

腾讯控股 [0700.HK]

政策监管仍是手游业务的不明朗因素；其他业务继续强劲增长

腾讯控股主要从事增值服务（VAS）、在线广告服务、云服务和支付相关业务。增值服务包括社交网络业务和网络游戏，其占2018年三季度总收入的54.7%。我们预计公司2019年净利润将达到人民币1,064亿元，2020年将达到人民币1,334亿元，分别同比增长23%和25.4%。虽然政策监管的因素将继续影响腾讯游戏业务的变现进程，并且市场或在短期内继续关注移动游戏的变现情况，但我们认为公司的基本面将变得更强，因为其他业务（如在线视频、在线广告和支付服务）仍处于行业领先地位，同时公司在平台的参与度不断增加，将继续支持公司长远录得可持续盈利增长。我们预计，其他业务收入占总收入的占比将从2017年的18%增加至2019年的28%。总体而言，我们认为股价短期内仍将波动，因为政府审批游戏的因素尚未完全明朗。根据我们的数据，腾讯的2019年市盈率为27.1倍，低于历史平均水平；根据我们的5年期贴现现金流模型，公司的目标价为341.9港元（约29倍2019年市盈率），这是基于9.0%的加权平均资金成本和3.0%的名义长远增长率假设。（详情请参阅今天发布的完整报告）

- 监管趋严，游戏业务处于转折点；行业整合加速。** 今年3月底，中国政府开始停止审批新游戏。监管机构表示要限制新游戏发布的数量，并控制儿童花在游戏上的时间，以解决儿童近视问题。我们预计，监管限制将在短期内继续对在线游戏行业和腾讯的游戏业务产生负面影响。政府对新游戏的监管，将给小游戏开发商带来更大冲击，迫使其中一些退出行业或与大公司合并，因此我们相信腾讯将从整合中受益。我们预计，2019年腾讯的网络游戏收入将达到人民币1,319亿元，同比增长25.0%，因预计政府将在2019年上半年恢复新游戏的审批。
- 腾讯其他业务分部持续快速增长，保持行业领先地位。** 腾讯社交网络和非社交网络服务的点击量和使用时间在2018年三季度继续攀升。微信和WeChat的每月活跃帐户达至10.83亿，按年增长10.5%，显示用户参与度和用户粘性提高。腾讯网络广告收入按年增长47.1%至人民币162亿元。强劲的表现主要受益于微信（朋友圈和「小程序」）和腾讯视频广告收入快速增长。2018年二季度，看点和手机QQ浏览器合计的日页面浏览量按年增长55%。受到原创内容推动，长视频内容的用户消费持续回升。我们预计网络广告业务占总收入比例将从2017年的17%增加至2019年的19%。我们预计，其他业务占总收入的比例会从2017年的18%增至2019年的28%。
- 腾讯正于自己的社交网络平台积极构建生态系统，如微信或Wechat。** 腾讯已投资于许多上市及非上市公司，包括京东[JD.US]、拼多多[PDD.US]、美团[3690.HK]、同程艺龙[0780.HK]及微盟。透过这些投资，腾讯可以将庞大的流量（如微信的每月活跃帐户）引流至投资公司，而这些公司能受益于腾讯产生的流量。

图1：财务指标概览

主要财务指标（百万人民币）	2016	2017	2018E	2019E	2020E
收入	151,938.0	237,760.0	313,275.6	429,643.1	560,950.6
变动（同比%）	47.7	56.5	31.8	37.1	30.6
毛利润	84,499.0	116,925.0	143,916.2	202,804.9	254,719.0
毛利润率	55.6	49.2	45.9	47.2	45.4
净利润	41,095.0	71,510.0	86,483.1	106,367.6	133,374.7
净利润率	27.0	30.1	27.6	24.8	23.8
每股收益	4.34	7.51	8.98	11.00	13.72
每股派息	0.61	0.88	0.91	0.91	0.91
净资产收益率（%）	27.9	33.2	29.3	27.8	27.0
股息收益率（%）	0.21	0.30	0.31	0.31	0.31
市盈率（倍）	69.1	39.8	33.3	27.1	21.7
市净率（倍）	16.4	11.2	8.7	6.8	5.3
自由现金流收益率（%）	2.01%	3.38%	4.84%	6.54%	8.49%
资本开支（百万元）	(9,905.0)	(12,154.0)	(14,943.5)	(16,437.9)	(18,081.6)
每股自由现金流	5.9	9.9	14.1	19.1	24.8
净负债比率（%）	net cash	net cash	net cash	net cash	net cash

来源：公司，中国银河国际证券研究部

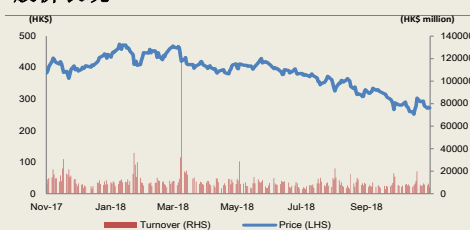
中国互联网行业

买入

收盘价：272.2港元（2018年11月14日）

目标价：341.9港元（+25.6%）

股价表现



市值	3,308.4亿美元
已发行股数	95.202亿股
核数师	PwC
自由流通量	59.9%
52周交易区间	251.4-476.6港元
三个月日均成交量	11.367亿美元
	Naspers Ltd (31.16%)
主要股东	马化腾 (8.61%) JP Morgan Chase & Co. (4.12%)

来源：公司，彭博

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Tencent Holdings Limited [0700.HK]

Regulatory Headwinds Remain for Mobile Games; Other Business Segments Continue to Boom

Tencent Holdings Limited engages primarily in value-added services (VAS), online advertising services, cloud services and payment-related business. The VAS include social network business and online games, which accounted for 54.7% of total revenue in Q3 2018. We expect the Company's net profit to reach RMB106.4bn in 2019 and RMB133.4bn in 2020, up 23.0% and 25.4% YoY, respectively. Although regulatory headwinds continue to affect Tencent's gaming monetization, and the market might continue to single-mindedly focus on the mobile game monetization issue in the near future, we believe the Company's fundamentals will become stronger because Tencent's other business segments, like online video, online advertising and payment services, remain in an industry-leading position, and the Company's growing platform engagement continues to pave the way for sustainable earnings growth in the long run. We expect revenue from other business segments to increase from 18% of total revenue in 2017 to 28% of total revenue in 2019. Overall, we believe the share price will remain volatile in the near term, as there has been no clarity on the game approval issue. According to our figures, Tencent is valued at 27.1x 2019 PER, lower than its historical average; and based on our 5-year DCF model, the Company is valued at a target price of HK\$ 341.9 (~29x 2019E PER), based on WACC of 9.0% and nominal long-term growth of 3.0%.

- Gaming business at a turning point amid regulatory crackdown, industry consolidation accelerating.** At the end of March this year, the Chinese authorities stopped approving new games. Regulators have vowed to cap the number of new game releases and limit the time children spend on games in a bid to address the myopia problem among children. We expect the regulatory restrictions to continue to negatively impact the online gaming industry and Tencent's gaming business in near future. The limitations on new games will deal a bigger blow to small game developers, forcing some of them out of business or into mergers with larger companies, so we believe Tencent will benefit from the consolidation. We expect Tencent's online game revenue to reach RMB131.9bn in 2019, up 25.0% YoY, as we expect the new game approval to resume in 1H 2019.
- Tencent's other business segments continue to grow rapidly and maintain an industry-leading position.** Tencent's social network and non-social network products continued to gain traffic and user time in Q3 2018. Weixin and WeChat's MAU reached 1,082.5m, an increase of 10.5% YoY, indicating greater user engagement and stickiness. Tencent's online advertising revenue increased 47.1% YoY to RMB16.2bn. The strong performance was driven mainly by rapid advertising revenue growth from Weixin (Moments and Mini Programs) and Tencent Video. The total daily page views of KanDian and the Mobile QQ Browser combined increased by 55% YoY in Q2 2018. User consumption of long-form video content continued to improve, driven by original content. We believe the fast development of other business segments will pave the way for Tencent to monetize its social assets in the long run. We expect the revenue contribution of the online advertising business to increase from 17% of total revenue in 2017 to 19% in 2019. We expect revenue from other business segments to increase from 18% of total revenue in 2017 to 28% of total revenue in 2019.
- Tencent is actively building an ecosystem over its own social network platforms, like Weixin/Wechat.** Tencent has invested in many listed and non-listed companies, including JD.com [JD.US], Pinduoduo [PDD.US], Meituan [3690.HK], Tongcheng-Elong [0780.HK] and Weimob. Through these investments, Tencent can direct its large traffic base, such as the MAU from Wechat, to these invested companies, and these companies can benefit from the traffic generated from Tencent.

Figure 1: Financials overview

Key Financials (in RMB m)	2016	2017	2018E	2019E	2020E
Revenue	151,938.0	237,760.0	313,275.6	429,643.1	560,950.6
Change (yoy %)	47.7	56.5	31.8	37.1	30.6
Gross Profit	84,499.0	116,925.0	143,916.2	202,804.9	254,719.0
Gross Margin %	55.6	49.2	45.9	47.2	45.4
Net Profit	41,095.0	71,510.0	86,483.1	106,367.6	133,374.7
Net Margin %	27.0	30.1	27.6	24.8	23.8
EPS (Basic)	4.34	7.51	8.98	11.00	13.72
DPS	0.61	0.88	0.91	0.91	0.91
ROE (%)	27.9	33.2	29.3	27.8	27.0
Dividend Yield (%)	0.21	0.30	0.31	0.31	0.31
PER (x)	69.1	39.8	33.3	27.1	21.7
PBR (x)	16.4	11.2	8.7	6.8	5.3
FCF Yield	2.01%	3.38%	4.84%	6.54%	8.49%
Capex (m)	(9,905.0)	(12,154.0)	(14,943.5)	(16,437.9)	(18,081.6)
Free cash flow per share	5.9	9.9	14.1	19.1	24.8
Net Gearing (%)	net cash	net cash	net cash	net cash	net cash

Sources: Company data, CGIS Research

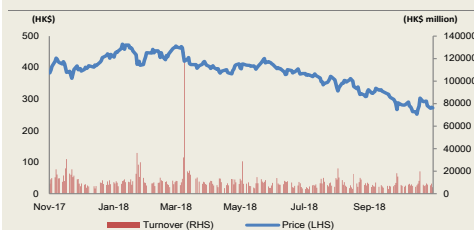
China Internet Sector

BUY

Close: HK\$272.2 (Nov 14, 2018)

Target Price: HK\$341.9 (+25.6%)

Price Performance



Market Cap	US\$330,840m
Shares Outstanding	9,520.2m
Auditor	PwC
Free Float	59.9%
52W range	HK\$251.4-476.6
3M average daily T/O	US\$1136.7m
	Naspers Ltd (31.16%)
Major Shareholding	Ma Huateng (8.61%)
	JP Morgan Chase & Co. (4.12%)

Sources: Company, Bloomberg

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Investment Highlights

1) Regulatory headwinds continue to impose pressure, accelerating industry consolidation.

In March this year, the Chinese government stopped approving new games and capped the number of new game releases. According to the government document, the State Administration of Press, Publication, Radio, Film and Television of China (SAPPRFT) rolled out regulations to control the total number of online games and limit the number of new online game titles. The authorities will work on a content rating system with recommendations and limits on the amount of time minors can play online games. The restrictions imposed by government will have a negative impact on Tencent's online games business. The Company's online game revenue decreased 3.8% YoY, but increased 2.4% QoQ to RMB25.8bn in Q3 2018. For the mobile game business, revenue increased approximately 7% YoY to RMB19.5bn and increased approximately 11% QoQ, mainly due to the contribution from new titles like "Free Fantasy Online" and "Saint Seya". Tencent has developed two mobile games leveraging the licensed IP of PUBG. The two games have achieved great popularity in China, but the Company has not been able to start monetizing them. However, according to the number on Tencent's PUBG official website, more than 12.5m people have pre-registered for the PC version and more than 9.1m Steam-PUBG players have bound their Steam account with their QQ account, which can be used to log in direct to Tencent's PUBG. Although the government has blocked the "green channel", we believe the close down of the "green channel" is for opening up the formal approval process.

The Chinese online gaming market is dominated by Tencent and Netease. According to Statista, Tencent and Netease had about a 51.1% and 14.8% market share, respectively, in Q1 2018. The tighter regulations imposed by the authorities are expected to accelerate consolidation in the online game industry in the short term and force game publishers to adopt a more global approach to survive.

Before the large-scale restructuring of government divisions that started in April 2018, the General Administration of Press and Publication (GAPP) and the Ministry of Culture (MoC) were the two authorities overseeing the online gaming industry in China. As part of the government division restructuring, the MoC has been merged with China's National Tourism Administration to form the new Ministry of Culture and Tourism. The GAPP, which is responsible for regulating the online game industry in China, will be carved out of the SAPPRFT and will be merged into China's Ministry of Propaganda (MoP). The announcement released by the State Commission Office for Public Sector Reform (SCOPSR) on Sep 10 did not state that the new Ministry of Culture and Tourism will have the power to oversee the online game industry.

Overall, we hold a constructive view on Tencent's online game business, since a) the tightening regulations will continue to have a negative impact on Tencent's online game business in the near future; b) given the large number of MAU for the PUBG game, we believe the market will re-value the Company as soon as the monetization issues are solved; c) Tencent will benefit from the tighter regulations in the long run as industry consolidation is accelerating.

