

17 July 2018

Global

## EQUITIES

700 HK Outperform  
Price (at 08:50, 17 Jul 2018 GMT) HK\$381.40

Valuation	HK\$	560.00
- Sum of Parts		
12-month target	HK\$	560.00
12-month TSR	%	+47.1
Volatility Index		Low
GICS sector		Software & Services
Market cap	HK\$bn	3,625
Market cap	US\$m	461,873
30-day avg turnover	US\$m	931.7
Number shares on issue	m	9,505

## Investment fundamentals

Year end 31 Dec		2017A	2018E	2019E	2020E
Revenue	bn	237.8	337.4	449.5	542.0
EBIT	bn	90.3	106.3	122.4	142.1
Reported profit	bn	71.5	81.0	94.6	110.7
EPS adj	Rmb	6.83	8.55	10.73	12.54
ROA	%	19.0	17.5	17.0	16.6
ROE	%	28.1	26.0	26.1	24.7
EV/EBITDA	x	26.8	23.6	21.1	18.7

## 700 HK rel HSI performance, &amp; 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, July 2018  
(all figures in Rmb unless noted, TP in HKD)

## Recent research:

[Tencent - A defensive player amid market volatility](#)  
[Spotify Technology - Topping the Charts](#)

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## Tencent

### Elephant can dance with the “MUSIC”

## Key points

- ▶ Tencent music is the most profitable music streaming company in the world.
- ▶ Tencent owns a 7.5% stake in Spotify, in return, Spotify takes 9% in TME.
- ▶ Positive for Tencent sentiment, unlock the value in music business.

## Event

- [Tencent filed to spin off its music business for US listing](#). This should help Tencent Music Entertainment (TME) to stay financially competitive for content bidding, further widen the gap with NetEase Music, Alibaba Music and Baidu music and pave the way for global expansion in the long term.

## Impact

- **No.1 music carved out of No.1 social network.** As said by Smule's founder, Music was the original social network before Instagram and Facebook. Backed up by the No.1 Chinese social network platform Tencent, TME becomes a clear leader in China's music streaming market with access to 90% music content. With the three most popular music apps in China, namely QQ Music, Kugou (酷狗音乐), and Kuwo (酷我音乐), its aggregate MAU was 930m and DAU was 207m in June on our calculation. Besides the traffic and content synergies, we believe TME is an important piece in Tencent's media matrix and creates chemistry with Tencent video and literature. We also view music as an important tool to help Tencent extend its entertainment coverage from PC/mobile to other smart devices and vehicles.
- **Higher growth and more profitable, yet lower paying conversion rate.** TME generates revenue through membership, live-streaming, sub-licensing, advertisements and game. We estimate its revenue to grow 86% in 2018, compared to 36% for Spotify. It is also more profitable with a 20% net margin in 2017, vs a 30% loss margin for Spotify. On the other hand, TME lags behind Spotify in terms of the paying conversion rate (3% vs 60%) and revenue scale (US\$1.4bn vs US\$4.1bn in FY17). We don't see Spotify's 5% low churn rate as achievable for TME given lower user loyalty in China. However, there is room for average user time spent per month to improve given where it stands now compared to Spotify, 4hr vs 25hr.
- **Valuation: TME = Spotify = NetEase.** Notably, the potential valuation of TME is **US\$29-31bn**, close to global music streaming leader Spotify's US\$34bn and its Chinese peer NetEase Music's parent company's total market cap of US\$35bn. We believe TME's valuation is well supported by its dominant market share, leading profitability, and ample room for the paying conversion rate and revenue expansion if we benchmark it against global peers.

## Earnings and target price revision

- We estimate the music business to contribute 5% revenue and 4% earnings in 2018. A 54% stake in TME will translate into HK\$14 per share value for Tencent.

## Price catalyst

- 12-month price target: HK\$560.00 based on a Sum of Parts methodology.
- Catalyst: TME listing, 2Q18 results on Aug 15.

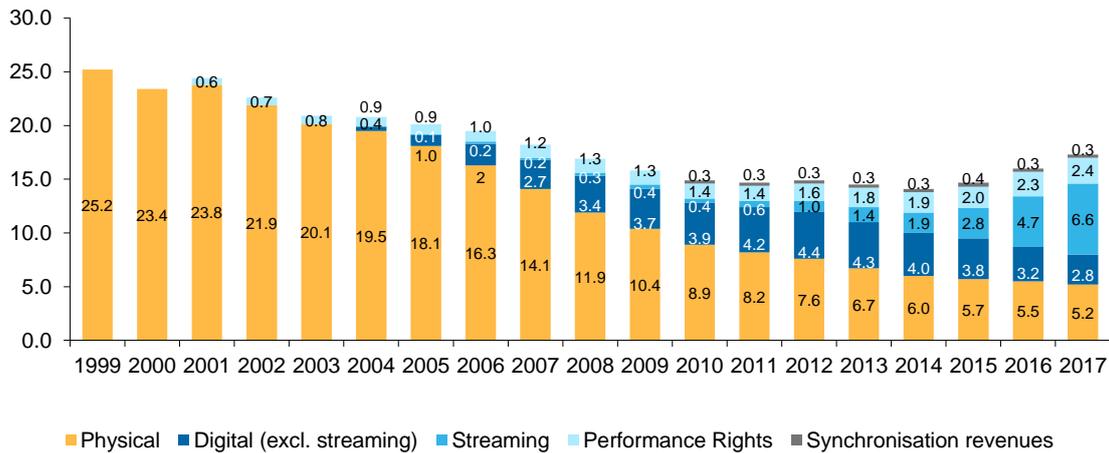
## Action and recommendation

Reiterate OP.

### Music streaming is taking off in China and globally

Global music market revenue bottomed in 2014 at US\$14.1bn, as the digital music revenue started to make up the loss in physical revenues. According to IFPI, digital including streaming, accounted for 54% of global music revenue in 2017 (Fig 2). Streaming music revenue alone increased 41% to \$6.6bn in 2017, with 176m paying users (adding 64m from last year) and accounted for 38% of global music revenue.

