

Tencent (700 HK)

Ecosystem value and growing diversification

Tencent is deploying its WeChat ecosystem, which we expect will disrupt consumer internet industry competition and partially offset slowing macro impact. Infrastructure to support real economy industries, such as enterprise and fintech services, overseas markets development will be Tencent's growth drivers for the long run. Due to revenue exposure to high ROE consumer internet business, revenue recovery coupled with Opex optimization will stabilize earnings from 2023 onwards. We transfer coverage with BUY rating.

- Ecosystem is the most defensive edge** - Tencent's ecosystem still remains under-leveraged, and video account progress marks the start of deploying WeChat's comprehensive social features and functionalities. Providing users extensive social, content and utilities value, will strengthen competitiveness, magnify merchants and content contributors' ROI, without having to compromise user experience. In China's highly competitive consumer internet industry, the ability to maintain a balance between user experience and monetization ROI is key to maintain sustainable leadership.
- Play supporting role in digital economy buildout** – Over the past few years, Tencent has made inroads into facilitating diversified industries' digitization process, such as the financials, industrials, manufacturing, healthcare, public services, retail and energy sectors. Tencent offers extensive technology infrastructure, including AI, Cloud computing, fintech, IoT and multiple frontier technologies. We expect Tencent will accelerate investments supporting digital economy buildout, aiding industries to improve efficiencies, costs optimization, output upgrades and market competitiveness. Over the long run, its revenue exposure from enterprise services will bypass consumer internet.
- Attractive valuation on solid earnings recovery.** Our SOTP-derived TP is HK\$398.0, which translates into 26/24x 2023/2024E non-IFRS PE, comprising HK\$146.6/24.1/22.3/98.0/16.1 for gaming/SNS/ad/fintech/cloud business and HK\$13.8/76.0 for net cash and strategic investment. Tencent currently trades at 17x 2023E PE (or 10x 2023E PE if excluding strategic investment and net cash). We forecast its earnings recovery in 2023/2024E will be +15.2/12.7% YoY.
- Catalysts:** 1) stronger than expected operating leverage; 2) accelerating monetization of Weixin Video Account; 3) macro recovery supports rebound of ad, fintech and enterprise services businesses.

Earnings Summary

(YE 31 Dec)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue (RMB mn)	482,064	560,118	558,042	614,074	664,661
YoY growth (%)	27.8	16.2	(0.4)	10.0	8.2
Gross margin (%)	46.0	43.9	43.0	43.0	43.2
Net profit (RMB mn)	159,847.0	224,822.0	95,240.2	119,418.2	134,311.0
YoY growth (%)	71.3	40.6	(57.6)	25.4	12.5
Adjusted net profit (RMB mn)	122,742.0	123,788.0	113,229.6	130,399.7	146,898.2
YoY growth (%)	30.1	0.9	(8.5)	15.2	12.7
EPS (Adjusted) (RMB)	12.93	12.99	11.87	13.66	15.38
Consensus EPS (RMB)	12.93	12.99	12.67	15.45	18.40
P/S (x)	3.9	3.3	3.3	3.0	2.8
P/E (x)	24.4	19.1	19.6	15.7	13.9
ROE (%)	28.1	29.8	11.2	12.6	12.6

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price **HK\$398.00**
 Up/Downside **86.7%**
 Current Price **HK\$213.20**

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Stock Data

Mkt Cap (HK\$ mn)	2,034,301.1
Avg 3 mths t/o (HK\$ mn)	286.7
52w High/Low (HK\$)	494.04/206.20
Total Issued Shares (mn)	9541.8

Source: FactSet

Shareholding Structure

MIH TC	28.7%
Advance Data Services Limited	8.4%

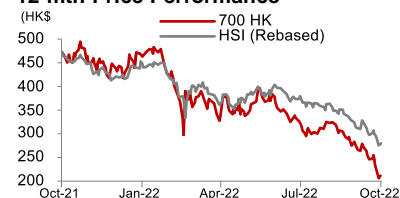
Source: HKEx

Share Performance

	Absolute	Relative
1-mth	-24.1%	-12.1%
3-mth	-33.4%	-10.8%
6-mth	-36.3%	-17.7%

Source: FactSet

12-mth Price Performance



Source: FactSet

Competitive edge to counter consumer internet slowdown

We forecast Tencent's total revenue to decline by 0.4% YoY to RMB558.0bn in 2022E, before rebounding by 10.0/8.2% YoY to RMB614.1/664.7bn in 2023/2024E. In 1H22, Tencent's total revenue and non-IFRS net income was down 1.5% YoY and 20.1% YoY, in the backdrop of macro challenges and resurgence of COVID-19. Looking into 2H22E, we forecast total revenue growth of +0.9% YoY, supported by 1) incremental contribution from deploying video account and WeChat ecosystem; 2) steady growth in FBS revenue; 3) while other segments will still be under negative impacts from softening macro conditions. However, Tencent has already started to optimize its opex since 2Q22. We expect operating leverage will help to stabilise net profit margins and non-IFRS net profit will return to grow by 5.1% YoY in 2H22E. Overall, we forecast non-IFRS net profit to decline by 8.5% YoY to RMB113.2bn in 2022E, before recovering by 15.2/12.7% YoY to RMB130.4/146.9bn in 2023E/2024E.

Figure 1: CMBIGM estimates vs consensus

RMB mn	CMBIGM			Consensus			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	558.0	614.1	664.7	578.4	660.9	745.4	-3.5%	-7.1%	-10.8%
Gross Profit	239.8	264.0	287.0	243.0	280.4	318.9	-1.3%	-5.8%	-10.0%
Operating Profit	138.2	152.9	168.9	163.2	191.3	218.4	-15.3%	-20.1%	-22.6%
Adjusted net profit	113.2	130.4	146.9	112.3	139.0	165.5	0.8%	-6.2%	-11.2%
Adjusted EPS (RMB)	11.7	13.5	15.2	12.7	15.4	18.4	-7.7%	-12.8%	-17.5%
Gross Margin	43.0%	43.0%	43.2%	42.0%	42.4%	42.8%	1.0 ppt	0.6 ppt	0.4 ppt
Operating Margin	24.8%	24.9%	25.4%	28.2%	28.9%	29.3%	-3.5 ppt	-4.0 ppt	-3.9 ppt
Adjusted net margin	20.3%	21.2%	22.1%	19.4%	21.0%	22.2%	0.9 ppt	0.2 ppt	-0.1 ppt

Source: Bloomberg, CMBIGM estimates

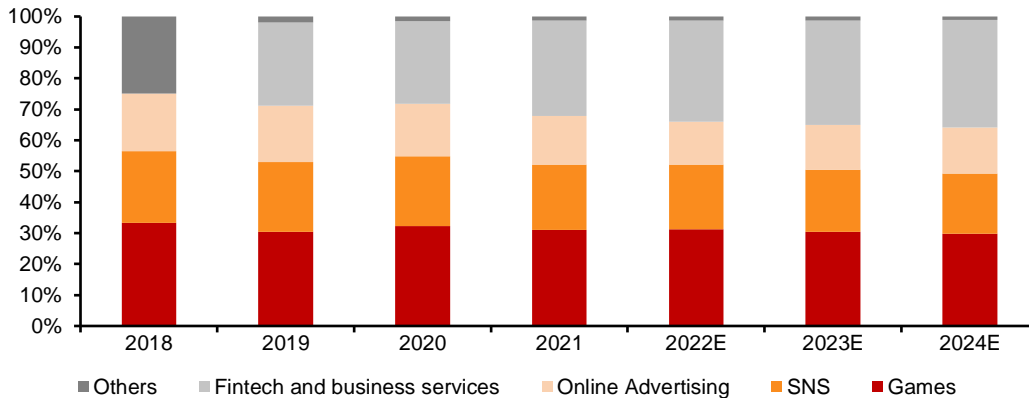
Figure 2: Tencent: key financial forecasts

