

Company update

Tencent Holdings

Research Team
China | Communication Services

Rating BUY (as at 17 November 2022)
 Last Close HKD 303.20
 Fair Value HKD 420.00

Positive news galore

- **Weak revenue trends but outlook is turning positive**
- **Cost discipline helped margins and EPS beat**
- **Meituan shares distribution a reward for shareholders**
- **Advertising and financial services businesses to drive growth going forward; FV of HKD428**

Investment thesis

Tencent's (700 HK) 3Q22 revenue trends were still relatively weak but there are glimpses of light at the end of the tunnel, with management citing advertising demand turning positive. Cost control efforts helped a significant beat at the bottom-line, with the company scaling back on loss-making activities in search of profitability. Tencent also delivered further positive news this quarter, announcing the distribution in specie of 90% of its stake in Meituan shares to shareholders. All in all, this turned out to be a relatively positive earnings season for Tencent. Over the long-term, we expect advertising and financial services business to be the growth engines for Tencent going forward while the domestic gaming business matures. Tencent continues to be a good allocator of capital, returning close to USD40b of capital (JD shares distribution, Meituan shares distribution and share buybacks) to shareholders in an extremely challenging macro environment in the past 12 months. Following adjustments to our estimates and assumptions, our fair value (FV) declines from HKD428 to HKD420, while maintaining our ESG discount of 5%. This FV includes the Meituan dividend in specie distribution of HKD16.

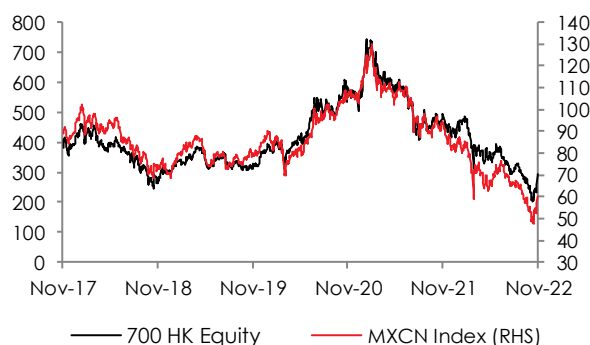
Investment summary

- **3Q22 results a beat on cost discipline** – Tencent revenue trends were still relatively weak, with Value Added Services revenues missing estimates. Domestic gaming revenues declined 7% year-on-year (YoY) as the gaming industry continues to face negative impact from regulations on the sector imposed in Sep 2021. Domestic gaming business should start growing again from 4Q22 as comps get easier. Advertising business was the bright spot in the revenue trends, improving from a revenue decline of -18.4% YoY in 2Q22 to -4.7% YoY in 3Q22. Gross margins across all major businesses improved quarter-on-quarter (QoQ), as company focused on more disciplined spending on channel and

Security information

Ticker	700 HK
Market Cap (HKD b)	2,820.7
Daily turnover (HKD m)	7,954.3
Free Float	63%
Shares Outstanding (m)	9,593
Top Shareholder	Naspers Ltd 28.1%

Price performance chart



Financial summary

CNY m	FY21	FY22E	FY23E
Revenue	560,118	558,403	619,709
Gross profit	245,944	241,348	278,196
Operating profit (adj)	152,889	145,522	169,289
Net profit (adj)	123,788	118,219	142,511
Earnings/Share (adj)	12.74	12.13	14.62

Key ratios

	FY21	FY22E	FY23E
Revenue growth	16.2%	-0.3%	11.0%
Gross margin	43.9%	43.2%	44.9%
Operating margin (adj)	27.3%	26.1%	27.3%
Net margin (adj)	22.1%	21.2%	23.0%
EPS (adj) growth	0.5%	-4.7%	20.5%

Source: Bloomberg, Company, Internal estimates

distribution costs, as well as content costs. Gross margins on Fintech and Business Services business improved almost 500bps from 3Q21, as Tencent scaled back loss-making activities and cloud deployment costs. Selling and marketing costs also declined 32% YoY due to cost efficiency efforts. Although 3Q22 revenue missed by 1%, adjusted EPS beat estimates by 10% due to higher margins.

