

# Tencent (700 HK)

## Eye-catching 1Q20 with strong game & social ads

Tencent delivered strong 1Q20 results, with revenue/adj. net profit +26% YoY/+29% YoY, +7%/+10% above consensus. We are more bullish on its game momentum with globalization and positive COVID-19 impact, and strong social ads also impressed us. 2Q20E could be another solid quarter, and we suggest keeping eyes on upcoming DNF Mobile. We raised its EPS by 2%/9%/10% in FY20/21/22E, and lifted our TP to HK\$500 from HK\$440. Maintain BUY.

- **1Q20 all-round beat.** 1Q20 revenue was RMB108.1bn, up 26% YoY, 7%/2% above consensus/our estimate, mainly on strong games and social ads. Non-GAAP net profit grew 29% YoY to RMB27.1bn, 9%/0% above consensus/our estimate. We are impressed by its game momentum (+31% YoY) and social ads performance (+47% YoY), and keep confident on its growth in next few quarters. We believe this eye-catching result would drive its price up, coupled with better outlook and multiple catalysts.
- **Strong game to continue in 2Q20E.** Game surged 31% YoY in 1Q20 (vs. +25% in 4Q19), in which mobile game +64% YoY (higher than consensus of ~40% YoY), mainly driven by strong key titles (e.g. HoK, PUBG Mobile) and increasing overseas contribution. We keep positive on its game momentum in 2Q20E, considering 1) overseas contribution with strong PUBG Mobile and Clash of Clans, under global COVID-19; 2) deferred revenue from solid key titles (deferred revenue +63% YoY in 1Q20); and 3) new game titles (e.g. DNF Mobile) to bring further upside.
- **Better-than-expected ads recovery.** Ads grew 32% YoY in 1Q20 (vs. 19% in 4Q19, higher than market expectation of +20% YoY), mainly driven by increased ads inventories & impressions and 4th Wechat momentum ads rollout. By segment, social ads/ media ads +47%/-10% YoY (vs. +37% YoY/-24% YoY in 4Q19). We view the ads growth much better than street estimates, and we believe Tencent ads would be more resilient to COVID-19 than other players. With continued share gain, we expect its ads to grow 23% YoY in FY20E (vs. previous 18%).
- **Maintain BUY.** We raised its EPS by 2%/9%/10% in FY20/21/22E, and lifted our SOTP-based TP from HK\$440 to **HK\$500**. Our new TP is equivalent to 29x FY21E P/E. Tencent could be more defensive under COVID-19 impact, and we suggest investors to watch its 2Q20E performance on strong mobile games, overseas expansion and solid social ads. Maintain BUY.

### Earnings Summary

(YE 31 Dec)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (RMB mn)	312,694	377,289	470,520	577,506	703,947
YoY growth (%)	31.5	20.7	24.7	22.7	21.9
Net income (RMB mn)	77,296	93,637	115,112	146,309	176,681
Adj. EPS (RMB)	8.1	9.8	12.0	15.3	18.4
YoY growth (%)	18.7	21.1	22.9	27.1	20.8
Consensus EPS (RMB)	NA	NA	11.8	14.5	17.5
P/E (x)	47.7	39.5	32.1	25.3	21.0
P/B (x)	11.3	9.4	7.6	6.3	5.2
Yield (%)	0.0	0.0	0.0	0.0	0.0
ROE (%)	25.4	23.9	23.8	23.8	24.8
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIS estimates

**BUY (Maintain)**

Target Price **HK\$500**  
 (Previous TP **HK\$440**)  
 Up/Downside **+16.3%**  
 Current Price **HK\$430**

### China Internet Sector

**Sophie Huang**  
 (852) 3900 0889  
 sophiehuang@cmbi.com.hk

### Stock Data

Mkt Cap (HK\$ mn)	4,104,055
Avg 3 mths t/o (HK\$ mn)	9,428
52w High/Low (HK\$)	448/312
Total Issued Shares (mn)	9,553

Source: Bloomberg

### Shareholding Structure

Naspers	31.0%
Ma Huateng	8.5%
JP Morgan	4.4%

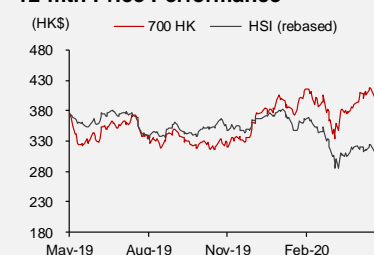
Source: HKEx

### Share Performance

	Absolute	Relative
1-mth	10.1%	10.4%
3-mth	4.9%	20.3%
6-mth	30.5%	45.7%

Source: Bloomberg

### 12-mth Price Performance



Source: Bloomberg

### Auditor: PwC

### Related Reports

1. Solid 4Q19 with game acceleration – 19 Mar 2020
2. Soft 3Q19; moving to 4Q19E better outlook – 14 Nov 2019
3. 3Q19 Preview: solid game with ads headwinds – 21 Oct 2019
4. Moving into 2H19E game performance – 15 Aug 2019

