

Buy

(Maintain)

# Tencent Holdings Ltd (0700.HK)

HK Stock

Game revenue from overseas got doubled increase,  
Fintech may become the new driver

March 23, 2020

TMT

Key Data

March 18, 2020

Closing Price (HK\$)	334.0
Total Shares (Bn)	9.55
Market Cap (HK\$/Bn)	3190.7
Net Assets (RMB/Bn)	488.8
Total Assets (RMB/Bn)	954.0
BVPS(RMB)	45.70

Key Financial Indicators

FY	2019A	2020E	2021E	2022E
Revenue (Mn/RMB)	377,289	474,558	589,357	721,624
YoY (%)	20.7%	25.8%	24.2%	22.4%
Non-IFRS Net Profit (Mn/RMB)	94,351	113,665	145,313	176,431
YoY (%)	21.8%	20.5%	27.8%	21.4%
Gross Margin (%)	44.4%	42.8%	44.0%	43.5%
Non-IFRS Net Profit Margin (%)	25.0%	24.0%	24.7%	24.4%
ROE (%)	19.6%	15.9%	16.6%	16.5%
Non-IFRS EPS (RMB)	9.97	12.01	15.35	18.63

Analyst

Yidong ZHANG

SFC: BIS749

SAC: S0190510110012

Contact

Venki Li

liwenjing@xyzq.com.cn

SAC: S0190118090169

Highlights

**Performance is in line with expectations.** The company's 4Q19 revenue was 105.77 billion yuan (YoY + 28%), and the annual revenue was 377.7 billion yuan, which was in line with our expectations (375.6 billion yuan). Due to the substantial increase in income generated from investments, net profit attributable to Tencent increased by 52% to 21.58 billion yuan And Non-IFRS net profit rose 29% year-on-year to 25.48 billion.

**Games: 1) The core games tend to stabilize, 2 important mobile games will be launched this year; 2) Overseas: PUBG and COD's success superimposing consolidation of Supercell will doubled overseas games.** In 4Q19, the company's online game revenue reached 30.29 billion yuan, an increase of 25% YoY, and the deferred revenue in 2019 increased 44% YoY. We expect that the increase in time length will drive core mobile games to reach a new high in January, and at the same time, two important mobile games will be launched this year. In addition, we are optimistic about overseas games, and expect them to double in 2020, with the proportion greater than 25%. We estimate that mobile games revenue will grow by 34% in 2020 (22% when excluding the impact of the consolidation of Supercell).

**Fintech: Leading number of transactions, and the growth of cloud business is notable.** In 4Q19, the company's fintech business revenue reached 29.9 billion yuan (YoY + 39%), with a proportion of 28.2%, approaching that of the game. In 2019, the company's total number of transactions reached 550.8 billion, 2.4 times that of Alipay, with daily number exceeding 1 billion. In addition, in 2019 the cloud services revenue exceeded 17 billion. We believe that the short-term payment pressure is due to the weakening of offline demand in special periods, but due to cost optimization + the growth of derivative financial services, the impact on profit is limited, and at the same time, we are long-term optimistic about the growth space of commercial payments and high-margin derivative financial services such as microfinance expand.

**Media advertisements as expected to decline by more than 20% in 4Q, and social advertisements have regained growth momentum.** In 4Q19, due to the release of advertising inventory, social advertising reached 16.27 billion yuan (YoY + 37%), and media advertising fell by 24% as expected due to deferred episodes and reduction in sports broadcasts. We expect the 1Q20 Internet advertising prosperity to decline, media advertising to continue to decline, and social advertising to maintain single-digit growth.

**Investment proposal: Maintain "Buy" rating.** We adjusted FY 20/21 revenue from 474.8 / 571.7 billion yuan to 474.6/589.4 billion yuan, and Non-IFRS net profit attributable to Tencent to 113.7 /145.3 billion yuan. Taking into account the recent macroeconomic weakness and financing costs, we Adjust the target price to HK \$ 421 (original target price: HK \$ 443) based on the DCF model, corresponding to 2020 Non-IFRS EPS of 30.5x PE, and maintain a "Buy" rating.

**Potential risks:** Policy regulatory risk; slower growth of game business; less than expected advertising business;

This English translation of the original Chinese version <海外游戏翻倍增长，金融科技或成新引擎 20200319> issued by Industrial Securities on 2020.03.19 is for information purpose only. In case of a discrepancy, the Chinese original will prevail.



Report Text

Event: Tencent Holdings (0700.HK) released the Q4 and full-year performance for 2019 on March 18:

1. Performance overview

The company's total Q4 2019 revenue was 105.767 billion yuan (same currency below), an increase of 25% year-on-year and a 9% quarter-on-quarter growth rate, in line with our expectations. The total revenue for the year was 377.289 billion yuan (yoy: + 21%). The company's total fee rate remains relatively stable, of which the sales expense rate in 19Q4 was 6.4% (compared to 5.6% for the full year 2019, Q3: 5.9%). Due to the substantial increase in the income generated from investments, the net profit attributable to Tencent increased by 52% to 21.58 billion yuan. The Non-IFRS net profit was 25.5 billion yuan with an increase of 51.7%, lower than expected. The combined monthly active accounts of "Weixin" and WeChat reached 1.165 billion, a year-on-year increase of 6%. QQ monthly active accounts reached 647 million, a year-on-year decrease of 7.5%.

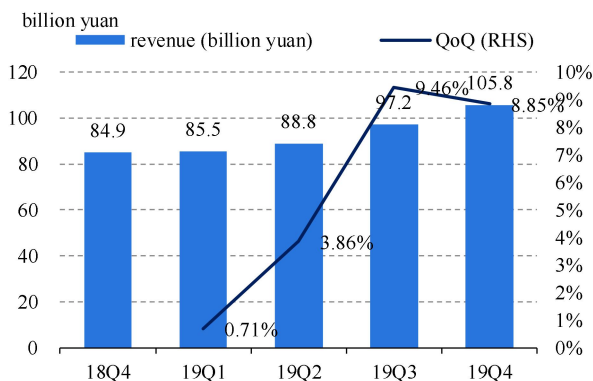
Table 1. Tencent 19Q4&2019 actual performance vs. Industrial Securities expected performance (million yuan)

	2019Q4E	2019Q4A	Diff(A/E-1)	2019E	2019A	Diff(A/E-1)
Revenue	104,052	105,767	1.65%	375,574	377,289	0.46%
YoY	23%	25%		20.11%	20.66%	
Cost of sales	-58,152	-59,659		-208,249	-209,756	0.72%
Gross profit	45,900	46,108	0.45%	167,325	167,533	0.12%
YoY	30.58%	31.17%		17.73%	17.88%	
Selling expense	-5,827	-6,712		-20,511	-21,396	
Administrative expense	-14,047	-16,002		-51,491	-53,446	
Operating profit	28,862	28,604	-0.89%	118,952	118,694	-0.22%
Net profit	22,943	22,373	-2.48%	96,459	95,888	-0.59%
Net profit attributable to Tencent	23,586	21,582		95,314	93,310	
YoY	65.76%	51.68%		21.08%	18.54%	
Non-IFRS net profit attributable to Tencent	26,135	25,484	-2.49%	95,774	94,351	-1.49%
YoY	32.46%	29.16%		23.63%	21.79%	

Source: Company disclosure, Industrial Securities Research Institute

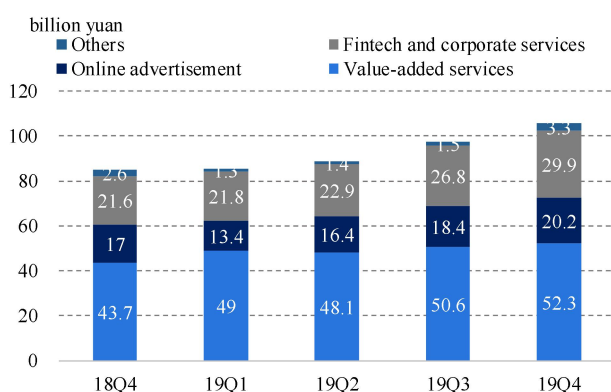
Segment revenue: Revenue structure continued to change, the proportion of value-added revenue continued to decline, and the proportion of fintech business rose to 28%. As of 19Q4, the company's value-added service revenue was 52.308 billion yuan, and the proportion of revenue dropped to 49%. Online advertising increased by 19% to 20.225 billion yuan, accounting for 19% of revenue; other business revenue increased to 33.234 billion, and the proportion of revenue up to 31%. The company's online game revenue reached 30.286 billion in Q4, and its revenue share remained 29% (Q3: 29%). The various incomes and proportions basically met our expectations.

