

Tencent Holdings Limited (SEHK: 700)

Facing increasing competitive pressure, DG to HOLD

- We downgrade Tencent to HOLD. We believe Tencent is: 1) losing dominant position in traffic; 2) lack of a competitive gaming pipeline in the near term; 3) facing uncertainty in regulation.
- Tencent may still have several catalysts, including <LOL Mobile>, <DNF Mobile>, and Channels (视频号). Yet, these catalysts are relatively minor compared with the above downside risks.
- Our Tencent 2Q21's result is in-line with cons, and we slightly cut Tencent 2021's mobile gaming and ads revenue growth. Our latest TP implies 36.7/31.8 PE in 21/22.

Tencent is facing more pressure from Bytedance

Over a long period, Tencent's major apps have been showing a lukewarm trend in user and time spent growth. For example, according to Questmobile, DAU of Wechat remains at around 800 mn and average user time spent was about 85 minutes in 1H21, which represents about 3%-5% YoY growth. On the other hand, DAU of Douyin had about 30% YoY growth in 2Q21. More importantly, Bytedance has been proactively increasing penetration in various sectors, like gaming, Ecommerce and local service. Besides, Bytedance is creating the synergy by sharing the user behaviour data across apps, including Douyin, Jinri Toutiao(今日头条), Dongchedi(懂车帝), Fanqie Xiaoshuo(番茄小说)etc. As a result, Bytedance has more advantage in amount and quality of traffic than Tencent.

Losing advantage in gaming and advertising

Tencent's dilemma has been reflected in some recent cases: 1) Tencent is marginalized in the generating process of hit titles. Tencent used to have tight control over all most powerful IPs and games, but most recent titles, like <Genshin Impact> and <Mole>, chose to skip Tencent channels. Bytedance recently published <Onepiece: Hot-Blooded Route> (航海王: 热血航线). Although quality of the game is ordinary, Bytedance demonstrates extraordinary publishing skills by mobilizing Douyin influencers to promote the game. 2) Our channel check suggests that PDD is shifting ads budget away from Tencent to Douyin/Kuaishou due to declining ROI. If Tencent is losing traffic advantage, then relationship with allies like PDD, JD and Meituan, will also be impacted.

Summary financial data

Highlights (RMB)	2019A	2020A	2021E	2022E	2023E
Revenues (RMB mn)	377,289	482,064	584,669	705,712	802,797
Non-IFRS op. profit (RMB mn)	128,822	200,465	228,643	257,552	281,411
Non-IFRS EPS (RMB)	10.7	12.7	14.9	17.2	19.1
IFRS EPS (RMB)	9.7	16.6	18.3	20.4	22.0
EBITDA margin	46.0%	52.1%	46.1%	43.9%	43.1%
P/E (non-IFRS)	29.7	37.7	36.7	31.8	28.5
Free cash flow yield (%)	2.60	3.41	3.53	4.67	4.23

Source: Tencent Holdings Limited, Blue Lotus (as of June 29, 2021)

See the last page of the report for important disclosures

Blue Lotus Capital Advisors Limited

BUY **HOLD** **SELL**

Target Price: HK\$649 **Current Price: HK\$596**
 RIC: (SEHK: 700) BBG: 700 HK
 Market cap (HK\$ bn) 5,718
 Average daily volume (HK\$ mn) 12,456
 Shares out/float (m) 9,595/5,985

Source: Bloomberg, Blue Lotus (as of June 29, 2021)

Key Changes

	New	Old	Diff
BLRI Recommendation	HOLD	BUY	--
BLRI Target Price (HK\$)	649	806	(19.5%)
2021E EPS (RMB)	14.9	15.6	(4.5%)
2022E EPS (RMB)	17.1	18.0	(5.0%)
2023E EPS (RMB)	19.1	20.0	(4.5%)

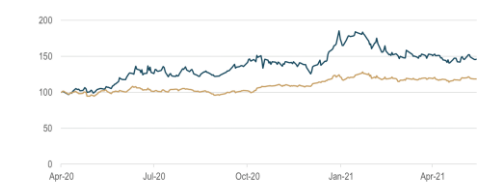
Source: Blue Lotus (as of June 29, 2021)

BLRI vs. The Street

No. of Bloomberg Recommendations	68
Target price vs. Bloomberg mean	(15.2%)
1-year-fwd EPS vs. Bloomberg mean	0.2%
Bloomberg recommendation	4.87

