Outperform

(Maintained)

TMT

Tencent Holdings Ltd (0700.HK)

HK Stock

Worst of Times Passed Away, Looking forward To B in the Future.

March 25, 2019

Key Data
Mar 25, 2019

Closing Price（HKD）	353.8
Total Shares (Mn)	95.22
Market Cap(HKD/Mn)	33,689
Net Assets (RMB/Mn)	3,562
Total Assets (RMB/Mn)	7,235
BVPS(RMB)	34.26

Analyst
ZHANG Yidong
zhangyd@xyzq.com.cn
SFC：BIS749
SAC：S0190510110012

Contact
Venki LI
liwenjing@xyzq.com.cn
SAC：S0190118090169

Key Financial Indicators

FY	2018A	2019E	2020E	2021E
Revenue (Thousand/RMB)	312,694	398,046	506,710	624,421
YoY (%)	31.5%	27.3%	27.3%	23.2%
Non-GAAP Net Profit (Thousand/ RMB)	77,469	91,973	114,653	142,235
YoY (%)	19.0%	18.7%	24.7%	24.1%
Gross Margin (%)	45.5%	42.5%	41.5%	41.2%
Non-GAAP Net Profit Margin (%)	25.6%	22.1%	22.5%	23.4%
ROE (%)	28.9%	19.4%	19.6%	19.6%
EPS (RMB)	8.43	9.75	12.42	15.19
OCFPS (RMB)	11.18	13.74	16.92	20.19

Highlights

Revenue was in line with expectations, net profit declined YoY due to the impact of impairment provision, but Non-GAAP's net profit increased YoY and QoQ. The company's revenue was 84.90 billion RMB (28% YoY) in Q4 2018, and annual revenue reached 312.7 billion, which was basically in line with expectations. As the other net income from investment-related projects increased significantly, the net profit attributable to equity holders fell by 31.6% YoY to RMB 14.23 billion, while Non-GAAP net profit increased by 13% YoY; in addition, the business structure optimization caused the gross margin to fall to 41.4%;

Game business is weak in 2019, the proportion of game business is expected to keep declining. The company's online game revenue (including mobile games commission) reached RMB 30.2 billion up to 18Q4, the proportion of revenue fell to 35.57%. Affected by the pause of game licenses' approval, the release of the new game is suspended, the head game baton is difficult to keep up, the future growth rate of Tencent games will continue to slow down. But we believe that the hardest time of game business has passed, the release of license number and the good momentum of going overseas will prompt the game revenue growth to pick up. It is estimated that the growth rate of mobile game in 2019 is 14.35% and the pc games' growth is negative.

The macro environment was sluggish, but advertising revenue was still outstanding. The overall growth rate of Internet advertising revenue in 18Q4 has tightened. In this downturn, Tencent's advertising revenue increased by 38% YoY, but due to the tightening of marketing expenses of brand manufacturers, the growth rate of social advertising in 18Q4 was 44% YoY, and the growth rate QoQ declined. However, as the continuous release of social advertising resources, it is expected that advertising business is still the engine of growth in the future.

Digital content performed well, and its profit contribution is waiting to be seen in the short term. As of 18Q4, the social network revenue was 19.5 billion yuan (yoy25%), and the video subscriptions reached 89 million, ranking first in all video platforms. However, we believe that its video business is currently in the input stage, and it will wait and see in the short term, but we are still optimistic about the pan-entertainment industry in the long run.

Infrastructure: Embracing To-B business, cloud business quickly seizes the market and payment of full scene + overseas expansion. Other businesses revenues in 18Q4 increased to 24.2 billion, yoy exceeding 70%, and revenue contribution increased to 28.5%. Cloud services revenue reached 9.1 billion in 2018, of which Q4 reached 3 billion in a single quarter. Its market share in the domestic market reached 16.5% in 18Q4, making it the fastest growing vendor in Top 5. In addition, the company's average daily payment transaction volume exceeded 1 billion in 2018, and the payment revenue doubled year-on-year. Merchant MAU in Q4 increased by 80% year-on-year.

Investing proposal: Raise the target price to HK$407.2 and maintain "outperform" rating. Due to the influence of game policies, its game business is under pressure, but we are optimistic about Tencent's strategy of optimizing its business structure and expecting the growth of advertising and infrastructure. We raise our target price of the company's stock based on the DCF model to HK$407.2 (original target price: HK$345.8), representing 32.4x Non-GAAP PE in 2019, and maintain "outperform" rating.

Potential risks: regulation risk; growth rate of game business lower than expected; advertising revenue lower than expected; financial indicators such as ROE, gross margin worsen; organizational structure adjustments not up to expectations; decline of user usage time of Tencent's products

This English translation of the original Chinese version <腾讯控股(0700.HK) 最坏的时刻已经过去，未来拥抱 To B _20190322> issued by Industrial Securities on 2019.3.22 is for information purpose only. In case of a discrepancy, the Chinese original will prevail.

Report Text

Event: Tencent Holdings Limited (0700.HK) released its Q4 2018 and annual results announcement on March 21st: the company's total revenue in Q4 2018 was RMB 84.90 billion (28% YoY, 5% QoQ), which is in line with our expectation. The annual revenue was RMB 312.69 billion (32% YoY). The company's three expense rates remain relatively stable, with 18Q4 sales expense ratio of 6.7% (7.7% for 2018, Q3: 8.2%). In addition, the net other income generated from investment-related projects fell significantly in the fourth quarter, resulting net income attributable to the Company's shareholders fell by 31.6% YoY, reaching RMB 14.29 billion, while the company's net income under Non-GAAP achieved a 13% increase, in line with our expectation. WeChat and QQ's combined monthly active accounts reached 1.10 billion, an increase of 11%. The number of QQ monthly active user accounts reached 807 million, an increase of 3% YoY.

Table 1、 Differences between Industrial Securities Research Institute forecast and actual result in 18Q4 and in FY2018

Million RMB	FY18A	FY18E	Diff(A/E-1)	4Q18A	4Q18E	Diff(A/E-1)
Income Statement						
Revenues	**312,694**	**312,695**	**0.00%**	**84,896**	**84,897**	**0.00%**
Growth Rate	32.00%	31.52%	1.52%			
Cost of revenues	**170,574**	**169,603**	**0.57%**	**49,744**	**48,773**	**1.99%**
Gross Profit	142,120	143,092	-0.68%	35,152	36,124	-2.69%
Operating profit	97,648	105,223	-7.20%	17,288	25,481	-32.15%
Profit before income tax	94,466	102,351	-7.70%	15,932	24,435	-34.80%
Profit for the period	**79,984**	**85,974**	**-6.97%**	**14,026**	**21,207**	**-33.86%**
Equity holders of the company	78,719	84,255	-6.57%	14,229	20,782	-31.53%
Non-controlling interests	1,265	1,719	-26.41%	-203	424	-147.88%
Non-GAAP profit attributable to equity holders of the company	**77,469**	**79,039**	**-1.99%**	**19,730**	**20,177**	**-2.22%**