Fig.1. Tencent quarterly revenue and growth rate



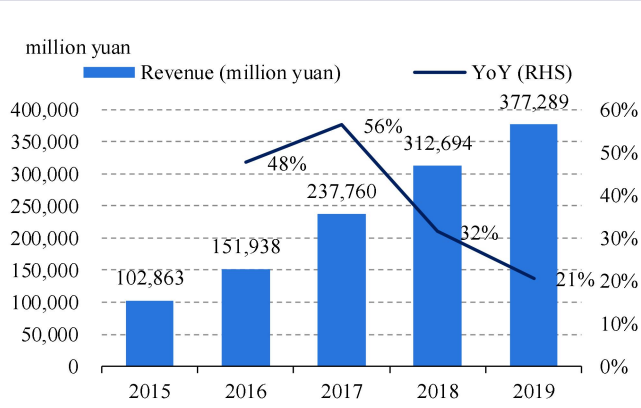
Source: Company disclosure, Industrial Securities Research Institute

Fig.2. Tencent quarterly revenue proportion



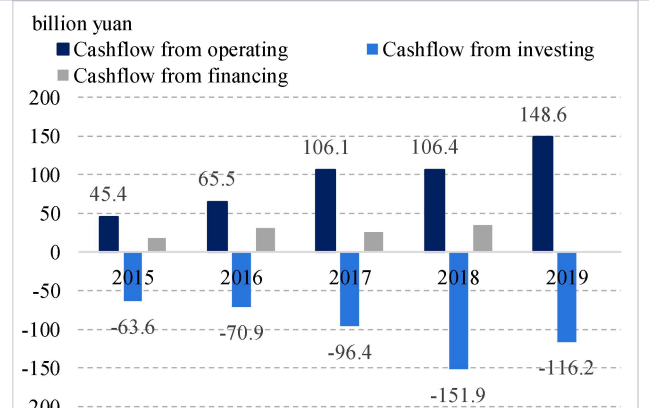
Source: Company disclosure, Industrial Securities Research Institute

Fig.3.Tencent quarterly revenue and growth rate



Source : Company disclosure, Industrial Securities Research Institute

Fig.4.Tencent quarterly revenue proportion



Source : Company disclosure, Industrial Securities Research Institute

Table 2.Tencent 19Q4&2019 actual performance vs. Industrial Securities expected performance (million yuan)

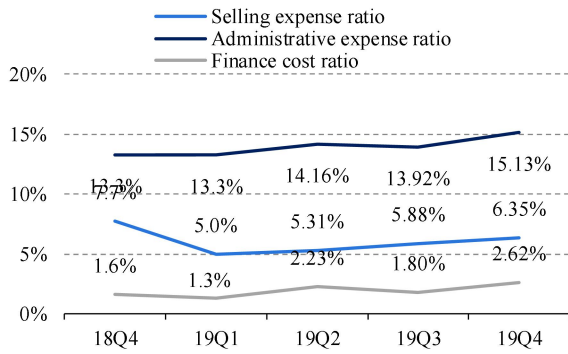
	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4
Value-added services	51.42%	57.30%	54.13%	52.07%	49.46%
Online games	28.50%	33.36%	30.74%	29.42%	28.63%
Social network	22.91%	23.94%	23.39%	22.65%	20.82%
Fintech and corporate services	25.67%	25.50%	25.77%	27.52%	28.29%
Online advertisements	20.06%	15.65%	18.47%	18.89%	19.12%
Media advertisements	6.11%	4.07%	4.95%	3.75%	3.74%
Social and other advertisements	13.95%	11.58%	13.52%	15.13%	15.39%
Others ( In old version F/S )	28.52%	27.04%	27.39%	29.05%	33.34%
Others ( In current version F/S )		1.55%	1.63%	1.53%	3.13%

Source: Company disclosure, Industrial Securities Research Institute

**The optimization of business structure led to a decline in gross profit margin.** In 4Q19, the company achieved a gross profit margin of 43.6%. The gross profit margin for the whole year decreased from 48.9% in 2018 to 44.3%. This is mainly due to the change in the company's business structure, and Tencent not only depends on the game business, with the proportion of value-added services with high gross profit margins, especially the game business, declining. In addition, the fourth-quarter sales expense ratio increased by 0.47 percentage points QoQ, mainly due to the promotion of mobile games and digital content and Supercell's expenses.

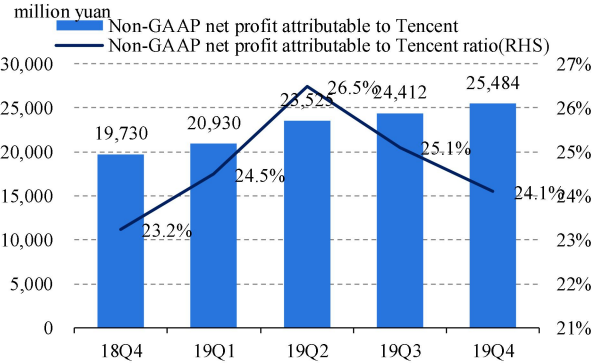
**Other income led to a substantial increase in Q4 net profit. Non-IFRS net profit attributable to Tencent was in line with expectations.** In Q4 2019, Tencent's net profit reached 21.6 billion yuan, an increase of 52% YoY and an increase of 6% QoQ, mainly due to the gains arising from the appreciation of certain investment companies (including vertical fields such as financial technology services, social media, education) And changes in capital activities of investment companies (transport services and online games, etc.). After excluding the effects of share-based compensation, amortization of intangible assets and provision for impairment, Non-IFRS net profit attributable to Tencent in the fourth quarter was 25.48 billion, YoY 29%. and the non-IFRS net profit margin was 25%.

Fig.5. Tencent quarterly expense ratio



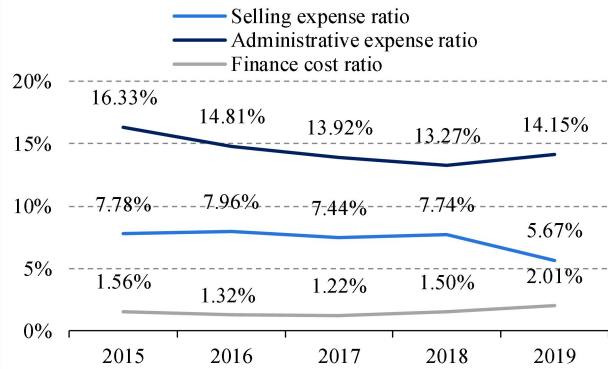
Source : Company disclosure, Industrial Securities Research Institute

Fig.6. Tencent quarterly Non-IFRS net profit attributable to Tencent and ratio



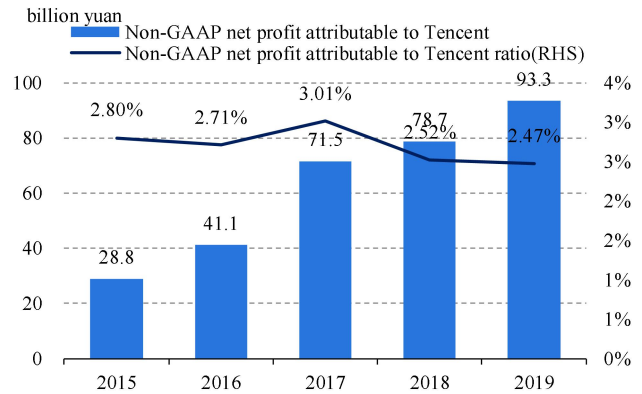
Source : Company disclosure, Industrial Securities Research Institute

Fig.7. Tencent annually expense ratio



Source : Company disclosure, Industrial Securities Research Institute

Fig.8. Tencent annually Non-IFRS net profit attributable to Tencent and ratio

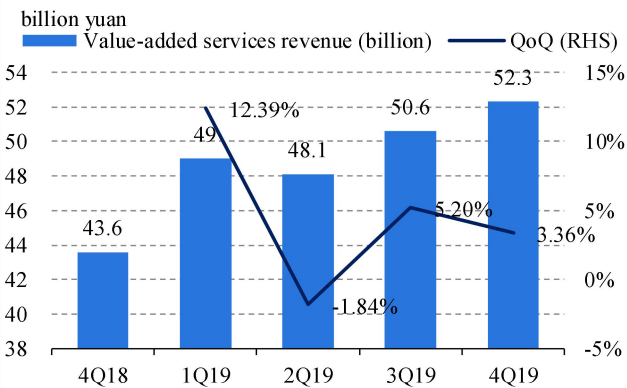


Source : Company disclosure, Industrial Securities Research Institute

2. Games: 2019 performance is in line with expectations, 2020 domestic core games exceeded expectations, and overseas games are expected to account for more than 25%

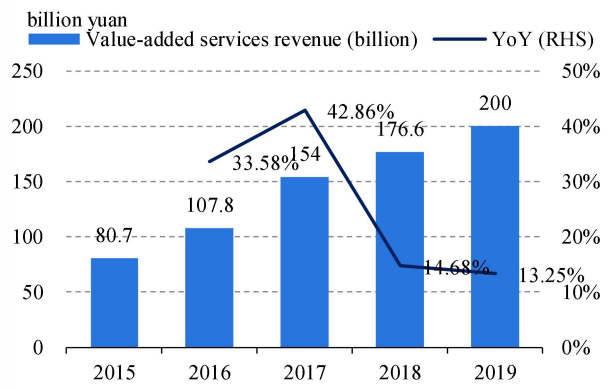
The growth of the gaming business was basically in line with expectations. 4Q online game revenue was 30.286 billion yuan, up 25% year-on-year. Mainly due to the steady growth of domestic head games and the impact of the consolidation of overseas games "PUBG Mobile" and Supercell; but the revenue of terminal games declined.