Source: Bloomberg Recommendation, Blue Lotus (5=BUY,1=SELL) (as of June 29, 2021)

Price performance and volume data



Source: Bloomberg (as of June 29, 2021)

Research team



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Tencent Holdings Limited: Financial Summary

Fiscal year ends-31-Dec

Exhibit 1 . Income statement

RMB mn	2020A	2021E	2022E
Revenues	482,064	584,669	705,712
Cost of revenues	(260,532)	(311,072)	(378,775)
Gross profit	221,532	273,597	326,937
G&A cost	(67,625)	(79,466)	(93,999)
Marketing cost	(33,758)	(40,843)	(48,313)
Operating profit IFRS	184,237	208,923	235,675
Share based compensation	(16,228)	(19,720)	(21,877)
Operating profit non-IFRS	200,465	228,643	257,552
Finance cost/income	(7,887)	(7,330)	(6,374)
Other income/cost	64,088	55,635	51,050
Share of profits of asso. and JVs	3,672	3,491	3,666
Pre-tax profit, IFRS	180,022	205,085	232,967
Income tax	(19,897)	(23,156)	(29,121)
Net income, IFRS	160,125	181,928	203,846
Non-controlling interests	278	3,587	3,432
EPS, IFRS (RMB)	16.6	18.3	20.4
EPS, non-IFRS(RMB)	12.7	14.9	17.2
Gross margin	46.0%	46.8%	46.3%
Operating margin, non-IFRS	41.6%	39.1%	36.5%

Source: Tencent Holdings Limited, Blue Lotus (as of June 29, 2021)

Exhibit 2 . Balance sheet

RMB mn	2020A	2021E	2022E
Cash and cash equivalent	152,798	125,185	264,828
Restricted cash and ST investment	2,520	3,024	3,629
Term deposits over three months	68,487	82,184	98,621
Accounts receivable	44,981	62,794	63,290
Prepayments and others	40,321	32,973	58,348
Inventory	814	2,470	1,235
Total current asset	317,647	308,630	489,952
Property and equipment	59,843	26,188	32,660
Construction in progress	4,939	2,470	1,235
Invest. in a jointly controlled entity	297,609	312,489	328,114
Intangibles, goodwill and others	159,437	22,675	31,449
Available-for-sale financial assets	403,669	444,036	488,439
Total non-current assets	1,015,778	906,274	989,275
Total assets	1,333,425	1,214,904	1,479,226
Account payables	94,030	107,805	144,185
Accrued expense and others	77,980	74,659	97,702
Deferred revenues	82,827	96,578	123,836
Short-term debt	14,242	14,954	15,702
Total current liabilities	269,079	293,996	381,425
Long-term debt	234,202	112,145	112,145
Other long-term liability	35,513	35,513	35,513
Total non-current liability	286,303	147,658	147,658
Total equity	703,984	696,641	870,858
Total liabilities and equity	1,333,425	1,214,904	1,479,226

Source: Tencent Holdings Limited, Blue Lotus (as of June 29, 2021)

Company Description

Tencent is China's 2nd largest internet company by revenue and profits and the largest by traffic measures. Founded in 1998, Tencent dominates China's online game industry with more than 50% market share in 2020. Apart from online games, the company also has online advertising, fintech, and company services, and other revenue streams.

Industry View

China's entertainment market has continued to grow in recent years. The online game market remains one of the most promising subsectors in the entertainment market. By Dec 2020, the number of mobile game players reached 654mn. In 2021, the total China mobile game market is expected to exceed RMB 240bn.

Exhibit 3 . Cash flow statement

RMB mn	2020A	2021E	2022E
Net income	160,125	181,928	203,846
Adjusted for:			
Depreciation & amortization	50,774	41,179	51,967
Taxation	19,897	19,189	23,642
Net Interest	492	2,491	(937)
Changes in			
Account receivable	(7,530)	(17,813)	(496)
Inventory	(95)	814	2,470
Account payables	13,033	13,775	36,380
Short term deposit	0	(14,201)	(17,042)
Other assets	0	0	0
Accrued liabilities and deferred revenues	21,012	19,819	50,301
Cash from operations	214,441	185,193	267,073
Capex, PPE	(34,070)	(15,866)	(19,151)
Capex, land and bldg.	(5,347)	0	0
Purchase of intangibles	(27,182)	(40,344)	(48,062)
(Increase) /decrease in term deposits	(59,169)	(6,336)	(7,603)
Cash paid for equity investment	(60,066)	(40,367)	(44,404)
Payment for business combinations	(15,097)	0	0
Cash from investing	(181,955)	(112,696)	(128,891)
Cash from financing	13,647	(100,110)	1,461
Change in cash	25,811	(27,613)	139,643
Cash at beginning	132,991	152,798	125,185
Cash at end	152,798	125,185	264,828

