

## Tencent Holdings Limited (SEHK: 700)

### Facing increasing near-term pressure, DG to SELL

- We cut our forecast of Tencent ads YoY growth to 6%/3% from previous 18%/18% in 3Q21/4Q21, if Tencent will acquire Sougou in 4Q21.
- Tencent is facing increasing near-term pressure, including regulatory issues, changing competitive landscape, and lack of hit titles. Our est. 3Q21 revenue increases 15.0%, and non-IFRS net income declines (0.3%) YoY, both slightly miss cons.
- We forecast that Tencent revenue/non-IFRS net income will have 8.6% YoY/3.7% YoY CAGR in the next 3 yrs. We cut Tencent TP to HK\$446, which implies 26X/27X PE in 21/22. For investors who would like to BUY Tencent, we suggest wait until all negative factors are priced in.

#### Regulation and weak macro hit online ads

According to our checks with several online ads agencies, we expect that total absolute amounts of Tencent ads revenue in 3Q/4Q21 will be similar to 2Q21's, if exclude Sougou. Several of Tencent key advertisers are showing weakness in 2H21. Major automobile advertisers cut spending because of disruptions in chip supply. Internet insurance, which is estimated to take about 5% of Tencent ads, sees a sharp drop after a notice published in August urging that there should not be lottery draw or other false information in internet insurance ads. Real estate, online gaming and online education advertisers continue to cut spending because of uncertain regulatory landscape. Meanwhile, the new policy about personal data and algorithm led to declined conversion in Tencent ads network and splash ads across major apps. We expect that Tencent ads YoY growth (excluding Sougou) will drop to 6%/(6%) in 3Q21/4Q21.

#### Channels remain a minor catalyst

Tencent increases leverage to Wechat Channels live streaming in 3Q21, including giving more traffic support to Channel live streaming and inviting more Wechat official account content creators to launch live streaming programs, etc. Some live streaming agencies are migrating to Wechat Channels live streaming because Douyin is suppressing music show live streaming for regulatory concerns. **(To be continued)**

#### Summary financial data

Highlights (RMB)	2019A	2020A	2021E	2022E	2023E
Revenues (RMB mn)	377,289	482,064	567,141	659,247	726,122
Non-IFRS op. profit (RMB mn)	128,822	200,465	230,761	233,447	239,294
Non-IFRS EPS (RMB)	10.7	12.7	14.4	13.9	13.9
IFRS EPS (RMB)	9.7	16.6	17.1	17.3	17.1
EBITDA margin	46.0%	52.1%	47.9%	43.2%	41.6%
P/E (non-IFRS)	39.0	33.0	29.1	30.1	30.1
Free cash flow yield (%)	3.78	5.01	4.95	6.00	4.84

Source: Tencent Holdings Limited, Blue Lotus (as of Oct 19, 2021)

BUY	HOLD	SELL
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<b>Target Price: HK\$446</b>	<b>Current Price: HK\$499</b>
RIC: (SEHK: 700)	BBG: 700 HK
Market cap (HK\$ bn)	4,780
Average daily volume (HK\$ mn)	14,719
Shares out/float (m)	9,596/5,986

Source: Bloomberg, Blue Lotus (as of Oct 19, 2021)

#### Key Changes

	New	Old	Diff
BLRI Recommendation	SELL	HOLD	-
BLRI Target Price (HK\$)	446	500	(10.8%)
2021E EPS (RMB)	14.4	15.0	(4.0%)
2022E EPS (RMB)	13.9	15.1	(7.9%)
2023E EPS (RMB)	13.9	15.8	(12.0%)

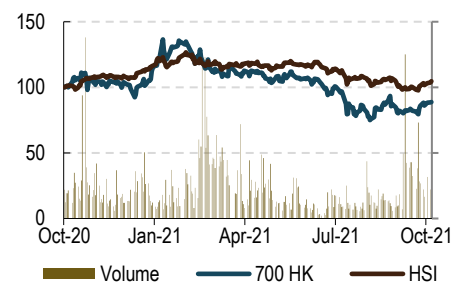
Source: Blue Lotus (as of Oct 19, 2021)

#### BLRI vs. The Street

No. of Bloomberg Recommendations	68
Target price vs. Bloomberg mean	(29.2%)
1-year-fwd EPS vs. Bloomberg mean	(10.9%)
Bloomberg recommendation	4.75

Source: Bloomberg Recommendation, Blue Lotus (5=BUY, 1=SELL) (as of Oct 19, 2021)

#### Price performance and volume data



Source: Bloomberg (as of Oct 19, 2021)

#### Research team



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Blue Lotus Capital Advisors Limited