(RMB mn)	2021	2022E	2023E	2024E	1H22	2H22E
SNS revenue	117.3	118.4	124.4	130.0	58.3	60.1
YoY %	8.5	1.0	5.0	4.5	0.8	1.2
As % of total revenue	20.9	21.2	20.3	19.6	21.6	20.8
Games revenue	174.3	170.6	183.6	194.8	86.1	84.5
YoY %	11.7	(2.1)	7.6	6.1	(0.6)	(3.6)
As % of total revenue	29.6	30.6	29.7	29.0	31.9	29.3
Online ad revenue	88.7	78.3	89.0	98.9	36.6	41.7
YoY %	7.8	(11.7)	13.7	11.1	(18.0)	(5.3)
As % of total revenue	15.8	14.0	14.5	14.9	13.6	14.4
FBS revenue	172.2	182.8	209.2	233.1	85.0	97.8
YoY %	34.4	6.2	14.4	11.4	5.0	7.2
As % of total revenue	30.7	32.8	34.1	35.1	31.5	33.9
Total revenue	560.1	558.0	614.1	664.7	269.5	288.5
YoY %	16.2	(0.4)	10.0	8.2	(1.5)	0.7
Gross profit margin (%)	43.9	43.0	43.0	43.2	42.6	43.3
G&A expenses as % of total revenue (%)	16.0	18.6	18.0	17.5	19.6	17.6
S&M expenses as % of total revenue (%)	7.2	6.1	6.3	6.1	5.9	6.3
Non-IFRS net profit margin (%)	22.1	20.3	21.2	22.1	19.9	20.6
Non-IFRS net profit	123.8	113.2	130.4	146.9	53.7	59.5
YoY %	0.9	(8.5)	15.2	12.7	(20.1)	5.1

Source: Company data, CMBIGM estimates

Revenue contribution from FBS business rose from 23.4% in 2018 to 35.1% in 2024E, as Tencent continued to step up investment in enterprise internet; revenue contribution from other consumer internet businesses, including games/SNS/online ad, were diluted from 33.3/23.2/18.6% in 2018 to 29.3/19.6/14.9% in 2024E.

Figure 3: Tencent: revenue mix

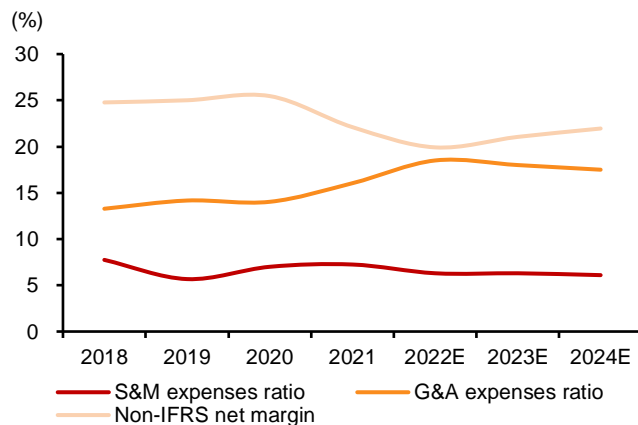


Source: Company data, CMBIGM estimates

Operating efficiency and margin sensitivity analysis

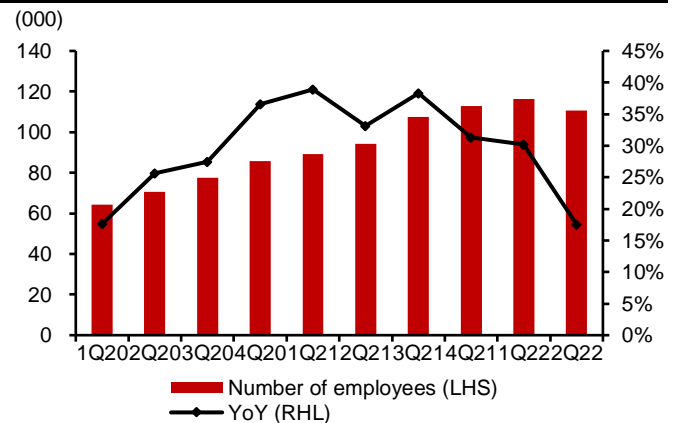
Amid macro headwind and tightening regulatory environment, Tencent has been actively controlling operating expenses and improving operating efficiency. On marketing front, we forecast selling and marketing expenses to revenue ratio at 6.1/6.3/6.1% in 2022/2023/2024E, down from 7.2% in 2021, as Tencent reduced marketing spending on gaming and non-core businesses. We expect general and administrative expenses will normalize from 18.6% in 2022E to 18.0/17.5% in 2023/2024E, since Tencent began to manage its headcount expansion. Tencent's number of employees dropped by 4.7% or 5,498 employees QoQ to 110,715 in 2Q22, the first-time sequential drop in headcount since 1Q19. Overall, we forecast non-IFRS net margin to bottom out from 20.3% in 2022E to 21.2/22.1% in 2023/2024E.

Figure 4: Tencent: margin analysis



Source: Company data, CMBIGM estimates

Figure 5: Tencent: number of employees



Source: Company data, CMBIGM

Given its ad/FBS businesses are highly sensitive to economic activities, we conduct sensitivity analysis to gauge the total revenue growth sensitivity to the online ad/FBS businesses. Under our bull-case assumption, if online ad/FBS revenue growth forecasts were raised by 1/3/5/8% in 2022E and 2023E driven by better-than-expected recovery of macro environment, Tencent's total revenue could have 0.5/1.4/2.3/3.7% upside in 2022E and 0.4/1.3/2.1/3.4% upside in 2023E. Under our bear-case assumption, if online ad/FBS revenue growth forecasts were lowered by 1/3/5/8% in 2022E and 2023E due to slower-than-expected recovery of macro environment, Tencent's total revenue could have 0.5/1.4/2.3/3.7% downside in 2022E and 0.4/1.3/2.1/3.4% downside in 2023E. We also

conduct sensitivity analysis to analyse the non-IFRS net income growth sensitivity to the opex control. Under our bull-case assumption, if total opex growth forecast were lowered by 1/3/5/8% in 2022E and 2023E thanks to effective cost control measures, Tencent's non-IFRS net income could have 1.0/2.9/4.9/7.8% upside in 2022E and 0.9/2.7/4.5/7.2% upside in 2023E. Under our bear-case assumption, if total opex growth were raised by 1/3/5/8% in 2022E and 2023E as Tencent increased investment in strategic initiatives, Tencent's non-IFRS net income could have 1.0/2.9/4.9/7.8% downside in 2022E and 0.9/2.7/4.5/7.2% downside in 2023E.

