.0x
15%	26.3x	29.1x	31.9x	34.6x	37.4x	40.2x	43.0x
16%	25.2x	27.9x	30.5x	33.1x	35.8x	38.4x	41.1x

Source: Macquarie Research, March 2015

Fig 77 Tencent's financial statements

YE 31 December	2012	2013	2014	2015E	2016E	2017E	14A-15E	15E-16E	16E-19E
<b>Consolidated Income Statement (RMB mn)</b>									
Revenue	43,894	60,437	78,932	98,791	125,587	157,691	25%	27%	21%
Social Network	11,803	13,020	18,554	24,776	30,456	36,955	34%	23%	20%
Online Game	23,915	31,965	44,756	56,584	67,494	78,390	26%	19%	13%
Online Ads	3,382	5,034	8,308	12,790	22,727	37,009	54%	78%	44%
e-commerce	4,428	9,796	4,753	1,572	1,280	1,043	-67%	-19%	-13%
Others	365	622	2,561	3,069	3,630	4,294	20%	18%	10%
Gross Profit	25,686	32,658	48,059	60,753	76,966	96,690	26%	27%	21%
GPM	59%	54%	61%	61%	61%	61%	61 bps	(21 bps)	(45 bps)
SG&A	10,759	15,684	21,952	26,790	33,880	41,852	22%	26%	17%
Operating Profit	15,479	19,194	30,542	36,363	45,486	56,438	19%	25%	22%
OPM	35%	32%	39%	37%	36%	36%	(189 bps)	(59 bps)	74 bps
PBT	15,051	19,280	29,013	34,680	44,425	56,250	20%	28%	24%
Income Taxes (Credit)	2,266	3,718	5,125	5,837	7,061	8,547	14%	21%	22%
Net Income	12,732	15,501	23,810	28,467	36,988	47,327	20%	30%	25%
Non-GAAP net income	14,286	17,005	24,224	32,460	42,075	53,904	34%	30%	24%
NPM	29%	26%	30%	29%	29%	30%	(135 bps)	64 bps	297 bps
Non-GAAP NPM	33%	28%	31%	33%	34%	34%	217 bps	65 bps	300 bps
EBITDA	18,100	22,784	35,339	41,760	51,483	63,035	18%	23%	20%
EBITDA Margin	41.2%	37.7%	44.8%	42.3%	41.0%	40%	(250 bps)	(128 bps)	(53 bps)
<b>Consolidated Balance Sheet (RMB mn)</b>									
Current Assets	36,509	53,686	75,321	113,037	150,839	199,678	50%	33%	27%
Cash +	29,709	43,982	62,685	98,404	133,847	179,922	57%	36%	29%
Receivables	2,354	2,955	4,588	5,742	7,300	9,166	25%	27%	21%
Inventories	568	1,384	244	306	250	203	26%	-19%	-13%
Other	3,878	5,365	7,804	8,584	9,443	10,387	10%	10%	10%
Non-current Assets	38,747	53,549	95,845	102,151	109,444	117,972	7%	7%	8%
PP&E	7,958	10,734	12,016	11,985	12,391	13,421	0%	3%	12%
Intangibles	5,514	4,974	10,055	9,647	9,139	8,531	-4%	-5%	-8%
Available-for-sale financial asset	5,633	12,515	13,277	13,941	14,638	15,370	5%	5%	5%
Deferred Taxes	169	431	322	386	464	556	20%	20%	20%
Term deposits	10,892	11,420	4,831	5,314	5,846	6,430	10%	10%	10%
Others (incl investment)	8,582	13,475	55,344	60,878	66,966	73,663	10%	10%	10%
<b>Total Assets</b>	<b>75,256</b>	<b>107,235</b>	<b>171,166</b>	<b>215,188</b>	<b>260,283</b>	<b>317,650</b>	<b>26%</b>	<b>21%</b>	<b>20%</b>
Current Liabilities	20,665	33,267	50,035	60,536	75,635	93,082	21%	25%	18%