**Figure 1: 1Q20 financial review**

RMB mn	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	QoQ	YoY	Consensus	Diff %	CMBI	Diff %
Revenue	84,896	85,465	88,821	96,830	105,767	108,065	2.2%	26.4%	101,060	7%	105,922	2%
Operating Profit	17,288	36,742	27,521	29,110	28,604	37,260	30.3%	1.4%	30,576	22%	37,652	-1%
Net profit	14,229	27,210	24,136	23,004	21,582	28,896	33.9%	6.2%	23,768	22%	27,917	4%
Adj. net profit	19,730	20,930	23,525	24,898	25,484	27,079	6.3%	29.4%	24,738	9%	27,094	0%
Adj. EPS	2.07	2.19	2.46	2.62	2.64	2.82	6.6%	28.6%	2.56	10%	2.83	0%
<b>Margin (%)</b>												
Gross Margin	41.4%	46.6%	44.1%	46.0%	45.0%	48.9%			45.1%		47.7%	
Operating Margin	20.4%	43.0%	31.0%	30.1%	28.3%	34.5%			30.3%		35.5%	
Adj. net margin	23.2%	24.5%	26.5%	25.7%	25.2%	25.1%			24.5%		25.6%	
<b>Growth (%)</b>												
Revenue (YoY)	27.9%	16.2%	20.6%	20.1%	24.6%	26.4%			18.2%		23.9%	
Revenue (QoQ)	5.3%	0.7%	3.9%	9.0%	9.2%	2.2%			-4.5%		0.1%	
Operating Profit	-32.8%	19.7%	26.2%	4.5%	65.5%	1.4%			-16.8%		2.5%	
Adj. net Profit	13.0%	14.3%	19.3%	26.3%	29.2%	29.4%			18.2%		29.5%	

Source: Company data, Bloomberg, CMBIS estimates

**Figure 2: Revenue breakdown**

RMB mn	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	QoQ	YoY
<b>Total revenue</b>	<b>73,528</b>	<b>73,675</b>	<b>80,595</b>	<b>84,896</b>	<b>85,465</b>	<b>88,821</b>	<b>96,830</b>	<b>105,767</b>	<b>108,065</b>	<b>2%</b>	<b>26%</b>
VAS	46,877	42,069	44,049	43,651	48,974	48,080	50,629	52,308	62,429	19%	27%
- Online games	28,778	25,202	25,813	24,199	28,513	27,307	28,604	30,286	37,298	23%	31%
- Social network	18,099	16,867	18,236	19,452	20,461	20,773	22,025	22,022	25,131	14%	23%
Online advertising	10,689	14,110	16,247	17,033	13,377	16,409	18,366	20,225	17,713	-12%	32%
Others	15,962	17,496	20,299	24,212	23,114	24,332	28,241	33,234	27,923	-16%	21%

Source: Company data

**Figure 3: CMBIS estimates vs consensus**

RMB mn, Dec-YE	CMBIS			Consensus			Diff (%)		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Revenue	470,520	577,506	703,947	464,776	566,716	675,058	1.2%	1.9%	4.3%
Gross Profit	211,104	254,922	306,173	205,578	250,588	297,865	2.7%	1.7%	2.8%
Operating Profit	148,669	181,379	215,959	134,868	164,743	200,039	10.2%	10.1%	8.0%
Net profit	115,112	146,309	176,681	113,782	141,828	169,755	1.2%	3.2%	4.1%
Adj. EPS (RMB)	12.01	15.26	18.38	11.80	14.51	17.53	1.7%	5.2%	4.9%
Gross Margin	44.9%	44.1%	43.5%	44.2%	44.2%	44.1%	+0.6ppts	+0.0ppts	-0.6ppts
Operating Margin	31.6%	31.4%	30.7%	29.0%	29.1%	29.6%	+2.6ppts	+2.3ppts	+1.0ppts
Net Margin	24.5%	25.3%	25.1%	24.5%	25.0%	25.1%	+0.0ppts	+0.3ppts	+0.0ppts