Source: Company Disclosure, Industrial Securities

Table 2、 Tencent's Segment revenue overview in 4Q17-4Q18

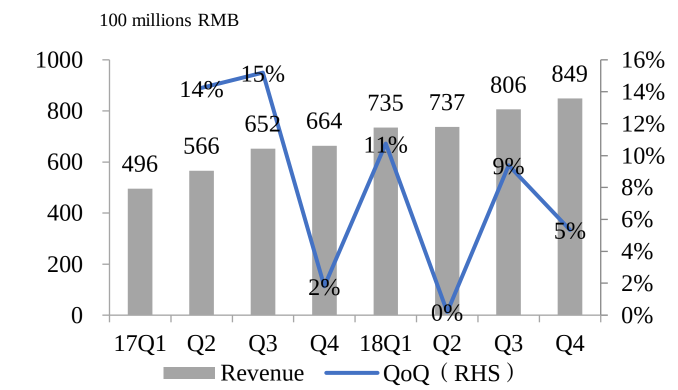
First Level Business	Second Level Business	Subdivision business	4Q17A	3Q18A	4Q18A
VAS	**Restore online games** (Including mobile game accounts in social networks)	Mobile Games (Including mobile game accounts in social networks)	16,900	19,500	19,000
		YoY	57.94%	7.14%	12.43%
		QoQ	-7.14%	10.80%	-2.56%
		Client Games	12,800	12,400	11,200
		YoY	64.76%	-15.07%	-12.50%
		QoQ	-12.33%	-3.88%	-9.68%
		Restore online games	29,700	31,900	30,200
		YoY	60.81%	-2.74%	1.68%
		QoQ	-9.45%	4.59%	-5.33%
	Online Games (Divided by financial report)	Mobile Games	11,567	13,413	12,999
		YoY	8.10%	9.55%	12.38%
		QoQ	-5.53%	9.03%	-3.09%
		Client Games	12,800	12,400	11,200
		YoY	64.76%	-15.07%	-12.50%
		QoQ	-12.33%	-3.88%	-9.68%
		Online Games (Divided by financial report)	24,367	25,813	24,199
		YoY	31.93%	-3.84%	-0.69%
		QoQ	-9.23%	2.42%	-6.25%
	Social network (Divided by financial report)	Revenues	15,580	18,236	19,452
		YoY	45.31%	19.35%	24.85%
		QoQ	1.96%	8.12%	6.67%
	Social Network	Revenues	10,247	12,149	13,451

	(Eliminate mobile game accounts)	YoY QoQ	- 9.90%	30.30% 5.01%	31.27% 10.72%
Online Advertising	Media advertising	Revenues YoY QoQ	4,121 15.62% -0.02%	5,090 23.48% 7.61%	5,187 25.87% 1.91%
	Social and other advertising	Revenues	8,240 74.00%	11,157 61.23%	11,846 43.76%
	Overall Online Advertising	Revenues QoQ	12,361 49.14% 11.95%	16,247 47.14% 15.15%	17,033 37.80% 4.84%
Others	**Other Revenues**	Revenues QoQ	14,084 - 16.94%	20,299 68.54% 16.02%	24,212 71.91% 19.28%
	Cloud Service	YoY		More than double	More than double

Source: Company Disclosure, Industrial Securities

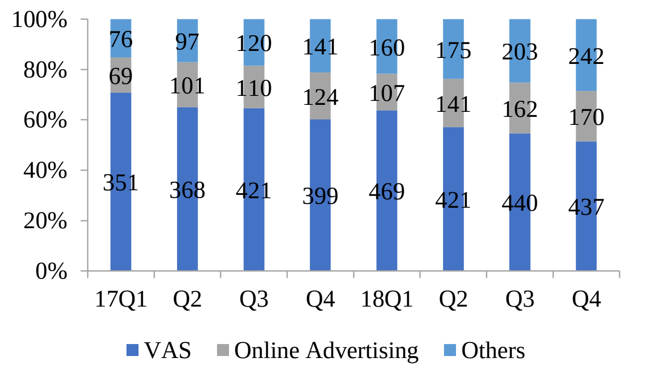
Segment revenue: The income structure continues to change, and the decline in game growth rate has led to a continued decline in value-added revenue. The company's value-added service revenue was RMB 43.65 billion up to 18Q4, and the proportion of revenue fell to 51%; online advertising increased 38% YoY to 170.33 billion, accounting for 20% of revenue; other business income increased to 24.21 billion, and revenue accounted for Up to 29%. The company's mobile games and client games income reached 30.2 billion in Q4, and the proportion of revenue continued to drop to 35.57% (Q3: 39.58%). The income and proportions are basically in line with our expectations.

Fig. 1、2017Q1-2018Q4 Tencent's revenues and growth rate QoQ



Source: Company Disclosure, Industrial Securities

Fig. 2、2017Q1-2018Q4 Tencent's segment revenue share



Source: Company Disclosure, Industrial Securities

Table 3、Revenue share of each segment in 16-18Q4

	2016	2017	2018 Q1	2018 Q2	2018 Q3	2018Q4	2018
VAS	70.96%	64.76%	63.75%	57.10%	54.65%	51.42%	56.49%
Online games revenues	46.63%	41.17%	39.14%	34.21%	32.03%	28.50%	33.26%
Client games revenues	29.43%	23.17%	19.18%	17.51%	15.39%	13.19%	16.18%
Mobile games revenues	17.19%	17.99%	19.96%	16.70%	16.64%	15.31%	17.07%
Mobile games revenues including mobile games comission	25.28%	26.41%	29.51%	23.89%	24.20%	22.38%	24.88%
Online games revenues including mobile games comission	54.72%	49.59%	48.69%	41.40%	39.58%	35.57%	41.06%
Social network revenue	24.33%	23.60%	24.62%	22.89%	22.63%	22.91%	23.25%
Online advertising	17.75%	17.01%	14.54%	19.15%	20.16%	20.06%	18.57%
Media advertising	10.38%	6.24%	4.49%	6.42%	6.32%	6.11%	5.85%
Social and other advertising	7.37%	10.77%	10.05%	12.73%	13.84%	13.95%	12.72%

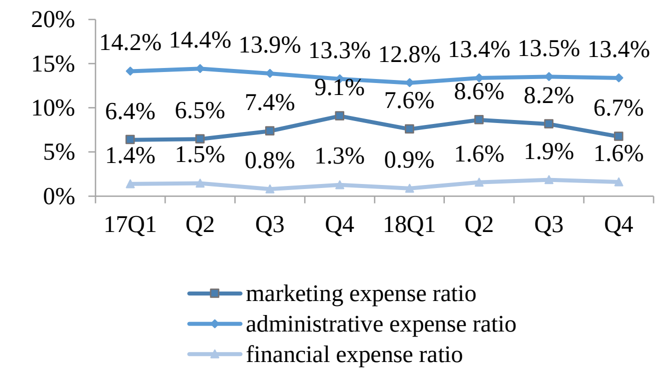
Others(payment and cloud service)	11.29%	18.23%	21.71%	23.75%	25.19%	28.52%	24.93%

Source： Company Disclosure, Industrial Securities

The change in business structure has led to a decline in gross profit margin. While the growth rate of the main business gradually slowed down, Q4 achieved a gross profit margin of 41.4% (Q2: 44.02%), mainly due to the change in the company's business structure. The value-added services of high gross profit margin, especially the gaming business, continued to decline. In addition, the sales expense ratio in the fourth quarter decreased by 1.5% QoQ, mainly due to the decrease in Q4 selling expenses.