Deferred revenue	8,115	11,841	16,153	20,217	25,701	32,271	25%	27%	21%
Payables	4,212	6,680	8,683	10,597	13,401	16,554	22%	26%	17%
ST debt	1,077	2,589	3,215	2,894	2,604	2,344	-10%	-10%	-10%
Others	7,261	12,157	21,984	26,829	33,929	41,913	22%	26%	17%
LT Liabilities	12,443	15,505	39,007	46,447	42,727	39,627	19%	-8%	-18%
<b>Total Liabilities</b>	<b>33,108</b>	<b>48,772</b>	<b>89,042</b>	<b>106,983</b>	<b>118,362</b>	<b>132,709</b>	<b>20%</b>	<b>11%</b>	<b>8%</b>
<b>Shareholders Equity</b>	<b>42,148</b>	<b>58,463</b>	<b>82,124</b>	<b>108,205</b>	<b>141,921</b>	<b>184,941</b>	<b>32%</b>	<b>31%</b>	<b>29%</b>
Common Stock	0.2	0.2	0.2	0.2	0.2	0.2	0%	0%	0%
Surplus	2,880	2,846	5,131	5,388	5,657	5,940	5%	5%	5%
Retained Earnings	38,914	53,292	75,340	101,164	134,611	177,348	34%	33%	30%
Others	354	2,325	1,653	1,653	1,653	1,653	0%	0%	0%
<b>Total Sh. Equity + Liabilities</b>	<b>75,256</b>	<b>107,235</b>	<b>171,166</b>	<b>215,188</b>	<b>260,283</b>	<b>317,650</b>	<b>26%</b>	<b>21%</b>	<b>20%</b>
<b>Consolidated Cash Flow (RMB mn)</b>									
Net Income	12,732	15,501	23,810	28,467	36,988	47,327	20%	30%	25%
+ Depreciation and amortization	2,620	3,590	4,797	5,397	5,997	6,597	13%	11%	9%
+ Interest (Income)/Expense	-348	-84	-1,182	-1,430	-1,290	-1,172	21%	-10%	-22%
+/- Change in NWC	3,837	8,186	13,210	8,826	13,028	14,944	-33%	48%	-2%
<b>Operating Cash Flow</b>	<b>18,841</b>	<b>27,193</b>	<b>40,635</b>	<b>41,259</b>	<b>54,723</b>	<b>67,695</b>	<b>2%</b>	<b>33%</b>	<b>19%</b>
Capex	-4,348	-3,378	-2,748	-3,458	-4,396	-5,519	26%	27%	21%
Intangibles	-2,247	-2,421	-1,970	-1,500	-1,500	-1,500	-24%	0%	0%
Other investment	-14,051	-12,566	-35,933	-6,746	-7,394	-8,106	-81%	10%	10%
<b>Investing Cash Flow</b>	<b>-20,645</b>	<b>-18,365</b>	<b>-40,651</b>	<b>-11,703</b>	<b>-13,289</b>	<b>-15,125</b>	<b>-71%</b>	<b>14%</b>	<b>13%</b>
Shares issued (redeemed)	1,436	1,937	1,613	257	269	283	-84%	5%	5%
Cash Dividends	-1,108	-1,123	-1,762	-2,643	-3,541	-4,590	50%	34%	27%
Debt increase (decrease)	-1,012	4,574	24,128	7,119	-4,009	-3,360	-70%	--	45%
Interest Income/(Expense)	348	84	1,182	1,430	1,290	1,172	21%	-10%	-22%
Others	579	-27	-6,442	0	0	0	--	--	--
<b>Financing Cash Flow</b>	<b>242</b>	<b>5,445</b>	<b>18,719</b>	<b>6,163</b>	<b>-5,991</b>	<b>-6,495</b>	<b>-67%</b>	<b>--</b>	<b>46%</b>
Net Change in Cash	-1,561	14,273	18,703	35,719	35,443	46,075	91%	-1%	15%
Cash at beginning of period	31,271	29,709	43,982	62,685	98,404	133,847	43%	57%	33%
Cash at end of period	29,709	43,982	62,685	98,404	133,847	179,922	57%	36%	29%

