

Tencent Holdings (700.HK)

Commercialization of Wechat will be major investment driver in the future



Phillip

Bloomberg | Reuters | POEMS

Phillip Securities Research

700.HK | 700.HK | 700.HK

Sector: Internet

08 Apr, 2014

Strategic Analysis

Rating : Buy Closing Price : 501.50 TP : 680

Summary

In 2013, the total revenue of Tencent reached RMB 60.44 billion, increasing by 37.7% on year-on-year basis. Therein, the income of value-added service increased to RMB 44.99 billion by 25.9% on a year-on-year basis, accounting for 74.4% of the total revenue of the group during this period, which mainly benefited from the income growth by major games and new games independently developed at home and abroad. During this period, the revenue of network advertisement increased to RMB 5.03 billion by 48.8% on a year-on-year basis, which mainly benefited from the significant growth of advertisements for social network effect and internet video as well as stable growth of advertisements for traditional brand exhibition. Moreover, during this period, the revenue of E-commerce trade increased to RMB 9.8 billion by 1.2 times on year-on-year basis.

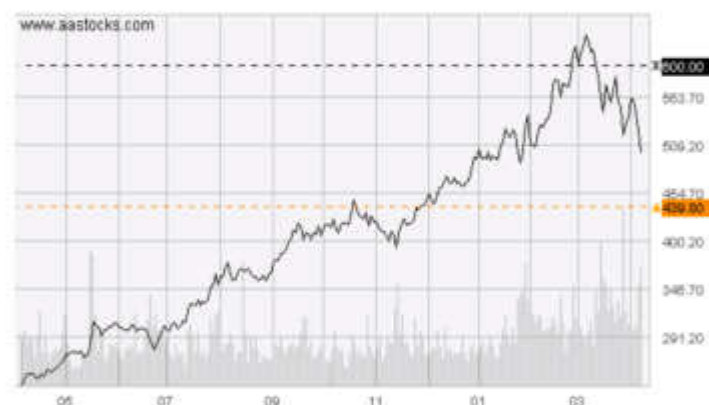
During this period, the gross profit increased to RMB 32.66 billion by 27.1% on a year-on-year basis, while the gross profit margin decreased to 54% from 58.5% of last year. The operating profit increased to 19.19 billion RMB by 24% on a year-on-year basis, while the profit for shareholders increased to 15.5 billion RMB by 21.8% on a year-on-year basis, with the earnings per share of 8.464 RMB. The profit margin decreased to 25.6% from 29% in the same period of last year.

By the end of 2013, the monthly active account of Tencent QQ increased to 808 million users by 1.2% on a year-on-year basis, while the consolidated monthly active account for both Wechat (domestic version) and WeChat (international version) greatly increased to 355 million users by 1.21 times on a year-on-year basis. The registered account of charging value-added service decreased to 88.60 million users by 15.2% on a year-on-year basis, which mainly resulted from that some users, who turned to use smart phones and continued to use basic services of the group (such as QQ and Qzone), reduced to use charging services.

Benefiting from the powerful performance of several major games in domestic market, League of Legends in global market and Blade & Soul newly launched in domestic market, Tencent's online game business still realized the growth of 34% on a year-on-year basis in 2013, reaching RMB 31.97 billion. Under the circumstance of overall slowdown for the growth of online game, it is rare and commendable. Moreover, the game center of mobile platform has launched a series of independently developed and third-party games, whose contribution to the revenue has exceeded RMB 600 million in the fourth quarter. Taking the circumstance that several hot games have been launched in the fourth quarter in 2013 and the first quarter in 2014 into consideration, the revenue of mobile game platform in the first quarter of 2014 is expected to increase significantly.

TENCENT

Rating	1.00	Buy
- Previous Rating	n.a.	Not Rated
Target Price (HKD)	680.00	
- Previous Target Price (HKD)	n.a.	
Closing Price (HKD)	501.50	
Expected Capital Gains (%)	35.6%	
Expected Dividend Yield (%)	0.2%	
Expected Total Return (%)	35.8%	
Raw Beta (Past 2yrs weekly data)	1.04	
Market Cap. (HKD mn)	9,349	
Enterprise Value (HKD mn)	694,627	
52 week range (HKD)	239-646	
Closing Price in 52 week range		



Key Financial Summary

FYE	12A	13A	14E	15E
Revenue (RMB mn)	43,893	60,437	79,862	101,265
Net Profit, adj. (RMB mn)	12,732	15,502	23,300	31,315
EPS, adj. (RMB)	6.97	8.46	12.50	16.80
P/E (X), adj.	28.58	45.60	42.98	31.98
BVPS (RMB)	22.28	31.12	40.48	47.52
P/B (X)	8.94	12.40	13.27	11.30
DPS (RMB)	0.80	0.94	1.10	1.30
Div. Yield (%)	0.40%	0.24%	0.20%	0.24%