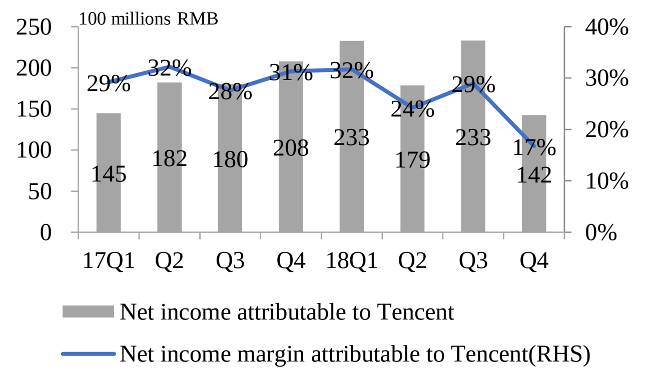
The decline in other revenue led to a decline in Q4 net profit and net profit margin. Non-GAAP net income attributable to the Company's shareholders fell YoY and QoQ, and margin declined slightly. In Q4 2018, Tencent's net income reached RMB 14.2 billion, a YoY decrease of 31.7%, a decrease of 39.1% QoQ. The margin fell to 16.52% compared with Q3 (29.04%), mainly due to: 1) provision for foreign investment impairment of RMB 2.1 billion; 2) Tencent Music paid a one-time stock fee of RMB 1.519 billion to record companies such as Warner and Sony in Q4. The 17Q4 investment income is as high as RMB 7.9 billion. After excluding share-based compensation, net (gains)/losses from investee company, amortization of intangible assets and impairment provision, the net profit of Non-GAAP profit attributable to equity holders of the Company in the fourth quarter reached RMB 19.73 billion, a YoY increase of 13%, while achieving a rare growth. Margin fell slightly, from 24.46% in Q3 to 23.24%.

Fig. 3、2017Q1-2018Q4 Tencent' expenses



Source： Company Disclosure, Industrial Securities

Fig. 4、2017Q1-2018Q4 Tencent's gross profit and gross margin

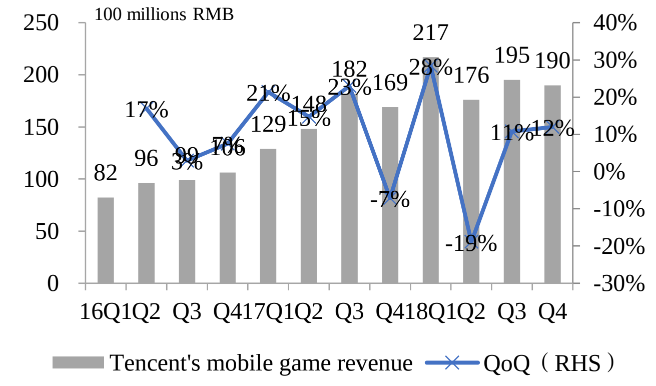


Source： Company Disclosure, Industrial Securities

1. Game business: the proportion fell to nearly 1/3, affected by the policy, it is expected to slow down in the future

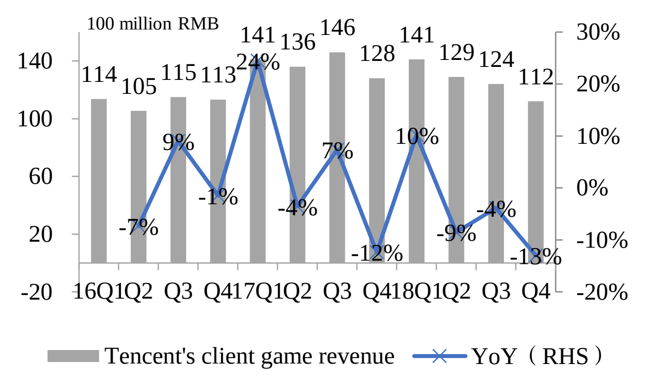
The freeze of license number directly affected the online game revenue in Q4, which was a YoY growth but a decline QoQ. The growth of mobile games slowed down, and PC games continued to grow negatively. Online game's revenue (mobile games + PC games) reached 30.2 billion yuan in Q4 (1.7% YoY and 5.3% QoQ). Among them, PC games' revenue continued to decline, the income of PC games in 18Q4 only reached RMB 11.2 billion, decreased by 13% YoY and 9.7% QoQ. The head PC games have maintained long life cycles. and there will not appear strong IP in short run. Given the trend of PC game players turning into mobile game players, we expect that the PC game revenue will continue to be under pressure. The revenue of mobile games in Q4 2018 reached RMB 19 billion, a YoY increase of 12% and a QoQ decrease of 2.6%. Mainly because the freeze of license number approval in the second half year, and all the 9 Tencent released mobile games are licensed in Q4.

Fig. 5、Tencent's mobile games revenues and growth rate YoY



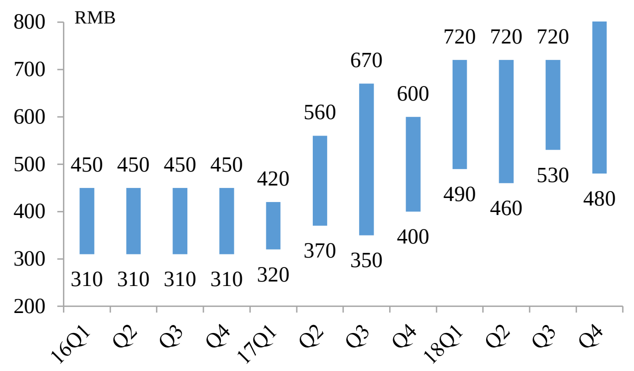
Source: Company Disclosure, Industrial Securities

Fig. 6、Tencent's PC games revenues and growth rate YoY



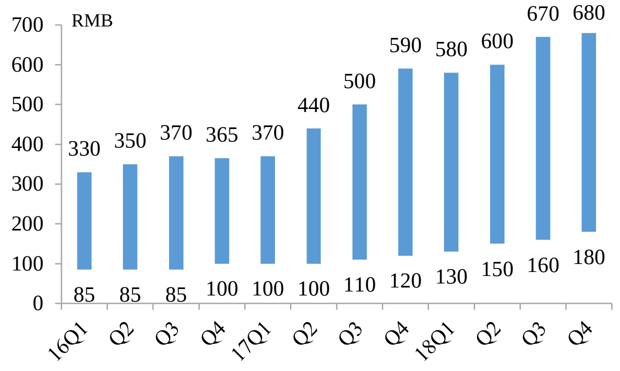
Source: Company Disclosure, Industrial Securities

Fig. 7、Interval of MMOG games ARPU



Source: Company Disclosure, Industrial Securities

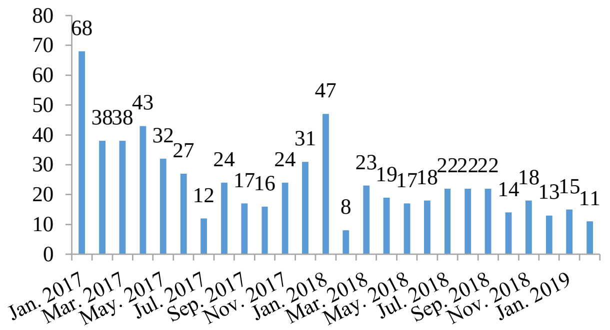
Fig. 8、Interval of ACG games ARPU



Source: Company Disclosure, Industrial Securities

The number of new games continues to decrease in 2019. After the approval of the license number restarted in December 2018, a total of 819 games have got license numbers so far, in which Tencent has only 7 mobile games and 1 PC game. Due to the current accumulation of a large number of applications, we expect that the release of future game schedules will continue to slow down in previous years.

Fig. 9、The number of new games in iOS daily bestseller ranking Top 200



Source: CNG, Industrial Securities

Table 4、New game revenue measurement ranking TOP 5 in Feb. 2019

Ranking	New games	Company	IP
1	The Croods	iQiYi	Film
2	Dragon Ball Awakening	CMGE	Anime
3	Douluo Continent	37 Interactive Entertainment	Novel
4	Destiny singer	Shanda Games	-
5	The imperial censor	Hero Entertainment	Anime

Source: CNG, Industrial Securities

Looking for a breakthrough overseas, Tencent's mobile game *PUBG Mobile* topped the APP revenue list and download list once again. According to Sensor Tower, in the China's overseas mobile game downloads list, Tencent's *PUBG Mobile* won the double champions of the income list and download list in February 2019. In January 2019, *PUBG Mobile* has achieved its first summit. From the aspect of the total revenue of mobile games, Tencent is currently in fourth place, next to FunPlus, IGG and Netease.