Regulatory headwinds continue to negatively impact the online game business

Large user base of PUBG game

Continued uncertainty about reforms by the authorities

Investment Highlights

2) Tencent's other businesses continue to shine and maintain their leading positions

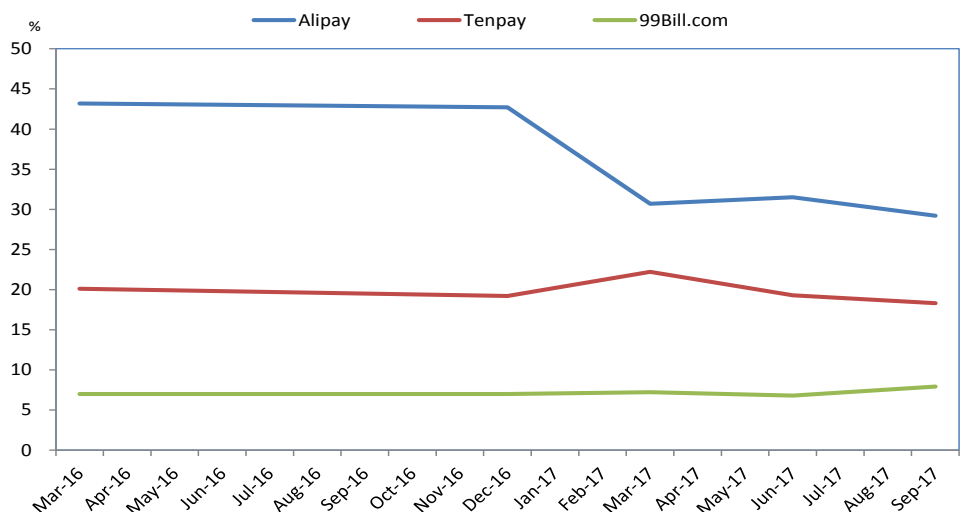
Although Tencent's online game business has been negatively impacted by tighter regulations imposed by government, the Company's other businesses, like payments, online advertising and Mini Programs, are growing rapidly. In Q3 2018, revenue generated from its online advertising business increased 47% YoY to RMB14.1bn. Social advertising revenue reached about RMB11.2bn, an increase of 61%, boosted by a) increasing ad inventory from Wechat moments, as the Company increased the number of feed ads per user per day in the second quarter this year; b) newly added inventory from Mini Program; and c) increasing traffic from QQ Kandian. We believe that currently, Tencent is relatively conservative in online advertising monetization on the Wechat platform, and we expect the Company to gradually release more inventory for Wechat Moment this year. The combined MAU of Weixin and Wechat increased 10.5% YoY to about 1.1bn, and we believe Tencent's social media advertising business will continue to benefit from growing traffic on the Weixin/Wechat platform. Media advertising revenue growth accelerated from 15% YoY in Q2 2018 to 23% YoY in Q3 2018, driven mainly by the popular content released by Tencent on Tencent Video. Also, Tencent launched more exclusive content for VIP users, which has less advertising monetization potential; and Tencent reduced the discount on media advertising for advertisers, which is positive for the gross margin of the media advertising business. We expect Tencent to continue to release high quality content for membership holders. Although the content is ad free, it will attract more paying users and increase subscription revenue. Tencent's other business revenue increased 69% YoY to RMB20.3bn in Q3 2018, boosted mainly by robust growth in payment-related services and cloud services. In Q3 2018, average daily transaction volume was up over 50% YoY, and offline commercial payment volume increased 200% YoY. Tencent's Mini Programs provide monetization opportunities for both online advertising business and payment-related services. Currently, Mini Programs covers four major use cases: transportation, retail, restaurants and mini games. As more and more mini apps are developed, we believe the Mini Programs will provide additional monetization opportunities for Tencent's online advertising business and payment services.

Social advertising boosted by increasing inventory from Wechat Moments and Mini Programs and increasing traffic from QQ Kandian

MAU of payment services continue to grow

Mini Programs provide additional monetization opportunities

Figure 2: Third-party payment market share comparison



Sources: iWind, CGIS Research

Investment Highlights

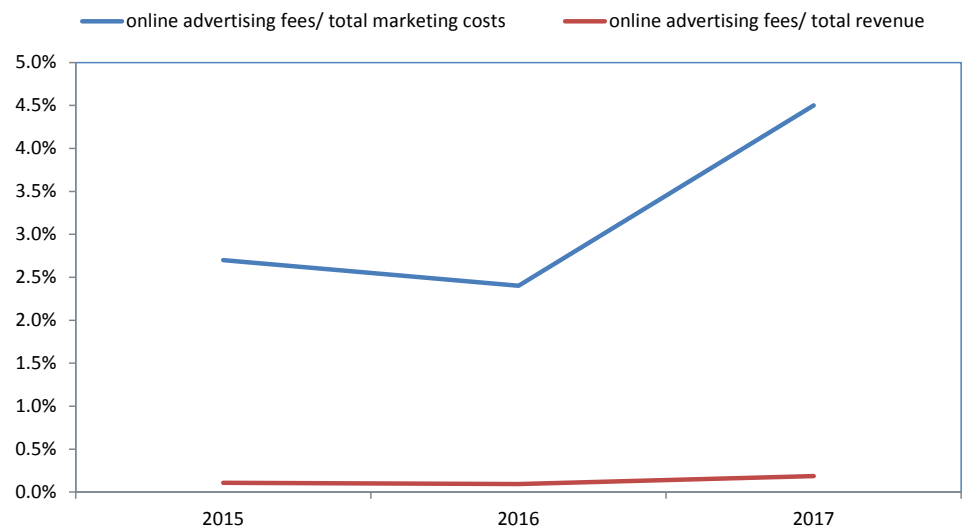
3) Tencent is building up its WeChat/WeiXin-based ecosystem by investing in and empowering other platforms

Invested companies enjoy a traffic bonus from Tencent

Tencent has invested in many online platforms, including e-commerce platforms like JD.com, Meituan and Pinduoduo and online advertising solution providers like Weimob. Currently, there are more than 3.5m active public accounts and 797m MAU on the Wechat/Weixin platform. For the Company's Mini Program platform, there are over 1m active mini programs and about 400m active mini program users. Through investment, Tencent will be able to empower other online platforms by directing its large traffic to the invested platforms. Tencent holds a stake of about 18% in JD.com. About 25% of JD.com's traffic is from Tencent, and about 18% of online orders are generated from JD.com's mini programs, called JD 618. In 2017, JD.com paid about RMB675m in advertising fees to Tencent, which accounted for about 4.5% of total fees in 2017. Tencent also has an ~18.5% stake in Pinduoduo. In Q1 2018, Pinduoduo paid about RMB207m to Tencent in total service fees. Tencent owns about 20% of Meituan Dianping's total shares, and Meituan paid Tencent about RMB420m for services, including RMB20m in technical fees, RMB310m in payment service fees, and about RMB90m in marketing fees. Also, Tencent owns about 23.2% of Tongcheng-Elong, which is expected to be listed this month. In 2017, Tongcheng-Elong paid approximately RMB413.4m in payment services fees and RMB5.2m in technical support fees to Tencent. By investing in other online platforms, Tencent will be able to establish a cross-sector ecosystem based on its Weixin/Wechat platform and empower invested platforms with Tencent's own large traffic. Moreover, Tencent has less financial risk through investment than starting a businesses by itself.

Figure 3: JD, com's advertising fees paid to Tencent

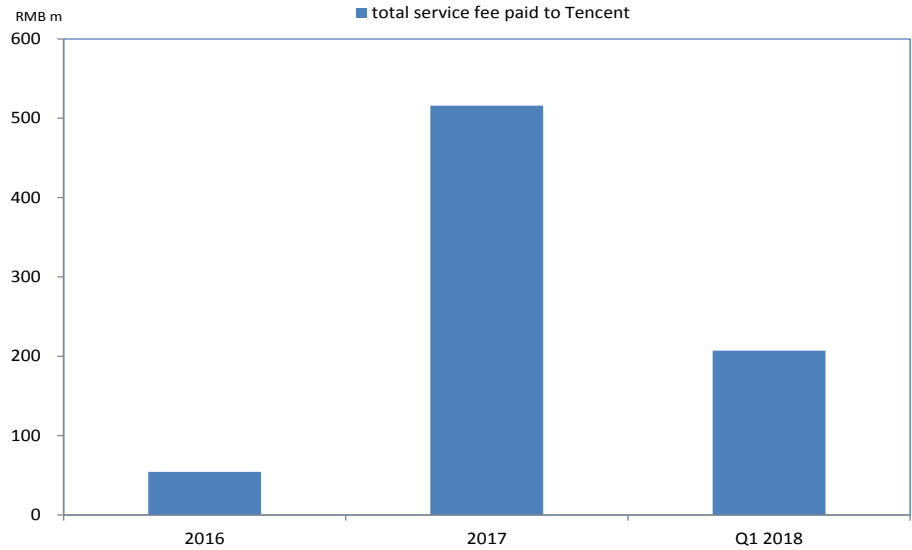
Service fees paid to Tencent



Sources: JD.Com, CGIS Research

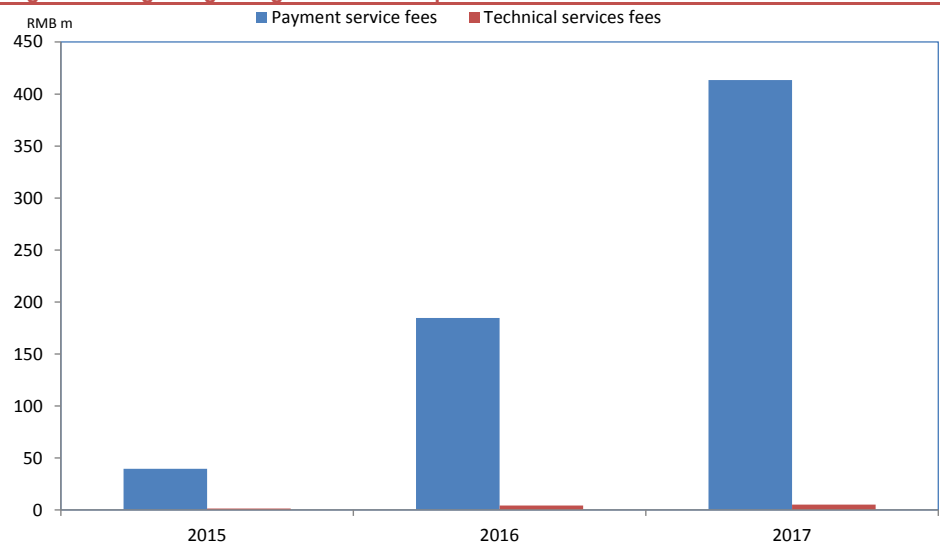
Investment Highlights

Figure 4: Pinduoduo's total fees paid to Tencent



Sources: JD.Com, CGIS Research

Figure 5: Tongcheng-Elong's service fees paid to Tencent



Sources: Tongcheng-Elong, CGIS Research

Company overview

Tencent Holding Limited operates three main business segments: a) value-added services (VAS); b) online advertising; and c) other business. Currently, Tencent dominates China's mobile gaming market. According to Statista, Tencent accounted about 51.1% of the total market share of listed video game companies in China in terms of mobile gaming revenue in Q1 2018. The MAU of QQ decreased 4.8% YoY to 802.6m in Q3 2018; and the combined MAU of Weixin and Wechat reached approximately 1,082.5m, up 10.5% YoY.

Tencent's VAS services cover mainly online games and social network business. In Q3 2018, the Company's VAS generated about RMB44.0bn, an increase of 5% YoY and accounted about 55% of total revenue. Smartphone games generated revenue of RMB19.5bn, up 7% YoY and down 11% QoQ in Q2 2018, owing to the release of new game titles. PC games generated about RMB12.4bn in revenue in Q3 2018, down 15% YoY and 4% QoQ, which was mainly due to a user shift from PC to mobile games.

Tencent launched marketing activities to celebrate the 10th anniversary of DnF in China in June, which helped increase the number of paying users and ARPU. LoL's DAU also saw QoQ growth, which was mainly due to the mid-season invitational (MSI) event in Paris. Social Network revenue increased 30% YoY to RMB16.9bn, which came mainly from digital content services, such as live broadcasts, online video subscriptions and online music subscriptions, and total fee-based VAS subscriptions reached 154m, up 30% YoY. The Company's digital content revenue increased at a high single-digit rate QoQ. Tencent's video service generated about 74m subscriptions, up 121% YoY, which was mainly due to the success of the Company's exclusive content in key video genres, like "Legend of Fuya" and "Produce 101".

The Company's online advertising business has two sub-segments: media advertising, and social network and others advertising. Revenue from media advertising increased 23% YoY in Q3 2018, which was boosted by the release of a series of popular content. Revenue from social network advertising business increased 61% YoY, owing to the release of advertising inventory in Weixin Moments and new inventory in Mini Programs.

Tencent's others business segments include mainly payment-related services and cloud services, which recorded revenue of RMB20.3bn in Q3 2018. As the Company continued to expand its payment business, MAU surpassed 800m at the end of June this year, and the average daily transaction volume increased by over 50% YoY.

Tencent is the leading player in the online games industry

Online advertising business continues to grow

Payment services continue to expand

Business Overview

OVERVIEW OF THE ONLINE GAME BUSINESS

Tencent's online game business is the major revenue contributor. It generated about 55%, 47% and 41% of total revenue in 2015, 2016 and 2017, respectively. According to Statista, China's gaming market is dominated by Tencent and NetEase [NTES.US], which held a 51.1% and 14.8% market share, respectively, in Q1 2018. The Company's online game business covers two sub-segments: PC games and mobile games. Tencent's PC games contributed about 38.9% of total online game revenue in Q3 2018. The Company successfully launched some famous PC titles, including "League of Legends" (LoL), "Dungeon & Fighter" (DnF) and "CrossFire". "League of Legends" is a popular multiplayer online battle arena game, published by Riot Games and Tencent, and contributed about US\$2.1bn in total revenue in 2017. "Dungeon Fighter Online" is the second most profitable PC game. It is published by Nexon and Tencent and generated about US\$1.6bn in 2017. "CrossFire", a shooter game also published by Nexon and Tencent, generated about US\$1.4bn last year. In Q3 2018, revenue generated from PC games was about RMB12.4bn, down 15% YoY and 4% QoQ, which was mainly due to users shifting from PC to mobile games. Tencent's mobile games have experienced rapid growth in the past several years. "Honor of Kings", one of Tencent's most successful mobile games, generated about US\$1.9bn in 2017. According to SuperData Research, "Honor of Kings" was the highest-grossing mobile game in 2018, NetEase's "Fantasy Westward Journey" ranked second, and Mixi's "Monster Strike" was third. Since the regulatory authorities stopped issuing licenses for new games at the end of March this year, and government regulators aim to restrict the number of games and limit the time children spend on games due to myopia problems among children, Tencent's overall online game business was affected negatively. Tencent will require all players to verify their identities against police databases starting next year. Currently, Tencent has made it mandatory for players in nine cities in China to verify their age to log in to "Honor of Kings", and the Company will roll out mandatory verification for another nine of its most popular games before next year. In 2017, Tencent announced a global retail game platform called WeGame as a Chinese-language site for video game livestreaming, social networking and downloading PC games. This was originally called the Tencent Games Platform (TGP). According to SCPM, WeGame has more than 220 game titles, including "Fortnite" and "Monster Hunter: World". According to news reports, Tencent is preparing to launch an international version of WeGame in Hong Kong. This will be available for overseas users, who will have access to more Chinese online games.