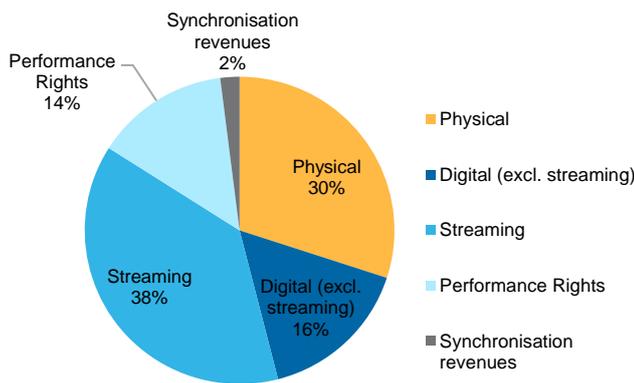
**Fig 1 Global recorded music industry revenues 1999-2017 (US\$ bn)**



Source: IFPI, Macquarie Research, July 2018

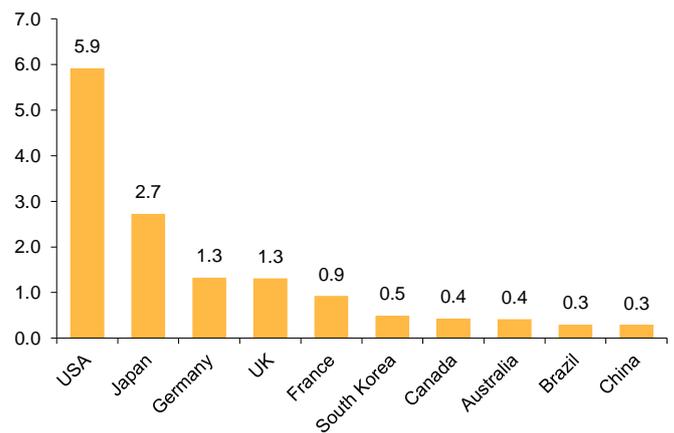
China music market revenue increased by 35% to \$292mn in 2017 according to IFPI, ranked 10<sup>th</sup> among the top music markets globally (Fig 3), up from 12<sup>th</sup> in 2016.

**Fig 2 Global recorded music revenue by segment 2017**



Source: IFPI, Macquarie Research, July 2018

**Fig 3 Top 10 music markets revenues 2017 (US\$bn)**



Source: IFPI, Macquarie Research, July 2018

## A clear leader in China online music industry

The China online music market is competitive with major players backed by internet giants Tencent, NetEase, Alibaba and Baidu.

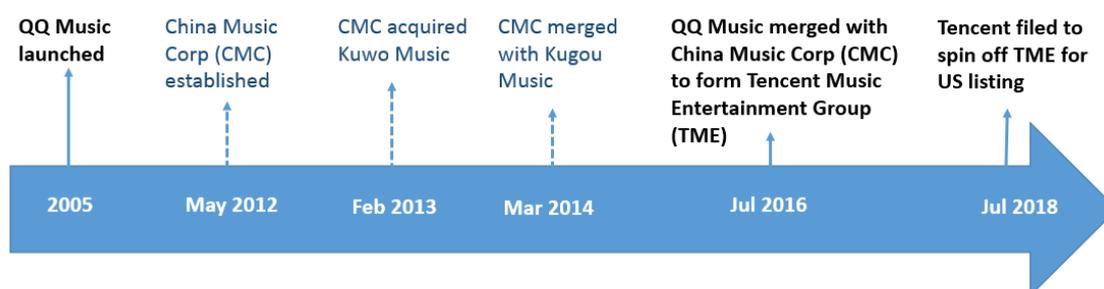
**Fig 4 Top 15 China mobile music apps by MAU (June)**

Rank	App	Avg. DAU (mn)	MAU (mn)	Total active users penetration %
1	Kugou Music (Tencent)	79	358	32.4%
2	QQ Music (Tencent)	56	284	25.6%
3	Tencent Karaoke (Tencent)	47	155	14.0%
4	Kuwo Music (Tencent)	24	131	11.8%
5	NetEase Cloud Music (NetEase)	22	114	10.3%
6	Himalaya FM	15	68	6.2%
7	Changba	5	27	2.5%
8	MIUI Music (Xiaomi)	3	26	2.3%
9	Xiami Music	3	23	2.1%
10	Lizhi	3	16	1.5%
11	Migu Music	1	14	1.3%
12	Qingting FM	3	11	1.0%
13	Tencent Radio (Tencent)	2	8	0.8%
14	iMusic	1	7	0.6%
15	Baidu Music (Baidu)	1	4	0.4%

Source: Questmobile, Macquarie Research, July 2018

Tencent launched QQ Music back in 2005 on PCs. In the ten years since, China's music market has been suffering from piracy issues. In 2011, Chairman of TME, Wu Weilin, joined Tencent and decided to clean up the pirated content on the QQ Music platform and started to purchase copyrights. In 2016, TME became officially established after it acquired and restructured Kugou and China Music Corporation. Backed by the No.1 Chinese internet giant Tencent, TME became a clear leader in China's music streaming market with the three most popular music apps in China, namely QQ Music, Kugou (酷狗音乐), and Kuwo (酷我音乐). The June MAU for Kugou Music reached 358mn, accounting for 32% of total Internet active users (Fig 4). The aggregate MAU and DAU of Tencent music apps are 930m and 207m as of June 2018 on our calculation.

**Fig 5 TME corporate history chart**



Source: Company data, Touchweb, Macquarie Research, July 2018

NetEase's NetEase Cloud music and Alibaba's Ali Music are two other key players in this space. NetEase Cloud Music and Alibaba's Xiami Music are the 5<sup>th</sup> and 9<sup>th</sup> largest music app in China in terms of user traffic. According to QuestMobile, in June 2018, NetEase Cloud Music app had 114m MAU and 22m DAU. Xiami Music app had 23m MAU and 2.7m DAU in June 2018. NetEase Music was valued at US\$1.2bn in its A-round of financing in April 2017 per Chinese media reports. Himalaya FM, ranked No.6, was also valued at US\$4bn in E-round financing in May 2018.

## China market consolidated post copyright regulations and content war

Similar to the US music market and China's streaming industry, the content library is crucial to China's online music platforms. It is one of the must haves to attract users and not surprisingly a chunky part in the cost component. Our US analyst Amy Yong noted that content accounted for 75% of Spotify's revenue as this US music streaming platform shares 70-72% of its revenue to labels. We also noted that content costs accounted for 73% of Chinese video streaming platform iQiyi's revenue and 64% of Chinese game streaming platform Huya's revenue in 2017.

In 2013, China Music Corp (previously 海洋音乐) accumulated the copyright for 20m songs and signed exclusive long-term agreements with over 40 records with music agencies and record labels. During the same period time, Tencent had 15m songs copyrighted after cash burning. The bidding war on the music content has pushed music copyright pricing higher by 10x so that no individual player in the market can afford it anymore.

Eventually, the government stepped in and requires all the players to share content with each other. The National Copyright Administration of the People's Republic of China (NCAC) issued "The Notice Regarding Termination of Disseminating Unauthorized Digitized Music"<关于责令网络音乐服务商停止未经授权传播音乐的通知> [on July 8, 2015](#), which urged online music services provider to take all unauthorized music products offline before July 31, 2015. [On Sep 12-13, 2017](#), the NCAC interviewed Internet music services providers and record companies, and stressed that music companies should avoid granting or purchasing exclusive copyrights. Thereafter, many music companies have formed copyright agreements for content sharing.