Source: CMBIS estimates, Bloomberg

**Figure 4: Earnings revision**

RMB mn, Dec-YE	New			Old			Diff (%)		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Revenue	470,520	577,506	703,947	463,886	555,764	673,147	1.4%	3.9%	4.6%
Gross Profit	211,104	254,922	306,173	207,876	241,739	287,298	1.6%	5.5%	6.6%
Operating Profit	148,669	181,379	215,959	148,943	173,400	203,924	-0.2%	4.6%	5.9%
Net profit	115,112	146,309	176,681	112,807	134,360	160,997	2.0%	8.9%	9.7%
Adj. EPS (RMB)	12.01	15.26	18.38	11.77	14.01	16.75	2.0%	8.9%	9.7%
Gross Margin	44.9%	44.1%	43.5%	44.8%	43.5%	42.7%	+0.1ppts	+0.6ppts	+0.8ppts
Operating Margin	31.6%	31.4%	30.7%	32.1%	31.2%	30.3%	-0.5ppts	+0.2ppts	+0.4ppts
Net Margin	24.5%	25.3%	25.1%	24.3%	24.2%	23.9%	+0.1ppts	+1.2ppts	+1.2ppts

Source: Company data, CMBIS estimates

**Figure 5: SOTP Valuation**

<b>SOTP</b>	<b>Valuation (HK\$ bn)</b>	<b>HK\$/Share</b>	<b>Implied FY21 P/E</b>
Core business	4,403	460	28x
Unlisted associates	100	10	
JD	128	13	
58.com	20	2	
Meituan	133	14	
<b>Total Valuation</b>	<b>4,785</b>	<b>500</b>	<b>29x</b>

Source: CMBIS estimates, Bloomberg, CMBIS estimates

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Revenue</b>	<b>312,694</b>	<b>377,289</b>	<b>470,520</b>	<b>577,506</b>	<b>703,947</b>
VAS	176,646	199,991	244,734	283,032	332,464
Ads	58,079	68,377	84,339	104,796	125,228
E-commerce	-	-	-	-	-
Others	77,969	108,921	141,446	189,678	246,255
<b>COGS</b>	<b>(170,574)</b>	<b>(209,756)</b>	<b>(259,417)</b>	<b>(322,584)</b>	<b>(397,775)</b>
<b>Gross profit</b>	<b>142,120</b>	<b>167,533</b>	<b>211,104</b>	<b>254,922</b>	<b>306,173</b>
S&M	(24,233)	(21,396)	(26,631)	(29,745)	(35,352)
Admin.Exp.	(41,522)	(53,446)	(64,677)	(75,558)	(89,799)
Interest income	4,569	6,314	7,036	7,740	8,514
Others	16,714	19,689	21,837	24,021	26,423
<b>Operating profit</b>	<b>97,648</b>	<b>118,694</b>	<b>148,669</b>	<b>181,379</b>	<b>215,959</b>
Financial cost	(4,669)	(7,613)	(6,736)	(6,736)	(6,736)
Associates	(1,265)	(2,578)	-	-	-
<b>Pre-tax Income</b>	<b>94,466</b>	<b>109,400</b>	<b>145,402</b>	<b>178,667</b>	<b>213,730</b>
Income Tax	(14,482)	(13,512)	(24,610)	(30,373)	(36,334)
MI	(1,265)	(2,578)	-	-	-
<b>Net profit</b>	<b>78,719</b>	<b>93,310</b>	<b>120,285</b>	<b>147,671</b>	<b>176,651</b>
<b>Adj. net profit</b>	<b>77,296</b>	<b>93,637</b>	<b>115,112</b>	<b>146,309</b>	<b>176,681</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Net income</b>	<b>78,719</b>	<b>93,310</b>	<b>120,285</b>	<b>147,671</b>	<b>176,651</b>
D&A	34,248	13,539	16,888	20,942	25,426
Change in WC	4,687	11,746	20,382	23,339	27,446
Income tax paid	(58)	(2,942)	7,824	4,063	4,202
Others	(11,153)	25,767	28,892	33,543	39,086
<b>Operating CF</b>	<b>106,443</b>	<b>141,420</b>	<b>194,271</b>	<b>229,558</b>	<b>272,811</b>
Capex	(22,151)	(32,369)	(42,070)	(51,636)	(61,368)
Associates	(39,699)	(43,669)	(48,036)	(52,839)	(63,407)
Others	(90,063)	(14,514)	(13,792)	(13,088)	(12,314)
<b>Investing CF</b>	<b>(151,913)</b>	<b>(90,552)</b>	<b>(103,898)</b>	<b>(117,564)</b>	<b>(137,090)</b>
Equity raised	525	0	0	0	0
Change of Debts	37,842	40,800	0	0	0
Others	(2,987)	(10,912)	(13,953)	(19,300)	(25,306)
<b>Financing CF</b>	<b>35,380</b>	<b>29,888</b>	<b>(13,953)</b>	<b>(19,300)</b>	<b>(25,306)</b>
<b>Net change in cash</b>	<b>(10,090)</b>	<b>80,756</b>	<b>76,419</b>	<b>92,695</b>	<b>110,416</b>
Cash (beg of yr)	105,697	97,814	178,570	254,990	347,685
FX	2,207	0	0	0	0
<b>Cash (end of yr)</b>	<b>97,814</b>	<b>178,570</b>	<b>254,990</b>	<b>347,685</b>	<b>458,100</b>