Source: company data, Macquarie Research, March 2015



Fig 78 Tencent's ratio summary

YE 31 December		2012	2013	2014	2015E	2016E	2017E	14-15E	15-16E	16-19E
Key ratios										
EPS (Non-GAAP diluted)	(HK\$)	1.91	2.32	3.30	4.41	5.70	7.27	34%	29%	24%
EPS (diluted)	(HK\$)	1.70	2.11	3.24	3.87	5.01	6.38	19%	29%	24%
DPS	(HK\$)	0.15	0.24	0.36	0.48	0.62	0.79	34%	29%	24%
BVPS	(HK\$)	5.63	7.96	11.19	14.71	19.21	24.94	31%	31%	28%
Cash per share	(HK\$)	3.99	5.49	4.60	8.54	13.92	18.60	86%	63%	36%
Diluted share - year end	(mn)	9,316	9,340	9,357	9,378	9,416	9,454	0%	0%	0%
Per Share										
EPS (non-GAAP diluted)	(RMB)	1.53	1.82	2.59	3.46	4.47	5.70	34%	29%	24%
EPS (diluted)	(RMB)	1.37	1.66	2.54	3.04	3.93	5.01	19%	29%	24%
DPS	(RMB)	0.12	0.19	0.28	0.38	0.49	0.62	34%	29%	24%
BVPS	(RMB)	4.52	6.26	8.78	11.54	15.07	19.56	31%	31%	28%
Cash per share	(RMB)	3.21	4.32	3.61	6.70	10.92	14.59	86%	63%	36%
Value										
EV/Revenue	X	24.1x	17.1x	13.1 x	10.4 x	8.2 x	6.5 x	--	--	--
EV/EBITDA	X	58.3x	45.3x	29.2x	24.7 x	20.0 x	16.3 x	--	--	--
EV/FCF	X	nm	91.2x	nm	30.1 x	22.7 x	18.5 x	--	--	--
P/E (non-GAAP)	X	76.0x	62.6x	43.9x	32.9 x	25.5 x	19.9 x	--	--	--
P/E (non-GAAP), ex cash	X	73.9x	60.2x	42.5 x	30.9 x	23.0 x	17.4 x	--	--	--
Price/ Sales	X	24.8x	17.6x	13.5 x	10.8 x	8.5 x	6.7 x	--	--	--
Price/ Book	X	25.8x	18.2x	13.0x	9.9 x	7.5 x	5.8 x	--	--	--
Key forecasts										
Revenue	(RMB mn)	43,894	60,437	78,932	98,791	125,587	157,691	25%	27%	21%
EBITDA	(RMB mn)	18,100	22,784	35,339	41,760	51,483	63,035	18%	23%	20%
Operating Profit	(RMB mn)	15,479	19,194	30,542	36,363	45,486	56,438	19%	25%	22%
Net Income	(RMB mn)	12,732	15,501	23,810	28,467	36,988	47,327	20%	30%	25%
Profitability										
EBITDA Margin	%	41%	38%	45%	42%	41%	40%	(250 bps)	(128 bps)	(53 bps)
Operating Margin	%	35%	32%	39%	37%	36%	36%	(189 bps)	(59 bps)	74 bps
Net Margin	%	29%	26%	30%	29%	29%	30%	(135 bps)	64 bps	297 bps
Cash Flow										
Operating Cash Flow	(RMB mn)	18,841	27,193	40,635	41,259	54,723	67,695	2%	33%	19%
Free Cash Flow :	(RMB mn)	1,208	11,324	4,473	34,262	45,492	55,778	666%	33%	17%
+EBIT*(1-t)	(RMB mn)	13,149	15,492	25,147	30,243	38,256	47,862	20%	26%	22%
+D&A	(RMB mn)	2,620	3,590	4,797	5,397	5,997	6,597	13%	11%	9%
+Capex & Investments	(RMB mn)	-18,398	-15,944	-38,681	-10,203	-11,789	-13,625	-74%	16%	14%
+Change in NWC	(RMB mn)	3,837	8,186	13,210	8,826	13,028	14,944	-33%	48%	-2%
Yield										
Dividend Yield	%	0.10%	0.17%	0.25%	0.33%	0.43%	0.55%	8 bps	10 bps	39 bps
FCF Yield	%	0.1%	1.1%	0.4%	3.2%	4.2%	5.2%	279 bps	104 bps	244 bps
Earnings Yield	%	0.9%	1.1%	1.8%	2.1%	2.7%	3.5%	34 bps	62 bps	252 bps
Balance Sheet										
Net debt (cash)	(RMB mn)	-29,902	-40,349	-33,766	-62,849	-102,833	-137,951	86%	64%	36%
Net debt/ equity	(RMB mn)	cash	cash	cash	cash	cash	cash	--	--	--
Shareholders Equity	(RMB mn)	42,148	58,463	82,124	108,205	141,921	184,941	32%	31%	29%
Efficiency										
ROE (average)	%	36%	31%	34%	30%	30%	29%	(396 bps)	(34 bps)	(299 bps)
ROA (average)	%	19%	17%	17%	15%	16%	16%	(237 bps)	82 bps	169 bps
ROIC (average)	%	34%	30%	31%	26%	27%	28%	(494 bps)	44 bps	47 bps