Tencent dominates China's online games industry with a market share of 51.1% in Q1 2018

Figure 6: Top mobile games by revenue in 2017

Rank	Title	Publisher	Revenue(US\$)
1	Honor of Kings	Tencent	1.9bn
2	Fantasy Westward Journey	NetEase	1.5bn
3	Monster Strick	Mixi	1.3bn
4	Clash Royable	Supercell	1.2bn
5	Clash of Clans	Supercell	1.2bn
6	Fate/Grand Order	Aniplex,Inc.	982m
7	Lineage 2: Revolution	Ner marble Games	980m
8	Candy Crush Saga	KING	910m
9	Pokemon Go	Niantic, Inc	890m
10	Ghost Story	NetEase	860m

"Honor of Kings" was the most profitable mobile game in 2017

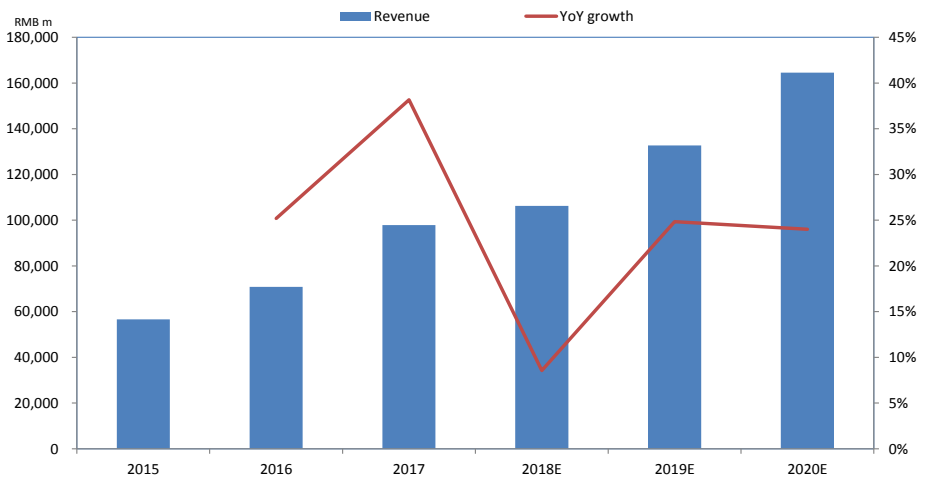
Sources: SuperData Research, CGIS Research

Tencent is the leading social network platform in China

OVERVIEW OF THE SOCIAL NETWORK BUSINESS

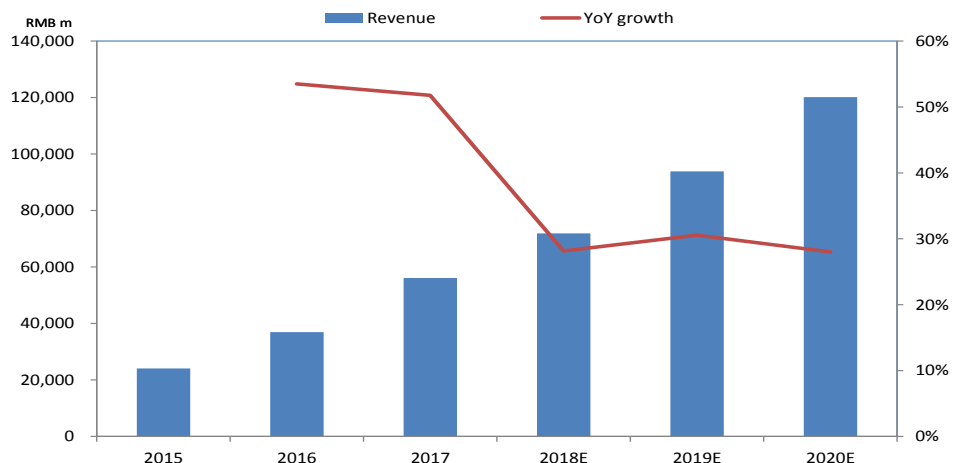
Tencent's social network business revenue increased from RMB15.3bn in Q3 2017 to RMB18.2bn in Q3 2018, up 19.3%YoY, owing mainly to the increasing revenue contribution from digital content services, like subscription video streaming and live broadcasts. Total VAS subscriptions reached 154.1m in Q3 2018, up 23% YoY, driven by an increasing number of subscribers for Tencent's self-produced original content. In Q3 2018, video subscriptions increased 79% YoY to 82m, and music live broadcast services increased monetization. Weishi, Tencent's short video app, allows WeChat users to share and post videos from the app on Wechat. According to Trustdata, Tencent's Weishi generated about 4.7m MAU in April 2018, an increase of 147% MoM. Tencent has released some popular content, including "Legend of Fuyao" and "Produce 101". In order to boost subscriptions, Tencent initiated several promotions, like social referrals, allowing users to gift subscription cards or day-trial services through red envelopes to Weixin and QQ friends. In Q2 2018, mobile DAU of Tencent Video grew by 24% YoY, daily video views increased by 53% YoY, and total time spent increased by 39% YoY.

Figure 7: Tencent's online game revenue



Sources: Company data, CGIS Research

Figure 8: Tencent's social network revenue



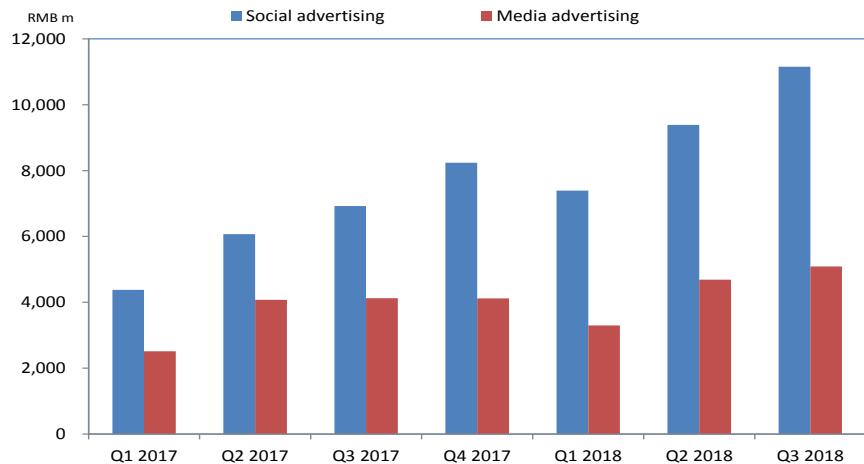
Sources: Company data, CGIS Research

Tencent's online advertising will benefit from the new ad inventory from Mini Program and Tencent Video

OVERVIEW OF THE ONLINE ADVERTISING BUSINESS

Tencent's online advertising business covers mainly a) media advertising, and b) social and other advertising. For social advertising business, Tencent increased its ad load for Weixin Moments in certain first-tier cities and lowered the traffic threshold for advertisements in Wexin Official Accounts to meet increasing demand from advertisers. Tencent has gradually opened its ad inventory on its mobile new app since Q1 2018, and the new ad inventory from Mini Program will provide additional monetization opportunities. For the media advertising business, as Tencent video continues to deliver solid growth, supported mainly by the development of original videos, we expect Tencent Video to continue to deliver strong growth in video advertising services in 2H 2018, as a) Tencent will continue to launch new original shows in 2H 2018, and b) it will release more inventory with exclusive content.

Figure 9: Tencent's online advertising revenue



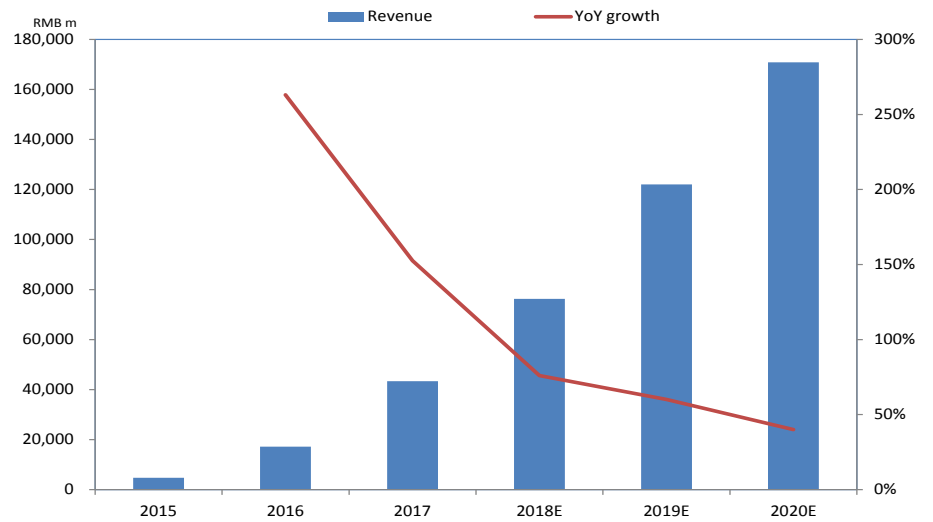
Sources: Company data, CGIS Research

The increasing reserve fund ratio will impact Tencent's interest income in the near term

OVERVIEW OF PAYMENT-RELATED BUSINESS AND CLOUD SERVICES

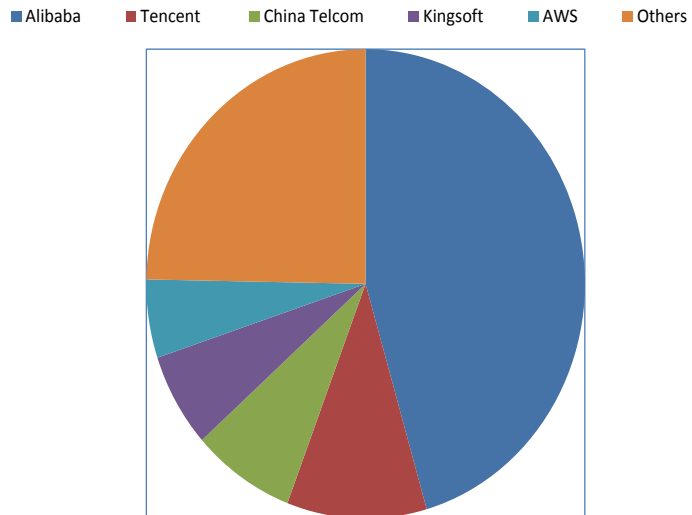
Tencent's other business segment includes mainly payment services and cloud computing business. In Q3 2018, revenue from other business segments increased 69% YoY to RMB20.3bn, driven mainly by the strong performance of payment-related services. Tencent's payment services have penetrated about 80% of total Weixin/Wechat users, and offline commercial payment volume increased by 280% YoY. Previously, third-party payment platforms were permitted to invest customer funds. In January 2017, the Central Bank announced that third-party payment platforms were required to keep 20% of customer deposits, and the ratio was increased to 50% in April. We believe that the increasing reserve fund ratio will impact Tencent's interest income from its client reserve fund, but that it will gradually diminish over the rest of the year.

Figure 10: Revenue from other business segments



Sources: Company data, CGIS Research

Figure 11: Market share of Tencent Cloud in 2017



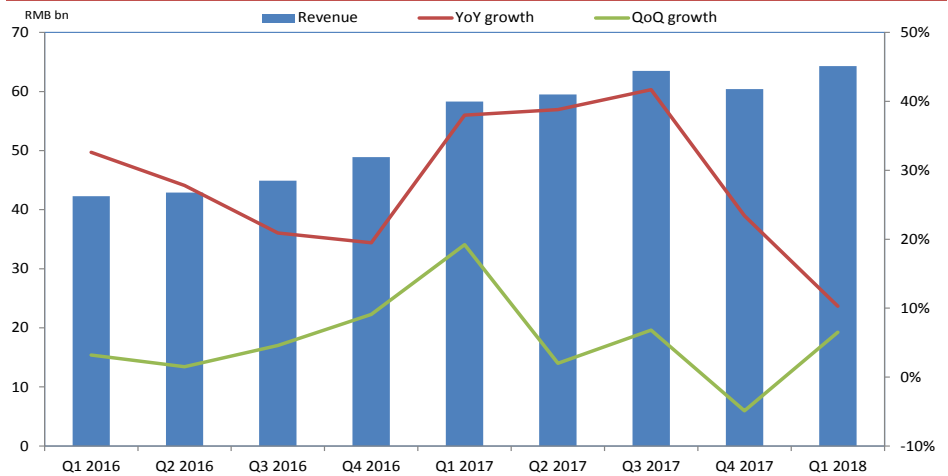
Sources: IDC, CGIS Research

Industry Landscape

OVERVIEW OF THE ONLINE GAME MARKET IN CHINA

According to iResearch, the total size of the global online game market was US\$108.9bn in 2017, up 9.3% YoY, and it is expected to grow at a CAGR of 5.2% from 2017 to 2022. The Asia-Pacific region was the largest online game market in the world in 2017, with a market size of US\$51.2bn. North America was the second largest region, with an estimated market size of US\$27.0bn in 2017. Currently, China is the largest online market in the world; it contributed about 31% of total global online game market revenue in 2017.

