

Tencent (700 HK)

Moving into 2H19E game performance

SUMMARY. Tencent's 2Q19 result miss on already-low topline, despite margin beat. We think market will focus more on its game & ads trend, rather than earnings number. Stock price might see short term pressure on its soft ads outlook and unsurprising results. But in the long run, we keep positive on its game momentum and new business expansion. Potential game acceleration in 2H19E could be further catalyst. We cut revenue by 3%/4%/3% in FY19/20/21E but raised adj. net profit 2%/3%/2% in FY19/20/21E, to reflect ads headwinds but effective cost control. Our TP of **HK\$420** is unchanged. Maintain BUY.

- **2Q19 margin beat while topline miss.** 2Q19 revenue grew 21% YoY, 5% below consensus, mainly on soft ads revenue. Adj. EPS came out at 19% YoY, 3% above consensus, mainly on lighter-than-expected S&M expenses and non-operating income (~Rmb2.4bn).
- **Games: expecting stronger momentum in 2H19E.** 2Q19 games revenue grew 8% YoY, in which mobile/PC games +26%/-9% YoY. We believe mobile momentum has been well anticipated by the market, while PC games is lower than expectation. However, we suggest market to look beyond 2Q19 numbers, as we turn more positive on 2H19E mobile game recovery, mainly on: 1) solid *HoK* and *Peacekeeper Elite* with strong pipeline; 2) deferred revenue growth accelerated to 25% YoY (vs. +9% YoY in 1Q19); 3) new games launched in 2Q19 & 3Q19 to contribute more in 2H19E (e.g. *Peacekeeper Elite*, *JXIII*, *KartRider Rush*); and 4) low base in 2H18. We forecast its game revenue to grow 8% YoY in FY19E.
- **Ads headwind yet over.** 2Q19 ads revenue came in at 16% YoY, below already-low market expectation, for its weak media ads (-7% YoY) partly offset by solid social ads (+28% YoY). We expect challenging ads trend to continue in 2H19E, mainly on: 1) macro headwinds yet over; 2) increasing ads inventory from top newsfeed and short video (e.g. Toutiao, Douyin, Kuaishou); and 3) potential delay of costume drama series.
- **Maintain BUY.** Given its softer ads, we cut revenue by 3%/4%/3% in FY19/20/21E. However, Tencent guided disciplined cost control and slower M&A. To factor in its lighter expenses and higher other income, we lifted adj. net profit by 2%/3%/2% in FY19/20/21E. We keep our TP of HK\$420 unchanged, which is equivalent to 38x/31x FY19/20E P/E. Maintain BUY.

Earnings Summary

(YE 31 Dec)	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue (RMB mn)	237,760	312,694	380,642	474,648	586,376
YoY growth (%)	56.5	31.5	21.7	24.7	23.5
Net income (RMB mn)	65,126	75,044	92,905	112,677	138,976
Adj. EPS (RMB)	6.9	7.9	9.7	11.8	14.5
YoY growth (%)	43.1	14.6	23.7	21.2	23.1
P/E (x)	43.6	38.1	30.8	25.4	20.6
P/B (x)	10.3	8.1	6.3	5.0	4.0
Yield (%)	0.0	0.0	0.0	0.0	0.0
ROE (%)	31.8	26.7	27.0	26.1	25.7
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, CMBIS estimates

BUY (Maintain)

Target Price	HK\$420
(Previous TP	HK\$420)
Up/Downside	+23.5%
Current Price	HK\$340

China Internet Sector

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Stock Data

Mkt Cap (HK\$ mn)	3,248,757
Avg 3 mths t/o (HK\$ mn)	5,590
52w High/Low (HK\$)	400/251
Total Issued Shares (mn)	9,555
Source: Bloomberg	

Shareholding Structure

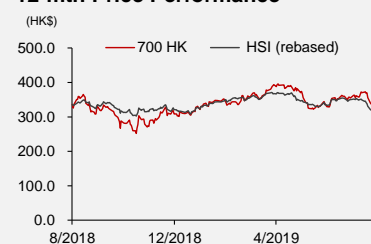
Naspers	31.0%
Ma Huateng	8.6%
JP Morgan	3.8%
Source: HKEx	

Share Performance

	Absolute	Relative
1-mth	-4.2%	7.8%
3-mth	-8.3%	2.0%
6-mth	-0.5%	11.8%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

Auditor: PwC

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Figure 1: 2Q19 financial review