- **NetEase and Tencent Copyright agreement.** NetEase Cloud Music and Tencent Music reached a Deep Copyright Agreement in Feb 2018. The amount of songs to be co-authorized to both platforms accounts for 99 percent of all exclusive songs. Both platforms have agreed to long-term music copyright sharing, and will actively authorize songs to other music platforms. ([link](#))
- **NetEase and Alibaba Copyright agreement.** Alibaba Group-owned Ali Music Group and NetEase Music have agreed to share parts of their libraries so that users of each platform will have an expanded catalogue of artists and songs for streaming online. Users of Ali Music's music streaming app Xiami can now access the music of NetEase's major music publishing companies like EE-Media, Avex, Forward Music and HIM International Music—including Japanese pop star Hamasaki Ayumi and Taiwanese singer A-mei. In return, Ali Music will give NetEase's users access to the library of Taiwan's Rock Records, Korea's S.M. and Germany's Bertelsmann Music Group, offering highly coveted titles from Mandopop greats such as Jonathan Lee to popular Korean boy band EXO. ([link](#))

After restructuring with China Music Corp and aggressive investment in music content, Tencent now has access to 90% of the copyrighted music in China and 17m songs in its library.

**Fig 6 Tencent wins over richer music copyright resources**

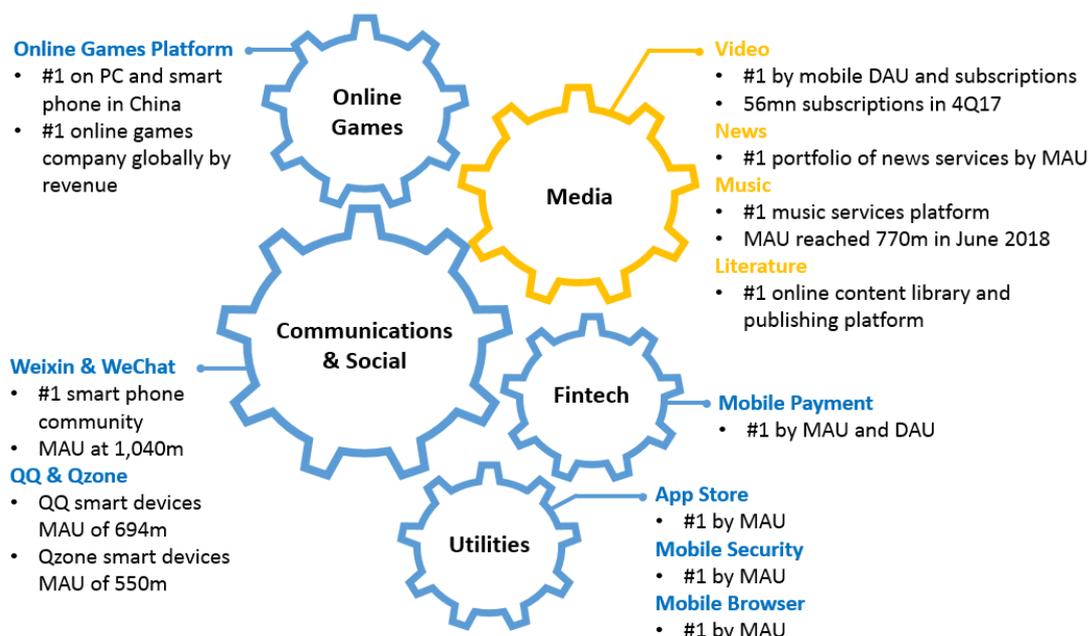
	TME	Ali Music	Baidu Music	Netease Cloud Music
Greater China	JVR Music International (Jay Chou) Linfair Records (Angela Zhang, Harlem Yu, Christine Fan); Yuehua Entertainment; (Geng Han, Anson Hu, A-do); Emperor Entertainment Group (EEG); Huayi Brothers; EE-Media; Taihe Rye Music; China Record; Peacock Records; Other famous artists: Leehom Wang, Sodagreen, TF Boys, Bibi Chou, Chris Lee	Rock Records & Tapes (non-exclusive); HIM International Music (non-exclusive); Media Asia Music	Rock Records & Tapes (non-exclusive); Ocean Butterflies Music	HIM International Music (non-exclusive); CS Music House; Rhymoi Music
Western	Universal Music Group (UMG); Warner Bros Entertainment; Sony Music	BMG	The Orchard	
Japan and South Korea	YG; JVR; JYP (non-exclusive)	SM		JYP (non-exclusive); Avex
Soundtrack from variety shows	"The Voice of China (中国好声音);" "I Am a Singer (我是歌手);" "Chinese Idol (中国梦之声);" "Sing! China (中国新歌声);" "Duets (最美和声);" "Crossover Singers (跨界歌王);" "Mask Singer (蒙面唱将猜猜猜)"			"I Am a Singer (我是歌手);" "Crossover Singers (跨界歌王);" "Come Sing with Me (我想和你唱);" "Super Boy (快乐男声)"

Source: Wallstreetcn, Macquarie Research, July 2018

## A critical piece in Tencent's entertainment empire

Besides the traffic and content cost benefit, we believe TME is an important piece in Tencent's media matrix and future IoT blueprint. It also generates chemistry with Tencent's other media assets such as video and literature.

Fig 7 Tencent key platforms



QQ smart devices MAU includes users who logged in and sent a message or participated in certain activities such as QQ Moments, games, Interest Tribes, live broadcast, online music & literature. All rankings refer to the China market, as of 31 March, 2018.

Source: Company data, Macquarie Research, July 2018

## Diversified revenue model leads to higher margins

- TME generates revenue through membership, live-streaming, sub-licensing (of concert), advertisement and game. QQ Music charges Rmb8/month or Rmb88/year for basic membership. Members can enjoy HD Lossless music, access a member exclusive music library, and download up to 300 songs per months.
- Thanks to its diversified revenue model, it is profitable well ahead of global peers despite rising content cost. According to Chinese media, the company generated Rmb5.0bn, Rmb9.4bn revenue in 2016 and 2017 and net profit was Rmb0.6bn and Rmb1.88bn in 2016 and 2017. The company targets revenue of Rmb17bn and net profit of Rmb3.65bn in 2018, implying 81% and 94% yoy ([link](#)). That said, TME has been profitable with its net margin reaching 20% in 2017, vs a 30% loss margin for Spotify. This is also clearly above the traditional music companies like Universal Music Group (UMG)'s 15% EBITDA margin in 2017.
- On the paying conversion rate and revenue front, TME still has a long way to go compared to the global peers but this also suggests to us big potential. Notably, its revenue was only US\$1.4bn in 2017, well below that of US\$4.1bn for Spotify and US\$6.6bn for UMG. The June MAU for the company's online music combined reached 773mn, which implies substantial room for revenue potential compared to Spotify's 170mn user base.