The old game continues to extend the cycle, *Honour of Kings*'s new skins, new hero and new system keep boosting ARPPU. According to gamma data, the omnichannel download volume of *Honor of Kings* decreased by 55% YoY in February 2019, but game revenue still ranked first. After three years of operation, *Honor of Kings* already has a huge user base, and it is difficult to expand the number of downloads and users. Around the Spring Festival of 19, in addition to the addition of heroes, skins, etc., *Honor of Kings* also launched a "warfare system" to boost ARPPU. We estimate that the game's revenue in omni-channel in February 2019 may have exceeded RMB 6 billion. In addition, overseas players of *Honor of Kings* have contributed more than USD $200 million in revenue.

Table 5、Changes of *Hornor of Kings* in iOS monthly free game ranking

Time	Ranking
February 2017	1
February 2018	3
February 2019	7

Source: App Store, CNG, Industrial Securities

Table 6、Game revenue measurement ranking list in Feb. 2019 by CNG

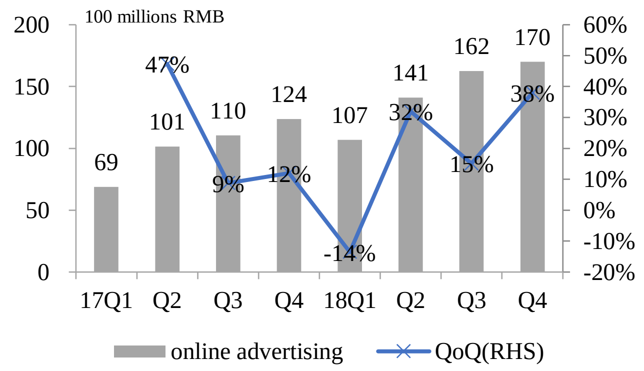
Ranking	Name	Company	Type	Ranking compared with January
1	Honor of Kings	Tencent	MOBA	-
2	QQ Speed	Tencent	Racing	1
3	Fantasy Westward Journey	Netease	Turn based RPG	-1
4	Onmyoji	Netease	Turn based RPG	6
5	Fate/Grand Order	Bilibili	Card	7
6	QQ Dancer	Tencent	Dance	1
7	Life After	Netease	Survival	-1
8	King of Chaos	Tencent	Strategy	-4
9	Cross Fire	Tencent	Shooting	8
10	New Westeard Journey	Netease	Turn based RPG	-5

Source: CNG, Industrial Securities

2. The advertising business grew steadily, WeChat's advertising advantage was obvious, and media advertising slightly exceeded our expectation

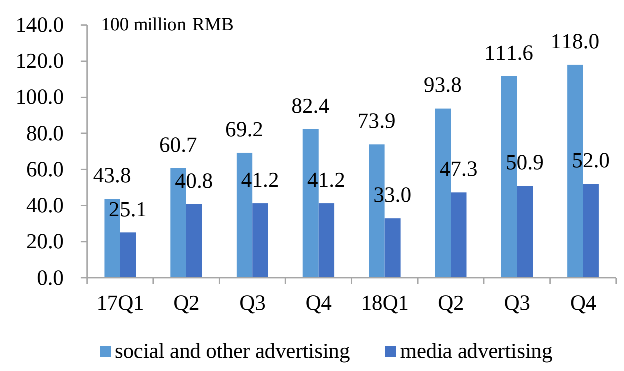
Media advertising continued to grow steadily in the face of a downturn in the market, with growth exceeding expectations. Online advertising revenue reached RMB 170.33 billion in Q4 2018, grew by 38% YoY and 5% QoQ. Among them, media advertising revenue exceeded expectations and reached RMB 5.19 billion(26% YoY and 2% QoQ). Social and other advertising revenues reached RMB 11.85 billion, increased by 44% YoY and 6% QoQ The performance in this period was good and basically in line with our expectations.

Fig. 10、Tencent's online advertising revenue



Source: Company Disclosure, Industrial Securities

Fig. 11、Media advertising, social and other advertising revenue



Source: Company Disclosure, Industrial Securities

In the fourth quarter of this year, due to the impact of the macroeconomic situation, the growth rate of Internet advertising revenue continued to shrink. Baidu and iQiyi's advertising revenue growth QoQ were negative in Q4, Weibo's advertising revenue QoQ increased by only 1.9% in Q4, and the growth rate slowed

down markedly. In the downturn, the advertising resources of WeChat Moments increased, the new advertising resources of Mini Programs, the high display volume of the company's mobile advertising alliance and eCPM, as well as the traffic growth and commercialization of QQ's news stream, helped the increase in Tencent's advertising revenue.

Table 7、 Other Chinese Internet companies' advertising revenues and growth rate in 18Q4

Company	Business Name	2018Q4	2018Q3	2017Q4	QoQ	YoY
Baidu	Online marketing services	21,197	22,481	20,418	-5.70%	3.80%
iQiYi	Online advertising services	2,203,637	2,396,247	2,142,839	-8.00%	2.80%
Sogou	Search and search-related advertising revenues	276,824	255,312	247,140	8.40%	12.00%
Qutoutiao	Advertising and marketing revenues	1,247.90	896.5	249.9	39.20%	399.40%
Bilibili	Advertising revenues	159,917	137,266	39,748	16.50%	302.30%
Yiche	Advertising and subscription business	1,162,867	1,056,096	1,009,160	10.10%	15.20%
Weibo	Advertising revenues	417,016	409,273	332,305	1.90%	25.50%

Source： Company Disclosure, Industrial Securities

The media advertisements exceeded expectations, the self-produced shows had a huge influence and new forms of marketing have emerged. In 2018, video advertising revenue increased by 34% YoY, and it increased by 21% YoY in Q4, mainly due to the increase in video view counts and advertising volume because of the popularity of self-produced variety show. In 2018, online video continued to innovate monetization ways. Tencent Video launched new marketing products with the ability to create popular TV series and variety shows: creative small theater, fresh implant mode and buy while watching, etc., to boost advertising revenue. In addition, the news advertising business resumed YoY growth after the system upgrade in the second half year, and media information flow advertising revenue increased by more than 10 times.

Social advertising grew steadily. Benefiting from the growth of WeChat Moments, Mini Programs, mobile advertising alliance and QQ Kandian's growth, social and other advertising revenues achieved steady growth:

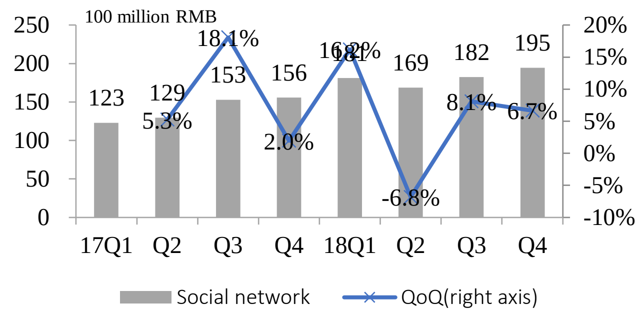
1） **Tencent's social advertising ranks first in the mobile advertising traffic platform and has a solid position.** According to App Growing, in the overall mobile advertising in Q4, Tencent social advertising, Baidu information flow, Toutiao advertising platform ranked the top three in the traffic platform promotion list, the unbreakable social traffic is the core competitiveness of Tencent social advertising business.