Source: Bloomberg, Tencent

*All multiples & yields based on current market price

Valuation Method

P/E

Chen Geng
chengeng@phillip.com.cn
 +8621 63512937-107

In our opinion, the application of Wechat in mobile game platform, mobile payment and O2O commercialization will be core driving forces for the future growth. Therein, the monetization of mobile game platform business has taken shape basically. It is expected that the net income of mobile game will reach 7.8 billion RMB in 2014, and the market share of mobile game will reach 45%. While mobile payment will focus on the breakthrough of policy restriction and the layout of business development. In 2014, O2O monetization of mobile terminal represents the process of integrating Tencent mobile terminal with various landing businesses, while the strategic cooperation with JD.COM and dianping.com reflects such a train of thought. O2O monetization will be an important weight for Tencent to keep the competitive edge in the industry, and an important driving force for its future share price as well.

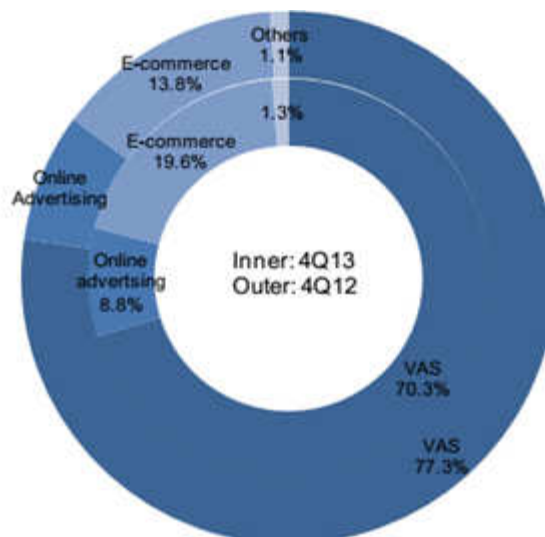
Tencent released an announcement regarding proposed share subdivision, which would increase the number of Share in issue, to enhance the liquidity in trading of Shares.

Tencent has significant advantage in Chinese Internet social platform, and it is one of the most excellent Internet companies in China. Better business models and more diversified Wechat services will support the monetization of mobile terminal, which will become the major driving force for the future share price. Based on the new upsurge of Internet application and favorable expectation on the development prospect of Tencent, we give Tencent Holdings the rate of "Buy", with the target price of 680 HKD for 12 months, which amounts to 43 times and 32 times of expected P ratio in 2014 and 2015 respectively.

Brief Comment on Performance in 2013

In 2013, the total revenue of Tencent reached RMB 60.44 billion, increasing by 37.7% on year-on-year basis. Therein, the income of value-added service increased to RMB 44.99 billion by 25.9% on a year-on-year basis, accounting for 74.4% of the total revenue of the group during this period, which mainly benefited from the income growth by major games and new games independently developed at home and abroad. During this period, the revenue of network advertisement increased to RMB 5.03 billion by 48.8% on a year-on-year basis, which mainly benefited from the significant growth of advertisements for social network effect and internet video as well as stable growth of advertisements for traditional brand exhibition. Moreover, during this period, the revenue of E-commerce trade increased to RMB 9.8 billion by 1.2 times on year-on-year basis.

Figure1, Revenue contributions from different business in 4Q2012 and 4Q2013



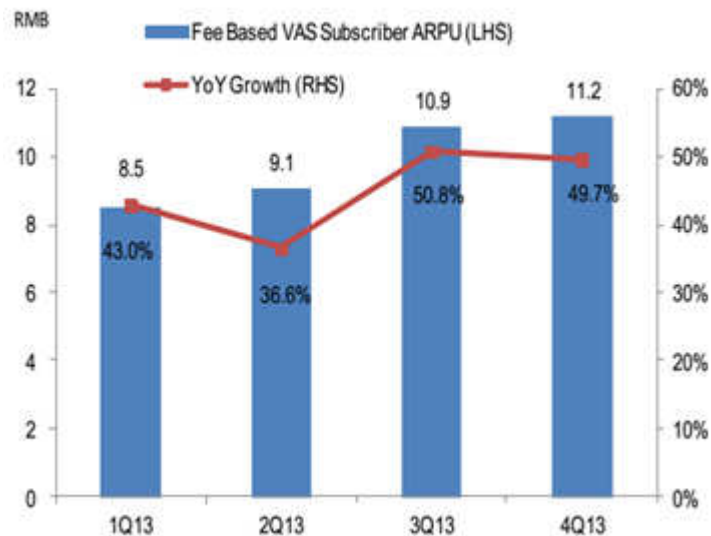
Source, Company Data

During this period, the gross profit increased to RMB 32.66 billion by 27.1% on a year-on-year basis, while the gross profit margin decreased to 54% from 58.5% of last year. The operating profit increased to 19.19 billion RMB by 24% on a year-on-year basis, while the profit for shareholders increased to 15.5 billion RMB by 21.8% on a year-on-year basis, with the earnings per share of 8.464 RMB. The profit margin decreased to 25.6% from 29% in the same period of last year.