Fig.9. Tencent quarterly value-added service revenue



Source : Company disclosure, Industrial Securities Research Institute

Fig.10. Tencent annually value-added service revenue

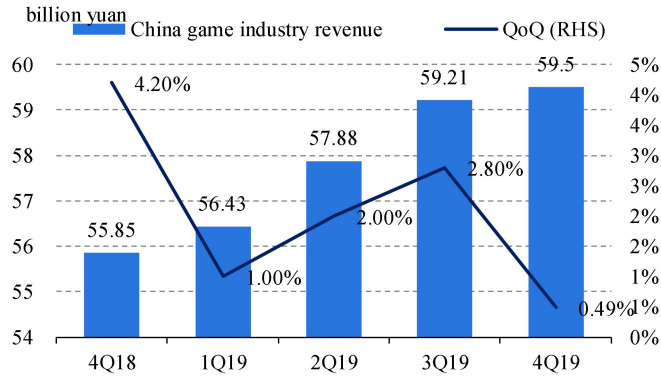


Source : Company disclosure, Industrial Securities Research Institute

Industry situation: The growth of mobile games in 2019Q4 is blocked, and the trend of recovery in

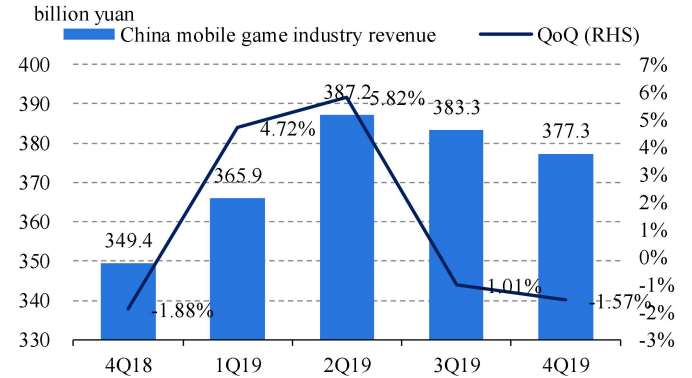
**2020Q1 is expected to be strong.** According to Gamma data, 4Q19 Chinese game market sales revenue increased by 6.54% QoQ, and mobile game market sales revenue decreased by 1.57% QoQ. The mobile game market showed a downward trend for two consecutive quarters, and capacity basically peaked. The 2020Q1 Spring Festival is superimposed with special public health events, and the mobile game industry is experiencing explosive growth with a year-on-year growth rate of 49.5%. Compared with February in the 2019 Spring Festival, the growth rate is 36.9%. After excluding the impact of days length, the growth rate is still to 23.6%.

**Fig.11. China game industry revenue**



Source: Gamma Data, Industrial Securities Research Institute

**Fig.12. China mobile game industry revenue**



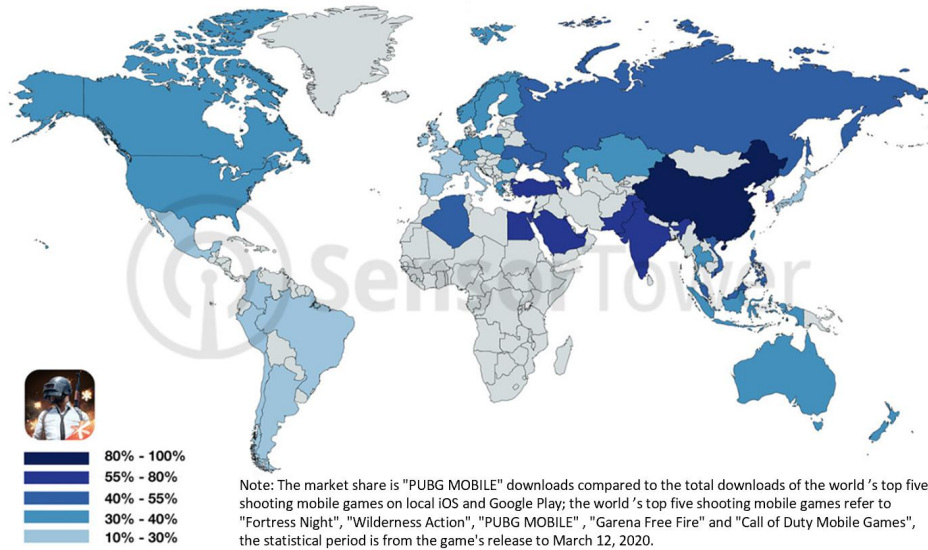
Source: Gamma Data, Industrial Securities Research Institute

**Core game situation:**

**"Glory of the King": In January, the water will reach a new high.** According to Aurora Data, King of Glory has the highest penetration rate of 17% in MOBA games. Affected by numerous activities and objective factors during the Spring Festival in 2020, the "Glory of the King" reached a record high in January. It is expected to reach 8.9 billion yuan in January 2020, an increase of about 25% over the same period last year. It is also expected to stably contribute to revenue in 2020 income.

**"Game for Peace" has grown rapidly, and "PUBG Mobile" is the first Chinese mobile game to successfully open the global market in 2019.** The Spring Festival stall the "Game for Peace" also performed great. We estimate that there will be about 2.5 billion revenue in January, which is an increase of more than 50% compared with the average monthly revenue. According to data from Sensor Tower, in January of this year, the overseas revenue of "PUBG Mobile" hit another record high, reaching nearly 83 million US dollars, an increase of 35.6% month-on-month and a 79.8% year-on-year increase. In addition, according to statistics, in the Chinese iOS market, "Game for Peace" has a market share of 81.5%, and in the Middle East, South Korea and South Asia, the market share exceeds 55%. As of March 15, 2020, the total overseas downloads of "PUBG Mobile" have exceeded 515 million times, with players all over the world. It is the first Chinese mobile game to successfully open the global market.

Fig.13. "PUBG MOBILE" market coverage (iOS & Google Play downloads)



Source: Sensor Tower, Industrial Securities Research Institute

**The agent game "Call of Duty: Mobile" performed well after went online.** According to Sensor Tower data, after the launch of "Call of Duty Mobile Games" in October last year, it achieved excellent results. In Q4 2019, it ranked in the top 5 revenue list, and contributed approximately US \$ 160 million in the three months of launch. "Call of Duty Mobile Games" ranked 21st in the whole year with only 3 months of revenue. However, in 2020, the revenue declined, exceeding 45 million US dollars in January, and fell to 30 million US dollars in February. The ranking of overseas revenue dropped from fifth in January to tenth in February. However, its download volume is high. As of March 15, 2020, the total overseas downloads reached 212 million. We expect to contribute nearly \$ 500 million in revenue throughout the year.

**The consolidation of Supercell has contributed to overseas game revenue accounting for more than 23%.** Supercell has launched five major games in the market, including "Brawl Stars", "Clash of Clans", and "Clash Royale", "Boom Beach", and "Hay Day". It is reported that Supercell's revenue in 2019 was US \$ 1.52 billion, a decline, mainly due to the company's long R & D cycle, and no new games have been launched since 2016. It is expected that the impact of the consolidation of Supercell on Tencent's mobile game revenue in 2020 will boost more than 13%.

Fig.14. Supercell revenue and annual growth

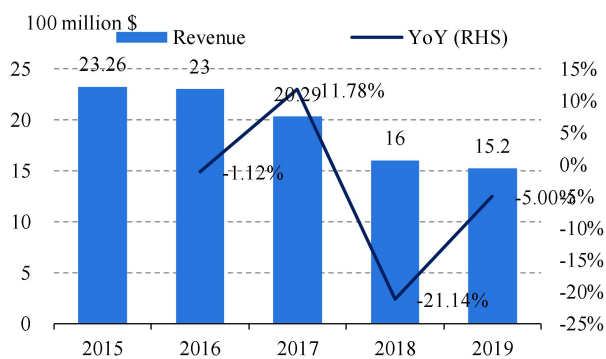
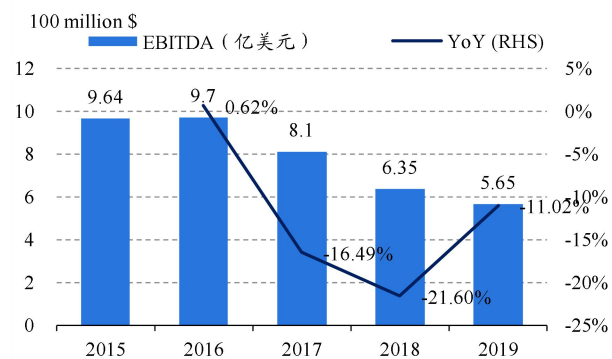


Fig.15. Supercell EBITDA and annual growth



Source: Sensor Tower, Industrial Securities Research Institute

Source: Sensor Tower, Industrial Securities Research Institute

**The "Dungeon and Fighter" (DNF) mobile game** opened for appointment on December 30, 2019, and as of March 18, 2020, the number of reservations has reached 23.58 million. The DNF classic IP is expected to bring strong willingness to pay for core users. After the launch, it is expected to contribute incremental income in the second half of the year.