2） **The exposure of Moments was effectively increased, and the click rate is the next focus.** The advertising fill rate of the circle of Moments was effectively improved, and about 50% of active users of Moments will browse the second advertisement. The ad click-through rate is currently at a healthy level and is a core element in the future to further increase advertising revenue.

3. Growth of digital content continues to be strong

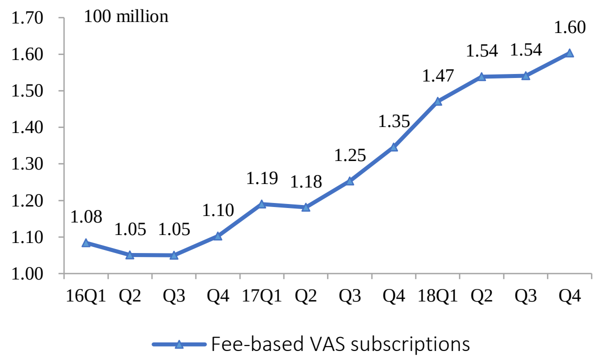
Revenue of social network was 19.452 billion RMB, up 25% year-on-year and 7% quarter-on-quarter. Due to the strong growth of video subscription service in the current period, fee-based VAS registered subscriptions increased by 19.1% year-on-year to 160.3 million, and video service subscribers reached 89 million at the end of the period, achieving a year-on-year growth of 58%, which continued to consolidate the company's leading position in the domestic video industry.

Fig. 12、Tencent's social network revenue



Source: Company Disclosure, Industrial Securities

Fig. 13、Tencent's fee-based VAS subscriptions



Source: Company Disclosure, Industrial Securities

- **Tencent Video: Subscriber users grew at a rate of over 50%.** In 2018Q4, Tencent video's MAU reached 454 million, down 9.1% year-on-year and 1.8% quarter-on-quarter. The long-term video platform saw a decline in monthly users in the fourth quarter. On the order of subscribers, Tencent Video achieved a 58% year-on-year increase to 89 million, slightly more than iQIYI (iQIYI: 87.4 million). Tencent's total number of digital content subscriptions exceeded 100 million, a 50% year-on-year increase. The long-lived video platform experienced a decline in monthly active users in the fourth quarter. In terms of subscribers, Tencent Video achieved a 58% year-on-year growth of 89%, slightly more than iQIYI (iQIYI: 87.4 million). Total subscriptions of Tencent's digital content exceeded 100 million, up 50% year-on-year.

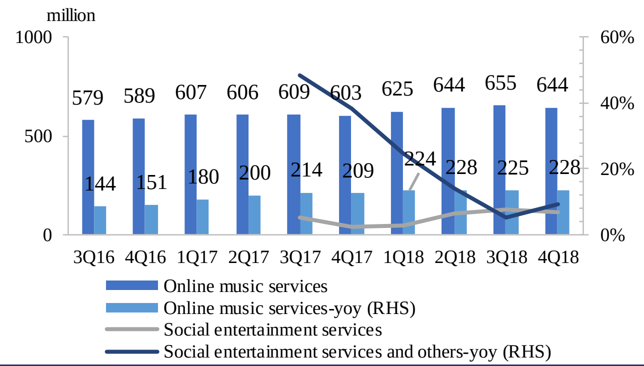
Table 8、Differences between Industrial Securities Research Institute forecast and actual result in 18Q4 and in FY2018

			MAU（10 thousand）			YoY			QoQ		
Code	APP	Type	18-Oct	18-Nov	18-Dec	18-Oct	18-Nov	18-Dec	18-Oct	18-Nov	18-Dec
IQ.O	iQIYI	Long video	54,645	54,756	53,803	10.00%	10.60%	5.60%	-1.20%	0.20%	-1.70%
700.HK	Tencent Video	Long video	46,569	46,204	45,383	-5.40%	-5.90%	-9.10%	0.70%	-0.80%	-1.80%
BABA.N	Alibaba	Long video	43,581	44,857	42,544	26.20%	19.40%	-0.30%	7.20%	2.90%	-5.20%

Source: Analysys, Industrial Securities

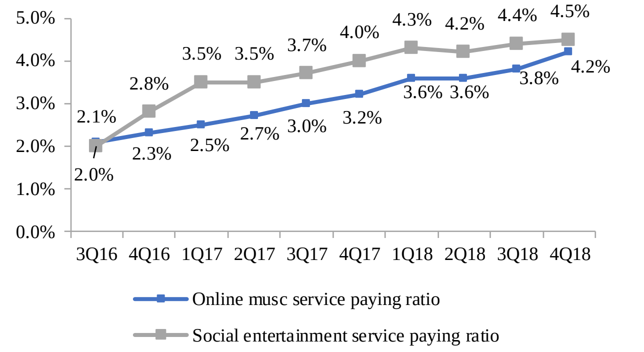
- **Tencent Music: The monthly active users are growing steadily, the music payment still has a bonus, and the social entertainment ARPU is obviously improved.** In 2018Q4, the MAU of online service business reached 644 million, up 6.8% stably under high penetration rate; the MAU of social entertainment service business reached 228 million, with a continuously slow-down overall growth rate. The payment rate of online music business increased to 4.2%, which is still low compared with Spotify and still has huge upside potential; payment rate of social entertainment service reached to 4.5%, with quarterly ARPU of 380.1 yuan, showing an obvious increase but the growth rate has slowed down. **The song library has increased to 30 million, and the form of content product is innovative, building a high content moat.** By the end of 2018, Tencent Music's song library had increased to 30 million; innovations in content format, such as music singing programs, co-production variety show "Producer 101", live talk show, long-audio radio show, and support for independent musicians helped to further enhance platform differentiation and build a content moat. In addition, Tencent Music has also established a joint venture with a record company to create new music themes.

Fig. 14、3Q16-4Q18 TME's segment MAU



Source： Company Disclosure, Industrial Securities

Fig. 15、3Q16-4Q18 TME's segment paying ratio

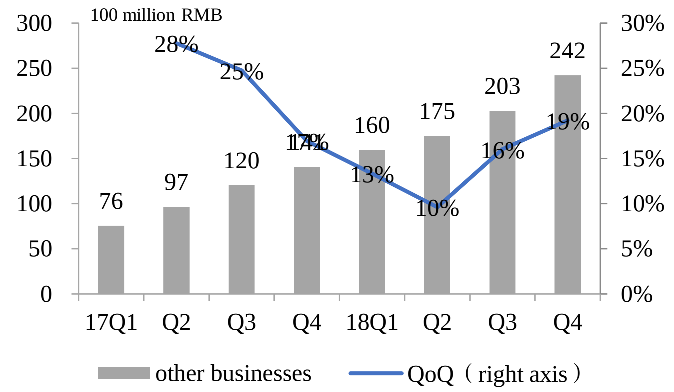


Source： Company Disclosure, Industrial Securities

4. Due to the transition to To-B, other businesses increased substantially, contributing 25% of total revenue (18.23% in 2017)

The revenue of company's other businesses reached 24.212 billion yuan, up 72% year-on-year and 19% quarter-on-quarter, with the growth rate continuing to be steady. The proportion of revenue contributed by this business has increased from 18.23% in 2017 to 25% in 2018, and the growth was mainly driven by the increase in revenue of Fintech, cloud service and film production business. Gross margins declined slightly, from 23.26% in Q2 to 23.12% in Q3, adversely affected by the People's Bank of China progressively increasing its centralized deposit ratio requirement for third party online payment services providers.