- **Distribution in specie of Tencent's stake in Meituan (3690 HK) to shareholders** – Tencent announced a distribution in specie of 15.5% out of its 17% stake in Meituan to shareholders, with an entitlement of 1 Meituan share (Class B) per 10 Tencent shares. The stake to be distributed amounts to a valuation of USD20.3b, and implies a yield of 5.5% based on the closing prices of Tencent and Meituan as of 16 Nov. This is a positive surprise to investors, coming on the back of the distribution of Tencent's stake in JD.com (9618 HK) earlier in 2022. The company cited this distribution as a move to return capital to shareholders
- **Adjust FV to HKD420** – During the conference call, management highlighted improving trends in online advertising business, with strong advertising demand for Video Account (VA) in-feed advertisements. Vendors have been asking Tencent for more advertising inventory so it suggests that this business should improve going forward. Management mentioned during the call that they are on track to exceed CNY1b quarterly revenue in VA monetisation by 4Q22. They also clarified that their growth in VA live streaming will be more incremental rather than cannibalising their existing advertising business such as Weixin Moments. For the domestic gaming business, although the company is seeing a more supportive regulatory environment and expects more licence awards going forward, they also highlighted that the Chinese government wants to promote a healthier gaming ecosystem, so growth is likely to trend lower than before. Given the recent news around Riot Games taking back the publishing of League of Legends (LoL) from Sea Limited (SE US), we believe Tencent could focus efforts on growing their international gaming business. Over the long-term, management believes that their financial business should return to a strong growth backdrop once macro headwinds start easing – their payments services and network help to generate incremental opportunities with their lending and wealth management businesses. We agree and expect the FinTech and business services segment as one of the key growth drivers both on the top-line and bottom-line as margins expand with operating leverage. We tweak our FY22 and FY23 estimates downwards and adjust our FV down slightly to HKD420. This FV includes the Meituan dividend in specie distribution of HKD16.

ESG Updates

- With about 39% of China's mobile payments market share (1Q20), research notes that WeChat Pay may be subject to stringent scrutiny in light of the regulator's clampdown on FinTech in China. Nevertheless, Tencent's expansion into retail microfinance and loans to small-medium enterprises through WeBank, may allow growth opportunities while expanding financial inclusion. Tencent appears to have a robust data privacy framework compared to its peers, despite a diverse portfolio of services. However, with 1.2b monthly active WeChat users (3Q20) resulting in substantial personal data management, Tencent's data practices, including consent, have attracted regulatory criticism. On carbon emissions, research notes that 83% of Tencent's revenues are from less carbon-intensive business lines relative to peers.

Potential catalysts

- Payment/cloud/subscription business could grow faster and be more profitable than anticipated
- International expansion could be better than expected, reigniting growth in users and engagement
- Advertising could scale faster than projected resulting in better growth and earnings
- Shorter/shallower-than-expected investment cycle

Investment risks

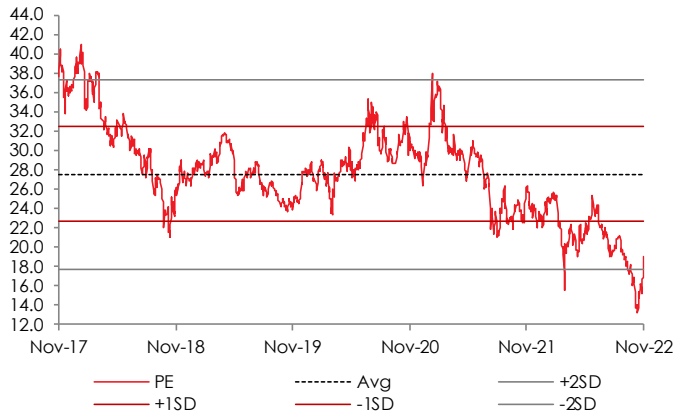
- Operates in highly sensitive areas which could see a clamp down from the Chinese government (gaming, social media, chat, online video, newsfeeds) or other regulatory headwinds
- Poor performance of legacy games or pipeline disappointment could result in drastic revenue slowdown
- Prolonged macro challenges and Covid-19 related lockdowns