Source: company data, Macquarie Research, March 2015

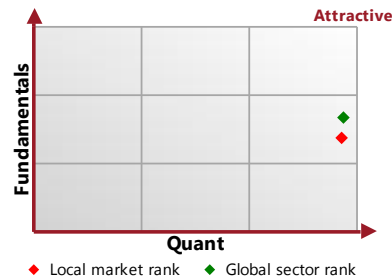
## Macquarie Quant View

The quant model currently holds a strong positive view on Tencent. The strongest style exposure is Profitability, indicating this stock is efficiently converting its investments to earnings as proxied by ratios such as ROE, ROA etc. The weakest style exposure is Valuations, indicating this stock is over-priced in the market relative to its peers.

**26/607**

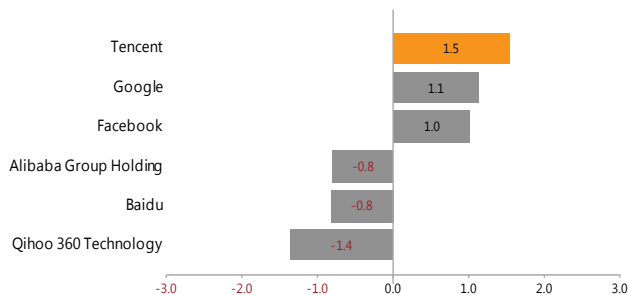
Global rank in  
Software & Services

% of BUY recommendations 91% (39/43)  
Number of Price Target downgrades 2  
Number of Price Target upgrades 25



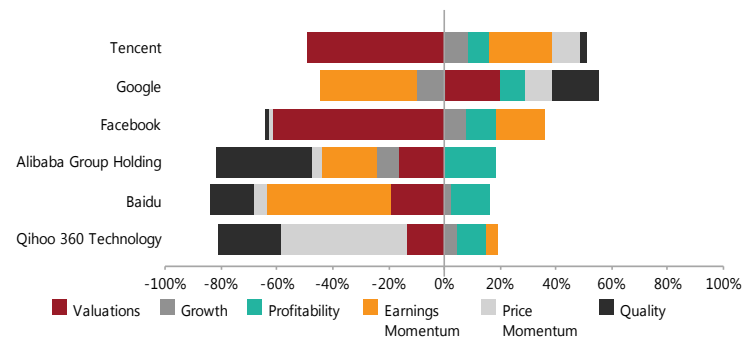
## Macquarie Alpha Model ranking

A list of comparable companies and their Macquarie Alpha model score (higher is better).