Source: Tencent Holdings Limited, Blue Lotus (as of June 29, 2021)

See the last page of the report for important disclosures

Concerns rise from weak pipeline

- **Tencent gaming pipeline is not attractive:** Within Tencent current gaming pipeline, three games have more than 5 mn pre-registered users: <LOL Mobile>, <DNF Mobile>, and <Undawn> (黎明觉醒). (See exhibit. 5) <LOL Mobile> has been launched in several key regions, like Southeast Asia, Latin America, and Europe, and now is ranked about No.100-500 in iOS downloads and gross billing ranking. <DNF Mobile> is still facing uncertainty in whether and when it could be launched. <Undawn> just conducted its first test on June 25. Although players' feedback is overall positive, the game may still face similar issues of NetEase's <Life After> (明日之后), like content update and players' life cycle, etc.
- **Tencent is at the bottom of product cycle:** Tencent started in self-developing innovative games in 2019 or 2020, which means these games will only be published after 2022. Tencent has slow and conservative reactions to the changing online gaming landscape, including Chinese gamers becoming more critical, rise of new gaming companies, and emergence of new channels. As a result, Tencent mobile gaming is highly relying on its two legacies, <HOK> and <PUBG>, which together account for about 70% of total mobile gaming gross billings in 2021.
- **Channels are unlikely to be monetized soon:** Gross margin of Tencent ads dropped to 45% in 1Q21, whereas the number remains at 49%-53% from 1Q20 to 4Q20. We see the lower gross margin of online ads will continue in 2Q21 because Channels doesn't contribute much revenue now but needs more cost in bandwidth. We estimate DAU and average daily time spent of Channels remains at about 300mn-350mn/20-25 minutes in 2Q21, showing flattish trend compared with 1Q21. Channels is still facing a series of issues in content quality, content creator, recommendation efficiency, and user recognition. Therefore, we expect Channels will continue to be a cost in the near term.
- **Regulation limits the monetization of payment business:** On June 18, China State Council initiate guidelines over commissions charged to small&median enterprises(SME). According to the rules later published by Payment& Clearing Association of China, payment association, including Tencent's Tenpay, are asked to lower commission by 10%, effective from September 30, 2021 to September 30, 2024. Ant Group and Tencent together take about 90% of China's online payment market share, and charged merchants about 0.4% of GTV as commission. We believe that Tencent's payment commission rate will negatively impacted by this new rule in the next three years, and cut our forecast of Tencent's FY21 revenue growth for Fintech and Business service from previous 28% to 24%YoY.
- **Cut forecasts of mobile gaming and ads:** We cut our forecasts of gross billings of mobile gaming in 2021 from 23% YoY to 21% YoY, and revenue from 32% YoY to 28% YoY. We also cut our forecast of online ads from 27% YoY to 26% YoY in 2021. Our latest 2Q21 rev. is in line with cons and non-IFRS net income beats cons by about 3%.

Tencent reacts slowly to the outside environment change.