**"League of Legends" mobile game is expected to go online in the second half of the year.** At present, the LOL mobile game has not yet obtained the mainland game license number. Through the trademark inquiry, it is found that the League of Legends mobile game is mainly concentrated in the

submission of trademark registration in June last year and January this year. The acceptance notice was issued on the 18<sup>th</sup> Feb, and it is still in the state of refusal to review. We expect that its design and gameplay will be more core, and it will contribute incremental income to overseas games after going online.

"Moonlight Blade" has already obtained a license number, and is expected to be launched in early Q3. "Moonlight Blade" PC version has some influence in the domestic swordsman game field, so mobile game has high expectations, and has obtained the license number on March 6th. Created by the Aurora studios, which is the creator for PC version of "Moonlight Blade", it focuses on high-quality art performance and national style to open the world. Last March, the TapTap score of the product's first test suit rose to 10 points.

**Table 3. Tencent 19Q4&2019 actual performance vs. Industrial Securities expected performance (million yuan)**

Game name	Type	Platform	Date acquired license	Self-developed or Agent
Chessrush	SLG	Mobile	Jan 10, 2020	Self-developed
Light and Night	RPG	Mobile	Jan 22, 2020	Self-developed
Qin's moon world	MMORPG	Mobile	Feb 25, 2020	Self-developed
Spiral storm	SLG	Mobile	Feb 10, 2020	Agent
Qin's moon	MMORPG	Mobile	Mar 6, 2020	Self-developed
Mario Kart 8	Platform jump	Switch	12 Mar, 2020	Agent
Super Mario Odyssey	Platform jump	Switch	12 Mar, 2020	Agent

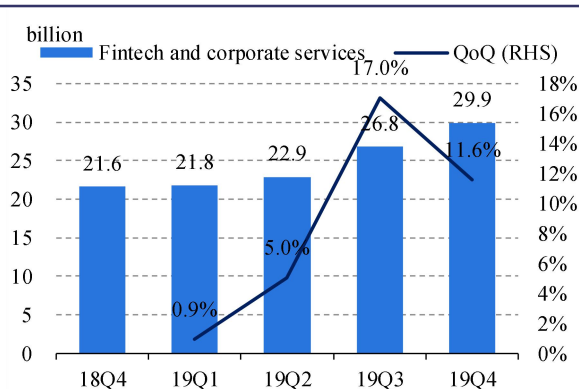
Source: General Administration of Radio, Film and Television, sorted out by industrial securities economic and Financial Research Institute

In 2020, only one of the Tencent games which obtained license was an agent, and the rest of the products were self-developed, and the categories were rich, demonstrating strong research and development capabilities. The frequency of launching new games since 2020 is not high, and no explosive games have appeared. "Toto Auto Chess", as Tencent's attempt in auto chess, has seen a rapid decline in subsequent follow-ups. It is expected that the "Teamfight Tactics" of the League of Legends IP will bring a breakthrough to the auto chess game category.

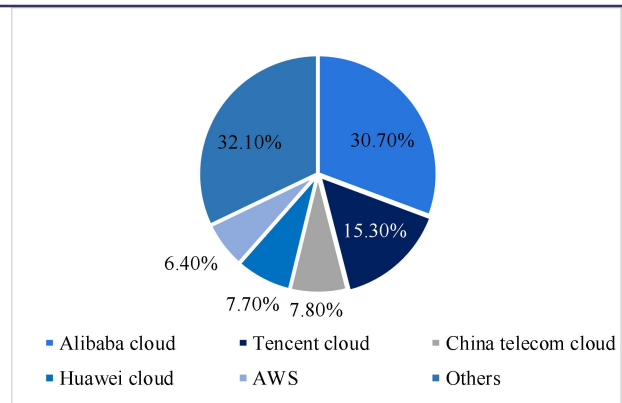
**3. The number of transactions is leading, the growth of cloud business is notable, and the contribution of fintech is increasingly prominent**

**Fintech and corporate services revenue accounted for 28%.** Fintech and corporate services revenue increased by 38% year-on-year to RMB 29.9 billion, in line with our expectations. The revenue share increased by 3 pcts to 28.3% (gaming: 28.7%). In addition, 2019 cloud services revenue exceeded 17 billion, paying customers More than one million. We believe that there is pressure in the short-term due to scenario constraints, but are long-term optimistic about the growth space of commercial payments sinks the expansion of high-margin derivative financial services such as micro-credit loans. In addition, the annual revenue of cloud business exceeds 17 billion yuan. In addition, due to the increase in user loyalty, more and more user funds pass through the Tencent financial ecosystem. The gross profit margin of fintech and corporate services was higher than expected, reaching 28.1% in 3Q. We are optimistic that the future profitability will be further enhanced. In the future, it will become the second largest "cash cow" besides games.

**Fig.16. Fintech and corporate services revenue and growth rate**



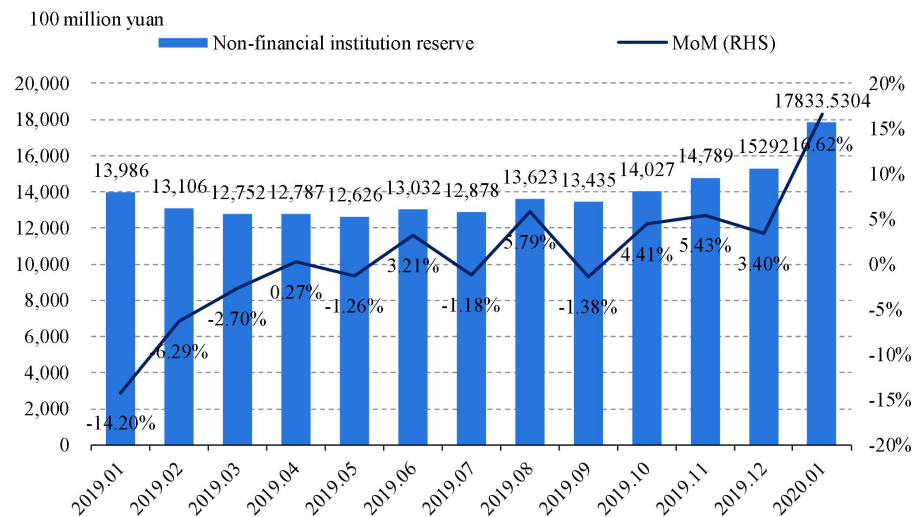
**Fig.17. 19H2 China public cloud IaaS market share**



Source: Sensor Tower, Industrial Securities Research Institute Source: Frost & Sullivan, Industrial Securities Research Institute

- The payment ecosystem is booming. The number of daily active users, per-user user transactions, and active merchants have all increased, which has promoted the strong growth of commercial payment transactions (especially offline payments) and transaction amounts. In 2019 the transaction amount is 550.8 billion, which is 2.4 times of that of Alibaba, the average daily number is more than 1 billion, the MAU is more than 800 million, and the monthly living merchants are more than 50 million. At the same time, in terms of wealth management, the number of wealth management users doubled year-on-year, and the amount of assets held increased by 50%.
- **The central bank's restart of reserves has brought about 2 billion yuan in revenue.** As of December 2019, the customer's reserve deposit deposited by payment institutions with the PBC is 1.78 trillion yuan, and This number set a record after 100% concentration of reserves. According to the current decision of 0.35% annual interest rate and reserve deposit, excluding 10% as non-bank payment industry security fund, the third-party payment institutions can obtain interest income of 5.61 billion yuan / year. According to Yiguan Analysis, Tencent Pay's market share is about 40%, so it can provide Tencent with 2.24 billion yuan of provision interest income in one year. We calculate that this policy can provide about 1.5% of the revenue increase for financial technology and enterprise service business, about 8% of the adjusted operating profit, affecting about 0.4% of the overall income, and nearly 2% of the overall adjusted operating profit.