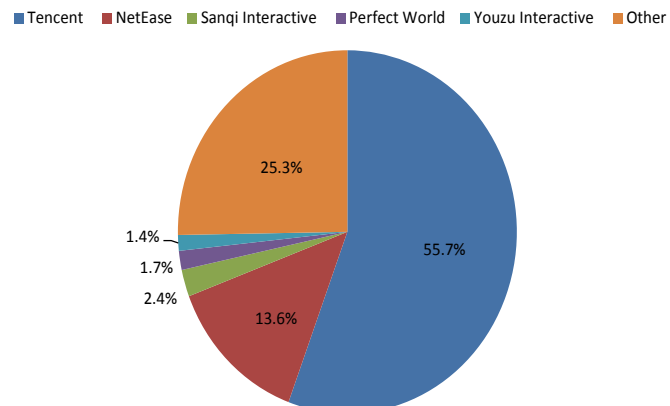
Figure 12: Revenue of China's online gaming market



Sources: iResearch, CGIS Research

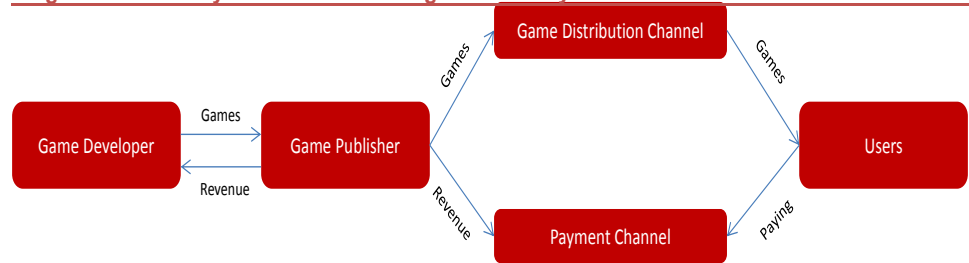
In Q1 2018, Tencent and NetEase together had about 69.3% of the online gaming market in China. The second-tier gaming companies are Wuhu Shunrong Sanqi Interactive Entertainment Network Technology [003666.CH], Perfect World [002624.CH] and Youzu Interactive [002174.CH].

Figure 13: China's online gaming market share in Q1 2018



Sources: iResearch, CGIS Research

Figure 14: Industry chain of the online game industry



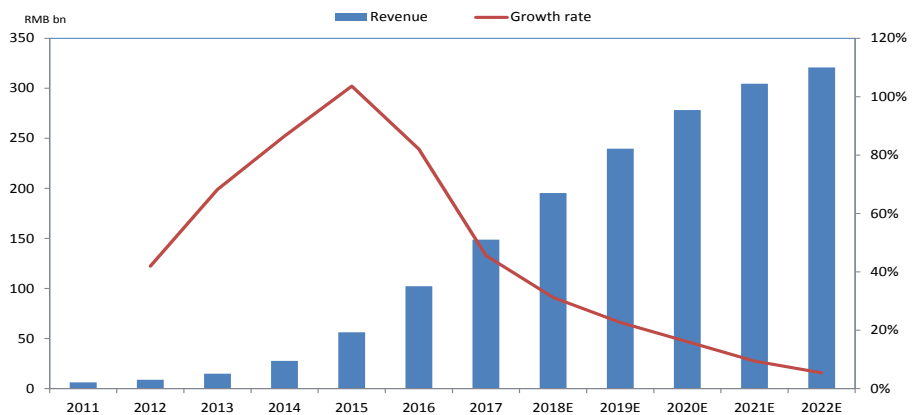
	Introduction	Revenue Model
Game Developer	Content producer in charge of developing and updating games	Selling games, authorizing game IPs and revenue share of users' online purchase and advertising income in the games
Game Publisher	Mainly focus on game promotion and marketing	Revenue share of users' online purchase and income from online advertisement in games
Game Distribution Channel	Allows user access through public platforms and websites for game distribution and promotion	Revenue share of users' online purchase; income from online advertisement in games; and advertising revenue of the platform
Payment Channel	Allow users can pay for the game or purchase virtual items	Transaction fees

Sources: iResearch, CGIS Research

OVERVIEW OF THE MOBILE GAME MARKET IN CHINA

In 2017, revenue generated by China's mobile game companies reached RMB148.9bn, an increase of 45.6% YoY. According to the "China Game Industry Report from January to June 2018", revenue generated from mobile games was RMB63.4bn in 1H 2018, up 12.9% YoY, which accounted for about 60.4% of the total online gaming market in terms of revenue. Most of the revenue was generated from the domestic market; revenue generated from overseas markets accounted about 26.5% of the total revenue of China's mobile game companies in 2017. After an exceptionally successful year in 2017, market growth has slowed down, mainly because of government tightening policies for the Chinese game market. The State Administration of Radio and Television (SART) halted the approval of new games at the end of March this year after beginning its own restructuring process. According to Niko Partners, 8,561 games were approved in 2017, while just 1,931 games have been approved for release this year.

Figure 15: Revenue of China's mobile game market



Sources: iResearch, CGIS Research

Figure 16: 1H 2018 TOP iOS Games

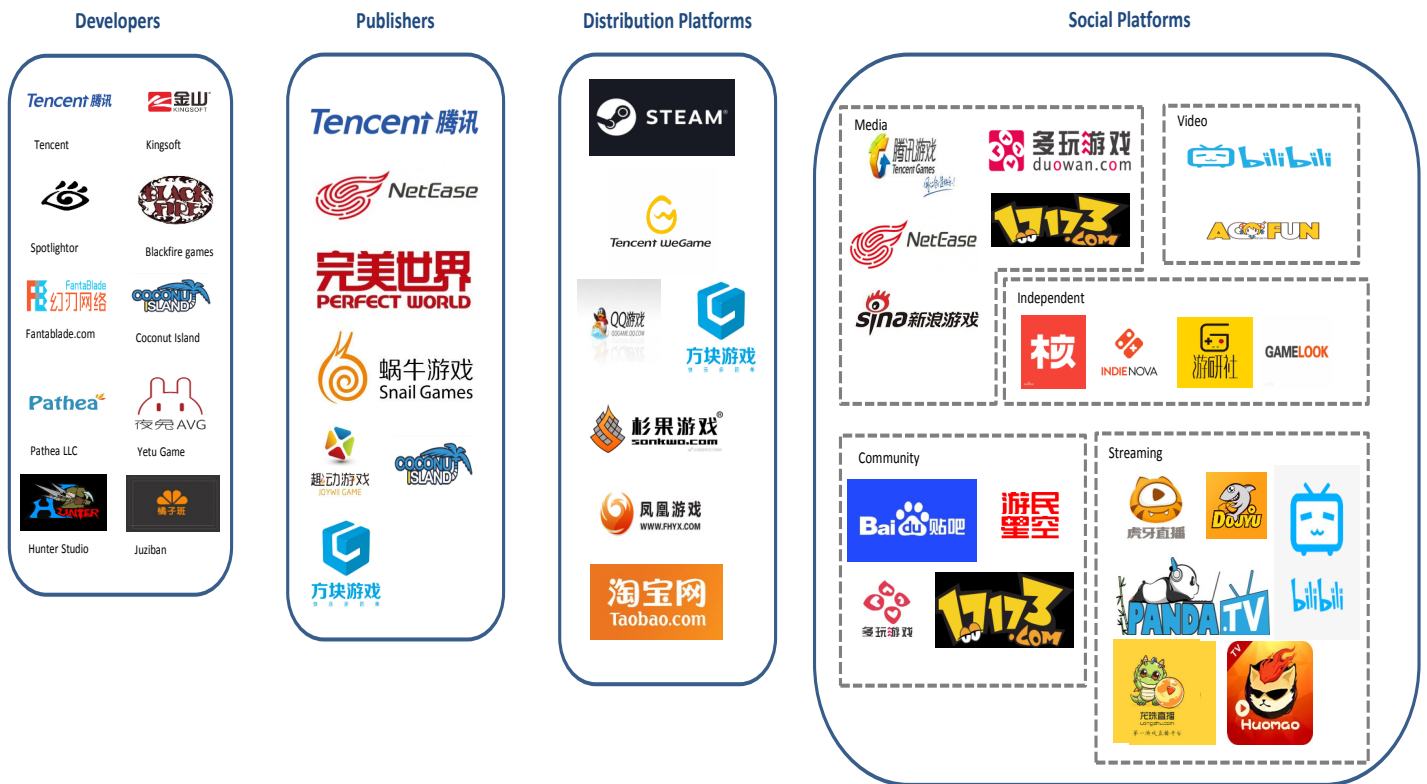
Downloads			Revenue		
Ranking	Game	Publisher	Ranking	Game	Publisher
1	PUBG Mobile	Tencent	1	Honor of Kings	Tencent
2	PUBG Army Attack	Tencent	2	Fantasy Westward Journey	NetEase
3	Identity V	NetEase	3	QQ Speed	Tencent
4	QQ Speed	Tencent	4	Chu Liuxiang	NetEase
5	Honor of Kings	Tencent	5	MU Awakening	Tencent
6	Travel Frog	Hit-Point	6	King of Chaos	Tencent
7	Knives Out	NetEase	7	Westward Journey Online	NetEase
8	Happy Landlord	Tencent	8	New Ghost	NetEase
9	Happy Mahjong	Tencent	9	Onmyouji	NetEase
10	Anipop	Happy Elements	10	QQ Dance	Tencent

Sources: iResearch, CGIS Research

OVERVIEW OF THE PC GAME MARKET IN CHINA

China is the world's largest PC online game market. According to Niko Partners, China's PC online game market was valued at the US\$15.5bn in 2017 and is expected to grow to US\$17.4bn by 2022. There were more than 300m PC online gamers in 2017, and the number is expected to reach 350m by 2022. Overall growth was offset by a decline in casual game revenue, as casual PC gamers shifted in droves to mobile. Tencent's WeGame, China's biggest PC game distribution platform, currently offers about 220 titles for download, including games developed overseas. Niko Partners estimates that total revenue from foreign games accounts for about 20% of total sales in China's PC and mobile game markets. Including revenue kept by Chinese partners, in 2016, South Korean games claimed roughly 14% of China's PC digital game sales, followed by U.S. PC game sales at 5%. Other foreign games accounted for only 1% of China's PC game market. There are several regulatory barriers that prevent foreign digital game firms from fully participating in the Chinese PC game market. Under Chinese law, the only legal way for foreign game developers to enter the Chinese market is to license their games to a domestic Chinese company. Overseas companies are not legally allowed to directly publish or operate online PC games.

Figure 17: PC Game Industry Chain in China

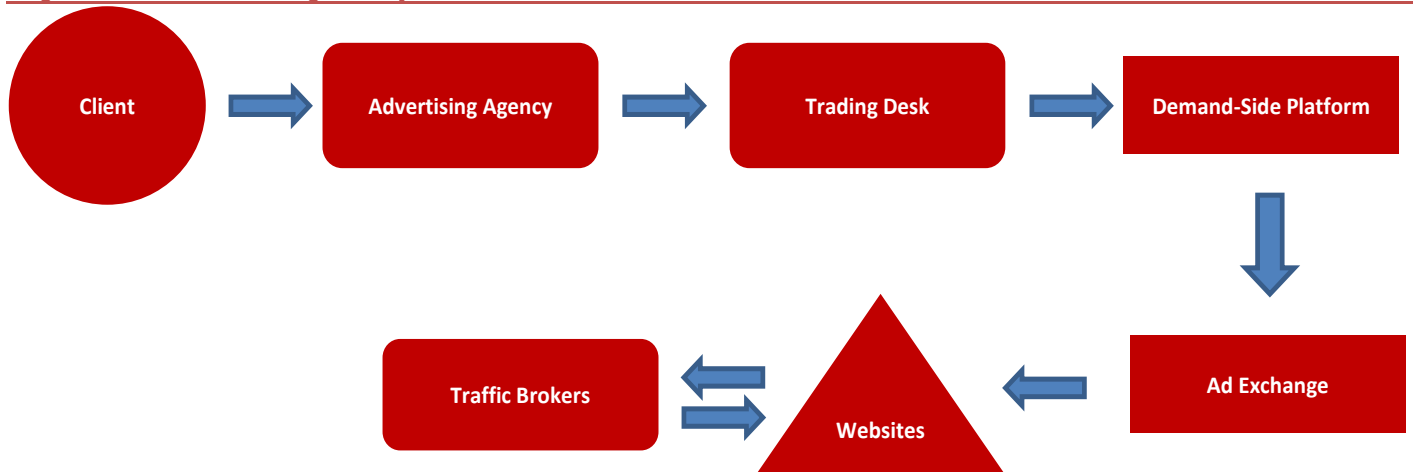


Sources: iResearch, CGIS Research

OVERVIEW OF THE ONLINE ADVERTISING MARKET IN CHINA

The rapid development of the Internet in China, especially mobile apps, has driven the growth of the online advertising industry. According to the China Internet Network Information Center (CNNIC), China now has over 772m Internet users, for a penetration rate of 55.8%, which exceeds the global average by 4.7ppt and the Asian average by 9.1ppt. In 2016, the overall market size of the online advertising industry in China was RMB290.3bn, up 32.9% YoY, and increased to RMB388.4bn in 2017, for a growth rate of 33.8% YoY. Online advertising is defined as a marketing strategy that uses the Internet as a medium to obtain website traffic and target and deliver marketing messages to target customers. There are several advantages to online advertising: a) it has wider coverage than traditional ads, which helps advertisers reach a wider audience; compared to offline advertising, online advertising helps advertisers reach their target customers, making advertising campaigns more efficient; b) online advertising is more cost-effective than traditional advertising, as online advertising can directly target a specific group of customers; c) online advertising can provide measurable data to advertisers, providing a better picture of their potential customers; for example, advertisers can use the free Google Analytics tool to calculate their return on investment; and d) online advertising allows advertisers to market their products and services to a target audience based on demography. In general, there are seven types of online advertising: a) display ads; b) social media ads; c) search engine marketing (SEM); d) native advertising; e) remarketing; f) video ads; and g) email marketing.