Exhibit 4 . Tencent's C2Q21E Earnings Preview Table

RMB mn	2Q21E	2Q21C	Diff	1Q21A	QoQ	2Q20A	YoY	3Q21E	3Q21C	Diff
Revenues	140,060	140,278	(0.16%)	135,303	3.5%	114,883	21.9%	153,442	153,282	0.10%
VAS	76,031			72,443	5.0%	65,002	17.0%	85,756		
Online games	45,060			43,600	3.3%	38,288	17.7%	50,082		
PC games	10,608			11,900	(10.9%)	10,912	(2.8%)	10,982		
Mobile games	44,169			41,500	6.4%	35,988	22.7%	50,129		
Social networks	30,971			28,800	7.5%	26,714	15.9%	35,673		
Online advertising	21,943			21,820	0.6%	18,552	18.3%	26,370		
Fintech and company svcs	40,535			39,028	3.9%	29,862	35.7%	39,765		
Cost of revenues	(75,186)			(72,668)	(3.5%)	(61,673)	(21.9%)	(81,616)		
Gross profit	64,874	63,069	2.86%	62,635	3.6%	53,210	21.9%	71,825	68,312	5.14%
Gross margin	46.3%	45.0%	1.36ppt	46.3%	0.0ppt	46.3%	0.0ppt	46.8%	44.6%	2.24ppt
S&M expenses	(9,933)			(8,530)	(16.5%)	(7,756)	(28.1%)	(11,013)		
G&A expenses	(19,207)			(18,967)	(1.3%)	(16,499)	(16.4%)	(20,440)		
SBC	(4,905)			(4,855)	(1.0%)	(4,019)	(22.0%)	(4,955)		
Operating profit	47,233	42,640	10.8%	56,273	(16.1%)	39,311	20.2%	51,873	46,637	11.23%
Operating margin	33.7%	30.4%	3.33ppt	41.6%	(7.9ppt)	34.2%	(0.5ppt)	33.8%	30.4%	3.38ppt
Operating profit, non-IFRS	52,138			61,128	(14.7%)	43,330	20.3%	56,828		
Pre-SBC operating margin	37.2%			45.2%	(8.0ppt)	37.7%	(0.5ppt)	37.0%		
Profit before taxation	46,030	46,814	(1.67%)	56,254	(18.2%)	37,011	24.4%	50,722	49,494	2.48%
Profit for the quarter	40,791	33,198	22.87%	49,008	(16.8%)	32,454	25.7%	45,457	37,330	21.77%
Net margin	29.1%	23.7%	5.46ppt	36.2%	(7.1ppt)	28.2%	0.9ppt	29.6%	24.4%	5.27ppt
Net income, non-IFRS	34,930	33,837	3.23%	33,118	5.47%	30,153	15.8%	39,629	35,628	11.23%
Operating matrices										
Mobile gaming gross billing										
HoK (est.)	16,500			20,000	(18.0%)	14,300	15.0%	22,000		
Peacekeeper Elite (est.)	5,400			9,500	(43.2%)	4,500	20.0%	6,950		
Fintech and company svcs										
Wexin pay take rate (est.)	0.42%			0.42%	-	0.42%	/	0.38%		

Source: Tencent, Bloomberg, Blue Lotus Estimates (as of June 29, 2021)

Exhibit 5. Key games from Tencent

Game Name (English)	Game Name (Chinese)	Genre	IP	Game Code	Launch Time	TapTap Rating	Pre-Register (wechat)
DnF Mobile	地下城与勇士	MMOACT	DnF	✓	Pending	1.5	17.8mn
LoL Mobile	英雄联盟手游	MOBA	LoL	✓	Jul 2021(beta testing)	9.2	18.3mn
Down Awakening	黎明觉醒	ARPG	/		2021/06/25(beta testing)	7.9	6.9 mn
LoL Esports Manager	英雄联盟电竞经理	Strategy	LoL	✓	Pending	7.9	1.6 mn
Dynasty Warriors: Dominate	真三国无双霸	ARPG	Dynasty Warriors	✓	2021/06/24(beta testing)	8.4	312k
Legendary World	传奇天下	ARPG	/	✓	Summer 2021(testing)	/	321k
Pokemon Unite	宝可梦大集结	MOBA	Pokemon		Pending	/	/
Tetris Adventure	俄罗斯方块环游记	Casual	Teris	✓	Pending	9.1	862k
Handmade Planet	手工星球	Sandbox MMO	/	✓	Pending	8.0	617k
Digimon: New Generation	数码宝贝: 新世纪	Card RPG	Digimon	✓	Pending	8.5	346k
Qing Yu Nian	庆余年	MMORPG	Qing Yu Nian	✓	Pending	8.8	278k
One Punch Man	一拳超人	Turn-based RPG	One Punch Man	✓	Pending	7.2	32k
Xuan Zhong Ji	玄中记	MMORPG	/	✓	Pending	8.2	25k
Light and night	光与夜之恋	RPG Romance	/	✓	2021/06/24	7.1	/

Source: Tencent, NetEase (as of June 29, 2021)

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