Fig. 16、Tencent's other businesses growth rate

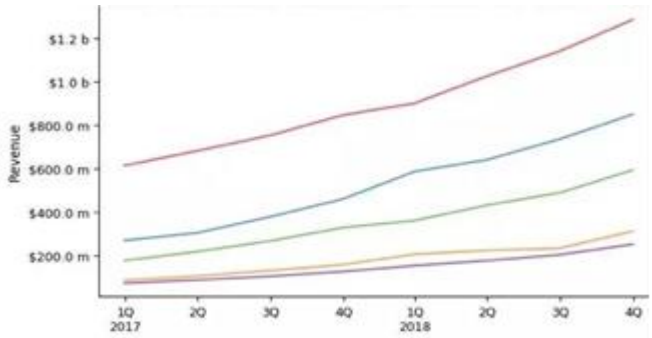


Source： Company Disclosure, Industrial Securities

- **Tencent Cloud: growth rate of revenue and customers doubled, expanded new application areas and developed new products.** Full year 2018, revenue of cloud service increased by over 100% year-on-year to 9.1 billion yuan, and revenue of Q4 reached 3.1 billion in a single quarter. Tencent maintained its leading position in cloud services, games, live broadcast, and video, and expanded its market share in other sectors such as finance and smart retail. In the fourth quarter, Tencent Cloud fee-based registered subscriptions doubled year-on-year. By the end of 2018, Tencent's global cloud infrastructure had covered 25 regions, operating in 53 availability zones worldwide, developed and launched new IaaS and PaaS products in the fourth quarter. In addition to online game and video field, it also uses AI and security technologies to further expand to the field of finance and retail cloud services. At present, Tencent Cloud is the preferred partner of Bank of China, China Construction Bank and China Merchants Bank. Most of the head Internet finance and insurance companies also cooperate with Tencent Cloud.

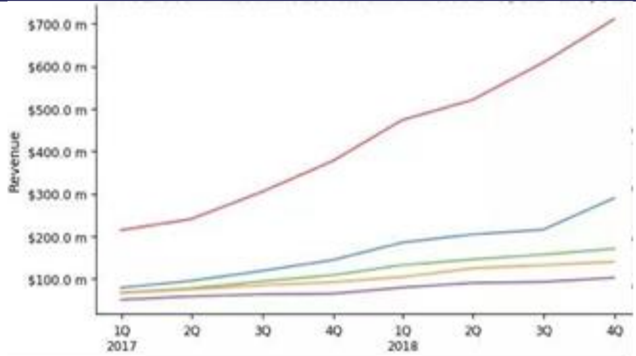
- **Tencent Cloud's market share has risen rapidly, with the fastest growth rate and huge potential.** According to the global cloud infrastructure services market data released by Synergy Research Group in the fourth quarter of 2018 and the whole year, Amazon, Alibaba and Microsoft still occupy the top three in the Asia-Pacific region. Tencent Cloud surpassed Google (4.7%)in the fourth quarter with a 5.8% share, ranked fourth in the Asia-Pacific market. Full year 2018, Tencent Cloud occupied 5.4% of the Asia-Pacific market, and also surpassed Google, ranking fourth. In the domestic market, Alibaba Cloud ranked first with a market share of 40.5%, Tencent Cloud following suit, with a share of 18.5% in 18Q4, and a market share of 15.3% for the whole year, the fastest growth among Top5 vendors. Its potential is huge.

Fig. 17、17Q1-18Q4 Asia Pacific Cloud Infrastructure Services Market Share



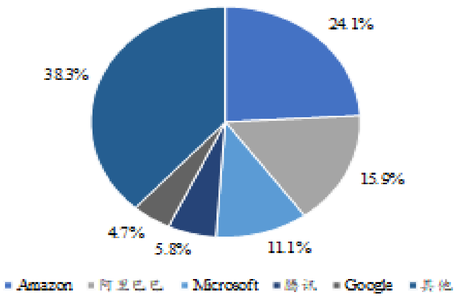
Source: Synergy Research Group, Industrial Securities

Fig. 18、17Q1-18Q4 China Cloud Infrastructure Services Market Share



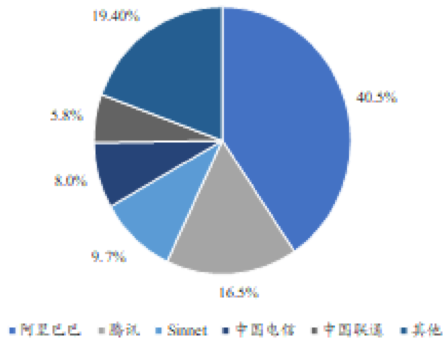
Source: Synergy Research Group, Industrial Securities

Fig. 19、18Q4 Asia Pacific Cloud Infrastructure Services Market Share



Source: Synergy Research Group, Industrial Securities

Fig. 20、18Q4 China Cloud Infrastructure Services Market Share



Source: Synergy Research Group, Industrial Securities

- **WeChat payment: Active users grew strongly and usage scenarios continued to increase.** In 2018, the average daily payment transaction volume exceeded 1 billion, and commercial payment revenue more than doubled year-on-year. In the fourth quarter, monthly active merchants increased over 80% year-on-year. Tencent boosted its payment penetration in the food and retail industries thanks to features such as Mini program and Scan-to-pay solution. In addition, WeChat Pay continued to expand its global footprint. In August 2018, WeChat Pay Malaysia services were officially launched. In October 2018, WeChat Pay launched the first-of-its-kind cross-border payment service in Hong Kong. Currently, it covers approximately 1 million merchants in Mainland China. The transaction volume of WeChat Pay Hong Kong increased more than 10 times year-on-year. WeChat payment is now available in 49 markets outside Mainland China, supporting cross-border payment transactions in 16 currencies. By the end of 2018, the company had accumulated 100 million users, helping to manage customer assets exceeding 600 billion yuan.

Users of Mini Programs became more sticky. Mini programs have generated revenue over 500 billion yuan. In 2019, GMV is expected to exceed one trillion and Mini Programs advertisement revenue expected to exceed 10 billion. Monthly retention rate of users of Mini Programs had increased from 18.3% in November 2018 to 19.5% in January 2019, and user stickiness had further increased. By the end of 2018, Mini Programs had created more than 500 billion commercial value. Apart from Mini Games, according to Aladdin's mini program, GMV of Mini Programs are expected to exceed one trillion, and Mini Programs' cumulative users are expected to be monetized this year. The average daily transaction volume of Mini Program advertising market has also reached nearly 30 million from 50+ million in

February 2018, an increase of nearly 600 times, and is expected to exceed 10 billion in 2019.

Table 9、Wechat Mini Program & Other Mini Program &App Store & Google play Comparison

	MAU	DAU	Number of Mini Programs/App	Retention rate in the next day	DAOT	DAF	2017 Revenue worldwide	2018Q3 Revenue in China	Release time
Wechat Mini Programs	700 million	2 亿	1200k	44.50%	15.5 minutes	4-6（58%）			9 Jan 2017
Ali Mini Programs	380 million	1.7 亿	65k	67.80%	4.7 minutes	≤1（44%）			18 Aug 2017
Baidu Mini Programs	320 million	1.5 亿	10k	12%	2.1 minutes	7-10（48%）			4 Jul 2018
AppStore	1 billion (2018-7-6)		3.6 million (China:1.78 million)				38.5 billion USD	23.7 billion RMB	10 Jul 2008
Google play	1 billion (2017-3-7)		2.8 million				20.1 billion USD		7 Mar 2012

Source： Company Disclosure, Industrial Securities

5. Investment Proposal: Raise the target price to HK$407.2 and maintain the “outperform” rating.

We use the DCF model to re-evaluate the company's stock, and the DCF model reflects the downward revision of the profit forecast (WACC=10%, Perpetual g=2%). According to calculation, Tencent’s total equity value excluding its investments based on FCFF discount is 275 billion RMB. We apply a 1.5x PB for Tencent’s investments according to the corresponding assets, and we also make a valuation of Tencent Video and Tencent Music, which contributed negative cash flow. Overall, we derive a total share price of HK$407.2.