Figure 18: Online advertising industry value chain

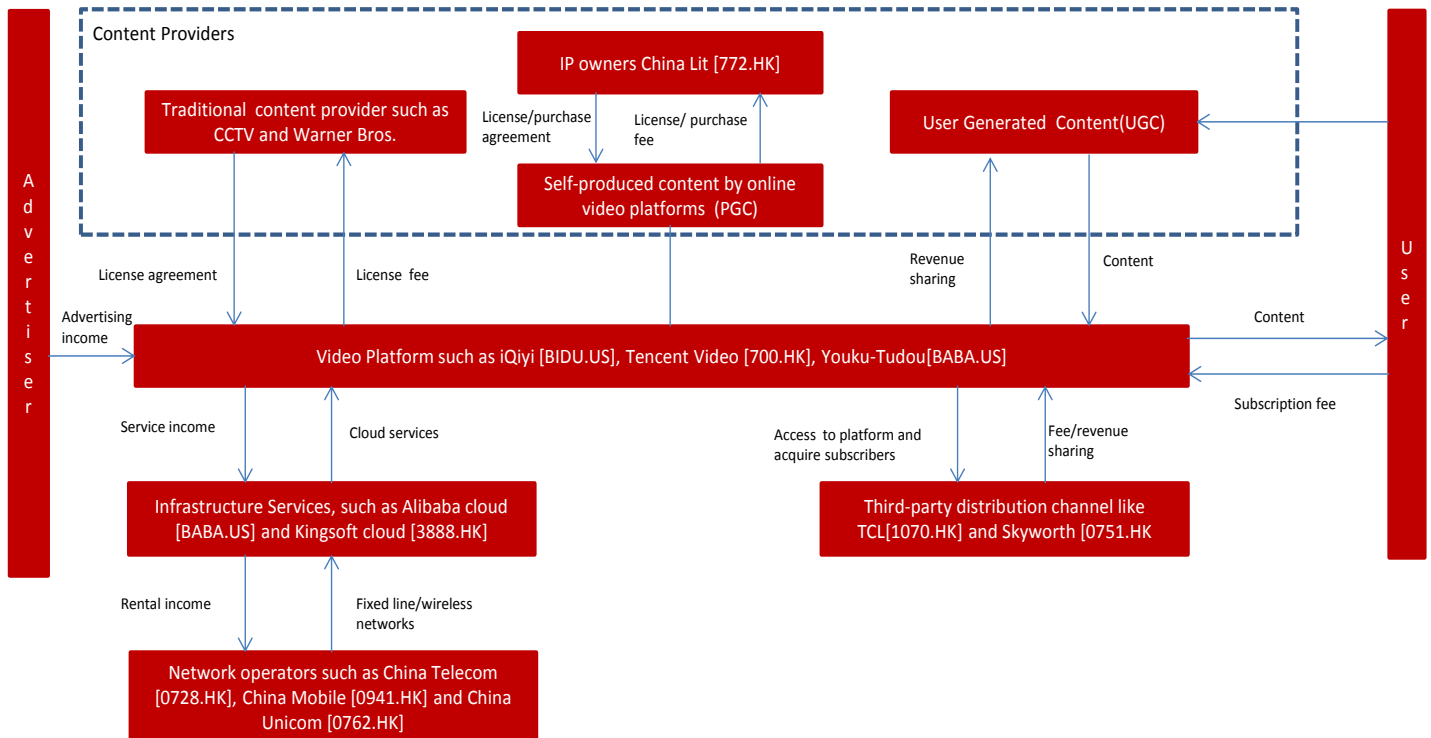


- Clients demand the Advertising Agency to run ad campaigns
- Based on the Client's requirements regarding its target consumer, the Agency tells its Trading Desk what kind of ad space to buy.
- The Trading Desk establishes a set of guidelines, and tells a Demand-Side Platform (DSP) to purchase ad space. DSPs run intelligent algorithms to pick the cheapest ad space relative to its quality.
- The DSP keeps tracking all the ad spots on Ad Exchanges; Ad Exchange is an open platform that enables websites to place their available ad space for anyone to buy in an auction.
- The websites can attract traffics naturally or purchase traffics from Traffic Brokers.

OVERVIEW OF THE ONLINE VIDEO MARKET IN CHINA

Currently, the entertainment industry in China is still at an early stage of development. Its market size is expected to reach about RMB2,768.6bn by 2022, for a CAGR of 17.3% since 2016. According to the National Bureau of Statistics of China, the ratio of the culture and entertainment industry GDP to total GDP is 4.1% in China, compared with 6.5% in the U.S. The online entertainment industry in China comprises internet video, live streaming, short videos, online literature, digital music, and recreational online anime and comics. Currently, the online video industry is experiencing rapid growth. It is the leading online entertainment format in China, as over 80% of time spent on online entertainment is spent on online video. According to iResearch, online video users in China increased from 372m in 2012 to 545m in 2016 and are expected to further increase to 766m in 2022, representing 66.4%, 74.6%, and 87.0% of total internet users in China in 2012, 2016 and 2020, respectively. The rapid growth of the online video industry in China has been driven mainly by a) a broad range of online content; b) higher content quality; c) AI and big data technologies, which help platforms deliver a more customized entertainment experience; and d) the increasing willingness of users to pay for online content. Currently, online video platforms generate revenue in five main ways: a) online advertising, which is the major revenue contributor; b) paid subscriptions, such as memberships or VIP fees; c) copyright re-sale; and d) other business, such as online shopping (buying while watching) and web game joint operations.

Figure 19: Online Video Industry Chain



Sources: iResearch, CGIS Research

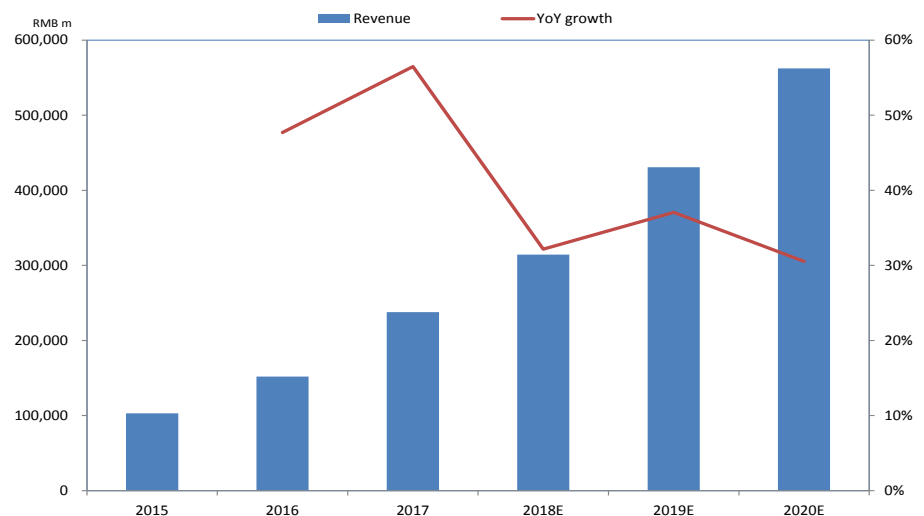
Earnings forecast

Steady turnover recovery in 2018E-2020E

Gross margin expected to come down gradually

- Tencent is projected to deliver net profit growth of 20.9%/23.0%/25.4% in 2018E/2019E/2020E, supported by steady recovery in the online game business and strong growth in Tencent's other business. We expect the overall net margin to fall gradually from 30.1% in 2017 to 23.8% in 2020E.
- Tencent's VAS business comprises online game business and social network business. We expect revenue from its online game business to grow at a CAGR of 18.7% from 2017 to 2020E. In 2015, 2016, 2017 and Q3 18, revenue from the online game business accounted for 55.0%, 46.6%, 41.2%, and 32.0% of total revenue, respectively. Online game business includes PC games and mobile games. We expect revenue from PC games to further decline 18% and revenue from mobile games to decline 10% YoY in Q4 2018 .
- We expect revenue from its online advertising business to grow rapidly at a CAGR of 38.1% in 2017-2020E, driven by strong growth in the social advertising business. Online advertising business is forecast to contribute a higher portion of the Company's turnover in 2020.
- Tencent's other business segment includes mainly payment-related services and cloud services. We expect revenue from other business segments to grow at a CAGR of 57.9% from 2017 to 2020E.
- Tencent's gross margins have been dragged down by higher cloud computing costs and the cost of fresh content. We expect Tencent to continue to experience margin pressure. Its gross margin is forecast to decrease from 49.2% in 2017 to 45.4% in 2020E due to a) lower revenue contribution from games; b) higher content costs; and c) higher revenue contribution from lower-margin business like cloud computing.

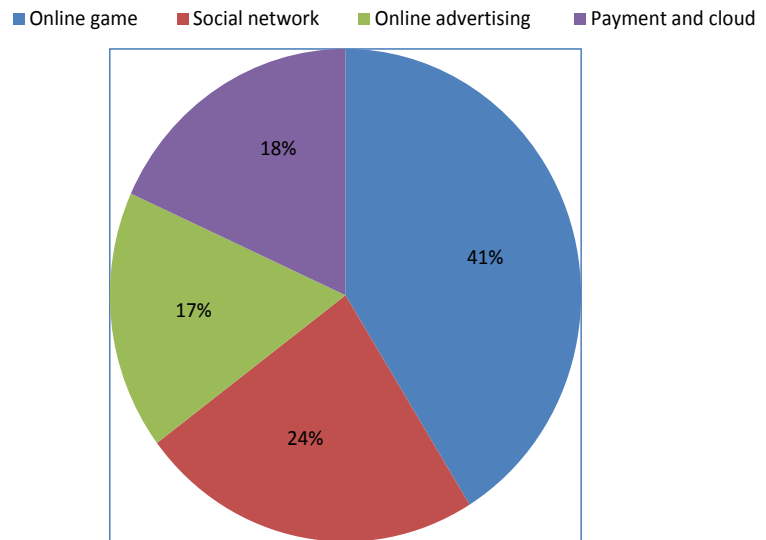
Figure 21: Tencent's revenue growth



Sources: Company data, CGIS Research

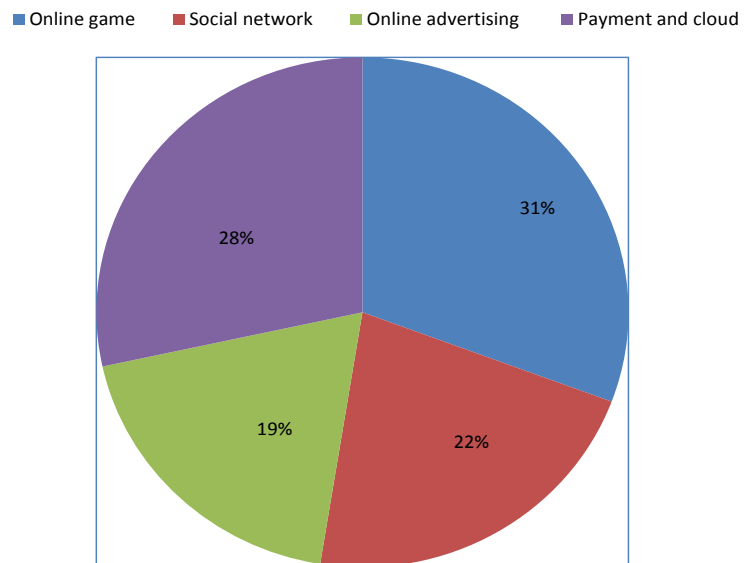
Earnings forecast

Figure 22: Tencent's revenue breakdown in 2017



Sources: Company data, CGIS Research

Figure 23: Tencent's revenue breakdown in 2019E



Sources: Company data, CGIS Research

Tencent's Q3 2018 Results Overview

Q3 2018 net profit increased 30.6%, which was higher than expected. Tencent's Q3 2018 turnover was RMB80.60bn, up 23.6% YoY (higher than the consensus estimate), and 9.4% QoQ. The Company's gross margin for Q3 2018 was 44.0%, down 2.8ppt QoQ; and the net profit margin in Q3 2018 was about 29%, up 4.7ppts QoQ. In Q3 2018, QQ's MAU was 802.6m, down 4.8% YoY and 0.1% QoQ; MAU of Weixin and Wechat increased 10.5% YoY to 1,082.5m, up 2.3% QoQ. In Q3 2018, revenue generated from PC games was about RMB12.4bn, down 15% YoY and 4% QoQ, which was mainly due to users shifting from PC to mobile games. Tencent released an internally-developed game called "Ring of Elysium", which is a tactical tournament game for the international market. This game ranked among top 10 games by peak concurrent users on Steam at launch. We expect PC game revenue to continue to be under pressure due to the shift to mobile. Smartphone games generated revenue of RMB19.5bn, up 7% YoY and 11% QoQ, which was due to the contribution from newly released game titles like "Free Fantasy Online Mobile" and "Saint Seiya". Currently, the Company has 15 games with monetization approval, most of them RPG or action titles. Social network revenue increased 19% YoY to RMB18.2bn, which came mainly from digital content services, such as live broadcasts, online video subscriptions and online music subscriptions; and total fee-based VAS subscriptions reached 154m, up 23% YoY. The Company's digital content revenue increased at a double-digit rate YoY and a high single-digit rate QoQ. Tencent Video generated about 82m subscriptions, up 79% YoY, which was mainly due to the success of the Company's exclusive content in key video genres, like *Legend of Fuya* and *Ruyi's Royal Love in the Palace*. Its online advertising revenue increased 47% YoY to RMB16.3bn. Media advertising revenue was RMB5.1bn, up 23% YoY; and social media and other advertising revenue increased 61% YoY to RMB11.2bn. The strong performance of the Company's online advertising business was driven by strong advertising revenue growth from Weixin (Moments and Mini Programs) and Tencent Video. Revenue from other business segments, including mainly cloud services and payment-related business, increased 69% YoY to RMB20.3bn in Q2 2018.

During the conference, management mentioned its strategy change from consumer Internet focused to Industrial Internet focused, extending its "connections" from connecting people and content to connecting industries via digital channels. Under the concept of the Industrial Internet, management believes the cloud computing business will be the key point. However, this requires capital expenditure, and margins are relatively low at the IaaS level. The Company's long-term strategy is to gradually shift from IaaS to PaaS and then to SaaS, which will provide higher margins. For its online game business, Tencent has released its healthy gameplay system, which identifies players aged 12 and below via real-ID verification and face recognition technology. Minors have a maximum one hour of game time daily, and log-in is blocked between 9pm and 8am. Currently, the system has been launched for "Honour of Kings", and it will be extended to 9 more game by the end of the year. Management believes the system will not impact its game revenue significantly, since most of its game revenue is generated from older users. In terms of the Mini Program, management mentioned that the major monetization methods are associated with mini games, and the Company expects more revenue contribution from retailers in the long run, as online retailers are actively building channels on Mini Programs to promote and sell their products.