**Fig.18.Changes in Payment Payments from Payment Institutions to Reserve Funds of the Central Bank**



Source: Central Bank, Industrial Securities Research Institute

- **The layout of other financial sectors with high profit margins has advanced steadily, and the space is gradually released.** Tencent continued to improve its financial management and loan business in terms of fintech services. The number of 4Q wealth management users has more than doubled year-on-year, and the number of assets held has increased by 50% year-on-year. Tencent's loan business mainly relies on Weizhong Bank's loan products and adopts a loan-assistance model. We estimate that micro-particle loan diversion revenue in 2019 will be 5.6 billion yuan. And its operating profit margin exceeds 80%; in terms of credit tools, the number of WeChat payment sub-users has exceeded 100 million, covering more than 30 industries, and 80% of deposit users have begun to enjoy deposit-free services.
- **Tencent Cloud's revenue surged 87% year-on-year to 17 billion yuan.** Mainly due to the successful expansion of market share (the laas market share of the public cloud market exceeded 15% in the second half of 2018) and continued expansion of business in vertical fields such as Internet services, tourism, livelihood services and industry. Although the implementation of cloud service-related projects has been delayed due to large public health events, which will have a negative impact on short-term revenue, it is still optimistic in the long

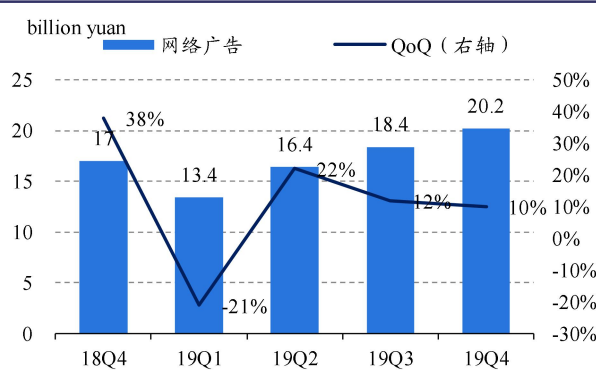
run. Customers will be more willing to use cloud services to meet remote office needs. The importance of telemedicine services is also manifesting.

- **WeChat Pay 1Q20 was adversely affected by revenue, but its profit impact was limited due to cost optimization + the growth of derivative financial services.** Due to the adverse impact of large public health events on payments, some small businesses were unable to receive QR code payments, and the number of payments was reduced. However, since mid-March, merchants' WeChat collection transaction volume has increased, and the number of consumer code scans has increased, but it will still have an impact on revenue. As for the profit side, recent marketing expenditures have been optimized. High-margin derivative financial services such as wealth management and lending services are very fast, and the business profits have a positive impact.

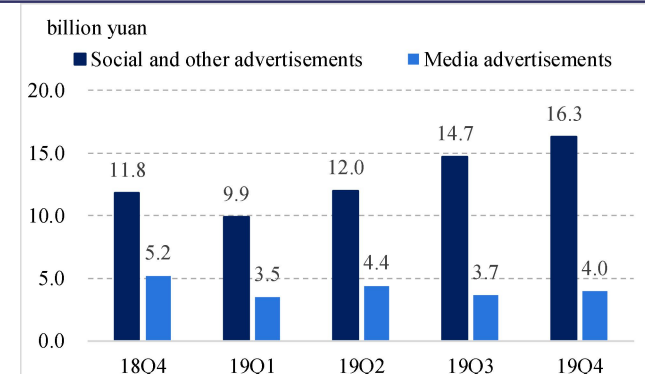
**4. Media ads fell as expected, and social ad growth was in line with expectations**

**Media advertisements are expected to decline by more than 20% in 4Q, and social advertisements have regained growth momentum.** In 4Q19, due to the release of advertising inventory + WeChat's traffic advantage, social advertising increased by 37% year-on-year to 16.27 billion yuan, which was slightly higher than our expectations; media advertising due to drama deferral + sports event broadcasts decreased 24% to 39.5 100 million yuan, in line with our expectations. We are optimistic about the competitive strength of social advertising, but expect the 1Q20 advertising prosperity to decline, which will lead to a decline in revenue.

**Fig.19.Tencent online advertisements revenue and growth rate**



**Fig.20. Quarterly revenue for social and media advertisements**



Source : Company disclosure, Industrial Securities Research Institute

Source : Company disclosure, Industrial Securities Research Institute

**The growth rate of Internet advertising revenue in 4Q19 continued to decline, and the prosperity in 1Q20 is expected to continue to decline.** In the depressed environment, the advertising resources of WeChat circle of friends increased, the company's mobile advertising network had a higher display volume, and eCPM helped Tencent's advertising revenue increase. In 4Q19, the overall revenue of the advertising industry showed a downward trend. Except for Bilibili, several other Internet advertising giants' FY19 Q4 advertising revenues fell year-on-year, and FY20 Q1 revenue guidelines were also unsatisfactory. Affected by major public health events, the growth rate of the advertising industry revenue slowed down and even showed negative growth.

**Table 4. Advertising revenue, total revenue and growth rate guidance of other China Internet companies**

Company	Account name	Unit	2019 Q4	2019 Q3	2018 Q4	QoQ %	YoY %	1Q20E Revenue growth Guidance
Baidu	Online-marketing expense	Million yuan	20,765	20,434	21,197	1.62%	-2.04%	(-13%, -5%)
Aiqiyi	Online-marketing service	Million yuan	1,883	2,067	2,204	-8.91%	-14.54%	(2%, 8%)
bilibili	Advertisements revenue	Million yuan	290	247	160	17.15%	81.11%	(57%, 60%)
Sogou	Search and search-related advertisements	Million dollar	275	288	277	-4.72%	-0.79%	(3%, 5%)
Weibo	Advertisements revenue	Million dollar	406	413	417	-1.60%	-2.66%	(-20%, -15%)

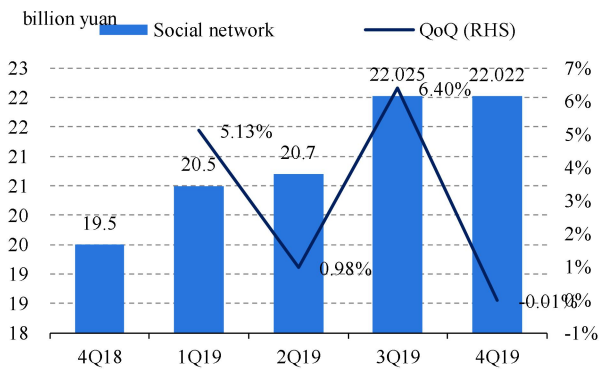
<b>Sina</b>	Advertisements revenue	Million dollar	461	461	484	-0.05%	-4.84%	-
-------------	------------------------	----------------	-----	-----	-----	--------	--------	---

Source: Company disclosure by above companies, sorted out by industrial securities economic and Financial Research Institute  
 Note: 1Q20E guideline refers to total revenue, Aiqiyi's 1Q20 advertisements revenue expected to decline 28% yoy.

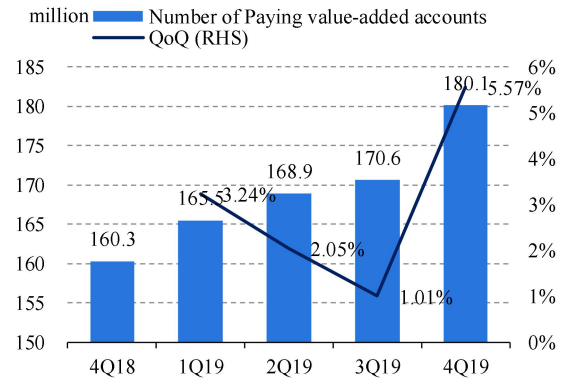
**5. Digital Content: Video Subscriptions Break 100 Million, Music Payout Rate Exceeds Expectations**

The company's 4Q social network revenue was 22.02 billion yuan, a year-on-year increase of 13%. The number of paid value-added service subscription accounts increased by 12.4% year-on-year to 180.1 million, of which the number of Tencent video subscription accounts increased to 100.6 million, but the annual operating loss of the video business decreased to less than 3 billion, which was lower than the industry average. In the music sector, the company's paid music library expanded, boosting the number of music subscription accounts by 42% year-on-year to 35.4 million.

**Fig.21.Tencent social network revenue**



**Fig.22.Number of Tencent paying value-added accounts**



Source : Company disclosure, Industrial Securities Research Institute

Source : Company disclosure, Industrial Securities Research Institute

- **Tencent Video: Due to the delay of the episode, the growth rate of subscribers has slowed slightly, but the loss has been significantly reduced.** According to Analysys, from September to December 2019, the MAU of Tencent Video reached 518 / 5.13 / 5.25 billion, and the number of subscribers reached 106 million. Due to the delayed release of popular episodes, the number of video subscription accounts increased Slow down. However, during the Spring Festival, the increase in the length of long video users' use promoted the rise of Tencent Video MAU. The growth rate in January / February this year exceeded 17%.