Table 10、Tencent’s FCFF forecast (in thousand RMB)

	2016	2017	2018	2019E	2020E	2021E
EBIT (excluding investments)	49,904,000	66,222,000	76,365,000	86,186,078	106,537,166	129,545,571
Tax rate	-19.74%	-17.85%	-15.33%	-15.00%	-15.00%	-15.00%
NOPLAT	40,053,662	54,403,158	64,657,953	73,258,167	90,556,591	110,113,736
add: Share-based compensation expenses	4,313,000	6,137,000	7,900,000	8,690,000	9,559,000	10,132,540
add: Depreciation and amortization	12,646,000	23,502,000	34,012,000	36,323,730	45,541,950	54,241,014
gross operating cash flow	57,012,662	84,042,158	106,569,953	118,271,897	145,657,541	174,487,290
less: additional working capital	43,466,000	-21,811,000	-14,239,000	-20,829,159	-24,897,576	-24,929,829
net operating cash flow	13,546,662	105,853,158	120,808,953	139,101,055	170,555,117	199,417,118
less: capital expenditure	12,100,000	12,768,000	23,941,000	34,714,450	43,393,063	52,071,675
FCFF	1,446,662	93,085,158	96,867,953	104,386,605	127,162,055	147,345,443

Source： Industrial Securities estimates

Table 11、DCF Valuation

FCFF Valuation	Discounted cash flow (thousands)	% of value
First stage	261,112,457	7.74%
Second stage	1,205,589,572	35.75%
Third stage(Final value)	1,260,480,378	37.37%
AEV	2,727,182,407	80.86%
less: net liabilities	131,157,000	-3.89%
less: non-controlling interests	34,892,103	-1.03%
add: cash	186,942,231	5.54%

Total equity value	2,748,075,534	
add: value of Tencent's investments	544,516,500	16.15%
add: value of Tencent Video	50,000,000	1.48%
add: value of Tencent Cloud	30,000,000	0.89%
value-added total equity value	3,372,592,034	100%
Total shares(thousands)	9,520,378	
stock price(RMB)	354.25	
stock price($HK)	**407.2**	

Source： Industrial Securities estimates

Table 12、 Tencent's income statement annual forecast (in million RMB)

	2016	2017	2018A	2019E	2020E	2021E
Revenues	151,938	237,760	312,694	398,046	506,710	624,421
Growth rate	47.71%	56.48%	31.52%	27.30%	27.30%	23.23%
Cost of revenues	-67,439	-120,835	-170,574	-228,927	-296,624	-366,869
Gross profit	84,499	116,925	142,120	169,119	210,086	257,552
Growth rate	38.00%	38.37%	21.55%	19.00%	24.22%	22.59%
Interest Income	2,619	3,940	4,569	5,483	8,772	14,036
Other(losses)/gains, net	3,594	20,140	16,714	14,148	19,876	24,217
Selling and marketing expenses	-12,136	-17,652	-24,233	-30,122	-36,663	-46,832
Proportion of income	-7.99%	-7.42%	-7.75%	-7.57%	-7.24%	-7.50%
General and administrative expenses	-22,459	-33,051	-41,522	-52,811	-66,886	-81,175
Proportion of income	-14.78%	-13.90%	-13.28%	-13.27%	-13.20%	-13.00%
EBIT	56,117	90,302	97,648	105,816	135,186	167,798
Finance costs, net	-1,955	-2,908	-4,669	-4,985	-5,384	-824
Shares of profit/(loss) of associates and joint ventures	-2,522	821	1,487	3,227	4,082	4,947
Profit before income tax	51,640	88,215	94,466	104,058	133,884	171,921
Income tax expense	-10193	-15744	-14,482	-16,254	-20,092	-25,788
Profit	41,447	72,471	79,984	87,804	113,792	146,133
Growth rate	42.39%	74.85%	10.37%	9.78%	29.60%	28.42%
Non-GAAP profit attributable to equity holders of the company	45,420	65,126	77,469	91,973	114,653	142,235
Growth rate	40.14%	43.39%	18.95%	18.72%	24.66%	24.06%
Profit attributable to equity holders of the company	41,095	71,510	78,719	85,609	111,007	141,019
Growth rate	42.66%	74.01%	10.08%	8.75%	29.67%	27.04%
Profit attributable to non-controlling interests	352	961	1,265	2,195	2,786	5,115

Source： Industrial Securities estimates

Table 13、 Tencent's income statement quarterly forecast (in million RMB)

	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4
Revenues	89,570	92,827	104,071	111,579	110,649	117,360	134,034	144,666
Cost of Revenues	-49,259	-53,225	-60,664	-65,779	-61,826	-68,106	-79,267	-87,426
Gross profit	40,310	39,601	43,407	45,800	48,823	49,255	54,767	57,241
Selling and marketing expenses	-6,986	-6,962	-7,805	-8,368	-8,299	-8,802	-8,712	-10,850
Proportion of income	-7.8%	-7.5%	-7.5%	-7.5%	-7.5%	-7.5%	-6.5%	-7.5%
General and administrative expenses	-12,092	-12,253	-13,737	-14,728	-14,606	-15,492	-17,692	-19,096
Proportion of income	-13.5%	-13.2%	-13.2%	-13.2%	-13.2%	-13.2%	-13.2%	-13.2%
EBIT	24,831	25,751	27,094	28,141	28,553	35,670	35,920	35,042
Finance costs, net	-706	-1,243	-1,582	-1,454	-763	-1,343	-1,676	-1,542

Profit before income tax	24,931	25,314	26,319	27,493	28,811	35,348	35,264	34,521
Income tax expense	-3,989	-3,924	-4,079	-4,261	-4,322	-5,302	-5,290	-5,178
Profit	20,942	21,391	22,240	23,232	24,489	30,046	29,975	29,343
Profit attributable to equity holders of the company	20,419	20,856	21,684	22,651	23,877	29,295	29,225	28,610
Non-controlling interests	524	535	556	581	612	751	749	734
Non-GAAP operating profit	21,680	25,914	28,770	27,435	24,481	35,254	37,250	34,855
Non-GAAP profit	18,386	23,178	26,397	24,878	21,068	31,415	34,036	31,740

Source： Industrial Securities estimates

In 2019, from the perspective of Tencent's different businesses: 1) Online game: Although the approval of mobile game license numbers has been restarted, due to the backlog of mobile games in license freezing time and the industry supervision environment is still not stable enough, the mobile games business will focus on expanding overseas markets in 2019. In the meantime, when license numbers are not available to self-developed games, licensed games will become an important supplement; **2) Digital content:** Content quality and quantity is the top priority for attracting users. In the future, Tencent will continue to increase the content investment of video and music business, and at the same time, through self-made drama or variety, build a content moat, increase the payment rate and ARPPU value, and continue to strengthen synergies of various pan-entertainment businesses, to realize mutual benefit and win-win; **3) Advertising monetization:** The growth momentum of social advertising is still mainly from WeChat Moments, Mini Programs (including Mini Games) and QQ Kandian. At present, the advertising fill rate is effectively improved, and the next focus will be on the improvement of click-through rate and conversion rate. This puts higher demands on the innovation of advertising forms and the accuracy of user positioning; in addition, hot dramas and variety shows have a great effect on the promotion of advertising revenue; 4) Other businesses: payment of full scene + overseas expansion, cloud business continues to seize the market, transform to To-B, continue to invest in the consumption Internet, embrace the industry Internet. 5) In addition, Tencent's investments are gradually embodying value. As the company's joint ventures and joint ventures grow, Tencent will enjoy an increasingly higher status and influence in various industries, which will benefit the company's steady development in the long run.