RMB mn	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	QoQ	YoY	Consensus	Diff %
Revenue	73,528	73,675	80,595	84,896	85,465	88,821	3.9%	20.6%	93,409	-5%
Operating Profit	30,692	21,807	27,861	17,288	36,742	27,521	-25.1%	26.2%	26,792	3%
Net profit	23,290	17,867	23,333	14,229	27,210	24,136	-11.3%	35.1%	21,101	14%
Adj. net profit	18,313	19,716	19,710	19,730	20,930	23,525	12.4%	19.3%	22,940	3%
EPS	1.91	2.06	2.06	2.07	2.19	2.46	12.5%	19.3%	2.39	3%
Margin (%)										
Gross Margin	50.4%	46.8%	44.0%	41.4%	46.6%	44.1%			44.6%	
Operating Margin	41.7%	29.6%	34.6%	20.4%	43.0%	31.0%			28.7%	
Adj. net Margin	24.9%	26.8%	24.5%	23.2%	24.5%	26.5%			24.6%	
Growth (%)										
Revenue (YoY)	48.4%	30.2%	23.6%	27.9%	16.2%	20.6%			26.8%	
Revenue (QoQ)	10.7%	0.2%	9.4%	5.3%	0.7%	3.9%			9.3%	
Operating Profit	59.3%	-3.3%	22.5%	-32.8%	19.7%	26.2%			22.9%	
Adj. net Profit	28.9%	20.3%	15.5%	13.0%	14.3%	19.3%			16.4%	

Source: Company data, Bloomberg

Figure 2: 2Q19 Revenue breakdown

RMB mn	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	QoQ	YoY
Total revenue	73,528	73,675	80,595	84,896	85,465	88,821	4%	21%
VAS	46,877	42,069	44,049	43,651	48,974	48,080	-2%	14%
- Online games	28,778	25,202	25,813	24,199	28,513	27,307	-4%	8%
- Social network	18,099	16,867	18,236	19,452	20,461	20,773	2%	23%
Online advertising	10,689	14,110	16,247	17,033	13,377	16,409	23%	16%
Others	15,962	17,496	20,299	24,212	23,114	24,332	5%	39%

Source: Company data

Figure 3: CMBI earnings revision

RMB mn, Mar-YE	New			Old			Diff (%)		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	380,642	474,648	586,376	396,937	500,979	627,355	-4.1%	-5.3%	-6.5%
Gross Profit	172,704	207,826	250,742	176,221	213,888	260,944	-2.0%	-2.8%	-3.9%
Operating Profit	129,283	156,856	191,884	127,812	155,876	192,307	1.2%	0.6%	-0.2%
Net profit	92,905	112,677	138,976	90,910	109,376	136,041	2.2%	3.0%	2.2%
Adj. EPS (RMB)	9.71	11.77	14.49	9.51	11.42	14.19	2.2%	3.0%	2.2%
Gross Margin	45.4%	43.8%	42.8%	44.4%	42.7%	41.6%	+1.0ppts	+1.1ppts	+1.2ppts
Operating Margin	34.0%	33.0%	32.7%	32.2%	31.1%	30.7%	+1.8ppts	+1.9ppts	+2.1ppts
Net Margin	24.4%	23.7%	23.7%	22.9%	21.8%	21.7%	+1.5ppts	+1.9ppts	+2.0ppts

Source: Company data, CMBIS estimates

Figure 4: CMBI estimates vs consensus

RMB mn, Mar-YE	CMBI			Consensus			Diff (%)		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	380,642	474,648	586,376	392,579	493,529	605,294	-3.0%	-3.8%	-3.1%
Gross Profit	172,704	207,826	250,742	174,980	216,956	261,424	-1.3%	-4.2%	-4.1%
Operating Profit	129,283	156,856	191,884	122,144	142,158	174,398	5.8%	10.3%	10.0%
Net profit	92,905	112,677	138,976	94,569	117,991	142,847	-1.8%	-4.5%	-2.7%
Adj. EPS (RMB)	9.71	11.77	14.49	9.80	11.99	14.65	-0.9%	-1.8%	-1.1%
Gross Margin	45.4%	43.8%	42.8%	44.6%	44.0%	43.2%	+0.8ppts	-0.2ppts	-0.4ppts
Operating Margin	34.0%	33.0%	32.7%	31.1%	28.8%	28.8%	+2.9ppts	+4.2ppts	+3.9ppts
Net Margin	24.4%	23.7%	23.7%	24.1%	23.9%	23.6%	+0.3ppts	-0.2ppts	+0.1ppts