Valuation analysis

	Price/Earnings		Price/Book		EV/EBITDA		Dividend Yield (%)		ROE (%)	
	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
TENCENT HOLDINGS LTD (700 HK)	22.4	18.7	2.9	2.5	16.4	13.6	0.5	0.5	12.1	13.7
META PLATFORMS INC (META US)	11.1	11.7	2.5	2.1	5.6	5.7	0.0	0.0	19.4	17.9
BAIDU INC (9888 HK)	14.1	12.0	1.0	1.0	7.5	5.6	0.0	0.0	6.1	7.5
ALPHABET INC (GOOGL US)	18.5	16.0	4.9	4.2	10.5	9.4	0.0	0.0	25.5	26.0

Source: Bloomberg

Price/Earnings chart



Source: Bloomberg

Price/Book chart



Source: Bloomberg

Exhibit 1: Summary of Tencent 3Q22 Results

	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22
Total Revenue (CNY m)	135,303	138,259	142,368	144,188	135,471	134,034	140,093
Value Added Services	72,443	72,013	75,203	71,913	72,738	71,683	72,727
Fintech & Business Services	39,028	41,892	43,317	47,958	42,768	42,208	44,844
Online Advertising	21,820	22,833	22,495	21,518	17,988	18,638	21,443
Others	2,012	1,521	1,353	2,799	1,977	1,505	1,079
Total Revenue % YoY	25.2%	20.3%	13.5%	7.9%	0.1%	-3.1%	-1.6%
Value Added Services	16.0%	10.8%	7.7%	7.4%	0.4%	-0.5%	-3.3%
Fintech & Business Services	47.4%	40.3%	30.3%	24.6%	9.6%	0.8%	3.5%
Online Advertising	23.2%	23.1%	5.4%	-12.7%	-17.6%	-18.4%	-4.7%
Others	39.0%	3.7%	30.2%	-21.0%	-1.7%	-1.1%	-20.3%
Gross Profit (CNY m)	62,635	62,745	62,747	57,817	57,074	57,867	61,983
VAS	39,910	38,123	39,859	35,044	36,683	36,303	37,588
Fintech & Business Services	12,598	13,420	12,362	13,016	13,499	14,075	14,942
Online Advertising	9,834	11,136	10,444	9,180	6,594	7,566	9,937
Others	293	66	82	577	298	-77	-484
Gross Margin %	46.3%	45.4%	44.1%	40.1%	42.1%	43.2%	44.2%
VAS	55.1%	52.9%	53.0%	48.7%	50.4%	50.6%	51.7%
Fintech & Business Services	32.3%	32.0%	28.5%	27.1%	31.6%	33.3%	33.3%
Online Advertising	45.1%	48.8%	46.4%	42.7%	36.7%	40.6%	46.3%
Others	14.6%	4.3%	6.1%	20.6%	15.1%	-5.1%	-44.9%
Adjusted Operating Income (CNY m)	41,144	41,172	39,125	31,448	34,801	34,722	38,579
Adjusted Operating Margin %	30.4%	29.8%	27.5%	21.8%	25.7%	25.9%	27.5%
Non-IFRS Net Income (CNY m)	33,118	34,039	31,751	24,880	25,545	28,139	32,254
Non-IFRS Net Margin %	24.5%	24.6%	22.3%	17.3%	18.9%	21.0%	23.0%
Non-IFRS Diluted EPS (CNY / share)	3.42	3.50	3.27	2.55	2.62	2.90	3.31
% YoY	21.2%	11.9%	-1.4%	-25.4%	-23.3%	-17.4%	1.1%

Source: Company, internal estimates

Company overview (as of 31 December 2021)