Figure 24: Key assumptions

	2015	2016	2017	2018F	2019F	2020F
Turnover (Rmbm)						
VAS	80669.0	107810.0	153983.0	177397.0	225742.5	283675.1
'-online games	56587.0	70844.0	97883.0	105499.0	131880.5	163531.8
'-social network	24082.0	36966.0	56100.0	71898.0	93862.0	120143.3
Online advertising	5033.9	8308.0	17468.0	26970.0	40439.0	59587.2
Others	4726.0	17158.0	43338.0	76291.4	122067.0	170893.7
YoY Change (%)						
VAS		33.6	42.8	15.2	27.3	25.7
'-online games		25.2	38.2	7.8	25.0	24.0
'-social network		53.5	51.8	28.2	30.5	28.0
Online advertising		65.0	110.3	54.4	49.9	47.4
Others		263.1	152.6	76.0	60.0	40.0
Cost of revenue						
VAS	28,422.0	37,622.0	61,389.0	72,942.5	91,936.6	124,114.5
Online advertising	8,941.0	15,396.0	25,586.0	38,339.4	50,346.7	67,968.0
Others	4,268.0	14,421.0	33,860.0	58,077.5	84,554.9	114,149.1
YoY Change (%)						
VAS		32.4	63.2	18.8	26.0	35.0
Online advertising		72.2	66.2	49.8	31.3	35.0
Others		237.9	134.8	71.5	45.6	35.0
Gross margin (%)	59.5	55.6	49.2	45.9	47.2	45.4
Net margin (%)	28.0	27.0	30.1	27.6	24.8	23.8
Cost (Rmbm)						
S,G&A	(24,818.0)	(34,595.0)	(50,703.0)	(67,200.5)	(96,076.6)	(109,385.3)
Financial Expenses	(1,618.0)	(1,955.0)	(2,908.0)	(4,448.0)	(2,908.0)	(4,071.2)
YoY Change (%)						
S,G&A		39.4	46.6	32.5	43.0	13.9
Financial Expenses		20.8	48.7	53.0	(34.6)	40.0

Sources: Company data, CGIS Research

Key financials

Income Statement (RMB m)	FY2016	FY2017	FY2018F	FY2019F	FY2020F
Revenue	151,938	237,760	313,276	429,643	560,951
Growth yoy%	n.a.	56.5%	31.8%	37.1%	30.6%
Gross Profit	84,499	116,925	143,916	202,805	254,719
Growth yoy%	n.a.	38.4%	23.1%	40.9%	25.6%
Selling General & Admin Exp.	(34,595)	(50,703)	(67,200)	(96,077)	(109,385)
Others Operating Expenses/Items	0	0	0	0	0
Operating Income	49,904	66,222	76,716	106,728	145,334
Growth yoy%	n.a.	32.7%	15.8%	39.1%	36.2%
Interest Expense	(1,955.0)	(2,908.0)	(4,448.0)	(2,908.0)	(4,071.2)
Interest and Invest. Income	2,619.0	3,940.0	4,073.8	3,962.5	4,487.6
Income/(Loss) from Affiliates	(2,522.0)	821.0	2,997.0	1,152.5	1,152.5
Other Non-Operating Inc. (Exp.)	3,594.0	20,140.0	23,981.7	25,778.5	25,778.5
Impairment of Goodwill	-	-	-	-	-
Gain (Loss) On Sale Of Invest.	-	-	-	-	-
Gain (Loss) On Sale Of Assets	-	-	-	-	-
Income Tax Expense	(10,193)	(15,744)	(15,580)	(28,673)	(39,717)
Minority Int. in Earnings	(352)	(961)	(1,257)	327	410
Net Income	41,095	71,510	86,483	106,368	133,375
Growth yoy%	n.a.	74.0%	20.9%	23.0%	25.4%

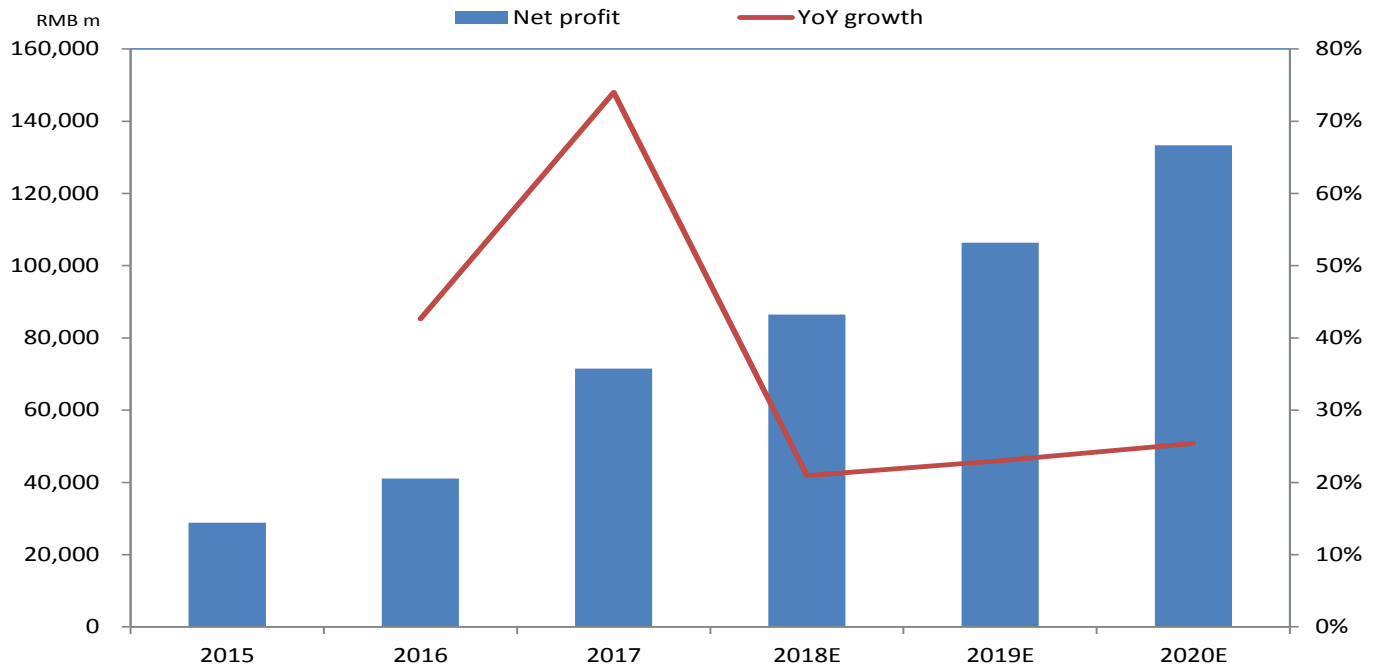
Balance Sheet (RMB m)	FY2016	FY2017	FY2018F	FY2019F	FY2020F
ASSETS					
Cash And Equivalents	71,902	105,697	241,710	417,037	633,915
Receivables	10,152	16,549	21,805	29,904	39,044
Inventory	263	295	413	554	681
Other Current Assets	66,837	55,905	60,874	69,248	78,697
Total Current Assets	149,154	178,446	324,803	516,743	752,338
Net Property, Plant & Equipment	23,748	31,871	38,879	45,040	50,841
Long-term Investments	154,702	241,797	241,797	241,797	241,797
Other Intangibles	36,467	40,266	45,810	54,681	68,877
Deferred Tax Assets, LT	-	-	-	-	-
Other Long-Term Assets	31,828	62,292	57,133	57,133	57,133
Goodwill	-	-	-	-	-
Accounts Receivable Long-Term	-	-	-	-	-
Total Long Term Assets	246,745	376,226	383,619	398,651	418,647
Total Assets	395,899	554,672	708,422	915,395	1,170,985
LIABILITIES & EQUITY					
Accounts Payable	27,413	50,085	70,198	94,022	126,930
Accrued Exp.	-	-	-	-	-
Short-term Borrowings	12,278	15,696	20,681	28,363	37,032
Curr. Port. of LT Debt	-	-	-	-	-
Curr. Income Taxes Payable	-	-	-	-	-
Unearned Revenue, Current	-	-	-	-	-
Other Current Liabilities	61,506	85,959	112,579	156,768	208,107
Total Current Liabilities	101,197	151,740	203,458	279,154	372,069
Long-Term Debt	57,549	82,094	108,168	148,348	193,686
Def. Tax Liability, Non-Curr.	5,153	5,975	5,913	10,882	15,073
Other Non-Current Liabilities	45,753	37,770	34,805	23,690	12,711
Total Liabilities	209,652	277,579	352,344	462,073	593,539
Common Stock	0	0	0	0	0
Additional Paid In Capital	-	-	-	-	-
Retained Earnings	174,624	256,074	333,801	431,373	555,908
Treasury Stock	-	-	-	0	0
Comprehensive Inc. and Other	-	-	-	-	-
Minority Interest	11,623.0	21,019.0	22,276.0	21,948.8	21,538.5
Total Equity	186,247	277,093	356,077	453,321	577,446
Total Liabilities And Equity	395,899	554,672	708,422	915,395	1,170,985

Cash Flow Statement (RMB m)	FY2016	FY2017	FY2018F	FY2019F	FY2020F
Net Income	41,095	71,510	104,771	136,469	175,600
Depreciation & Amort.	12,741	23,611	26,964	29,306	31,352
Change in Working Capital	10,967	23,663	34,505	41,832	56,799
Cash from Ops.	65,518	106,140	151,070	201,299	259,089
Capital Expenditure	(9,905)	(12,154)	(14,944)	(16,438)	(18,082)
Sale of Property, Plant, and Equipment	-	-	-	-	-
Change in Investing Activities	(61,018)	(84,238)	(23,926)	(50,925)	(71,920)
Cash from Investing	(70,923)	(96,392)	(38,869)	(67,363)	(90,002)
Net increase in bank borrowings	37,464	29,012	32,569	50,187	56,631
Issuance of Common Stock	225	171	0	0	0
Common Dividends Paid	(4,606)	(5,998)	(8,756)	(8,797)	(8,839)
Special Dividend Paid	-	-	-	-	-
Other Financing Activities	(1,640)	3,413	0	0	0
Cash from Financing	31,443	26,598	23,813	41,391	47,791
Net Change in Cash	26,038	36,346	136,014	175,327	216,879

Ratios	FY2016	FY2017	FY2018F	FY2019F	FY2020F
Profitability					
Return on Assets %	11.7%	15.0%	13.7%	13.1%	12.8%
Return on Capital %	20.2%	16.6%	14.7%	14.6%	15.2%
Return on Equity %	27.9%	33.2%	29.3%	27.8%	27.0%
Margin Analysis					
Gross Margin %	55.6%	49.2%	45.9%	47.2%	45.4%
SG&A Margin %	22.8%	21.3%	21.5%	22.4%	19.5%
EBIT Margin %	32.8%	27.9%	24.5%	24.8%	25.9%
EBITDA Margin %	41.2%	37.7%	33.1%	31.6%	31.5%
Net Income Margin %	27.0%	30.1%	27.6%	24.8%	23.8%
Asset Turnover					
Total Asset Turnover	0.4x	0.4x	0.4x	0.5x	0.5x
Fixed Asset Turnover	6.4x	7.5x	8.1x	9.5x	11.0x
Accounts Receivable Turnover	17.7x	17.8x	16.3x	16.6x	16.3x
Inventory Turnover	577.7x	806.0x	757.7x	775.8x	823.7x
Liquidity					
Current Ratio	1.5x	1.2x	1.6x	1.9x	2.0x
Quick Ratio	1.3x	1.0x	1.5x	1.7x	1.9x
Avg. Days Sales Out.	24.4	25.4	25.4	25.4	25.4
Avg. Days Inventory Out.	0.6	0.5	0.5	0.5	0.4
Avg. Days Payable Out.	116.7	117.0	129.6	132.1	131.7
Avg. Cash Conversion Cycle	-40.0	-50.6	-55.5	-53.6	-56.4
Net Debt to Equity	0%	0%	0%	0%	0%
Growth Over Prior Year					
Total Revenue	56.5%	31.8%	37.1%	30.6%	29.9%
Net Income	42.7%	74.0%	20.9%	23.0%	25.4%
Payout Ratio %	11.2%	8.4%	8.4%	6.4%	5.0%

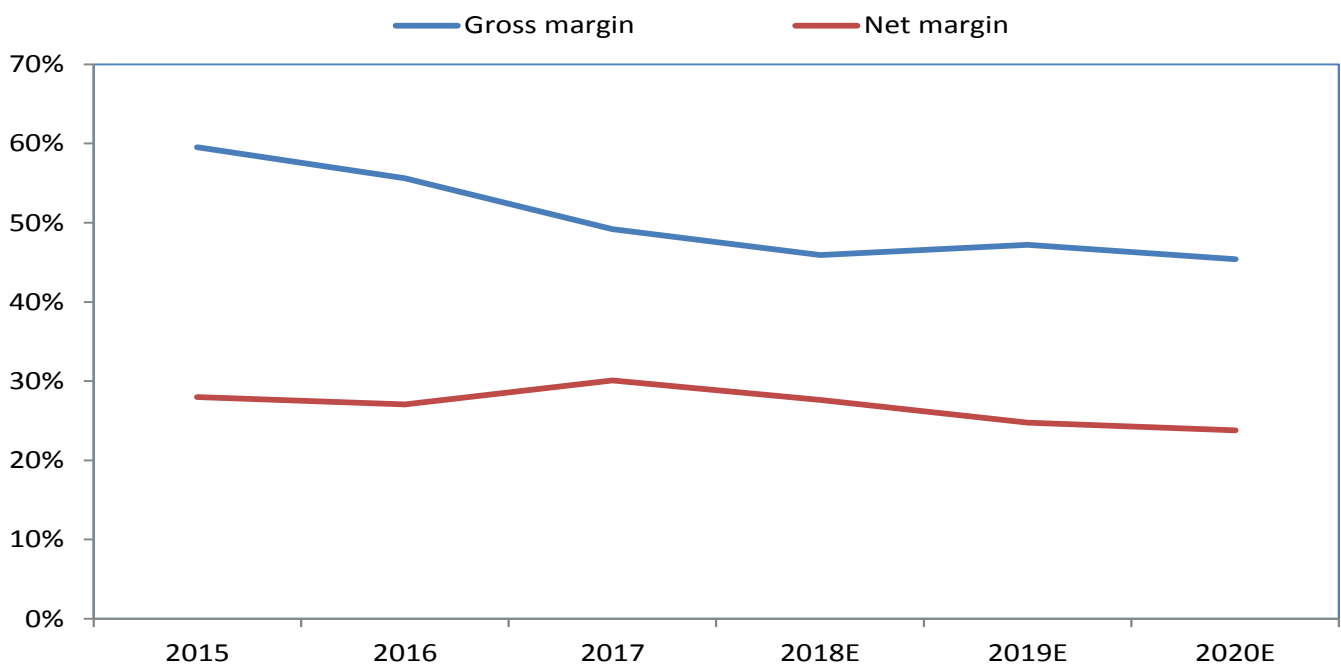
Source: Company data, CGIHK Research estimates