By the end of 2013, the monthly active account of Tencent QQ increased to 808 million users by 1.2% on a year-on-year basis, while the consolidated monthly active account for both Wechat (domestic version) and WeChat (international version) greatly increased to 355 million users by 1.21 times on a year-on-year basis. The registered account of charging value-added service decreased to 88.60 million users by 15.2% on a year-on-year basis, which mainly resulted from that some users, who turned to use smart phones and continued to use basic services of the group (such as QQ and Qzone), reduced to use charging services.

The growth of online game business is still powerful. Benefiting from the powerful performance of several major games in domestic market, League of Legends in global market and Blade & Soul newly launched in domestic market, Tencent's online game business still realized the growth of 34% on a year-on-year basis in 2013, reaching RMB 31.97 billion. Under the circumstance of overall slowdown for the growth of online game, it is rare and commendable. Moreover, the game center of mobile platform has launched a series of independently developed and third-party games, whose contribution to the revenue has exceeded RMB 600 million in the fourth quarter. Taking the circumstance that several hot games have been launched in the fourth quarter in 2013 and the first quarter in 2014 into consideration, the revenue of mobile game platform in the first quarter of 2014 is expected to increase significantly.

Figure2, ARPU and growth of VAS subscriber



Source, Company Data

The monetization of mobile terminal will be the major investment focus in 2014. In our opinion, the application of Wechat in mobile game platform, mobile payment and O2O commercialization will be core driving forces for the future growth. Therein, the monetization of mobile game platform business has taken shape basically. It is expected that the net income of mobile game will reach 7.8 billion RMB in 2014, and the market share of mobile game will reach 45%. While mobile payment will focus on the breakthrough of policy restriction and the layout of business development. In 2014, O2O monetization of mobile terminal represents the process of integrating Tencent mobile terminal with various landing businesses, while the strategic cooperation with JD.COM and dianping.com reflects such a train of thought. O2O monetization will be an important weight for Tencent to keep the competitive edge in the industry, and an important driving force for its future share price as well.

Table1, Major acquisition in 4Q2013 and 1Q2014

Time	Company
Mar 2014	15% Jingdong
Feb 2014	20% Dianping
Jan 2014	9.9% China South City Holding (1668 HK)
Dec 2013	Plain Vailla
June 2013	Snapchat
June 2013	Fab.com
Sept 2013	36.5% Sogu
May 2013	Kingsoft
April 2013	20% Didi Taxi apps

Source, Company Announcement

Proposed share subdivision. Tencent also released an announcement regarding proposed share subdivision, which would

increase the number of Share in issue, to enhance the liquidity in trading of Shares.

Risk:

- The growth of mobile game fails to realize the desired result;
- The progress of O2O landing fails to realize the desired result;
- Competitors race to control the market share;
- The policy restricts the mobile payment.

Valuation:

Tencent has significant advantage in Chinese Internet social platform, and it is one of the most excellent Internet companies in China. Better business models and more diversified Wechat services will support the monetization of mobile terminal, which will become the major driving force for the future share price. Based on the new upsurge of Internet application and favorable expectation on the development prospect of Tencent, we give Tencent Holdings the rate of "Buy", with the target price of 680 HKD for 12 months, which amounts to 43 times and 32 times of expected P ratio in 2014 and 2015 respectively.