**Table 5.Main long-video App' MAU in 4Q19**

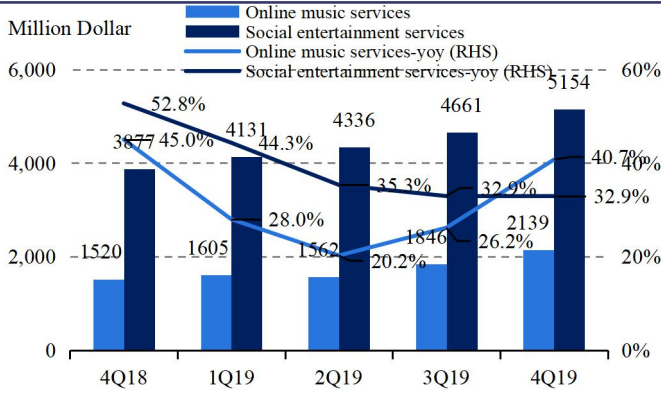
Company code	APP	Type	MAU (10 thousand)					YoY				
			Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20
IQ.O	Aiqiyi	Long video	60,32	60,20	61,30	62,93	65,02	10.39%	10.0%	13.9%	12.7%	13.1%
700.HK	Tencent vedio	Long video	51,79	51,33	52,49	53,84	55,00	11.21%	11.1%	15.7%	17.4%	17.7%
9988.HK	Youku	Long video	45,52	45,99	46,73	48,53	50,13	4.46%	2.5%	9.9%	12.6%	12.7%

Source: Analysys Qianfan, sorted out by industrial securities economic and Financial Research Institute

- **TME: Profitability exceeded expectations,Continuous strength content in 2020**

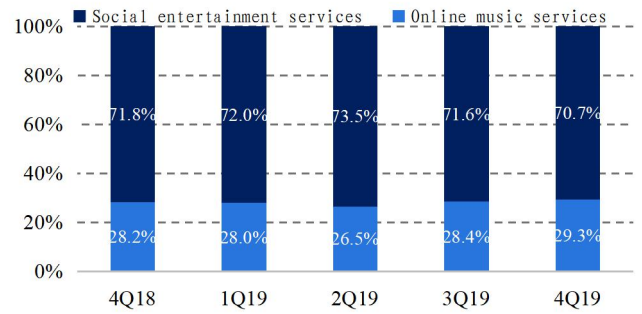
**Financial performance summary: Topline is higher than expected.** Quarter: 2019Q4, TME's revenue reached 7.293 billion RMB, YoY 35.1%, which was higher than Bloomberg's consensus. Online music service revenue reached 2.14 billion RMB, a great increase of 40.7%; Social entertainment service revenue reached 5.154 billion RMB with a increase of 32.9%; Non-IFRS was 1.342 billion RMB, and Non-IFRS Per ADS is 0.8 RMB, profitability is higher than Bloomberg's consensus (0.7RMB). The full Year: TME's revenue reached 25.434 billion RMB in the whole year of 2019, with a growth of 34%, which was higher than Bloomberg's consensus (25.26 billion), Non-IFRS Per ADS is 3.0 RMB.

**Fig.1、TME's segment revenue and growth rate**



Source: Company Disclosure, Industrial Securities Research Institute

**Fig.2、TME's online music break down**

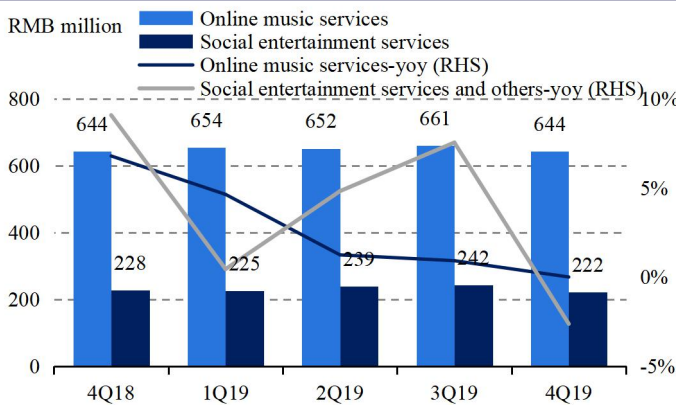


Source: Company Disclosure, Industrial Securities Research Institute

**The growth of MAU has stagnated, but the paying ratio & ARPPU have exceeded our expected.**

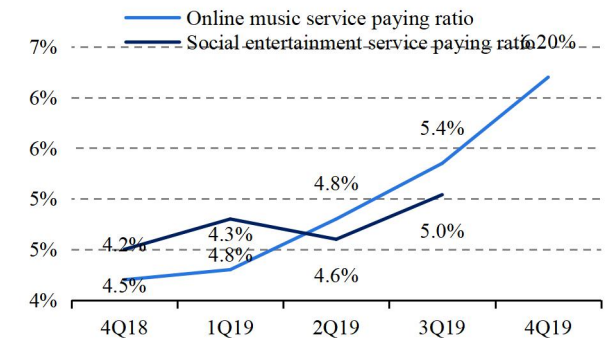
2019Q4, online music MAU reached 640 million. The social entertainment services MAU reached 220 million with a decline of 2.6%, MAU growth is relatively weak. While due to the improvement of upstream content and good control of fans' ecology, the online music paying users reached 39.9 million, with a great growth of 47.8%, the paying ratio reached 6.2% (compared with 4.2% in 4Q18), the number of paying users of social entertainment services also increased by 22% YoY, the ARPPU increased by 9% YoY. The company is increasingly mature in the mining of business model, and the user participation and loyalty are rising.

**Fig.11、4Q18-4Q19 TME's segment MAU growth rate**



Source: Company Disclosure, Industrial Securities Research Institute

**Fig.12、4Q18-4Q19 TME's segment paying ratio**



Source: Company Disclosure, Industrial Securities Research Institute

**Pan-entertainment cooperation to expand the scope of content.** The company is continuously expanding to include short video, long audio, music variety and OST. 1) Abundant OST music copyright: At present, it has covered more than 90% of the OST music rights of movies and TV programs and all the most popular variety shows in 2019. 2) Self-made radio programs: in addition, The Company produced over 200 episodes of the variety show MR RADIO, which generated 660 million video views in 2019.. At present, the program has become an important platform with influence on the distribution and promotion of new songs; 3) Cooperation with China Literature to develop audio books: In March this year, the company signed a cooperation agreement with China Literature. The company will be authorized by China Literature the online articles library to produce specific audio books, which will be distributed globally on TME and China Literature platforms.

**6. The small app is growing steadily**

- **Special periods catalyze the growth of small apps.** In February this year, small apps ushered in a big outbreak, with DAU reaching 450 million. The DAU of the entire network of applets reached 450 million in February 2020, an increase of 120 million compared with December last year. The number of small apps reached 3.9 million. In the fields of entertainment, online shopping, and

online learning, there has been a significant increase in user stickiness in areas such as health, tools, education, and online shopping.

**Table 6.Small apps industry comparison**

	DAU	MAU	Number of merchants	Industry covered
<b>Wechat small apps</b>	350 million	700 million	8200	200+
<b>Alipay small apps</b>	DAU	Number of users	Number of users of Taobao small app	Number of small apps
	230 million	640 million	100 million	1.7 million+
<b>Baidu small apps</b>	MAU	Developer	Open source alliance member	Number of small apps
	300 million	300 thousand	24	150 thousand +
<b>Quick app</b>	Devices covered	MAU	Times turned on	Desktop app retention
	1 billion	300 million	2 billion	100 million

Source: Aladdin index, sorted out by industrial securities economic and Financial Research Institute

- **The reshaping of small apps scenarios is conducive to Tencent's multi-industry penetration.** In addition, the Top 100 small apps in the Aladdin Index involve a total of 16 industries (10 industries were listed in February last year), and the application scenarios are more diverse. From the number of users and application scenarios, it can be seen that the APP accelerates the migration from the operating system to head applications (such as WeChat). The number of visits related to the mini-programs of supermarkets increased by 115% year-on-year, the mini-programs of fresh fruits and vegetables increased by 168% year-on-year, and the mini apps of community e-commerce increased by 83% year-on-year.
- **The commercialization scene continues to expand, and the live function went on small apps.** On February 17, 2020, the live broadcast of the small app was launched in public beta, and the live broadcast component was launched. Through the live broadcast, merchants can realize the closed-loop of live broadcast interaction and merchandise sales in the applet without jumping to other apps. "Goddess Festival" WeChat Mini App live broadcast data shows that 2,000 anchors have accumulated a live broadcast time of nearly 900 hours, with an average of 280 likes per user, and 20,000 live broadcasts with the highest number of shares. Through the live broadcast of small programs, the order volume of some brands increased by nearly 12 times, the transaction volume of some brands increased by 5 times, and the single-day sales of brands exceeded the 20 million yuan mark.