Fig 8 Tencent Music financials 2016-2018E

Rmb bn	2016	2017	2018E
Revenue	5	9.4	17~18
yoy%		88%	81%-91%
Net income	0.6	1.88	3.1~3.65
yoy%		213%	65~94%
Net margin	12%	20%	17~21%

Source: Wallstreetcn, Touchweb, Macquarie Research, July 2018

Fig 9 Tencent Music's diversified revenue model

Platform	Category	User base	MAU mn		Paid-users (Sep 2017) mn	Paying penetration %	Subscription fee Rmb/yr
			Jun-18	Sep-17			
QQ Music	Online music (在线音乐)	800mn registered user accounts (4Q17)	773	631	17	3%	96-180
Kugou Music		Not disclosed					
Kuwo Music		Not disclosed					
Kugou Live	Pan- entertainment live (泛娱乐直 播)	Not disclosed	2.2	1.6	na	na	308-4998
WeSing	Online karaoke (在线K歌)	460mn registered user accounts (4Q17)	155	137	na	na	240

Source: Company data, Questmobile, Macquarie Research, July 2018

While we have limited information about TME's ad revenue, we believe TME is also exposed to internet ad dollars and radio ad dollar spending in the long term. According to GroupM, total ad revenue in China was Rmb569bn, of which internet ad was Rmb329bn and radio ad was Rmb11bn. For reference, its US peer Spotify is currently generating 10% of its revenues from ad and our US analyst Amy expects this contribution to go up to 20% in the long term.

### Still a long way to go globally but the journey has begun

Admittedly, although TME's MAU is 5x that of Spotify (170m), it is still mainly China-focused. In comparison Spotify has a presence in 65 countries, with only 37% of its 1Q18 from the US. However, Tencent also started paving the way for its global expansion 2 years ago. In 2016, Tencent invested US\$85m in Korea music entertainment company YG entertainment (122870.KS, NR). In May 2017, Tencent invested US\$54m in the No.1 singing app in AppStore Smule. In Jan 2018, TME joined forces with Sony Music to create a new Asia-based label Liquid State. Most recently in June 2018, Tencent invested US\$115m in India music streaming platform Gaana.

Also noteworthy is that Tencent has penetrated the HK, Taiwan, India and ASEAN markets with its overseas music platform Joox. In the non-Asia market, we see the potential for a deeper collaboration between Tencent/TME with Spotify given the deal Spotify inked with Facebook.

## Tencent 2Q18 Result preview

Tencent will report its 2Q18 results on 15 August, and will host an earnings call at 8pm HKT. The dial-in details for the live conference call are as follows:

US Toll free:	184 4760 0770
HK:	+852 3018 8307
China (landline):	80087 00532
China (mobile):	40062 40407
International:	+65 6713 5330
UK:	+44 20371 35084
Passcode:	267 9428

Fig 10 2Q18 results preview

(RMB mn)	2Q17A	1Q18A	2Q18E	QoQ	YoY	Consensus	vs consensus
<b>Revenue</b>	<b>56,606</b>	<b>73,528</b>	<b>79,622</b>	<b>8%</b>	<b>41%</b>	<b>79,325</b>	<b>0%</b>
Social networks	12,943	18,099	18,703	3%	44%		
Online games	23,861	28,778	27,359	-5%	15%		
Online ads	10,148	10,689	14,407	35%	42%		
Others	9,654	15,962	19,154	20%	98%		
Cost of sales	-28,300	-36,486	-41,068	13%	45%		
<b>Gross profit</b>	<b>28,306</b>	<b>37,042</b>	<b>38,555</b>	<b>4%</b>	<b>36%</b>	<b>37,368</b>	<b>3%</b>
Operating expenses	-11,830	-15,000	-16,620	11%	40%		
S&M	-3,660	-5,570	-5,944	7%	62%		
G&A	-3,929	-4,424	-5,255	19%	34%		
R&D	-4,241	-5,006	-5,421	8%	28%		
Operating profit	22,560	30,692	23,934	-22%	6%	25,522	-6%
<b>Non-GAAP OP</b>	<b>20,720</b>	<b>21,614</b>	<b>25,271</b>	<b>17%</b>	<b>22%</b>	<b>NA</b>	<b>NA</b>
Net income	18,231	23,290	17,847	-23%	-2%	19,383	-8%
<b>Non-GAAP net income</b>	<b>16,391</b>	<b>18,313</b>	<b>19,527</b>	<b>7%</b>	<b>19%</b>	<b>19,780</b>	<b>-1%</b>
Diluted EPS (RMB)	1.91	2.44	1.86	-23%	-3%	2.00	-7%
<b>Non-GAAP diluted EPS (RMB)</b>	<b>1.72</b>	<b>1.91</b>	<b>2.04</b>	<b>7%</b>	<b>19%</b>	<b>2.08</b>	<b>-2%</b>
GPM	50.0%	50.4%	48.4%	(196 bps)	(158 bps)	47.0%	146 bps
GAAP OPM	39.9%	41.7%	30.1%	(1168 bps)	(980 bps)	32.2%	(211 bps)
Non-GAAP OPM	36.6%	35.0%	32.2%	(280 bps)	(443 bps)		

Source: Bloomberg, Macquarie Research, July 2018

Fig 11 SOTP valuation (2019)

(RMB mn)	2019E revenue	2019E non-GAAP earnings	Valuation (2019)	Est. fair value (RMB bn)	Fair value (US\$ bn)	Fair value/share (HK\$)
Social networking (QQ + Weixin VAS)	105,897	40,513	30x PE	1,215	187	151
Online game (PC + Mobile game)	145,839	55,793	18x PE	1,004	155	125
Online ads (Portal + Video + Social ads)	76,517	8,702	30x PE	261	40	33
Payment + Cloud	121,265		15x PS	1,819	280	227
Total EV				4,300	661	536
2019E cash per share (HK\$)					29	24
<b>Target price (HK\$)</b>						<b>560</b>