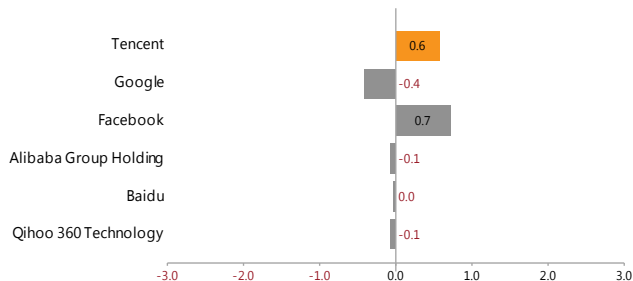
## Factors driving the Alpha Model

For the comparable firms this chart shows the key underlying styles and their contribution to the current overall Alpha score.



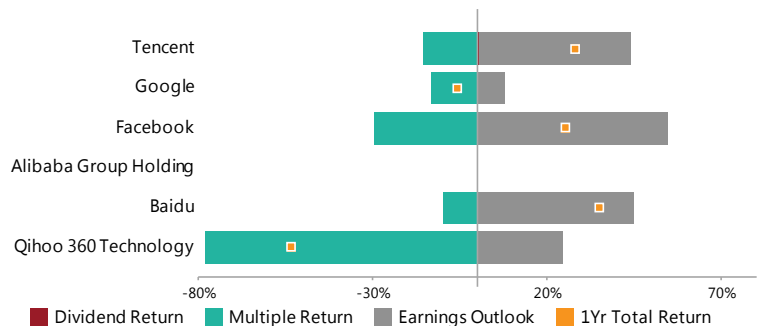
## Macquarie Earnings Sentiment Indicator

The Macquarie Sentiment Indicator is an enhanced earnings revisions signal that favours analysts who have more timely and higher conviction revisions. Current score shown below.



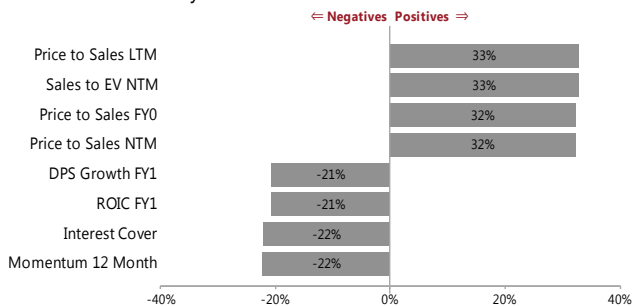
## Drivers of Stock Return

Breakdown of 1 year total return (local currency) into returns from dividends, changes in forward earnings estimates and the resulting change in earnings multiple.



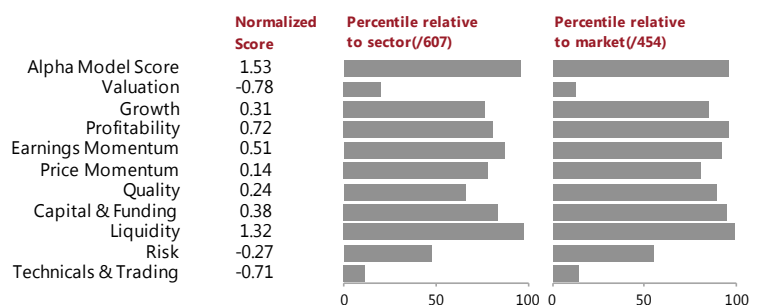
## What drove this Company in the last 5 years

Which factor score has had the greatest correlation with the company's returns over the last 5 years.



## How it looks on the Alpha model

A more granular view of the underlying style scores that drive the alpha (higher is better) and the percentile rank relative to the sector and market.