Figure 6: Tencent total revenue: sensitivity analysis

2022E (RMBmn)	Change in online ad revenue growth forecast (2022E)	2022E online ad revenue growth (2022E)	Change in FBS revenue growth forecast(2022E)	2022E FBS revenue growth (2022E)	Revenue	Comparison with base case
Case I	-8%	-19.7%	-8%	-1.8%	537,173	-3.7%
Case II	-5%	-16.7%	-5%	1.2%	544,999	-2.3%
Case III	-3%	-14.7%	-3%	3.2%	550,216	-1.4%
Case IV	-1%	-12.7%	-1%	5.2%	555,433	-0.5%
Base case		-11.7%		6.2%	558,042	0.0%
Case V	1%	-10.7%	1%	7.2%	560,650	0.5%
Case VI	3%	-8.7%	3%	9.2%	565,868	1.4%
Case VII	5%	-6.7%	5%	11.2%	571,085	2.3%
Case VIII	8%	-3.7%	8%	14.2%	578,911	3.7%

2023E (RMBmn)	Change in online ad revenue growth forecast (2023E)	2023E online ad revenue growth (2023E)	Change in FBS revenue growth forecast(2023E)	2022E FBS revenue growth (2023E)	Revenue	Comparison with base case
Case I	-8%	5.7%	-8%	6.4%	593,183	-3.4%
Case II	-5%	8.7%	-5%	9.4%	601,017	-2.1%
Case III	-3%	10.7%	-3%	11.4%	606,240	-1.3%
Case IV	-1%	12.7%	-1%	13.4%	611,462	-0.4%
Base case		13.7%		14.4%	614,074	0.0%
Case V	1%	14.7%	1%	15.4%	616,685	0.4%
Case VI	3%	16.7%	3%	17.4%	621,908	1.3%
Case VII	5%	18.7%	5%	19.4%	627,130	2.1%
Case VIII	8%	21.7%	8%	22.4%	634,964	3.4%

Source: Company data, CMBIGM estimates

Figure 7: Tencent non-IFRS net income: sensitivity analysis

2022E (RMBmn)	Change in opex YoY growth	S&M expense YoY growth	G&A expense YoY growth	Implied S&M expense ratio	Implied G&A expense ratio	2022E Non-GAAP NPM	2022E Net profit	Comparison with base case
Case I	-8%	-24.1%	7.5%	5.5%	17.3%	21.9%	122,100	7.8%
Case II	-5%	-21.1%	10.5%	5.7%	17.8%	21.3%	118,773	4.9%
Case III	-3%	-19.1%	12.5%	5.9%	18.1%	20.9%	116,556	2.9%
Case IV	-1%	-17.1%	14.5%	6.0%	18.4%	20.5%	114,338	1.0%
Base case		-16.1%	15.5%	6.1%	18.6%	20.3%	113,230	0.0%
Case V	1%	-15.1%	16.5%	6.2%	18.8%	20.1%	112,121	-1.0%
Case VI	3%	-13.1%	18.5%	6.3%	19.1%	19.7%	109,903	-2.9%
Case VII	5%	-11.1%	20.5%	6.5%	19.4%	19.3%	107,686	-4.9%
Case VIII	8%	-8.1%	23.5%	6.7%	19.9%	18.7%	104,360	-7.8%

2023E (RMBmn)	Change in opex YoY growth	S&M expense YoY growth	G&A expense YoY growth	Implied S&M expense ratio	Implied G&A expense ratio	2023E Non-GAAP NPM	2023E Net profit	Comparison with base case
Case I	-8%	5.6%	-1.5%	5.9%	16.6%	22.8%	139,773	7.2%
Case II	-5%	8.6%	1.5%	6.0%	17.2%	22.2%	136,258	4.5%
Case III	-3%	10.6%	3.5%	6.1%	17.5%	21.8%	133,915	2.7%
Case IV	-1%	12.6%	5.5%	6.2%	17.8%	21.4%	131,571	0.9%
Base case		13.6%	6.5%	6.3%	18.0%	21.2%	130,400	0.0%
Case V	1%	14.6%	7.5%	6.4%	18.2%	21.0%	129,228	-0.9%
Case VI	3%	16.6%	9.5%	6.5%	18.5%	20.7%	126,885	-2.7%

2022E (RMBmn)	Change in opex YoY growth	S&M expense YoY growth	G&A expense YoY growth	Implied S&M expense ratio	Implied G&A expense ratio	2022E Non-GAAP NPM	2022E Net profit	Comparison with base case
Case VII	5%	18.6%	11.5%	6.6%	18.8%	20.3%	124,542	-4.5%
Case VIII	8%	21.6%	14.5%	6.7%	19.4%	19.7%	121,027	-7.2%

Source: Company data, CMBIGM estimates

Key business segments forecasts

In 1H22 Tencent proactively adjusted its strategy of business service segment to focus on quality growth, prioritizing self-developed products and reducing loss-making projects exposure. Besides, the pandemic has negatively impact the commercial payment revenue growth in 1H22. As a result, we forecast FBS revenue growth to slow to 6.2% in 2022E (2021: +34.4% YoY) and represent 32.8% of total revenue. In view of the current industry situation, we expect FBS business will remain under some pressure in 2H22, to deliver 7.2% YoY revenue growth. We forecast FBS revenue to deliver a rebound of 14.4/11.4% YoY in 2023/2024E, as the payment volume and economic recovery should propel enterprise digitization process back on track.

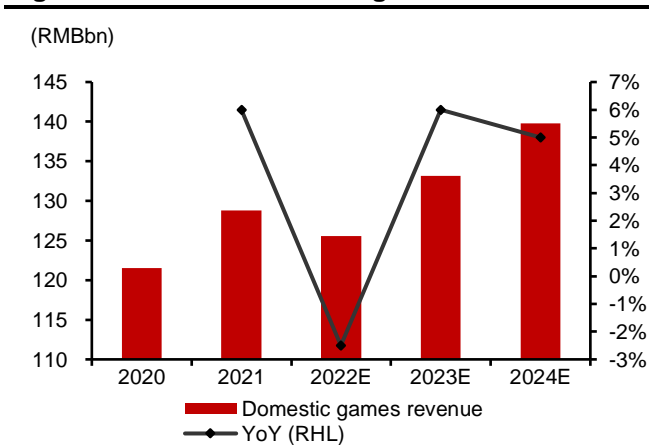
We forecast online games revenue to decline by 2.1% YoY to RMB170.6bn in 2022E, mainly due to lack of new game titles and the implementation of minor protection measures. We estimate online games revenue to recover by 7.6/6.1% YoY to RMB183.6/194.8bn in 2023E/2024E, mainly driven by overseas games growth (2022E-2024E CAGR: 10.5%). Overseas games revenue growth slowed to 1% YoY in 1H22, as widespread COVID-19 social distancing measures widely relaxed in overseas market and players time spent normalized from peak condition. We remain positive on the growth potential of Tencent's overseas gaming business in 2023/2024E, driven by a solid global pipeline.

As the pandemic impact wears off and Weixin Video Account begins to make meaningful revenue contribution, we expect online advertising business will return to positive YoY revenue growth in 4Q22 (+1.2% YoY). We forecast online ad revenue to increase 13.7/11.1% YoY to RMB89.9/98.9bn in 2023E/2024E. Please see our modelling of video-account potential revenue contribution in Fig16 on page 8.

Games (30.6% of 2022E revenue)

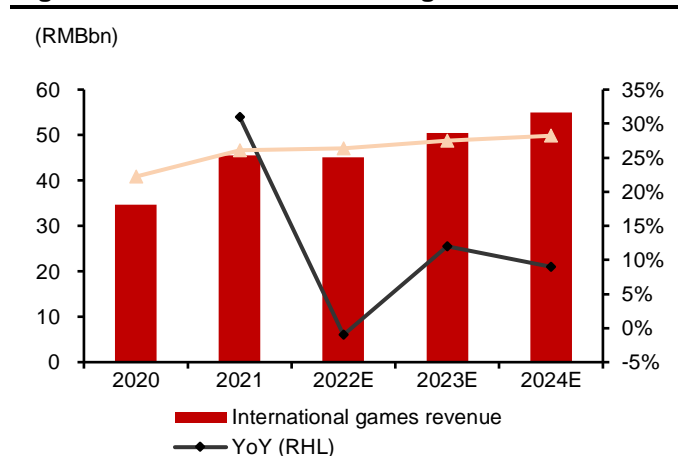
We forecast games revenue to rise 7.6/6.1% YoY to RMB183.6/194.8bn in 2023E/2024E, mainly driven by growth in overseas games revenue (2022E-2024E CAGR: 10.5%). Overseas games revenue growth slows in 2022E, as the overseas gaming market experienced post COVID-19 normalization. That said, we remain positive on the growth potential of Tencent's overseas gaming business in 2023/2024E, driven by a solid global pipeline.