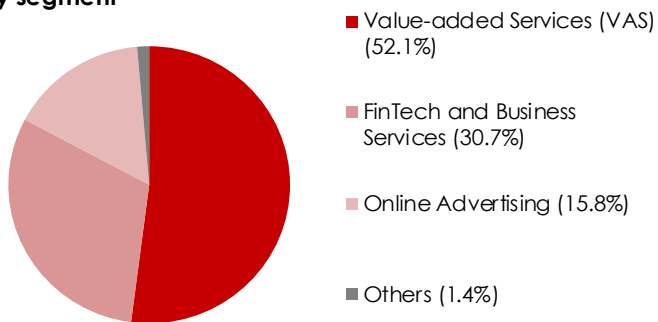
Company description

Tencent's communication and social services, Weixin and QQ, connect users with each other and with digital content and services, both online and offline. Its targeted advertising service helps advertisers reach out to hundreds of millions of consumers in China. Its FinTech and business services support partners' business growth and assist their digital upgrade.

Tencent invests heavily in talent and technological innovation, actively promoting the development of the Internet industry. Tencent was founded in Shenzhen, China, in 1998. Shares of Tencent (00700.HK) are listed on the Main Board of the Stock Exchange of Hong Kong.

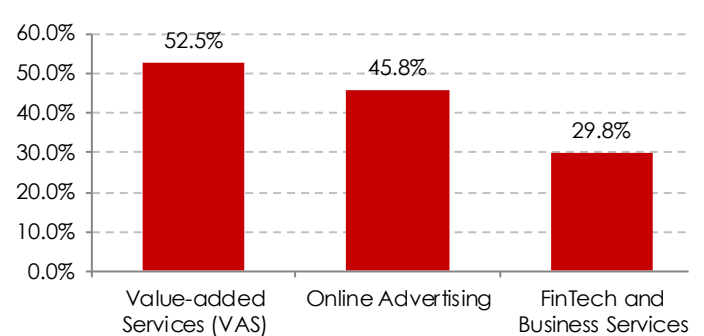
FY21 Revenue breakdown

By segment



Source: Company, Internal estimates

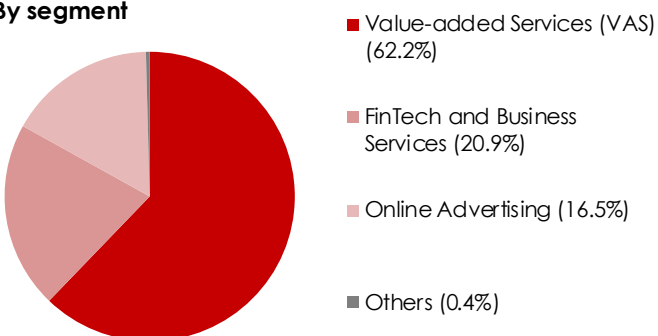
FY21 segment gross margin



Source: Company, Internal estimates

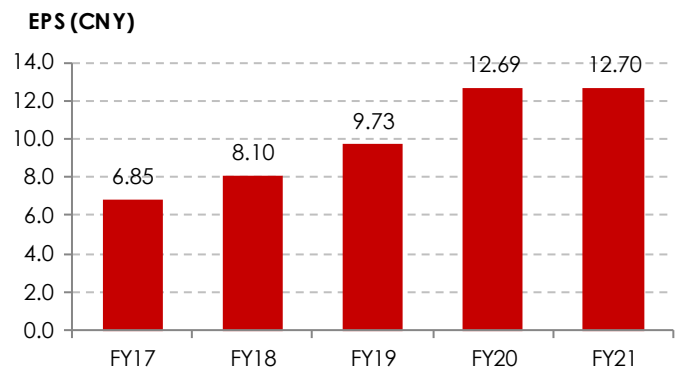
FY21 Gross profit breakdown

By segment



Source: Company, Internal estimates

Earnings per share (adjusted)