Source (all charts): FactSet, Thomson Reuters, and Macquarie Research. For more details on the Macquarie Alpha model or for more customised analysis and screens, please contact the Macquarie Global Quantitative/Custom Products Group ([cpq@macquarie.com](mailto:cpq@macquarie.com))

## Tencent (700 HK)

Quarterly Results		4Q/14A	1Q/15E	2Q/15E	3Q/15E	Profit & Loss		2014A	2015E	2016E	2017E
Revenue	bn	21	23	24	26	Revenue	bn	79	99	126	158
Gross Profit	bn	13	14	15	16	Gross Profit	bn	48	61	77	97
Cost of Goods Sold	bn	8	9	9	10	Cost of Goods Sold	bn	31	38	49	61
EBITDA	bn	13	10	11	12	EBITDA	bn	39	46	57	70
Depreciation	bn	5	1	1	1	Depreciation	bn	8	5	6	7
Amortisation of Goodwill	bn	0	0	0	0	Amortisation of Goodwill	bn	0	0	0	0
Other Amortisation	bn	0	0	0	0	Other Amortisation	bn	0	0	0	0
EBIT	bn	8	9	10	10	EBIT	bn	31	40	51	63
Net Interest Income	bn	-1	-0	-0	-0	Net Interest Income	bn	-2	-2	-1	-0
Associates	bn	0	0	0	0	Associates	bn	0	0	0	0
Exceptionals	bn	-1	-1	-1	-1	Exceptionals	bn	-0	-4	-5	-7
Forex Gains / Losses	bn	0	0	0	0	Forex Gains / Losses	bn	0	0	0	0
Other Pre-Tax Income	bn	0	0	0	0	Other Pre-Tax Income	bn	0	0	0	0
Pre-Tax Profit	bn	7	7	9	9	Pre-Tax Profit	bn	29	35	44	56
Tax Expense	bn	-1	-1	-2	-2	Tax Expense	bn	-5	-6	-7	-9
Net Profit	bn	6	6	7	7	Net Profit	bn	24	28	37	47
Minority Interests	bn	0	0	0	0	Minority Interests	bn	0	0	0	0
Reported Earnings	bn	6	6	7	7	Reported Earnings	bn	24	28	37	47
Adjusted Earnings	bn	7	7	8	8	Adjusted Earnings	bn	24	32	42	54
EPS (rep)		0.63	0.64	0.76	0.79	EPS (rep)		2.54	3.04	3.93	5.01
EPS (adj)		0.72	0.73	0.87	0.90	EPS (adj)		2.59	3.46	4.47	5.70
EPS Growth yoy (adj)	%	51.2	32.0	38.0	30.9	EPS Growth (adj)	%	42.2	33.7	29.1	27.6
						PE (rep)	x	44.8	37.6	29.0	22.8
						PE (adj)	x	44.1	33.0	25.5	20.0
EBITDA Margin	%	62.2	44.0	47.3	46.0	Total DPS		0.36	0.48	0.62	0.79
EBIT Margin	%	39.4	38.1	41.7	40.7	Total Div Yield	%	0.3	0.4	0.5	0.7
Earnings Split	%	27.8	21.1	25.0	26.0	Basic Shares Outstanding	m	9,355	9,392	9,430	9,468