Figure 8: Tencent: domestic games revenue



Source: Company data, CMBIGM estimates

Figure 9: Tencent: international games revenue



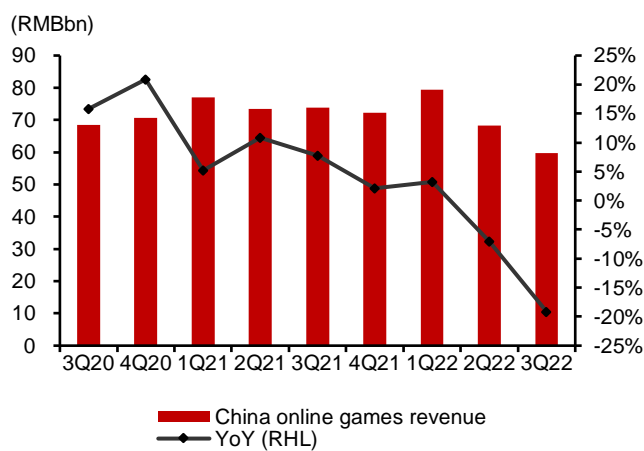
Source: Company data, CMBIGM estimates

Domestic online gaming sector is facing challenges due to stringent regulatory environment and lack of new games titles. According to CNG, domestic online gaming sector revenue

has declined YoY at an accelerating rate since April 2022. In 3Q22, total domestic online gaming revenue was down by 19.1% YoY to RMB59.7bn. Despite the sector headwind, Tencent continued to reinforce its leadership in content development and user engagement. According to QuestMobile and Tencent, Honour of Kings and Peacekeeper Elite remained as the top two highest-ranked games by total time spent across the industry, and each increased their total time spent by adult users YoY.

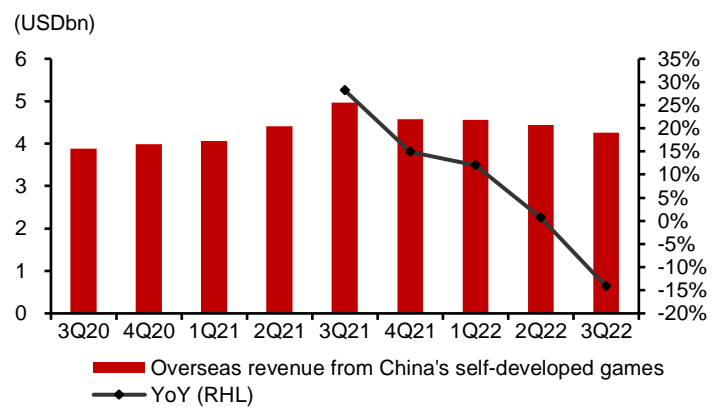
The overseas revenue from China's self-developed games also declined in 3Q22, as the international gaming market is experiencing a post-pandemic normalization. User spending on the three major overseas mobile games markets, US/Japan/South Korea, declined by 10/13/2% YoY in 1H22. 3Q22 overseas revenue from China's self-developed games was down by 14.2% YoY to USD4.3bn in 3Q22. Nonetheless, we remained positive on the long-term growth potential of the overseas game market, given the enormous TAM. Tencent, with strong development capabilities and deep pocket, are well-positioned to capture the overseas opportunities, in our view.

Figure 10: China: domestic online game revenue



Source: CNG, CMBIGM

Figure 11: Overseas revenue from China's self-developed games



Source: CNG, CMBIGM

Looking ahead, Tencent has a solid overseas gaming pipeline covering a wide spectrum of genres and platforms. We expect its overseas pipeline to drive international game revenue to reaccelerate in 2023E.

Figure 12: Tencent: major overseas pipeline

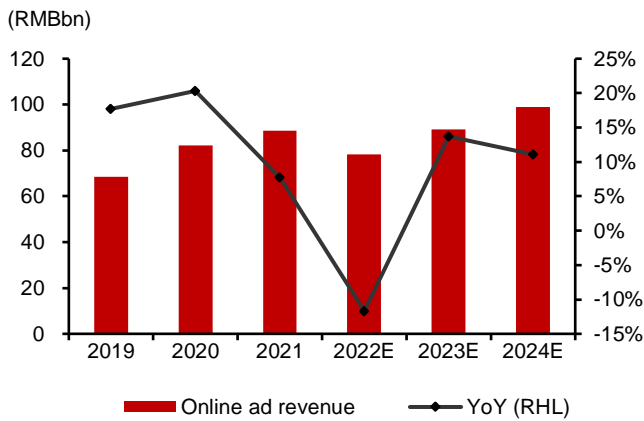
Games	Genre	Publisher	Developer	Platform	Launch time
SYNCED: Off-Planet	FPS	Level Infinite	NExT Studios	PC	2022E
Don't Starve: Newhome	Survival	Level Infinite	Shengqu	Mobile	TBD
Clash Mini	Chess	Supercell	Supercell	Mobile	TBD
Clash Heroes	RPG	Supercell	Supercell	Mobile	TBD
Song of Nunu	Action	Riot Games	Tequila Works	Console/PC	2023E
CONV/RGENCE	Action	Riot Games	Double Stallion	TBD	TBD
Warhammer 40,000: Darktide	Action	Fatshark	Fatshark	Console/PC	2022E
Path of Exile 2	MMORPG	Grinding Gear Games	Grinding Gear Games	Console/PC	TBD

Source: Company data, CMBIGM

Online advertising (14.6% of 2022E revenue)

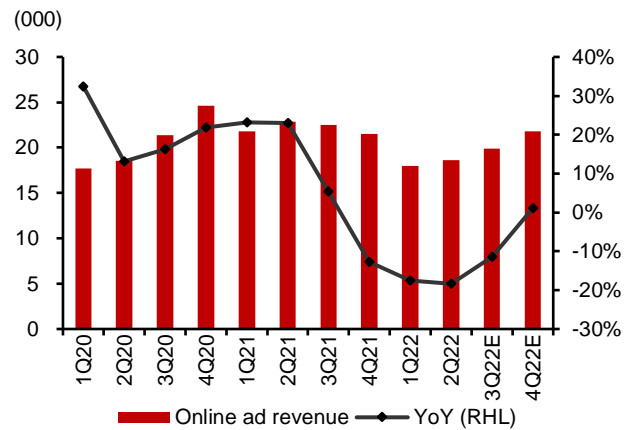
As the pandemic impact wears off and Weixin Video Account begins to make meaningful revenue contribution, we expect online ad business will return to positive YoY revenue growth in 4Q22 (+1.2% YoY). Driven by revenue growth in new ad properties and recovery of macro environment, we forecast online ad revenue will increase 13.7/11.1% YoY to RMB89.9/98.9bn in 2023E/2024E.