#### 7. Accelerate penetration in other scenarios such as telecommuting

**Tencent telecommuting helps special period:** For the special period, Tencent has 7 remote tools including enterprise WeChat, Tencent meeting, Tencent document, Tencent Lexiang, TAPD Tencent agile collaboration platform, Tencent worker bee and Tencent Wei cloud Member services. At the same time, the number of online editors has been increased to 200. The collection form enables 7,600 people to fill in. Moreover, a number of practical templates have been launched, and the "stop work without stopping" mode has officially been opened. The Tencent Conference expanded its daily capacity to nearly 15,000 cloud hosts from January 29 to February 6. The total expansion of more than 100,000 cloud hosts in 8 days involved a total of over 1 million cores of computing resource investment. Tencent Conference became the most used video conferencing application in China, with a DAU of more than 10 million in February 2020. With the mining of online education and online office demand points, the demand for Tencent meetings and WeChat will gradually rise.

According to the estimates of the Institute of Foresight Industry, the number of China's telecommuting users was less than 5 million in the same year (more than 30 million people in the United States in the same year), and the enterprise team collaborative software market was less than 150 million US dollars, accounting for only 5% of the global market share. With the recent rise in domestic demand, user scenarios and commercialization are expected to grow at a high speed, while driving data traffic and infrastructure investment. We are optimistic about the penetration of Tencent in multiple scenarios and the new model of user office, which will help to further increase the user's use time in the Tencent department.

**Table 7. Tencent's telecommuting expands due to high demand**

APP	Expansion time	Expansion situation
Tencent meeting	Jan 29 to Feb 6	The average daily expansion of cloud hosts is close to 15,000, and the total expansion of more than 100,000 cloud hosts in 8 days involves a total investment of over 1 million cores of computing resources.
Tencent document	Mar 2	Supports 100,000 people to fill in a single collection form, and the number of online editors is increased to 200
QQ	Feb 14	All QQ group file storage has been upgraded from 2GB to 10GB.

Source: Tencent, Tencent cloud, sorted out by industrial securities economic and Financial Research Institute

Tencent Health has become an important channel for more than 300 million WeChat users to obtain real-time epidemic data, online consultation and AI self-diagnosis. Tencent Health Code has become the most commonly used electronic passport for health and travel records during the epidemic. Since its launch in February this year, the Health Code has been used by 900 million users in more than 300 counties and cities, with a total of 8 billion visits.

### 8. Investment proposal

**Slightly adjusted target price to HK \$ 421 and maintain "Buy" rating.** We use the DCF model to revalue the company's stock (WACC adjusted from 10% to 11%, Perpetual g = 1.5%). According to the calculation, the total equity value calculated by FC discounted by Tencent excluding the investment part is 2.95 trillion yuan Renminbi, and due to the impact of the macro environment, we reduced the given PB of Tencent Investment's corresponding assets from 1.2 to 1 PB, and valued Tencent Video and Tencent Cloud, which contributed negative cash flow, and the total share price was 421 Hong Kong dollars.

**Table 8. FCFF calculation ('000 RMB)**

	2017A	2018A	2019A	2020E	2021E	2022E
<b>EBIT</b> (Excluding investment income)	66,222,000	76,365,000	92,691,000	111,193,136	144,899,675	175,338,168
Tax rate	-17.85%	-15.33%	-12.35%	-15.50%	-15.50%	-15.50%
<b>NOPLAT</b>	54,403,158	64,657,953	81,242,730	93,958,200	122,440,225	148,160,752
Add: Share-based payment	6,137,000	7,869,000	10,500,000	12,176,650	14,003,148	16,103,620
Add: Depreciation and amortization	23,502,000	34,248,000	44,577,000	87,257,460	82,573,335	79,677,476
Gross cashflow from operating	84,042,158	106,774,953	136,319,730	193,392,310	219,016,707	243,941,848
Less: Additional working capital	-21,811,000	-14,239,000	-6,930,955	-35,161,087	-22,566,654	-33,382,707
Net cashflow from operating	105,853,158	121,013,953	143,250,684	228,553,397	241,583,361	277,324,556
Less: Capital expenditure	12,768,000	23,941,000	34,714,450	43,393,063	52,071,675	62,486,010
<b>FCFF</b>	93,085,158	97,072,953	108,536,234	185,160,335	189,511,686	214,838,546

Source: Company disclosure, sorted out by industrial securities economic and Financial Research Institute

**Table 9. DCF valuation**

FCFF Valuation	Discounted cash flow (thousands)	% of value
First stage	193,200,131	5.57%
Second stage	1,561,571,144	45.03%
Third stage(Final value)	1,183,965,172	34.14%
<b>AEV</b>	<b>2,938,736,448</b>	<b>84.75%</b>
less: net liabilities	114,791,000	-3.31%
less: non-controlling interests	56,118,000	-1.62%
add: cash	187,348,955	5.40%
Total equity value	2,955,176,403	
add: value of Tencent's investments	432,437,000	12.47%
add: value of Tencent Video	50,000,000	1.44%
add: value of Tencent Cloud	30,000,000	0.87%
value-added total equity value	3,467,613,403	100%

Total shares(thousands)	9,468,000
stock price(RMB)	366.25
stock price(\$HK)	<b>421</b>

Source: Company disclosure, sorted out by industrial securities economic and Financial Research Institute

**Table 10. Tencent's income statement quarterly forecast (in million RMB)**

	2019Q4	2020Q1E	2020Q2E	2020Q3E	2020Q4E
Revenue	105,767	100,330	111,590	126,239	136,399
Cost of sales	-59,659	-56,202	-63,526	-72,169	-79,531
Gross profit	46,108	44,128	48,064	54,070	56,868
Selling expense	-6,712	-4,515	-6,472	-7,953	-8,184
Proportion	-6.3%	-4.5%	-5.8%	-6.3%	-6.0%
Administrative expense	-16,002	-13,645	-15,176	-17,168	-18,823
Proportion	-15.1%	-13.6%	-13.6%	-13.6%	-13.8%
EBIT	28,604	28,729	30,218	32,340	34,832
Net finance cost	-2,767	-1,285	-2,279	-2,184	-3,182
Profit before tax	24,509	26,874	27,367	29,586	31,079
Income tax	-2,137	-4,031	-4,105	-4,438	-4,662
Net profit	22,372	22,843	23,262	25,148	26,417
Profit attributable to Tencent	21,582	22,157	22,564	24,393	25,625
NCI	790	685	698	754	793
Non-IFRS operating profit	30,306	29,559	33,168	35,377	39,222
Non-IFRS net profit	26,639	25,837	27,996	31,180	32,742
Non-IFRS net profit attributable to Tencent	25,484	25,002	27,151	30,098	31,414

Source: Company disclosure, sorted out by industrial securities economic and Financial Research Institute

**Investment proposal: Maintain "Buy" rating.** We adjusted FY 20/21 revenue from 474.8 / 571.7 billion yuan to 474.6/589.4 billion yuan, and Non-IFRS net profit attributable to Tencent to 113.7 /145.3 billion yuan. Taking into account the recent macroeconomic weakness and financing costs, we Adjust the target price to HK \$ 421 (original target price: HK \$ 443) based on the DCF model, corresponding to 2020 Non-IFRS EPS of 30.5x PE, and maintain a "Buy" rating.

**Potential risk:** Policy regulatory risks; the growth of the game business has slowed; the advertising business falls short of the expected risk;