Revenue Growth	%	23.6	23.9	22.9	29.1	Diluted Shares Outstanding	m	9,357	9,378	9,416	9,454
EBIT Growth	%	56.4	33.0	28.5	25.5						
Profit and Loss Ratios						Cashflow Analysis		2014A	2015E	2016E	2017E
Revenue Growth	%	30.6	25.2	27.1	25.6	EBITDA	bn	39	46	57	70
EBITDA Growth	%	62.0	16.6	23.6	23.1	Tax Paid	bn	0	0	0	0
EBIT Growth	%	49.6	30.4	25.3	24.6	Chgs in Working Cap	bn	-10	-9	-13	-15
Gross Profit Margin	%	60.9	61.5	61.3	61.3	Net Interest Paid	bn	0	0	0	0
EBITDA Margin	%	49.7	46.3	45.0	44.1	Other	bn	2	4	11	13
EBIT Margin	%	39.2	40.8	40.3	40.0	Operating Cashflow	bn	31	41	55	68
Net Profit Margin	%	30.7	32.9	33.5	34.2	Acquisitions	bn	0	0	0	0
Payout Ratio	%	13.9	13.9	13.9	13.9	Capex	bn	-4	-3	-4	-6
EV/EBITDA	x	28.2	24.3	19.7	16.1	Asset Sales	bn	0	0	0	0
EV/EBIT	x	35.8	27.5	22.1	17.8	Other	bn	-31	-8	-9	-10
Balance Sheet Ratios						Investing Cashflow	bn	-35	-12	-13	-15
ROE	%	34.5	34.1	33.6	33.0	Dividend (Ordinary)	bn	0	0	0	0
ROA	%	22.2	20.9	21.3	21.8	Equity Raised	bn	0	0	0	0
ROIC	%	32.5	27.1	26.3	27.2	Debt Movements	bn	6	7	-4	-3
Net Debt/Equity	%	48.6	47.8	37.3	29.9	Other	bn	15	-1	-2	-3
Interest Cover	x	20.2	24.0	47.7	335.2	Financing Cashflow	bn	22	6	-6	-6
Price/Book	x	13.0	9.9	7.6	5.8	Net Chg in Cash/Debt	bn	18	36	35	46
Book Value per Share		8.8	11.5	15.0	19.5	Free Cashflow	bn	27	38	50	62
						Balance Sheet		2014A	2015E	2016E	2017E
						Cash	bn	7	7	7	8
						Receivables	bn	3	3	4	4
						Inventories	bn	0	0	0	0
						Investments	bn	0	0	0	0
						Fixed Assets	bn	12	12	12	13
						Intangibles	bn	10	10	10	9
						Other Assets	bn	139	183	227	283
						Total Assets	bn	171	215	260	318
						Payables	bn	9	11	13	17
						Short Term Debt	bn	16	20	26	32
						Long Term Debt	bn	31	38	34	31
						Provisions	bn	3	3	3	2
						Other Liabilities	bn	30	35	42	50
						Total Liabilities	bn	89	107	118	133
						Shareholders' Funds	bn	82	108	142	185
						Minority Interests	bn	0	0	0	0
						Other	bn	0	0	0	0
						Total S/H Equity	bn	82	108	142	185
						Total Liab & S/H Funds	bn	171	215	260	318