Figure 13: Tencent: online ad revenue



Source: Company data, CMBIGM

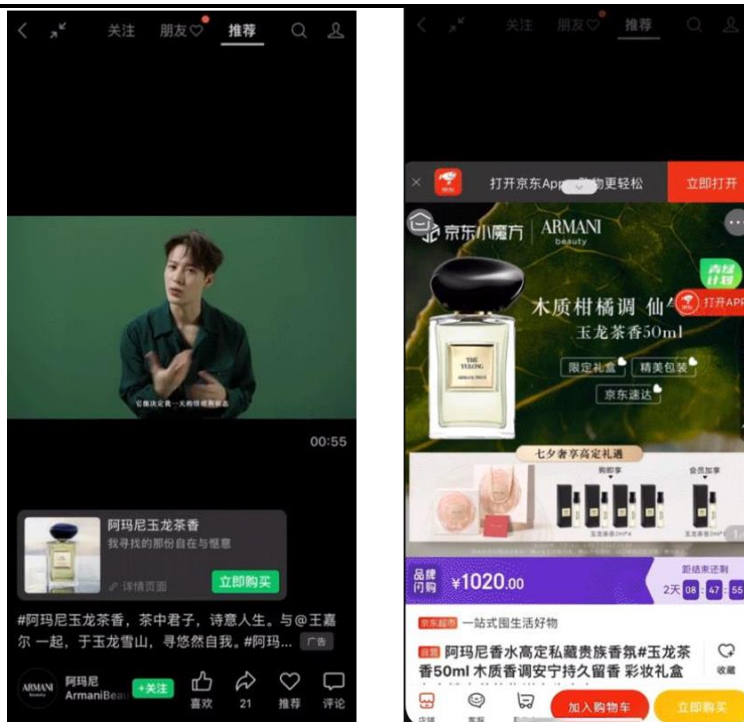
Figure 14: Tencent: online ad revenue (quarterly)



Source: Company data, CMBIGM

We expect Weixin Video Account to be a key driver of Tencent ad business going forward. In 2Q22, total user time spent on Weixin Video Account already exceeded 80% of Moments'. In July 2022, Tencent launched Video Account in-feed native ads, initially selling the ads on the contract basis and covering only limited number of brand advertisers. By the end of August 2022, Tencent will be increasing additional ad inventory, sold on a bidding basis, in order to unleash monetization potential.

Figure 15: Weixin video account: native ads



Source: Company data, CMBIGM estimates

Based on our estimate, Weixin Video Account will be a key driver of Tencent's online ad business and will generate ad revenue of RMB3.2/12.7/27.4bn in 2022/2023/2024E, accounting for 4/14/28% of Tencent total ad revenue over 2022-2024E. Leveraging massive Weixin's user traffic, we expect Video Account DAU could reach c.500mn in the long term (2025E). Due to the relatively high proportion of casual users, user time spent on Video Account shall be lower at c.60 minutes compared to Kuaishuo's (128 minutes) at mature stage. We also assume more conservative ad load rate of 10% (Kuaishou/Douyin: 12/15%) in 2024E, given Weixin's priority on user experience.

Figure 16: Weixin Video Account: revenue potential estimate

Metrics	2022E	2023E	2024E	2025E	Comment
a) Weixin DAU (mn)	826.3	826.3	826.3	826.3	Stable at 826.3mn (DAU in Jun-22)
b) Weixin Video Account DAU penetration (%)	40.0%	50.0%	55.0%	60.0%	
c) Video account DAU (mn)	330.5	413.2	454.5	495.8	Kuaishou: 346mn (1Q22)
d) Daily time spend (mins)	35.0	45.0	55.0	60.0	Kuaishou: 128minutes (1Q22)
e) Feeds per minutes	1.5	1.5	1.5	1.5	
e) ad load (%)	2%	5%	8%	10%	Kuaishou/Douyin: 12/15%
f) Average daily ad impression (mn times)	347	1,394	3,000	4,462	= a * b * c * d * e
g) eCPM (RMB)	25.0	25.0	25.0	25	Kuaishou/Douyin: c.RMB20/30
h) Video account annual ad revenue (RMBmn)	3,167	12,724	27,371	40,718	'= f / 1000 * g * 365
Tencent ad revenue (RMBmn)	78,313	89,049	98,939	108,875	
Video account as % of ad revenue	4%	14%	28%	37%	

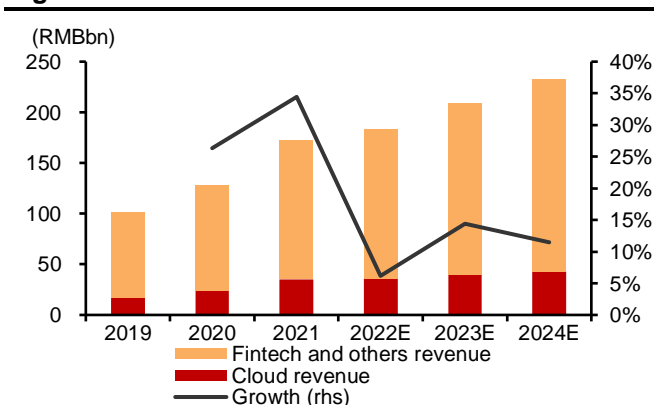
Source: Company data, CMBIGM estimates

Fintech and business services (32.8% of 2022E revenue)

Tencent proactively adjusted its strategy of business service segment to focus on quality growth, prioritizing self-developed products and reducing loss-making activities. Besides, the pandemic has negatively impacted the commercial payment revenue growth in 1H22. As a result, we forecast FBS revenue growth to slow to 6.2% in 2022E (2021: +34.4% YoY) and represent 32.8% of total revenue. After that, we expect FBS revenue to deliver a rebound of 14.4/11.4% YoY in 2023/2024E, as the payment volume recovers and the cloud business regains traction.

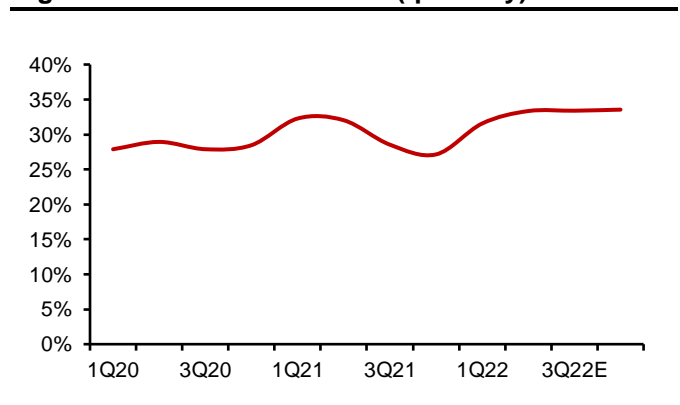
Tencent's strategic adjustment on the cloud business already began to bear fruit in 2Q22. FBS gross margin improved by 1.3pp YoY and 1.7pp QoQ to 33.3% in 2Q22, driven by favorable revenue mix shift and cost control. Tencent's self-developed and higher margin PaaS product TDSQL database recorded revenue growth of over 30% YoY and accounted over 5% of total cloud revenue in 2Q22. With self-developed PaaS/SaaS products accounting for a greater percentage of its cloud revenue, we expect the FBS GPM has further improvement potential.

Figure 17: Tencent: FBS revenue



Source: Company data, CMBIGM estimates

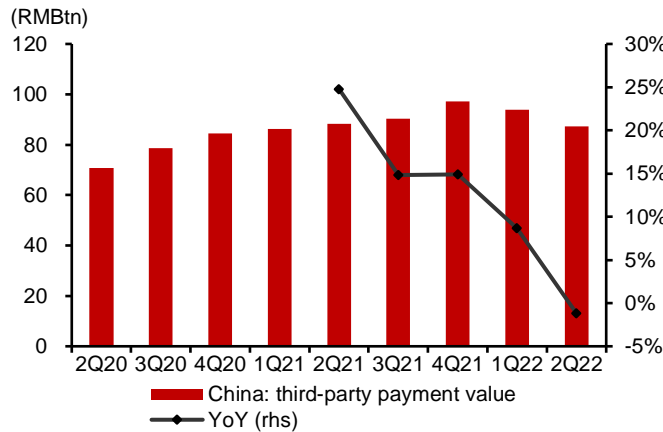
Figure 18: Tencent: FBS GPM (quarterly)