Source: Company data, Macquarie Research, July 2018

Fig 12 Tencent Financials

YE 31 December	2014	2015	2016	2017	2018E	2019E	2020E	17-18E	18E-19E	18E-21E
<b>Consolidated Income Statement (RMB mn)</b>										
Revenue	78,932	102,863	151,938	237,760	337,426	449,518	541,952	42%	33%	23%
Social Network	18,554	24,082	36,966	56,100	79,997	105,897	121,305	43%	32%	20%
Online Game	44,756	56,587	70,844	97,883	119,514	145,839	165,377	22%	22%	15%
Online Ads	8,308	17,468	26,970	40,439	58,552	76,517	99,178	45%	31%	29%
e-commerce	4,753	645	0	0	0	0	0	--	--	--
Others	2,561	4,081	17,158	43,338	79,363	121,265	156,093	83%	53%	31%
Gross Profit	48,059	61,232	84,499	116,926	163,413	208,856	247,761	40%	28%	21%
GPM	61%	60%	56%	49%	48%	46%	46%	(75 bps)	(197 bps)	(259 bps)
SG&A	21,952	24,818	34,595	50,703	71,811	94,409	113,703	42%	31%	22%
Operating Profit	30,542	40,627	56,117	90,303	106,253	122,447	142,058	18%	15%	16%
OPM	39%	39%	37%	38%	31%	27%	26%	(649 bps)	(425 bps)	(521 bps)
PBT	29,013	36,216	51,640	88,216	102,848	119,632	139,537	17%	16%	16%
Income Taxes (Credit)	5,125	7,108	10,193	15,744	19,088	22,343	26,097	21%	17%	17%
Net Income	23,810	28,806	41,095	71,511	81,028	94,558	110,707	13%	17%	17%
Non-GAAP net income	24,411	32,410	45,420	65,127	81,893	103,178	121,052	26%	26%	20%
NPM	30%	28%	27%	30%	24%	21%	20%	(606 bps)	(298 bps)	(342 bps)
Non-GAAP NPM	31%	32%	30%	27%	24%	23%	22%	(312 bps)	(132 bps)	(169 bps)
EBITDA	35,339	47,256	68,746	113,775	130,325	147,119	167,330	15%	13%	13%
EBITDA Margin	44.8%	45.9%	45.2%	47.9%	38.6%	33%	31%	(923 bps)	(590 bps)	(821 bps)
<b>Consolidated Balance Sheet (RMB mn)</b>										
<b>Current Assets</b>	<b>75,321</b>	<b>155,378</b>	<b>149,154</b>	<b>178,446</b>	<b>260,922</b>	<b>361,728</b>	<b>475,862</b>	<b>46%</b>	<b>39%</b>	<b>32%</b>
Cash +	62,685	135,500	122,972	144,027	217,904	308,974	414,547	51%	42%	34%
Receivables	4,588	7,061	10,152	16,549	23,486	31,288	37,722	42%	33%	23%
Inventories	244	222	263	295	200	200	200	-32%	0%	0%
Other	7,804	12,595	15,767	17,575	19,333	21,266	23,392	10%	10%	10%
<b>Non-current Assets</b>	<b>95,845</b>	<b>151,440</b>	<b>246,745</b>	<b>376,226</b>	<b>396,008</b>	<b>421,849</b>	<b>453,259</b>	<b>5%</b>	<b>7%</b>	<b>7%</b>
PP&E	12,016	14,513	19,428	27,560	35,116	46,460	60,839	27%	32%	30%
Intangibles	10,055	15,732	41,641	45,377	32,655	19,833	6,911	-28%	-39%	--
Available-for-sale financial assets	13,277	44,339	83,806	127,218	133,579	140,258	147,271	5%	5%	5%
Deferred Taxes	322	757	7,033	9,793	11,752	14,102	16,922	20%	20%	20%
Term deposits	4,831	3,674	5,415	5,365	5,902	6,492	7,141	10%	10%	10%
Others (incl investment)	55,344	72,425	89,422	160,913	177,004	194,705	214,175	10%	10%	10%
Total Assets	171,166	306,818	395,899	554,672	656,930	783,577	929,121	18%	19%	18%
<b>Current Liabilities</b>	<b>50,035</b>	<b>124,406</b>	<b>101,197</b>	<b>151,740</b>	<b>184,203</b>	<b>237,359</b>	<b>282,099</b>	<b>21%</b>	<b>29%</b>	<b>21%</b>
Deferred revenue	16,153	21,122	31,203	42,132	59,793	79,656	96,036	42%	33%	23%
Payables	8,683	15,700	27,413	50,085	70,935	93,258	112,317	42%	31%	22%
ST debt	3,215	11,429	12,278	15,696	14,126	12,714	11,442	-10%	-10%	-10%
Others	21,984	76,155	30,303	43,827	39,348	51,731	62,303	-10%	31%	22%
<b>LT Liabilities</b>	<b>39,007</b>	<b>60,312</b>	<b>108,455</b>	<b>125,839</b>	<b>120,519</b>	<b>107,119</b>	<b>107,119</b>	<b>-4%</b>	<b>-11%</b>	<b>-4%</b>
<b>Total Liabilities</b>	<b>89,042</b>	<b>184,718</b>	<b>209,652</b>	<b>277,579</b>	<b>304,722</b>	<b>344,478</b>	<b>389,218</b>	<b>10%</b>	<b>13%</b>	<b>12%</b>
<b>Shareholders Equity</b>	<b>82,124</b>	<b>122,100</b>	<b>186,247</b>	<b>277,093</b>	<b>352,208</b>	<b>439,099</b>	<b>539,903</b>	<b>27%</b>	<b>25%</b>	<b>23%</b>
Common Stock	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0%	0%	0%
Surplus	5,131	12,167	17,324	22,204	23,314	24,480	25,704	5%	5%	5%
Retained Earnings	75,339	101,503	138,908	205,274	279,278	365,004	464,583	36%	31%	28%
Others	1,653	8,430	30,015	49,615	49,615	49,615	49,615	0%	0%	0%
<b>Total Sh. Equity + Liabilities</b>	<b>171,166</b>	<b>306,818</b>	<b>395,899</b>	<b>554,672</b>	<b>656,930</b>	<b>783,577</b>	<b>929,121</b>	<b>18%</b>	<b>19%</b>	<b>18%</b>
<b>Consolidated Cash Flow (RMB mn)</b>										
Net Income	23,810	28,806	41,095	71,511	81,028	94,558	110,707	13%	17%	17%
+ Depreciation and amortization	4,797	6,629	12,629	23,472	24,072	24,672	25,272	3%	2%	2%
+ Interest (Income)/Expense	-1,182	-1,618	-1,955	-2,908	-3,085	-2,815	-2,521	6%	-9%	-6%
+/- Change in NWC	13,210	58,915	15,490	38,888	25,433	44,833	37,451	-35%	76%	10%
<b>Operating Cash Flow</b>	<b>40,635</b>	<b>92,732</b>	<b>67,259</b>	<b>130,963</b>	<b>127,448</b>	<b>161,248</b>	<b>170,909</b>	<b>-3%</b>	<b>27%</b>	<b>13%</b>
Capex	-2,748	-4,491	-8,100	-9,094	-12,906	-17,194	-20,729	42%	33%	23%
Intangibles	-1,970	-3,218	-4,000	-4,491	-6,000	-6,000	-6,000	34%	0%	0%
Other investment	-35,933	-47,421	-64,481	-117,613	-24,947	-27,320	-29,953	-79%	10%	10%
<b>Investing Cash Flow</b>	<b>-40,651</b>	<b>-55,130</b>	<b>-76,581</b>	<b>-131,198</b>	<b>-43,854</b>	<b>-50,513</b>	<b>-56,682</b>	<b>-67%</b>	<b>15%</b>	<b>13%</b>
Shares issued (redeemed)	1,613	13,813	26,742	24,481	1,110	1,166	1,224	-95%	5%	5%
Cash Dividends	-1,762	-2,643	-3,690	-5,145	-7,024	-8,832	-11,128	37%	26%	23%
Debt increase (decrease)	24,128	29,519	48,992	20,802	-6,890	-14,813	-1,271	--	115%	-45%
Interest Income/(Expense)	1,182	1,618	1,955	2,908	3,085	2,815	2,521	6%	-9%	-6%
Others	-6,442				0	0	0	--	--	--
<b>Financing Cash Flow</b>	<b>18,719</b>	<b>35,213</b>	<b>-3,206</b>	<b>21,290</b>	<b>-9,718</b>	<b>-19,664</b>	<b>-8,654</b>	<b>--</b>	<b>102%</b>	<b>2%</b>
<b>Net Change in Cash</b>	<b>18,703</b>	<b>72,815</b>	<b>-12,528</b>	<b>21,055</b>	<b>73,877</b>	<b>91,070</b>	<b>105,574</b>	<b>251%</b>	<b>23%</b>	<b>15%</b>
<b>Cash at beginning of period</b>	<b>43,982</b>	<b>62,685</b>	<b>135,500</b>	<b>122,972</b>	<b>144,027</b>	<b>217,904</b>	<b>308,974</b>	<b>17%</b>	<b>51%</b>	<b>42%</b>
<b>Cash at end of period</b>	<b>62,685</b>	<b>135,500</b>	<b>122,972</b>	<b>144,027</b>	<b>217,904</b>	<b>308,974</b>	<b>414,547</b>	<b>51%</b>	<b>42%</b>	<b>34%</b>