Source: Company, Internal estimates

Company financials

Income Statement

In Millions of CNY except Per Share 12 Months Ending	FY2017 31/12/2017	FY2018 31/12/2018	FY2019 31/12/2019	FY2020 31/12/2020	FY2021 31/12/2021
Revenue	237,760	312,694	377,289	482,064	560,118
- Cost of Revenue	120,835	170,574	209,756	260,532	314,174
Gross Profit	116,925	142,120	167,533	221,532	245,944
+ Other Operating Income	--	--	--	--	--
- Operating Expenses	26,623	44,472	48,839	37,295	-25,676
Operating Income or Losses	90,302	97,648	118,694	184,237	271,620
- Interest Expense	3,060	4,898	7,690	7,449	6,310
- Foreign Exchange Losses (Gains)	--	--	--	--	--
- Net Non-Operating Losses (Gains)	-973	-1,716	1,604	-3,234	17,248
Pretax Income	88,215	94,466	109,400	180,022	248,062
- Income Tax Expense (Benefit)	15,744	14,482	13,512	19,897	20,252
Income Before XO Items	72,471	79,984	95,888	160,125	227,810
- Extraordinary Loss Net of Tax	--	--	--	--	--
- Minority/Non Controlling Interests (Credits)	961	1,265	2,578	278	2,988
Net Income/Net Profit (Losses)	71,510	78,719	93,310	159,847	224,822
Net Inc Avail to Common Shareholders	71,510	78,719	93,310	159,847	224,822
Abnormal Losses (Gains)	--	--	--	--	--
Tax Effect on Abnormal Items	--	--	--	--	--
Normalized Income	63,661	93,670	91,956	148,590	142,381
Basic Earnings per Share	7.6	8.3	9.9	16.8	23.6
Basic Weighted Avg Shares	9,411	9,444	9,468	9,490	9,528
Diluted EPS Before Abnormal Items	7.5	8.2	9.6	16.5	23.2
Diluted EPS Before XO Items	7.5	8.2	9.6	16.5	23.2
Diluted EPS	7.5	8.2	9.6	16.5	23.2
Diluted Weighted Avg Shares	9,536.0	9,568.0	9,603.0	9,650.0	9,696.0

Profitability Ratios

12 Months Ending	FY2017 31/12/2017	FY2018 31/12/2018	FY2019 31/12/2019	FY2020 31/12/2020	FY2021 31/12/2021
Returns					
Return on Common Equity	33.21	27.16	24.68	28.12	29.77
Return on Assets	15.25	12.52	11.43	14.00	15.47
Return on Capital	64.65	48.24	36.25	25.86	20.33
Return on Invested Capital	46.89	34.04	24.59	16.14	12.75
Margins					
Operating Margin	37.98	31.23	31.46	38.22	48.49
Incremental Operating Margin	1.03	0.82	1.01	1.21	1.27
Pretax Margin	37.10	30.21	29.00	37.34	44.29
Income before XO Margin	30.08	25.17	24.73	33.16	40.14
Net Income Margin	30.08	25.17	24.73	33.16	40.14
Net Income to Common Margin	30.08	25.17	24.73	33.16	40.14
Additional					
Effective Tax Rate	17.85	15.33	12.35	11.05	8.16
Divd Payout Ratio	9.77	10.67	11.12	8.15	5.63
Sustainable Growth Rate	33.17	27.13	24.65	28.10	29.76

Credit Ratios

12 Months Ending	FY2017 31/12/2017	FY2018 31/12/2018	FY2019 31/12/2019	FY2020 31/12/2020	FY2021 31/12/2021
Total Debt/EBIT	1.89	2.28	2.43	2.12	2.62
Net Debt/EBIT	-0.15	0.16	0.48	0.27	0.48
EBIT to Interest Expense	22.75	16.09	12.45	16.60	19.58
Long-Term Debt/Total Assets	20.09	19.17	20.55	18.33	18.55
Net Debt/Equity	0.04	0.14	0.23	0.15	0.16

Source: Refinitiv

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