Source: Company data, CMBIGM estimates

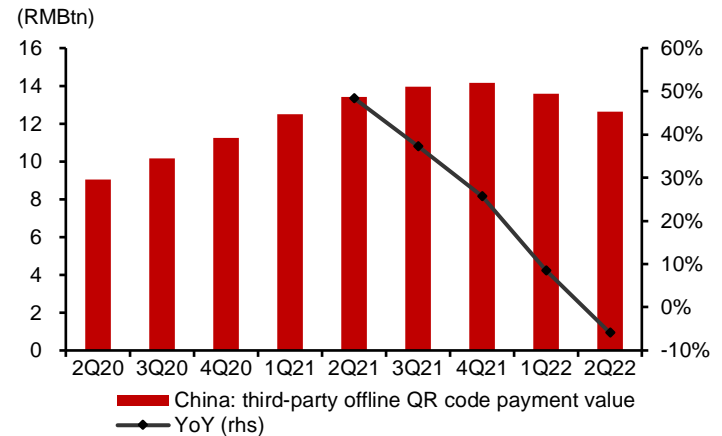
China's third-party payment value declined by 1.2% YoY and 7.1% QoQ to RMB87.2tn in 2Q22, mainly due to the resurgence of COVID-19 in major cities and the weak consumption sentiment, per Analysys. Offline payment market experienced a greater decline of 5.9% YoY in 2Q22. That said, WeChat continued to maintained its market share despite sector headwind, supported by its unparalleled user traffic advantages. We are upbeat on the recovery of Tencent fintech business in 2H22E and 2023E, once the payment market recovers with the overall consumption sentiment.

Figure 19: China: third-party payment value



Source: Analysys, CMBIGM

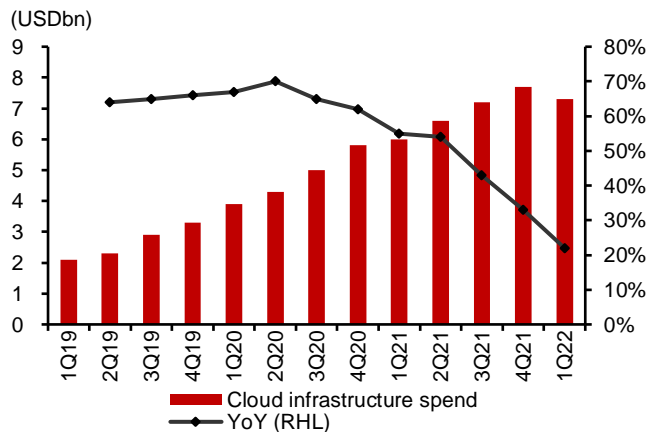
Figure 20: China: third-party offline QR code payment



Source: Analysys, CMBIGM

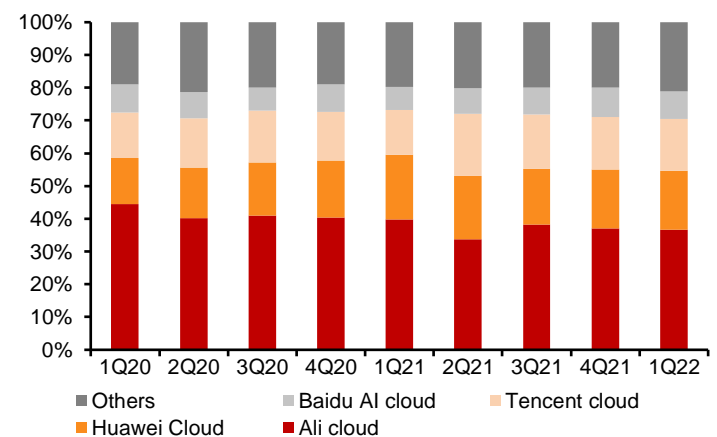
China's cloud sector is experiencing transitional challenge, as the macro economic growth slows down and internet companies scale down their capital expenditure. According to Canalys, China cloud infrastructure spending YoY growth rate decelerated to 22% in 1Q22. Tencent Cloud loss market share from 16.0% in 4Q21 to 15.7% in 1Q22, as the company is undergoing strategic adjustment. To mitigate the impact of sector slowdown, Tencent Cloud began to focus more on the clients in the traditional sectors, such as retail, healthcare and industrial etc.

Figure 21: China: cloud infrastructure spending



Source: Canalys, CMBIGM

Figure 22: China cloud spending mkt share

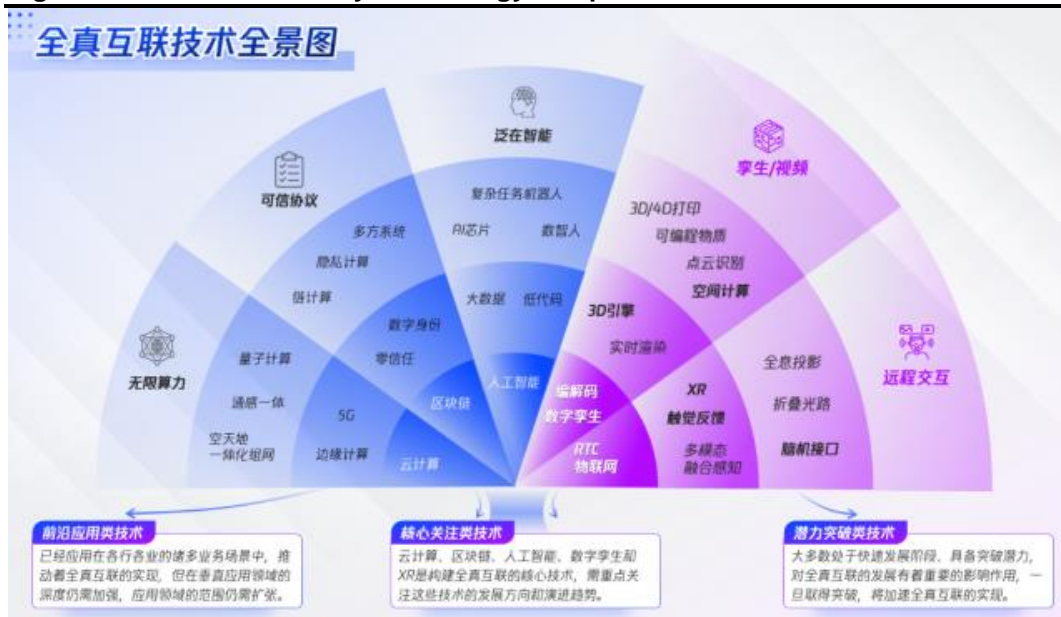


Source: Canalys, CMBIGM

Tencent is already well-positioned to prepare for the next-generation internet, i.e. the Internet of Reality (全真互联网), given its strong online ecosystem and robust technology infrastructure. Tencent highlighted five investment areas that will serve as the key tech infrastructure for the Internet of Reality: 1) unlimited computing power (e.g., cloud computing); 2) trusted protocol (e.g., blockchain); 3) ambient intelligence (e.g., AI); 4) digital twins/video (e.g., coding and decoding); 5) remote interaction (RTC and IoT). Tencent has been investing heavily in these areas, which in our view will facilitate itself to achieve the vision of Internet of Reality. Comparing to its global peers such as Meta, Tencent has full

spectrum of technology, infrastructure, content, comprehensive consumer and enterprise use cases.