# Tencent Holdings Limited: Financial Summary

Fiscal year ends-31-Dec

## Exhibit 1 . Income statement

RMB mn	2020A	2021E	2022E
Revenues	482,064	567,141	659,247
Cost of revenues	(260,532)	(311,963)	(365,594)
Gross profit	221,532	255,178	293,653
G&A cost	(67,625)	(80,657)	(93,755)
Marketing cost	(33,758)	(41,421)	(48,148)
Operating profit IFRS	184,237	203,628	213,010
Share based compensation	(16,228)	(27,133)	(20,437)
Operating profit non-IFRS	200,465	230,761	233,447
Finance cost/income	(7,887)	(7,347)	(6,374)
Other income/cost	64,088	70,528	61,260
Share of profits of asso. and JVs	3,672	(1,088)	(1,142)
Pre-tax profit, IFRS	180,022	195,193	205,494
Income tax	(19,897)	(25,576)	(32,879)
Net income, IFRS	160,125	169,617	172,615
Non-controlling interests	278	3,255	3,432
EPS, IFRS (RMB)	16.6	17.1	17.3
EPS, non-IFRS(RMB)	12.7	14.4	13.9
Gross margin	46.0%	45.0%	44.5%
Operating margin, non-IFRS	41.6%	40.7%	35.4%

Source: Tencent Holdings Limited, Blue Lotus (as of Oct 19, 2021)

## Exhibit 2 . Balance sheet

RMB mn	2020A	2021E	2022E
Cash and cash equivalent	152,798	114,843	236,813
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	58,818	58,408
Prepayments and others	40,321	33,183	54,960
Inventory	814	2,470	1,235
Total current asset	317,647	294,522	453,667
Property and equipment	59,843	25,738	31,073
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	21,192	26,862
Available-for-sale financial assets	403,669	444,036	488,439
Total non-current assets	1,015,778	904,342	983,101
Total assets	1,333,425	1,198,864	1,436,767
Account payables	94,030	104,643	134,194
Accrued expense and others	77,980	72,858	92,003
Deferred revenues	82,827	91,200	114,702
Short-term debt	14,242	14,954	15,702
Total current liabilities	269,079	283,655	356,601
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	690,943	853,223
Total liabilities and equity	1,333,425	1,198,864	1,436,767

Source: Tencent Holdings Limited, Blue Lotus (as of Oct 19, 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	169,617	172,615
Adjusted for:			
Depreciation & amortization	50,774	41,031	51,143
Taxation	19,897	18,337	21,971
Net Interest	492	2,491	(937)
Changes in			
Account receivable	(7,530)	(13,837)	410
Inventory	(95)	814	2,470
Account payables	13,033	10,613	29,551
Short term deposit	0	(14,201)	(17,042)
Other assets	0	0	0
Accrued liabilities and deferred revenues	21,012	12,640	42,648
Cash from operations	214,441	172,380	244,334
Capex, PPE	(34,070)	(15,391)	(17,890)
Capex, land and bldg.	(5,347)	0	0
Purchase of intangibles	(27,182)	(38,348)	(44,257)
(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)	(110,225)	(123,825)
Cash from financing	13,647	(100,110)	1,461
Change in cash	25,811	(37,955)	121,970
Cash at beginning	132,991	152,798	114,843
Cash at end	152,798	114,843	236,813

Source: Tencent Holdings Limited, Blue Lotus (as of Oct 19, 2021)

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## Issues remain to affect the growth

- **(Continued)** We estimate that Wechat Channel monthly live streaming gross billing reaches about RMB 300-500 mn in 3Q21, or as 2%-3% of total social network revenue. Payout ratio of Wechat Channel is about estimated to be about 50%-60%, similar to other live streaming platforms. We also estimate Wechat Channels will gradually begin to launch more ads in 2022, and has the potential to contribute RMB 5-6 bn, or as 5-6% of total ads revenue in 2022. Meanwhile, major ads platforms, like Wechat, Tencent Video, and Tencent News, will all see flattish or declining trend in 2022.
- **Slightly raise forecast of mobile gaming:** We estimate that Tencent PC games will have slight decline (1.67%) in 3Q21, and mobile game grows by 13.1% in 3Q21. We slightly raise Tencent mobile game outlook because of: 1) <Golden Shovel Battle> (金铲铲之战), which is expected to generate about RMB 1.5-2 bn in the first month after publishing in August. 2) <Pokemon Unite>, a Pokemon-IP backed MOBA game developed by Tencent, officially launched at the Nintendo Switch platform on 21th July and reached 9mn downloads as of Sept 16th. Other than that, other games have lukewarm performances: 1) an increasing number of players complain about the quality of <League of Legend: Wild Rift>, and we maintain our previous assessment that the game will contribute about RMB 5 bn for the annual gross billing. 2) <HOK> and <PUBG Mobile> had flattish performances in 3Q21, and <PUBG Mobile> sees about (20%)-(30%) YoY decline in DAU, according to Questmobile.
- **Old issues will be more obvious:** We see the major issues raised in our previous note <Facing increasing competitive pressure, DG to HOLD>, and we think issues will only become more obvious in 2H21 and 2022: 1) Tencent is losing dominant position in traffic because of competition from Bytedance; 2) Tencent's lack of a competitive gaming pipeline in the near term; 3) Tencent faces uncertainty in regulation. Hence, we cut our TP to HK\$446, which implies 16.7X/16.1X PE in 21/22, excluding net cash and investment values.