Source: Company data, Macquarie Research, July 2018

Fig 13 Ratio summary

YE 31 December		2015	2016	2017	2018E	2019E	2020E	17-18E	18E-19E	18E-21E
<b>Key ratios</b>										
EPS (Non-GAAP diluted)	(HK\$)	4.13	5.38	8.16	10.61	13.31	15.55	30%	25%	20%
EPS (diluted)	(HK\$)	3.67	4.87	8.96	10.49	12.20	14.22	17%	16%	16%
DPS	(HK\$)	0.47	0.61	0.88	1.14	1.44	1.68	30%	25%	20%
BVPS	(HK\$)	15.55	22.08	34.72	45.61	56.64	69.36	31%	24%	23%
Cash per share	(HK\$)	9.90	2.65	0.31	10.78	24.40	38.03	3353%	126%	70%
Diluted share - year end	(mn)	9,430	9,484	9,528	9,578	9,617	9,655	1%	0%	0%
<b>Per Share</b>										
EPS (non-GAAP diluted)	(RMB)	3.44	4.79	6.84	8.55	10.73	12.54	25%	25%	20%
EPS (diluted)	(RMB)	3.05	4.33	7.51	8.46	9.83	11.47	13%	16%	16%
DPS	(RMB)	0.39	0.54	0.74	0.92	1.16	1.35	25%	25%	20%
BVPS	(RMB)	12.95	19.64	29.08	36.77	45.66	55.92	26%	24%	23%
Cash per share	(RMB)	8.24	2.36	0.26	8.69	19.67	30.66	3223%	126%	70%
<b>Value</b>										
EV/Revenue	X	28.5 x	20.6 x	12.4 x	8.4 x	6.3 x	5.2 x	--	--	--
EV/EBITDA	X	62.1 x	45.6 x	26.0 x	21.8 x	19.3 x	17.0 x	--	--	--
EV/FCF	X	63.4 x	5422.1 x	300.2 x	28.9 x	22.8 x	22.3 x	--	--	--
P/E (non-GAAP)	X	92.4 x	70.8 x	46.7 x	36.0 x	28.7 x	24.5 x	--	--	--
P/E (non-GAAP), ex cash	X	90.0 x	70.3 x	46.7 x	34.9 x	26.8 x	22.1 x	--	--	--
Price/ Sales	X	28.9 x	20.9 x	12.6 x	8.5 x	6.4 x	5.3 x	--	--	--
Price/ Book	X	24.5 x	17.3 x	11.0 x	8.4 x	6.7 x	5.5 x	--	--	--
<b>Key forecasts</b>										
Revenue	(RMB mn)	102,863	151,938	237,760	337,426	449,518	541,952	42%	33%	23%
EBITDA	(RMB mn)	47,256	68,746	113,775	130,325	147,119	167,330	15%	13%	13%
Operating Profit	(RMB mn)	40,627	56,117	90,303	106,253	122,447	142,058	18%	15%	16%
Net Income	(RMB mn)	28,806	41,095	71,511	81,028	94,558	110,707	13%	17%	17%
<b>Profitability</b>										
EBITDA Margin	%	46%	45%	48%	39%	33%	31%	(923 bps)	(590 bps)	(821 bps)
Operating Margin	%	39%	37%	38%	31%	27%	26%	(649 bps)	(425 bps)	(521 bps)
Net Margin	%	28%	27%	30%	24%	21%	20%	(606 bps)	(298 bps)	(342 bps)
<b>Cash Flow</b>										
Operating Cash Flow	(RMB mn)	92,732	67,259	130,963	127,448	161,248	170,909	-3%	27%	13%
Free Cash Flow	(RMB mn)	46,286	578	9,839	98,184	124,570	127,530	898%	27%	12%
+EBIT*(1-t)	(RMB mn)	32,653	45,040	74,186	86,533	99,579	115,489	17%	15%	16%
+D&A	(RMB mn)	6,629	12,629	23,472	24,072	24,672	25,272	3%	2%	2%
+Capex & Investments	(RMB mn)	-51,912	-72,581	-126,707	-37,854	-44,513	-50,682	-70%	18%	15%
+Change in NWC	(RMB mn)	58,915	15,490	38,888	25,433	44,833	37,451	-35%	76%	10%
<b>Yield</b>										
Dividend Yield	%	0.12%	0.16%	0.23%	0.30%	0.38%	0.44%	7 bps	8 bps	21 bps
FCF Yield	%	1.5%	0.0%	0.3%	3.3%	4.2%	4.3%	301 bps	88 bps	125 bps
Earnings Yield	%	0.8%	1.1%	2.0%	2.2%	2.6%	3.0%	25 bps	36 bps	128 bps
<b>Balance Sheet</b>										
Net debt (cash)	(RMB mn)	-77,731	-22,356	-2,492	-83,258	-189,141	-295,986	3241%	127%	70%
Net debt/ equity	(RMB mn)	cash	cash	cash	cash	cash	cash	--	--	--
Shareholders Equity	(RMB mn)	122,100	186,247	277,093	352,208	439,099	539,903	27%	25%	23%
<b>Efficiency</b>										
ROE (average)	%	28%	27%	31%	26%	24%	23%	(512 bps)	(185 bps)	(421 bps)
ROA (average)	%	12%	12%	15%	13%	13%	13%	(167 bps)	(25 bps)	(59 bps)
ROIC (average)	%	27%	24%	26%	24%	24%	24%	(162 bps)	(23 bps)	(95 bps)