FYE	FY12	FY13	FY14F	FY15F
Valuation Ratios				
P/E (X), adj.	28.58	45.60	42.98	31.98
P/B (X)	8.94	12.40	13.27	11.30
EV/EBITDA (X), adj.	33.27	38.89	24.99	19.12
Dividend Yield (%)	0.40%	0.24%	0.20%	0.24%
Per share data (RMB)				
EPS, reported	6.97	8.46	12.50	16.80
EPS, adj.	6.97	8.46	12.50	16.80
DPS	0.80	0.94	1.10	1.30
BVPS	22.28	31.12	40.48	47.52
Growth & Margins (%)				
Growth				
Revenue	54.03%	37.69%	32.14%	26.80%
Operating profit	26.33%	24.00%	44.74%	33.55%
EBT	24.40%	28.10%	42.82%	34.43%
Net Income, adj.	24.79%	21.76%	50.30%	34.40%
Margins				
Gross profit margin	58.52%	54.04%	54.20%	53.60%
Operating margin	35.27%	31.76%	34.79%	36.64%
Net profit margin	29.01%	25.65%	29.18%	30.92%
Key Ratios				
ROE (%)	36.50%	31.20%	30.88%	35.35%
ROA (%)	19.30%	17.00%	16.52%	18.30%
Net Debt/(Cash)	net cash	net cash	net cash	net cash
Net Gearing (X)	net cash	net cash	net cash	net cash
Income Statement (RMB mn)				
	FY12	FY13	FY14F	FY15F
Revenue	43,893	60,437	79,862	101,265
Cost of sales	(18,207)	(27,778)	(36,577)	(46,987)
Gross profit	25,686	32,659	43,285	54,278
Operating profit	15,479	19,194	27,782	37,102
EBT	15,051	19,281	27,538	37,019
Tax	(2,266)	(3,718)	(4,158)	(5,560)
Tax rate	15.06%	19.28%	15.10%	15.02%
Profit for the year	12,785	15,563	23,380	31,448
Minority interests	(53)	(61)	(80)	(133)
Net profit	12,732	15,502	23,300	31,315

Source: BLOOMBERG, Tencent and Phillip Securities

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within \pm 5% from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

GENERAL DISCLAIMER

This publication is prepared by Phillip Securities (Hong Kong) Ltd ("Phillip Securities"). By receiving or reading this publication, you agree to be bound by the terms and limitations set out below.

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

The information contained in this publication has been obtained from public sources which Phillip Securities has no reason to believe are unreliable and any analysis, forecasts, projections, expectations and opinions (collectively the "Research") contained in this publication are based on such information and are expressions of belief only. Phillip Securities has not verified this information and no representation or warranty, express or implied, is made that such information or Research is accurate, complete or verified or should be relied upon as such. Any such information or Research contained in this publication is subject to change, and Phillip Securities shall not have any responsibility to maintain the information or Research made available or to supply any corrections, updates or releases in connection therewith. In no event will Phillip Securities be liable for any special, indirect, incidental or consequential damages which may be incurred from the use of the information or Research made available, even if it has been advised of the possibility of such damages.

Any opinions, forecasts, assumptions, estimates, valuations and prices contained in this material are as of the date indicated and are subject to change at any time without prior notice.

This material is intended for general circulation only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. The products mentioned in this material may not be suitable for all investors and a person receiving or reading this material should seek advice from a financial adviser regarding the suitability of such products, taking into account the specific investment objectives, financial situation or particular needs of that person, before making a commitment to invest in any of such products.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any product described in this material is suitable or appropriate for the recipient. Recipients should be aware that many of the products which may be described in this publication involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Nothing in this report shall be construed to be an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in this research should take into account existing public information, including any registered prospectus in respect of such security.

Disclosure of Interest

Analyst Disclosure: Neither the analyst(s) preparing this report nor his associate has any financial interest in or serves as an officer of the listed corporation covered in this report.

Firm's Disclosure: Phillip Securities does not have any investment banking relationship with the listed corporation covered in this report nor any financial interest of 1% or more of the market capitalization in the listed corporation. In addition, no executive staff of Phillip Securities serves as an officer of the listed corporation.

Availability

The information, tools and material presented herein are not directed, intended for distribution to or use by, any person or entity in any jurisdiction or country where such distribution, publication, availability or use would be contrary to the applicable law or regulation or which would subject Phillip Securities to any registration or licensing or other requirement, or penalty for contravention of such requirements within such jurisdiction.

Information contained herein is based on sources that Phillip Securities (Hong Kong) Limited ("PSHK") believed to be accurate. PSHK does not bear responsibility for any loss occasioned by reliance placed upon the contents hereof. PSHK (or its affiliates or employees) may have positions in relevant investment products. For details of different product's risks, please visit the Risk Disclosures Statement on <http://www.phillip.com.hk>.

Contact Information (Regional Member Companies)

SINGAPORE

Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

HONG KONG

Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites: www.phillip.com.hk

INDONESIA

PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

THAILAND

Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website www.phillip.co.th

UNITED KINGDOM

King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

AUSTRALIA

PhillipCapital Australia
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96188238
Fax (613) 92002272
Website: www.phillipcapital.com.au

MALAYSIA

Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

JAPAN

PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website: www.phillip.co.jp

CHINA

Phillip Financial Advisory (Shanghai) Co. Ltd
No 436 Heng Feng Rd,
Greentech Tower Unit 604, Shanghai
Postal code 200070
Tel (86-21) 51699400
Fax (86-21) 63532643
Website: www.phillip.com.cn

FRANCE

King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED STATES

Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005