Figure 23: Internet of Reality: technology blueprint



Source: Company data, CMBIGM

SOTP valuation

Our SOTP-derived target price of HK\$398.0 comprises, per share:

- 1) HK\$146.6 for the online games business, based on a 17x 2023E PE, which is on par with the average PE for its global gaming peers.
- 2) HK\$24.1 for the SNS business, including the market cap of Tencent's stake in its subsidiaries, the valuation of Tencent Video (based on a 3.5x 2023E PS, at a premium to the 2.2x average PS of its peers given its content and user traffic leadership), and the valuation of other membership services (based on a 2.0x 2023E PS).
- 3) HK\$22.3 for the advertising business, based on a 15x 2023E PE, at a premium to the industry average (11x), given Tencent's strong ecosystem that could offer substantial ad monetization potential in the long term.
- 4) HK\$98.0 for the fintech business, based on a 5.0x 2023E PS, at a discount to the peer average (6.2x), to factor in regulatory pressure and relatively lower margins.
- 5) HK\$16.1 for the cloud business, based on a 3.5x 2023E PS, at a discount to the industry average (3.6x) as Tencent's current offerings come mainly from the lower-margin IaaS business.
- 6) HK\$76.0 for strategic investments, based on the fair value of Tencent's equity investment as disclosed in its 2Q22 earnings release. We applied a 30% holding company discount to the fair value of Tencent's equity investment.
- 7) HK\$13.8 for net cash.

Figure 24: Tencent: SOTP valuation

	2023E net profit (RMBmn)	2023E revenue (RMBmn)	2023E PE (x)	2023E PS (x)	Market cap (RMBmn)	Valuation to Tencent (RMBmn)	As % of total valuation	Per share valuation (HK\$)
Online games	74,525		17x			1,266,924	36.8	146.6
Social network services (SNS)		124,367				207,912	6.0	24.1
Tencent Music (TME)					45,014	24,802	0.7	2.9
China Literature					18,652	11,038	0.3	1.3
Huya					3,056	1,449	0.0	0.2
Online video – subscription		27,300		3.0x		81,900	2.4	9.5
Others		44,361		2.0x		88,722	2.6	10.3
Online advertising	13,397		15x			200,962	5.8	23.3
Fintech		169,330		5.0x		846,652	24.6	98.0
Cloud (business services)		39,845		3.5x		139,459	4.1	16.1
Net cash						119,633	3.5	13.8
Valuation of core business						2,781,541		
RMB/HK\$						0.89		
Valuation of core business (HK\$m)						3,121,820		
Valuation per share – core business (HK\$)						322.0		
Valuation per share – investment (HK\$) (30% holding discount)						76.0	19.1	
Valuation per share – Tencent (HK\$)						398.0		

Source: Company data, CMBIGM estimates

Figure 25: Peer comparison: online games and advertising sector

Companies	Ticker	Price (Local)	EPS growth (YoY %)			PE (x)		
			FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Online games								
NetEase	NTES US	56.7	10	14	10	13	11	10
Activision Blizzard	ATVI US	72.5	(26)	35	7	26	19	18
Electronic Arts	EA US	127.7	27	2	8	18	18	17
Take Two Interactive	TTWO US	122.7	(18)	(2)	63	25	25	16
IGG	799 HK	2.2	na	na	65	na	22	14
iDreamSky	1119 HK	3.3	na	na	76	na	18	10
Nexon	3659 JP	2,418.0	10	9	16	20	18	16
Nintendo	7974 JP	5,922.0	4	3	(8)	16	16	17
Bandai Namco	7832 JP	9,645.0	61	28	2	27	21	21
Perfect World	002624 CH	11.7	101	14	16	13	11	10
37 games	002555 CH	14.5	17	16	14	10	9	8
Yoozoo	002174 CH	7.8	(19)	18	9	16	14	13
Average PE						18	17	14
Online advertising								
Focus Media	002027 CH	4.9	(35)	55	17	18	12	10
Baidu	BIDU US	81.0	(1)	19	21	11	9	8
Meta	Meta US	97.9	(26)	7	15	9	8	7
Google	GOOG US	92.6	(6)	15	15	17	15	13
Average PE						14	11	9

Source: Company data, CMBIGM estimates

Note: data as of the market close on 27 October; all data are based on Bloomberg consensus estimates

Figure 26: Peer comparison: online video, fintech, and cloud sectors

Companies	Ticker	Price (Local)	Revenue growth (YoY %)			PS (x)		
			FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Online video								
iQiyi	IQ US	2.1	(16.9)	6.2	5.2	0.4	0.4	0.4
Mango Excellent Media	300413 CH	22.1	(19.4)	15.9	13.7	2.2	2.8	2.4
Average PS						1.8	2.2	1.9
Cloud								
Microsoft	MSFT US	226.8	9.0	13.3	12.5	7.8	6.9	6.1
Google	GOOG US	92.6	(7.8)	13.0	11.8	5.0	4.5	4.0
Salesforce	CRM US	159.8	17.0	14.7	16.9	5.2	4.5	3.8
Kingsoft Cloud	KC US	2.7	(9.9)	18.6	18.6	0.5	0.4	0.4
Amazon	AMZN US	111.0	11.0	14.6	15.4	2.2	1.9	1.6
Average PS						4.1	3.6	3.2
Fintech								
PayPal	PYPL US	87.4	9.9	13.3	14.4	3.6	3.2	2.8
Square	SQ US	60.3	(0.7)	14.2	21.7	2.0	1.8	1.5
Visa	V US	204.3	20.9	10.3	12.3	15.0	13.6	12.1
Average PS						6.9	6.2	5.5

Source: Company data, CMBIGM estimates

Note: data as of market close on 27 October; all data are based on Bloomberg consensus estimates

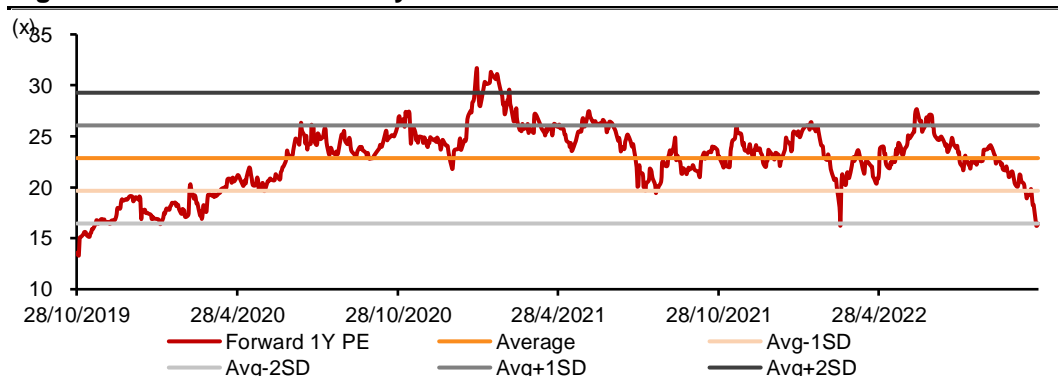
Our calculation for the valuation of Tencent's strategic investments is based on the total fair value of Tencent's equity investment as disclosed in its 2Q22 earnings release, with an assumed 30% holdco discount.

Figure 27: Tencent: strategic investment calculation

Equity investment	(RMBmn)
Investments in associates (Fair value of listed entity + Book value of unlisted entities)	600,387
FVPL (Financial assets at fair value through profit or loss, excl. treasury investment)	194,129
FVOCI (Financial assets at fair value through other comprehensive income, excl. treasury)	142,389
Total value of Strategic investment	936,905
Holdco discount	30.0%
Total value of Strategic investment after discount	9,679
Investment per share (RMB)	67.8
Investment per share (HKD)	76.0

Source: Company data, CMBIGM

Tencent's current valuation of 16.7x forward 1-year PE offers attractive risk-reward compared to its 3-year historical average (22.9x). The current PE is 2 S.D. below its historical average.