Source: Company data, Macquarie Research, July 2018

**Covered companies mentioned:**

NetEase Inc (NTES US, US\$268.07, Outperform, TP: US\$302.00, Marcus Yang)

Alibaba Group Holding (BABA US, US\$190.35, Outperform, TP: US\$249.00, Wendy Huang)

Baidu (BIDU US, US\$267.08, Outperform, TP: US\$314.00, Wendy Huang)

Spotify Technology (SPOT US, US\$184.22, Outperform, TP: US\$225.00, Amy Yong)

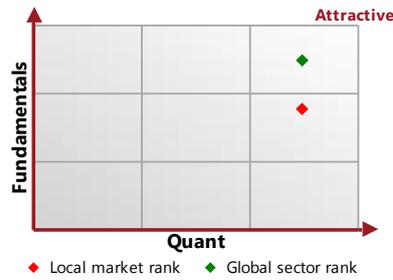
# Macquarie Quant View

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

**142/816**

Global rank in Software & Services

% of BUY recommendations: 98% (45/46)  
 Number of Price Target downgrades: 0  
 Number of Price Target upgrades: 11

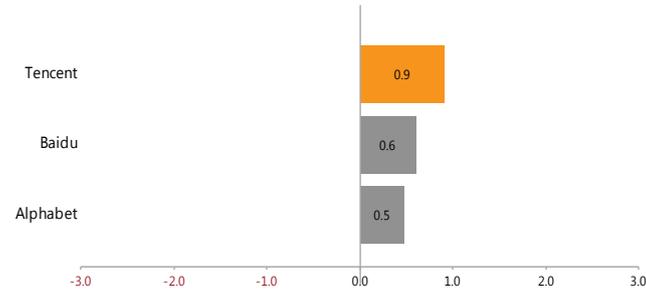


Displays where the company's ranked based on the fundamental consensus Price Target and Macquarie's Quantitative Alpha model.

Two rankings: Local market (Hong Kong) and Global sector (Software & Services)

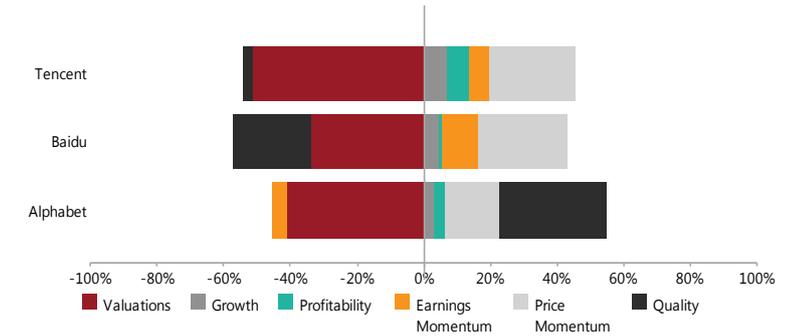
## Macquarie Alpha Model ranking

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



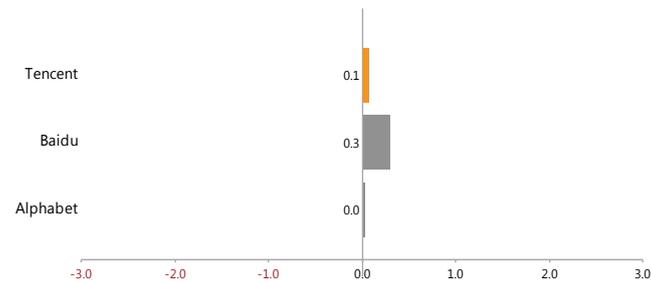
## Factors driving the Alpha Model

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.



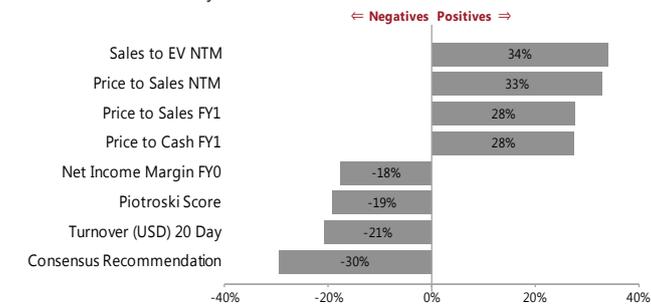
## Drivers of Stock Return

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



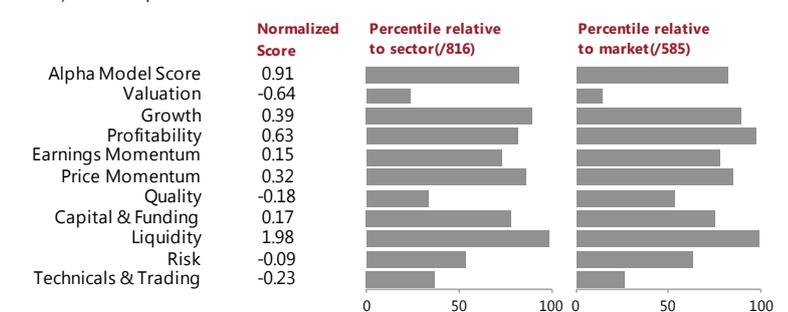
## What drove this Company in the last 5 years

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, Outperform, Target Price: HK\$560.00)