## Appendix

<b>Balance sheet</b>		RMB in millions		
<b>Fiscal year</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	
<b>Current assets</b>	<b>253,968</b>	<b>390,527</b>	<b>541,509</b>	
Inventories	718	516	627	
Accounts receivable	58,311	74,811	94,766	
Cash and cash equivalents	138,359	258,621	389,536	
Other current assets	56,580	56,580	56,580	
<b>Non-current assets</b>	<b>689,171</b>	<b>752,714</b>	<b>830,814</b>	
Property, plant and equipment	46,824	54,463	61,201	
Construction in progress	3,935	3,935	3,935	
Investment properties	855	885	915	
Land use rights	15,609	17,257	18,872	
Intangible assets	128,860	107,316	97,390	
Investments in associates	221,894	265,610	309,993	
Available-for-sale financial assets	210,543	242,597	277,857	
Other Non-current assets	60,651	60,651	60,651	
<b>Total assets</b>	<b>943,139</b>	<b>1,143,241</b>	<b>1,372,323</b>	
<b>Current liabilities</b>	<b>236,877</b>	<b>298,235</b>	<b>350,868</b>	
Accounts payable	125,864	177,222	219,855	
Borrowings	22,695	32,695	42,695	
Other current liabilities	88,318	88,318	88,318	
<b>Non-current liabilities</b>	<b>216,578</b>	<b>231,578</b>	<b>251,578</b>	
Long-term payables	104,257	119,257	139,257	
Other Non-current liabilities	112,321	112,321	112,321	
<b>Total liabilities</b>	<b>453,455</b>	<b>529,813</b>	<b>602,446</b>	
<b>Equity attributable to equity holders of the Company</b>	<b>432,706</b>	<b>552,260</b>	<b>703,351</b>	
Share capital and Share premium	35,271	35,271	35,271	
Shares held for share award schemes	-4,002	-4,002	-4,002	
Treasury shares	16,786	20,806	24,192	
Retained earnings	384,651	500,185	647,890	
<b>Non-controlling interests</b>	<b>56,118</b>	<b>60,308</b>	<b>65,666</b>	
<b>Total equity</b>	<b>488,824</b>	<b>612,568</b>	<b>769,017</b>	
<b>Total equity and liabilities</b>	<b>942,279</b>	<b>1,142,381</b>	<b>1,371,463</b>	
<b>Cash Flow</b>				
<b>Fiscal year</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	
Profit before tax	109,400	114,906	151,246	
Depreciation and amortization	44,577	87,257	82,573	
Interest expense	7,613	8,930	9,823	
Change of working capital	-11,391	-16,500	-19,956	
Others	26,693	24,929	7,090	
<b>CF from operating</b>	<b>176,892</b>	<b>219,522</b>	<b>230,777</b>	
<b>CF from investing</b>	<b>-156,969</b>	<b>-116,104</b>	<b>-119,244</b>	
<b>CF from financing</b>	<b>20,622</b>	<b>16,844</b>	<b>19,382</b>	
Net change in cash and cash equivalents	40,545	120,262	130,915	
Cash and cash equivalents beginning of the year	97,814	138,359	258,621	
Cash and cash equivalents end of the year	138,359	258,621	389,536	

<b>Income statement</b>		RMB in millions		
<b>Fiscal year</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	
<b>Revenues</b>	<b>377,289</b>	<b>474,558</b>	<b>589,357</b>	
Cost of revenues	209,756	271,428	330,122	
Gross profit	167,533	203,130	259,235	
Interest income	6,397	8,316	10,810	
Other gains, net	19,689	6,611	7,975	
Selling and marketing expenses	21,396	27,124	35,361	
General and administrative expenses	-53,446	-64,813	-78,974	
<b>Operating profit</b>	<b>118,694</b>	<b>126,119</b>	<b>163,685</b>	
Finance costs, net	-7,613	-8,930	-9,823	
Share of profit of associates and joint ventures	0	-2,284	-2,616	
<b>Profit before income tax</b>	<b>109,400</b>	<b>114,906</b>	<b>151,246</b>	
Income tax expense	13,512	17,236	23,443	
<b>Profit for the period</b>	<b>95,888</b>	<b>97,670</b>	<b>127,803</b>	
Profit attributable to Non-controlling interests	2,578	2,930	4,473	
<b>Profit attributable to equity holders of the Company</b>	<b>93,310</b>	<b>94,740</b>	<b>123,330</b>	
<b>Non-GAAP profit attributable to equity holders of the Company</b>	<b>94,351</b>	<b>113,665</b>	<b>145,313</b>	
<b>EPS(RMB)</b>	<b>9.86</b>	<b>10.01</b>	<b>13.03</b>	
<b>Non-GAAP EPS(RMB)</b>	<b>9.97</b>	<b>12.01</b>	<b>15.35</b>	

### Key Financials

<b>Fiscal year</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	
<b>Growth(%)</b>				
Revenue	20.7%	25.8%	24.2%	
Operating profit	17.9%	21.2%	27.6%	
Net income	19.9%	1.9%	30.9%	
Net income attributable to equity holders of the Company	18.5%	1.5%	30.2%	
<b>Profit Margin (%)</b>				
Gross Margin	44.4%	42.8%	44.0%	
Non-GAAP Net Margin	25.9%	24.8%	25.2%	
Non-GAAP Net Margin attributable to equity holders of the Company	25.0%	24.0%	24.7%	
ROE	19.6%	15.9%	16.6%	
ROA	10.1%	8.5%	9.2%	
<b>Solvency test (%)</b>				
Net asset ratio	95.2%	88.4%	79.9%	
Debt ratio	48.8%	46.9%	44.4%	
Current ratio	1.06	1.30	1.53	
Quick ratio	1.05	1.29	1.53	
<b>Operation(times)</b>				
Assets turnover	39.5%	41.1%	42.6%	
Accounts payable turnover	0.15	0.16	0.16	
<b>Per share (RMB)</b>				
Non-GAAP EPS	10.0	12.0	15.3	
EPS	9.9	10.0	13.0	
BPS	45.7	58.3	74.3	
<b>Multiple(x)</b>				
PE(Non-GAAP)	29.2	24.2	18.9	
PB	6.4	5.0	3.9	

## 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

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

- **Buy:** With a markup more than 15% better than that of the market;
- **Outperform:** With a markup 5% to 15% better than that of the market;
- **Neutral:** With a markup less than 5% better or worse than that of the market;
- **Underperform:** With a markup more than 5% worse than that of the market.

### Information Disclosure

The Industrial Securities Co., Ltd. fulfills its duty of disclosure within its sphere of knowledge. The clients may visit the column of Insider Trading Prevention and Control at [www.xyqz.com.cn](http://www.xyqz.com.cn) for the arrangement of the quiet period and the affiliates' shareholdings.

### Important statement

The information contained in this report is derived from public information. We do not warrant the accuracy and completeness of such information, nor do we guarantee that the information and recommendations contained will never change. We have tried our best to be objective and fair about the content of this report. The opinions, conclusions and recommendations in the article do not constitute any bid or offer price for the target securities. Our company and the author are not responsible for any investment decision made by the investor.

### Analyst Certification

We are conferred the Professional Quality of Securities Investment Consultant Industry by the Securities Association of China and have registered as the Securities Analysts. We hereby issue this report independently and objectively with due diligence, professional and prudent research methods and only legitimate information is used in this report. We hereby certify that the views expressed in this report accurately reflect our personal views about any or all of the subject securities or issuers referred to herein. We have never been, are not, and will not be compensated directly or indirectly in any form for the specific recommendations or opinions herein.

### Disclaimer

Industrial Securities Co., Ltd. (hereinafter referred to as the 'Company') is a qualified securities investment consulting institute approved by the China Securities Regulatory Commission.

The report is distributed in Hong Kong by China Industrial Securities International Brokerage Ltd., which is regulated by the Hong Kong Securities and Futures Commission (HKSF CE No. AYE823). Queries concerning the report from readers in Hong Kong should be directed to our Hong Kong sales managers.

The report is to be used solely by the clients of the Company. The Company will not treat unauthorized receivers of this report as its clients. The clients understand that the text message reminder and telephone recommendation are no more than a brief communication of research opinions, which are subject to the complete report released on the Company's website (<http://www.xyqz.com.cn>). The clients may ask for follow-up explanations if they so wish.

Based on different assumptions or standards and with different analytical approaches, the Company's salespersons, traders and other professionals may express views, written or oral, towards market trend and securities trading which are inconsistent with opinions and recommendations contained herein. The views in this report are subject to change, and the

### Company has no obligation to update its information with all receivers of the report.

The Company's asset management department, proprietary business department and other investment-related departments may make independent investment decisions based on investment that are inconsistent with opinions and recommendations contained herein.

The report is not delivered to investors, including but not limited to US residents, who may mislead the Company to violate local laws and regulations of any counties, regions or jurisdictional areas (except for the "major U.S. institutional investors" specified in Rule 15a-6 under the Securities Exchange Act of 1934).

The report may contain hyperlinks to external websites. The Company has not referred to and will not be responsible for the contents on the external websites. The hyperlinks are only provided for the convenience and reference for the receivers. The contents on the external websites do not constitute a component of the report or implying any recommendation of securities. The receivers should treat them cautiously and solely at their own risk.

The report is based on public information; however, the authenticity, accuracy or completeness of such information is not warranted by the Company. The materials contained herein are for the clients' reference only, and are not to be regarded or deemed as an invitation for the sale or purchase of any securities. The clients should make investment decisions independently and solely at their own risks.

Under the legal framework, the Company may take positions in and trade stocks of the companies referred to herein, which may receive investment banking services from the Company. The clients shall consider the Company's possible conflict of interests which may affect the objectivity of this report, and shall not base their investment decisions solely on the report.

Independent investment consultant should be consulted before any investment decision is rendered based on this report or at any request of explanation for this report where the receiver of this report is not a client of the Company.

The Company possesses all copyrights of this report and reserves all rights related to this report. Unless otherwise indicated in writing, all the copyrights of all the materials herein belong to the Company. In the absence of any prior authorization by the Company in writing, no part of this report shall be copied, photocopied, replicated or redistributed to any other person in any form by any means, or be used in any other ways which will infringe upon the copyrights of the Company. No one shall have the right to redistribute the report at any circumstances without the prior consent of the Company.