### Balance sheet

YE 31 Dec (RMB mn)	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Non-current assets</b>	<b>506,441</b>	<b>543,193</b>	<b>591,204</b>	<b>657,090</b>	<b>736,049</b>
Fixed asset	47,076	67,188	93,702	129,748	171,042
Associates	219,215	213,614	213,614	213,614	213,614
Intangible assets	56,650	50,237	39,533	28,829	18,125
Others	183,500	212,154	244,355	284,899	333,268
<b>Current assets</b>	<b>217,080</b>	<b>293,262</b>	<b>384,742</b>	<b>494,492</b>	<b>625,065</b>
Cash	97,814	178,373	254,990	347,685	458,100
Deposit over 3 months	62,918	46,911	46,911	46,911	46,911
Account receivable	28,427	34,299	42,775	52,501	63,996
Others	27,921	33,679	40,066	47,396	56,058
<b>Current liabilities</b>	<b>202,435</b>	<b>183,187</b>	<b>216,914</b>	<b>270,072</b>	<b>338,219</b>
Borrowings	26,834	22,695	22,695	22,695	22,695
Account payable	73,735	90,672	112,139	139,445	171,948
Tax payable	11,259	10,771	18,595	22,659	26,861
Other	90,607	59,048	63,484	85,273	116,715
<b>Non-current liabilities</b>	<b>164,879</b>	<b>219,404</b>	<b>226,270</b>	<b>231,149</b>	<b>236,038</b>
Borrowings	87,437	104,257	104,257	104,257	104,257
Deferred taxation	10,964	10,230	18,632	22,995	27,508
Others	66,478	104,918	103,381	103,897	104,274
MI	32,697	39,825	48,903	59,698	72,227
<b>Total net assets</b>	<b>356,207</b>	<b>433,865</b>	<b>532,762</b>	<b>650,361</b>	<b>786,857</b>
<b>Shareholders' equity</b>	<b>323,510</b>	<b>394,039</b>	<b>483,859</b>	<b>590,663</b>	<b>714,629</b>

### Key ratios

YE 31 Dec	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Sales mix (%)</b>					
VAS	56.5	53.0	52.0	49.0	47.2
Ads	18.6	18.1	17.9	18.1	17.8
E-commerce	0.0	0.0	0.0	0.0	0.0
Others	24.9	28.9	30.1	32.8	35.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Growth rate (%)</b>					
Revenue	31.5	20.7	24.7	22.7	21.9
Gross profit	21.5	17.9	26.0	20.8	20.1
EBIT	8.1	21.6	25.3	22.0	19.1
Net profit	18.7	21.1	22.9	27.1	20.8
<b>P&amp;L ratios (%)</b>					
Operating margin	31.2	31.5	31.6	31.4	30.7
Pre-tax margin	30.2	29.0	30.9	30.9	30.4
Adj. net margin	24.7	24.8	24.5	25.3	25.1
Effective tax rate	-4.6	-3.6	-5.2	-5.3	-5.2
<b>Returns (%)</b>					
ROE	25.4	23.9	23.8	23.8	24.8
ROA	11.7	10.7	11.2	11.8	12.7
<b>Per share</b>					
EPS (RMB)	8.1	9.8	12.0	15.3	18.4
DPS (RMB)	1.1	1.4	1.9	2.4	3.1
BVPS (RMB)	34.0	41.2	50.5	61.6	74.5

Source: Company data, CMBIS estimates

# Disclosures & Disclaimers

## Analyst Certification

The research analyst who is primary responsible for the content of this research report, in whole or in part, certifies that with respect to the securities or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by that analyst in this report.

Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the stock(s) covered in this research report 3 business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong listed companies covered in this report; and (4) have any financial interests in the Hong Kong listed companies covered in this report.

## Disclaimer

CMBIS or its affiliate(s) have investment banking relationship with the issuers covered in this report in preceding 12 months.