Quarterly Results					Profit & Loss						
		1Q/18A	2Q/18E	3Q/18E	4Q/18E		2017A	2018E	2019E	2020E	
Revenue	bn	74	80	88	96	Revenue	bn	238	337	450	542
Gross Profit	bn	37	39	42	46	Gross Profit	bn	117	163	209	248
Cost of Goods Sold	bn	36	41	46	50	Cost of Goods Sold	bn	121	174	241	294
EBITDA	bn	37	30	31	32	EBITDA	bn	114	130	146	166
Depreciation	bn	6	6	6	6	Depreciation	bn	23	23	23	23
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	31	24	25	27	EBIT	bn	90	106	122	142
Net Interest Income	bn	-1	-1	-1	-1	Net Interest Income	bn	-2	-3	-3	-3
Associates	bn	0	0	0	0	Associates	bn	0	0	0	0
Exceptionals	bn	5	-2	-2	-2	Exceptionals	bn	6	-1	-9	-10
Forex Gains / Losses	bn	0	0	0	0	Forex Gains / Losses	bn	0	0	0	0
Other Pre-Tax Income	bn	-5	2	2	2	Other Pre-Tax Income	bn	-6	1	9	10
Pre-Tax Profit	bn	30	23	24	26	Pre-Tax Profit	bn	88	103	120	140
Tax Expense	bn	-6	-5	-6	-5	Tax Expense	bn	-17	-22	-25	-29
Net Profit	bn	23	18	19	21	Net Profit	bn	72	81	95	111
Minority Interests	bn	0	0	0	0	Minority Interests	bn	0	0	0	0
Reported Earnings	bn	23	18	19	21	Reported Earnings	bn	72	81	95	111
Adjusted Earnings	bn	18	20	21	24	Adjusted Earnings	bn	65	82	103	121
EPS (rep)		2.44	1.86	1.96	2.20	EPS (rep)		7.51	8.46	9.83	11.47
EPS (adj)		1.91	2.04	2.14	2.45	EPS (adj)		6.83	8.55	10.73	12.54
EPS Growth yoy (adj)	%	28.2	18.5	19.7	34.0	EPS Growth (adj)	%	42.7	25.1	25.5	16.9
						PE (rep)	x	43.6	38.7	33.3	28.6
						PE (adj)	x	47.9	38.3	30.5	26.1
EBITDA Margin	%	49.7	37.4	35.0	33.9	Total DPS		0.74	0.92	1.16	1.35
EBIT Margin	%	41.7	30.1	28.3	27.7	Total Div Yield	%	0.2	0.3	0.4	0.4
Earnings Split	%	22.4	23.8	25.1	28.7	Basic Shares Outstanding	m	9,536	9,593	9,631	9,670
Revenue Growth	%	48.4	40.7	35.7	44.3	Diluted Shares Outstanding	m	9,528	9,578	9,617	9,655
EBIT Growth	%	59.3	6.1	10.2	3.3						
Profit and Loss Ratios					Cashflow Analysis						
		2017A	2018E	2019E	2020E		2017A	2018E	2019E	2020E	
Revenue Growth	%	56.5	41.9	33.2	20.6	EBITDA	bn	114	130	146	166
EBITDA Growth	%	65.5	14.0	12.5	13.4	Tax Paid	bn	0	0	0	0
EBIT Growth	%	60.9	17.7	15.2	16.0	Chgs in Working Cap	bn	-39	-25	-45	-37
Gross Profit Margin	%	49.2	48.4	46.5	45.7	Net Interest Paid	bn	0	0	0	0
EBITDA Margin	%	47.9	38.4	32.5	30.5	Other	bn	56	23	60	43
EBIT Margin	%	38.0	31.5	27.2	26.2	Operating Cashflow	bn	131	127	161	171
Net Profit Margin	%	27.4	24.3	23.0	22.3	Acquisitions	bn	0	0	0	0
Payout Ratio	%	10.8	10.8	10.8	10.8	Capex	bn	-9	-13	-17	-21
EV/EBITDA	x	27.0	23.8	21.3	18.8	Asset Sales	bn	0	0	0	0
EV/EBIT	x	34.0	29.1	25.3	21.9	Other	bn	-122	-31	-33	-36
						Investing Cashflow	bn	-131	-44	-51	-57
Balance Sheet Ratios						Dividend (Ordinary)	bn	0	0	0	0
ROE	%	28.1	26.0	26.1	24.7	Equity Raised	bn	24	1	1	1
ROA	%	19.0	17.5	17.0	16.6	Debt Movements	bn	21	-7	-15	-1
ROIC	%	38.9	29.2	32.2	37.3	Other	bn	-24	-4	-6	-9
Net Debt/Equity	%	3.5	-14.8	-31.1	-41.8	Financing Cashflow	bn	21	-10	-20	-9
Interest Cover	x	43.3	31.2	43.5	56.3						
Price/Book	x	11.3	8.9	7.2	5.9	Net Chg in Cash/Debt	bn	21	74	91	106
Book Value per Share		29.1	36.7	45.6	55.8	Free Cashflow	bn	122	115	144	150
						Balance Sheet					
							2017A	2018E	2019E	2020E	
						Cash	bn	144	218	309	415
						Receivables	bn	17	23	31	38
						Inventories	bn	0	0	0	0
						Investments	bn	0	0	0	0
						Fixed Assets	bn	28	35	46	61
						Intangibles	bn	55	44	34	24
						Other Assets	bn	311	336	363	392
						Total Assets	bn	555	657	784	929
						Payables	bn	50	71	93	112
						Short Term Debt	bn	42	60	80	96
						Long Term Debt	bn	111	106	93	93
						Provisions	bn	16	14	13	11
						Other Liabilities	bn	58	54	66	77
						Total Liabilities	bn	278	305	344	389
						Shareholders' Funds	bn	277	352	439	540
						Minority Interests	bn	0	0	0	0
						Other	bn	0	0	0	0
						Total S/H Equity	bn	277	352	439	540
						Total Liab & S/H Funds	bn	555	657	784	929

All figures in Rmb unless noted.

Source: Company data, Macquarie Research, July 2018

**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 – 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 / epowa\*

**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 30 June 2018**

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	52.87%	61.26%	48.86%	47.54%	69.86%	46.61%	(for global coverage by Macquarie, 3.51% of stocks followed are investment banking clients)
Neutral	34.10%	27.25%	36.36%	46.72%	21.92%	43.22%	(for global coverage by Macquarie, 2.10% of stocks followed are investment banking clients)
Underperform	13.03%	11.49%	14.77%	5.74%	8.22%	10.17%	(for global coverage by Macquarie, 0.00% of stocks followed are investment banking clients)

**700 HK vs HSI, & rec history**



(all figures in HKD currency unless noted)

**NTES US vs S&P 500, & rec history**



(all figures in USD currency unless noted)

**BABA US vs S&P 500, & rec history**



(all figures in USD currency unless noted)

**BIDU US vs S&P 500, & rec history**



(all figures in USD currency unless noted)

**SPOT US vs S&P 500, & rec history**



(all figures in USD 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, July 2018

**12-month target price methodology**

700 HK: HK\$560.00 based on a Sum of Parts methodology

NTES US: US\$302.00 based on a Sum of Parts methodology

BABA US: US\$249.00 based on a Sum of Parts methodology

BIDU US: US\$314.00 based on a Sum of Parts methodology

SPOT US: US\$225.00 based on a DCF methodology

**Company-specific disclosures:**

**700 HK:** Macquarie Capital Limited makes a market in the securities of Tencent Holdings Ltd.

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

Date	Stock Code (BVG code)	Recommendation	Target Price
17-May-2018	700 HK	Outperform	HK\$560.00
08-May-2018	700 HK	Outperform	HK\$550.00
22-Mar-2018	700 HK	Outperform	HK\$555.00
16-Nov-2017	700 HK	Outperform	HK\$450.00

17-Aug-2017	700 HK	Outperform	HK\$378.00
18-May-2017	700 HK	Outperform	HK\$304.00
11-May-2017	700 HK	Outperform	HK\$293.00
23-Mar-2017	700 HK	Outperform	HK\$265.00
17-Nov-2016	700 HK	Outperform	HK\$240.00
15-Aug-2016	700 HK	Outperform	HK\$241.00
19-May-2016	700 HK	Outperform	HK\$204.00
18-Mar-2016	700 HK	Outperform	HK\$196.00
11-Nov-2015	700 HK	Outperform	HK\$198.00
13-Aug-2015	700 HK	Outperform	HK\$197.00

**Target price risk disclosures:**

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