Figure 26: Tencent's net profit growth

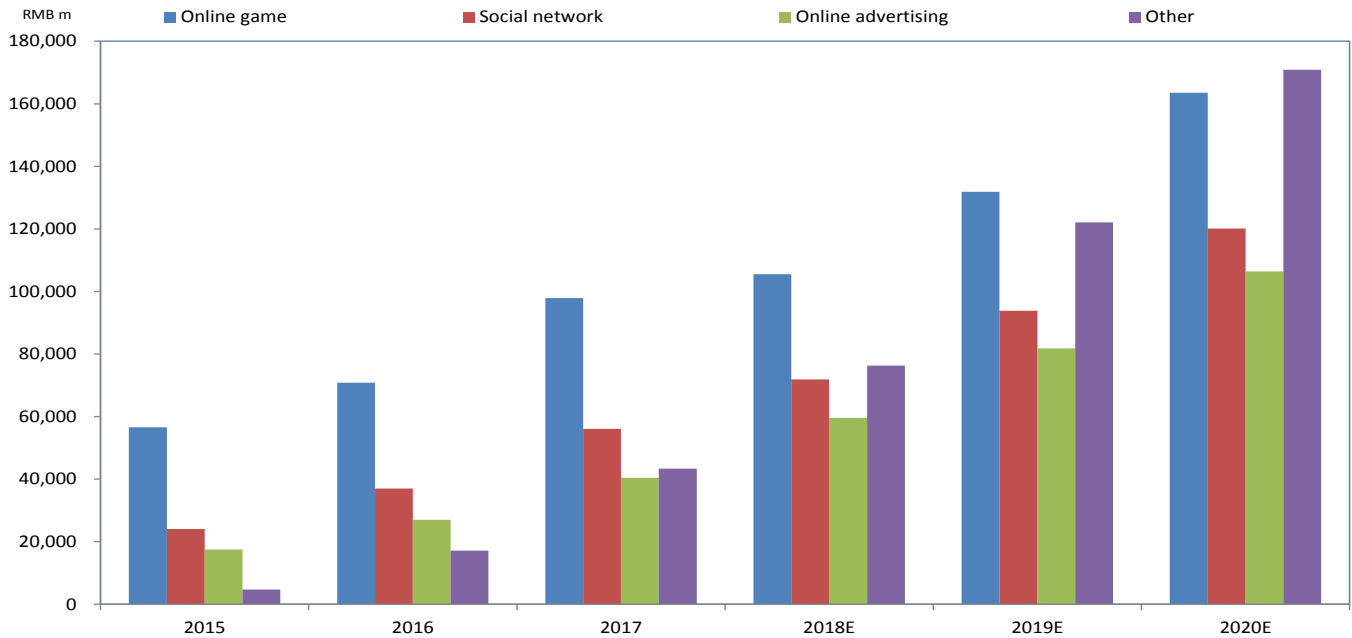


Sources: Company data, CGIS Research

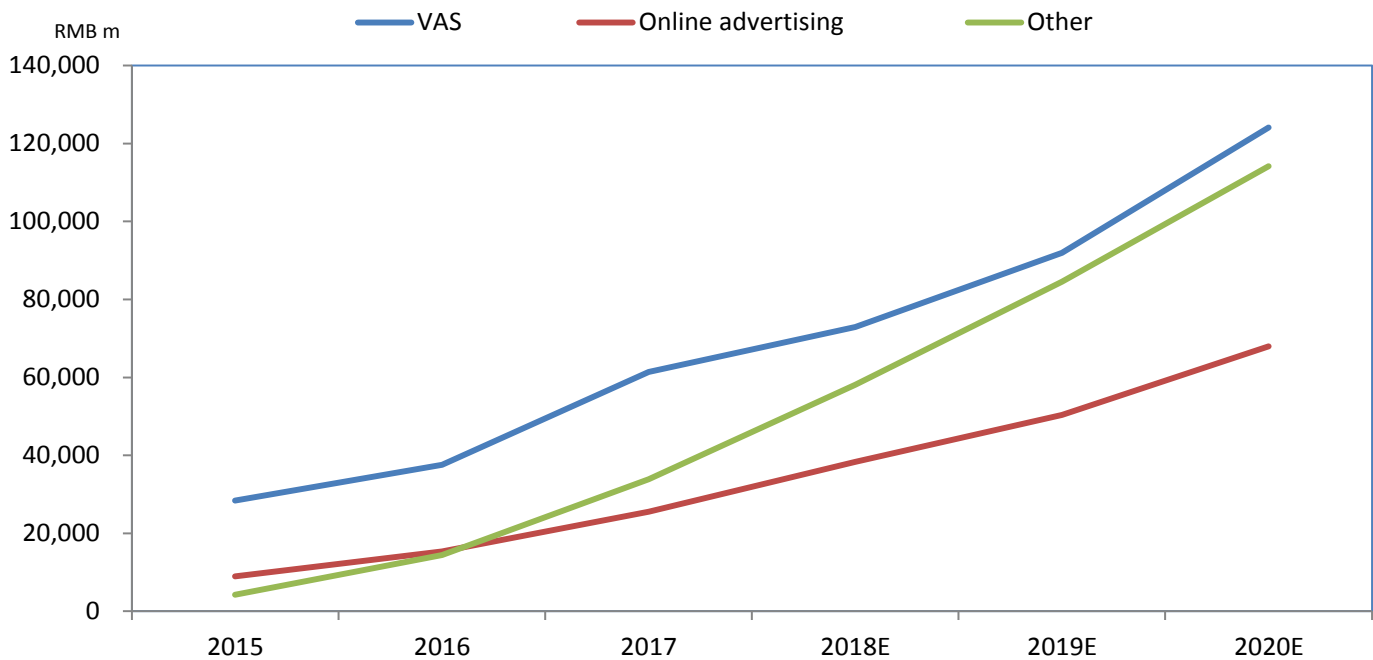
Figure 27: Tencent's margin performance



Sources: Company data, CGIS Research

Figure 28: Revenue projections by business


Sources: iResearch, CGIS Research

Figure 29: Revenue projections by segment


Sources: iResearch, CGIS Research

Valuation

Initiate coverage with a BUY rating and target price of HK\$341.9

We initiate coverage on Tencent because a) it is the largest online gaming company in the world in terms of revenue; and b) it maintains a leading position in various industries in China, such as online video, payment services and cloud computing. We set a target price of HK\$341.9, which implies upside of 25.6% from the closing price of HK\$272.2 on Nov 14, 2018.

Our 5-year DCF model projects a target price of HK\$341.9 for Tencent with a WACC of 9.0% and terminal growth rate of 3%. Please refer to the following table for a detailed breakdown of our DCF model.

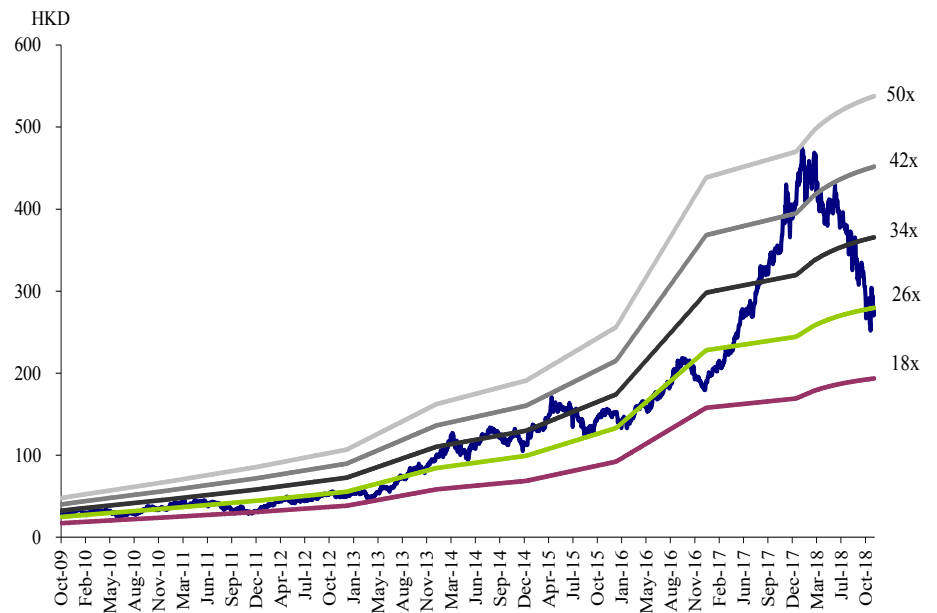
Figure 30: Key Numbers for DCF Model

HK\$ (m)	2017	2018E	2019E	2020E	2021E	2022E
Operating Profit	90,302	104,771	136,469	175,600	204,568	261,344
Interest Income	(3,940)	(4,074)	(3,963)	(4,488)	(5,827)	(7,688)
Other gains	(20,140)	(23,982)	(25,778)	(25,778)	(25,778)	(25,778)
Depreciation	4,850	8,233	10,575	12,621	14,526	16,398
Amortization	18,622	18,622	18,622	18,622	18,622	18,622
Share-based compensation	6,253	6,253	6,253	6,253	6,253	6,253
EBITDA	95,947	109,824	142,178	182,829	212,363	269,150
Change in WC	(23,663)	(34,505)	(41,832)	(56,799)	(76,374)	(95,218)
Capex	(14,643)	(14,944)	(16,438)	(18,082)	(19,890)	(21,879)
Tax	(15,744)	(15,580)	(28,673)	(39,717)	(44,363)	(56,853)
FCF	41,897	44,795	55,235	68,232	71,737	95,199
NPV of FCF		275,484	251,556	214,079	159,039	182,502
Discounted value		269,409	225,601	176,066	119,921	126,168
Terminal value						2,087,026
Explicit Forecasts		917,164				
Terminal Valuation		2,087,026				
Total Expected Operating Value		<u>3,004,191</u>				
Bank & Other Debt		102,542				
Minorities		<u>21,019</u>				
Total Value Attributable to Equity Holders		2,880,630				
Value Per Share (HK\$)		341.9				
Risk free rate		3.7%				
Beta		1.27				
Risk Premium		7.1%				
Cost of equity		12.7%				
Cost of debt		4.3%				
WACC		9.0%				
Terminal growth rate		3.0%				

Sources: Company data, CGIS Research

Currently, Tencent is trading at FY19E/20E PER of 23.1x/18.1x. Our target price implies a FY19E/20E PER of 27.1x/21.7x, lower than its historical mean. We believe this premium is justified because of a) continued strong growth in Tencent's other business, like online advertising, payment services and online video services; and b) its projected earning's CAGR of 23.1% from 2017 to 20120E.

Figure 31: Historical PER Band



Sources: Bloomberg, CGIS Research

Despite Tencent's already large business scale, the Company looks interesting, given its a) dominant position in China's online gaming industry; b) exposure to various market-focusing segments other than online games, including online advertising, online video, payment services and cloud computing; and c) large traffic from Weixin/Wechat, QQ, and its invested companies like JD.com, Meituan Dianping and Pinduoduo.