Source: Company data, Bloomberg

Financial Summary

Income statement

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue	237,760	312,694	380,642	474,648	586,376
VAS	153,983	176,646	203,331	231,483	261,624
Ads	40,439	58,079	69,681	87,101	106,263
E-commerce	-	-	-	-	-
Others	43,338	77,969	107,630	156,064	218,489
COGS	(120,835)	(170,574)	(207,938)	(266,822)	(335,634)
Gross profit	116,925	142,120	172,704	207,826	250,742
S&M	(17,652)	(24,233)	(23,638)	(28,002)	(32,864)
Admin.Exp.	(33,051)	(41,522)	(50,170)	(59,432)	(69,751)
Interest income	3,940	4,569	5,510	6,612	7,934
Others	20,140	16,714	24,877	29,852	35,823
Operating profit	90,302	97,648	129,283	156,856	191,884
Financial cost	(2,908)	(4,669)	(7,063)	(7,063)	(7,063)
Associates	821	1,487	(187)	(374)	(449)
Pre-tax Income	88,215	94,466	122,033	149,419	184,373
Income Tax	(15,744)	(14,482)	(19,157)	(23,456)	(28,943)
MI	(961)	(1,265)	(1,494)	(1,829)	(2,257)
Net profit	71,510	78,719	101,382	124,134	153,173
Adj. net profit	65,126	75,044	92,905	112,677	138,976

Cash flow summary

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
Net income	71,510	78,719	101,382	124,134	153,173
D&A	23,611	9,470	12,257	14,186	16,282
Change in WC	23,322	9,134	6,694	1,576	3,302
Income tax paid	2,071	(698)	2,585	2,378	3,035
Others	(14,374)	19,597	30,156	37,083	45,390
Operating CF	106,140	116,221	153,074	179,357	221,182
Capex	(12,126)	(23,941)	(24,868)	(29,220)	(34,293)
Associates	(39,879)	(43,867)	(48,254)	(53,079)	(58,387)
Others	(44,387)	18,215	19,156	20,258	21,580
Investing CF	(96,392)	(49,593)	(53,966)	(62,041)	(71,100)
Equity raised	171	-	-	-	-
Change of Debts	29,012	-	-	-	-
Others	(2,585)	(9,933)	(11,869)	(16,490)	(23,138)
Financing CF	26,598	(9,933)	(11,869)	(16,490)	(23,138)
Net change in cash	36,346	56,695	87,239	100,826	126,944
Cash (beg of yr)	71,902	105,697	162,392	249,631	350,457
FX	(2,551)	-	-	-	-
Cash (end of yr)	105,697	162,392	249,631	350,457	477,401

Balance sheet

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
Non-current assets	376,226	429,430	487,401	556,691	643,587
Fixed asset	31,871	50,306	66,998	86,111	108,202
Associates	113,779	113,779	113,779	113,779	113,779
Intangible assets	40,266	35,778	28,524	20,364	12,204
Others	190,310	229,566	278,101	336,437	409,402
Current assets	178,446	246,402	338,225	448,981	587,282
Cash	105,697	162,392	249,631	350,457	477,401
Deposit over 3 months	36,724	36,724	36,724	36,724	36,724
Account receivable	16,549	21,765	26,494	33,037	40,814
Others	19,476	25,521	25,375	28,763	32,343
Current liabilities	151,740	166,792	227,963	289,542	367,795
Borrowings	15,696	15,696	15,696	15,696	15,696
Account payable	84,270	100,857	164,243	225,979	303,777
Tax payable	9,642	8,944	11,529	13,907	16,942
Other	42,132	41,296	36,495	33,960	31,380
Non-current liabilities	125,839	155,819	145,557	144,730	147,018
Borrowings	82,094	82,094	82,094	82,094	82,094
Deferred taxation	5,975	5,496	7,270	8,902	10,984
Others	37,770	68,229	56,192	53,734	53,940
MI	21,019	26,794	34,295	43,344	54,317
Total net assets	277,093	353,220	452,106	571,400	716,056
Shareholders' equity	256,074	326,426	417,811	528,056	661,740

Key ratios

YE 31 Dec	FY17A	FY18A	FY19E	FY20E	FY21E
Sales mix (%)					
VAS	64.8	56.5	53.4	48.8	44.6
Ads	17.0	18.6	18.3	18.4	18.1
E-commerce	0.0	0.0	0.0	0.0	0.0
Others	18.2	24.9	28.3	32.9	37.3
Total	100.0	100.0	100.0	100.0	100.0
Growth rate (%)					
Revenue	56.5	31.5	21.7	24.7	23.5
Gross profit	38.4	21.5	21.5	20.3	20.7
EBIT	60.9	8.1	32.4	21.3	22.3
Net profit	43.4	15.2	23.8	21.3	23.3
P&L ratios (%)					
Operating margin	37.1	30.2	32.1	31.5	31.4
Pre-tax margin	30.1	25.2	26.6	26.2	26.1
Adj. net margin	27.4	24.0	24.4	23.7	23.7
Effective tax rate	17.8	15.3	15.7	15.7	15.7
Returns (%)					
ROE	31.8	26.7	27.0	26.1	25.7
ROA	15.9	14.0	14.8	14.9	15.0
Per share					
EPS (RMB)	6.9	7.9	9.7	11.8	14.5
DPS (RMB)	0.9	0.8	1.0	1.2	1.4
BVPS (RMB)	29.2	37.0	47.3	59.7	74.7

Source: Company data, CMBIS estimates

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