**Exhibit 4 . Tencent's C3Q21E Earnings Preview Table**

RMB mn	3Q21E	3Q21C	Diff	2Q21A	QoQ	3Q20A	YoY	4Q21E	4Q21C	Diff
Revenues	144,215	146,262	(1.40%)	138,259	4.3%	125,447	15.0%	149,365	154,798	(3.51%)
VAS	78,329			72,013	8.8%	69,802	12.2%	78,844		
Online games	46,657			43,000	8.5%	41,422	12.6%	45,948		
PC games	11,438			11,000	4.0%	11,631	(1.7%)	10,053		
Mobile games	42,951			40,800	5.3%	39,173	9.6%	43,775		
Social networks	31,672			29,000	9.2%	28,380	11.6%	32,896		
Online advertising	22,718			22,833	(0.5%)	21,351	6.4%	24,729		
Fintech and company svcs	41,616			41,892	(0.7%)	33,255	25.1%	44,240		
Cost of revenues	(82,211)			(75,514)	(8.9%)	(68,800)	(19.5%)	(81,571)		
Gross profit	62,004	65,407	(5.20%)	62,745	(1.2%)	56,647	9.5%	67,794	67,837	(0.06%)
Gross margin	43.0%	44.7%	(1.72ppt)	45.4%	(2.4ppt)	45.2%	(2.2ppt)	45.4%	43.8%	1.57ppt
S&M expenses	(11,168)			(10,013)	(11.5%)	(8,920)	(25.2%)	(11,710)		
G&A expenses	(19,090)			(22,638)	15.7%	(17,189)	(11.1%)	(19,961)		
SBC	(7,426)			(7,376)	(0.7%)	(3,517)	(111.1%)	(7,476)		
Operating profit	45,246	39,008	16.0%	52,487	(13.8%)	43,953	2.9%	49,623	41,408	19.84%
Operating margin	31.4%	26.7%	4.70ppt	38.0%	(6.6ppt)	35.0%	(3.7ppt)	33.2%	26.7%	6.47ppt
Operating profit, non-IFRS	52,672			59,863	(12.0%)	47,470	11.0%	57,099		
Pre-SBC operating margin	36.5%			43.3%	(6.8ppt)	37.8%	(1.3ppt)	38.2%		
Profit before taxation	44,095	30,756	43.37%	46,688	(5.6%)	44,638	(1.2%)	48,156	35,096	37.21%
Profit for the quarter	37,546	32,014	17.28%	43,022	(12.7%)	38,899	(3.5%)	40,041	33,220	20.53%
Net margin	26.0%	21.9%	4.15ppt	31.1%	(5.1ppt)	31.0%	(5.0ppt)	26.8%	21.5%	5.35ppt
Net income, non-IFRS	32,189	32,585	(1.22%)	34,039	(5.43%)	32,302	(0.3%)	34,721	33,278	4.34%
<b>Operating matrices</b>										
<b>Mobile gaming gross billing</b>										
HoK (est.)	16,000			15,000	6.7%	14,100	13.5%	15,000		
Peacekeeper Elite (est.)	7,080			5,400	31.1%	5,900	20.0%	4,800		
<b>Fintech and company svcs</b>										
Wexin pay take rate (est.)	0.38%			0.42%		0.42%		0.38%		

Source: Tencent, Bloomberg, Blue Lotus Estimates (as of Oct 19, 2021)

**Exhibit 5. Tencent's new released games and key pipeline**

Game Name (English)	Game Name (Chinese)	Genre	IP	Game code	Launch Time	TapTap Score
DnF Mobile	地下城与勇士	MMOACT	DnF	✓	Pending	2.5
Down Awakening	黎明觉醒	ARPG	/	✓	Pending	7.3
LoL Esports Manager	英雄联盟电竞经理	Strategy	LoL	✓	Pending	7.5
Legendary World	传奇天下	ARPG	/	✓	Pending	/
Handmade Planet	手工星球	Sandbox MMO	/	✓	Pending	8.1
Qing Yu Nian	庆余年	MMORPG	Qing Yu Nian	✓	Pending	8.9
One Punch Man	一拳超人	Turn-based RPG	One Punch Man	✓	Pending	8.6
Xuan Zhong Ji	玄中记	MMORPG	/	✓	Pending	8.1
Digimon: New Generation	数码宝贝: 新世纪	Card RPG	Digimon	✓	2021/10/21	7.7
LoL Mobile	英雄联盟手游	MOBA	LoL	✓	2021/10/08	9.2
Pokemon Unite	宝可梦大集结	MOBA	Pokemon	/	2021/09/22	/
Dynasty Warriors: Dominate	真三国无双霸	ARPG	Dynasty Warriors	✓	2021/08/10	8.4
Tetris Adventure	俄罗斯方块环游记	Casual	Teris	✓	2021/07/29	7.6
Alchemy Stars	白夜极光	RPG	/	/	2021/06/17	8.3

Source: Tencent Holdings Limited, Blue Lotus (as of Oct 19, 2021)

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