Figure 32: Peer comparison

TMT non-hardware Ticker	Company	Price	Market Cap US\$M	PE		P/B		P/S		P/B		ROE		ROA		Div yield		Share Price Performance			
				2018F	2019F	2018F	2019F	2017	2018F	2017	2018F	2017	2018F	2017	2018F	1M	3M	6M	YTD		
HK Listed IT Services & Internet Names																					
IT Services	Kingdee International Srvr	7.26	3,056	55.6	42.4	7.5	6.1	4.0	4.4	8.3	8.2	5.8	5.5	0.2	0.2	2.5	-28.3	-10.7	65.0		
	1297 HK	2.26	353	9.3	7.7	3.4	2.9	2.1	1.8	20.7	18.8	17.8	15.7	1.4	1.6	11.9	-18.1	-33.7	2.7		
	354 HK	4.60	1,427	14.0	11.2	0.9	0.8	1.8	1.7	12.0	13.6	8.1	8.2	0.4	0.4	9.8	-19.7	-30.3	-11.1		
	596 HK	3.70	538	14.8	12.3	1.8	1.5	1.6	n.a.	5.9	12.4	8.5	n.a.	0.8	n.a.	18.6	38.1	27.1	72.9		
	881 HK	3.84	623	19.2	15.1	0.4	0.4	0.3	n.a.	-5.7	3.3	0.7	1.1	0.0	0.7	-0.5	-0.5	-19.3	-27.7		
	856 HK	3.98	744	6.4	5.5	0.1	0.1	1.2	1.1	16.5	17.3	4.3	3.7	5.0	2.6	3.6	-1.6	-1.6	-17.4		
	1588 HK	8.09	224	18.9	18.0	3.3	3.0	1.2	1.3	22.1	7.0	16.1	6.5	0.0	0.0	-8.6	-29.0	-35.2	-27.9		
	763 HK	15.30	11,300	n.a.	13.9	0.9	0.8	2.6	1.8	15.7	-15.7	-3.8	-3.6	2.4	0.0	31.7	12.2	-40.2	-47.5		
	434 HK	1.66	155	n.a.	n.a.	n.a.	n.a.	0.5	n.a.	11.5	n.a.	10.3	n.a.	0.0	n.a.	3.1	-1.1	-4.7	-48.8		
Game Developer & Social Netw orking	Sinca Vision Worldwide Holdn	0.44	158	n.a.	n.a.	n.a.	n.a.	0.7	n.a.	-0.9	n.a.	4.4	n.a.	0.0	n.a.	1.1	-8.3	-6.7	-8.6		
	3886 HK	12.14	2,129	47.5	15.0	2.6	1.9	1.1	1.2	32.1	2.7	14.0	1.8	n.a.	0.8	-4.1	-7.9	-51.7	-53.3		
	8899 HK	0.73	102	n.a.	n.a.	n.a.	n.a.	0.6	n.a.	-1.8	n.a.	-15.9	n.a.	0.0	n.a.	-2.7	-6.4	-41.6	-72.0		
	8287 HK	0.69	32	n.a.	n.a.	n.a.	n.a.	0.4	n.a.	-34.9	n.a.	-28.2	n.a.	0.0	n.a.	4.5	-13.8	-23.3	-56.9		
	2100 HK	0.44	158	n.a.	n.a.	n.a.	n.a.	0.7	n.a.	10.6	n.a.	7.8	n.a.	12.2	n.a.	-0.9	-6.3	-21.6	-25.0		
	799 HK	9.25	1,514	7.6	6.8	1.9	1.7	5.9	4.0	73.4	62.8	51.3	47.8	3.4	6.1	5.0	-7.4	-25.8	9.6		
	484 HK	5.95	104	n.a.	n.a.	n.a.	n.a.	0.9	n.a.	6.8	n.a.	-13.9	n.a.	0.0	n.a.	-11.1	-22.3	-51.1	-45.5		
	1980 HK	4.09	662	12.1	12.1	n.a.	n.a.	1.6	n.a.	12.2	n.a.	14.0	n.a.	1.6	n.a.	2.8	-16.9	-41.7	-33.6		
	543 HK	1.05	152	n.a.	n.a.	n.a.	n.a.	1.2	n.a.	10.6	n.a.	7.8	n.a.	12.2	n.a.	-0.9	-6.3	-21.6	-25.0		
	700 HK	272.20	330,845	28.2	23.0	7.2	5.5	7.8	6.9	33.2	26.1	14.4	13.2	0.3	0.4	-5.6	-21.9	-33.9	-33.0		
	1357 HK	4.20	2,240	n.a.	n.a.	4.0	3.7	3.2	3.1	-3.4	-11.4	-13.0	-10.4	0.0	0.0	-9.5	-23.1	-49.8	-61.4		
	777 HK	14.28	968	48.9	24.9	1.4	1.2	1.5	1.4	-0.5	3.7	-0.4	3.0	6.4	1.0	7.5	0.3	-28.0	-34.2		
	8086 HK	0.12	48	n.a.	n.a.	n.a.	n.a.	1.7	n.a.	-27.8	n.a.	-19.9	n.a.	0.0	n.a.	-19.1	-50.8	-50.8	-52.7		
	2022 HK	0.29	73	n.a.	n.a.	n.a.	n.a.	1.5	n.a.	5.7	n.a.	3.8	n.a.	0.0	n.a.	-71.8	-73.4	-76.3	-75.6		
	797 HK	1.42	483	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	61.9	n.a.	28.2	n.a.	0.0	n.a.	1.4	4.4	n.a.	n.a.		
	6860 HK	1.45	370	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	48.5	n.a.	31.8	n.a.	n.a.	n.a.	-38.8	-41.3	n.a.	n.a.		
Online-entertainment	5100 HK	29.70	1,879	110.8	36.7	7.3	6.0	4.0	4.5	41.0	5.4	11.0	4.3	0.3	0.3	29.1	1.4	17.4	n.a.		
	751 HK	1.88	735	4.5	3.6	0.1	0.1	0.3	0.3	8.6	6.9	1.1	2.6	4.8	8.2	-8.3	-34.3	-48.4	-44.0		
	1070 HK	3.27	975	8.0	6.9	0.2	0.1	0.8	0.9	11.6	11.0	5.6	3.2	3.0	4.1	-3.0	-9.7	-13.0	-13.0		
	1280 HK	0.36	115	n.a.	n.a.	n.a.	n.a.	1.6	n.a.	n.a.	n.a.	-20.9	n.a.	0.0	n.a.	0.0	0.0	0.0	-53.9		
	82 HK	0.27	115	n.a.	n.a.	n.a.	n.a.	0.4	n.a.	-22.0	n.a.	-11.6	n.a.	0.0	n.a.	-43.8	-48.6	-28.6	-28.6		
	772 HK	43.40	5,666	36.2	24.9	7.6	5.5	2.6	2.3	6.3	6.7	7.1	5.5	n.a.	3.1	-0.2	-21.9	-37.2	-47.9		
	3700 HK	2.18	574	5.1	4.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-10.6	n.a.	n.a.	n.a.	-8.8	-0.9	n.a.	n.a.		
E-commerce	3690 HK	56.90	39,896	n.a.	n.a.	4.3	2.8	n.a.	7.1	n.a.	-96.9	-28.0	-8.9	0.0	n.a.	-4.0	n.a.	n.a.	n.a.		
	453 HK	0.93	1,899	63.7	20.6	0.7	0.2	0.2	0.2	4.7	0.2	0.6	0.8	0.0	0.0	-0.6	-0.6	-26.6	-26.6		
	400 HK	2.92	547	n.a.	n.a.	n.a.	n.a.	1.0	n.a.	8.4	n.a.	3.9	n.a.	0.0	n.a.	10.6	7.7	-23.2	-29.6		
	2280 HK	4.85	694	13.3	9.8	0.5	0.3	1.2	1.0	8.1	7.7	5.1	4.2	0.0	0.0	7.1	2.1	-8.0	-15.4		
	8085 HK	0.49	941	n.a.	54.4	7.4	3.2	n.a.	1.1	-16.7	-9.3	n.a.	n.a.	0.0	n.a.	3.0	-41.0	-41.0	14.0		
	1060 HK	1.13	3,677	n.a.	n.a.	n.a.	n.a.	1.1	n.a.	-60.0	n.a.	-5.2	n.a.	0.0	n.a.	13.0	27.0	20.2	7.6		
	847 HK	0.11	364	n.a.	n.a.	n.a.	n.a.	1.8	n.a.	-43.7	n.a.	-25.6	n.a.	0.0	n.a.	7.0	-10.1	-33.5	-38.5		
Average				25.6	18.7	3.2	2.3	3.2	2.5	8.2	3.7	1.8	5.4	1.2	1.8	-2.5	-12.1	-28.3	-24.3		
300253 CH	Winning Health Technology-A	14.00	3,254	70.7	52.2	14.2	10.7	7.6	7.6	9.3	10.9	7.8	8.1	n.a.	0.3	14.3	4.5	18.1	106.6		
300168 CH	Beijing Orient National A	12.39	1,883	23.4	18.4	6.7	5.3	2.8	2.6	10.3	11.1	9.1	10.5	1.7	10.7	16.9	-11.5	-13.7	-1.3		
600588 CH	Yonyou Net Technology-A	25.45	7,014	72.5	52.7	5.9	4.7	7.9	7.5	6.7	10.7	6.0	5.2	n.a.	0.7	12.3	-10.1	-9.7	56.4		
300271 CH	Beijing Thomson Corp Ltd-A	14.28	1,552	22.1	17.5	3.8	3.1	2.7	2.6	13.9	11.9	9.4	8.9	n.a.	0.5	19.4	-14.5	-19.6	-4.0		
600410 CH	Beijing Orient National Technology-A	6.50	1,031	n.a.	n.a.	n.a.	n.a.	1.5	n.a.	4.7	n.a.	0.7	n.a.	0.0	n.a.	11.7	-22.2	-49.9	-38.2		
600718 CH	Neusoft Corp-A	11.63	2,079	29.1	24.2	1.9	1.7	1.6	1.5	12.7	5.0	8.2	3.0	n.a.	0.7	19.3	-10.3	-18.2	-20.7		
000097 CH	Inspur Electronic Informat-A	19.82	3,676	38.0	27.0	0.6	0.5	3.3	3.2	7.6	8.3	2.6	2.5	n.a.	0.3	-3.2	-28.2	-14.1	-0.3		
300290 CH	Bingrispring Science And Te-A	6.43	313	n.a.	n.a.	n.a.	n.a.	2.5	n.a.	2.4	n.a.	1.4	n.a.	n.a.	n.a.	32.6	-7.5	-4.6	-21.9		
000503 CH	Yigong Information Technology-A	5.95	727	30.7	23.7	1.5	1.4	1.5	1.4	9.1	11.4	5.1	4.9	n.a.	1.8	7.8	-3.7	-5.1	-21.6		
000555 CH	Digital China Information -A	10.80	1,497	20.4	23.5	1.1	1.0	2.0	1.9	6.4	9.6	4.9	4.5	n.a.	0.5	8.0	-12.3	-23.3	-8.1		
300144 CH	Songfeng Performance Deve-A	22.74	4,751	24.3	21.1	9.6	9.4	3.0	3.9	15.5	16.2	14.2	14.5	n.a.	0.7	6.8	-10.4	9.1	21.9		
300431 CH	Baofeng Group Co Ltd-A	10.66	505	22.7	17.2	1.6	1.4	4.0	2.8	5.6	13.4	-7.6	-1.9	n.a.	n.a.	18.4	-6.2	-51.8	-51.1		
000576 CH	Zhejiang Sunway Culture-A	4.75	443	n.a.	n.a.	n.a.	n.a.	1.5	n.a.	4.9	n.a.	3.8	n.a.	0.0	n.a.	11.7	-9.7	-15.9	-43.7		
002292 CH	Alpha Group-A	6.35	1,240	27.5	19.7	2.6	2.2	1.5	1.6	1.9	5.5	-1.8	4.1	n.a.	0.1	21.9	-15.3	-46.8	-55.6		
002127 CH	Nanj E-Commerce Co Ltd-A	8.09	2,857	23.0	16.4	7.2	5.4	5.9	2.3	23.5	23.8	23.5	18.4	n.a.	0.4	25.4	2.9	-21.5	-0.5		
600652 CH	Shanghai UI Game Co Ltd-A	4.70	563	n.a.	n.a.	n.a.	n.a.	2.3	n.a.	-21.7	n.a.	-21.2	n.a.	n.a.	n.a.	26.0	-6.9	-25.0	-35.4		
600533 CH	Zhejiang Daily Digital Cui-A	8.56	1,603	34.3	32.6	1.9	1.8	1.4	1.5	23.1	11.4	5.1	4.9	n.a.	1.8	7.8	-3.7	-5.1	-21.6		
002188 CH	Bus Online Co Ltd-A	3.90	166	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-193.5	n.a.	-174.7	n.a.	n.a.	n.a.	41.3	18.2	-13.7	-75.3		
300418 CH	Beijing Kunlun Tech Co Ltd-A	14.94	2,475	13.4	11.3	3.8	3.2	2.9	2.4	16.8	24.1	13.5	14.5	n.a.	2.0	20.2	-14.4	-31.6	-27.4		
300017 CH	Wangsu Science & Technology Co Ltd-A	8.34	2,919	22.0	17.9	3.1	2.5	2.4	2.3	10.9	10.9	8.2	8.7	n.a.	0.6	12.4	-16.8	-32.6	-21.6		
002624 CH	Parfact World Co Ltd-A	25.38	4,800	18.2	15.0	3.7	3.1	4.1	3.5	19.8	19.4	10.9	10.6	n.a.	0.7	20.6	-6.7	-29.3	-24.1		
002555 CH	Wuhu Shunrong Sanqi Inter-A	12.52	3,827	15.4	13.1	3.7	3.4	4.3	3.2	28.1	21.5	18.1	17.0	n.a.	1.1	31.0	19.4	-9.9	-39.0		
002174 CH	Youzu Interactive Co Ltd-A	16.99	2,171	15.8	13.1	4.0	3.3	3.7	3.1	19.4	19.5	13.6	14.1	n.a.	0.7	20.2	0.5	-22.7	-23.8		
600373 CH</																					

Major Risk Factors

- **Potential risks from the political and economic environment.** Most of Tencent's operations are conducted in China, and most of its revenue is generated in China. Accordingly, Tencent's results of operations, financial condition and prospects depend to a significant degree to the economic, political and legal developments in the PRC. Adverse changes in the political and economic policies of the PRC government could have a material adverse effect on the overall economic growth of China, which could reduce demand for Tencent's services and adversely affect its business and results of operations.
- **Potential risks from a slowdown in the Chinese economy.** Tencent's financial results have been, and are expected to continue to be, affected by the growth in the Chinese economy and the Internet and telecommunications industries. Although the Chinese economy has experienced significant growth in the past decade, there can be no assurance that this growth will continue at the current rate or at all. The Company's revenue is affected by the overall Chinese economy, since spending on Internet and telecommunications value-added services are likely to decrease in a slowing economy.
- **Potential risks from the regulation of the online game market in China.** Tencent's operations are generally subject to the laws and regulations of the PRC. The online game business is currently the major revenue source for Tencent, and the Company requires government approval to monetize its games. However, since the government authorities stopped issuing licenses for new games at the end of March this year and there is no clear schedule for resuming the approval process, Tencent's online game business will be further impacted.
- **Potential risk of some online games business activities being deemed to be in violation of the law.** Although Tencent believes that once it obtains the relevant licenses, permits and approvals to conduct its online games business, that its business will be in compliance with current PRC laws and regulations, and that the Company has been advised by its PRC counsel that such business will not be in violation of any officially promulgated PRC laws and regulations upon obtaining such relevant licenses, permits and approvals, there can be no assurance that the MII or another government authority will not interpret existing laws, regulations or policies in such a way, or implement new laws, regulations or policies, that would require the Company to cease or modify the Company's online games business to avoid any violation of PRC laws or regulations.

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