## CMBIS Ratings

<b>BUY</b>	: Stock with potential return of over 15% over next 12 months
<b>HOLD</b>	: Stock with potential return of +15% to -10% over next 12 months
<b>SELL</b>	: Stock with potential loss of over 10% over next 12 months
<b>NOT RATED</b>	: Stock is not rated by CMBIS

<b>OUTPERFORM</b>	: Industry expected to outperform the relevant broad market benchmark over next 12 months
<b>MARKET-PERFORM</b>	: Industry expected to perform in-line with the relevant broad market benchmark over next 12 months
<b>UNDERPERFORM</b>	: Industry expected to underperform the relevant broad market benchmark over next 12 months

## CMB International Securities Limited

**Address:** 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

**CMB International Securities Limited ("CMBIS") is a wholly owned subsidiary of CMB International Capital Corporation Limited (a wholly owned subsidiary of China Merchants Bank)**

## Important Disclosures

There are risks involved in transacting in any securities. The information contained in this report may not be suitable for the purposes of all investors. CMBIS does not provide individually tailored investment advice. This report has been prepared without regard to the individual investment objectives, financial position or special requirements. Past performance has no indication of future performance, and actual events may differ materially from that which is contained in the report. The value of, and returns from, any investments are uncertain and are not guaranteed and may fluctuate as a result of their dependence on the performance of underlying assets or other variable market factors. CMBIS recommends that investors should independently evaluate particular investments and strategies, and encourages investors to consult with a professional financial advisor in order to make their own investment decisions.

This report or any information contained herein, have been prepared by the CMBIS, solely for the purpose of supplying information to the clients of CMBIS or its affiliate(s) to whom it is distributed. This report is not and should not be construed as an offer or solicitation to buy or sell any security or any interest in securities or enter into any transaction. Neither CMBIS nor any of its affiliates, shareholders, agents, consultants, directors, officers or employees shall be liable for any loss, damage or expense whatsoever, whether direct or consequential, incurred in relying on the information contained in this report. Anyone making use of the information contained in this report does so entirely at their own risk.

The information and contents contained in this report are based on the analyses and interpretations of information believed to be publicly available and reliable. CMBIS has exerted every effort in its capacity to ensure, but not to guarantee, their accuracy, completeness, timeliness or correctness. CMBIS provides the information, advices and forecasts on an "AS IS" basis. The information and contents are subject to change without notice. CMBIS may issue other publications having information and/ or conclusions different from this report. These publications reflect different assumption, point-of-view and analytical methods when compiling. CMBIS may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.

CMBIS may have a position, make markets or act as principal or engage in transactions in securities of companies referred to in this report for itself and/or on behalf of its clients from time to time. Investors should assume that CMBIS does or seeks to have investment banking or other business relationships with the companies in this report. As a result, recipients should be aware that CMBIS may have a conflict of interest that could affect the objectivity of this report and CMBIS will not assume any responsibility in respect thereof. This report is for the use of intended recipients only and this publication, may not be reproduced, reprinted, sold, redistributed or published in whole or in part for any purpose without prior written consent of CMBIS.

Additional information on recommended securities is available upon request.

For recipients of this document in the United Kingdom

This report has been provided only to persons (I) falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended from time to time) ("The Order") or (II) are persons falling within Article 49(2) (a) to (d) ("High Net Worth Companies, Unincorporated Associations, etc.") of the Order, and may not be provided to any other person without the prior written consent of CMBIS.

For recipients of this document in the United States

This report is intended for distribution in the United States to "major US institutional investors", as defined in Rule 15a-6 under the US, Securities Exchange Act of 1934, and may not be furnished to any other person in the United States. Each major US institutional investor that receives a copy of this research report by its acceptance hereof represents and agrees that it shall not distribute or provide this research report to any other person.

For recipients of this document in Singapore

This report is distributed in Singapore by CMBI (Singapore) Pte. Limited (CMBISG) (Company Regn. No. 201731928D), an Exempt Financial Adviser as defined in the Financial Advisers Act (Cap. 110) of Singapore and regulated by the Monetary Authority of Singapore. CMBISG may distribute reports produced by its respective foreign entities, affiliates or other foreign research houses pursuant to an arrangement under Regulation 32C of the Financial Advisers Regulations. Where the report is distributed in Singapore to a person who is not an Accredited Investor, Expert Investor or an Institutional Investor, as defined in the Securities and Futures Act (Cap. 289) of Singapore, CMBISG accepts legal responsibility for the contents of the report to such persons only to the extent required by law. Singapore recipients should contact CMBISG at +65 6350 4400 for matters arising from, or in connection with the report.