All figures in Rmb unless noted.

Source: Company data, Macquarie Research, March 2015

## Important disclosures:

## Recommendation definitions

## Macquarie - Australia/New Zealand

Outperform – return >3% in excess of benchmark return  
 Neutral – return within 3% of benchmark return  
 Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

## Macquarie – Asia/Europe

Outperform – expected return >+10%  
 Neutral – expected return from -10% to +10%  
 Underperform – expected return <-10%

## Macquarie First South - South Africa

Outperform – expected return >+10%  
 Neutral – expected return from -10% to +10%  
 Underperform – expected return <-10%

## Macquarie - Canada

Outperform – return >5% in excess of benchmark return  
 Neutral – return within 5% of benchmark return  
 Underperform – return >5% below benchmark return

## Macquarie - USA

Outperform (Buy) – return >5% in excess of Russell 3000 index return  
 Neutral (Hold) – return within 5% of Russell 3000 index return  
 Underperform (Sell) – return >5% below Russell 3000 index return

## Volatility index definition\*

This is calculated from the volatility of historical price movements.

**Very high–highest risk** – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

**High** – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

**Medium** – stock should be expected to move up or down at least 30–40% in a year.

**Low–medium** – stock should be expected to move up or down at least 25–30% in a year.

**Low** – stock should be expected to move up or down at least 15–25% in a year.  
 \* Applicable to Asia/Australian/NZ/Canada stocks only

**Recommendations** – 12 months

**Note:** Quant recommendations may differ from Fundamental Analyst recommendations

## Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense  
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

**EPS** = adjusted net profit / efpowa\*

**ROA** = adjusted ebit / average total assets

**ROA Banks/Insurance** = adjusted net profit / average total assets

**ROE** = adjusted net profit / average shareholders funds

**Gross cashflow** = adjusted net profit + depreciation

\*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

## Recommendation proportions – For quarter ending 31 December 2014

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	51.80%	58.06%	45.07%	44.42%	60.54%	46.81%	(for US coverage by MCUSA, 5.29% of stocks followed are investment banking clients)
Neutral	31.80%	27.37%	30.99%	50.10%	35.37%	33.51%	(for US coverage by MCUSA, 3.08% of stocks followed are investment banking clients)
Underperform	16.39%	14.57%	23.94%	5.48%	4.08%	19.68%	(for US coverage by MCUSA, 0.44% of stocks followed are investment banking clients)

## 700 HK vs HSI, &amp; rec history



(all figures in HKD currency unless noted)

Note: Recommendation timeline – if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, March 2015

## 12-month target price methodology

700 HK: HK\$189.00 based on a Sum of Parts methodology

## Company-specific disclosures:

Important disclosure information regarding the subject companies covered in this report is available at [www.macquarie.com/disclosures](http://www.macquarie.com/disclosures).

Date	Stock Code (BBG code)	Recommendation	Target Price
26-Aug-2014	700 HK	Neutral	HK\$138.00
19-May-2014	700 HK	Neutral	HK\$112.00
07-Apr-2014	700 HK	Neutral	HK\$112.00
15-Nov-2013	700 HK	Underperform	HK\$60.00
15-Aug-2013	700 HK	Underperform	HK\$52.00
16-May-2013	700 HK	Underperform	HK\$39.00
16-Aug-2012	700 HK	Underperform	HK\$36.00

## Target price risk disclosures:

**700 HK:** Any inability to compete successfully in their markets may harm the business. This could be a result of many factors which may include geographic mix and introduction of improved products or service offerings by competitors. The results of operations may be materially affected by global economic conditions generally, including conditions in financial markets. The company is exposed to market risks, such as changes in interest rates, foreign exchange rates and input prices. From time to time, the company will enter into transactions, including transactions in derivative instruments, to manage certain of these exposures.

## Analyst certification:

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### Head of Equity Research

John O'Connell (Global – Head)	(612) 8232 7544
Peter Redhead (Asia – Head)	(852) 3922 4836

### Automobiles/Auto Parts

Janet Lewis (China)	(852) 3922 5417
Zhixuan Lin (China)	(8621) 2412 9006
Amit Mishra (India)	(9122) 6720 4084
Takuo Katayama (Japan)	(813) 3512 7856

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Nicolaos Oentung (Indonesia)	(6221) 2598 8366
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Thomas Stoenner (Singapore)	(65) 6601 0854
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RJ Aguirre (Philippines)	(632) 857 0890
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David Liao (Taiwan)	(8862) 2734 7518
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Prem Jearajasingam (Malaysia, Singapore)	(603) 2059 8989

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Andrew Lee (Asia)	(852) 3922 1167
Azita Nazrene (ASEAN)	(603) 2059 8980
Corinne Jian (Taiwan)	(8862) 2734 7522

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Alan Hon (Hong Kong)	(852) 3922 3589
Inderjeetsingh Bhatia (India)	(9122) 6720 4087
Prem Jearajasingam (Malaysia)	(603) 2059 8989
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Jim Lennox	(4420) 3037 4271
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Bharat Rawla (India)	(9122) 6720 4100
Riaz Hyder (Indonesia)	(6221) 2598 8486
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Paul Colaco (San Francisco)	(1 415) 762 5003
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Angus Kent (Thailand)	(662) 694 7601
Ben Musgrave (UK/Europe)	(44) 20 3037 4882
Julien Roux (UK/Europe)	(44) 20 3037 4867

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Stanley Dunda (Indonesia)	(6221) 515 1555

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