Figure 28: Tencent: forward 1-year PE band

Source: Bloomberg, CMBIGM

Financial Summary

INCOME STATEMENT	2019A	2020A	2021A	2022E	2023E	2024E
YE 31 Dec (RMB mn)						
Revenue	377,289	482,064	560,118	558,042	614,074	664,661
Cost of goods sold	(209,756)	(260,532)	(314,174)	(318,277)	(350,045)	(377,623)
Gross profit	167,533	221,532	245,944	239,765	264,029	287,038
Operating expenses	(48,839)	(37,295)	25,676	(101,587)	(111,103)	(118,091)
Selling expense	(21,396)	(33,758)	(40,594)	(34,041)	(38,687)	(40,544)
Admin expense	(53,446)	(67,625)	(89,847)	(103,796)	(110,533)	(116,316)
Others	26,003	64,088	156,117	36,250	38,117	38,769
Operating profit	118,694	184,237	271,620	138,178	152,926	168,947
Share of (losses)/profits of associates/JV	(1,681)	3,672	(16,444)	(16,047)	(3,209)	(1,284)
Interest income	6,314	6,957	6,650	6,356	7,327	7,055
Interest expense	(7,613)	(7,887)	(7,114)	(7,797)	(6,357)	(6,426)
Pre-tax profit	109,400	180,022	248,062	114,334	143,359	161,238
Income tax	(13,512)	(19,897)	(20,252)	(17,150)	(21,504)	(24,186)
After tax profit	95,888	160,125	227,810	97,184	121,855	137,052
Minority interest	(2,578)	(278)	(2,988)	(1,944)	(2,437)	(2,741)
Net profit	93,310	159,847	224,822	95,240	119,418	134,311
Adjusted net profit	94,351	122,742	123,788	113,230	130,400	146,898
Gross dividends	9,880	12,653	12,704	6,189	7,760	8,728
BALANCE SHEET						
YE 31 Dec (RMB mn)						
Current assets	253,968	317,647	484,812	462,653	577,365	677,687
Cash & equivalents	132,991	152,798	167,966	261,724	314,396	416,328
Account receivables	35,839	44,981	49,331	45,572	48,643	51,071
Inventories	718	814	1,063	1,794	1,875	1,928
Prepayment	27,840	40,321	65,390	36,770	72,275	42,212
ST bank deposits	46,911	68,487	83,813	102,194	124,157	150,307
Financial assets at FVTPL	7,114	6,593	10,573	11,102	11,657	12,240
Other current assets	2,555	3,653	106,676	3,499	4,362	3,603
Non-current assets	700,018	1,015,778	1,127,552	1,167,781	1,232,518	1,277,644
PP&E	46,824	59,843	61,914	74,350	85,107	94,333
Deferred income tax	18,209	21,348	26,068	19,724	30,666	23,875
Investment in JVs & assos	221,894	305,258	323,188	338,245	353,790	369,811
Intangibles	128,860	159,437	171,376	195,135	216,377	236,796
Financial assets at FVTPL	128,822	165,944	192,184	192,184	192,184	192,184
Other non-current assets	155,409	303,948	352,822	348,143	354,394	360,646
Total assets	953,986	1,333,425	1,612,364	1,630,434	1,809,883	1,955,331
Current liabilities	240,156	269,079	403,098	303,685	354,875	359,347
Short-term borrowings	33,229	14,242	19,003	17,051	18,753	20,230
Account payables	80,690	94,030	109,470	97,615	127,862	112,946
Tax payable	9,733	12,134	12,506	14,236	15,344	16,222
Other current liabilities	113,225	144,851	256,673	169,338	187,470	204,502
Lease liabilities	3,279	3,822	5,446	5,446	5,446	5,446
Non-current liabilities	225,006	286,303	332,573	360,967	377,522	392,863
Long-term borrowings	104,257	112,145	136,936	139,423	140,182	140,411
Bond payables	83,327	122,057	145,590	156,509	162,378	165,423
Deferred income	7,334	6,678	4,526	12,731	14,002	15,105
Other non-current liabilities	30,088	45,423	45,521	52,304	60,960	71,924
Total liabilities	465,162	555,382	735,671	664,652	732,397	752,209
Retained earnings	384,651	538,464	669,911	757,056	866,323	989,218
Other reserves	48,055	165,520	136,388	136,388	136,388	136,388
Total shareholders equity	432,706	703,984	806,299	893,444	1,002,711	1,125,606
Minority interest	56,118	74,059	70,394	72,338	74,775	77,516
Total equity and liabilities	953,986	1,333,425	1,612,364	1,630,434	1,809,883	1,955,331

CASH FLOW	2019A	2020A	2021A	2022E	2023E	2024E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	109,400	180,022	248,062	114,334	143,359	161,238
Depreciation & amortization	41,528	50,774	56,818	60,230	69,928	78,472
Tax paid	(13,512)	(19,897)	(20,252)	(17,150)	(21,504)	(24,186)
Change in working capital	15,330	27,423	(2,844)	34,909	9,721	29,699
Others	(4,156)	(44,203)	(106,598)	0	0	0
Net cash from operations	148,590	194,119	175,186	192,323	201,505	245,224
Investing						
Capital expenditure	(32,369)	(33,906)	(34,931)	(34,106)	(36,780)	(39,013)
Acquisition of subsidiaries/ investments	(68,512)	(108,665)	(117,642)	(22,216)	(56,120)	(41,454)
Net proceeds from disposal of short-term investments	16,411	15,376	0	0	0	0
Others	(31,700)	(54,760)	(25,976)	(62,319)	(65,147)	(69,104)
Net cash from investing	(116,170)	(181,955)	(178,549)	(118,641)	(158,047)	(149,572)
Financing						
Net borrowings	22,961	44,490	45,239	19,967	18,094	16,593
Proceeds from share issues	272	1,716	0	0	0	0
Others	(21,561)	(32,559)	(23,619)	110	(8,880)	(10,313)
Net cash from financing	1,672	13,647	21,620	20,076	9,214	6,280
Net change in cash						
Cash at the beginning of the year	97,814	132,991	152,798	167,966	261,724	314,396
Exchange difference	1,085	(6,004)	(3,089)	0	0	0
Cash at the end of the year	132,991	152,798	167,966	261,724	314,396	416,328
GROWTH	2019A	2020A	2021A	2022E	2023E	2024E
YE 31 Dec						
Revenue	20.7%	27.8%	16.2%	(0.4%)	10.0%	8.2%
Gross profit	17.9%	32.2%	11.0%	(2.5%)	10.1%	8.7%
Operating profit	21.6%	55.2%	47.4%	(49.1%)	10.7%	10.5%
Net profit	18.5%	71.3%	40.6%	(57.6%)	25.4%	12.5%
Adj. net profit	21.8%	30.1%	0.9%	(8.5%)	15.2%	12.7%
PROFITABILITY	2019A	2020A	2021A	2022E	2023E	2024E
YE 31 Dec						
Gross profit margin	44.4%	46.0%	43.9%	43.0%	43.0%	43.2%
Operating margin	31.5%	38.2%	48.5%	24.8%	24.9%	25.4%
Adj. net profit margin	25.0%	25.5%	22.1%	20.3%	21.2%	22.1%
Return on equity (ROE)	24.7%	28.1%	29.8%	11.2%	12.6%	12.6%
GEARING/LIQUIDITY/ACTIVITIES	2019A	2020A	2021A	2022E	2023E	2024E
YE 31 Dec						
Net debt to equity (x)	0.2	0.1	0.2	0.1	0.0	(0.1)
Current ratio (x)	1.1	1.2	1.2	1.5	1.6	1.9
Receivable turnover days	34.7	34.1	32.1	29.8	28.9	28.0
Payable turnover days	(140.4)	(131.7)	(127.2)	(111.9)	(133.3)	(109.2)
VALUATION	2019A	2020A	2021A	2022E	2023E	2024E
YE 31 Dec						
P/E	30.2	24.4	19.1	19.6	15.7	13.9
P/E (diluted)	30.6	24.8	19.4	19.9	15.9	14.1
P/B	6.5	5.5	5.3	2.1	1.9	1.7

Source: Company data, CMBIGM estimates. Note: The calculation of net cash includes financial assets.

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