Investment Proposal: Maintain the "outperform" rating and raise the target price to HK$407.2. Tencent almost occupies the first echelon in all areas of the mobile Internet and we believe that this position is still stable and will not be shaken. However, due to the macro policies, game business is under great pressure. In addition, Tencent is optimizing its business structure to reduce the reliance on game business. As a result, the company's profit margin and other indicators will continue to be under pressure in the short term. However, from a long-term perspective, the business outlook remains optimistic. We are optimistic about the release of the company's advertising business and the growth of its to-B business. Therefore, we slightly raise its target price to HK$407.2(original target price: HK$345.8) based on our DCF model, representing around 32.4x Non-GAAP PE in 2019 and we maintain an outperform rating, with 15.09% upside compared with the closing price on March 25, 2019.

Potential risk： regulation risk;growth rate of game business lower than expected;advertising revenue lower than expected;financial indicators such as ROE, gross margin worsen;organizational structure adjustments not up to expectations;decline of user usage time of Tencent's products

Appendix

Balance sheet RMB in millions

Fiscal year	2018E	2019E	2020E	2021E
Current assets	**217,080**	**253,618**	**317,414**	**412,039**
Inventories	324	435	563	697
Accounts receivable	46,920	59,727	74,512	89,985
Cash and cash equivalents	97,814	121,434	170,317	249,336
Other current assets	72,022	72,022	72,022	72,022
Non-current assets	**506,441**	**628,774**	**771,166**	**916,277**
Property, plant and equipment	35,091	45,102	55,380	65,081
Construction in progress	4,879	5,979	6,979	8,979
Investment properties	725	755	785	815
Land use rights	7,106	8,434	9,735	11,010
Intangible assets	56,650	72,488	91,866	110,149
Investments in associates	227,790	311,817	396,699	482,446
Available-for-sale financial assets	135,221	145,221	170,743	198,817
Other Non-current assets	38,979	38,979	38,979	38,979
Total assets	**723,521**	**882,392**	**1,088,580**	**1,328,316**
Current liabilities	**202,435**	**234,812**	**281,622**	**329,159**
Accounts payable	107,047	140,794	180,605	221,141
Borrowings	26,834	25,464	32,464	39,464
Other current liabilities	68,554	68,554	68,554	68,554
Non-current liabilities	**164,879**	**194,879**	**224,879**	**254,879**
Long-term payables	87,437	117,437	147,437	177,437
Other Non-current liabilities	77,442	77,442	77,442	77,442
Total liabilities	**367,314**	**429,691**	**506,501**	**584,038**
Equity attributable to equity holders of the Company	**323,510**	**417,809**	**542,658**	**699,110**
Share capital and Share premium	27,294	27,294	27,294	27,294
Shares held for share award schemes	-4,173	-4,173	-4,173	-4,173
Treasury shares	729	729	731	-1,277
Retained earnings	299,660	393,959	518,806	677,266
Non-controlling interests	**32,697**	**34,892**	**39,420**	**45,167**
Total equity	**356,207**	**452,701**	**582,078**	**744,278**
Total equity and liabilities	**723,521**	**882,392**	**1,088,580**	**1,328,316**

Cash Flow

Fiscal year	2018E	2019E	2020E	2021E
Profit before tax	94,466	104,058	133,945	171,921
Depreciation and amortization	34,012	36,324	45,542	54,241
Interest expense	4,669	4,985	5,384	824
Change of working capital	-13,261	-12,807	-14,784	-15,473
Others	-13,443	-1,769	-8,966	-19,276
CF from operating	**106,443**	**130,790**	**161,121**	**192,237**
CF from investing	**-151,913**	**-135,800**	**-139,681**	**-138,077**
CF from financing	**35,380**	**28,630**	**27,443**	**24,859**
Net change in cash and cash equivalents	-10,090	23,620	48,882	79,019
Cash and cash equivalents beginning of the year	105,697	97,814	121,434	170,317
Cash and cash equivalents end of the year	97,814	121,434	170,317	249,336

Income statement RMB in millions

Fiscal year	2018E	2019E	2020E	2021E
Revenues	**312,694**	**398,046**	**506,710**	**624,421**
Cost of revenues	170,574	228,927	296,624	366,869
Gross profit	142,120	169,119	210,086	257,552
Interest income	4,569	5,483	8,772	14,036
Other gains, net	16,714	14,148	19,876	24,217
Selling and marketing expenses	24,233	30,122	36,663	46,832
General and administrative expenses	-41,522	-52,811	-66,886	-81,175
Operating profit	**97,648**	**105,816**	**135,186**	**167,798**
Finance costs, net	-4,669	-4,985	-5,384	-824
Share of profit of associates and joint ventures	1,487	3,227	4,082	4,947
Profit before income tax	**94,466**	**104,058**	**133,945**	**171,921**
Income tax expense	14,482	16,254	20,092	25,788
Profit for the period	**79,984**	**87,804**	**113,853**	**146,133**
Profit attributable to Non-controlling interests	1,265	2,195	2,846	5,115
Profit attributable to equity holders of the Company	**78,719**	**85,609**	**111,007**	**141,019**
Non-GAAP profit attributable to equity holders of the Company	**77,469**	**91,973**	**114,653**	**142,235**
EPS(RMB)	**8.27**	**8.99**	**11.66**	**14.81**
Non-Gaap EPS(RMB)	**8.43**	**9.75**	**12.42**	**15.19**

Key Financials

Fiscal year	2018E	2019E	2020E	2021E
Growth(%)				
Revenue	31.5%	27.3%	27.3%	23.2%
Operating profit	21.5%	19.0%	24.2%	22.6%
Net income	10.4%	9.8%	29.7%	28.4%
Net income attributable to equity holders of the Company	10.1%	8.8%	29.7%	27.0%
Profit Margin (%)				
Gross Margin	45.5%	42.5%	41.5%	41.2%
Non-Gaap Net Margin	25.7%	23.3%	23.3%	23.2%
Non-Gaap Net Margin attributable to equity holders of the Company	24.8%	23.1%	22.6%	22.8%
ROE	28.9%	19.4%	19.6%	19.6%
ROA	11.1%	10.0%	10.5%	11.0%
Solvency test (%)				
Net asset ratio	103.1%	94.9%	87.0%	78.5%
Debt ratio	50.8%	48.7%	46.5%	44.0%
Current ratio	1.07	1.08	1.13	1.25
Quick ratio	1.07	1.08	1.13	1.25
Operation(times)				
Assets turnover	43.2%	45.1%	46.5%	47.0%
Accounts payable turnover	0.15	0.15	0.15	0.14
Per share (RMB)				
Non-Gaap EPS	8.4	9.8	12.4	15.2
EPS	8.3	9.0	11.7	14.8
BPS	34.0	43.9	57.0	73.4
Multiple(x)				
PE(Non-Gaap)	37.6	32.5	25.6	20.9
PB	9.3	7.2	5.6	4.3

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Introduction of Share Investment Rating

Industry Investment Rating

When measuring the difference between the markup of the industry index and that of the market's benchmarks (Shanghai Composite Index/Shenzhen Component Index) within twelve months after the release of the report, we define the terms as follows:

- **Overweight：** Industry performs better than that of the whole market；
- **Neutral：** Industry performs about the same as that of the whole market；
- **Underweight：** Industry performs worse than that of the whole market

Company Investment Rating

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